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# EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

## TRADING WITHOUT DIRECTION

## NON-DIRECTIONAL TRADING

AN INTERVIEW WITH
David Fisher, CEO, optionsXpress

Trading Ranked Volatility with Non-Directional Spreads

EXPIRING MONTHLY
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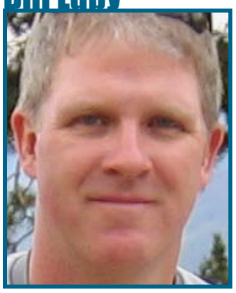
## Bill Luby



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*

With equities having moved relentlessly upward for the past six months with nary one meaningful correction, the editors have elected to make non-directional trading the focus of this issue of *Expiring Monthly*. Part of the rationale for this emphasis is that I expect the raging bull will tire in short order and usher in a regime of non-trending stocks, highlighting the importance of non-directional options strategies.

Mark Wolfinger authors this month's feature on non-directional trading: a thorough overview of the subject. In a tangential article, Jared Woodard discusses the rationale for using a ranked volatility approach for trading volatility in non-directional spreads. I elect to tackle the broader subject of what a non-trending market is and offer a three-pronged approach for evaluating the strength of a market trend.

For the second month in a row, we have two interviews. Mark Sebastian talks with David Fisher, CEO of optionsXpress about a wide range of issues; and Mark Wolfinger interviews Michael Benklifa, the author of a new book on iron condors.

Elsewhere, Mark Wolfinger's "New Options Trader" column address addresses pin risk and the role of box spreads; guest author Brian Overby details some of the most important risk factors for early exercise; and Mark Sebastian reflects on the lifecycle of trading strategies and the implications for success in "Whose Bones Are You Eating?"

Mark Sebastian also authors this month's Follow That Trade article, which focuses on a strategy he calls a "surgical strike calendar," which he likes to employ when front month volatility spikes. In this real-life example, Mark executes a surgical strike calendar with the SPX at the height of the crisis in Egypt.

In Wolf Against the World, Mark Wolfinger and 'SurlyTrader' debate the value of trading plans, including such issues as the importance of flexibility vs. rigidity.

The EM team is back once again to answer reader questions in Ask the Xperts. Finally, in the Back Page segment titled "Living and Dead History," Jared discusses the fine line between historical determinism and the accident of history as we know it, with some reflections on the implications of that distinction.

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

Have a good expiration cycle and be wary of the end of the trend,

Bill Luby
*Contributing Editor*

# Ask the Xperts

*The Expiring Monthly Editors*

***Q:** Do you always or often take a market-neutral view? Why do options traders so often seem to be oriented toward non-directional trading?*

*—Eric T.*

**A:** I won't speak for all options traders in general, but I usually trade a set of several different strategies, some of which are persistently market-neutral. Traders who like straddles, strangles, butterflies, and condors will fall into that category, but it's worth mentioning that you can fine-tune any of the spreads just mentioned so that they have a directional bias that reflects your own market view. For example, you could sell two calls slightly out of the money and then buy single calls above and below the short strike to create a butterfly spread with some bullish price exposure.

One of the reasons traders follow market-neutral strategies is that, historically, it has not been easy to predict the direction of the market over a given day or week. And even for traders who think they have a handle on directional predictions, trading a thesis about volatility—rather than price—adds some strategic diversification.

Besides those non-directional or market-neutral strategies, I think it's also important to look at classical trend-following and mean reversion strategies, in which you take directional positions that reflect a view about whether the market is in a trending or mean-reverting regime. Options can be helpful in executing such strategies because they allow you to take directional positions on a risk-defined basis. If you're prepared to lose all of the premium paid for a long put or call, you can consider your position as already having a stop-loss point in place.

—Jared

***Q:** I'm excited about the possibilities of options, but have not yet made an options trade. You often write about 'downside protection.' It seems to me that there's less downside protection when writing covered calls that have a higher strike price. This doesn't make sense to me. Please clarify.*

*Is it protection against a significant drop in the stock price? With an OTM option, you'd collect the premium, but would be left holding a stock that's worth less than you paid.*

*Was also wondering whether selling options precludes one from setting a stop order on your stock—if it were set below the option strike price?*

*—Paul*

**A:** Hello, Paul, I'm pleased to see that you are taking the time to ask questions—before you begin trading.

The strategy under discussion is writing covered calls. 'Down side protection' is simply: The amount by which the stock price can decline, before the covered call writer begins to lose money—at expiration. This is always equal to the price (premium) that you collected when selling the option.

> Example: Buy 100 shares of XYZ at $68,
> Sell one XYZ call option, with ANY strike price, and collect $220.
>
> Your downside protection is $220. In other words, when expiration arrives, if the stock is lower than $65.80 [That's $68 less the $2.20 premium] you have a loss. The option premium provided $2.20 worth of 'protection' against a move to the downside.

Call options with a higher strike price, have a smaller premium than those with lower strike prices—and that translates into less protection when selling them. This is not complicated. Don't let the fact that some words or phrases may have definitions you have not previously encountered get in the way.

Some brokers allow the placement of a stop loss order on the stock and others do not. Most new

traders are not allowed to be short call options without owning the underlying stock. If the stop is triggered and the stock sold, that leaves you naked shot the call option—and it's likely that your broker does not allow you to own that position.

If the broker is reasonable, they will allow a stop loss on the stock, but only when accompanied by an OTO (one triggers the other) order to immediately buy back that call option—at the market. You must ask your broker if they allow the placement of a stop loss order under those conditions.

—Mark W.

*Q: When should one use an iron butterfly or iron condor instead of just a regular butterfly or condor?*

*—Eric*

**A:** In practice there is no difference between a condor or butterfly and an iron butterfly or iron condor. One should select the vehicle based on price. In order to calculate the better trade, take the difference between the meat of the fly or condor and the long strike, and subtract the credit from the iron version. If the value is lower than that of the traditional call or put condor/fly, do the iron equivalent. If not, do the traditional.

Example, if I was going to trade a 45-50-55 butterfly for 2.00, but can sell the 45-50-50-55 iron butterfly for 3.10. I should trade the Iron Fly, as 5 (the spread between the meat and the wings)–3.10 (the credit) =1.90, a value less than 2.00.

—Mark S.

# Pin Risk

*Mark D Wolfinger*

A reader's question prompted this month's article:

*I was wondering about reverse Iron Condors. For example—on Google: If I buy a 600 call and sell the 610 call, and then buy the 610 put and sell the 600 put—I have a delta neutral position.*

*My question is this: If the ask price of the condor is $11 and I know the value of this position is only $10, if I* do not get assigned an exercise notice—*I will lose $100. However, if the call is assigned—then wouldn't this all be profitable because the put spread would still have value? I could sell it immediately, and the profit from the call spread would be there.*

*Am I missing anything?*

*Thanks for your help.*

*—DC*

Yes, unfortunately you are missing several things.

1) This position is not a 'reverse iron condor.' More than that, there is *no possibility* that you can earn a dime.

This is a box spread, a riskless (also rewardless) position, of no use to the retail trader. Market makers trade boxes with each other to eliminate expiration problems known as 'pin risk.' A box is also used to play interest rates. If a trader buys a longer-term box, and if interest rates decline, the trader shows a small gain. [Because the cost to hold the trade through expiration decreases and the interest paid is less than anticipated.]

As you may guess from the phrase, pin risk refers to the risk associated with a position when the stock's closing price for an expiration cycle is exactly equal to the strike price. The common phrase is that the stock was 'pinned' to the strike. [Some people mistakenly believe that traders, acting in collusion, can pin stocks to a given strike.]

A retail trader with a covered call position may not care whether he/she is assigned or still owns the stock after expiration. However, professional traders want no part of that risk. Why? When the market opens Monday morning, the trader wants to be flat (neutral), and does not want to discover hundreds or thousands of unexpected shares in the account. Neutral is the path towards trading with less risk.

When such a trader buys calls, the best hedge is to sell stock and sell the corresponding put option. [The entire position is called a reverse conversion, or reversal.] When the trade is completed at good prices, the profit is locked into the trade—and market risk is eliminated. This is a good deal for the trader—if it can be done. Life is not always that simple.

Assume that the trader owns 50 calls (strike price 80), is short 5,000 shares of stock, and owns 50 puts. When expiration arrives, the position disappears. If the calls are in the money (ITM), they are exercised and short stock position is cancelled. If the puts are ITM, the trader is assigned an exercise notice and thereby buys stock to cover the short stock.

However, when the stock closes at the strike price, it's a true dilemma. The trader has no idea whether he/she will be assigned on the puts and thus, does not know how many, if any, calls to exercise. Remember the goal is to have no residual stock Monday morning.

The solution to this pin risk situation? Trade 50 box spreads—preferably with another trader who owns the opposite position and who has a similar problem. The trader sells 50 of the 80 calls (closing the position, and buys 50 of the 80 puts (closing the position). To keep the trade riskless,

the two traders, who are helping each other, complete a box spread by using the 75 calls and puts or the 85 calls and puts. Note that there is zero risk of being short the 75 or 85 calls (or puts) when the stock is 80 and it is late Friday afternoon on expiration day.

That's how market makers can use box spreads to eliminate one specific risk.

### Back To Your Question

2) If the value is only $10 (and you are correct that a 10-point box will be worth $10 when expiration arrives), you may safely ignore the asking price of $11. [You never want to pay $11 for a spread that will never be worth more than $10. That's just foolish.] Assuming it's not near expiration, you can buy as many of these box spreads as you want by bidding $10.05. It's almost free money for the MMs. 'Almost' because there is pin risk.

3) However, do not buy this spread. It is a waste of time and effort. And it's especially a waste of money.

4) In your scenario, you will lose $100, plus commissions, plus the interest that you failed to collect by removing $1,100 (or $1,005) cash from your account.

You will lose this money. You will be assigned an exercise notice. The only possible exception occurs when your option is exactly ATM. And that is a very bad situation for you because it is you who has the pin risk. Let's say GOOG closes at $600.

Do you exercise the calls to buy stock at $600 per share? You want to do that if you are going to be assigned an exercise notice on the puts. However, if you are not assigned, then you would own a very expensive stock (Do you have a spare $60,000 per 100 shares to pay for that stock?) and must sell it on Monday.

**Pin risk refers to the risk associated with a position when the stock is 'pinned' to the strike price.**

If the stock opens higher on Monday, you get a bonus. If it opens lower, you have a loss. And worse than that—what happens if you get stubborn, refuse to take that loss, and hold the shares, waiting for a rally—and that rally never comes. Who knows when a stubborn trader may finally sell and take the loss?

And all this for what? There is zero chance to make any money.

5) The call will not be exercised prior to expiration. Why would anyone pay $61,000 cash (you are short the 610 call) for the privilege of owning stock when owning the call option is enormously safer? Own the stock and potential losses are huge. Own the option and potential losses are limited. Only someone who has no clue how options work would exercise a GOOG 610 call prior to expiration. It will not happen.

But if miracle of miracles, it does happen, then the call would be very far ITM, and the put spread would be worth almost zero. You would not be able to collect very much when selling it. In your scenario – certainly nothing near the $100 needed to break even on the overall trade.

Yes the call spread is profitable. But you also own a put spread and you cannot look at only the call side of the equation. When assigned (it will not happen when you hope), it's worth $10 (just exercise your GOOG 600 call). But you own a box. The put spread would be essentially zero. Sure, you may be able to get five cents for it, but that's not even enough to pay commissions.

Don't make this trade. EM

# Whose Bones Are You Eating?

*Mark Sebastian*

What is the difference between a professional trader and a retail trader? The answer is: very little, except one thing—timing. Let me explain:

Many do not remember this, but there was a time when the S&P 500 futures traded almost completely in the floor-traded pit, using the big futures. By the early 2000s the e-mini S&P 500 futures were starting to get a foot hold as the more liquid and easy-to-trade product. During this transition, a brief trade popped on the trade scene, the Big Future-E-mini Arbitrage. The spread was created because the E-mini futures traded in .25 increments. The Big futures did (and still do) trade in .1 increments. The trade was as follows:

If I have a broker who was bidding for S&P 500 futures in the pit, with the S&P 500 futures trading 1320.45, the broker might bid 1320.4 for 1000. Knowing that trade is there allowed the futures trader to 'lean' on that big bid. Since the E-mini's traded in .25 increments, the screen market would be 1320.25 bid or 1320.50 bid. Since the screen essentially could not be 1320.40 bid, I (the savvy floor trader) could bid 1320.25 for E-mini futures and then, as I got filled, sell 1320.40 big futures to the broker on a 5 to 1 ratio (5 minis for every 1 big). If I could get this trade off 100 times a day, I could make .15 times 250 (the multiplier of the big future) times 100 every day, or $3750.00 a day! Multiply that times 255 days of trading in a year and the trader is looking at clearing just under a million dollars a year . . . more if the trader was really good at this.

I heard stories of guys that cleared 2.5 million dollars in 2003. However, like all trades the word got out on this trade. Pretty soon, the small group of guys that had figured this trade out had competition, and pretty soon the .15 spread tightened to .05. The numbers of traders racing to get the big and mini futures caused the trade to be harder to execute. Finally, the E-minis stole so much of the volume from the big futures that the trade disappeared. Those that got into the trade early hung up their jackets for a short time and looked for new opportunities. These traders made a nice chunk of change and had the wherewithal to know when it was time to leave. The late-comers, however, had it a little worse. These vultures were left flying around a dead carcass of a trade. These traders soon were out of the business, off trading somewhere else (if they were lucky),

**These traders want to eat from the scraps of someone else's kill.**

or more likely circling a new dead carcass of another trade for which they were late to the party.

What does this have to do with retail trading? In my time working with many retail traders I have found that there are three groups. The consistent traders, those that find an approach to trading, learn it backwards and forwards and get good at it (notice I said an approach, not a particular trade). These traders remind me of the majority of the professional trading world. There, traders aren't flashy, they aren't ultra-rich, but they do well for themselves and 'grind out a living.' Second, there are the innovators, the Bill Lubys and Jared Woodards of the world. These traders make a name for themselves by being innovative in how they trade and how they approach trading. I know many think that complex trading has to be done by the professional shops, but these guys prove them wrong. These guys are also extremely rare in the world. Finally, there are the vultures.

*(continued on page 38)*

# Trading Ranked Volatility with Non-Directional Spreads

*Jared Woodard*

There are plenty of reasons to prefer option spreads that don't express a view about the future price of the underlying asset. During periods of marked uncertainty or range-bound trading, price exposure may be simply undesirable. Even during calm bull markets, the idiosyncrasies of some particular commodity, company, or industry may trigger a preference for exposure in areas other than price. It is important to recognize, however, that opting for a non-directional approach to trading is not an escape from the risks associated with price uncertainty; it is, instead, a question of exchanging one kind of risk for another, since every market-neutral options spread will still express a view about volatility.

A trader who decides to put on a non-directional, market-neutral, or delta-neutral position must still decide whether to be long or short volatility. At this point, we might expect a discussion to ensue about preferences for gamma and vega exposure, but I think a simpler route may be helpful. Because a non-directional trader will have to decide whether to be long or short volatility, we should stop to wonder how you could ever justify such a view. If non-directional traders are unwilling to express a view about likely future prices, how could they ever—rationally—be willing to express a view about volatility? The latter is certainly a significantly more complicated concept. On first glance, it seems like taking a volatility-oriented, price-neutral position is about as reasonable as betting on the ancestry of the winner of the next Kentucky Derby while refusing to bet on whether the winner will be a horse.

In fact, devoting capital to bets on volatility over price can be perfectly rational. Volatility, as the slogan goes, is mean-reverting, and while price-oriented trades may last just days or even minutes, volatility is usually measured over the course of weeks and months, such that market-neutral volatility trades tend to have a longer horizon—and therefore more time to recover from the unexpected. And they are fundamentally different sorts of forecasts—one depends on expectations about price levels, and the other depends only on the rate of change of prices. Still, even if there is no inherent epistemic error in market-neutral trading, there is still the practical issue of deciding whether to put on positions that are generally "long" or "short" volatility.

> A **ranked measure** of the volatilities in play will reveal that differential where a chart plotting **absolute levels** might not.

## Measuring the Volatility Landscape

There are several reasons you might enter into a market-neutral short volatility position. (The inverse of each reason would justify long volatility exposure.) By a "short volatility" position I will assume we are talking about short gamma spreads in only one contract month, so: straddles, strangles, butterflies, and condors. Adding time spread elements introduces another—potentially desirable—factor, but let's keep things simple.

Historical volatility alone can justify a trade, given the assumption that extreme volatility tends to be followed by less extreme volatility. You could look at recent historical volatility (HV) in isolation, or at estimates of short- and medium-term historical volatility (still

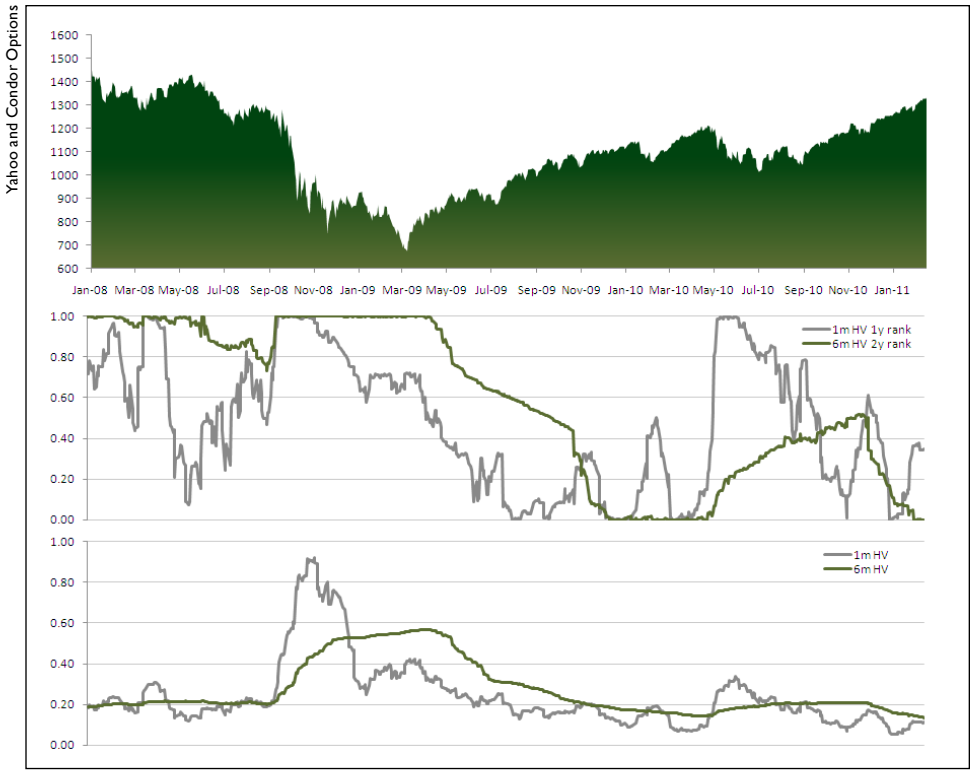



***FIGURE 1*** *S&P 500 ranked and unranked 1- and 6-month historical volatility*

in terms of absolute annualized percentages), or even at ranked measures of those estimates. Figure 1 shows S&P 500 index prices since 2008, along with 1- and 6-month close-close HV estimates in both ranked and unranked formats. For the middle, ranked chart, we plot 1-month volatility as a percentage of the past year of 1-month estimates, and plot the 6-month rank versus the prior 2 years of estimates.

Ranked estimates can bring into sharper focus divergences that might not look significant in absolute terms, and this becomes especially helpful when considering another reason to take a short volatility position: a significant divergence between recent historical and current implied volatility. For example, if an asset has exhibited 1-month HV of 11% and options expiring in 21 days are priced at an IV of 17%, you might first be a little ambivalent about that information. For many stocks and other issues, 17% is not a high IV in absolute terms—not at all. But in a range-bound or steadily rising market, the large gap between IV and HV can justify a trade, especially if the trade is executed in a "swap-like" fashion—i.e., by receiving IV via short options exposure and paying HV by delta-hedging with the underlying asset. Attentive position sizing can help here: in turbulent markets, small position sizes are usually sufficient, since the high absolute levels of volatility provide ample potential for risk and reward. During quieter market environments, position sizes can be scaled up to take advantage of divergences like the one just discussed. A ranked measure of the volatilities in play will reveal that differential where a chart plotting absolute levels might not. EM

# What Is a Non-Trending Market?

*Bill Luby*

Trend-following is a time-honored tradition among traders. From the moment a new trader is born, he or she is inundated with the collective wisdom of the trading crowd in the form of warm and fuzzy phrases like "the trend is your friend," cautionary reminders such as "don't buck the trend," and more ominous sounding pronouncements, including the oft-repeated "*always* trade with the trend."

While I cannot trace its precise origin or locate the appropriate supporting statistical analysis, I have heard from various sources on a number of separate occasions that markets trend about 30% of the time and move sideways in a trading range approximately 70% of the time. Depending upon the market in question or the source of the opinion, one might also hear that markets trend 20–25% of the time. Of course each market has its own idiosyncrasies, but I think it is safe to say that investors have generally concluded that markets are locked in a trading range anywhere from two to four times as often as they are trending.

For options traders, distinguishing between 70–30 and 80–20 markets is critical to success, but if any of this information is to be of value, we must first determine exactly what is meant by a "trending" and a "non-trending" market.

Let us start by defining a trending market. Ask most traders to define what a trending market is and you will often hear something along the lines of an up trending (down trending) market being one in which prices are consistently above (below) a specified moving average. In a related vein, some traders prefer to think in terms of markets that continue to make N-period highs (lows) on a regular basis. From a technical analysis perspective, a trending market is one in which prices make a series of higher highs and higher lows or conversely make lower highs and lower lows. For the chartist, these trends are noteworthy in that prices remain above (below) a rising (falling) diagonal support (resistance) trendline.

When looking for evidence of a trend, traders invariably have two questions that are top of mind: how strong and how long?

A non-trending market, therefore, is a market which lacks any of the above characteristics. Personally, I find this type of definition to be only marginally useful and am therefore going to use the balance of this article to lay out a three-part approach, which I call the XY Box method, to assist traders in evaluating the extent by which markets are trending or trading in a range.

### The XY Box Method

First of all, the act of determining whether or not a market is trending is inherently a backward-looking endeavor. Predictions about future quantitative easing policies, unrest in the Middle East or Portuguese sovereign debt are not relevant to this process. Instead, one is forced to rely entirely on historical data and choose an appropriate look back window, typically 3–6 months, in which to conduct the analysis.

When looking for evidence of a trend, traders invariably have two questions that are top of mind: how strong and how long? For the most part, this translates as questions about the magnitude (price movement) and persistence (duration) of the trend.

In Figure 1 below, I have created a box that represents a generic look back window, with price on the y-axis and time on the x-axis (for the moment we can ignore the "range" label.)

While there are many ways to think about the price of the underlying on the y-axis, there is a lot to be said for simplicity. In simple terms, let me propose that if the y-axis incorporates the full range of prices for the look back period, the underlying is non-trending if it exits the box in the middle of the price range. Using the 70% non-trending reference point, let us define an upward trend as one in which the underlying exits the box in the upper 15% of the price range; a downward trend as one in which the underlying exits the box in the lower 15% of the price range; and a non-trending market as one in which the underlying exits the box in the middle 70% of the trading range.

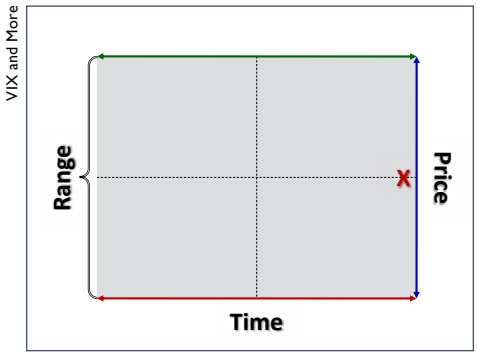



*FIGURE 1 XY Box*

One of the most important inputs into the process of evaluating trend strength is the selection of a look back window that covers an appropriate amount of time. As most options traders use a single trading day as their basic unit of time, yet think in terms of expiration cycles as the appropriate time span for when to deploy options strategies, I recommend a look back window that represents a multiple of 21-day expiration cycles. Accordingly, a 21-day look back window would be the absolute minimum historical period to evaluate. Personally, I tend to gravitate toward 42-day and 63-day look back windows, as these time frames neatly circumscribe about 95% of the holding periods for my options trades. As longer-term trends often make for the best trading setups, I also encourage traders to evaluate look back periods of 6–12 months or longer.

For the second part of evaluating trend strength, using x-axis and focusing on time, note that my intent is to utilize the data in the box in a very different manner. For that reason, I have elected to define the strength of the trend in terms of time as the percentage of the look back window since the data series made a new high and a new low. Using the same numbers as the y-axis, should a new series high (low) occur in the most recent 15% of the time frame or the series low (high) in the occur in the earliest 15% of the time frame, then this would signal an upward (downward) trend. On the other hand, should the series highs and lows date from the middle 70% of the time frame covered by the look back box, then the x-axis analysis would conclude that the market is non-trending.

A third way to analyze trend strength in the context of the box is to evaluate the extent to which the height of the box is changing over time. Simply stated, the smaller the box, the narrower the trading range. A larger box whose price range is growing over time generally means a growing trend. It can, however, also reflect increasing volatility. For this reason, box height should be considered more of a confirming piece of analysis than a primary analytical too.

## Conclusion

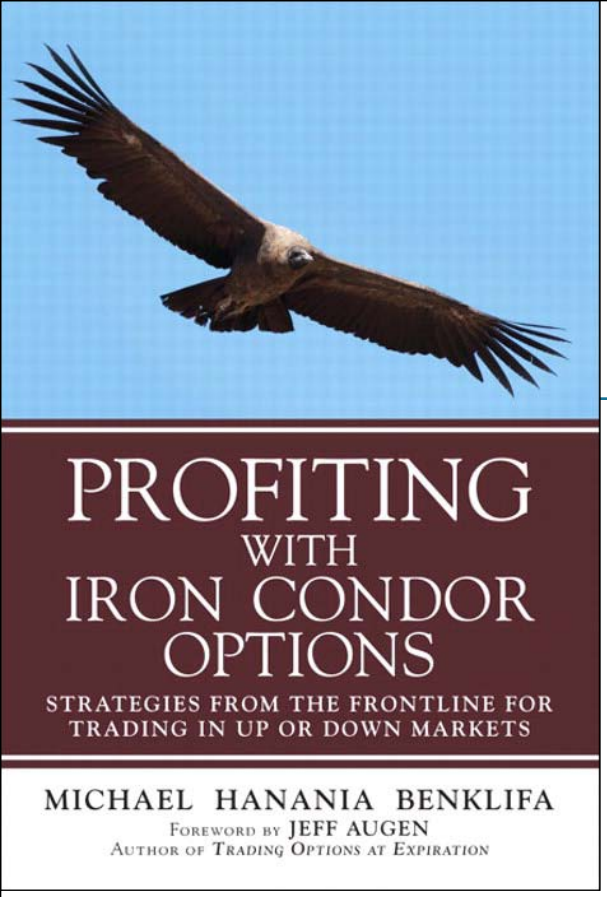
The XY Box method of evaluating trend strength aims to evaluate historical price data in three very

different ways. Traders can elect to use a binary trend-no trend cutoff with 70%–30% settings, 80%–20% or whatever best suits their trading needs. Alternatively, one can combine all three inputs to rank a market on a 0–100 scale.

The technically inclined reader will no doubt have noticed that scoring trend strength using each of the three approaches outlined above lends itself to using some popular technical analysis tools. For the y-axis price analysis, the Williams %R or Stochastics Oscillator %K are well suited to evaluating current price strength in the context of a historical price range. For time-based analysis on the x-axis, the Aroon indicator is an excellent fit, with the Aroon Up and Aroon Down components matching the analysis described above. Finally, for determining the change in the height of the box, Bollinger Band width (%b) and Average True Range are two ways of measuring box height or series price range in such a manner that makes it easy to compare to historical data.

The goal of the XY Box method is to bring together three very different measurement approaches to come up with a more holistic three-dimensional evaluation of trend strength. Consider for a moment the diverse analytical approach involved in using Williams %R, Aroon and Bollinger Band width to establish the strength of a trend.

So the next time you want to determine whether a market is trending or not trending, don't just look at the chart, use a more rigorous analytical approach such as the XY Box method to measure just exactly how much a market is trending. EM




*Profiting with Iron Condor Options, Michael Hanania Benklifa (FT Press: 2011)*

# Expiring Monthly Interview with Michael Benklifa

*Mark Sebastian*

*For our second FT Press Author interview I sat down with Michael Benklifa, author of* Profiting with Iron Condor Options. *I have to admit, I was intrigued by the arguments his book makes.*

***Expiring Monthly:*** *Why did you begin trading options?*

I am a money manager; I had a client ask me to find him something different from hedge funds and mutual funds. In particular, he wanted to find a way to trade options. I became intrigued by market neutral strategies which lead me to research trading condors. I like condors because they allow me not to have an opinion on where the market is heading.

***EM:*** *What inspired you to write this book?*

I talk to a lot of people who do not know much about options and condors. The goal of the book was to try and help people make money. There are retirees and others out there that could take this approach and make some money. I trade a large amount of capital for people; I do not need your account. I want people to read this book and do it for themselves.

***EM:*** *What differentiates the book?*

My approach to condors is to not be in them for very long. I look for the right opportunity to get in to a trade, I do not teach a 'just get in' approach. I think that approach is crazy. One should have a reason to enter the market.

If I get up 3 or 4% quickly that can be 25% of the total credit. I have people tell me that if I stay in longer I can make more money. However, the longer one is in the market, the longer they have capital at risk. I believe in walking away, not getting greedy.

The other differentiation is time. Most people think selling premium really close to expiration makes the most sense; the books approach is to enter the trade with a long time to expiration with wide wings. Since I set the trade far out if the market does have a crash I am generally okay.

***EM:*** *Who is the audience for this book?*

The person who is afraid to trade; someone who reads this will learn the value of being patient. One can make more money with less risk if one takes their time. There are a lot of traders who like to constantly trade. A trader

that wants to be a thoughtful trader should read this book, someone who wants to be thinking when entering and exiting a trade.

Most traders love to trade and they want to be in the market all the time. I am not one of those people. If I go to Las Vegas I don't gamble. I want the odds in my favor… most trades are not like that. I am not trading every day. This book is the ultimate Zen trade, doing nothing is something. If you love to be constantly in the market, this book is not for you.

This book is the **ultimate Zen** trade, doing nothing is something. If you love to be constantly in the market, this book is not for you.

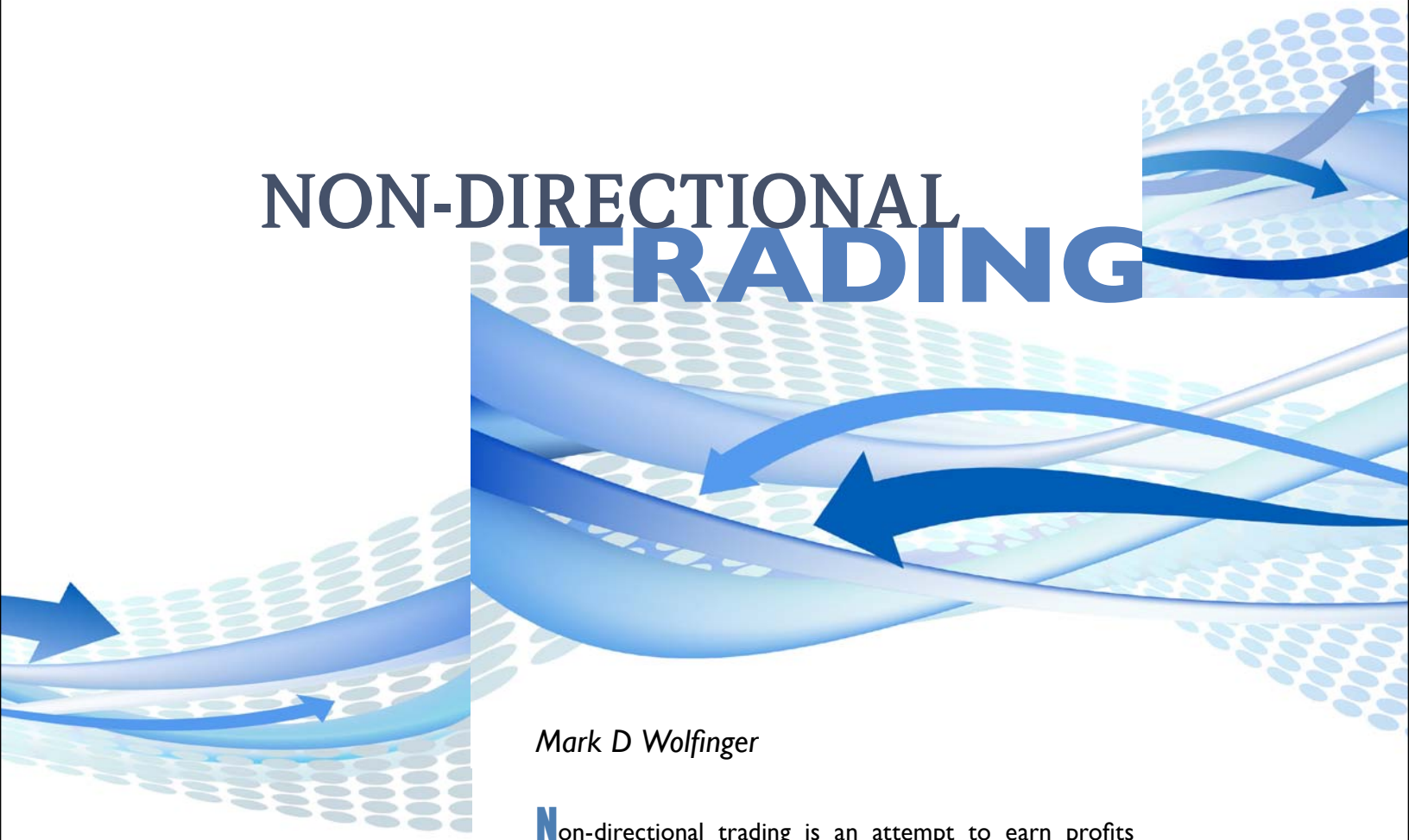
Our approach to condors is that I am a bit of chicken trader, and that getting good at condors is like mastering the art of the imperfect trade.

***EM:*** *Do you have any parting thoughts?*

People are very opinionated about condors. Traders are going to love this book, or totally disagree. Keep an open mind and think about what you are trying to accomplish as a trader. It's about the return, treat the condor with some respect because it can make a very good return.

***EM:*** *Thank you, Michael.* EM

# NON-DIRECTIONAL TRADING



*Mark D Wolfinger*

Non-directional trading is an attempt to earn profits without making a commitment on whether the stock market (or individual stocks) will be moving higher or lower.

At one time — not so long ago — there was no choice. Investing 'obviously' required a belief that the stock being purchased had a strong record, a bright future, and that the share price would eventually head higher. Short selling was allowed, but was adopted by only a fraction of those who trade stocks.

The introduction of exchange listed put options in 1977 (call options began trading on an exchange in 1973) opened the world for investors who no longer were left with two investment alternatives: bullish or bearish. Stock options allowed a far wider variety of investing and trading opportunities.

The traditional method of directional trading did not disappear. However, traders who preferred a non-directional approach could participate. A recent issue of *Expiring Monthly* included a discussion on directional trading.[1]

The introduction of exchange-listed put options **opened the world** for investors who no longer were left with two investment alternatives: **bullish** or **bearish.**

Much of what we understand today about the pricing of options was not yet understood during the early years of listed options trading. Some important ideas (skewness and kurtosis) were unknown. Today's non-directional trader can use powerful computers, along with automated trading algorithms, to generate positions that are about as non-directional and non-risky as one can get. Such traders build delta-, gamma-, vega-, theta-, rho-, (plus many of the secondary greeks) neutral positions. Their profit potential comes from buying options at less than fair value and selling options that are richly priced.

Such trading works for today's market makers, who enter their positions by making trades (presumably at a favorable price). Unlike the old-fashioned market makers who stood in the trading pits, today's market maker (who is probably trading by using an off-floor computer to generate his bid/ask quotes) has new positions hedged almost instantaneously by a computer, which is operating away from the trading floor. The algorithm that makes trades to neutralize the portfolio depends on how much leeway the trader is will to be away from total neutrality.

Despite the lack of sophistication, some non-directional trading was already popular in the 1970s. Covered call writing has been a popular strategy since the early years of the CBOE. We know this strategy is far from market neutral. However, to the traditional stock investor, this hedged position was a big step in moving from fully bullish to owning a position that gave the investor a modicum of downside protection along with a chance to earn money when his/her stock did not rally. In other words, it appeared to be market neutral to the unsophisticated eye, compared with the buy and hold strategy.

Today many other trading strategies are in use, even among individual investors who lack those sophisticated computers and their software. Each strategy has one item in common: The trader does not care whether the market moves higher or lower.

### Positive Gamma

Some non-directional strategies are designed to earn big profits when the market makes a significant move. The main negative feature is that option values erode over time, and if that big move—whether sudden or incremental—does not occur, losses can be substantial. For the non-directional trader, it's always important to recognize when to give up on a given trade and salvage a portion of the original investment.

Such strategies are characterized by positive gamma and vega. Examples include long straddles and strangles, and put or call backspreads. The purchase of individual puts or calls is an easy-to-understand (by the novice) concept, and is the single most popular option strategy. However, it is a directional play, designed to make money on a specific market move. To be a non-directional play, both puts and calls must be bought (or both sold).

These methods have one important, risk-related item in common: Losses are limited to the premium paid to own the position, and profits can be enormous. However, when buying straddles or strangles, losses can be large.

Backspreads are different beasts and although the initial cash outlay is small (and often cash is collected), the fact that there is a short option in the position allows for losses when the short option is ITM and the longs expire worthless.[2]

### Negative Gamma

Another category of non-directional trades involves positions that are the complete opposite of those with positive gamma. Negative gamma, non-directional,

To make money as an options trader, you must have an edge.

trades are frequently referred to as 'income generating' strategies. There's nothing to be done about the fact that options trading lends itself to big lies and much hype. It's true than these methods can be treated as income producing, but in reality the income comes from trading gains. When there are no gains, there is no income. That does not prevent some people from falsely claiming that iron condors or covered calls offer steady monthly income.

As a group, these strategies attract many adherents because they have one alluring feature that is difficult for many traders to resist: positive time decay. For rookie readers, that simply means that the theoretical value of the position is less today than it was yesterday; and it will decrease in value again tomorrow. Thus, making the trade, offers a small daily gain. Of course, that's only part of the picture.

One important consideration was omitted from the above paragraph: 'All things being equal.' All things seldom tend to be equal. Option values can increase in value because there is much more that goes into the value of an option than the rate at which it loses value over time.

When the market moves, two of the greeks, delta and gamma, play a big role in the price of an option. However, the most important factor that affects the option price can come as a surprise to the new trader, but is understood and taken into consideration by the experienced trader. That risk factor is described by vega, and represents the risk associated with a sudden change in the implied volatility of the option. The small profit earned from the time decay is often dwarfed by those other factors.

We have two groups of non-directional traders. One group wants to see a huge market move and the other prospers when the markets are dull and boring. It's possible to own both types of trades, as a market-neutral hedge, but most traders prefer one type of position to the other.

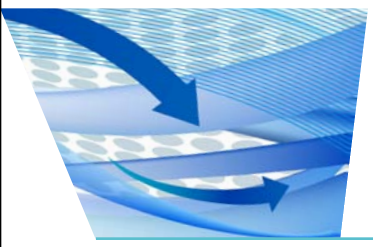
### The Hidden Truth

To make money as an options trader, you must have an edge. The most sought after edge is to buy options worth more than the premium charged and to sell options worth less than the premium collected. Because it is so difficult to estimate future volatility—and thus make a good estimate of the value for each option, this task is best left to the professionals who have the technology to discover any mis-pricing of options—and more importantly, the computer power to grab that edge before it disappears.

Another edge comes when the trader has skills at timing market moves. However, let's assume you lack those or you would not be interested in making non-directional plays.

That doesn't leave much room for an edge. To make up for that, the trader must exercise excellent judgment when selecting the opening position, managing the trade, and exiting. The point is that too many beginners find these trade ideas to be so attractive that they jump right in by opening positions. They hope the magic of time decay will solve all problems. The fact that these strategies often work as planned is problematic. Once the trader has a small string of winning trades, it's very difficult to convince that trader that risk is greater than imagined. Too often, the 'successful' trader increases position size to take advantage of the free money, only to discover the truth.

The chances of success are not good when all a trader does is open the trade and close his/her eyes, hoping for



> Non-directional trading was tailor made for traders who **have no clue** what is going to **happen in the future.**

a good outcome. Please have the patience to practice, and gain experience before using real money, because you will be required to make important decisions (hold/fold) as you wait for the days to pass.

Let's look at some of these strategies.

### Naked vs. Hedged Selling

When selling option premium, the trader brings in net cash. These trades can be naked sales, or spreads (hedged trades). Naked sales involve greater risk because losses can be unlimited (at least when selling calls). Thus, selling spreads is the overwhelming choice for traders who understand the game.

One warning about choosing a specific trade: Do not be concerned with 'how can I earn a lot of money.' It's far more efficient to be concerned with 'how much can I lose and how do I avoid losing that amount?' One idea is to limit both profits and losses by trading spreads. That means always owning at least one option for each option sold.

To survive over the long term, the trader's number one priority must be avoiding blowing up the trading account. To do that, large losses must be prevented. Never being exposed to a gigantic, essentially unlimited, loss is the way to meet that objective. Never selling naked options [okay; if you *want* to buy a specific stock at a below-market price, then you can sell the occasional naked put] is the direct way to be certain that does not happen to you.

The most important risk management method is to properly size your trades. Simply put, that means don't own or be short too many options at any one time. Be aware of the worst case scenario and be certain that if it occurs, you can take the hit. There is no point in risking ruin over a single trade (or a whole portfolio of trades).

### Is It Worth the Effort For the Individual Investor?

Professional traders do not consider their trades to be investments. Trading is the job and each trade is an attempt to earn a profit. However, many individuals hold stocks for a long time, and some may wonder whether a partial hedge—such as covered call writing makes sense.

Let's consider whether the average individual investor is well-served when writing covered calls or selling cash-secured puts. Evidence supports the premise that it's more profitable to hedge than to adopt buy and hold as a strategy. Writing covered calls on the S&P 500 index (BXM index) and writing cash-secured puts (PUT index) have track records demonstrating outperformance. Just be aware that the strategy adopted by those indexes is to hold the position with no adjustments. That's not realistic.

There is no need to go into more details here because this topic was discussed recently,[3] and data is available at the CBOE web site.

### Choose Your Poison

There are a significant number of strategies that a trader can adopt when making non-directional plays. However, the primary decision is whether to play for the big market moves or make the play that prospers when the market remains within a reasonable range.

The majority of traders who have a market opinion have a specific idea. They are either bullish or bearish on a specific stock, sector, or the entire market. These traders choose directional plays.

Non-directional trading was tailor made for traders who have no clue what is going to happen in the future, or for those who believe there will not be any significant moves (this latter group is truly directional, with the direction

The simplest, and most risky, trade is to sell calls and puts.

being 'going nowhere'). The versatility of options has opened our eyes to a variety of trading methodologies that had never existed. I suspect few ever admitted to being 'market neutral' before options gave them the opportunity to make investments that suited that outlook.

The flexible (i.e., intelligent) trader takes advantage of opportunities, and does not stubbornly repeat the same strategy at every opportunity. Recognizing that the trader mindset and comfort zone play a large role when making trade decisions, nevertheless, it's smart for the habitual premium seller to at least *consider* the idea of owning options when prices are deemed too low to sell. I admit it. I don't buy options with the intent of earning a profit by guessing a market move. However, I make this compromise: I buy strangles as insurance against my otherwise negative gamma portfolio. Theta and gamma are both reduced, the position is safer, and black swan profitability is thrown in as a bonus.

The typical premium buyer also has to recognize when prices are simply too high. One prime example occurs prior to an earnings announcement. Options are attractive to own when there's a good chance that the stock will take a big move—soon. The difficult task for the buyer is deciding how much to pay for the options because the size of the potential move is unknown.

The less aggressive buyer can make hedged trades, reducing exposure to the almost inevitable collapse in implied volatility. Once the news is announced, there are few option buyers. Sellers predominate, and prices move lower. The trader who is willing to fade those high option prices is certainly well advised to refrain from selling naked options into a known news event. Spreads limit risk.

## Premium Selling Examples

For readers who may not be familiar with some of the positions described below, detailed information is available elsewhere (use Google, read books).

- Sell straddles and strangles
- Buy butterfly or iron butterfly spreads
- Buy condors or iron condors
- Write covered calls or sell naked puts[4]

## How Different Are These Strategies?

The simplest, and most risky, trade is to sell calls and puts. Those are straddles (options have same strike price) and strangles (calls and puts have different strike prices). They have the most rapid time decay, the most negative gamma, and come with unlimited risk.[5]

For traders who insist on avoiding the sale of naked options, OTM calls and puts can be purchased to cover (limit the loss of) each leg in the straddle. For example:

Straddle:
- Sell one INDX May 800 call
- Sell one INDX May 800 put

Hedged Straddle:
In addition to the above trade, also buy the wings:
- Buy one May 810 call
- Buy one May 790 put

*Note: This hedged straddle is an iron butterfly*

Because the iron butterfly is equivalent to the butterfly, if you hedge a straddle, you own the butterfly equivalent.

The very risky straddle and the much safer butterfly are similar in many ways. The difference is ownership (or not) of the wing options. Owning the wings comes with a substantial reduction in possible losses and gains.

Adopting the same ideas expressed above, we see that the iron condor, and condor, are very similar to a strangle. The difference comes from owning protection (the wings) which limits losses and makes the position much safer, and less profitable, to own.

Assuming the options bought are equally far from the short options, then the straddle becomes an iron butterfly when hedged. Similarly the strangle becomes an iron condor. For the inexperienced trader who trades without knowing what he/she owns it may be a surprise to learn that the butterfly is a protected straddle. Similarly the condor (and iron condor) is a protected strangle.

## Conclusion

You don't have to possess the ability to predict market direction to become a successful options trader. This article focuses on the concept of earning money by making a different type of prediction. Instead of *which* direction the market will move, the bet is on *whether* the market will move.

Those with long gamma need the big, preferably quick, price change, while traders who own negative gamma must see the market trade within a range to earn their profits.

Please recognize that these non-directional strategies are useful, viable, and can produce significant earnings. However, this is not a standalone, complete methodology. Discipline, control of emotions, and most of all—proper risk management—are essential before you can expect to prosper as a non-directional trader. EM

[1] *Expiring Monthly*, Vol. 1, No. 9, Sep 2010, pp. 10–14, 30.

[2] Consider a back spread in which you own calls with an 80-strike price and are short a smaller number of 75-strike calls. If the stock slowly moves towards 80 as expiration nears, your long calls are heading towards worthless while the 75 call is picking up value.

[3] *Expiring Monthly*, Vol. 1, No. 3, May 2010, pp. 15–23.

[4] These plays are bullish. However, for the buy and hold investor getting started with options, they significantly less directional than the old strategy.

[5] If the put sold has a low strike price, then the risk is very limited. The discussion is about the generic case of selling options with high strikes.

# Early Exercise: Knowing When You Are About To Be Assigned

*Brian Overby, Guest Editor*

If you're selling options—either as single contracts or as part of spreads—chances are, sooner or later you'll get hit with a hot potato: the surprise early exercise. The fact is, many traders have never planned for this possibility and feel like their strategy is falling apart when early exercise does occur. How can you be prepared and react to early exercise intelligently? In this article, we will analyze some scenarios.

### First, to the Dictionary!

It is always good to define our terms before really diving in. Options are, of course, contracts conferring rights and obligations. The buyer of an option is paying for a certain right: to buy or sell a stock at the strike price. Option buyers—those who are long the contract—hold the rights and therefore call all the shots. If a buyer decides to exercise those rights before expiration—well, fittingly, that's called early exercise.

Now put yourself in the option seller's shoes, i.e. those who've shorted the option. Option sellers take on certain obligations and get compensated for that by the proceeds of the option sale. If you sell a call, you must be ready to sell stock at the strike price; if you sell a put, you stand ready to buy stock at the strike price. Again, as an options seller, you aren't running the show, because the options buyers have all the rights. Instead, you may be subject to assignment: you must fulfil your contractual obligation if a buyer decides to exercise the contract.

### End-Games for Options

Everyone knows you can buy options, but the really great thing about the options market is that you can also sell options without owning the underlying asset, creating a short position. Many traders know this but don't think about the big picture, that is, the various outcomes that can happen after the position is established and how often each outcome tends to happen. So, assume you've bought or sold options to open a long or short position. What now? There are three possible "end games," or results, of your trade.

1. The options are bought or sold to close the position prior to expiration.
2. The options expire worthless.
3. The options are exercised or assigned prior to or at expiration, resulting in a trade of the underlying stock.

A common misconception is that #2 is the most frequent result, but actually #1 is. If your option trade is working in your favor, you can choose to cash in. If, on the other hand, your trade is going against you, it's perfectly fine to cut your losses and close out the trade early. After all, you don't have to wait until expiration to "see what happens." Once an option is closed in the marketplace, it ceases to exist. That's why, when you enter an order, it is often referred to as an order to buy or sell "to open" or "to close." The Options Clearing Corporation keeps track of those stats and displays them to the public as the figure called "open interest." If more of the trading volume is marked "closing" then the next day, the open interest

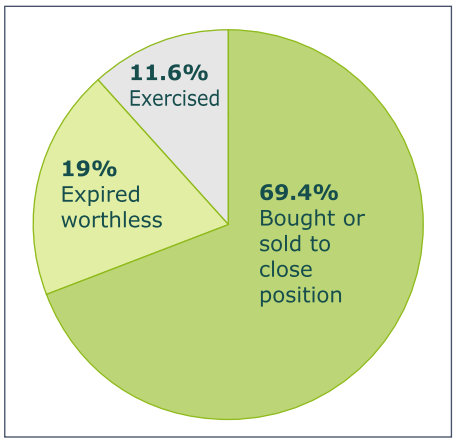



**FIGURE 1**
*Option Outcomes: Calendar Year 2008*

number deceases; if more volume is marked "opening," the open interest will increase.

For many options traders, the fact that 11.6% of options are exercised and assigned is eye-opening (Figure 1). This doesn't imply that exactly 11.6% of your short positions will be assigned, but it is a big-enough figure to suggest that you if continuously have a short option position in your account, eventually you'll be assigned and sooner or later it will happen prior to expiration. If you are short an option, the only way to ensure that you will not be assigned is to buy to close the position, thus removing your obligation.

### What Happens at Assignment, Anyway?

Assignment happens via a random lottery system run by the Options Clearing Corporation (OCC). When the OCC receives an exercise notice, it is assigned randomly to a member firm—possibly your brokerage firm. Your broker in turn assigns exercise notices to short options positions, either randomly or on a "first-in, first-out" basis.

### American Versus European

When we talk about early exercise, we're always talking about so-called "American-style" options.

**A common misconception is that most options expire worthless; actually, most are bought or sold to close.**

European-style options can only be exercised on the last trading day before expiration, so early exercise isn't an issue for them. American-style options, on the other hand, can be exercised anytime, from immediately after purchase, right up until expiration.

As of this writing, all equity options traded in the U.S. are American-style, as are some index options like the OEX (S&P 100 Index). Most indexes are European-style, including the DJX, SPX, XEO, and MNX. As for options based on Exchange-Trade Funds (ETFs), there's no hard-and-fast rule—it depends on the individual contract. Before you set up a new position, it's critical to know whether the options you're using to construct it are American- or European-style, so you know if early assignment could happen to you.

### The Plot Thickens . . .

Here are a few tell-tale signals that help you determine if your short option position is more or less at risk for early exercise. If you keep an eye out for these clues, it could help you avoid getting blind-sighted. Note that anytime you're short a stock option, you can be assigned. While the following quantitative factors may affect your chances of being assigned early, options buyers are humans, not machines, and sometimes humans do things for not entirely rational reasons. The day may come where none of the following conditions apply, and still your short option gets assigned. The only way to ensure that you will not be assigned is to buy to close the position and remove your obligation. Keep this in mind as you read on.

### Risk Factors for Early Exercise: Short Calls

***Whether you're in-the-money (ITM) or out-of-the-money (OTM)***

It may sound obvious, but an OTM short option is less likely to get exercised than a short option that is ITM. (Keep in mind: an OTM call has a strike above the current stock price; an ITM call has its strike below the current stock price.) Call buyers usually don't want to exercise to buy stock if the strike/purchase price for the stock would be higher than

if they just bought the stock in the marketplace. As the saying goes: why pay more?

***Time to Expiration***

Generally, if an option is ITM but still has some time premium in the option price, it does not make sense for the option buyer to exercise the option. Usually, it is more beneficial for the buyer just to sell the option in the open marketplace, capturing that time value in the process. If the buyer were to exercise the call and then sell the actual stock, that excess time value in the options premium would be lost. ("Time value" refers to the amount of premium in the option's price above the intrinsic value, i.e. how much the option is in-the-money. Time value plus intrinsic value = total options premium.)

***Time Value of Money***

This is similar to the section we just finished, but different enough that it bears mentioning. In addition to the benefit of capturing time value by selling the option (versus exercising it), if you think about what happens when you exercise a call there's another reason not to exercise early. If the call buyer exercises, he or she has to come up with the cash to buy the stock at the strike price. That strike price or purchase price won't change throughout the life of the option; after all, that's the attraction to owning it. Exercising now means the call buyer has to spend cash now; exercising later (at expiration) means spending cash later.

If you know what price you're definitely going to pay to buy, then why not wait until later to do so? The only quantifiable reason to exercise a call and spend the cash now is to capture an upcoming dividend on the stock . . . leading to my next factor, dividends.

***Dividends***

Stay aware of your underlying stock's dividend schedule when you sell call options, especially the ex-dividend date. Many option buyers are enticed to exercise early to capture an upcoming dividend. When a stock pays a dividend, the stock price decreases by the dividend amount on the ex-dividend date. For the call buyer (who is long that call) the strike price doesn't change at all, even though we all know the stock is going to decrease in price.

So some of the call buyers that plan to exercise anyway will do it before the ex-dividend date, becoming the stock owners of record and therefore becoming entitled to receive the dividend. If the dividend being paid is larger than the time premium in the option contract, it may make sense to them to take this route. Note that, in many cases, the best route for the owner of the call that wants to capture a dividend is just to sell the long calls in the open market, buy the stock, and do this all before the ex-dividend date. As mentioned above, when you are short options, you are not in control and not sure what the end result will be.

If you are short option contracts, keep your eye on dividends as early-exercise triggers and pay especially close attention as expiration nears if the dividend is likely to be large. In rare instances where the dividend is extremely large, strike prices may be altered by the exchanges.

**Stay aware** of your underlying stock's dividend schedule **when you sell call** options, especially the ex-dividend date.

## Risk Factors for Early Exercise: Short Puts

***Whether You're ITM or OTM***

For puts, it is also the case that an

OTM short option is less likely to get exercised than a short option that is ITM. For puts, OTM means the strike is below the current stock price; ITM means the strike is above the current stock price. Put owners usually don't want to exercise and sell a stock for less than it would fetch in the open marketplace.

### *Time to Expiration*

The story here is the same for puts as previously described for calls: generally, if an option is ITM but still has some time premium in the option price, it usually doesn't make sense for the option buyer to exercise. The put buyer is usually better off selling the put in the open market and capturing that excess time value.

### *Time Value of Money*

The matter of the time value of money works a little differently for puts than for calls. Puts may be more likely to be exercised early compared to calls because of the time value of money. Think of it this way: if the put owner exercises early, he or she sells stock at the strike price and brings in cash. As anyone who's outspent their paycheck knows, sometimes getting cash now will trump getting cash later. Because exercising a put can bring in necessary cash at the right time, put buyers may occasionally take this route and exercise early.

That said, many times it's still a better idea for the buyer to sell that put in the open market to capture the excess time value. But as expiration approaches, the time value of the put becomes a smaller and smaller part of the total ITM put price—and the odds of early exercise start to increase.

In part two, we'll look at some cost-to-carry and other considerations that can help us know when option sellers are more likely to face assignment. EM

*Brian Overby, Senior Options Analyst at TradeKing, has worked in the financial industry since 1992. He has served as an option trading specialist for Charles Schwab, a senior staff instructor for the Chicago Board Options Exchange (CBOE), and managed the training department for one of the world's largest market makers, Knight Trading Group. Brian has given over 1,000 seminars worldwide, written numerous articles on option trading and appeared on Bloomberg, CNBC and other financial media. He is also author of the TradeKing Options Playbook.*

*Options involve risks and are not suitable for all investors. Prior to buying or selling options, an investor must receive a copy of Characteristics and Risks of Standardized Options, sent to you in previous communication. Additional copies may be obtained by calling TRADEKING at (877)495-KING visiting www.tradeking.com/ODD.*

# Surgical Strike Calendars

*Mark Sebastian*

One of my favorite trades is what I call the "Surgical Strike" calendar. The reason for the name is because of the short term nature of the trade, the precision needed to enter and exit, and of course the general rate of success of the spread when one has the opportunity to enter. The premise of the calendar is as follows:

The surgical strike calendar is not a vega play, it is a play on the volatility spread between the front month the trader is selling, and the back month the trader is buying. The goal of the calendar is to put on a 2-month time spread when the spread is "out of whack."

For instance, if one were to keep track of the IV spread between a front month SPX contract and the second month contract, one would find that there is a consistent pattern that exists between the months. At times this spread tightens, at times it widens, and inside of 10 days till expiration the spread is completely unpredictable. Generally, though, aside from close to expiration, volatility spreads, just like volatility itself, are mean reverting.

In the case of the SPX, generally the spread between front month and second month options holds at around 1%, with the back month options holding a higher implied volatility. During times when IV becomes overly depressed this spread can widen to near 2% (this can actually be a great time to sell time spreads). In times when the market gets a sharp shock, the spread often becomes extremely positive (a situation where the front month options have a higher IV than back month options). When an IV spread becomes positive, this is the time to enter the surgical strike, especially if it is a non-systematic event.

**When an IV spread becomes positive this is the time to enter the surgical strike.**

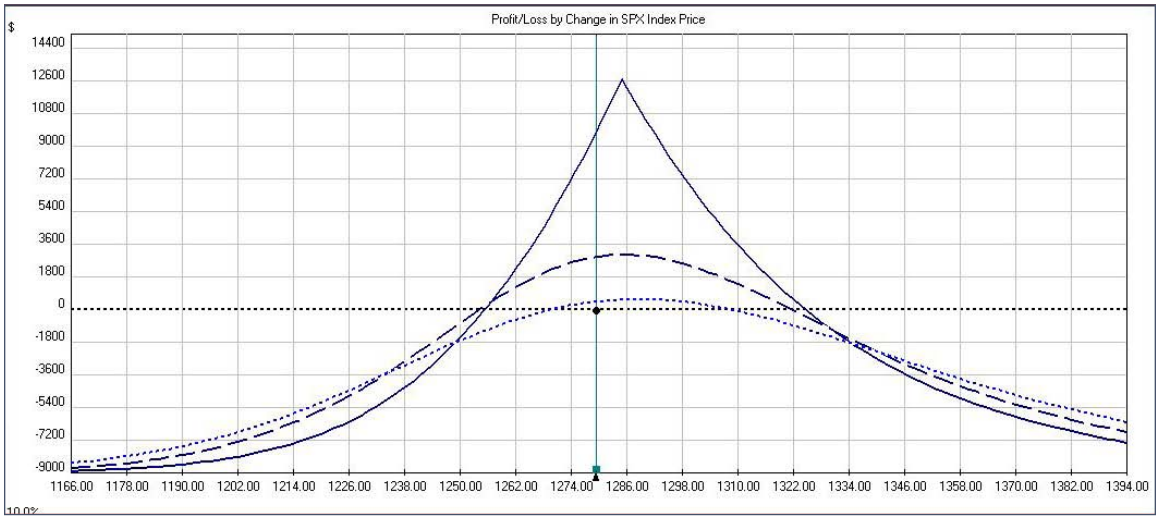
This typically happens toward the end of the sell-off. As the market capitulates the spread between front month and back month options gets the most out of whack. At that point, the trader places a slightly bullish calendar, typically less than a one day standard deviation away from the current price. The trader is selling a relatively expensive volatility against buying a relatively inexpensive volatility. Once the market calms down, even for a day, there is typically a small rally in the underlying and a reduction in the front month-back month spread. In theory,

between the deltas and the volatility spread the trader should be able to exit for close to a 10% return.

This happened recently on the January 28, 2011, during the Egyptian sell off. On that day, the SPX sold off about 25 handles, dropping from near 1300 to about 1275. Toward the end of the day as the market reached its lows, February (the front month at the time) became so expensive that its IV was greater than that of March, creating a surgical strike opportunity. I entered on the 1285 line with the following characteristics:

OptionVue6

| FEB <21> | | | | | | MAR <49> | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| MIV | MktPr | Trade | Ex.Pos | Delta | Vega | MIV | MktPr | Trade | Ex.Pos | Delta | Vega |
| 15.8% | 15.70 | -10 | | 44.1 | 121 | 15.6% | 24.70 | +10 | | 46.0 | 185 |




***FIGURES 1 & 2***

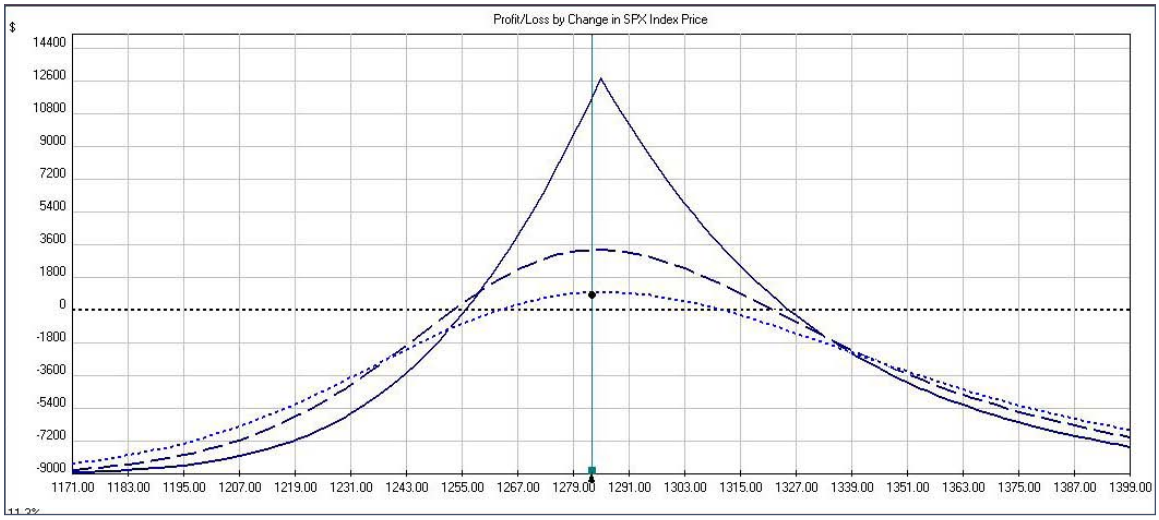
Despite having 21 days to expiration, I was able to buy a calendar somewhat close to at the money for 9.00. While IV was up across the board, the calendar itself got cheaper compared to the day prior. This was caused by the IV of Feb rising quickly to a level of 15.8% vs. March rising to 15.6%.

The spread was long vega, long delta and short an overpriced time spread. If the market rallied, my surgical strike would work. If the market did not rally, because the IV spread had already widened, my cheap entry price would allow for some protection should IV have increased from there.

As we all know, nothing came out of Egypt that weekend. The following Monday, as I had hoped, the market rallied, and implied volatility fell somewhat aggressively.

OptionVue6

| FEB <18> | | | | | | MAR <46> | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| MIV | MktPr | Trade | Ex.Pos | Delta | Vega | MIV | MktPr | Trade | Ex.Pos | Delta | Vega |
| 15.4% | 15.70 | | -10 | 47.2 | 113 | 15.5% | 25.60 | | +10 | 48.0 | 181 |




***FIGURES 3 & 4***

By 11 am central time, the SPX was trading at 1282.5 up about 6.5, and the spread had softened from +.2 to -.2 as the front month IV fell about .4% while the back month didn't budge. Between the rally and the IV tightening, the calendar gained $0.90. Before commissions, the calendar returned 10%.

I have found that in the major indexes the opportunity to enter these spreads is not common, typically happening about once a month. Also, just because the spread looks like a surgical strike does not mean it will work. There are instances where the calendar still loses. This can happen when the market rallies too fast, IV falls too quickly, or if the market keeps heading south.

In this case the trade worked out very well, and I was certainly happy to have this surgical strike weapon in my arsenal. EM


# Trade Plans: Not Necessary for Options Traders

*Surly Trader and Mark D Wolfinger*

## PRO

*By Surly Trader*

Cut your losses short and let your winners run. It is such simple advice, yet can lead to such emotionally taxing decisions while trading. The vast majority of aspiring traders fail to heed this creed and end up losing the majority of their seed money.

My first lesson in trading was that if you were able to cut your losses quickly and break even after a year of trading, then you should become a successful trader over time. Trading strategies and plans are meant to systematically keep your emotions in check and increase your odds of winning against your own weaknesses.

Psychology is what puts up the barriers to trading success. Our emotions can be our worst enemies as traders, because they fog rational decision making and logical actions. A trading plan sets the parameters for the trade before you actually enter into a position, which should limit the amount that emotions impact your trading decisions. Trading plans are crucial for those who find themselves praying for losers to come back while being too eager to take gains once the markets actually work in their favor. On the flip side, rigid trading plans allow little flexibility to adapt for changing market conditions.

The key to becoming a truly great trader is to be able to adapt and recognize different market regimes. Human traders blow up because their emotions get the best of them. Black box algorithmic traders blow up because they cannot recognize changing conditions and adapt their trading rules. If you can find the sweet spot between being too flexible in action or too rigid in rules, you may just stand a chance against the test of time.

If you were an option seller from 2005 until today, you have experienced implied and realized volatility

Trading strategies and plans are meant to systematically keep your emotions in check and increase your odds of winning against your own weaknesses.

that were historically unprecedented. An option trader who set his trading parameters in the calm markets prior to the global financial crisis would find himself in a world of pain if he stuck to his same trading plan through the flare up of 2008. That trader should have moved his strikes further out of the money and allowed his option valuations to move in multiples of what he set as stop losses in 2005. In addition, a seller of naked options would have been wise to shift towards spread selling and reduced his position sizes to risk positions that matched his prior trades. If he did not, then he would have most likely been stopped out by a losing trade nearly every time he sold an option. That inflexible trader would not have survived long enough to monetize on the declining volatility of 2009 and 2010.

The catch-22 of trading flexibility is that if you believe too much in your ability to judge or time the market's sentiment, then you end up making the same mistakes as emotional traders but most likely with larger size and conviction. If ego creeps too much into the trader's mastery of adapting to the market, then it is almost guaranteed that a sharp lesson from the venerable market soon follows.

## CON

*By Mark Wolfinger*

It's true that traders can get by without writing a trade plan for every trade. In fact, not writing the plan saves time and effort. I was one of those retail traders who never wrote a plan. I now believe they are an important part of becoming a successful trader. This is especially true for scalpers, but options traders can benefit.

Trading plans benefit the new trader because he is forced to think about the trade, instead of taking the easy action of entering an order—just to see how it plays out.

The experienced trader gains by having the 'general idea' in written form, allowing a more thorough analysis. This trader may discover alternative actions when he has the opportunity to evaluate contingencies before (or immediately after) the trade is made.

Having a trading plan requires establishing a profit objective. Too often the plan is to 'take it off when I feel like it.' If the profit goal is not chosen at random, and if some thought goes into the process, then when the time comes to take that profit, it's easy to follow the plan. The experienced trader already knows the profit target based on his/her longevity as a trader. However, paying more attention to this detail—in advance—may suggest alternatives.

The rookie has a difficult time knowing where to establish that target. However, one benefit is immediately obvious: A planned exit represents better risk management that holding all trades through expiration. Furthermore, for the rookie, thinking about the trade in more detail may convince him that the trade does not truly represent a good profit opportunity.

One of the two major emotions that kills traders is greed (fear is the other). By establishing the target before committing to the trade, it becomes easier to accept that target and avoid being overwhelmed with greed.

The second important aspect of the plan is establishing a maximum loss. In some situations that's not necessary. For example if the trader buys 10 contracts at 20 cents (probably not a good trade), there is no need to worry about a maximum loss. It's already set at $200. If you cannot afford to lose that amount,

then your account is far too small to be trading options.

There are many more scenarios is which limiting loss is a crucial decision. For option buyers, there is no reason to allow all trades to be held to expiration where the result is likely to be that the options expire worthless. At some point the rationale for making the trade disappears and the loss should be accepted and the trade closed. Having that maximum loss as part of a plan makes it easier to pull the trigger when the time comes.

Similarly, sellers of credit spreads already have a maximum loss. But allowing the position to drift towards that maximum is foolish. When the trade is not working as planned, there must be an exit point. Describe that exit point as part of the plan.

The newbie plan writer will not make the best decisions. Practice makes for better decisions. The benefit of writing the plan is that forces a trader to think about the trade, rather than randomly making the trade with an air of confidence. People do slap on a trade and hope for the best. It happens all the time: beginners don't know any better and experienced traders may have too much confidence to take the time to write a plan. Writing a detailed plan helps develop good habits.

Additional important items go into the plan, and getting started with plan writing is a skill worth having. Such items may be a target exit date, a price at which the trader begins to scale out of the trade, an estimate of the stock price at the point when an adjustment is to be made, steps to take if IV changes significantly, etc.

The trading plan serves multiple purposes. Number one is forcing the trader to think about the trade. EM

*SurlyTrader is the pseudonym of a portfolio manager for a large financial institution who specializes in trading derivatives. He has been in the financial services industry for over a decade and would like to share his experience and enthusiasm in the financial markets with those who have a natural curiosity and passion to learn. He completed a BS in Computer Engineering with a minor in Mathematics, and a MBA in Finance. He is also a CFA Charterholder and Global Association of Risk Professionals Financial Risk Manager (FRM). He writes at www.surlytrader.com.*

# Expiring Monthly Interview with David Fisher CEO, optionsXpress

*Mark Sebastian*

*Mr. Fisher currently serves as the Chief Executive Officer and is a member of the Board of Directors of optionsXpress Holdings Inc. He has been with the Company for over four years. Prior to assuming the role of Chief Executive Officer, Mr. Fisher served as President of the Company. Previously, he served as the Chief Financial Officer of the Company. He was responsible for all aspects of the Company's finances, accounting and investor relations, including the Company's successful IPO in 2005.*

*Mr. Fisher has played an instrumental role in creating a strong, recognizable brand and driving the Company's most important initiatives including the conversion to self-clearing, the acquisition and integration of online futures broker XpressTrade, LLC and the initial public offering.*

**Expiring Monthly:** *As you know, NYSE Euronext and Deutsche Borse recently announced a merger. How could this affect the options industry as a whole?*

**David Fisher:** It is really interesting; the new entity will have a 50% market share. I'll be interested to see what the regulator does. While regulators did let the CBOT/CME merger get done, in this case they may have to sell an exchange.

**EM:** *How would you envision an ISE/AMEX/NYSE group trading?*

**DF:** If they (the NYSE-Deutche Borse) decided or are allowed to keep all three of those exchanges, one of the three platforms has to disappear, since there is little need for that many market structures. It has clearly been demonstrated that it is beneficial for companies to hold 2 entities (*one maker-taker model, the other traditional*). The NASDAQ has done a great job with its exchange and the PHLX, and CBOE with C2 is off to a nice start, but there is a limit to how many you need. There are only so many things you can offer.

**EM:** *What about selling one of the exchanges. Could the ICE or a futures exchange be a potential buyer?*

**DF:** I think if the group wanted to sell one, there would be buyers. Possibly BATS or the NASDAQ. Another interesting player might be whatever new entity comes out of the TMX-LSE merger. That is, if they wanted the cash or were forced to sell.

As far as the ICE, I think getting into equity products gets the futures exchanges too nervous. Don't count on it.

**EM:** *With the ubiquity of standard equity options, the exchanges are trying to differentiate themselves with more new products. What products do you foresee being interesting?*

**DF:** The VIX product is big, and will grow. CBOE has been successful and is not stopping there. As you know, they recently applied the VIX methodology to individual equity stocks. Now, these are not tradable indexes, they are only tracking vols. However, once developed they could be turned into a tradable product. That is potentially very interesting.

Weekly options have been a huge success and continue to grow; they could roll out additional classes. Both retail and institutional investors like the weeklys.

The industry also continues to roll out option products that start looking like futures option products, like options on the GLD ETF, which has been the most successful ever. Now they are pushing platinum, palladium and silver. These have been very popular, and in many ways may be cheaper to trade than futures products.

**EM:** *Where do you see the direction of brokerage going over the next year or two? Will there be more consolidation or an increase in smaller shops popping up?*

**DF:** The industry is stabilizing, volumes are improving, and growth is improving. It is counter-intuitive, but this will lead to higher levels of consolidation. Most assume that going into a major shakeup leads to tons of deals, but it doesn't. The future is too uncertain, making it harder to build your models; the firms can't predict cash flow.

If they (the NYSE-Deutche Borse) decided or are allowed to keep all three exchanges, one of the three platforms has to disappear.

Over the last 3 years almost no deals got done . . . only 2: LightSpeed bought Terranova, and Ameritrade bought thinkorswim. Many would have expected more big deals, and how could some of these little firms not come together? There will be a few of these smaller firms bought up rather than more little guys popping up. That will keep it from being a free for all.

At this point there are only a handful of big guys left, and they know who they are. There are actually not many big deals to get done; Ameritrade and E-Trade will happen at some time. Actually, it has taken longer than I expected.

Smaller guys haven't been successful enough to be an acquirer. Look at TradeMonster and TradeKing . . . established smaller guys. None of them have really come into a position where the firms above them feel comfortable enough to acquire them. It shows how hard it is to grow a brokerage firm.

We are still able to grow because we started so long ago. I am glad we did and got a couple hundred thousand accounts head start. We are able to grow and be profitable. I do think you will see the days of consolidation pick up, but it won't be a mad house. There isn't a need to get these deals done.

**EM:** *Discount brokers keep trying to undercut on commission. Regularly optionsXpress execution bests the other discount and full service brokers out there. Why do you think customers tend to focus on upfront commission and exclude good execution? Do you have data on your execution?*

**DF:** We try to educate customers on execution. For example, we do publish price improvement, when you place a trade it shows the dollar value of price improvement. In many cases the dollars saved is more than the commission.

There is tremendous value to trading at optionsXpress. I think more sophisticated customers do see it, which is why smaller firms have small traders and smaller average per trade; they are novice, so it is hard to become profitable. Our customers tend to be larger, more sophisticated and more profitable, and they do value execution, and we try to protect them from fast moving markets.

**EM:** *Best execution can mean a few things. How do you weigh marketing cost vs. routing? How does that go into decision making process?*

**DF:** We do accept payment for our flow. We do it for our customers. What we are doing is taking money out of the pockets of huge market making firms, the Goldman's, the Citadel's and the Susquehanna's, and giving it back to our customers through lower commissions and pools. We look at all other factors first, tighter markets, highest level of liquidity, and then only after all those things are measured equally do we look at highest payment.

**EM:** *What concerns me with best execution is when CBOE is up 1000 SPY at 133.78 at 133.80, and BATS at is offering 133.79 on a 2 lot. That is where it gets tricky. Do you send 50 lot orders BATS? You will get better execution at CBOE. Those 2 contracts will get routed out CBOE through linkage and now there are linkage fees.*

**DF:** There is a difference between liquidity between maker taker and the traditional model exchanges. One of the most difficult aspects of the options industry is that the maker-taker model will often show better pricing but low liquidity.

There are different products that trade better in different markets. SPY is not the best example. It should trade in maker-taker because there is plenty of volume even at a penny wide. Then you get to

One of the **most difficult** aspects of the options industry is that the maker-taker model will often show **better pricing** but low **liquidity.**

products with less liquidity in the further out months, and for more complex orders, so you need to encourage someone to supply liquidity. So you need a traditional market structure.

We like that complexity, because we can manage it well for customers. We have invested a lot in our smart router systems, so we can make sure we are getting great execution for our customers. Despite the complexity, our customers are getting good execution. Having only one exchange or type of market structure would not favor retail customers.

**EM:** *OptionsXpress has been pushing the Xtend platform. Is this a game changer, is the net goal to be a head-to-head against thinkorswim? What other advancements are in the OX pipeline?*

**DF:** Xtend is a great head-to-head platform for all active for retail clients. We are not trying to be a professional platform and go after institutions, but we want the active retail trader, because the growth there has been tremendous. People like interacting in multiple ways: the web is good for quick and easy trading, but those that want the more active experience use Xtend.

Our mobile platforms are developing and are popular as well. Initially, customers could check quotes and interact with customer service, but now they are trading a lot on these things. It is very powerful, a great trading device. We recently had a customer trade 700 times on an iPhone.

What else is coming up? Two interesting things at opposite ends of spectrum. Our new trade ticket is exciting. It is an all-in-one trade ticket. This all-in-one ticket allows you to do everything from one single ticket, anything the exchange will allow.

The other thing in the pipeline, at the opposite end of the spectrum is that we are jumping into the social fray. We are launching optionsXpress Social. We sat back and watched what other firms were doing; they set up a sort of free-for- all. Our

approach was to add value, find ways to really engage our customers and offer real ideas. We did not want a free-for-all. Instead, we built a series of tools that try to bring wisdom of crowds to a more manageable place. So other customers can get a good knowledge base. We have a prediction market that does this every day. We have an in-house market analyst look at what is going on in the world. One example: during the BP spill, we let customers vote when BP would cap the well. Customers voted, and got pretty close. The idea is that the wisdom of masses will come out to be accurate.

**EM:** *What are some things retail traders don't think about that they should in terms of trading and interactions with their broker?*

**DF:** It's not just lowest price, but best overall execution and experience. Customer support matters: everyone on our desk is an options principal, and 75% are futures principals. We provide real expert support with the first. There is basically expiration every week now with weeklies, and there are firms screwing it up. When choosing a broker, look what you get with the package. You might save a few bucks with a particular trade, but lose in the long term. Focus on experience and not the lowest cost.

**EM:** *What do you find are the retail public's biggest mistakes as traders?*

**DF:** There is a sub-set that takes on too much risk and doesn't know how to manage risk. They turn options that are beneficial to risk into risky trades. Options risk can be easier to manage than stock risk. Sometimes new customers don't understand how to manage the risk.

**EM:** *Thanks so much for your time.*

**DF:** Any time. EM

# Living and Dead History

*Jared Woodard*

Consider how poorly equipped we are, as individuals, to trace the long arc of history. In the developed world, many of us will live for seventy years or longer. But the major economic and political shifts that so comprehensively define our experiences of the world do not happen on any regular schedule, and they do not recur as quickly as do human generations. This mismatch between the pace of historical change and the biology of animals like us has two effects: it encourages us to take a dismissive attitude toward history, and it causes us to over-emphasize the present as a source of knowledge. I'll discuss the first of those effects here.

## Museum pieces can't hurt us; dialectical partners can.

We tend to reify historical events. Instead of treating the news of some historical date as part of an ongoing process involving many accidents, surprises, tricks, and mistakes, we pretend that historical events are near cousins of laws of nature: immutable, inevitable, and almost beyond our ken. Just think of the reverence that citizens of nearly any nation-state have for the founding myths of their country: this or that revolution or uprising or monarchist instantiation is treated not as something that happened that time before, but instead as a direct intervention of God, or of The People, or of [insert your favorite Agent, whether secular or divine]. In the United States, the "Founding Fathers" are given verbal oblations usually reserved for saints or demigods in earlier societies; the Constitution is treated not as the best attempt that some guys could make at putting a country together, or as the expression of the interests of some rich people who really hated paying taxes, or etc., but as the infallible footnotes to the Book of Romans. There is probably no better example of this phenomenon that the attitude many of us have toward the contingent, fractured economic arrangement involving capital and labor: when conceived as one of many ways of structuring society, market economies are subject to the same process of critique as every other method for engaging in production and consumption. But when this particular configuration of society becomes Capitalism, holy and reified, careful reflection about the normative consequences of market functions is tantamount to an attack on society itself.

My purpose is not to demean achievements in human history toward justice and equality. Quite the opposite: when we make living, contingent history into a fixed and dead thing, we inoculate ourselves against the possibility of learning from it. Ossified stories can be safely ignored—the fact that they're always there if we need them ensures that no one will ever think to bring them up, except as talismans in trite, reactionary political discourse. Instead, the best way to acknowledge the value and importance of people and events in history is to engage with them as equals, to apply the give-and-take of argument to all comers, whether living or not. Museum pieces can't hurt us; dialectical partners can.

Examined closely, the sacred figures of the past turn out to have wooden teeth, bad hair and even worse attitudes toward their inferiors. For all that, they also have some amazing, three-quarters-right ideas. To return to my earlier examples: while legal and political rights may be woefully incomplete without economic empowerment, the former are still genuine innovations that should be extended and defended. While market economies are often viscerally unjust, there is no question of returning to or pining for the

backwardness and narrow prejudices of premodern communitarianism. But the only way to determine what is valuable or not about any argument or idea—whether current or historical—is to approach it not with reverence but with reason.

When we treat the circumstantial and contingent features of some process or event as part of an ineluctable essence, placed on a golden pedestal and framed by Corinthian columns with a soundtrack of angelically-intoned long vowels, we give up precisely that element that makes progress possible: a willingness to look at the world, identify what's wrong with it, and make efforts to change it. EM

**Whose Bones Are You Eating?** *(continued from page 9)*

Vultures are not exactly the same as those I described from the S&P 500 E-mini arb, but they are pretty close. These traders do few tell-tale things. One: they go after the trade that is making them money right now. If a trade loses once or twice, they give up. If a trade works, they will do it again and again, ignoring all else . . . until it blows up in their face. They do not have the time to research the risks associated with the trade. They would rather take the word of the person showing them the trade than learn for themselves. I can tell a vulture when they ask one of two things, "Does this have any real-world application?" or "What are the trading rules?" I infer a complete disregard of fundamental knowledge from the trader when I hear the former. I infer a complete lack of knowledge on how to manage risk on one's own from the later. Essentially, these traders want to eat from the scraps of someone else's kill. The problem, in the retail world, is that by the time the vulture gets to the kill, those bones are cleaned, bleached, and in a science lab. Sadly, these vultures usually end up being the kill in the end. EM