

Volatility Filter

Volatility based trading is the most commonly used method in analyzing option trades. Seasoned traders use various tools to perform volatility analysis with the expectation that this will give them a competitive advantage over the rest of the market.

Ez Trade Builder allows performing Volatility Analysis by using two groups of filters:

- Volatility Filter
- Volatility Percentile Filter

It allows searching and comparing two types of Volatilities: Statistical and Implied.

Before explaining how to use Volatility filters in **Ez Trade Builder** let's first emphasize the difference between Statistical and Implied Volatilities.

Statistical Volatility is a measure of the historical movement of the underlying and can be seen as a reflection of market participant's view of the particular underlying asset.

Implied Volatility is a completely different 'animal.' Even if both of these volatilities have a high correlation, they reflect two different points of view and it is very important to understand this.

Implied Volatility is a characteristic of an Option premium and it reflects the option markets future expectations of the underlying asset's movements.

When these two forces have the same view on the underlying, then Statistical and Implied volatilities are typically close. When their views are different, you can see discrepancies in volatilities.

Nobody has a crystal ball to see what will happen in a future. Neither force is always right. Your ability to compete against these groups is exactly what keeps the options market alive!

This is why traders are looking for Implied Volatility that is either low or high compared to its historic levels.

The reason for this is the so called the "**Rubber Band effect.**" When Volatility reaches its extreme position there is a high probability that it will turn around and start moving in the opposite direction. This pattern or "Rule" of Volatility behavior is the driving force behind Volatility based trading.

Volatility traders believe at certain points Volatility behavior becomes more predictable than the behavior of the underlying asset.

For example, if you look at stock prices in the last couple of years, you will notice that prices can increase or decrease dramatically and cross confirmed Support and Resistance levels. In all likelihood, some "expert" says that a particular stock cannot go up or down any further, then "boom", the price suddenly takes a turn and moves twice what was expected in a very short period of time.

Volatility is another story. Look at any Statistical (historical) or Implied Volatility graphs and you will always see the same pattern. Volatility rises to a certain level and then turns around and starts moving into the opposite direction.



Volatility cannot continue to rise like a stock, or just fall to zero. It must “snap” back at some point. This makes Volatility a predictable and powerful component for options traders.

There is only one exception to this rule and you have to watch for it each time you are analyzing Low Volatility stocks. If somebody is buying the company or it is in the merger talks, Volatility drops and will not reverse itself. The reason for this is very simple. The price of the stock has been determined and therefore little to no movement is expected.

How to set-up Volatility Filter.

Volatility

<input type="text"/>	>	20 Days Stat. Vol.	END
Implied Volatility		4 Days Stat. Vol.	
4 Days Stat. Vol.		5 Days Stat. Vol.	
5 Days Stat. Vol.		6 Days Stat. Vol.	
6 Days Stat. Vol.		10 Days Stat. Vol.	
10 Days Stat. Vol.		20 Days Stat. Vol.	
20 Days Stat. Vol.		40 Days Stat. Vol.	
40 Days Stat. Vol.		50 Days Stat. Vol.	
50 Days Stat. Vol.		90 Days Stat. Vol.	
90 Days Stat. Vol.		100 Days Stat. Vol.	
100 Days Stat. Vol.		Implied Volatility	

As can be seen **Ez Trade Builder** allows comparing different Statistical Volatilities between themselves as well as with Implied Volatility.

Here is a sample of how a Volatility Filter could be set-up:

Volatility

Implied Volatility	>	20 Days Stat. Vol.	AND
Implied Volatility	<	100 Days Stat. Vol.	AND
10 Days Stat. Vol.	>	20 Days Stat. Vol.	END

In the next chapter we will continue the description of Volatility based trading, but this time using Volatility Percentile.

For more in-depth coverage please check information on our on-line Webinars or Mentoring programs.