

# Tracking the Smart Money

by Jay Shartsis

DIVERGENCE IS AN IMPORTANT CONCEPT IN TECHNICAL ANALYSIS. THE venerable Dow Theory, for example, issues buy and sell signals based upon divergences—or the lack thereof—between the industrials and transports.

Divergences between stocks and options on them also occur, and savvy investors can capitalize on them. Usually, when stocks rise, associated call options go up, too. That makes sense, because a call gives its holder the right to purchase a stock at a certain price over a specific period. A rising stock price leads to hope that the shares will climb still higher, to a level that will allow the call buyer to exercise his option at a profit.

But what if a stock jumps, but its calls stay flat or sink? Or a stock slumps and its puts, which let holders sell the stock at a certain price, don't fall? My interest in these kinds of divergences began in 1996, when call options on Conrail—a stock I was watching for a client—jumped on very unusual volume, even though there had been no news. The next day, CSX made a buyout bid, and Conrail shares skyrocketed. The call buyers apparently had known what was coming.

Incidents like this remain far from uncommon. To cite a few from 2007:

► July 31: **Interoil** (IOC) is trading at \$20.31, down seven cents. Yet its August 25 calls are up 32 cents, to \$1.24—way above their theoretical value of 89 cents. The call buyers turn out to be very lucky—or knowledgeable. IOC explodes to \$42 nine trading days later, and those August 25 calls hit \$18. The catalyst: good production news.

► Aug. 24, 2007: **SPX** (options on the Standard & Poor's 500 index) stand near 1470, having risen a spectacular 110 points in the prior seven sessions. That afternoon, with the SPX up another eight points, the VIX—the Chicago Board Options Exchange volatility index—is off 1.32, to 21.30, a bullish indication for stocks. But VIX puts don't rise. In fact, the September 20 puts are quoted at \$1.35, down four cents from the previous close and 48 cents beneath their theoretical \$1.83 value. The weakness of these and other VIX puts suggests that volatility will rise and that stocks will fall, as they promptly do. Over the next three sessions, the SPX loses nearly 40 points.

► Sept. 5, 2007: **Forest Labs** (FRX) is trading at \$37.09, down 79 cents. Around 11:10 a.m., the September 40 calls soar to \$2.82, more than triple the previous close of 85 cents. Within 30 minutes, the stock leaps to \$43.38, on—surprise!—good news on a drug patent.

► Oct. 24, 2007: At 2:18 p.m., **Microsoft** (MSFT) is trading at 30.80, down 10 cents. Suddenly, its December 32.5 calls jump from 64 cents to 78 cents. Three days later, strong quarterly results help Microsoft open at 36.01—\$4.02 higher, one of its best showings in years. Those MSFT December 32.5 calls open at \$3.70.

A caveat: As *Barron's* noted last year (Striking Price, Nov. 27, 2006), the options market's abilities to predict certain events, particularly takeovers, has waned somewhat as regulatory scrutiny has risen and more corporate linkups are leveraged buyouts—financed with cash, not stock. Still, it's unlikely that options will ever lose all of their predictive power. At least not when the smart money tries to stay smart by staying a jump ahead of other investors. ■

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