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The SP Oscillator provides directional guidance.
Which is better? Are the two indicators in sync?
Is the VIX still effective?
Can we tame the Volatility beast and bend it to our will?

Abstract

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Does it contradict the VIX?
Do they somehow work in conjunction?

By: Randy Warren,
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Created by the Chicago Board Options Exchange (CBOE), the Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments. It is also known by other names like "Fear Gauge" or "Fear Index." Investors, research analysts and portfolio managers look to VIX values as a way to measure market risk, fear and stress before they make investment decisions.

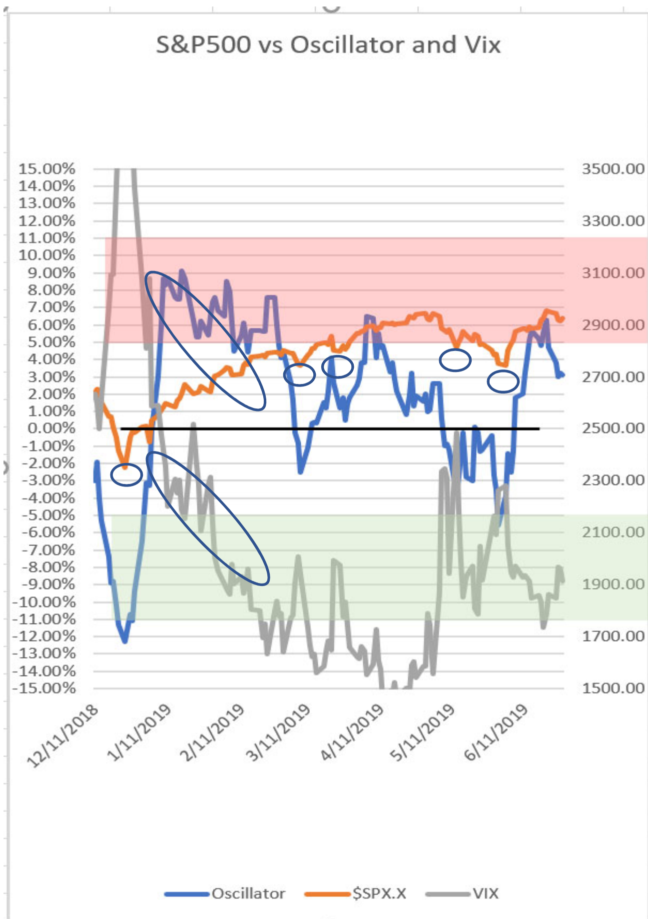
That's the clinical definition of the VIX. Some pundits have suggested that the VIX is losing its mojo, perhaps it just doesn't work as well as it used to.

For many investment professionals and savvy individual investors the VIX is not the only risk benchmark to pay attention to in today's uncharacteristic market performance. Take the S&P Oscillator Index. No joke. Sounds way too technical to even bother to understand but that's what the VIX was to many investors 20 years ago. Investment personalities like Jim Cramer, in recent years, have helped to commercialize the meaning behind the Oscillator.

Does the S&P Oscillator confirm the VIX? Does it contradict the VIX? Do they somehow work in conjunction?

According to Giacomo Santangelo, "Traders utilize the (Oscillator) index, because it is used to predict the direction of an individual stock or index, and it also serves as an indicator to provide more information on the causes of volatility occurring in the market currently", said Santangelo, an economics lecturer at Fordham University in New York.

Since the Oscillator sounds like it has more of a "crystal-ball" benefit to it, which is what all investors seem to want, is the VIX as effective as it used to be? There are a few ways to answer that but let's stay focused on what matters when using it as a tool to gauge fear.



When the oscillator moves into the red it is "overbought" and time to sell stocks

When the oscillator moves into the green it is "oversold" and time to buy stocks

The chart above shows the SP500 vs the Oscillator vs the VIX. We had to play with the scale and use multiple vertical axis in order to improve the visual understanding of the movements.

One thing to remember is that both the VIX and the Oscillator are "mean reverting" which simply means that their mathematical tendency is to return to some state of "normal" after they've been stretched or extended. The S&P500 however is not necessarily mean reverting, or at least the axis with which it may be shown to be reverting would be an upward sloping axis.

As the SP500 dropped in December 2018, the Oscillator quickly responded with "oversold" readings and the VIX quickly climbed to show the stress in the markets. In essence the Oscillator and the VIX move in opposite directions except for those periods when they are "returning to their normal state". The time period on the chart where both the VIX and the Oscillator were in agreement was during the SP recovery from Jan through the end of March. The rest of the time the oscillator and the VIX were moving in opposite directions, each throwing off their appropriate trading indication.

Notice that every time I drew a small circle on the chart, the SP was dropping, the VIX was spiking (on a relative basis) and the oscillator was moving towards "oversold".

The finer more subtle points to remember about these indicators are

1) Mean reversion
2) They move relatively. For example, you may hear that the VIX is up 20% this week, but from what level? If it started at 12 and is up 20%, that's only a reading of 14.4 which is NOT consistent with great stress in the marketplace.
3) The VIX moves in an exponential pattern in terms of its relative readings, whereas the Oscillator does not. Volatility has its very own unique "signature". Volatility is like a black swan – extreme readings are very rare, but the closer the market comes to extreme readings, the more likely further extreme readings become, like lemmings jumping off a cliff. The Oscillator has a more integer-like, non-exponential "signature", moving between overbought (+5% or more extreme) and oversold (-5% or more extreme)
4) The Oscillator is overall a "better" reading of short-term market movements. Examine the chart and notice how the Oscillator moved from an extreme oversold to an extreme overbought situation in a matter of just a few days. When reading the Oscillator think in terms of weeks not months. The main benefits that can be derived from the VIX are based around a little bit longer term market outlook (1-6 months) because the best information is derived from extended (stretched) VIX readings.

What are the Best Practices for Using these Indicators?

1) If you manage money, you know how markets can play on your psychology. The very best use of these indicators is in understanding when to buy and when to sell.
2) Without the Oscillator, you might be frozen in fear and miss out on a great opportunity to buy when the market gets dramatically oversold. When using the Oscillator, your feeling that you "understand" the market will be increased and you will take action when appropriate because your indicators give you the psychological "go ahead".
3) Without the VIX, in times of great stress, when the VIX is topping 40, you might miss epic opportunities to buy due to extreme paralyzing fear.
4) Selling is even more nuanced with both indicators. The Oscillator can remain in "overbought" conditions for a few days, or even a few weeks, so patience is the key. A portfolio manager can't simply read an "overbought" condition and react by immediately selling. Notice on the chart how the SP500 continued to climb for weeks after the first Oscillator "overbought" reading. Even after flashing overbought in Jan and several more times throughout the whole first quarter, the SP continued to climb.

In summary, the VIX and the SP Oscillator tools are working well together, each confirming the movements of the other. These are the most sophisticated tools that we have available for understanding, and eventually capturing volatility and bending it to our will. Remember, when the market is dropping one thing is sure: volatility will be rising. So, harnessing the power of exponential explosions in volatility can create profits and alpha. Certainly, it takes a bit of practice and experience to understand the nuances of these tools regarding "when" and "how" to use them. Warren Financial has tremendous experience using these tools, especially the VIX, trading VIX options on futures, almost since the creation of the product by the CBOE.

Warren Financial has built math models that analyze the volatility marketplace searching for target prices and utilizing greek calculations such as delta, gamma, and theta. The models can detect just-in-time hedging opportunities to aid the creation of alpha for equity portfolios. The only inputs needed are portfolio sizing and beta. These models do everything except place the trades which allows the final judgement call to be in the hand of experienced traders.

About Warren Financial: Since 1965, Warren Financial has been providing best in class services for wealth and investment management to high net worth individuals and couples. Building on the vision and legacy of the founder, Bill Warren – that each person has a unique purpose and desire to make an impact in their world – Warren Financial builds unique and focused plans for clients that deliver on the promise of serving our clients and enabling them to achieve their Greater Purpose tm. We believe that clients are unique and that their portfolios and investment strategies should also be unique. Using extensive research and analysis, including listening and understanding client needs and expectations, we create financial plans and models to design the investment plan that best serves our clients' greater purpose. And then we execute. Consistently.

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