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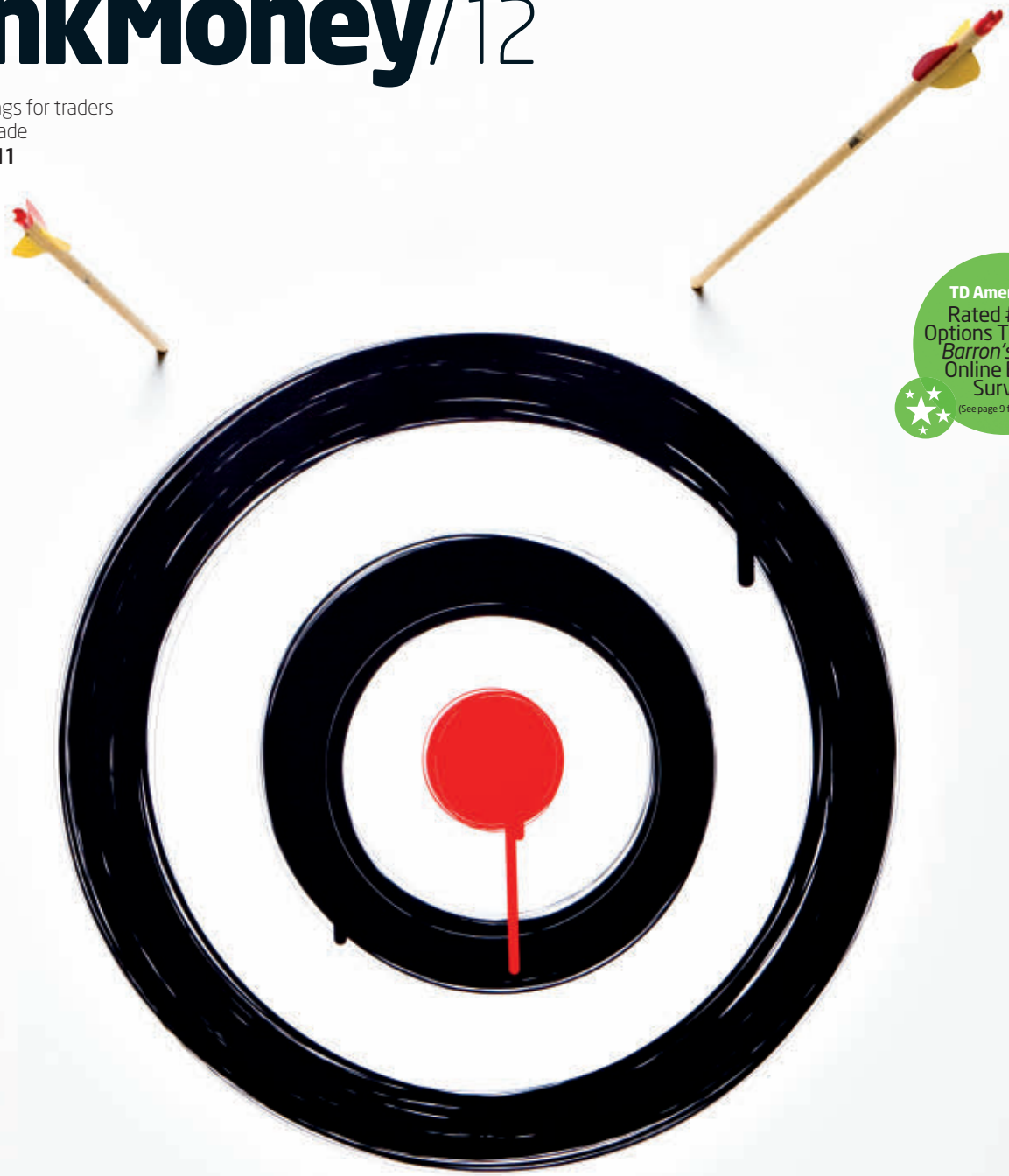
random musings for traders
at TD Ameritrade
Summer 2011



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Fredrik Brodén

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YOU MISSED THE RALLY. SO WHAT?

Missing out on a rally hurts, but so does losing money. Instead of always playing Monday morning quarterback, it's time to develop some skills that help keep your fear in check.

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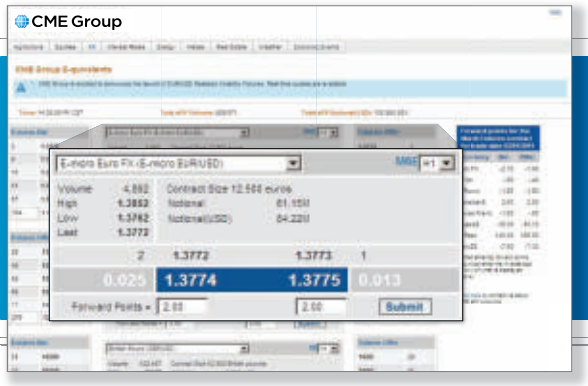

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18/Love Your Diagonal
For all their diversity, diagonal spreads have long been ignored by most option traders. Despite their complex appearance, they're pretty straightforward, and pretty darn flexible to boot—particularly if you want to capture both time and trend.

22/When the Cookie Crumbles
While a breakup of the euro is an unlikely event, when it comes to the markets, perception often overrules reality. So what would the weather man say if in fact the perfect storm is coming? Here are five checkpoints that could signal a reason to sport your slickers.

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VOLATILITY SPECIAL
Talking heads sure talk about volatility a lot, but few seem to really understand it. Whether volatility is high or low, without it, there are no trading opportunities. Rather than fear it, you need just need to "get it."
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TD Ameritrade Contact Info You Could Use
Client Services Representative: 800-669-3900
New Accounts: 800-454-9272

thinkorswim from TD Ameritrade Support
Dedicated Support Desk 800-672-2098/ thinkorswim@tdameritrade.com
Platform Feedback: thinkorswimfeedback@tdameritrade.com
Tech Support: thinkorswimtechsupport@tdameritrade.com
For all other inquiries: please visit tdameritrade.com/contact

General Mailing Address
PO Box 229
Omaha, NE 68103

thinkMoney is published quarterly. If you prefer not to receive this publication, please email us at thinkmoney@tdameritrade.com.

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A Quick Howdy

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EDITORIAL DIRECTOR
Kevin Lund

EDITOR
Thomas Preston

TECHNICAL EDITOR
Alex Mendoza

ART DIRECTOR
Tom Brown

ASSISTANT EDITOR
Jennifer Agee

DESIGNER
Jennifer Roberts

CONTRIBUTING WRITERS
Nicole Sherrod
Frederic Ruffy
Matt Blackman
Tony Battista

CHIEF PHOTOGRAPHER
Fredrik Brodén

CONTRIBUTING ILLUSTRATORS
Brian Cairns, Evonrude

PUBLISHER
T3 Publishing
Email: info@t3publishing.com
www.t3publishing.com

ADVERTISING CONTACT
sales@t3publishing.com

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edit.

Have No Fear

• Superman would be a great options trader, what with being able to leap tall buildings and all. And though his only known weaknesses are a form of green stalagmite and Lois Lane, he typically doesn't fall prey to his emotions—at least when it comes to scary situations and high volatility. But it's not just that he doesn't fear evil, it's that he doesn't really fear missed opportunity, either. He seems content just being a klutzy, understated reporter when he isn't capturing megalomaniacal villains as a caped avenger.

Case in point: He has no fears, and he gets results. Okay, so maybe it helps that he was born with freakishly obscene strength and was brainwashed with a Harvard-equivalent education en route to planet earth before the tender age of three. But that's irrelevant right now.

Fear is a trade-killer. It causes us to sell too soon, buy too late, or leaves our stomachs growling by 4 p.m. because we refused to step away from our oversized position to take a snack break. But if the market moves based on a disproportionate aggregate of fear or greed, is it really possible to overcome fear? If the answer could simply be bottled up, we'd all buy that elixir. But since that's not going to happen, perhaps instead you should be asking if there are any tools you can use to protect yourself from yourself the next time fear rears its ugly head. Lucky for you, help is on page 10 with our cover feature, "You Missed the Rally. So What?"

And speaking of fear, what does the collective consciousness of all that fear and greed create? Uncertainty. And with uncertainty, there's volatility. Without volatility, there's no market to trade—which is really bad for the stock market business. So if the subject of volatility has you even slightly confused or at less than Clark Kent-y standards, our volatility primer starting on page 34 will at least help you understand, and possibly tame, the volatility beast. Do you have what it takes?

Happy trading!
TD Ameritrade

PHOTOGRAPH: FREDRIK BRODÉN

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important info

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• TD Ameritrade was evaluated against 23 others in the March 2011 Barron's *Online Broker review and was named "Best for Options Traders" and one of the two "Best for Long-Term Investing." TD Ameritrade earned the highest score in the categories of "Research Amenities" and "Portfolio Analysis and Reports" and shared the highest score with one other broker in "Trade Experience" and "Range of Offerings."* Barron's *is a trademark of Dow Jones & Co., L.P. All rights reserved.*

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• TD Ameritrade was ranked #1 and received an overall score of 5 stars (tied for first place with one other broker) in the Kiplinger's Online Broker Ratings, Kiplinger's Personal Finance, *February 2011. Fourteen brokers were rated in the categories: Costs, Web Site Usability, Investment Choices, Customer Service, and Research and Tools.*

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Overcoming Fear

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AT SOME POINT IN YOUR TRADING CAREER, YOU'RE GOING TO LOSE—LOSE ON A TRADE, ON A STRING OF TRADES, OR MISS OUT ON A RALLY. HERE ARE A FEW TRICKS THAT MAY HELP YOU RISE ABOVE YOUR FEARS.

YOU MISSED THE RALLY. SO WHAT?

WORDS BY **MARK AMBROSE**

PHOTOGRAPH BY FREDRIK BRODÉN

12 cov. story

Overcoming Fear

Photograph by
Fredrik Brodén

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IN THE PAST FEW MONTHS, I've seen several articles describing how young people are shying away from investments. The scenario goes something like this: In the summer of 2008, a particular 20-something is enjoying life, employed, living in her own house, and investing a little money here and there in addition to a 401(K). Then the financial world melts down in late 2008 and she loses money on her investments (bad), loses her job (worse) and loses her house (badder and worser). Now in 2011, while she may have found a job, has a place to live, and has a couple bucks to invest, she shies away from equities because of what happened a couple years ago. She's a bit older and presumably a lot wiser. Who can blame her?

THE MARKET'S BABY DUCKS

This particular article isn't going to go all Pollyanna on long-term equity investments as the way to financial success. The fact is, no one knows what the market will do in the future. Maybe it will go up over the long term. Maybe it won't. But even if you're not in your 20s, that fear of uncertainty from what happened in 2008 may still be there. It reminds me of a story I read about Richard Dennis, legendary futures trader, talking about rookie traders. He said that new traders/investors are like baby ducks. When a baby duck hatches, it thinks the first thing it sees is its mother. If the first thing it sees is a battleship, the duckling will follow that battleship around forever. Traders can be the same way. The first big market event they experience—whether it's a market crash and a big loss or an unending rally and a big profit—they think that's the way the market always works. And that kind of baby-duck thinking can be lethal to a trading account or investment portfolio.

If you started investing during 2003 through 2007, when the S&P 500 rose over 50%, you might have thought that markets go up consistently and you didn't really have to worry about the downside risk. Then when the market crashed in 2008, that shock not only cost you money—it imprinted on you the fear that another crash might happen at any moment.

Since the market crashed in 2008, the S&P 500 has risen pretty consistently. At the time of this writing, it's basically at the level it was in the summer of 2008. The market crashed and bounced back. So now, you can add to the fear of uncertainty the regret of not participating in the rally, plus the hope that if the market does drop back down, you'll step in and buy. But then of course, the market might keep on crashing. You just never know.

TRICKS OF THE TRADE

So, how do you get past all this? If you don't try to get some return on your money—whether through equity investments, bonds, or a bank account—that can also be a recipe for financial woe in the long run. What you need are some specific approaches to investing that will help you move forward. I can't promise you'll make money, or that you'll never be scared. But you will feel much more in control. Here are a few ideas.

Risk and Capital Management

Risk and capital management should come first and foremost, but they're consistently missing from investment strategies. Most investors think only about the potential profits, not the possible losses. But when those losses do occur, they can be bigger and happen faster than anticipated. You can read whole books devoted to risk management, but very simply, it just means factoring in how much loss a particular position might incur if the stock or market makes a big move in the opposite way you think it will. If you think a stock will go higher, and you put on a long position or a bullish option strategy, what happens if the stock drops 10%? 20%? 30? What if it goes to zero? Now, this isn't being pessimistic, and it doesn't mean that you shouldn't do the trade. It just means you should be prepared for what might happen in a worst-case scenario. Using the tools on the thinkorswim from TD Ameritrade desktop and mobile apps, you can simulate those types of price changes and see how big the loss might be on the position. If you look at the maximum possible loss and it's too big for you, you can reduce the size of the position (i.e., 100 shares instead of 200) or add some protection, such as a stop-loss order or a hedge using options. Or reduce the size and add the protection. The point is that you're taking positive steps to help limit the potential loss of your position, and that's the heart of risk management.

Related to that is capital management, which is making sure that if that worst-case scenario happened to all your positions, you would still have enough money left to continue to trade. As a place to start, I'd suggest making sure that if every stock or option position you had experienced its maximum loss, you'd still only be risking 20% of your total trading or investment capital. Hey, losses happen to even the sharpest traders. The difference between them and the newbies is that professional traders always make sure they have capital to trade with despite losses. Risking 20% (or less if

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you're more risk-averse) leaves you with 80% of your capital to continue trading after a string of losses.

Learn to Hedge Your Investments

Sure, "hedge" has become something of a four-letter word in public opinion, given the stories we've all heard about hedge funds. But hedging is a key to risk management, and it just means you employ certain trading strategies to try to reduce potential losses to a level that you can handle. Hedges for stocks and even whole portfolios can be as simple as long puts, or more complex strategies such as vertical spreads, calendar spreads, and even futures. The more types of hedging strategies you understand, the better you can employ them under different market scenarios and on different positions. Volatility levels, your time frame, and the amount of hedge you think you need versus how much a hedge might cost you will affect the type of strategy you use. You need to remain flexible—there isn't one single hedging strategy that you can use in every scenario. There are different ways to learn about hedges, including live classes.

Think of it as another form of preparation. The more you learn, the better prepared you'll likely be for the next financial meltdown.

Remain Nimble

What does being nimble have to do with investments and trading? It means you're not just a buy-and-hold investor who is willing to get slugged around by turbulent markets and who is just waiting for his stocks to go up eventually. Stocks and markets go up, down, and sideways. You can take advantage of that and get a potentially better return on your money by using strategies that are designed to be profitable in those rising, falling, or stagnant markets. For example, if you think that the market might not move up or down much for a certain amount of time, plain long stock positions might not work. A positive time-decay, defined-risk option position might work out better. If you think that the market might sell off and that volatility might go higher, long stocks might not do so well. Instead, option spread strategies designed to profit if the market goes lower and volatility goes higher might be a better choice. Don't be a one-trick trader. Use the strategy for what you think a particular stock or the market overall will do.

THESE SUGGESTIONS ARE ALL RELATED AND HAVE A couple central themes: prepare and learn. In fact, by learning, you're helping yourself become more prepared. That's going to make you more confident and smarter about the investment choices you make. Don't let a single bad investment experience scare you out of the market forever. Overcome the fear, and you're a step closer to becoming a more confident and prepared trader.

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Love Notes

Hyperbole and Trading Pearls From ... You.

Photograph by **Fredrik Brodén**

• Life affords us many teachers. Often they appear, and we are unaware of the lesson that is being taught, gaining wisdom of what we think we already know.
Denny

• An offer on a street corner is called solicitation, and is illegal. In the Pit it's called ... business.
Keri

• Buy the fear, sell the euphoria.
Shauna

• Trading IS: The KNOWLEDGE to know when odds are in your favor, having PATIENCE to wait for that moment, then having DISCIPLINE to handle the trade properly when it goes in your favor and properly when it goes against you.
David

• 90% of trading is mental. The rest is all in your head.
Michael

Got a quip? Good, bad, and ugly, send your best to thinkmoney@tdameritrade.com.

• The human mind has an uncanny ability to find patterns in random phenomena.
Steven

• I feel like an abandoned baby in an engulfing diaper pattern.
Sam

• *From the thinkorswim from TD Ameritrade Chat Rooms*
[CLIENT 1]: On every take-off I plan for an engine failure. I don't pick where I'll land—just the failure.
[CLIENT 2]: The scary thing is that [Client 1's] wife used to fly with him and says the same thing ;)

• Trees that don't bend with the wind, won't last the storm.
Maile

• Don't ask me. I am on my fourth college degree—none in finance.
Jerry

• I thought I made some pocket change this a.m. And then I realized it was on paperMoney® ... that sucks.
Buster

• I'm a liberal conservative socialist capitalist. Really.
Dave

• I go by how long Maria [Bartiromo] smiles for her first 30 seconds ... above 25, short, below 5, long.
Dennis

• If you stay wrong until you're right you'll miss a lot of right and wrong opportunities and you'll never really know if it was right to stay wrong to be right.
Sandra

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News+Views

A hodgepodge of stuff we thought you should know.

Toys for Traders

Our favorite new gadgets

Nickel Buy-Back
Why risk leaving those worthless short options open when you can close them out for free? Depending on how much time you have left, anything can happen before expiration. You can now close out any short option bid at a nickel or less at any time—commission free. We'll make the decision easy and you can move onto your next trade.

CNBC Mobile
If you're able to sneak your iPad into work, not only can you sneak trades in real time on TD Ameritrade Mobile, our new iPad app, but you can get your CNBC fix as well. The network now streams live through your app. So be sure you have the latest upgrade… Shhh…Your boss is coming!

news.

INDUSTRY SPOTLIGHT

High Frequency Trading–Good for the Little Guy?

by Adam Warner

The answer is: Maybe. On one hand, it adds liquidity and tightens markets. On the other hand, all those pennies you save could turn into dollars you lose when the system goes *on tilt* like it did last May.
But in some ways, it's not a question you even need to bother asking. Because as the little guy, you basically have no say. Sure, you can voice your opinions, and perhaps your opinions will be heard. That's never a bad idea. Just don't do it on trading time. You're better served spending those hours trying to figure out how to trade in a world dominated by high-frequency trading (HFT) than fretting about its existence.

If you believe HFT adds to market volatility, then trade accordingly. Buy or hold puts. Demand better prices when shorting options. Put higher targets on short-term holdings, and widen stops. If, on the other hand, you believe HFT reduces market volatility, do pretty much the reverse. Tighten your targets and your stops. Trade options as if implied volatility will stay heavy, and so on. If you believe HFT keeps a permanent bid under the market, then don't do much shorting. It's all about adapting.

Personally, I believe HFT has gone too far. If it accounts for the majority of volume, then we really spend a lot of time watching one machine trade with another for the tiniest of edges. It pumps up the volume and gives the illusion of activity, when there's really not much meaning behind it. And we all got a first-hand look last May at what can happen when there's a hiccup.

Again, though, the Algo Machines are not going away today or tomorrow or next week, so the important thing is to devise a trading or investment plan that acknowledges their existence. It compresses volatility the overwhelming share of the time, with the occasional blip of decompression. So it's worth considering to follow what the machines do and trade a little tighter, for the most part—but walk away when things look shaky.

•

The information contained in this article is not intended to be investment advice and is for educational purposes only. Clients must consider all relevant risk factors, including their own personal financial situations, before trading.

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Ask The Suit

A little Q&A with Nicole Sherrod, Managing Director, Trader Group at TD Ameritrade.

TD Ameritrade has been winning a lot of accolades lately. What are you most proud of?
We just made it through another grueling season of "broker scorecard" reviews, where all the major magazines rank the brokerage firms in terms of service, technology, value, and other factors. During this process, I feel like a bossy, overbearing beauty pageant mom whose child is being judged in front of millions. But not only did we win #1 online broker from *Kiplinger's*, but we were also named the Best Online Broker for Options Traders by *Barron's*. (See page 9 for details.)

Thanks for the advice last month to check out myTrade.* I'm now a junkie. What other advice do you have about thinkorswim from TD Ameritrade?
Our platform is unique because it has life. It has a heartbeat. The audio feeds are a great example. Sure, other brokers allow you to see what the futures markets are doing, but through our MarketCast audio feed, you can hear Ben Lichtenstein talk to you from the S&P Futures Pit in Chicago where his boots are firmly planted. Ben will give you a heads-up when a big trader has just entered the pit if he thinks things could really start moving. And when I hear that, I will cancel meetings and kick people out of my office if need be so that I can trade. Cuz that's how I roll … .

Who do you see as your number one competitor?
We compete a lot to get to the head of the lunch line each day. Zeppy who works on the trade desk in Chicago always seems to have the edge.

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BY **THOMAS PRESTON** PHOTOGRAPH BY **FREDRIK BRODÉN**

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Diagonals

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❤ YOUR DIAGONAL

DIAGONALS HAVE LONG BEEN TREATED AS THE RED-HEADED STEPCHILD OF OPTION SPREADS. BUT NOT ONLY ARE THEY RELATIVELY STRAIGHTFORWARD, THEY'RE FLEXIBLE TO BOOT. PARTICULARLY IF YOU WANT TO CAPTURE BOTH TIME AND TREND.

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Diagonals

Photograph by
Fredrik Brodén

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THE DIAGONAL SPREAD. UH-OH. Potential boring alert. Could be another option strategy that's used only by floor traders or too hard to understand and just not very useful for retail traders and investors. Let me get back to my stocks, thank you.

Now, hold on. Sure, sometimes options can be tough to figure out—at first. And sometimes trading articles (even by yours truly) can drill down a little too deep into the options stuff for a stock investor. But diagonals really aren't that tricky to understand once you see how they're put together. And as for being useful, diagonals could be your next step into options trading if you're a stock investor who's ever sold a covered call. Why?

Because diagonals are simply made up of a short call or put option in a near-term expiration at a particular strike price, and a long call or put in a further expiration at a different strike. The term "diagonal" comes from looking at options on a typical quote screen, where the short option and long option are oriented sort of diagonally from each other on the page. But don't spend too much time thinking about the name. What's the whole point of the diagonal?

DIAGONAL BUILDING BLOCKS

It starts with that short option. The fact that there's a short option involved in the diagonal at all might be a clue that the spread involves positive time decay—meaning you make money from the passage of time. And indeed, it does.

An option that's closer to expiration is going to have a higher rate of time decay, and if you're short that option, as you would be in a diagonal, that's a good thing. The problem with naked (read: unhedged) short options is that they have enormous potential risk if the underlying stock makes a big move up (if it's a short call) or down (if it's a short put). So, you can buy a long option as a hedge for the short option. But which one?

Imagine you're short the June 110 strike on our old favorite, XYZ. To preserve the positive time decay of the short option, you could buy an option slightly further out-of-the-money and in the same expiration to create a short vertical spread. That further out-of-the-money option is cheaper than the close-to-the-money short option. That's fine, but if your strategy is to short options that are closer to expiration month after month, you're going to have to buy that option as a hedge month after month, too. That creates a lot of transaction costs, i.e., commissions and contract fees.

As an alternative, you could buy an option at the same strike price as the short option, but in a further expiration—say, a September 110—to create a long calendar spread. That does hedge the short option, and if you buy an option with an expiration that's a few months further out than the expiration of the short option, you don't have to keep buying the hedge. But the further expiration option is more expensive than the near expiration option. And it's susceptible to a drop in implied volatility. Both those can put a dent in your positive time decay.

However, a third option of putting that long option hedge at a further out-of-the-money strike price and a further expiration does a few things.

(1) The further out-of-the-money strike price makes the long option less expensive, which means you preserve a bit more of the positive time decay from your short option.

(2) The further expiration means you don't have to keep buying that hedge every time you short a near-term option. That reduces transaction costs.

(3) You've just created a diagonal.

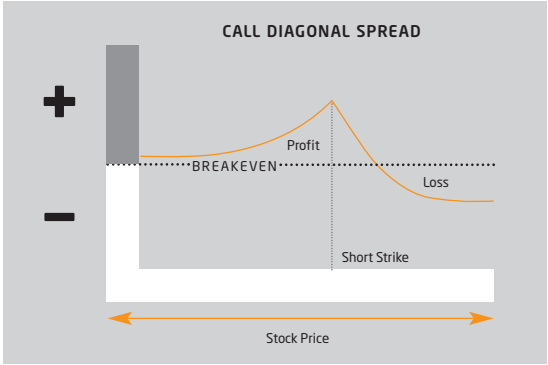

FIGURE 1: Call Diagonal P/L The shape of this graph will vary depending on where you place your short and long strikes, but this graph represents a short at-the-money shorter-term call with a farther out-of-the-money, longer-term call.

WHAT ABOUT THE STOCK GUY?

That's fine and good if you're an option trader looking to short options. But what about the stock investor? Well, most stock investors are long stock. Long stock can use up a lot of capital, and have a lot of risk if the stock moves lower. Because of that, some stock investors buy in-the-money call options in a further expiration instead of buying stock. The calls are less expensive than the stock, and their risk is limited to the price of the call. And similar in strategy to shorting an out-of-the-money call option against a long stock position (i.e., a covered call) to create some positive cash flow, you could instead sell an out-of-the-money call in a near-term expiration against that long call in the further-term expiration. And that, folks, is a diagonal, too. Just as with a covered call, you can sell the out-of-the-money options in each new expiration cycle in the diagonal to keep that cash flow coming. But rather than think about selling the option with each new expiration, think about it as "rolling" that short option from one expiration to another.

SEE
GLOSSARY
PAGE 42

AS YOU KEEP ROLLING THE SHORT OPTION FROM ONE EXPIRATION TO THE NEXT, YOU GENERATE ADDITIONAL CREDITS. THOSE OFFSET THE COST OF BUYING THE STOCK (FOR A COVERED CALL) OR THE LONG OPTION IN THE FURTHER EXPIRATION (FOR A DIAGONAL). HENCE, YOU INCREASE YOUR POTENTIAL FOR PROFIT.

If diagonals aren't enough, there's plenty of options trading fodder with our live Options Huddle webcasts. Just login to your account at **tdameritrade.com and click path Education> Webcasts.**

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MMM MMM ... ROLLS

"Rolling" is an important concept in trading, particularly when it comes to calendars and diagonals. The roll is when you buy to close the near-term short option and sell to open a further-term option at the same strike price, while leaving the long option alone. Because the near-term option is cheaper than the further-term option, that transaction generates a credit. The idea is that as you keep rolling the short option from one expiration to the next, you generate additional credits whether it's done in a covered call or a diagonal. The additional potential credits offset the cost of buying the stock (for a covered call) or the long option in the further expiration (for a diagonal). Hence, you increase your potential for profit. The bigger the credits you get for the rolls, the more you offset the cost of the stock or the debit of the long option. On the flip side, with smaller credits for the rolls, you don't offset the cost as much, and your risk (amount of potential loss) isn't reduced as much. A word of caution: Due in part to the uncertainty of the total credits you can get from the rolls, an adverse price move in the stock is still a risk to your positions.

With diagonals, you can keep rolling that short option expiration after expiration until you end up rolling the short option to the same expiration as the long option. At that point, you've created a vertical.

Back to our XYZ example. This time, you're long the 90 strike call in December expiration, and you short the 110 strike call in the June expiration to create a diagonal. When you roll the June option to July, the July option to August, and so on until you roll the short November option to December, you'll still be long the Dec 90 strike call and now short the Dec 110 strike call, which creates a long Dec 90/110 call vertical. But the interesting thing about a diagonal is that you can choose a different strike to roll the short option to. That long Dec 90/110 call vertical is a bullish strategy—it goes up in value when the stock price rises. What if you think the stock might go down now? You're still long that Dec 90 call, but let's say you roll the short 110 call to a short 85 strike call. That creates a short 85/90 call vertical, which is a bearish position. Simply by rolling the short option to a different strike, you can change the bullish/bearish posture of the diagonal. That's why they're so flexible in different market environments. It's much harder to do that with a long stock position.

As an option trader, you might start with a short June 90 put, and buy a September 85 put as a hedge to create the diagonal. Rolling the short 90 put from one expiration to the next may create a bullish bias in the position. But if you roll the short 90 put to a short 80 put, the short 80 put combined with the long 85 put creates a bearish bias in the position. Slick.

NOW THAT YOU'VE TAKEN THE DIAGONAL PRIMER, are you convinced that they're not quite as bad as you thought? Hopefully so. And if you decide to trade them, use the free tools on the thinkorswim from TD Ameritrade platform to analyze the strategy and see where it loses money, as well as how to enter the diagonal order as a single spread.

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The information contained in this article is not intended to be investment advice and is for educational purposes only. Multi-legged 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 transaction 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. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.

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Trader Econ

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THERE'S BEEN A LOT OF CHATTER ABOUT WHETHER THE EURO WILL SURVIVE. THE ECONOMIES OF SOME MEMBER STATES, INCLUDING GREECE, IRELAND, ITALY, PORTUGAL, AND SPAIN, HAVE STRUGGLED UNDER THE BURDEN OF A STRONG CURRENCY. WILL THE PRESSURE PROVE TOO MUCH, OR WILL THE 12-YEAR-OLD CURRENCY PASS THE DARWINIAN ACID TEST? AND WHAT'S THE PUNCH LINE FOR TRADERS?

WHEN THE COOKIE CRUMBLES

WORDS BY **MATT BLACKMAN**
PHOTOGRAPH BY FREDRIK BRODÉN

GREAT MONETARY EXPERIMENT

Since its formal launch on January 1, 1999, when 11 original members called it their currency, the euro has come a long way. By the time euro notes and coins entered circulation on January 2, 2002, 12 nations were on board. Today, member states that have adopted the euro include Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Back in 1999, confidence was high that the grand euro experiment would unite Europe as an economic powerhouse and create a market trade zone to rival that of the U.S. and its North American Free Trade Agreement (NAFTA) partners Canada and Mexico.

But from the very beginning, there were problems. A big part of belonging to the euro clan was the requirement that nations with very different histories of fiscal responsibility adhere to the Maastricht Treaty, which limited annual budget deficits to a maximum 3% of GDP.

However, the playing field was anything but level. For example, French corporate taxes at 34.4% (2009) are nearly triple the Irish corporate rate of 12.5%, a factor that helped transform Ireland's economy into the Celtic Tiger. You only need to look at the *Forbes* Tax Misery Index[1] to realize how different tax rates are among euro nations sharing a common currency. Low interest rates needed to help weaker eurozone economies created serious inflation in strong economies like Ireland, and contributed to frothy real estate prices. This is just one of the many challenges member nations have faced.

How could such disparate economies be expected to live by the same set of economic rules in both good times and bad?

FIRST REAL TEST

The 2007–08 financial crisis revealed just how different the fiscal disciplines really were. Even before the crisis began to unravel, it was evident that the Maastricht Treaty was a failure. Members routinely exceeded the 3% budget deficit threshold, and the single currency was a strong incentive to do so. Financial shortfalls in one nation were shared by all, while the penalties for breaches were virtually nonexistent. Before the 2009 Greek election, the world was told that the nation's budget deficit was 6%. It wasn't until the new party took power in late 2009 that we learned that the true deficit was 12.7% as the modern-day Greek tragedy began to unfold.

If the euro survives, it will be the first case of a single currency shared by nations that do not share the same political system. For this reason, detractors say it's doomed to fail. They argue that when nations with different political parties give up monetary autonomy, they surrender the ability to adjust currency values. Without an independent monetary policy, Greece was unable to devalue its way out of trouble. Greece's subsequent bailout—thanks to a $1 trillion fund set up by the EU and IMP with strong support from Germany—showed that fiscal irresponsibility was implicitly encouraged. But how long would German taxpayers be willing to finance such bailouts?

EURO ACHILLES' HEEL?

Iceland was Europe's financial crisis coal mine canary—the first economy to succumb in the wake of the crisis. Although a member of the European Free Trade Association (EFTA), it has not adopted the euro. In the fall of 2008 as economic difficulties worsened, the total liabilities of Iceland's failed banks equaled 10 times the nation's total GDP, according to Iceland's Ministry for Foreign Affairs. The Icelandic government was forced to nationalize three banks in the wake of the British government's decision to freeze the banks' assets in the UK. In 2009, Iceland's budget deficit hit 12% of GDP (which, although high, was still less than Greece's budget deficit).

During the first two weeks of October 2008, the Icelandic krona shot from 94 to 200 kronas to the dollar, which immediately cut Icelandic asset values in half. It was a painful step, but it helped stem the crisis. Iceland's economy has recovered, and the krona was trading around 117 to the dollar in February 2010. By Q3 2010, Iceland's GDP was growing at 1.2% compared to a 6.5% contraction in 2009.

Iceland's recovery provides a classic example of the advantages of an independent monetary system. (It is interesting to note that a January 19, 2011, poll showed that 65.4% of Icelanders were in favor of continuing negotiations to join the eurozone and make the euro the official currency.[2])

So is a common currency shared by politically disparate nations workable long-term? Can currency socialism survive the test of time?

FIVE KEYS TO EURO SURVIVAL

Whether the euro survives is anyone's guess at this point. However, if it is to survive, it will first have to pass five checkpoints. The failure of any one of them could threaten the status of the euro as "the other" global reserve currency.

1.

WATCH THE PIIGS

• Eurozone member nations Portugal, Ireland, Italy, Greece, and Spain are the most economically vulnerable and at risk of dropping out of the euro. Staying with the euro has caused untold strain on Greece and her population, which has struggled under the terms of the 1992 Maastricht Treaty amid falling wages and soaring costs of living. According to Rogoff and Reinhart in *This Time Is Different*,[3] Greece has spent more than 50% of the time between 1800 and 2008 in financial default or debt rescheduling. But one-time economic poster child Ireland has also been severely impacted since the global economy began to unravel. In January, the Irish Prime Minister offered his resignation. With an Irish public debt–to-GDP ratio above 94%, the second highest in the eurozone, and a whopping external debt–to-GDP ratio of 983% (see Figure 1),(more than 10 times that of the U.S.), Ireland could well be the first real test of the euro in the post-financial crisis world.

COUNTRY	GDP 2010 (BILLIONS USD)	JOBLESS RATE	PUBLIC DEBT/GDP	EXTERNAL DEBT/GDP	ANN. GDP GROWTH RATE TO Q4-10
Italy	$1,782.0	8.4%	126%	110%	1.09%
Spain	$1,374.0	20.0%	63%	172%	0.23%
Greece	$321.70	12.0%	144%	167%	-4.71%
Portugal	$247.0	10.7%	86%	267%	1.40%
Ireland	$174.0	13.7%	95%	983%	-0.64%
U.S.	**$14,700.0**	**9.0%**	**68%**	**95%**	**3.21%**

FIGURE 1: The Trouble with PIIGS As these eurozone countries struggle under that weight of their own debt, staying with the euro continues to cause considerable strain.

Portugal is next in the firing line, with a public debt-to-GDP ratio north of 85% and external debt-to-GDP above 265%. If bond investors tire of the risk, Portugal could also suffer a default and be forced out of club euro.

But with an economy nearly twice as big as Greece, Ireland, and Portugal combined, Spain poses a greater risk to the euro. Spanish public debt and external debt-to-GDP (63% and 172%) exert considerable strain on its economy. Spanish unemployment is the highest in the eurozone at 20%. How Spain responds to the more than 190 billion it is scheduled to repay this year, which is one-fifth of the total debt, will be crucial, according to financial journalist Raphael Minder.[4] However, with public debt and external debt-to-GDP of 126% and 110%, respectively, and an economy larger than Spain's, Italy also poses significant potential systemic risk to the euro.

2.

TRACK ECONOMIC GROWTH

• A recovery would go a long way toward mending the euro crisis. According to Trading Economics.com, economic growth in the euro area between 1995 and 2010 averaged 0.41% per quarter, which translates to 1.64% annualized growth (see Figure 2). A sustained recovery would take much pressure off ailing economies, reduce unemployment, and help ease budget deficits. Conversely, a double dip would be bad news for both euro member states and the euro.

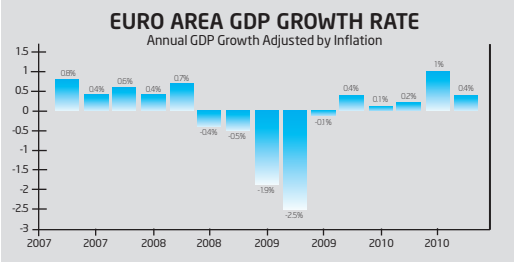

FIGURE 2: GDP growth for the eurozone through the financial crisis. *Source: TradingEconomics.com*

3.

DEBT COOPERATION IS ESSENTIAL

• So far, the euro has survived thanks to intervention from the European Central Bank, IMF, and EU backed by political support from stronger eurozone members. Without continued financial aid and cooperation by its members, it's a slippery slope for the euro. If this support shows signs of weakening, the chances of the euro surviving diminish.

4.

MONITOR EURO BOND RATES

The difference in spreads between different eurozone bond issues tells much about the willingness of bond investors to finance the weaker eurozone members. As Figure 3 shows, the spread between German and eurozone bond rates hit an all-time high in early 2011. For example, the difference between Greek and German 10-year bonds remained at nearly 800 basis points in early February 2011, and the spread between Irish and German bonds hovered above 500 basis points. A sustained drop in the spreads between German and PIIGS bond rates would be positive for the euro.

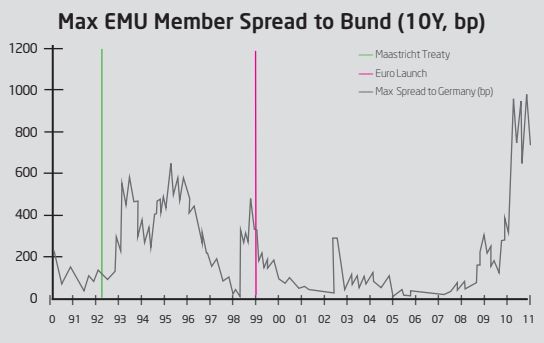

FIGURE 3: Basis-point (BP) spread between German (Bund) and EMU Member bonds showing the spread hitting a record 1,000 BP in January. This reflects the financial stress in bond markets. Chart courtesy of Knight Capital.

5.

CHART THE EURO

As you can see in the chart in Figure 4, once the eurozone's coins and notes went into circulation in 2002, with the exception of 2005-2006, the euro rose steadily against the US dollar until the collapse of world's capital markets in 2008. Traders operate on the assumption that asset prices are a leading indicator of performance, since the fundamentals often lag price action. For example, more than a month before the world learned that the Greek budget deficit was more than double the official number, the euro began to fall. A rising EUR/USD confirms strength in the euro economy. Any sustained drops in the euro would be bearish for its recovery.

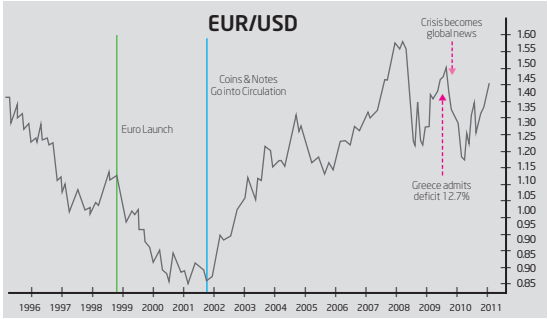

FIGURE 4: Charting the euro against the US dollar (EUR/USD) could help to provide clues as to the strength of the currency's future. Just prior to the rest of the world learning of the Greek budget debacle, the euro started to fall.

WHAT'S THE TRADE?

Now this may all seem a bit complicated if you don't have a Ph.D. in economics. But when trying to answer the "What does it mean for me as a trader?" question, keep it simple. This article isn't intended to make predictions about bulls or bears. If all these things came to be or you believe in the warning signals, it's not about what stocks or companies you should be looking to go long or short. And it may not even be about global stock markets, either. In my opinion, the results of a euro failure will ultimately manifest in the bond markets. Put simply, it will most likely be a bond trade. Which bonds remains to be seen, but by paying attention to the warning signs listed here, you could be well ahead of the curve.

•

The commentary and opinions expressed are solely those of the author, and do not reflect those of TD Ameritrade. The information contained in this article is not intended to be investment advice. Clients must consider all relevant risk factors, including their own personal financial situations, before trading.

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Trading Tools

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OUT WITH THE OLD, IN WITH THE FEW

IF YOU NEED ANOTHER ALTERNATIVE TO COMBINE YOUR TRADE RESEARCH, ANALYSIS, AND IMPLEMENTATION ALL ON ONE, SIMPLE PLATFORM, WEB-BASED TRADING WITH **TRADE ARCHITECT** WILL QUELL YOUR JONES WHEN THE MARKETS COME CALLING, BE WARNED: OTHER PLATFORMS MAY SEEM LIFELESS.

A REVIEW BY
NICOLE SHERROD
Managing Director, Trader Group at TD Ameritrade
PHOTOGRAPH BY FREDRIK BRODÉN

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Trading Tools

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TEST DRIVE IT

If you're ready, give Trade Architect a whirl. We can't promise it will change your social status, but it certainly couldn't hurt your image. Login to your account at tdameritrade.com and click the "Launch Trade Architect" link at the top of the page. There's no download necessary. Just start tinkering.

"I'm proud of what I created. Why wouldn't I be? I exposed people to magic. I exposed them to something they otherwise would not see in their boring normal lives. I gave that to them." —CHARLIE SHEEN

I'm with you, Charlie. I am right there with you. Now, contextually, I realize that Sheen was referring to exposing multiple female "actresses" to substances that make you see things like flying unicorns, but I can still appreciate the sentiment. As builders of trading technology, my team delights in rolling out new tools that help our clients pursue their investment goals. For years now, we've heard from traders and investors that the thinkorswim from TD Ameritrade trading platform is widely regarded as one of the most sophisticated trading platforms on the market. Translation: It's not for everyone. For some, it's a little too complex. A little too sensational. A little too awesome. No problem.

A SWEET ALTERNATIVE: Trade Architect

If thinkorswim from TD Ameritrade is too intense for you, take a look at Trade Architect. It runs on 100% Tiger Blood. Okay, not really. But it does run on a Mac. It's also fast, and it's Web-based, so there's nothing to install. This is perfect for our beloved clients who aren't able to download the thinkorswim platform because their corporate overlords don't allow desktop installations due to "firewall issues." Um, it's not a firewall issue, people. They just don't want you trading at work because when you trade at work, well, you generally aren't working. Plus, your corporate overlords probably fear that you might make more money trading than working. And then you won't need them. Why, you might say they fear that our new trading platform will allow you to rise up and revolt. In which case, Viva la Trade Architect!

Okay, let's cut to the chase. Here are five reasons you might want to check out Trade Architect.

1 TWO LETTERS: EZ

This platform is simple and easy to use. Seriously, it really is. It's designed for the investor who is aspiring to take his or her game up a few notches, but also for the veteran trader looking for a great web-based trading platform. With a slick design and customizable components, you can easily build layouts that can help you see the markets in ways you may never have—streaming in real time. We put considerable time into the design and aesthetics of the platform. Because let's face it, I spend more time looking at my trading platform than looking at my husband. I deserve a good-looking platform. But judge for yourself (Figure 1).

2 TOP DOWN

The beauty of Trade Architect is that it provides so much visibility around the broad markets. It offers visual context so that you can better understand how the market is behaving, which helps you form an opinion. Instead of showing a table of data representing the broad markets or individual sectors, we integrated a little piece of magic we like to call heat maps (Figure 1, red box). Heat maps help you to understand at a glance what is going on in the broad market and allow you to pinpoint sectors of potential strength or opportunity.

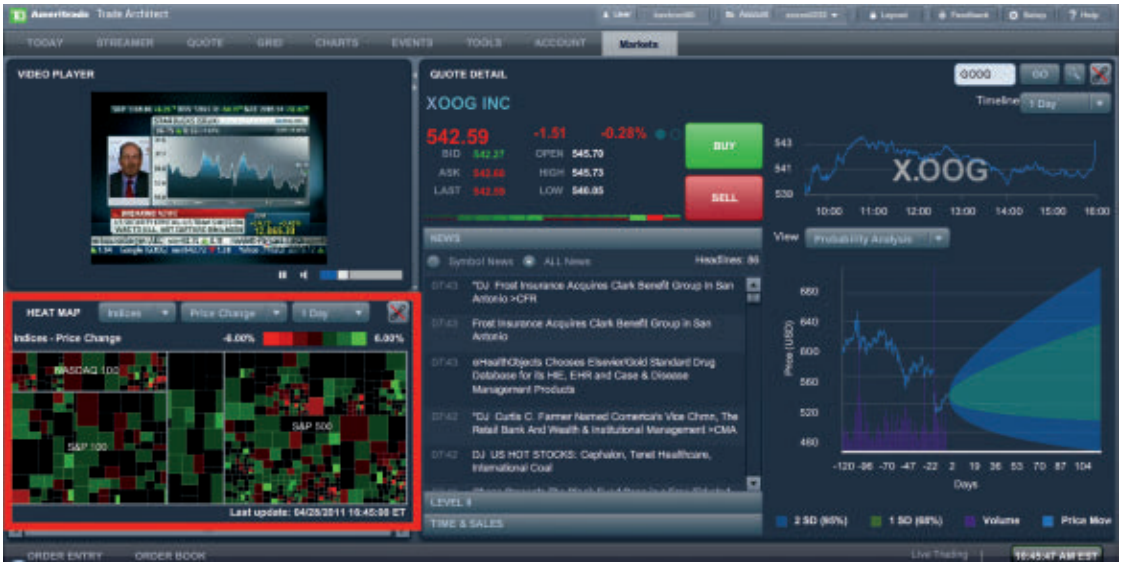

FIGURE 1: Trade Architect. A web-based trading platform built for "the rest of us." Sneak in live CNBC commentary at work, get a top-down view of the market with Heat Maps (red box), or just simply trade without the hassles. What can't it do? Cook your lunch.

3 DECISION SUPPORT

Active traders tend to be highly confident individuals. They pull the trigger with conviction. They scoff at the notion of "analyst opinions" because they believe that they know more than your typical Wall Street analyst. But this platform is built more for the investor. We have found that investors are looking for validation before they place a trade. We've integrated both earnings information and third-party analyst recommendations in a visual format. So instead of having to read a detailed report, you can look at a trend of recommendations.

Suppose I see that company XYZ has increased in terms of the number of analysts covering it and that there is also a near-term increase in the buy rankings. I might view that as positive reinforcement to a long trade. Many of our clients are fancy business people. They run their business and make decisions based on charts. Our platform functionality is designed to mimic other effective ways that we make decisions.

4 STRATEGY

Options represent over 25% of our total retail trades per day. So, in case you were wondering, more TD Ameritrade clients are trading options than mutual funds and fixed income combined. Today, options are a mainstream product, but we still hear from clients that they struggle to understand them. If you aspire to become an options trader, there are two things you ought to consider doing:

1) Check out the option features in Trade Architect. We break out all of the strategies based on what they seek to accomplish (bullish, bearish, neutral, or strong move). When you select a strategy, it highlights the areas of potential profitability on the price chart so that you know where the stock has to go in order for you to make money on the trade—a very simple but also an extremely valuable concept.

2) If you're still confused, consider taking an introductory course on options from Investools, our investor education affiliate. And I don't just say that because the smart, handsome gentleman who runs the business sends me a bottle of wine whenever I plug them. (Ahem, Ted—Cakebread Cab, please.) Investools presents options in a way that is easy to understand.

WE DESIGNED AN ORDER ENTRY EXPERIENCE THAT IS QUICK AND SIMPLE. TRADERS PLACE TRADES TO MAKE MONEY, AND YOU CAN REST EASY KNOWING WE AREN'T GOING TO MAKE YOU WAIT.

Need help getting going? A great place to start is the integrated education center in the upper right-hand corner of the Trade Architect platform. Just click the Help button, then "Quick Start."

FIGURE 2 & 3: Strategy Analyzer. From the Quote tab, click on Strategy Chain in the center screen. Choose a strategy and click on the trade you're interested in. For chart nerds, view a P&L of the position (top). For everyone else, the stock chart (bottom) displays the Target Zone (green and yellow shade), where the trade makes a profit.

5 QUICK CHECK-OUT

There's nothing I hate more than standing in line when it's time to check out. If I want to give my money to a company, they shouldn't make me wait. Figuring I wasn't the only one, we designed an order entry experience that is quick and simple. Traders place trades to make money, and you can rest easy knowing we aren't going to make you wait.

I WOULD BE REMISS IF I DIDN'T CONCLUDE BY emphasizing that this platform has not yet achieved the level of maturation that we're seeking. But what trading platform really has? After all, like our sister trading platform, thinkorswim from TD Ameritrade, it's wonderful, but we'll be constantly improving it with new tools and surprises based on client feedback (that means you). We'll also be making monthly enhancements such as integrated fundamentals, alerts, paper trading, research, and more.

Market volatility and system availability may delay account access and trade executions. Options involve risk and are not suitable for all investors. Investools, Inc. does not provide financial advice and is not in the business of transacting trades. Investools, Inc. and TD Ameritrade, Inc. are separate but affiliated companies that are not responsible for each other's services or policies.

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Ask the Trader Guy

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Saving traders, one question at a time.

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Photograph by **Fredrik Brodén**

trdr.

Q: Trader Guy! What's with all the new exchanges? BATS? BOX? Can I start one myself?
A: In the past few years, we've seen some new stock and option exchanges start up, particularly the Boston Options Exchange (BOX) and the BATS Global Markets, and you may be wondering what that means to you. For starters, creating an exchange isn't something you can do yourself like, say, creating your own Facebook page. There are a lot more moving parts. But they can mean something of utmost importance to the retail trader and investor—tighter bid/ask spreads. Exchanges are like any other business. They respond to competition by making their products better and/or less expensive. The product of exchanges is, well, transactions in stocks, options and futures, and the bid/ask spread is how that product is displayed to the world. Because the exchanges want your transactions to take place with them, they'll try to make their bid/ask spreads narrower, which reduces your execution costs. The new exchanges are growing in terms of the value of the transactions taking place on them, and that means competition for places like the NYSE, NASDAQ, and CBOE. You can try to use that competition to your advantage by working limit orders in between those tighter markets.

Q:Trader Guy! Help! My mother is out-trading me, and she takes every chance to rub it in. What should I do?
A: OK, it's generally bad form to dis your Mom. Even death row inmates sport "Mom" tattoos. While you can pour your beer over your buddy's head when he or she starts bragging about a string of winners, it's not something you do to your mother unless you want to appear on Jerry Springer. And that just ain't you. But if your mother's being a real jerk about her trading skills vis-à-vis your disappointing performance (again!), you may want to try to stick it to her without ending up on the most wanted list. Uninstall the thinkorswim by TD Ameritrade trading platform from her computer. When she tries to log in the next morning, her ensuing shrieks will make up for years of abuse. Reinstallation is quick, and the damage won't be permanent. You can mumble something about corrupted jar files and operating systems while you quietly log in on your iPad. Strike a blow for adult children worldwide.

Q: Trader Guy! My husband spends all my trading profits on organic foods, but they don't taste any better to me. Please, Trader Guy, save my marriage.
A: You know, I wonder how many times marriage counselors hear, "For crying out loud, a tomato is a tomato!" Food is one of our last great taboos. You can insult my intelligence, my heritage, my various beliefs. But if you insult what I'm eating for lunch, WHAM! POW!! That's it, baby! Making money trading is hard. Perhaps your spouse does not understand that fully, and is content to squander your earnings on higher-priced produce and meats that rot and go rancid faster. This must stop.

Start by diverting your profits into secret accounts that only you can access. Eat a Twinkie and proceed to crush a can of fully caffeinated soda in front of him to display your health and vigor. Maybe gulp Slim Jims whole. This twin-pronged attack from financial and physical angles has the greatest chance, I feel, of convincing him that this organic stuff is just a fad. And that really smart people create vats of chemical additives to help us live better lives through creamy fillings with decades of shelf life.

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The information contained in this article is not intended to be investment advice and is for educational purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.

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Capiche?

cap.

Lessons from a veteran floor trader.

The Long Call Blues

The risk in your long call isn't always what you pay.

• I've been trading so long, I can't exactly remember when I learned the basics about options. You know, what a call is. What a put is. Max profit potential, max possible loss. Exercise and assignment. Like everybody else, I started with the simplest stuff and worked up, and I went a long way with the basics. But one expiration taught me a little lesson that I won't forget.

One of the first things you learn is that a long call has a maximum risk equal to the debit you pay for it. If I buy a call for 1 point, which is $100 cash, and the stock goes down so that the option is out-of-the-money at expiration, I'll lose $100 plus any commissions I paid. No more, no less. You've heard me going on and on about managing risk, knowing the max risk of a trade, don't take too much risk, yada yada yada. You'd think that if you buy a call, you could then forget about it because you have the risk under control. What could happen?

RUDE AWAKENINGS

I'll tell you what can happen. I was an index option trader, and didn't do too much with individual stock options. But once in a while I'd take a shot on something. I bought a call on a stock I thought was going up. I think it cost me half a point. I kept tabs on it, but my main focus was on my index option trading. I'd see the stock rally and come back down, rally and come back down. Expiration was approaching. The option was getting cheaper and cheaper, and I didn't think it would do much. To be honest, I kind of forgot about it. Hey, my maximum possible loss was $50.

But when I wasn't watching, the stock closed above the exercise price of the call on expiration Friday. My call was in-the-money by $0.20 or so. Now you might think that was a good thing, and I suppose it could be, because theoretically that call was worth $0.20 and not 0, so my loss was smaller. But my long call was automatically exercised because it was in-the-money at expiration, and I got long stock in my account. On Monday morning, I noticed the long stock (remember, I had kind of forgotten about my long call). So, I checked the price of the stock and … C$@p! It's down $2!

I sold the stock that day and figured out my loss after the close. I had bought the call for $0.50; the call was exercised and I bought the stock at the strike price, and then I sold that stock at $1.70 below the strike price. I lost $0.50 on the call and $1.70 on the stock, for a total of $220—way more than the max loss on the call!

You see, back when there was a lot more manual stuff going on to handle expiration, long options weren't automatically exercised unless they were $0.50 in-the-money. But as systems improved, that number dropped to $0.25, then $0.05, and then $0.01. So today if you have a stock-settled option and it's $0.01 or more in-the-money, it's going to be automatically exercised* unless you call your broker. If not, you're going to have a stock position. And that stock's next move can potentially create larger losses than you might have had with just the long call.

The solution: monitor all your positions at expiration. If you have long or short options that are in- or at-the-money, just close them out. If I had been paying attention, I might have been able to avoid the extra risk.

TD Ameritrade, Inc. does not solicit or recommend any form of trading in any specific securities. Please do careful, independent research before investing any money as well as weigh the possible consequences on your particular financial situation before doing so. The risk of loss may be substantial. Options involve risks and are not suitable for all investors.

**TD Ameritrade may take action to close out any position that your account cannot support at any time on the last trading day for options contracts. Such action could result in a sellout fee in addition to the applicable commission charges.*

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

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Special Focus: Volatility Primer

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Photograph by
Fredrik Brodén

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Markets Move. Get Over It

Just the thought of a little volatility can send a timid trader running for the hills. But without volatility, there are no trading opportunities. So to revere it rather than fear it—you need just need to "get it."

WORDS BY **THOMAS PRESTON**

FOCUS:
Volatility Primer

SOMETIMES THE MARKET MOVES A LITTLE.

Sometimes the market moves a lot. Why? It might be political unrest in the Middle East. It might be earnings season. It might be the release of economic data. Or the talking heads on TV may have found some story that they can tie to today's up, down, or stagnant market. … Yawn.

Volatility—the measure of the magnitude in the changes of the price of a stock or index—happens. It might seem high, or it might seem low. But no matter what volatility has done, will do, or is doing right now, traders keep on trading. What traders don't do is scratch their heads trying to figure out the cause, and then wait … wait … wait for the perfect volatility scenario to come. Why not? Because it doesn't exist.

Imagine you're shooting an arrow at a target, and it's windy. The wind is going to push that arrow a little bit to the left or right depending on which direction it's blowing. But you

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Special Focus: Volatility Primer

Photograph by **Fredrik Brodén**

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don't pack up and go home. You aim the arrow a little bit left or right to account for that wind so that, hopefully, the arrow hits the bull's-eye. Trading in the presence of volatility means you may need to adjust your trading strategy a bit. You don't quit trading.

But maybe you find some of the volatility talk confusing. That's completely understandable. No one springs from the womb a full-blown trader or nimble investor. There's a learning curve. And when the lessons get to volatility, that curve can steepen a bit. The goal of this article is to flatten the curve, get you smarter, and make you more confident in dealing with the inevitable and rarely dull prevailing wind in the trading atmosphere: volatility.

VOL JARGON

Since we're not going to be able to avoid the big words, first, here are some terms you're likely to hear in volatility discussions at your next cocktail party. (Hey, a trader can dream, can't he?)

Implied Volatility

In my opinion, implied volatility is best learned from back to front. The theoretical value of an option is determined using a theoretical pricing model (Black-Scholes, Bjerksund-Stensland, etc.) that requires certain inputs. In particular, the pricing models usually require a current stock price, the strike price of the option, whether it's a call or a put, the time to expiration, the cost of carrying the stock until expiration, and some volatility number. All the parameters are known (or should be known) except for volatility. So, you plug a volatility number along with the other parameters into a pricing model, and you get a theoretical option price. As you change the volatility input and you keep the other inputs the same, the theoretical option price changes up or down. Now, if you can see the current market price of the option (the average of the current bid and ask, for instance), and you change the volatility input up or down so that the theoretical price is equal to the market price of the option, then you've discovered the option's implied volatility.

The implied volatility of an option is tied directly to the price of the option, specifically, its extrinsic value (time premium). Implied volatility is available only for options. Stocks don't have implied volatility. Neither do futures. Implied volatility is based solely on current data; it's not backward looking at all. And traders use it to estimate of the potential volatility of the underlying stock or index in the future. How far in the future? Well, an option is only interested in the underlying stock until expiration. Looking at the implied volatility of options from one expiration to the next, you may see that the implied volatility of an at-the-money option is much higher in a near-term expiration than in a further-term expiration when there is news, like an earnings or news announcement, that is creating short-term uncertainty. When the news comes out, the stock might have a lot of large price changes in the short term, but then settle down once the news has been digested over the long term. The implied volatility of the options in different expirations can reflect that. That's why I like to think of that volatility wind filling up an option's extrinsic value like a balloon. When there's lots of uncertainty, the wind picks up and the balloon gets bigger, just like extrinsic value. But when the uncertainty dies down, so does the wind, and the balloon deflates, just like extrinsic value.

Don't be misled by far out-of-the-money options with really high implied vols. Do they indicate the possibility of really huge short-term price changes in the stock? Not necessarily. While a stock or an index can have very large percentage changes in price in a short amount of time, the reason those out-of-the-money options have such large implied vols has more to do with their small prices and low vega, which describes an option's sensitivity to changes in volatility. All other things being equal, the less time to expiration, the lower an option's extrinsic value. When there are only a few days left until expiration, and the options are so far out-of-the-money that they might be 0.00 bid and 0.01 ask,

Ready to jump into forex? For more info, go to **tdameritrade.com/trade/forex.html.** If you are new to futures trading, we encourage you to read "An Introduction to Futures and Options" from the CME.

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to have any value at all requires a very high implied volatility, because the vega of those options is very low.

Historical Volatility

Historical volatility is based on the stock or index price over some period of time in the past. It looks at the percentage change in the stock price from one period to the next, whether that period is one year, one day, or one minute. Historical volatility is the standard deviation of those percentage changes, and it indicates the magnitude of the percentage price changes in the past. The trick with historical volatility is the amount of past data you use in the calculation. For example, if you use the past 30 days of price data to calculate the historical volatility of a stock, you'll likely get a different number than if you used the past 60 days of price data. Because knowing what happened to a stock yesterday isn't nearly as important to a trade's profit or loss as what happens to the stock tomorrow, the value of historical volatility is limited by its complete reliance on past data. As they say, past performance is not indicative of future performance. And that's especially true for the market. But historical volatility can be interesting for comparing the performance of two stocks. For example, if two stocks A and B both rose 10% in the past year, but B had a much higher historical volatility, that indicates that you would have had a much wilder ride if you held stock B in your portfolio, and perhaps it contributed to more of the swings in profit and loss you had over the past year if you did hold it.

Skew

Ever notice how the implied volatility for options is different from one strike to the next? That's called skew, and it exists because our models can't quite figure out how to make the theoretical value of all the options equal to their current market value with one single volatility input. If there's a lot of uncertainty about what might happen and the market is fearful of a big percentage change, the out-of-the-money options start getting "bid up." That's where buyers start buying more and market makers raise their prices in response to the increased demand. Those buyers might be hedgers protecting a large position against a big move, or speculators hoping that the next crash is about to happen. The effect on the volatility of the options is the same. What you see in U.S. equity markets is that the implied volatilities are generally higher the more out-of-the-money the strike is. The implied volatility skew looks like a wide "U" or "V" shape, sometimes tilted in one direction or the other.

Historical vs. Implied

One of the main things people want to see is where implied volatility is in relation to historical volatility. One may be higher than the other, but some traders believe that over time, historical and implied volatilities will move toward each other so their levels are pretty close. I'm not going to judge whether that's true or not, but you can see that relationship graphically on the thinkorswim from TD Ameritrade platform.

You can see the two volatilities overlaid on each other on the Charts tab; the studies you'll want to add are "ImpVolatility" and "HistoricalVolatility." But there's a secret to getting them scaled properly to each other: three lines of thinkScript code. Don't worry, you don't need to be a programmer. From the top right of any chart, select STUDIES > EDIT STUDIES > STRATEGIES, and look for the "NEW" button in the lower left-hand corner. Type the following code into the NEW SCRIPT box, hit the OK button, and then APPLY:

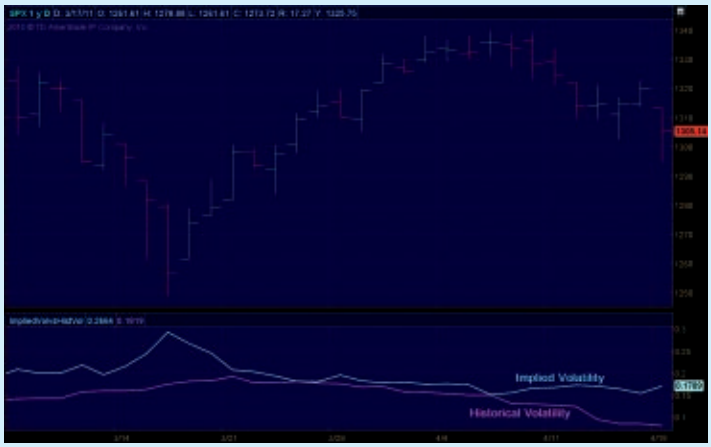

FIGURE 1: SPX options' higher implied volatility relative to the index's historical volatility might help traders determine that option premiums are higher than normal.

```
declare lower;
plot data = imp_volatility();
plot data2 = historicalvolatility();
```

The default number of days in the historical volatility calculation is 20. To change that in the code to, say, 40, use this:

```
plot data2 = historicalvolatility
(shortlength = 40);
```

The "ImpVolatility" study is the Vol Index for the options on a particular stock. It weights the out-of-the-money options for the front two expirations into an overall implied volatility.

VOL FOR STRATEGY SELECTION

You're ready to trade and hit the bull's-eye, but the volatility wind is blowing. How do you account for that with your strategies? It doesn't have to be complicated when you understand how volatility affects the prices of options and spreads. All other things being equal,

higher volatility means the extrinsic value of options is higher. Conversely, lower volatility means the extrinsic value of options is lower. Also, the more time to expiration the option has, the more sensitive it is to changes in volatility. Specifically, strategies that involve shorting options (like covered calls) or shorting spreads (like verticals or iron condors) generate smaller credits when volatility is lower. Because the credit comprises the potential profit of those trades, the lower volatility makes the max risk higher and the potential profit lower, given the same strike prices and days to expiration. On the other hand, strategies like calendar spreads can have lower debits when volatility is low. That decreases their maximum risk. A trader may bias her trades toward doing more calendar spreads, say, and fewer short verticals when volatility is lower. When volatility is higher, she may put on fewer calendar spreads and more short verticals.

VOL FOR POSITION SIZING

From a risk management perspective, an option trader or stock investor may adjust his position size depending on volatility. When volatility is high and there's lots of uncertainty spooking the market, reducing the size of your positions can be prudent. Now, here's a trick question: When volatility is lower, do you increase your position size? Not necessarily. Generally, you should have some maximum amount of risk in mind that you're not willing to go beyond. No matter how low volatility gets, you should not exceed that number. So, if you've reduced your positions from that max risk amount when volatility is high, you might want to increase your positions closer to the max amount when volatility drops.

How To "See" Volatility

Vol doesn't have to live in the abstract when you have tools that give you a bird's eye view

For more information on forex trading with TD Ameritrade, go to **tdameritrade.com/trade/forex.html.**

FIGURE 1: The Analyze page in thinkorswim from TD Ameritrade gives you a price range for a stock based on probabilities across any date over the life of an option position.

vol.

• In and of themselves, volatility numbers may not mean much. Traders need to estimate how much the market expects a stock to move given some level of volatility. Volatility numbers on the platform are annualized, which means that they estimate how much the stock might move up and down between the current date and one year forward. If you see a volatility number of 25%, for example, it indicates that the stock price might be between down 25% and up 25% in one year. In geek-speak, that range is one standard deviation wide, and theoretically covers 68% of the possible stock price changes. If you don't want to see one year's move, but a shorter time frame like one month or one week, the Analyze tab on the thinkorswim from TD Ameritrade platform has a couple tools that let you do that quickly.

Bird's Eye View

The profit/loss graph on the Analyze page shows a light blue box in the middle, nearly centered on the current stock price. By default, it shows the range from one standard deviation down to one standard deviation up (covering that theoretical 68% of possible price changes) in the stock price between the current date and the future date that's in the "prob date" (short for "probability date") field in the upper right-hand corner. You can move the cursor over the edges of the blue box to see the stock prices encompassing that range on the *x*-axis of the graph.

Custom Ranges

One of the strengths of the Analyze page is that it lets you tailor some of the inputs to see different likely ranges. For example, by default, the probability date is the front-month expiration date of the options on that stock or index symbol. You can edit that probability date to be, say, one week ahead of the current date to see what the probable range is over the next week. And if you want to see an even wider possible range, you can change the "prob range" field (short for "probability range") to 95% in the upper right-hand corner to see what the stock price might do from down two standard deviations to up two standard deviations, or to 99% to see

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up/down three standard deviations. Having an idea of the possible range of the stock price may help you decide where to place a protective stop order on a long stock position, for example, or check to see whether the price points that you determined from technical or fundamental analysis are in line with what the market's thinking.

A Picture of Skew

Another handy tool on the platform is the Widget 360 feature on the Tools tab, which can be configured to display implied volatility skews. First, you select the data that the Widget 360 displays at the bottom of the screen from the two drop-down menus. Select "Imp Vol" to see the implied volatility skews. In the upper right-hand corner, you'll find ways to filter the data. The "View" menu lets you see the implied vols for calls, puts, out-of-the-money options, or an average of the call and put implieds. Then you can focus the data using the "Series" and "Strikes" drop-down menus. The Widget 360 displays the curves of the implied volatility skews to let you see the different shapes of the skews in different expirations, as well as how much overall one expiration's implied volatility is higher or lower than another's.

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The information contained in this article is not intended to be investment advice and is for educational purposes only. Multi-legged options transactions such as spreads, straddles, iron condors, and butterflies will incur contract fees on each leg of the order, which may impact any potential return. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.

VOLATILITY

Q+A:

Q: Q: What is the Vol Index?

A: The Vol Index that you see as menu choices in the Market Watch and Scan tabs, as well as the probability page on the Analyze tab, stands for "Volatility Index." This is similar to the CBOE's VIX. It's a calculation that uses the out-of-the-money options in the front two expirations to generate a single number that represents the overall volatility of the stock's or index's options. We use that for the probability analysis tab because it needs one, single volatility input that can be used for a stock or index rather than picking the implied volatility of a single option.

THINK ABOUT THE CRASH OF 2008. IN A FEW DAYS, VOLATILITY LEVELS DOUBLED. THEY MIGHT THEN APPEAR TO HAVE BEEN MEAN REVERTING AROUND A MUCH HIGHER LEVEL WITH BIG SWINGS.

Q: What is the volatility number on the right-hand side for each expiration?

A: That number is the same calculation as the Vol Index, but uses only the options in that single expiration month. That's useful for comparing inter-month implied volatility levels when there's news or company announcements coming out. Higher overall volatility in one month can mean traders think that most of the uncertainty will be around until that expiration.

Q: Is volatility mean reverting?

A: "Mean reversion" is a term used to describe data (any data) that moves up and down around some average level. If it is above the average, it tends to move down; if it's below the average, it tends to move up. Sometimes volatility levels seem to be mean reverting. Volatility can move around some average level without making a consistent move higher or lower. But counting on that mean reversion is tricky, because the mean (or average level) can change overnight.

Think about what happened in the Crash of 2008. In a few days, volatility levels doubled. They might then appear to have been mean reverting around a much higher level with big swings up and down. Over 2009 and 2010, volatility drifted to lower levels, and moved up and down around those. So while you might be comfortable with the current mean reversion around the current volatility level, you never can tell when the world's perception of risk will change and send that level to much higher values.

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Forex 4 Fun

Currency trading nuggets, one dollar at a time.

Words by
Blake Young
Investools Instructor

How to Hedge Your Grocery Bill

FX strikes back at the rising cost of Twinkies.

fx.

• According to the Bureau of Economic Analysis (BEA), consumer consumption accounts for 65% or more of the U.S. Gross Domestic Product (GDP). This means that nearly two-thirds of our entire economy depends on consumers spending money. When Jane Public stops buying because loss of employment, lower wages, decline of confidence, or simply lower purchasing power of the income received, GDP is negatively impacted. Today, consumer purchasing power is declining significantly. Bottom line: The same monthly income just doesn't go as far today as it did a year ago, particularly when it comes to buying our groceries.

As agricultural prices have climbed much higher in recent months, consumers are feeling the pinch. When the dollar's purchasing power diminishes, the relative commodity prices rise. And when prices rise in the exchanges, they also rise at the checkout stand. If the monthly grocery bill is high, the expendable income for the non-necessities (items we can live without) declines and negatively impacts the economy.

But have no fear, forex is here. There is a way to hedge some of the rising commodity prices and higher grocery bills within the currency markets.

Commodity Currency

The Canadian dollar, the Australian dollar, and the New Zealand dollar are all considered commodity currencies. These countries export commodities, and their economies rely on the sales. When commodity prices rise, their economies do well, and their currencies strengthen. Historically, when commodity prices rise, the U.S. dollar typically weakens. When this happens, you might consider selling the U.S. dollar to buy Australian dollars, Canadian dollars, or New Zealand dollars.

FIGURE 1: As the correlation indicator (lower study) indicates, from July 2010 to February 2011, as agricultural prices rose, so did Australia's currency—a country rich in commodities.
Source: thinkorswim from TD Ameritrade

Since it's the longer-term rise and fall of agricultural prices that ultimately impacts prices at the grocery store, look for confirmation on the weekly charts of any of an agricultural index, such as the Nasdaq OMX Global Agriculture Index (QAGR), which began to rise in July of 2010. Notice the correlation study comparing QAGR to the AUD/USD in Figure 1. The correlation has remained positive for nearly a year and has maintained a correlation of over 50% for much of that time.

The Trade

How would this work in the real world? Suppose you spent on average $500 a month in groceries and saw your grocery bill increase incrementally by the same 50% over eight months that the QAGR saw. You would have paid approximately $1,000 more than "usual." Meanwhile, purchasing one mini contract of the AUD/USD on July 1 when QAGR was breaking through its highs would have generated over $1,500 in the same time frame. That hedge would have taken care of the increase in grocery prices—with $500 to spare.

Because the forex spot market continually rolls over, this type of hedge can be left on for multiple months if it is monitored carefully and proper money management is in place (read: set your stops).

Now, who said that you have to stop buying Twinkies?

Trading forex is not suitable for all investors. Trading forex involves speculation, and the risk of loss can be substantial. Investors must consider all relevant risk factors, including their own personal financial situations, before trading. Trading foreign exchange on margin carries a high level of risk, as well as its own unique risk factors. Forex investments are subject to counterparty risk, as there is no central clearing organization for these transactions. Before considering the trading of this product, please read the Forex Risk Disclosure available at www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf. A forex dealer can be compensated via commission and/or spread on forex trades. TD Ameritrade is subsequently compensated by the forex dealer. Forex accounts are not protected by the Securities Investor Protection Corporation (SIPC).

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Gear Head

Cool things to do with what we've got.

Words by
Damon Pavlatos
Managing Director of Futures, TD Ameritrade

gear

Swing Trading with Monkey Bars

Turning an old favorite of futures traders on its head.

For years we have been hearing from futures traders that Market Profile—a study that displays the market's price activity in relation to time in a bell curve—is an integral component of their trading strategies that they couldn't live without. In our minds, it was a dated proprietary study that was too expensive to implement. So we resisted—for eight years. Everything changed when we hired this cerebral, 25-year CME veteran uber-trader named Damon Pavlatos. He convinced us that the underlying principles of the study have merit, although it hadn't kept up with major changes in market structure. It was invented in the early '80s, when electronic data didn't exist and Damon sported a mullet in a rock band. So we told him to run with the concept and make it better. Make it easier. Reinvent it. Sans mullet.

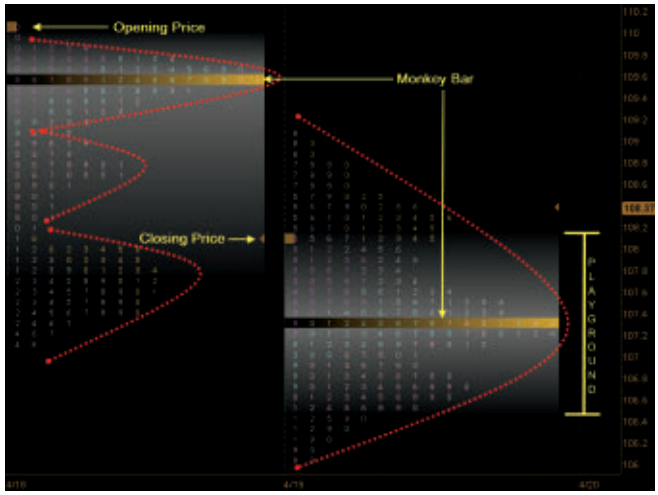

FIGURE 1: MONKEY BARS. Follow the 24-hour trading sessions of the U.S. afterhours (pink numbers), Asia (blue), Europe (salmon), and U.S. day (white/yellow). When longer-term traders are in control, the ranges are fragmented, as on 4/19. When short-term traders are in control, a unified bell curve forms around the Monkey Bar, as on 4/20.

Wanna play with Monkey Bars? Learn how by visiting the **Trader Lounge Chat** from 02/09/11 with Linda Raschke.

Introducing Monkey Bars

This study—located as a study in the thinkorswim from TD Ameritrade charts—displays numbers in a bell curve that represent each instance a price falls into a specified interval. The longest row of numbers in the study is called the Monkey Bar. The Monkey Bar exposes the price level that was the most frequently traded during the specified time period. The price range surrounding the Monkey Bar is where 70% of the trading activity takes place for the specified time. We call that "The Playground."

Monkey Bars starts recording at 3:30 p.m. and ends at 3:15 the following day. This way a trader can have some reference point in the morning for how the market traded overnight. In fact, there is a different color to represent each time zone. At a glance, you can differentiate the U.S. trading session from U.S. afterhours, the Asia Trading session from the European trading session, and so on.

So, How Do You Use It?

When the market is in an orderly bell-shape formation, it's balanced and shows the short-term traders are in control (see Figure 1). The short-term trader will usually trade around the Monkey Bar. Think of it as a magnet or mean that usually attracts the market—typically in periods marked by low volume.

When the short-term traders have control of the market, long-term traders may enter when new highs or lows are made without volume. Longer-term traders like to take advantage of the unfair pricing caused by these spikes, because they are generally larger institutions and hedge funds and are looking at the bigger picture. They are less sensitive to price entry.

When large funds come in and out of the market, they are focused on what they perceive to be the new fair value. Since they are looking at longer time frames, they can move the markets to new sustained highs or lows by the sheer volume. When the market pushes outside the playground with volume, this is a sign that longer-term traders are in control.

Obviously, this isn't enough information for you to become the master of the Monkey Bars. Our cranky editor wouldn't give us more space on this topic. For more information, we suggest that you visit our Trader Lounge Chat from Wednesday, February 9, featuring Linda Raschke. You can access this by clicking on Support/Chat on the upper left-hand corner of the platform, and then click on Seminars.

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The Token Glossary

Terms you might stumble across in this issue.

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Short Vertical

found on pages: 13, 20 & 28

• A defined-risk spread constructed of a short option and a further out-of-the-money long option, both calls or puts. Short verticals are put on for a credit. Short put verticals are bullish and short call verticals are bearish. As time passes, and/or volatility drops, the short options decay faster than the longs, provided that the stock remains closer to the short option than to the long one. The strategy is designed to profit when you can buy back the spread for less than you sold it for, or at expiration, the short option is at- or out-of-the-money. The risk is typically limited to the difference between the strikes, minus the premium received.

Vega

found on page: 36

• A measure of an option's price sensitivity to a one percentage-point change in its implied volatility.

COVERED CALL

found on pages: 22 & 38

• A limited-reward strategy constructed of long stock and a short call. Ideally, you want the stock to finish at or above the call strike at expiration, in which case, you'd have your stock "called away" at the short call strike. In this case, you would keep your original credit from the sale of the call as well as any gain in the stock up to the strike. Breakeven on the trade is the stock price you paid minus the credit from the call.

Long Calendar Spread

found on pages: 13, 20 & 38

• A DEFINED-RISK SPREAD STRATEGY, CONSTRUCTED BY SELLING A SHORT-TERM OPTION AND BUYING A LONGER-TERM OPTION OF THE SAME CLASS (I.E. CALLS OR PUTS), AND THE SAME STRIKE. THE GOAL: AS TIME PASSES, THE SHORTER-TERM OPTION TYPICALLY DECAYS FASTER THAN THE LONGER-TERM OPTION, AND PROFITS WHEN THE SPREAD CAN BE SOLD FOR MORE THAN YOU PAID FOR IT. THE RISK IS TYPICALLY LIMITED TO THE DEBIT INCURRED.

Spread

found on pages: 13, 20 & 37

• *An option position or order that contains two or more option "legs" and typically includes at least one long and one short option.*

Iron Condor

found on page: 38

• A defined-risk, short spread strategy, constructed of a short put vertical and a short call vertical. You assume the underlying will stay within a certain range (between the strikes of the short options). The goal: As time passes and/or volatility drops, the spreads can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the difference between the strikes minus the total credit received.

Positive Time Decay

found on pages: 13 & 20

• When a strategy is designed to profit from the passage of time. Such a strategy is usually constructed of at least one short leg.

Implied Volatility

found on pages: 12, 20 & 36

• The market's forecast of the future volatility of the underlying security, and is directly reflected in an option's premium. Implied volatility, expressed as an annualized number, is forward-looking and can change.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multi-legged options transactions such as spreads, straddles, iron condors, and butterflies will incur contract fees on each leg of the order, which may impact any potential return. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.

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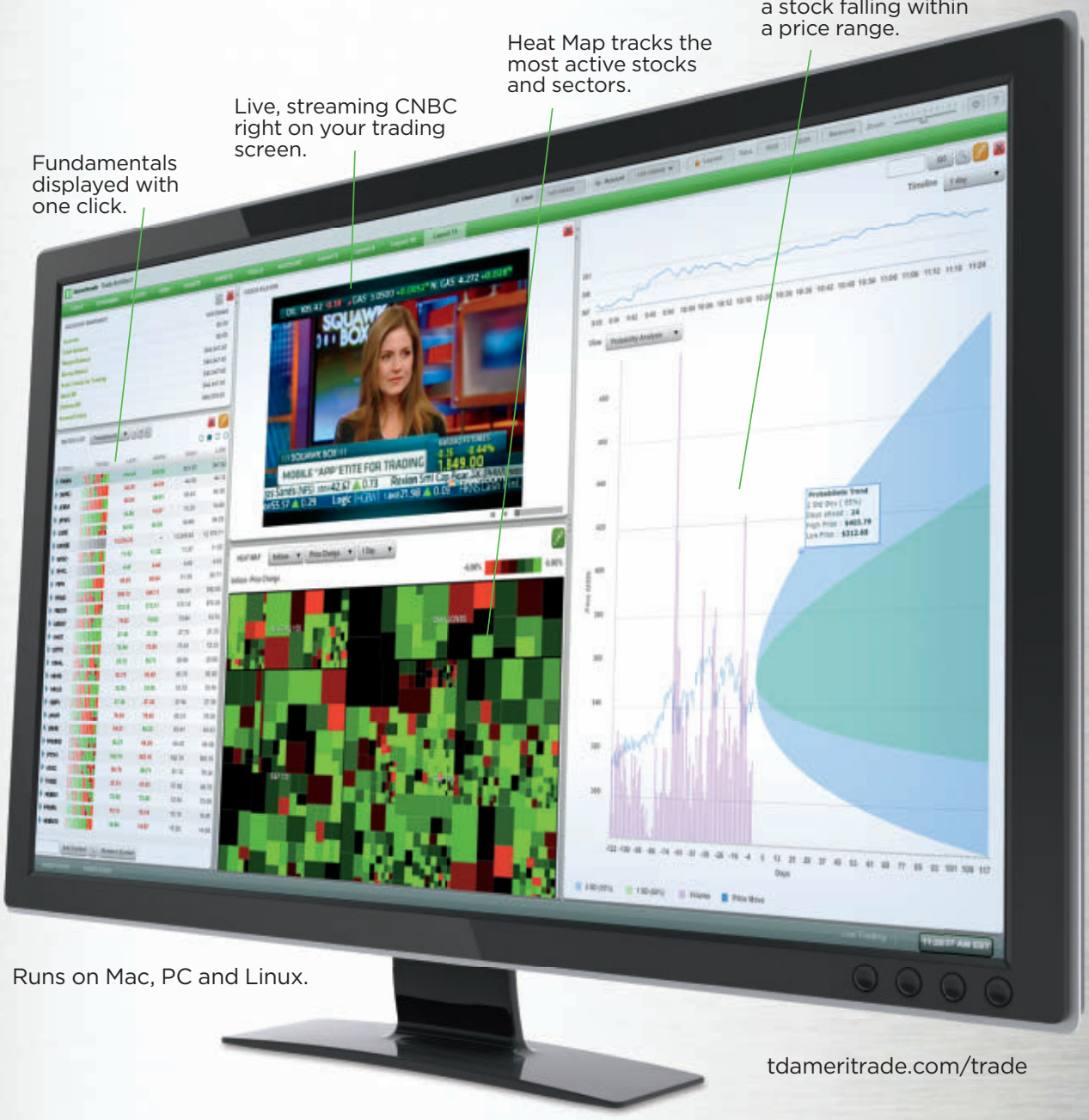

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