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Moving the Market -- Tracking the Numbers / Street Sleuth

Can Options Call Market Direction?

Seeking High, Low Signals, Adviser Levi Puts His Faith In Ratio That Tracks Mood

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DOW JONES NEWSWIRES

EDWARD LEVI thinks he has found the Rosetta stone of market sentiment.

In a long quest for knowledge of stock-market performance, the 61- year-old financial consultant for Citigroup Inc.'s Smith Barney in Beverly Hills, Calif., has zeroed in on a measure of activity in the options market as a way to decipher where stocks are headed -- though he still performs the usual tire-kicking on the stocks he picks for his well-heeled clients.

For the past 15 years, Mr. Levi has used the ratio of puts to calls traded on the options market as his own personal guide. (A put gives the holder the right to sell a specific number of shares at a set price by a particular date; a call gives the holder a similar right to buy.)

"When the public is extremely bullish, they buy calls, and when everyone is buying calls, it means the market has topped out," he explains.

Mr. Levi began by using a proprietary put/call ratio calculated by Smith Barney. But the firm no longer produces that metric, so now he relies on the International Securities Exchange's ISE Sentiment Index, or ISEE, a ratio of calls to puts bought on that electronic exchange. The ISEE differs from similar ratios in that it counts only transactions in which a customer is opening an options position rather than closing one, and it excludes trades by market makers. Mr. Levi relies on a 50-day moving average of the ratio.

"When they are bullish to extremes in a period of 50 days, then you are seeing a topping market," he says. "When they are bearish in a period of 50 days, you are seeing a bottoming market."

Based on his observations, Mr. Levi concluded that when the ISEE's 50-day moving average closes in on the 200 mark it is sending a sell signal, and when it falls to about 145 it is sending a buy signal. That would mean the index was telling investors to sell in February 2004, buy in September 2004, sell in January 2005 and buy at the end of last May. And indeed, from each of these points, the market moved in the direction -- up or down -- "predicted" by the index.

But the signals don't always come so often. "Sometimes we'll get one a year, sometimes none," Mr. Levi adds.

As a financial adviser, Mr. Levi doesn't rely solely on the indicator. Instead he uses it to supplement his old-fashioned, fundamental research. He values the indicator in large part because he tends to pick stocks whose prices are prone to moving a lot.

"As much as I love my stocks, I think that the vast majority of them have the potential to go down very dramatically in a bear market," Mr. Levi says. So he uses the ISEE as a guide. When he gets that sell signal on the market, Mr. Levi advises clients to start protecting their portfolio against a potential downturn.

It also means that the adviser does most of his business in very short bursts, building positions one week of the year, and taking them down a second week. Between those periods, his job is mostly fine- tuning and a lot of monitoring.

Mr. Levi's experience with the stock market began at age 19, when he invested whatever he could save up from his job at his parents' liquor store. It was 1964.

"My first stock investment was Mattel," he recalls, "and the only reason I bought it was because I thought, 'It's December -- why not buy a toy stock in December?' "

But he quickly became a fan of techniques like the one he follows today. "All I did in the 1960s was look at charts," he says.

For the next two decades he used a tool called the speculation index -- a ratio of volume on the American Stock Exchange to volume on the New York Stock Exchange, viewed as a measure of speculative activity among investors.

But starting in the mid-1970s, that indicator began to fail him, as trading activity slacked off on the Amex and picked up on the Nasdaq. In 1981, Mr. Levi says, he lost nearly all the money he had earned trading, more than $1 million.

"That speculation index never told me to get out," he recalls, and using borrowed money only made matters worse. "I was a young guy going for broke."
The failure, though, came with a lesson. "If you do have a technical indicator, especially a sentiment indicator, you better make sure that that indicator always makes sense," he says.