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Portfolio Insights

The VIX: What is it and How is it used?

If you pick up the Wall Street Journal or happen to flip on CNBC, chances are you have at one point come across an economic indicator called the VIX. Some may know it as the 'Fear Index' or 'Fear Gauge.' The Volatility Index (VIX) is a measure of the *implied* volatility of the S&P 500 in the short term. The VIX was created by the Chicago Board Options Exchange in 1993 as a tool to track volatility. This measurement was initially implemented primarily to help traders determine option prices. It is important to note that this is different from realized volatility, which is a measure using *historical* prices.

This VIX is referred to as the 'Fear Index' or 'Fear Gauge' because a high VIX suggests investors are beginning to feel more uncertain or fearful about the future (more volatility on the way). More volatility means more movement in stock prices. This causes options to be more valuable (higher chance of being exercised). When an option is deemed to be more valuable, option premiums go up. Since the VIX uses these premiums in the calculations, the VIX will increase.

A general relationship exists between the S&P 500 and the VIX, which can be seen below. Stock markets do not like uncertainty, preferring certainty. Thus you see the S&P 500 showing signs of an inverse correlation with the VIX

Source: Bloomberg

Typically a major political or geographic event will cause a spike in the VIX. Deteriorating markets can also cause the VIX to rise. Conversely, the VIX stays low during periods of calm in the market. However, global events are not the only factor for surges in the VIX.

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Michael Williams is a Financial Analyst Clearwater Capital Partners LLC, assisting in portfolio management and analysis, trading and using analytics to provide critical insight to clients. In addition, he is also involved in estate structuring and charitable gift giving.

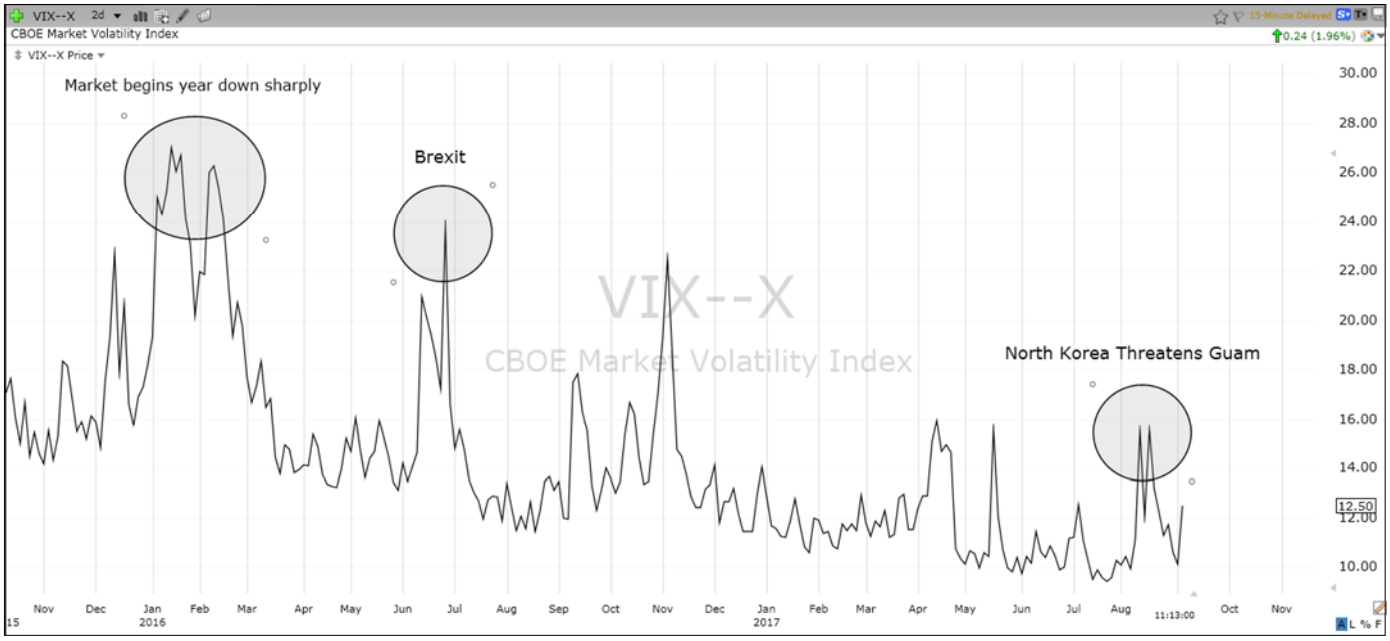
New Location

The move to our new location is now complete. Please note our office address is now:

2800 W Higgins Road, Suite 1025
Hoffman Estates, IL 60169

Our phone number remains:
(847) 841-8650

Take a look at the graph below; notice a spike during BREXIT, the correction in early 2016 and the most recent news from Korea threatening Guam. These are all events that cause uncertainty in the markers and in each case the VIX has either surged or maintained a high level. In two of the three circumstances a surge in the VIX only caused short term price movements and the threats were dealt with. But in the case of the surge seen in the first part of 2016, this corresponded with a downturn in the markets. On the flip side, if you look at the VIX in the past few months, you can see that it has been steadily low and this has corresponded to markets hitting and maintaining all-time highs.



Source: Free Stock Charts

The VIX is widely used and tracked by many investment professionals, but it should not be relied upon too heavily. As with all indicators, it will not be correct all the time but this does not devalue its worth. When used in conjunction with macro and fundamental indicators, the VIX is another piece to the puzzle in developing our thesis for the short and long term.