VOLATILITY/VIX TRADING

YOUR STEP-BY-STEP GUIDE TO STOCK TRADING AND OPTIONS TRADING WITH VOLATILITY

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Volatility/Vix Trading

Your Step-by-Step Guide to Stock Trading
and Options
Trading with Volatility
Table Of Contents

Introduction

Chapter 1 – What Is Volatility?

Chapter 2 – The Volatility Index

Chapter 3 – Volatility as Insurance
Chapter 4 – How to Trade the VIX

Chapter 5 – Volatility Trading Step-by-Step

Chapter 6 – Identifying Market Trends

Chapter 7 – Warning & Tips: The Institutional Investors

Chapter 8 – Final Notes
Conclusion
Introduction


This book is the ultimate beginner’s guide to trading with volatility and the
Volatility Index (VIX).

In this book, you'll discover what volatility is and how it works, and you'll learn step-by-step how to use volatility and VIX to identify market trends and trading opportunities.

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Chapter 1 – What Is Volatility?

Whatever financial asset you consider it has a price every day or every moment of the day. Clearly the prices change every day or every minute of each day and these movements are represented in price charts.
Every day the prices reach a minimum and a maximum level and this difference is called *fluctuation*. If in a certain period of time, such as three months, the fluctuation is higher than that registered in the same previous period of time, we say that the *volatility* is higher. Let’s take an example: if today the currency pair EUR/USD has a maximum price of 1.40 and a minimum of 1.37, whereas
yesterday it had a minimum of 1.385 and a maximum of 1.40, you can see that the volatility today is higher (0.03 versus 0.015).
An In-Depth Look at Volatility

Usually, volatility is connected to the uncertainty of the financial markets or to an unstable economic outlook of a company, country or macroeconomic area. This normally happens when there’s a crisis or some economic or macroeconomic factors that may generate it.
Psychologically, many traders and investors are forced to buy or sell their financial assets to protect their capital, or to reduce their losses by opting for shelter goods such as gold or the US dollar. When the markets do not have a clear direction like an uptrend or downtrend, the prices look like a rollercoaster and they fluctuate dramatically.
Even though it can be seen as harmful for your investment, volatility can also represent a great opportunity to make some profits if you are able to take advantage of it.

In order to measure the relative volatility of a certain stock to the market, the Beta is used. This parameter is related to the relevant benchmark: if the stock is included in the S&P 500’s
list, the reference will be the S&P 500 index. How it is calculated? It considers the returns of the stock versus the index ones: if the security has a beta value of 1.2 this means it moved 120% for every 100% move in the benchmark. If a stock has a beta value of 0.8, it moved 80% for every 100% index move.

However, the most important
parameter used to measure volatility is the so-called Volatility Index (VIX).
Chapter 2 – The Volatility Index

What is the Volatility Index?
It is used to identify the market expectations in the near term. It has been considered for a long time as a valuable tool to understand investor sentiment and volatility, or to measure the perceived risk of the
investors. If they are expecting or perceiving a higher risk or if they are mostly buying protection put options, the VIX will be higher and the market will probably drop.

In fact, the VIX grows every time the markets are facing uncertainty or are “nervous” and decreases whenever the markets are growing: there is a contrarian correlation
between the two factors. So if you look at the VIX and observe its movements, you will probably know the direction of the markets.

Let’s take an example: if you are an investor who has bought a lot of stocks and you are now concerned that the market could face a downwards trend, you would buy protection put options to protect your stock
investments. Moreover you would stop buying stocks since you could lose money if the market prices drop. If a lot of large investors stop their purchases in this way, the markets won’t grow and they will probably experience a downturn.
Chapter 3 – Volatility as Insurance
As it is considered an important contrarian signal, let’s consider the following chart.

As you can see there is not always an adverse correlation, but usually when the VIX started to grow, the S&P 500 index fell. We can see it in 1990, 1998, 2002-
2003 and most of all in 2008. During these times, there were financial “storms” like the Gulf War, the Japanese stock market crisis, the scandals of Enron and WorldCom, the new war in Iraq and finally the sub-prime crisis that affected worldwide stock markets and economies.

It could be considered as a type of insurance: it starts growing when the investors
perceive a higher degree of uncertainty or when the markets could drop. What is needed now is to learn how and when to use the VIX: when it is low, it can create excellent opportunities to buy protective put options at a reasonable price.

This is the best time to protect your portfolio: when the price is low and volatility could grow in the future.
Chapter 4 – How to Trade the VIX

When can the VIX be considered low? Normally when it’s located below 15, it’s a good time to play the VIX.

In fact, when the VIX is as low as 15, the markets have grown so much that they are ready to go down at a certain
point as it’s likely that they have reached a peak. This will certainly happen but it’s difficult to predict when.

When the VIX is low, in order to trade in the simplest way, you need to consider the VIX futures-exchange traded notes (ETN) and exchange traded funds (ETF) such as the iPath S&P 500 VIX Short-Term Futures ETN (NYSE: VXX) or the S&P
VIX Mid-Term Futures ETN (NYSE: VXZ).

Why are we trading them? The ETFs and ETNs are cheaper and the futures can be a good guideline for what the market directions might be. If you buy at a cheaper price, your risk is lower in terms of potential loss, but your profits, although somewhat protected, could also be more limited.
You should be protected when the bullish period is over or when some economic news might cause a slowdown. The VIX will start to grow, and the VXX and the VXZ with it.

If you buy puts when the VIX is low, it’s like betting that the market is almost near the top and will probably go down. Since the VIX movements are the opposite
of the S&P 500 index, when the VIX is going up, it is most likely that the S&P 500 will start dropping.

Another option is to buy leverage inverse ETFs - such as ProSharesUltraPro S&P 500 (NYSE: UPRO) or ProSharesUltraShort S&P 500 (NYSE: SDS). These ETFs will allow you to make profits even when the markets are dropping.
Although the VIX is a stock market volatility index, you need to understand that it’s not that different from any other investment tool. It can change in response to the news, announcements, economic data and dynamic market expectations.

When you invest in a VIX-linked product, in fact, you should keep in mind that it is
a short-term investment and carries consequent risks. This means you should act fast and not wait too long when it comes to making investment decisions.

The most important thing you need to consider is that you cannot use the VIX by itself: you need to use it together with the S&P 500 index.
Chapter 5 – Volatility Trading Step-by-Step
During panic times, the VIX tends to move more aggressively than the stock markets. Let’s re-check the same chart.

As you can see, during the financial crisis of 2008, the VIX grew by more than 300% versus a total drop of the S&P 500 of around 50%. What does this mean? It
means that the VIX movements are not proportional to the ones of the stock market. On average, a 10% decrease in the stock market index may cause a VIX increase of between 30% and 50%.

So the first point you need to consider is that the VIX reacts more aggressively and not proportionally to the S&P 500.
The second point consists in the identification of sentiment extremes. As we have already seen, if we consider the highs of the stock markets or the lows of the VIX, we can identify fear and complacency in the market investors and this normally means an upcoming reversal of the S&P 500.

However, sometimes it can take longer before the
reversal occurs. If we come back to the chart, you may have noticed that the VIX created something of a range market and stayed for a long time between 10 and 15, values that are generally considered to indicate a potential and upcoming reversal in the S&P500.

How could you identify whether there’s a possibility of reversal? You need to draw
two lines: the first one is the resistance line corresponding to the high reached around 2006 and the other is the support line corresponding to the low reached in 2006.

You can see that the VIX broke the resistance line in the second half of 2007 and created a second range market with a resistance line around 30. In 2008 this second resistance line was
again overcome by the VIX which reached 80.

After reaching that peak twice, the VIX dropped to the levels of 2007, except for another peak of 50. If you also look at the S&P 500 trend, you can see that the VIX movements are inverse compared to the S&P500, and the movements of the stock index may help you in your investment decisions.
What should you have done?

- When the VIX was low, you could have bought some protection put options (or leverage inverse ETFs) and sold the stocks when the resistance line was broken.
- When the VIX was extremely high, it was a good chance to buy
stocks or some call options.
Chapter 6 – Identifying Market Trends
The VIX can also be useful to confirm a market trend. Let’s take the same chart.

As you can see, every time the VIX peaks, it corresponds to a low or drop in the stock market. If you focus on the period 2003-8, you can see that the stock market started to grow again after the tensions of the war in Iraq in
2003 and the scandals of Enron and WorldCom that affected Wall Street.

The VIX dropped to the minimum levels and then grew again: you can also see that in 2007 the VIX started to grow, indicating a stock market reversal. The VIX increase was confirmation of investor sentiment that the markets would drop significantly in 2008 (the fear
was increasing and in fact “exploded” in September 2008), in anticipation of the sub-prime crisis that affected worldwide economies, but especially those in Europe and North America.

The S&P index, in fact, dropped to the levels reached in 1996.

You can see another market confirmation in 2009: the
markets, after the low of September 2008, started to run again, and the VIX started to decrease significantly again.

Please be aware that when the VIX movements are in a range, it means that typically the volatility is not confirming the market movements (the so-called divergence) and the trend could be short-lived. When
it’s more evident, it is more likely to be confirming the market trend.
We have established that the VIX measures the fear or the complacency of the markets towards the financial or economic situation. However, how can a single investor
understand how large the VIX movement might be? Or how long a move could last?

A significant part of the answer concerns the so-called “Institutional Investor Selling” and to what extent it is occurring at the same time. This index is determined by a three-day exponential moving average and a six-day weighted moving average. These two averages design
the short term selling trend by institutional investors.

This indicator has to be compared to, and might even anticipate, the VIX movement. It is important to understand what is going on in the market as this can help in understanding where the VIX will go.

The Institutional Investors normally determine the
market trend, since they are those institutions (banks or even central banks) that move enormous quantities of money and are able to determine an uptrend or a downtrend, speculative movements or an increase or drop of a single company security.

These indicators can tell us many things but not all: so it’s important to use more
charts in order to get the whole picture and make the correct investment decision.

One prudent rule is that you should never go against what the Institutional Investors are doing as that would probably mean a loss for you. You are a small investor compared with these Goliaths with enormous amounts of money at their disposal. The general rule is to follow what they are doing.
The VIX is useful to confirm a market direction and can be a valuable signal to understand where the markets could go. However, it should not be used alone to determine your investment decisions: you need to compare it to the S&P 500.
index and also use the Institutional Investor Selling index which can anticipate big investor sentiment.

However, uptrends in stock markets should be confirmed by a VIX downtrend, and stock market downtrends by an increase in the VIX. If these correlations are broken, it is likely that the market direction will be unsustainable in the short
term and that a possible market trend is just a short-term one. This would probably indicate a range market.

A good approach in that case is to use price action trading.

When the VIX gets close to a peak or a low, the current market trend could experience a reversal, but this reversal does not happen
immediately as you saw in the previous chart. In fact, when the VIX reaches a range level of between 10 and 15 or goes over 30, it could grow or drop, but it is necessary as usual to also check the S&P 500 index to get the overall picture in order to try to predict a direction.

It is better to use more indicators and indexes together in order to make the
best decisions, and remember not to go against the Institutional Investors since you could lose a lot of money.
Thank you again for downloading this book!

You should now have the knowledge you need to get started trading use volatility and VIX.

The next step is to take action!
Finally, if you enjoyed this book, please take the time to share your thoughts and post a review on Amazon. It’d be greatly appreciated!

Thank you and good luck!

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Table of Contents

Introduction
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Chapter 1 – What Is Volatility?
Chapter 2 – The Volatility Index
Chapter 3 – Volatility as Insurance
Chapter 4 – How to Trade the VIX
Chapter 5 – Volatility Trading Step-by-Step
Chapter 6 – Identifying Market Trends
Chapter 7 – Warning & Tips: The Institutional Investors
Chapter 8 – Final Notes
Conclusion