

VOLATILITY INDEX



vEcoSys

Understanding Volatility Index

– By Prof. *Simply Simple*™



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Some people enjoy dancing in the rain but some really hate getting drenched. Some people enjoy the stock market volatility but some get killed by the same volatility. Different people view the same thing differently.

But all of them seek one thing above all else: Clarity.

In this lesson, I will try to provide clarity on the 'India Volatility Index' or 'India Vix' in short.



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- ❑ **First of all, Volatility denotes the extent to which the value of our investment may be subject to the mood of the market over a given period of time.**
- ❑ **In other words, volatility refers to the amount of uncertainty or risk about the size of changes in a security's value.**
- ❑ **Commonly, it is observed that the higher the volatility, the riskier the security.**



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So what is Volatility Index?

- ❑ A volatility index tells us about the market expectations over the short term, usually a month.
- ❑ It tries to capture the sentiments of the market—whether the market is in a complacent or anxious mood.
- ❑ Volatility is what makes our short-term investments look more dangerous than our long-term investments.



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Some investors feel that surviving short-term market volatility is more challenging than surviving in the long run.



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Now...

- ❑ Volatile markets can turn upside down in very quick time.
- ❑ In fact, John Maynard Keynes himself once said that markets can remain irrational longer than you can remain solvent.
- ❑ So every now and then, we may see investors getting caught on the wrong side of market irrationality.
- ❑ A volatility index captures implied volatility in the market.



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Okay, so how does it work?

- ❑ Implied volatility draws its conclusions from the present pricing of options and not from historic volatility figures.
- ❑ It is expressed in terms of a percentage like 20%, 30%, etc. In a range-bound market, where prices are moving gradually, the volatility index remains low.
- ❑ It is believed that when the volatility index is less than 20%, the market is in a complacent mood and is not expecting any catastrophe.



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Now...

- ❑ A low volatility index is therefore, associated with price rise.
- ❑ But when the volatility index is greater than 30%, then the market is in the fear zone.
- ❑ A high volatility index is associated with a fall in market prices.
- ❑ In this manner, a volatility index helps investors gauge the mood of the market.



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So what is the India Volatility Index?

- ❑ **India Vix is the first volatility index launched in India by the National Stock Exchange.**
- ❑ **For your additional information, the Chicago Board of Options Exchange (Cboe) introduced the first volatility index for the US markets in 1993.**
- ❑ **Cboe Vix uses the Standard and Poor's 500 Index Options for calculating implied volatility, which is reflected by the changes in pricing of options.**
- ❑ **India Vix is based on the Nifty 50 Index Option prices.**



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Okay, so how does it work?

- ❑ It calculates the percentage of volatility by using a detailed computational methodology which relies on the best bid and offer price of the Nifty 50 index call and put options.
- ❑ Other than gauging the mood of the stock market, a volatility index can also be used to design derivative products in which the volatility index is used as an underlying asset.
- ❑ Investors who are averse to volatility can hedge their portfolio by purchasing derivative products based on the volatility index.



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- ❑ And investors with a good appetite for volatility can take the risk by selling the same derivatives product.
- ❑ All in all, a volatility index provides a new game of hedging and trading for market participants.
- ❑ *But how is hedging through volatility index derivatives different from hedging through single stock or index derivatives?*
- ❑ Well, hedging through single stock or index derivatives is like purchasing a comprehensive insurance which covers many risks that you may not be even aware of.
- ❑ But a derivative product based on volatility index keeps its focus narrow—it provides a hedge against only market volatility.



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Finally...

- ❑ So if the prices of your company's shares are likely to fall due to poor quarterly results, then purchasing volatility index derivatives may not protect you.
- ❑ The market may remain calm even though your own individual portfolio may be performing badly.
- ❑ But if the prices of your stocks are likely to fall due to poor market sentiments and not due to any company-specific reason, then a volatility index derivative may be your right bet.



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To Sum Up

- ❑ **What:** Volatility index measures implied volatility in the market over the short term, usually a month. India Vix is the first volatility index launched by the National Stock Exchange.
- ❑ **How:** India Vix calculates volatility by computational methodology, which relies on the best bid and offer price of the Nifty 50 index call and put options.
- ❑ **What:** Volatility index can also be used for designing derivative products in which the volatility index is used as an underlying asset.



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Hope you have now understood
the concept of Volatility Index

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