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The VIX and How To Use IT

For all the quantitative models and computing power and economic fundamentals and things logical applied to stocks and the stock market, it never helps to ignore the simple part that raw investor emotions play in the decision-making process that leads to the concluding real-time action of buy this and sell that right this second.

Services measure those emotions in various ways. There's the well-known put/call ratio; when investors expect stocks to drop, they buy more puts than calls; when they expect stocks to go up, they buy more calls than puts. There's the percentage of newsletter editors who are bullish or bearish; Investor's Intelligence tracks this. There's the percentage of individual investors who are bullish or bearish; AAII measures this. Another way of measuring investor expectations is the reading of the VIX. It is to the VIX that I want to look at more closely.

The main thing to keep in mind when considering investor emotions is that they should be used as a contrary indicator; we generally want to act opposite to how the crowd is behaving. If everyone is bullish, then everyone has bought. Who is left to push the market higher, to buy tomorrow at a greater price? Conversely, if everyone is bearish, then presumably everyone has sold. Who is left to sell next at the lower prices? So, if everyone is bullish, we want to behave in the opposite direction. If everyone is bearish, we want to behave in the opposite direction.

The VIX

What is the VIX? It stands for volatility index. It is a measure of investor expectations of the future value of volatility in the stock market. In short, many call it the "fear gauge". When the market expects low volatility, the VIX typically reads below 20. When the market expects high volatility, the VIX typically moves above 30. You may see on the long-term chart below, however that its range has been between 10 and 90 over the last 10 years.

A higher reading normally means not only that investors believe the market is heading lower, but also that investors think the market may rebound sharply. It is not simply a measure that investors think the market will continue to plunge, but rather that its volatility will continue to stay high.

Likewise with a low reading, it simply means that investors expect stability in the months ahead, whether that is a steady decline or a steady increase.

Having said that it measures expectations both up and down, I would reiterate that most investors hear and think about the VIX as a “fear gauge”. Typically the higher the VIX, the more fear there is in the market. The lower the VIX, the more complacency there is in the market. This too makes sense. When investors do not fear a loss of money, the VIX drops, but the market will fluctuate and sometimes it fluctuates wildly. It is when investors forget that and are complacent as measured by the VIX that it is time to consider vacating the premises.

More Information

Here are a few links with more information about the VIX.

http://en.wikipedia.org/wiki/VIX
http://www.investopedia.com/terms/v/vix.asp
http://cboe.com/search/default.aspx

VIX Uses

As a precise timing tool of when the tree in the forest will fall or rise, the VIX doesn’t help. But as an overall view of the forest, it does a great job. In other words, it doesn’t pinpoint the exact top or bottom, but does give an overall view of investor fear and complacency. In turn, that helps to gauge market risk.

The lower the VIX the more confidence there is. In turn, this can lead to complacency, which is the expectation that everything will continue without interruption in the direction it was going.

The higher the VIX the more fear there is. The fear is that the market is going to zero and I have to get out now.

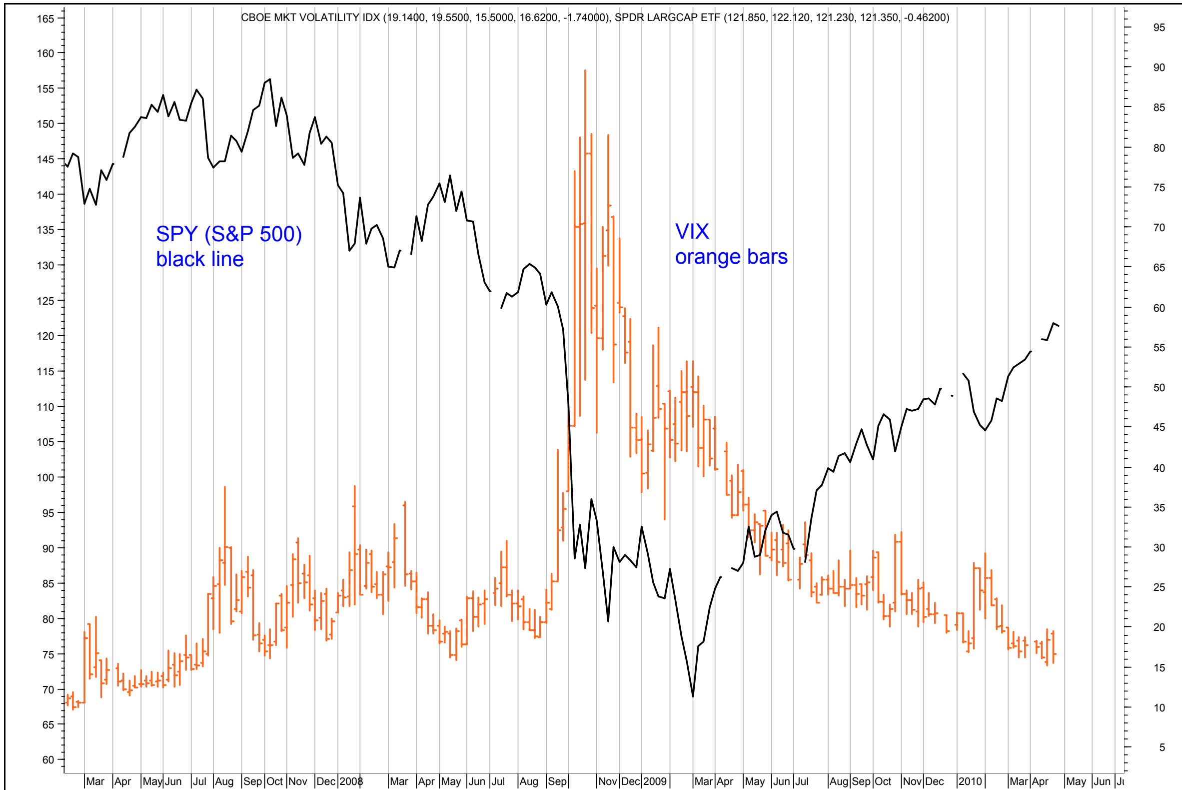
These extremes may be seen on the following charts.

Charts

These charts show the weekly prices for the S&P 500 (SPY) and the VIX over various time periods.

This first chart shows the VIX and S&P 500 from 01/2000 through 04/2010
The VIX has ranged between 10 and 90 (right scale).

From the previous bull market peak in 10/2007 to its final low in 03/2009, the chart below shows how the VIX moved from one extreme (all is well in the world) to another (all is over for the world), from everything is fine to nothing is fine.



This last chart shows the VIX and S&P 500 from the bear market bottom in 03/2009 through the bull market 04/2010. During that period, the VIX has moved inversely to the S&P 500. It has changed from fear to complacency as fundamentals improved.