

Using The Put/Call Ratio

A useful indicator of sentiment

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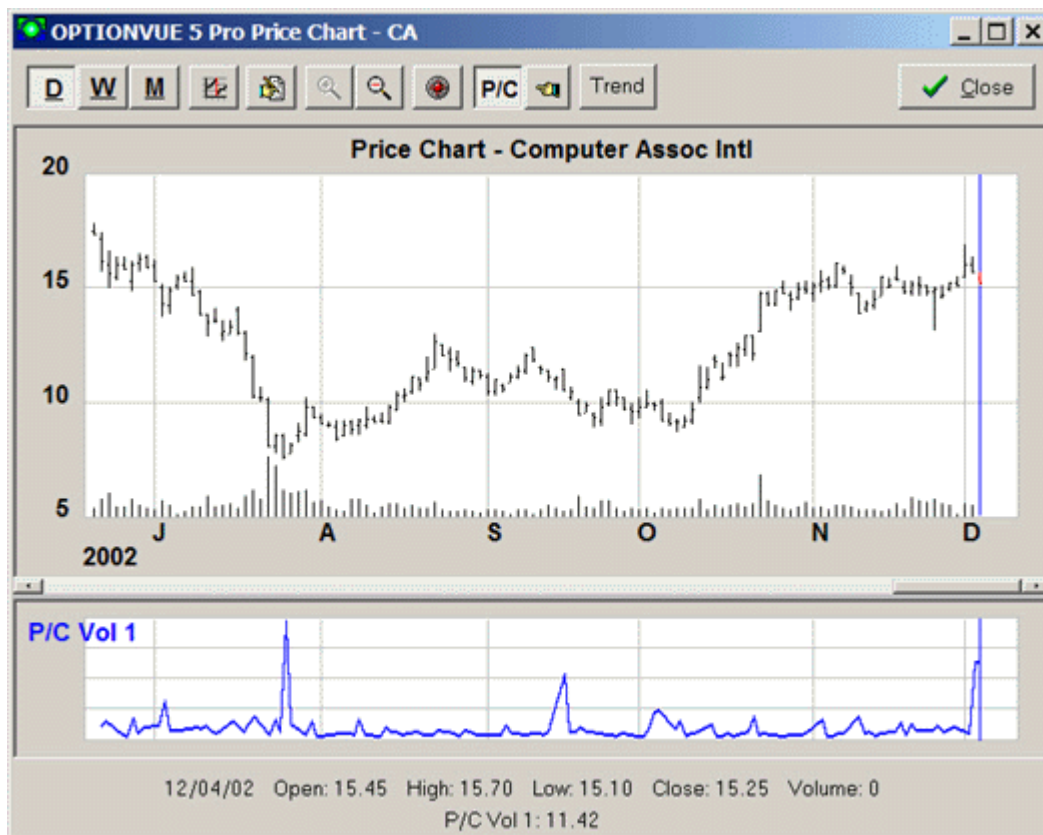
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At OptionVue Research, we have always felt that using both technical and fundamental analysis techniques will give better results than either on their own. But we often bring a third dimension – sentiment – into trading decisions.

For this we use the Put/Call ratio, which is one of the more reliable measures of sentiment for predicting future market direction. The Put/Call ratio simply looks at the difference in trading volume between puts and calls. A Put/Call ratio above one means more puts than calls are being traded, indicating the majority of traders are bearish.

But the Put/Call ratio is a contrarian indicator, so that an extreme reading above one is actually a bullish indicator. By the same token, an extreme reading below one (i.e. more calls than puts traded) would be a bearish indicator. That is not saying that option traders are always wrong. There are many uses for options besides speculation on market direction. But for whatever reason, it does turn out that the actions of option traders as a whole do provide good signals for market tops and bottoms. And at least at the extremes, it pays to go against the crowd.

There are a number of ways the Put/Call ratio can be calculated, and all of them can be useful in different situations. The Put/Call ratio in its most basic form would be the number of put contracts divided by the number of call contracts traded for a single day. The ratio can also be calculated using dollar volume, an average over any number of days, or as what is called a “normalized” Put/Call ratio, which is computed as the put volume, divided by total put and call volume. It can be calculated for any individual stock, index, or futures underlying. Below is an example of the price chart for Computer Associates, with the simple Put/Call Ratio displayed in the lower window:



While it is not always exact, periods when the Put/Call spiked up did tend to correspond to at least a short-term bottom for the stock price. You can also see how it spiked up a couple days ago, just as we received a bullish technical signal on the stock. This was just one additional piece of evidence that helped us decide to recommend a bullish trade at that time. But only time will tell you if in fact it was a correct trading decision.

Some traders feel a dollar weighted Put/Call ratio is more useful than one using contract volume. This ratio is constructed using not only the volume of each option traded, but its price as well. The reasoning is that it is more important to know how much total money is being spent on puts versus calls, rather than just simple contract volume. And that does make some sense when you think about it.

For example, an investor that is hedging a position might not really be all that bearish. He just wants to buy some insurance. In that case, he would likely buy far out-of-the-money puts that cost very little money. A really bearish speculator, on the other hand, would probably choose an option with a higher delta – an at-the-money, or just in-the-money, put option. If you believe that to be true, then it would make sense that as traders get more bearish, the Put/Call ratio using dollar volume would show a larger increase than the one using contract volume.

The one drawback using volume when calculating the ratio is that you have no idea whether that volume is the result of new positions being accumulated, old positions being liquidated, or just the result of very active day-trading. And what we are really interested in is volume that results in new positions being accumulated. Calculating the Put/Call ratio with Open Interest allows us to determine whether volume did in fact translate into new positions. In conjunction with the standard Put/Call Ratio, this can be a very useful confirming indicator.

Finally, I talked previously in terms of a single day's trading volume. But there are advantages to using a moving average that smooths out short-term fluctuations. It allows you to screen out much of the daily "noise" and focus on what the indicator is telling you about the long-term trend.

The moving average is probably one of the most common indicators used in technical analysis, and each individual asset can have its own "best" time period to use. I've seen all kinds of numbers recommended as best for the Put/Call ratio, with 5, 10, and 21 days being the most common. I've always felt the 21-day moving average is a good length, although you can feel free to experiment with others.

When choosing to use a moving average, you also have to decide whether to use a simple or exponential average. The only significant difference between these two moving averages is the weight assigned to the most recent data. Simple moving averages apply equal weight to each day's volume. Exponential moving averages apply more weight to the most recent volume.

There are also good reasons for superimposing a couple different moving averages over each other. Changes in the indicator over time might not follow just a single cycle. In fact, there may be multiple cycles, such as a shorter-term cycle over a longer-term trend. And if you believe such cycles exist, and will continue in the future, the point where the moving averages cross is often a good sign that a turning point of some type has been reached. A moving average trading system will not get you in at the exact bottom, or out at the exact top, but it can be helpful for confirming that in fact a top or bottom has been reached.

Of course the critical element in a moving average system is the time period used to calculate the average. Looking at any individual asset, you can always use hindsight to find a moving average that would have been profitable. But the key is to find a moving average that will be consistently profitable in the future. The more optimized a system is to fit historical data, the less successful it tends to be going forward.

When using the Put/Call ratio to measure sentiment, remember that it is a contrarian indicator. When it reaches excessive levels, the market usually corrects by moving in the opposite direction. Also, keep in mind that signals from any contrarian indicator are always more valuable when they are opposite the current market direction. A Put/Call ratio that shows pessimism in a down trending market is expected, and consequently not too useful. But skepticism in a rising market is a very bullish combination, since market tops are rarely reached until optimism reaches an extreme level.

It has always been difficult to accurately measure investor sentiment. There are weekly polls conducted which try to measure sentiment, but I have never been that happy with them myself. For one thing, they only ask how people are feeling, not what they are doing with their money. Like all technical analysis tools, the Put/Call ratio works best in conjunction with other market indicators and analysis. But its big advantage is that it gives you an easy way to find out whether investors are putting their money where their mouths are.