

Simple Steps You Can Take Right Now To Trade Volatility Like A Pro

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About Me

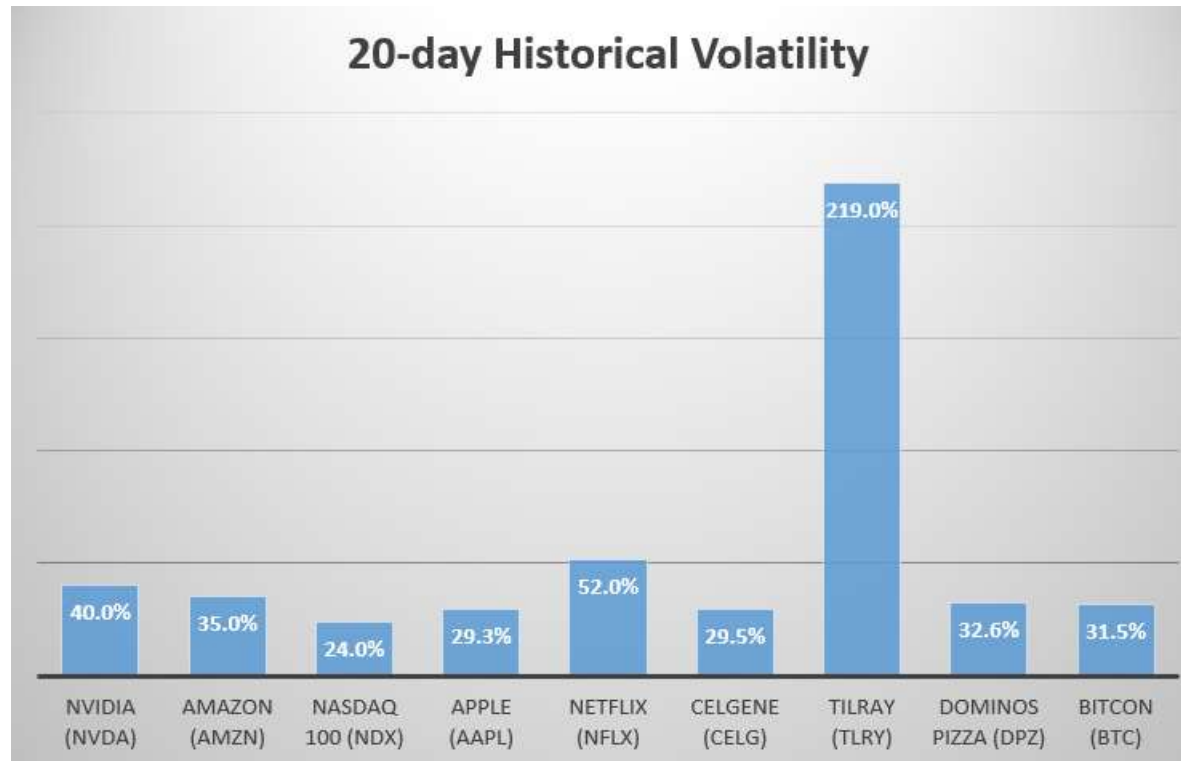
- 20 years of experience trading options
- 8 years of online research & options services
- CBOE floor trader and market maker – provided liquidity on the largest options exchange in the world for stocks like Amazon
- Hedge fund analyst, options portfolio
- MBA, MSIM, Arizona State University
- BA Economics, University of Illinois



Options Trading Online Resources

- Marketchameleon.com (analytics, screener)
- Cmlviz.com (backtesting)
- Cboe.com (videos, education)
- Optionseducation.org (education)
- Vixcentral.com (volatility)
- Sixfigureinvesting.com (volatility)

Volatility Is Not Always Where You Expect



*<https://www.marketwatch.com/story/whats-more-volatile-than-bitcoin-you-may-be-surprised-2018-10-22>

What Is Options Volatility?

- Despite the previous chart, when we talk about options volatility, we are generally referring to **implied volatility**
- Implied volatility measures the expected rate of change of a stock price (or any other underlying asset)
 - Expressed as a percentage (annualized version of standard deviation of daily price moves)
 - Better seen as an example – so if Coca-Cola (KO) has a 11% implied volatility, it's expected to move 11% up or down over the next year
 - Compare KO to Tesla (TSLA), considered a more volatile stock, which has an implied volatility of 57%
 - For SPY, the S&P 500 ETF, October IV got up to 22% from about 9% in September. For reference, the HV for SPY peaked at around 23% (it was 7% at the end of September)

Why Trade Volatility?

- Volatility tends to be more predictable than asset prices (despite what happened in February and after)
- It has mean reverting characteristics (statistical evidence)
- It's relatively easy to trade volatility with options or ETPs (not quite so much at the moment with ETPs – though that could change)
- My favorite way to sell volatility is with **iron condors**, although there are many different ways to do so

Step 1: Follow Volatility Metrics

- Keep an eye on the VIX and how its price compares to past levels
 - The VIX is the S&P 500 Implied Volatility Index (more in a minute)
- The VIX isn't the perfect indicator of market volatility but it does a good job for what it is – and it's easy to find and compare to past data
 - Remember, it only measures the S&P 500 implied volatility
- VIX can be a signal of a major upcoming move in the market
 - It can help show you when to increase hedging
 - It can also be a decent indicator of “all clear”

What Is The VIX?

- The calculation isn't important
- It's a measure of 30-day implied volatility, so it's what the market expects to happen

Here's why the VIX is important:

- As more people buy options, the VIX goes up
- Investors tend to buy options when they are worried (especially to the downside) so the VIX goes up when investors are worried
- That's why it is commonly known as the investor "fear gauge"
- It's a major source of hedging by institutions and funds

$$\sigma^2 = \frac{2}{T} \sum_i \frac{\Delta K_i}{K_i^2} e^{RT} Q(K_i) - \frac{1}{T} \left[\frac{F}{K_0} - 1 \right]^2 \quad (1)$$

WHERE...

σ is $VIX/100 \Rightarrow VIX = \sigma \times 100$

T Time to expiration

F Forward index level desired from index option prices

K_0 First strike below the forward index level, F

K_i Strike price of the i th out-of-the-money option; a call if $K_i > K_0$; and a put if $K_i < K_0$; both put and call if $K_i = K_0$.

ΔK_i Interval between strike prices - half the difference between the strike on either side of K_i

$$\Delta K_i = \frac{K_{i+1} - K_{i-1}}{2}$$

(Note: ΔK for the lowest strike is simply the difference between the lowest strike and the next higher strike. Likewise, ΔK for the highest strike is the difference between the highest strike and the next lower strike.)

R Risk-free interest rate to expiration

$Q(K_i)$ The midpoint of the bid-ask spread for each option with strike K_i

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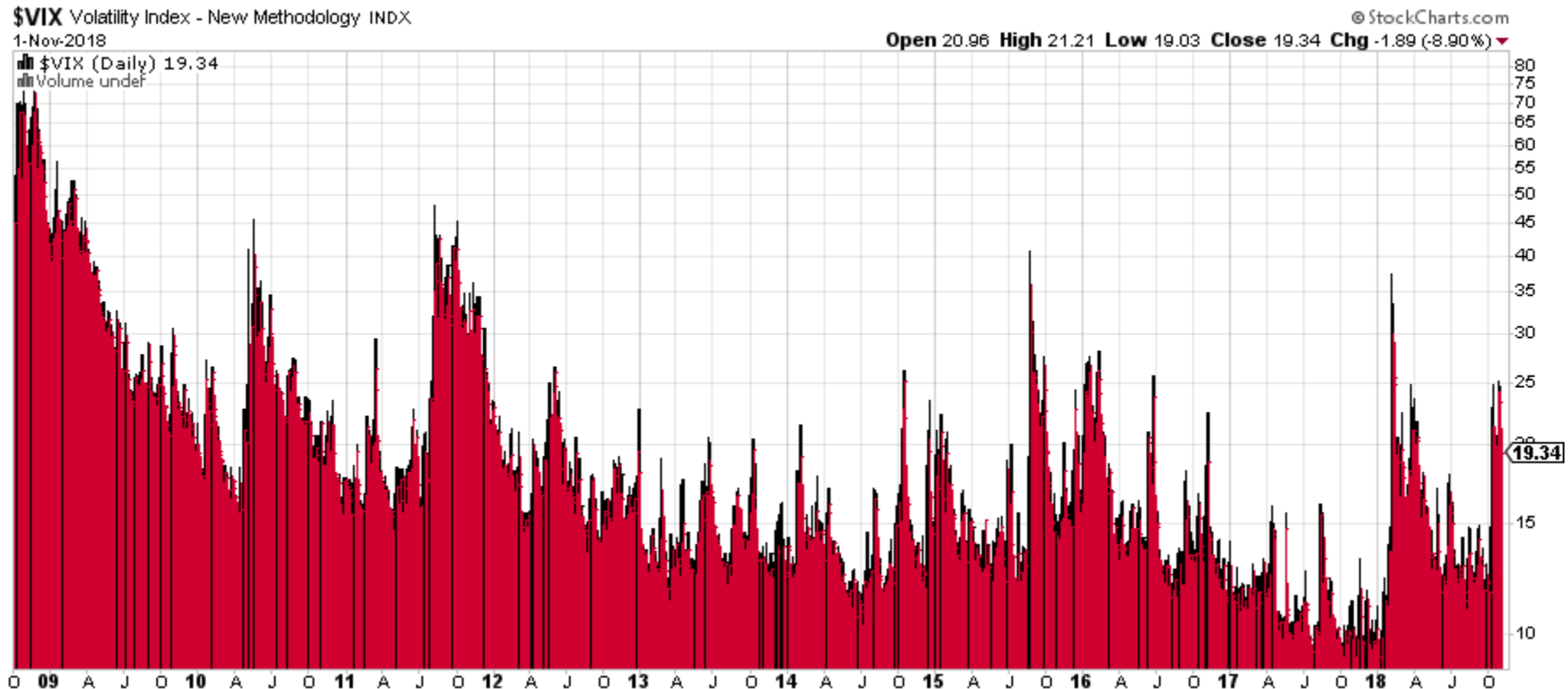
More About The VIX

- The VIX itself isn't tradeable, only futures, options, and ETPs
- Volatility ETPs are very popular (but none truly replicate the VIX)
 - VXX (short-term futures) – the most popular
 - ~~XIV (inverse)~~
 - SVXY (from -1x to -.5x)
 - TVIX (leveraged 2x, no options)
 - UVXY (from 2x to 1.5x)
 - VXZ (medium-term)
- Everything in the market goes in cycles, and no doubt these products will once again grow in number

Step 2: Selling Volatility Is Still Good

- It's true despite the two big volatility events we've had in 2018 (February and October)
- I mentioned before the volatility has mean reverting characteristics, and it's very apparent with the VIX
 - The VIX is normally low
 - When it spikes, it tends to come back down quickly (unless there's a major dislocation – see February 5th)
 - VIX up days tend to be infrequent and spread out
 - Magnitude is larger than down days in most cases
 - VIX down days are the norm and usually occur in bunches
 - It's important to stay away from the short volatility strategy when there is a lot of uncertainty in the market (politics, Fed, etc.)

Why It's Usually Better To Sell Volatility



Why It's Usually Better To Sell Volatility Part 2



Quick Definition: Delta

- For my upcoming trading strategies and examples, I talk a lot about delta.
- Delta tells you how much an option price will move in relation to the underlying, so for example a 50 delta option will move \$0.50 for every \$1 move in the underlying asset
- Delta gives you a rough probability of the option finishing in the money, so a 50 delta options has about a 50% chance of ending up in the money, 30 delta/30% and so on
- 50 delta options are at the money, below 50 are out of the money, and those are the options we usually deal with.

Shorting Market Volatility: Results

Bottom line: Using the widely popular VXX ETN (short-term VIX), you would have made money over the last five years buying puts or selling call spreads

Long VXX Put

Buy 50 Delta Put	
Expiration:	30 Days
<u>Risked:</u>	\$550
Total Return:	\$2864
% Return:	521%
Commissions:	-
% Wins:	56.3%
Wins: 36	Losses: 28
Gain: \$7120	Loss: -\$4256

Buy 30 Delta Put	
Expiration:	30 Days
<u>Risked:</u>	\$481
Total Return:	\$1025
% Return:	213%
Commissions:	-
% Wins:	40%
Wins: 26	Losses: 39
Gain: \$3784	Loss: -\$2759

Short VXX Call Spread

Sell 50 Delta, Buy 40 Delta Call	
Expiration:	30 Days
<u>Risked:</u>	\$210
Total Return:	\$1119
% Return:	533%
Commissions:	-
% Wins:	81.5%
Wins: 53	Losses: 12
Gain: \$2139	Loss: -\$1020

Sell 30 Delta, Buy 20 Delta Call	
Expiration:	30 Days
<u>Risked:</u>	\$323
Total Return:	\$918
% Return:	284%
Commissions:	-
% Wins:	89.2%
Wins: 58	Losses: 7
Gain: \$1947	Loss: -\$1029

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Selling Volatility: Disclaimer

- I wrote this before February 5th and the aftermath and now we've had another volatile month in October
- Keep in mind, funds use the VIX to hedge, so there will always be demand for long VIX
- However, don't forget, the VIX can move up in a hurry when the market starts to worry
 - Huge gaps can occur and you may not have time to exit positions
 - Always be aware of the macro environment
 - Try not to go short volatility through major events (like elections/FOMC uncertainty)
 - The ETP blowup in February was unforeseen but the political drama is more predictable

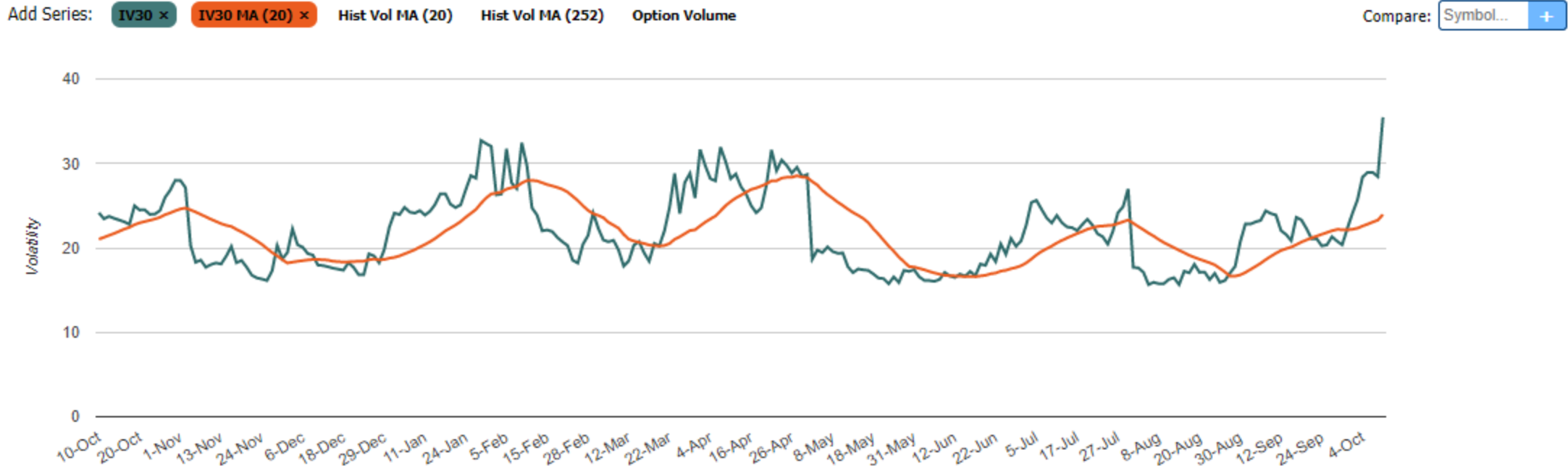
Step 3: Follow The Implied Volatility

- Market volatility (VIX) isn't the only way to trade volatility
- Every stock, index, ETF, commodity, currency, bond, etc. has its own implied volatility curve you can look at and use to make trade decisions
- For most any asset, implied volatility will also revert to the mean
- Single stocks have more volatility buying opportunities than index ETFs due to earnings, but both tend to mean revert.
 - AAPL versus SPY

AAPL Implied Volatility Curve



Historical 30-Day IV and Realized Stock Volatility



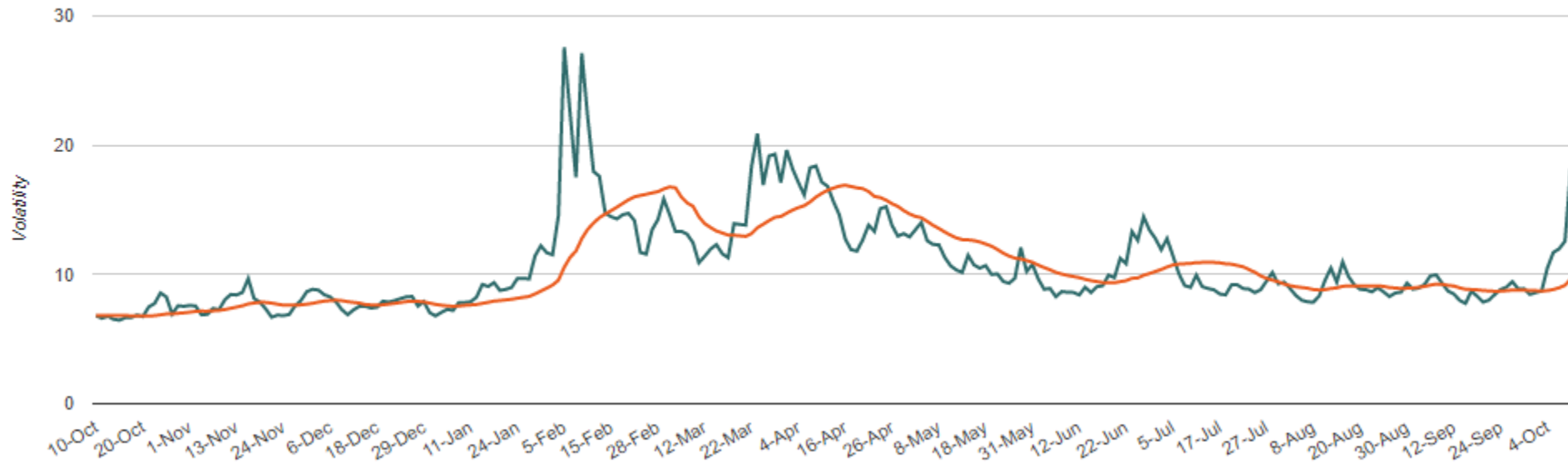
SPY Implied Volatility Curve



Historical 30-Day IV and Realized Stock Volatility

Add Series: **IV30** × **IV30 MA (20)** × Hist Vol MA (20) Hist Vol MA (252) Option Volume

Compare: Symbol... +



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How To Sell Volatility In Equities

- Unlike with the VIX, there isn't an ETP available for individual stocks or ETFs
- As such, you have to use options to sell volatility
- My favorite way to sell volatility is using iron condors, which limits risk and margin requirements

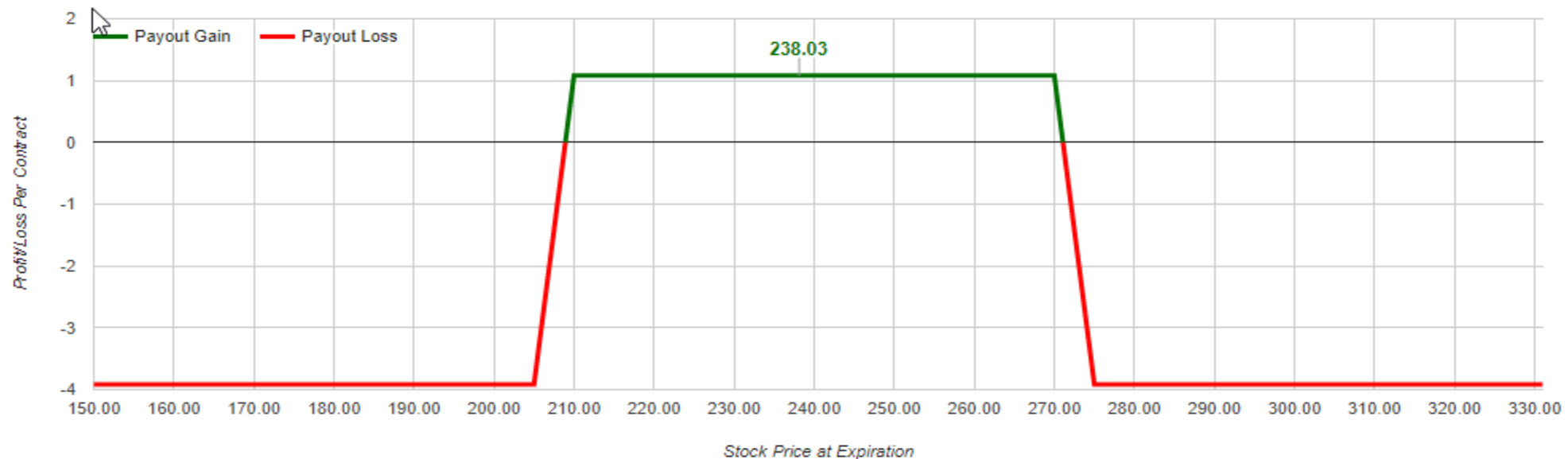
What's An Iron Condor?

- An iron condor is simply selling an OTM call spread and an OTM put spread in the same expiration
 - The goal is pick a range you expect the underlying asset to remain in
- Index iron condors are the most popular to sell but they can be used in just about any underlying asset
 - Indices/ETFs like SPX and SPY are the most popular underlying assets for trading iron condors
 - I like using expensive (price level) tech stocks
- You want your underlying to be more volatile than normal, but not too volatile.
 - Low volatility assets don't have enough juice in the options
 - The same is true for low priced stocks/ETFs

Iron Condor Example

- You expect Adobe (ADBE) to stay in range (\$60) over the next 40 days
- Implied volatility is over 35% with the IV 20-day moving average at 25% (and no earnings prior to expiration)

ADBE 16-Nov-18 Payout Chart: Long 1 Call: 275 Strike @ \$1.19 Short 1 Call: 270 Strike @ \$1.68 Long 1 Put: 205 Strike @ \$2.08 Short 1 Put: 210 Strike @ \$2.68 Credit: \$1.09



market
CHAMELEON

Selling Volatility: Iron Condor Results

IWM: Sell 15 Delta Call & Put, Buy 10 Delta Call & Put

Expiration: 45 Days

Risked: \$408
Total Return: \$686
% Return: 168%
Commissions: -
% Wins: 78.6%
Wins: 33 **Losses:** 9
Gain: \$1477 **Loss:** -\$791

SPY: Sell 15 Delta Call & Put, Buy 10 Delta Call & Put

Expiration: 45 Days

Risked: \$505
Total Return: \$884
% Return: 175%
Commissions: -
% Wins: 76.2%
Wins: 32 **Losses:** 10
Gain: \$1863 **Loss:** -\$979

AMZN: Sell 15 Delta Call & Put, Buy 10 Delta Call & Put

Expiration: 45 Days

Risked: \$6464
Total Return: \$3809
% Return: 58.9%
Commissions: -
% Wins: 67.3%
Wins: 33 **Losses:** 16
Gain: \$10600 **Loss:** -\$6791

MSFT: Sell 15 Delta Call & Put, Buy 10 Delta Call & Put

Expiration: 45 Days

Risked: \$398
Total Return: \$495
% Return: 124%
Commissions: -
% Wins: 76.6%
Wins: 36 **Losses:** 11
Gain: \$764 **Loss:** -\$269

GS: Sell 15 Delta Call & Put, Buy 10 Delta Call & Put

Expiration: 45 Days

Risked: \$467
Total Return: \$420
% Return: 89.9%
Commissions: -
% Wins: 76.5%
Wins: 39 **Losses:** 12
Gain: \$2442 **Loss:** -\$2022

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Summary

- Keep an eye on the VIX
 - Understand its limitations
- Selling volatility has a high probability of success
 - Know the risks
- You can trade individual equities by following implied volatility
 - Compare current implied volatility to the average
- Iron condors are a very good way to trade volatility as long as the right conditions are met

Bonus Training

Be sure to sign up for my newest training presentation, “Become a Fearless Options Trader in 60 Minutes or Less.”

Here’s what you’ll learn in this new training session...

- **The 3 Steps to Fearless Options Trading**
- **The Real Reason Why 80% of Options Traders Fail (And How Not to)**
- **My “Do Less Make More” Options Trading “Hack”**
- **How to average a 28% gain on every winning trade by playing both sides of the.**
- **How to put it all together ... and create your own “No Fear” options**

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