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EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

AN OVERVIEW OF DIRECTIONAL TRADING

Steven Place
on Weekly Options

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

EXPIRING MONTHLY
THE OPTION TRADERS JOURNAL

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About the Expiring Monthly Team

Adam Warner

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

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

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

Bill Luby

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

His first book, *Trading with the VIX*, is scheduled to be published by John Wiley & Sons in 2011.

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

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

Jared Woodard

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

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

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

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

Mark Sebastian

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

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

Mark Wolfinger

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

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

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

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

Editor's Notes

Bill Luby

In spite of all the predictions of doom and gloom, the September options expiration cycle turned out to favor the optimist's portfolio, with bullish directional traders logging substantial gains in spite of lackluster volume and enthusiasm.

It just so happens that directional trading is the theme of this issue, with a feature article on the subject penned by Mark Wolfinger. Mark also squares off with Mark Sebastian in a discussion about the value of directional trading as it applies to options in Wolf Against the World. Adam Warner takes up the theme and discusses various approaches to trading an anticipated directional explosion, while Jared Woodard provides some counterpoint in his review of *Option Strategies for Directionless Markets* by Anthony Saliba.

In related subjects, Mark Sebastian discusses how to enhance upside opportunities in credit spreads and Jared Woodard explores how limiting down side risk with call options can enhance risk-adjusted returns.

Farther afield, guest author Steven Place chimes in with a thoughtful piece on how weekly options has changed the way he trades earnings and how weeklys are taking the veil off of the impact earnings has on implied volatility.

Elsewhere, I offer a six point interpretive framework for analyzing VIX futures and the opportunities presented by the VIX futures term structure.

This month's Follow That Trade comes from Mark Sebastian, who bravely attempts some gamma scalping with Potash Corp. in the middle of a bidding war. (We all wish him well.)

In his recurring column for new options traders, Mark Wolfinger talks about how to think about exits. Another monthly favorite has the EM team answering reader questions in Ask the Xperts.

Finally, Jared Woodard graces the back page again, somehow managing to walk nimbly through a mine field of tax cuts, incomes and consumer demand.

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

Have a good expiration cycle,

Bill Luby
Contributing Editor

Ask the Xperts

The Expiring Monthly Editors

Regarding credit spreads, if my short option has moved into the money on a current position, and I see no light at the end of the tunnel, is there a rolling technique that you recommend?

Or is it best to close it and open a new spread with enough credit to cover the loss?

— Don

Hi Don,

From my perspective, I like neither where you are nor where you are headed.

Suggestions:

a) Waiting until a position has moved into the money before taking action is a very high risk trading style. It's certainly not for inexperienced traders. I suggest you consider (it's your decision) a different adjustment style.

The part that bothers me is that you see 'no light.' If you believe the stock will continue to move against you, why are you still holding onto this losing trade? Shouldn't you have already exited?

b) I recommend only one technique for rolling. It's really very simple:

Consider the new position. Do you 'love' this position? Are you pleased to have it as part of your portfolio? If yes, then rolling is a good idea. If 'no' then do not make this roll. Exit and take the loss.

c) If you roll to a new position with the goal of collecting enough cash to cover the loss, you are making a huge mistake.

You already have a loss. Accept that fact. Find a new spread to trade—one that you believe has a good chance to earn a profit. Do not roll the old, losing trade into another bad position. If you are 'forced' by your system to collect a cash credit for the roll, then your choices are limited and you will open bad trades. Please, do not do that.

Choose a good trade, based on your trade plan. Don't chase lost money. Your goal is to earn money going forwards, not to recover losses or get back to even.

— Mark W.

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I read that I can hedge my directional exposure in an option spread by offsetting the deltas in the spread. But how do I determine what my delta exposure is? And once I know that, how do I offset it?

— Matt P.

The net delta exposure of a given option spread is just the sum of the deltas of the individual legs of the spread. For example, a long put vertical with a -45-delta long strike and a -20-delta short strike will have a net delta exposure of -25 (-45 + 20). If you need to offset the deltas in a given position you can use the underlying asset, other options, or some combination thereof to achieve the desired hedge. The -25-delta put vertical could be hedged by buying 25 shares of the underlying stock or ETF, or buy purchasing a call option with a delta of 25.

— Jared

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Mark,

I hear you talk about 'units' all the time. What exactly are they?

— Bill

Bill,

A unit is a term that most floor traders use to describe a cheap out of the money option that will have unpredictable Greeks in the event of a multi-standard deviation move in the underlying. In the case of the unit, in the event of a market crash or a stock crash, the put unit can easily return more than 1000%. For

instance: consider a cheap put, such as the SPX May 1045 put bought for .90 on April 29th. This put returned more than 1000% in one day during the flash crash, and without getting within 100 points of its strike. A quick guide for how much to pay for a unit based on price of the underlying is:

Stock price	Unit price
100	.15
200	.25
500	1.25
700	2.00
1100	2.50
1500	3.50

— Mark S.

I'm intrigued by the idea of collaring VXX this fall. As usual, this is probably initially appealing but impractical and short-sighted. What do you think? Last I checked there were favorable prices/strikes.

— Brendan

First, let's distinguish between collars with the underlying and collars without the underlying. A collar with the underlying is essentially a covered call that utilizes most or all of the proceeds from the sale of the call to purchase a protective put. As VXX is essentially a volatility play that benefits from sharp movement, a collar caps that movement in both directions and therefore negates most of the rationale for being either long or short VXX. For this reason I will address a collar without the underlying. This position is also known as a short combination and sometimes as a synthetic short with split strikes; it involves buying an out-of-the-money put and financing most or all of that transaction with the sale of an out-of-the-money call.

For the record, while I trade VXX and VXX options a great deal, I have not yet put on a short combo trade with VXX or VIX. Be that as it may, I like the rationale behind a VXX short combo, given that VXX options are always priced to account for the possibility of a big spike in volatility. Also, there is usually a sense of some sort of volatility floor (the VIX has not been under 15 in three years and may never go under 8, so VXX puts always assume a limited downside potential as well.) This means that VXX options have a substantial positive skew almost all the time. At the time of this writing, the implied volatility for the Oct 24 and 25 VXX calls is in the high 60s, yet the IV for the Oct 17 and Oct 18 puts are in the low 50s.

As a result, with VXX trading in the 20–21 range, you can sell VXX Oct 25 calls for 0.65–0.70 (or the Oct 24s for 0.80–0.85, the Oct 22s for 1.25–1.30, etc.) and use the proceeds to buy VXX Oct 18 puts for 0.40–0.50, pocketing the difference and having some significant upside if VXX makes a run at 18.00. With strong VXX contango right now, I think the market is under-pricing the likelihood of VXX falling steadily.

Of course, this is a very high-risk play. Assuming you have no long position in the underlying, from a risk perspective, the biggest issue is that you are exposed to a VIX spike. On the plus side, by using the short calls to finance most or all of the long put position, one can establish what is essentially a synthetic short stock/ETN position with very little capital up front.

If I were to put on this trade, I would probably look to do so after the VIX had spiked substantially. Of course, in that situation I would probably favor a bear call spread in order to limit risk, but that is just the way I look at this particular opportunity.

— Bill

How Weekly Options Changed the Way I Trade Earnings

Guest Author Steven Place

Earlier this year, the CBOE began a rollout of weekly option chains. These instruments offer traders a unique opportunity to exploit options behavior that is only seen during the latter stages of the options expiration cycle. Many feel that the risks and pitfalls associated with near-term options cause them to be unworthy of trading; however, they do have advantages for shorter-term traders, and also provide unique insights and trading opportunities into corporate earnings events.

We can see how short term options can benefit traders when examining Google (GOOG) earnings. Google reports tend to fall on the day before options expiration. The motivations of the timing are suspect, but the short-term risk in GOOG front month options can provide a positive feedback loop for the price of GOOG after an earnings event.

If the options market had underestimated the size of the gap, it often causes a short volatility squeeze. As option shorts are forced to cover, the market makers will buy stock to hedge, fanning the flames and sending the price in the direction of the gap; it will also keep the implied volatility elevated, which is an extra boon to those who bought premium into the move. A good example of this price movement in GOOG can be seen from April of 2008. I remember this example specifically because it reflects the "lotto ticket" bias prevalent in options trading—the at-the-money (ATM) straddle went from $30 to $100 overnight. It also shows that while selling volatility can have an 80% success rate, the losers can easily wipe out your gains if risk is not managed properly.

This used to be a unique case; the combination of a company with a liquid options board lined up with options expiration seldom occurred. However, with the introduction of weekly options, companies such as Apple (AAPL), Baidu (BIDU), Cisco (CSCO) and Netflix (NFLX) will have the same characteristics. This provides significant advantages to option traders.

First, we now know the pure volatility reading. If a company reports earnings three weeks before option expiration, other factors will have to be accounted for in the option price besides the stock price and event risk: baseline implied volatility, time, and market risk also have to be included. So measuring earnings risk in these events becomes an art, where one has to look at the past implied volatility drops as well as current IV readings to approximate how much premium will come out after the event. These approximations can be close, but there will never be a true reading of what magnitude of a move the options are currently pricing in.

With options expiring shortly after the earnings event, the premium in front month and front week options will stay very elevated going into options expiration—nearly all of the premium is associated with the event risk rather than the time risk. Due to this option pricing, the market shows us the pure volatility reading going into the earnings event. With weekly options, the expected movement post-earnings can simply be measured by looking at the ATM straddle price to give an expected range. From there a trader can bet on the over/under and structure trades to take advantage of these events.

Second, weekly options give traders the opportunity to incorporate double calendars more often into their event trading strategies. A double calendar is essentially a play that sells volatility on the near month (or week) options and buys volatility on back month options. Profit occurs if the move of the underlying is not that large post earnings, and the premium drop in

the options sold is greater than the options bought.

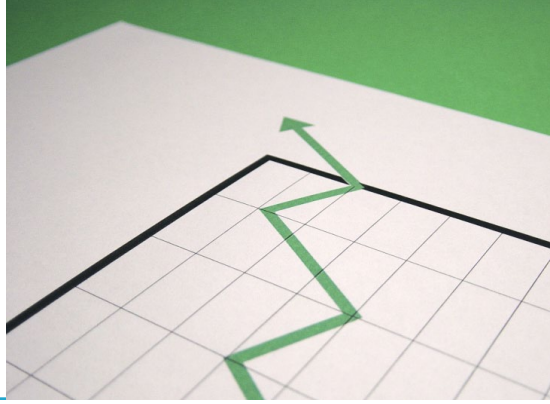
The reason double calendars are advantageous in this environment is that the implied volatility differential becomes very great when an event occurs near options expiration. Consider this analogy—the premiums for my home owner's insurance would be much higher during hurricane season compared to other times of the year. Due to the heightened risk of movement after an earnings event, the front month options will have much more premium; while sometimes that premium is justified by large price moves, often it isn't, and a double calendar is a great strategy for that situation. With the introduction of weekly options, this setup is now a more common occurrence, and has been quite profitable through this past earnings season.

Remember, many option traders won't trade options that have under two weeks left as they are not comfortable with the gamma or theta risk; I am one that thrives during that time period. Weekly options should be viewed with a degree of caution due to their short term risks, but, as always, the trade-off of higher risk is higher reward. EM

Steven Place is a professional trader specializing in swing trading equity options. He earned a degree from the University of Central Florida in Electrical Engineering and publishes the popular Investing With Options blog where he brings clarity and color to the equity options markets.

Upside
Credit Spreads

Mark Sebastian



One thing I hear from traders (and I often agree) is that it is better to collect premium than to pay it. This makes a lot of sense in many cases since, as we have heard over and over again, most options go unexercised. When a trader tells me that he or she likes a stock and therefore sold a put spread, I am not shocked. In fact, I am pleased. This is the sign of a trader who understands a stock is far more likely to simply not go down than to actually go up. But what if a trader could make money if a stock simply didn't go down, but made even more if the stock went up? I have developed a little trick that can make a put credit spread provide more bang for the buck.

In late April 2009 I was talking to a trader who *loved* Ford Motor Company (F). Ford was trading at a little over $5 at the time, and the trader thought that the company had not needed a bailout, was not going bankrupt, and that the economy was going to recover to some degree. The trader was certain that Ford was not going to be going down, and was likely to rally. The trader proposed selling 10 of the Jan 2010 2.5/5 put spreads at $1.15. I told the trader I liked the trade, but that I did have a one concern. If the trader really felt that strongly, why didn't he give himself some upside?

I proposed the trader take a mere 10% of his credit—115 dollars—and buy calls. What this did was create a small risk reversal within his put spread. This allowed the trader to make money if F went nowhere, and allowed for some continued upside if the trader was really right about the stock.

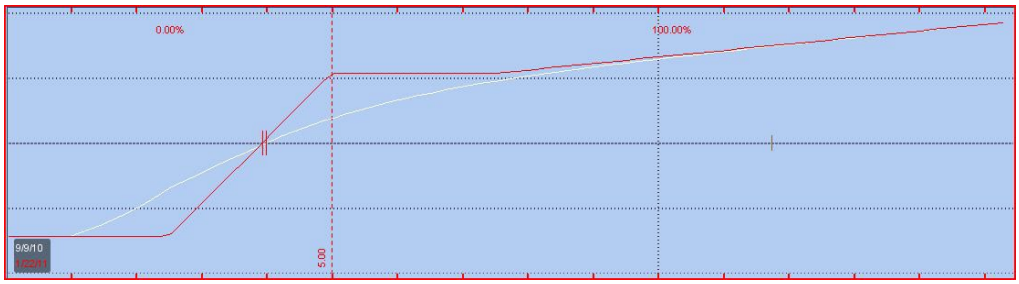
The trader decided to follow my advice and bought 1 Jan 7.5 call for $0.80. This ended up being less than 7% of the credit he had received on the trade. The trade ended up looking like this:

In a case like Ford, the trader was *very* happy that he had bought that extra call. The put spread did great, collecting all $1150 that the trader had collected. On its own the trader should have been pleased with his play in Ford. However, the call that he had purchased for $0.80 made the trade a home run. Ford ran up, and at Jan 2010 expiration the stock had was trading at $11.60. The call was now worth over $4, more than five times the value of the original purchase price.

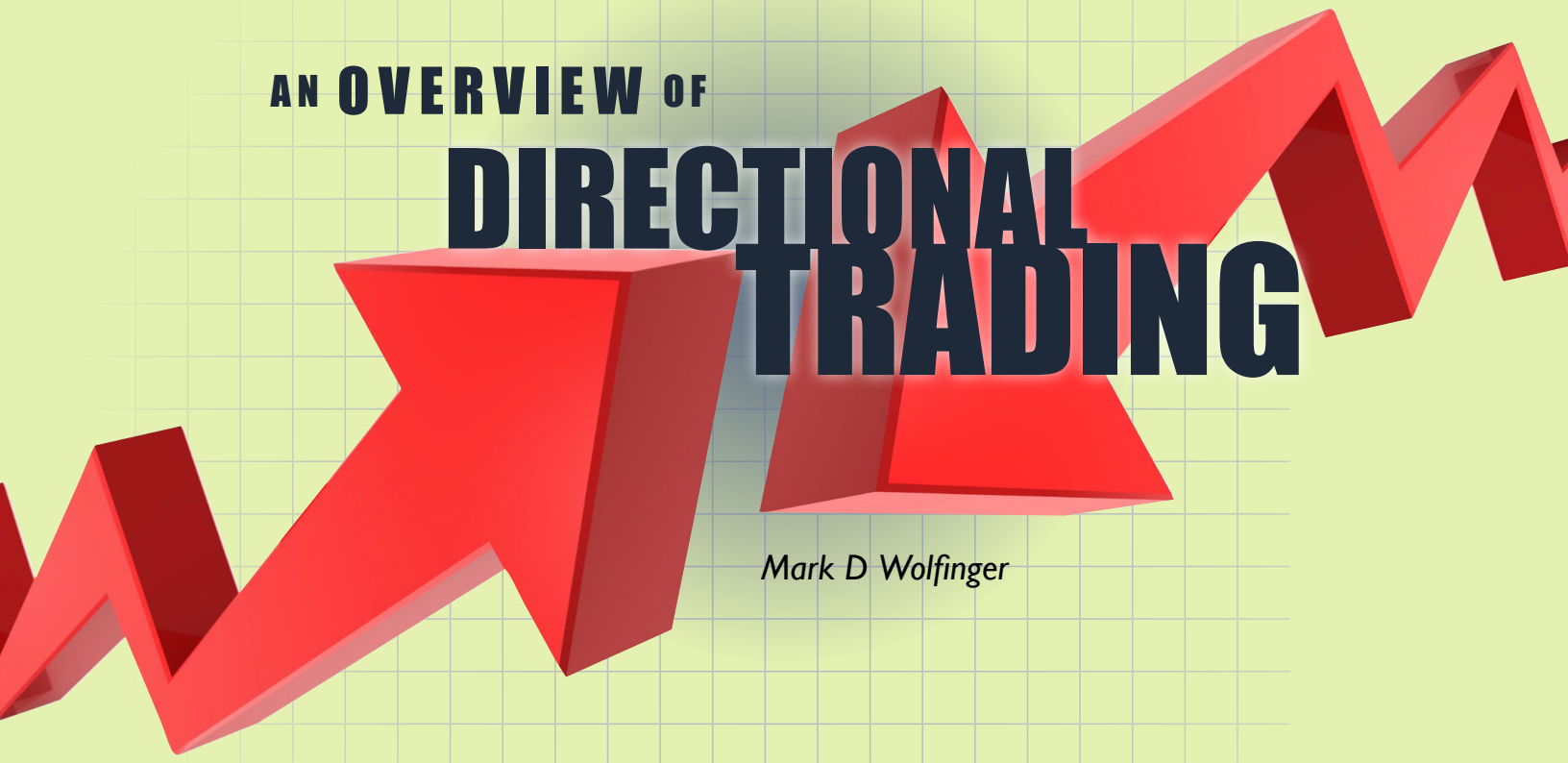
I have developed a little **trick** that can make a **put credit spread** provide more **bang for the buck.**

This method will not always work. I have found that it is a great trade for cheaper stocks and can be an effective trade for certain drug and bio tech stocks. It also has value for fallen angels or stocks that have been hit for systemic issues instead of company-specific issues. There will be many times that a trader will try a trade like this and not collect on the call. But, in the instance that it does work the trader should be happy that he or she did not limit the upside of this trade. EM

Figure 1



AN OVERVIEW OF DIRECTIONAL TRADING



Mark D Wolfinger

IF there is one topic (other than politics) that is certain to begin an animated discussion among folks gathering at a party, it's the stock market. When a bull market (remember those?) is raging, everyone takes pride in choosing their investments—even novices who own mutual funds (and pay ridiculous management fees) feel they made the all-important decision to invest. The fact that they know nothing about the fund, or what type of stocks it holds, is unimportant and they take pride in having been bullish at the right time.

When times are tough and a bear market is underway, there's nothing much to discuss, except how badly one's broker or financial planner has performed. If left to their own devices, the members of this discussion circle believe they would have performed better on their own.

It's a natural phenomenon. Individual investors who know almost zero about stocks, markets, or how to trade take credit for prospering during a rising market and blame others when their accounts falter. These people want to have a stock market opinion. They want to trade with a market bias. And that bias is always bullish.

Experienced investors have a better understanding and sometimes prefer to be bearish. However, most don't know how to accomplish that. The best they can do is to make an attempt to time the markets by occasionally cashing in some stocks or funds, hoping to reinvest at lower prices. For most, this strategy fails miserably.

The point is that almost everyone has an opinion. Individual investors choose mutual funds or index funds, thereby making a bullish directional play. I suspect they are unaware that they are making a directional play on the market—because for them, there is only one direction and that is 'up.'

And up has been the winning direction—at least for people who came of age after WWII. Sure, there have been mishaps over the years, but owning stock has worked, and worked well.

Now we are in the 21st century, and the results have been far less rewarding. We've had stagnant markets before (1970s), and the fact that recovery followed (even if delayed) makes investors continue to cling to their bullish hopes. Unfortunately, many of those investors seem to get bearish after a large decline and pull out of the market near the lowest levels, telling themselves that they will never again invest in stocks.

I'm not suggesting whether these investors should have gone short or stayed with their long-term bullish plan, but the fact is that the general population tends to know only two ways to invest: bullish or frightened. When frightened they move to cash.

When more sophisticated traders mention the term 'directional trading,' they are referring to methods more sophisticated that owning mutual funds or sitting on the sidelines.

Directional Trading

Today, the term directional trading refers to taking a stance that the market (or a specific stock or sector) is likely to trend higher or lower over the near to intermediate term, and the investor makes a trade that benefits when that prediction comes true. It is far more involved than simply buying or shorting stock.

One of the beautiful things about using options is their flexibility. They can be used to take big risk (boo, hiss), or they can be used to make reasoned plays with reduced risk—i.e., reduced when compared with simply buying or shorting individual stocks.

The variety of option strategies and modifications to those strategies offer the trader a number of plays from which to choose. Not only bullish and bearish, but options offer the trader with a market-neutral opinion a way to prosper from markets that are range bound. That's something no other investment vehicle can offer.

It should be unnecessary to provide a list of individual strategies that allow the trader to adopt wildly bullish to wildly bearish—or anything between those extremes—strategies. That information is widely available, and here is a sample from Wikipedia.

Volatility

When we think of directional trading, the terms 'bull' and 'bear' come to mind. However, the more sophisticated trader can make a directional play on more than just stocks. Volatility is in play and traders can own positions that benefit when option implied volatility moves higher or lower (or remains in a range).

The trader always had the choice of owning positions with long or short vega, but in recent times a number of products have been released that allow the less

experienced player to take a stance on market volatility. VIX and VXX options and VIX futures are merely two such items, and more products are being planned. As is usually true, those less experienced traders would be better served learning how these items work before making any attempt to trade them.

The more sophisticated trader can make a directional play on more than just stocks. Volatility is in play and traders can own positions that benefit when option implied volatility moves higher or lower (or remains in a range).

The ability to make a directional play in the world's equity markets is obvious. The trader can use equities, futures and options. The big decision involves the wisdom of trying to make money, or earn a living, by trading with a directional bias.

Is Directional Trading Right for You?

For many years, the ideas of the academics ruled. While many experienced traders vigorously disagreed, it was generally accepted that markets are efficient and that no one trader/investor has any inherent advantage over another. All the information that can be known is known immediately after it is made available.

The Efficient Market Hypothesis (EMH) can be summed up in a single sentence: "one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information publicly available at the time the investment is made." Of course, the assumption must be made that everyone makes intelligent (efficient) use of that information, which is an unlikely situation.

There is a decent entry in Wikipedia that describes the historical and theoretical arguments behind this hypothesis.

In more recent times, arguments against EMH have gained in popularity. The increasing prominence of behavioral finance delivers additional naysayers who take a stand against EMH. Then there are the arguments of value investors such as Warren Buffett who claim that EMH cannot tell the whole story. By simply noting that value investors are among the world's best money managers is a pretty strong argument that luck is NOT the reason some investors are more successful than others. It's difficult to argue with Buffett's statement that it's their intelligence and hard work that allows some value investors to achieve great success over the long term.

And we cannot ignore the large number of investors who use technical analysis and tell anyone who will listen that they can, and do, earn good profits by making directional plays based on historical information, i.e., charts and graphs. This investment technique runs contrary to the teachings of EMH.

Despite the strong arguments against EMH, one group adamantly holds onto EMH and refuses to lighten its grip. Sadly, that group is entrusted to guide millions of individual investors in planning for their financial futures. I'm referring to financial planners and financial advisors who believe in The Prudent Man Rule and EMH. They believe in asset allocation (actually, a decent idea—but it does not solve the problem all by itself) and diversification.

While many **experienced** traders vigorously disagreed, it was generally accepted that **markets are efficient** and that no one trader/investor has any inherent advantage over another . . . In more recent times, **arguments** against EMH have gained in **popularity.**

A growing number of financial professionals are beginning to understand that being bullish forever is not the best solution, and that appropriate hedging (yes, with options) is an intelligent thing to do.

But, I digress.

Everyone has a market bias, even when not expressed. Traditional investors are bullish. Those who sit on the sidelines with fear are bearish—or are acting bearish. Asset allocators are bullish because they are invested, but at least some positions are hedged. Premium-selling option traders generally have a neutral bias, but they too can adopt a bullish or bearish portfolio.

Should you trade with a directional bias? Or do you accept the traditional wisdom that it's foolish to try to time the markets? Most of us can agree that market timing is not for the individual investor who pays scant attention to the markets. However, the vast majority of traders do trade with a market bias. How can they avoid doing so? Portfolios, or individual trades, must be neutral or not. It's true that when neutral, the portfolio can be constructed to be 'Greek' neutral—and that means as hedged as possible. And many professional traders and trading companies do just that.

However most people who consider themselves to be traders do trade with a bias. Our positions are either long, short, or market neutral. And market neutral allows for plays on volatility as well as placing a bet that the markets will (or will not) be volatile or make a large unidirectional move. Options allow us to hold hedged positions (limited risk) that involve a directional bias.

For less experienced traders who want to invest with a directional bias, it's not as simple as it may appear. There are decisions to be made:

Bulls

- Is it a good move to go with the crowd and remain invested in the stock market for the long term? If yes, should you pick your own stocks or simply own index funds?
- If being fully invested appeals to you, how much, if any, of your portfolio should be hedged (options offer alternatives) to reduce risk? Or, as opposed to hedging, should you trade on margin and increase leverage?
- Do you have any plan to manage risk, or are you going to take your chances? Do you recognize that proper risk management is one of the keys to long-term success?
- Do you need advice, guidance, and risk management help from professionals, or can you handle these decisions on your own?

Bears

- Are you willing to fight the very long-trend of rising stock markets? Does the argument that stocks have proven to be the best anti-inflation protection in the past—have any influence on making your trade decisions now?

- Is this the time when it will be correct to say that 'this time it's different?'
- Is the overwhelming bad news being ignored? Do you just 'know' that judgment day is imminent? Or are you following the opinion of others when being bearish?
- Should you remain invested but fully hedged (perhaps with collars). Should you invest your money and bet on that down move? Can you afford to do that? How do you plan to manage risk?

Market Neutral

- How does it feel to do your own thing and not care whither the market heads?
- Is it sufficiently satisfying to make your money with little excitement?
- Exciting markets tend to be bad for the market-neutral crowd. How will you feel during a major bullish run when everyone else is gloating and you are having a difficult time?
- Have you a solid plan in place for when the market inevitably makes a big move—in one direction or the other? Are you complacent and overconfident, or do you have an appropriate amount of money at risk at any one time?
- Do you know exactly what steps you will take to manage risk? For premium sellers, risk management and money management are essential—not only for success—but for survival.

No matter what your market bias, and no matter how you plan to place your directional bets, managing risk (in this writer's opinion) should be the top priority of your investing program.

Track Record

Track records are seldom mentioned in the financial press, whether traditional or blogs: Do you have a proven track record of predicting market direction? If you have that record, if you have demonstrated your ability to make money in almost any market condition, then congratulations. You are obviously well-suited to making directional plays.

What about the rest of you? If you have not yet built a track record, or if you are new to the investing game, or if your track record is poor, why do you believe that you have the ability to make winning investment decisions? Do you believe it's easy to make good money by reading a few charts and placing your bets? There are many people looking for investors who believe that is possible. They are ready to take your money, sell expensive courses and newsletters, and encourage you to believe.

I understand how it is. New traders come to stocks and options hearing (the probably exaggerated) stories of colleagues who claim to have made big bucks in the market. If they can do it, so can you—is the general rationale. But you must know that's not true. Highly paid, professional money managers fail to consistently outperform the markets. Why do you believe you can do it when they cannot?

Or have you been trapped by the hype of Internet ads claiming unreasonable monthly profits—perhaps 10% per month or higher? You know that's not achievable over the longer term, don't you? And if it were possible to earn that much, why would the owner of that system sell that information? That rate of return makes anyone rich beyond expectations after a few years of compounding earnings.

(continued on page 30)

Trading the DVI Indicator with Call Options

Jared Woodard

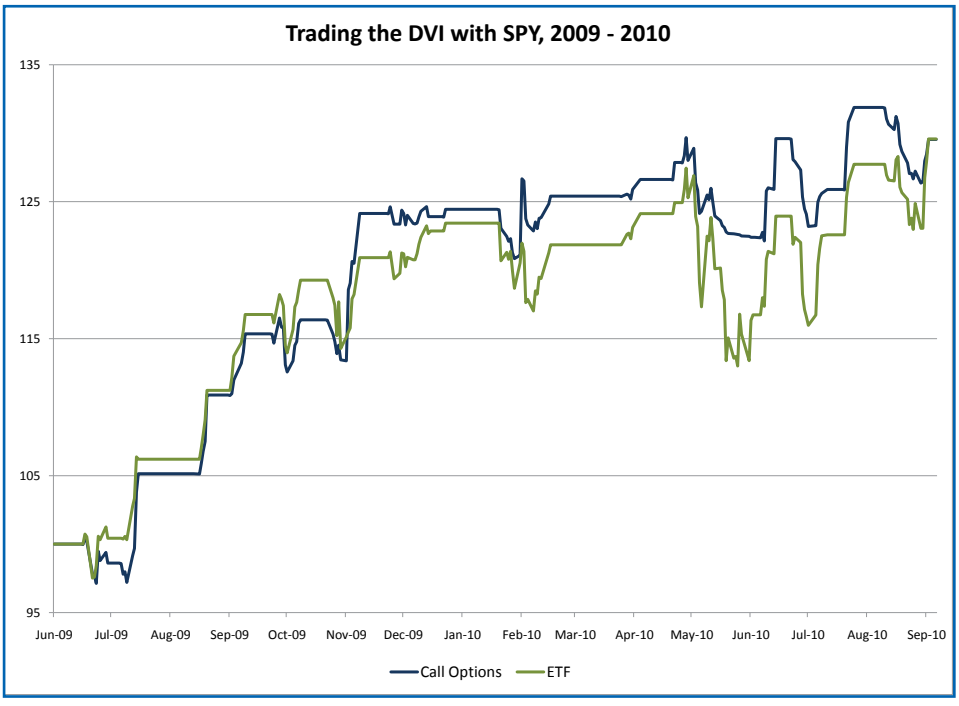
Using options to speculate on future price changes in an underlying asset is an inherently weird thing to do, like using a pick-axe to scratch your nose. Why invite all the complexity that comes with options if all you really want is exposure to the underlying stock or futures contract? Trading options instead of the underlying might entail higher transaction costs, and adds exposure to time decay and implied volatility. Given those factors, the burden of proof seems to be on the options trader when it comes to price-based directional positions: if the likely costs of using options aren't more than offset by improved risk-adjusted gains, it will probably make sense to trade directionally using the underlying asset.

To consider this matter in more detail, I conducted a comparison of two strategies that rely on the same indicator and trading signals. Both strategies use David Varadi's popular DVI indicator to generate long signals following significant market pullbacks. When DVI falls below 50%, the strategies initiate long positions and hold those positions until DVI closes above 50%. Short positions are not taken. I used SPY price data and options for this study.

The first strategy takes maximally-sized long positions in SPY shares. The second strategy buys the nearest-term call options with at least 20 days until expiration, selecting the strike price with a delta closest to 0.40 at the trade's inception. I selected 40-delta options more or less on a whim: the at-the-money strike price seemed too conventional, deeper in-the-money strikes merely pushed us toward stock-like performance, and further out-of-the-money strikes weakened the comparison with the first strategy. I tested straight-forward call purchases instead of spread strategies for the sake of simplicity.

The position sizing for the second strategy requires some explanation. The formula used was: (account balance / (SPY price * 40)), or the value the second strategy's hypothetical balance divided by the product of the closing SPY price and 40. The rationale was that, since we're always buying 40-delta calls, we'll be effectively long 40 SPY shares for every call purchased. While a single SPY call option represents the right to buy 100 shares at or before expiration, using the live delta value of the option results in a tighter comparison between the two strategies.

Figure 1



While they offered nearly **identical** returns, the call option version achieved much better **risk-adjusted returns.**

The Sortino ratio—a variation of the popular Sharpe ratio—analyzes risk more realistically because it only penalizes downside volatility, instead of both upside and downside volatility.

The chart above shows the equity curves for the two strategies. While they offered nearly identical returns, the call option version achieved much better risk-adjusted returns. Of particular note is the large drawdown that occurred during May 2010: this was the worst period for both strategies, but here the use of options offered a meaningful advantage. Since the maximum possible loss for the options-based strategy was limited to the premium paid for the calls, as the market fell in May the premium simply dwindled out of the options, in contrast to the more sizable losses experienced in the ETF-based strategy.

The options-based strategy offered lower return volatility, a smaller maximum drawdown, and superior Sharpe and Sortino ratios. The difference between the two strategies is most visible in the latter ratio. Importantly, this comparison includes the costs I mentioned earlier. Commission charges of $1.25 per contract were included for the option trades, and when recording option prices I selected the least favorable prices (hitting the bid and lifting the offer) to account for slippage. The effects of time decay and changes in implied volatility are also reflected in the test, although these were mitigated somewhat by the relatively brief holding periods for most trades and by the fact that I used options with a few weeks remaining until expiration.

	ETF	Call Options
CAGR	22.76%	22.72%
Max DD	11.03%	5.61%
Volatility	15.08%	12.05%
Sharpe	1.34	1.68
Sortino	2.01	3.33

Table 1 Condor Options

This is obviously a small sample size, and the study only considers one technical indicator, so no general conclusions are warranted about trading directionally with options. One point I would emphasize is that any directional trade—whether using options or only the underlying asset—is only as good as the indicator or other set of rules that generates it, so comparisons of trading vehicles should occur only with indicators that have proven their reliability. For this particular application of the DVI indicator, over the test period it seems that the use of options offered significant benefits in risk-adjusted terms, even after accounting for increased costs. EM

A Hybrid Play on Gold

Adam Warner

I got this question recently:

"I seriously think gold has a great chance of going parabolic . . . So, then, to ask the question: suppose you are of the opinion that some underlying is going parabolic—is there a structured option trade that makes more sense than simple "long calls"? I know you guys really hate those . . . "

Let me start by saying I don't actually hate just naked long calls. It's not my sort of trade, but there's absolutely nothing wrong with it. Provided, of course, you have this sort of an opinion on an underlying asset. If I have a directional opinion, I tend to just go naked short puts. But that's personal preference; I prefer earning time decay than paying it. But by the same token, I don't tend to outright play for parabolic moves. I could fill a room with times I had a decent directional call and totally minimized the gain by using put or put spread sales. That sounds whiny, complaining about a profit, but I could also fill a room with bad plays I have to defend too. You really need to max out your winners and minimize your losers in this business . . . in fact that's arguably more important than the mere percentage of your winners. So an insufficiently profitable "win" will come back to bite you someday.

How about a kind of hybrid of the two, though? A play I like is a sort-of collar trade. I buy modestly out-of-the-money (OTM) calls, sell OTM puts, and short some stock. If I have a bullish opinion, I under-short the stock. This leaves me with both extra calls on the up-side for that "parabolic" move, with modest or neutral decay.

My sort-of collar trade:
I buy modestly OTM calls, sell OTM puts, and short some stock.

Let me use the gold ETF (GLD) as an example, since that's where the question arose. The stock is roughly $124 as I type. So let's say I purchase 10 December 125 calls at $4.35, and short 10 December 120 puts at $2.90. I pay a debit of $1.45 for that combo. The calls have a 48 delta, and the puts have a 34 delta, so the combo gets me long the equivalent of 800 shares of GLD. So, theoretically, I should short that amount. But I'm bullish, so let's say I "only" short 500 shares. How do I win?

Well, on the upside, I effectively just own the December 125 straddle 5 times (long 10 calls vs. short 500 shares) and have reduced my cost via the sale of the puts. So an explosion in GLD to the upside clearly works great, the same as it would for a simple straddle purchase.

On the downside, those puts can come back to haunt me. Let's say GLD declines through 120. I'm exposed on 500 shares and I essentially got a lousy price for it as I paid more for the calls than I took in on the put sale. Riding the 500 shares of short stock down to 120 assuages some of it, but the long lean in general is unhelpful. But again, that was ostensibly my opinion to begin with, and it's not much different exposure as if I simply sold some puts.

Ultimately, I'm rooting for either a stock explosion or a slow drift to the strike I shorted, the 120's. I'm rooting against either GLD just hovering near 125, or GLD getting clocked. EM

Successful Traders Make Their Money via Directional Trading

Mark D Wolfinger and Mark Sebastian

PRO

By Mark Sebastian

What do Bill Gates, Larry Ellison, Steve Jobs, and Warren Buffet have in common? They are all directional traders. What do Goldman Sachs, Morgan Stanley, and Bank of America have in common (okay, besides bailout money)? They all engage in directional trading. The fact of the matter is that just about everyone has chosen to enter directional in some form or another.

For option traders things are a little different: the option trades we enter have a limited life to them. This is why I do think it can be poison to go out and buy calls or puts based on a directional bias. While sometimes these calls and puts can pay off big, most of the time they expire worthless.

That does not mean a trader has to only trade non-directionally. Remember that there are really 3 directions: up, down, and nowhere. If a trader makes smart trading decisions in picking stocks, she can put two out of those three directions on her side. This can be done by selling put spreads and call spreads instead of buying them. This way, the trader is getting 2 directions instead of just one.

Looking out at the professional world, this is one of the most common practices engaged by traders. Traders trade covered calls, call spreads and put spreads; many of them do so successfully. The ability of a short option trade to collect decay if the trader is a little wrong—and put cash in the trader's pocket quickly if the trader is right—is a great benefit.

Non-directional trading is great, but there are times where a trader should pick a side. Ask non-directional traders how the period of March 2009–September 2009 worked out for them. Traders that could see the writing on the wall smartly sold put spreads instead of condors.

Finally, even non-directional traders end up being directional traders when they 'leg' into a spread. I am sure there are traders out there that have played what Bill Luby calls the strangle-pong. In the trade the trader begins with a directional bet and converts it into a non-directional spread (for more info visit Bill's blog at vixandmore.blogspot.com). The truth is, when you break it down, even the most ardent non-directional better ends up being forced to make directional bets every now and then.

CON

By Mark D Wolfinger

It's a great feeling. You know a stock is moving higher. You get long by buying shares, calls, or by adopting any of a number of bullish option strategies. The stock moves as anticipated and you rake in the dough. Sweet.

Is it really that easy? Is this how the majority of successful traders make their money?

Technical Analysis For those whose primary investment technique is technical analysis, directional trading is their bread and butter. Many swing traders and investors/traders use charts to make stock selections. Statistics on their success are not available, but if they continue to trade, we can assume the meet with some success.

Individual Investors Data collected by researchers Odean and Barber[1] found that individual retail investors who trade frequently underperform other investors. These frequent traders are likely to be placing directional bets rather than investing, but that is conjecture on my part.

Trading Companies Perhaps we should look to the biggest players for clues. These include proprietary trading groups and hedge funds. These big money players are not out to take risk. Their focus is making money with as little risk as possible, by finding an edge and patiently waiting for that edge to turn to cash.

Proprietary trading companies use sophisticated programs to select which options to buy and sell, based on their estimated value for those options. Their objective is to buy options that are undervalued and sell others that are overvalued. Then they build their portfolios with one goal in mind: to eliminate as much risk as possible and eventually collect profits as the mispriced options return to 'normal.' They own portfolios that are neutral on all the Greeks we commonly use, plus additional risk factors that are considered only by more sophisticated traders.

These businesses do not take directional plays. They are efficient, patient traders who take advantage of situations that offer a statistical edge, and then neutralize all risk. We, as traders, cannot do the same. We can reduce risk, but hardly to the same extent. If trading without a directional bias works for these big players, that's more than enough to demonstrate that it's a viable trading method.

From my perspective, trading without a directional market bias eliminates a major risk factor depending on market direction to earn my profits. It's true that trading market-neutral represents a different directional bias, but to me it's the least risky. EM

[1] Barber, Brad M. and Odean, Terrance, *The Journal of Finance,* Vol. LV, No. 2, April 2000

An Interpretive Framework for VIX Futures

Bill Luby

Last month, in *Exploring the VIX Futures Term Structure, Part 1,* I offered up some introductory facts and concepts about CBOE Volatility Index (VIX) futures in hopes of laying a foundation for a more in-depth analysis of the VIX futures term structure. Just to review, I place so much emphasis on the VIX futures because the term structure of those futures is what drives the prices and investment opportunities for the full range of VIX products, notably VIX options and the VIX ETNs, VXX, VXZ and XXV.

This month, my intent is to focus on the VIX futures term structure and to offer six different analytical approaches to the term structure that, when taken as a whole, should help to identify a number of strategic approaches and trading opportunities.

When looking at a chart of the VIX futures term structure, the first question to ask is whether the term structure slopes upward from left to right, reflecting a condition known as 'contango' in which the front month futures are less expensive than that back month futures. Figure 1 shows an example of relatively strong contango in the VIX futures curve on August 24th and extreme contango as of September 13th. Historically, VIX futures have been in contango about 75% of the time since their launch in March 2004. Generally, this is due to the fact that investors have a tendency to see more uncertainty in the future and ascribe more volatility to future influences than to proximate events.

The flip side of contango is known in the futures trade as 'backwardation' and occurs when the term structure slopes downward from left to right, with the front month more expensive than the back month. For the most part, backwardation occurs only after a significant VIX spike. Contango, on the other hand, is most likely to be present after a period of a falling or relatively benign volatility.

In an effort to establish whether the VIX futures term structure is in contango or backwardation, investors will invariably encounter periods in which the term structure curve rises in certain time frames and falls in others. In other words, the term structure is not uniformly directional. In Figure 1, the August 24th term structure has three instances in which the curve dips into backwardation: November to December; January to February; and March to April. On balance, I consider the August 24th term structure to be in contango, but the lack of uniform directionality over the course of the term structure is not unusual. Factors such as uncertainty over the elections can certainly elevate expectations about

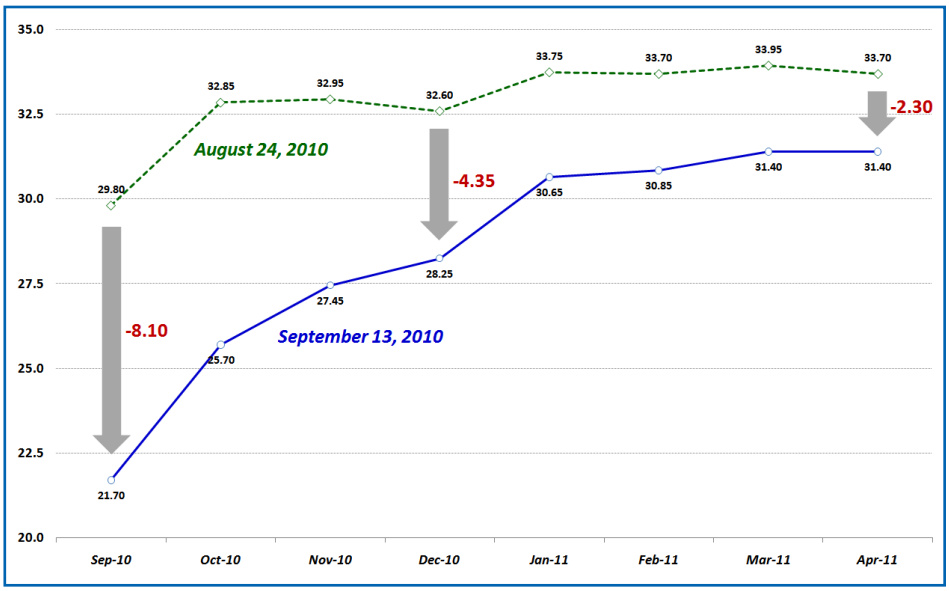


Figure 1: VIX Futures Term Structure—Effect of Three Weeks of Falling Volatility

VIX futures have been in contango about 75% of the time since their launch in March 2004.

volatility in stocks going into the elections, while the holiday season has a tendency to dampen volatility during the last month or so of the year. Other one-off events such as the results of bank stress tests, key regulatory and legislative efforts, important political meetings, etc. can also increase uncertainty and produce outliers in the term structure.

The third thing to evaluate in the VIX futures term structure is the month in which the futures have the largest net change. This typically happens between the front month and the second month, as in the case with both the August 24th and the September 13th term structure. In both instances, the change in price between the front month and second month futures is more than twice what it is in any other two month period in absolute terms and even larger in percentage terms.

Somewhat related to determining the consecutive months with the largest net change, it is also important for traders to determine the degree of contango or backwardation over the entire VIX futures term structure. There are a number of ways to evaluate this, such as the differential between the front month and furthest month futures, the number of contango increments versus backwardation increments, etc. A proprietary measure I use to evaluate contango strength shows VIX futures contango over the full term structure was higher on September 13th than at any time in the 6 ½ year history of VIX futures. Recent history notwithstanding, it is important to understand that while the first two months often paint a strong directional trend, the balance of the VIX back month futures often tells an entirely different story.

Another factor I like to focus on is something I call the "terminal VIX." This is essentially the terminal value of the VIX indicated by the VIX futures term structure. When the back month futures suggest a plateau, then the furthest month futures is a good choice for a terminal VIX value. For September 13th, this means a terminal VIX of 31.40. For the August 24th futures, which show a small decline from March 2011 to April 2011, it generally makes sense to assume that the prevailing trajectory continues into the future, so that an appropriate terminal VIX might be on the order of 33.50 or so. Keep in mind that mean reversion will usually dictate the direction in which the curve in the most distant months in the term structure will bend. With the lifetime average of the VIX currently at 20.40, mean reversion should act as a magnet of sorts and pull back months in the direction of the 20–21 area.

A final factor consider is to take the above elements of the VIX futures term structure and put them into motion over the course of the last few weeks. Is contango or backwardation strengthening? Weakening? How is the differential between the two front months being affected? Are certain points in the VIX futures term structure drifting in such a manner as to become outliers? Is the terminal VIX rising or falling?

In summary, investors attempting to evaluate the VIX futures term structure should consider the following factors:

1. Contango vs. backwardation
2. Uniformity of direction
3. Largest net change
4. Degree of contango or backwardation
5. Terminal VIX
6. Evolutionary changes over time

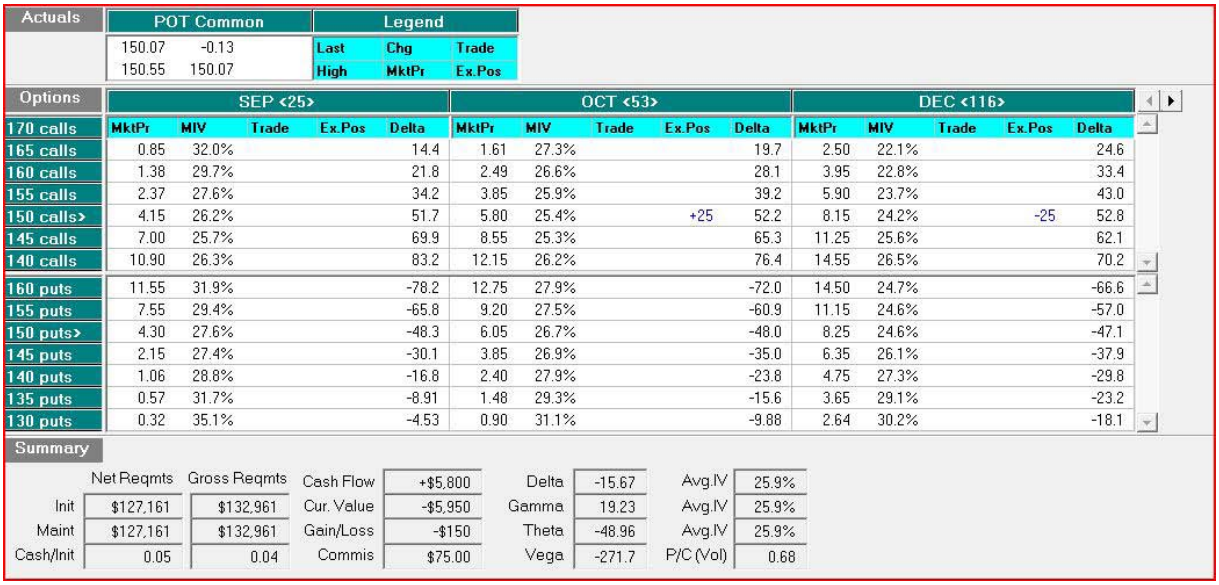
In the next installment, I will expand upon the above analytical framework and discuss some of the implications for various VIX term structure patterns as they apply to trading VIX options and VIX ETNs. EM

Follow
That Trade

Mark Sebastian

When I was asked by the team to do a trade for Follow That Trade on gamma scalping, I wasn't exactly sure where to start. Rarely do I actually initiate long gamma trades. Granted, as a market maker I had them on all the time, but that was because I was taking the other side of a trade, not because I initiated it. So I wanted a good reason to enter a back spread. Then the Potash (POT) news came out, and I thought that this would be a fun stock to trade. I decided to demonstrate how selling a time spread works in a buyout situation. My hope, of course, was that the stock would get bought quickly, and that the spread would collapse to 0. In the mean time, I decided to scalp gamma in POT to attempt to pay the decay on this stock.

I opened up the trade on August 24th. I bought 50 of the POT Oct 150 calls and sold 50 of the December 150 calls. The net credit on the trade was $2.35. With October IV hovering at 26%, I was going to need POT to move about $1.625 per trading day in order to pay this stock's decay—something that I knew off the bat was unlikely to happen. However, by doing some basic buying and selling, and cleaning up deltas when my position delta became plus or minus 100, I thought I would at least be able to manage.



Actuals

POT Common		Legend		
150.07	-0.13	Last	Chg	Trade
150.55	150.07	High	MktPr	Ex.Pos

Options

	SEP <25>					OCT <53>					DEC <116>				
170 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
165 calls	0.85	32.0%			14.4	1.61	27.3%			19.7	2.50	22.1%			24.6
160 calls	1.38	29.7%			21.8	2.49	26.6%			28.1	3.95	22.8%			33.4
155 calls	2.37	27.6%			34.2	3.85	25.9%			39.2	5.90	23.7%			43.0
150 calls>	4.15	26.2%			51.7	5.80	25.4%		+25	52.2	8.15	24.2%		-25	52.8
145 calls	7.00	25.7%			69.9	8.55	25.3%			65.3	11.25	25.6%			62.1
140 calls	10.90	26.3%			83.2	12.15	26.2%			76.4	14.55	26.5%			70.2
160 puts	11.55	31.9%			-78.2	12.75	27.9%			-72.0	14.50	24.7%			-66.6
155 puts	7.55	29.4%			-65.8	9.20	27.5%			-60.9	11.15	24.6%			-57.0
150 puts>	4.30	27.6%			-48.3	6.05	26.7%			-48.0	8.25	24.6%			-47.1
145 puts	2.15	27.4%			-30.1	3.85	26.9%			-35.0	6.35	26.1%			-37.9
140 puts	1.06	28.8%			-16.8	2.40	27.9%			-23.8	4.75	27.3%			-29.8
135 puts	0.57	31.7%			-8.91	1.48	29.3%			-15.6	3.65	29.1%			-23.2
130 puts	0.32	35.1%			-4.53	0.90	31.1%			-9.88	2.64	30.2%			-18.1

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	+$5,800	Delta	-15.67	Avg.IV	25.9%
Init	$127,161	$132,961	Cur. Value	-$5,950	Gamma	19.23	Avg.IV	25.9%
Maint	$127,161	$132,961	Gain/Loss	-$150	Theta	-48.96	Avg.IV	25.9%
Cash/Init	0.05	0.04	Commis	$75.00	Vega	-271.7	P/C (Vol)	0.68

Figure 1

The next day, POT took a bit of a dive and I bought 100 shares of POT at $145.57. I was also up money, and if I was on the floor I would have adjusted this trade somehow. Since this was a demonstration, I decided to leave it alone.

Actuals | POT Common | Legend

	145.50	-3.61		Last	Chg	Trade
	147.50	145.50	+100	High	MktPr	Ex.Pos

Options

	SEP <24>					OCT <52>					DEC <115>				
170 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
165 calls	0.37	32.4%			7.37	1.09	29.4%			13.6	2.13	24.7%			19.0
160 calls	0.57	29.4%			11.7	1.70	28.5%			20.1	3.05	24.5%			26.2
155 calls	0.98	26.6%			19.5	2.85	28.9%			29.0	4.65	25.5%			34.7
150 calls	1.96	25.0%			33.3	4.45	29.1%		+50	40.6	6.65	26.4%		-50	44.1
145 calls>	3.90	24.6%			53.5	6.75	29.8%			53.4	9.10	27.4%			53.8
140 calls	7.20	26.2%			73.0	9.70	30.6%			66.0	12.10	28.5%			62.8
160 puts	15.00				-88.3	16.20	28.0%			-79.9	17.65	24.7%			-73.8
155 puts	10.45	26.2%			-80.5	12.30	28.3%			-71.1	14.10	25.2%			-65.3
150 puts	6.45	24.9%			-66.8	8.95	28.7%			-59.6	11.00	25.8%			-55.8
145 puts>	3.40	24.5%			-46.5	6.30	29.8%			-46.8	8.55	27.0%			-46.2
140 puts	1.67	26.1%			-27.0	4.25	30.6%			-34.2	6.50	28.0%			-37.1
135 puts	0.81	28.5%			-14.6	2.75	32.0%			-23.7	4.90	29.3%			-29.2
130 puts	0.44	32.2%			-8.05	1.79	33.5%			-15.8	3.80	31.3%			-22.7

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$2,897	Delta	-79.68	Avg.IV	26.9%
Init	$220,015	$217,118	Cur. Value	+$3,400	Gamma	31.65	Avg.IV	26.9%
Maint	$217,109	$214,212	Gain/Loss	+$503	Theta	-113.2	Avg.IV	26.9%
Cash/Init	-0.01	-0.01	Commis	$89.95	Vega	-547.9	P/C (Vol)	0.67

Figure 2

The following day POT dove again, so I bought another 100 shares, cleaning the delta up to about flat. At this point the trade was profitable by more than $1000, a spot where smart traders should exit. I did not.

Actuals | POT Common | Legend

	144.75	-0.75		Last	Chg	Trade
	146.66	144.75	+150	High	MktPr	Ex.Pos

Options

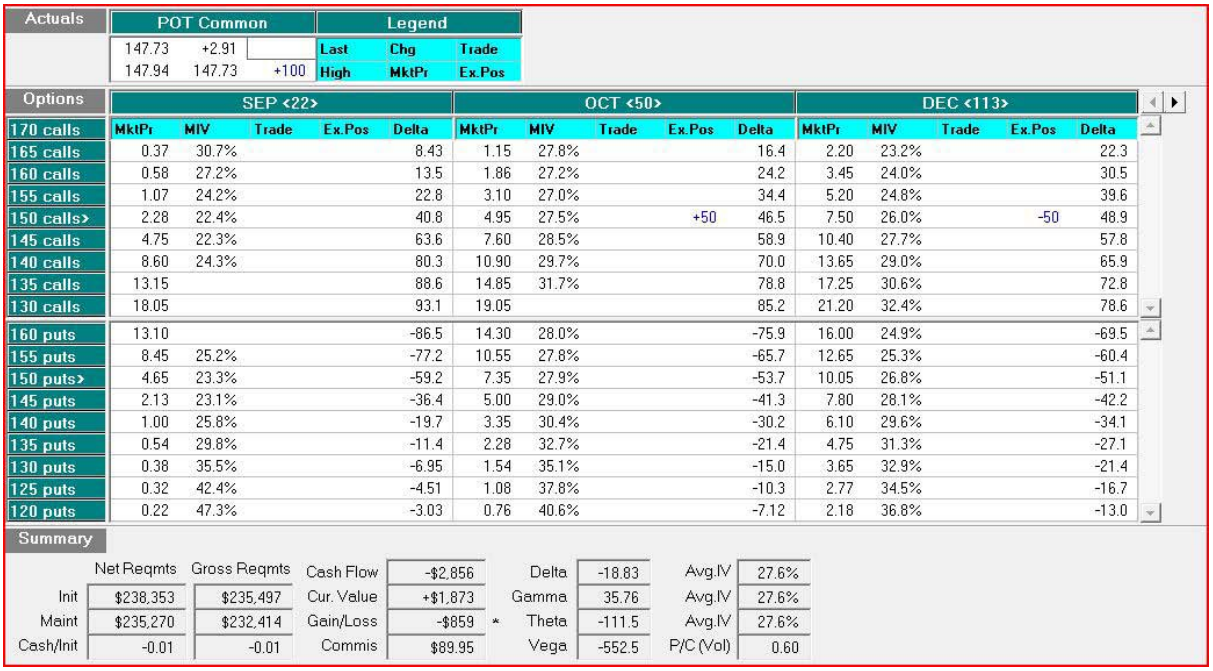
	SEP <23>					OCT <51>					DEC <114>				
170 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
165 calls	0.36	34.1%			6.58	1.14	30.9%			13.0	1.85	24.3%			18.5
160 calls	0.54	30.7%			10.5	1.77	30.2%			19.7	2.85	24.6%			25.7
155 calls	0.91	27.9%			17.2	2.75	29.9%			28.4	4.40	25.8%			34.1
150 calls	1.71	25.5%			29.9	4.30	30.0%		+50	39.4	6.35	26.7%		-50	43.3
145 calls>	3.45	24.6%			50.2	6.45	30.4%			51.7	8.75	27.5%			52.5
140 calls	6.55	26.0%			70.9	9.30	31.3%			63.6	11.60	28.7%			61.3
135 calls	10.65				84.0	12.85	33.0%			73.9	15.15	30.5%			69.2
160 puts	15.85				-89.6	17.05	30.0%			-80.4	18.25	25.1%			-74.3
155 puts	11.15	27.8%			-82.8	13.00	29.7%			-71.7	14.60	25.6%			-65.8
150 puts	7.00	25.7%			-70.1	9.60	30.0%			-60.7	11.70	26.9%			-56.7
145 puts>	3.70	24.6%			-49.8	6.80	30.6%			-48.5	9.05	27.7%			-47.4
140 puts	1.85	26.4%			-29.1	4.60	31.5%			-36.6	7.00	29.1%			-38.6
135 puts	0.94	29.4%			-16.0	3.10	33.0%			-26.3	5.35	30.3%			-30.8
130 puts	0.57	33.8%			-9.12	2.03	34.6%			-18.3	4.10	32.0%			-24.2
125 puts	0.39	39.2%			-5.37	1.37	36.8%			-12.5	3.00	33.0%			-18.8

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$10,149	Delta	-41.33	Avg.IV	27.7%
Init	$215,245	$205,095	Cur. Value	+$11,312	Gamma	28.70	Avg.IV	27.7%
Maint	$210,943	$200,794	Gain/Loss	+$1,163	Theta	-121.3	Avg.IV	27.7%
Cash/Init	-0.05	-0.05	Commis	$104.90	Vega	-550.2	P/C (Vol)	1.14

Figure 3

The following day demonstrated why traders close out winning trades: POT rallied hard and even though I got to sell some stock, the trade had swung from winning to losing.



Actuals

POT Common			Legend		
147.73	+2.91		Last	Chg	Trade
147.94	147.73	+100	High	MktPr	Ex.Pos

Options

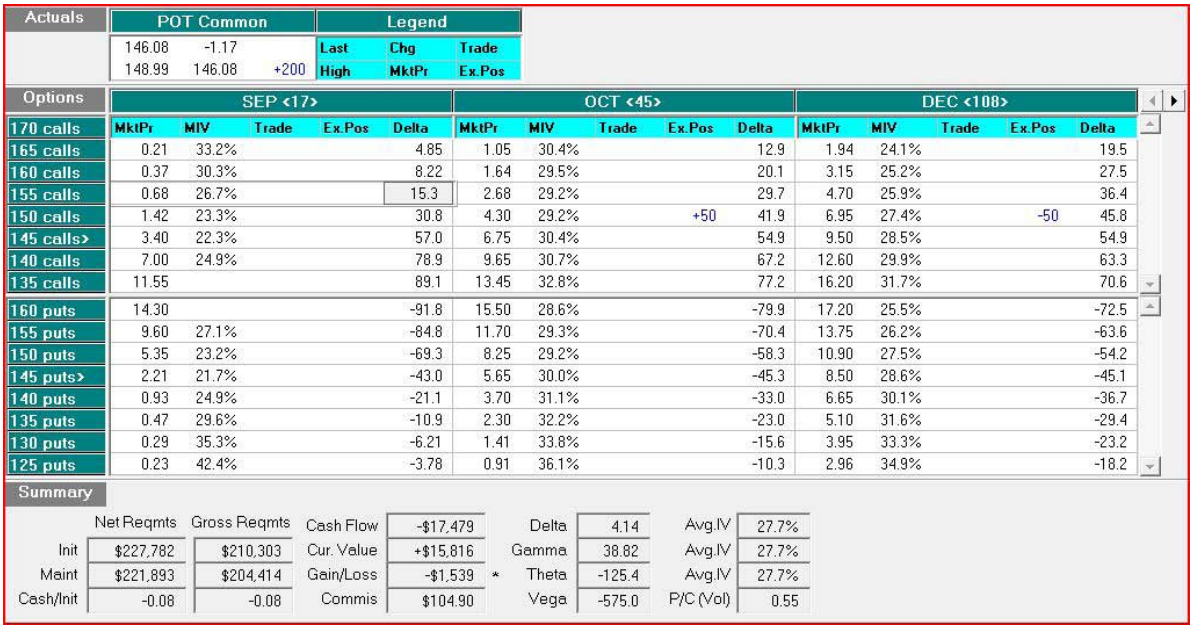
	SEP <22>					OCT <50>					DEC <113>				
	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
170 calls															
165 calls	0.37	30.7%			8.43	1.15	27.8%			16.4	2.20	23.2%			22.3
160 calls	0.58	27.2%			13.5	1.86	27.2%			24.2	3.45	24.0%			30.5
155 calls	1.07	24.2%			22.8	3.10	27.0%			34.4	5.20	24.8%			39.6
150 calls>	2.28	22.4%			40.8	4.95	27.5%		+50	46.5	7.50	26.0%		-50	48.9
145 calls	4.75	22.3%			63.6	7.60	28.5%			58.9	10.40	27.7%			57.8
140 calls	8.60	24.3%			80.3	10.90	29.7%			70.0	13.65	29.0%			65.9
135 calls	13.15				88.6	14.85	31.7%			78.8	17.25	30.6%			72.8
130 calls	18.05				93.1	19.05				85.2	21.20	32.4%			78.6
160 puts	13.10				-86.5	14.30	28.0%			-75.9	16.00	24.9%			-69.5
155 puts	8.45	25.2%			-77.2	10.55	27.8%			-65.7	12.65	25.3%			-60.4
150 puts>	4.65	23.3%			-59.2	7.35	27.9%			-53.7	10.05	26.8%			-51.1
145 puts	2.13	23.1%			-36.4	5.00	29.0%			-41.3	7.80	28.1%			-42.2
140 puts	1.00	25.8%			-19.7	3.35	30.4%			-30.2	6.10	29.6%			-34.1
135 puts	0.54	29.8%			-11.4	2.28	32.7%			-21.4	4.75	31.3%			-27.1
130 puts	0.38	35.5%			-6.95	1.54	35.1%			-15.0	3.65	32.9%			-21.4
125 puts	0.32	42.4%			-4.51	1.08	37.8%			-10.3	2.77	34.5%			-16.7
120 puts	0.22	47.3%			-3.03	0.76	40.6%			-7.12	2.18	36.8%			-13.0

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$2,856		Delta	-18.83	Avg.IV	27.6%
Init	$238,353	$235,497	Cur. Value	+$1,873		Gamma	35.76	Avg.IV	27.6%
Maint	$235,270	$232,414	Gain/Loss	-$859	*	Theta	-111.5	Avg.IV	27.6%
Cash/Init	-0.01	-0.01	Commis	$89.95		Vega	-552.5	P/C (Vol)	0.60

Figure 4

On Sep 11 was down again, so I bought 100 shares of POT just above $146.



Actuals

POT Common			Legend		
146.08	-1.17		Last	Chg	Trade
148.99	146.08	+200	High	MktPr	Ex.Pos

Options

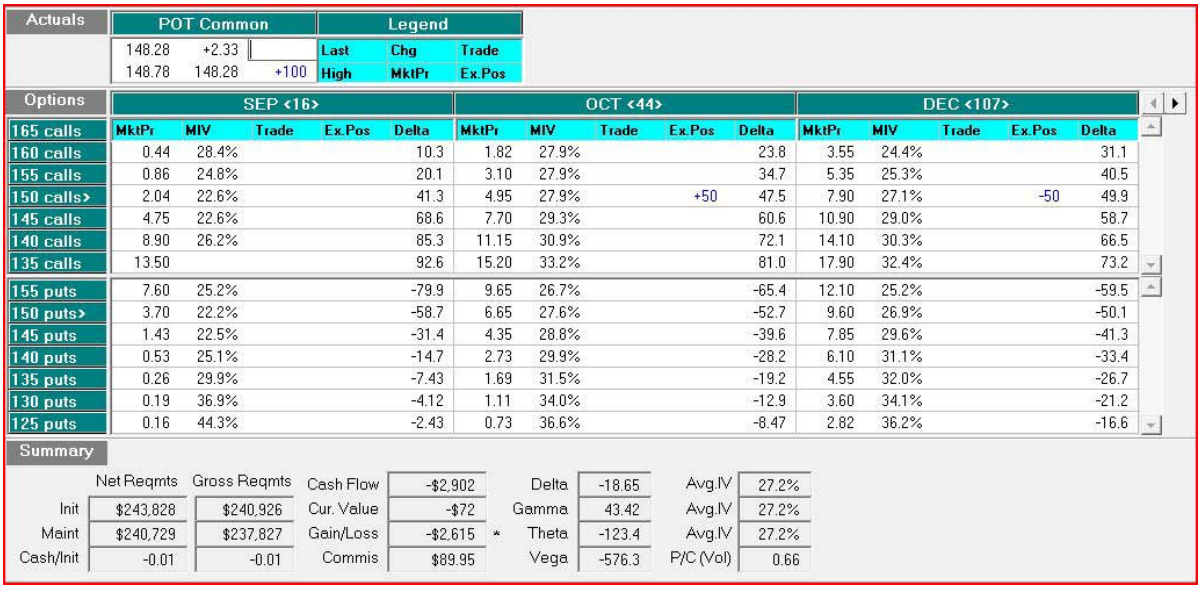
	SEP <17>					OCT <45>					DEC <108>				
	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
170 calls															
165 calls	0.21	33.2%			4.85	1.05	30.4%			12.9	1.94	24.1%			19.5
160 calls	0.37	30.3%			8.22	1.64	29.5%			20.1	3.15	25.2%			27.5
155 calls	0.68	26.7%			15.3	2.68	29.2%			29.7	4.70	25.9%			36.4
150 calls	1.42	23.3%			30.8	4.30	29.2%		+50	41.9	6.95	27.4%		-50	45.8
145 calls>	3.40	22.3%			57.0	6.75	30.4%			54.9	9.50	28.5%			54.9
140 calls	7.00	24.9%			78.9	9.65	30.7%			67.2	12.60	29.9%			63.3
135 calls	11.55				89.1	13.45	32.8%			77.2	16.20	31.7%			70.6
160 puts	14.30				-91.8	15.50	28.6%			-79.9	17.20	25.5%			-72.5
155 puts	9.60	27.1%			-84.8	11.70	29.3%			-70.4	13.75	26.2%			-63.6
150 puts	5.35	23.2%			-69.3	8.25	29.2%			-58.3	10.90	27.5%			-54.2
145 puts>	2.21	21.7%			-43.0	5.65	30.0%			-45.3	8.50	28.6%			-45.1
140 puts	0.93	24.9%			-21.1	3.70	31.1%			-33.0	6.65	30.1%			-36.7
135 puts	0.47	29.6%			-10.9	2.30	32.2%			-23.0	5.10	31.6%			-29.4
130 puts	0.29	35.3%			-6.21	1.41	33.8%			-15.6	3.95	33.3%			-23.2
125 puts	0.23	42.4%			-3.78	0.91	36.1%			-10.3	2.96	34.9%			-18.2

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$17,479		Delta	4.14	Avg.IV	27.7%
Init	$227,782	$210,303	Cur. Value	+$15,816		Gamma	38.82	Avg.IV	27.7%
Maint	$221,893	$204,414	Gain/Loss	-$1,539	*	Theta	-125.4	Avg.IV	27.7%
Cash/Init	-0.08	-0.08	Commis	$104.90		Vega	-575.0	P/C (Vol)	0.55

Figure 5

The following day I sold it right back, and as the position continued to decay I was not covering the trade's nut. I lost a big chunk of cash into Labor Day.



Actuals | POT Common | Legend

148.28	+2.33		Last	Chg	Trade
148.78	148.28	+100	High	MktPr	Ex.Pos

Options

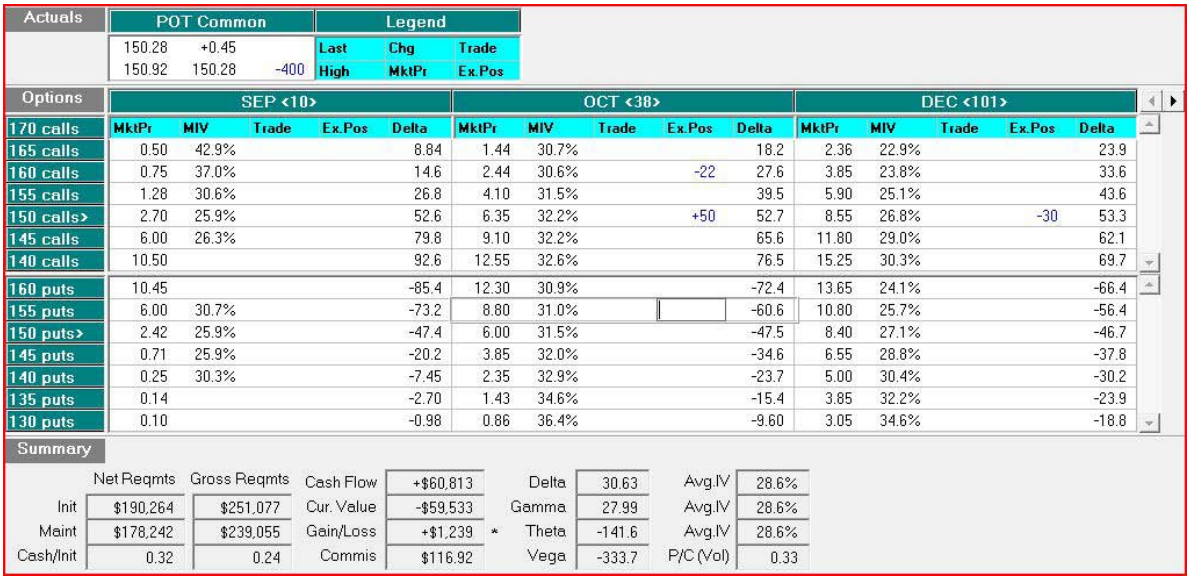
	SEP <16>					OCT <44>					DEC <107>				
165 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
160 calls	0.44	28.4%			10.3	1.82	27.9%			23.8	3.55	24.4%			31.1
155 calls	0.86	24.8%			20.1	3.10	27.9%			34.7	5.35	25.3%			40.5
150 calls>	2.04	22.6%			41.3	4.95	27.9%		+50	47.5	7.90	27.1%		-50	49.9
145 calls	4.75	22.6%			68.6	7.70	29.3%			60.6	10.90	29.0%			58.7
140 calls	8.90	26.2%			85.3	11.15	30.9%			72.1	14.10	30.3%			66.5
135 calls	13.50				92.6	15.20	33.2%			81.0	17.90	32.4%			73.2
155 puts	7.60	25.2%			-79.9	9.65	26.7%			-65.4	12.10	25.2%			-59.5
150 puts>	3.70	22.2%			-58.7	6.65	27.6%			-52.7	9.60	26.9%			-50.1
145 puts	1.43	22.5%			-31.4	4.35	28.8%			-39.6	7.85	29.6%			-41.3
140 puts	0.53	25.1%			-14.7	2.73	29.9%			-28.2	6.10	31.1%			-33.4
135 puts	0.26	29.9%			-7.43	1.69	31.5%			-19.2	4.55	32.0%			-26.7
130 puts	0.19	36.9%			-4.12	1.11	34.0%			-12.9	3.60	34.1%			-21.2
125 puts	0.16	44.3%			-2.43	0.73	36.6%			-8.47	2.82	36.2%			-16.6

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	-$2,902	Delta	-18.65	Avg.IV	27.2%
Init	$243,828	$240,926	Cur. Value	-$72	Gamma	43.42	Avg.IV	27.2%
Maint	$240,729	$237,827	Gain/Loss	-$2,615	Theta	-123.4	Avg.IV	27.2%
Cash/Init	-0.01	-0.01	Commis	$89.95	Vega	-576.3	P/C (Vol)	0.66

Figure 6

On September 8th rumors begin to circulate that POT was going to get bought out imminently, or that there would be a raise in the bid price. Notice the pump in implied volatility. I decided to finally do something about the pump in IV: I bought back some December options, sold some October, and sold a little bit of stock. This was an effort to take advantage of the increase in IV while still making the position able to win.



Actuals | POT Common | Legend

150.28	+0.45		Last	Chg	Trade
150.92	150.28	-400	High	MktPr	Ex.Pos

Options

	SEP <10>					OCT <38>					DEC <101>				
170 calls	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta	MktPr	MIV	Trade	Ex.Pos	Delta
165 calls	0.50	42.9%			8.84	1.44	30.7%			18.2	2.36	22.9%			23.9
160 calls	0.75	37.0%			14.6	2.44	30.6%		-22	27.6	3.85	23.8%			33.6
155 calls	1.28	30.6%			26.8	4.10	31.5%			39.5	5.90	25.1%			43.6
150 calls>	2.70	25.9%			52.6	6.35	32.2%		+50	52.7	8.55	26.8%		-30	53.3
145 calls	6.00	26.3%			79.8	9.10	32.2%			65.6	11.80	29.0%			62.1
140 calls	10.50				92.6	12.55	32.6%			76.5	15.25	30.3%			69.7
160 puts	10.45				-85.4	12.30	30.9%			-72.4	13.65	24.1%			-66.4
155 puts	6.00	30.7%			-73.2	8.80	31.0%			-60.6	10.80	25.7%			-56.4
150 puts>	2.42	25.9%			-47.4	6.00	31.5%			-47.5	8.40	27.1%			-46.7
145 puts	0.71	25.9%			-20.2	3.85	32.0%			-34.6	6.55	28.8%			-37.8
140 puts	0.25	30.3%			-7.45	2.35	32.9%			-23.7	5.00	30.4%			-30.2
135 puts	0.14				-2.70	1.43	34.6%			-15.4	3.85	32.2%			-23.9
130 puts	0.10				-0.98	0.86	36.4%			-9.60	3.05	34.6%			-18.8

Summary

	Net Reqmts	Gross Reqmts	Cash Flow	+$60,813	Delta	30.63	Avg.IV	28.6%
Init	$190,264	$251,077	Cur. Value	-$59,533	Gamma	27.99	Avg.IV	28.6%
Maint	$178,242	$239,055	Gain/Loss	+$1,239	Theta	-141.6	Avg.IV	28.6%
Cash/Init	0.32	0.24	Commis	$116.92	Vega	-333.7	P/C (Vol)	0.33

Figure 7

This is where things currently sit. I have included a trade log and a picture of what our current position looks like according to OptionVue 6.

Options

Account **Sample** Cancel OK

	Date	Time	Code	Qty	Symbol	Type	Price	Commis	Net	R	Desc	Asset File	Notes
1.	08/24/10	09:00	Buy	50	POT 10J1	O	5.80	37.50	-29,037.50		POT Oct150 calls	POT.STK	
2.	08/24/10	09:00	Sel	50	POT 10L1	O	8.15	37.50	40,712.50		POT Dec150 calls	POT.STK	
3.	08/25/10	15:00	Buy	100	POT	S	145.57	14.95	-14,571.95		POT Common	POT.STK	
4.	08/26/10	15:00	Buy	100	POT	S	144.75	14.95	-14,489.96		POT Common	POT.STK	
5.	08/27/10	15:00	Sel	100	POT	S	146.70	14.95	14,655.05		POT Common	POT.STK	
6.	09/01/10	15:00	Buy	100	POT	S	146.08	14.95	-14,622.95		POT Common	POT.STK	
7.	09/02/10	15:00	Sel	100	POT	S	148.27	14.95	14,812.05		POT Common	POT.STK	
8.	09/08/10	15:00	Sel	22	POT 10J1	O	2.44	33.00	5,335.00		POT Oct160 calls	POT.STK	
9.	09/08/10	15:00	Buy	10	POT 10L1	O	8.55	15.00	-8,565.00		POT Dec150 calls	POT.STK	
10.	09/08/10	15:00	Buy	10	POT 10L1	O	8.55	15.00	-8,565.00		POT Dec150 calls	POT.STK	
11.	09/08/10	15:00	Sel	500	POT	S	150.28	29.90	75,110.10		POT Common	POT.STK	
12.													

Figure 8

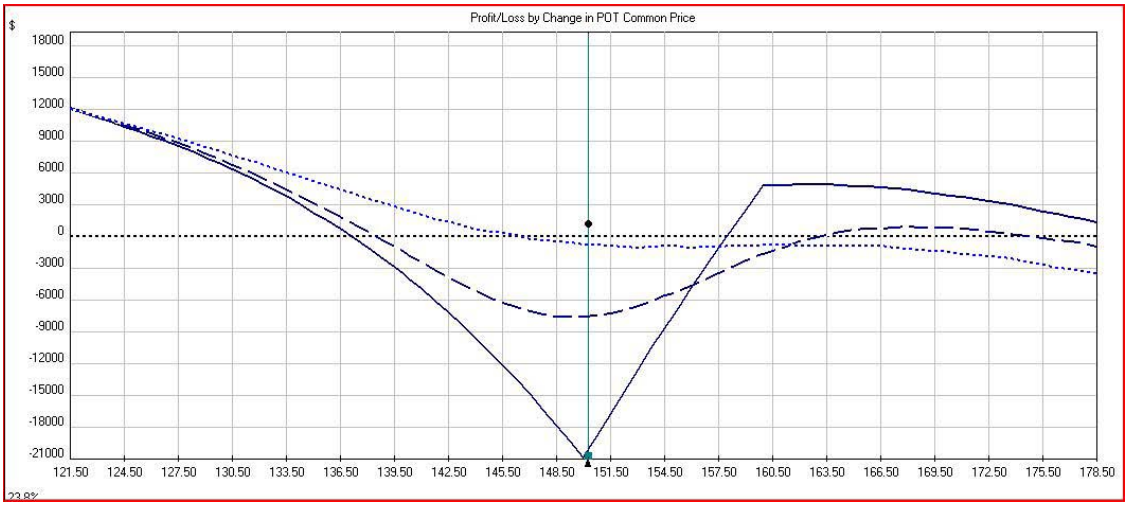


Figure 9

I will keep you up to date with how this trade unfolds in next month's issue.

Trading Advice

From a Different Perspective

Mark D Wolfinger

When venturing into a new business, the vast majority of people construct a business plan that guides them when it's time to make important decisions. Often they can learn from the experience of others by reading, asking questions, or hiring help.

When people begin investing, they often feel confident enough to proceed by themselves, despite lack of prior experience. They often read material produced by their brokers and option traders are given an important pamphlet (ok, it's electronic these days) to read. Perhaps they grab some books or search blogs. But for the most part, they are often content to begin trading first and try to learn as they go.

Lessons are learned the hard way—often by incurring unnecessary losses. In the spirit of minimizing those losses, let's discuss one common situation from a different perspective. I'll tell you up front that most traders disagree with my approach to this situation, but I know that if you adopt it as part of your individual trading philosophy that you will do better over the longer term.

> Your job is to **exit** now and make a **better trade** when you find it.

The principle is fairly simple: When you own a position, especially an options position for which the calendar plays a vital role, there will come a time when you know it's best to exit the trade.

Why exit? When expiration arrives, the options expire and the trade is over. You may want to make a trade to 'renew' the position for another month or two, but that's a separate decision. When expiration arrives, the current position goes away. Another reason for exiting is that the market has moved and suddenly your position is too risky too hold. That's true both for traders who own options and for those who sold them. The time remaining prior to expiration plays a big role in deciding whether to hold 'em or fold 'em.

Alternatively, traders often exit a trade to lock in a profit before it disappears.

Advice

Most traders are very willing to exit any position for which they have earned a profit. Those same traders are seldom willing to exit a trade when it has been a money-losing proposition. This style of trading feels as if it makes sense. Everyone likes to earn money and if you take a profit you succeeded. Similarly, once a trader takes the loss, the position is closed, and the loss is a loss forever. Traders don't like losses.

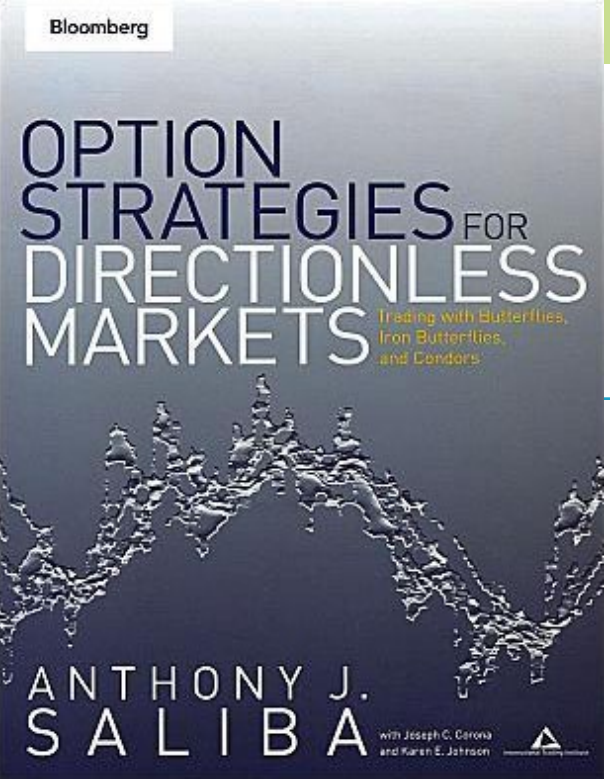
That last statement requires clarification. Experienced traders, and especially successful traders, love losses. They know when to take those losses as a method of

preventing large losses. The willingness and ability to exit a trade when it is underwater is necessary for long-term success. Many traders lost their entire investment accounts because of a 'need' to break-even before exiting a trade . Think of it like this: The trader holds to earn 10 or 20 cents from a trade before being willing to exit. Part of the time, the position moves further against them, and the resulting loss is several dollars (per share). Sometimes they make that extra 20 cents, but sometimes they lose 20 times as much by refusing to exit. Traders who act according to this 'I cannot take a loss' mindset are not likely to succeed.

So here's the advice: When it comes to managing risk or when it's time to exit a trade, base that hold/fold decision on the position as it exists today. Look at that position. Do you love it? Are you tempted to buy more? If yes, then this is no time to exit the trade.

However, if you believe risk is too great or that the probability of making any money (from today forward) is very low, then there is no reason to own the position. Ask yourself: if I have a small profit or loss on this trade, how does that change the fact that this is a poor position, is no longer working, and is too risky to hold? Logic should tell you that it has no bearing on whether to own the trade. You know it's a bad position, so exit. It does not matter whether it's a loss. Surely you can find a better trade with an improved probability of earning a profit.

Your job as trader and risk manager is to make money in the future. You cannot change the past. If you do not believe your current holdings can do the job—or are too risky to take the chance—then your job is to exit now and make a better trade when you find it. There is no urgency in finding that new trade. EM



Option Strategies for Directionless Markets: Trading with Butterflies, Iron Butterflies, and Condors, Anthony J. Saliba, with Joseph C. Corona and Karen E. Johnson (Bloomberg Press: 2008)

Book Review

Jared Woodard

Investors whose only exposure to options is through the mainstream financial press might be forgiven for thinking that the only purposes of options are wild speculation during bull markets and frantic put-buying during crashes. *Option Strategies for Directionless Markets* represents a decisive refutation of that caricature. It is the first book-length discussion I've seen devoted entirely to market-neutral spreading strategies, and it is also the first book aimed at general readers to really delve into multi-legged options spreads. The book succeeds in several areas. It clearly explains the structure and characteristics of strategies that, on first glance, may seem prohibitively complex to newer traders. Every strategy is presented as practically as possible, always in the context of risk characteristics and the profits/losses at possible future outcomes. Each chapter concludes with exercises, a quiz, and answer keys—they aren't overly difficult, and they assess the most important aspects of the material. One nice feature is that the authors don't try to reach for the lowest common denominator: this is not a book for someone who has never traded options before, and it is refreshing in a book this practical to be spared explanations of what puts and calls are.

My complaints are few. Although nobody reads an options trading book for the entertainment value, this text is particularly austere. Except for the concluding interview with the author, the book reads more like a manual or workbook than anything else. This isn't a major criticism: explaining wingspreads is not a task for which a strong narrative voice is required. But at times, the risk graphs and profit/loss tables are so prolific that they break up the body of the text and become very distracting—after you encounter the *n*th decomposition diagram or example trade, they all start to look the same. Replacing half of the repetitive tables with more trade selection criteria or some historical research would have improved the book considerably. Also, the glaring omission of any discussion of position management means traders new to market-neutral spreads will finish the book with no idea how to manage a trade once it has been opened.

The first chapter explains what the authors mean by a "direction-less market," how to identify one, and why options can be used to

profit from such environments. The next two chapters lay out the basics of butterflies and condors. Chapters four and five cover the greeks, in theory and in practice, and what's notable here is that gamma and vega are given as much attention as delta and theta. This is in contrast to many trader-oriented books on options, which often rush through gamma and vega as quickly as possible; obviously, that won't work for strategies like butterflies and condors that depend so much on an adequate understanding of those variables.

Chapters six and seven get into the real meat of these strategies, covering the iron variations of butterflies and condors, as well as broken-wing spreads and iron condors with gaps between the short strikes. (Strangely, Saliba et al. call these latter trades "iron pterodactyls.") Chapter eight brings the themes of prior chapters together, showing how the different strategies relate to one another and can be applied in different market contexts based on movement in price and volatility. The book concludes with an interview with Saliba, a final exam, and a concise glossary.

One of the nice things about the latter part of the book is the presence of some pretty advanced topics, like the synthetic equivalence of "guts" and "classic" butterflies and condors, or the use of box spreads to demonstrate that credit and debit wingspreads are synthetically equivalent once interest rate components are factored in. I don't remember seeing some of these topics discussed anywhere else.

Saliba explains that traders shouldn't prefer iron "classic" credit butterflies and condors over the "guts" debit versions because there's anything special about bringing in cash up front (there isn't); factors like better liquidity, tighter spreads, and lower execution risk are the real reasons, he says, to trade out-of-the-money wingspreads.

The book succeeds at its central task—explaining market-neutral option spreads, and it is one of the only texts available discussing in detail the purpose and structure of butterflies, condors, *and* their iron variations. Explanations are clear and concise, and while this isn't a book for complete options novices, one needn't have any prior experience with the strategies discussed. **EM**

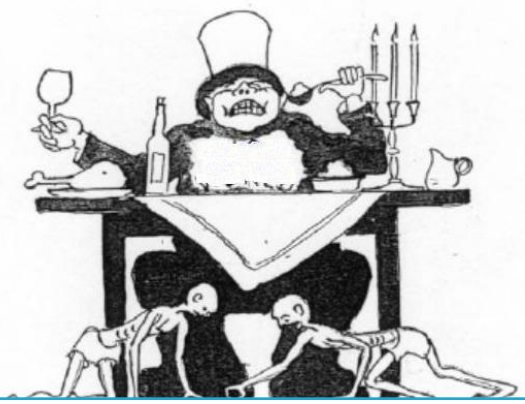
An Overview of Directional Trading *(continued from page 14)*

It's not that easy to predict market direction. Option buyers have an especially difficult time. They must be correct on market direction, the timing of the move, and often, the size of the move. If you have a track record of being able to make money by buying options, I truly tip my hat to you. For me, the obstacles for success are insurmountable, and I always warn rookie traders that this tempting strategy is extremely risky.

Betting on range-bound markets may seem easy. Just sell some options or option spreads and wait for them to decline in value as time passes. The sad part is that too many people believe it's just that simple. Such investors/traders are totally unaware that there is nothing quite like the panic of being short put options (even when they are not naked) in a rapidly falling market, watching implied volatility move rapidly higher and your account value moving steadily lower. That's the part of market-neutral trading that's seldom mentioned when someone is explaining how to trade credit spreads, iron condors, and short strangles. They may speak of their 90% success rate, but it's the size of the losses that occur the other 10% of the time that matter the most.

Directional trading is enjoyable. The ego boost that comes from being right and making money is very rewarding. However, it can quickly lead to overconfidence. It's fine to make directional bets, but please understand that it's important to practice good risk management and recognize when your opinion was incorrect. Do not stubbornly stay with losing trades when you lose confidence in them. **EM**

The Fable of the Trickling Tax Cut



Jared Woodard

Congress is debating whether to allow the tax cuts enacted in 2001 and 2003 to expire for those with annual incomes above $200,000. It is unclear whether "debate" is really the best term to describe what's taking place, however. The situation looks more like a standoff between rude, cold appeals to data and research and the warm, comforting fantasy stories that so many have grown to love.

The Fable

There once was a group of super men, creative, productive, and proud. Through their toil and ingenuity they built a thriving society to rival any in the world. Taking nothing from no one, they were self-reliant islands of power and innovation. But the sniveling, seething masses of blood-sucking hangers-on—"workers," they called themselves—hated the *ubermenschen* for their freedom and their wealth and their superiority. These inferior men conspired together and contrived ways of stealing money and power from the producers. They formed nation-states, and refused to "work" in the absence of the recognition of their "rights," and extorted the property of the producers in the form of taxes.

As ever, the workers had failed miserably to understand the natural order of things. As they siphoned away the hard-won capital of the producers, the vibrancy of the society declined, and life became harder for everyone. Producers could not exercise their magnificent talents, and there was less productive potency for the workers to leech away.

Having long understood every facet of this problem, some of the producers heroically abandoned their world-making for a time in order in infiltrate the nation-states of the *untermenschen*. They revealed the truth of the gospel and science of the Supply Side to the world. The world received this truth with rapt attention, and even some of the workers were able to comprehend its axiomatic elegance. Freed from their resentful ways, some of the workers agreed, along with the producers, that the bounty of the world-makers should remain with them; the theft known as taxation was halted, and the super men were freed to create and build and enjoy. Their surplus extended even to the undeserving workers, and growth and vitality returned to the world.

The Data

According to a recent report from Moody's Analytics spanning 20 years of government data, when couples with annual incomes above $210,000 receive a tax cut, they typically save rather than spend the money. Spending and investment by the wealthy have, historically, been far more connected to the business cycle than to changes in tax rates. Since filers with lower incomes have been far more likely to spend those marginal dollars, policymakers whose goal is to boost aggregate demand would appear to be more successful by targeting fiscal loosening at middle- and lower-income filers.

But then, why should we let something as boring and inconvenient as empirical evidence get in the way of a good story? EM