When NOT To Go Short Volatility

***e*Research Corporation** is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan examines the VIX and XIV, and discusses when to play and when not to play the volatility factor.

The article is reproduced below, beginning on the next page, or you can use this link to go to the article directly:

http://www.mcoscillator.com/learning_center/weekly_chart/when_not_to_go_short_volatility/

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Bob Weir, CFA
Director of Research

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The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

When NOT To Go Short Volatility

The VIX is a supposed "volatility index", but it does not really measure actual volatility. Instead, it measures what options traders think about volatility.

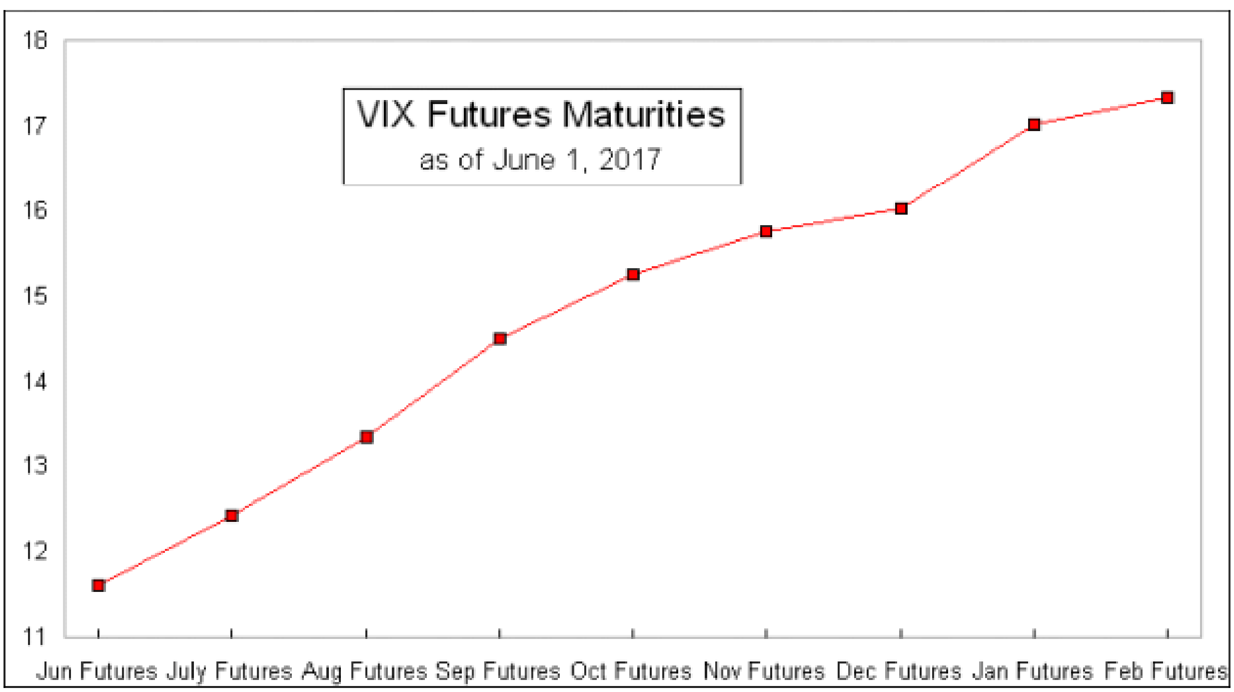
All of the various investment vehicles that have popped up in recent years that are tied to the VIX have enabled traders to go long or short "volatility" with relative ease compared to a few decades ago.

The short volatility trade has been among the most profitable, especially since the Fed, ECB, and BOJ started various flavors of quantitative easing in 2009. Betting on increased volatility has only worked a small fraction of the time.

VXX and XIV are ETNs that allow investors to pretty easily go long or short volatility. VXX bets on a rising VIX, or perhaps I should more precisely say that it bets on rising prices for VIX futures, since that is what it actually invests in. And XIV is a short VIX ETN which tracks the overall stock market very closely. So as stock prices rise, the VIX typically falls, and thus XIV goes up.

What's more, XIV gets a further boost from the contango in VIX futures. It goes short at a (usually) higher-priced contract 3 months out, and then covers when that contract is in its final month before expiration. Usually that works out well for XIV investors who get to harvest that "contango".

Here is what the current term structure in VIX futures looks like:

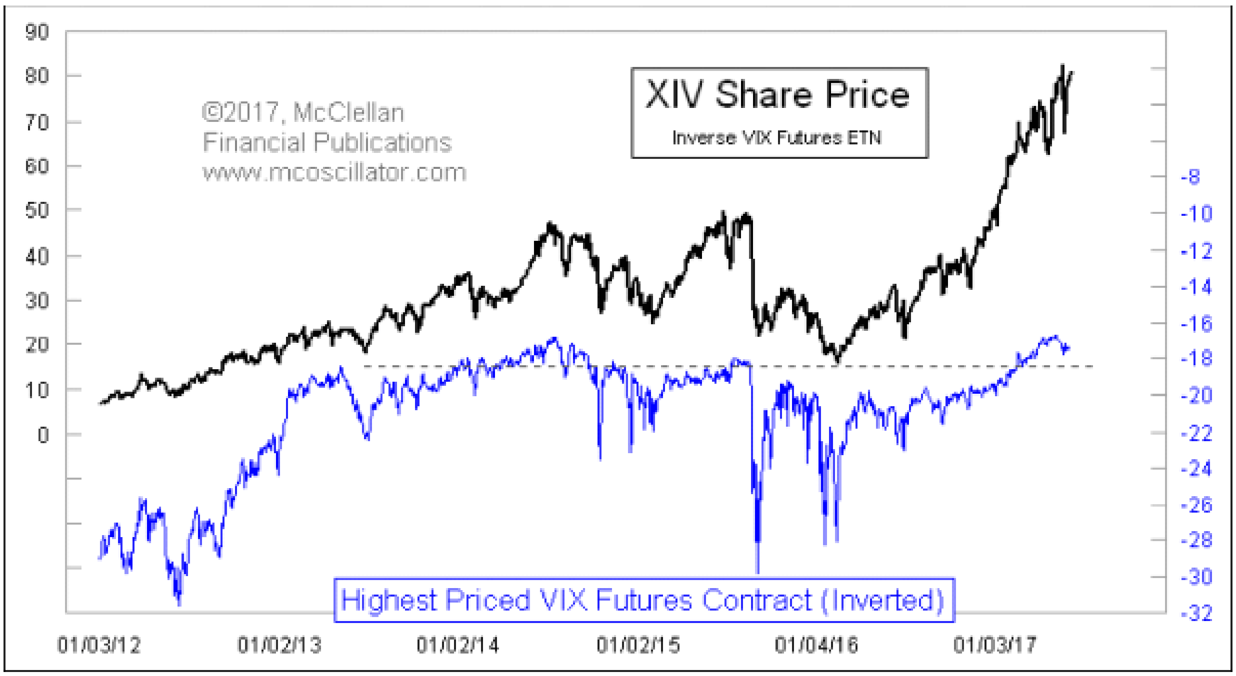


So as long as the spot VIX Index remains low, and VIX futures retain their nice, steep contango, it is a gold mine to own XIV and harvest that contango. That is what has led some analysts to proclaim that XIV is a great solution as a permanent part of one's portfolio.

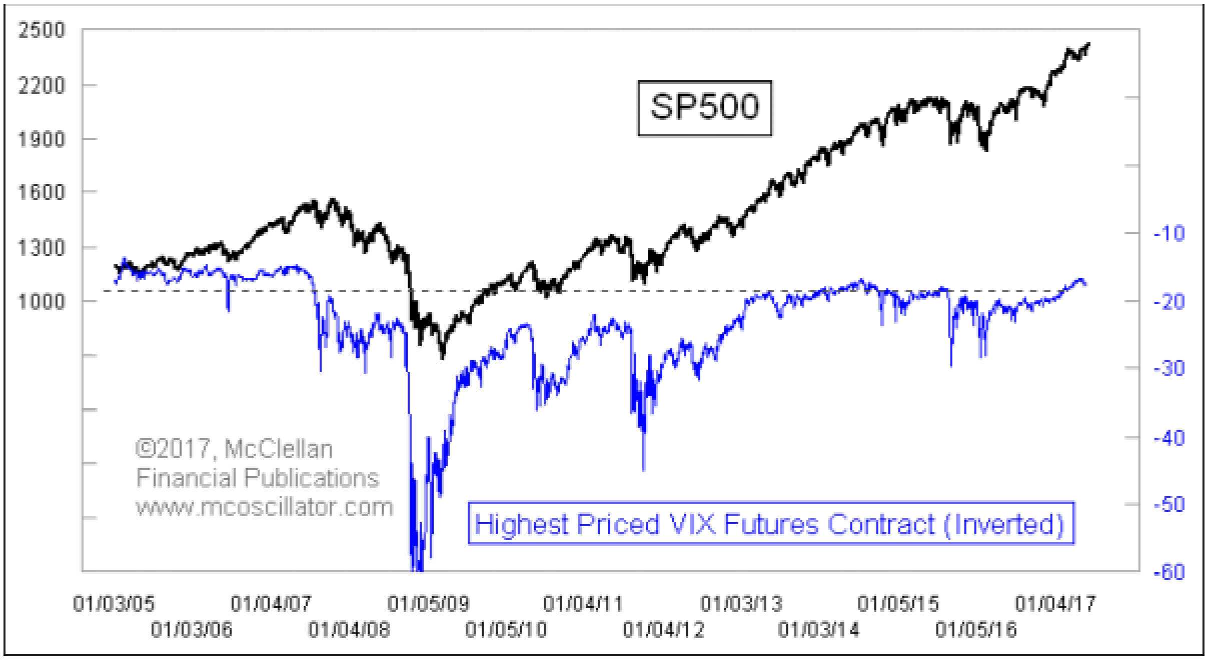
But there are times when XIV turns out not to be such a good investment, times when there is very little opportunity left to harvest.

This next chart (below) helps us to see when those times are, and the key is to look at the price level of the highest-priced VIX futures contract. When that falls to a low level, there is little opportunity left to harvest that contango, and there is also arguably too much optimism.

The price of the highest VIX futures contract is shown in the top chart on an inverted scale, the better to correlate with price action. When that price gets "below" 18 (high readings on the chart), that tends to mark a topping condition for XIV. In other words, there is little opportunity left.



Here is a longer term chart of that inverted scale price history of the highest VIX futures contract, versus the SP500:



Clearly the better opportunities to invest in the stock market, or to short volatility, come when the VIX futures are at really high prices (low chart readings), and when the highest VIX futures contract's price falls into the teens, there is not much opportunity left to be short volatility, at least not profitably.

This is not to say that the market has to go down, nor that volatility has to shoot up right now. All it says is that risk/reward is now no longer in favor of those who have enjoyed and profited from shorting volatility in the recent months. Someday, the market will present us with a better opportunity.

Tom McClellan

Editor, The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* follows on the ensuing page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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