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How to spot opportunity in options?

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- Understanding option pricing is key for premium sellers. To calculate it, we introduce the Normalized Volatility Risk Premium (NVRP)—a ratio that compares Implied Volatility (IV) to Realized Volatility (RV) to identify prices of options.

- A high NVRP signals an opportunity to sell premium, leveraging the market’s tendency to overestimate future volatility. By systematically using NVRP, traders can gain a mathematical edge and optimize returns in a market.

- So, how can traders spot opportunity in options?

How to spot opportunity in options?

- This is the mathematical expression of the he Normalized Volatility Risk Premium (NVRP).
- Where:
  - IV is Implied Volatility (IV) ansd
  - Realized Volatility (RV)

$$NVRP = \frac{IV - RV}{RV}$$

- For additional context, let's calculate the NVRP since the beginning of 2025.

Symbols	IV(%)	RV(%) OR HV	Ratio (NVRP)
SPY	17%	12%	47%
NVDA	59%	74%	Less than 0 *(-20%)*

- What do these results indicate?

Study:

- AAPL,TSLA, NVDA, SPY, QQQ, IWM.
- 2020 - Present (5 years)
- 16 Delta Strangles
- 45 DTE and managed at 21 days
- computed:
  - IV, Realized Volatility.
  - Premium/BP, Worst loss, Win rate.

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- This example illustrates varying ratio levels across different stocks. Based on our study, a ratio above 15% is considered high, while a ratio below 15% is considered low.

Symbols	IV(%)	RV(%) Or HV	Ratio (NVRP)
AAPL	32%	29%	10%
AMZN	37%	34%	9%
NVDA	53%	51%	4%
SPY	18%	15%	20%
QQQ	23%	20%	15%
IWM	25%	21%	19%

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Ideal Trade Selection & Sizing Based on NVRP

- **Higher NVRP → Larger Trade Allocation**
  - If NVRP is higher (%), allocate a larger portion of portfolio capital.
  - If NVRP is lower (%) reduce position size or avoid trade.

- **Ideal Strategies Based on NVRP Levels:**
  - If NVRP is higher → Short Strangles / Straddles (maximize premium harvesting)
  - If NVRP is intermediate → Iron Condors / Credit Spreads (risk-defined selling)
  - If NVRP is lower → Avoid selling or consider long vol trades

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- Below is an example using strangles, where we observe the following:
  - A higher NVRP ratio results in greater premium collection per unit of buying power and reduces the worst loss per trade. The win rate remains relatively unchanged

Symbol	Ratio (NVRP)	Premium/ Av.BP	Worst Loss	Win rate
AAPL	10%	2%	-$6,014	69%
AMZN	9%	4%	-$47,668	72%
NVIDIA	4%	3%	-$35,582	68%
SPY	20%	5%	-$5,492	73%
QQQ	15%	7%	-$3,055	72%
IWM	19%	7%	-$4,072	72%

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TAKEAWAY:

- Understanding option pricing presents an opportunity for premium sellers to capitalize on the market's tendency to overestimate future volatility, ultimately optimizing returns.
- By analyzing the Normalized Volatility Risk Premium (NVRP) ratio, a higher ratio allow traders to allocate a larger portion of their portfolio capital and collect higher premiums relative to buying power.
- Conversely, when the NVRP ratio is lower and implied volatility is not meaningfully overestimated, the risk increases. In such cases, a well-defined strategy is essential to mitigate risk or potentially avoid the trade altogether.