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EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

THE RISE AND FALL OF THE AMERICAN STOCK EXCHANGE

A Sit-Down with Author

Sheldon Natenberg

Plus, Market Insight & Commentary

From Five of the Top
Option Trading Bloggers

EXPIRING MONTHLY
THE OPTION TRADERS JOURNAL

TABLE OF CONTENTS

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Editor's Notes

Bill Luby

Welcome to the inaugural edition of *Expiring Monthly: The Option Traders Journal.*

I am delighted to join four other top options bloggers to collaborate on a new type of magazine: one that focuses on options and brings to bear five very different experiences with options, approaches to trading strategies and ideas about the investment universe. We intend to unleash this five-headed monster every Monday following options expiration to tackle a wide range of timely issues relating to options.

The goal of this magazine is to be an educational resource for the novice to advanced investor, focusing primarily on equity options, but encompassing the full range of subjects that are found in the same orbit.

In this issue, Mark Sebastian talks with Sheldon Natenberg about how the options world is changing and what lies ahead; Adam Warner chronicles the rise and fall of the American Stock Exchange;

Mark Wolfinger begins an ongoing series for traders who are new to options; Jared Woodard discusses the relationship between implied volatility and stock returns; and I weigh in on VXX, the VIX futures exchange-traded note.

As a group, the five contributing editors firmly believe there are many ways to successfully trade options. In these pages, we hope to spoon feed some readers and challenge others. Better yet, we will do our best to avoid trying too hard to be fair and balanced; instead, we will speak out when we have strong opinions. After all, options are ultimately all about understanding probabilities and cutting corners when it makes sense to do so.

In future issues we will introduce features which will create more interaction among the contributing editors and also engage readers more directly. We encourage readers to join us in this discussion and to send questions and comments to **editor@expiringmonthly.com.**

Have a good expiration cycle,

Bill Luby
Contributing Editor

Ask the Xperts

The Expiring Monthly Team

Each issue, we select some insightful questions sent by our readers and answer them here. If you have a question about options, contact us at editor@expiringmonthly.com.

I am sure this is a simple one question, but it confuses me. If I buy a call at 50 cents and the following day the same call is trading at 60 cents, can I sell that call for profit? In doing so, do I become responsible to deliver shares if the buyer exercises, or is that the responsibility of the original call writer? This really confuses me because one book I read makes it seem as though I am now obligated to honor that call should it be exercised. I was under the impression that if I buy a call and then sell it, the position is simply closed.

Thanks for the help.
NC

NC,

It's important that everyone understand the subtleties of trading options, and this is a good question.

1) Yes, you can sell the call at a profit, but do not ignore commissions. They are often high enough to turn trades such as the one in your example into a losing proposition.

2) Your original impression is correct. The only time you are obligated to 'deliver shares' occurs when you receive an exercise notice. The only time you are eligible to receive such a notice occurs when you are net short that option at the end of a trading day. For that to happen you must sell options without buying them back; or you must sell more options than you own. You did neither.

3) FYI, the 'original call writer' is out of the picture. Once an option is traded, the buyer and seller are not connected. When an option owner exercises, the person assigned that exercise notice is chosen randomly. When you buy (to close) and no longer have any position in that option, your obligations are canceled. You cannot be forced to sell shares.

-Mark W.

I have lost my faith in calendars as an alternative to low probability condors or butterflies. I have not witnessed an occasion in which calendars outperformed a butterfly.

Regards,
Michelangelo

Michelangelo,

In my opinion, there is definitely a time and place for a calendar spread. They have been rough trading over the last year as implied volatilities have been, until recently, on strong a downward trend. In an environment with smooth upward moves in implied volatility, calendars can do exceedingly well. The key is timing, and understanding how calendars make and lose money. Calendars quickly make money for the owner when:

1) Implied volatility rallies across the board (this is less common, but the more widely understood function of calendars).

2) The relationship between the front month and the back month changes to the benefit of the owner. This is actually more common because the front month is more sensitive to changes than the back month.

As for the second part of your question, calendars can certainly outperform butterflies. I have seen calendars make 10% in one day. I have never seen that in a butterfly. In those cases, typically, the relationship between the short option in the front month and the long option in the back month temporarily changes. The trader enters the trade when the temporary change happens (typically front month gets bid up too high), and exits when the relationship reverts back to normal. One common misconception about calendars is that they are simple. Just because a trade is easy to execute does not mean it is not complex. Calendars are actually far more complex than butterflies, in my opinion. For example, butterflies do not have term risk, while calendars do.

-Mark S.

If you think the economy is fundamentally weak and that we might be in for a double-dip recession, wouldn't you want to avoid trades that are short volatility, like vertical spreads and iron condors? In other words, shouldn't you select spreads to match the general type of market?

Anonymous

Not necessarily. It depends on the time frame of the trade you are examining. Here are two examples:
1. If you're considering whether to sell a put vertical spread on an equity index and the options have ten or twelve months until expiration, that position might be a poor fit if you also expect the market to decline around that time, since the short put vertical will suffer if prices decline and/or implied volatility increases. But notice that what makes the trade a poor fit is its relation to your forecast for the time period under review, not some general rule pairing different spreads with market types.

2. If you're looking at an iron condor with forty days to expiration, it wouldn't make sense to abandon that trade just because you think that volatility might start to increase many months from now. If your opinions about the economy, or volatility, or whatever else aren't pertinent to the next forty days, then you shouldn't rely on those opinions for constructing a short-term trade.

What matters is whether the price and volatility profile of a trade matches with your own expectations for price and volatility over the period covered by the trade. I certainly wouldn't choose option spreads based on whether we're in a "bull" or "bear" market – it makes much more sense to base those decisions on specific views you have about the underlying over the relevant time frame.

-Jared W

I've heard from several people that the VIX is too easily manipulated and can give false readings and that a person is better off tracking the VXO for a truer gauge. What are your thoughts?

Martin

Martin,

In short, yes, it is easier to 'manipulate' the VIX and because one can buy VIX futures and options (unlike VXO), there is also more of an incentive to manipulate the VIX. That being said, the correlation between the VIX and VXO is so high (over 99%) that the two are – for all practical purposes – interchangeable.

Perhaps more importantly, there is a very limited reason to attempt to manipulate the VIX on any other day than VIX expiration, so for 20 out of every 21 trading days, I suspect no one bothers. On that 21st day, VIX options expiration, it is expensive but possible to manipulate the VIX.

There was indeed one dramatic instance of VIX manipulation back in October 2008.

If you are looking for an indicator of market volatility, watch the VIX. It is what everyone else is watching. If you want to trade a volatility index, the VIX is one of only four that have options and/or futures associated with it and it is hundreds of times more liquid than the others – so it is once again the only realistic choice.

Finally, I believe that most of the people who use VXO are those who built trading systems around VIX signals before the VIX became the VXO in 2003 (when a new VIX calculation was introduced). You can watch both, but you will quickly realize that the incremental information from watching a second volatility index is practically zero – at least in my opinion.

-Bill L.

If a trader wanted to use a calendar (either OTM to express directional skew or ATM to express a range-bound view) for an earnings play, would this strategy be less likely to work effectively because you are using the earnings-month option as the short leg? This short leg is expected to rise in IV as earnings approaches. Is the trader at risk of selling low IV and buying it back when higher? Will the back-month leg (which you're long) have an insufficient rise in IV to offset what your short leg experiences because it's not an earnings month?

Anonymous

Anonymous,

It depends on the specifics. Don't forget that the market generally knows which cycles contain the earnings, so if it's XOM which has earnings in February, the February options will already reflect a higher volatility for the earnings. The options will be bid up along with the volatility as earnings aproaches, but it's really not going to hurt the trader much, if at all. If possible, it is best to wait on a calendar until closer to earnings, but for a different reason, as the near month short option may not compensate you enough for the risk between when you initiate the trade and earnings day. In other words, if XOM moves between the trade date and the earnings date, that's where you might get a small hit as your short will not get the full benefit of time decay.

-Adam W.

The New Option Trader

Mark Wolfinger

Money. It's always about the money. The purpose of investing or trading is to grow your capital. There is no denying that the faster it grows the better. However, expectations must be realistic.

Questions

Most newcomers to the options world recognize that there is much to learn and it is only natural to ask questions in order to accelerate that learning process. I encourage those questions, but the following questions suggest that a new trader is not facing reality:

- I have $1,000. How long will it take to turn that into $50,000?
- I read that it's easy to earn 10% per month with this or that strategy? Can you teach me how to use that strategy?

Simple arithmetic tells you that $1,000, growing at 10% per month, requires only 12 years and two months to become one billion dollars (ignoring taxes). Surely you know that's not going to happen, and those who state otherwise are not telling the truth.

- I read an advertisement where one guy made 92 consecutive winning trades. Can I expect to do the same?

On the other hand, the options rookie who asks questions of the following type demonstrates an understanding that trading options is not the path to instant riches:

- Is it possible to make money consistently when trading options?
- Can you estimate how long it will be before my trading becomes profitable?

You may have read or heard claims by individuals who made or lost large sums when trading options. When you hear about the winners, it is easy to get carried away and feel an urge to begin trading options today. I encourage you begin with an education, then ease into trading.

When you hear sob stories from the losers, you may hear how the 'options game is rigged' and that 'the market makers cheated me.' Those are the laments of people who made big mistakes. They took big chances (a polite term for gambling) with their money by trading options before making an effort to understand how options work. The truth is that options were designed as risk-reducing investment tools, but that is not how they are perceived by the majority of the investing public. Too many traders use options to place wagers on whether the market or an individual stock is going to move higher or lower over the short term. Human nature often sends people down the wrong path. If gambling, or placing such wagers, makes you happy, so be it. When trying to earn money when using options, you will have a much better chance of achieving success if you use options to hedge (reduce risk), rather than to place bets.

The New Option Trader

The purpose of this column is to help you learn to use options with less risk. You may ask, 'less risk, compared with what?' That is a good question. You can use options to have less risk than when you adopt a buy and hold investing philosophy.

Learning the option business is no different from learning any other business. People want your money and some use deceptive practices to take it, while others are out in the open, selling expensive lessons for introductory option courses. Save your money. You can learn the basics from a quality beginners book or by getting free instruction from the Chicago Board Options Exchange (CBOE) or the Options Industry Council (OIC). And be sure to ask questions.

The New Option Trader

Mark Wolfinger

It is fun and satisfying to earn profits when trading. But there's another side of the story – and it cannot be ignored. It is widely circulated that more than 90% of new traders lose money. While I cannot confirm the validity of this number, I wonder how many of these traders give up vs. how many go on to become successful traders. I have never seen any study on that issue. One thing is certain: becoming a successful trader takes much more than desire. If you have the necessary skills and the patience to learn, you have a chance to succeed. No guarantees are offered.

Risk vs. reward

Because trading is all about the money, there is nothing wrong with being concerned with potential profits. It is important that you understand what you have to gain, not only with options, but with any investment.

However, it is more important to be aware that profits are not being given to anyone who asks for them. Profits must be earned. You must always be aware of the possibility of losing money, the chances of losing money, and especially how much money is at risk (the maximum possible loss).

In other words, the winning trader understands the risk and reward potential for a given trade – and the probability of success. Only then can a reasonable decision be made about whether to make the trade or to pass. Sadly, too few bother to pay any attention to the risk side of trading because potential rewards are often so attractive (lottery tickets, anyone?) that the risk of losing all or a significant portion of the investment is ignored.

Successful traders do not operate when wearing blinders. In this writer's opinion, the key to success depends on how well you respect your money – and that's defined by how carefully you manage risk when trading.

To request a specific topic to appear in this column, send e-mail to: mark@expiringmonthly.com

Predicting Stock Returns with Implied Volatility

Jared Woodard

Options traders are smarter than you might think. One of the implications of a recent study in the *Journal of Asset Management* is that the lagged implied volatility in options prices is a more accurate predictor of asset returns than the historical volatility of stock prices. Options traders – or at least options markets – seem to have a better grasp on likely future returns than can be had by looking at recent price action alone.

In their recent paper, "Do implied volatilities predict stock returns?" Ammann, Verhofen & Süss survey a database of individual equity options for the U.S. stock market from January 1996 to December 2005 and analyze the relationships among implied volatility, historical volatility, and stock returns. Their primary observation is that there is a "significant, highly positive relation between returns and lagged implied volatilities." On average, they find that an 1% increase in 3-month (91 calendar day) at-the-money (ATM) call implied volatility in the lagged month leads to an increase in returns of about 2% in the following month. In other words, a stock whose implied volatility rose last month can be expected to show a higher return this month. This effect was much stronger for small capitalization stocks versus than those with high capitalizations; the effect was about the same for growth and value stocks. The authors also conclude that "implied volatility carries some information beyond that implied by CAPM and the Carhart four-factor model."

What about historical volatility – surely recent price behavior already reflects much of the same information? In fact, tested against historical volatilities of 30, 60, and 91 days, lagged ATM call option implied volatilities with the same durations all proved more informative. The table below, constructed from data in the paper, shows the coefficients (higher is better) and goodness-of-fit from the volatility measures evaluated. If we take these results as is, it seems that implied volatilities have substantially more predictive power than information gleaned from price action alone as summarized in historical volatility calculations.

91d IV	2.021					
60d IV		1.734				
30d IV			1.902			
91d HV				0.337		
60d HV					0.263	
30d HV						0.506
R^2	0.008	0.008	0.0075	0.0085	0.0078	0.0062

An Earnings Explanation

One intuitive explanation of these results comes to mind: earnings cycles. Since the options being tested are individual equity options, they will reflect investor expectations for earnings results in advance of the actual announcement. In the days prior to an earnings announcement, stock volatility will often decline significantly as traders adopt a wait-and-see approach, while implied volatility over the same period will often rise considerably as sentiment about likely short-term moves is reflected in options prices. If, for example, Apple, Inc. beats earnings estimates for a given quarter and the stock rises 5% over the next week or two, backward-looking comparisons will certainly treat elevated implied volatility as more "telling" than flat historical volatility.

This explanation, if true, would not actually diminish the importance of the results above: a lift in implied volatility could just as easily have been found to coincide with lower average future returns. This earnings and news-based interpretation of the results does not explain much. If it did, we should see the shorter-term implied volatility reading anticipate significantly better results than its longer-dated counterparts. But notice that in the table above, returns following an increase in 30 day IV are no better than those following 60 and 91-day readings.

Jared Woodard

Excluding Put Skew

The most interesting aspect of this research, to me, is something the authors do not discuss at all. The fact that they are only using price data from call options, instead of both puts and calls, precludes the most likely explanation for the observed relationship between implied volatility and future returns: elevated put skew. Recall that there are two types of implied volatility skew: vertical and horizontal. Horizontal or calendar skew occurs when options in one month reflect a different implied volatility than options with the same strike in another month. Vertical skew occurs when put and call options in the same month reflect different implied volatilities.

Because equity investors tend overwhelmingly to be long stock, in times of uncertainty they turn to put options for protection. This increased demand for put options is reflected in the prices of those options, so it is common to see the implied volatility for out-of-the-money (OTM) put options consistently higher than that of equidistant OTM calls in the same expiration cycle. Given the conclusions of this research, it is tempting to think that the observed phenomenon is simply due to the presence of put skew – that is, as stock declines, increased put implied volatility might normally be expected to anticipate positive returns in the stock due to simple short-term mean reversion. But the fact that the authors studied ATM call implied volatility alone excludes this (or any) explanation based on vertical skew.

Two Implications

Covered call strategies are often critiqued for offering too little in the way of downside protection, and rightly so. But if this research is correct, traders might also want to reconsider selling calls against long stock if the call implied volatility has been rising: the premium received might not be worth the opportunity cost of missing out on a stock with increased potential to run.

Secondly, this study is neutral-to-positive for traders who tend to be net short gamma at the index level and net long gamma at the equity level. It may be counter-intuitive to buy calls or straddles in names whose implied volatility has already been increasing, but hedging those equity positions with long theta/short gamma index trades can help smooth returns.

Out-of-sample results were not as strong as those for the historical period tested, so the conclusions of this research are not as compelling as they might have been. Even so, the contrarian bias with which many traders approach implied volatility may be less warranted when it comes to options on individual stocks.

EXPIRING MONTHLY FEATURE

The Rise and Fall of the American Stock Exchange

Adam Warner

So it's March 1988 and everyone on the floor has NCAA Fever! March Madness is upon us. But it's the AMEX and we here scoff at your mere "brackets." No, we're traders. Instead of picking teams on a sheet of paper, we're going to buy and sell them. Here's how it works. Let's say I buy 1 Connecticut from you for $20. If Connecticut wins, you owe me $400 less what I paid you, or $380. If Connecticut loses, I owe you the $20, payable the next business day in cash. Why $400? I'm not sure; no one thought it out that well I guess. But hey, who am I to argue. I'm a scrawny 22-year-old just starting out in the business; I'm happy to do anything to fit in. And at the time I loved college hoops.

This whole "market" started out with a few guys in the Phillip Morris crowd, one of the busier spots on the floor at the time. Little did they know what they begat. By that afternoon, trading in NCAA tournament teams had morphed into a crowd rivaling a busy futures pit in both size and noise level. Guys were literally getting off floor orders phoned in. And it was 1988, so it was not as if someone could go hit up Bodog for actual odds (though I'm sure guys had bookies on the line). I had my plan. The markets were not efficient. Obviously only one team could win, while the others would all expire worthless. And if you mentally summed up the price of the prime teams, they added up to over $400. So I sold a bunch, took in the $400 and basically had the "field" for free. I didn't even need to win. My plan was that I would just ultimately sell my "field" teams as the tournament goes on and pocket way more than $400. Except it didn't really work. I'm short Oklahoma and they keep winning, so they keep ramping in price. I hate the odds at every juncture. Finally we're at the end: it's Oklahoma vs. Kansas. I have no Kansas position, so I now have a de facto $400 bet on them. I'm a kid and just starting out, it's a boatload of money. Wtf was I thinking? But as you might remember, Danny Manning played like the future superstar he'd have been without all the injuries, Kansas won, and I learned two valuable lessons. One was, don't gamble. The other was, is there a better place in the world to work? I doubt it.

Everyone always got the impression back then that all exchanges resembled the orange juice pits in Trading Places. Not quite. You had your occasional days with the trading like that, but by and large it was a pretty collegial atmosphere. You stood in a trading crowd in front of a specialist and took the other side of the public order flow. Another myth was that you were in violent competition with the other traders in your crowd. Not so much. You became kind of a club. You tended to work together and share and did not outbid or out offer each other, or the specialist. Your real competition was not on your floor, it was the Evil Upstairs Trader. He saw every order before it hit the floor. He could hedge. When the time was right and the order finally hit the floor, the executing broker would do his best to protect the interests of the upstairs trader. He would attempt to "cross" the trade and shut you out as best he could. If you, the crowd and specialist, wanted to participate, you pretty much had to work as one. It was just business.

And by and large, the business worked. On one hand, you were a sitting duck. Many was a time that Goldman or Morgan would dump 1000 calls of something in your face. You had to short stock against it, but you can't get a plus tick because everything still traded in eighths. When you finally shorted your stock, you simply owned options gamma in a stock that magically never moved again.

But the flip side was you got to do everything at your price. Busy options products today might have bid/ask spreads of a five cents or less. Bid/ask spreads in the 80s into the mid to late 90s were often as high as 1/4 or 3/8. Buy enough times on your bid and short enough on your offer and the clunkers would work out. My big theory on making money back then? Don't lose money. I'm totally serious. You had enough edge on the good trades, especially the smaller ones, that if you could just defend the "pick-offs" well enough, you'd do fine.

The Rise and Fall of the American Stock Exchange

Adam Warner

Another positive had to do with my timing. I started in 1988 and the first few years were relatively lean. Volume was kind of light coming out of the crash, but you didn't get picked off quite as much then either, so business was OK. But if you hung in there to the mid-90's, you were in for a treat. Order flow tended to give you long volatility positions as the "public" mostly sold you calls. But along about 1995 or so, options volatility started to climb. Then you got to execute trades on your bids and offers more often than not AND you got left with winning positions. Stocks and volatility rallied in unison.

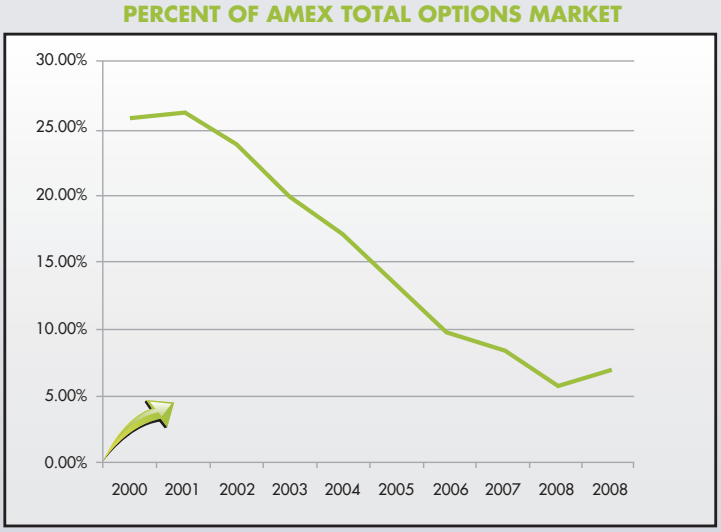
Like Greece and ancient Rome and the Chicago Bulls dynasty of the 1990s, all things must come to end. So did the physical options exchange as we knew it. Oh sure, they all still exist in name, but it's a virtual shadow of a bygone era.

A little over a decade ago, the AMEX was the 2nd busiest of the four options marts in terms of volume, ranking below the CBOE but ahead of the PHLX and the P-Coast. We can blame automation, dual-listing, increased competition, et al. for the fact that today's AMEX is now essentially a quiet room on the NYSE. But more than a small part of the demise the exchange begat upon themselves. There were proposed mergers that never happened (with the Philadelphia Exchange and the P-Coast), there was a brief and ill-fated merger that did happen (with the NASDAQ) and there was just a general inability to keep up with the pace of innovation around the street.

If one asks others in the options business at the time to explain what happened to the AMEX, they will typically say the culprit was our markets. Apparently we were called the "Scamex" around the street. Because? Well, I'm not sure we did anything worse than any other exchange. Believe it or not, we had to honor the markets on our screens just like everyone else. If one must blame something for the perceived poor markets, blame the pace of innovation, or lack thereof. The year 2000 saw the entry of the International Stock Exchange (ISE) into the business, followed in 2004 by the Boston Options Exchange. What set these two apart was that they took the same specialist (or Designated Market Maker) structure of the existing exchanges and applied it to a "virtual" floor, where the "crowd" exists only in cyberspace. The result was remote market making with instant execution.

The CBOE followed the ISE first into instant execution and later into a hybrid structure where traders could still congregate in a physical crowd at the same time as they could make markets from a remote location. The AMEX? Not so much. One thing I discovered when I left the floor in 2001 and began trading as a customer was that their fills were the slowest, even if you hit a bid or took an offer. In fact, that bid or offer you attempted to trade with may have disappeared while an order was en route. The AMEX eventually caught up to the other exchanges, but it was too little, too late. Once a customer changes his or her trading habits away from an exchange, it is notoriously tough to get that customer back.

The AMEX's "demise" only exists from certain perspectives. Volume on the exchange as measured in absolute terms has done fine as a rising volume tide has lifted all boats. A total of 3.6 billion options contracts changed hands across all exchanges in 2009, compared to 507 million in 1999. That is roughly a 7-fold increase in a decade. But the AMEX now has a reduced share of a much larger pie In 1999, the AMEX ranked 2nd in market share, with 25.53%. It actually increased that number to over 26% in 2001, despite the introduction of the ISE. In 2009, the AMEX ranked 5th in volume market share with 6.87%, trailing the CBOE (31.41%), the ISE (26.58%), the PHLX (16.79%) and the NYSE (11.66%).



Market Maker Trading Tips

Understanding Fake Deltas

Mark Sebastian

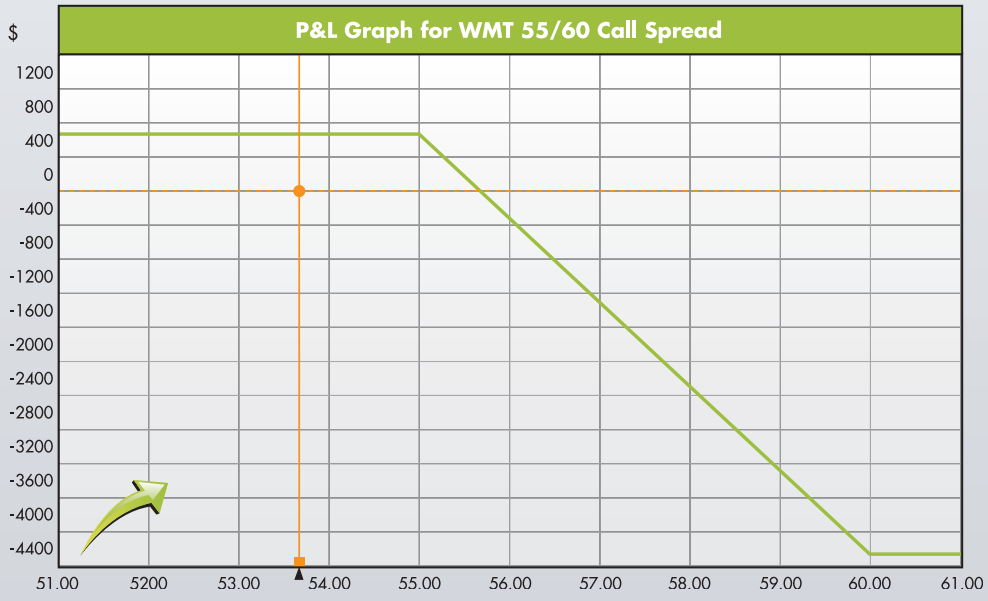
In late December 2002 one of the stocks I was trading was Home Depot (HD). Loews was just starting to really dig into the company's market share and for the first time they warned on profit. On Friday January 3rd, 2003, HD hit one of its all time lows and dropped 3.50, trading down to about 21.32. This is when I learned one of my best lessons as a floor trader. I learned about how pricing models will break down and a position will have fake deltas. Here is what happened:

A customer was long several thousand February 27.5 calls. The broker wanted to sell several thousand calls at 0.10. I could buy as many or as few as I wanted. I thought to myself, "I'll take a shot!" I bought a 100 of them. The calls had a delta of 8 causing me to sell 800 shares of HD stock at around 21.35 against the position (I do not remember the actual fill price). My thinking was that if the stock rallied a little I could sell them at a profit. If it didn't rally I was only out $1,000. Over the next two weeks Home Depot rallied over 1.00. At this point most novices would think that would be good for this position, but it wasn't. My calls that I had bought for 0.10 were still worth 0.10. However, the 800 shares of stock I sold for around 21.35 were now worth somewhere near 22.50. I had actually LOST almost $1,000 on some cheap calls….AND THE STOCK WENT UP! I had been fooled by "fake deltas".

Options that have fake deltas typically have a few things in common. They are out of the money, they have a long time to expiration and they are cheap. The typical action of an option with fake deltas is that the underlying will move in the direction that is favorable to the option, according to its delta. But, the option gains little or no value, certainly less than what its delta predicts. In the case of the HD trade, I should have known that if the stock didn't rally quickly, my short stock was going to be a loser – and it was.

While hedging with stock is something only traders with deep pockets do, the average trader can apply the concept of fake deltas to his or her trading. If traders avoid fake deltas when trading credit spreads, butterflies, or condors, the trader will have far more predictable outcomes from his or her positions. Here is an example of how simple applying this concept can be:

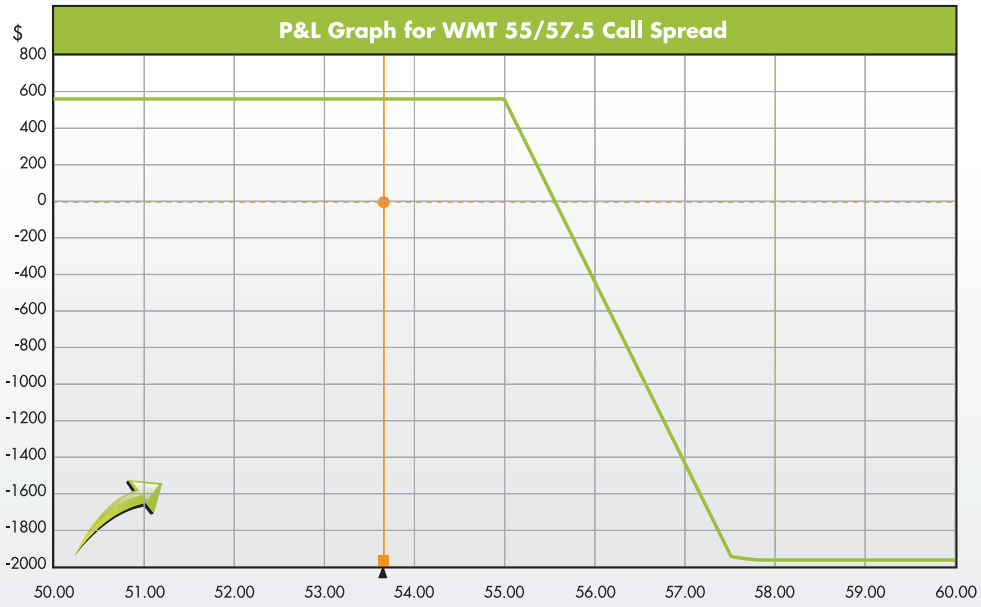
Suppose on January 15th I want to sell 10 WMT call spreads. With WMT trading 53.65 I can sell the February 55 calls which have a 36 delta for 0.75. If I set up the trade as a 5 point spread I would buy the February 60 calls. They are trading 0.08 and have a 4 delta. If WMT rallies 1.00 over the next week, the model predicts that I would lose $280 from my deltas. My bet would be that I will actually lose well over $300.



Market Maker Trading Tips Understanding Fake Deltas

Mark Sebastian

What if I set the trade up as a 2.5 point vertical instead? I can buy the 57.5 calls that have a delta of 13 for 0.21. That is only 0.13 more than the 60 calls, yet my bet is that the credit spread will act far more predictably. If the stock rallies 1.00 over the next week the model predicts that I will lose $230. I believe that is probably pretty close to accurate.



Comparing the two, for an extra $130 I have a position that has a more predictable price action and has $2500 less risk.

As presented above, most traders would quickly conclude that the 2.5 point vertical is a smarter trade than the 5 point vertical. However, many traders do not actually think about this when they are trading. Many retail traders (and even professional traders) robotically trade 5 point verticals every month, or set up a butterfly or condor with wings at a specific width. Understanding fake deltas and using this knowledge BEFORE entering into trade and when evaluating position risk can help a trader reduce risk, reduce the cost of a trade, and increase predictability of profit.

Options Graphics and Data

Charting the Market

Bill Luby

Each month in this space, Expiring Monthly intends to present a handful of graphics and data sets that will illuminate some of what is happening in the options world. Some of these are intended as regular features and others are meant to shed light on developments which are specific the most recent month. For this reason, we encourage reader feedback and suggestions.

For last Friday's quadruple witching, we note active trading volumes in the financial and technology sectors, while the stocks with the highest implied volatility (and prices of at least 5.00) were overweight in technology, biotechnology and China.

The last month has seen several measures of historical volatility plummet to multi-year lows, with 20-day HV now well below 30-day IV for the S&P 500 Index. On the other hand, stocks have continued to trend upward, short straddles on the SPX and most other indices have lost money in the past month, as directional movement has overwhelmed time decay.

Both the CBOE Volatility Index (VIX) and recent equity put to call activity on the CBOE indicate that options investors are aggressively bullish and more than a little complacent.

Looking ahead to earnings options plays, one to keep an eye on is Oracle (ORCL), where several strong recent earnings reports have generally favored the bulls. Oracle is schedule to report earnings after the market closes on Thursday, March 25.

EXPIRING MONTHLY: OPTION DATA HIGHLIGHTS

MOST ACTIVE OPTIONS (3/19/10)

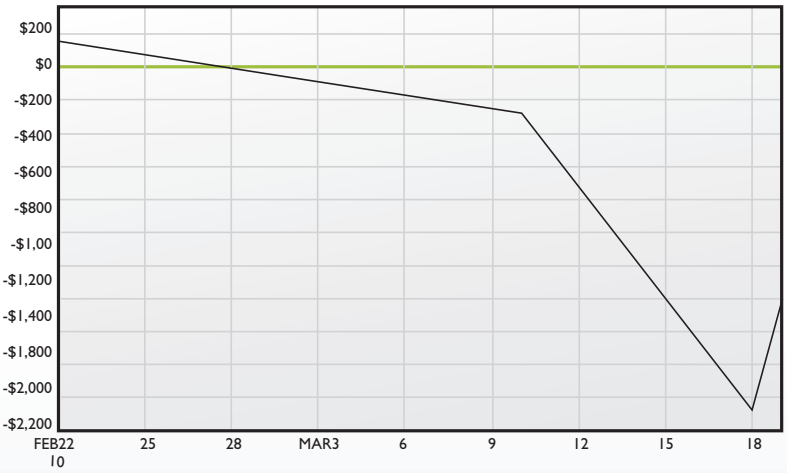
RANK	UNDERLYING	CLOSE	OPT VOL (1000S)
1	SPY	115.90	1,384
2	C	3.91	962
3	IWM	67.28	691
4	QQQQ	47.47	476
5	BAC	16.77	377
6	F	13.31	319
7	GLD	108.30	299
8	EEM	41.23	267
9	PALM	3.97	252
10	AAPL	221.75	171
11	XLF	15.66	156
12	INTC	21.94	147
13	PFE	16.92	125
14	GE	17.99	123
15	GOOG	559.89	115
16	RIMM	73.20	112
17	EWZ	71.26	105
18	UNG	7.53	101
19	CHK	24.20	98
20	DIA	197.33	98
21	QCOM	39.69	91
22	FAS	92.00	85
23	BBY	40.81	81
24	MSFT	29.58	80

OPTIONS WITH HIGHEST IV (3/19/10)

RANK	UNDERLYING	CLOSE(>5)	IV
1	VHC	6.02	119.73
2	SMOD	6.67	110.06
3	CONN	6.15	108.83
4	MDCO	9.30	103.74
5	MNKD	7.50	102.75
6	MNTA	13.99	96.09
7	CAGC	27.00	93.93
8	RINO	23.12	91.74
9	SQNM	5.67	88.46
10	WNC	7.65	85.63
11	SIGA	7.18	84.16
12	FUQI	11.92	83.37
13	XNPT	9.06	80.73
14	PUDA	9.82	80.34
15	ICXT	7.45	79.80
16	IRE	6.99	77.86
17	LDK	6.72	76.71
18	JAZZ	12.65	76.38
19	TLB	11.65	76.24
20	DNDN	36.16	75.40
21	CLDA	21.34	75.38
22	OPTT	6.84	75.17
23	HEAT	12.03	74.36
24	EDZ	44.97	74.30

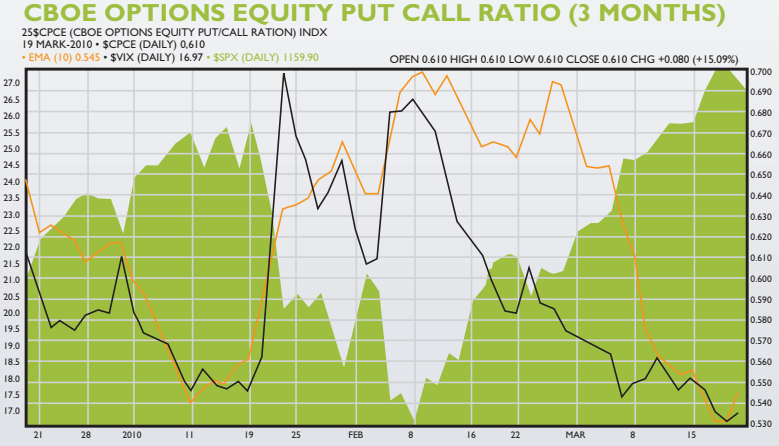
Bill Luby

PROFIT & LOSS FOR AN ATM SPX STRADDLE SOLD AT THE OPEN ON FEBRUARY 22,2010



COMPARISON OF SPX 30-DAYLMPIED VOLATILITY AND SPX 20-DAY HISTORICAL VOLATILITY (3 MONTHS)

CBOE OPTIONS EQUITY PUT CALL RATIO (3 MONTHS)



PRICE, STRADDLE AND IV HISTORY FOR RECENT ORACLE (ORCL)EARNINGS REPORTING PERIODS

The Monthly Option Report

Adam Warner

If I had a dime for every time some pundit or some stock "tweeter" declared the VIX "cheap" I'd...well, I'd certainly be able to buy many cheap options.

The VIX attempts to be a proxy for the volatility for SPX options. It averages about 20 over the course of time and that level looks like a magnet so far in 2010. But that says literally nothing about cheap. We can only measure the "value" of VIX in relation to the volatility of the SPX itself.

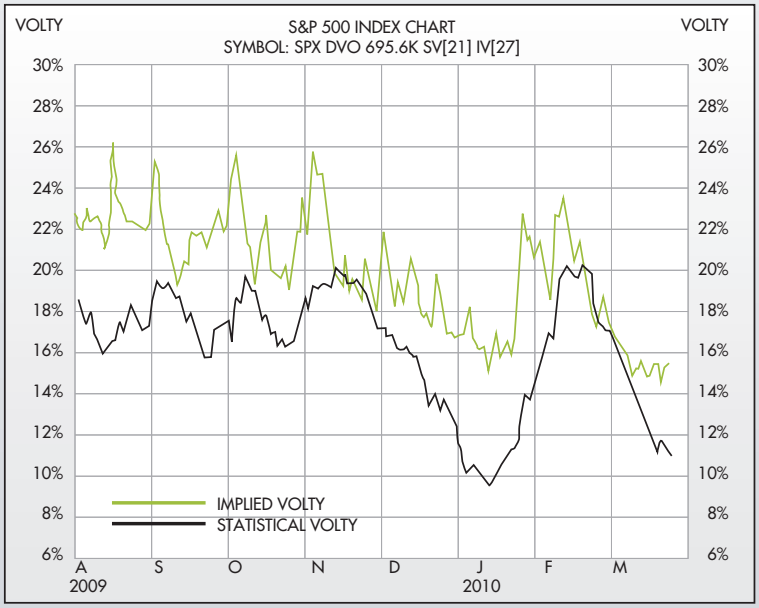
How volatile is SPX? Not very. We see blips of action here and there, but at the end of day, it's gone nowhere. Since June of 2009, the 10-day historical volatility of SPX has spent the lion's share of the time fluctuating up and back between 10 and 20. That suggests 15 or so is a fair estimate for SPX index volatility. The VIX incorporates OTM puts into its equation and given the natural skew in SPX options, those puts tend to trade at a higher volatility than ATM options. Thus, "fair" VIX is about 3 points above SPX volatility. That would put "fair" VIX roughly 18.

In the past 9 months, the VIX has only gone below 18 once, in mid-January. By the above definition, that was the only time "cheap" aptly described it. But in reality, even then the "cheap" label did not apply, because while volatility is mean reverting, that mean is never static. The 10-day realized volatility in SPX from early to December to the middle of January fluctuated between 10 and 12.5. Even if a trader believes the VIX is entitled to an even greater premium, it still suggests maybe a VIX of 16 is fair.

Of course that dip in both realized and implied volatility preceded the rather swift and large January volatility pop. Option sellers at those levels got smoked, but that is easier to see in hindsight than it was at the time of those sales.

What am I trying to say here? Well, run, don't walk, from anyone that looks at some absolute VIX on the board and declares it cheap as he likely knows not of what he speaks. Different markets have different pulses. The VIX is only "cheap" if SPX option implied volatility underprices realized volatility going forward. There is no way to know realized volatility going forward, so the best predictor is realized volatility going backward. Unless the VIX is at or below that realized volatility, it's not accurate to call it cheap.

Want an easy way to "snapshot" realized volatility? Take the range of a given day in percentage terms and multiply it by 16 (that's approximately the square root of 252, the number of trading days in a year.) Thus, if SPX moved 0.5% on a given trading day, multiply that by 16 and that day suggests that implied volatility is an 8. If a trader sees a bunch of days like that, an 18 VIX won't seem so cheap.



Follow That Trade

Mark Wolfinger

This month's trade is an iron condor executed by Mark D. Wolfinger

Trade date: Thursday Dec 10, 2009; 70 days before expiration. RUT (Russell 2000 Index) is at 597.22.

The trade:
Buy 10 RUT Mar 510 puts
Sell 10 RUT Mar 520 puts
Sell 10 RUT Mar 670 calls
Buy 10 RUT Mar 680 calls
net credit (cash collected); $2.65 per iron condor
Authors note: Commissions and other fees are ignored

The position: 10 RUT Feb 510/520P; 670/680C iron condors,
Maximum profit: $2,650.
This occurs at expiration if RUT >520 and <670

Maximum loss: $7,350.
This occurs at expiration if RUT <510 or >680

Risk profile (figure 1).
The black line shows profit and loss (scale at left), if RUT moves to the price (scale at bottom) today. NOTE: Real world conditions affect option prices. Thus, graph represents an estimate.

	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA	HEDGE	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-4,048		-7	-1	-156	28				-4,048		-7	-1	-156	28
RUT <CBEO>			-4,048		-7	-1	-156	28				-4,048		-7	-1	-156	28
2010-02-18			-4,048		-7	-1	-156	28				-4,048		-7	-1	-156	28
RUT FEB 18 '10 500.00 PUT OPTION RUWNZ		6.60	0		0	0	0	0			6.65	0		0	0	0	0
RUT FEB 18 '10 510.00 PUT OPTION RUWNB	10	7.70	-88,237		-148	2	602	-157		10	7.85	-88,237		-148	2	602	-157
RUT FEB 18 '10 520.00 PUT OPTION RUWND	-10	8.10	102.773		172	-3	-665	169		-10	9.25	102,773		172	-3	-645	169
RUT FEB 18 '10 530.00 PUT OPTION RUWNF		10.90	0		0	0	0	0			10.95	0		0	0	0	0
RUT FEB 18 '10 650.00 PUT OPTION RUYBJ		8.10	0		0	0	0	0			7.95	0		0	0	0	0
RUT FEB 18 '10 660.00 PUT OPTION RUYBL		6.00	0		0	0	0	0			5.90	0		0	0	0	0
RUT FEB 18 '10 670.00 PUT OPTION RUYBN	-10	4.50	-84,929		-142	-4	-587	101		-10	4.35	-84,929		-142	-4	-587	101
RUT FEB 18 '10 680.00 PUT OPTION RUYBP	10	3.30	66,345		111	-3	494	-85		-10	3.20	66,345		111	-3	484	-85

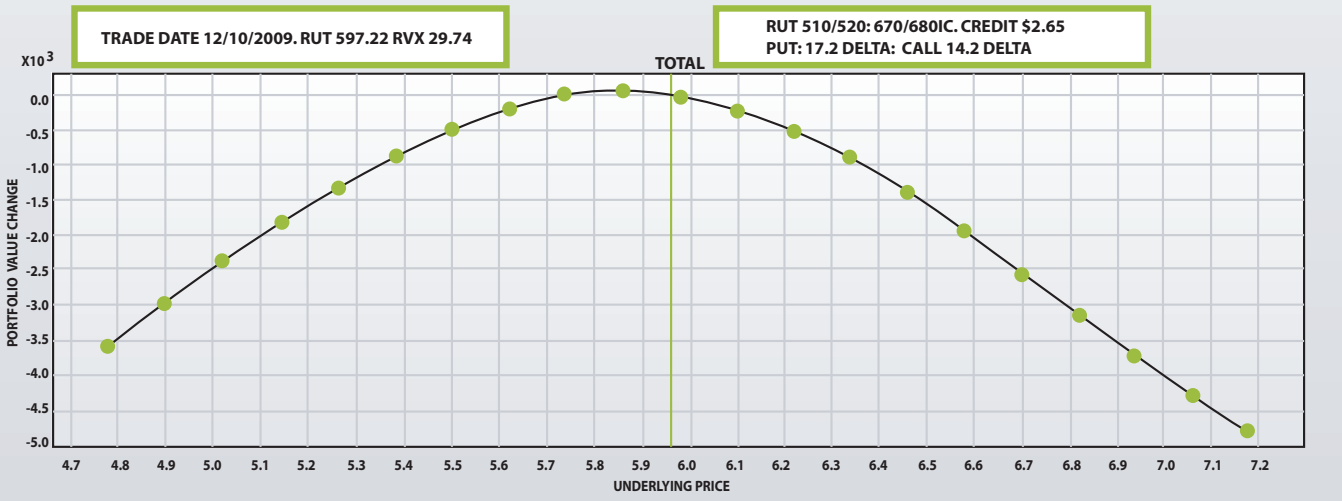


FIGURE 1

DELTA	GAM	VEGA	THET
-7	-1	-156	28

GREEKS FIG 1

NOTE: These graphs represent risk on the day the graph is drawn. Profits earned to date are ignored. Thus, all up and down moves for RUT show that the position loses money. Cash earned prior to today has no effect on potential losses when considering what the future holds.

Mark Wolfinger

Rationale for trade:

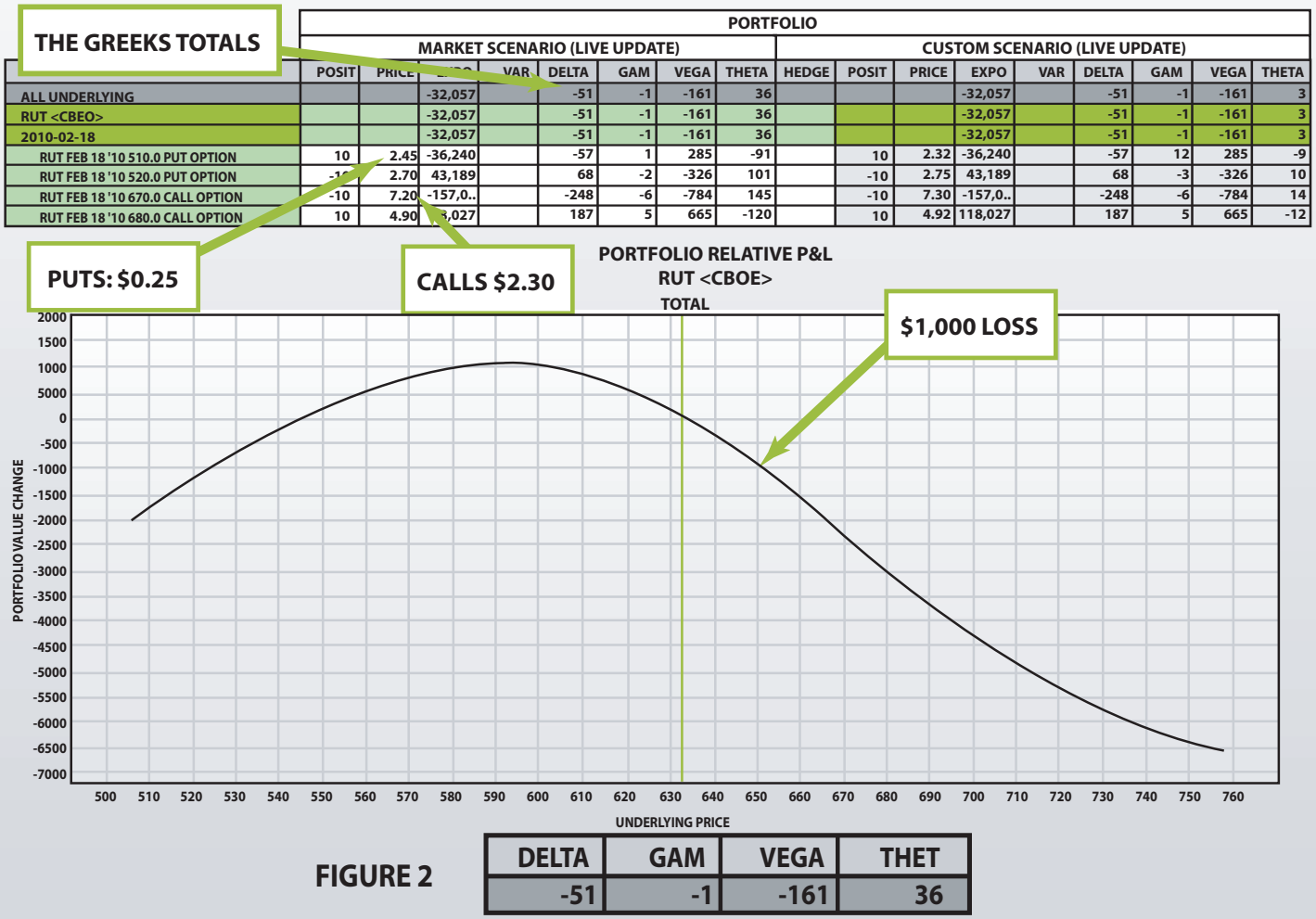
If RUT remains within the boundaries set by the strike prices (520 and 670), the options slowly erode and their prices move towards zero. At an appropriate time – to be determined – the plan is to close the position for a substantial profit ($2,650 less cost to exit). However, getting the timing right for exiting the position is often a difficult task. As indicated in the graph, a substantial change in the price of RUT wreaks havoc with those plans.

The delta of the options sold are 17.2 and 14.2 (see figure 1). Thus, the probability is > 31% (sum of deltas) that one of these options expires in the money (ITM). There is more to worry about than expiration. For instance, at any time prior to expiration there is a possibility that the position becomes too uncomfortable (risky) to hold. If that happens, preventive action ('making an adjustment') will be taken.

NOTE: RVX is the CBOE Russell 2000 Volatility Index

Update after 14 days:
Thursday, December 24, 2010 (56 days until expiration).

RUT is higher, in a seemingly never-ending rally. It is mid-morning and RUT is currently at 632. Figure 2 represents a 'real time' snapshot of the iron condor position. Risk has not increased sufficiently to warrant an early adjustment.



	PORTFOLIO																
	MARKET SCENARIO (LIVE UPDATE)									CUSTOM SCENARIO (LIVE UPDATE)							
	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA	HEDGE	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-32,057		-51	-1	-161	36				-32,057		-51	-1	-161	3
RUT <CBEO>			-32,057		-51	-1	-161	36				-32,057		-51	-1	-161	3
2010-02-18			-32,057		-51	-1	-161	36				-32,057		-51	-1	-161	3
RUT FEB 18 '10 510.0 PUT OPTION	10	2.45	-36,240		-57	1	285	-91		10	2.32	-36,240		-57	12	285	-9
RUT FEB 18 '10 520.0 PUT OPTION	-10	2.70	43,189		68	-2	-326	101		-10	2.75	43,189		68	-3	-326	10
RUT FEB 18 '10 670.0 CALL OPTION	-10	7.20	-157,0..		-248	-6	-784	145		-10	7.30	-157,0..		-248	-6	-784	14
RUT FEB 18 '10 680.0 CALL OPTION	10	4.90	118,027		187	5	665	-120		10	4.92	118,027		187	5	665	-12

FIGURE 2

DELTA	GAM	VEGA	THET
-51	-1	-161	36

There are several points of interest:

1. Delta. The 670 call's delta is 24.8. For conservative traders, this may be a danger point. For others, it's merely a yawn. Current position delta is -51: I expect to lose more than $500 if RUT rallies another 10 points. Delta is not large enough to cause concern. Gamma (rate of change of delta when RUT moves one point) is -1, confirming that the position is not in trouble.

2. The position shows a small profit (see graph for prices)

3. The true market for the put spread is $0.20 bid and $0.55 offered. The market for the call spread is a wide $2.00 to $2.60. I am confident I could buy (to close) this spread for $2.40.

4. Figure 3 indicates a $1,000 loss from today's prices if RUT moves to 650. A move of that magnitude would represent another 18 points, or 3%. The rate at which RUT has been moving higher provides no confidence that 650 is out of reach. A nervous investor should seriously consider making a small adjustment (perhaps buying back one or two of the call spreads) at this time. If the position makes you nervous, it is not a good idea to do nothing. The conclusion to hold without reducing risk is based on my comfort zone.

Decision: No adjustment needed.

Update after 26 days:
January 5, 2010 (44 days until expiration)

Yesterday RUT rose more than 14 points to 640. The Feb 670 calls are now 30 points (less than 5%) out of the money; the delta is approaching 30. Conservative traders would already have adjusted their positions. At this stage, some investors may elect to take a small loss by paying less than $3.00 to exit the trade. (Remember, we collected $2.65).

IMPORTANT NOTE:
If a trader eliminates risk by closing the 10 call spreads, the trader should not ignore the put spreads. Many traders would hold the put position, hoping to earn a small profit (from today's price) to partially offset the loss on the call portion of the iron condor. That is generally not recommended. The put spread offers little profit potential and can result in a large loss. Experienced traders generally would not take that chance. When the trader closes the calls, the savvy trader closes the puts.

Making risk-reducing trades is often more profitable than exiting the position. The easiest adjustment is to reduce position size by closing one, two, or three call spreads. If a trader buys only a few call spreads, it is not necessary to buy the put spreads. For traders who prefer to reduce size, I recommend buying two of the RUT 670/680 call spreads for $2.90.

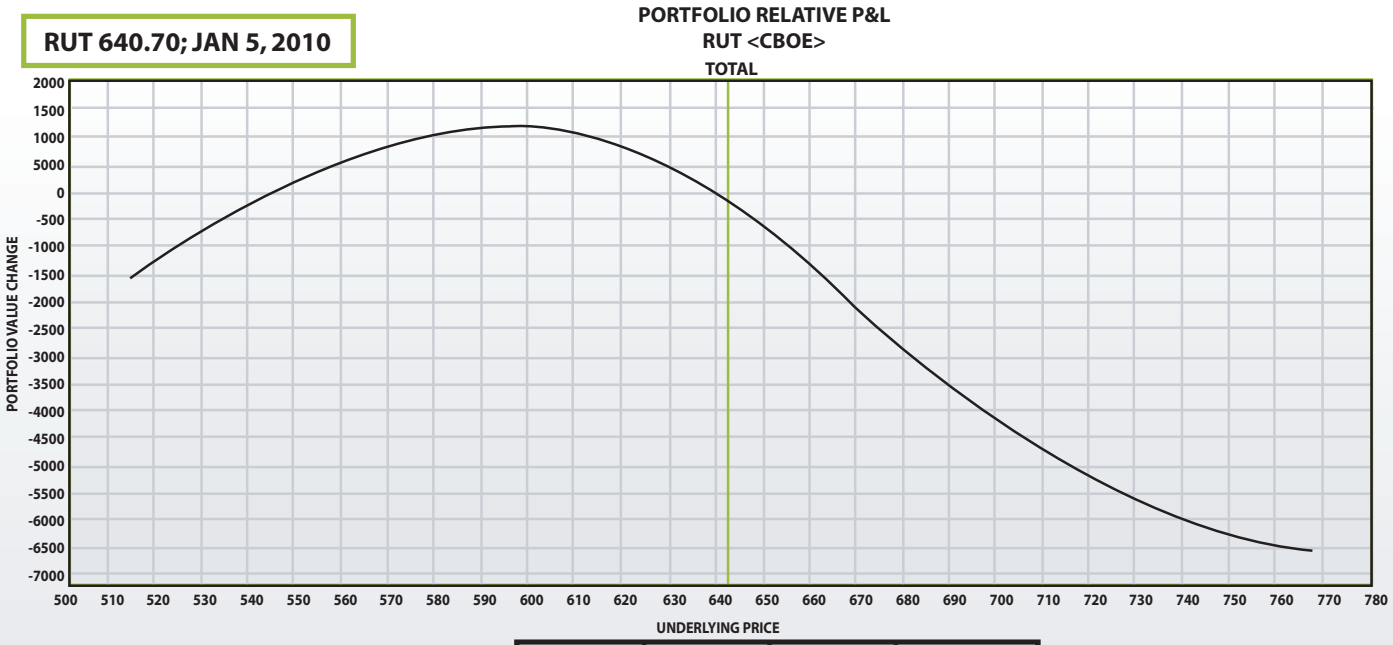
I prefer to do nothing right now, but if RUT moves near 645, then I will act. However, this Expiring Monthly feature is meant to be educational as well as informative. I consider adjusting at this time to be a borderline decision. I am opting for the less risky approach. There are many trades available, and I am selecting a method that works well (for me) under similar conditions.

Adjustment trade: Buy one call with a useful strike price (it is ITM if RUT rallies and threatens the 670 calls). To offset part of the cost, I sell an additional out of the money (OTM) call spread. With the addition of one long call to the position, much of the upside risk disappears. A significant profit is possible if the rally is strong enough (figure 4).

The RUT has advanced to 640.70; this is the risk graph (figure 3):

The RUT has advanced to 640.70; this is the risk graph (figure 3):

	MARKET SCENARIO (LIVE UPDATE)								CUSTOM SCENARIO (LIVE UPDATE)								
	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA	HEDGE	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-40,835		-64	-1	-141	42				-40,835		-64	-1	-141	42
RUT <CBEO>			-40,834		-64	-1	-141	42				-40,834		-64	-1	-141	42
2010-02-18			-40,834		-64	-1	-141	42				-40,834		-64	-1	-141	42
RUT FEB 18 '10 510.0 PUT OPTION	10	1.65	-25,992		-41	1	194	-85		10	1.50	-25,992		-41	1	194	-85
RUT FEB 18 '10 520.0 PUT OPTION	-10	1.95	-31,228		49	-1	-225	95		-10	1.78	-31,228		49	-1	-225	95
RUT FEB 18 '10 670.0 CALL OPTION	-10	7.70	-180,939		-282	-7	-753	183		-10	8.03	-180,939		-282	-7	-753	183
RUT FEB 18 '10 680.0 CALL OPTION	10	5.40	-134,869		211	6	643	-151		10	5.29	-134,869		211	6	643	-151



Notice that the potential loss is ~ $4,300 if RUT moves to 700.

FIGURE 3

DELTA	GAM	VEGA	THET
-64	-1	-141	42

Adjustment trade:

Buy one Feb 650 call; sell three Feb 670/680C spreads; cost $785.

Figure 4 shows the same position after the adjustment. The potential loss at RUT 700 is now ~ $1,800.

	MARKET SCENARIO (LIVE UPDATE)									CUSTOM SCENARIO (LIVE UPDATE)							
	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA	HEDGE	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-25,882		-40	-1	-84	28				-25,882		-40	-1	-84	
RUT <CBEO>			-25,882		-40	-1	-84	28				-25,882		-40	-1	-84	
2010-02-18			-25,882		-40	-1	-84	28				-25,882		-40	-1	-84	
RUT FEB 18 '10 510.0 PUT OPTION	10	1.60	-25,835		-40	1	193	-85		10	1.48	-25,835		-40	1	193	
RUT FEB 18 '10 520.0 PUT OPTION	-10	1.90	-30,982		-48	-1	-224	94		-10	1.76	30,982		48	-1	-224	
RUT FEB 18 '10 650.0 CALL OPTION	1	15.50	-28,059		-44	1	88	-23		1	15.84	28,059		44	1	88	
RUT FEB 18 '10 670.0 CALL OPTION	-13	7.55	-234,229		-366	-9	-977	238		-13	8.00	-234,229		-366	-9	-977	
RUT FEB 18 '10 680.0 CALL OPTION	13	5.00	-175,140		273	8	835	-197		13	5.31	175,140		273	8	835	

ADD; BUY 1 FEB 550C; SELL 3 ADDITIONAL FEB 670/680C SPREADS

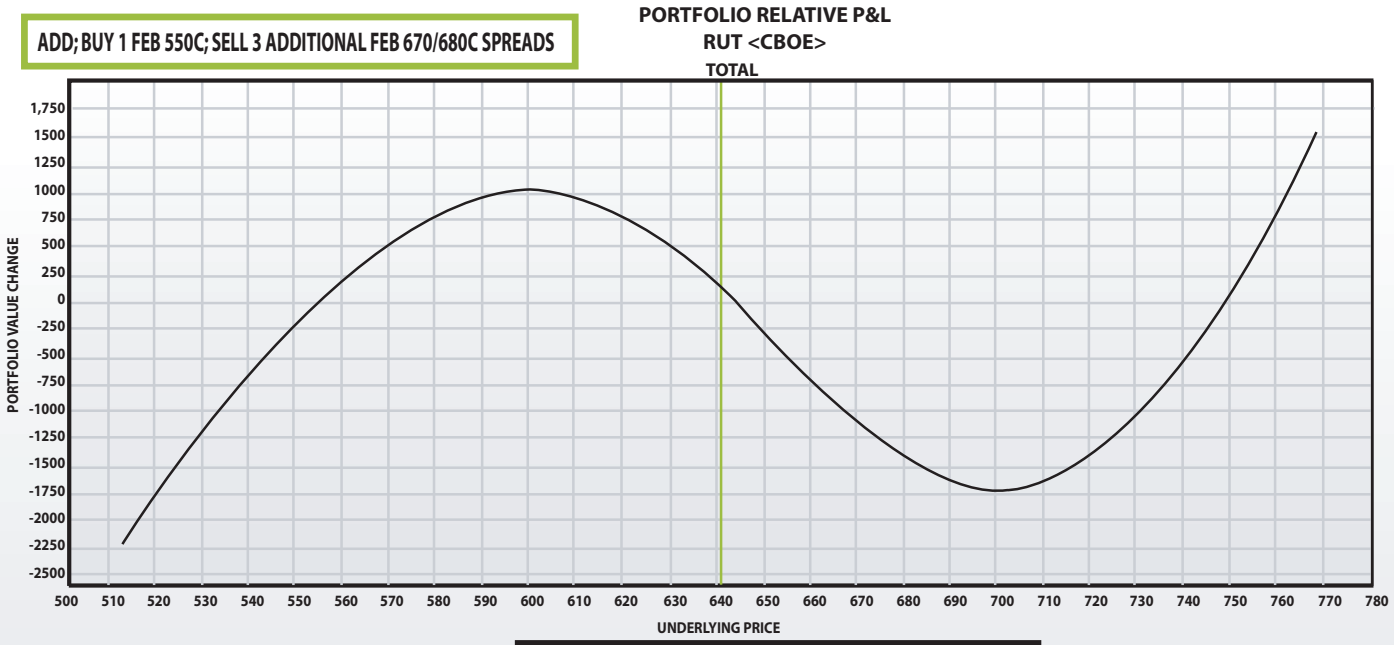


FIGURE 4

DELTA	GAM	VEGA	THET
-40	-1	-84	28

Short delta was reduced from -64 to -40 thus improving the risk profile. The additional $785 of funds is a considerable price to invest in this position. For less cash, the trader may consider buying back two of the 670/680 call spreads.

Update: January 15, 2010 (34 days until expiration) • **Update after 40 days:** January 19, 2010 (30 days until expiration)

FIGURE 5

	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-31,935		-50	-1	-122	41
RUT <CBEO>			-31,935		-50	-1	-122	41
2010-02-18			-31,935		-50	-1	-122	41
RUT FEB 18 '10 510.0 PUT OPTION	10	0.55	-15,199		-24	1	108	-63
RUT FEB 18 '10 520.0 PUT OPTION	-10	0.75	-18,546		29	-1	-127	70
RUT FEB 18 '10 650.0 CALL OPTION	1	10.35	-24,830		39	1	71	-23
RUT FEB 18 '10 670.0 CALL OPTION	-13	4.30	-168,202		-264	-10	-705	205
RUT FEB 18 '10 680.0 CALL OPTION	13	2.60	-108,091		169	8	529	-149

JAN 15, 2010; RUT: 637.96
ORIGINAL IRON CONDOR IS $0.20 -$1.70 = $1.90; NO ACTION NECESSARY

Adjustment trade: To eliminate all downside risk, I bought to close the 10 short 510/520 put spreads. Cost: $0.15, or $150. At that price, there is too little to gain by holding the position.

FIGURE 6

	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-44,123		-68	-1	-109	38
RUT <CBEO>			-44,123		-68	-1	-109	38
2010-02-18			-44,123		-68	-1	-109	38
RUT FEB 18 '10 650.0 CALL OPTION	1	12.10	29,046		45	1	73	-24
RUT FEB 18 '10 670.0 CALL OPTION	-13	4.60	,199,387		-309	-12	-745	228
RUT FEB 18 '10 680.0 CALL OPTION	13	2.60	126,218		196	9	563	-166

PORTFOLIO RELATIVE P&L
RUT <CBOE>

COVERED FEB PUT SPREAD
@ $0.15
REMAINING POSITION IN GOOD SHAPE
WITH RUT @ 645, MID-MORNING
1/19/2010

Update after 42 days: January 21 (28 days until expiration)

RUT is 6 points lower this morning, at 633. I entered a bid of $0.80 to cover the 13 short 670/680 call spreads. I will sell the one-lot Feb 650 call if filled.Position closed. Paid $0.80; sold Feb 650 call @ $5.80. RUT is now at 628.

Comment: I do not usually pay as much as 80 cents to exit, but there are still four weeks remaining before expiration, the put portion of the iron condor has already been covered at a good price, the market has been down hard over the past two days, and although I never predict market direction, I fear a rally. Under these circumstances, prudence dictates closing the trade and taking the early profit.

FIGURE 7

	POSIT	PRICE	EXPO	VAR	DELTA	GAM	VEGA	THETA
ALL UNDERLYING			-28,0...		-44	-2	-112	38
RUT <CBEO>			-28,0...		-44	-2	-112	38
2010-02-18			-28,0...		-44	-2	-112	38
RUT FEB 18 '10 650.0 CALL OPTION	1	6.75	19,356		31	1	62	-22
RUT FEB 18 '10 670.0 CALL OPTION	-13	2.20	-101,...		-161	-8	-466	150
RUT FEB 18 '10 680.0 CALL OPTION	13	1.15	54,074		86	5	292	-91

PORTFOLIO RELATIVE P&L
RUT <CBOE>

Results:
Opening trades:
- Collected: $2.65 each for 10-lots of the iron condor
- Paid: $785 for one adjustment
- Net cash collected: $1,865

Closing trades:
- Paid $0.95 for iron condor
  Bought puts early, @ 0.15
  Bought calls @ $0.80
- Sold adjustment position, collected $340
  (NOTE adjustment lost $445)
- Net cost: $610

Net profit: $1,255

Many traders prefer to hold iron condor positions until the position decays even further, thus increasing profitability. For long-term safety, my style is to exit early – when feasible.

There are no hard and fast rules to follow, but when Expiring Monthly follows a trade, the trading style of the writer affects trade decisions. Each month a different writer will follow the trade, each with his own take, our hope is that it will increase the amount of knowledge that can be attained by our readers.

The VIX ETNs: VXX and VXZ

Bill Luby

In the course of my conversations with a broad cross-section of investors, I cannot help but conclude that the popular VIX ETN, VXX, is probably the most misunderstood of all actively traded securities. In this article, I will attempt to look under the hood of VXX, explain how various factors impact the movement of VXX and offer some suggestions about how to approach trading VXX.

First, a little history is in order. Launched in 1993, the CBOE Volatility Index, commonly known as the VIX, is an index created by the Chicago Board Options Exchange (CBOE) for the purpose of calculating the implied volatility of options on the S&P 500 index for the next 30 calendar days. A source of frustration for many investors is that for the entire history of the VIX, it has not been possible to trade this index directly. In 2004, the CBOE addressed the demand for volatility products by launching the first VIX-based product: VIX futures. These were an immediate success and paved the way for the launch of VIX options in 2006. While VIX futures and options changed how investors thought about trading volatility, many retail investors were left out in the cold, due to the fact that they were not comfortable trading futures and options or did not have brokerage accounts that enabled them to do so. For this reason, a large number of retail investors were unable or unwilling to trade volatility products directly until the January 30, 2009 launch of two VIX Exchange Traded Notes (ETNs): the iPath S&P 500 VIX Short-Term Futures ETN (VXX); and the iPath S&P 500 VIX Mid-Term Futures ETN (VXZ).

In order to understand the VIX ETNs, it is essential to have a basic grasp of VIX futures. Very briefly, VIX futures are contracts that are based on the market expectation of the future value of the VIX at the time the futures contract expires. Based on the number of emails I receive on the subject, it appears as if a surprisingly high percentage of investors mistakenly believe that VIX options are based on the spot VIX (the index) when in fact they are priced off of VIX futures. As is the case with VIX options, the value of the two VIX ETNs is linked not to the spot VIX, but to the VIX futures. So while the spot VIX is the ubiquitous VIX seen in the media spotlight, all three VIX products are based not on the spot VIX, but on the much lesser known VIX futures.

Investors were relatively slow to warm up to the two VIX ETNs, but once the spot VIX began to drop below the 20.00 level toward the end of 2009, investors decided that the VIX had fallen too far relative to the breadth and magnitude of the threats to the economy. Suddenly VXX became the fashionable way to bet that volatility would rise; retail investors flocked to the product, many completely unaware of what they had purchased. Meanwhile, the longer-term VIX ETN, VXZ, was relegated to obscurity after investors tired of a product that typically moved less than half as quickly as its short-term sibling.

What many VXX longs have failed to realize is that the calculations which determine the value of this ETN are based on the price of two different VIX futures: the front month and second month futures. In order to maintain a constant 30 day maturity, VXX rebalances the two near-term VIX futures contracts on each trading day. The result is that every day VXX converts approximately 1/22 (assuming 22 trading days per month) of its portfolio from front month VIX futures to second month VIX futures.

Depending upon the VIX futures term structure, the daily rebalancing can have a substantial impact on the value of the VXX ETN. During the first two weeks of March, for instance, the front month (March) VIX futures hovered around the 19.00 level, while the second month (April) futures averaged about 22.00. As a result, on a typical day during early March, VXX was selling 1/22 of the portfolio with VX H0 futures at 19.00 and replacing it with VX J0 futures at 22.00. This 3.00 loss on a basis of 19.00 translates into a 15.8% loss for the 1/22 of the portfolio that was rolled from front month to second month futures each day. Multiplying the 15.8% roll loss by the 1/22 of the portfolio that is rolled on a daily basis, you can calculate that VXX was losing approximately 0.72% per day due to roll yield losses from the daily rebalancing efforts. Over the course of a week, this is a 3.6% loss. With VXX trading at about 24.00 during this period, VXX was losing an estimated 0.17 per day and 0.86 per week due to negative roll yield.

If some of this sounds familiar, this is the same futures contango problem which has plagued two other futures-based ETFs: United States Oil Fund (USO); and United States Natural Gas Fund (UNG). Simply stated, any ETF which utilizes multiple futures positions to create a portfolio with a constant maturity will have exposure to the slope of the term structure curve. When the futures are in contango (an upward sloping term

structure in which the futures are more expensive than the spot price), the rolling from a nearer month to a more distant month will have a negative impact on the value of the ETF. Conversely, when the futures are in backwardation (downward sloping term structure in which the futures are less expensive than the spot price), the rolling process has a positive impact on the ETF price.

While contango, backwardation and roll yield are critical aspects of VXX, it is vitally important not to lose sight of the fact that VIX futures prices reflect the direction and magnitude market participants believe volatility will move in the future. This is because VIX futures have mean reversion expectations built in to the term structure. This also means that when there is substantial negative roll yield, such as was the case in the first half of March, the negative roll yield is a side effect of investor expectations of an increase in volatility and suggests that investors believe current volatility levels are a short-term aberration.

In some respects, the VXX price action reflects a tug of war between roll yield and volatility expectations. One way of thinking about long VXX positions is to consider them somewhat analogous to owning a call option on volatility, with negative roll yield akin to time decay. As with options, it is important to understand the magnitude of the daily time decay and the size of the volatility spike required in order to make long VXX positions profitable.

To sum up, investors who are interested in incorporating long or short volatility positions in their portfolios should give some thought to the following:

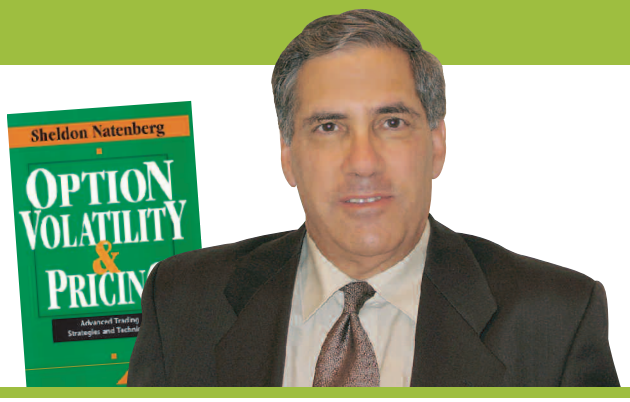
1. Focus more attention on the underlying VIX futures and less on the VIX ETNs
2. Determine whether VIX futures are in contango or backwardation
3. Know the current VXX roll yield (differential between front month and second month VIX futures)
4. Understand the tug of war between roll yield and mean reversion expectations
5. Consider trading VIX futures directly and avoid the complications of the roll yield
6. Investigate an SPX/SPY straddle in order to have a 'pure' volatility position

THREE MONTH PRICE CHART

A Sit-Down with Author

Sheldon Natenberg

Mark Sebastian



I still remember the day I found out I would be working for Group 1 Trading in New York City. Three things happened. First, they told me that I had the job. Next, they told me when I was starting. Finally, they said, "We are sending you a book called *Option Volatility & Pricing*. Have it read before you start." I did just that, thus beginning my love affair with options. I later discovered that most traders consider the book to be the bible of professional option trading. I personally have read many of the chapters three or four times. I figured there would be no one better to interview for our inaugural issue than the man who first introduced me to options, the author of the aforementioned book, Sheldon Natenberg.

What inspired you to write "Option Volatility & Pricing"?

When I started at the CBOE (Chicago Board Options Exchange), I took a class taught by Marty O'Connell. I was fascinated by how he taught and I got it in the back of my head that I might enjoy teaching, despite having no teaching background at all. So I decided to take a crack at it. I put out notices that I was interested in teaching some courses. I got one response; the firm was Chicago Research and Trading, so I taught there. Next, the CME (Chicago Mercantile Exchange) asked me to teach. I had prepared some class notes for my students. I guess the notes were helpful because an individual suggested to me that that the notes could be the basis for a book on option trading.

I began to look for an editing company and I called Dow Jones. They sent an editor. They said they weren't interested, but they had had three editors just leave and start their own firm. It was a small company called Probus Publishing. They were brand new to publishing and decided to give the book a shot.

Were you surprised by its success? Why do you think it has become the 'trading manual' of many firms?

I was surprised. Over time I've come to think that it was successful because it was written from the point of view of the professional trader. At the time option books were written for either retail traders or academics. The book was fortunate in that it was written for professional traders. It wasn't academic, but it wasn't overly simplified either. What made it successful was it turned out a lot of other traders – besides market makers – liked reading the book as well. At one point I asked the editors what they needed to make money. They said we needed to sell two printings of 2000-2500 copies to get their money back. It's now gone through over 30 printings.

Have you thought about a third edition? What might you be looking to add?

I am thinking about doing a third edition of *Option Volatility & Pricing*. I am actually working on the edition; it might end up being a little more academic, although still from the point of view of a trader. I will talk about volatility skews and intermarket spreading. I might do a chapter on volatility contracts.

What are your thoughts on the CFE (Chicago Futures Exchange) volatility futures and options on volatility indexes, like the VIX and the RVX?

For retail traders, I think the value is mostly speculative. For fund managers, volatility futures and volatility options give the ability to take an outright volatility position and hedge it. Many managers actually have natural volatility positions and do not realize it. Let's take a hedge fund manager. The fund has a portfolio that needs to rebalance every so often. When volatility goes up the cost of rebalancing is much higher.

He really has an indirect volatility position. A lot of hedge fund managers got hurt badly because they did not realize their exposure to volatility. A manager could hedge away some of the fund's volatility risk with these products.

Take a common way of using options to help manage a portfolio, the buy-write. If I am a portfolio manager I want to do two things: I want to beat the market; and I want to make money. If the market goes way up I will make money, but I won't beat the market because my options will get called away. If the market goes down I will beat the market because I am selling call options, but I won't make money because the market dropped. What is my volatility position? I am short volatility because I want the market to stay relatively stable. A buy-write will always do the best in low volatility conditions. I can use futures from the CFE or volatility options to hedge my volatility risk.

Here is another example: a market making firm. There is a correlation between higher volatility and higher volume. The market making firm wants more volume to take advantage of the bid-ask spread. Thus the market making is indirectly long volatility. The market making firm could hedge its indirect volatility using CFE or CBOE volatility products. There is a whole group of funds and traders that aren't really trading volatility and would never say they have a volatility position, yet because of the mechanics of the market they have a relatively large indirect exposure to volatility.

How do you think the proliferation of ETFs (exchange-traded funds) has changed the landscape of options?

I don't think it has changed the landscape of the options very much, but it has been a huge positive for the public. It's great because the public that wants to be long the market can go in and buy ETFs. Before the ETF, the only way to go long the market was the S&P 500 futures contract which took a lot of work to get into and to understand. Now the public can go in and buy the market with an ETF in SPY or DIA. Another positive is that they have driven down fund management fees.

In 1987 you were on the CBOT (Chicago Board of Trade) trading bond options. How does the 1987 crash compare to what happened in 2008? If 1987 brought us skew, what will 2008 bring us?

I am convinced there was skew before 1987, but it wasn't as dramatic as after the crash. I traded agricultural options; there was always a skew in those options, except in the other direction. For a few hours I thought the market might collapse and our business might disappear. I had just signed the mortgage on my house and I commented that I was hoping I could get a job as a ditch digger. Looking back, it turned out it was a one-time thing and ended up being a localized event. By contrast, 2008 had a much broader effect on the world. When you are standing in the middle of a crash you really don't know what to think. It is really hard to be objective when there is fire all around you.

2008 was interesting in that it seemed nobody did well into that market.

In 2008 it is likely that a lot of market making firms did well. If a market making firm entered September of 2008 without a major position they did great because the bid-ask spread was so wide when the market got out of alignment. It was the firms that had major positions that had their bell rung.

How is trading changing? Why are firms leaving the floor?

When I first started trading you borrowed money from your mom and dad, maybe an uncle, and leased a seat. The only thing a trader really cared about was what the guy next to him would trade an option for. Now, the markets have become so big and there is so much capital required that it has become big business. On top of that the technology and modeling required is so substantial. I don't think any firm can survive without integrating trading, financial engineering and technology. Many firms are leaving the floor because there is no money in it.

Mark Sebastian

Market making is also getting more and more difficult because of information. It used to be as a market maker you had access to information that the public or retail traders didn't have (in terms of orders that are being shopped and in the book.) Now the tables have turned and in many cases the retail traders and big banking customers may have more information than the market maker.

What do you think about penny pricing? Are we going to see the whole market in pennies?

I think penny pricing has been a real problem for the industry. The concept sounds good but the markets have turned into a free for all. There is a big difference between a free for all and a free market. But it looks like that is the direction the industry is going. If you add the tightening of the bid-ask spread, with the availability of information, market making has become very difficult. This has contributed to the decline of big market making firms.

How should the next generation of trader get into the business?

Most firms don't care about knowledge of derivatives. They figure they can teach you derivatives. Most firms want math and numerical skills. Firms will take anyone that they think can meld financial engineering, technology and trading. There are a lot of firms out there; door knocking will still at least get your foot in the door.

Over the next few years, how do you think the trading landscape will change?

I don't have a crystal ball. One thing that seems to be happening is trading for pennies and milliseconds. Firms are really interested in speed. CPU's are being moved closer and closer to the exchanges. Firms are researching and developing high frequency trading. Firms want as much speed as possible. If they can trade in 20 milliseconds they want it down to 10 and so on and so on.

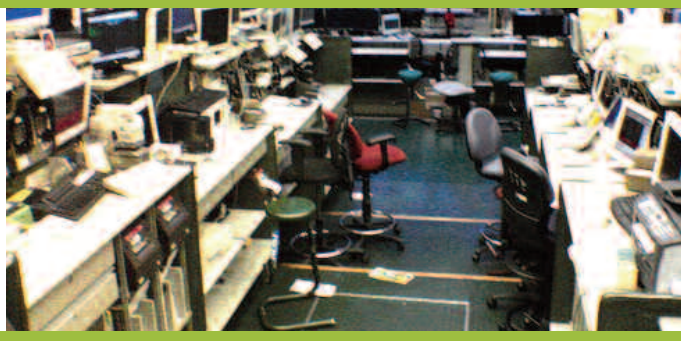
If you were to tell a new retail trader option trader one thing, what would it be?

Even if you think you are trading directionally, you need to understand the volatility component of options.

Floor Stories

Worst Trade Ever

Adam Warner



The time is February of 1999; the place is the American Stock Exchange. It was perhaps right at the apex of the floor trading business. I made easily the worst series of trades I ever made. Nothing before or since has ever come close. I left the AMEX 8 years ago last October and I'm not sure I've even had a year where I earned as much as I lost in that one trading session.

The option that did me in that day? Pediatrix Medical Systems. Frankly, I had never heard of it either until that day. They apparently don't exist anymore, at least as a stock.

Back in 1999 I was a market maker on the AMEX. My job was to provide liquidity to the options marketplace, i.e., take the other side of public order flow. If Merrill wanted to buy some calls in Caterpillar (CAT) and I was a market maker trading CAT, I had to sell him some set amount on my offering price. In fact, I WAS a market maker in CAT and American Home Products (now Wyeth) and Fleet Bank (now part of BAC) and as a host of other stocks.

At the time, you physically stood in a "crowd" in front of specialist. That specialist typically had a "book" of several options. In general, the crowd made markets in his more liquid options, basically participating in every trade on the posted bid or offer. The less liquid ones, however, we tended to just ignore. The specialist had to play them.
We did not…unless he asked us to.

That is just what happened on that fateful February Friday. Out of the blue, put buyers walked into PDX. It is noteworthy any time there is a bevy of put bids in any name when there is nothing on the tape to explain why. (Yes, it was "the tape" back then.) Traders had a handful of newswires they could see. It is particularly noteworthy when it is an option that literally never trades.

Your first reaction when you see that sort of order flow is to raise the price. That's what our specialist, who I'll call "Bob" (because that is his name) did. Bob kept raising the volatility and the stock kept falling. It did not matter; the public kept buying PDX puts. Wash, rinse, and repeat. Bob got a bit sick of the drill and pointed out to all of us MMs that we got a lot of benefits trading the order flow over the years and this was one of those times we needed to step up and provide some liquidity.

After playing some small violins, we agreed. Besides, he had made all the early sales; these puts were fat now. I mean FAT. All a trader had to do was short stock anywhere remotely near where it was trading now and you came close to locking in a winning trade. What could go wrong?

Well for starters, it was 1999. There was no penny trading in stocks. You still needed a plus tick to short stock. And to say plus ticks were few and far between was an understatement. We would sell a small quantity of puts at a silly price and raise them to a sillier price. Then sell a few more.

By the end of the day everyone in the crowd got short a decent quantity of puts and a very small quantity of stock. And remember, even if the trader could short stock 1:1, the trader probably would not. The puts were ATM or OTM, so if the trader sold stock 1:1, he would have synthetically shorted a bunch of ITM calls. Again though, moot point; there was no way to short anywhere near that much stock.

Well, it was a Friday afternoon and over the weekend the news hit the tape. I don't remember the story exactly, but as best I can recall, PDX owned medical facilities in Florida and there was some sort of fraudulent book-keeping going on (imagine that).

Come Monday or Tuesday (I believe it was President's Day weekend), PDX re-opened at about half its Friday closing price. Ouch!!! Major ouch!!!! PDX was maybe 70 before that on Friday and now it was about 35. The puts had some decent premium in them, but not anywhere close to the $20 or $30 intrinsic value ramp.

Wah!!!!!!!!!!!!!!!!!!!!!!

Now this wasn't the first or last one day hit I ever took. But, every other time, the hit was in a name I actively traded. Much easier to get rocked in a name that's already paid me off. None were anywhere near the dollars involved in PDX.

That's the sob story part. The good news? It was 1999. It was just a great time to be a market maker. The market was exploding and volatility was actually going higher into the price lift. Despite taking my single biggest hit and withstanding the August onset of losing our exclusive listing of options, I still had my best trading year ever. In fact I'm not even sure I had a down month. Man those were good times.

I suppose if I learned one thing, it's that truly anything can happen in this business. All the edge in the world means about zero sometimes. The best way to make money is often simply avoiding losing money. In 1999, in the options world a trader could earn back almost anything he or she lost. In 2010 with spreads of a penny…not so much.

Back Page

On Eating What We Kill

Jared Woodard

The slogan, popular among many traders, that "we eat what we kill" isn't just absurd, it's dangerous.

The cliché is absurd because every tick in profit and loss that accrues to a trader's account is the result of a series of institutions, laws, practices, labor hours, and countless other concrete relations of production without which trading would be inconceivable. The chain of dependence that leads to a successful "predatory" financial transaction is, in fact, so much more protracted than the series typical of ordinary "agrarian" cubicle work that we might instead regard trading as among the most tenuous, gossamer pursuits anywhere in Western culture. Recent hysterical outbursts among banks, hedge funds, and high-frequency shops over the mere mention of the possibility of a Tobin tax on financial transactions illustrate the extreme fragility of the business of trading. But an environment of perpetual regulatory capture is just the most obvious in the long chain of conditions necessary for presumably independent, carnivorous traders to exercise their purported skills.

Every financial instrument is a derivative, after all, of the work that goes on elsewhere in the material economy. When that material world occasionally impinges on the austere realm of finance – in interruptions natural, political, workerist, and so on – it becomes clear just how entirely reliant the financial sector is on the people and relationships that it exploits for profit. The impetus for the slogan, I take it, is that whereas ordinary workers depend on bosses or consumers or other businesses for their livelihoods, traders have severed such ties and are free to take profits wherever they find them. But this is just irredeemable mythology, and it gets the relationship precisely backwards. Medicine will never be a useless profession as long as people get sick; farmers, chefs, and vintners will be needed to keep us fed and happy; and we can think of similar explanations of the importance of teachers, barbers, police officers, and so many others. My claim is not that traders are useless to society; that's a question for another time. But whereas the allocation and reallocation of capital to different assets is an activity so utterly reliant on the strength of the material economy, boasts of carnivorous independence on the part of traders seem immediately not just false, but also in poor taste. Traders proud of their supposed predation are the anemic leonine aristocracy of a protected nature preserve, oblivious to the guards, gates, and smaller animals without whom they would quickly die.

Beyond the absurdity of bluster about "eating what we kill," I've claimed that the slogan also represents a dangerous attitude. If, instead of an attitude of humility and circumspection, I approach markets with all the maturity of a frat boy, I dramatically increase my chances of making serious errors. The conceptual mistake here, for one, is in attributing any success I have to my own efforts, rather than to luck; in the absence of statistically robust performance data, any claim about my own trading prowess is just a swaggering invitation of future losses. And even if we exclude discretionary traders, a healthy dose of overconfidence is a great way for a mechanical or systems trader to fail to notice important changes in the market. In addition to being an obviously false description of reality, the mythology of self-reliance is a distraction and a cognitive bias that we can all do without.

A more accurate summary might be something like, "we eat whatever we're lucky enough to find." I don't expect that inelegant phrasing will ever catch on, but the best traders don't tend to think in slogans, anyway.

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 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.

About the Expiring Monthly Team

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.