

# How To Take Advantage Of The Coming Rise In Volatility



## Introduction...

If you've spent any amount of time following the market, then you're familiar with the term 'volatility'. You'll often hear financial media types discussing volatility when the markets are really active, and especially on down days.

To put it as simply as possible, volatility is one way to measure market risk. The more volatility - the more stocks and other financial instruments move - the more perceived risk there is.

We're going to take a close look at what exactly volatility is and why it's set to rise in the coming months.

More importantly, we're going to go over three proven methods for profiting off volatility. There's no better way to capture volatility than by trading options.

**And there's absolutely no reason to let fear of volatility keep you from making money.**

Let's get right to it.

## What Exactly Is Volatility?

By definition, volatility is a measure of the variation of the price of a financial instrument over time. In other words, it's how much a financial instrument, say a stock or option, moves over a certain period of time.

Keep in mind, a financial instrument can be volatile without moving significantly in one direction. For example, a stock that starts and ends a period with the same price can still be volatile if it jumped up and down quite a bit over the period.

Here's the thing...

**Investors care about volatility because large swings in an investment's price equate to risk.** That may be okay with some investors seeking higher returns. But, generally volatility makes people nervous – especially those looking for safe investments.

That being said, what's most important for what I'm about to talk about is how volatility impacts options. You see, volatility is a key component in how options get priced. Basically, the higher the volatility or expected volatility of the underlying, the higher the price of the options.

It makes sense if you think about it. The more volatility the more chance an option finishes in the money. So, you have to pay more for the higher probability of success.

So what's it mean when the overall market is volatile?

Essentially a volatile market means more financial instruments are likely to be volatile than under normal conditions. The result is effectively the same for options. Whether a stock is volatile because of individual news, or because the overall market is volatile – it still results in a higher price for its options.

## The Coming Rise In Volatility

Since the beginning of 2012, market volatility has been low by historical standards. In fact, the markets have been very calm overall over the last couple years.

One way to measure market volatility is to look at the **CBOE S&P 500 Volatility Index** (VIX). The VIX basically provides the average volatility levels for options on the S&P 500 stocks.

Historically, a VIX under 20 is considered a relatively low risk environment. On the flip side, when the VIX climbs over 20, investors are really starting to worry.

Since the beginning of 2012, the VIX has been over 20 only a handful of times, and never reached as high as 30 during the period. And in 2013, the widely watched "fear index" has only been over 20 twice.

So is there any reason to worry about volatility with the markets acting so calmly of late?

**As of a matter of fact, there are several reasons to expect a significant increase in volatility over the next six months or so.**

Here's the deal...

The political situation in the US is far from ideal. There's no end in sight to the hardcore partisanship occurring in Congress and the White House.

That means, there's going to be significant confrontations ahead from a political and potentially economic standpoint. For instance, the debt ceiling issue is still out there. And, plenty of budgetary decisions have yet to be addressed.

What's more, conflict in the Middle East is flaring up once again. And it will continue to be a hot spot for months (and possibly years) to come. Syria, Iran, Egypt, and others are going to continue to create dilemmas for the US and other developed countries.

All this geopolitical and economic uncertainty could explode at any point and turn into a market meltdown. But even the thought of a major turn in the market can and does raise investor fear.

In other words, we could be seeing a lot of over 20-VIX days over the next half year or more.

## **Top Three Ways To Use Options To Take Advantage Of Volatility**

Okay, so volatility is set to rise.

What can we do about?

How can we take advantage of higher volatility?

Fortunately, there's no better way to capture volatility than by trading options. And I've got three excellent, time-tested methods of profiting off the coming rise in volatility.

### **Option Trade #1: Buy Index Straddles**

The key to profiting off volatility (using options) is actually quite simple. Instead of betting on market direction, you're betting on higher volatility.

In other words, you don't really care what direction a stock or other underlying moves in. You just expect it to move.

And if it moves enough, you win.

**That's where the options straddle trade comes in.**

A straddle is a type of spread where the trader purchases a call and a put at the same strike in the same month. For example, with theoretical stock XYZ trading at \$50, the January at the money (ATM) straddle would involve purchasing the January \$50 strike call and put at the same time.

The benefit to this trade is regardless of which direction the stock moves, the straddle owner can make money. So, if XYZ goes a reasonable amount higher or lower, the straddle is a winner.

Okay, let's look at one of the best ways to make use of a straddle.

Here's the deal...

If you really want to capture volatility using a straddle, don't just bet on one stock. There are too many factors at play. If you simply believe the market is going to be volatile, why not just bet on market volatility?

As such, for this straddle trade, we'll choose the **SPDR S&P 500 ETF** (SPY). As the most popular index ETF, the SPY captures the ups and downs of the market much more so than a single stock might.

Okay, let's say SPY is trading at "normal" volatility levels. I'll define normal as levels where the market's not too worried about a crash but there's a little bit of fear lingering out there.

For an ATM straddle expiring in roughly a year, you'd pay about \$24 a straddle or \$2,400 total. Remember, that means you'd be purchasing the ATM call and put with about a year to go.

In order to make money on this trade, SPY needs to move more than 24 points in either direction. Put that in terms of the S&P 500, it would need to move more than 240 points in either direction.

Let's say the S&P 500 is trading around 1,600. A 240 move is equal to a 15% move in the index. If the S&P 500 moves more than 15% over the course of year, you profit on the straddle.

Keep in mind, it's extremely common for the S&P 500 to move more than 15% over the course of any single year period. Heck, in 2013, the benchmark index climbed 20% in just six months!

Easy enough right? And that's all it takes to profit off of market volatility using an index straddle.

## Option Trade #2: Use Option Strangles

Okay, so let's say you like the idea of SPY straddles but feel they are just too expensive. Dropping \$2,400 per straddle is simply too rich for your tastes.

Don't worry, there's a perfect solution. **They're called options strangles.**

Strangles have most of the benefits of straddles, but they're cheaper alternatives. You see, with a strangle, you're buying out of the money (OTM) calls and puts instead of at the money. That makes the options considerably cheaper. (The farther out of the money an option is, the cheaper the option.)

So for our theoretical company XYZ trading at \$50, you may look at the \$40/\$60 strangle. That would mean you're buying the \$40 put and the \$60 call.

As I mentioned, the benefit to this is cost. The total cost will be far less than the straddle. On the other hand, the drawback is it will require a bigger move in the underlying for the trade to pay off.

Let's get right to our trade...

With a strangle, we're not going to use the SPY. Since we're further away from the actual price, we're going to want to choose something a bit more volatile.

We're still not looking at individual stocks – once again, too many unforeseeable factors. However, there are more volatile indices we can use instead of the S&P 500... like a small cap index. (Small cap stocks are almost always more volatile than large caps.)

The most popular small cap index is the Russell 2000, with its corresponding most popular ETF, the **iShares Russell 2000 Index ETF** (IWM).

At current levels of volatility, we'll look at a 10% OTM strangle. That is, a strangle at strikes 10% up or down from the ATM price. The total 10% OTM strangle price would be roughly \$12 or \$1,200.

Let's say the Russell 2000 is trading for 1,000. The 10% strangle would cover strikes for a move below 900 or above 1,100.

Clearly, \$12 for a strangle is considerably cheaper (half as much) as the ATM straddle we looked at on the SPY. However, it will take a 10% move just for either of options to become ATM options. And then, the index would have to move further to actually make money on the trade (depending quite a bit on how much time is left in your options).

Still, it could be a risk worth taking for half the cost of a straddle. It comes down to how much you want to pay versus how much you expect the index to move.

## Option Trade #3: Buy The VIX

Finally, let's change gears a bit. Instead of using options to capture volatility second hand, you can actually trade volatility itself using the VIX.

As I mentioned earlier, the VIX is the CBOE S&P 500 Volatility Index. It measures the average volatility across options on all the S&P 500 stocks. The VIX is a heavily followed index and is often considered the investor fear gauge.

The higher the VIX goes, the more investors are starting to worry. And, the more volatility investors are expecting in the market.

The benefit of using the VIX is it's a pure play on volatility. **And, taking a long position on rising volatility is as simple as buying calls on the index.** You don't need to use spreads or decide between strangles and straddles.

However, the drawback is once again cost. The VIX is both a major institutional product and popular with retail investors. As with anything in high demand, it tends to be expensive.

For our VIX trade, we're going to assume the VIX is trading at common levels in times of moderate volatility. Remember, over 20 is when the market is considered to be more volatile than usual.

And as the market picks up volatility, the VIX will become more expensive.

That being said, if we look at calls 20% out the money (higher) which are about six months out, they're trading for around \$3.50. It's reasonable to assume this pricing during these market conditions - 20% OTM calls with about six months to go until expiration should be priced between \$3.50 to \$4.00 each.

Keep in mind, if volatility ramps up quite a bit, those 20% calls will inflate in value, so you'll need to adjust your budget. One quick and easy way to deal with this situation is to simply purchase less calls than you would have in less volatile times.

Back to the trade...

For roughly \$350 per call, you have unlimited upside protection for six months, once the VIX moves 20% higher. That's a good amount of protection and not an unreasonable amount to spend.

Like the straddle and strangle, you'd need to weigh the cost benefit of this trade. Compared to the first two strategies, this one only covers six months out (as opposed to a year). And, as I mentioned, the cost of the calls can really explode during times of high volatility – so if you don't get this trade on soon, it may be too late.

## A Final Word

As you can see, there are multiple ways to trade volatility for profit. And, there's simply no reason to let volatility keep a savvy trader from making profits.

It's a just another example of how powerful options can be... in just about any situation.

**Done correctly, capturing volatility through option trading can provide huge upside potential. Even better, it can help you significantly lower your risk by protecting assets you already own.**

You've seen just how easy it is to use three different strategies to take advantage of the coming rise in volatility. Depending on your situation, buying SPY straddles, IWM strangles, or VIX calls can all be very beneficial additions to your overall trading strategy.

And there's so much more to discover about options than these three strategies. We just scratched the surface of all the possibilities...

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