The VIX as a Guide to Your Investing

By: www.ProfitableInvestingTips.com

The VIX or so-called "fear index" is an indicator of near-term stock market volatility. Using the VIX as a guide to your investing can keep your portfolio out of trouble and result in profits. Since this indicator focuses on the options market 23 to 37 days hence, it is a better tool for guiding short and medium term investing more so than the long term. Never-the-less, long term investors commonly step into the market to pick up bargains during downturns which makes the VIX a useful tool in alerting these investors as to when a correction will be coming.

What Is the VIX?

The VIX or fear index is the CBOE Volatility Index. It was created by the Chicago Board Options Exchange and shows options market expectations in real time. It assesses near-term expiration (23-37 days out) options for the SPX index which in turn tracks the S&P 500. It indicates apprehension in the wider market and gives a heads up for coming market volatility, either up or down. The VIX doesn't say which way the market is going. It just indicates volatility in the coming days.

VIX Calculation

The VIX is arrived at daily by a complex calculation. It uses SPX put and call options that expire 23 to 37 days out and generates a volatility measurement for the next 30 days. Using options prices to determine volatility is one of two means of measuring volatility. The VIX looks at prices of calls and puts within the time frame measured and uses that information to tell us what the options market expects. The calculation is complex and has been updated from its original form. By checking a range of strike prices of the dates sampled it provides a real-time measure of expected volatility.

Volatility and Your Investments

The stock market corrects by 10% or more about every two years on the average. Stock market crashes of 20% or more happen every decade or more often, on the average as well. Meanwhile, the market and individual stock bounce up and down as market sentiment drives them. Market volatility may mean investment risk but also can lead to significant profits. Long-term investors watch stocks during volatile markets and compare market prices with projected prices based on intrinsic stock value. They pick up underpriced stocks that have been dragged down by market panic and enjoy the fruits of their investing for decades as these solid stocks continue to grow and produce solid cash flow. The bottom line is that you can use the VIX to spot volatility and then scout for bargains.

What is a Normal VIX?

First of all, market volatility comes and goes, so a "normal" VIX simply is any number that reflects current market expectations. An "average" VIX in an average market runs between 12 and 22. A VIX less than 12 is seen in a very quiet market and any VIX above 23 goes with increasing volatility. It is important to realize that the VIX is, to a degree, self-correcting. The market looks volatile. Options traders hedge their bets and the VIX goes up. Investors and traders adjust their tactics based on the expectation of increased volatility and thus volatility generally goes down. This is, in fact, "normal" VIX behavior.

Can You Buy the VIX?

The VIX is an index just like the S&P 500 whose call and put options it tracks to make its calculations. As such you cannot buy or trade the VIX directly. But, just like you can buy or trade the SPX which tracks the S&P 500, you can buy shares of ETFs and ETNs that track the VIX. But, while you could buy and hold shares of any of these ETFS or ETNs, you very likely do not want to, EVER! These instruments are useful for short term traders in stocks, futures, and options. Because the VIX goes up and down, so do these ETFs and ETNs. There are highly experienced traders who "buy" and "sell" volatility in terms of these instruments on a daily basis in search of short term profits. This is not the place for a long term, buy and hold investor to be.

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