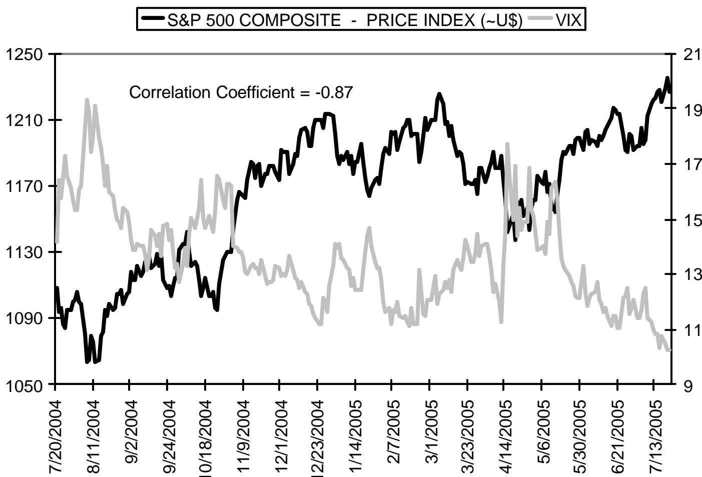
VIXens Don't Know the VIX is Worthless

If you aren't a chart-addicted momentum investor (I hope not) you may be unfamiliar with this particular insidious Question One myth. The Chicago Board Options Exchange (CBOE) Volatility Index, referred to fondly by its ticker, VIX, is meant to show the market's expectation of 30-day volatility for the S&P 500. Fair enough! It's forward looking and well-constructed from a comprehensive range of S&P 500 index options—both calls and puts. There is simply nothing wrong with it.

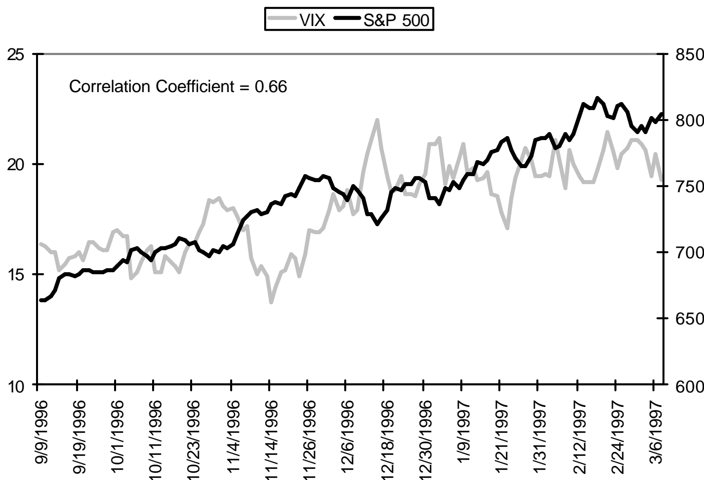
However, led by technical investors, chartists, momentum investors, and tarot card readers, there is a stoutly held view, common in the media, that the VIX is predictive of future stock returns. The VIX shows expectation of future volatility, or "fear" as VIXens would have you believe. Spikes in the VIX show increased fear, providing the "Wall of Worry" for stock prices to climb—hence spikes in the VIX are thought to lead to good stock returns. The saying goes, "When the VIX is high, its time to buy." And, "When the VIX is low, it's time to go." Supposedly low VIX levels indicate lack of fear, excess complacency, and a downdraft ahead

It's pretty cute and not a bad theory, if the VIX were really measuring what people want it to measure, which it doesn't, and statistically is predictive of nothing at all except momentum investors getting whip-sawed again. Let's use Question One to see. Normally, I'd instruct you to look at long time periods, but the VIXens don't look at long time periods. Don't care about them at all! So let's look at it like they do—over short periods.



What you see in this illustration is the VIX demonstrating a strong negative correlation with the S&P 500 in the time period we chose. If you had bought at relative VIX peaks here, you would have enjoyed a nice short-term run-up. And, the time period we chose was marked by lots of fear, so this seems to work. In 2004 we were fearing Middle East Violence plus terrorism on our own doorstep. So maybe we can use it to decide when to get back into the market if we're out, or even to time short-term swings.

But hang on—check the graph again. The moves happen simultaneously. How do you know if it's a peak or trough until after it finished forming? And, each of the peaks and troughs is relative. You have no way to know the VIX is peaking or bottoming relatively until you see it afterwards—very backwards-looking. You may think the VIX is peaking, only to have it climb to new relative highs or stay high—where it was. Or, you might be waiting for it to peak when it moves suddenly to a new trough. Plus, this pattern only emerges for short spurts. Consider another period when the VIX doesn't tell us anything about the S&P 500 at all. In fact—here it's positively correlated. How much help is that when it's supposed to be a negative indicator?



How would you know when the "right" short time period for using the VIX had started? You wouldn't, until it was over. The VIXens claim the tool works when there is "heightened fear," but that is subjective as well. Only hindsight bias allows investors to look back and say, "Well, I wasn't nearly as fearful then as I am now." Every time the stock market has you fearful, you feel like you are experiencing "heightened fear." That doesn't mean the VIX is negatively correlated to the market. It means you need to look at it longer term, and in the longer-term you have no idea when it will work and when it won't. Don't use it. It's fun to look at historically, but as a forward looking tool, is wholly useless.