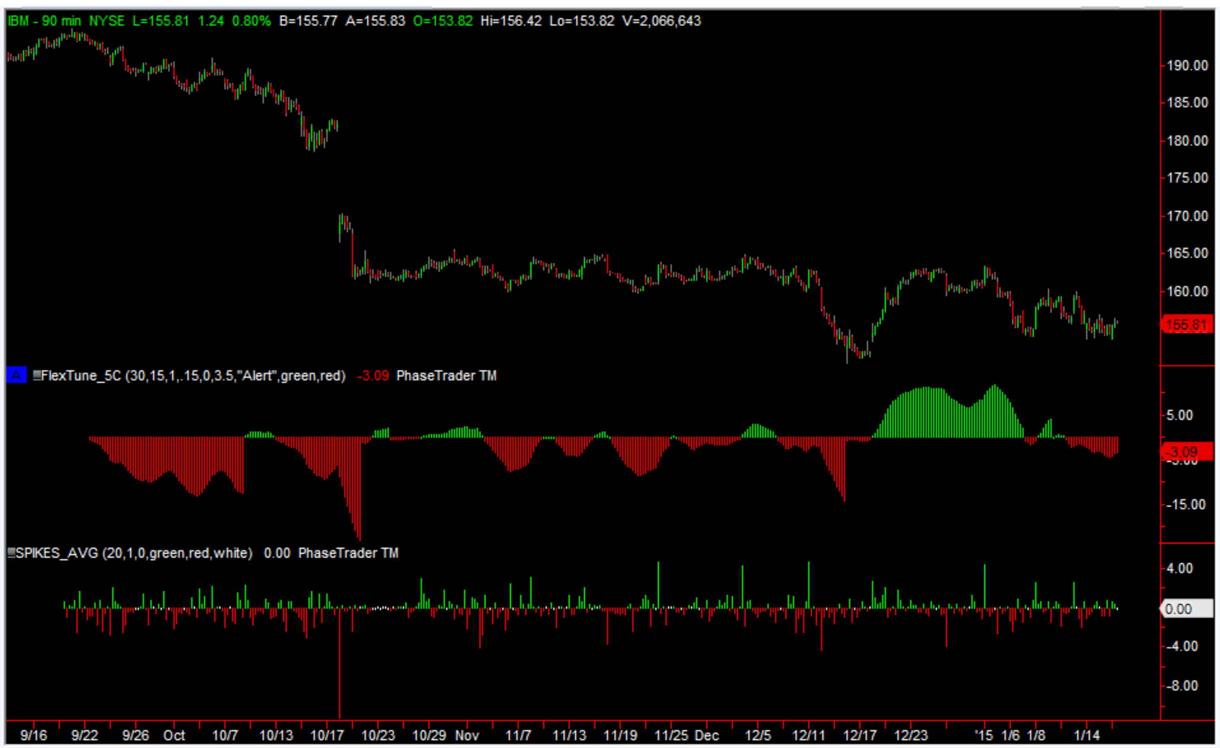
Earning's season is underway and for the first time in several quarters, rising volatility is the dominant theme. The December FOMC-driven rally is over, the dollar index has flattened and weakening of the yen has slowed. But most importantly, stock buybacks have also slowed as large corporations reach fundamental limits on the amount of debt they can safely handle. As everyone knows, the market is responding with tremendous uncertainty. All of these factors superimposed on global deflationary concerns are creating a rising volatility environment and setting the stage for one of the most active earnings seasons in many years.

We can capitalize on this unusual earnings season with simple option trades on stocks that confound option pricing theories. IBM, which we have discussed many times, is one of the best examples. Virtually everyone who follows the stock believes that revenue will shrink for a 10th consecutive quarter. But with all the earnings downgrades, company re-statements, and lowered forecasts, it is anyone's guess whether they will also miss earnings.

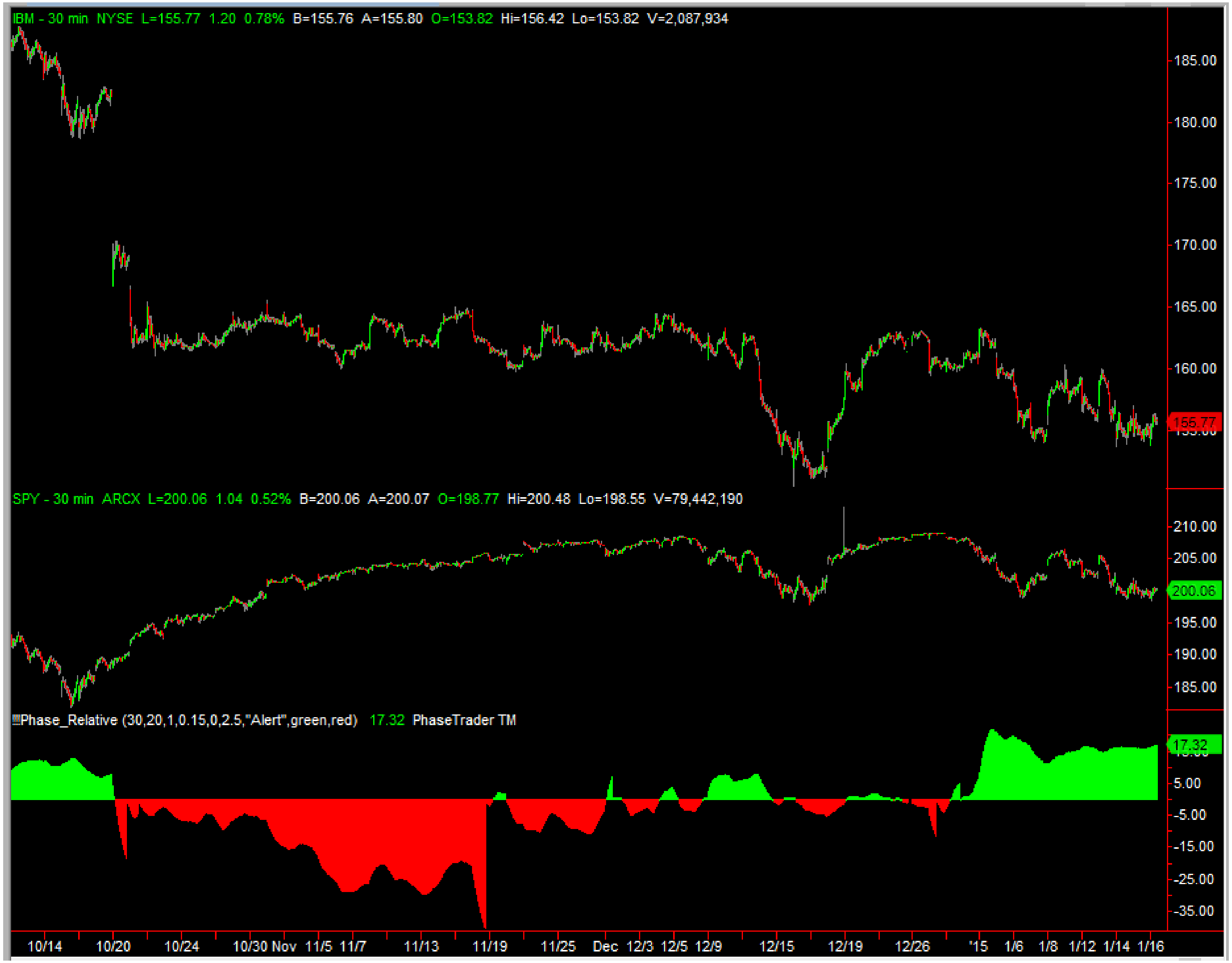
Many believe we'll see an upside surprise; even more assume that any positive surprise will be driven by financial engineering that the market is likely to reject.

Fortunately we can structure a simple trade that makes money in either case. Our example today will be a standard short butterfly with only $5 spacing between the strikes.

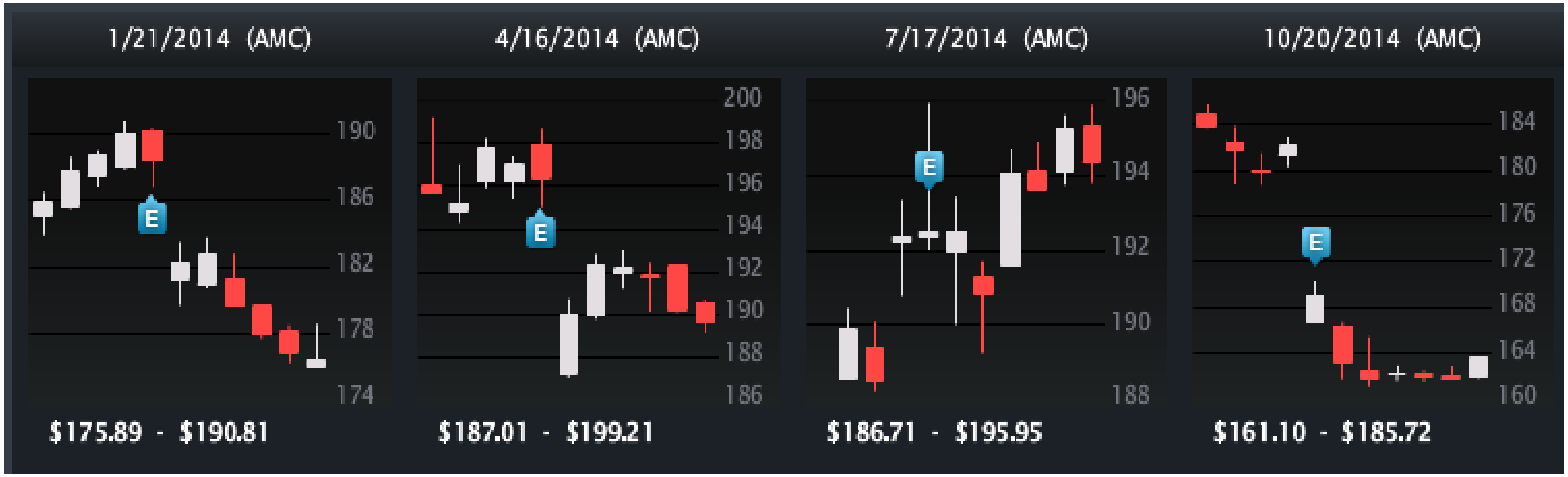
Before we visit a possible trade some analysis is in order. The following chart reveals that the stock is trendless. No matter how we tune PhaseTrader, there has been no direction since the last disastrous earnings dropped the stock $25 points – a shocking 11 Stdev. Since that time there have been 4 moves larger than 4 Stdev, mostly at unexpected times and unrelated to specific news items (chart below).



Relative Phase fails to clarify the situation with IBM oscillating between outperforming and underperforming the market. More detailed analysis reveals that the stock tends to underperform on down days and outperform on up days – more unusual still.



Earnings for the past year have been quite wild with the average move just over $15.



But the options market is betting on a much smaller move. A $5 spaced short butterfly expiring next week has a credit greater than $1. The trade, therefore, only requires a $4 move to be profitable. This price distortion is based on the assumption that further downside surprises are unlikely because the market has already assumed the worst, but that the stock has very little potential to rally. Both views are overly simplistic and analysts setting price targets are mixed. Averaging the range of disagreement is precisely what has created this unusual price distortion.

Following are current prices for near-the-money calls expiring on Jan 30 with the stock at $155.55.

Delta	Imp Volatility	Mid	Bid	Ask	Strike
0.7020	37.43 %	7.80	7.35	8.25	150
0.6308	33.43 %	5.75	5.55	5.95	152.5
0.5348	32.55 %	4.25	4.10	4.40	155
0.4322	31.37 %	2.96	2.82	3.10	157.5
0.3305	30.56 %	1.97	1.89	2.05	160
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Earnings will be announced after the close on Tuesday. The $5 spaced short butterfly mentioned above is:

1 short $150 call
2 long $155 calls
1 short $160 calls

Midpoint Credit (maximum profit) = $1.27

Many other trades are also possible. We could for example structure the trade with a later expirations – Feb. 27 is listed below:

Delta	Imp Volatility	Mid	Bid	Ask	Strike
0.6820	24.87 %	8.40	8.00	8.80	150
0.6152	23.07 %	6.50	6.30	6.70	152.5
0.5341	22.40 %	5.00	4.85	5.15	155
0.4501	22.30 %	3.83	3.60	4.05	157.5
0.3688	22.20 %	2.86	2.61	3.10	160

This version has a similar midpoint credit ($1.26) and 42 days remaining before expiration. The upside is smaller because the stock has been known to fall or rally after earnings, then reverse direction and return to a point near its former price (which would erase the benefit of the trade). Because of the considerable time remaining, the trade would initially deliver less profit if the stock moves just outside the range. Holders of the trade would be forced to wait longer to "cash out." But the risk from collapsing implied volatility and rapid time decay is much smaller if the stock remains in the strike range.

Finally, rising volatility on Monday and Tuesday (especially Tuesday) will likely erase much of the remaining credit as earnings approaches and a simple strategy involves closing the trade before earnings if there is a significant profit. At this point it is impossible to know how the market will price volatility for this stock as earnings approaches, but right now it is significantly lower than past earnings results would suggest – approximately half.

We'll be exploring additional examples, but IBM is likely to serve as a broad indicator of what will develop because it reflects the effects of a global demand-driven slowdown, engineered earnings, and stock buybacks.