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Being Right is Not Enough: Buying Options to Bet on Higher Realized Volatility

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Speculators who wish to bet on higher future volatility often purchase options to “go long volatility.” Should investors who buy options expect to profit when realized volatility increases? If so, under what conditions? To answer these questions, we conduct an analysis of the relationship between long volatility performance (buying options) and contemporaneous changes in volatility. We find that buying one-month S&P 500 options is only consistently profitable in the highest decile of changes in one-month volatility. Buying options consistently loses money in the lowest seven deciles of changes in volatility. We then study the trade entry and exit timing required to retain the profits from long option positions during significant volatility increases. We find similar results in global equity option markets.

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