

thinkMoney/07

• random musings
for thinkorswimmers
Fall 2009



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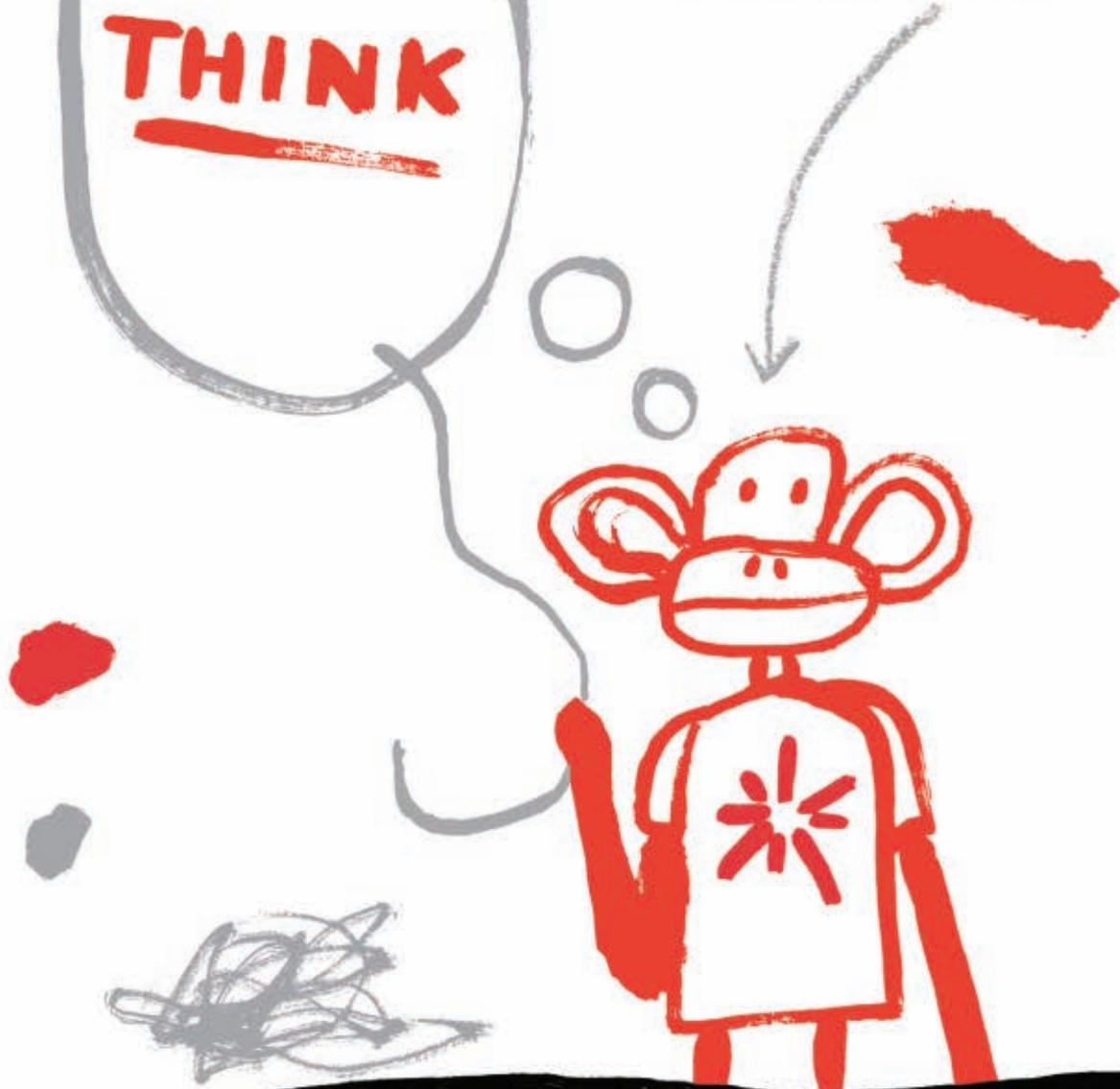
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Risk Doesn't Sleep (Neither Should You)

If you think you'll be fine just checking in on those put-protected stocks now and then, think again. Learning how to actively manage your put hedges is not only smart, but also, you'll sleep much easier.



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With so many new volatility indexes, is the VIX still a relevant indicator of things to come, or should you be paying more attention to its brethren?



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If we could imagine a chat with TD Ameritrade's Chairman, it'd probably go something like this.

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At some point, every rookie has to make the jump from the locker room to the playing field. Likewise, every pro knows to take a step back to test a theory in practice before executing a new play on game night. When it comes to paper trading, there's something here for everyone.



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No, you're not seeing double—that's just our new risk graph overlay. Looking for advanced technical alerts? Yeah, we've got that too.



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If it seems like we have all the answers to trading, we'd humbly deny it. But if you want to know if you should quit your day job, we just might have the answer.



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What's the risk of rising interest rates and a spiraling deficit? Hyperinflation might not be on everyone's radar yet, but with a little history as your guide, and a crash course in trader economics, you just might be in a better position to insulate your portfolio.



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41/Forex for Fun

When it comes to FX, every trade is a pairs trade. So pay attention to your rollover rate, or your P&L will surely cry foul.



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To understand what greeks are is to understand what they aren't. Even die-hard geeks like us know when to hold 'em and when to fold 'em when the actual versus theoretical collide.

PLUS:

STRATEGY FOCUS Wouldn't it be neat to forward test your greeks? Oh yeah, you can—right here.
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23/Hey Monkey!

Our resident primate opines on flash trading, lambskin pants, and other important trading matters.



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• thinkMoney is published quarterly. If you prefer not to receive this publication, please call 773-435-3210.

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Boom-Boom Pow!

Forgive us for starting out with the title of an arguably overplayed pop song. But hey, we can't really think of any phrase more apropos to describe the market's giddiness since "the March low." And thankfully you didn't think to ask us where we actually thought the market would go or by how much, because if you had, we'd have had some explaining to do about why Monkey took out a second mortgage to sell put spreads on SPY (he's got connections). The truth is, any question about market direction is about as loaded as the eternal question, "How does my butt look in these jeans?" that men have endured since denim was invented. We figure the question is ephemeral, so if we talk long enough around it, the inquisitor might forget he asked it (or just go away).

Rhetoric aside, all systems are go at TOS, and we couldn't be happier. We got just enough readership

survey responses from you to keep Monkey employed at least until the next banana harvest. For those of you who didn't get a chance to give your input, it's not too late. Just point your own banana to www.thinkorswim.com/survey and give us your thoughts.

All things considered, a lot of stock portfolios that were torn and tattered at the dawn of the new year are starting to look like new growth forests after a nasty brush fire. And while some savvy investors are wisely hedging their stocks with

puts, this is not the time to take your eyes off the ball. Our cover story, "Risk Doesn't Sleep (Neither Should You)," will guide you through the process of dynamically hedging your stock with puts. And for those of you making a fortune paper trading, but who can't seem to put some real skin in the game, check out "So, You Wanna Be a Trader" for some coaching lessons.

All in all, despite the "Great Recession," it seems that our loyal followers are, for the most part, still in one piece and ready to take on the next trade. And if we happen to have something to do with that, then we've gladly done our job.

Happy Trading!
TOS



We want to hear your pros and cons! Please send your comments to editor@thinkmoneymag.com.

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Feature #1

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MARRYING A PUT TO A STOCK POSITION IS A GREAT WAY FOR INVESTORS TO HEDGE THEIR BETS. BUT LIKE ANY SUCCESSFUL MARRIAGE, IT TAKES WORK. IF YOU THINK IT'S SAFE TO JUST "SET IT AND FORGET IT," THINK AGAIN.

Words by
Thomas Preston
Photograph by
Fredrik Brodén

cov.
story

RISK
DOESN'T
SLEEP
(AND
NEITHER
SHOULD
YOU)



Cover Feature

•
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YOU CAN BUY A PUT AGAINST A LONG STOCK POSITION and be hedged against a drop in the stock's price. But saying you're "hedged" is a little like describing anything with six legs as a "bug." It's not very precise, and there's a world of difference between a mosquito and a butterfly (the insect, not the position). Turning a critical eye toward that put as market conditions change can be the difference between having actual protection for your position, or just a squashed bug.

What am I talking about? Take an ETF like SPY trading at \$90. Say you're long 1,000 shares and you want to hedge some of the downside risk in case the market crashes. To keep it simple, you could buy ten 85 strike puts that have about 40 days to expiration for a 1.40 debit. Now let's say the S&P 500 drops 3% tomorrow. With the SPY at \$87.30, you've lost \$2,700 on your long 1,000 shares. But the 85 puts will have a theoretical value of about 2.25, assuming volatility doesn't change. That means your 10 long puts have made \$850, which partially offsets the loss on the long SPY shares (your breakeven is \$83.60 on SPY at expiration). It's not a perfect hedge, but it can provide some protection.

But let's say the SPY doesn't drop 3% tomorrow. In fact, it sits right where it is for 30 days. Then, on the 31st day, it drops 3%. You expect your long 10 puts to provide a bit of a hedge at least, so you take a look at where they're trading. Theoretically, they're worth about 0.70. Yikes! You just lost money on your long SPY position, and you lost money on the hedge itself. In other words, you didn't really have a hedge after all. At some point the long puts stopped being a possible hedge and started being useless. How did this happen?

Losing Time

Time decay is one of the few constants in options trading. It inexorably whittles down the extrinsic value of an option. And the closer you get to expiration, the more extrinsic value gets whittled down every day. If you're long an option, that negative time decay, or theta, is hurting you. Unless there is a jump in volatility or a favorable move (in terms of the option) in the stock price, that long option will drop in value. And even if there is an increase in volatility or the stock moves your way, it may not be enough to offset the loss from time decay.

The other issue is that for out-of-the-money options, the delta moves toward zero as you approach expiration (see page 39 for the definition of delta and the formula for its calculation). In the case of a long put, delta indicates how much "hedging power" it has. A lot of negative deltas provide more of a hedge if the market drops. Fewer nega-

tive deltas give you less protection. That means your protection is getting smaller and smaller as time passes.

The day before the SPY dropped 3%, those 85 puts had 10 days to expiration and had a theoretical value of about 0.25. If you had been watching your account, you would have seen their loss of \$1,150. So, on the 31st day, even though the SPY dropped 3%, and the 85 puts went from 0.25 to 0.70, you'd still be down money on them.

A Better Band-Aid

A smarter approach is to keep an eye on your hedge to make sure that it provides the level of protection you need. A quick way to do that is to compare the price of the put a couple strikes higher than the put you have on. Why? The out-of-the-money put that you have now will be less out of the money if the stock drops; its value will look something like a less out-of-the-money put does right now. For example, with the SPY at \$90, the 85 put is 5 points out of the money. But if the SPY drops down to \$87.30, that 85 put will only be 2.30 out of the money. You can estimate its value if that happens by looking at the put that is about 2 points out of the money with the SPY at \$90. That's the 88 put. And what's it trading at right now? 2.25! That's right where we estimated the theoretical value would be if the SPY dropped 3%. So, if you want to see what the value of the 85 put might be if the SPY drops \$3.00 (it's easier to use points than percentages here), look at the put that has a strike 3 points higher—the 88. How much might the 85 put be worth if the SPY drops 5 points? Check the 90 put. How about if the SPY rises 2 points? Look at the 83 put.

Sure, you can get more precise values if you use the TheoPrice tools on the TOS software, but this is how we used to do it on the trading floor before everyone had trading sheets or handheld computers. And it's accurate enough to evaluate the "hedging" power of your put, and simple enough that you can do it quickly.

Looking at the 85 puts with 40 days to go, a 3-point drop in the SPY would push them to 2.25. If that \$850 potential profit is enough of an offset against a \$3,000 loss, then you can stop right there. But if you want more of a hedge, look at the 87 puts trading at 1.90 right now, and compare them to the 90 puts trading at 3.00. If the SPY drops 3 points, 10 long 87 puts would make \$1,100 to offset the loss on the SPY shares (breakeven on this trade would be \$85.10 at expiration).

If you do this exercise every day or so, you can decide for yourself whether the gain on the long put is enough of a hedge against a drop in value of the long shares. If it isn't, you need to change your hedge. You can do that by either buying more of the same puts, or closing out the existing puts and opening a position in puts with a different strike price or expiration, or both.

Fast-forward 25 days. Your 85 puts are now at 0.35—ugh. The hedge cost you 1.05 per option. Well, that's the



WHEN YOU USE
OPTIONS AS A HEDGE,
YOU HAVE TO UNDERSTAND
THEIR DYNAMIC
NATURE. BUT DON'T
BE SCARED BY IT.



•
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please go to
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Money](http://thinkorswim.com/think
Money).**

price of insurance. What you have to decide now is whether that 85 put still provides enough of a hedge. The 88 puts are worth 0.90. If the SPY drops 3 points, the 85 puts might jump to 0.90 and offset \$550 of the \$3,000 loss on the SPY shares. If that's not sufficient, look at how many days to expiration you have in the current month. With 15 days to expiration, your out-of-the-money put hedge is racking up daily losses because of time decay. It might be more prudent to look for protection in a different expiration.

The next expiration has 40 days to go. The 85 put there is worth about 1.50, and the 88 is worth 2.40. If the SPY drops 3.00 points, 10 of those puts could increase by \$900, and offset some of the loss. That's more in keeping with the \$850 that the original hedge generated, so if I want to turn my 85 put hedge that has 15 days to expiration into the 85 puts that have 40 days to expiration, I can buy the 85 put calendar. That closes out the long puts

with 15 days to expiration, and opens the position in the puts with 40 days to expiration. It will cost me about 1.20 to do that, but I've updated my hedge.

The (Nearly) Free Put Hedge

Want to take it a step further? A collar is a hedge for long stock that combines a short out-of-the-money call with a long out-of-the-money put. The premium you get from selling the call offsets the premium you pay for the put. As you monitor the long put for its ability to hedge, monitor the short call for the amount of positive time decay you're generating. As time passes, that out-of-the-money call gets cheaper and cheaper. That's good if you're short. But when most of its value is gone as you approach expiration, it may make more sense to roll it to a strike price closer to the money or to a further expiration month. You can use the tools on the Analyze page to estimate how much positive decay a short call is generating for you, and whether you'd generate more by changing it to a different strike or expiration.

If you start doing this, you'll be in better control of the risk of your positions. When you use options as a hedge, you have to understand their dynamic nature. But don't be scared by it. What you learn about options with a simple long put hedge or collar can be applied to more advanced strategies. And then, you won't just be hedging any more.

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The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be

sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situation, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting us at support@thinkorswim.com or 600 W. Chicago Ave., Suite 100, Chicago, IL 60654-2597.

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Dear Swim

A collection of your best quips to the Trading Desk

Photograph by Fredrik Brodén

• A customer calls asking me to help him plot a simple moving average for his volume. He says that he cannot trade without it because his friend told him as much. So I get him set up. Then he asks, "Now that I have it set up, can you tell me what it means?"

Jeff (from the trading desk)

• Re: Software release notes. I'm going to try this line with my wife and see how it goes over ... The next time she asks, "Did you take out the trash?" I'll

say, "It's in development!" HOW VERY DISAPPOINTING!

Sam

• The charting genius award goes to the fellow I spoke to running 81 charts with three studies each on a wireless card and 2 GB of RAM! He wonders why the software has lost its pep! TGIF

J

• Hey Monkey, We are trading in unprecedented trou-

bled financial times—is it possible to add a button into the analysis page to allow us to activate the Osterhagen Key?

Yours in sheer panic,

Shane

• Thanks for your explanation, but how do you buy back an option that you have sold—and suppose the person that bought it doesn't want to sell it back to you?

Thanks again,

Jim

• As a student I have no money to spare from my diet of ramen and beer, but once I graduate, I will be using the ideas from thinkMoney as a base for trading and getting through the boredom in the working world.

Brad



Got a quip? Send your best to editor@thinkmoneymag.com.

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• I think the monkey looks lonely. He may need a girlfriend. Nothing serious, just a little side dish.

Mary

[From a live Service chat]

LITTLETIGER: hello

LT: my friend get t-shirt from TOS, after he begin trading, can you send me too, or other souvenir, maybe hat or something with logo TOS

TECH-MR. WEI: you didn't get the monkey?

LT: what monkey

TMW: there is a stuffed monkey we sent to all funded accounts

TMW: email support@thinkorswim.com

TMW: tell them you didn't get your monkey

LT: the words i say monkey

TMW: yep

TMW: it is a stuffed monkey

TMW: all funded accounts are mailed one.

LT: monkey = animal??

TMW: monkey stuffed animal

TMW: a doll

TMW: like a teddy bear

LT: I just want souvenir like t-shirt, hat with logo TOS, not live animal

LT: are you kidding?

TMW: it's not a live animal

TMW: http://most-expensive.net/wp-content/uploads/2007/04/teddy-bear.jpg

TMW: like this

TMW: but it is a monkey, not a bear

TMW: just email support@thinkorswim.com

• I would trade my spouse for a guaranteed lifetime subscription to thinkMoney!

Anonymous

16

Vol Watch

Analyzing the markets through the eyes of volatility—sans charts.

vol.

• I'll be the first to admit that the CBOE's VIX didn't foresee the Crash of '08. As a trader who's had more than my fair share of indices blast right through the wings of iron condors, I know those killing moves can come when the VIX is high or low. But now with more than a dozen volatility indices readily visible on your trading platform, does the VIX still matter? Or more to the point, why look at the VIX when there might be something else out there?

One of your options is the CSFB (Credit Suisse) market sentiment index, which compares the price of a 10% out-of-the-money (OTM) SPX call with an equally priced OTM SPX put. It finds the SPX put that has the same price as that 10% OTM call. The index is how far out of the money that SPX put is. If the SPX put that's 15% out of the money has the same price as the 10% OTM call, the CSFB fear index is 15%. The farther out of the money that put is, the higher the CSFB. If the put is far out of the money, that suggests that there is more fear in the market, which pushes up the value of those OTM puts. If the put is closer to the money, that suggests that there is less fear in the market, which pushes the price of the OTM puts lower. Like the VIX, the CSFB measures how much fear or complacency there is in the market. But is it better? Or worse?

Neither. They're just different. To say that the VIX is no longer a valid measure of the

Words by **Thomas Preston**
Photograph by **Fredrik Brodén**

fear or complacency in the market is to miss the point. The VIX, like the CSFB, uses SPX options in its calculation. When those SPX option prices are higher, both the VIX and the CSFB go up. When the SPX option prices are lower, the VIX and the CSFB go down. They both take in information about the volatility skew. But if there's a lot of fear in the market, both calls and puts get pushed up in value. Why? Because fear works both ways. Volatility doesn't care if the big move is up or down. Iron condors get killed by both. If the OTM calls are trading higher, they'll buy an even further OTM put. That drives the CSFB up. And the higher SPX option prices also push the VIX up. They're two measures of SPX option volatility, and each can be analyzed and used—or misused—as a directional indicator. But FYI, don't go looking for quotes on this index anytime

Does the VIX Still Matter?

• There's some new competition in the crowded room of volatility indexes. Which one stands out above the rest?



soon. It's proprietary to CSFB, and they're cautious about who gets to see it. For that reason alone, the VIX still has value as an actively quoted and traded product.

BY THE WAY, WANNA SEE SOMETHING NEAT about the CBOE's SPX binary options (BSV)? Their values track the probability numbers for SPX options that you see on thinkorswim. For example, when the Sep 1050 BSZ options were trading 0.18 – 0.34 (I know, I know, you can drive a truck through that market), the probability of the SPX 1050 call being in the money by September expiration was 26%! And 0.26 is smack dab in between 0.18 and

0.34. Now, I'm not saying those BSZ market makers are using the TOS probabilities as their theoretical values, but they could certainly do worse.

• *The views in the section above are those of the author, but are not necessarily those of thinkorswim, Inc. and are not intended to be specific investment advice. The information contained in this article is for illustrative purposes only. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade.*

WARNING: Don't Invest In The Gold Market

Until you read a copy of my weekly gold letter, "The Gold Report". It contains vital information you need to be able to navigate and trade the gold mining equities, and right now I want to let you try "The Gold Report"



ABSOLUTELY FREE!

Gold is getting ready to move again! Savvy investors will have all the information beforehand so they will be ready when it does.

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Tom O'Brien is the author of the acclaimed Amazon.com bestseller, "Tom O'Brien's Timing The Trade; How Price & Volume Move Markets" and host of the nationally syndicated radio program, "The Tom O'Brien Show"

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TOS News+Views

A hodgepodge of stuff we thought you'd like to know.

Toys for TOS
New treats for swimmers

Single Order for Multiple Accounts

• Custom allocations for trading across multiple accounts now lets you enter a single order with pre-defined quantities and cancel or replace the entire group with a single click.

Complex Formulas Tool

• Now you have the ability to set up your own variations of studies, receive alerts and route orders based on them, as well as see their values on the custom fields on the Quotes tab.

iSwim Update

• The trading app for the iPhone now has charts and news. Find it under thinkorswim on the App Store.

Reuters News Source

• Updated to include stories for currencies as well as stocks, indexes, and economic news.

INDUSTRY SPOTLIGHT

Health Reform for Traders

Wherever you stand on the healthcare reform debate, it's likely to continue to be the big political story for a while. But if you consider the issue carefully, it's not really about healthcare so much as *paying* for healthcare. Who's going to pay for it? And how much? As a trader or investor, that's the key. Healthcare reform won't be about how doctors and nurses are trained, how drugs and medications are developed, or even about caring for the

sick. The price tag on drugs might look dramatic if you have to pay for them yourself, but it's only a fraction of what's causing healthcare costs to rise. Rather, the debate is really about how the costs of providing a certain level of care for our nation will be distributed.

When you think about paying for medical care, insurance companies come to mind. Traditionally, this sector has led the market, particularly in rallies.

This year, however, the returns on these stocks relative to the S&P 500 have been a mixed bag. But any of the healthcare plans being pushed forward in Washington will impact those stocks. And while the news might not be bearish, an increase in their price volatility is likely. Even if a government-run insurance plan never appears, any legislation that changes how insurance companies deal with

something like pre-existing conditions or health insurance portability will affect how those companies generate revenues, keep costs down, and hold risk in check.

As a trader, though, what's the punch line for insurance stocks? Some people are bullish on them because the complex economics and difficult politics of any health "cost" legislation could kill any bill before it even sees daylight outside committee. But the temptation to make insurers the villain in a story of ever-increasing health care costs looming over an economically battered populace is powerful electoral stuff (has anyone actually ever enjoyed a phone call to the claims department?). Be cautious trading

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The Dichotomy That is Wall Street



fyi.

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- Invites to ostentatious parties in the Hamptons
- Eddie Lambert

THINKORSWIM

- Pre-market chat with groggy trade desk staffer to see what SPUs did overnight
- Impenetrable maze that is the Analyze page, causing bad dreams and bed-wetting
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- Regular trader group meetings at late-night buffet line makes Swimmers easy to spot
- Naughty Monkey

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Pot Shots

Beer and trading—a regional affair

KEY:

2 Buy Tickets = 

1 Buy Ticket = 

1 Sell Ticket = 

2 Sell Tickets = 

Boston



The well-educated trader:

Bud Lite—it’s what Obama drinks.

Wisconsin



The earnest trader:

Pabst—Tastes like crap, but no one will think you’re from Boston.

Seattle



The slacker trader:

Coffee-flavored microbrew—lets you trade all night and work on your album all day.

Texas



The cowboy trader:

Shiner Bock—bottles also make excellent pistol targets.

Florida



The retired trader:

Beer is bad for colitis. Prefers Maalox.



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21

Gear Head

Cool things to do with what we've got.

Seeing Double

Two new gadgets designed to make your fingers giddy

tech.

Overlay Risk Graphs

For traders learning about new strategies, we've added the ability to look at the risk profiles of two different positions simultaneously. You can now compare how much two or more positions make or lose when the stock price changes, and even when volatility moves up or down and time passes.

A rule of thumb when you're trading options is that you want the stock or index to go to your short strike at expiration. Butterflies and calendar spreads are two positions that can make money if that happens. But to see how they're different, you can use the overlay tool on the Analyze page, simulate positions in each of them, and see how each can make or lose money in different scenarios.

Let's try it. Go to the Add Simulated Trades section on the Analyze page and type in the symbol of a stock, ETF, or index. Next, create a simulated trade for a butterfly, then another one for a calendar spread by right-clicking on an option in the chain to open up the spread menu. Then, switch from Add Simulated

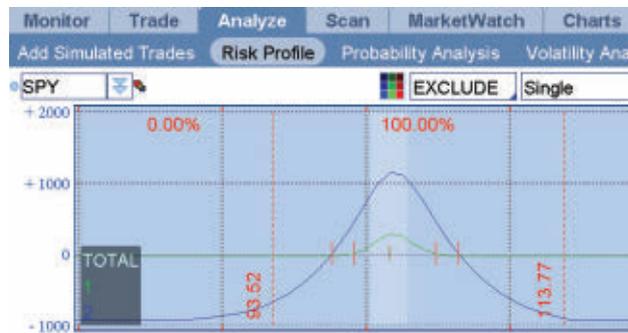


FIGURE 1: Which trade is right for you? Here, our new overlay risk graphs show the difference between a butterfly (green) and a calendar spread (blue).

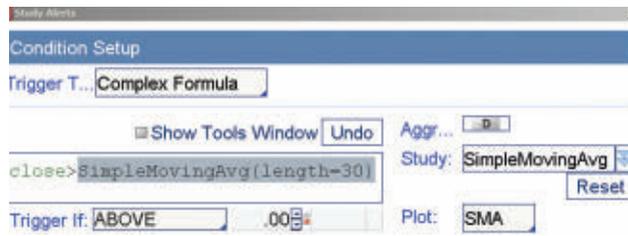


FIGURE 2: Implementing alerts on technical triggers is now possible.

Trades to Risk Profile in the menu at the top of the page. Look at the top middle of the Risk Profile page for the "plot lines" dropdown menu, and select "Single." (If you don't do this, you can't overlay the risk profiles.)

To see the risk profiles at expiration, go to the "Date" field in the lower right-hand corner and set it to the expiration date of the butterfly or the front-month option of the calendar. Finally, look on the left-hand side of the lower Simulate Trades section and you'll see small check boxes. Uncheck the left boxes and check the right ones to view the two risk profiles in the chart above (see Figure 1).

Complex Formulas for Alerts

If you can't sit in front of your trading screen all day, or you're trading so many products that you can't monitor all their conditions at once, our new alerts for complex formulas might be just what you need.

On the Alerts section of the MarketWatch tab, click on the bid or ask of the stock to open up an Alert entry panel. Click on the "Alert" dropdown menu in the middle of the panel, scroll down to "Study," then click on "Edit." That will open up the "Study Alerts" box. At the top of the box, look for the "Trigger Type" menu and select "Complex Formula." Now, here comes the fun part.

Let's say you want to be alerted when the stock goes above the 30-day simple moving average. Check the "Show Tools Window" box and click on the "Study" dropdown menu. Look for SimpleMovingAvg, and click "Insert." You'll see "SimpleMovingAvg()" in the formula



To learn all about all the latest new TOS toys, go to our archived Release Notes at thinkorswim.com, then follow the path to Support > Software Support.

space. Type "close >" to the left of that and change the "length" field on the right hand side to "30". The formula will now read "close > SimpleMovingAvg(length = 30)". Finally, look for the "Trigger if" control below the formula space,

select "Above", and then "0.00". You're creating a condition with a value of "1" if true (stock price is above the moving average) and "0" if not true (the stock price is below the MA).

Now, if the stock price crosses over that 30-day MA, you'll get an alert. And hey, you can even set it up to route the order! In the order entry panel on the Trade page, click on the gear icon on the right. In the Order Conditions section, click on the "Method" menu and select "Study." But be careful—a bad tick can affect the study or even route an order.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting us at support@thinkorswim.com or 600 W. Chicago Ave., Suite 100, Chicago, IL 60654-2597.

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The Fearless Technician

When technical analysis meets random walk.

tech.

• Pivot point analysis is one of the most powerful systems that I have relied on for the past 30 years. To cut to the chase, this lesser-known tool uses a series of mathematical formulas to predict support and resistance levels. Over the years I have developed my own indicator, known as Person's Pivots, that actually filters out a potential price range for the time period immediately *following* the current one—whether you're using daily, weekly, or monthly periods—based on the indicator's reading of the market outlook.

That's why we call this tool "predictive": If the market is deemed to be bullish or bearish now, then Person's Pivots will give you a hint as to what the high and low prices might be for the next time period using the same periodicity (i.e. 5-minute, 30-minute, daily, etc.). When you combine this with other setups, you can develop a great trading plan—or at least have a better clue as to a potential market turning point.

For example, another proprietary candle pattern I developed, the high close doji (HCD) and the low close doji (LCD), can be combined with a moving average (based on the average of the high, low, and close rather than traditional simple, weighted, or exponential, which all use the closing price). This setup will strengthen the confirmation that prices are indeed reversing and/or respecting a new trend condition. The power of this method of

Words by **John Person**



FIGURE 1: To find Person's Pivots, go to TOS Charts > Studies > All Studies > P-R > Persons Pivots. Then visit > Support > Options School > Chat Archives to find out more.

Embrace Your Inner Pivot

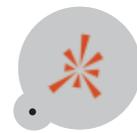
• Here's how swimmers can gain an edge using the predictive Person's Pivot.

market analysis is that I can develop a trading plan with potential profit targets while defining risk.

Indicator in Action

If you like trading ETFs, the Person's Pivot should be right up your alley. Take a look at Figure 1, which is the PowerShares Deutsche Bank Agriculture Index (DBA). It is relatively equally weighted toward corn, soybeans, sugar, and wheat prices. According to the *Commodity Trader's Almanac*, grain complex traditionally peaks out in late May to early June. This year, the monthly Person's Pivot accurately gave almost the exact high and low for June. Additional confirmation of the change in momentum came when the very bearish island top pattern formed on 6/1/09, the same day as the first Person's Pivot in June, followed by a moving averages bearish cross on 6/11/09.

As with any indicator, especially in absurdly bullish or bearish market conditions, nothing works perfectly. A good example of an extreme bearish market condition was back in the fall of 2008. Case in point, If you used the monthly Person's Pivots at the end of August to get the outlook for September in the QQQQ's, the targeted low for the month



John Person is a trader, author, and founder of Nationalfutures.com, an investment advisory company (www.nationalfutures.com).

was projected at 44.10. Within three trading days the market had blown below the predicted support target like a hot knife through butter. By the end of September, the market closed at 38.91 with a low for the month at 37.18—well below the Person's Pivot targeted support. However, using the Person's Pivot would still have helped a trader, as further examination revealed the market, for

the most part of the month, was not trading within the predicted market condition and projected support level. In fact, the support started acting as resistance.

If you have an idea of the specific seasonality of supply and demand cycles for a given commodity, you can scan for price action near the respective monthly support and resistance levels. Along with grains, try crude oil, natural gas, gold, silver, and the host of other commodities with corresponding ETFs. With Person's Pivots, you can navigate and filter out trading opportunities a little easier.

• *The views in the section above are those of the author, but are not necessarily those of thinkorswim, Inc. and are not intended to be specific investment advice. The information contained in this article is for illustrative purposes only. The example above and its historical data cannot be construed as predicting future results. Customers must consider all relevant risk factors, including their own personal financial situations before trading.*

Hey Monkey!

A spattering of our resident primate waxing philosophical and answering your trading questions.

Illustration by
Evonrude

Q: Hey, Monkey, I wanna be a flash trader! Where do I send my résumé?

A: Money for nothing. All you traders dream about that. And you think “flash orders” are the ticket? Think again. First off, figuring out how flash orders work and how traders may or may not use them is more complicated than guessing the door codes at the lab. The idea is that a stock order might be “flashed” to a certain group of market makers for 30 milliseconds. That’s about 10 times faster than the blink of an eye. To even see that type of order and maybe act on it takes piles of money and sharp programmers. But

flash trades were supposedly invented to try to give customers a little better fill price. Whether or not institutions are able to take advantage and front-run large orders is beyond this monkey to judge.

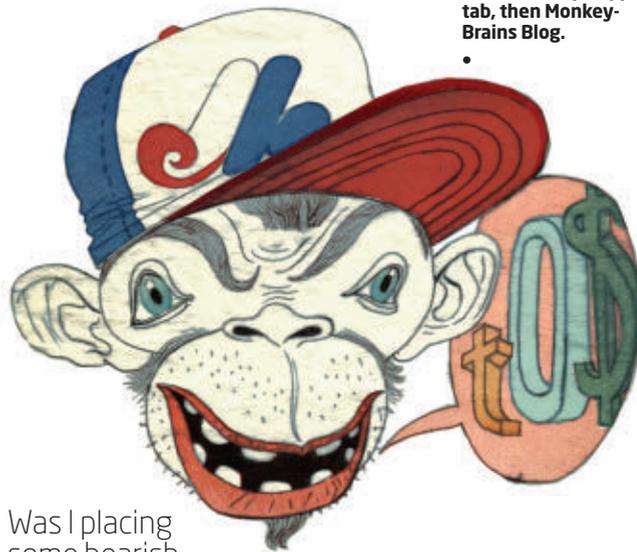
Sure, it looks a little suspicious, especially after some of these institutions racked up record profits this year. But hey, if they can help you get a penny better on a fill, even for only 100 shares, it’s a benefit. If it adds ultra-short-term volatility because institutions are front-running each other, it’s bad. Bottom line: If you’re holding your stock for anything longer than, say, a day, I think other factors even more beyond your control will be pushing that stock price around. Don’t blame flash orders for all your losing trades.

Q: Hey, Monkey! Do you ever dream, as I do, of someday being a real, live boy?

A: Um, no. I’m happy with real, live quotes.

Q: Hey, Monkey! Some rally, huh? How’s it feel being a contrarian bear now? Huh? Huh?

A: Was I placing some bearish bias bets when the market was rallying? Sure. Did I lose money on them? Absolutely. Would I do anything different? No. Why? Because there’s nothing that said at the beginning of July that the market was going to continue to rally and not slam back to the lows it made in March. At best, you might make an educated guess. I had a hunch that the market might not keep going up, and I put on some bearish bias trades that met my risk and probability criteria. Did I lose some money? Yes. Everything? No. As a trader, you have a game plan and you execute that game plan. You might not win every game, but hopefully you have enough winners to make a career of it. If you bought on every low of 2009, good for you. Now get back to polishing your crystal ball.

Q: Hey, Monkey! Why don’t I just sell straddles ahead of every single earnings announcement and capture all that nice fat premium?

Was I placing some bearish bias bets when the market was rallying? Sure. Did I lose money on them? Absolutely. Would I do anything different? No.

• *No primates were harmed in the production of this article. The information contained in this article is not intended to be investment advice and is for illustrative purposes only.*

A: You know in *Braveheart* when Mel Gibson was channeling Henry V and told his troops that they could retreat, but if they survived, they’d look back and want that one chance again to fight the Brits? Options are fairly priced. The world already knows that the earnings are coming out, and the straddles are fat (or not) for a reason. Even though most of the time the stock might not move much on the news, all it takes is one huge price change to cause massive losses on a short straddle. Trading isn’t for heroes. Even Mel was drawn and quartered by the end of the movie. Don’t be one of those broke, erst-



For more Monkey business, daily market wraps, and trading ideas, visit the **MonkeyBrains blog** at thinkorswim.com. Select the top Support tab, then **MonkeyBrains Blog**.

while traders who lies on his deathbed wishing for one chance, just one more chance to hedge that position!

Q: Land sakes, Monkey! You’ll catch your death trading naked like that!

A: For your information, granny, I don’t live in a zoo. The lambskin pants I’m wearing right now probably cost more than the PC you’re trading on. And I look damn good in them. A little Gold Bond powder and I can wear them comfortably from the opening bell to the closing night cap. If you have the right physique, I highly recommend a pair.

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Strategy

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Photograph by
Fredrik Brodén

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thinkorswim.com

So, You Wanna be a Trader

IT'S BEEN SAID THAT THE BEST WAY TO LEARN TO SKI IS TO LEARN HOW TO FALL FIRST. THE SAME THING COULD BE SAID OF TRADING OPTIONS. UNTIL YOU EXPERIENCE THE THRILL OF THE HILL, YOU'RE MISSING OUT ON OVERCOMING A NEW TRADER'S GREATEST OBSTACLE—MIND OVER MATTER. BUT PAPER TRADING DOES HAVE ITS PLACE, EVEN FOR THE PROS. • Words by **MARK AMBROSE**



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Strategy

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CLICK. CLICK. BING! SOLD -100 SPY DEC 105 CALLS @.30. WAIT, I ONLY WANTED TO SELL 1. I SOLD 100! WHAT DO I DO?! WHAT DO I DO?!

Take a deep breath. It's only paperMoney®.

No one emerges from the womb a full-blown options trader. There's a learning curve involved: Long. Short. Vertical. Calendar. Volatility. Theta. Put. Call. Risk. It can be pretty steep, especially if you're excited and want to start trading effectively, quickly. We know that. We were there, too.

Even though I cut my teeth on the trading floor, the mistakes were sometimes similar. You think I haven't done a trade, looked to hedge my delta risk, turned around to my futures clerk, and sold 10 instead of 1? And then watched bond futures rally 20 ticks against me? Yup. Been there, done that. With no "reset" button, I learned really fast not to make that type of mistake again. Chalk it up as "tuition."

But fast-forward 15 years, open up the thinkorswim platform, and see all the flashing numbers and buttons to click, and you are a bit taken aback. I'll be the first to admit that the TOS software is dense with functionality. But if you're a beginner, you want to test out how to create orders, use the analytical tools, and generally kick the tires without accidentally routing that 100 lot of short calls. That's why we created paperMoney. It's the TOS paper trading platform, and it's identical in every way to the live trading platform except for two things. First, the trades and the money are fake. Second, you can reset or adjust your positions and cash at any time on paperMoney.

PaperMoney is great, but it's not real trading. So, if you're stuck on the "paper route," and don't know how to get off, read on.

It Ain't the Real Thing, Baby

Like any tool, paperMoney has its uses, but it also has some limitations. It can teach you how to use the TOS platform, but it won't teach you how to trade. Why?

First, execution prices in paperMoney are not the same as in live trading. For one thing, the quotes are delayed by 20 minutes. Also, by default, paperMoney will fill an order at the mid-price of the stock, option, or spread. The mid-price is the average of the bid/ask prices. It's possible to get filled at the mid-price in live trading, especially for actively traded stocks and options that trade in penny increments (for a live view of those options, check out the public Watch Lists). But that doesn't happen all the time, or even a majority of the time. The only way to learn about actual execution prices is to execute actual trades.

The second limitation is more psychological, but ultimately, more important. With paperMoney, there's no referee. The score isn't real. Sitting by yourself at home, it's all too tempting to hit that "Reset Cash and Positions" button to set your paperMoney account back to square one, convinced that if you were trading with real money, you would never have done those trades. It can be very difficult to be completely honest with paperMoney. Would you really have been as brave riding those short at-the-money options into expiration with real money? Would

you really have let the profit run on that position with such huge paperMoney risk, or would you really have hung on to that loser until it turned profitable? A major challenge of trading is commanding your emotions and feelings about making and losing money. You won't learn how to do that until you risk real money on real trades, and see how you actually feel and respond. Until then, you're not a trader, no matter how well you think you understand the markets and products.

Why Paper Trade (Even if You're a Pro)?

Aside from the obvious benefits to the total novice, what does an old pro have to gain by using paperMoney?

1. LEARN THE LAY OF THE LAND

On thinkorswim, there are more than 20 different types of orders, from trailing stop limits to submitting orders based on a set of complex conditions. Each type has pros and

A MAJOR CHALLENGE OF TRADING IS COMMANDING YOUR EMOTIONS AND FEELINGS ABOUT MAKING AND LOSING MONEY. YOU WON'T KNOW HOW TO DO THAT UNTIL YOU RISK REAL MONEY ON REAL TRADES.



cons, and may or may not be a useful part of your trading strategy. But to learn how each one works, it's useful to experiment without risking real money on real trades. PaperMoney lets you set up different types of stock, option, futures, and FX (foreign exchange) orders to see how and when they are executed without worrying about slippery fingers or a sticky mouse.

2. STRESS TEST YOUR PORTFOLIO

One of the more powerful uses of paperMoney is that it lets you import or create positions from other accounts to see the total risk of your portfolio in aggregate. The beta-weighting tool, which is unique to the thinkorswim platform, takes your stocks, options, and mutual funds positions and combines their risk into that of a single index, such as the S&P 500, NASDAQ 100, or Russell 2000. It allows you to see if any single position represents a disproportionate amount of risk in your portfolio, or whether your entire portfolio is too risky for your liking. Then, because it's paperMoney, you can add simulated trades to see how much they might reduce the risk of your portfolio. Using stocks, index futures, or options can provide different levels of risk reduction, and you can learn a lot by experimenting in paperMoney.

3. NAVIGATE MARGIN RULES

A third benefit is that paperMoney allows you to enter in complex option and stock positions and see how much capital they require. The margining rules can seem arcane at first, especially if you have overlapping option trades. If your trading strategy is based on layering multiple positions, it's valuable to know how your trading capital is reduced or increased with each one. Experienced traders know how to use capital efficiently, and you can learn this in paperMoney without any risk.

Are You Trader Enough?

So, back to the would-be trader. How do you transition from paper trading to real trading?

The main thing is to start slow and small. Two mistakes that new traders often make are overtrading and undertrading. It's my opinion that it's easier to cure overtrading; you just have to rein in your enthusiasm. That can happen if you hit a losing streak, or if you check your year-to-date commissions and see that they could have been a down payment on a house. The lesson? Slow down. There will be plenty of trades tomorrow.

But if you're undertrading, you have to battle all sorts of demons about losing money, fear of failure, and uncertainty about whether you're cut out for this trading thing at all. To be a trader, you have to get over it. It's as simple (or hard) as that. Start by trading small positions with defined risk. That means you know approximately what your maximum risk in the trade is going to be in the worst-case scenario before you put the trade on, and if that terrible scenario happens, your finances can handle it. You can learn how to calculate the maximum risk of your positions by attending our free classes, participating in online training, or calling the experienced traders on our support desk. In fact, we have a whole educational division with live and archived resources that can help you get started.

That's doable.

Next, you have to pull the proverbial trigger and send the order. If you have those "trading jitters" that prevent you from clicking the Send button, call our trade desk for help. There are no extra charges to do so. A live broker can route that order for you in your account. But at some point, you have to do it yourself (this is online trading, after all). And it's much faster to trade directly on the platform than to call the trade desk.

One tip to try is to enter a limit order that can't be filled. Want to sell a put vertical whose mid-price is 0.45? Enter an order at 0.55 limit. It probably won't fill unless the stock drops suddenly. Look! You're working a live order! Not so bad, right? Now cancel it. Whew. The sky didn't fall, and your dog still loves you. Now put it in again at 0.45—right at the mid- or theoretical price. You might get filled there, but you might not. If you do get filled at the mid-price, congratulate yourself on a good fill! You don't know whether the trade will make money or not, but you know that you have reduced your execution costs by limiting your slippage. If you're not filled at 0.45, cancel it and take the limit price down to 0.44 (assuming that you've made a choice to trade options that have penny trading increments). Are you filled yet? No? Then cancel it. You don't need to "chase" an order to get filled at this point. You're just starting out, and you want to learn good habits. But whether you get filled or not, keep doing this once or twice a day. Some days you'll fill a trade; others, you might not. As you begin to get the small (1 or 2 contracts) orders filled, keep an eye on the total risk of all your positions so you'll know when to stop until some of those positions are closed.

Once you've racked up a few wins (hopefully) and losses (all but certain) with real money, you will have learned a lot more about trading than you ever would paper trading. PaperMoney has its place, like Little League. Use it to take a few practice swings, but eventually, you'll have to step up to the plate with a live account if you want to be a trader.

- *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting us at support@thinkorswim.com or 600 W. Chicago Ave., Suite 100, Chicago, IL 60610.*



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Analysis
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Photograph by
Fredrik Brodén
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LOOKING
FOR
THE
OTHER

SHOE

DESPITE BULLISH PUNDITS CALLING THE "STIMULUS" A STAVING OFF OF FINANCIAL ARMAGEDDON, UNANSWERED QUESTIONS LOOM ABOUT THE HEALTH OF THE RECOVERY AS INFLATION RISK REARS ITS UGLY HEAD. WHAT'S AN INVESTOR TO DO IF THE OTHER SHOE DROPS? ACT MORE LIKE A TRADER.

words by **Matt Blackman**



Wanna start trading interest rate futures? Then you need a futures account. For more info, go to thinkorswim.com. Select Why thinkorswim > Order Types and Products. In the submenu at the top, select Futures and read on. Or call our Help Desk at 866-839-1100.



Having a sense of humor is not normally considered a requisite skill for Congress, but any politician who appears on late-night comedy TV must have something going for him in the wit department.

Barney Frank, Chairman of the House Financial Services Committee and stalwart member of the Nancy Pelosi gang on Capitol Hill, took the plunge when he appeared on *The Daily Show with Jon Stewart*. When asked by Stewart if he thought the multi-trillion-dollar stimulus would work, Frank adroitly skirted the question with an admission that the “message experts in Washington” had asked politicians not to use the word “stimulus” but to replace it with the word “recovery” when discussing various programs. Frank quickly added that he didn’t agree with that strategy because he thought ... (wait for it) ... “people would rather be stimulated than recovered.” Badda bing, badda boom!

But by the end of the interview, other than offering a terse “yes, I think it will,” he still hadn’t explained exactly how the trillions in stimulus programs would repair the economy. He also avoided discussing the impact trillions in added debt and higher taxes would have on a recovery.

Frank isn’t the first politician to play bailout detail avoidance, but fortunately, there are a number of credible estimates of the massive tab. In July, CNNMoney.com put

the total costs at \$10.5 trillion, while Bloomberg News estimated the total to be \$12.8 trillion. But these pale in comparison to an estimate by Neil Barofsky.

And Barofsky should know. Appointed as the Troubled Asset Relief Program (TARP) Inspector General, his job is to total the cost of “50 or so” government and Federal Reserve stimulus programs. By July, the total potential taxpayer liability, assuming the worst-case scenario, was a mind-boggling \$23.7 trillion.

DO THE MATH

The amount committed to by the government and the Fed is enormous by any measure. As one angry Republican member of the House Committee on Oversight and Government Reform quoted by the *Wall Street Journal* said upon hearing Barofsky’s report, “If you spent a million dollars a day going back to the birth of Christ, that wouldn’t even come close to just \$1 trillion—\$23.7 trillion is a staggering figure.”

But it is only part of the picture. As of mid-2009, government debt was \$1.5 trillion, which represents just 22% of \$52.94 trillion in total credit market debt as of Q1 2009 owed at all levels of our economy, according to the Federal Reserve. This works out to 375% of Q1 ‘09 U.S.

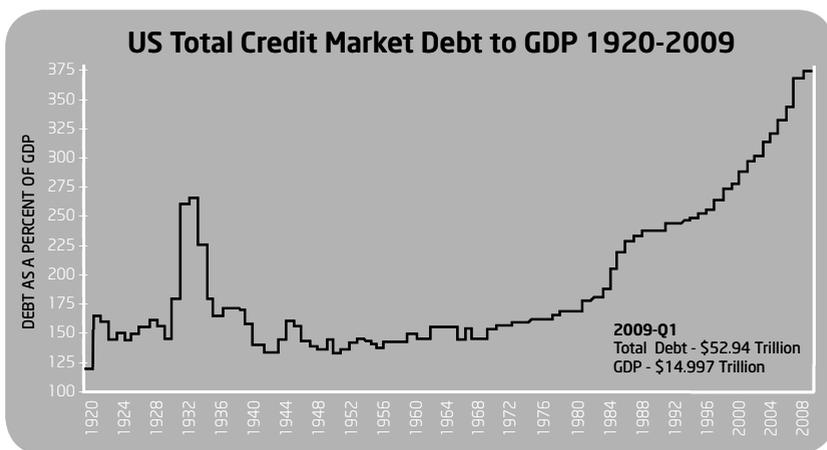


FIGURE 1: Annual chart of U.S. total credit market debt from 1920 to mid-2009. Data sources: Gabelli Mathers Funds and the U.S. Federal Reserve.

gross domestic product (GDP), or more than \$180,000 for every man, woman, and child in the country. This figure does not include the majority of recovery costs contained in Barofsky’s report. Total credit market debt has grown 35% faster than the economy since 2000.

Put simply, we are living beyond our means at a rapidly increasing rate.

With the U.S. having gone from the world’s banker to the globe’s largest consumer and debtor in just 30 years, we’ve created enormous challenges for our financial system. Top it off with the skyrocketing costs of Social Security and Medicare/Medicaid added to the liability ledger and ... well, you get the picture. Put it all together and you have a situation that is clearly unsustainable.

So how do you protect yourself in this challenging new financial environment? Consider taking a page from a trader’s handbook. But first, it is important to identify the specific challenges we face.

Reading the Future with Futures

• If you want to trade rates, Treasury futures products offer direct exposure. Thirty-year bond (ZB) and ten-year note (ZN) futures are for the long end of the term structure, and five-year note (ZF), two-year note (ZT) and 30-day Fed Funds (ZQ) are for the short end of US rates. Eurodollar (ZGE) and LIBOR (ZGLB) futures are also available. Most of them have options, so you can use the same defined-risk, positive time decay strategies that you might use for equity and index option trading. These products are also sensitive to government data and economic reports, so even if you don't trade them, watching them around an unemployment number, for example, can give you an indication of how the market interprets the information. Treasury futures trading opens an hour before stocks do, and news that spooks or heartens the bonds can transfer directly into S&P futures.

To trade futures, you have to apply for futures approval for your margin or IRA account. For more information, and to see the margin requirements, tick values and trading hours for futures, follow the path at thinkorswim.com > Whythinkorswim > Order Types and Products.

HYPERINFLATION—THE ULTIMATE BUBBLE?

Over the last three decades, governments have found creative ways to maintain our profligate spending ways and provide the improving standard of living we voters have demanded. But that luxury has come at tremendous cost. Compare the buying power of a dollar in 1970 to what it is today, and it's clear that inflation is a powerful government tool.

According to the official Consumer Price Index (CPI) published by the Bureau of Labor Statistics, today's dollar purchases \$0.18 worth of the goods that a dollar bought in 1970. That's a devaluation of nearly 82% (see Figure 2).

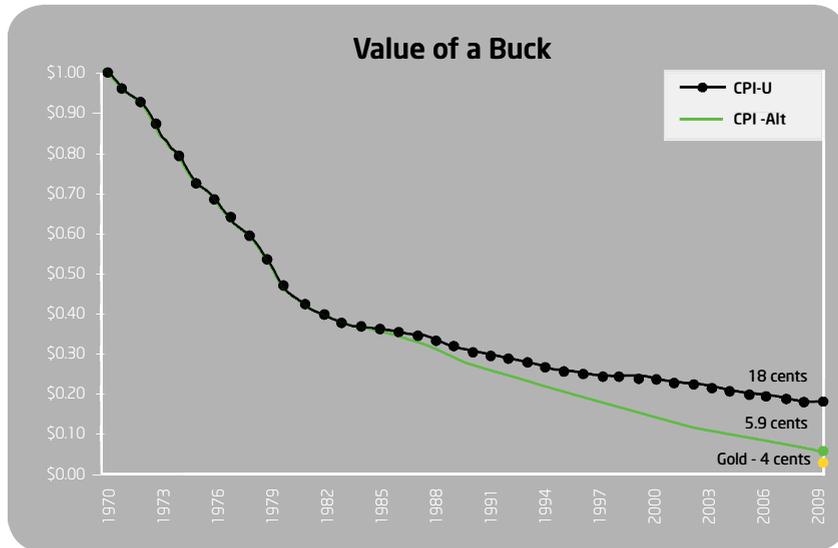


FIGURE 2: Three different estimates for the real value of the U.S. dollar. The highest estimate (black) is based on the official consumer price index (CPI) published by the Bureau of Labor Statistics. The second is CPI calculated with the statistical changes to the metric post-1982 by ShadowStats.com. And the last (and lowest) estimate of the current value of the U.S. dollar (green) was derived by calculating the difference in the price of gold in 1970 versus the average 2009 gold fixed price to mid-July.

Data sources: Federal Reserve, ShadowStats.com, and London Fixed Gold Price.

But that estimate is actually very conservative thanks to the many modifications to CPI since 1982, which have made inflation appear lower than it really is. If we calculate CPI as it was pre-1982 (which is necessary when comparing historical data), a 2009 dollar is worth \$0.06. That works out to a real dollar devaluation of 94% over the last four decades.

Having a hard time believing that figure? Let's forget about government stats for a moment and go back to the original measure of money. In 1970, an ounce of gold averaged \$35.94/oz (London fixed metal price). In the first six months of 2009, the same ounce of gold averaged \$916.91. In 1970, \$100 purchased 2.78 ounces of gold. Today, it will buy you 0.109 ounces. That works out to a dollar devaluation of 96%, making your 2009 dollar worth a little less than 4 cents from 1970.

What does this mean for those of us who want to protect ourselves financially? First, anyone who tells you that inflation is not a threat is ignoring financial history as well as the current reality. Since 1970, inflation has eroded dollar buying power every single year up to 2008, according to the official CPI. And now that indicator says defla-

tion has become the new reality in 2009? Can anyone really buy that argument, especially when you consider the massive debt levels and trillions in stimulus funds being pumped into our economy?

Any investment or trading strategy that does not address an inflation threat is risky for three simple reasons.

By 2007, total U.S. government debt obligations—including Social Security, Medicare, and so on—exceeded \$60 trillion. That number has grown significantly since then. This represents more than three times the debt obligations of all other industrialized governments in the world combined, according to ShadowStats.com. As the nation with the largest debt, we rely on foreigners to finance it for us—they were responsible for more than 80% of net U.S. Treasury purchases in 2007, according to the Federal Reserve. At some point in the not-too-distant future, foreigners will either tire of financing us or will not have enough money to keep up with demand. Is it any wonder foreigners are beginning to lose interest? Yields for the benchmark 10-year

Treasuries lost 4.5% in value during the first half of 2009 for their worst performance in 30 years, according to Bloomberg.

"The fall in international [U.S. Treasury] demand reinforces the fact that based on our massive borrowing needs we are very vulnerable," said Mark MacQueen, partner and portfolio manager at Sage Advisory Services Ltd., in a July 18 Bloomberg article entitled "Treasuries Fall for First Time in Six Weeks." Not only are Treasury investors losing money on a nominal basis, but the current yield is nearly 2.5% below the real rate of inflation—not a situation that will sit well with investors for long.

In the absence of a fiscal miracle of biblical proportions, it will be virtually impossible to pay back the debt we now owe in the absence of significant inflation. Rising inflation results in rising interest rates, which will negatively affect most equities, bonds, real estate, and the

Analysis

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economy. Inflation is also more politically popular than deflation, which would mean having to pay back debt accumulated in inflationary times with fewer available (more valuable) dollars. Ben Bernanke promised that deflation would not occur on his watch, and he (with lots of help from the U.S. government) appears intent on keeping this promise.

Every dynasty or civilization that has utilized fiat paper money (currency not backed by physical gold or silver) since it was first introduced in China in 1024 has experienced hyperinflation and economic chaos, according to Ralph Foster, author of *Fiat Paper Money: The History and Evolution of Our Currency*. Since August 15, 1971, when Richard Nixon announced that the dollar would no longer be redeemable for gold, the greenback (and the currencies of every other nation that has taken similar steps) has by definition been a fiat paper currency backed by nothing more than a government's promise to pay. By year-end 1979, just eight years after being removed from the gold standard, the buying power of the dollar had been cut in half—in a trend that continues. Will we be any different from every other civilization that has adopted a fiat currency? Maybe, but don't count on it.

THREE-STEP PLUMMET PROTECTION PLAN

Given the rapid increase in debt levels, along with the clear and present dangers that lie ahead, many asset classes will be hurt and a few will profit as inflation infiltrates our economy. But the market will act like a bouncing ball. Initially inflation will buoy stocks, but then as interest rates rise and the cost of money increases to offset the inflation risk, stocks, bonds, and the economy in general will begin to struggle. The rallies we have seen since March 6 are a good example of this—investors believe that inflation risk is muted and are buying stocks to profit in an economy that they believe is improving. But at the first hint of rising interest rates, this trend could reverse, and quickly.

Here are three steps to help hedge the impact on your portfolios.

1 As long as interest rates remain low, equities should continue to perform well. Low interest rates and a weak dollar favor multinational companies that earn income in stronger foreign currencies; these should continue to do well as long as the global economic recovery continues (think conglomerates in the consumer goods and technology, for example). In a stable interest rate environment, U.S. Treasuries and government bonds have limited upside potential and will encounter headwinds at the first hint of rising rates, since yields and bonds move inversely to each other.

2 At the first sign of rising rates, inverse treasury funds issues (ETFs) that move opposite of Treasuries will begin to move higher. This is one way to offset both inflation and rising interest rate risk. Inverse stock funds such as

the ProShares UltraShort S&P500 ETF (SDS) and ProShares Short Dow ETF (DOG) move inversely to the general stock market and are optionable. However, they don't track dollar for dollar, and so it's important to understand the risks and how to use these ETFs effectively (see "Capiche," page 40, in this issue). An alternative to bond ETFs, of course, is to trade bond futures and options directly. You can do this in a TOS account, including IRAs (see sidebar, page 31). These are just a few examples of issues you can buy to take advantage of drops in the stock or bond market.

3 Depending on how quickly investor sentiment deteriorates, other ETFs that track metals like gold and silver would be good initial steps to help offset inflation and dollar devaluation risk. However, in a worst-case scenario, many investors opt for the outright purchase of physical silver and/or gold, as this removes the risk of fund managers going under and the value of the fund plummeting. Again, this is an unlikely event and designed as a hedge only. The key here is that diversification between different asset classes offered by different fund or ETF managers helps mitigate the risk of loss due to bankruptcy or insolvency.

It is important to point out that this list is by no means complete. The important takeaway is that inflation risk is real, and traders who have an inflation contingency plan will be in a far better position to weather the storm. Given the evidence, the chances that inflation will remain tame for the next few years should be considered slim indeed. But rather than wait for the other shoe to drop, you might want to check your laces.

The risk of loss in trading securities, options, futures, and forex can be substantial. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. See the Options Disclosure Document: Characteristics and Risks of Standardized Options. A copy can be requested via email at support@thinkorswim.com or via mail to 600 W. Chicago Ave., Ste. 100, Chicago, IL 60654-2597. Trading foreign exchange on margin carries a high level of risk, as well as its own unique risk factors. Please read Forex Risk Disclosure (available at <http://www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf>) before considering trading this product. thinkorswim is compensated through a portion of the forex dealing spread. Funds deposited into an account with a broker-dealer for investment in any currency, or which are the proceeds of a currency position, or any currency in an account with a broker-dealer, are not protected by the Securities Investor Protection Corporation (SIPC).

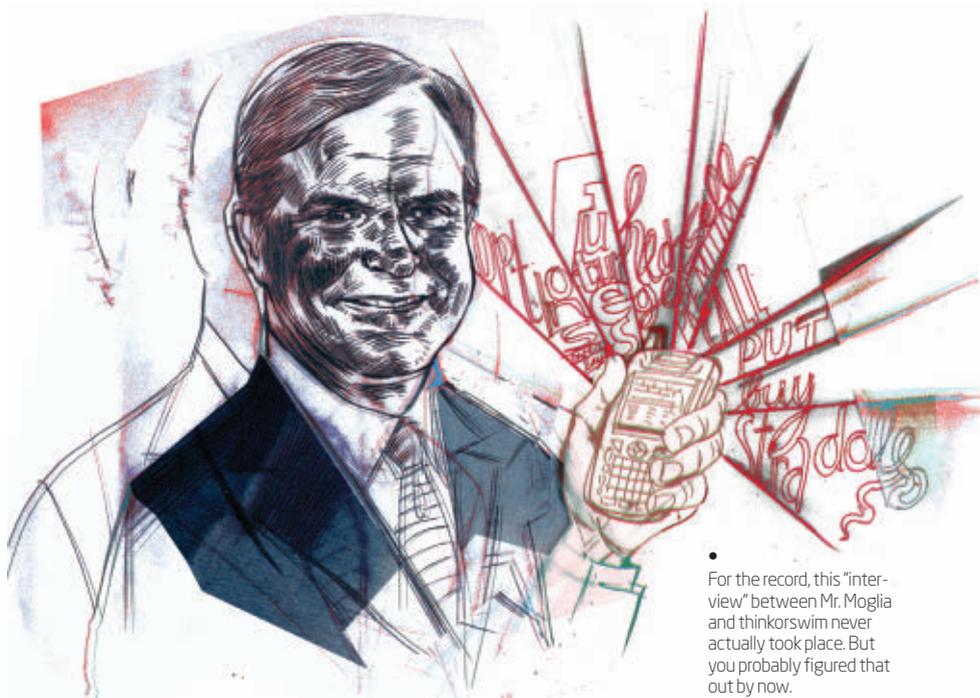
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Lunch with...

Joe Moglia (Chairman Turned Market Junkie)

(Not necessarily) a real interview
with a market VIP

Illustration by **Evonrude**



For the record, this "interview" between Mr. Moglia and thinkorswim never actually took place. But you probably figured that out by now.

Q + A:

TOS: It's great to be able to sit down with you since the acquisition.

JM: Oh, no problem. Mind if we switch seats?

TOS: Sure. You like to be able to watch the front door for wiseguys?

JM: Nah, but I need better reception. I'm in the middle of trading...YES, filled!!

TOS: Wow! You're trading online?

JM: You bet! When we bought TOS they gave me a login for the platforms. And I'm thinking, "Hey, I'm the Chairman of the Board. I'm not a trader. I'm an investor. But I'll toss 'em a bone and look at their stuff." So I log in one night and I'm watching the futures ticking, and I'm like, "I HAVE to get me some of this!!" This stuff is sweet.

TOS: Life-changing, eh?

JM: Yeah, kind of like when my brother nailed me in the head with a musk melon back in my Dad's fruit store. That's where I learned the value of a helmet.

TOS: Speaking of helmets, football seemed to be working out for you. Why did you leave to do the smile and dial at Merrill Lynch?

JM: Coaching in the Ivy League is a little like eating tofu. I mean, it's not like it's going to make you sick or anything, and it kind of fills you up, but it's not real food.

TOS: So you conquer the corporate world, but when Nebraska football calls, you pick up.

JM: Absolutely! There was no way I was going to let Buffett get the life coach job. And he wanted it bad. But you have to get up pretty early in the morning to beat Joe Moglia!

TOS: I have to ask, is this trading stuff taking attention away from being Chairman of the Board?

JM: I trade around a core position. I hedge a little here. Sell a little premium there. I just don't schedule anything around a number. And if the market gets crazy and I'm not at my screen, I muscle my way through the board meeting and get back to trading. Let's just say I've become very efficient at working with others.

TOS: And you say you just started trading options?

JM: My whole career I was a stock and bond guy. And six expirations ago, I didn't know a vertical from a window blind. Now, I have option overlays on all my long-term positions and I'm hedging the whole thing with SPUs... hang on ... [on phone] Get me a new market on that calendar from this morning ... Yes, it is more than 10!

TOS: Sounds like you're trading a lot. Are they giving you a break on commissions?

JM: They still have me on the rack commission rate.

TOS: Really? No employee discount?

JM: Are you kidding me? They're using my commissions for new servers to handle the order flow.

TOS: At least you got the monkey, right?

JM: Yeah. The dog got it, though. Hang on, it's the wife. [on phone] Yes, of course I'm watching them! The straddle's jacked because of the number! I know! I get it! But look at the theta! Goodbye!!

TOS: Tension at home?

JM: Last time I open a joint trading account!
TOS: So, you did the football thing, the gig as CEO, now you're trading. What's the next step?

JM: I'll be trading until I die. I just need one finger functional to click the mouse. I'll just have a nurse give me the quotes and keep the tubes hooked up.

TOS: Sounds like it could get expensive.

JM: Nah, I can call in a few favors in the 'hood and get one cheap.

TOS: Speaking of favors, my brother's having trouble with the Alderman's office. Do you suppose you could...

JM: Get outta here!

TOS: Sorry, Joe. I guess we should wrap this up.

JM: Yeah, I gotta take some stuff off in the bonds before they close ... [on phone] Hey! Where's the Nov 14/17 strangle? Size!!

Special Focus:
Greeks

Photograph by
Fredrik Brodén

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WHEN

ALTHOUGH
GREEKS ARE A
GREAT TOOL TO USE
TO DETERMINE
FUTURE PRICES OF
AN OPTION,
BLIND FAITH
CAN LEAD TO A
CASE OF MISTAKEN
IDENTITY.

words by
Thomas Preston

FAIL



**Special Focus:
Greeks**Photograph by
Fredrik Brodén

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Want more on when to ignore the greeks? Go to the chat archives at thinkorswim.com, then Support > Option School > Chat Archives. Type in "greeks" and you'll be right there.

FOCUS:

grk

"TIMEO DANAOS ET DONA FERENTES..."

While you might not think that this line from Virgil—spoken by a Trojan priest who was suspicious of a wooden horse offered up by the Greeks—is particularly relevant to option trading, the "greeks," as the various metrics of option price sensitivities are known, can seem like the best gift a trader ever had—until that trader accepts them blindly and gets slaughtered.

The gift of the modern greeks (named after Greek letters, except for vega) is a set of numbers that at a glance can tell you both the risk of a position as well as how the price of an option might be changing. Delta tells you how much a position can make or lose if the stock goes up or down \$1.00. Gamma tells you how much your delta will change if the stock goes up or down \$1.00. Theta tells you how much one day passing will change the value of the position. Vega tells you how much your position might make or lose if volatility goes up or down 1%. And rho tells you how much your position might make or lose if interest rates go up or down 1%.

What are they good for? While you might know that a long call is supposed to rise in value when the underlying stock goes up, you'll find that it doesn't always happen. That's when understanding the greeks—theta and vega in particular—can help you see why the call dropped in value despite the rally in the stock.

But focusing too much on the greeks can mean you're missing the forest for the trees. All positive delta positions aren't created equal. The long call and short put may both have positive deltas, but the long call has a maximum risk equal to its price, while the short put has a max loss equal to the strike price minus the put's price. And that's why it's important to understand what greeks can't do for you.

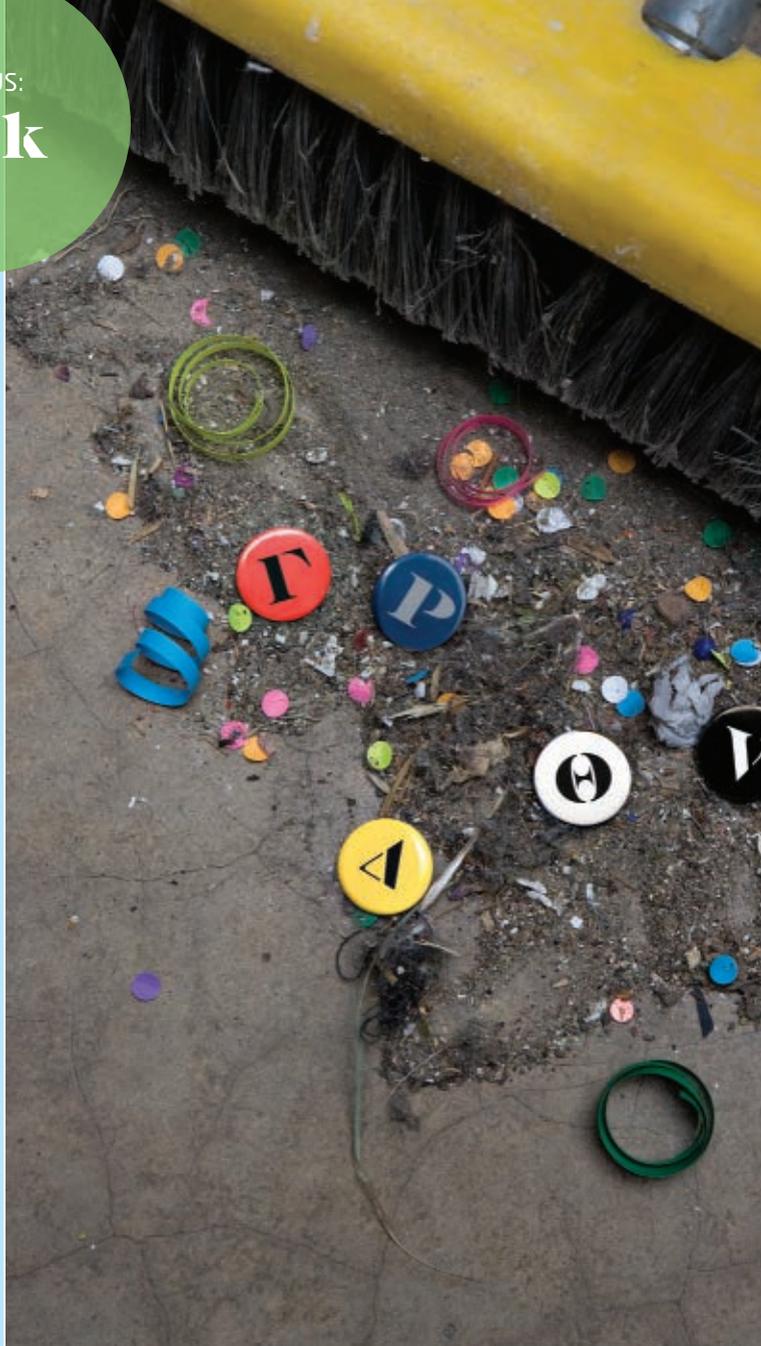
Keep in mind, we're not bashing the greeks. Quite the opposite, actually. We wouldn't have made them available to you with real-time values right in the middle of the TOS platform if we didn't feel that they had some value. But it's critical that you understand when to use them—and when not to.

What Greeks are Not

One of the mistakes new traders sometimes make is thinking that greeks somehow make up an option's price. They don't. If an option is a derivative, think of the greeks as a derivative of the derivative. They're not used

to calculate what an option's price is, but to estimate what it *might become* as the stock price changes, time passes, or volatility or interest rates change. You can "stress test" an option or position with greeks. What will happen if volatility changes? Check your vega. What will happen when one day passes? Check your theta. What will happen if the underlying stock or index moves up \$1.00? Check your delta. How about \$2.00? Check the delta and gamma.

But the phrase you'll hear over and over again is, "all other things being equal." Delta can estimate how much the option's price will change if the stock moves up \$1.00—as long as time doesn't pass, and volatility and interest rates don't change. That's nice for a textbook, but useless in real trading. Everything's moving all the



Option Greeks 101

Delta: The rate of change in an option's value for each \$1 move in the underlying. In the TOS platform, delta is written as a decimal, so that 0.50 equals 50 deltas, which is equal to \$50 per \$1 move in the underlying. An option's delta ranges between zero and 100. Long calls and short puts have positive (+) deltas, whereas long puts and short calls have negative (-) deltas.

Gamma: The change in delta per \$1 move in the underlying. Gamma is highest for at-the-money options (those at the same strike as the underlying's price), and approaches zero as the option moves further in or out of the money.

Theta: The rate of change in an option's value as each calendar day passes. Positive theta refers to option positions that gain in value as time passes, whereas negative theta refers to positions that decay as time passes.

Vega: The rate of change in an option's value for each 1% change in its implied volatility.

Rho: The rate of change in an option's value for each 1% change in interest rates (referred to as the risk-free rate of return). This number's impact becomes more significant the farther out in time an option expires.

FOR SOME REAL FUN
see page 39 for the long-hand greek formulas.

time. And you have to make a trading decision in that environment. Fun, huh?

When More is Less

Consider the net delta of two different long SPY call positions. With the SPY at 100 and 45 days to expiration, the 100 calls are worth \$3.25 and have a delta of 0.52 and a gamma of 0.05. The 105 calls are worth \$1.20 and have a delta of 0.26 and a gamma of 0.04. If you buy 5 of the 100 calls, you'll have 260 positive deltas. And if you buy 10 of the 105 calls, you'll still have 260 positive deltas. In fact, you'll spend a total of \$1,625 for the 5,100 calls, and \$1,200 for 10 of the 105 calls. You get the same delta exposure (positive 260) for less money with the 105 calls. That's a better trade, right? Well, not necessarily.

Let's say the SPY drops \$2.00 to \$98, volatility moves up 1%, and one day passes. The 100 calls are now worth \$2.45, and 5 of them would have lost \$400. The 105 calls are now worth \$0.77, and 10 of them would have lost \$430. Hmm... larger loss in a big one-day move, and higher commissions. What's the upside of those out-of-the-money calls again?

While the maximum loss on the 10 long 105 calls is lower (\$1,200) than on the 5 long 100 calls (\$1,625), that's at expiration, when gamma, theta, and vega

don't matter anymore. But before expiration, it's all up for grabs. In this case, the 10 long 105 calls had higher gamma and higher time decay than the 5 long 100 calls. The higher gamma was good because it reduced the delta of the position faster when the SPY dropped. But with higher gamma comes higher theta, and that steadily whittles down the value of an option. Also, the vega of the 100 calls was higher, and so the increase in volatility benefited them more than the 105 calls.

If you're having a hard time understanding all this, think of it this way. The 10 long 105 calls have a much higher profit potential than the 5 long 100 calls if the SPY goes to, say, \$120. If the out-of-the-money calls make more money

EVEN IF YOU'RE GOOD AT USING THE GREEKS TO ESTIMATE HOW CHANGES IN THE MARKET AFFECT YOUR POSITIONS, THERE ARE TIMES WHEN THE GREEKS CAN BE MISLEADING—EVEN WHEN THEY ARE MATHEMATICALLY CORRECT.

quickly when the SPY goes up, it stands to reason that they'd lose money more quickly when the SPY drops. That's not to say that one trade is better or worse than the other. But it does mean you need to understand the risks as a whole. In exchange for the larger potential reward of the 10 long 105 calls, there is additional risk that isn't readily apparent if all you do is look at delta. If you're going to look at one greek, you have to look at them all.

No Greeks Allowed

Even if you're good at using the greeks to estimate how changes in the market affect your positions, there are times when the greeks can be misleading—even when they are mathematically correct:

NEAR EXPIRATION

One of the biggest problems is the delta of your position as it approaches expiration, particularly if you have a lot of contracts in out-of-the-money options. Even though the option is basically worthless, 0.00 bid/0.05 ask, it still has a delta. And even though that delta might be small for one option, it can get significant if you have 100. That can lead to over-hedging if you are trying to get your position delta close to zero, or if you're thinking that you have more deltas than you actually do. While the delta of those out-of-the-money expiring options is theoretically correct, a SPY call option that is 5 points out of the money on expiration will not really budge from 0.00 bid/0.05 ask if the SPY moves up 1.00 point. Those calls are generating deltas that don't really indicate the risk involved. They won't get any cheaper if the SPY moves down 1.00 point. So, if you're looking at those calls as a hedge against a short delta position, you should probably look for another hedge.

The flip side is when you are short a lot of out-of-the-money options that may be generating a delta that seems small. The problem is, that small delta tells you nothing about the risk of the position. Last fall during the Crash, those cheap out-of-the-money puts that had very little delta turned into big, fat puts that were near the money. A lot of money was lost because traders ignored the real risk in favor of looking at the greeks.

HARD TO BORROW

The greeks can also be misleading when there is a corporate action, like a special dividend or merger, or when the stock is hard to borrow, meaning it's very difficult for traders to short. In this scenario, the greeks calculated off of the current stock price are misleading because they don't accurately reflect the impact of the corporate action. The puts on a hard-to-borrow stock may look

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Greeks Focus

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very expensive, but have a low delta. That's because the current stock price is relatively high compared to the synthetic stock price. And if the current stock price is higher, the delta of the put is lower, even though its price seems to move as if it's in the money. The harder a stock is to borrow in order to short, the bigger the discrepancy between the delta of the put and the way its price moves.

This is by no means an exhaustive list, but it should get you thinking about whether you rely too much on greeks in your trading. Don't abandon them, but remember that a good trader considers all the possibilities. Understand the potential losses of your position as well as the greeks. Use each when it suits your purpose. Be aware of the situations in which your greeks need to get kicked to the curb, and use your trading know-how to figure out your real risk exposure.

And by the way, Laocoön, the priest that gave the warning, was devoured by a pro-Greek sea serpent moments after uttering his line. Sounds a little like trading—heh, heh...

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting us at support@thinkorswim.com or 600 W. Chicago Ave., Suite 100, Chicago, IL 60654-2597.

How to Greek like a Geek

Analyzing the greeks with TOS.



FIGURE 1: Analyzing the position greeks on a short call vertical.



FIGURES 2: Using the TOS Analyze feature to fast-forward a couple of weeks will teach you a lot about how greeks move as time passes.

grk

So, how did we figure out what the delta and other greeks for an option would be when the stock price, time, and volatility changed? The Analyze page, of course!

First, create a simulated trade on the Analyze page, then look in the Price Slices section. You'll see the current stock price in the middle, and the stock prices plus and minus 1.0% above and below. For simplicity, you can delete the plus and minus 1.0% slices by clicking on the blue dot on the left-hand side and choosing "Delete Slice" from the dropdown menu. The remaining slice will be for the current stock price, and it'll show

you the greeks from left to right for the position.

For the simulated trade, it's sometimes easiest to work with one contract. The greeks that you see will be "position greeks," which are the theoretical greek values multiplied by 100. For example, an option that has a theoretical delta of 0.06 and a gamma of 0.02 may show a position delta of 5.65 and gamma of 1.55 for one contract. Why? The position delta indicates the number of dollars you might make or lose if the stock price moves up or down 1.00 point, all other things being equal. Most clients want to see their deltas in terms of the number of dollars of risk, so we multiply the greeks by the dollars per point for the option. Typically, that's \$100 per point. The inter-

esting thing is that the position greeks will show you more of the true value because they go beyond just two decimal places. The delta of 0.06 is really just a rounded-up value of 0.0565, which the position delta reveals.

So, once you see your position greeks on the Analyze page, how do you test them? In the lower right-hand section of the Analyze page, look for the Date field and the small wrench icon. If you set that date to a day in the future, the theoretical model will change the value of the greeks accordingly. If you click on the wrench icon, that opens up fields where you can change the yield, volatility, and stock price that the model uses. Incidentally, the vol adjust field moves volatility up or down a number of vol points, not a percentage of volatility. For example, if vol is 20% and you make the vol adjust field +5%, the model will use a volatility of 25%, not 21% (20 * 1.05). The Greeks on the Analyze page use each option's implied vol as part of the calculation, so the vol adjust impacts each implied vol equally.

And if you really want to have some fun, go to the Risk Profile section of the Analyze page and look in the top middle section for the "P/L Open" dropdown menu. You can select to see graphs of any of the greeks of your position, which can have some pretty interesting shapes... Well, okay, maybe we've just been doing this too long!

For more on the definitions of the greeks and view their formulas, see "Greeks Focus Q&A," this page.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting us at support@thinkorswim.com or 600 W. Chicago Ave., Suite 100, Chicago, IL 60654-2597.

GREEKS FOCUS

Q + A:



Things you wanted to know about option greeks (but were afraid to ask).

Q:
What volatility do the models use to calculate the greeks?

A:
On the Trade page, each option's greeks are calculated with its own implied volatility.

Q:
Is theta based on calendar or trading days?

A:
Theta on TOS is per calendar day, 365 days per year (yes, leap year too!).

Q:
How does TOS treat dividends in the greeks?

A:
TOS uses a continuous yield dividend model.

Q:
Is delta the same as the probability of expiring?

A:
No. Even though traders sometimes use delta as a proxy for the probability that an option will expire in the money, theoretically it isn't correct. The formula for probability is different from delta, even though it uses the same inputs.

Q:
What does each option greek tell you and what are the formulas used to come up with them?

Delta (Δ) – The rate of change in the price of an option for each \$1 move in the underlying.

$$\Delta = \frac{\partial V}{\partial S}$$

Gamma (Γ) – The rate of change in delta for each \$1 move in the underlying.

$$\Gamma = \frac{\partial \Delta}{\partial S} = \frac{\partial^2 V}{\partial S^2}$$

Vega (typically written as the letter nu (ν) in the Greek alphabet) – The rate of change in the option for each 1% change in implied volatility.

$$\nu = \frac{\partial V}{\partial \sigma}$$

Theta (Θ) – The rate of change in the price of an option for each passing calendar day. Also known as time decay.

$$\Theta = - \frac{\partial V}{\partial \tau}$$

Rho (ρ) – The rate of change in the price of an option for each 1% move in interest rates (the risk-free rate of return).

SOURCE: WIKIPEDIA

$$\rho = \frac{\partial V}{\partial r}$$

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Capiche?

Lessons from a veteran floor trader

• OK, like most people, I'm not big on fine print. It seems like the lawyers who write this stuff are paid by the word. You know ... cell phone agreements, microwave instruction manuals, who needs them? You press some buttons and they work. Mostly.

But when a customer came up to me and asked me about his "inverse" ETF position, I had to tell him I'd get back to him after I did a little investigation. And what did I end up having to do? Read the fine print. Because although these inverse ETFs can be an interesting trade, if you don't understand the details of how they work, you might get an unpleasant surprise.

Now, the "inverse" ETFs are the ones that move opposite of the index they're tracking. They were built to try to create inverse movements to the indexes they mirror. In other words, they go up when their underlying index moves down. It's a little like dancing on the market's grave. Bad news for the index is good news for its inverse ETF. Because these instruments are traded as a stock, they can be used in trading accounts that prohibit the trading of short stock or options. But if you look at a daily year-to-date percentage chart of, say, DIA, which is the underlying index of the DOG (1x inverse) ETF and DXD (2x inverse) ETF, the percent that DOG and DXD are up isn't 1x or 2x the drop in DIA. Hmm ... Here's where the fine print gets important. If you read the contract specs of the inverse ETFs carefully, they don't move point for point down with every point up in the index. They move in the opposite daily *percent*. If DIA moves down 1% today, the inverse ETFs move up 1% (DOG) and 2% (DXD) today. No big deal, right? But the key is that the percentages are based on the price change of a single

Words by **Tony Battista**
Photograph by **Fredrik Brodén**

Inverse ETF'n

These clever toys might be good for short-term action, but don't forget to read the fine print.



Low Vol	Index	2x Inverse ETF
Start	\$100	\$100
Day 1: +1%	\$101	\$98
Day 2: -1%	\$99.99	\$99.60
Day 3: +2%	\$101.99	\$95.96

FIGURES 1 & 2: Tracking the rate of change over three days of high and low volatility in the inverse ETF on DIA, despite approximately the same change in DIA.

High Vol	Index	2x Inverse ETF
Start	\$100	\$100
Day 1: +10%	\$110	\$80
Day 2: -20%	\$88	\$112
Day 3: +16%	\$102.08	\$76.16

day, not a couple days or a week or a month or a year. So, even if the DIA drops 10% over a year, the inverse ETFs won't necessarily be up 10% or 20% in that year, because the return on the inverse ETF depends heavily on the day-to-day volatility. Look at a case where an index starts at \$100. Suppose the sum of the percentage changes equal +2% over three days with high and low volatility. First, let's look at low volatility (see Figures 1&2):

As you can see in the top table, the change in the inverse ETF (\$-4.04) is very

close to 2x the increase in the index (\$1.99). There is only a \$0.06 error.

When volatility is higher, there is a loss in both the index and the inverse ETF, despite the same change (+2%) in the underlying index over three days. But the error is now \$19.68! The daily pattern of the volatility of the performance of the inverse ETF when you look at anything other than day-to-day percent changes.

So, where does this leave you as a trader? The inverse ETFs aren't bad trading products, but you do have to understand that there's more to them than just the opposite performance of the underlying index. The fact that their price action is based on a percentage of the index means that even if you're right in the long term and the index drops, the inverse ETF might not have the performance you think it will. So, be very careful about using them for longer-term trades, greater than two months, because short-term percentage changes are typically smaller. That way, the long-term effect of the inverse percent change won't impact your trade performance as much.

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Forex for Fun

And you thought we were just for option traders.



• If you're day-trading foreign exchange (forex or FX), calculating the profit/loss ratio (p/l) is easy. But if you hold a position overnight, the p/l calculation gets a little more complicated. This article will teach you what's going on behind the scenes so your FX trade performance makes a bit more sense.

Every country has some interest rate that you can earn if you own that country's currency. In the U.S., for example, it's the Fed funds rate. You earn that rate if you're long a currency, and pay that rate if you're short it. That's important, because every FX trade is a pairs trade where you're buying one currency and shorting another. If you buy the USD/JPY and hold that overnight, you're buying the U.S. dollar and shorting the Japanese yen.

Because you're long the dollar, you receive the dollar interest rate. Because you're short the yen, you pay the yen interest rate. The net difference between the rates is debited or credited to your account, depending on whether the dollar rate is higher or lower than the yen rate. Now, the method by which the interest is debited or credited is called the overnight roll, and is done by actually closing the position you have and reopening it at a price that reflects the interest debit or credit. That is, it trans-

Words by **John Hart**

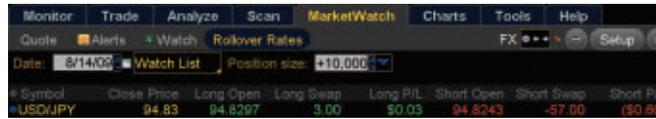


FIGURE 1: A sample of rollover rates on USD/JPY

Checkin' Your Rollover Rates

• If you plan to hold your forex positions overnight, keeping tabs on the correct P&L is a snap.

lates the interest differential into a number of "pips" for the trade. All this happens after 2:00 p.m. Central Time behind the scenes, so you don't have to do anything yourself.

Let's look at an example.

Suppose a trader buys \$10,000 USD/JPY at a price of 94.20, which means she bought \$10,000 USD and sold \$10,000 USD worth of Japanese yen, which translates to short ¥942,000 JPY.

On the TOS MarketWatch tab, you'll see the "Rollover Rates" page. That gives you an idea of what the debit or credit for overnight FX positions is. There are seven fields for each pair: close price, long open, long swap, long p/l, short open, short swap, and short p/l. For the USD/JPY, the close price was 94.42, the long open was 92.418, the long swap was 20.00 yen, the long p/l was \$0.22, the short open was 92.426, the short swap was -74.00 yen, and the short p/l was -\$0.80.

Notice how the long open is lower than the close price. With U.S. interest rates higher than Japanese interest rates, I earn more interest being long USD than the interest I pay being short JPY. The net interest on an overnight long USD/JPY position is credited to my account by closing my long USD/JPY position at 92.40 and reopening it at a lower price of 92.418. That difference is 20 yen (92.40 - 92.418), which is the long swap, and the value of the 20 yen is 20 / 94.218, or \$0.22.



For more information on opening a forex account at TOS, go to **thinkorswim.com**
> Why Thinkorswim > Order Types & Products

If you were short the USD/JPY, you'd look at the short rates. In that case, a short position would be closed at 94.20 and reopened at 92.4126. That difference represents 74 yen, which is the short swap. The value of the 74 yen

is $74 / 92.4126 = \$0.80$, and is the amount you're paying in interest by holding the short USD/long JPY position overnight.

This example is based on \$10,000 of USD/JPY, but if you did \$50,000, the long and short swap as well as the long and short p/l numbers would be five times larger. That's because the bigger the trade, the bigger the net interest number. The Rollover Rates page lets you see these numbers with any size of trade by adjusting the "Position Size" field at the top.

• *The risk of loss in trading forex can be substantial. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Please read the Forex Risk Disclosure (<http://www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf>) before considering the trading of this product. thinkorswim is compensated through a portion of the forex dealing spread. Funds deposited into an account with a broker-dealer for investment in any currency, or which are the proceeds of a currency position, or any currency in an account with a broker-dealer, are not protected by the Securities Investor Protection Corporation (SIPC).*

"...we're not just for trading anymore..."

Dear Tom,

Are you having trouble with life's difficult decisions? Why make them at all?
No matter what life throws at you, thinkorswim can help.

Introducing thinkLife. We're not just for trading anymore.

With **thinkLife**, you have a personal life coach at your fingertips. Whether it's assessing the long-term viability of your job or simply what to wear, just type in a question, input the variables, and *voila!* You're provided a personal solution in the form of a trade, complete with probabilities of success based on the possible outcomes.

We've put the system to the test on one of our own...

Mr. and Mrs. G: "When we learned that our daughter was engaged to thinkorswim's Chief Derivatives Instructor, we were a little nervous. We first met him at an Option Planet event near our home. We're not big on options trading, but Don seemed like a nice boy. Very lively. But it's not like he's a doctor or something that people understand. We had, well... questions."

That's when the Gs came to **thinkLife**. They needed some help figuring out how to best play the engagement with a positive time decay, defined-risk, high-probability approach. Thomas Preston, **thinkLife**'s chief architect, attacked their problem head on...

"I created a multi-factor two-asset volatility model to assess the viability of this union. It was a challenge to determine the proper input variables, particularly the requisite correlation coefficient. Aside from the outward signs of affection, I needed to assess the couple's future volatility, taking into account stuff like kids, prison time, dramatic changes in weight or hair loss, gambling debts, that sort of thing.

"I looked for some comparables to try to estimate the volatility of the marriage with the vol of the hedge. I scanned various industry sectors looking for the right stocks as comparables—furniture and fixtures, rubber and miscellaneous plastics, amusement and recreation... No luck. So, I pulled a number out of my ass—45%."

... And thinkLife delivered results ...

"**ThinkLife** told us we could trade the marriage with an outright bullish position on our daughter and a short premium, short-term neutral, long-term bearish position on Don. It's a classic pairs trade! Thank you, **thinkLife**."
—Mrs. G



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