Dealing with volatility

One could buy stocks cheap, sell if the market rises or do nothing. All these decisions would be correct

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There are many types of "volatility". The word is often used incorrectly. For example, TV commentators often use it as a synonym for a falling market but never as a synonym for a rising one. Ignoring the bias, this usage is often wrong. A market can drop without volatility. It can rise with volatility. It can go up, down or sideways, with a lot of volatility or very little.

Volatility is rapid, unpredictable and relatively large changes of prices. "Rapid" and "unpredictable" are key words. Consider "unpredictable". In a falling market, a further drop is not volatility because it is predictable. In a rising market, a further rise is not volatility.

Volatility happens when price changes are against the prevailing trend. For example, a downtick in a rising market is a sign of volatility and so is an uptick in a falling market.

Mathematically, volatility shows up as high variance or deviation from the average change over a period. This description is incomplete in practice. A market that rises for, say, 10 sessions in succession and then falls for 10 sessions in succession is not the same as a market that alternates between rising and falling sessions, although they might register similar variance. In practice, the first market is trending - a trader could go long, and then short. The second type of market is more difficult to trade.

Matters are further complicated because "rapid" means different things for players focused on different timeframes. Traders and investors rarely bother to define their timeframes in conversations with each other.

For a highly leveraged day-trader, volatility occurs in five-minute segments of a single session, when prices go the "wrong" way. For a position trader, volatility might occur across a few sessions within a given monthly settlement. A long-term investor could think of entire months or years as being excessively volatile.

This week could see a lot of short-term volatility. Settlement is due on Thursday. Settlement week usually sees wide high-low daily ranges. In the 38 sessions since May 1, there have been five sessions where daily Nifty losses were over 1.5 per cent. There have been three sessions where daily gains amounted to over 1.5 per cent. That is eight swing sessions in the past seven weeks.

The chances are high that next week will see at least one, maybe two such sessions, with net changes of 100-odd Nifty points or more. Those sessions could cancel out by going in opposite directions. Or they might be additive, leading to a gain or a loss of 200-250 points over the week. In effect, traders should be braced for swings of anywhere between Nifty 5400 and 5900 points.

The prevailing short-term trend last Thursday, June 20, changed to down. There was a semi-recovery on Friday, June 21, due to short-covering ahead of the weekend. But there have been net losses in the past week and key indicators are indicating more bearishness. I suspect the net change next week could be down and there's a decent chance of a new 2013 low being established, breaking the 5477 of early April. However, there is also the chance of a bounce.

If you're comfortable with options, you could try the strategy that made Nassim Taleb rich. Buy long puts and long calls cheap at a distance from the money. For example, a long Nifty 5500 put costs about 8, while a long Nifty 5800 call costs about 7. The combined price for a market lot of each is about Rs 750. If either option is struck, you will make close to 150 per cent profit because that option will rise to over Rs 30 in value. Otherwise, you will lose 100 per cent.

A long-term investor could buy stocks at lower levels or book profits if the market bounces. Any of these decisions could be correct. Just keep calm.