Guides

VIX Series – Part 3: Chicago Board of Options Exchange (CBOE) Builds The VIX

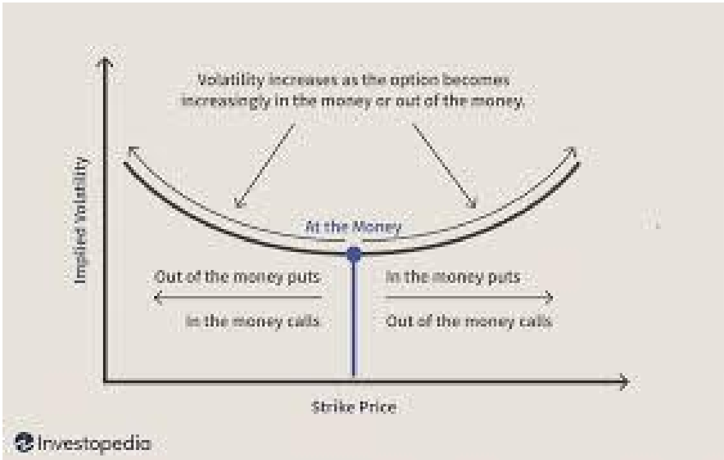
August 25, 2020

FSInsight Team

For most of human history, if you were a victim of the regular fits and starts that affect commerce on Earth, you were pretty much out of luck. Of course, there were old versions of state bailouts every once and a while, but generally, the risk was not a very easy thing to manage. One lousy season or one bad storm could often ruin the farm or the business. This problem eventually led to the establishment of futures markets for agricultural commodities. The Chicago Futures Exchange (CFE) would pioneer many of the strategies that have become common in futures markets. These innovative instruments, which gave people an unprecedented ability to hedge risk, would forever change how business was done, and the risk was managed. Chicago, which was geographically positioned in the middle of America's heartland, would become one of the world's most critical commodities exchanges and innovation-centers for finance. The CBOE volatility index changed how volatility can be used and prepared for by investors. We're not teaching you to how to trade the VIX, as this is very complicated and requires more than a few years of experience in derivatives valuation. We do, however, want to make you appreciate this complicated financial instrument that many investors perceive incorrectly.

The Greek letter used for Implied Volatility in the Black-Scholes Options Pricing Formula is Sigma. Therefore, the first iteration

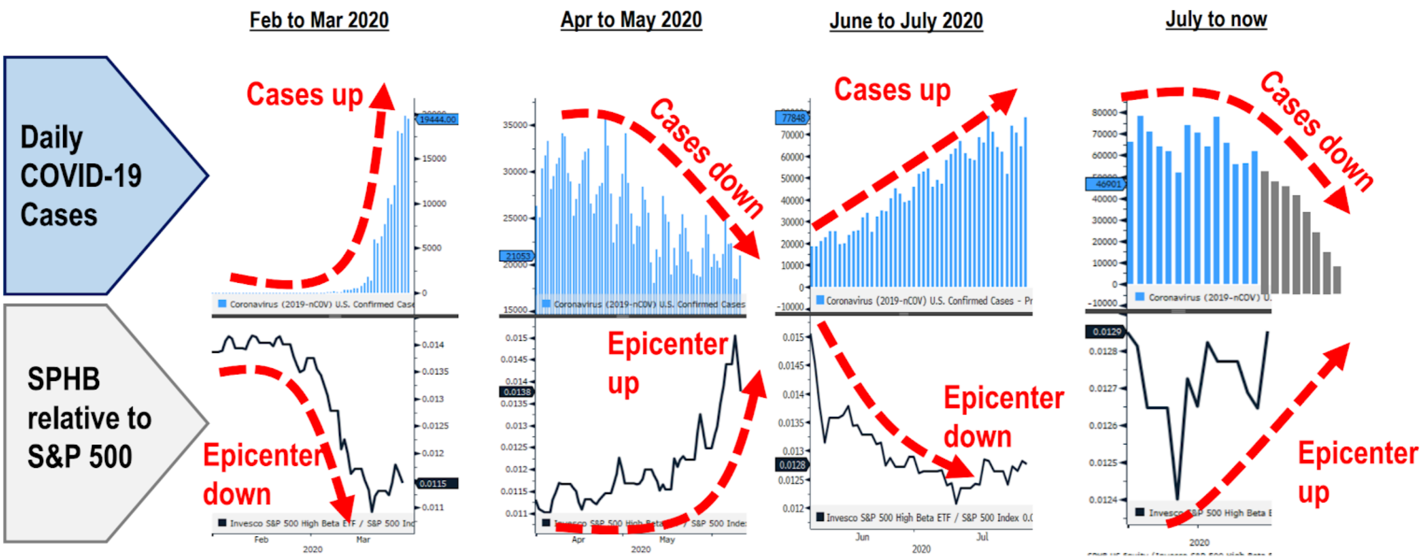
of what would become the VIX be called the Sigma Index in an early paper published by Brenner and Galai in 1989. By 1993, the first version of the index, based on the S&P 100 (OEX) index, was formulated. This 'old VIX' is now under the ticker VXO. It was met with extreme demand from retail and institutional investors. The VIX is the CBOE's most popular product ever in a long list of popular and widely used financial instruments. Technically, the VIX is the volatility of a variance swap, not an actual volatility swap. This is for reasons of calculation because a variance swap can be more easily replicated through vanilla put options and call options. History was made when volatility could first be 'bought' and 'sold' as an asset. How to trade the VIX successfully is not easy though.



By 2003, the methodology had changed, with the help of Goldman Sachs, and the VIX index option prices were now being calculated on the broader S&P 500. The actual number of the VIX should not be construed as a percentage, as that is inaccurate. However, the way the VIX is designed is to have its number interpreted as an implied volatility reading. Since the VIX is calculated from the price of SPX options, which is the best proxy for the broader American stock market, it is considered a macro-indicator. However, volatility indexes can be set up for any stocks; in fact, CBOE does them for many large caps. It uses a variant of the VIX calculation to create a similar index from each name's options market. Other VIX calculations result in other indexes. VIX calculations are done in real-time. However, if you're going to trade the VIX and intend to exercise, be sure to read up on the settlement rules. Many a trader who has thought they had a pretty sweet in-the-money position until they realized that the VIX is settled for exercise in an entirely different way than it is calculated in real-time. VIX options usually expire on Wednesdays as opposed to Friday, even though the underlying SPX options all still expire on Friday.

How To Trade The VIX

This important index regularly fluctuates based on threats to market stability. Unlike single stock names, the price action in the VIX is very much a comprehensive picture of how markets feel. Trading this asset can be incredibly difficult since it can become very headline dependent. However, the thrust of our research is data so when top-down investing environments dependent on headlines develop we get right into the relevant data and give you useful insights for ***how to trade the VIX***.



As you can see, we have been monitoring different groups of stocks compared to daily cases and have been trying to keep our community one step ahead of the crowd. ***How to trade the VIX***, you ask us? Always maintain an edge in the data and ahead of the competition and you will; be off to a good start. Whether you're a new investor or a sophisticated trader we believe you will find our analysis useful. Also, check out our industry-leading technical analysis by Rob Sluymer.

Quick Navigation on this series

VIX Series – Part 1: What Is The VIX And How Does It Work?

VIX Series – Part 2: What Is Volatility?

VIX Series – Part 3: Chicago Board of Options Exchange (CBOE) Builds The VIX

VIX Series – Part 4: How To Read The Fear Gauge: VIX Value and How It's Calculated

VIX Series – Part 5: How To Trade (And Read) The CBOE Volatility Index (VIX)

< Previous

Next >

FSInsight Team

Disclosures (show)

This research is for the clients of FSInsight only. FSI Subscription entitles the subscriber to 1 user, research cannot be shared or redistributed. For additional information, please contact your sales representative or FSInsight at fsinsight.com.

Conflicts of Interest

This research contains the views, opinions and recommendations of FSInsight. At the time of publication of this report, FSInsight does not know of, or have reason to know of any material conflicts of interest.

General Disclosures

FSInsight is an independent research company and is not a registered investment advisor and is not acting as a broker dealer under any federal or state securities laws.

FSInsight is a member of IRC Securities' Research Prime Services Platform. IRC Securities is a FINRA registered broker-dealer that is focused on supporting the independent research industry. Certain personnel of FSInsight (i.e. Research Analysts) are registered representatives of IRC Securities, a FINRA member firm registered as a broker-dealer with the Securities and Exchange Commission and certain state securities regulators. As registered representatives and independent contractors of IRC Securities, such personnel may receive commissions paid to or shared with IRC Securities for transactions placed by FSInsight clients directly with IRC Securities or with securities firms that may share commissions with IRC Securities in accordance with applicable SEC and FINRA requirements. IRC Securities does not distribute the research of FSInsight, which is available to select institutional clients that have engaged FSInsight.

As registered representatives of IRC Securities our analysts must follow IRC Securities' Written Supervisory Procedures. Notable compliance policies include (1) prohibition of insider trading or the facilitation thereof, (2) maintaining client confidentiality, (3) archival of electronic communications, and (4) appropriate use of electronic communications, amongst other compliance related policies.

FSInsight does not have the same conflicts that traditional sell-side research organizations have because FSInsight (1) does not conduct any investment banking activities, (2) does not manage any investment funds, and (3) our clients are only institutional investors.

This research is for the clients of FSInsight only. Additional information is available upon request. Information has been obtained from sources believed to be reliable, but FSInsight does not warrant its completeness or accuracy except with respect to any disclosures relative to FSInsight and the analyst's involvement (if any) with any of the subject companies of the research. All pricing is as of the market close for the securities discussed, unless otherwise stated. Opinions and estimates constitute our judgment as of the date of this material and are subject to change without notice. Past performance is not indicative of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The opinions and recommendations herein do not take into account individual client circumstances, risk tolerance, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies. The recipient of this report must make its own independent decision regarding any securities or financial instruments mentioned herein. Except in circumstances where FSInsight expressly agrees otherwise in writing, FSInsight is not acting as a municipal advisor and the opinions or views contained herein are not intended to be, and do not constitute, advice, including within the meaning of Section 15B of the Securities Exchange Act of 1934. All research reports are disseminated and available to all clients simultaneously through electronic publication to our internal client website, fsinsight.com. Not all research content is redistributed to our clients or made available to third-party aggregators or the media. Please contact your sales representative if you would like to receive any of our research publications.