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Stuck in a Rut! What's Happened to S&P Volatility & System Performance?

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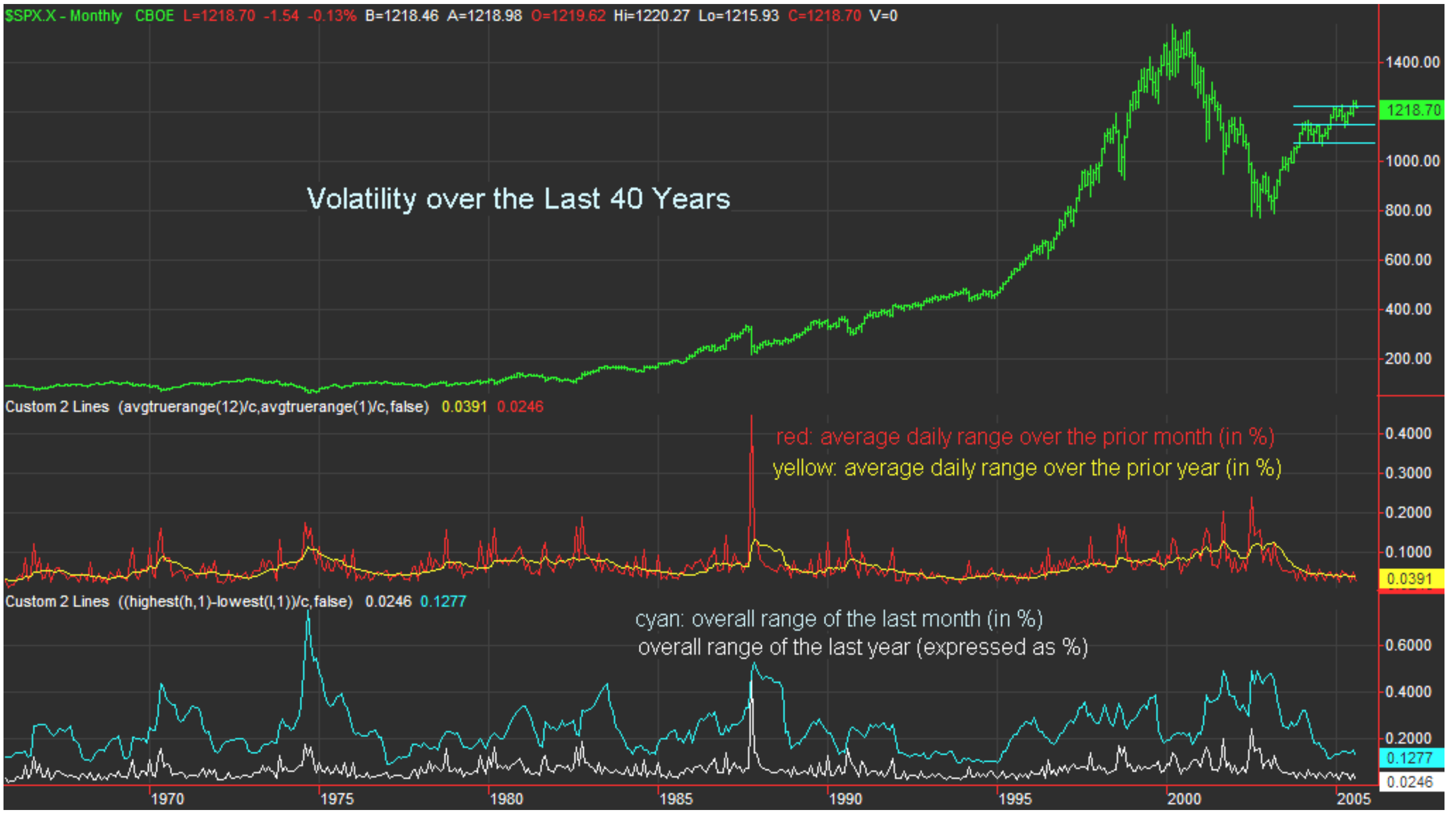
(August 12, 2005) As a developer, I'd like to blame the markets when a system isn't performing. This can certainly be a copout, but to an important degree, a system can only do so much with what the market is offering. The recent S&P action—or lack of action—is a good example.

This very important change in volatility can be seen by looking at the chart of the daily S&P cash.

First, average true range has relentlessly been declining since late 2002. Consider the indicator in subgraph one, the yellow line showing the average daily true range (as a percentage of the index) over that last year, and the red line showing it over the last month (July-August, 2005). The current levels are the lowest they've been since 1997. This daily level of volatility most affects day trading systems, since they must have enough daily range from which to carve a successful trade, and the ineffectiveness of many such systems in the last couple years can largely be explained by this phenomenon.

Secondly—as would be expected--swing ranges (ranges over days and weeks) have also declined radically. This can be seen in the bottom subgraph, where the cyan line represents the high-low range for the whole prior year (expressed as a % of the index), and the white line represents the same over the prior month. The current levels have not been seen since 1995. In fact, the last month reached a meager level seen only 3 times since 1985! It's notable that the 2.2% range of the last *month* is about what the range was running on a *daily* basis for the last half of 2002 (more than 100 days in 2002 had a range of over 2%)! This change is swing ranges can also be seen in the price chart where two congestion periods have been marked. The first lasted from December of 2003 to November of 2004, and the second from November of 2004 to July of this year, two very long range-bound periods. Sea changes like this have a big impact upon swing system performance, since there just aren't the swings to provide sizable profits, or worse, the swings are just large enough to trigger whipsaw trades.

For a long-range look at volatility, the chart below shows the same indicators, but adjusted to fit monthly data. As you can see, we are at the lower end of volatility cycles over the years.



When or why volatility will pick up in the future is impossible to say, though it does look from the chart that it may happen sooner (in 1-2 years) rather than later. When it does, be ready for some increased profits!

Fortunately, not all systems will do poorly at the same time. Some are not as sensitive to volatility, and some will operate well through different phases of volatility. But most systems find increased profits in moderate and high-volatility environments.

So what does one do to deal with a less-than-optimum trading environment? The temptation is to drop the system and/or the market, but because it's so hard to predict changes in markets, this risks putting us on the sidelines when volatility returns. And just because a system isn't performing presently on a market, doesn't mean the system or the market is broken or even that the market should be dropped. A better alternative may be to consider diversifying.

Diversification is essential in any investment arena, and especially in futures, precisely because the investor is then less subject to the whims of one highly leveraged market or system. The change in the S&P has been a healthy one that has caused many of us to broaden our perspectives to look at other indices. The two that I've found especially worthwhile are the emini Russell 2000 (eRL) and Midcap (eMD). Although all the indices have to some degree experienced reductions in volatility, both of these markets provide more volatility than the S&P, and even more importantly, they have dollar values per point twice that of the mini S&P ($100 vs. $50). Volatility*point value=opportunity, and eRL/eMD have 2-3 times the opportunity of ES. Trades that are unsuccessful on an ES swing can succeed on eRL/eMD because there's enough dollar-valued movement to get in and out of the trade at a gain or breakeven.

Will we return to the heyday of the S&P? If history is an indication, I believe so, but I don't know just when. In the meantime, there are excellent alternatives, and three TradingVisions systems—AXIOM Index, Impetus, and Spectrum (available separately or in combinations as the Vista Portfolios)—are available to trade them.