BARRON'S ONLINE

FORMAT FOR PRINTING sponsored by TOSHIBA Leading Innovation >>>

**Monday, January 7, 2008**

THE STRIKING PRICE

# Trading Earnings-Day Volatility

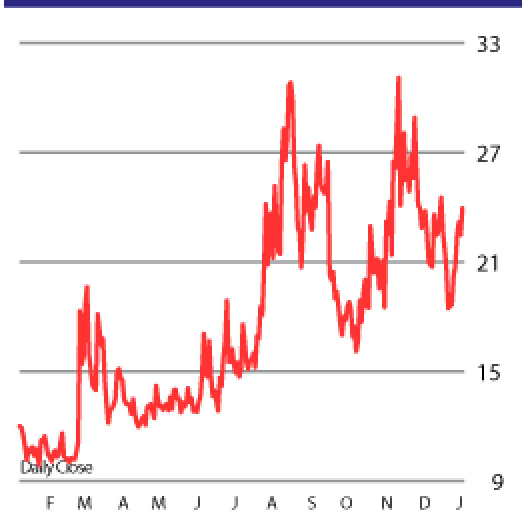
**By JOHN MARSHALL and MARIA GRANT**

**THE LATEST EARNINGS SEASON** was one of the most volatile in the past 10 years for many stocks. The increase in earnings-day volatility was especially jolting for investors after the unusually low-volatility environment of early 2007. This may be just a preview of coming attractions; we expect buying strategies related to short-term, single-stock volatility to gain in popularity ahead of earnings events in the first half of 2008.

Earnings-day moves in the third-quarter reporting season were high, not only relative to those in recent quarters but also to those in the past decade. We analyzed one-day moves following earnings in the past 40 quarters for our universe of 300-plus stocks. One-day moves on days when earnings were reported were larger, on average, in the latest earnings season than in any quarter in the past five years. In our 10-year study, earnings-day stock volatility was only slightly greater in two quarters out of 40 (both in 2002).

The pickup in volatility on days when earnings were announced was driven by exceptionally large moves in financials and consumer-discretionary stocks. The average stock moved up or down 4.9% on its earnings day in the most recent quarter. This was 45% greater than moves in the April 2007 quarter and 20% above-average, relative to the past five years.

CBOE VOLATILITY INDEX




Source: CBOE

As fourth-quarter earnings season kicks off next week, we focus on financial stocks. Among those reporting before the January expiration, options already imply unusually large moves for many financials, including **Merrill Lynch** (ticker: MER), **Washington Mutual** (WM) and **Citigroup** (C).

We expect the current elevated-volatility environment to continue for single stocks owing to several factors.



**DOWNWARD REVISIONS ARE** expected in the next few months to 2008 earnings estimates. Goldman Sachs portfolio strategist David Kostin believes that analysts' consensus EPS estimates aren't consistent with expectations of slowing economic growth and a hardly trivial chance of recession. Consensus forecasts are currently 20% above his top-down estimates.

Changes in these estimates could create even more stock volatility than in the past quarter.

**FEDERAL RESERVE ACTIONS** remain uncertain. Financials and materials have been the most volatile around the past three rate cuts. Rate uncertainty is likely to put upward pressure on volatility in these sectors for at least a few more months.

**CREDIT SPREADS ARE** persistently wide. Our credit strategists see little chance that spreads will narrow meaningfully until risks to economic growth show signs of receding. This seems unlikely until we are through the wave of subprime-mortgage resets in March 2008. Because of the high correlation of implied volatility and credit spreads, we expect continued upward pressure on options prices.

There are several implications for volatility traders: Even at higher prices than a year ago, single-stock volatility may still be a good value. Long volatility strategies ahead of earnings events and other known catalysts is likely to be a more popular strategy in the first half of 2008 than in prior years. Just be selective in choosing specific stock and strategies, given the risks involved.

---

JOHN MARSHALL and MARIA GRANT are derivative strategists at Goldman Sachs.

---

E-mail comments to: editors@barrons.com[1]

**URL for this article:**
http://online.barrons.com/article/SB119949042192568815.html

**Hyperlinks in this Article:**
**(1)** mailto:editors@barrons.com