

STRUCTURED EQUITY PRODUCTS

March 29, 2006

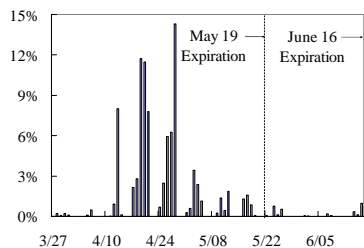
Equity Derivatives Strategy

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Figure 1: S&P 500 Earnings Announcement Dates, by Index Weight



Source: Bear Stearns Equity Derivatives Strategy.

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VOLATILITY TRADING STRATEGIES

S&P 500 Index Variance

Buying Earnings Volatility

SUMMARY

- Between now and May 19th, most of the S&P 500 is scheduled to report earnings results. To capture the potential increase in realized index volatility that could occur on account of earnings-related stock price fluctuations, investors might consider buying May 06 S&P 500 variance, while simultaneously selling June 06 variance. The trade may be attractive because June variance is currently trading ~ 60 bps over May variance, despite the fact that the June post-earnings period is typically quieter than May.

SEASONAL CHANGES IN VOLATILITY

Each quarter, single-stock realized volatility exhibits cyclical behavior. First, it begins to rise in the two months preceding an earnings announcement. Volatility spikes on the announcement date, and then gradually declines, reaching its lowest point in the cycle approximately one month after the reporting date.¹

Figure 1 shows the weight (by market capitalization) of S&P 500 companies that are expected to report results, arranged by date, for the 06Q1 earnings season. Between now and May 19th, 91% of the S&P 500 (by market cap) is scheduled to report earnings results. Only 3.3% of the index is scheduled to report after May 19th, but before June 16th.

We looked at levels of realized 80-day volatility ending on June expiration and realized 52-day volatility ending on May expiration to determine the potential impact that earnings announcements have on S&P 500 volatility.² While there is not a statistically significant result that would show that volatility drops in June (over the last 50 years), we did find that **since 2000, realized volatility on June expiration has been, on average, 1.62 volatility points below realized volatility on May expiration. In fact, May realized volatility has been above June realized volatility in each of the last six years.** It might be that earnings are to some extent responsible for the recent difference between the May and June realized levels.

S&P 500 INDEX VARIANCE SWAP TERM STRUCTURE

Figure 2 (below) shows the term structure of S&P 500 Index variance.³ Currently, each successive maturity of S&P variance is trading above prior-maturity levels. **The S&P 500 variance swap market is currently implying that realized volatility from now to May 19th expiration will be 60 bps below realized volatility from now to June 16th expiration.**

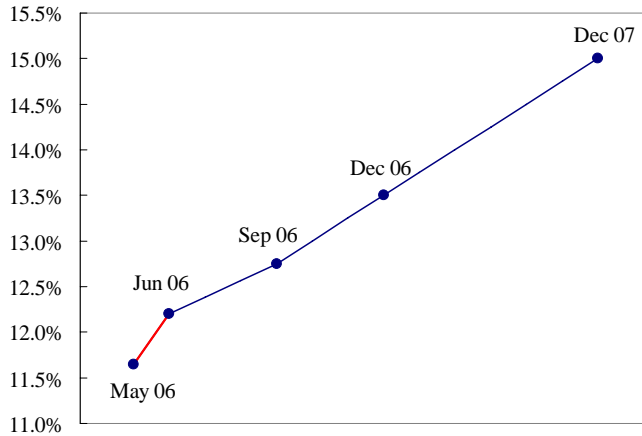
¹ To learn more about this seasonal effect, please see our report from October 2005, *Earnings Announcements: Drivers of Stock Performance and Volatility*.

² The number of days was chosen to reflect the approximate number of days between now and the maturities of S&P Index variance swaps.

³ Mid-market levels, as of March 28th close.

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Fig. 2: S&P 500 Variance Swap Term Structure, as of March 28th (close)



Source: Bear Stearns Equity Derivatives Strategy, Bloomberg.

While the current S&P 500 earnings announcement schedule is skewed toward late-April/early-May announcements; and despite the fact that 52-day realized volatility on May 19th has, over the last six years, been ~ 1.62 volatility points above 80-day realized volatility on June 16th, the market is still implying that realized volatility between May and June expiration will be higher than realized volatility between now and May. In addition, the weighted average volatility of single-stocks in the S&P 500 Index has flat May to June term structure.

Investors may consider buying May 06 expiration S&P 500 variance, while simultaneously selling June 06 expiration variance. At current mid-market levels, this investor will purchase May volatility at 60 bps below June volatility. **By doing such a trade, the investor is expressing the view that realized volatility between now and May 19th will be higher than realized volatility between May 19th and June 16th on account of earnings.** If realized volatility during the May-June period were to fall by an amount equivalent to the six-year historical average drop, than the estimated gain from the trade might be ~ 2 volatility points (the 60 bps due to term structure, combined with the average difference of ~ 1.62 volatility points between the May and June realized levels).

S&P 500 Index Variance**Buying Earnings Volatility****Disclaimer**

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