

Understanding Volatility

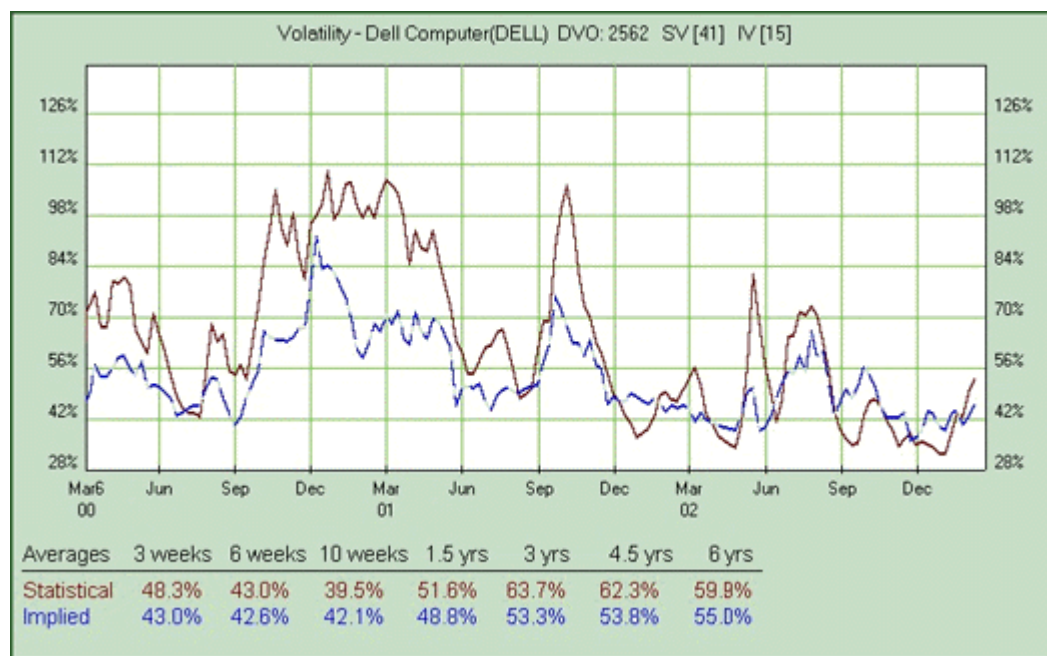
...is of Vital Importance to Option Traders

Len Yates

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Volatility is often the most neglected of the major factors that influence option prices. But we make sure never to make that mistake when we consider possible trade recommendations. Every asset has quiet periods when its options are cheap, and volatile periods when its options are expensive, so understanding volatility is a vitally important consideration in options trading.

Professional option traders are always aware of current volatility levels in relation to their historical context. To gain that perspective, they view historical volatility charts. The figure below shows a sample Volatility Chart from the MarketVue Tools for Dell Computer:



The Volatility Chart displays two lines - one for statistical volatility (SV) and the other for implied volatility (IV). The solid SV line represents, at each point the actual volatility of the stock's daily price volatility. Statistical volatility is often referred to as "historical" volatility, but we prefer the term statistical since volatility charts contain historical data for both SV and IV. The dashed IV line represents, at each point, the average implied volatility for the stock.

In other words, the SV line shows you the actual volatility of the stock, while the IV line shows you the volatility implied by the prices of the options of that stock. They should normally be fairly close together. If they are not, it would indicate the price of the options is not reflecting the actual volatility of the stock. At the bottom of the chart is a table that summarizes the average SV and IV for various time periods.

Volatility Charts are also useful for determining what "normal" volatility is. This can help you profit when current volatility temporarily goes much higher or lower than in the past. It can also be useful for spotting patterns in volatility you can take advantage of.

The price of a stock can range from zero to infinity. Volatility cannot range that far. The investor can always count on volatility eventually returning to normal levels after going to an extreme. This principle is called "the mean reversion tendency of volatility". It may take anywhere from days to months, but sooner or later volatility always comes back to middle ground.

Generally, implied volatility tends to increase as stock prices decline, and decreases as the stock prices rise. The reason this occurs is because falling stock prices mean greater uncertainty with regards to future risk. This leads to an institutional demand for insurance against future losses, meaning a higher demand for put options. This demand for puts drives implied volatility upward. On the other hand, increasing stock prices mean less uncertainty and subsequently less demand for put options resulting in lower implied volatility.

This knowledge is very useful for option buyers. For instance, while the value of a call will increase with the stock price, the relationship between price and volatility means the call will lose some (sometimes a lot!) of its value due to the falling volatility. It is good news for put buyers, however, because puts will increase in value from the double effect of falling prices and increasing volatility.

At times, implied volatility and statistical volatility will be in close agreement, while at other times one soars way above the other. You should always be aware of current news on the stocks you are trading.

Sometimes events can overwhelm historical volatility patterns. Be careful of situations where implied volatility is high and statistical volatility is extremely low. Find out if there is a takeover deal on the table. These deals often freeze the target company's stock in a narrow trading range for a while. Meanwhile, the options may maintain high premiums because of the possibility of a sudden change in the deal.

In general, unusual events can be treacherous for options traders - so be careful!