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EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

EXPLORING PUT TO CALL RATIOS

The Many Virtues of a
Put Selling Strategy

Preparing for EU Trouble with
Volatility Products

AN INTERVIEW WITH
Larry McMillan

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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

This month's options expiration cycle began with a trio of disasters in Japan and unrest across the Middle East and North Africa. The VIX started the expiration cycle off in the 24s and ended the cycle just over 15. Over the course of the month investors have shifted their focus from geopolitical events to economic fundamentals such as earnings, growth, interest rates and debt.

The April edition of *Expiring Monthly* also shifts focus a little. While the focus of this magazine remains on trading options, we would be remiss in not delving into the subject of options as market sentiment indicators. This month I somewhat gingerly open that can of worms with a feature article, Exploring Puts and Calls. Going forward we will be sure to revisit put to call ratios in future issues and also analyze the use of the VIX as a market sentiment indicator.

Puts also play a starring role in guest author Jason Ungar's review of the CBOE S&P 500 PutWrite Index (PUT) and put selling strategies.

Mark Sebastian has been busy on the interview front. This month he sits down with options legend Larry McMillan and also interviews Ping Zhou, a co-author of Trading on Corporate Earnings News.

As investors begin to refocus on the European sovereign debt issues, Jared Woodard has a timely look at three different ways to play the European sovereign debt crisis using various volatility products.

In the latest installment of his column aimed at new option traders, Mark Wolfinger opines on risk, timing and the fallacy of 'house money.' Mark also squares off with David Blair in the popular Wolf Against the World feature, where the two debate the merits of using options for the purposes of speculation.

In two of our recurring features, Mark Sebastian has this month's Follow That Trade, in which he navigates the always tricky management of an OEX butterfly and the EM team answers reader questions in Ask the Xperts.

Finally, on the Back Page, Mark Wolfinger ruminates about the growing trend in which options brokers are putting limits on customer trading on the last trading day of the expiration cycle.

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

Q: *Mark, great article [Expiring Monthly, Mar 2011, Vol. 2 No. 1, pp. 34–38]. I thought, based on reading your Q&As of your blog, that you used the Kites to protect your iron condors instead of standalone trades? What would have been the results if you had been using the C3 and P3 Kites in the article to hedge an iron condor?*

—Steve

A: The '**kite spread**' is the term I adapted for the position described in the article: Long one call (or put) and short 3–5 farther OTM call (or put) spreads. [The term C3 (P3) means that three call (put) spreads are sold per long call. The requirement for this trade is for it to be impossible to lose money (other than debit paid to open) on a big move. It is intended to reduce losses if an iron condor (or credit spread) gets into trouble.

When using kites as protection, and assuming that the trade is sized appropriately for your individual comfort zone, I buy 10 kites to protect between 50 and 100 additional iron condors. Thus, if I traded 30 iron condors as the initial trade, the adjustment may be to buy four kite spreads.

Regarding the article, I did not record the prices for the individual options for this trade, but the iron condor was priced above $3. Trading 60–70 additional iron condors would have been enough to generate more than $18,000. That's enough to offset the original debit.

I would have closed the trade prior to expiration. Thus the overall profitability would depend on how many iron condors were sold and exactly how many kites were purchased. This specific kite/extra iron condor combination would have earned a small profit, in your scenario.

Kites may be used as standalone plays, but they are obviously long vega with negative theta. As a standalone trade, the plan is to exit fairly quickly with a satisfactory profit.

—Mark W.

Q: *Hi, I just read your e-book, and was following up on some of the papers you mentioned. I was intrigued by the thesis about a volatility risk premium in TLT, the iShares long-term bond ETF. I took a look at HV vs. IV for the last year, and HV seemed to spend much of the time above IV. Does the relationship cited in this paper just no longer exist, or am I missing something?*

—Andrew

A: One thing to keep in mind when evaluating the IV of options is that, while an option's price today will be influenced by recent historical volatility, whether or not that option will prove to have been expensive or cheap depends on the volatility in the underlying that occurs in the future. For comparisons of HV and IV, then, it is helpful to introduce a lag into your IV measure so that you're comparing, for example, the one-month HV of the underlying and the IV of that underlying's options as measured one month ago.

Another consideration is that what matters for the thesis of the paper you mentioned is just that there is a persistent premium on average over time, which is consistent with there being periods during which options are actually cheaply priced instead of being expensive (versus future HV). Also, if you look at the one-year history of TLT, you'll see some days on which the ETF rose rather dramatically—and since HV just involves the magnitude of price changes and not their sign, fast and sizable rallies can increase HV readings even though they will likely cause IV levels to stay flat or even decline.

Finally, given the macroeconomic changes over the last year—especially interventions on the part of the Fed—I'm very reluctant to draw any conclusions on the basis of the last year of data. One year is never enough data anyway, but given the unusual nature and effects of QE2 and related policies, I'll take a wait-and-see attitude before revising earlier conclusions about the

premium in Treasury bond options.

—Jared

.....

Q: *Mark, I am somewhat new to trading. What kind of expectations should I set?*

—John

A: John, expectations are one of the best and most dangerous things to a trader. Newer traders often get fooled into thinking they should expect the world. The truth is that almost all traders never make a cent after commission. There are many brokerage firms, educators, and newsletters out there promising high returns. Guys like Jared and Bill do not place expectations of 100% return in a given year and these are two guys that know what they are doing. For a new trader such as yourself, if you can beat a CD account at a bank I would consider that a small win. If you can beat the interest rate on your house, I would consider that a monumental win.

—Mark S.

Q: *Bill, today I noticed the VIX dropped suddenly, but I can't figure out what caused this large move. I would appreciate any guidance you can offer about when a big VIX move might be a bad print or exchange error or when I should consider the move to be genuine.*

—A.S.

A: The cash/spot VIX or VIX index is generally correlated to a number of other volatility indices and products. If you keep track of a handful of them, you can usually spot the outlier when one or more move independently of the others.

In addition to the VIX index, which looks at SPX implied volatility going out 30 days, it is also helpful to monitor VXV, which looks at SPX IV with a 93-day time horizon. There are also two little know VIX component indices that allow investors to track the near month SPX options implied volatility used in the VIX calculation as well as the far month used in the VIX calculations. These have the tickers VIN and VIF, respectively.

If you have access to VIX futures data, this is the best way to keep track of the pulse of the VIX. Watch the front month and second month closely. If the VIX index moves sharply in one direction or the other due to a bad print or exchange error, the VIX futures traders are not likely to be fooled.

If you do not have access to VIX futures data, check to see if VXX is mirroring the move in the VIX. If the move is a big one, you would also expect to see a spike in VXX volume too. If neither the VXX price or volume is moving, you can probably discount the move in the VIX.

Finally, there are other volatility indices for other indices. The best known of these are VXN and RVX, but some also use VXO and VXD. Again, if VIX is moving and these other indices are not, then I would not put much credence in the move in the VIX.

Watch all of these and you should be able to tell almost instantly if the VIX is making a big move or if it is just bad data.

—Bill

The Trader Mindset

Mark D Wolfinger

The new options trader can become overwhelmed with ideas. There are definitions to learn and strategies to understand. Then there's always an urgency to get started—based on the false assumption that all option traders make a ton of money and that there is not much skill required.

Instead of adding to the trader's burden of new stuff to learn, this time I want to ease that burden. These thoughts apply equally as well to the person who is new to any type of trading. This is not specific to options.

The time to hold is when you believe the position is priced correctly and that your potential gain is sufficient to take the risk required.

Traders come in all stripes with varying backgrounds and baggage. They have different personalities and basic beliefs. Some of those beliefs—which I refer to as 'mindsets'—are detrimental, while others make it easier to succeed.

Below I discuss two of my basic beliefs, and I know they are valuable enough for me to share with new traders. One word of caution: These are not universal beliefs and you will find people who disagree. That means you can make your own decisions.

1. It's your money

When trading, it's always your money that is on the line. When your account value declines as a result of losing trades, there is no one who is going to replace that missing cash. It is the same with profits. When your account value increases because you are making winning trades, every cent in that account is your money. It must be treated with respect.

Don't be tempted to gamble with it, thinking of it as 'house money.' Don't fall for that. Just as no one replaces your losses, you must not replace the losses of others. When your account grows you have a profit. You earned it. It's your cash. Protect it.

2. Manage risk and only risk

Most traders look at current positions and evaluate them based on whether the position is profitable or is losing money. I suggest dropping that mindset and looking at all positions from only one perspective. Risk.

Although I do not suggest doing this every day, this is the true situation when you own a position such as a long option, covered call, iron condor, credit spread etc.:

The position can be closed at its current price. You have a choice. You may exit or hold. You may even add to the position if you love the current price. What you cannot do is trade the position at a different price (let's ignore when the stock moves because that's not the point under discussion).

The time to hold is when you believe the position is priced correctly and that your potential gain is sufficient to take the risk required to achieve that gain. If you don't like the trade because of some risk factor (the stock price, the greeks etc.) then there is no valid reason to own the position. It should be sold. However, most traders don't analyze their holdings that way. If they conclude that the trade is not good enough to hold, they choose to exit *only* when the position has earned a profit. If it is under water, they hold.

To me that is foolish. You can exit such a position and make a new trade. Sure, it costs a bit in

commissions, but you have a better position with better profit expectations and less risk. Doesn't that feel right? Yet most traders refuse to take those losses.

If your mindset is "profits only and never take a loss," I urge you to reconsider.

3. Enough

Traders can adopt strategies in which profits are limited. That occurs when cash is collected by selling an option or an option spread. When $200 is collected, the best possible result is to earn every one of those $200.

Unless the trader sold a naked option, losses are also limited. That's the tradeoff for such positions. Limited gains and limited losses.

It is always gratifying to earn the maximum by allowing the short position to expire worthless. The mindset is that the short option is very far out of the money and has no chance of moving into the money prior to expiration. The trader who thinks this way also knows that he/she does not want to spend $5 or $10, plus commissions, to cover the short option and lock in the profit. That final few dollars is so tempting and feels so secure.

However, ask if they would open a new position by selling the same option at $0.10 and there's a high probability that they would decline. Yet already being short the option distorts the picture and tricks them into believing that holding is not the same as opening a fresh trade.

It's just not worth holding out to the end. Let someone else have the last nickel or two, and you can chalk up another gain and remove all risk. That's a winning combination. EM

The Many Virtues of a Put Selling Strategy

Jason Ungar, guest contributor

Introduction

Investment portfolios come in all shapes and sizes, but there is one thing on which I think the vast majority of investors would agree: it would be great to find a strategy that generates equity-like returns, but is less volatile than a traditional long-only allocation to stocks. The Chicago Board Options Exchange (CBOE) has created several index option strategy benchmarks that accomplish just this feat, and the strategies underlying these indices are finally starting to receive the interest they deserve from investors both large and small. This article considers one of the most compelling of these indices, a cash-secured, S&P 500 Index put writing program that the CBOE tracks as the S&P 500 PutWrite Index (PUT), and reviews its recent performance. This exercise is particularly interesting because, as you will see, the PUT significantly outperformed the S&P 500 during the recent financial crisis, despite the fact that it does the very thing most options traders will tell you is the worst thing to do in a down market, it sells puts.

Performance

Many readers are already familiar with the advantages and characteristics of index option strategies, so I begin with a brief performance update of the PUT compared to the S&P 500 and BXM Indices from inception to the present, with a focus on the period from November 2007 to March 2011. This extends the period that was studied in a paper[1] on the PUT Index I coauthored with the CBOE's Matt Moran. I will then go into detail about the reasons why index option strategies are a compelling alternative to long only equity strategies.

The PUT Compared to the BXM

The PUT Index is a companion to the CBOE's well known S&P 500 BuyWrite Index (BXM), which tracks the returns of a strategy that systematically sells at-the-money (ATM) S&P 500 Index calls with one month to expiration against a long position in the S&P 500. Since July 1986 (the date the CBOE begins tracking the BXM) the index has generated compound annual returns almost identical to the S&P 500, but it has done so with almost 34% less volatility, and significantly lower maximum draw downs (see Figures 1a–1d). When Ibbotson Associates studied the BXM in 2004, they found it "to have the best risk-adjusted performance of all equity-based instruments, both before and after controlling for the possible effects of the skew and kurtosis of the BXM index[2]." The PUT Index is noteworthy because its performance consistently *surpasses* the BXM's, both in terms of returns and risk.

It is important to understand that from a risk-reward perspective, a cash-secured ATM put writing strategy (like the PUT) is identical to an ATM covered call strategy (like the BXM). In both strategies, the most that can be earned in any expiration cycle is the amount of premium taken in from the sale of the option (this amount is the same in both strategies, since they both sell at-the-money options and, due to put/call parity, receive comparable premiums), and the downside is equal to that of the S&P

The PUT **significantly outperformed** the S&P 500 during the recent financial crisis, **despite the fact** that it does the very thing most options traders will tell you is the worst thing to do in a down market, it sells puts.

7/1986 – 3/2011	S&P 500 TR	PUT	BXM
Compound ROR	9.46%	10.58%	9.25%
Standard Deviation	15.83%	10.47%	11.22%
Sharpe (5%)	0.33	0.60	0.44
Max Drawdown	50.95%	32.66%	35.82%
Cumulative Returns	837%	1105%	793%

FIGURE 1A *PUT, BXM and S&P 500 Total Return Index Over Last 25 Years*

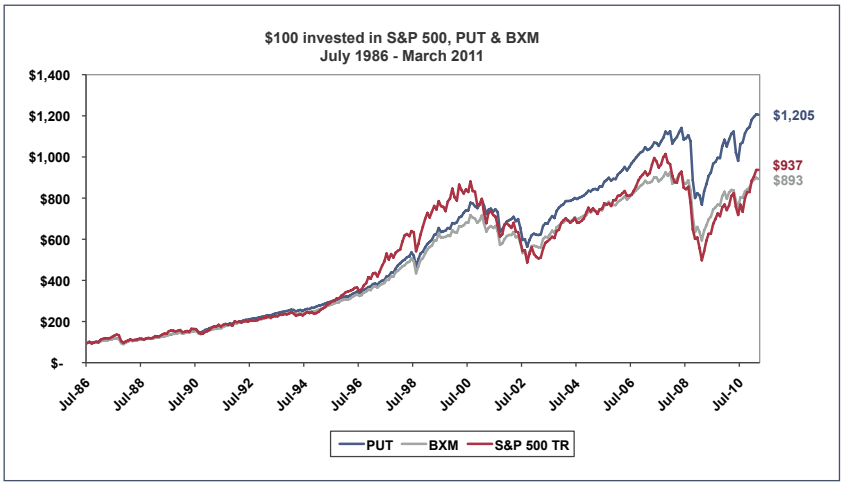
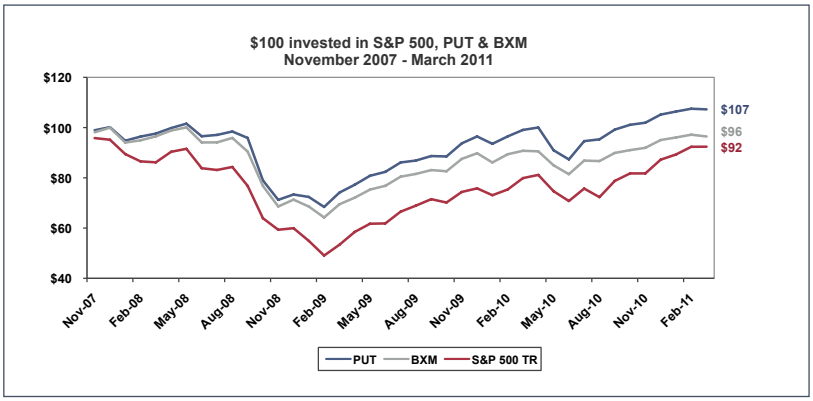


FIGURE 1B *Equity Curve of PUT, BXM and S&P 500 Total Return Index Over Last 25 Years*

11/2007 – 3/2011	S&P 500 TR	PUT	BXM
Compound ROR	-2.29%	2.07%	-1.05%
Standard Deviation	20.98%	16.73%	16.22%
Sharpe (5%)	-0.14	0.08	-0.11
Max Drawdown	50.95%	32.66%	35.82%
Cumulative Returns	-8%	7%	-4%

FIGURE 1C *PUT, BXM and S&P 500 Total Return Index Since Nov 2007*



Figures 1a–1d: Gresham Investment Management

FIGURE 1D *Equity Curve of PUT, BXM and S&P 500 Total Return Index Since Nov 2007*

500 minus the premium received. Figure 2 will be familiar to most readers as the risk-reward diagram for a covered call compared to a long only investment, but it is also accurate for a cash-secured short put. If, however, the strategies are essentially the same, one must ask why the PUT outperforms the BXM. Unfortunately, this article is not long enough to go into the detail necessary to fully explain this phenomenon. Suffice it to say here that the primary reason for the outperformance is that there are certain aspects of the methodology the BXM uses to roll expiring options into new ones that impair its performance versus the PUT. The more important questions, however, are why the risk-adjusted returns of both the BXM and PUT are so much higher than the S&P 500's, and whether this outperformance can be expected to continue.

The Volatility Risk Premium

Index option strategies such as the BXM and PUT outperform the S&P 500 by monetizing the robust volatility risk premium. This premium comes from the consistent positive spread between the future volatility predicted, or "implied", by index option prices (implied volatility) and the subsequent volatility experienced by the index (realized volatility).

Gresham Investment Management

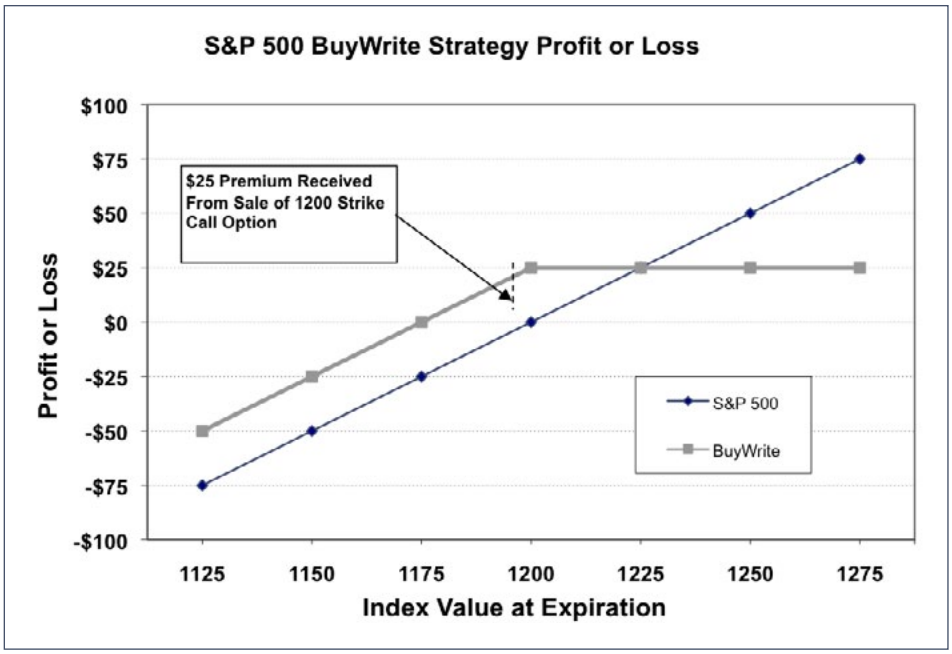


FIGURE 2 *Profit and Loss Graph for S&P 500 Buy-Write*

Another way of saying this is that index option prices have historically overestimated the future volatility of the index, and a strategy that sells index options can turn this overpricing into excess return. One should not, of course, take this to mean that it is a good idea simply to sell index options willy-nilly, but in the context of a relatively high beta strategy like the PUT or BXM, such an approach actually has less absolute risk than a long only S&P 500 allocation, the strategy is extremely attractive.

Why Are Index Options Overpriced?

The PUT and BXM take advantage of the large and persistent volatility risk premium. Investors considering these strategies need not worry that this premium will diminish or disappear due to arbitrage, because it stems from a basic market fact that is unlikely to change: investors willingly overpay for out-of-the-money index puts to insure their equity portfolios. This drives up the prices of all index puts above fair value, because the overpricing gets carried up the entire option chain, and causes the familiar index option "skew". Investors buy index puts because the correlations between individual equities skyrocket during big draw downs, so they can rely on broad based index puts to insure diversified equity portfolios.

Importantly, index put buyers are hedgers who spend a relatively small amount to insure a much larger investment against the unlikely event of a precipitous loss; they are not hoping to turn a profit on the trade. Put writers, on the other hand, are speculators who receive a fixed amount of money in return for providing portfolio protection. The writer of a put option can never make more than the premium received, but could lose a much greater amount in a big drawdown. This asymmetrical payoff means that, as with anybody who provides insurance, the put writer can demand a premium for offering this protection. Index put buyers are usually better off not having to rely on the hedge at all. In this they are comparable to flood-insurance policy holders, who are willing to renew policies ad infinitum despite the knowledge that the premiums overestimate the likelihood of a flood and without ever filing a claim.

When the goals and risk/reward parameters of both parties to this transaction are understood, it is clear that there will always be a far greater number of natural put buyers than writers, and that writers will continue to successfully demand a premium well above the expected value of the puts for the protection they provide. Widespread knowledge of this

premium over the past 24 years has done nothing to weaken it, and skeptics would do well to look at other risk transfer markets where examples abound of speculators successfully demanding premiums from hedgers for the insurance they provide. Those familiar with the commodity futures markets see such evidence in Keynesian Normal Backwardation, and property and causality-insurance providers continue to be extremely profitable despite policy owners knowing for centuries that they pay an inflated premium for their insurance protection they receive.

Index Options vs. Single Stock Options

To many investors it seems almost too good to be true that simple passive strategies such as the BXM and PUT could be so effective, and there are those who claim that it is better to write single stock call options on equity baskets specially chosen for their "rich" premiums. Unfortunately, the research shows that for most individual stock options there is no volatility risk premium[3], so these strategies cannot benefit from the rich source of excess returns that powers index option strategies. The returns of stock-picking covered call strategies have historically reflected this disadvantage, particularly in the amount of return they generate per unit of risk.

Bull Market Underperformance

Another concern that many investors have when considering these strategies is that they cap the potential upside each month. The fact is that, over the long term, the PUT has significantly outperformed the S&P 500, and any short term underperformance has historically been recompensed relatively quickly by the consistent collection of richly priced premium. But this may be cold comfort to those who must report returns quarterly. Another way to look at this is to consider that since index option strategies have historically entailed so much less risk than long only allocations, it would be responsible to maintain or even increase allocations to a strategy like the PUT when one might otherwise consider reducing S&P 500 exposure due to its recent volatility and low returns. From a total portfolio perspective, then, being able to maintain a significant allocation to equity-like strategies means that the portfolio will participate in a bull market as fully, or perhaps even more so, than it would have if it simply reduced exposure to the S&P 500.

Conclusion

Due to their long term equity like returns and relatively low volatility, index option strategies such as the PUT and BXM are compelling equity replacement strategies for investors looking for liquid alternatives to traditional long only strategies. Future articles may look at how the returns from these strategies can be enhanced through active management of the options positions as well as some of the interesting return characteristics of leveraged versions. EM

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[1] Ungar, Jason, and Matthew T. Moran. "The Cash-secured PutWrite Strategy and Performance of Related Benchmark Indexes" The Journal of Alternative Investments (Spring 2009), pp. 43–56.

[2] Ibbotson Associates. "Highlights from Case Study on BXM Buy-Write Options Strategy" (2004).

[3] Gârleanu, Nicolae, Pedersen, Lasse Heje and Poteshman, Allen M., *Demand-Based Option Pricing* (January 2006).

Jason Ungar is the Director of Marketing and Head of Product Development for Gresham Investment Management LLC, a $13 billion asset management firm specializing in commodity investment strategies for institutional investors. Prior to joining Gresham, he was a Director at Ansbacher Investment Management Inc., where he developed and implemented short volatility strategies designed to meet the needs of institutional clients. Before working at Ansbacher, he was a Partner at Apogee Capital, LLC, and a Financial Advisor with RBC Dain Rauscher. He is Series 7, 66, and 3 licensed. Mr. Ungar received a BA in Philosophy from St. John's College, Annapolis.

Preparing for EU Trouble with Volatility Products

Jared Woodard

I was going to begin this column with a mention of some newfound complacency about the sovereign debt situation in Europe:

> Irish government debt led a rally by bonds from Europe's high-deficit nations amid speculation that optimism the region's fiscal crisis will be contained is prompting investors to exit their bets on declining prices.[1]

Later the same day, however, Portugal admitted that it would need to draw on a projected sum of $100–$114bn in European Financial Stability Facility (EFSF) funds to finance its public obligations and to support creaking banks.[2] While this move was not a complete surprise, observers noted that Portuguese government bonds did not see the same kind of immediate rally that occurred when Greece and Ireland made their own bailout requests.

There are three factors that make it difficult to envision a smooth resolution of the sovereign debt problems in Europe. First, many participants question the viability of the EFSF itself: the facility was initially constructed such that participating countries would provide loan guarantees on a pro rata basis, with Greece assumed to be excluded. If Greece, Portugal, Ireland, and Spain were all to "step away" from their guarantee provisioning and instead request aid (as the first three now have done), it will fall to the remaining EFSF guarantor countries to make up the difference. The issue has been framed in terms of liquidity provision, but solvency is the real concern now, and a situation in which Spain switches from creditor to debtor status may also be a situation in which other EU countries face increased pressures of their own, making it difficult for the EFSF to secure the necessary funding at all.

A bet on increasing volatility in the Euro/US dollar currency pair is another way to play a crisis in Europe.

Second, even if we grant that a sufficiently-resized EFSF will be economically feasible, every new pressure increases the risk of a political misstep. Sarkozy and Merkel are particularly vulnerable here, with Marine Le Pen of the far-right, anti-EU Front National party recently polling ahead of Sarkozy (though both polled in early April well behind a presumed Socialist ticket led by Dominique Strauss-Kahn, the IMF managing director). French elections won't be held until the spring of 2012. Sarkozy has already begun moving further to the right, and if the political winds continue to turn against increased commitments to the EFSF, it is easy to imagine him attempting to co-opt Le Pen supporters and Euro-skeptics and drawing a sharper distinction with Strauss-Kahn by becoming more reticent about French participation in an expanded facility. For her part, Merkel has long resisted any expansion of the EFSF beyond its €440bn current size; if Spain begins looking more vulnerable, Merkel may have to choose between electoral defeat and economic calamity.

Finally, high food and energy costs are no greater a blessing for Europe than they are for any other consumer-driven economy. Net exporters like Germany are seeing some trivial inflation emerge—sufficient, apparently, to drive the ECB to hike interest rates—but higher rates only increase the risk to weaker countries like Portugal and Spain. If, going forward, high energy costs translate to greater economic pressure directly (via high costs for consumers) and indirectly (via increased risk of further rate hikes),

then we have a new path to sovereign debt crisis running from MENA countries to Lisbon and Madrid.

Investors can be ready, should the situation in Europe get out of hand, to hedge their portfolios and/or speculate on increased volatility in the following ways:

1. Long VSTOXX Mini Futures (FVS)

First, I want to make clear that I'm not suggesting these positions are appropriate at this moment. The portfolio hedging strategy we run for clients takes something like a trend-following approach to volatility: since it's unlikely that the first large volatility pop you see will be a singleton, you can afford to miss the first portion of any volatility explosion as long as you catch the bulk of it. The same notion applies here: I wouldn't be interested in sizable long volatility exposure to Europe absent evidence—in the form of obvious, multi-day large equity market declines—that the EU is losing control.

VSTOXX Mini Futures (V2TX: Eurex) settle to a calculated value of the EURO STOXX 50 Volatility Index, the VIX-style calculation of a constant 30-day exposure to EURO STOXX 50 options. The futures will be familiar to those who have traded VIX futures in the U.S. There are also options on the VSTOXX index and exchange-traded products (under the Barclays iPath label) targeting short- and mid-term exposure to VSTOXX futures, similar to VXX and VXZ in the U.S.

Because a real crisis in Europe will be felt in emerging markets and in North America—and because many investors don't have access or permissions for these products (including all U.S.-based customers until the CFTC grants approval)—hedging-oriented investors may do just as well to protect their portfolios with more familiar SPX- or VIX-based products. U.S. traders are permitted to trade futures and options on the EURO STOXX 50 index, letting a volatility breakout provide the entry signal.

2. Long VSTOXX / Short VIX Futures

However, a worst-case scenario—in which the sovereign debt crisis metastasizes globally—is also not the most likely scenario. A more likely outcome is that EU countries see continued uncertainty and occasional breakouts of real danger, but with accompanying policy responses sufficient to let the monetary union muddle through. A rolling long VSTOXX / short VIX

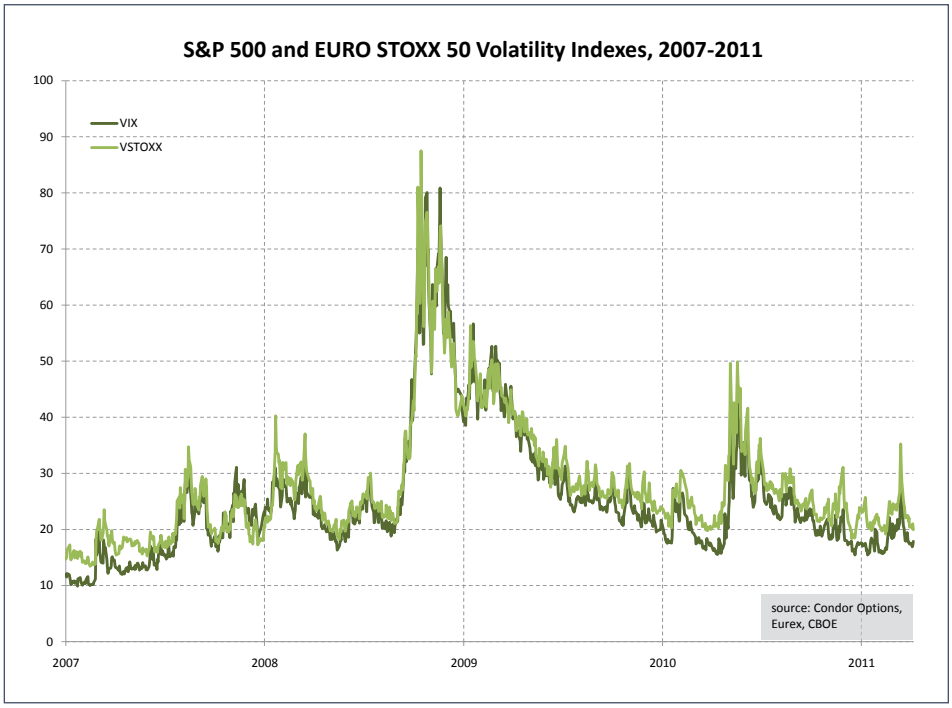


FIGURE 1

position would perform best if equity market volatility increased in Europe but remained relatively contained in the U.S.

VSTOXX futures have been priced slightly above the VIX curve for quite some time (Fig. 1 compares spot index values since 2007), so there is a definite cost to holding this position. To reduce the effect of that inter-market premium, I suggest using even a rudimentary market-timing rule to keep exposure small under normal circumstances with increased exposure indicated when the spread increases beyond a medium-term simple moving average.

Because the two futures complexes have similar durations, the only real logistical task is to size the positions to have equal notional value.

3. EUR/USD Realized Volatility Futures (16E/36E: GLOBEX)

A bet on increasing volatility in the Euro/U.S. dollar currency pair is another way to play a crisis in Europe. As tracked by the CME Group 6E futures contract, the EUR/USD pair has seen one-month annualized volatility over the last three years below 7% and as high as 25%. While that's a narrower range than equity volatility over the same period, it still represents a very tradeable range

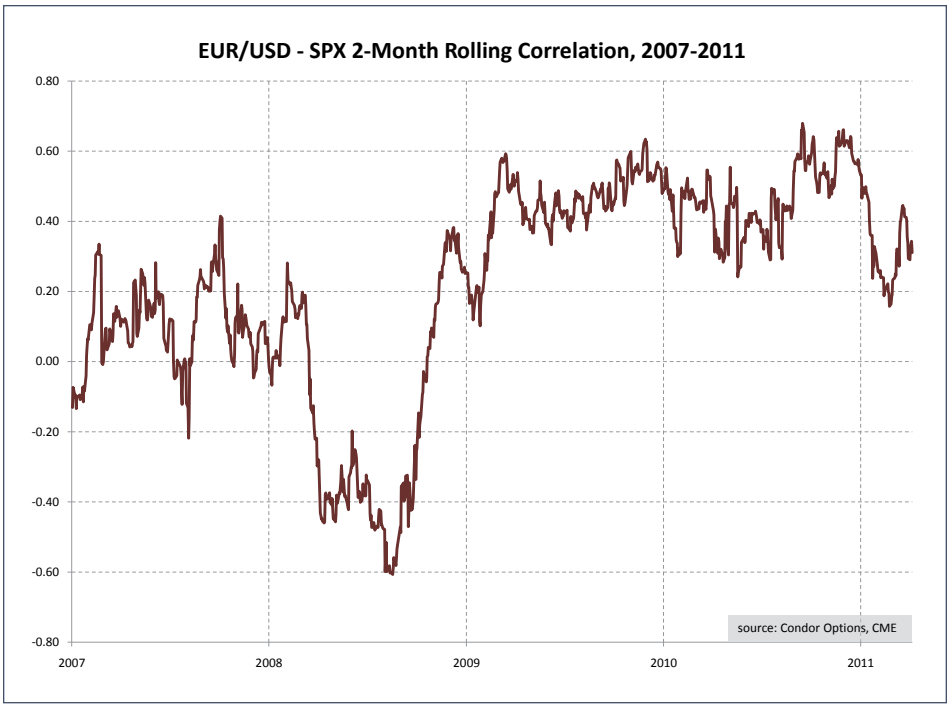


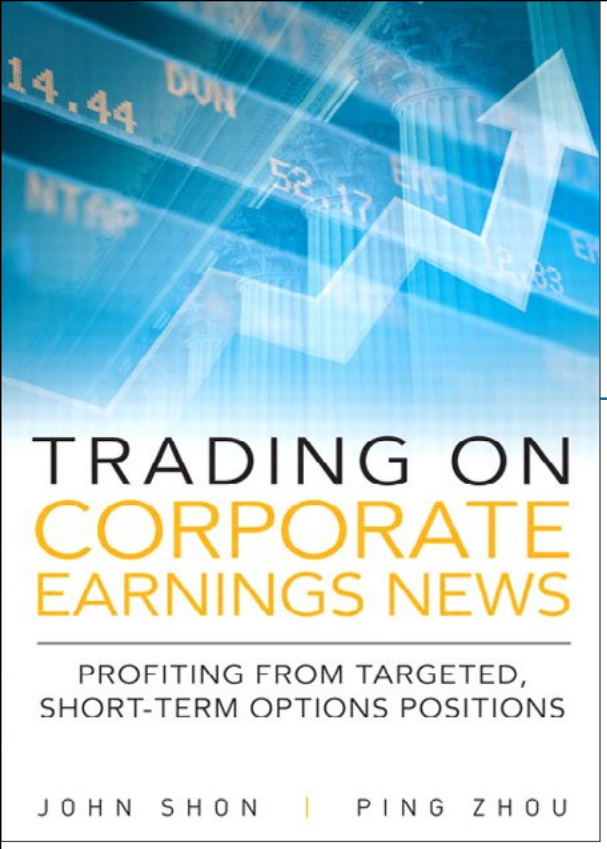
FIGURE 2

for speculative positions. The new EUR/USD 1- and 3-month Realized Volatility contracts provide a way to take direct bets on volatility in the underlying without the added costs or the complexity of managing a large options book. (The contract was discussed in some detail in my January interview with Robert Krause and Charles Barwis of VolX.)

I like the idea of using these contracts instead of or in addition to equity-linked products as a way of avoiding increased correlations among equity markets. Over the last several years, we have seen traditionally distinct asset classes converge into a "risk on/risk off" trade, making diversification and tactical clarity more difficult to achieve. While there are periods during which EUR/USD and the S&P 500 are somewhat correlated, this relationship is not so stable, especially during tumultuous periods (see Fig. 2). Attention paid to macroeconomic events should bear more fruit with the addition of exposure to currency volatility. EM

[1] Lucy Meakin and Paul Dobson, "Irish, Spanish, Portuguese Bonds Rally on Bets Crisis Contained," Bloomberg, April 6, 2011.

[2] Peter Wise, "Cost of Lisbon bail-out put at €80bn," Financial Times, April 7, 2011.



Expiring Monthly Interview with
Ping Zhou

Mark Sebastian

This month's FT Press Author Interview is Ping Zhou, author of *Trading on Corporate Earnings News*. In this fascinating interview we discuss the ins and outs of earnings, some of his and his co-author's findings, and talk about who can use this book.

Expiring Monthly: *Why don't you tell us about your history?*

Ping Zhou: John and I went way back. We were both accounting professors at City University of New York - Baruch College. We have been working together in academia for about 3 years. We wrote many academic papers together, and were good friends. One of the strengths of this book is about the earnings announcement phenomenon rather than option trading. That is part of research area that John and I specialize in. In research and from personal experience we find that it's hard to predict earnings surprises and even harder to predict earnings announcement returns. Even if you get earnings surprises correct you can still be wrong 40% of the time about the earnings announcement returns. We thought about it and we think much of the academic research (including our own work) is not well known to the public. Most people don't know that the size of earnings announcement return is quite large compared to annualized return.

EM: *How and why does this happen?*

PZ: A very interesting questions. It gets more and more common that earning surprises are having the opposite signs of earning announcement returns. There are a couple of reasons, I think. One reason is the earning surprises are becoming less of a surprise. It is in everybody's interests to not have a negative surprise. Interestingly, there are many more positive earnings surprises to negative surprises. There is some very interesting academic research on this subject. The result though is that investors aren't surprised when they see a positive earning surprise. That is why a positive surprise is not necessarily good news to the market. The negative earning surprises are harder to explain. The other reason why earnings surprises and earnings announcement returns may have opposite signs is that in recent years, more and more information is released during earning announcement. Not necessarily about earning surprises, but the other information. For example, Research in Motion has beat earnings several quarters in a row, but every quarter they got sold off after their earnings announcements. Their revenue is

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Ping Zhou, PhD, *Senior Vice President and Portfolio Manager of the Quantitative Investment Group at Neuberger Berman, currently manages U.S. and global equity funds for institutional investors. Zhou's expertise is in portfolio theory, market anomalies, investor behavior, corporate finance, and risk management. He previously served as Professor of Accounting at City University of New York - Baruch College. He holds a PhD in Accounting from Georgia State University.*

below market expectations, or they guide down. They almost always get hammered due to non-earnings surprise information/disclosure. This additional disclosure is probably what makes the earnings and returns so hard to predict, and it is why focusing on earnings surprises alone is a misguided effort.

EM: *You came across this interesting data, why write the book?*

PZ: We think this is a much more practical topic than typical academic papers, and we feel that investors can benefit from these topics. We felt many people are treating the earning announcements as good news or bad news and that making directional trades may not be the best way to trade the situation.

The straddle may be a good idea and can be played in both ways depending on your view of the volatility, earnings and returns from these companies. As I said earlier, we felt that there is tremendous research that has been conducted in academia that is not well known to the public, and we feel investors can benefit from a little information on that as well.

EM: *Who is the book written for?*

PZ: This is not for institutional traders, trading hundreds of millions dollars, you just cannot trade that many options. The liquidity in the option market cannot handle that, at least for now. But for smaller traders that are looking for some kind of leverage, if they are willing to allocate a small fraction of their investments, they may be able to implement these kinds of higher risk-high returns strategies. We think that is probably interesting. The point of the book is about earning and returns, why it is important and difficult to forecast, and why you shouldn't trade earnings directionally and directions, why it is important to use options.

EM: *How predictive do you think straddles prices are in terms of earnings announcements?*

PZ: That is an interesting question that we cannot answer, because we didn't have the data to test. But we are planning to begin testing to research this question on how profitable or unprofitable a straddle is. Based on our anecdotal evidence, if you could do a blanket a straddle strategy I'm not sure how profitable it will be, because I think the market is more or less efficient. But, if you selectively pick stocks with certain characteristics, there may be some edges you can have to improve the profitability.

EM: *Can you explain an edge?*

PZ: If you focus on companies that are likely to have spikes, for example we have shown there are persistent surprises. A company announcing good earnings for several quarters in a row is more likely to report good earnings in the future. Another example is that high-flying stocks are likely to be volatile during earnings announcements. For example salesforce.com, Netflix, Amazon are all the companies with high expectations, whatever news they have, good or bad, the market tends to react much more strongly to those companies than say a utility. Thus, by tilting your trades more towards those companies or companies with those characteristics, then one may be able to increase their chances of making profits. However, if the options traders already anticipated this, the option prices may reflect that premium. If the premium is already high, straddles may lose.

EM: *Sounds like a great book for the retail investor. Anything else you want to say?*

PZ: This is definitely for retail investors, and we think it is actually even better for people without a large amount of money. It is better for small investors as you know the options market is not as liquid. If one wants to do a lot of contracts, one can't do it. For small investors this becomes less of a constraint. Then the only issue is transaction cost which is a large concern in this type of strategy. EM

EXPLORING PUT TO CALL RATIOS

Bill Luby

The last few years have seen not only a huge spike in interest in options trading, but also a dramatic increase in the use of options as market sentiment indicators. The most famous options-based sentiment indicator is probably the CBOE Volatility Index, commonly known as the VIX. More than two decades before the VIX was hatched, however, enterprising investors were using put to call ratios as a means by which to gain an edge in forecasting future market direction. The purpose of this article is to provide an overview of the put to call indicator space, provide some insight into the intricacies of the ratio and offer some thoughts on how options and non-options traders might want to incorporate put to call ratio data into their own trading.

Contrarian Indicators and Put to Call Ratios

First articulated in detail in Humphrey Neill's 1954 classic, *The Art of Contrary Thinking*, Neill's study of contrary opinions led him to famously assert, "The public is right during the trends but wrong at both ends." There is little doubt that investors have a tendency to exhibit herd behavior and engage in investment groupthink, often resulting in financial manias and subsequent crashes. Charles Mackay's *Extraordinary Popular Delusions and the Madness of Crowds*, Edward Chancellor's *Devil Take The Hindmost: A History of Financial Speculation, and Manias, Panics and Crashes* by Charles Kindleberger and Robert Aliber all serve as a testament to propensity of the masses to overreact to economic events, particularly when a larger percentage of one's personal fortune is at stake.

Those who investigate put to call systems should give substantial thought to the importance of scaling in to new positions.

Simply stated, contrarian indicators attempt to measure those instances in which crowd behavior reaches extreme proportions, just before it becomes self-correcting. Historically contrarian analysis has focused on surveys of investor bullishness or bearishness (two of the most famous being from Investors Intelligence and the American Association of Individual Investors), odd lot sales, short interest ratios and similar measures.

A Brief History of Put to Call Ratios

In 1970 Marty Zweig pioneered the use of put to call ratios as a critical component in his stable of thirty or so sentiment indicators. At that time, options were traded over the counter and the first exchange, the Chicago Board Options Exchange (CBOE), would not open its doors for three more years. While institutions dominated options trading in the early years, over time retail investors began to warm up to options trading and put to call ratios began to reflect a broader range of options activity.

For many years, those who wished to keep track of put to call data had to calculate ratios by hand. The CBOE was the first exchange to publish put to call data and maintains a ratio of total puts to total calls traded each day going back to 1995. In 2003 the International Securities Exchange (ISE) launched a competing product, which they called the ISEE. The ISEE attempted to improve upon the CBOE's methodology by including only opening long customer transactions as part of their ratio calculations. This excluded transactions such as covered calls, naked shorts and spreads from the ratio calculations. The methodology went further in looking at classes of customers and excluded for the purpose of the ratio calculations all orders originating from market makers (presumably for the purpose of providing liquidity) as well as all orders from firms, which were aimed at eliminating the noise generated by a number of complex strategies being implemented by proprietary trading firms.

In an effort to help to differentiate between institutional and retail activity, both the CBOE and ISE added separate index and equity put to call (or call to put) ratios in 2007, with historical data that now traces back to 2003 for the CBOE and 2006 for the ISEE.

While the product arms race between the two competing exchanges seems to have died down in the past few years, the rise in popularity of ETFs has raised the question of

where ETFs fall in the spectrum of indices and equity securities. Some ETFs are as broad as indices and in many cases (SPY, QQQ, DIA, etc.) are almost identical to some of the most popular indices. On the other hand, with the passage of time there has been an increasing trend toward more specialized ETFs that are concentrated in very narrow slices of the equity pie, such as sub-sectors or single country ETFs. In many cases investors are treating these just as they would individual equity securities and using these more for speculation than hedging. At the very least, ETFs have blurred the lines between an index and an equity security.

Retail Speculation vs. Institutional Hedging

The efforts by the CBOE and ISE to refine the calculations for put to call ratios are based on the idea that it is important to distinguish between retail activity and institutional activity. The underlying assumption is that the majority of retail options trades are speculative directional trades, while a large portion of institutional options trades make use of options to hedge risk in underlying portfolio positions. Further, contrarian theory posits that when the market has a large emotional component to it, whether it is greed or fear, the signal to noise ratio will increase, with retail traders making a higher proportion of directional trades while institutional hedging ramps up or down according to perceived risk.

While either retail or institutional activity should be appropriate for applying put to call ratios, the problem with institutional activity is that hedging volumes are notoriously uneven, with intermittent large bulk trades often making it more difficult to discern trends. For this reason, most put to call analysis focuses on retail traders and attempts to isolate the activities of individual investors rather than small hedge funds and the like. In short, not all options transactions are created equal. This is why both the CBOE and ISE break out index and equity options trade, so that analysts can use equity transactions as a proxy for the activity of retail traders and index transactions as a proxy for institutional activity. This also explains why the ISEE has chosen to emphasize customer opening long transactions.

The bottom line is that given the choices available, most students of put to call data prefer to focus on the equity-only data as the best proxy for the activity of the small retail investor, whether their preferred data source is the CBOE or the ISE.

Analyzing Put to Call Data

While raw put to call data is useful, it tends to be noisy. For this reason, most investors who study put to call data use a smoothing factor such as a moving average. The length of the moving average is ultimately a matter of personal preference, but most of the moving averages I have seen applied to put to call data fall in the range of 7–70 days, with 10 days and 21 days perhaps being the most common.

In recent years, some analysts have attempted to improve upon traditional analytical techniques by advocated migrating from measuring option volume to open interest. In other instances, an emphasis had been placed on using dollar-weighted volume to help differentiate between high volume low dollar far out-of-the-money options trades and similar volume trades utilizing much more capital with in-the-money and at-the-money options. While I find these developments intriguing, my experience has been that any advantage gained by adding this level of complexity to the analysis is relatively minor.

Looking at a History of Put to Call Extremes

The biggest question most investors have about put to call ratios is whether they work and if so, under what conditions.

When looking at historical data such as put to call ratio numbers, I like to look at two things in particular:

1. How did stocks perform after put to call ratio extreme highs and extreme lows?

2. What sort of readings and/or signals were the ratios generating prior to major market moves, such as the 2007 top in stocks, the 2008 financial crisis, the 2009 bottom, etc.?

Turning first to the CBOE equity put to call ratio, the graphic below, courtesy of StockCharts.com captures a 10-day exponential moving average (EMA) of the equity put to call ratio since 2004. Note that the two peaks in the 10-day EMA (blue line) come from March 2008, when Bear Stearns was imploding, and November 2008, at the height of the financial crisis. As it turns out, both of these bullish signals came on the heels of sharp declines in the S&P 500 index (gray area chart). In both cases, stocks saw a bullish move for about two months following these extreme readings, but it was quite a few months before stocks ultimately bottomed and saw any significant bounce.

StockCharts.com

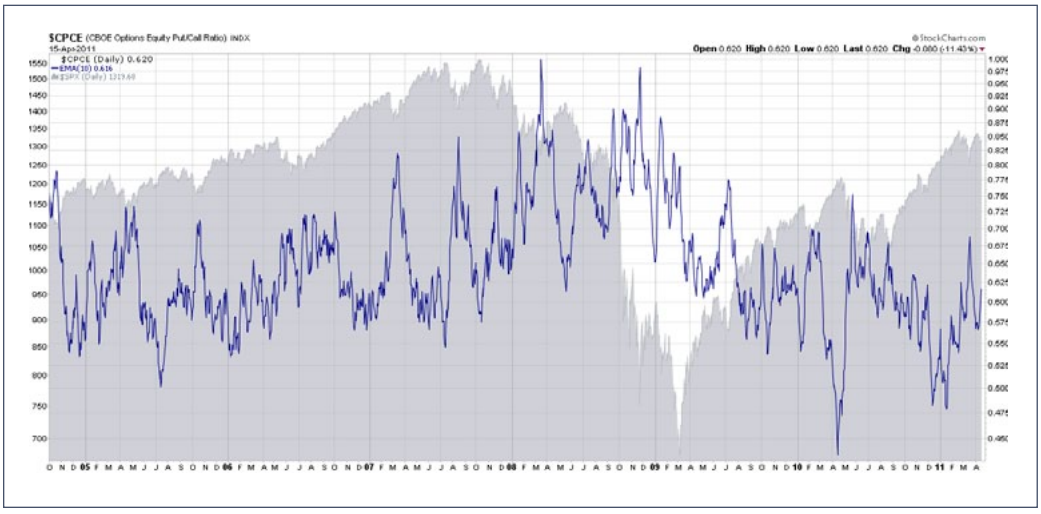


FIGURE 1 CBOE Equity Put to Call Ratio from 2004

The biggest downward spike in the graph dates from April 2010 and coincides with an intermediate-top in stocks that was almost immediately followed by selloff which lasted about 4 ½ months. Interestingly, the second largest downward spike was registered in January 2011 and followed closely behind another sharp spike down from December 2010. So far this bearish signal has not resulted in any significant selloff, but investors may wish to give extra weight to the next sharp downward spike. Looking back in the period from 2004–2007, peaks in the put to call ratio during this period coincided nicely with intermediate bottoms in the SPX and made timely buy-on-the-dip signals. Similarly, downward spikes in the put to call ratio during this period generally marked good times to take profits.

The data from the ISEE equity call to put ratio reflect almost the exact same extremes as the CBOE data. Here the highs (this ratio is inverted) come from December 2010 and January 2011, while the lows come from March 2008 and late November 2008. Again, the extreme put readings (March and November of 2008) both suggested winning bullish setups with a market reversal that lasted approximately two months. The extreme call readings are inconclusive at best.

Looking back at the 2007, the 2008 financial crisis and the 2009 bottom in stocks, the put to call ratios gave strong overbought signals in July and October of 2007, but were of little use in the turmoil created during the 2008 financial crisis and the aftermath as it spilled over to the March 2009 bottom.

Here I feel compelled to note that I believe the 2004–2007 period is a more meaningful market period for analyzing the put to call ratios than the 2008–2009 period, not just because put to call ratios were more effective in the period prior to the financial crisis than during the crisis, but also because I believe the magnitude of market moves and investor emotions going forward is more likely to reflect what was experienced during 2004–2007 than in 2008–2009.

Toward a Unified Theory of Contrarian Indicators

As someone who has spend a lot of time studying options and volatility, I have always likened the VIX to a measure of the intensity of demand for options, while I have tended to view put to call ratios as an indication of the balance of that demand. Both the VIX and put to call data measure different aspects of the emotional content of decision-making as it affects retail investors. In this sense we are talking about the same elephant, with one indicator examining the trunk and another the tusks.

Some investors have found novel ways to combine put to call ratios and the VIX in order to arrive at a more holistic view of retail investor sentiment in the options market. Tom Drake is one such investor. His 2CS indicator multiplies the VIX by the CBOE Total Put to Call Ratio and take a five-day moving average of this number. The result means that both indicators generally need to confirm the extreme reading to generate an actionable signal.

With the recent release of the CBOE SKEW Index, the potential to combine options data into more robust market sentiment indicators only increases.

Conclusion and Implications for Trading

While most readers of this magazine focus more on trading options than on using them as market timing or direction indicators, it is worth remembering that more people use options as indicators than as trading vehicles. It has been my experience that high put to call extreme readings generally offer better trading signals that low put to call readings, but data from 2008–2009 does not support this contention. By combining put to call data with trend indicators, traders can also better distinguish between trend reversals and pullbacks that are part of continuation patterns.

As is the case with all sentiment data, there is always the risk that extreme readings can persist or become even more extreme. For this reason, those who investigate put to call systems should give substantial thought to the imporance of scaling in to new positions.

Looking ahead, some studies show that algorithmic trading now accounts for over 70% of all stock trades. This trend is likely to persist and could ultimately call into question the value of put to call ratios as a measurement tool for evaluating investor emotions. For now at least, both the CBOE and ISEE equity data continue to provide valuable insight into the actions of the retail investor.

More people use **options as indicators** than as **trading vehicles.**

Finally, there is no reason why options traders cannot simultaneously use options as an indicator and trading vehicle. For those who are partial to selling options, high put to call ratios often confer an advantage to sellers of puts and bull put spreads, while low put to call ratios can signal opportunities for selling calls or bear call spreads. With a little analysis and experimentation, options strategists who use market sentiment to their advantage are bound to increase the effectiveness of their options trading. EM

Managing an OEX Butterfly

Mark Sebastian

Trading butterflies is not an easy business, even in times of relative calm. In order to improve a butterfly's chance of success, I look for certain conditions that I think make a butterfly a more favorable trade. I am really looking for three things:

1. Falling ATM IV
2. A Flat Put Curve
3. A Sloping Call Curve

In looking for these three characteristics I have found that I am buying a butterfly for the cheapest debit—or in this case selling an iron butterfly for the most favorable credit—relative to what is generally available. I did this trade live for my Option Pit students (during the Afternoon Pit Report) so that they could see how I traded into, managed, and got out of a butterfly. As this was my 'work' trading account I only did a 1-lot.

I used the OEX because, of the 4 major indexes, at the time this index has the best combination of the 3 characteristics I look for. IV was in fact falling, the put curve while not flat was still 'normal,' and the call curve was sloping. Since conditions are rarely perfect, I am often entering trades that I call 'better than good enough but not great.'

Trade entry:
At midday on March 28th, with the OEX trading around 590.00 I sold the April 575-590-605 butterfly. I also bought a 'unit put' in OEX. When I think IV is somewhat low and the curve flat, I generally prefer a 'unit' to a hedge in the VIX. I would normally flatten my delta in general, but as I could not buy a call that fell 'inside' the curve I decided to let this trade stand as-is (Figure 1).

The next day, the market fell off in the morning and at that point, the delta of the trade had fallen sufficiently enough that I could buy a 605 call and flatten the delta without getting long deltas (Figure 2).

Actuals	OEX Index		SPX Index			
	589.90	+2.00	1316.60	+2.80		
	591.12	588.58	1319.80	1314.50		
Futures	JUN <81>		SEP <172>		DEC <263>	
	1311.80	+1.80	1307.30	+2.30	1302.00	+2.50
Options	APR <19>				MAY <54>	
615 calls	0.30	10.8%		18.5 7.07	2.90	12.6%
610 calls	0.65	11.2%		28.3 12.8	4.30	13.0%
605 calls	1.45	11.7%	+1	38.4 20.6	6.00	13.5%
600 calls	2.80	12.3%		46.8 30.0	8.10	14.1%
595 calls	4.80	13.2%		52.0 40.3	10.50	14.8%
590 calls>	7.50	14.1%	-1	53.7 50.5	13.30	15.4%
585 calls	10.70	15.1%		52.0 59.9	16.40	15.9%
590 puts>	0.40	15.5%	-1	53.7 -49.6	15.30	16.2%
585 puts	6.50	16.3%		52.0 -40.2	13.30	16.7%
580 puts	4.90	17.0%		40.1 -31.9	11.50	17.2%
575 puts	3.80	17.8%	+1	42.9 -25.0	10.00	17.8%
570 puts	2.90	18.5%		37.3 -19.5	8.60	18.3%
565 puts	2.25	19.4%		31.8 -15.2	7.40	18.7%
560 puts	1.70	20.2%		26.9 -11.9	6.40	19.4%
555 puts	1.35	21.1%		22.7 -9.38	5.60	20.0%
550 puts	1.05	22.0%		19.1 -7.47	4.80	20.5%
545 puts	0.80	22.8%	+1	16.1 -5.96	..s..	

Summary	Net Reqmts	Gross Reqmts	Cash Flow	+$961	Delta	-11.25	Avg.IV	17.7%
Init	$539	$1,500	Cur. Value	-$1,060	Gamma	-0.60	Calls.IV	15.6%
Maint	$539	$1,500	Gain/Loss	-$99	Theta	1.09	Puts.IV	19.4%
Cash/Init	1.78	0.64	Commis	$18.95	Vega	-10.03	P/C (Vol)	0.68

OptionVue

FIGURE 1

This is what the butterfly looked like at completion of the trade (Figure 2 fly).

OptionVue

Actuals	OEX Index		SPX Index	
	585.70	-1.34	1307.60	-2.60
	586.70	585.04	1309.70	1305.30
Futures	**JUN <80>**		**SEP <171>**	
	1303.30	+1.00	1296.00	-0.90
Options	**APR <18>**			
615 calls	0.25	12.6%	7.68	2.45
610 calls	0.50	12.6%	15.9	6.14
605 calls	1.00	12.9% +1	+1 26.4	12.2
600 calls	2.00	13.6%	36.9	20.5
595 calls	3.60	14.4%	45.4	30.4
590 calls	5.80	15.3%	-1 50.4	41.0
585 calls>	8.60	16.5%	51.8	51.2
590 puts	11.00	15.8%	-1 50.4	-59.2
585 puts>	8.50	16.6%	51.8	-49.1
580 puts	6.70	17.3%	50.2	-39.9
575 puts	5.20	18.1%	+1 46.5	-32.0
570 puts	4.00	19.1%	41.6	-25.3
565 puts	3.10	19.8%	36.4	-19.9
560 puts	2.40	20.7%	31.3	-15.6
555 puts	1.90	21.6%	26.6	-12.3
550 puts	1.45	22.5%	22.4	-9.70
545 puts	1.15	23.4%	+1 18.9	-7.69

FIGURE 2

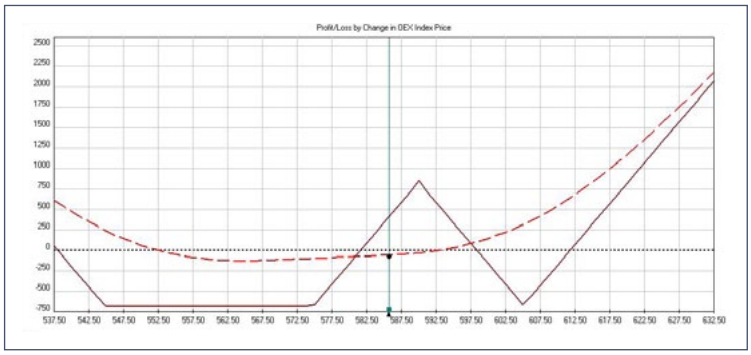


FIGURE 2 FLY

The next day the market 'roared up' and, seeing this as an opportunity, I did something I rarely do. I rolled a hedged call out of the curve. I did this on a whim as I was personally bearish. I was lucky this worked out in the end, because this was an irresponsible trade (Figure 3, Figure 3 fly).

OptionVue

Actuals	OEX Index		SPX Index	
	595.54	+4.72	1330.30	+10.80
	595.70	591.46	1330.70	1321.90
Futures	**JUN <79>**		**SEP <170>**	**DEC <261>**
	1326.00	+9.50	1320.50 +9.00	1313.00 +6.00
Options	**APR <17>**			**MAY <52>**
615 calls	0.50	10.5%	25.8 12.0	3.90 12.5%
610 calls	1.10	10.8% +1	36.3 20.3	5.70 13.0%
605 calls	2.35	11.5% -1	+2 44.9 30.3	7.70 13.7%
600 calls	4.30	12.3%	49.9 41.1	10.20 14.3%
595 calls>	7.10	13.3%	51.2 51.6	13.10 14.9%
590 calls	10.30	14.3%	-1 49.3 61.2	16.20 15.6%
585 calls	14.20	15.6%	45.2 69.4	19.60 16.1%
590 puts	5.30	15.1%	-1 49.3 -38.9	12.20 16.0%
585 puts	3.90	15.8%	45.2 -30.7	10.40 16.4%
580 puts	2.95	16.8%	40.0 -24.0	8.90 16.9%
575 puts	2.10	17.5%	+1 34.5 -18.6	7.70 17.6%
570 puts	1.60	18.5%	29.3 -14.5	6.60 18.1%
565 puts	1.20	19.2%	24.7 -11.3	5.70 18.7%
560 puts	0.95	20.3%	20.7 -8.80	4.90 19.3%
555 puts	0.75	21.3%	17.3 -6.92	4.20 19.8%
550 puts	0.60	22.6%	14.4 -5.50	3.70 20.5%
545 puts	0.45	23.3%	+1 12.0 -4.37	..s..

Summary of ☐ Existing ☐ Trades ☑ Both

	Net Reqmts	Gross Reqmts						
			Cash Flow	+$939	Delta	5.33	Avg.IV	17.1%
Init	$561	$1,500	Cur. Value	-$910	Gamma	1.32	Calls.IV	15.1%
Maint	$561	$1,500	Gain/Loss	-$64	Theta	-5.64	Puts.IV	18.6%
Cash/Init	1.67	0.63	Commis	$63.80	Vega	29.21	P/C (Vol)	1.74

FIGURE 3

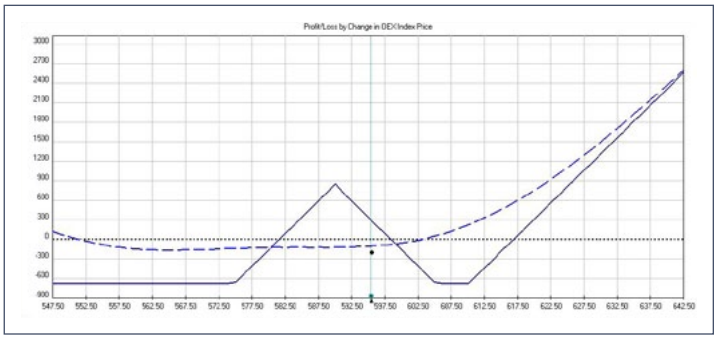


FIGURE 3 FLY

Several days passed. On April 8th I almost reached my breaking point. The trade was sitting at a break even point, was essentially flat profit and loss, and had a big short delta. I told myself that if we broke any higher I was killing the trade. Luckily, we didn't. At the same time I noticed that the lower half of the butterfly's long put was essentially worthless. As this is a huge risk, I decided to 'Reverse Harvey' the lower portion of the trade, buying the 575-580 put spread for .25 (Figure 4).

This is often a spot where traders are fooled by their greeks. The pricing model at the time read this as a huge change in delta and theta. Knowing that .25 of premium in actuality was

OptionVue

FIGURE 4

going to have little effect on how the position would act is a skill I learned through 10+ years of trading. For retail traders it is a lesson that is rarely taught, but is very important. For the general trader, it is important to understand how one's risk is really changing. Do not simply follow a model; learn how cheap options act at expiration (Figure 5).

We lucked out in that the top of the OEX was just below my breaking point. By Thursday afternoon, the OEX was already turning around and ended down on the 8th, before we killed the trade on April 11th . . . (Figure 6)

OptionVue

Actuals	OEX Index		SPX Index	
	596.34	+0.14	1333.40	0.00
	598.66	595.52	1339.50	1331.60
Futures	**JUN <70>**		**SEP <161>**	
	1329.50	+1.00	1324.30	+1.00
Options	**APR <8>**			
615 calls	0.10		3.87	1.71
610 calls	0.25	10.3%	+1 11.9	6.96
605 calls	0.75	10.3%	+1 23.7	18.7
600 calls	2.30	11.3%	32.9	35.9
595 calls>	5.00	12.7%	35.0	54.1
590 calls	8.60	14.4%	-1 31.3	69.4
585 calls	12.90	16.2%	25.1	80.3
590 puts	2.25	13.2%	-1 31.3	-31.2
585 puts	1.35	14.4%	25.1	-20.5
580 puts	0.85	15.8%	+1 19.3	-13.6
575 puts	0.60	17.5%	-1 +1 14.7	-9.16
570 puts	0.40	18.9%	11.3	-6.47
565 puts	0.30	20.9%	8.74	-4.67
560 puts	0.25	22.8%	6.88	-3.45
555 puts	0.15	24.2%	5.49	-2.65
550 puts	0.15		4.45	-2.06
545 puts	0.15	28.7%	+1 3.66	-1.61

FIGURE 5

Actuals	OEX Index		SPX Index	
	594.42	-1.78	1328.20	-5.30
	598.66	592.22	1339.50	1323.00
Futures	**JUN <70>**		**SEP <161>**	
	1323.80	+0.50	1318.50	+0.30
Options	**APR <8>**			
615 calls	0.10		3.73	1.64
610 calls	0.20	10.8%	+1 10.3	5.84
605 calls	0.60	10.7%	-1 +1 20.7	15.3
600 calls	1.90	11.9%	+1 30.6	30.2
595 calls>	4.30	13.4%	35.0	47.7
590 calls	7.40	14.3%	-1 33.2	63.6
585 calls	11.50	16.7%	27.9	75.8
590 puts	3.30	14.6%	-1 33.2	-36.8
585 puts	2.05	15.6%	27.9	-24.7
580 puts	1.35	17.0%	+1 22.0	-16.6
575 puts	0.95	18.8%	17.0	-11.4
570 puts	0.70	20.7%	13.3	-8.12
565 puts	0.50	21.7%	10.5	-5.95
560 puts	0.45	24.8%	8.38	-4.47
555 puts	0.40	27.0%	6.79	-3.40
550 puts	0.25	27.4%	5.57	-2.71
545 puts	0.25	30.4%	+1 4.64	-2.16

FIGURE 6

. . . for a net return of just over 300 dollars less commissions.

Final Result

This position worked despite one silly trade, but also because I pulled the trade together as the market moved. By starting at a good entry point, managing the deltas the right way, getting lucky on a bad trade, and understanding the model, I managed to make a trade that *should* be profitable, profitable. EM

Options Were Designed for Speculation

Mark D Wolfinger and David Blair

GIVEN:

When trading options, speculating is a worthwhile strategy.

PRO

By David Blair

When trading, *caveat emptor*: let the buyer beware. That is especially true when trading options. When trading equities, the swing trader locates an edge, establishes a position, and manages it with profit and loss targets. Being aware of certain unknowns such as an analyst upgrade or downgrade, an earnings warning, or general market news (think Japan in March 2011) is necessary.

When trading options, the trader must also consider time decay, option strike (ITM, ATM, OTM), option bid/ask spread at time of purchase, volume, volatility, etc. However, this should not prevent the market speculator from trading options—allowing analysis paralysis to take precedence over the opportunity to benefit from an otherwise well-calculated trade. All trading involves speculation, no matter the instrument of choice.

Speaking only from the experience of a swing or trend trader (I actually refer to it as "swend" trading), I choose to keep my options trading very simple by using options as if they were stock. In other words, profit targets are based on a stock's movement over days to weeks, not hours; and multiple dollars, not nickels and dimes.

My very simple options rules require that I purchase ITM options that expire at least three months out when trading on a daily time frame. I trade six-month options when, on rare occasion, I enter a trade based on the weekly chart. This gives my trade adequate time to work when it is slow to reach a suitable profit point, while reducing time decay issues associated with purchasing front or 2nd month options.

I also consider the option spread in relation to the stock price, choosing not to buy when the spread is greater than .30—unless I am trading a volatile stock such as Priceline.com (PCLN). These stocks can move double digits on any given day. In this case, a 1.00 bid to 1.50 ask is expected. If I am unfamiliar with the options of a particular stock, I will "test trade" the options several times before committing

When trading, it is *caveat emptor:* let the buyer beware.

real funds—to get a feel for how the options, and the stock, move. These rules are applied to any stock or ETF.

In sum, when trading options I choose to think about opportunity, moving away from the cynical-sounding *caveat emptor* to the more opportunistic-sounding "conscious *emptor*"—or, let the buyer be aware.

CON

Mark D Wolfinger

Option buyers gain leverage when they do their thing. The possibility of turning a few dollars into a nice pile of cash is tempting. It's the same dream (with a much lower chance of success) that keeps people playing the lottery week after week. Nevertheless, for the vast majority, buying options is a losing game.

We are all familiar with the arguments:

- The trader must correctly predict the direction of the move.
- The trader must be fairly accurate in timing the move.
- The move must be large enough to overcome the extrinsic value paid for the option.
- The trader must not pay far more than an option is worth.

Trite or not, those arguments are still valid.

David adopted a system that overcomes most of the difficulty that plagues option buyers. His use of ITM options, and the payment of a small time premium, gives him both limited risk and the time needed for the prediction to come true.

However, attempting to predict market (or single stock) direction is still speculation and is a suitable strategy only when the trader has a proven track record. The problem occurs when the amateur trader/investor believes he has such a track record, without examining the data.

Studies show that most traders do not perform as well as they believe they do. And that's why speculation is so dangerous to the financial health of the average investor. I'll assume that David is well aware of his past performance and is thus capable of finding success as a speculator.

One problem that is always of concern is that professional money managers—the guys and gals who manage mutual funds—don't seem to be able to outperform their benchmark indexes. Their trading expenses and management fees make these funds a very poor choice for the individual investor. Yet, some pros do very well. Those who manage the endowments funds of the large universities have (with the exception of some huge, well-publicized losses) seem to outperform.

Although I am not a fan of my co-writer's overall idea of market speculation, he found an option-trading strategy that uses some of the special characteristics of options. And that idea—how a swing trader uses options as a stock replacement—is worth spreading. EM

David Blair is a professional equities and options trader with over 8 years experience.

He designed and developed the Crosshairs Trading Method, combining characteristics of swing and trend trading. This intersection forms the proprietary Crosshairs Indicator, programmed into the TradeStation platform. It helps him simplify an overly complex trading environment. and has led to long term success.

He enjoys sharing his method with novice and experienced traders via the blog, webinars coaching, and public appearances.

David lives in the beautiful state of North Carolina with his wife and three kids.

Expiring Monthly Interview with
Larry McMillan

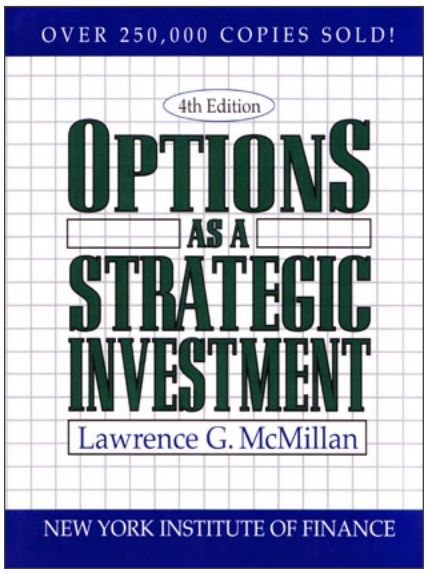
Mark Sebastian

Larry McMillan has authored two best selling books on options—including Options as a Strategic Investment*—recognized as essential resources for any serious option trader's library. As president of McMillan Analysis Corporation, he authors the "Daily Volume Alerts," and edits and publishes "The Option Strategist," a derivative products newsletter covering equity, index, and futures options. Recognized as an options trading industry expert, serious investors have relied on his insights, observations and recommendations for years. Mr. McMillan received the prestigious Joseph W. Sullivan Award in 2011, recognition of outstanding contributions to the U.S. options industry.*

For our inaugural issue of *Expiring Monthly*, I had the chance to talk to Shelly Natenberg. If *Option Volatility and Pricing* is the bible of the industry, then *Options as a Strategic Investment* is the catechism of the industry. I had a chance to sit down with its author, Larry McMillan, "The Option Strategist."

Expiring Monthly: *How did you get into the options business?*

Larry McMillan: I was working at a law office in 1973 when options exchanges started, and I was doing my own trading. My broker called and said that they had just started a listed options exchange, and asked if I would be interested. I started fooling around with different strategies and soon options started to make sense to me. I then started a newsletter. The newsletter got me a job with Thompson and McKinnon, which I eventually I left to start The Option Strategist.



EM: *How did the book get published?*

LM: The book really came from the newsletter. Several people in finance encouraged me to publish a book talking about market strategy. I wrote a 35-page outline, which was nice because the book was partially done before I started writing.

EM: *What happened then?*

LM: The book led to some notoriety and I was successful as a strategist. People wanted me to manage money for them and to educate them. 20-plus years ago I decided to start The Option Strategist and have been running my own company ever since.

EM: *What made you decide start your own business? Why are you still successful 20 years later?*

LM: We play a really clean business, and I think people appreciate that. We are not just making recommendations—we are educating people. An individual trading on his own account doesn't simply want guidance from me; he or she also wants an education.

People can learn by example, and can turn to us for an education. We aren't like a lot of the firms that are out to make a bunch of short term options buys and then burn out; we do not do that. We are constantly working on strategies, approaches, and on educating our customers. It is interesting: I have more problems with self-directed individuals than I do money managers, because the money managers listen.

EM: *What do you think the general public misunderstands about options the most?*

LM: Most of the retail world thinks of options as a speculative product. The more educated user understands options as a lower risk hedging tool; a more sophisticated client will almost always understand that. We don't try to market to the guy to make the quick buck in the option market on speculative plays; maybe that another reason we have been here so long.

EM: *One big strategy out there is to teach people to sell premium. Some people pitch this as an easy way to make money. They tell people they don't need to worry about the hard stuff. What do you think about this trend?*

LM: I never believed in telling people to sell premium if they don't understand what they are doing. If that's their attitude, you will get yourself in trouble. We have changed our strategy based on what the market is giving us.

VIX itself and the VIX futures are probably the best products that have ever been introduced.

Since markets seem to be somewhat manipulated by the federal government, and they keep taking quantitative actions that have encouraged upward market trends, we had to change our strategies to fit the market. We adjusted our approach based on technicals and what volatility is giving us. We do a lot of work with volatility. It is extremely important to our trading approach.

EM: *Getting back to the book, there are about 2 or 3 books that have stood the test of time. What do you think has differentiated them to make them the bibles of the options trading industry?*

LM: None of the books that stand the test of time teach traders to make a quick million on Wall Street. When a book like mine actually gives the reader an education in a way that the reader can better understand the options, those books will stand the test of time. My book is out to educate: it teaches traders not how to trade options but how options function.

EM: *If I were a retail option trader, what steps should I be taking before I trade one option? What do a lot of people skip?*

LM: People skip really understanding what options are, and how they work: they need to know parity, synthetics values, and intrinsic values. All of the stuff that takes time to learn. Read the first few chapters in my book. If you are able to comprehend what I am discussing then you are probably a person that can learn how to trade options.

EM: *What do you think are the big mistakes that get traders into trouble?*

LM: Typically it is greed. If they are selling options they are pushing, selling too cheap, if they are buying the out of the money options because they want the big bang, they don't want the smart play that is more likely to work. Also, many investors lack discipline. They don't enforce their trading approach. Often it is because of greed which can take over a trader.

EM: *What do you think of the market for the rest of the year?*

LM: We have a volatility forecast every year. I am something of a skeptic, but things seem to be setting up bullish. The more the market just keeps going up, that is so typical of a bull run. I am never super bullish, but it is the way it looks right now.

EM: *What do you think of all of the volatility products coming out these days?*

LM: VIX itself and the VIX futures are probably the best products that have ever been introduced. They have good liquidity. They can be a bit tricky, but properly implemented I think they are a great product to hedge and speculate with. I am interested to see how the GVZ futures trade in the coming weeks. GVZ is like a VIX for gold, and gold is such a hot market right now. I think GVZ could have some real value, although, just like VIX futures (at their inception), there doesn't seem to be much volume. We shall see once the options start trading on April 12th.

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

LM: Get yourself educated. That's the number one thing, and if you have a sound basis, you should be able to trade pretty successfully. It is amazing to me how many people do not understand options and yet still trade.

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

WOLF AGAINST THE WORLD

Invitation

To all subscribers: This is an open invitation to participate in the monthly *Expiring Monthly* feature: WATW.

The Simple Rules

1. Make a short statement that has some relationship to options.
2. State whether you agree or disagree with that statement.
3. Option:
   - **a.** Write your half of the article and submit it. Target 400–600 words.
   - **b.** Write your portion only after hearing from us that we want to publish your idea.
4. Wolf will take the side that disagrees with your stance.

Please keep in mind that this is discussion. It is an attempt to present readers with an opportunity to see both sides of an issue.

- Controversy encouraged
- Educational topics are even better
- This is an opportunity to discuss something that has been bothering you

Send all entries to mark@expiringmonthly.com

Changing the Rules After

The Game Has Begun

Mark D Wolfinger

Just as I complained about how the brokerage industry treats its customers when it comes to auto-exercise of ITM options at expiration (*Expiring Monthly*, July 2010, Vol 1, No 5, pp 36–37), another practice to limit traders is gaining popularity among brokers.

Some brokers adopted a policy of not allowing some traders to open positions on expiration Friday. The decision point is simple:

> If the customer does not have enough buying power in his/her account to buy or short the underlying stock, then the trade is not allowed.
>
> The broker is being certain that the customer does not forget about those options—which may move ITM—and be exercised by exception (exercised automatically].

On the surface this is a reasonable concern for the broker. After all, if the customer pays $0.05 or $0.10 for 100 lots of an OTM call or put for a high priced stock, it is *possible* that the stock may make a move very late in the day, preventing the trader from disposing of the newly purchased position.

If the stock gaps on Monday, the customer can easily lose more than the value of the account. (I heard at least one such horror story.) That does leave the broker on the hook for the balance of the loss because not every customer has the wherewithal to pay the debt.

Being forced to exercise the option would incur a $2,000,000 margin call—if the stock is priced at $200. It's the same problem whether the trader owned puts or calls.

More sophisticated traders—such as EM readers—would have known to enter an order to sell the options about an hour before the market closed—just in case. Having failed to take that action, the customer could attempt to trade 10,000 shares in the aftermarket (assuming the broker doesn't block the trade due to buying power limitations) to neutralize the effect of exercising the options.

Another obvious method to eliminate the problem is for the customer to sacrifice current profits by telling the broker to submit 'Do not exercise' instructions for those options. No exercise translates into no positions on Monday morning and no problems.

The Problem with the Brokers' 'Solution'

Brokers grant traders the right to trade options. There may be restrictions (limited number of strategies) for newer or less well financed customers, but once the broker has already extended the right to open and close positions, it doesn't seem right to limit the number of days on which that applies.

For now—and I'm sure this policy will spread, rather than be eliminated—it turns out that the right to trade is limited (for some customers) to every day except for Friday (one day prior to the options official expiration day). I recognize that the broker must protect itself from uneducated customers who are not aware of the auto-exercise situation. But, the question remains as to whether this is the best way to solve the problem. I know that there are fairer methods for dealing with this scenario. For example, the broker could request that the customer submit "do not exercise" instructions before being allowed to make the trade.

That seems right to me. If the customer fails to sell the options and if he/she cannot meet the margin call, then the options should be allowed to expire worthless.

By making automatic exercise of ITM options the rule, the powers that be changed the terms for option owners from the "right but not the obligation" to exercise—to an obligation. Now limits are being placed on who is allowed to buy new positions on expiration Friday. What's next? EM