CHAPTER 13: SPECULATING IN VIX FUTURES ISN'T FOR EVERYBODY

In a *Trader's First Book on Commodities*, the focus was to teach readers all they needed to know about the commodity markets before considering market strategy. I went into detail about each of the popular commodity markets and guided traders on how to calculate profit, loss, and risk, in each commodity market. However, a market that regrettably wasn't discussed but has quickly become a popular topic in the trading community is the Chicago Board of Options Exchange (CBOE) listed volatility index, more commonly known as the VIX. Because of its exclusion from other books I've written, and the fact that I receive countless inquiries from my brokerage clients about trading it, I feel compelled to outline some of the advantages and disadvantages of trading the VIX. In addition, it is a unique product that isn't offered at all futures brokerage firms. Thus, anybody interested in speculating in the VIX will want to keep this in mind when shopping around for a commodity broker.

> "It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong." — George Soros

The CBOE describes the VIX as a "key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices." Because the VIX value is derived from the implied volatility (the portion of an option price attributed to expectations of future volatility) in S&P options, it is commonly referred to as the *fear index*. The VIX was introduced by the CBOE in the early 1990s and is often considered to be the benchmark barometer of investor sentiment and market volatility. Because the VIX is so widely watched and mentioned, it is only natural for futures traders to get involved. What started out as an informational index at the CBOE eventually became a highly popular, yet unique, leveraged futures trading instrument.

In essence, VIX futures give speculators an opportunity to directly trade human emotions, specifically fear and complacency. Those interested in attempting to profit from changes in investor sentiment will likely find the VIX a convenient trading vehicle. Yet it is also requires a brassy attitude.

Nonetheless, there are some aspects of the VIX futures market that traders should be aware of before risking their trading capital. Trust me when I say, along with being among the most lucrative futures contracts available to trade, it is also the most unforgiving. There are unique attributes of VIX futures that should be known and largely work against speculators, but there are times in which the VIX offers relatively predicable opportunities for those with strong stomachs for risk. Let's take a closer look.

THE VIX IS NOT AN INVESTMENT VEHICLE, IT IS A TRADING VEHICLE

Unlike traditional stock and bond investments, the VIX doesn't pay dividends or interest, nor does it provide ownership of an underlying asset that holds value. Instead, the value of the VIX is purely derived by human opinion, emotion, and perception. Playing the VIX is highly speculative, even more so than any other commodity because the underlying is not an asset, it is an opinion. In contrast, commodity futures contracts are similarly leveraged and without income-producing elements, but their redeeming quality is being backed by tangible goods.

Nonetheless, despite the lack of a concrete asset, there are times in which the odds of success in trading VIX are eye catching, making it an (occasionally) attractive arena.

THE VIX TRADES INVERSELY TO THE S&P

Although the word *volatility* generally refers to extreme price movement in any direction, in reference to the VIX and its value, volatility is highly directional. The VIX goes up when stocks drop but it goes down when stocks rise. This is the case even if the stock market is soaring higher at an unusually quick pace. For this reason, traders and investors should look at bullish speculations in the VIX, as being a bearish stance in the equity market, and vice versa. They should not assume that a highly volatile bullish breakout in the S&P will increase the value of the VIX.

THE VIX, AND MORE SO VIX FUTURES, ERODE WITH TIME

Newbie traders to VIX futures have been known to opt for going long the VIX as a substitute for purchasing a put option on the e-mini S&P 500. On paper, it appears to be sound logic; unlike a long put option, which exposes traders to the obstacle of time value decay, a futures contract shouldn't see time value erosion. Yet, in the case of the VIX it does—and it can cause substantial losses to a trading account. Like long options, the VIX often wears away in value every day that lacks conviction selling in the S&P. If you've ever bought an option, only to watch the value of it dwindle to nothing while you were waiting for the market to move, you've experienced what I'm referring to.

In other words, a trader looking for the equity markets to sell off in the near future might consider buying the VIX as a hedge against their stock portfolio or as a speculative play. However, if we see a week or two of sideways action, the VIX will likely have lost value because traders then adjust their expectations of future volatility to lower levels.

In such an instance, the trader wasn't necessarily wrong about the direction of the S&P; they simply weren't immediately right. In the VIX, that is enough to lose money. VIX bulls typically have less capacity for miscue than bulls in other markets might, due to the erosion factor, shown in Figure 51.

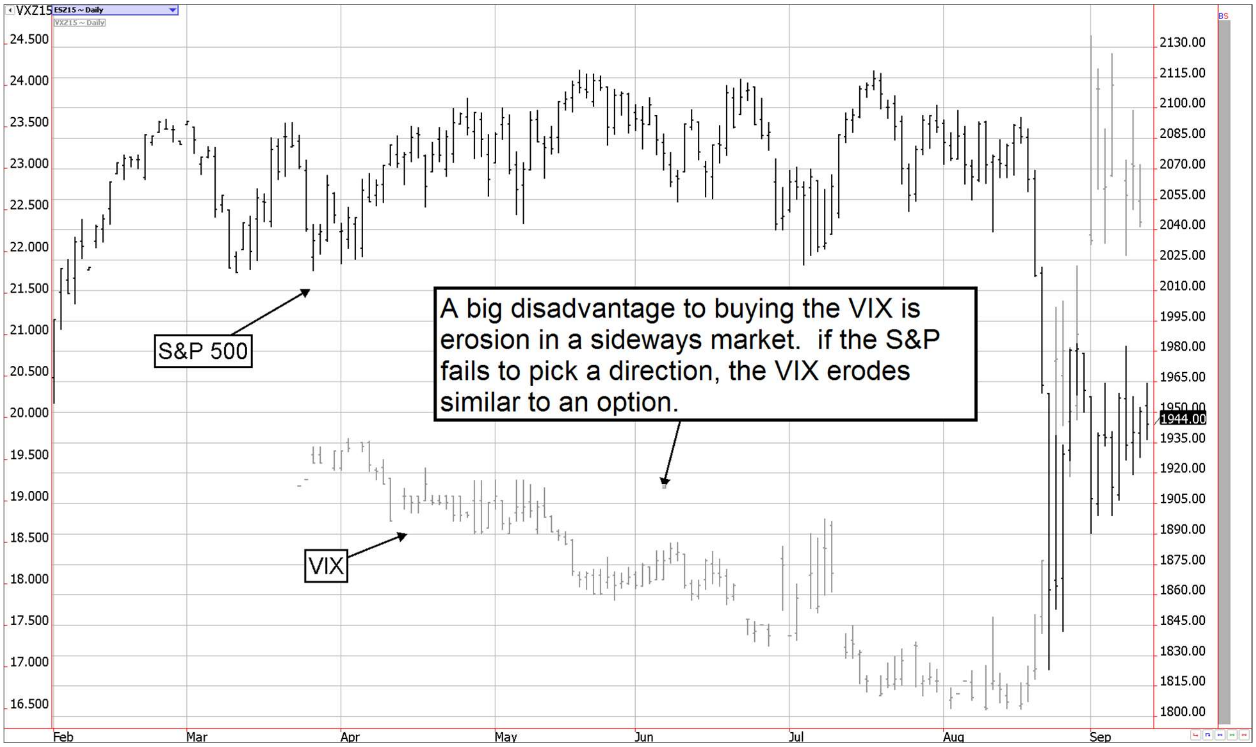

Figure 51: The VIX futures contract erodes over time if the S&P 500 doesn't decline because, like options, the market generally builds expectations of future volatility into its price.

THE VIX ISN'T A COMMODITY, BUT IT HAS A "CONTANGO"

Contango is a term used frequently but understood rarely. The term is exclusive to the commodity industry and is used to describe the relationship between the cash market of a commodity and the futures market. It is also commonly used to identify a scenario in which the value of futures contracts expiring in the near future are discounted relative to contracts with distant expiration dates. In essence, contango is an environment in which people are willing to pay more for a commodity at some point in the remote future than the actual expected price of the commodity in the proximate future. To clarify, a corn futures contract expiring in March 2016 might be trading near $3.70, but the futures contract representing delivery of the same underlying asset in September 2016 would reasonably be valued at $3.85. In agricultural products such as corn, the price discrepancy is related to the cost to carry such as storage and insurance. However, in the VIX futures, the contango is due to the uncertainty of human emotions and expectations. As time goes on, uncertainty dissipates.

In most cases, the CBOE's published VIX value (cash market) for purposes of market analysis is listed at a discount to the front month futures price, which is a tradable asset (and I use that term loosely). Similarly, the next expiring futures month is typically higher than the front month. Because the VIX trades at a contango, if all else remains equal a trader long the VIX will lose money as time goes on because the futures price and the cash market price will converge.