

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

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In addition, you can go to [www.Optionsfloortrader.com](http://www.Optionsfloortrader.com) to find out more about the product.

# About Me

- 21 years of experience trading options
- 9 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



# Which Portfolio Do You Prefer?



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# What Is Options Volatility?

- 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 14% implied volatility, it's expected to move 15% up or down over the next year
  - Compare KO to Tesla (TSLA), considered a more volatile stock, which has an implied volatility of 47%
  - For reference - SPY, the S&P 500 ETF, December IV got up to 33% from about 9% in September (currently 17%)

# Why Trade Volatility?

- Volatility tends to be more predictable than asset prices (despite what 2018 being an unusual year)
- It has mean reverting characteristics and clustering properties (all heavily backed by research) – more in a minute
- It's relatively easy to trade volatility with options or ETPs (with more ETPs likely on the way)

# 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
- The VIX is generally the best measure of market volatility conditions – 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 concerned
- That's why it is commonly known as the investor "fear gauge"
- In other words, the VIX is essentially the cost of buying portfolio protection

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

### WHERE...

$\sigma$  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  $K_i = K_0$ .

$\Delta K_i$  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:  $\Delta K$  for the lowest strike is simply the difference between the lowest strike and the next higher strike. Likewise,  $\Delta K$  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  $K_i$

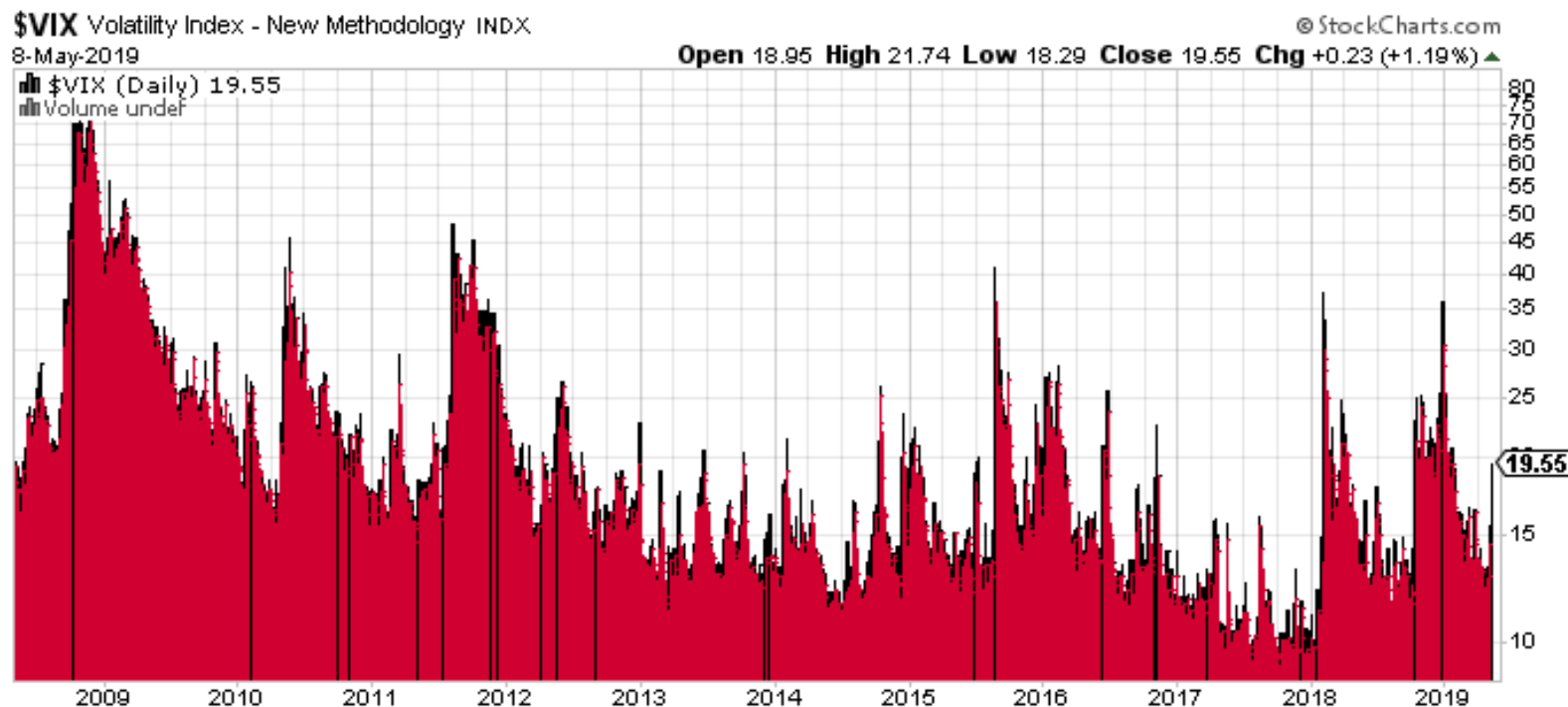
# More About The VIX

- The VIX itself isn't tradeable, only futures, options, and ETPs
- 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)
- 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-December)
- 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 5<sup>th</sup>)
  - 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 (major political event, Fed meeting, etc.)

# Why It's Usually Better To Sell Volatility



# 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 very 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 UVXY ETN (short-term 1.5 leveraged VIX futures), you would have made money over the last five years buying puts or selling call spreads (no stops, holding to expiration)**

## Buying UVXY Puts

| Buy 50 Delta Put    |                |
|---------------------|----------------|
| Expiration: 30 Days |                |
| <u>Risked:</u>      | \$1628         |
| Total Return:       | \$4412         |
| % Return:           | 271%           |
| Commission:         | -              |
| % Wins:             | 59.1%          |
| Wins: 39            | Losses: 27     |
| Gain: \$15348       | Loss: -\$10936 |

| Buy 30 Delta Put    |               |
|---------------------|---------------|
| Expiration: 30 Days |               |
| <u>Risked:</u>      | \$156         |
| Total Return:       | \$2780        |
| % Return:           | 1782%         |
| Commission:         | -             |
| % Wins:             | 51.5%         |
| Wins: 34            | Losses: 32    |
| Gain: \$9226        | Loss: -\$6446 |

## Selling UVXY Call Spreads

| Sell 50 Delta, Buy 40 Delta Call |               |
|----------------------------------|---------------|
| Expiration: 30 Days              |               |
| <u>Risked:</u>                   | \$303         |
| Total Return:                    | \$1659        |
| % Return:                        | 548%          |
| Commission:                      | -             |
| % Wins:                          | 81.8%         |
| Wins: 54                         | Losses: 12    |
| Gain: \$3946                     | Loss: -\$2287 |

| Sell 30 Delta, Buy 20 Delta Call |               |
|----------------------------------|---------------|
| Expiration: 30 Days              |               |
| <u>Risked:</u>                   | \$729         |
| Total Return:                    | \$932         |
| % Return:                        | 128%          |
| Commission:                      | -             |
| % Wins:                          | 84.4%         |
| Wins: 54                         | Losses: 10    |
| Gain: \$3131                     | Loss: -\$2199 |

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# Selling Volatility: Disclaimer

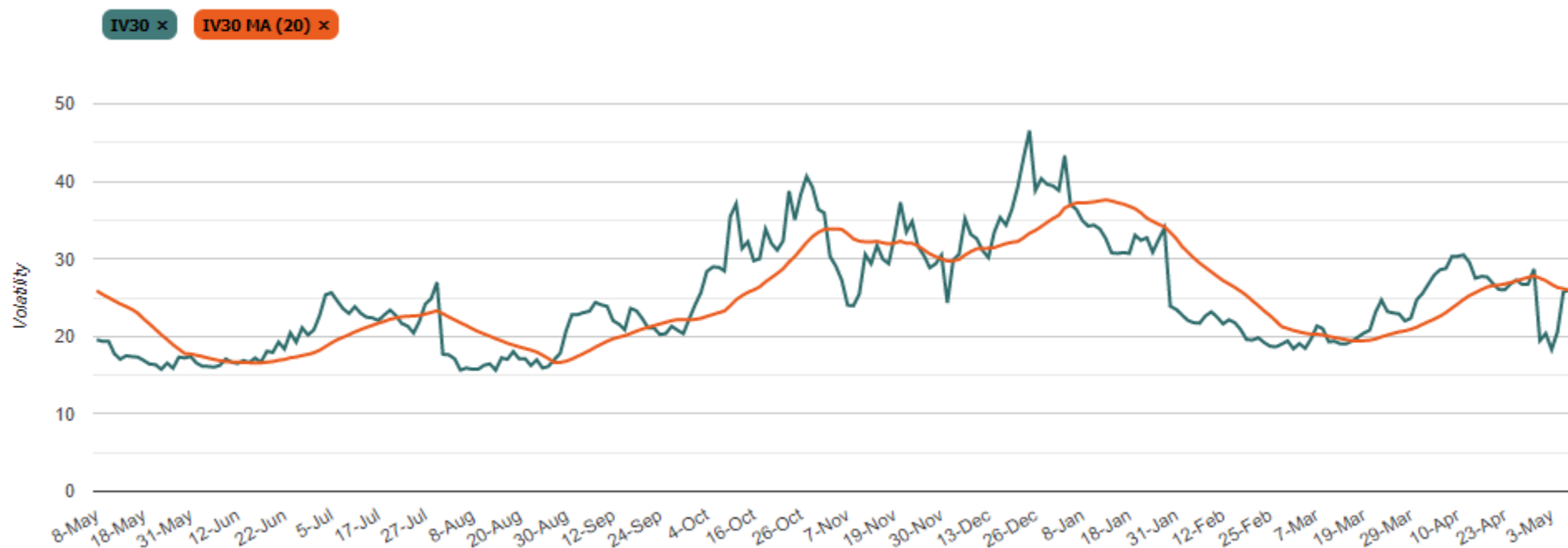
- 2018 should be a perfect case study as to why selling volatility needs to be approached with caution
- Keep in mind, funds use the VIX to hedge, so there will always be demand for long VIX
- However, don't forget, the VIX can move up in a hurry when the market starts to worry
  - Huge gaps can occur 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)
    - Notice both VXX strategies are designed to limit risk

# 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 (on average it works best with index volatility, but still plenty of opportunity in other assets)
- 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

market  
CHAMELEON

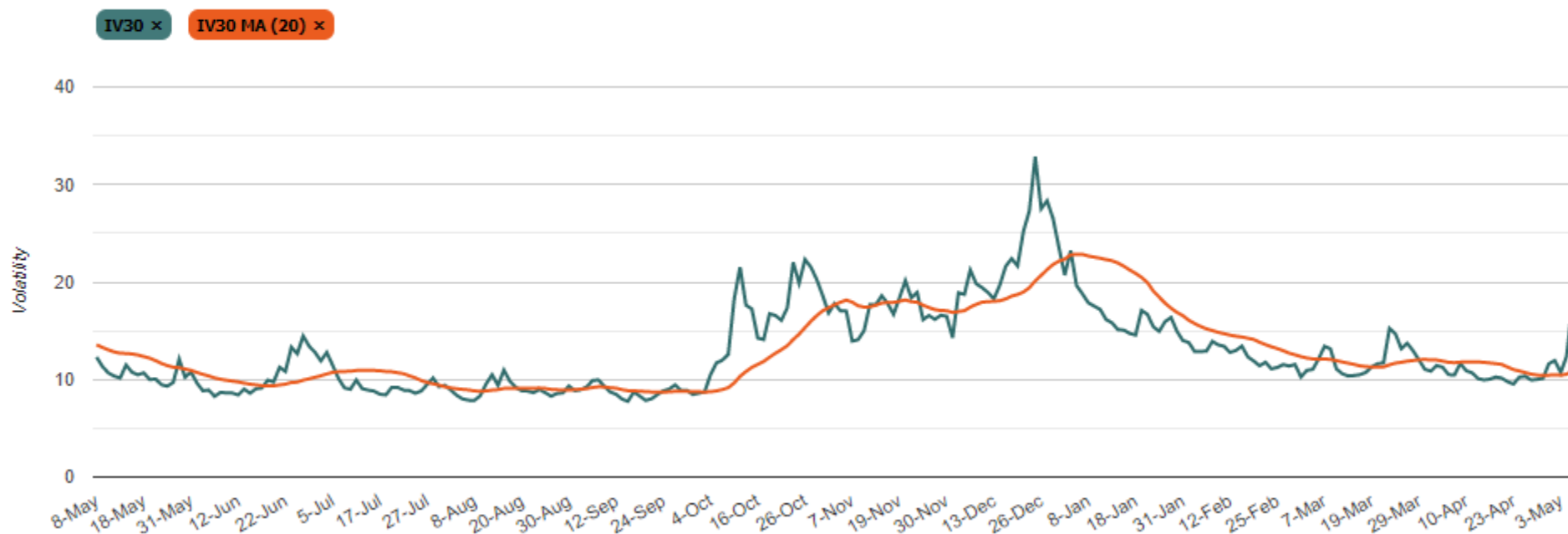


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# SPY Implied Volatility Curve

market  
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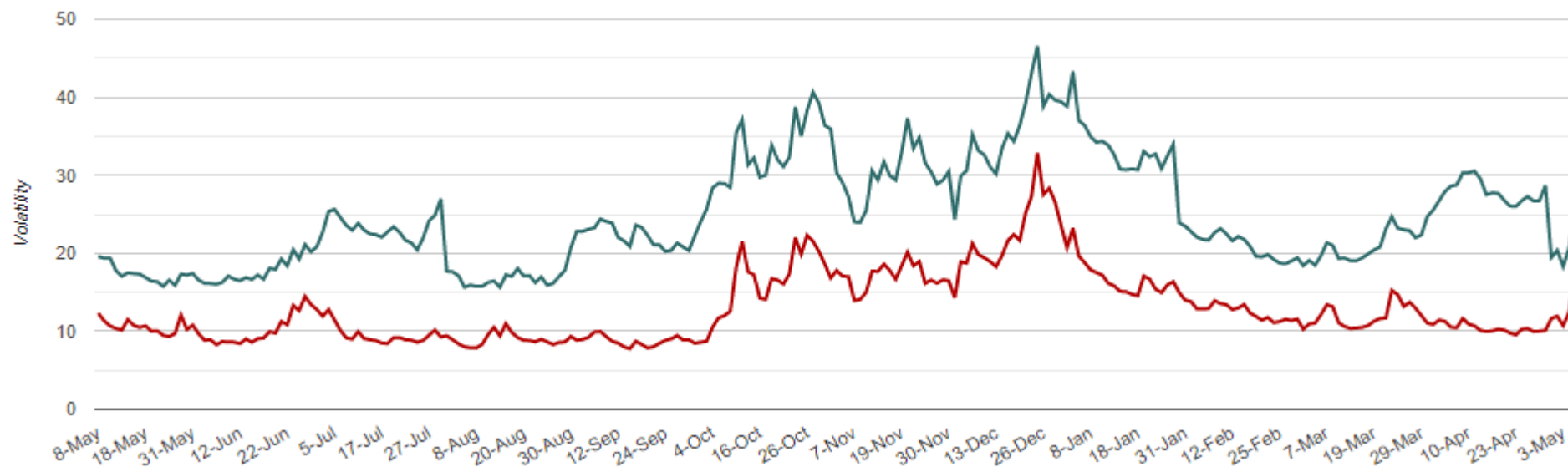


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# SPY (red) vs AAPL (green)

market  
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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 credit put spreads across multiple stocks and hedging the entire portfolio with index/ETF put spreads
  - Spreads limit risk and margin requirements
  - The hedge is necessary to help focus on volatility and significantly reduce directional exposure

# Put Credit Spread Example

- You expect Netflix (NFLX) to stay at or above \$350 the next 45 days (current price \$365)
- Implied volatility is about 35%, but it's normally 25%-30% after earnings come out
- You can collect a credit of \$160 to trade the June 21<sup>st</sup> 345-350 put spread
- So you risk \$3.40 (5-wide strike gap - \$1.60 premium) to make \$1.60, but there's roughly a 70% probability of success, not including adjustment or rolling.

# Put Credit Spread Example

NFLX 21-Jun-19 Payout Chart: Long 1 Put: 345 Strike @ \$9.98 Short 1 Put: 350 Strike @ \$11.58 Credit: \$1.60



market  
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# Selling Volatility: Put Credit Spread Results

|                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                      |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| AMZN: Sell 30 Delta, Buy 20 Delta Put<br>Expiration: 30 Days<br><b>Risked:</b> \$1644<br>Total Return: <b>\$11553</b><br>% Return: <b>703%</b><br>Commission: -<br>% Wins: <b>78.8%</b><br>Wins: <b>52</b> Losses: <b>14</b><br>Gain: <b>\$27880</b> Loss: <b>-\$16327</b> | MSFT: Sell 30 Delta, Buy 20 Delta Put<br>Expiration: 30 Days<br><b>Risked:</b> \$253<br>Total Return: <b>\$693</b><br>% Return: <b>275%</b><br>Commission: -<br>% Wins: <b>78.6%</b><br>Wins: <b>55</b> Losses: <b>15</b><br>Gain: <b>\$1362</b> Loss: <b>-\$669</b> | PG: Sell 30 Delta, Buy 20 Delta Put<br>Expiration: 30 Days<br><b>Risked:</b> \$334<br>Total Return: <b>\$282</b><br>% Return: <b>84.6%</b><br>Commission: -<br>% Wins: <b>78.8%</b><br>Wins: <b>52</b> Losses: <b>14</b><br>Gain: <b>\$1148</b> Loss: <b>-\$866</b> | SPY: Sell 30 Delta, Buy 20 Delta Put<br>Expiration: 30 Days<br><b>Risked:</b> \$395<br>Total Return: <b>\$1456</b><br>% Return: <b>369%</b><br>Commission: -<br>% Wins: <b>85.9%</b><br>Wins: <b>55</b> Losses: <b>9</b><br>Gain: <b>\$3520</b> Loss: <b>-\$2064</b> | QQQ: Sell 30 Delta, Buy 20 Delta Put<br>Expiration: 30 Days<br><b>Risked:</b> \$150<br>Total Return: <b>\$1217</b><br>% Return: <b>811%</b><br>Commission: -<br>% Wins: <b>90.8%</b><br>Wins: <b>59</b> Losses: <b>6</b><br>Gain: <b>\$2531</b> Loss: <b>-\$1314</b> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

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Variables: Last 5 years, every 30 days, no earnings periods, no stops for gains/losses, held to expiration

# 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
- Put credit spreads are a very good way to trade volatility as long as you are also hedging against market risk (which is the generally the main risk to the downside)

# Options Floor Trader Pro

- Long-only options service
  - Trades calls, put, straddles, and strangles
- Potential for large returns on individual trades
- Defined and limited risk
- Bi-weekly newsletter, with a new trade each issue
- Education section in every issue
- 1-year full refund period
- Very good way to get started with options
- Physical and digital trading checklist

# Q&A

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