Ideas @ Edelweiss Multi Strategy Funds – Bank Nifty VIX

The NSE publishes an implied volatility index for near dated Nifty options known as the VIX. This index is based on the equivalent formulation of the CBOE for S&P 500 options and is understood to be a gauge of market participant's fear and their expectations for near term index fluctuations. The India VIX has been studied widely and even has an equivalent futures contract, but to our knowledge no one has studied the properties of an implied volatility index constructed on the Bank Nifty. The Bank Nifty has a deep futures and options market and in this month's Ideas @ Edelweiss Multi Strategy Funds, we use our historical database going back to June 2005 to construct and analyze the Bank Nifty VIX based on the exact same methodology used for the India VIX.

Over the common period during which both volatility indices were available (Nov 2007 to present), the Bank Nifty VIX averaged 33.01% versus the Nifty VIX which averaged 25.18%. Both indices displayed a significant annual volatility premium at 3.13% to 3.53% respectively. This represents the excess implied volatility being used to price index options over and above the realized volatility. The two indices are 83.8% correlated and generally have moved in lock-step. Digging deeper, two interesting insights emerged from our analysis.

First, the Bank Nifty VIX displayed higher volatility-of-volatility and second, the Bank Nifty VIX is a better predictor of short-term market movements. To understand this better, the Bank Nifty is a far more concentrated index with 12 stocks versus the Nifty's 50. HDFC Bank and ICICI Bank make up close to 50% of the index and the top 5 names make up close to 85% of the index. Hence, the Bank Nifty is closer to a small basket of stocks than a broad based index and displays less stability. On the second point, the banking system is the nervous system of a country's economy. Hence, economic warning signs often emerge first in the banking system and then spread to Main Street. Banks maintain a high degree of leverage viz-a-viz their manufacturing peers and hence tend to be high-beta names that sell-off first and much harder in tough times. The Bank Nifty VIX is therefore a better harbinger of impending trouble.

We encourage the NSE to publish and maintain the Bank Nifty VIX because it will be a useful indicator for investors and traders alike.