Not All Volatility Indices Make Sense

What To Do With A Different Skew

One of the great questions of our age is why people will trade volatility when they simply can trade price. If you tell me the VIX will rise when the U.S. stock market falls, I will nod in assent. If you tell me the VIX will fall when the U.S. stock market rises, I will cheer a thousand huzzahs. But if you tell me you want to go long the VIX because you expect the market to fall, I will stare blankly in your general direction and mutter something like, 'Why not simply short the market?"

Yes, I know the answer: Because you are an expert on forward-start volatility swaps whose future level is unaffected by today's events.

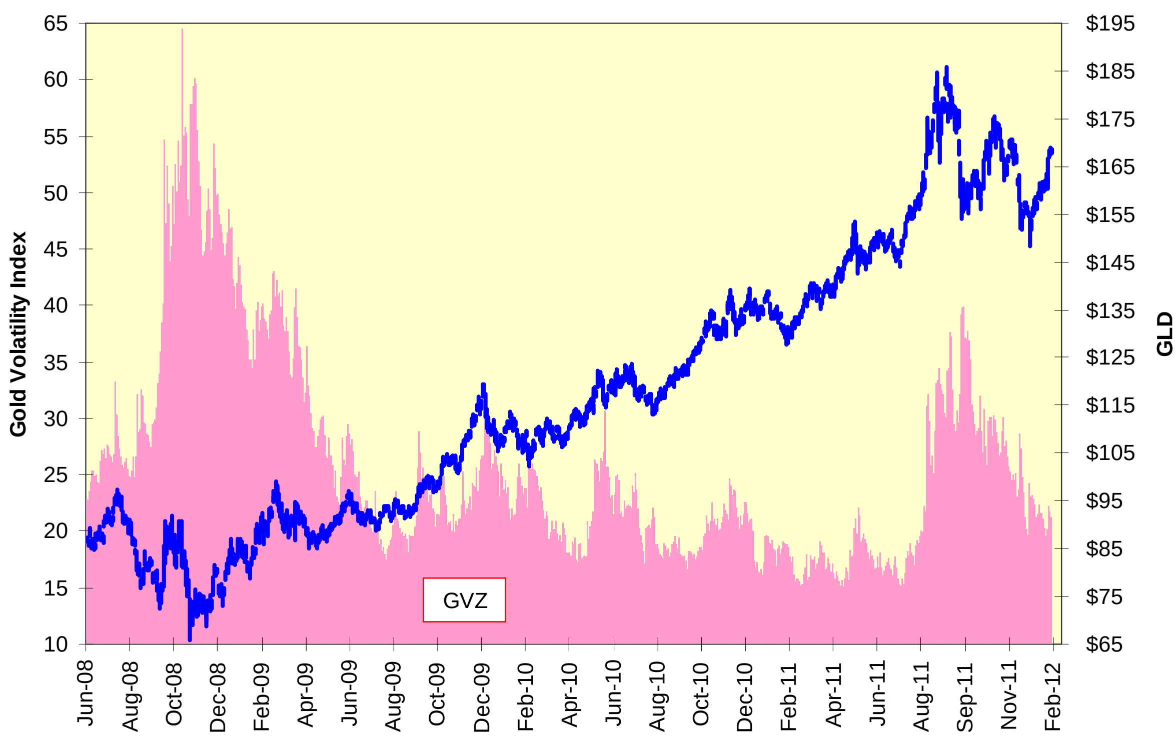
Marketing Matters

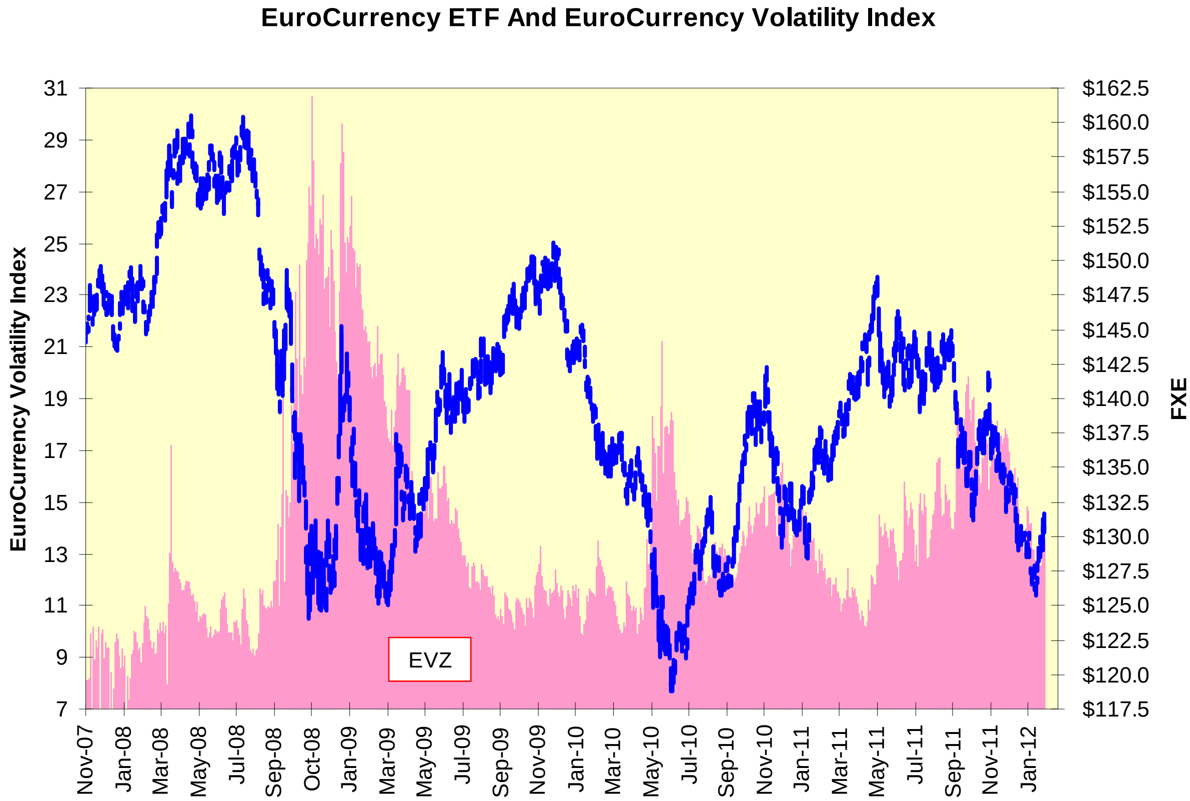
Regardless of my opinion, there is no question VIX futures and options have been a commercial success. And like Hollywood, the financial services industry understands the principle of product line extensions and sequels. However, just slapping the VIX methodology on another market will not work if the underlying asset lacks the simple, mechanical and very understandable market-down / VIX-up or vice-versa relationship noted above.

Let's take two examples, one for gold and one for the euro (GVZ and EVZ, respectively); these are linked to the GLD and FXE ETFs, respectively. As both of these ETFs are successful and as most investors have an opinion bordering on the obsessive for at lease one of these two markets, you might think they would have duplicated the VIX' successes, but this has not been the case.

Let's provide a simple explanation. Take a look at the two charts below and tell me if there is a regular relationship between the GVZ and the GLD or between the EVZ and the FXE.

Gold ETF And Gold Volatility Index





The answer, without narrating the history, is no regular relationship exists. The reason is neither gold nor the euro have either what is called an investor skew or a demand skew. An investor skew is present in stocks; here there are few natural shorts seeking protection from higher prices and many natural longs seeking protection from lower prices. Demand skews exist in commodities such as soybeans where a small number of buyers is naturally short and the large number of sellers is not involved in price-hedging transactions (that is what government price supports are for).

Gold lacks either skew as its buyers regard higher prices as a blessing from Above. Lower prices are seen as a buying opportunity (I exaggerate, but not by much). The euro, as I noted in May 2011's [Why You Should Never Over-Interpret Alternating Face-Plants of Dollar and Euro], has a bimodal distribution of returns and therefore a meaningless (and near-zero) skew.

The net result here is simple: If you want to trade price, trade price. If you want to trade volatility, trade price.