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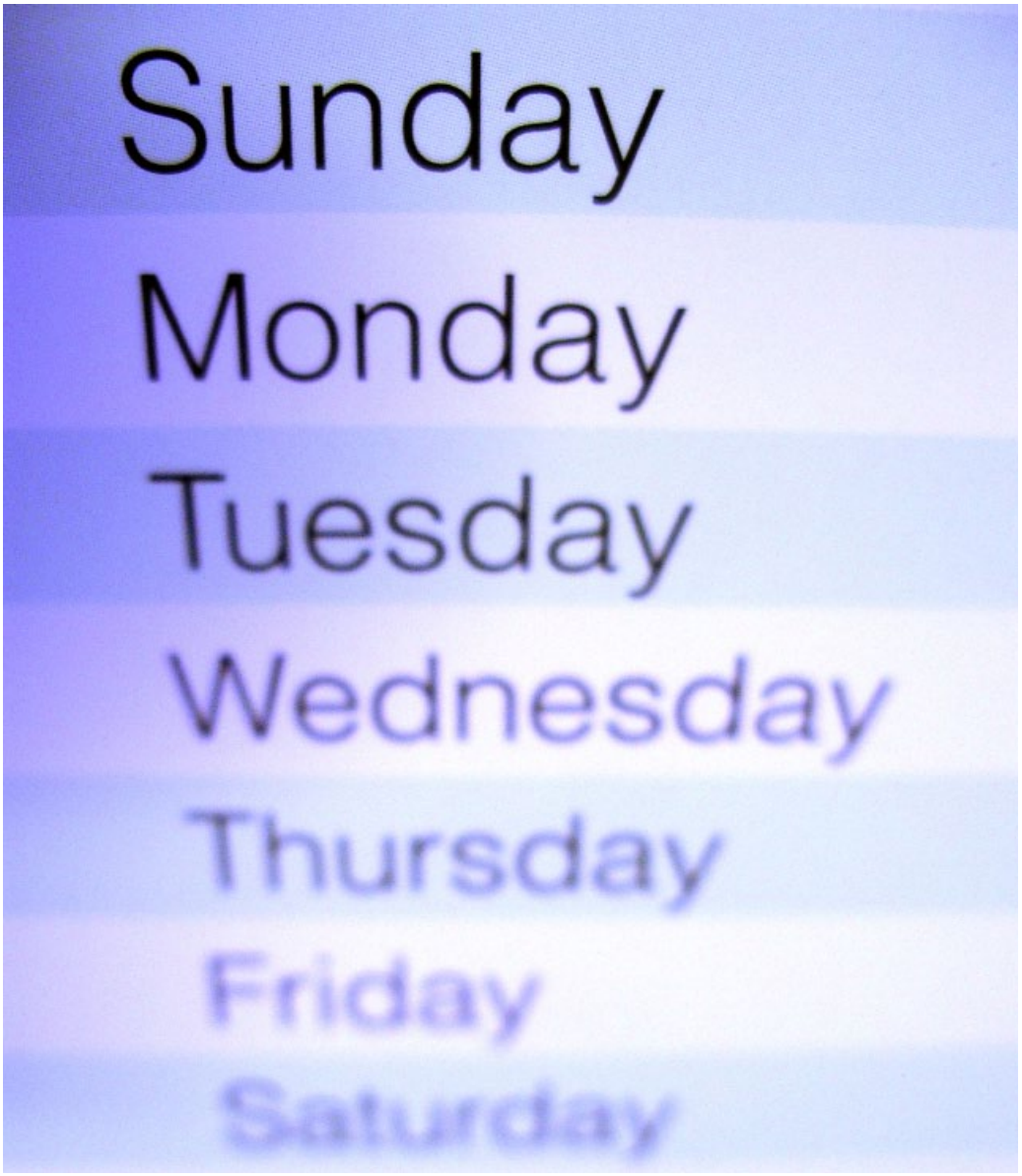
EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

THE WEEKLYS



An Interview with Trader and Author
Jay Kaeppel

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

EXPIRING MONTHLY
THE OPTION TRADERS JOURNAL

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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 2011.

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

Bill Luby

After all the drama of the last few months, the August expiration cycle turned out to be relatively tame, in keeping with the end-of-summer tradition of shrinking volatility.

This month's issue tackles two themes in particular: weekly options and options on futures. Part of the intent is to encourage readers to get out of their comfort zones and explore some new options products and vehicles that might yield a new set of profitable opportunities.

A guest article from Vance Harwood examines the increasingly popular weekly options and looks at some trading approaches and some anomalies. Adam Warner chimes in on the same subject and outlines a scenario in which he believes weekly options might increase volatility. Adam also squares off with Mark Wolfinger in a debate about whether weekly options are a positive or negative development for traders

Elsewhere, Simon Germantis won last month's EM contest with *The Making of an Options Trader.* His article is included here as it might suggest a path forward for some who are new to options trading. Speaking of which, Mark Wolfinger's recurring column looks at the pros and cons of out-of-the-money, in-the-money and at-the-money options from the perspective of a new options trader.

In his market-maker trading tips column, Mark Sebastian evaluates the effectiveness of 'units' (cheap out-of-the-money options) as portfolio insurance for all types of traders.

Jared Woodard and I both have contributions that are intended to get readers thinking about expanding the scope of options they analyze and trade. Jared offers up an introduction to options on interest rate products and also has a Follow That Trade article using a straddle on the 10-year Treasury Note as a complement.

I focus more on the commodity space in an interview with Jay Kaeppel, whose wide-ranging career had included lot of experience in the area where futures and options intersect. On a related note, I also have a review of *The Complete Guide to Options Selling (2nd edition)* by James Cordier and Michael Gross, where the focus is on selling options on futures.

This month I have also decided to begin a series on the VIX futures term structure, with this month's contribution serving as an introductory piece.

Finally, see Jared Woodard's thought-provoking back page piece on why you should ignore the 2008 financial crisis.

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

Have a good expiration cycle,

Bill Luby
Contributing Editor

Ask the Xperts

The Expiring Monthly Editors

How long is the learning curve to using options, and when can I expect to become profitable?

—George E.

As you may suspect, each trader has his/her own learning curve based on how much trading experience that person brings to the table. A seasoned stock trader had a head start and the investing newbie has more ground to cover.

You are asking the wrong question. You can 'expect' to become profitable from your very first trade, and remain profitable for quite awhile. If you adopt a strategy with a 99% probability of success, there is no reason why it would not work for you. The problem is that the reward is tiny and the risk is enormous. You will win for awhile, but the long-term picture for traders who adopt these strategies is dismal.

Thus, 'becoming profitable' should not be the primary goal. Learn how options work; understand your rights and obligations as an option trader; be certain you understand exactly what you are trading. (Simple example: VIX options are not options on the VIX index; they are options on VIX futures.)

Next, practice (in a paper-trading account) using a strategy. Learn the strategy. Get a feel for potential profits and losses when practicing. If you simply make a trade, hoping to learn on the fly, then you must depend on good luck to earn profits. That is not a viable plan.

The bottom line is that you can become profitable from the very beginning, if you have the patience to take the time to learn, adopt a viable methodology (not that 99% probability trade), and have an understanding of how money is lost. (You will discover that this is far more important than discovering how profits are earned.) Do that, and you can be successful.

Option trading is not similar to day-trading stocks where specific *trading skills* take time to develop. Your job is to know what you are doing well enough so that when (not if) trouble looms, you can take action to be certain that losses remain small. This requires a very clear understanding of the given strategy as well as the ability to take reasonable defensive action.

A quick study can be ready to trade in a matter of weeks. But please use that practice account.

—Mark W

Mark

I placed "identical" trades in SPX and SPY for the month of August. They are combos of calendars, butterflies, and verticals with the same amount of capital deployed in each trade. The Greeks for SPY: Delta 67, Gamma -176, Theta 100, Vega -94 and for SPX: Delta 15, Gamma -2, Theta 130.58, Vega -114. My question is: why is Gamma so different between the two trades?

—Brad

Brad,

This is actually a pretty simple answer. It is because gamma and delta are not weighted automatically to the size of the contract. One definition I like for gamma is that it is a measure of how sensitive a position is to price movement relative to a 1 point move in the underlying. Now, think about the reason a 1 point move in the SPY and a 2 point move in the SPX. A 1 point move in the SPY is certainly a noticeable move in the SPY. Thus it would make sense that the position would change significantly if the SPY moves 1 points (thus the high gamma). In the SPX a 1 point move is not even a sniffle of a move. It would be considered flat to most traders. Thus, it would

make sense for the SPX to have a lower gamma. The lower gamma is made up by the average-size move of the underlying. Currently, one standard deviation in the SPY might be 1.50 points. In the SPX it would be 15 points or so. If we multiply the gammas by the average move, what is the net change in deltas? It's actually greater in the SPX!

—Mark

I'm thinking of leaving [broker A] because their commissions are significantly higher than [broker B]'s. I know that commissions aren't the only factor worth considering, but once we start talking about execution, technology, education, and so on, it becomes a bit too complicated. What's a good general way to evaluate brokers?

— Peter V.

Retail traders, in my experience, often give far too much weight to up-front commission costs, ignoring (or paying too little attention to) other important issues like execution and market access. If a brokerage can consistently improve your execution by two or three ticks compared to some low-commission competitor, that improvement could easily overcome a higher commission bill, and then some. Technology, market access, and education are worth something, too: better risk management tools or an insightful online seminar might make all the difference in a given trade. Since individual needs vary so much, I don't know of a general way to evaluate brokers other than by trying out several platforms until you find one that suits your needs.

— Jared

Exploring the VIX Futures Term Structure

Part 1

Bill Luby

Without a doubt, the one subject that seems to cause the most confusion with investors who trade CBOE Volatility Index (VIX) options or the VIX ETNs (VXX, XXV and VXZ) is the VIX futures term structure. Since this is a complex subject, I have elected to address it over the course of several issues. This month is intended as in introduction to the VIX futures term structure and in subsequent months I will devote more time to discussing various structure data, offer a framework for interpreting the term structure and discuss the implications for various options strategies.

Due to the fact that the VIX index cannot be traded, VIX futures have become the key to understanding the intricacies of the entire VIX product line. As of this writing, every single VIX product (options, ETFs and futures) is priced off of VIX futures, so if you intend on trading any VIX product, it is important to understand how VIX futures work.

Simply stated, VIX futures are standard futures contracts based on the VIX and settled in cash on Wednesdays 30 days prior to SPX options expiration, in the same manner and using the same special opening quotation (SOQ) as VIX options. In essence, VIX futures contracts allow investors to speculate on the implied volatility of S&P 500 index options at various future expiration dates. For those seeking more information about VIX futures contract specifications and other details, the CBOE Futures Exchange (CFE) is an excellent source of information.

VIX futures contracts are available for the first seven consecutive months. This means that as this magazine goes to press, the VIX futures contracts currently quoted are:

- September 2010 (ticker VX-U0)
- October 2010 (VX-V0)
- November 2010 (VX-X0)
- December 2010 (VX-Z0)
- January 2011 (VX-F1)
- February 2011 (VX-G1)
- March 2011 (VX-H1)

The ticker format specifies the underlying in the first two letters (VX), followed by the expiration month (F=Jan, G=Feb, H=Mar, J=Apr, K=May, M=June, N=July, Q=Aug, U=Sep, V=Oct, X=Nov, Z=Dec) and the last digit of the year. By convention, the next contract to expire, in this case September 2010, is known as the front month. Subsequent months are known as the second month (October), third month (November), etc. All months other than the front month are collectively known as the back month.

A typical VIX futures contract sees very little volume or volatility in the first few months of its life, but sees increased trading and more volatile moves in the two to three months prior to expiration. More importantly, the longer the time to expiration, the more likely a VIX futures contract is to diverge substantially from the VIX.

Figure 1 below shows the history of the VIX August 2010 futures contract (solid blue line), which last traded on Tuesday, August 17th and was settled with a special opening quotation at the open of Wednesday's session. Note that from December through April, the VIX August futures contract had limited volume and demonstrated very little volatility. At the same time, while the VIX routinely traded in the teens and even closed as low as 15.58 in April, the August VIX futures contract never closed below 22.45 and continued to predict an August VIX futures settlement in the vicinity of 25. As it turned out, the August VIX futures settled at 24.82, making VIX futures traders in the early months of 2010 look quite prescient.

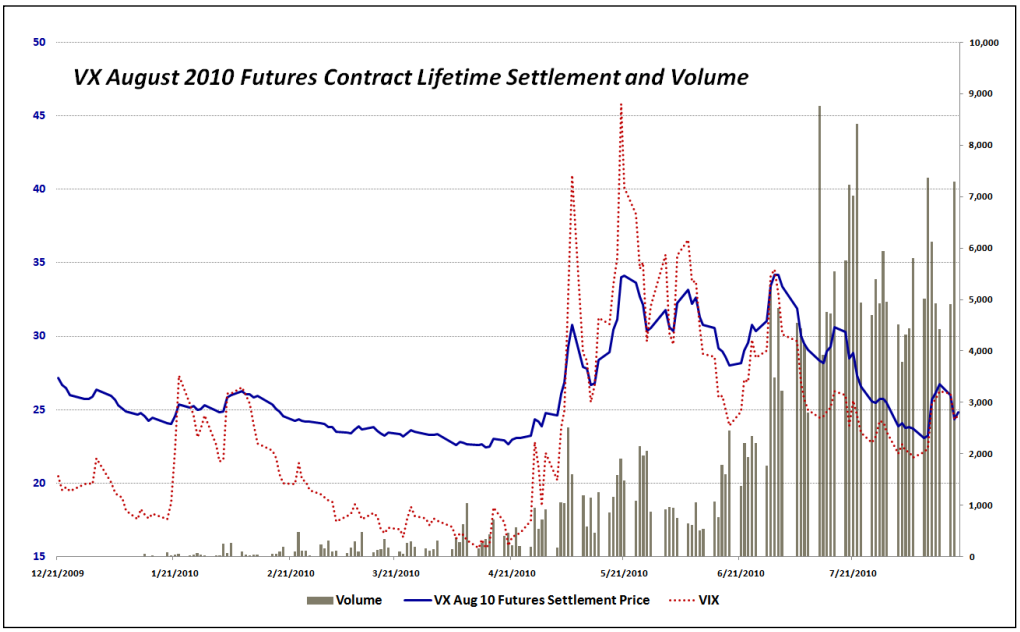


Figure 1: VIX August 2010 Futures

The chart also shows that when the VIX (dotted red line) spiked into the upper 40s in May, the VIX August futures had a much more muted reaction. When the VIX closed at its 2010 high of 45.79 on May 20th, the VIX August futures, which were estimating where the VIX would be three months hence, settled only at 34.00.

The April and May reaction of the August VIX futures relative to the VIX demonstrate how mean reversion affects the pricing of VIX futures. As a rule, the farther the VIX strays from its lifetime mean (currently 20.39) the less responsive back month futures are going to be to those sharp moves. To exaggerate this point, let's assume you know what the price of the S&P 500 index will be 20 years from now and are asked to guess what the VIX will be on that day. Whether the SPX is at 500 or 10,000, the best guess for what the VIX will be on that day is probably about 20. To carry that scenario one step further, should both Greece and Portugal default on their sovereign debt tomorrow, you probably would not be inclined to revise your estimate for the VIX 20 years into the future. That is VIX mean reversion in a nutshell.

The VIX term structure then is simply a current snapshot of the available VIX futures contracts, plotted (sometimes with the VIX and sometimes without) to show how the expectations of future volatility in the S&P 500 index vary based on future expiration dates. Figure 2 below shows a 'normal' VIX term structure curve, represented by the dotted black line. It shows a typical VIX term structure curve that

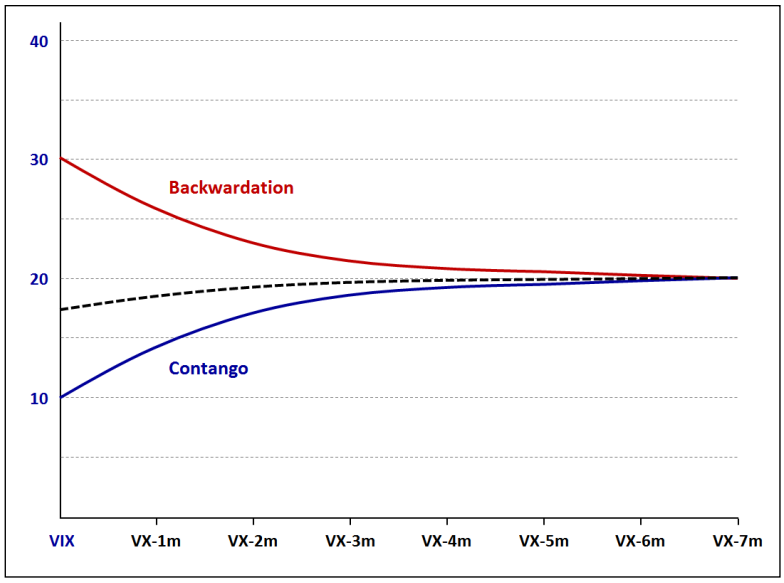


Figure 2: VIX Term Structure Conceptual Overview

existed prior to the 2008 financial crisis, with a VIX in the high teens and back month futures sloping slightly upward to about 20.

After the VIX spiked to record highs in the 80s in October and November of 2008 and stocks eventually formed a bottom in March 2009, investors anticipated that measures of implied volatility such as the VIX would begin to revert to the historical mean of about 20. During most of 2009, the VIX term structure was in backwardation (a downward sloping term structure), with the VIX and front month VIX futures at the high end of the term structure curve and the back months pricing in a decline in the VIX. The solid red line in Figure 2 is an example of a VIX term structure in backwardation.

By early 2010, most investors had concluded that the VIX had fallen too far and too fast relative to risk factors that included European sovereign debt, a Chinese real estate bubble, a potential double dip recession in the United States, and other factors. As a result, the predominant VIX futures term structure had an upward slope that reflected predictions of higher future volatility. This upward sloping term structure is what futures traders refer to as contango; it has been responsible for much of the poor performance of the iPath S&P 500 VIX Short-Term Futures ETN (VXX) and has created some interesting opportunities for VIX options traders as well.

Next month, I will have a more detailed look at VIX futures backwardation and contango, along with a discussion of the implications for VIX options and ETF strategies.

The Making of an Options Trader

Simon Germantis

It's 5:56 AM on an unusually cold winter morning as I sit transfixed by flashes of green and red on the screen in front of me. The U.S. markets are about to come to a close on the other side of the world as I reminisce how it is that I got here.

It all began a few years back while I sat slumped in a cubicle in what could have been any office building in any suburb, going through the motions in a job that I was finding neither challenging nor stimulating. Apart from having a few laughs with my co-workers, there was nothing there for me. I wanted more and was determined to find out what that was.

I started writing a list of everything I wanted in a job, and by the end I had a comprehensive list. The more I wrote, the more it looked like a lifestyle rather than an actual job. I then set out to discover what could get me there. It was easy to rule out many jobs, because most jobs didn't get past my first few points: flexibility, freedom, passion, to name a few. It wasn't until I had combed over just about every vocation I could think of that the word trader kept staring back at me. At first I thought this to be more a fantasy than anything else, because how could someone with little knowledge of the stock market expect to make any money, let alone carve out a living?

The more books I read about trading, the more intrigued I became, and months quickly turned into a year. Before I knew it, I went from a novice investor of equities to a more informed and educated one. My interest in the markets had been transformed into a passion for trading that kept me enthralled, even when the theory was overwhelming. I pushed on to gain an inner confidence that just maybe I might be able to find my niche somewhere in the world of investing.

I was barely into my second year and still making loads of mistakes and losing money when I discovered options. It was all-consuming. As with learning anything new, the fundamental and technical analysis to which I devoted so much of my time took a back seat, as I immersed myself into the complex world of options. I began by reading all the recommended books, attended seminars, joined

Contest II Winner

As a reminder, these were the rules:

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

Thanks to everyone who entered. We appreciate the time and effort that each of you devoted to the contest.

Congratulations to the winner, Simon Germantis. His prize is a full year's subscription to *Barron's*. In this article, Simon shares his learning experiences.

The runner-up is Dr. Bill Burton, who wins a one year subscription to *Expiring Monthly*.

newsletters and watched CBOE webcasts. I became fascinated and determined to understand the intricate world of options and wasn't going to let my basic level of mathematics or lack of screen time stand in my way. I began paper trading.

I started traded without getting intimate with the greeks, and this became my Achilles heel. Strategies that I would eagerly implement would fail to come to fruition as I neglected to give the greeks the respect they deserved. I was stubborn to the point that I wouldn't accept that not knowing how delta, gamma, vega and theta affected one another was impacting my trading in a negative way.

After 6 months of paper trading my persistence and dedication was starting to pay off. Immersing myself in the greeks—which initially seemed like financial rocket science—was like discovering a missing piece of a puzzle. I started trading small lots as I familiarized myself with the subtleties of volatility and even continued to draw risk graphs by hand—all with the intention of building a strong foundation from which to work. By the end of my second year I was more committed than ever, and as my account grew, so did my confidence and skills.

What came next was getting my head right for trading. This required a complete mental shift. I'm talking about the stuff that so often doesn't get mentioned enough in books—the psychology required to become a successful trader. So that was my next task. I read a few books before coming across *Trading in the Zone* by Mark Douglas. Not only did it cast a brighter light on trading psychology, but it also encouraged me to explore my weaknesses. I was now looking at trading as a game of mind control; the more disciplined I could became the better my trading would be.

I'm now three years in, and turned fantasy into reality as a full time independent trader. My skills continue to improve, and with each month that passes, I become better at managing risk and controlling my emotions. I treat trading as you would any business. In essence, I'm always working on making myself a better options trader.

Simon Germantis is a professional options trader, actively trading Index, commodity and FX options.

The New Option Trader

OTM, ATM, or ITM?

Mark D Wolfinger

One of the traps that attract the novice option trader is the desire to purchase out-of-the-money options (OTM). There is something about buying options at a low price that attracts the newcomer. I suspect that people buy these options, seeing them as mini-lottery tickets. They become extremely attractive when the trader has a feeling, or hope, that the given stock is about to make a major move.

Sadly, this idea also traps some experienced traders.

It's important to understand that OTM options are cheap for a reason. They offer little chance of earning a profit. On the bright side, there is the chance of earning a big profit from a small investment, and that *possibility* is always going to look attractive to some traders. (Warning: just because these options tend to be unprofitable for buyers does not translate into a recommendation to sell.)

It's not *always* a bad idea to buy OTM options. They offer excellent insurance against a major market move. If you have a position that fares poorly on a huge rally or decline, then owning some inexpensive calls or puts can make all the difference between suffering a large loss and coming out unscathed. Just remember that choosing to pay a premium for insurance is not the same as making a directional wager on a specific stock or index.

Out-of-the-money options have their place. However, I recommend not getting into the habit of buying them as a speculative, directional play.

Which Option to Buy

One important aspect of trading options is to have a good understanding of how options work. The best way to accomplish that is to make the trade and follow it—as many times as is feasible. However, people who are first learning about options cannot (ok, they can, but it is ill-advised) do that. The best way to accumulate experience in making trades and trading decisions is to practice your strategy in a paper trading account. If it is not confusing, take advantage and manage several trades simultaneously. That affords an opportunity to gain real experience in less time.

Until you have hands-on experience it is not easy to develop confidence. It's a good idea to learn from others by reading books, blogs and attending free webinars, but certain concepts require that you to learn by doing. Buying OTM options (in a paper-trading account) and seeing how often the entire investment is lost is one way to learn how these options work.

If you want to make a play based on market (or individual stock) direction, and if you recognize that picking direction is not easy, then begin by trading options that reward you (in trading profits) when you are correct. Begin with in-the-money options (ITM). An ITM call option has a strike price below the stock price. It already has some intrinsic value when you buy it. An ITM put option has a strike price above the stock price. It already has some intrinsic value when bought.

When choosing the option to buy, there are two conflicting goals and it is necessary to compromise. As an option buyer, you want the option to move higher as the stock moves in your predicted direction. You also don't want to pay too much in time decay when owning the option.

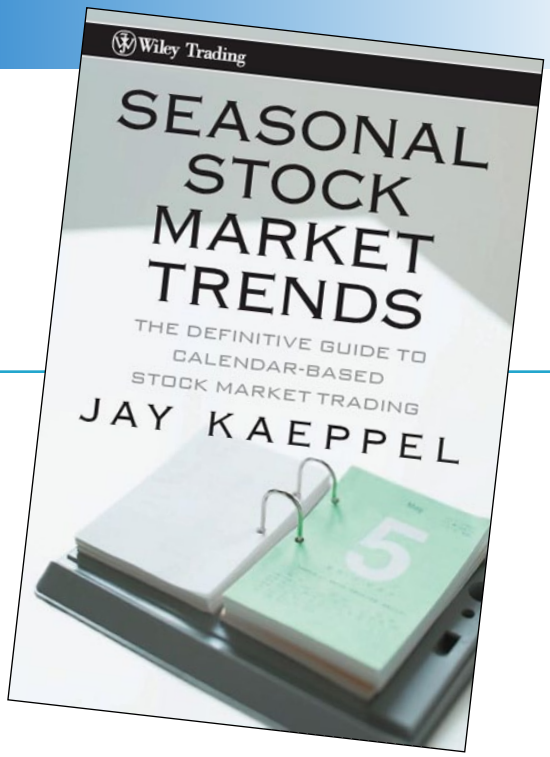
Experience helps, but to get started, I recommend buying an option that is ITM by 3–5 points. This is a decent compromise. The option has a delta > 0.50, and you get to participate in most of the move (if your predicted move comes true), and because these options don't have

a good deal of time premium, time decay is minimal. This is a convenient method for buying calls and puts, for now, until you have a better understanding of how options work.

I am not suggesting this is the ideal strategy for everyone. In fact, I don't ever recommend buying single options as a directional play. Nevertheless, option buying is the favorite trade for many investors, and I encourage you to practice and learn to think for yourself. The point of this discussion is to be certain that readers understand that buying inexpensive, out-of-the-money options is a losing strategy for the majority who play that game. In addition, buying options that are at-the-money (ATM) involves paying a substantial premium for the right to own an option. ATM options may be suitable for traders who understand how to mitigate risk and hedge their trades. However, I strongly recommend that new traders have the patience to gain practice with both real-money trades and paper trades before considering the purchase of anything other than ITM options.

Expiring Monthly Interview with
Jay Kaeppel

Bill Luby



Jay Kaeppel is an independent trader, author and a Trading Strategist with Optionetics, Inc. A former CTA, Kaeppel is the author of *Seasonal Stock Market Trends, The Four Biggest Mistakes in Option Trading, The Four Biggest Mistakes in Futures Trading* and *The Option Trader's Guide to Probability, Volatility and Timing.* Jay writes a weekly column titled "Kaeppel's Corner" for Optionetics.com and can be followed on Twitter at www.twitter.com/jaykaeppel. Contributing editor Bill Luby interviewed Jay for this issue.

Expiring Monthly: Do you see the current options environment as presenting any unique risks or opportunities?

Jay Kaeppel: I talk to people about options a lot, including people who don't trade them. I tell them that there has really never been a better time to expand your horizons. One of the things I have told a lot of people who are not in the financial arena is that even though the Dow and S&P have been down to unchanged for 10–12 years, from what I can tell, you still have a generation of people who only know how to be long the stock market. With everything that is going on, with ETFs, options on ETFs, you can go long gold, short the euro, bullish on bonds using leverage or whatever you want to do. That's why I think options are a great market to be in right now.

EM: How do you think the recent financial crisis has changed the options landscape or the factors that influence options?

JK: I think everybody is so much more focused on the short term. Volatility will shoot up and down much more quickly than it used to. It has always been the case where the VIX would rise rapidly when the market went down, but now it's like a hair trigger. Everybody, especially the professionals, is saying, "Oh my goodness, what's coming next?"

I think the other thing that has really been a factor—and it's both good and bad—is high frequency trading. It scares me a little bit; I read recently that 70% of the volume is coming from high frequency trading. There's nobody manning the gate, so to speak. After May 6th my fear after that, whether it was due to high frequency trading or not, is that if you have all these computers, it seems inevitable that at some point they are all going to line up in the same direction.

EM: As an option trader, with volatility moving up and down more quickly than it used to and high frequency perhaps having compressed time, does this mean that the nature of the volatility equation has changed because time has warped?

JK: Looking at it from an objective trading approach, the one thing you want to avoid is to say, "Everything has changed, so now I have to throw out everything I've been doing and start with something new." If you are trading options and limited risk positions to begin with, then maybe you don't have to worry quite as much about all these fluctuations and volatility. If I know my maximum risk on a trade and I'm willing to risk that, then I'm not going to let short-term changes in the market influence my thinking. I'm just going to stick with my approach.

EM: Let's say you view the world primarily through a technical lens, with technically-based systems: how do you weave some macro thinking into what is largely a technically-based approach?

JK: I try to avoid macro thinking, because it colors my outlook. The trend following models and seasonal indicators that I follow are presently bearish right now so I feel I have no choice but to be bearish whether I want to or not. Still, I wrote an article recently titled "I Hope I'm Wrong."

EM: If you have a set of indicators that start to point to a range-bound trading situation or no obvious trend, do you switch to directionally neutral income-oriented options strategies?

JK: I look at that. I look at iron condors. One of the articles I wrote for *Stocks and Commodities* uses a strategy I learned from an instructor at Optionetics, Mitch Genser. It is called a "modidor." Basically, instead of doing a condor where you are selling at equal distance away from the current price and buying the wings at an equal distance away, you adjust that so you put more of the risk on one side of the trade. So instead of having a break even above and a break even below, you are positioned so you break even on one side of the market.

If it goes in your direction, you make money, if it stays where it is, you make even more. If it goes against you by a certain amount, you still have a chance to make money.

EM: What is it that gets the beginning options trader who started selling covered calls and buying an out-of-the-money put or call to be able to make the leap to really understanding options and becoming a profitable options trader?

JK: For someone who is new to trading, there are essentially three things you can do with options. You can speculate on direction, hedge existing positions, or take advantage of the unique options strategy opportunities, whether it be buying straddles, iron condors, other neutral trades or something like that.

I taught a class recently for Optionetics to beginners. One of the things I suggested was to take a minimum of one month to put your plan together, then trade it using ridiculously small amounts of money—trade a one lot or a two lot, which is better because you can sell half—and get in there and trade the plan for four months.

In four months, you're going to get some good trades and get some bad ones. Whether you make money or lose money, as long as you trade small, it almost doesn't matter. The trick is to become comfortable in: finding the opportunities, making sure you have a plan for each trade, and placing the orders, which goes into the psychological aspect of trading.

Do a one lot or a two lot so you are not afraid to take the trade. The other thing that is hard for people to do is to follow the plan, which includes things like selling half if part of the position goes up a certain amount or selling half if it goes down a certain amount. If that event happens, you have to pull the trigger. That's what the first four months is all about: getting used to doing what you have to do. The bottom line is to try to build confidence in making money after you're done, maybe making a few mistakes. That is how I set people in the raft and gently push them out into the water.

EM: Is the psychological aspect of trading options more difficult than it is for trading stocks?

JK: I think for a lot of people it is. People come to options from lots of different avenues. People trade stocks and they get frustrated. They get into options and they start to understand the leverage involved and they say, "I'm just going to go for the gusto here." I'm going to buy that cheap option. They don't worry about time decay. It's a different game.

The best thing about option trading is also, ironically, the worst thing about option trading. The best thing is that there are so many opportunities and so many strategies, so many things you can do. Whatever it is you want to do, you can do it. The bad news is that this overwhelms some people.

EM: Given all that complexity and the need to focus, do you think it is better for someone to have 2–3 strategies to focus on, perhaps a half dozen, or the complete options menu, though with less experience with each strategy? Are there an ideal number of options strategies to play with?

JK: For somebody starting out, 2–3 options strategies are plenty. As you get more experienced and

you understand certain strategies are going to work better in certain environments, such as high volatility vs. low volatility, it makes sense to change.

From that class I taught, for beginners, the three strategies that I suggested for that four-month incubation period were:

1) Bull call and bear put—you can do it for very little money;

2) Something I called "covered call without the stock." For example, if the stock was trading at 40, you could buy the October 35 calls and sell the August 40 call. If you drew the risk curve, all your risk is on the down side, but you have a little bit of down side protection and the opportunity to make money on time decay;

3) Out-of-the-money butterfly, which is essentially a directional play, but you can do it for very little money.

Let me mention one other trade. I learned a variation on the out-of-the-money butterfly from someone else at Optionetics, Gustavo Guzman. He calls it the 'garbage trade.' It's an out of the money butterfly, but he does it as more of a hedge. Every time the market rallies, he'll buy a put option about 5% out of the money, then go down strike prices until he can sell two at a given strike that will pay for the first one he bought, then go another equal distance of strikes down and buy the further out-of-the-money put to make it a butterfly.

Then if the market drops out of the sky for even a couple of days, then this position will explode to the upside. You can do this for any market. If you thought gold was going to top out or the euro or any market. You could do it to the up side too. That's not something you're going to put all your money in to, but it's just another strategy that people can look at. The upshot was that he said May 6th was his best day of the year. That was one of those things where I said to myself, "Why didn't I think of that?"

EM: You've traded futures for a long time and now you trade a lot of ETFs, do you have any thoughts on options on futures vs. options on commodity, currency and bond ETFs?

JK: The advantage of options on futures is that you have a lot more profit potential when something moves. The down side it that a lot of times the bids and asks are a lot wider. You have to be more conscious of working an order.

If you are trading SPY options as an ETF, for the most part, if you were so inclined as to put in a market order, you'd still get a pretty good fill. If you did the same thing on soybean options, when that fill comes back, you're probably going to be surprised, and not in a good way.

I think a lot of people should be looking at commodity ETFs. So many people, all they know how to do is be long the stock market. There are bonds, currencies, metals, so on and so forth. With ETFs you can buy gold without having to buy bullion or gold futures. Or you can buy put options if you are bearish. Options on futures – you really have to want to do it. You have to be able to spend the time to pay attention to getting the right fills and how to work the orders, etc. Options on commodity ETFs are, I think, a great way for the beginner to diversify and take advantage of things.

EM: As a systems developer, how do you approach options back testing, given that the data and tools are not as robust as what is available for stocks and futures?

JK: The first thing I start with is something in the Optionetics Platinum software that I use called a Stock List Filter tool. Basically, you find all the stocks that have tight bid-ask spreads, however you define that, say 1% or 2%. Right there you just throw out about 2000 stocks and you are down to 200 to 800, whatever the case may be, depending on how wide you go. From there you filter the trend. If you are buying a covered call without the stocks, you want stocks that are either neutral or up trending. Everyone has their own way of defining that, but you have to make your own decisions about how you want to define that. Basically, you are looking for trades that have the best premium, and that is just a mathematical calculation of the software.

(continued on page 29)

An Introduction to Options on Interest Rate Products

Jared Woodard

As I've noted here before, there's not much sense in hunting for viable options trades on very highly correlated underlying assets since, over time, those additional options trades will function as little more than duplicate bets. Over the last five years, 30-year U.S. Treasury bond returns have shown a correlation with S&P 500 returns of negative seven per cent. In an environment marked by increasingly high correlations among individual stocks, interest rate ("IR") products therefore offer a genuine opportunity for diversification. Additionally, the steady decline in bond yields over the last several months has prompted some observers to wonder how much lower yields can go, with attendant speculation on that question evident in options markets. In this article, I will review the interest rate products with the most actively traded options and will mention some of the idiosyncrasies of this asset class.

Actively-Traded Interest Rate Options

The table below shows some of the most actively-traded vehicles, listed in order of maturity. I'm restricting this review to U.S.-based federal government debt products for simplicity.

The open interest totals in this table should be interpreted with the contract multipliers of the futures in mind. Options on Treasury note and bond futures are roughly ten times the size of similar ETF options. For example, purchasing a short term, at-the-money (ATM) 10-year note put option for 56/64 means risking $875, while a similar put option on IEF bought at $0.75 would entail risking $75. Given the relative size of the options on futures, it is fair to say that while ETF products have made significant progress in attracting investor interest, the bulk of the order flow in interest rate options still occurs

Name	Ticker Symbol	Recent Options OI[1]
Short term		
Eurodollar Futures	GE (GLOBEX)	12,943,720
2-Year U.S. Treasury Note Futures	ZT (GLOBEX)	188,448
iShares Barclays 1–3 Year Treasury Bond Fund	SHY	32,217
Medium Term		
5-Year U.S. Treasury Note Futures	ZF (GLOBEX)	353,085
iShares Barclays 7–10 Year Treasury Bond Fund	IEF	27,472
10-Year U.S. Treasury Note Futures	ZN (GLOBEX)	2,106,822
Long term		
U.S. Treasury Bond Futures (15+ Year Maturity)	ZB (GLOBEX)	411,168
iShares Barclays 20-Year Treasury Bond Fund	TLT	353,576
ProShares UltraShort 20-Year Treasury	TBT	605,879

Table I

on the futures side of the regulatory divide.

Although I elected to include them here, options on SHY and on IEF are very quiet, and may not be viable for spread strategies.

One surprising area of activity is the interest in TBT, the Proshares ETF that allows investors to take leveraged bets against the Barclays 20+ Year Treasury Index. TBT seeks returns that are 2x the inverse of the tracking index; the conventional wisdom that has emerged about these products is that they are suitable as short-term trading vehicles, but not as long-term holdings. Because of the inherent leverage in the underlying, options on TBT are priced at significantly higher levels of implied volatility. Recent at-the-money TLT options expiring in 30 days implied 17% volatility, whereas analogous TBT option prices implied volatility around 38%. Some traders use options on leveraged ETFs to attempt to capture the decay caused by daily rebalancing, via short gamma spreads and option sales.

Idiosyncrasies of Interest Rate Options

In the financial media, IR products are typically discussed in terms of yield, rather than price, e.g. "The yield on the 10-year note fell three basis points today to 2.71%." In the case of Eurodollar futures and options, this difference is taken a step further: the historical volatility of Eurodollar futures and the volatility implied by Eurodollar options are calculated to reflect variance in rates, not prices.[2] This emphasis on rates is intuitive: many IR trades are conducted to hedge or alter existing rate exposure elsewhere in a portfolio, rather than simply to speculate on the future direction of a rate-linked product, so analyzing products in terms of rates or yield makes comparison easier.

Over the last five years, 30-year U.S. Treasury bond returns have shown a correlation with S&P 500 returns of negative seven per cent.

Another distinctive feature of IR options is the importance of the term structure within products and the yield curve across products. While one-month and one-year options on some stock are clearly derivatives of the same underlying asset, the same principle does not hold for a given series of futures contracts. For example, 10-year Treasury Note futures expiring in September 2011 recently traded at 118´285, while September 2010 T-note futures are currently bid at 125´275. This is a typical term structure, in which higher long-term rates reflect the desire of participants to be compensated for the added uncertainty about macroeconomic changes, government policy, etc. Conceptually, it may help to think of the two contracts as entirely distinct—if highly correlated—assets. A time spread using options on a single underlying, e.g., short an ATM August call and long an ATM September call on the September 2010 T-note contract is, in this sense, less risky than a spread that is short an option on one contract and long an option on a different contract, since the latter position entails an additional bet about changes in the relationship between the two contracts. Term structure considerations are familiar to futures traders, but they also apply to IR ETFs, even if the opacity of ETFs obscures that fact.

[1] Data: CME Group, thinkorswim. Open interest data retrieved August 11, 2010.

[2] See Galen Burghardt, The Eurodollar Futures and Options Handbook (McGraw-Hill, 2003), ch. 19.

Follow
That Trade

Jared Woodard

In conjunction with my column for this month, I thought it would be interesting to follow a trade using options on interest rates. In mid-July, the implied volatility in short-term Treasury options had fallen to nearly one-year lows, as measured by the Merrill Lynch MOVE Index, below. The MOVE Index is a yield curve weighted index of implied volatility on one-month 2-, 5-, 10-, and 30-year Treasury options. Although the methodology is different, it can be thought of as a VIX proxy for the bond markets.

The 21-day historical volatility of 10-year Treasury Note futures had also fallen below 5%, as shown in Figure 2.

Initial Trade Setup

Taking a speculative view that the volatility of T-Note prices was likely to rise over the short term, on July 21 I bought the ZNU0 123 straddle two times, comprised of the 123 call bought for 1˝10 (or 1.15625) and the 123 put for 0˝42 (0.65625).[1] The total price of $1.8125 meant I was risking $3625 ($1.8125 * 1000 * 2) for a straddle expiring on August 27, and the break-even points for the trade were therefore $121.19 on the downside and $124.81 on the upside (i.e., the strike price plus/minus the premium paid).

With the underlying futures trading at 123´20, I needed at least a 0.96% move higher or a 1.97% move lower to profit on the trade. As you can tell from those percentages, and from the fact that the calls were slightly in-the-money, this trade was structured with some positive deltas—more out of respect for the trend than anything else. Now, the options were pricing in about 5.75% annualized

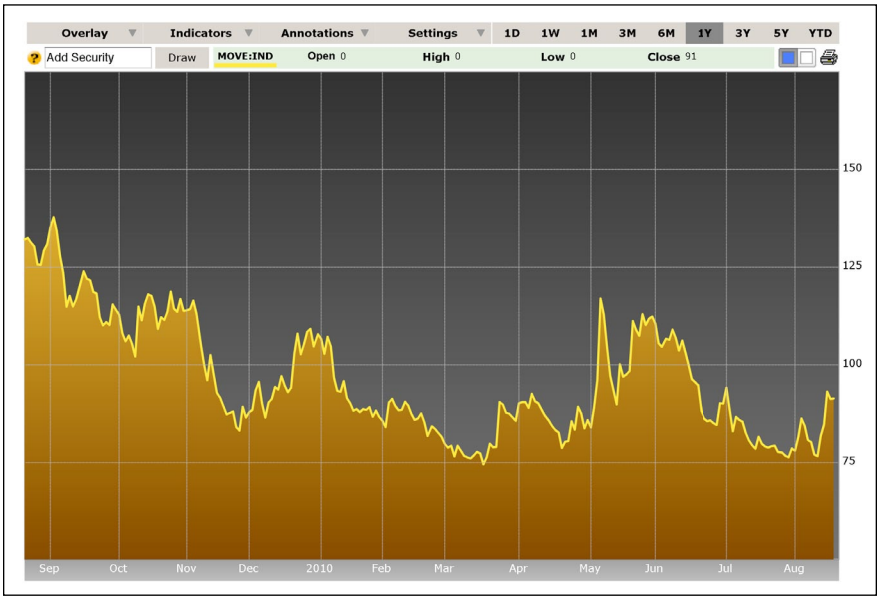


Figure 1

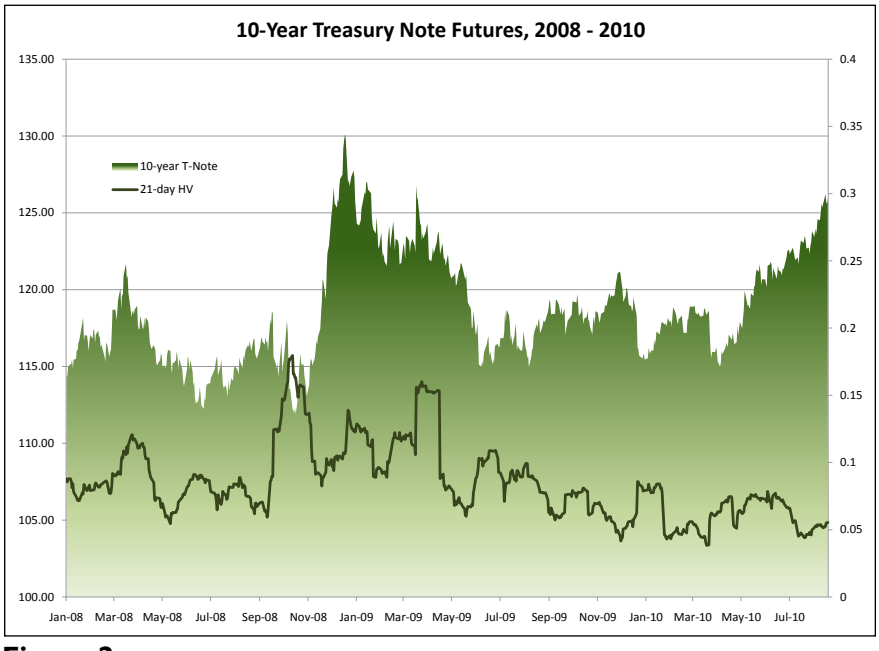


Figure 2

volatility against a 21-day annualized historical vol. of 4.4%, so the speculative thesis definitely needed to be correct to overcome that hurdle. Figure 3 shows the risk profile of the trades along with the greek values at inception and at the break-even points.

I elected to delta-hedge the position at the close of trading if the net deltas were greater than 1000 or less than -1000—1000 is the delta value of a single futures contract—because some light gamma-scalping can help offset the costs of holding long volatility positions.

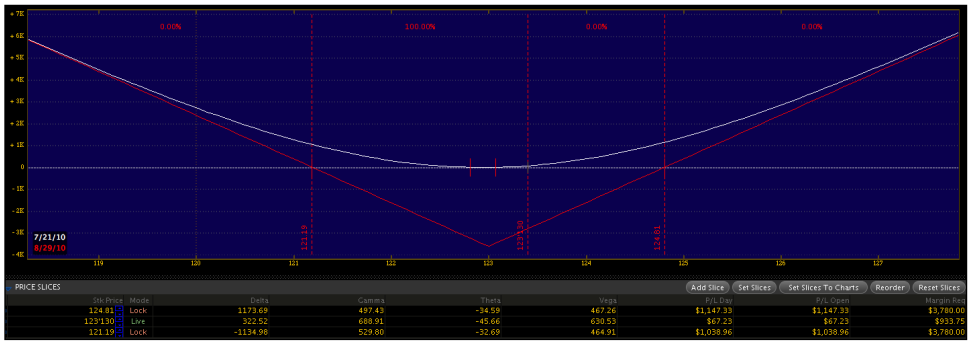


Figure 3

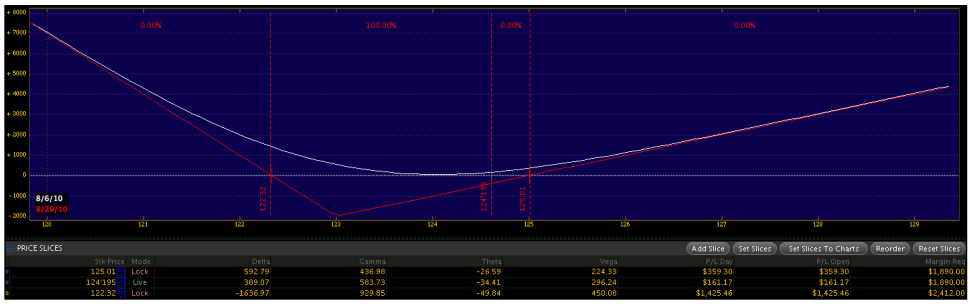


Figure 4

Trade Adjustments

Over the next two weeks, ZN futures declined a bit and then resumed the trend, moving to new highs on July 30th. By August 6, the trade was showing some very small profits—but more importantly, with 10-year note futures trading at 124′19, the predefined delta band had been breached, so I sold short one futures contract at the close. That action altered the position's risk profile in a predictable way—it reduced the upside potential but also cut the maximum loss in half (Fig. 4). Conceptually, after riding the trend for a few weeks, nudging the position in the direction of a little mean reversion—or at least a less aggressive bullish stance—seemed reasonable enough.

In fact, however, the trend continued. This is the same move in interest rates that has many traders currently looking to short TLT or buy TBT to catch the "top" in bond prices. ZN futures closed on August 16 a bit above the 126 level, and at this point the total position was profitable by about $1200. The short futures contract had cost just over $1500, but it had served its purpose.

One noteworthy item was the reaction in options prices to the move higher in the underlying. Unlike what typically happens with equities, the implied volatility of the options did not decline with a price rise in the underlying. At-the-money options expiring in August were still at about 5.6% implied volatility, with slightly out-of-the-money options approaching 6%. The MOVE index rose significantly as well.

Trade Exit

The position was exited on Thursday, August 19. With only a week remaining until expiration, the risk of a turnaround in yields and the increasing time decay didn't seem worth paying for. The 123 put was no-bid, and the 123 call was sold for 2″29, for a gain of $1281.25 on the options. At 125′30, the futures contract was bought back for a loss of $1343.75. All told, the trade was basically a scratch.

As it happens, this position was open for 21 days, and over that period the underlying exhibited an annualized volatility of 5.69%—slightly lower than the ATM average implied at the inception of the trade. The speculative thesis was not correct: had we let the straddle ride instead of selling short the futures, the trade would have been more of a directional bet on prices, rather than a volatility trade.

[1] 10-year Treasury Note futures are priced in 32nds, while the options are priced in 64ths.

Guest Author

Expiring Weekly

Vance Harwood

Expiring Weekly: AAPL, AMZN, EEM, FAS, FAZ, GLD, GOOG, IWM, USO, SPY, and more

Now every week is expiration week for nearly 30 options listed by the CBOE on popular indexes, ETFs, and stocks. Unlike their long standing weekly options on SPX, DJX, OEX, and XEO, these recently added listings have vanilla style specifications—they are both physically settled and American exercise. The CBOE WEEKLYS℠ typically start trading on Thursdays nine days before their Friday afternoon expiration, but they aren't offered on the weeks that standard monthly options expire—there's no point.

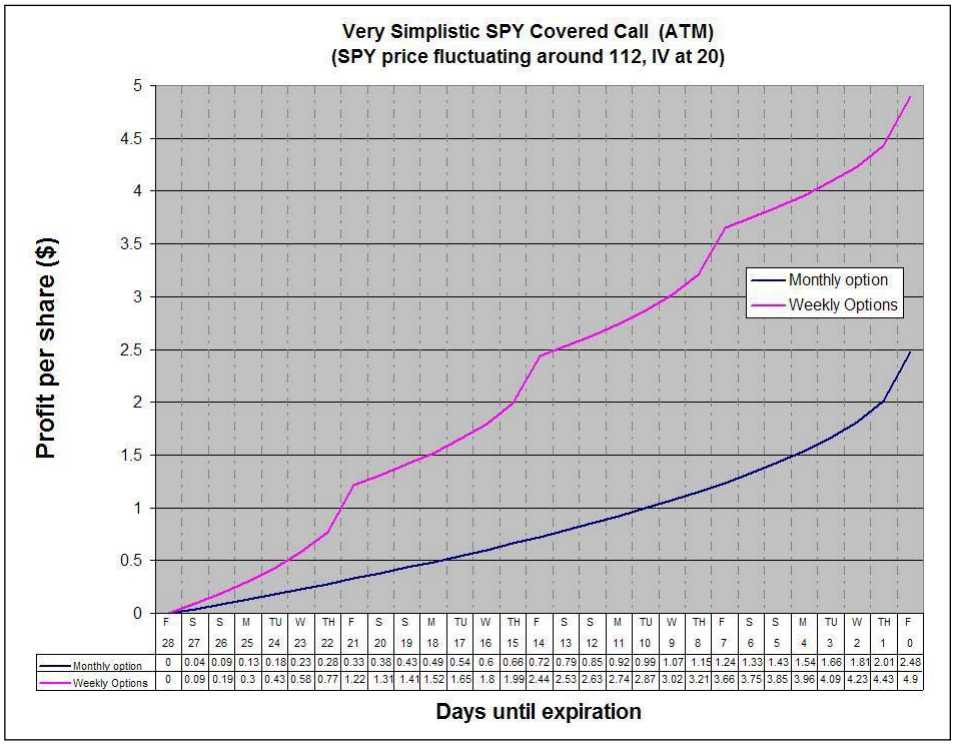
If you're typically long, these options might not have much appeal—it seems like they already expire way too soon—but there are real advantages to trading options right before expiration. In addition to the obvious high leverage opportunities for speculation on market moves and earnings announcements, there are other strategies to pursue. In his book, *Trading Options at Expiration,* Jeff Augen mentions three of these near-expiration effects:

- Implied volatility collapse (option IVs dropping to zero on the last day of trading)
- Strike price effects (e.g., stock pinning)
- Rapidly accelerating time decay

As a covered call writer, I'm particularly fond of the last item—accelerating time decay (theta). With monthly options I often wait until a week or two before expiration before I initiate my positions. The additional premium gained by creating the position earlier doesn't seem to justify the longer exposure to market risk. Now, with weekly options I can take advantage of the richest part of the time decay before expiration every week. The chart below gives a simplistic, near best-case performance comparison between using standard options and *rolling* weekly options.

Assumptions and disclaimers for the model:

- SPY price is at 112 when selling options, sell calls at strike price of 112
- Implied volatility (IV) is the same between the weekly and monthly options



	F	S	S	M	TU	W	TH	F	S	S	M	TU	W	TH	F	S	S	M	TU	W	TH	F	S	S	M	TU	W	TH	F
	28	27	26	25	24	23	22	21	20	19	18	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1	0
Monthly option	0	0.04	0.09	0.13	0.18	0.23	0.28	0.33	0.38	0.43	0.49	0.54	0.6	0.66	0.72	0.79	0.85	0.92	0.99	1.07	1.15	1.24	1.33	1.43	1.54	1.66	1.81	2.01	2.48
Weekly Options	0	0.09	0.19	0.3	0.43	0.58	0.77	1.22	1.31	1.41	1.52	1.65	1.8	1.99	2.44	2.53	2.63	2.74	2.87	3.02	3.21	3.66	3.75	3.85	3.96	4.09	4.23	4.43	4.9

Figure 1

- Weekly options are rolled to the next series on Friday when their premium drops to 0.02.
- This chart does not show the downside risk of a covered call position—which is roughly equivalent to being long SPY minus the selling price of the calls.

I have been monitoring and trading weekly options (mainly SPY) for a few weeks now. Some observations:

- The list of available options varies week to week. The CBOE provides a spreadsheet showing the active and upcoming series. The stable new listings over the last two weeks are: AAPL, AMZN. BAC, BIDU, BP, C, CSCO, DNDN, EEM, F, FAS, FAZ, GE, GLD, GOOG, GS, IWM, QQQQ, SPY, USO, and XLF.
- Upcoming earnings announcements and volume leading options (e.g., BP) appear to be part of the selection criteria for the variable part of each week's listings.
- Not all major brokerage firms provide quotes or allow trading of these options. I spoke with one of the laggards and they said they are working on it, but it will be a month or two before their software can handle it.
- Some option chains show a (W) near the symbol to indicate weekly options, but don't display the expiration date. I predict trouble ahead with investors not understanding the significance of the (W). I think explicitly showing the expiration date is a less error prone approach. The new symbology initiative solves this problem, but brokers prefer to use shorter option symbols.
- Volume and bid/ask spreads have been respectable. ATM (at-the-money) options often run more than 1,000 trades per day and ATM bid/ask spreads are usually around 0.02 to 0.03. On relatively quiet days I received good fills on limit orders that beat the spread by 0.01.
- The number of strikes per series runs in the 10 to 20 range, roughly centered around the underlying price when the options are created.
- All newly listed weeklies expire Friday afternoon after the close of trading, while regular monthly options officially expire on Saturday. In an email conversation with CBOE on SPY options they stated "Both standard and the WEEKLYS℠ SPY options use exercise-by-exception processing (automatic exercise) on the same time of day on Friday of the expiration" so in practice there is no difference between the two different series.
- On some trading platforms the reported greeks drift away from reality as expiration day approaches, with many options showing delta and gamma = 0 and other nonsensical values on Friday. Because of their Friday expiration date I think some greek calculations are off by a day when computing the time remaining on the options. For example, at opening Thursday there are almost two full days of time left on the weekly options, but a simplistic time to expiration calculation based on a Friday date would set the time remaining at one day. Some quick checks confirm this error is present on at least one major broker's trading package. On the other hand, Livevol™ offers free options chains that appear to report the greeks correctly, even near expiration.
- The IVs of many of these options have been running high, compared with the monthly options (e.g., IV for SPY ATM calls as high as 30 compared with 20 or the monthlies). I don't know if this is market or news driven (e.g., monthly jobs report, Fed announcements) or a structural feature. My guess is that the IVs will typically be elevated relative to the longer-term series.

Short-term options players have some shiny new toys—and judging from the trading volume we will be seeing more of them.

Vance is a private investor whose interests include macroeconomic forecasting, investor psychology, and risk management strategies. His investment activities include trading index ETFs, VIX index-related ETNs and their associated options as well as authoring the blog: Six Figure Investing. Vance graduated from the University of Colorado with a degree in Electrical Engineering and manages a team of engineers for a telecommunications company. He and his wife Nancy live in Northern Colorado.

The Monthly Options Report

Weeklys & More Weeklys

Adam Warner

So we have these weeklys now in a growing list of names; what exactly to do with them?

Selling them sure feels tempting. I mean the decay curve is exponential. By that I mean that an option decays more overnight when it has 1 day of life remaining than it does when it has 2 days, and more when it has 2 days remaining than 3 days, and so on. So when you start selling with a week to go and then roll it each Friday for 4 weeks (the most frequent length of an expiration cycle), it stands to reason you will do better than if you just sell a 4 week option once. Right?

Well, unfortunately we don't know. If the stock itself is volatile, the 4-week option likely works better (or at least less-bad) as the whipsaw of 4 consecutive short-dated, high gamma options will prove disastrous. Pretend you are comparing ATM straddles in SPY that don't work. If you sell 4-week options once, you will lose much less than if you sell 1-week straddles with tiny premium cushion on 4 separate occasions.

If the stock is non-volatile, the weeklys will work better for the reasons given above, namely the accelerated time decay.

So since we don't know exactly what the market will do over the next month (well, we mortals don't), how to decide?

Well, one thought is to use some simple VIX rule. If VIX is above a certain absolute level, or a certain amount above a moving average, maybe you should go further out in time. So in this case sell the monthly options. If not, sell the weeklys.

There's no backtest you can try yet, as weeklys have not existed long enough to see it over time. You could of course simulate weeklys: just come up with a volatility where they would have traded, then run them vs. monthlys with different criteria.

But I would suggest this will lead to bad conclusions. Namely because the mere existence of weeklys changes the realized volatility of the underlying. We all know how pins work. If there's high open interest in a near money option and a non-volatile underlying, we are more likely to pin. But in order to have open interest and the resulting tug on the stock, it needs to actually trade.

In other words, we don't exactly how weeklys will effect trading. It obviously depends on volume and open interest. The more popular they get, the more it impacts realized volatility. And it's important to note this can work both ways. Regular expiration week is not as volatile as they lead you to believe on TV. But it is moderately more volatile than a regular week, and anecdotally more likely to accelerate trend moves. Pins and their volatility-damping effects get all the press, but there's a flip side too. Options shorts often get trapped and forced to chase moves. So if weeklys get more popular, expect to see more Thursday and Friday squeezes.

Wolf Against the World
Weekly Options

Mark D Wolfinger and Adam G. Warner

Premise *The CBOE has expanded its list of Weeklys. These options are born on Thursday, and expire at the close of trading about one week later. Is this a good thing?*

Yes *by AG Warner*

I believe I have mellowed in my old trader age. The younger me resisted all new options-related products. The older me says: just learn what you trade.

Weeklys are the new "it" trading product. They're in the pilot-ish stage now, but are growing in trading popularity by the minute.

And I like them.

Let's say you want to make an options bet on an earnings move. But there are still 4 weeks until the next regular expiration. Well, you'll find you not only are making a bet on the actual earnings reaction, but you're also wagering on what will happen to implied volatility after the news is out. Remember, there's still a full cycle of life in these options.

Weeklys let you avoid that second bet and concentrate on the first one.

And it doesn't have to be just earnings. What about an FDA ruling? A Fed meeting? A new iPhone? Weeklys lend themselves to any targeted bet.

For option sellers with comfort managing high gamma, these pups are a dream. The time decay curve is exponential, speeding up as expiration gets closer and closer. Well, with weeklys, it's *always* close.

Of course, you need a buyer. And that works too in weeklys, if that's your game. Namely, a relatively low dollar, high leverage shot at a move. And the mere presence of weeklys will ultimately add juice to that move if/when these options gain in popularity.

The bottom line is that these are just the same options we have listed for decades, just with added timing flexibility. There's no mandate that says you have to trade them. I personally haven't touched a LEAPS since I left the AMEX. So to me, the mere creation of weeklys is a pure Pro.

Not So Fast *by MD Wolfinger*

Weeklys are destined to become a very popular product for the CBOE. They afford 40 extra opportunities (52 vs. 12) every year for those who enjoy trading into options expiration. And I must admit that it's very tempting, even though I avoid trading front-month options.

This is good for the CBOE and its shareholders. And it's great for Jeff Augen, whose excellent book, *Trading Options at Expiration,* is bound to experience a buying surge.

Traders who love the [positive theta/negative gamma] 'action' have the chance to play their favorite games more often.

So, if this is going to be a well-traded product and if it gives more traders more opportunities, what's with the negative attitude?

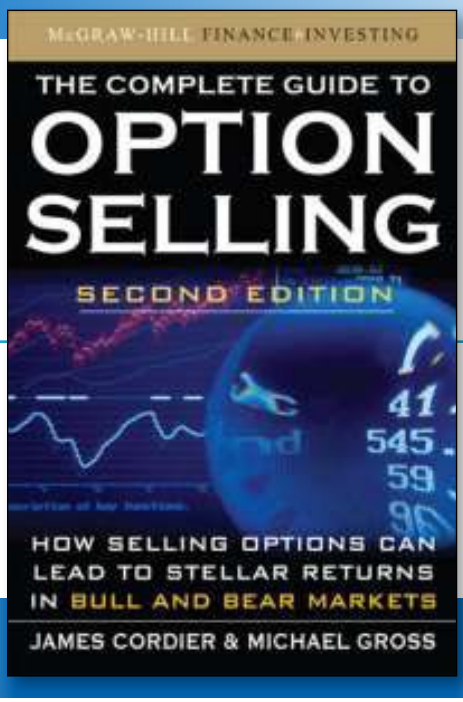
It's difficult to explain. I prefer to look at options as investment tools that are best used to mitigate risk. Not everyone has to be a conservative trader, and it takes all types of traders with a multitude of opinions to make a market. But I fear too many small players are going to enter the fray and get blown away.

The older Adam likes this product, but the (even older) old Mark thinks that options are primarily becoming tools for wagering on market movement, and are no longer considered to be hedging tools. The action provided by rapidly changing option prices (as they zoom through the strike with little time remaining before expiration) is much more attractive to gamblers. Okay, it's much more attractive to option buyers, but the rapid time decay is going to lure a lot of option sellers.

Too many people already consider options to be tools for the gambler, and this self-serving CBOE action is not going to alleviate that situation. In fact, it's now almost impossible to make the argument (to convince new investors to use options) that options are appropriate tools for serious investors who can use them to reduce risk.

The Complete Guide to Option Selling
Book Review

Bill Luby



The Complete Guide to Option Selling (2nd Edition); James Cordier & Michael Gross

In *The Complete Guide to Option Selling,* James Cordier and Michael Gross have delivered a book which should appeal to beginning options traders who have an interest in learning options selling strategies and particularly to those who are open to venturing outside of the stock world and into a broader investment universe populated by commodities and other futures products.

What I find most appealing about this book is the focus on selling options and emphasis on futures. Both of these two aspects position *The Complete Guide to Option Selling* as an attractive niche product. Whereas many introductory books define the options world narrowly and give short shrift to short options positions, I thought it was refreshing to see an emphasis on selling options and on using coffee and soybeans as examples rather than AAPL and GOOG. It is important to note that traders who are comfortable only in the world of equities are almost certain to be put off by this futures-centric approach.

A third element of this book which is unusual is that the strategic underpinnings of the options strategies emphasize fundamental factors and seasonality instead of a technical approach. In terms of selling, futures and fundamentals, there is much that is refreshing here and that sets Cordier and Gross' approach apart from the crowd.

Unfortunately, however, the book fails to fully deliver on its promise. Starting with the title, this is nowhere near to being a complete guide to selling options. In fact only four options strategies are discussed at any length:

- naked short puts and calls
- vertical credit spreads
- covered calls
- short strangles

The primary strategic focus of the authors is on selling naked short puts and calls. Specifically, the authors endorse a strategy of selling options which are far out-of-the-money (low deltas) and are 2–6 months from expiration. This is indeed the proverbial picking up nickels in front of a bulldozer approach that has been responsible for the ruin of many an experienced trader, not to mention novices.

In fairness, the authors devote an entire chapter to risk control and the advice here is generally very solid. The important point is that particularly with naked short puts and calls, traders will need to have a solid grasp of risk management strategies, a plan for each trade and the discipline to stick to that plan as events unfold. As the appeal of the book is primarily to beginning options traders, my concern is that some traders will have difficulty implementing a risk management plan that looked good on paper, but falters when unforeseen events and emotions conspire to undermine discipline and decisiveness, while bringing the risk of ruin into play.

Another subject which I would expect to see in a complete guide to selling options is a discussion of probability vs. expectancy. With a strategy of selling far

out-of-the-money puts and calls, each trade has a high probability of being profitable. In terms of expectation, however, there is no statistical free lunch, just as there is no benefit to having a 95% success rate if losing trades have average losses that are 20 times as much as average winners. Of course, this is the reason why the risk management approach is so important to these options selling strategies, especially in a world where wheat, coffee, sugar and other commodities have exhibited so much volatility in recent weeks.

One shortcoming which the authors attempted to address in the second edition of the book is the absence of any detailed treatment of volatility and the implications for fluctuations in volatility on various options selling strategies. The authors added a new chapter in the second edition to address this omission, but even though this effort carries the title of "Volatility Simplified," the authors ultimately dismiss the importance of volatility in their options selling strategies:

> *We are going to discuss methods we are a) familiar with; b) have worked well in our portfolios; and c) are simple and applicable to the mainstream, individual investor.*

I was left to wonder whether volatility fell short on the third count only or if the authors have not been able to find a way to make profitable use of volatility analysis in their various options selling portfolios.

The last bone I have to pick with *The Complete Guide to Option Selling* is the emphasis on futures as the preferred underlying, with nary a nod in the direction of exchange-traded funds that are based on futures, commodity ETFs and similar products. For the beginning options seller, ETFs are likely to be more accessible, more liquid and easier to manage. Ultimately, the treatment of these and other subjects in the book results in a bias toward using commodity trading advisors (CTAs) in a managed futures approach to selling options, for better or for worse. While I would expect that most *Expiring Monthly* readers would prefer to go it alone, utilizing a CTA is an excellent way to at the very least add some diversification to the strategies and markets one trades.

The bottom line is that for beginning to intermediate traders with an interest in selling options and/or getting involved in futures, this book is a great way to whet one's appetite. It works better as a niche book than a general reference and should in no way be considered complete or encyclopedic. I would also caution traders who are new to selling options about the importance of being able to properly control risk—both in theory and in practice—when selling far out-of-the-money puts and calls.

This is a non-essential book, but it is a well-written and capable introduction to futures as well as to selling options on both futures and equities.

Options for Rookies, a blog dedicated to options education: http://blog.mdwoptions.com/

Market Maker
Trading Tips

Mark Sebastian

At Option Pit, one of the things I always teach is how important it is for traders to insure an income position. There are many ways to do this, and some consider a butterfly as already insured. I do not. One of my goals as a trader is to protect my position in case of a major down move (such as the flash crash). The way I have always taught traders to insure a position is to own units.

Units are a floor trader's term for cheap, out-of-the-money options that are so out-of-the-money that the model has trouble quantifying its greeks properly. Units are effective because they are bought far down on the skew curve. This is the section of the curve that completely explodes when the market is collapsing. For instance, when the flash crash happened, the SPX June 900 puts went from a value $2.10 on May 5th, to a value of $10.40 on May 7th, after a relatively small close-to-close move of 45 dollars. If price wasn't the factor, what caused the value to go up so much? The IV of the puts was the culprit, as IV went from just over 41% to 52%. Prior to the crash, the greeks of the 900 puts predicted they would only move about $1.50.

This is the power units have, but where does this power come from? Skew shift. The downside curve shifted upward so much, that the value of the puts exploded. This creates a snowball effect: IV goes up, the put gains delta, the put gains gamma, the put gains vega, then the underlying price drops and IV moves higher again.

This may seem like a fool-proof plan, but it is not. What if the skew curve has already shifted upward? Will the unit still be effective? Yes, probably. Are there better ways of ensuring a position? Maybe. One idea I have is to buy a VIX call instead of buying the unit put. While I do not think this method should completely replace units, it may make sense to use VIX calls to partially insure a portfolio.

Let us look at 3 positions, all consisting of 10 SPX July 1050–1110–1170 butterflies entered on June 21st. I chose this date because it is shortly before the market completely bottomed out on July 2nd. We neutralize the delta at the start of the position by buying 3 July 1140 calls. In portfolio 1 we will have our control group with no insurance. In portfolio two we will insure by spending 10% of the margin on units. In portfolio three we will spend 10% of the margin on VIX calls. We are not going to make adjustments on the trade (we know all of you would). Which spread will perform best?

Portfolio 1 is our control group. This group actually does end up performing best in terms of maximum P&L. However, on the way there the trader would be down almost twenty thousand dollars.

Portfolio 2: the trader protects against a cataclysmic move by buying 12 July 950 puts for $2.00. While these do mitigate risk at the bottom to some degree, the amount of P&L loss mitigated barely exceeds the cost of these insurance puts. The reason for this: skew was already sky-high in July. Thus, the 950 puts did not gain an excessive amount of value on the major downturn as we would hope when buying these puts.

Group	Margin	P&L High	P&L Low	P&L at Expiration
Control	25200	21280	-19437.5	21280
Units	27800	15792	-17217.5	15792
VIX Calls	27760	19740	-16797	16842

Table 1

Portfolio 3: In this portfolio, we bought 8 VIX July 26 calls instead of units. The portfolio in my opinion performed greater than the other two. It had the highest low point and the second highest high point. If the trader held the VIX calls—which did not expire until the July 25th—the trader would have given up almost nothing on these calls. Assuming the portfolio is closed at SPX expiration, the VIX and SPX combo still outperforms units and the raw portfolio, if one considers volatility of P&L important (which I do).

Using protection is an important part of any professional trader's strategy. Just about any trader can tell you that. However, figuring out the best strategy can be extremely difficult. In the scenario above we saw VIX calls outperform units, but in many other scenarios that is not the case. It takes experience and knowledge of volatility to figure out the best option in options. Even then, the trader is not likely to be right all the time. Heck, traders that make money are barely right more than 50% of the time. It is important to be willing to use and understand all forms of hedges.

Expiring Monthly Interview with Jay Kaeppel (continued from page 16)

EM: When you have a bunch of positions on, how are you handling overall portfolio or individual position management on a day-to-day or week-to-week basis?

JK: In terms of options positions, I try not to put on too many at one time. I try to look at them a couple of times a day. I find that if I follow my positions too closely, I start to think too much, which isn't always a good thing. And obviously you can't just put them on and forget about them.

So if I look at them at 2:30 in the afternoon and something has hit a profit target or whatever, then I still have time during the day to either adjust the trade or exit the trade or whatever the case may be. One thing that is really powerful in options trading, but that takes awhile to really grasp is adjusting an existing position. That was really the hardest thing for me to learn when I went to Optionetics. I'm from a futures trading background, where you get in and you already know when you are going to get out, whether it goes up a certain amount or down a certain amount.

And with option trading, you can take a long call and if you get a certain profit, you can turn it in to a butterfly and you've locked in a profit. And it's like, "Wait a minute. Wow. What is this?" It's a whole new level, but it's a very powerful level.

EM: In terms of making adjustments versus exiting a trade, the preference in the industry seems to be to adjust the trade to either lock in some profit or minimize that risk or sometimes to increase the odds of getting one's money back. Is that ease of adjustment dangerous versus making the decision to exit?

JK: To me the catalyst for making an adjustment should be planned in advance. The exact adjustment may depend upon where the market is, where the volatility is, the price of the option, etc.

For me, most of those adjustments would come after there is a profit. If I have a dollar amount that I am willing to risk on a trade and I hit that, then that's it. Sometimes people will roll down or double down or whatever the case may be. Going back to trading plans, you make your plan. I'm going to risk

$1000 on that trade and that's the maximum; if that's hit, then you're done, that's it.

If you're looking at adjustments on the up side: let's say if you buy a call, the oldest trick is that if it doubles, then you sell half, which is fine, but in reality that doesn't always happen.

Another thing I'll look at is the action of the stock itself. Let's say you buy a 10 lot of a call and that stock reaches an overbought level, based on whatever technical indicators you're using; there is nothing wrong with saying, "Okay, if this technical indicator says that it is overbought, then I am going to sell part of this position to try to lock in a profit."

EM: So you're looking at support and resistance on the chart or maybe looking at overbought-oversold indicators on the underlying at least as much as you are looking at the options Greeks?

JK: Correct. Let's look at it this way. Let's say I buy a slightly out-of-the-money call that has a delta of 40, and if the stock gets overbought based on a Bollinger Band or if it hits a delta that exceeds 70 (there is nothing hard and fast about that, I'm just using that number as an example), or if the option doubles in price—if any one of those things happen, then that's a trigger and it's time to do something, whether it's to sell just one contract or two or ten or whatever the case may be. Basically, I'm just trying to lock in a profit as quickly as possible, and as long as you still have some upside potential, then you can just kind of let it go. And you've freed up a fair amount of capital and you still have a trade that can make more money. That's kind of the goal . . . and sometimes it even works.

EM: If you start with one position and it morphs into a different position, how does this change your approach to managing risk?

JK: One of the most important things for me is the risk curve, which shows the expected profit or loss at a given price for the underlying asset. For me, that picture is the forest from the trees. If it gets down to this price, I'm going to start giving up too much profit or have a certain loss if it gets up to here, etc.

That picture tells a lot, so I always, always tell people that with whatever software you use, you have to look at that risk curve to get a feel for what it is going to takes for this trade to make money or when it might be time to take some money off the table.

EM: How useful are put to call ratios and volatility indices such as VIX and VXO as indicators?

JK: I think they're very useful, but there are so many people looking at them now that the original rules that I set up for the PCVXO have not worked very well in recent years. All those put to call ratios and VIX indicators are great perspective indicators, because when they spike up, it's telling you something is coming.

In the original days of the VIX, Larry Connors did a lot of work with VIX reversals and things like that which had specific buy and sell signals. Those tend not to work as well these days. I don't know if it is because everybody is watching them or because we are simply in a less bullish environment, but when the VIX shoots way up, sooner or later the market is going to rally. The way I look at that kind of stuff now, whether it is put-to-call ratios, the VIX, or especially if it is both: if they reach high levels, it is time to start watching for a reversal in the market rather than to pre-empt it by trying to get in while the market is still going down. That's a very dangerous game these days.

Another indicator I follow is the McClellan Oscillator. It had a series of oversold signals in May, June and early July. If you were looking at each dip in that indicator as a buy signal, then you would just keep buying while the market was going down, down, down. But if you have some sort of market trigger that tells you when the market turns, then those indicators are all still very useful, just not always as timely as they used to be.

EM: Do you think the presence of more algorithm-based trading and black boxes than humans is partly responsible for some of these changes?

JK: Could be. I wouldn't be surprised. I would say that's probably true.

EM: Presumably the black boxes are less likely to get fearful and panic than the humans . . .

JK: The week after May 6th my weekly column was titled, "World Economy Swirls into the Abyss, Computers Panic."

EM: You recently wrote a book about seasonality. When it comes to stocks, is there something at the root of seasonality over and above people looking at the Stock Market Almanac and saying, "Uh oh, September–October, here we go again."

JK: It kind of depends upon which trend you are talking about. The end of month-first of month phenomenon and also the middle of the month is something that for me is very real, because if you think about it, how many millions of people get money taken out of their paycheck at the end of the month and the middle of the month and it just automatically gets invested? That's built-in demand. That doesn't mean it works every month, but it is a viable long-term trend.

I have a book out called *Seasonal Stock Market Trends* that came out last year. I have a graph of the middle of the month phenomenon, [trading] days nine through twelve. I traced it back from 1900-1980 and it was basically flat. Not flat, but up and down. The end result was that it made no money during those four days.

EM: But of course there was not much in the way of 401k money back then . . .

JK: Exactly. Then, when IRAs came around in the next 20–30 years, it's up, up, up—with pullbacks, of course. It basically proves the point to me that when there is built-in demand, seasonality works.

Also, the mid-year 14–15 month cycle starting in October or November through the end of next year . . . you get that mid-term election out of the way and a lot of uncertainty leaves the market. That's the big thing right now. There is so much uncertainty: what government is doing and how it is going to affect business; what foreign country is going to go bankrupt . . . There is just so much uncertainty right now that it is really hard to get a handle on things, which is why at the outset I said that having some objective methods and strong risk control is anybody's best bet.

EM: Where do you see the options market going in the next couple of years? What changes do you see on the horizon that have either started or are going to come down the 'pike?

JK: Options on ETFs: I don't know if they are going to become a bigger thing, but for anyone who is trading, that's the place to look. You can do just about anything you want to do with those: gold, bonds, euro, stock market, long-short, etc. I'm not too good at predicting the future and I don't know exactly what the trends will be in options, but I've been telling people to start taking a look at options on ETFs.

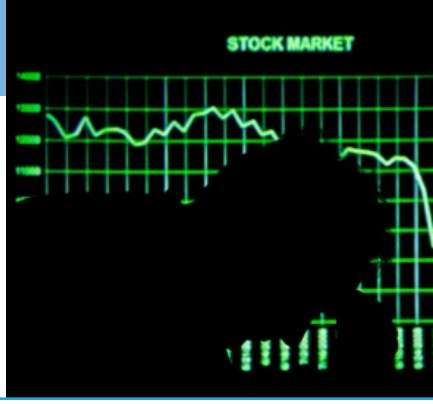
One indicator you may have seen is Larry McMillan's research showing that T-bill yield moved two years forward, which tends to presage the VIX. T-bill yields are like zero. That doesn't mean the VIX will go to zero, but it does suggest it will likely trend lower for the next couple of years.

I follow a lot of seasonal indicators. Just for the record, every seasonal indicator that I follow is going to be bearish from about the middle of August to the end of October. That doesn't mean that I plan to be bearish, but if the market is down (e.g. the Dow is below a moving average or whatever the case may be) and if the trend-following indicators are bearish or turn bearish sometime in August, I'll be playing the down side.

The other thing is that the most bullish part of the election cycle technically starts October 1st and goes through the end of next year. Seasonal stuff is not precision timing, but, like the VIX, it's a good perspective indicator and gives you a sense of where you should be looking.

In my perfect prediction, the stock market gets clobbered sometime between now and the election and after the election into next year, we get a nice rally. We'll see what happens . . .

EM: Thank you very much, Jay.



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Why You Should Ignore 2008

Jared Woodard

The time series of equity returns since 2000 raises two questions for any strategy under consideration:

1. Did the strategy outperform buy-and-hold approaches under normal market conditions?
2. Did the strategy move to cash and/or to short positions during the 2008 financial crisis?

It is important to keep these questions distinct when evaluating the returns—or especially the equity curve—of a given strategy, since a positive answer to the second question will yield results that might obscure the relevance of the answer to the first. For virtually any strategy with the capacity to take short positions, it is easy to arrive at an equity curve that looks something like this:

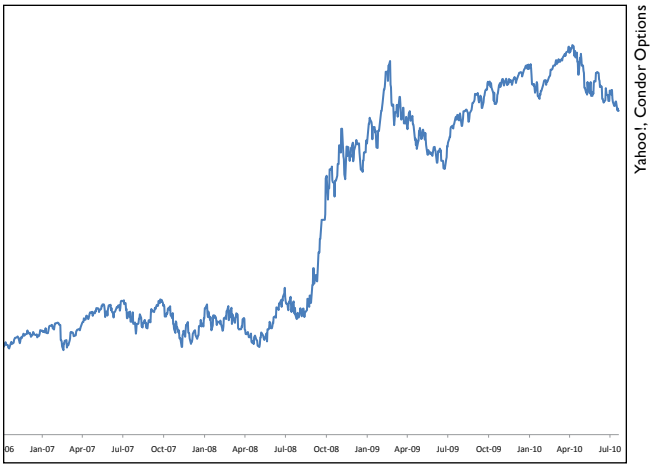

Figure 1

On first glance, this looks like a fantastic strategy: it didn't get crushed during the crisis, the equity curve slopes upward over time, etc. But the bulk of the gains came during late 2008, and because of that it is more difficult to answer the first question, whether the strategy outperformed a buy-and-hold approach under normal market conditions. The answer is clearer if we exclude the returns from October–December 2008 from the equity curve.[1]

Figure 2

Fig. 2 shows the original strategy, plus the S&P 500 and strategy returns excluding the financial crisis. As of August 2010, the equity curves of the strategy and of a buy-and-hold approach ended at almost exactly the same value when we exclude returns from late 2008. If we account for slippage, transaction costs, tax implications, etc., the strategy will look even worse.

Now, four years of data isn't enough to confirm or deny the usefulness of anything, and we could make the argument that the "crisis period" extends from September 2008 through March 2009 (or maybe only from October to November 2008, or . . .). But I think it is fair to say that the strategy fails to satisfy the first test—it doesn't meaningfully outperform a buy-and-hold approach during normal market conditions. Even if you think the next decade will be dominated by 2008-like crisis environments every few years, it is crucial not to ignore the viability of a strategy under normal conditions. And to do that, you might just need to pretend, for a moment, that the financial crisis never happened.

[1] I took the daily log returns from the original strategy and the S&P 500 and set the returns during the specified "crisis" period to zero.