Volatility Energizes 0-DTE

[00:00:00] All right. It is Monday, September 20th, and today is another zero DTE day. And today is the 38th episode of the Xero DTE podcast. Today. I'm going to talk about, volatility and what it really means to our strategy. Or what it means to just about any trading strategy, particularly when you're dealing with options.

[00:00:25] What is volatility? Volatility is the measure of how excited or how random or how much energy there is in the market. So generally, we, attribute volatility with down markets and that's because when we have down markets, we tend to have larger ranges in our minute-to-minute moves because people are panicked.

[00:00:56] So generally when we have panic, the size of the moves in, in anything or any kind of decision decisions or radical, going from point a to point B is more erratic when you have that kind of movement that is also associated with uncertainty. You know, other things that might cause uncertainty is well, things that are in the future, anything that's in the future.

[00:01:24] And particularly if it's in the future and it appears to be deleterious or bad for you. When something's bad for you, you get panicked and you make erratic moves, and you make bad decisions. And that all of that is bad. So, for that reason, volatility, we associate with fear because, I guess those types of feelings that I just express are, are all associated with fear as well.

[00:01:55] When you have something that's unknown, that's fearful. We tend to play. A higher premium on it because of that unknown, that might sound, I guess, backwards or maybe antithetical to what we mean when we think of, you know, premium or something that's worth more.

[00:02:18] We think of it in a more positive sense, but what this is really saying is. We're taking more risk. Therefore, it's going to cost us more. So, when you take more risk, you're putting more at stake. And so that's why premium grows now. Options. Are made up of several pricing components of which volatility is one of them.

[00:02:44] It's one of the major ones. Also, time, time and volatility are sometimes the same thing, but particularly when you have time associated with erratic movements in the market. And the reason for that is that time. And the further out you go, the further things are unknown when things are unknown.

As I had said earlier, there's a premium associated with that, and we see this in interest rates.

[00:03:11] So for instance, longer-term interest rates tend to have higher rates associated with them. And that's because they're more unknown as we get closer and closer and closer maybe down. 30 years to 10 years, to five years, to six months to two months to one month to one day that premium or that unknown is lessened and therefore the premium or the cost of that is less.

[00:03:44] That's basically what volatility is. It is this premium that we associate with things that are either. Uh, unknown or in our, limited understanding we should be fearful of them or concerned, I guess concerned might be a better word, but there are cases where we are fearful.

[00:04:07] So one thing that we've been experiencing over the past, Five or six trading sessions in the S&P is a lot more volatility. And that's happened as the market has been moving down day in, day out, one day after another. And that is cause for concern, particularly when people are used to seeing the market go up, up, up, and never look back.

[00:04:33] And so people are wondering, you know, Is this the end, is this the end of our streak, or we no longer going to enjoy the fruits of all this free money coming from the federal reserve.

[00:04:45] So the federal reserve has, has been injecting quantitative easing or injecting cash or buying bonds and other types of securities in the market at the rate of about $120 per. So that's not what is causing the volatility on the contrary, that injection or that infusion of cash or what some people are, what I call hopium for the market, because it tends to elevate the market or not tends to it.

[00:05:18] Damn well. Does elevate the market. That injection of cash is being threatened by a couple of other factors that are happening in the market. Such as the continual rise of inflation and whether that inflation is going to have sticking power into the future. Now, the reason why that is a cause for being fearful.

[00:05:45] Is because if inflation gets too high, then the federal reserve is going to have to do something to stem that inflation, because we don't want runaway inflation where prices just start increasing at a rate that, you know, we can't absorb, and it will cause a systemic problem across every part of our economy.

[00:06:10] The thing is there's a double-edged sword going on here. The reason why we're having the inflation is because of the federal reserve injecting the money into the market, causing a, an overabundance of dollars. So the supply of dollars are becoming greater. And when you have an oversupply of something that causes the value of the dollar to go down.

[00:06:38] And so things cost more relative to the value of the dollar and that's causing inflation. So, we need more dollars to pay for things. And we don't want this. We, you know, we can stand a metered increase in the dollar value. And as long as our growth continues at a rate that can sustain that, then we can justify the prices of things for paying more dollars for them.

[00:07:09] But when the dollar decreases in value so fast, that prices rise so quick, then people's incomes can't catch up and other things can't catch up with it. And so we have a problem. We have an imbalance, we get volatility. And that's what we're experiencing now. There's this fear that inflation is going to go run away, that the federal reserve has been trying to tell us that it's all a transitory, that there are, it is only associated with certain types of inflation on certain types of products or services that are only temporary because of the pandemic.

[00:07:51] However, this inflation is creeping into things that are not necessarily associated with things that are transitory. So now the fed is in a tough spot. They're in a tough spot because they want to be looked upon as in foul. They truly do they want you to believe that they are infallible, that what they're doing is guiding this market and with great skill and, , knowledge and with all their big degrees and big heads that they have, that they're doing the right thing.

[00:08:32] But in fact, what they are doing. The fact is that they are causing the inflation and then they are proposing a solution to that inflation. So they are causing the problem and then saying that they have the solution to the problem, which, by anyone's account, is a fool's errand.

[00:08:53] I mean, you must be foolish to be able to believe. That's the entity that causes a problem is also the entity that we should look towards for the solution. But that's the world we live in. That is the world we live in. So, inflation is increasing. And with that, the fear of what that might mean and what might it mean.

[00:09:21] Well, what it might mean is if inflation increases, they, the fed will then have to reverse what they're doing that causes the inflation. In other words, they would have to stop or at least do something that they call taper the amount of quantitative easing, or the amount of buying that they're doing in the bond market.

[00:09:42] In other markets to trim that down from the $120 billion a month to something. Now there's another thing that is in that is contributing to this inflation is that every time that they buy something, they increase their balance sheet, which is now north of $8 trillion. Imagine that, and so true tapering would be a complete stop of the quantitative easing and then the lowering of their balance sheet.

[00:10:15] But that's not going to. There's no way that's going to happen. So they play this word game with us, telling us that they're going to, they're going to taper, but taper really means just a decrease in the continual buying of assets. So the balance sheet will continue to grow, but it will grow at a slower rate.

[00:10:40] Now they'll couch this, or they will. Paraphrase or they will put this into words that will make it appear as if they're doing something to address the inflation. And sometimes that's all that's really needed is words. And in fact that is probably their most powerful tool is words. And so here we are.

[00:11:05] Afraid or we're becoming panicked because the federal reserve might pull back some of their quantitative easing, which is allowing the market to rise at a steady clip. They are fixing the problem that they caused. And then because of that, that inflation, that, and that volatility is causing the market to pull back some.

[00:11:30] And people are starting to become fearful. And that volatility, which is a principal component of certain types of assets, particularly options, they become more inflated. The fear component, the value of the future value of a contract becomes more valuable, right?

[00:11:54] Someone who is an insurer of, of price levels or a writer of options or someone who sells options loves this. We love it because here at zero DTE, that's what we do. We sell premium. We collect premium. That is our primary way that we make money with our straps. We like inflation. I'm sorry. We like volatility.

[00:12:21] We don't like inflation, but we do like volatility. Volatility is our lifeblood. You need a certain amount of volatility in the market just to make it move and to make it worth something. If there were no volatility in the market, if there were, if it just went straight up or a straight sideways, There would be no more market.

[00:12:45] It would cease to exist. You need that up and down movement. You need buyers, sellers competing against price. If there's no competition, there's no life. There's no movement. There's no reason to invest a dollar into something expecting a higher dollar later.

[00:13:04] Volatility is a, an essential component and enough volatility will provide enough vitality in the market to make it healthy too much. Then it becomes anemic, sedentary, dead. Eventually when there's no in too much, you know, basically we have to be in this sort of Goldilocks zone in the same, in the same way that our world benefits from being a certain distance from the sun. If it were to close, it would burn up. If it were too far away, would turn into an ice ball. We are in that Goldilocks zone. So, it is with inflation we're in that zone of not too much, not too little, just right now. What does that mean for us as traders?

[00:14:00] Well, that means that when we have. Now it would be great. Let me just back up here. It would be great if inflation where this sort of steady thing, I'm sorry. I keep on in, conflating inflation with, with volatility. It would be great if volatility were this steady thing, but it doesn't work that way.

[00:14:21] If it were steady, then there would be no volatility. There would be a constant, but volatility comes in huge spurts. It comes in spurts. And then. Dwindled away comes in. Another spirit, dwindles away comes in another spirit, dwindles away. Sometimes those spurts are, are relatively, um, benign. Sometimes they're big.

[00:14:43] Sometimes the huge, like when we get a market crash from back in the pandemic, crash is a good example. Volatility jumped up to enormous Heights and it took a long time for it to come down and he's even as it came down or the range that we would have in the markets that started to slowly decrease, but it was still range.

[00:15:07] And that range allowed people to buy low, sell high, or sell high, buy low, depending on which side of the market you're coming in on. And then as it got down further and further and further, it got to such a point where it started to become. Where you could no longer figure out where I could buy into or sell into because the lines between what appeared to be a range and what was just normal noise became blurred.

[00:15:37] So now, now that you know everything about inflation and what it really means to, a trader, I'll tell you how that applies to the zero DTE and why a good, healthy amount of a volatility is good for us. And a small amount is not good for us. And we have a zone, a Goldilocks zone that we're well aware of where things work and then where things don't.

[00:16:08] For us, if you were to look at the primary mechanism that measures volatility, and that is the volatility index, the VIX,

[00:16:17] our Goldilocks zone is very well-defined. It is between a VIX of 17 and 34. So when we get below 17, we find it very difficult. Now, it's not like we can just say, there's not some thing that flips or whatever, but it becomes very apparent when we get to 17 a below, it makes it very difficult to find trades and to put them on and to get enough, premium in our trades to make it worth doing the trade.

[00:16:47] But when we get above there and we start getting into the twenties, Mid-twenties, upper twenties, even the low thirties, there's this sort of Nirvana of trading Nirvana. That's what I like to call it where it's very easy to put on trades. And in fact, even though it, it may appear to somebody that we have more uncertainty because of the.

[00:17:11] Wide range of things. It gives us a higher degree of probability of making profit because now the premium has expanded and when premium expands and the type of trades that we put on are these premium collection trades, things like a butterfly. The butterfly is the best example. A butterfly is composed.

[00:17:36] To short strikes and to long strikes. And the long strikes are either the two short strikes or the same strike. And they provide us with all of our premium because they're short, anything that is short or you're selling, an option, then that's where you're collecting your premium. And then the two long strikes will provide a hedging, uh, to those, to hedge the risk.

[00:18:00] Now that creates a. Profit and loss graph structure that looks like a pyramid. And I guess if you're creative enough, you could look at it and say, oh, it looks kind of like a butterfly, but it looks more like a pyramid. Now imagine a pyramid that is say equal lateral it's 60 degrees on every vertical.

[00:18:29] And it has a certain base with, and then if you were to intersect that with the zero line of where profit is and you dissect that pyramid right in the hat right in half. All right. So now as it's coming down on its sides, you have a certain width that is intersecting at the. Zero line a profit line and we'll call that level.

[00:18:58] Oh, I don't know. Low volatility, low volatility level. That's maybe 17. Now what happens when volatility rises the pyramid itself relative to the zero line starts rising. And when the pyramid is rising, It's basis rising and coming closer to that zero line and the distance between where it intersects the zero line starts increasing because it's a triangle and it's moving up and we're getting closer to the base, which is wider than the apex.

[00:19:36] That is the effect of volatility on our trades. So. If the butterfly, if the width of that butterfly where it intersects the zero line of profit represents also the range of prices that we can be profitable under then as volatility pushes that pyramid up that range of prices that where we can be profitable, starts increase.

[00:20:05] Not only does the range of prices increase, but the height from the zero to the apex of the butterfly also increases that represents the total amount of premium that we can collect and simultaneously the risk decreases. And that is the base of the pyramid to the zero line starts getting closer and closer.

[00:20:28] And so that distance represents the. So that is why when we have higher volatility that are, that means that we have more premium and greater range and an easier time of placing our, our trades so that we can expect, uh, a higher degree of probability that price will end up closing. To those short strikes, which are, which is represented by the apex of that pyramid.

[00:21:03] I hope I drew a good enough picture in your mind. And if I had my iPad working here, I would have drawn a nice, pretty picture. Maybe I'll get that working for next time, but that's, that is, you know, from that's the best way that I can describe why volatility is so important to us volatility. Is like, it's like the tide at a dock.

[00:21:31] Imagine that I'm a boat, a sailboat, because they are, you can picture the triangle with the sails, right? The tide, as it rises, that's volatility. It, it moves the boat up right. Relative to the dock, the dock level down to the water, it could be your risk. And then as the tide rises, that risk gets less and less and less.

[00:21:59] It's kind of like the same thing. It is almost like volatility is that tide and the butterfly strategy is the boat and it's rising. They say that all ships rise with the tide. So now, hopefully that was a clean explanation for you. Now, as we stand right now, we put on two trades today.

[00:22:24] We put on one trade after the market had moved down significantly before the market opened with the expectation that, we would find. A bottom to this move. And that is all determined by our analysis of the volume profile. There was a huge, huge volume node with a lot of room underneath where it appeared that that would provide significant support and it did for a while, but then it broke through.

[00:22:53] So we were looking to capture that. And perhaps move it up. What we would call a transitory trade and now we're betting that we're going to go further down, and that trade is working out great. It's very difficult to put on a trade when you're during creating the volatility.

[00:23:18] I mean a lot of people talk about that when markets are falling like that, it's very difficult to catch the falling knife. And that's essentially what we were trying to do.

[00:23:27] However this volatility, once you have that injection of volatility, , it's something that is long lasting and it takes a little while for markets to recover from that. In the meantime, we should enjoy higher volatility over the coming days. And so this moved down over the past six or seven days, and we don't even know if we're done yet, but probably this move over the past six to seven days is going to have a lasting effect for us where volatility.

[00:23:57] We'll be elevated and placing trades in that market will be much easier because now we can create, um, spreads that a much wider and much taller. In other words, much more range, much higher probability of profit, much more premium with lower risk and because the expected move is larger. We can literally place those trades further from us.

[00:24:26] If we can get the directional attitude right. In other words, if we can guess direction, sometimes we don't even have to be close on the direction. In other words, we could say, oh yeah, we're going to have a bullish day today where it's going to, we expect the market to move up. Or there's a range of prices, an expected move of 40 points plus, or minus it could move up 40, it could move down 40, or it could move up 20 and down 20 at the same time.

[00:24:51] Right. So we'll put our butterfly somewhere within reach of that expected range And then as the day progresses because we are trying to collect premium three times a week with expiration happened three times a week, every Monday, Wednesday, and Friday, that pyramid. We'll shrink down into the ocean.

[00:25:18] It will fall down below that zero line. If it starts very high, then we can get it in a position where we have lots of range, lots of premium, and then it will sink down and we'll collect a lot of premium. We do that three times a week. The higher we can start, the more premium that we can collect and the higher probability that we will have now, of course, when you get over a certain amount of volatile, We start getting into the sort of chaotic condition it's where we've exceeded the limits of entropy, I guess.

[00:25:54] And so that's why you have this kind of goal of the zone in the same way that when it gets below, and you have. This a anemic condition under 17 of the Vicks. It makes it very difficult to put on a trade when it gets above 34 and apparently 34 is about that number and 34 35, somewhere around there. Then volatility starts getting a little out of hand and it's very difficult to then predict where price is actually.

[00:26:23] So that's where we sit. There's our Goldilocks zone, the VIX 17 to 34. We are squarely within that range right now, as I speak, volatility is sitting at 27, 8 28. That is perfect. We love that.

[00:26:41] There's your lesson on why volatility helps the zero dash DTE trade. If you'd like to try and try out our strategy, go to 0-dte.com/try. All right. That's all I've got to say for today. Happy Monday, Mondays are always happy for us and we'll see you on Wednesday. Oh, we have a question.

[00:27:06] The old videos of the Xero DTE started with the, in the money credit spread. Why switch to butterflies as it related to this volatility idea? Yeah, it actually goes back to an idea that I had a long time ago when weekly options for a started with that. And I'd been working with this premium collection idea for a long time.

[00:27:26] And I found that, the problem with credit spreads or, or spreads in the money spreads is that they provide you with too great of a risk to re potential reward. And the strategy that we came up. Totally flips that around. So where prior to this, we were looking for. Something like, two parts risks to one part reward that would be considered a good ratio for us.

[00:27:59] There was way too much. And sometimes it was even more than that. And what some people do is they go nine parts, risks to one part,reward, particularly if they put on a, an iron condor hoping to expand that area of profitability. But what it also does is it changes the whole risk reward scenario with this new scenario, this new methodology that we use, we've completely inverted.

[00:28:24] The risk to reward equation, while not giving up the probability of profit. So now instead of being a nine to one risk to reward where more like a one to nine risk to reward without decreasing the probability of profit. And this volatility idea, yes, you are in fact, correct. Helps us do that.

[00:28:47] So that's where we are at. Thank you for that. All right now, it's time to go, got to get back to work. We have a trade on, and it is making money. So we've got to tend to it, got to manage those profits because we don't manage risk. Managing risk is inherent in the strategy. All right. Thank you very much.

[00:29:06] Take care. Have a great day. Where is that off button? There? It is

[00:29:12] Peace to you all.