Volatility: The Income Investor's Friend

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7600A Leesburg Pike
West Building, Suite 300
Falls Church, VA 22043-2004
U.S.A.

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Volatility: The Income Investor's Friend

By Jim Pearce (bio at end)
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Stock market volatility does not have to be your enemy. In fact, it can become your best friend if you know how to use it to your advantage. Even better, you do not need to be able to predict correctly which direction volatility will occur to make money from it. The mere fact that volatility exists is sufficient for you to pocket double-digit gains with remarkable ease.

You need look no further to do it than the standard measure of stock market volatility, the **CBOE Volatility Index** (VIX), or "fear index". With the exception of a brief spike at the beginning of August, the VIX has spent much of the past few months trading in the $12 - $13 range. That is normal and suggests that the institutional investors who use index options to protect their massive portfolios are not worried about a stock market correction anytime soon. However, the folks trading options on the VIX apparently do not feel the same way. As you might expect, the "implied volatility" on the VIX call options are huge. That is because they increase in value if stock market volatility goes up.

But there are some investors out there who are afraid that volatility will drop too much and are willing to pay you to protect them from that risk, too.

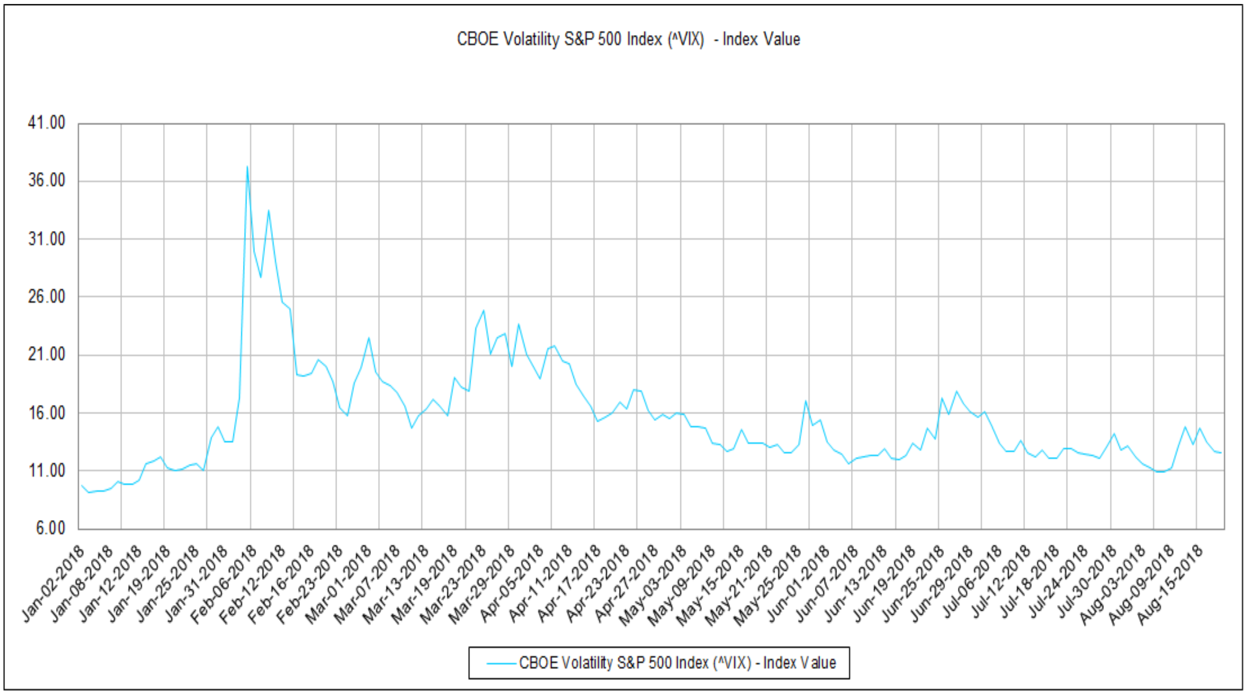
Put the Odds in Your Favor

For example, a few days ago, while the VIX was priced at $12.50, you could sell a put option with a strike price of $12 that expires on October 17 for 32 cents. That works out to a 2.7% option premium over a 59-day holding period, or 16.5% on an annualized basis. Of course, during that time, you are at risk of having that contract exercised against you if the VIX drops below $12. Over the past 100 trading days, the VIX has closed beneath $12 only seven times. Those are pretty good odds, considering five of those days occurred consecutively at the start of this month after a string of strong Q2 results temporarily calmed the nerves of jittery investors.

But all that good news is behind us now and, once we get past the Labor Day weekend, everyone will start focusing on the mid-term elections in November. No matter how good the Q3 results are that get reported in October, most investors will be more concerned with what could go wrong the following month.

If the VIX does trade below $12 between now and October, the worst case is you end up owning shares at a relatively modest price heading into what might quickly turn into an extremely volatile market. If that happens, then the price of the VIX could quickly escalate above $20, as it did in March, when the stock market hit the skids for a couple weeks.

You may recall in January that the VIX shot all the way up to $37 when inflation fears spooked the market (see chart below).



Hold on to Your Seats

That will not be the issue this time. Instead, investors may worry that President Trump's pro-growth agenda may get derailed if the Republican Party loses too many seats in the November's mid-term elections. That fear is why the call options on the VIX that expire in November have "implied volatility" of well over 100%. I won't go into the mathematical formula that determines implied volatility but, suffice to say, that a reading that high means a lot of people are worried that the market may take a dive this fall.

Even more surprising is the extent to which there are call options trading way "out-of-the-money," with strike prices far removed from the current value of the VIX. On the same day that the VIX was trading at $12.50, over 260 contracts (representing 26,000 shares) traded at a strike price of $55.

The last (and only) time the VIX traded above $55 was 10 years ago during the depths of the Great Recession when the S&P 500 Index lost half its value. I am not expecting anything like that this time, but I would not be surprised to see the VIX double in value at some point before this year is over.

If you are a gambler, buying a call option on this VIX may pay off handsomely if things get a little crazy. But if you prefer your returns to be slow and steady, selling a put option against the VIX may be the better way to go.

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About the Analyst

Jim Pearce
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Jim Pearce is the Chief Investment Strategist of *Personal Finance*, our flagship publication. He is also the Director of Research at Investing Daily, overseeing the work of our entire analyst team. He began his career as a stockbroker in 1983 and over the years has managed client investment portfolios for major banks, brokerage firms and investment advisors. Jim has a BA in Business Management from The College of William & Mary, and a CFP from the College for Financial Planning.