How Warren Buffett Trades the Fear of War

There's still a considerable amount of fear that North Korea could potentially strike Guam this month, which would bring about a monstrous U.S. response.

That's part of the reason the Dow Jones has now sunk 200 points in days.

That's also why the VIX is now spiking above 13.

In my personal opinion, though, I don't think North Korea will act.

Instead, I strongly believe this will all cool off, near-term, presenting us with another opportunity at market upside. For the markets, the worst part of the situation is the uncertainty of military conflict. If we look at the history of previous conflicts, we can see that markets typically dip prior, and run shortly after.

In the months leading up to the Gulf War for example, the S&P 500 fell about 12%. However, once the war began, the S&P 500 gained 32 points, and then 28% over the following year. Plus, if we look back at 14 major events dating back to Pearl Harbor in 1941, the median one-day decline was 2.4%. Dates such as September 11, 2001 and the 1962 Cuban missile crisis (which resulted in declines of 7.4%) saw a recovery within two weeks, as pointed out by Smedley Financial.

We've seen similar action during the Iraq war in 2003 and the Syrian issue in 2011.

Even famed investors like Warren Buffett have used the fear of war as an opportunity. As he once noted:

> If you tell me all of that's going to happen, I will still be buying the stock. You're going to invest your money in something over time. The one thing you can be quite sure of is, if we went into some very major war, the value of money would go down -- that's happened in virtually every war that I'm aware of. The last thing you'd want to do is hold money during a war. So if you don't want to hold cash, what do you want to own?
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> You might want to own a farm, you might want to own an apartment house, you might

> want to own securities. During World War II, the stock market advanced -- the stock market is going to advance over time. American businesses are going to be worth more money, dollars are going to be worth less, so that money won't buy you quite as much, but you're going to be a lot better off owning productive assets over the next 50 years, than you will be owning pieces of paper.

In times of chaos, Warren Buffett tells us to be fearful when others are greedy, and greedy when others are fearful. Baron Rothschild teaches us to “buy the blood in the streets” and Sir John Templeton teaches us to buy excessive pessimism.

If we apply that to the current situation, we’d begin to go long as others flee.

One way to trade the current situation is by shorting volatility with the fear gauge for example. Here’s a two-year chart of the VIX with overlays with Bollinger Bands, MACD, relative strength and Williams’ %R. Look at what happens when they each agree that a volatility spike is overdone. We begin with a look at VIX at upper Bollinger Band (2,20). It has a tendency to fail at that point. The “rubber band” has been pulled too far. Then again, we can’t just rely on Bollinger Bands to make our argument.

Now look at what happens when that upper Band is hit or penetrated to the upside, as RSI tests

its 70-line, as MACD begins to spike, and as Williams' tests its 20-line historically.

A simple way to play the short side of volatility is by buying to open a put option on the Volatility Index (VIX) itself. We can buy the VIX October 18, 2017 15 put, and or the October 18, 2017 14 put at market prices as well.

Or, if you'd prefer to trade an ETF that rises as volatility drops, we can always take a position in the Pro Shares Short VIX Short-Term Futures ETF (SVXY) or even the Velocity Shares Daily Inverse VIX Medium-Term ETN (ZIV).

At some point, the excessive fear and volatility will begin to cool off.

As that begins to happen, we want to be in place to profit from it.