Understanding the Basic Concepts of Implied Volatility, the VIX, is Critical in Having Consistent Success with Index Iron Condor and Credit Spread Options

Implied Volatility (IV) is a measure of how much the "market place" expects the price of an underlying stock or index to move; i.e. the volatility that the market itself is implying for the underlying stock or index. The VIX index represents the Implied Volatility for the S&P 500 index (SPX), therefore giving us a prediction of the potential size of future price swings for the SPX. Wall Street, in general, uses the VIX to represent the volatility of the stock market as a whole, and not just the SPX. One of the variables of pricing an option is IV. Thus, when IV for an underlying stock or index increases, the price of options on that stock or index increases. Conversely, when IV for an underlying stock or index drops the price of options on that stock or index decreases. For traders like us who write (sell) index credit spreads and iron condors, we like higher IV because we can collect more premium for the options that we write.

Implied Volatility (IV) is also called the fear index. When the market goes down the VIX goes up - i.e. investors are getting more fearful. On the contrary, when the market rallies, IV drops and fear subsides because investors start feeling more comfortable with the market. Therefore, there is an inverse relationship between the underlying index or stock and its IV. Figure 1 shown below demonstrates the inverse relationship of the Russell 2000 index (RUT) to the VIX. As you can see, when the RUT sells-off investors get more fearful and the VIX climbs; and when the RUT rallies, investors feel more comfortable with the market and the VIX subsides.
Sometimes the VIX moves in the same direction as the underlying index or stock. Figure 2 below shows that in May, June, and July of 2007 the VIX trended upward along with the market. This is a sign that the market could be topping-out and is ready for a pause or correction. The psychology behind this is that even though the market is trending upward and "looking" healthy, investors are getting worried that the market is getting over extended and/or the fundamentals behind the economy are slowly deteriorating. Therefore, when we see the situation where the VIX (fear) trends upward along with an upward trending market we need to be careful and watch the market closely for a possible correction.
Another observation that we can see in Figure 2 is that the VIX many times will increase just prior to an event such as the Federal Reserve Open Market Committee meeting where they make the decision to either raise interest rates, hold them steady or lower them. The VIX climbs because there is uncertainty on what the outcome will be. This is what happened in late June, as shown above, where the VIX spiked up to almost 19. However, as soon as the Fed announced their decision on interest rates and the uncertainty diminished, the VIX immediately deflated back down to 16. We sometimes want to time the writing of our credit spreads with events like this since the quick spike of the VIX will substantially increase the price of the credit spreads options that we are writing (selling).

To summarize, below are some general trading rules using the VIX when deciding to open 30 to 40 day index bull put credit spreads, bear call credit spreads or iron condor options: 1) If the VIX is holding steady and is not dropping from day to day when we are about 30 to 40 days out to expiration, we can usually take our time to open our spreads for that month and gradually "collect" premium over a two week period. 2) If the VIX is slowly dropping day to day when we are 30 to 40 days out to expiration, we then will have to move more quickly and open our trades before the premium of the credit spreads that we're selling "dries up". 3) Once we open our bottom bull put spreads, and if the VIX starts to creep up from the time we opened our trades, we need to closely monitor the VIX because it could be warning us that a "storm" is coming, where we might need to close our bull put spreads early and only focus on the top bear call spreads for that particular month.
About The Author
Brad Reinard is Editor-in-Chief of Monthly Cash Thru Options LLC, a leading index credit spread & iron condor options advisory newsletter, which has the following track record:  92% 2009; 33% 2008; 63% 2007; 42% 2006; 50% 2005. The MCTO advisory focuses on a non-directional, income generating options trading strategy using the DJX, SPX, SPY, OEX, RUT and QQQQ indexes and ETFs. For more information on the robust technical, fundamental & macroeconomic analysis that the MCTO team performs weekly to help guide our credit spread and iron condor trades, please visit www.monthlycashthruoptions.com or call Brad directly toll-free at 877-248-7455. Brad has a B.S. in Electrical Engineering from Columbia University and an MBA from the University of Chicago Booth School of Business. He resides in the San Francisco bay area with his wife and 3 children.

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