

Thursday, December 22, 2011

Trading on Volatility

Volatility is the term commonly used to describe the degree of movement in stock prices. The VIX, which is an acronym for Volatility Index, is an index that measures the volatility implied in options prices, otherwise expressed as Implied Volatility.



The Volatility Index (VIX) has traded in a range between 18 and 48 during the year. When the VIX is low, option prices are cheap. Conversely, when the VIX is high, option prices are expensive. Smart money buys volatility when it is cheap and sells volatility when it is high. Now, what does that mean and how do you do it?

Let's assume that your outlook on the market is bullish and you have a stock on your radar that you would like to acquire. You could just pull the trigger and buy the stock. Or you could use options to leverage your intended position. With the VIX near its extreme low today at 21, the premium required over the intrinsic value is small. Here is an actual example of a trade I put on recently taking advantage of a low Implied Volatility.

On December 15, HJ Heinz Co (HNZ) was trading around \$53 per share. I was able to purchase a Call option (the right to purchase 100 shares) expiring on January 21, 2011 at a strike price of \$50.00 for \$3.15. The total outlay was \$315.00, which, incidentally, was my total downside risk. The intrinsic value of this option, referred to as "in the money" was \$2.95. The premium over parity (out of the money) was only \$.15. If the VIX were at higher levels, I could easily expect the premium to be three times or more of that amount. So with this low premium, the option price should pretty much track the movement in the underlying security. Sometime before expiration date, I will need to either close my position by selling the option or exercise my right to purchase HNZ at \$50.00 per share. Using this method, I was able to enter this position at a cost of \$315 vs \$5,300 had I purchased the stock outright.

As noted above, my downside risk for this trade is \$315. That is equivalent to putting a stop loss order at 6% below the purchase price had I purchased the stock outright instead of taking the option route. If the stock moves to \$55 just before expiration, the option value would be close to \$5 reflecting the difference between the market price and the exercise price. Closing this position would yield a profit of \$1.95. Not bad for a \$3 investment.

This is an example of buying volatility. Next time I will describe the process of selling volatility using puts instead of calls.