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

What Is Options Volatility?

- When we talk about options volatility, we are generally referring to **implied volatility**
- Implied volatility measures the <u>expected</u> 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%

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 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 <u>expects</u> 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 knows as the investor "fear gauge"
- It's a major source of hedging by institutions and funds

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

WHERE...

σ is	$VIX/100 \Rightarrow \mathrm{VIX} = \sigma \times 100$
T	Time to expiration
F	Forward index level desired from index option prices
K_o	First strike below the forward index level, F
K_i	Strike price of the ith out-of-the-money option; a call if $K_i > K_o$; and a put if $K_i < K_o$; both put and call if $K_i = K_o$.
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.

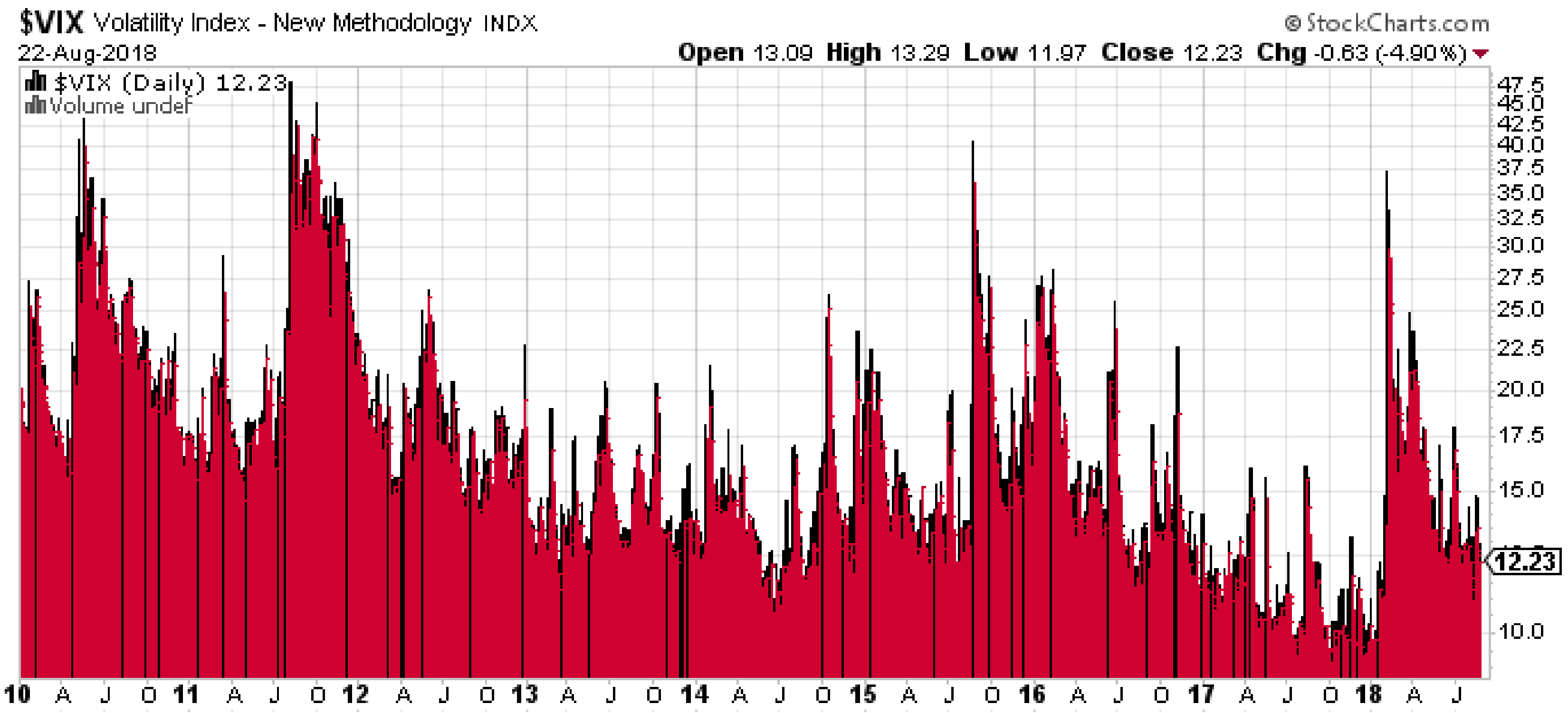
More About The VIX

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

Step 2: Selling Volatility Is Still Good

- This used to say “Selling Volatility Is Key” – times have changed
- 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, economics, etc.)

Why It's Usually Better To Sell Volatility



Shorting Market Volatility: Results

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

	Buy 50 Delta Put	Buy 45 Delta Put	Sell 55 Delta Call	Sell 50 Delta Call
Expiration:	30 Days	30 Days	30 Days	30 Days
Risked:	$1407	$1195	$615	$615
Total Return:	$2547	$2292	$3182	$2919
% Return:	181%	192%	517%	475%
Commissions:	-	-	-	-
% Wins:	64.1%	61.5%	87.2%	89.7%
Wins:	25	24	34	35
Losses:	14	15	5	4
Gain:	$5288	$4762	$6753	$6229
Loss:	-$2740	-$2469	-$3571	-$3310

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Selling Volatility: Disclaimer

- I wrote this before February 5th and the aftermath and it still applies
- 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)
        - The ETP blowup was unforeseen but the political drama was more predictable

Step 3: Follow The Implied Volatility

- Market volatility (VIX) isn't the only way to trade volatility
- Every stock, index, and ETF 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

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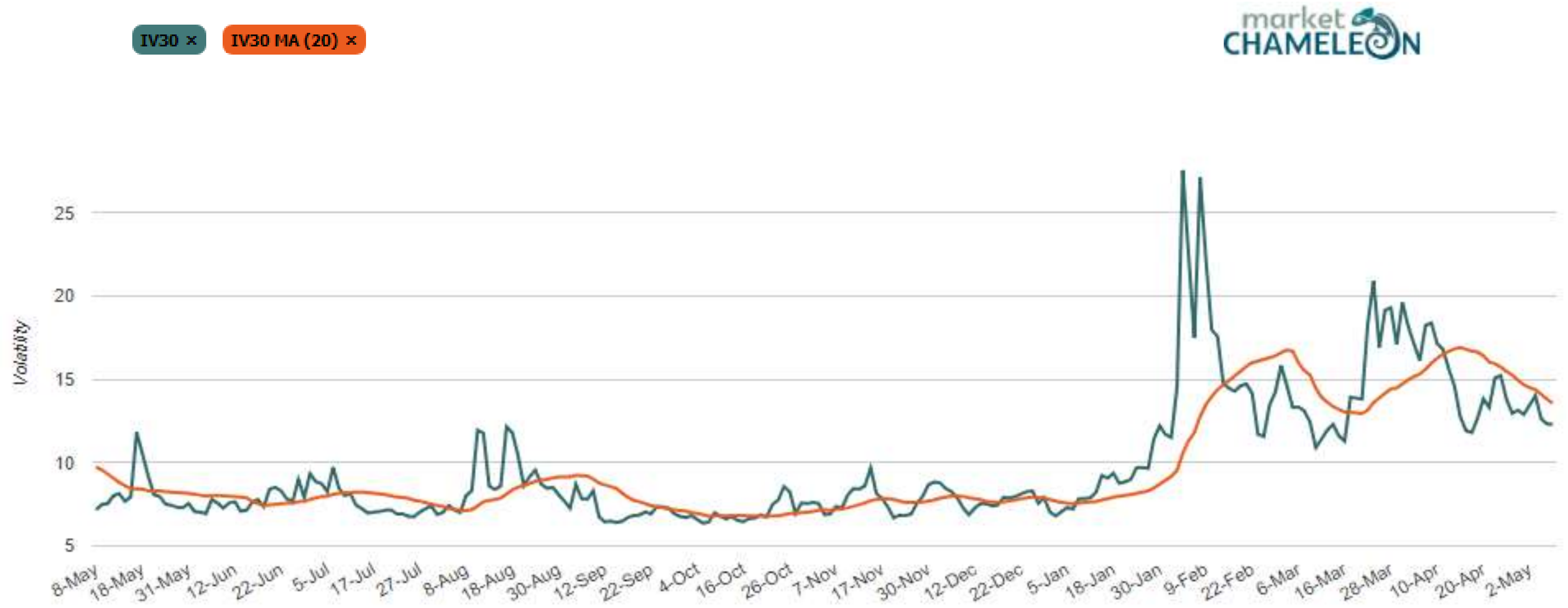
SPY Implied Volatility Curve



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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
  - An iron condor is simply selling an OTM call spread and an OTM put spread in the same expiration
  - Index iron condors are the most popular to sell but they can be used in just about any underlying asset

Selling Volatility: Iron Condor Results

	SPX: Sell 20 Delta Call & Put, Buy 15 Delta Call & Put	RUT: Sell 20 Delta Call & Put, Buy 15 Delta Call & Put	AAPL: Sell 20 Delta Call & Put, Buy 15 Delta Call & Put	GLD: Sell 20 Delta Call & Put, Buy 15 Delta Call & Put
Expiration:	45 Days	45 Days	45 Days	45 Days
Risked:	$3628	$1230	$672	$182
Total Return:	$2516	$6578	$1274	$245
% Return:	69.3%	535%	190%	134%
Commissions:	-	-	-	-
% Wins:	64.3%	75%	72.7%	69.8%
Wins:	27	33	32	30
Losses:	15	11	12	13
Gain:	$15079	$15612	$3436	$1268
Loss:	-$12563	-$9034	-$2161	-$1023

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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
  - I like using iron condors for this purpose
- There are many ways to sell volatility, but ultimately you need to trade your edge (even if it means being a volatility buyer)

Q&A

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