Implied vs historical volatility: what's the difference?

What is implied volatility?

Volatility measures price movements over a specified period.

A highly volatile stock is one that has large swings in price, whereas a low volatility stock has a more stable price. As an example, a stock that trades between $20 and $40 would be considered more volatile than another that trades between $25 and $30. For the comparison to be meaningful, however, both must be measured over the same period.

Implied volatility, often referred to as projected volatility, is simply an estimation of the future volatility of a stock or index, based on option prices. Implied volatility tends to increase in bearish markets, which is when investors believe equity markets are likely to decline. This is due to these market conditions being considered 'riskier' for most investors.

It's important to note that implied volatility is not an exact science — it is a forward-looking calculation that allows investors to estimate where the market is headed.

The VIX Index is one of the most commonly-used measures of implied volatility and can be a helpful tool when formulating an investment strategy, especially if you are targeting volatile stocks.

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How is historical volatility calculated?

Unlike implied volatility, historical volatility (as the name suggests) is backward looking and is calculated using the variability of prices that are already known.

Historical volatility does not consider market direction — rather, it looks at how far a price deviates from its average value, up or down, within a specified period.

Historical volatility is the average deviation from the average price of a security, expressed as a percentage, and is useful when comparing it with other stocks or indices. The higher the percentage, the higher the volatility, and thus the ‘riskier’ the security is perceived to be (and vice-versa).

When a security’s historical volatility is rising, or is higher than usual, this means prices are moving up and down to a greater degree and/or more quickly than usual. This tells investors that the market expects something to change, or that something to do with the security has already changed.

Investors in stocks with a high historical volatility tend to have a higher risk tolerance — but of course, a stock having a higher historical volatility than another is not necessarily a bad thing, as risk can mean better returns for investors too.

This article is written by Fidelity International.

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