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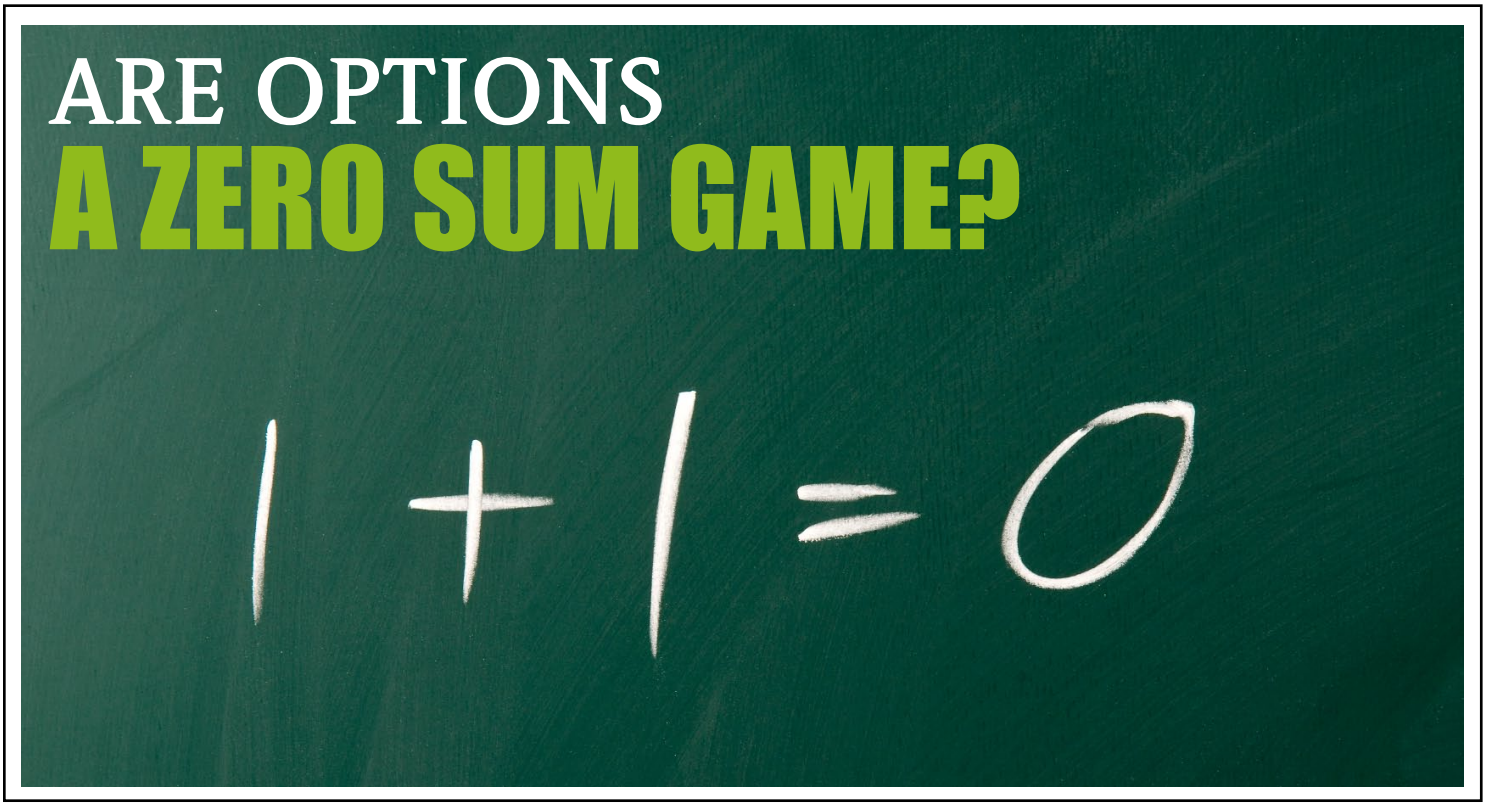
EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL



An Interview with
Charles Cottle

Plus, Market Insight & Commentary
From Five of the Top
Option Trading Bloggers

EXPIRING MONTHLY
THE OPTION TRADERS JOURNAL

Contact Information:
Editorial Comments: editor@expiringmonthly.com
Advertising and Sales
Expiring Monthly President
Mark Sebastian: marks@expiringmonthly.com
Phone (773) 661 6620

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About the Expiring Monthly Team

Adam Warner

Adam is the author of *Options Volatility Trading: Strategies for Profiting from Market Swings* released in October 2009 from McGraw-Hill. He co-wrote the options column on Street Insight from spring 2003 to spring 2005, and is currently Options Editor at Minyanville.com.

When not writing, Adam is a proprietary option trader with Addormar Co, Inc. He traded as a member of the American Stock Exchange from 1988–2001, and in several off-floor locations since then.

Adam Warner graduated from Johns Hopkins University with a degree in Economics.

Bill Luby

Bill is a private investor whose research and trading interests focus on volatility, market sentiment, technical analysis, and ETFs. His work has been has been quoted in the Wall Street Journal, Financial Times, Barron's and other publications. A contributor to Barron's and Minyanville, Bill also authors the VIX and More blog and an investment newsletter from just north of San Francisco. He has been trading options since 1998.

His first book, *Trading with the VIX*, is scheduled to be published by John Wiley & Sons in 2010.

Prior to becoming a full-time investor, Bill was a business strategy consultant for two decades and advised clients across a broad range of industries on issues such as strategy formulation, strategy implementation, and metrics. When not trading or blogging, he can often be found running, hiking, and kayaking in Northern California.

Bill has a BA from Stanford University and an MBA from Carnegie-Mellon University.

Jared Woodard

Jared is the principal of Condor Options. With over a decade of experience trading options, equities, and futures, he publishes the Condor Options newsletter (iron condors) and associated blog.

Jared has been quoted in various media outlets including The Wall Street Journal, Bloomberg, Financial Times Alphaville, and The Chicago Sun-Times.

In 2008, he was profiled as a top options mentor in Stocks, Futures, and Options Magazine. He is also an associate member of the National Futures Association and registered principal of Clinamen Financial Group LLC, a commodity trading advisor.

Jared has master's degrees from Fordham University and the University of Edinburgh.

Mark Sebastian

Mark is a professional option trader and option mentor. He graduated from Villanova University in 2001 with a degree in finance. He was hired into an option trader training program by Group 1 Trading. He spent two years in New York trading options on the American Stock Exchange before moving back to Chicago to trade SPX and DJX options For the next five years, he traded a variety of option products successfully, both on and off the CBOE floor.

In December 2008 he started working as a mentor at Sheridan Option Mentoring. Currently, Mark writes a daily blog on all things option trading at Option911.com and works part time as risk manager for a hedge fund. In March 2010 he became Director of Education for a new education firm OptionPit.com.

Mark Wolfinger

Mark grew up in Brooklyn and holds a BS degree from Brooklyn College and a PhD (chemistry) from Northwestern University. After working as a research chemist for Monsanto Company, in December 1976 he packed his belongings, left a career as a research chemist behind, and headed to Chicago to become a market maker on the trading floor of the Chicago Board Options Exchange (CBOE).

Over the next 23 years, he worked primarily as a market maker, and also held a variety of positions in the industry.

After leaving the CBOE (2000), he became an options educator and stresses conservative methods, as detailed in his newest book, *The Rookie's Guide to Options*.

He currently resides in Evanston IL with his life-partner, Penny.

Editor's Notes

Jared Woodard

Market action in recent weeks has continued to justify increased attention to volatility and risk management, and several articles in this issue offer commentary on those topics. In our featured article, Mark Sebastian analyzes the popular notion that trading is a "zero sum game," noting that the different needs of traders, market makers, portfolio managers, and other market participants mean that it is rarely the case that a trade has an unequivocal winner and loser. Speculators and hedgers may take opposite sides of a trade and yet each may be happy with the outcome. Mark Wolfinger's column echoes this theme by noting how central risk management is to success in trading, and in "Wolf Against the World," he engages several subscribers on the question of whether the break-even points of options trades mandate special attention.

Several articles this month take a close look at trading volatility directly. Adam Warner discusses the meaning of the contango in VIX futures, as well as some ways to play elevated implied volatility. Bill Luby considers a VIX call backspread trade for gaining protection against a downturn in stocks. Mark Sebastian's Follow that Trade tracks an expiration straddle on GE, and Mark Wolfinger gives a favorable review of *Volatility Trading* by Euan Sinclair.

My column reviews the impact of retail traders on implied volatility, and analyzes the prospects for profiting from retail trader sentiment. Guest contributor Tyler Craig considers the use of adjustments to allow traders to lock in gains and reduce risk. Interview subject Charles Cottle offers his thoughts on the changing trading landscape as well as some techniques for structuring more nuanced trades. On the Back Page, Mark Wolfinger asks whether banks and brokers are "cheating the little guy."

As always, readers are encouraged to send questions and comments to editor@expiringmonthly.com.

Have a good expiration cycle,

Jared Woodard
Contributing Editor

Ask the Xperts

The Expiring Monthly Editors

Many people recommend closing out option trades prior to expiration. Is this really so important? Looking back at my own trades, it seems I would've had better returns letting my vertical spreads and iron condors expire worthless.

James L.

Traders whose portfolios are typically short gamma / long theta always have to decide how to balance the benefit of theta and the risk of gamma. If you're trading a rule-based strategy of some kind, it's a straightforward matter to review your trade history and see whether holding to expiration would have offered enough of an improvement in absolute returns to justify the additional risk. And even if it would, you have to be aware of your own psychology and risk tolerance, because an improvement on paper is useless if you aren't able to apply the change consistently in a live situation. In my experience, most traders are better off closing out short gamma positions well before expiration, especially if those positions are at all near the money. As expiration nears, short gamma option spreads become more and more similar to lottery tickets: the more exciting they are, the less control you have over them.

– Jared

Q: Since the VIX has no underlying instrument and therefore no exercise, wouldn't a great advanced strategy be to buy low risk/high reward debit spreads OTM out a few months, and then hedge with front-month credit spreads at higher strikes?

A: It sounds like a decent idea, my only comment would be there's often little correlation between different VIX cycles, near month moves with VIX itself, outer month may sit and sit.

Q: Thanks for answering the VIX question. As a follow-up, I am thinking of calls, and benefiting from an eventual big run-up in the VIX if/when we sell off hard. Would that hedged approach make some sense?

A: I'd sooner just own SPY puts, but I know people get attracted to the big returns you can get on cheap VIX calls. So don't let me discourage you if you find it works for you.

– Adam

I've started collecting data and I'm very excited about the covered calls opportunities that exist.

Ed S.

Hello Ed,

For people who are first learning about options, writing covered calls seems to be free money. It is not.

Please be aware of the large downside risk that exists. It's true that a covered call is a hedged (risk-reducing) position, but the protection is very limited.

I agree that the potential profits can be exciting, but you must be aware of potential losses before deciding if this strategy is good for you.

– Mark W.

What, if any, is the relationship between the bid-ask spread and the implied volatility of an option?

– Chad

Chad,

There is a not a huge link between bid ask spread and implied volatility in the traditional sense. However, there is some relationship. The tighter the bid ask spread, the more fluid the movement in implied volatility. This is because as options get bought or sold the bid and offer may only move up or down by one or two cents. Leading into expiration most options, even the inexpensive names, have more than one or two

cents worth of vega, and the implied volatility will not jump around.

At this stage in the game, when an option has a wide spread, it means that it trades infrequently and lacks liquidity. These options will see implied volatility remain constant for extended periods of time, and then quickly have IV spikes (up or down). This is because the market does not have the ability to absorb very much order flow.

– Mark S.

I am concerned about the possibility of backwardation and its effect on VXX roll yield, so I was wondering if you knew of any indicator revealing the amount of time during which the VIX futures curve has been in contango vs. backwardation? I'm just trying to get some evidence on the assertion that VIX futures are generally in contango.

– Pierre

Hi Pierre,

As I see it, since the January 2009 launch of VXX, the VIX futures curve has gone through three distinct cycles. For the first two months or so, through early April 2009, the VIX front and second month futures (the only part of the VIX futures term structure that is relevant to VXX) were in backwardation (first month more expensive than second month) about than 95% of the time. Then the VIX futures term structure began to assume an upward slope and for 95% of the next 13 months, the VIX front and second month futures were in contango. That contango trend appeared to come to an end in early May of this year. Since the beginning of June, however, the VIX futures have been back in contango.

Looking back at the 1½ years since the launch of VXX, the front two months of VIX futures have been in contango about 80% of the time. Before one jumps to conclusions, I would be remiss in not pointing out that VXX was launched during an unprecedented drop in volatility from an all-time high level, at a time when systemic risk was probably as high as it has ever been, so I do not think the 1½ years of post-launch data is necessarily a representative data set from which to extrapolate about the future VIX term structure.

As I see it, over the long-term I expect that VIX futures would be in contango something more along the lines of 60–70% of the time. This is just a guess, but it is a long way from the 95% we saw recently that may have led some observers to make dangerous assumptions about VIX futures contango over the course of an extended time period.

Cheers and good trading,
Bill

The New Option Trader

Risk Management

Mark D Wolfinger

When corresponding with new traders, the two points that I must convey are:

- Don't trade before understanding how options work
- Your trading career depends on your ability to manage risk

The first suggestion is frequently ignored by those who are anxious to get started. There's not much that can be done about that because each trader has his/her own emotions with which to deal. Some have the patience to learn the basic concepts regarding options before placing money at risk, while others cannot hold back. Lack of emotional discipline is a serious detriment that the newbie does not yet understand.

It's the second suggestion that is far more important. However, it's a notion that goes against the grain for beginners. It's common for option rookies to believe that strategy selection is the top priority. I agree that strategy is important, but it is not sufficient. Your friends may have made some money when writing covered calls, or buying out of the money strangles, but that's no reason to believe either of those methods are appropriate for you.

Some strategies may fail the 'common sense' test while others may be more difficult to grasp. Surely new traders must have a sense that it takes practice to understand when to initiate, adjust, and exit the trade. Yet, some begin trading with real money despite knowing that important aspects of the trade process remain a mystery. I believe the culprit is overconfidence. New traders arrive on the scene with an optimism that is difficult to explain.

Risk

I know from experience that managing risk is essential. My philosophy of trading is based on the premise that there is one primary rule when trading: Don't go broke.

This is a difficult concept to discuss. The rookie is anxious to learn new 'stuff' and get to work using all the new ideas. In general, option educators take the optimistic approach, talking and writing about profits. Internet ads tell the gullible how easy it is to make 10% every month.

There is less talk of risk and possible losses. That's easy to understand. When someone charges thousands of dollars for seminars and lessons, the goal is to get people to pay for those services. The idea of possible losses drives away customers. Thus, the optimistic sales pitch.

I've been there. When I was a market maker, I often worked with risk managers because I owned positions with far too much risk. They intelligently and patiently explained that my risk was beyond acceptable, but I wouldn't listen to those 'non-traders.' They did what they could and I was lucky to survive the disasters.

Having learning the lesson, I fully understand the importance of being aware of, and managing, risk when trading. I repeatedly explain that betting against the unlikely event every time will eventually result in a big loss. It may feel safe betting that an event with a 2% chance will not occur. But a 2% chance is not zero. In fact, when the time scale is one month, there is a >50% probability that you will see the 2% event occur once every three years, and >70% chance every five years.

It's not rocket science. All that a trader has to do is to be certain that the unlikely event results in a profit or a acceptable loss. Many traders grasp this concept right away. Others must learn for themselves. Risk can be measured (or at least estimated) and managed. A mindset that convinces a trader to own a portfolio with limited risk places that trader in position to succeed.

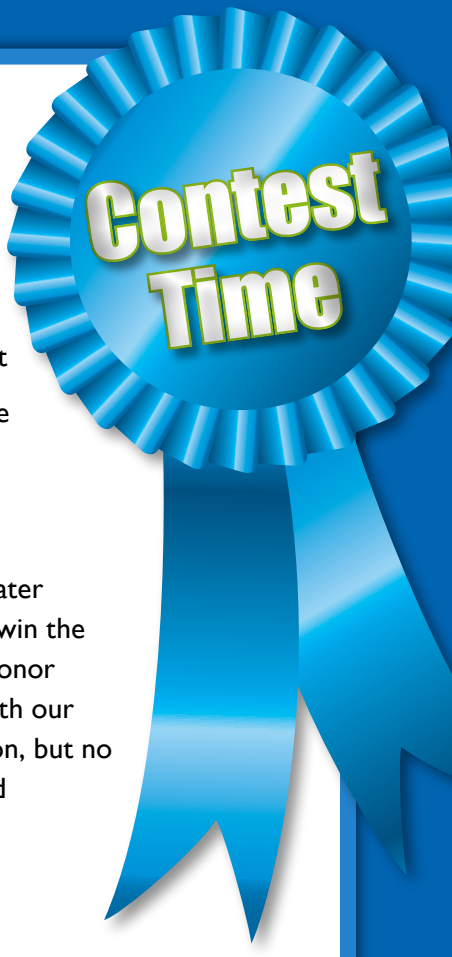
Any options education book or coursework must include a thorough discussion of risk and how to handle it. Trading with limited loss is essential.

Risk can be defined as the probability of loss, but I prefer to define it as the amount that can be lost. If you run out of money the game is over. Large losses are psychologically damaging and can have a lasting negative impact – perhaps for your entire career as a trader.

A simple method for limiting risk is to properly size trades. When positions are too large, you risk the unrecoverable loss. Would you bet your future financial health on a single trade that produces a nice profit 99 times out of 100 when that 100th occasion results in a complete wipeout? The answer to that question may define your chances of becoming a successful trader.

Write a Guest Article

Prize: One-year subscription to Barron's



Contest Details

This month, the contest requires more effort. If you want an opportunity to express yourself, please write a column to be published in *Expiring Monthly*.

Some readers are bloggers and professional writers. This contest is also open to you.

Rules

- Submit an article on *any topic* related to options, option traders, the options industry, etc
- Advanced topics (the readership skews professional) or topics for the educated beginner are welcome. Or anything in between.
- Length guideline: 800 to 1,000 words preferred
- **Submission deadline: August 9, 2010**
- Attach a short (50–75 words) bio – if you want to share those details with readers
- Send entry via email to VXX@expiringmonthly.com
- Request: Please place your name and bio on the same page as the entry

Selecting the Winner

Our goal is to select a well-written article that we believe will be of interest to the majority of our readers

The decision of the judges (MDW, with input from other contributing editors) is final

We reserve the right to publish submissions in addition to that of the winner

Prizes

- The subscriber who submits the 'best' article per 'selecting the winner' above, receives a one year subscription to Barron's. This prize will be awarded, even if a non-subscriber wins the contest
- If a non-subscriber wins the contest, that person wins a one-year subscription to Expiring Monthly
- If we use your article at a later time (because you did not win the contest), you receive the honor of being published along with our thanks for your contribution, but no other prize will be awarded

Good writing to all

Contest I: Results

Predict VXX closing price July 16, 2010

The contest had an exciting finish. With VXX closing at 27.37, the following entries were all very near the mark:

VXX	Entrant
27.10	HS
27.22	JC
27.23	DLS
27.50	T
27.70	ES
27.75	C
27.76	LT

The winner (a subscriber) is Thiru who gets the iVolatility package. The estimate missed the closing price by 0.13.

The runner-up, a non-subscriber (Roger) missed by 0.14. The prize is a year's subscription to Expiring Monthly.

Our condolences to JC who was only 0.01 out of the running.

The Monthly Options Report

Dancing the Contango

Adam Warner

We've spilled a whole lot of options (virtual) ink discussing the VIX Contango in the past few weeks.

In case you missed it, the nickel version is that while the VIX itself has meandered in the mid 20's, the VIX term structure is rather steep, such that we've seen inordinately high premiums in VIX futures. October/November futures traded as much as $8 above the *spot* VIX in early-mid July, about as high a premium as anyone has seen in VIX futures of this duration. It's normal to expect higher volatility in the Fall than in the summer, just not such a high magnitude gain.

But even if there's some seasonality involved, that doesn't explain everything. August VIX also traded at a large premium, hovering near $4 above VIX. Last I checked, August still is a summer month. It's important to note that VIX looks forward 30 days, and 30 days forward from August VIX expiration takes you into mid-September.

No matter how you slice it, we can say with some assurance that the options marts expect some fireworks within the next few months.

We can debate the meaning of it. Should we worry? Do options markets know something? Should we consider this Fear to be overblown and fade it (i.e., get bullish)? I lean towards the latter interpretation, but that's not the purpose of this piece.

Nope, what I am really wondering is: Must I have an opinion which side proves *right*? What if I sell index options (or VIX futures/VIX options) in the fatter month's like October-November and buy August index options, say in SPY?

The answer is that it may work splendidly. It also may produce losing trades on both sides. And that's the big problem. It's not a terribly well-hedged trade, despite outward appearance to the contrary.

What if we buy August SPY ATM straddles and then sell October VIX futures? Pending specifics, it would effectively buy volatility at a much lower level than you get for the October VIX sale. But unfortunately, the two bets may not always offset. Your August bet will sink or swim based on the realized volatility in SPY itself between now and August expiration. The time from now to mid-August is hardly a volatile time of year, and August options are not particularly cheap right now. So let's say the August part does not work, shouldn't October VIX drift lower in response to lower realized volatility?

In normal times, yes,. But as we noted, October and November VIX is trading for a Fall volatility snapback. There's no particular reason that opinion will change in a slow July–August.

So what if we scratch that August SPY part and replace it with August VIX? The trade is now a simple VIX calendar spread.

Well, there's even more problems with this play. First and foremost, August VIX snapshots the VIX on August expiration. And it's hardly cheap, being only 2–3 points below October. Sure you can sell it, but where's the edge? That's not a high number.

Bottom line is that the huge VIX futures premium looks like an inviting target to fade, there's just myriad ways such a play can go bad. It can go right also (the market could go nuts next month) but that's not the point. Rather, it's that it's two separate risk plays and should be treated as such.

Wolf Against the World
A Dialog

Mark D Wolfinger

This month we're doing something different: Subscribers were invited (via e-mail) to participate in writing this article. We chose several replies (rather than only one) for publication. Thus, each reply has been slightly edited (shortened).

If you have a topic to suggest for 'Wolf Against the World,' send that idea via e-mail to mark@expiring-monthly.com.

Premise: Good Traders Always Pay Attention to the Break-Even Point

Con Mark Wolfinger

Traders love profits and detest losses. However, experienced traders recognize the need to accept a loss when positions don't work as planned. There are times when we must recognize that our rationale for making the trade is no longer relevant, the position is not going to work and must be closed at a loss. There are other times when an adjustment can be made to reduce risk and transform the position into one worth holding.

Traders often allow the profitability of the trade determine their action. When closing a *profitable* trade that they no longer want to own, the decision is easy. However, when closing would result in a realized loss, traders are far more likely to hold the position – 'just until it gets back to break-even.'

How often do you hold a trade with a small loss – for the sole reason that getting back to even appears to be an attainable goal? It's a very common occurrence.

I find this line of reasoning to be unreasonable and unprofitable. Why hold a position when the maximum potential is earning an extra dime or two (to get to break-even), when the position has become too risky to hold?

Why would any prudent risk manager allow that? When a position is too risky, it's time to adjust or exit. Holding a position to avoid taking a loss, makes no sense. When the potential reward is only pocket change – because you plan to exit when you no longer have a loss – and the potential loss is much larger because a stubborn trader may never exit – this is not a sound trading plan.

I know how good it feels to get that winning result and maintain a high percentage of winning trades. But, at what risk? It's the total dollars you earn that matters, not the percentage of winning trades.

When you own a position, the only price that matters is the current price. The only market conditions that should affect trade decisions are the current conditions. You can add to the trade, reduce the size, exit, or do nothing. The careful risk manager takes the appropriate action, based on current conditions. The original cost of the trade is immaterial. I cannot imagine making a risk-related decision based on cost basis. That cost is history. Risk/reward, as it exits right this minute, is (or should be) the only consideration.

You want your money invested in a specific position, or you don't. That decision has nothing to do with your entry point of yesterday, last week, or last month. My advice: after you record your entry price in a trading journal, forget it. Get it out of your head and concentrate on managing that position for its risk and reward potential – going forward.

Pro #1 Daniel B Stern

Profits and losses do matter.

As far as I am concerned, trading is all about risk, reward and money management. **[MDW: Agree 100%]** If one lets money interfere with "the trade," then focus is lost. Why did you make this trade? What is your profit objective? What is the

point at which you are going to take a loss? And I do not mean a loss with a "mental stop." That does not work.

However, in gauging dollar loss potential it is important to relate that to the number of contracts traded. I made a trade in corn futures this week. My opinion is that I am risking .0375 cents per contract. The question is: 'how many contracts am I willing to trade for that risk?' Answer: more contracts than if the risk were larger.

Will this trade be a "winner"? I hope so, but there is no guarantee. Can I make $50 or $75 per contract? Again, I do not know. However, what I do know is that I am willing to take a certain amount of risk, for the chance to make whatever it is I end up making.

It cannot be stressed enough that this will not be the last trade of my career. Every trader lives for another day. If I take a profit prematurely, so be it. You cannot go broke taking profits. And one reason to take a profit is to free capital for another trade that I believe has more profit potential now. I may take a loss for the same reason. **[MDW: Yes!]**

Profits and losses always matter and affect trade decisions. That is human nature, whether one is willing to admit it or not. If you have a game plan before trading, it helps block out "emotional trading."

And as for the discussion of risk and current positions I believe the following. Regardless of where you initiated a position, it is where it is trading now, and that is just as important, if not more so. One cardinal sin is to let nice profits turn into losses. Holding a position based on hope is for amateur traders.

AS MY FATHER ALWAYS TOLD ME" NEVER RISK MORE THAN 20% OF YOUR NET WORTH ON A TRADE".

Dan is a managing member at Stern Investment Advisors

Pro #2 Dennis Lastor

Option trading can be an exciting and lucrative endeavor for those willing to put forth the effort, develop a plan, know the underlying, and never lose sight of the main goal – making a profit.

Adjustments are often necessary (especially in today's volatile markets), and one should never lose sight of the main goal in option trading – making a profit. Adjustments should be initiated to increase profits, secure existing profits, or increase the likelihood of profit without a meaningful reduction in potential profit at expiration. **[MDW: Can you adequately manage risk when worried about the cost?]**

This is not to say there is no room for risk management; however mitigating large risk should be built into the plan prior to establishing a position. A proper plan has a defined risk, a defined profit point, and a defined maximum loss.

For example, at the time of this writing a specific 20-point RUT Iron Condor can be traded for a credit of $245 and a max loss of $1755 at expiration. This position has a near 80% chance of maximum profit. *Due to the relatively low credit, making adjustments to manage risk throughout the life of the trade can be costly.* **[MDW: That's one problem with low credit iron condors.]**

Since markets rarely 'crash up', buying "insurance" on the down side may mitigate potential black-swan events, provided the insurance costs are only a fraction of the original $245 credit. **[MDW: Another limitation of small credit iron condors]**

After the trade with insurance is initiated, it can be managed based solely on the profit and loss of the position. For example, at two to three weeks into the trade if RUT is still centered in the middle of the condor, one adjustment (based purely on maximizing profits and *increasing* risk) is rolling one or both sides of the condor in closer to the spot price; in effect tightening the spread between the short strikes. This not only takes some profits off the table, but also provides more headroom (by increasing theta) for increased profits. **[MDW: It takes zero profits off the table. It merely gives you a closer to the money IC.]**

Unlike stock, options allow the trader to define risk prior to entering the market. Black-swan events, fat-tails, geo-political risks

always exist, and to mitigate disaster, downside protection should be initiated with the original position. However, dynamically adjusting positions based on potential risk negatively impacts profits. **[MDW: No insurance is free]** Further, lower risk positions require longer exposure to the market to achieve the max potential profits, **[MDW: A 3rd limitation of the small credit IC]** a factor rarely considered by the overly risk averse trader.

Dennis is a retail options trader who holds two graduate degrees in computer engineering, and engineering management ("High Tech MBA"). He is currently pursuing a graduate work at Stanford in Quantitative Methods in Finance and Risk management.

Pro #3 Jason T

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
– *Mark Twain*

I understand that in an ideal world a trader would look at each position as it currently stands and make a decision because he or she believes it will make money starting today. And for experienced traders with years of experience, such reasoning makes sense. But for less seasoned traders, it too often it leads to letting losses run or cutting winners too early.

Even experienced traders can let a particularly good or bad run infect their risk management decisions. Nothing is more ruinous than turning a trade into an investment, and especially in the heat of the moment, it is all too easy to rationalize that the market cannot possibly move further against you. **[MDW: Been there]** The most important traits a trader can possess are objectivity and discipline. Hard stop loss and 'take profit' levels remove emotion from the decision making process.

I believe that holding a position because you believe it can make money starting today can lead a trader to make the cardinal sin of letting a trade turn into an investment, be it a winner or a loser. **[MDW: Not when the decision is *based on risk*]** We often have unconscious biases that blind us, and trading without hard stops or taking profits can lead traders to rationalize bad losses without the benefit of an objective benchmark. These levels do not have to be monolithic, but it is good practice for a trader to be very slow in changing the [stop loss and take profit] levels, and documenting exactly why a change is necessary. After all, a stop loss that keeps rolling down is not much of a stop loss.

This is not to say that we should remove all subjectivity from trading – it is after all a profession based on opinions. As a trader gains experience and becomes more confident in his or her abilities, he can combine stop losses and take profits with a more subjective feel for whether they think a trade will make money going forward. Traders should track both their intuition and hard stop/take profit levels to see if to see if their instincts are as attuned as they think they are. Once they have developed a feel to where their biases are, traders can more confidently (and most importantly, more safely) combine the art and science of trading.

Note: no bio by request

Pro #4 Simon

When making a trade decision the only result that matters is the end result, and the end result is whether a profit or loss has occurred. **[MDW: The end justifies the means and risk doesn't count?]**

There is no doubt that trading is difficult to master. One must be in possession of, or acquire, the correct skill set and attain the right mindset to become a successful trader. A fundamental understanding of profit and loss is necessary to achieve this.

Profit and loss are how a trader or investor keeps score; it determines if money is being made or lost. When a trade is made the purpose behind the decision is fuelled by acquiring a final result. To make a trade that is not based on profits and losses is equivalent to a professional basketball player choosing not to make the shot and instead passing it off. That is no way to gain a result. **[MDW: Why take a 50% shot when teammate has a clear lane to a layup?]**

As human beings we seek instant gratification, to be rewarded for job well done and to be able to quantify

our actions. By determining if a profit or loss has occurred provides this sense of fulfillment. Referring to Maslow's hierarchy of needs, the need for self esteem and achievement creates confidence which in turn puts a trader on the right psychological pathway to gaining a winning attitude. Thus, ignoring profit and loss and only focusing on the trade at present is essentially adopting a losing mentality. **[MDW: Risk doesn't matter? Do you EVER exit a trade?]**

Trading is a business just like any other; the books must balance, profits and losses must be realized to determine whether money is being made or lost. **[MDW: Agree]** When a trader chooses not to base a trading decision on whether a profit or loss has been made the trader is essentially doing a disservice to their business, the trader cannot therefore realistically ascertain how successful the trade is and is ultimately is in denial of the quality of the trade.

In conclusion a trader cannot ignore profit and loss when making a trade decision, **[MDW: A trader cannot ignore risk when making a trade decision]** because it is the profit and losses that determine the success of the trade. [And it is risk management that determines the success or failure of your entire trading career]

Simon is a professional options trader who actively trades Index, commodity and FX options.

Pro #5 Steve Lapper

Traders trade for a variety of reasons, net profitability chief among them. Yet, current prices of positions don't always reflect the true value of a trade, and as such, the trades eventual (net) profitability isn't always clear enough to make a smart liquidation decision. **[MDW: If the value is truly there, the position will pass the risk test]** Today's markets are rife with examples of conditions that produce this confusion. Small sharp moves in both directions, coupled with whippy volatility moves, can prove maddening for premium sellers. Yet, carefully selling elevated premiums can be highly profitable.

Traders using noose-like stop orders **[MDW: Would anyone do that?]** would end up with fatal losses in such an environment, if they ignored the entry point price and just focused on current price. Using the entry point as a risk guide (i.e., setting allowable percentages for loss and gain) can serve as an effective tool for profitably managing expectations and portfolio risk.

Another good example of the validity of using entry point prices for managing risk is an options position entered as an offsetting hedge for another position. In that case the aggregate position risk uses current price (of the options position) only as one of many inputs to make a shrewd portfolio trading decision. The entry point for that position clearly retains value for measuring trade risk. **[MDW: This discussion is for standalone option trades. Agree that current price of a *hedge* is immaterial.]**

Mark's position does strengthen considerably when management of absolute risk becomes paramount. He is right to set entry point aside and focus on the current price. In today's nervous markets, absolute risk should be the primary factor in learning how to make your winning streaks last and losing streaks dwindle.

Steve Lapper spent more than 15 yrs market-making options and futures on the CBOE, PSE, NYFE, NYSE and CBOT. His firm, Far Hills Capital Partners, uses expertise with derivatives and risk management to advise hedge funds and family offices. Steve graduated from George Washington University and has studied post-graduate at both The Wharton School and the University of Chicago's Booth School of Business.

Are Options a ZERO SUM GAME?

Mark Sebastian

One of the buzz phrases thrown around the trading industry is that trading is a 'zero sum game.' This refers to the belief that for every winner in a trade, there must be a loser. But is this the case? While in a pure sense, there may be some truth to that statement, in reality, nothing could be further from the truth. Futures are the classic example of a' cut and dried' case of zero sum game, but is that necessarily true? Probably not. In the case of options, I think that zero sum game belief is even less apt.

When I was in college, one of the things that first got me interested in trading was 'introduction to derivatives.' In this course it was hammered home to me that there is a buyer of a future and a seller of a future: one wins, and one loses. At the CME the educational material says much the same thing. However, I would argue that that example is only true in the case of a pure speculator.

Imagine I am a manager of a large hedge fund, and I am long a very large basket of stocks. Let's pretend the position is as follows (Table 1):

Now imagine that the market rallies for two consecutive weeks. The hedge fund manager still likes the stocks, or he or she wants to collect future dividends. However, that manager hates current market conditions. Essentially, the manager is bullish on the portfolio, but hates the market and wants to hedge any 'systemic risk' of these underlyings. What would the manager do?

The manager could:

a. Unload all positions, forgo any dividends, and get into cash. This is a fine move, but what if these stocks outperform the general market? The manager would be frustrated if the market sold off 5% and these stocks only sold off 1%. It's possible this mix of stock could even move higher, and this is certainly the most clear cut reason for hedging systemic risk of a portfolio

b. The manager can sell futures, either S&P or NDX futures. This allows the manager to hedge systemic risk without killing the upside for these stocks.

If the manager chooses option B, and sells enough futures to hedge a portion of the portfolio risk,

	Position
GE	1000
IBM	1500
MRK	2000
EXC	1000
BA	1500
A	3000
T	5000
BAC	5000
JPM	1000
GS	1000
AAPL	3000
INTC	1500
GOOG	1000

Table 1

and if the S&P rallies 1%, the manager loses on his or her futures position. But what if the basket of stock gained 3% at the same time? Not only did the manager make money, the manager actually BEAT the S&P 500. I would have a hard time calling the managers futures trade a loser.

Determining whether options are a zero sum game can be put to rest when looking at delta hedging. Options are designed to allow both the speculator and hedger to win at the same time. This is because the professional is managing the position, and the speculator is not.

On May 18th 2010, MRK was trading 32.35. The June 35 calls were available for purchase for 23 cents. The speculator thinks MRK is going up and thus purchases 100 MRK Jun 35 calls for 23 cents. The professional trader, after selling the calls, sees that the sale produced a negative 1500 MRK deltas. He or she hedges this short delta by buying 1500 shares for 32.35. Let us follow the paths of these two trades.

On Thursday, May 27th, 2010 MRK is now trading 33.60. The speculator is down about 200 dollars because the calls are currently marked at .21. The speculator could be happier, but is probably not too dismayed at this point.

The professional is currently up about 1600 dollars. The stock made a full 1.10*1500. The options made another 200. The trader is likely to be happy with the position. That said, if he or she is hedging actively he is probably getting close to pulling the trigger on buying more stock.

MRK Common			Legend		
32.35	-0.43		Last	Chg	Trade
33.00	32.35	+1,800	High	MktPr	Ex.Pos

MAY <4>					JUN <32>				
MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
0.01				0.00	0.11				8.08
0.02				0.09	0.22	28.6%		-100	15.7
0.03				4.91	0.44	29.4%			27.1
0.18	31.6%			30.8	0.79	30.4%			41.4
0.67	35.2%			66.5	1.29	31.6%			56.2
1.47				88.3	1.95	33.6%			75.3
2.64				-100	3.20	27.0%			-84.3
1.67				-95.1	2.42	29.0%			-72.9
0.81	29.9%			-69.2	1.75	30.3%			-58.6
0.30	33.5%			-33.5	1.22	32.1%			-43.8
0.11				-11.7	0.84	34.2%			-30.6
0.03				-3.33	0.57	36.5%			-20.4
0.02				-0.86	0.39	39.1%			-13.7
.....				-0.22	0.27	41.8%			-9.17

OptionVue

Figure 1

Actuals	MRK Common			Legend		
	33.59	+1.17		Last	Chg	Trade
	33.67	33.59	+1,500	High	MktPr	Ex.Pos

Options	JUN <23>					JUL <51>		
37 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade
36 calls	0.07				8.27	0.36	25.3%	
35 calls	0.21	23.1%		-100	20.7	0.62	26.1%	
34 calls>	0.54	24.5%			39.9	1.01	27.3%	
33 calls	1.10	26.4%			69.5	1.55	28.7%	
32 calls	1.86	29.1%			85.2	2.21	30.4%	
31 calls	2.74				93.4	3.00	33.0%	
30 calls	3.70				97.0	3.85		
35 puts	1.96	22.3%			-79.3	2.40	26.0%	
34 puts>	1.26	24.1%			-60.1	1.78	27.0%	
33 puts	0.77	26.1%			-39.5	1.31	28.6%	
32 puts	0.45	28.5%			-23.1	0.95	30.4%	
31 puts	0.27	31.6%			-13.1	0.69	32.5%	
30 puts	0.17	35.1%			-7.64	0.51	35.0%	
29 puts	0.12				-4.49	0.38	37.5%	
28 puts	0.09				-2.68	0.29	40.1%	

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$46,502	Delta	-565.8
Init	$97,734	$51,232	Cur. Value	+$48,135	Gamma	-1,638
Maint	$86,727	$40,225	Gain/Loss	+$1,633	Theta	135.2
Cash/Init	-0.48	-0.91	Commis	$176.94	Vega	-225.1

OptionVue

Figure 2

On June 3rd MRK is now up to 34.33. The speculator is starting to feel pretty good. The 100 calls are now worth .32 each. The position is up 900 dollars, for a 37.5% return. If I were the speculator I might be looking to reduce this position. But our speculator is a tough guy (or gal) and stays in the trade.

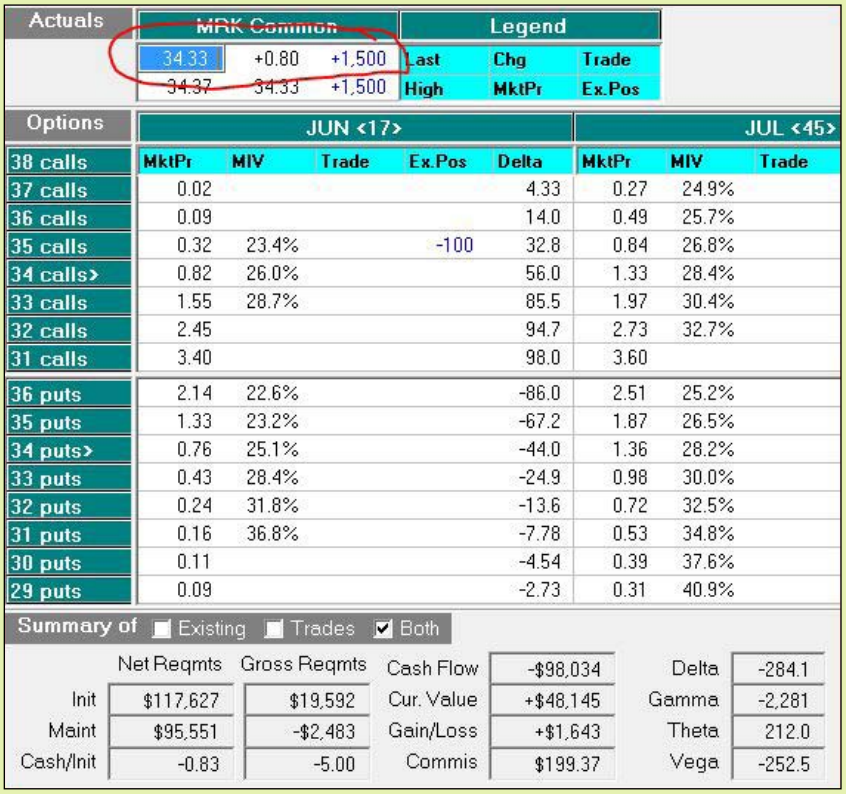
The professional takes one look at the position delta and realizes there is market risk. The pro still has 1600 dollars in his or her pocket, but the risk of being short over 1700 deltas is now too significant to let slide. The trader buys 1500 more shares of MRK for 34.33 to hedge delta risk. The position is now short 100 35 calls, and long 3k shares of MRK.

On June 14 MRK is now trading near 35.10. Our speculator is dancing in the streets as the position is making 2000. That is a nice 83% return. If I were managing this trader's risk, I would order him or her to unload at least half of the position. However, this trader truly believes the stock is going higher. Thus, the trader stay in the trade.

The professional again has a delta problem. The position is now up $2700.00, but the position is short over 2500 deltas. The trader decides that he or she should cover another 2500 shares of stock for 35.06. The trader is now long 5500 shares of stock against being short 100 of the 35 calls.

On June 15th Mrk is up another .50.

The speculator is has now turned 2300 dollars into 6300.00. That is a return of just over 270%. Not bad, if this trader didn't exist in my imagination, he or she would be vacationing in Bimini or Aruba. Heck, this trader does this a few more times; he or she can simply buy an island.



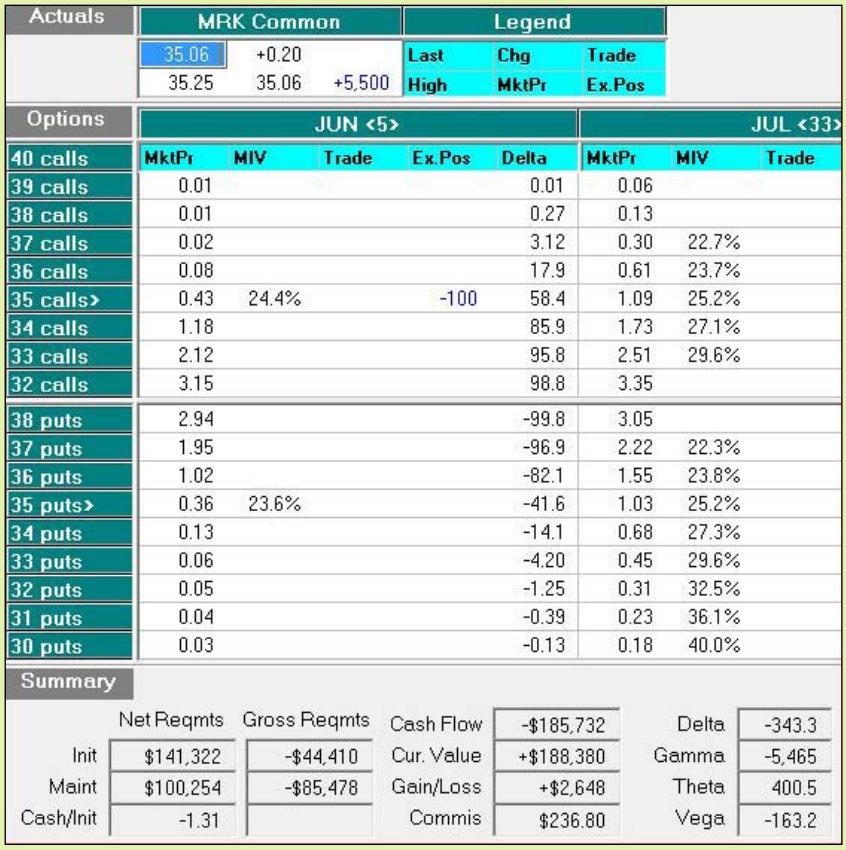
Actuals	MRK Common			Legend		
	34.33	+0.80	+1,500	Last	Chg	Trade
	34.37	34.33	+1,500	High	MktPr	Ex.Pos

Options	JUN <17>					JUL <45>		
	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade
38 calls	0.02				4.33	0.27	24.9%	
37 calls	0.09				14.0	0.49	25.7%	
36 calls	0.32	23.4%		-100	32.8	0.84	26.8%	
35 calls	0.82	26.0%			56.0	1.33	28.4%	
34 calls>	1.55	28.7%			85.5	1.97	30.4%	
33 calls	2.45				94.7	2.73	32.7%	
32 calls	3.40				98.0	3.60		
31 calls	2.14	22.6%			-86.0	2.51	25.2%	
36 puts	1.33	23.2%			-67.2	1.87	26.5%	
35 puts	0.76	25.1%			-44.0	1.36	28.2%	
34 puts>	0.43	28.4%			-24.9	0.98	30.0%	
33 puts	0.24	31.8%			-13.6	0.72	32.5%	
32 puts	0.16	36.8%			-7.78	0.53	34.8%	
31 puts	0.11				-4.54	0.39	37.6%	
30 puts	0.09				-2.73	0.31	40.9%	
29 puts								

Summary of ☐ Existing ☐ Trades ☑ Both

	Net Reqmts	Gross Reqmts	Cash Flow	-$98,034	Delta	-284.1
Init	$117,627	$19,592	Cur. Value	+$48,145	Gamma	-2,281
Maint	$95,551	-$2,483	Gain/Loss	+$1,643	Theta	212.0
Cash/Init	-0.83	-5.00	Commis	$199.37	Vega	-252.5

Figure 3



Actuals	MRK Common			Legend		
	35.06	+0.20		Last	Chg	Trade
	35.25	35.06	+5,500	High	MktPr	Ex.Pos

Options	JUN <5>					JUL <33>		
	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade
40 calls	0.01				0.01	0.06		
39 calls	0.01				0.27	0.13		
38 calls	0.02				3.12	0.30	22.7%	
37 calls	0.08				17.9	0.61	23.7%	
36 calls	0.43	24.4%		-100	58.4	1.09	25.2%	
35 calls>	1.18				85.9	1.73	27.1%	
34 calls	2.12				95.8	2.51	29.6%	
33 calls	3.15				98.8	3.35		
32 calls	2.94				-99.8	3.05		
38 puts	1.95				-96.9	2.22	22.3%	
37 puts	1.02				-82.1	1.55	23.8%	
36 puts	0.36	23.6%			-41.6	1.03	25.2%	
35 puts>	0.13				-14.1	0.68	27.3%	
34 puts	0.06				-4.20	0.45	29.6%	
33 puts	0.05				-1.25	0.31	32.5%	
32 puts	0.04				-0.39	0.23	36.1%	
31 puts	0.03				-0.13	0.18	40.0%	
30 puts								

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$185,732	Delta	-343.3
Init	$141,322	-$44,410	Cur. Value	+$188,380	Gamma	-5,465
Maint	$100,254	-$85,478	Gain/Loss	+$2,648	Theta	400.5
Cash/Init	-1.31		Commis	$236.80	Vega	-163.2

Figure 4

Our market maker is now short another 2000 delta, and while the position is up almost 3k, the professional cannot risk being short 2k delta. The trader decides to buy another 1500 deltas. [A different trader might decide that downside risk is high and take profits rather than add to this risk]

On June 17th, the day before Expiration, the speculator decides to close the position. Selling the calls at .87. The trader has now made 8700.00 on an investment of 2300. That is a phenomenal return of 378%. I think this trader deserves a vacation.

At the same time our professional has a cool profit of just under 3200 dollars. The professional buys the calls at .87, losing 6400 dollars on the calls. However, with 4 stock buys, one of 32.33, another of 34.59, another for 35.06, and another for 35.49, the trader made almost 10,000 dollars on the stock.

Close Trade

After completing this exercise could there be any argument that options are NOT a zero sum game? Traders are always picking one angle or another to approach trading. Thus, while the speculator may be right or wrong,, when a market maker takes the other side of the trade, the professional is not hoping the speculator loses. In fact, it may be just the opposite. After all, who doesn't like it when everyone is a winner?

Actuals | MRK Common | Legend

35.48	+0.46	+1,500	Last	Chg	Trade
35.53	35.48	+5,500	High	MktPr	Ex.Pos

OptionVue

Options	JUN <4>					JUL <32>		
40 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade
39 calls	0.01				0.01	0.06		
38 calls	0.01				0.33	0.15	20.9%	
37 calls	0.02				4.83	0.35	21.3%	
36 calls	0.10				28.1	0.71	22.5%	
35 calls›	0.63			-100	75.6	1.27	24.3%	
34 calls	1.52				93.1	1.98	26.3%	
33 calls	2.49				98.1	2.80	28.7%	
32 calls	3.50				99.4	3.70		
38 puts	2.53				-99.7	2.66		
37 puts	1.54				-95.2	1.87	21.4%	
36 puts	0.63				-71.9	1.24	22.8%	
35 puts›	0.15	23.1%			-24.4	0.79	24.4%	
34 puts	0.06				-6.88	0.51	26.6%	
33 puts	0.04				-1.95	0.33	29.3%	
32 puts	0.03				-0.61	0.23	32.3%	
31 puts	0.03				-0.22	0.17	35.9%	
30 puts	0.02				-0.09	0.14		

Summary of ☐ Existing ☐ Trades ☑ Both

	Net Reqmts	Gross Reqmts	Cash Flow	-$238,989	Delta	-555.6
Init	$154,025	-$84,964	Cur. Value	+$188,690	Gamma	-2,941
Maint	$101,310	-$137,679	Gain/Loss	+$2,958	Theta	439.6
Cash/Init	-1.55		Commis	$259.24	Vega	-130.7

Figure 5

Follow
That Trade

Mark Sebastian

We at *Expiring Monthly* thought it would be fun to trade an expiration straddle. The only way I could come up with a way to make the trade more fun would be to make it an earnings/expiration play. There are very few opportunities to get a pure earnings play. For this to happen the underlying must announce earnings on Thursday afternoon or Friday morning, expiration day. GOOG famously does this three quarters per year. So does General Electric.

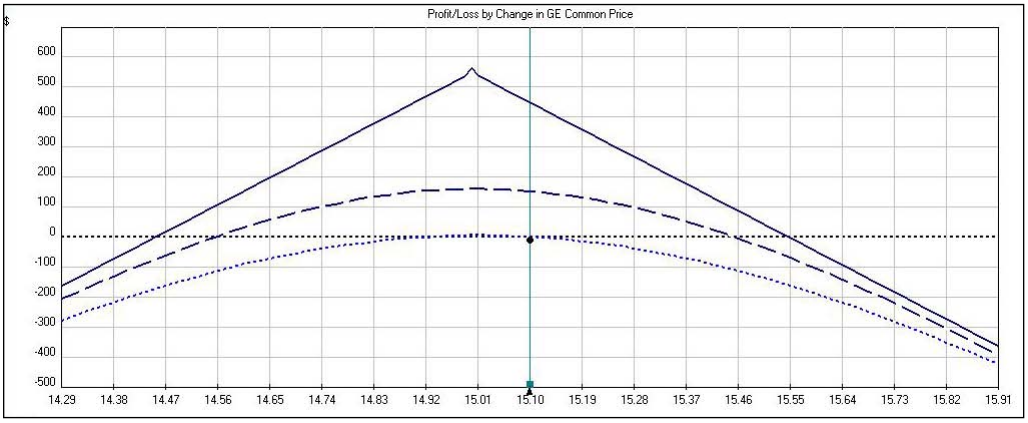
When I was a trader on the American Stock Exchange, I traded GE in the pit. I always liked to sell premium. Well, a client of mine at Option Pit had the same idea. Yesterday he sold the GE July 15 straddle and collected a net of .56 cents.

	Date	Time	Code	Qty	Symbol	Type	Price	Commis	Net	R	Desc	Asset File
1.	01/01/03	12:00	Dep						50,000.00	ø		
2.	07/15/10	14:30	Sel	10	GE 10G15	O	0.32	0.00	320.00	ø	GE Jul15 calls	GE.STK
3.	07/15/10	14:30	Sel	10	GE 10S15	O	0.24	0.00	240.00	ø	GE Jul15 puts	GE.STK

With the stock trading 15.10.

GE Common	
15.10	-0.10
15.20	15.10

The risk is obviously a big surprise move in General Electric. When GE opened Friday morning, if the stock was more than ~50 cents away $15.00 he was almost certainly going to be a loser.



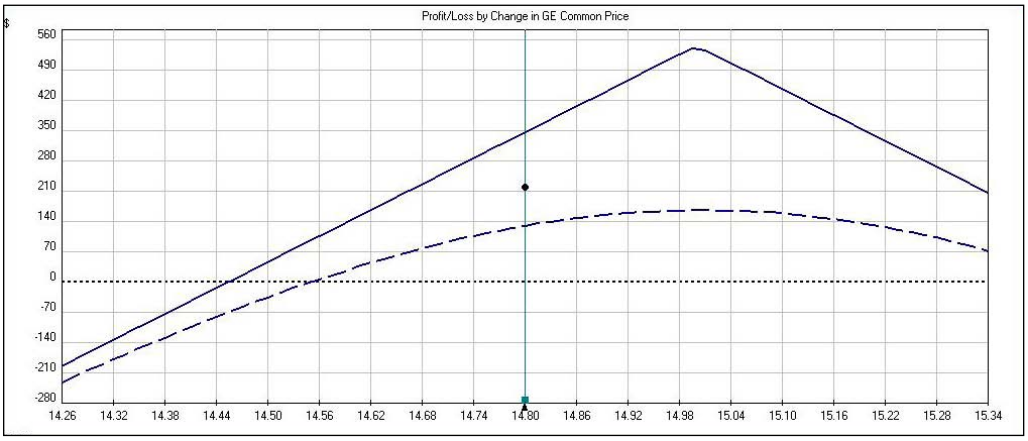
While the position has the Greeks below, he need not be concerned with the Greeks because he has predictable and limited risk. If GE moves less than .50 he should be a winner; if it moves

more than .50, he would probably lose. As luck would have it, GE did nothing on earnings. The stock was trading at 14.80.

Delta	-138.5
Gamma	-1,197
Theta	130.0
Vega	-8.78

GE Common	
14.80	-0.45
15.06	14.80

The straddle completely collapsed, the trade earned more than 200 for the 10-lot straddle. Traders should know better than to hold in a situation like this. The calls are worthless and the puts basically represent the same profit and loss as the movement in the stock. If you think GE is going to rally from here, buying the stock makes more sense than holding onto a winning short straddle position like this one.



The trader closes the trade, paying ~0.36, walks away with 200 bucks in his pocket and grabs a sandwich. The way trading should be.

	Date	Time	Code	Qty	Symbol	Type	Price	Commis	Net	R	Desc	Asset File
1.	01/01/03	12:00	Dep						50,000.00	ø		
2.	07/15/10	14:30	Sel	10	GE 10G15	O	0.32	0.00	320.00	ø	GE Jul15 calls	GE.STK
3.	07/15/10	14:30	Sel	10	GE 10S15	O	0.24	0.00	240.00	ø	GE Jul15 puts	GE.STK
4.	07/16/10	09:00	Buy	10	GE 10G15	O	0.05	15.00	-65.00		GE Jul15 calls	GE.STK
5.	07/16/10	09:00	Buy	10	GE 10S15	O	0.26	15.00	-275.00		GE Jul15 puts	GE.STK

The Impact of Retail Traders on Option Volatility

Jared Woodard

The last decade has seen a dramatic surge in the participation of retail traders in options markets. While several recent academic papers have examined the impact on individual stock returns of participation by retail traders, "Retail Clientele and Option Returns" (Choy [2010]) is the first to consider the impact of retail traders on option volatility. Choy's thesis is that "retail investors may be willing to pay a lottery premium on the volatility component of options, leading to overpricing of options with high retail trading activities." Heavy speculative trading may have effects on both the stock price and option volatility, so in order to isolate the volatility effect, Choy focuses on delta-hedged option returns for the stocks identified as having a higher proportion of retail trading activity. The results are significant:

> A higher RTP [retail trading proportion] is found to be related to lower future delta-hedged option returns, and the phenomenon is more pronounced before earnings announcements, indicating that retail investors in general speculate in the option market and the behavior is more pronounced before scheduled information events. In particular, one standard deviation increase of RTP results in approximately 13.5% lower annualized delta-hedged option returns. (2)

To clarify: consider two hypothetical stocks with liquid, actively traded options: ZZZ is mostly ignored by retail traders, while the options of YYY have a high proportion of retail participation.[1] ZZZ and YYY are otherwise very similar – they're in the same industry, have the same growth prospects, etc. This paper suggests that, in the days leading up to major news events for those stocks, we should expect the YYY options to be bid higher in implied volatility terms. A trader who buys out-of-the-money (OTM) calls on each stock and hedges the delta exposure daily will earn lower returns for YYY – the heavily retail-traded options – than for its unloved counterpart.

Before considering ways to take advantage of this apparent mispricing, we should first ask whether the premium identified is significant, over and above the variance risk premium – i.e., the premium investors generally pay above the fair value of options in order to protect against the variance of returns.[2] Choy examines this possibility, and concludes that retail trading still has a statistically significant effect on option prices even after controlling for the variance risk premium.

The natural response, then, would be to pursue a contrarian approach to retail sentiment, selling options on stocks with high RTP and delta-hedging periodically. We can wonder, in fact, why such a large mispricing would be allowed to persist. Choy concludes that limits to arbitrage prohibit profitable exploitation of the anomaly: commissions and bid-ask spreads, along with the costs incurred from delta-hedging, would consume a meaningful portion of the expected return.

I don't think that the existence of transaction costs renders the effects of retail options trading irrelevant, however. There are several ways that a high proportion of retail trading may be of interest to other traders. First, an investor seeking exposure to some particular sector might do well to avoid options on high-RTP stocks in favor of other issues, at the very least to reduce the expected variability of returns. Second, I wonder whether alternative approaches to delta hedging would render an arbitrage strategy more successful: the study here involves daily rebalancing of a hedge against short one-month options, and I

wonder whether structuring the hedge around changes in delta and/or gamma would be more economical. Finally, traders who are already employing strategies to capture the variance risk premium in equity options could consider targeting stocks with high RTP. Since they are net sellers of options in any case, it seems intuitive to be short those options with the maximum premium above fair value. The premium contributed by speculative retail traders may not be economically attractive on its own after transaction costs, but may still be attractive in conjunction with other arbitrage opportunities.

[1]"Retail trading proportion" is defined as the proportion of trades in a stock in a given month with a dollar volume less than or equal to $5000; this metric has been used in several prior studies, including Barber (2009) showing that it served as a successful proxy for the activity of individual investors.

[2]See Carr and Wu (2009).

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Adjustment Trading

No Fixed Positions!

Tyler Craig

In helping bring order to the options market, most educational texts divide the various option strategies into separate categories. Some separate them based on whether they are designed to exploit volatility, stock direction, or time decay. Of course, some option strategies can be largely affected by two or even all three variables and thus may fall under multiple categories.

Perhaps the most popular distinction between option strategies is whether they are directional or non-directional. Since traders like to play to their strengths, those feeling they have a knack for chart reading and forecasting price direction are instinctively going to lean towards directional strategies. On the other hand, those a bit more ambivalent towards technical analysis may feel more comfortable dabbling with non-directional strategies. Over time, as traders experiment with both types of strategies, they will likely realize their individual risk tolerance and psychology is more in harmony with one approach over the other.

The Non-Directional Approach

A peek into the typical non-directional trader's toolbox is likely to reveal strategies such as condors, calendars, naked puts, and covered calls. Suppose we built a trading model using one of these strategies, such as the condor. If we used wide, high probability condors what type of outcome might be expected? Well, as is the case with just about any high probability trading strategy, we would experience more winning trades than losing trades. Suppose it comes out to a 70% win ratio.

At face value most traders are attracted toward higher probability trades because they like the idea of winning more times than they lose. Though this view is certainly understandable, keep in mind the markets aren't known for doling out freebies. In college I had an Economics professor whose favorite phrase was, "There's no such thing as a free lunch." Such is true in economics; such is true in the financial markets.

High probability trades don't offer something for nothing. While the number of wins versus losses looks appealing, an assessment of the average gain versus loss yields a more complete picture of this approach. With condors the typical loss can easily dwarf the typical gain. Although most non-directional strategies can provide long strings of winners, don't let multiple wins lull you into a false sense of security. When the market finally does move adversely, condors can amass losses very quickly. Complacent condor traders face a rude awakening if they lack strategic risk management techniques.

As with any strategy your long term success isn't so much reliant on what you do with your winners, but rather how you manage the losers.

The Directional Approach

Admittedly non-directional trading isn't for everyone. For starters, some traders feel they have an edge in forecasting price direction. Perhaps they have a few tried and true chart patterns that aid in betting correctly which way the market will move. They may also be put-off by the inability to hit the occasional home run with non-directional trades as most offer limited rewards. A glimpse into their toolbox may reveal numerous strategies such as calls, puts, and directional spreads.

If we built a trading model involving the purchase of straight call and put options, what type of outcome might we expect? The expected win ratio is likely quite a bit less than the condor. Let's say it's only 40–50%. While the smaller winning percentage may not instill much confidence, unlike condors, long options have unlimited rewards, making it easier to accumulate larger gains. Provided you rack up large enough gains, you may still achieve long term profitability despite the lower win ratio.

In my experience the difficulty with using calls and puts in the directional approach is two-fold. First, it's often difficult to minimize losses because options can be quick to punish when the market moves adversely. Second, it's difficult to rack up sufficient profits on the occasional winners to offset the losers. This may be because the stock doesn't move as much as expected or because you exited to quickly lock in profits.

When attempting the occasional long option trade, I've found increased success when using various adjustment techniques. While minimizing losses certainly deserves attention, today's focus will be on using adjustments to better maximize one's gains.

Adjustment Trading

The adjustment trading philosophy helps a trader adapt to changing market conditions. Because markets rarely move straight up or down in an orderly manner, traders who maintain a flexible approach are better equipped not only to survive, but thrive. The two primary objectives of adjusting are *locking in gains* and *reducing risk*.

Using adjustments effectively requires a basic knowledge of risk graphs. These graphs can be a very useful tool to model various adjustments and determine which offers the best outcome.

Let's explore how adjustment trading works using a long call option example. Suppose on June 9th, we decided to play the breakout in NFLX over $115 by purchasing an at-the-money July 115 call option for $9.80. Take note of the risk and reward displayed in Figure 1. A few short days later with NFLX trading at $126, our long call option had risen in value to $16 giving us a nice $620 unrealized profit. At this point we're faced with the fortunate dilemma of either selling the call option to lock in profits or letting it ride.

The beauty of the adjustment trading philosophy is that it provides a nice compromise to said dilemma. We can make a trade adjustment capturing some of the gains while still leaving ourselves open to additional profits. Instead of exiting the 115 call option, suppose we sell the Jul 125 call for $10 creating a Jul 115–125 call vertical spread. The premium received from the 125 call is more than sufficient to pay for the 115 call, our maximum risk of $980 turns into a minimum reward of $40. As a trade-off for eliminating the risk, we capped the maximum reward at $1040 (see Figure 2).

By rolling our long call position to a call spread we've succeeded in capturing gains and reducing overall risk. Not only were we able

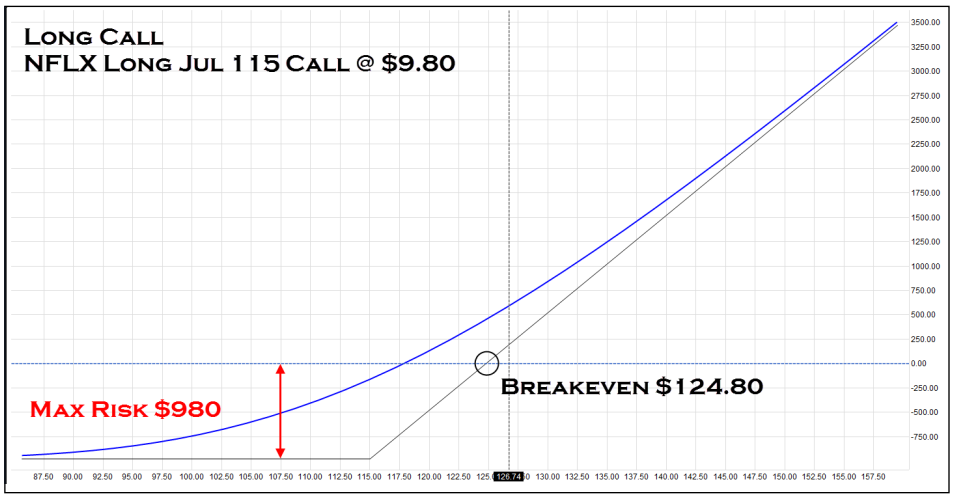

Figure 1

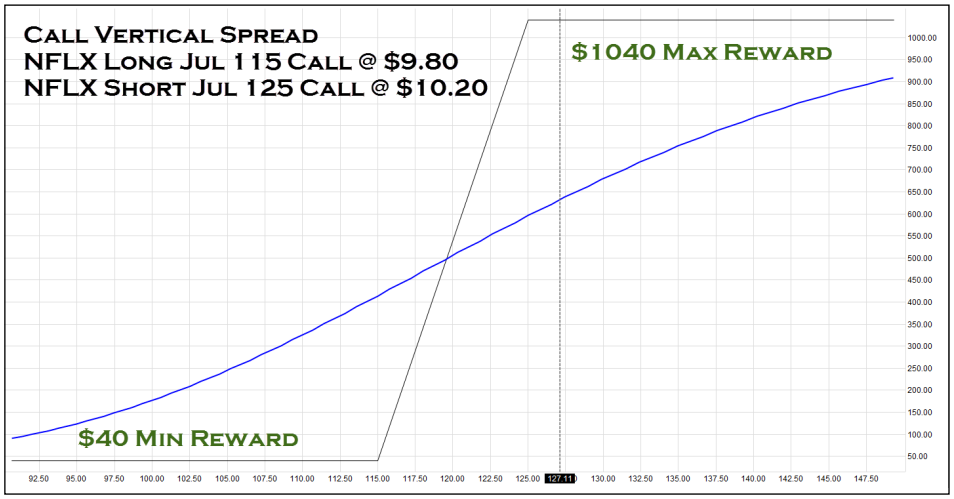

Figure 2

to reduce risk, we were able to eliminate it completely. Though we can certainly give back accumulated profits, our original risk capital has been taken off the table.

Now suppose over the next week NFLX stalls out in the $126 area and we become a bit more neutral in our outlook. Might we be able to make one more adjustment to capture further gains and shift the risk graph to yield higher returns at current prices? You betcha! Suppose we roll the long call spread into a condor by adding a short call spread with higher strikes. Let's sell the July 135–145 call spread for $2.70. Consider the new position in Figure 3.

The $270 credit received from shorting the call spread increases our minimum reward to $310. In addition, our maximum reward has also increased to $1310. Notice how both adjustments (long call to call spread, call spread to condor) accomplished the two key objectives of adjustment trading – locking in gains and reducing risk.

Decision Trees

In adopting the adjustment trading philosophy, there are various adjustments traders must a trader must learn. As a precursor to understanding how to adjust one position to another, you must first understand each position individually. After all, it's going to be quite difficult to rol a call spread to a butterfly if you're not up to speed on how a butterfly is structured. To better grasp the mechanics of each, take the time to paper trade them individually until you feel confident. Afterward you'll be much better equipped to use them in your adjusting.

To bring more consistency to the adjustment trading arena, decision trees serve as an effective tool for outlining your trading plan. They offer the ability to model potential trade adjustments based on changes in the underlying market. In the tree highlighted in Figure 4 I've displayed the typical trade adjustments for profitable long call positions. T1 represents the original trade, while T2 and T3 represent secondary and tertiary adjustments. The beauty of the decision tree lies in its flexibility, as it allows users the ability to create very simple, or largely complex models. Were we to display a more complex tree, we could have outlined potential adjustments worth considering if the stock dropped in value.

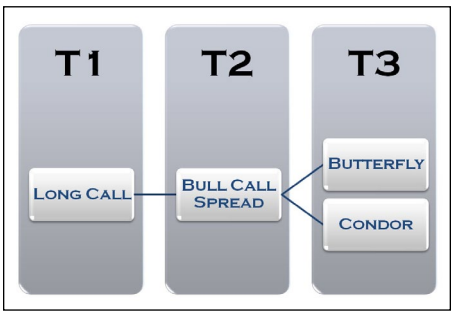

Figure 4

Perhaps an appropriate motto for this style of trading is **No Fixed Positions**. Rather than treating option trading as a static, rigid endeavor where we enter a position and ride it to the end, we're continually fine tuning our position to capture gains while leaving ourselves open to further profits. The ultimate goal of this approach is to increase our likelihood of long term trading success.

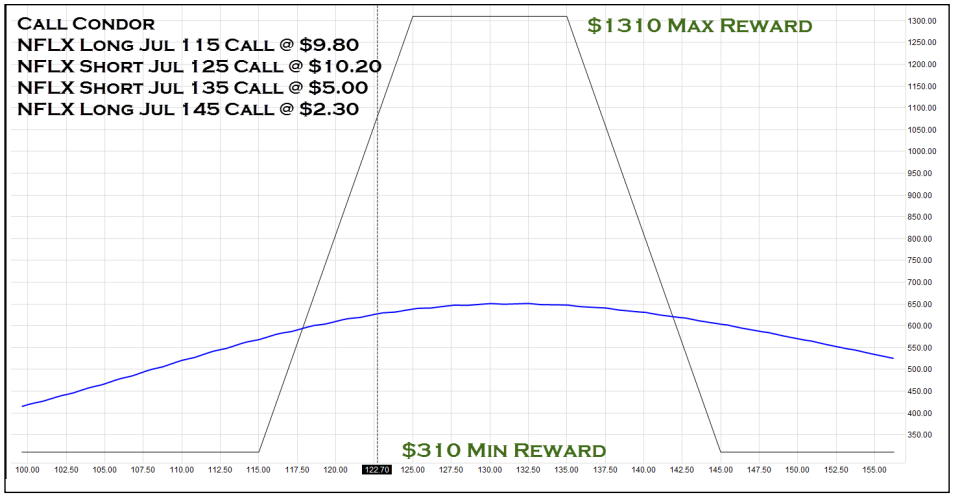

Figure 3

Tyler Craig is president of TC Trading, Inc. He has personally coached hundreds of traders over the years through his contract work with one of the nation's leading educational firms. He is an avid writer and current monthly contributor to the Wealth Intelligence Magazine. In 2009 he began his venture into the blogosphere by starting Tyler's Trading, where he can be found giving daily market commentary for stocks and options.

An (Almost) Free VIX

Disaster Protection Play

Bill Luby

In the options world, you never get something for nothing. The trick is to find a trade with a risk-reward profile which justifies a trade based on your expectations concerning future price movements. Particularly when your view of the future is at odds with what the market is doing.

Lately I have been hearing from quite a few traders who are convinced that between the European sovereign debt crisis, a slowdown in China, and a potential double dip in the United States, equities are overpriced and VIX is underestimating the magnitude of the challenges ahead.

With the VIX under 25 at the moment, and at the bottom of its ten week range, quite a few traders are looking at a speculative volatility play in the event we see another large VIX spike. Another group of traders is in search of a volatility trade that provides a hedge for long positions, in the event of a sharp downturn in stocks.

Two of the most popular alternatives have significant shortcomings. Buying an out-of-the-money VIX call subjects the position to considerable time decay, with VIX implied volatility in the low 90s. Another popular long volatility play is the iPath S&P 500 VIX Short-Term Futures ETN, which is better known by its ticker, VXX. The problem with a VXX long position right now is that the underlying VIX futures are currently in an extreme contango* situation, which is bringing a substantial negative roll yield into play.

Thinking out of the box a little, I have an idea for a trade that has the potential to pay off handsomely for those who wish to speculate on a VIX spike. It also serves as a disaster hedge of sorts. It is a VIX call backspread using out-of-the-money options for both the short and long legs. This trade can easily be structured to earn a profit should the VIX decline, move sideways or increase by a small amount. Further, should gathering storm clouds cause the VIX to spike back into the mid-40s or higher, this trade would begin to show a significant profit.

Figure 1 shows a snapshot of one possible VIX call backspread (data from the end of July 14th session). With the VIX at 24.89, the trade is to sell one slightly out-of-the-money VIX September call and use the proceeds to buy two less expensive out-of-the-money calls at a higher strike. In the example below, one VIX September 25 call is sold for $7.20 and two VIX September 35 calls are purchased for $2.95 each, for a net credit of $1.30.

The blue line shows the profit and loss at expiration; the green line shows the profit and loss one week after the position has been opened. Note that if the VIX is below 25.00 at expiration, all calls expire worthless and the $130 is retained. The position also makes money if the VIX is higher than 43.70 at expiration, earning $100 per point over 43.70. The worst-case scenario occurs when the VIX rises, investors fail to panic, and the VIX finishes near 35.00. The maximum loss is $870, as shown in the table to the right.

In summary, this position is ideal for a black swan scenario or an environment in which volatility expectations decline or remain relatively steady. Something short of a black swan – call it a dark gray swan – could turn out to be problematic.

In a sense, the key to the VIX call backspread is being able to estimate where there may be a tipping point. One can argue, for instance, that a VIX spike below 35.00 will not generate much fear, resulting in the VIX falling back down into the 20s. On the other hand, a VIX spike back above 40 or 45 could cause the type of panic that pushes the volatility index into the 50s. Figure 2 below assumes a log-normal distribution for future VIX prices. If an investor

believes there is a tipping point, the ideal position is constructed where the trough of the V in the profit and loss graph sits right over the anticipated tipping point.

In order to ensure that the upper break-even point (43.70 in this example) is not unrealistically high, it is preferable to initiate the VIX call backspread when volatility expectations are relatively muted – such as now, when SPX has rallied for six consecutive days. The ratio in the example above is 2:1, but traders can use 3:2 or any other ratio. The goal is to break even or make a small profit when volatility does not rise, while ensuring that the upper profit zone is not unrealistically high.

Additionally, traders who can use options that do not expire for at least 2–3 months get a longer life out of the hedging aspect of this trade. Note that I am using the term 'hedge' loosely here. The call backspread is much more of a speculative trade than a hedge. It will not limit losses on a dollar for dollar basis and does not provide protection against moderately large increases in volatility. Instead, this is a disaster protection play.

In terms of exits and adjustments, the green line in Figure 1 confirms that the call backspread does much better if the volatility spike comes shortly after the trade is initiated (backspreads are negative theta positions). In addition to closing the entire position when VIX rises, another alternative is to sell one of the long calls to transform the position into a bear call spread.

Ultimately the beauty of any call backspread is that the unbalanced legs allow a trader to own calls for free and turn those surplus calls into substantial profits – should the underlying make a sharp upside move. The risk for such a position, while limited, can be substantial. When a trader is able to identify an appropriate tipping point, and steer clear of gray swans, a VIX call backspread can be a powerful speculative play *and* a helpful disaster hedge.

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* Contango: Contract month pricing situation in which future prices get progressively higher as contract dates get progressively longer, creating negative spreads as contracts go further out. The increases reflect carrying costs, including storage, financing, and insurance.

Figure 1 – VIX Call Backspread, Basic Profit & Loss Diagram, 7/14/2010

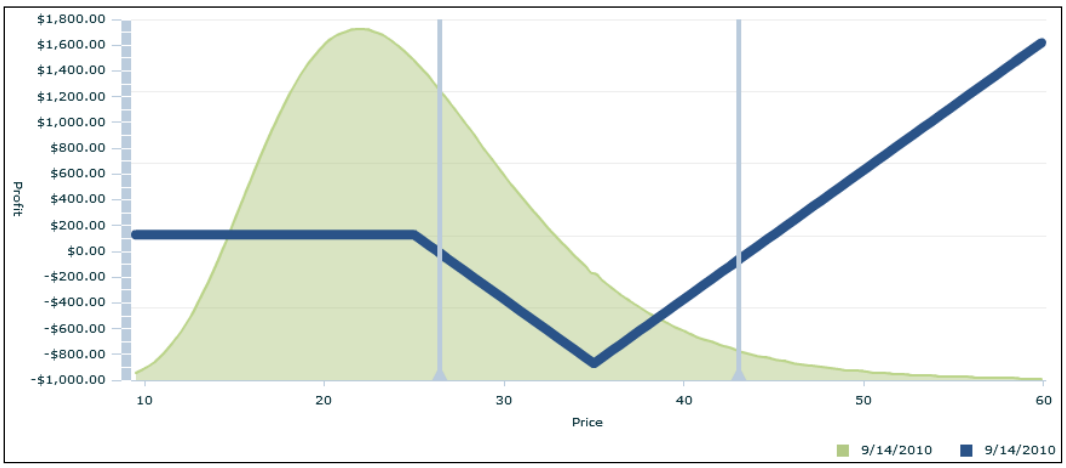
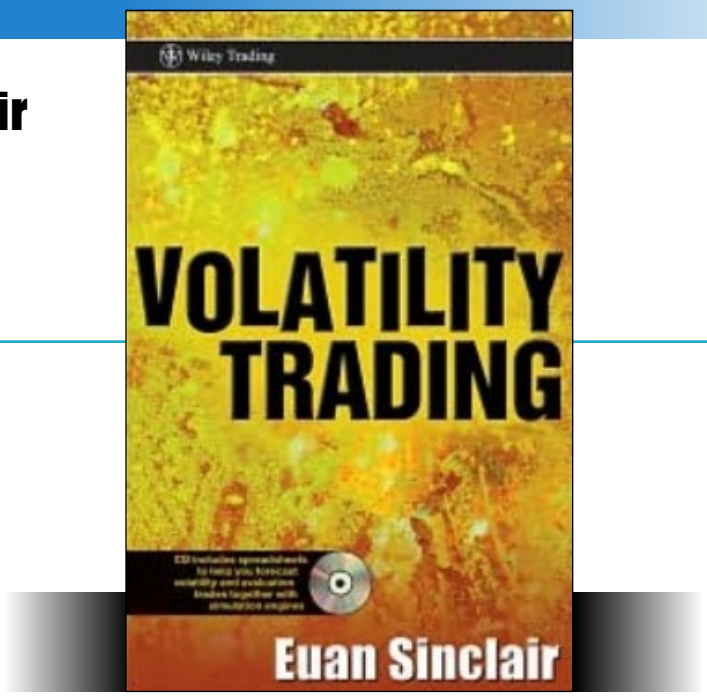


Figure 2 – VIX Call Backspread, Basic Profit & Loss Diagram, 7/14/10

Volatility Trading by Euan Sinclair

Book Review

Mark D Wolfinger



The most obvious feature of *Volatility Trading* is that it is not for the mathematically unsophisticated. Sinclair holds a PhD in theoretical physics and he trades self-designed quantitative models. That may make the book difficult to follow for many readers (alas, I am included in that group because my advanced math training ended in my junior year when I chose chemistry over math), yet his conclusions are worthy of discussion.

As indicated by the title, this book covers the idea of trading volatility, and to do that one must have (or develop) the ability to forecast future volatility. Sinclair teaches that the idea of trading is to generate profits when your forecast volatility more accurately reflects realized volatility than does current implied volatility. The goal is to concentrate on the edge that your forecasting abilities provide and the purpose of hedging is to eliminate profit and loss associated with other factors. NOTE: His play is: Trade volatility forecast, neutralize all other risk.

This idea is certainly foreign to beginners, but if you have ever made a 'volatility play' by taking a position that is long or short vega, then you traded volatility. Sinclair prefers to trade volatility in its purest sense and that requires hedging (reducing risk). He reminds readers that if they are taking directional bets on the underlying, that they are not hedging.

To make volatility trading even more complicated, profit and loss is very path dependent (It's not just the final result that matters, but how we get there). Thus, being correct in the volatility forecast is not sufficient to guarantee profits.

Sinclair does not provide 'trading rules.' He believes in education through the learning of general principles. That makes sense to me. He also goes out of his way to mention that markets are not easy to beat.

He begins by discussing how options are priced. He draws our attention to some of his main conclusions:

- The Black-Scholes (or any) model is used to find trades. It is not used to control risk
- The pricing model is not intended to reflect reality. It's a "framework to think within and a consistent intellectual backdrop that helps us build intuition."
- Measuring and forecasting volatility is essential when trading options.
  - It's best to use a variety of forecasting models because none is 'best.' Be aware of the benefits of each method
  - Choose a relevant time period. Some data is too old to be relevant, but using too few data points is inefficient
  - Always look at the broad market when deciding whether the specific implied volatility being studied is reasonable. Consider the state of the market

One obvious sound piece of advice that is too often ignored: "Be selective. Wait for an edge."

The trader must be aware of realized volatility and implied volatility (IV)

because it is the spread, or difference, between these two that provides the edge for the volatility trader. The most important IV level to watch is that of the ATM (at the money) options.

Sinclair reminds us that volatility is mean-reverting and offers a mathematical guide for taking advantage of that information. In the simplest (far too simple to trade this way) form, the message is 'when in trouble, double.' Simply stated, when the odds of winning improve (that occurs when the original trade is losing money), add to the position.

However, doubling-up is not the solution and he discusses sizing positions and how to add to the original trade. For the unsophisticated, doubling bets is a dangerous play. A good understanding of when and how to increase position size is essential for the successful trader. Sinclair does acknowledge that this is a very aggressive money management scheme.

Recognizing the importance of money management and the sizing of trades, some of Sinclair's advice (sometimes at variance with conventional wisdom) is:

- Don't choose a random money management scheme. Be clear on what the trader is trying to accomplish
- When you have more edge, trade bigger size
- When there is more uncertainty, trade smaller
- Exit a trade when you are wrong, not at some arbitrary price point
- Size: Profit should be large enough to mean something, but not so large that a loss can be catastrophic

Sinclair believes in record keeping, stating: It is impossible to improve if you don't know how good you are and what areas need improvement.

He also recognizes the importance of paying attention to certain psychological factors. As a result, he provides a short list for traders, including: 'Don't trade too often or too big and 'know where your edge is coming from.' He mentions the importance of making serious attempts to learn all that you can learn about trading. I know I've been guilty of ignoring that guideline.

Sinclair's summary is that successful trading is all about developing a consistent process. It's tempting to jump from one idea to another, but his suggestion is:

- You must have a goal.
- You must find trades with edge.
- You must size each trade correctly.
- Everything else must be done within this framework.

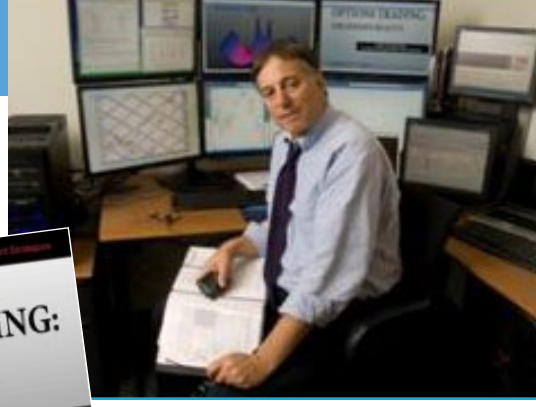
This book contains much good advice. To get the most out of the discussion requires following along with the math. However, the discussion affords a great deal of insight. I strongly recommend this book, with the caveat that it does contain more math than the average investor can readily understand.

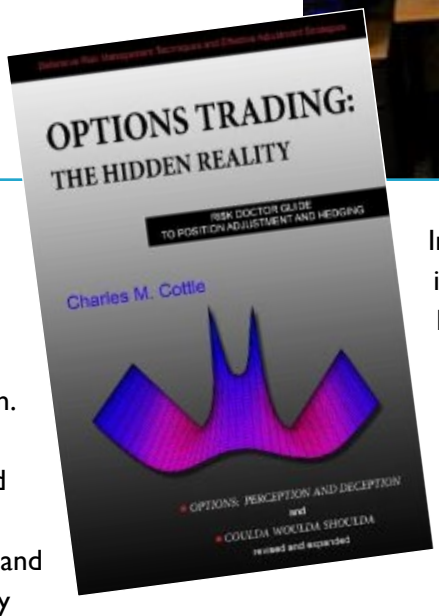
Also by Euan Sinclair: *Option Trading: Pricing and Volatility Strategies & Techniques*

Consider Options for Rookies to be your blog. Submit questions; suggest topics; start a debate

Expiring Monthly Interview with
Charles Cottle

Mark Sebastian





We are here with my new friend Charles Cottle (author of *Options Trading: The Hidden Reality* and *Options: Perception and Deception*).

Expiring Monthly: I am interested in how you teach gamma scalping. It is definitely different. You teach that when a stock rallies you can sell deep ITM calls, and buy twice as many out of the money calls. I find that to be interesting. I always take the approach of trying to trade different call spreads and turning positions into butterflies. I had never seen someone sell a deep call and buy twice as many longs.

Charles Cottle: It's a big, bad back spread for credit. On its own, it's a horrible trade. When it's an adjustment to take care of long deltas as a gamma scalp, it's really cool, especially in a market that keeps going up. Most of us who gamma scalped learned to sell or buy stock or futures to offset the generated deltas. That has the effect of losing units. If you keep doing it, you turn calls into synthetic puts every time you sell stock. Eventually you are just long many worthless puts. [To make money] your average sale price of the stock has to be enough to overcome the cost of the original straddle investment. Usually it is hard to make back that cost unless you are catching a lot of up and down gaps, and that does not happen very often. What my friend Tony Saliba would do is a big back spread for credit and buy twice as many options as he sold. That gained units.

EM: What caused him to do the deep option as opposed to selling stock against it?

CC: Selling stock would lose the units (net options). Teledyne (the stock he traded) kept going. He parlayed this into more and more long units. In an extended move, if you adjusted with stock you would come out of the month frowning, whereas he was wealthy because of it. He was adding net units long.

EM: Tell me about how you got onto the floor.

CC: I was an accountant at a family firm started by my grandfather. I tried it for a year and then gave them a year's notice after I met somebody on the floor. I went to free seminars given by O'Connell & Piper and got the fever. I raised some money, got a seat right away, and ran out of money in 6 months.

Instead of going back into the family business, I continued to work on the floor by getting a job as a clerk.

I predicted what happened to GM, but was 30 years too early. The calls I sold did not go out worthless. I did. As I was buying back those worthless calls for $1, after selling for almost nothing, I saw the other guys buying those calls were not panicking like me. They were just lining up to get their fair share and turning around and waving something [orders to short stock vs. the calls they just bought].

I always had the attitude that we're the smart money and the customers are the dumb money. I was the dumb money and I wanted to learn to be the smart money and take the emotion out of trading.

They were doing stock against everything. I never did stock against anything. 99% of what a market-maker does is against the underlying. When all these trades are going on, they automatically do the hedge. Every trade is a delta-neutral synthetic straddle (long or short). Market makers try to maintain delta,

vega, gamma, theta and neutral to the skew.

EM: When did you end up leaving the floor?

CC: In 1985, I went over to the CME and traded in every pit before putting a trader in each of those pits. I traded the position, and then handed him my position to manage. That lasted until one of my off-floor traders put on a big ratio spread [selling units] in the bonds right before the 1987 crash which put an end to that whole thing. It was a nightmare. I got through it and it was a blessing in disguise because my life got really good. I went back to trading in the CME, just myself.

Soon after, I hung up my trading coat for good and started traveling around the world teaching and writing. I've had a really great life ever since. I wrote my first book because I thought there would be a lot of derivative debacles like we're experiencing now, and I'd be the go-to guy to get people out of trouble. I didn't know that companies would call Morgan Stanley or Goldman Sachs and sell the positions for $0.10 on the dollar [rather than call on me]. That business never grew.

However, soon I wrote a business plan and it turned into thinkorswim. We started to build the platform in 1999. It took us a couple of years to build the platform and I stayed on until 2003.

EM: What are your thoughts on why 2008 happened, and, more importantly, what permanent changes are going to happen in the market because of what happened?

CC: We won't be able to use our houses as an ATM machine anymore. That's why the housing market is going to be in a fickle. Consumerism and businesses aren't going to do as well. That's a major problem. We're not the only ones suffering from it. It's a worldwide phenomenon. We were the ones who got credit cards mailed to us every other week at 0% interest (to start). That was crazy in the minds of Europeans in the 1990s, but it wasn't crazy after 2000. It was normal. Everybody is in hot water with that.

AIG was the other thing that put me out of business as the derivatives debacle go-to guy. AIG insured everything. Moody's AAA rating and S&P AAA rating was all a big ponzi scheme.

Also, the salaries of all the traders changed. I was in Germany and the traders are making $90,000 per year and they couldn't believe guys in London and New York could make millions. All of a sudden, in 1995, the whole thing changed. The culture changed and that culture spiraled into these crazy salaries and bonuses.

There were always discretionary bonuses when I was going through it, and I hated that deal. If some guy lost money on another side of the bank, I wouldn't get my bonus. There was so much fat and fees because they started to develop all these new products. I remember the first products they were starting to sell. It would be some clouded, nontransparent way of tying performance to the stock market in some kind of zero interest bond.

I personally don't think we should have rallied like we did. The entire stimulus was crazy. I voted for Obama. I thought he was great and was looking for change. I think he got to Washington and the door closed in the Oval Office and there were a bunch of old white guys sitting in there who said, "Welcome to the presidency. Now, you can sing your songs about the environment and health care but this is the way it's gonna be…" He seems powerless against Goldman Sachs and all Wall Street/Treasury guys. They have an agenda and are used to getting paid the big bucks. They don't want to see that culture change.

The banks got all this TARP money, bought the stock market at the bottom, and rode it all the way up. Bank of America was the first to unload their shares and paid off their stimulus money out of the profits they made on the stock market. If you were a trader on the ropes, you became a cab driver. These guys got rewarded and had nothing to lose. I wouldn't predict what's going to happen, but it seems to me there is going to be a day of reckoning.

EM: How do you think the financial markets have changed for traders? Because of 1987, some people learned about put

skew. What are the changes in how risk is handled?

CC: There are very few individual market-makers remaining. It's all conglomerates that do high volume and low markup. For the future of trading, I think it's the heyday for the retail investor because the playing field is level. Commissions and the bid-ask spreads are down. Market-taking has never been as good especially when you have around 100 stocks with penny increments and the markets are two cents wide. On one hand, for the market-makers that narrows the profit margin, but the trade size can get bigger now. I think smaller traders are better off being away from the floor and doing it from home with a reasonably good computer. They can manage risk very well and get a lot of edge.

EM: Do you always trade with a market opinion?

CC: I always try to predict and have a market opinion. I place my bet and finance it in some way with the sale of other stuff I think will go out worthless. Take the classic Broken Wing Butterfly, which I use to call "Ratioed Verticals". I like to buy an out of the money butterfly or vertical and look to sell a greater quantity of further away verticals [to help pay for the purchases]. It's a way of playing ratio spreads in a limited risk fashion. The object is to buy a position that can maximize with other things paying for it. Hopefully the stuff you're selling is going out worthless and the stuff you're buying gets maxed out.

Many of my students, prior to working with me, want to do it on both sides of the market, putting on a put and call configuration. I find that to be inefficient. Over time you have to be adjusting and by throwing a lot of money at it. I like to pick one side and play for that. I use technical analysis to identify a likely expiration range.

EM: What kind of technical analysis do you do? On what do you base your technical analysis?

CC: I'll chart volatility, the stocks, or the futures using my own proprietary program because I teach it to a lot of people. It's called Diamonetrics™:

Diamonetrics identifies symmetrical bull and bear trends and where the bulls and bears are at a temporary stalemate. Even though one trend might be dominant, with their push and pull, consolidation happens when neither side has any stronghold. There's always bull and bear trends within bigger bear and bull trends and vice-versa. When there is going to be a slowdown, a likely consolidation area, I play for that. I target the stuff that will go out worthless by placing short call strikes above resistance and short put strikes below support. Hopefully, my long stuff will blossom and my shorts will contract – if everything goes right.

I look to harvest various embedded butterflies to lock in profits in order to finance cheap protection, reducing risk, along the way. The cost going in is a small debit, or credit or for even-money. I don't mind paying for spreads. (The GOOG BWB illustrated in the images was put on for even money – zero cost and for a .pdf covering all 19 trades between 4/29/10 and 6/18/10, email Charles@RiskDoctor.com).

I then dissect the position and manage it using RiskIllustrator™. RiskIllustrator shows me where all the adjusting and harvesting is going to come from.

Figure 1 – Diamonetrics™ GOOG BWB: 4/29/10 to 6/18/10

Figure 2 – RiskIllustrator™ Embedded Baby Butterflies in GOOG BWB: 5/7/100

The important thing about putting on something like this is you must have a predetermined spot where you say, "I'm wrong" and then change the play when it gets there. You take it off or adjust it into something new that warrants being help. I say "I was wrong about that" then try to make sense of a new right thing to do. If I can do that, I will. If not, I take my lumps or profits (smaller than anticipated) and exit.

And I'll chart volatility, as well, using Diamonetrics. What I come up with there is, "Do I want to place my longs in the deferred months because I think we're going to get a pop in volatility?" Volatility is not money. It does not move uniformly between the months. The traditional vega plays assume that volatility will move uniformly. That is theory and reality is something else.

EM: Do you trade indexes or options on individual stocks?

CC: You can do it on individual stocks. I think the problem with individual stocks is that it takes a little more research. There should be a definitive relationship between the months of the indexes. Think about it like an earnings play. At the beginning of the cycle, you're looking at the volatility. At the end of the cycle, you're looking at the price of the straddle. Same thing with this kind of play, when you say: "What's the volatility versus what's the price of the straddle?"

It's all relative. If you're trading AAPL and the underlying is at 150 and you ask, "What's the straddle. " Then you're up at 200, that straddle price is going to be based on an underlying price that is 33% higher.

EM: Do you think the markets are efficient?

CC: I'm pretty narrow-minded in thinking efficiency is based on how wide the bid-ask spreads are. I think they are very efficient.

EM: Where do you think the landscape is going in the next few years for traders, retail and institution?

CC: I think the auto-quoting functionality has gotten to a point where the intelligence of the trader has gotten mapped out in programming. You don't need people anymore. I think the day of the professional trader is going the way of the American workforce. Instead of being shipped overseas, it's being shipped to the computers, which bodes well for the retail investor. The only thing that will continue to help the retail investor is if commissions continue to come down.

I would hope that Glass-Steagall is going to be un-repealed. There should be more Chinese walls and regulation. Banks shouldn't be able to do all this. I see that whole landscape getting crushed if they continue to get away with their previous practices.

EM: In 2008 and 2009, the VIX was well above its traditional average, with 21 about the normal. What are your thoughts on volatility as a whole?

CC: Higher. That VIX product is the volatility of the hedge level. I think you're going to have a down market.

I didn't think this retracement would come back this far north, a little more than 61.8% on the SPX and the Dow. It went to 85% retracement on the NASDAQ. What is the world thinking? Things aren't going to be as good, yet if they can keep manipulating and keep the day of reckoning away, I'm going to be wrong. I think we should be visiting the lows again. What's that going to create? Demand for puts. When you buy puts that means someone has to sell them. When they short puts, the sellers become the demand to buy them back. When the neutral volatility people sell premium, they have to buy premium. There is always going to be a pit for it [trading volatility]. When the market is going down, order flow is going to make them sell premium. That means they will be demanding to buy it back. Premium will stay pumped.

EM: If I were Jonny Investor and asked you for one thing I really needed to know, what would it be?

CC: Yourself! Peter Steidlmayer wrote this great chapter called "You" in his first book *Markets and Market Logic*. It's about knowing yourself. Knowing yourself when you are feeling giddy or depressed and knowing how to let that stay outside of your trading decisions and your emotional profile. If you can keep that steady, you will trade well, always. As long as the emotions come in and you let that affect you, it's a recipe for disaster. You must have your action points and get out where you predetermined. It does not matter if you are wrong or right. It's how you play the game and act on your decisions.

Too many people who come to me for mentoring are looking for the automatic do, and less work. They don't want to take control. We live in a cause and effect world and a lot of people would rather be the effect of some other advisor's great strategy and place their money on other people's hope rather than taking the responsibility of being the cause, and owning it. Own your trade.

EM: Charles, thank you for your time.

Cheating the Little Guy

Mark D Wolfinger

I hate to see banks change from institutions that earn money from banking to businesses that earn money from proprietary trading, especially when they take unlimited risk and know they can depend on the taxpayers to eat their losses.

But even worse is the heartless manner in which they earn huge profits by collecting fees from customers who don't pay close attention to the rules. I understand that it is the customer's responsibility to read the rules and understand them before entering into agreements. But the fact is that the vast majority cannot be bothered. And for those who have the patience to try, the legal language is often too complex for a significant portion of the population. Why would anyone anticipate a problem when opening a checking account or getting a credit card? The basic rules are fairly simple.

When you buy an option, the rules are also simple. There's no reason to anticipate trouble.

Ignoring integrity, it' profitable for businesses to take advantage of customers and seek every possible penny when dealing with them. That irks me. I believe in fair play, and that means I'm living in the wrong century. Cheaters go unpunished, risk-takers get rewarded whether they win or lose, and the little guy pays the bills.

If a credit card payment arrives one day late, pay $39 plus interest on the entire balance. Bounce a check, pay $35. Overdraw a checking account when using a debit card, $35 per. These fees are disgusting and represent a profit center for the banks. They are not an attempt to recover the bank's actual cost. These fees are punitive. The saddest part is that studies show it's the poorest segment of the population who gets hit the hardest with these fees. It's predatory.

Wasn't banking once an honorable profession? I know I am being naïve, but I want the little guy to stand a chance. No one has to hand him/her a pot of gold, but there is no need to take advantage of someone who is essentially helpless and asks nothing more than to be treated fairly.

How does the brokerage industry treat the little guy?

As a trader, I'm more concerned with brokers than with bankers.

I find one specific industry practice to be reprehensible. This practice takes money out of the pockets of unsuspecting and unsophisticated investors, but it does so under the pretense that this is beneficial to the customer. It's the duplicity that bothers me.

I'm referring to the practice referred to as 'automatic exercise.' I found this definition on the Internet: "The procedure that prevents in-the-money equity options from expiring and becoming worthless . . . thus allowing option holders who may not be monitoring an option to still capture a profit."

Customers can opt out of this 'convenience' by notifying the broker NOT to exercise. However, the person who gets caught in this trap is not aware of the need to opt out.

Think about the definition of an option: An option represents *the right, but not the obligation* to buy or sell 100 shares at the strike price at any time before the option expires. Yet, the industry has conspired to change the definition. Now the option owner has the obligation to exercise (an ITM option). How is that possible? How dare the powers that be take away the *rights* of an option

owner and replace them with an obligation? I'm not a fan of litigation, but I suspect the industry would have a great deal of trouble defending itself against a class action lawsuit over this practice.

What's the big deal? What's so bad about this practice?

This rule serves only two purposes:

- It's convenient for the OCC (Options Clearing Corporation) and allows them to take care of all exercise and assignments quickly and efficiently. This is a good thing.
- It allows brokers to extract extra commissions from their naïve customers. This is highly unethical.

When someone buys an option with the *promise* that he/she has the right, but not the obligation to exercise, it comes as a rude awakening to discover that the 2-lot of calls (which the customer tried to sell, but there were no buyers) has been converted into 200 shares of stock. The industry claims that this customer saves $2 or $4 of intrinsic value, yet they have no problem imposing was a commission of $14.95. I agree not not all brokers charge this much, but any fee is too high. How can anyone with a conscience justify that practice? By what right can anyone take away the very basic premise of an option? An option owner has only rights and NO OBLIGATIONS.

And it gets worse. The small customer doesn't want this stock and is forced to pay yet another $14.95 to sell the shares. It's a cruel joke played by the greedy on the innocent.

Bottom line; business as usual:

- Convenient and expedited process for OCC. We all benefit from that expedited process
- Unearned fees for the brokers for performing a dis-service
- The little guy loses again

To the brokerage industry: If you feel that your customers benefit by by exercising, then how about charging zero whenever the option is in the money by 10 cents or less? Then it would be a convenience for your customers.

Apparently 'automatic exercise' is not the proper terminology and the correct term is 'EXERCISE BY EXCEPTION.'

"Exercise by exception" is an administrative procedure used by The Options Clearing Corporation ("OCC") to expedite the exercise of expiring options by Clearing Members. It is important to note "exercise by exception "is a procedure between OCC and its Clearing Members and is not intended to obviate the need for customers to communicate exercise instructions to their brokers."

In June 2008, the SEC (Securities & Exchange Commission) approved the OCC request to reduce the exercise threshold to one penny.