thinkMoney/14

random musings for traders
at TD Ameritrade
Winter 2012

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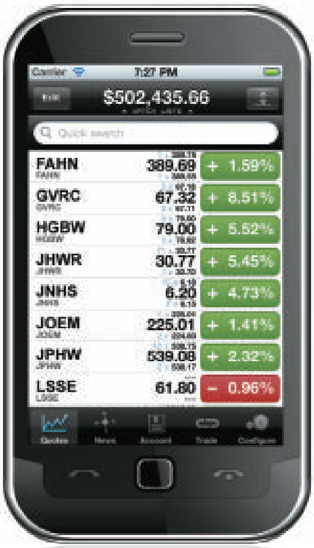

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Fredrik Brodén

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TD Ameritrade Contact Info You Could Use
Client Services Representative: 800-669-3900
New Accounts: 800-454-9272

thinkorswim Support:
800-672-2098
thinkorswim@tdameritrade.com
Platform Feedback:
thinkorswimfeedback@tdameritrade.com
Tech Support:
thinkorswimtechsupport@tdameritrade.com
paperMoney Support:
thinkorswimpapermoney@tdameritrade.com
For all other inquiries:
tdameritrade.com/contact

General Mailing Address
PO Box 229
Omaha, NE 68103

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A Quick Howdy

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EDITORIAL DIRECTOR
Kevin Lund

EDITOR
Thomas Preston

TECHNICAL EDITOR
Alex Mendoza

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ASSISTANT EDITOR
Lindsey Peacock

DESIGNER
Jennifer Roberts

CONTRIBUTING WRITERS
Nicole Sherrod
Adam Warner
Brandon Chapman
Alex Mendoza
John Brodemus

CHIEF PHOTOGRAPHER
Fredrik Brodén

CONTRIBUTING ILLUSTRATORS
Brian Cairns, Evonrude

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

ADVERTISING CONTACT
sales@t3publishing.com

edit.

Do You Need a VIX Fix?

• An old rule of thumb that many traders have leaned on for years goes, "When the VIX is low, it's time to go. When the VIX is high, it's time to buy." Then there's the other adage by regular people that goes, "Just when you think you've figured it all out, suddenly, you don't."

If you're trying to figure out what's considered "low" these days in the CBOE's Volatility Index (VIX), get in line. The market has been a little bit hysterical the past couple of years, making a "mean-reverting" index like the VIX a little more challenging to pinpoint exactly what it's telling us.

But don't let that deter you. Our cover story on the VIX (page 10) ought to debunk any burgeoning myth that somehow the now-famous volatility index just ain't working the way it once was. It was never meant to predict the future, but it can help to clue you into what traders overall are thinking, and how to develop a strategy.

Speaking of volatility, there comes a time when most traders—especially new—get spooked out of a trade by taking on too much risk when volatility strikes. Since "weak hands" don't win, "How to Keep Your Head" on page 24 will clue you in with some tips on how you might rise above the noise when things go a little topsy-turvy.

And lastly, if margin has you scratching your head trying to figure out what it all means, how to calculate margin for a particular strategy and some of its special considerations, be sure to read this issue's Special Focus on margin, page 32.

So, enjoy the latest serving of *thinkMoney*. We're pretty sure you're going to like what you see. Let us know. Go to tdameritrade.com/tmsurvey.

Happy trading!
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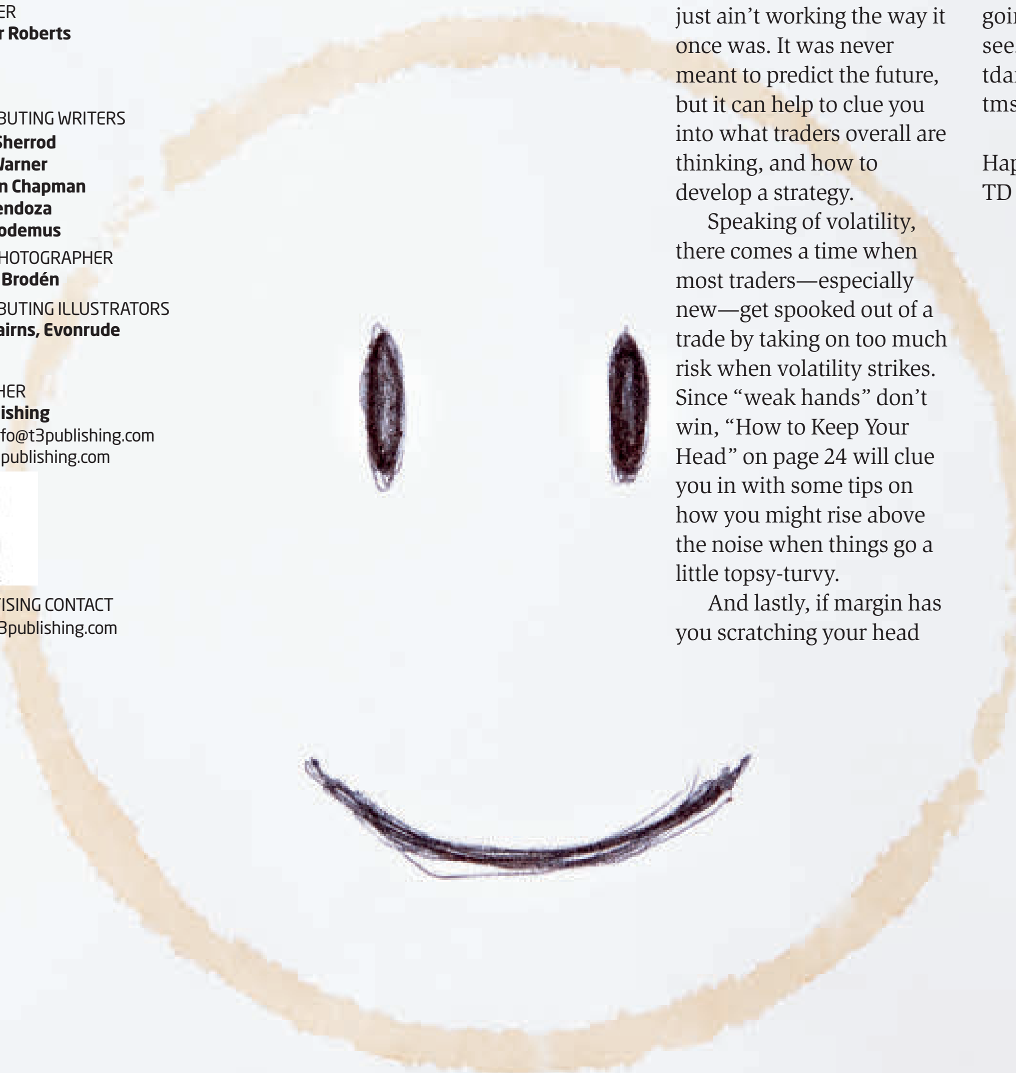
What has thinkMoney done for you lately? Climb to the highest treetop and shout it out. Or you could just go to **tdameritrade.com/tmsurvey** to let us know.



PHOTOGRAPH: FREDRIK BRODÉN

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FOR YEARS, THE VIX VOLATILITY INDEX WAS USED PRIMARILY BY TRADERS TO PREDICT MARKET DIRECTION. BUT SOME ARE BEGINNING TO QUESTION ITS RELEVANCE. TODAY, SOME TRADERS SIMPLY USE IT TO INFORM THEIR STRATEGY DECISIONS.

THE VIX GREW UP, HAVE YOU?

WORDS BY **THOMAS PRESTON**

PHOTOGRAPH BY FREDRIK BRODÉN

Photograph by
Fredrik Brodén

--BACK IN THE EARLY '90S, WHEN THE CBOE'S VIX volatility index was first concocted, I was sitting in a class at the University of Chicago GSB taught by Robert Whaley, who had created the original VIX a couple of years before. I was already working on the trading floor, trying to square up what I was hearing in class and what I was seeing on the job. I could see the amount of buy orders and sell orders flow into the trading pits, and see option prices change in response, and then see how those option prices would change the implied volatility. That VIX indicator looked like a handy tool to gauge the fear or complacency in the market rather than have to watch the order flow.

And later, when the VIX was published as an index everyone could see updated live on trading platforms, more and more people started to believe a low VIX was an indication the market might be too complacent, overconfident and over-bought. A sell-off might be in the offing. If the VIX was high, fear was rampant. And while everyone else was panicking, some thought the high VIX was an indication the market would bounce back.

Maybe that's true. Maybe not. There's been a lot of chatter this past year about whether the VIX can predict the direction of the market, whether it's is a leading or lagging indicator, whether it's useful or not, etc. Some people are now thinking that the VIX is unreliable. Useless. Wrong, even.

IT'S NOT THE VIX, IT'S THE TRADER

It's not the easiest calculation in the world, but the VIX is just a weighted average of the out-of- the-money SPX options in the first two expirations, and then adjusted to mimic the volatility of an option with 30 days to expiration. Because it works off the actual bid/ask prices of those SPX options, it's never "wrong." It's just a calculation. It is what it is. But what about "unreliable," or "useless?"

To a savvy trader or investor, those are the wrong questions. While everyone else is asking, "The VIX is here, where's the market going?," you need to ask, "The VIX is here, so what strategy am I going to employ?" You can't control where the market is going. Even picking direction is basically 50/50. But you can control the trading and investment strategy for your money. To me, the VIX is less of a market indicator and more of a strategy indicator. While less informed market participants and "talking heads" focus solely on the VIX as a number, many experienced traders aren't put off by how high or low the VIX is. They watch it to make more informed decisions about strategy.

As a trader, you have to stay a step ahead of the noise. Stocks, indices, commodities, indicators—they all go up, down, or both, every day. Analysts usually try to attach some news or reason to try to explain why the market did what it did. But that's looking backwards. A trader has to be forward looking. And the VIX can help you with that.

USING VIX 2.0

Think about the VIX all by itself for a moment, divorced from the rest of the market. If the VIX is going up, it means the out-of-the-money option prices, which are used in the VIX calculation, are rising. What's making them go higher? Mechanically, it's because market participants—traders, investors, money managers, you, me—are trying to buy more of them. That buying pressure pushes up the prices of options, which, in turn, pushes up the VIX. So, if you see the VIX staying pretty constant, it means the out-of-the-money option prices aren't moving much higher or lower, which could mean there really isn't any strong buying or selling pressure on them. You don't have to know why, necessarily. Again, it just is what it is.

Now, combine the VIX that's not moving with a market that is moving lower. If the market's moving lower, but the participants aren't bidding up those out-of-the-money options, chances are it's because they're either already hedged, or are less leveraged, and a sell-off isn't that scary to them. They don't perceive they have the risk they might have had. And maybe that's why the VIX can be seen by some as not that useful ("Hey! The market's selling off but the VIX isn't going higher!").

But think about the VIX as a tool to make more informed strategies, rather than to predict market direction. Is it high or low relative to where it's been for the past few weeks? What you're trying to do is gauge the overall level of fear or complacency in the market, and how that's impacting option values. Here's how.

1. IF THE VIX IS LOW, that's an indication that market participants are a bit complacent, and option premiums are relatively low, too. It doesn't mean they're undervalued. It just means there's less extrinsic value in those options than there would be if the VIX were high. That makes some option strategies, such as covered calls, naked short puts, or short verticals, for example, less

cov.

AS A TRADER, YOU HAVE TO STAY A STEP AHEAD OF THE NOISE. STOCKS, INDICES, C OMMODITIES, INDICATORS—THEY ALL GO UP, DOWN OR BOTH ... A TRADER HAS TO BE FORWARD LOOKING. AND THE VIX CAN HELP YOU WITH THAT.

SEE GLOSSARY, **PAGE 42**

The VIX is as easy to see on our trading platforms as the sun is in Florida. Just fire up **thinkorswim or Trade Architect** platforms, access your charts page and type in the symbol VIX in thinkorswim or $VIX.X in Trade Architect.

attractive because the lower option values means less credits taken in for those strategies, which decreases potential profits and increases potential risk.

Strategies such as buying slightly in-the-money calls in further expirations as a stock replacement strategy can make sense, particularly if you sell nearer-term expiration out-of-the-money calls against them. It's like a covered call strategy, but when you use the in-the-money call instead of long stock, you have lower capital requirements and lower risk if the stock drops sharply. Also, in a low-vol environment, the long calls have lower extrinsic value, making them less expensive and have lower risk.

That's a straightforward transition from a covered call, which is buying stock and selling an out-of-the-money call.

2. IF THE VIX IS HIGH, that's an indication that there's a lot of uncertainty in the market, with fear about what might happen in the near term future. Often, the VIX is higher when the market has sold off sharply. Instead of buying stock, you might consider shorting a naked put. This is a strategy some consider when the market or an individual stock has sold off and volatility, i.e. the VIX, is up. The reason is if the stock has hit a recent low, the put is going to have a greater value because the stock price is down and volatility is higher. When you sell an out-of-the-money put for a higher credit, your cost basis for the stock is lower if the stock price declines further and you're assigned on the put. And that means your maximum loss is lower and your potential profit is higher. (For more on selling naked puts, see "Naked Short Dos and Don'ts," *thinkMoney*, Fall 2011.)

But what if the market moves up or down, and the VIX doesn't change much at all? A trader might scan the rest of the market, from the S&P 500 to the NASDAQ composite, bonds, gold, oil, the US dollar and bell-weather stocks. If, say, the market is down, but larger stocks are up, then the VIX could be indicating the market isn't in "panic mode" quite yet. Alternatively, if the equities in general are up and you expect the VIX to be lower and it's not, that might indicate growing fear and uncertainty in some of the market participants who are still buying those out-of-the-money options as protection.

THE POINT IS THAT YOU DON'T HAVE TO BE A HARD-core option trader to use the VIX. Even novice investors who are getting started with options can use it to help make simple adjustments to their strategy that can potentially work to their advantage. The VIX is simply a tool. Whether it's good or bad for your trading depends on how you interpret it. It is what it is.

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Love Notes

Hyperbole and Trading Pearls From ... You

Photograph by **Fredrik Brodén**

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• I heard the iPhone 4S demo not only found a Greek restaurant in Cupertino, but a German national willing to pay for lunch.
Stan

• The problem is, in the stock market, the enemy is not wearing a uniform. You don't know who the enemy is until after they have left you battered and broken.
Joe

• The credit crunch is getting bad. I let my brother borrow a tenner a couple of weeks back. It turns out, I'm now Canada's fourth biggest lender.
Dieter

• The most successful investor was Noah. He floated stock while everything around him went into liquidation.
Pauline

• I'm a huge fan of Darwinism. It's amazing I have made it this far.
Jess

• EXECUTIVE TO ASSISTANT: Call my broker
SECRETARY: Stock or pawn?
Shannon

• I wish we could get rebates when we take liquidity out ...
Chris

• Greece announced they're switching to Geico. Saving a lot of money on car insurance.
Chris

• We are all newbies, only at different levels.
Craig

• FedEx just delivered a new battery for my Taser. I tried to burn a wart off and woke up ten minutes later.
AJ

Got a quip, a poem or a pearl you'd like to share? Send us your best prose to thinkmoney@tdameritrade.com.

• Markets' Fear, and Markets' Greed (hand in hand) like identical twain.
Facilitators of success, or massive pain.
To work, they go in "Waves" constrained.
In peaks and troughs, up and down again and again.
Ride them waves for success, and do not complain.
And you can cross her ocean of wealth, or become insane.
Mark ye well my friend, to avoid this looming abyss of possible pain.
Know well then, when to get in, and when to get out again.
Wisely so, and not in vain.
Go with her momentum, again and again.
And when Momo's energy is drained, my friend,
find a new wave and ride it again.
Ride them waves one by one, up and down, ad-infinitum.
And you shall surely conquer Wealth's unfathomable ocean with richness' joy gladly devoid of a pauper's pain.
Ride them waves up and down, again and again.
Wherefore on her crests and troughs you shall find Wealth's enriching tide.
So in her flow, there you can successfully abide.
This is the way of the Markets' ocean' tide.
Courageously cross it, but never hide.
Just one Humble Opinion for a successful ride.
Robby

News+Views

A hodgepodge of stuff we thought you should know.

Photographs by **Fredrik Brodén**

nws.

INDUSTRY SPOTLIGHT

Is There Value in Social Investing?

by Adam Warner

Traders are bombarded with news and opinions, be it from the people you love or the media. Whether or not you agree with someone or something is irrelevant. The question is, is it useful? Absolutely, but in smaller doses that are part of your plan, not just random wavelengths you react to willy nilly.

We all need information. TV, Twitter and your message stream all provide that. So, maybe don't avoid and ignore everything altogether. Just put it into perspective, narrow your choices. Think about to who you're listening. CEOs, for example, can provide great information when interviewed, but they rarely have bad things to say about their companies when they miss.

Then there's the money manager who inevitably "lightens up" near the top and "gets long" at the bottom. Except maybe he doesn't. He's managing other people's money and has different goals and concerns than you do. He probably needs a certain equity allocation. He's also not as nimble as you. And so on.

In trading, it's been said it's all in the strategy, not the stock. Ask two analysts where they think stock XYZ is going in the short term, and one guy thinks it's going higher, while another guy thinks it's going down. What may really happen in the short term? The reality is, probably nothing. It's a good idea to hear the consensus, but what you do with that information is what counts. And since, for the most part, it's a coin-toss about who's right and who's wrong, strategy becomes your key to success.

Using defined-risk, high-probability trades such as short out-of-the-money vertical spreads, for example, make sense when you consider the diversity of the market's collective opinion about the state of things or the direction we're headed next. Stocks can move up, down or sideways, and since short out-of-the-money verticals profit when the stock stays above the short strike of the spread, at least two of those scenarios work in your favor. It's only when the stock moves against you do these spreads create a loss. (For more on short verticals, read "Down and Dirty with Verticals," *thinkMoney*, Winter 2011).

If you trust the source, by all means, listen. And if that guest on TV has some useful insight, take note. Use every forum you can to get ideas. But then do your own due diligence and trade with your head, not from a tweet.

Important Information

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 situation before trading.

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fyi.

Ask The Suit

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

Q: **It seems like you guys are rolling out more new features. Can we expect even more in the coming weeks?**
A: Now that the clearing conversion is over, you'll see that we are making good on our promise to continue to innovate and improve both thinkorswim and Trade Architect. In fact, in December we had three new feature releases which introduced great new functionality on both platforms. We're just getting warmed up. There's much more to come in 2012!

Q: **What is your favorite technical study?**
A: There are three things I consider to be highly personal and have a really difficult time disclosing: 1) My iPod music library, 2) my DVR list and 3) my technical studies. But in the spirit of sharing, I like Falco. There, I said it. Rock Me Amadeus is a survivor. I DVR Grey's Anatomy because once a week, I like to have a good cry. But when it comes to technical studies, I'm a Person's person. I love my Person's Pivots.

Q: **What's it like working on your team?**
A: There's a lot of work hard, play hard that goes on with our team. But they're crazy, talented maniacs. We live thinkorswim. You're lucky to be trading on a platform built by people who are never satisfied. And we never forget to have a good time. In fact, just the other day we closed out the work day by busting out an Air Supply sing-a-long to "All Out of Love," led by our pseudo celebrity, JJ Kinahan.

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Pot Shots

What's the most realistic trading movie?

KEY:

2 Buy Tickets =

1 Buy Ticket =

1 Sell Ticket =

2 Sell Tickets =

Wall Street (1 Buy Ticket, 1 Sell Ticket)

"Greed is good" earned a place in American lexicon. But c'mon, is Darryl Hannah really worth jail time? Nah.

Trading Places (2 Buy Tickets)

Funny, but insider trading is insider trading. Let's hope Mortimer and Randolph enjoy their orange juice in prison!

Rogue Trader (1 Buy Ticket, 1 Sell Ticket)

Nothing you couldn't learn from the Internet, and killing Barings Bank apparently didn't kill Nick Leeson's career. He's now a motivational speaker.

Boiler Room (2 Sell Tickets)

Trading? Um, no. The movie's intrigue and drama can't quite hide the dreariness and desperation of chop shop crooks.

Mean Girls (2 Buy Tickets)

Okay, it's not a trading movie. But seriously, the Plastics would be awesome traders.

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Calendar Spreads

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IT'S ABOUT TIME

STOCKS MOVE UP. STOCKS MOVE DOWN. BUT MUCH OF THE TIME, THEY'RE RANGE BOUND. IF YOU'RE LEFT SCRATCHING YOUR HEAD AS TO HOW TO TAKE ADVANTAGE OF THAT AT A FRACTION OF THE COST OF BUYING THE STOCK, HOW ABOUT A CALENDAR SPREAD?

WORDS BY
ALEX MENDOZA
PHOTOGRAPH BY
FREDRIK BRODÉN

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Calendar Spread

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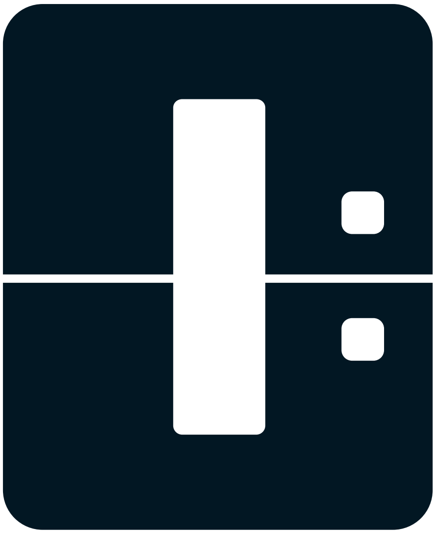


Imagine, for a moment, you could periodically collect option premiums such as a covered call trader, but at a fraction of the stock risk. That's precisely the function of a calendar spread. It's designed to profit on something we all count on—the passage of time.

By definition, you construct a calendar spread by selling a near-term option and simultaneously buying a longer-term option of the same strike and type. How do you accomplish this? First, you pick a near-term option that you want to sell. Then, you find a longer-term option with the same strike and buy it. Sounds simple enough, but there are other considerations.

CALENDAR MECHANICS

Calendar spreads can be created using any two options of the same stock, strike and type (both calls or both puts), but of differing expirations. As an example, consider XYZ stock currently trading for $100 per share. If we buy one December 100 call for $2.50 and sell one November 100 call at $1.50, we have bought the December/November 100 Call calendar spread in XYZ for a $1 debit.

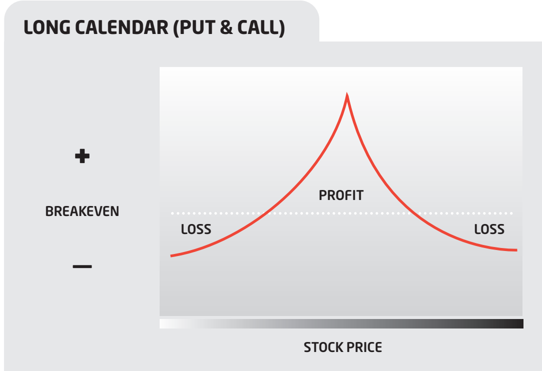


FIGURE 1: Time Awaits The calendar spread will profit when the underlying stock settles within a certain range at the expiration of the short leg, assuming volatility doesn't decline significantly.

This is a trade using equity options, which typically implies American exercise style. This means the December option fully contains the November option. For this reason, if you paid $1 for the package, your maximum risk on the trade is typically limited to that amount.

The maximum reward and breakeven levels of a calendar spread are contingent on the time value inherent in the options. Those calculations are best done with the help of an option-pricing model. The thinkorswim platform gives you a graphical representation of how your trade may pan out using current market parameters.

Want to see what your trade could do if the stock price or volatility levels changed? Our platform lets you run through just about any what-if scenario you can imagine.

A GREEK BREAKDOWN

We don't want to make this a discussion about Greeks, but it helps to know what makes this trade tick. If both options are near or at-the-money, the difference in delta between the long and short options is likely to be small, or delta neutral (meaning, at that moment, they pose no directional risk). However, as the options move significantly in or out of the money, the deltas can pile up and work against you.

The good news is near-term options have greater theta (a measure of time decay sensitivity) than longer-term options, so provided your stock remains in a trading range, you may expect to collect a small amount of money on this trade due to time decay working in your favor. This time decay element, similar to that of the covered call position, represents how you typically expect to make your money.

Then there's volatility to consider. Vega measures an option's sensitivity to changes in implied volatility. Calendar spreads have positive vega—meaning

SEE GLOSSARY **PAGE 42**

TRADING VIDS

Calendar spreads are cool. But for more options, market, and trading education, check out the **TD Ameritrade Webcast Series** at www.tdameritrade.com/learn. And hey, if you miss one, they're archived for at least a little while, too.

they're helped by an overall increase in volatility. But should overall volatility drop, so goes your premiums—and your trade.

THINGS TO THINK ABOUT

If you're thinking about trading calendars, here are a few things to consider.

1) Pick a stock that is range-bound, but not comatose. You typically want to trade stocks that trade in a decent range, but not a flat-liner. Without some sort of volatility, there's little premium to sell.

2) Implied volatilities should be near the low end of their range. Because this is a vega-positive trade, an overall rise in implied volatility tends to help your position. You want to give yourself a decent chance to catch the occasional jump in overall implied volatility levels.

3) Decide between calls or puts. While call-and-put calendars are synthetic equivalents (i.e. they accomplish the same thing), ideally you want to stick with the spread that holds the out-of-the-money options. By doing so, you are typically exposed to tighter bid-ask spreads, and as an added benefit, you minimize the likelihood (and nuisance) of early assignment.

4) Beware of trading "skew." Buying lower implied volatility levels in one month and selling higher levels in another month doesn't always accomplish what retail traders think. In fact, it typically makes your trade harder to manage. So, if you're just starting to trade calendars, you may want to steer clear of skew for now.

5) Avoid weekly options. This is not to say that you won't ever trade "weeklys" in this strategy, but options move extremely fast during the last week of their life. If you're just starting to trade calendars, try to sell an option with at least two to four weeks to expiration, and buy the next month or further out. As you get your bearings, then start to experiment with different bounds.

6) Be ready to act on expiration week. While calendars are trades in which time decay typically works in your favor, the water can get a bit cloudy during expiration week. Sometimes, the near-term option has decayed so much the incremental benefit of holding the trade one more day is outweighed by the far greater exposure in the higher-priced, longer-term option. You may have a position in which there is no more time decay (reward) for you to gather. Any time you're in a trade where there's no more reward, but plenty of risk, that usually represents a good point to close the trade out.

CALENDARS FOR CREDITS?

When it comes to calendars, there are moments that seem too good to be true. Such is the case sometimes when it appears you can enter one for a credit. This is most likely to happen when you're looking to trade calendars on European-settled indexes such as the NDX, or on instruments with multiple underlying products such as the VIX.

As mentioned earlier, the maximum risk in an American-settled equity option calendar spread is the debit paid for the position. This is because the minimum value such a spread can achieve is zero. This is not the case for European-settled index option calendars. On those spreads, calendars may be valued for less than zero, so when the value inverts, you can see them trade for credits.

The moral here is if something can trade for a credit, and if you have no idea how large that credit can get, then you cannot get a firm grasp on your maximum risk. That said, if you try to trade calendars on index products, your short options will be considered unhedged (naked) for margin purposes. Trade them at your own peril.

WHEN TRADING EQUITY OPTIONS, CALENDAR spreads can provide the opportunity to collect time decay for a fraction of the overall risk of a covered call position. In fact, while your maximum risk is typically limited to the debit paid for the trade, a calendar will only rarely achieve maximum loss, due to the fact that the front month option loses all of its time value, while the longer-term option tends to still hold some residual value. This usually means even when they go bad, calendars still have a residual roll value (see sidebar) you can salvage.

Monitor Page

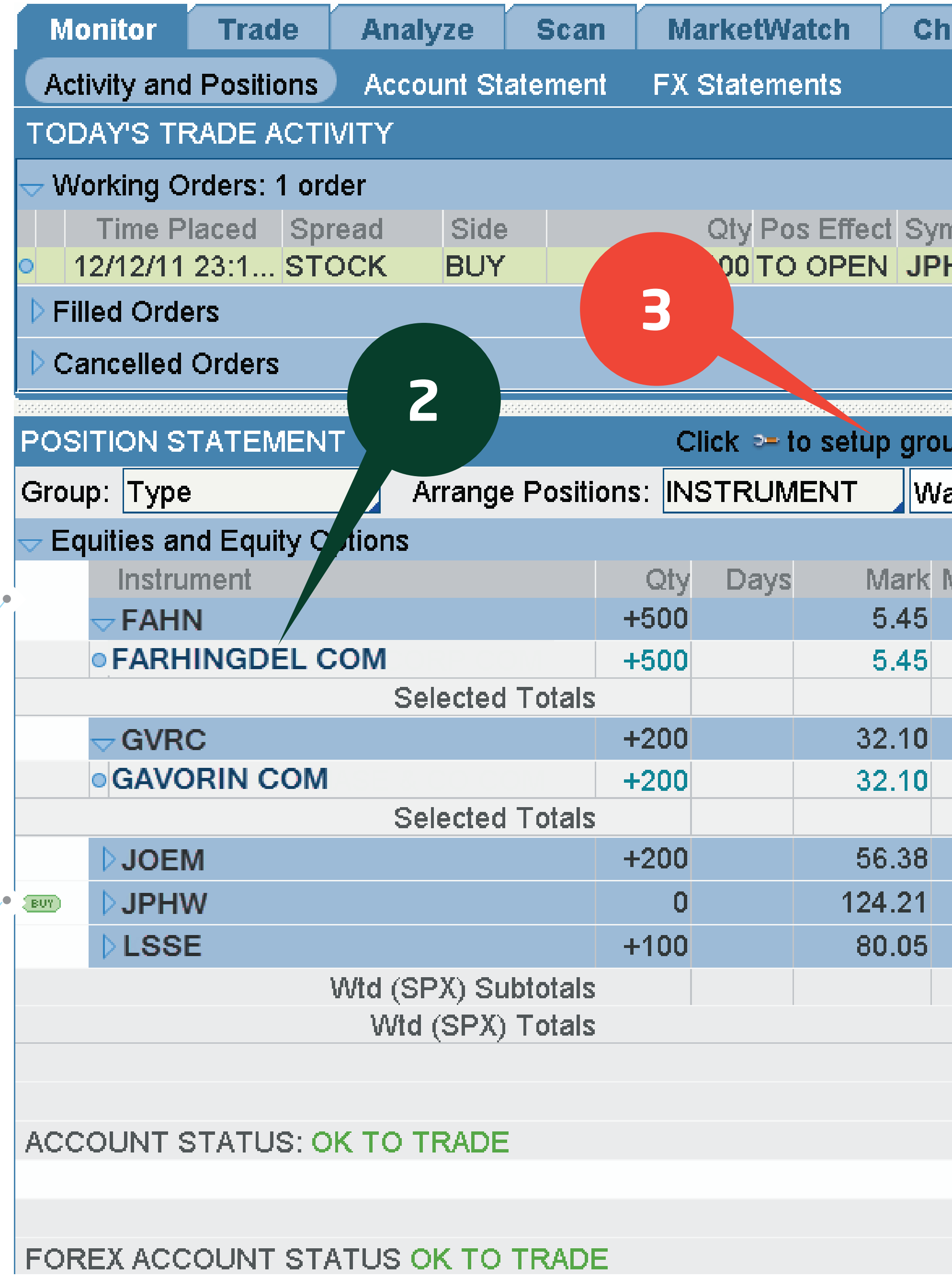
The thinkorswim feature that answers the burning question, "What's my money up to today?"

When you log in to the thinkorswim trading platform, you have questions. "How are my positions doing today? How much did I make on XYZ this year? How much money do I have free to trade?" And of course, "What's the lunch special at Mangia?" While we don't know what's for lunch today, the answers to the rest of these, and many more questions, live on the Monitor Page.

Now, watching your account balance move in real time is as fun (or cruel) as watching the markets move in real time. If you're one of those traders who wants to watch their account balance and position P/L rise and fall in real time, the first place you'll want to go in the Monitor page is the "Activity and Positions" screen. Here's how it breaks down:

- **Today's Trade Activity:** This will tell you everything you've done today, as well as every order still pending. Click on the left arrow on Working Orders to see orders entered today that remain unfilled. Once your order has been executed (filled), it moves to the Filled Orders tab. If your order remains unfilled today, or you manually nix it, you'll find it by click on the Cancelled Orders arrow. Note though GTC orders (Good Til Cancelled) will remain under Working Orders.

- **Position Statement:** The Position Statement is a detailed snapshot of what your positions are up to, grouped in alphabetical order by default. However, you can change that default at any time. Organize the view of your positions in groups by type, capitalization, industry and account, simply by clicking the drop-down menu next to Group in the upper left of the Position Statement.



This is not a trade recommendation and is for illustrative purposes only.

5 Cool Tips for Those That Like Tips

1/Beta Weighting

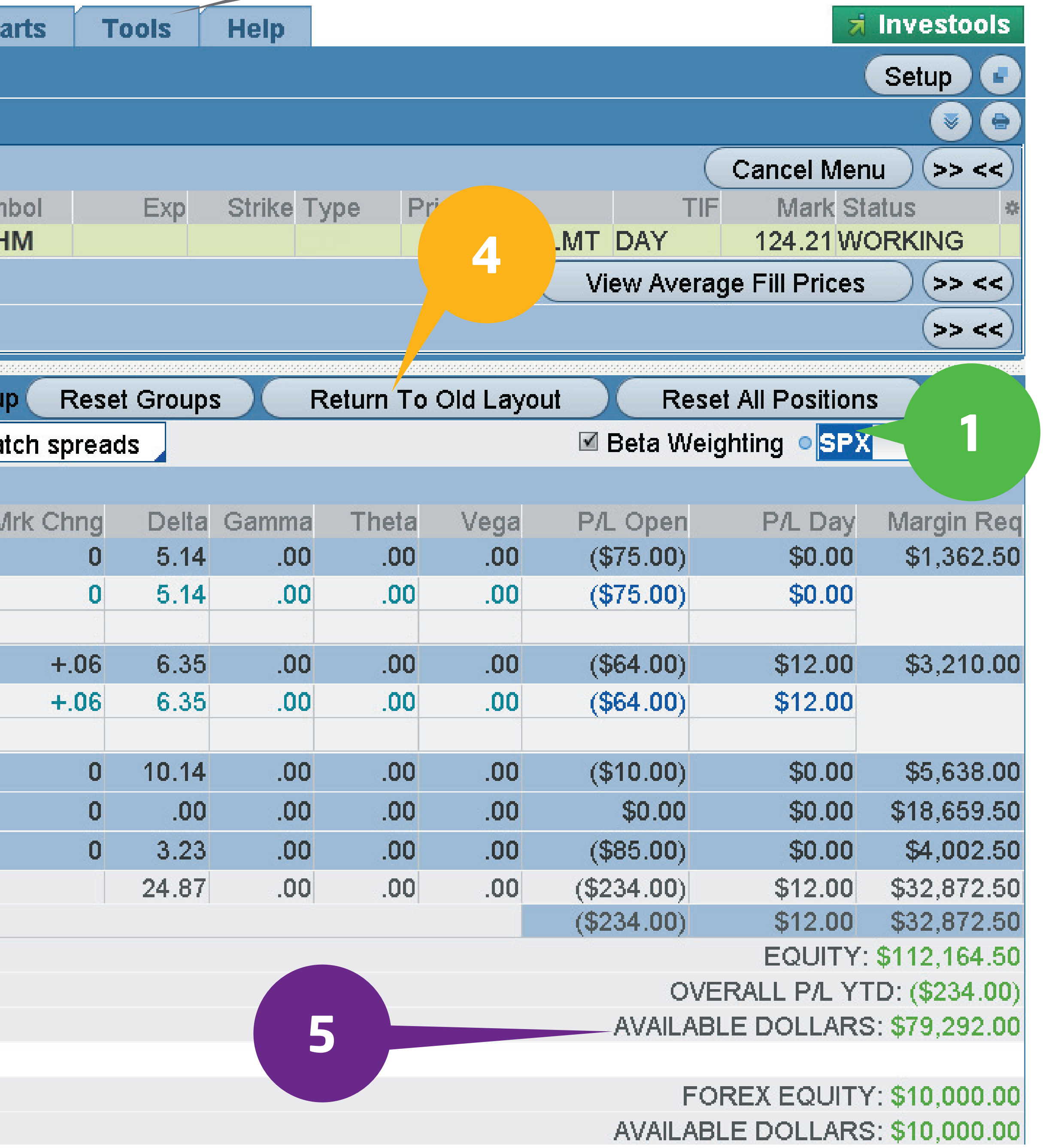
How much risk do you have in your trading portfolio, and how will you hedge it? Not sure? That's what the beta-weighting tool attempts to answer. Using any optionable stock or index as the common denominator, the beta weighting tool converts the deltas of your individual positions into stock/ index-equivalent deltas for you. The portfolio delta, then, is the sum of the stock-equivalent deltas. In this example, we beta-weighted the portfolio against SPX.

2/Option Legs

To get details on your position, left click the little blue arrow to the left of the underlying equity symbol in the list. Out pops all the position specifics for each class of option in your position. If you right click the blue arrow next to the symbol, you can send in an order to close out all the legs of your position at once.

SEE
GLOSSARY
PAGE 42

Hot Tip
By default, you can peek at your current "buying power," here or change to view available margin. (See "How to: Check Your Margin Balance in thinkorswim," p. 36)



Need more help with thinkorswim? Check out **thinkmanual**, the thinkorswim companion that changed the world (well, ours anyways). While logged in to thinkorswim, click the Help tab and select the icon to download the User Manual.

3/Customize
Don't like the default data we give you in the columns? No problem. You can change it. In the Position Statement, far right, click the little wrench to launch the customize feature. Click on the "Customize Columns" button that appears. Then, the data you want from the left menu of choices and remove the data you don't want from the right menu. Click "OK" to see your new layout.

4/ Return to Old Layout
There are two layout views to choose from—the old school view and the new school view. If you're a die-hard fan of old school, you don't have to spend time customizing to get it back. Simply click the "Return To Old Layout" button.

5/Your Bottom Line
At the bottom of the Activity and Positions tab, you see your money—how much cash you have, available dollars to trade with, and your overall profit and loss year-to-date (P/L YTD). If your account is in good standing, you'll see the words "OK TO TRADE" in green letters.

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Trading Mindset

tdameritrade.com

HOW TO CHECK YOUR HEAD

IN VOLATILE MARKETS, WEAK HANDS LOSE, PERIOD. IF YOU PANIC EVERY TIME THE MARKET TICKS AGAINST YOU, YOU'RE PROBABLY FOCUSING ON THE WRONG THING. VOLATILITY ISN'T GOING ANYWHERE, SO SOMETIMES YOU HAVE TO LOOK AT YOUR STRATEGY, NOT YOUR STOCK, IN ORDER TO AVOID THE NOISE.

WORDS BY **MARK AMBROSE**
PHOTOGRAPHS BY FREDRIK BRODÉN

(WHEN EVERYONE'S LOSING THEIRS)

T

THIS PAST YEAR HAS BEEN ONE crisis after another. Failing economies. Battling politicians. Debt crises. High unemployment. Falling interest rates. Take your pick. Market commentators and talking heads have used any and all of these—and then some—to explain why the stocks are down. If it bleeds, it leads, even in financial news. But how can an investor sort out—or throw out—all this information? How do you keep your head when everyone else seems to be losing theirs?

The one thing you don't want to be is a "weak hand"—the person who panics when the market moves lower and who usually has two things working against them:

1. Their positions are too big for their account or risk tolerance.
2. They're overleveraged and have to exit positions—usually at a loss—to avoid margin calls.

The weak hand at the table also doesn't have a real strategy. Buying stocks and hoping they go up--and panicking when the market is volatile--isn't a strategy. And maybe worst of all, the weak hand is buffeted by the constant stream of financial and economic news and every uptick and downtick in the market.

TRADING THE NOISE

To a trader, this is all noise. Markets go up, and markets go down. Volatility is a fact of market life. The "why" isn't nearly as important as the "what." Most stocks go down when the market's crashing. Good stocks and bad stocks. Good CEOs and bad CEOs. All the analysis in the world about what a "good" investment is won't do you much good in a crash. So, data won't save you. You need to focus on trading results using a pragmatic analysis of what you're going to do in a crash instead of just data-driven analysis. In other words, you need to synthesize what you see happening in the market and use that to create a smart trading or investment strategy. Do that, and you won't be the weak hand at the table.

1) First, don't just "look" at the market. Take note and "see" the market. Sometimes, one or two commodities get everyone's attention and lead the market. Gold and Treasury bonds were big news in 2011. If the S&P 500 futures (the "SPUs") are down, is gold down? Bonds, too? Are you getting confirmation from a rise in volatility? If oil and bonds are down and vol is stagnant, then S&P futures being down is a little unusual.

Forget the news (the "why"), and look at the downside risk in the market (the "what"). Have the SPUs been rallying every day for a week? Then maybe a bull has to be cautious—the downside risk might be a little too big. But if the SPUs are down sharply, volatility isn't spiking, bonds are up only a little and gold is weak, this might be the end of the decline and might be a time to buy. While you do this in about 90 seconds, everyone else is watching the news for 90 minutes, trying to figure out why the SPUs are down. You are seeing the market and synthesizing the live information!

2) When you look at a chart, don't stop with your technical analysis. How much downside or upside is there really in a stock or index? If you look at the lows made during the crash of 2008, that's what can happen when just about everything goes wrong. If your stock's down, how close is it to that 2008/2009 low (*see Figure 1*)? The theoretical maximum risk of a long stock position is achieved if the stock goes to zero. But how many times do major stocks go to $0? OK, Lehman Brothers, Bear Stearns, GM. Name some more. It gets a little hard. Particularly if you look at stocks in the Dow Industrials or the S&P 500. Is it possible? Sure. So, during a sell off, look at some of the stocks' lows during that crash.

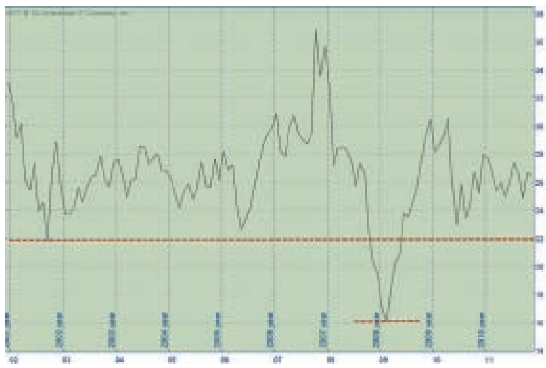

FIGURE 1: Even during the two major market crashes since 2000, this stock never dipped below $16. Where do you think super-long-term support is? ***Source: thinkorswim Charts***

3) Look at what the options are telling you if they're available for a stock. Are the option values at strikes near those previous lows 0 bid at .05? Then the market doesn't see a lot of possibility that the stock will get to that level any time soon. If the options are, say, .20 or .30 or .40 or higher, then yes, the market thinks there's a higher probability that will happen. Sure, the stock can make a move to and past those higher or lower boundaries, but it's a question of probability. Anything's possible, but is it likely? What you're trying to do is estimate the probable range of a stock or index, and if there is more upside in that range than downside. It's not exact. It's not about a stock being "cheap" or "expensive". It's just trying to use the information the whole market is giving you to make a more informed decision and hopefully get the odds on your side.

RUBBER, MEET ROAD

In practice, there are a few things you can do to cut through the noise a little faster and easier. One strategy may be to trade and invest in products with liquidity. Liquidity describes how quickly you can enter or exit a trade at a "fair" price. I might be willing to pay .01 or .02 more when buying or take .01 or .02 less when selling,

THE WEAK HAND AT THE TABLE ALSO DOESN'T HAVE A REAL STRATEGY. BUYING STOCKS AND HOPING THEY GO UP AND PANICKING WHEN THE MARKET IS VOLATILE ISN'T A STRATEGY. VOLATILITY IS A FACT OF MARKET LIFE. YOU NEED TO FOCUS ON TRADING RESULTS USING A PRAGMATIC ANALYSIS OF WHAT YOU'RE GOING TO DO IN A CRASH INSTEAD OF JUST DATA-DRIVEN ANALYSIS.

TEST YOUR HEAD
Hey, you don't have to risk real money while you're testing your skills. Take it to paper trading first. Fire up the **thinkorswim** trading platform and at the log in screen, choose the **"paperMoney"** option above your log in credentials. You'll start with $100,000 in fake capital, and you'll be able to trade in nearly identical fashion as you would in the "Live Trading" experience.

but not much more. A liquid product lets me do that. An illiquid product means that I may have to give up a lot more in order to execute an order. And an illiquid product with a wide bid/ask spread in a calm market is going to be even less liquid with wider bid/ask spreads when the market's collapsing. How can you check liquidity? It's pretty straightforward.

1) Search for penny increments. If you fire up the thinkorswim platform, on the MarketWatch tab, in the Quotes sub tab, open up the "Penny Increment Options" list from the "Public" menu. That starts you out by showing only symbols with options that trade in .01 increments. That's a good place to start because the options that trade in .01 increments tend to be a bit more actively traded and have narrower bid/ask spreads.

2) Next, sort by volume. Take your list and sort by the volume column, from high to low by simply clicking on the column header "volume." That shows you the stocks with the most number of shares traded today. [NOTE: You can drill down a bit further if you want, by creating a Scan Query on the Quote sub tab. When you do that you can scan for "Penny Increment Options" and have that list intersect with, say, the S&P 500 or NASDAQ 100, for example. That will show you the symbols for stocks that are components of those major indices that have options with tighter bid/ask spreads. Then you can sort by volume to see the most actively traded stocks with options that trade in .01 increments.]

3) Check open interest. As a final check on liquidity, you can go to the thinkorswim Trade page to see the volume and open interest for a stock's options. The most liquid options trade thousands of contracts a day and have tens of thousands of contracts in open interest. But even if the stock you're looking at has options that trade a few hundred contracts a day and have a few thousand in open interest, you're still probably looking at pretty liquid options.

By the way, if you'd rather trade another stock in the same sector, but you don't know which sector it's in, just go back to the MarketWatch tab, then the Quotes sub tab. Next, add in the columns Industry Division, Industry Group and Industry Sector. When you type your symbol onto that Quote page, you'll see what part of the market it resides. Then go to the Watch sub tab (also under the MarketWatch tab), and drill down into the Index Watch section. When you select a watch list from the drop down menu, look in the Industry menu. You can follow the Division, Group and Sector of your original stock to find other stocks in that category. Then check those stocks' liquidity. If one is much more liquid than the other, you might think about replacing your original stock with a more liquid competitor.

STOCKS WITH HIGH VOL

You can also view stocks whose options have a higher-than-normal volatility. That means the stock's options have higher premiums than they normally do. When you work with short-option strategies such as cash-secured short puts, short call or put verticals, the higher volatility increases the credit you can take in when you do those trades. That extra premium means your potential profit is increased, and the risk of the position might be lower. You can do that on the MarketWatch tab, Quotes sub tab fairly easily. Create a custom column with this formula:

Plot data = highest(imp_volatility, 262)/imp_volatility;

That displays the ratio of the highest level that implied vol has been for a stock and the current implied vol. The closer that number is to 1, the higher the current implied volatility is to previous highs. Bear in mind, this number is always greater than or equal to 1. Since we're approaching 1 from a higher value, lower numbers are better.

BREAKOUT STOCKS

Finally, check out stocks that might be getting close to a 52-week high or low. Is that a magic number? No, but if you're bullish on the market, for example, a stock near a 52-week low, some feel it might be a candidate for a bounce higher. The opposite is true if you're bearish on the market, and a stock near its 52-week high. Some feel it might be a candidate for a move lower. You can see how far away stocks are from their 52-week (or any other time period, for that matter) high or low using the custom column feature on the Quote sub tab of the MarketWatch tab. Create a custom column with this formula:

Plot data = close/lowest(low, 262);

That column will show you the ratio of the current stock price to the lowest price in the last 262 trading days (about 52 weeks). The closer that number is to 1.00, the closer the current stock price is to the 52 week low.

LET'S FACE IT. WEAK HANDS DON'T HAVE A GOOD reason for doing what they do when markets fall. Typically, they panic because they're trading too big relative to account size or they're over-leveraged on margin. If you're acting out of fear with very little rationale, it's probably not your stock—it's your strategy. These strategies are really just the beginning, but hopefully, you'll start to take a common-sense approach to trading volatile markets.

TD Ameritrade

THE MARKET MOVES FAST. STAY AHEAD OF THE CURRENT.

Swim Lessons gives you tips and techniques for using the thinkorswim platform.

SWIM LESSONS IS A **FREE** AND **DAILY** WEBCAST THAT WILL SHOW YOU:

- How, when, and why to use thinkorswim
- Tools to implement your strategies in any market
- The possible impact of current events on your portfolio

Log on to thinkorswim to get Swim Lessons every weekday from 10:30 a.m. to 1:30 p.m. CT.
Support/Chat > Chat Rooms > Swim Lessons

31

Ask the Trader Guy

Saving traders, one question at a time.

Photograph by
Fredrik Brodén

Q:Hey Trader! When will stocks go up again?
A: Dang, I just traded my crystal ball for a pair of Bulls' tickets, since they both stink for picking market direction. Listen, nobody knows which way a stock or the market is going to go. But by your question, it sounds like you're long some stocks, and they're losing you money. You might want to consider selling some calls against your stock positions. Typically, when volatility is high, it tends to push up the value of out-of-the-money options. You can collect some income and reduce the cost basis of your positions by selling covered calls. Just remember: Your stock can get called away any time, if it takes off, and rob you of all that extra potential. In some cases, particularly if volatility keeps rising, it could force you to buy the option back for a higher price than you sold it for.

SEE GLOSSARY, PAGE 42

Q: Hey Trader! Will a stop order protect my long stock position in a crash?
A: Well, define "protect." A stop order turns into a market order when the stock hits the stop price. And a market order offers no guarantee of execution of price. You have no control over the price when you enter a market order or, by extension, a stop order. When a stock or the market is dropping rapidly, it can become much harder to get an order filled at a particular price as traders become more cautious and widen out their bid/ask spreads. If the stock gaps lower, it can blow right through a stop price, triggering a market order when the stock is far lower. You could potentially get filled at a price much lower than your stop price, creating a loss that's greater than what you might have calculated at your stop price.

Q: Hey Trader! My astrological forecast indicates I'll have seven years of good fortune! Gimme some trades!
A: When the moon is in the seventh house, and Jupiter … You know, it doesn't matter when you start trading. How about a call calendar for a Capricorn? A put spread for a Pisces? Maybe after your seven years are up, you could start using yourself as a counter-indicator. Good money can be made betting against yourself.

Q: Hey Trader! I'm thinking about getting a pet to keep me company when I trade. The local rescue has some really cute cats. Any thoughts?
A: Sitting in front of a trading screen all day, you think you'll crave interaction, and a nice cat will give you something to play with while you wait for the next opportunity. Stop—pets and trading don't mix. Cats? They step on keyboards and mouse buttons. Dogs aren't much better. Their dopey eyes and plaintive whines take away the mental edge you need when trading. Calculate four-legged spread prices in your head. That will make you forget you're lonely.

FOCUS:
mrgn.

Special Focu
Margin

Photograph by
Fredrik Brodén

tdameritrade.com

NOW YOU SEE IT,

TRADING ON MARGIN CAN BE AN EFFECTIVE STRATEGY TO BOOST YOUR PERFORMANCE. IT CAN ALSO BE A BLACK HOLE OF LOSSES. KEEPING YOUR EYES WIDE OPEN IS HALF THE BATTLE. THE OTHER HALF IS UNDERSTANDING WHAT YOU'RE DOING.

NOW YOU DON'T

WORDS BY **ADAM WARNER**

Special Focus: Margin

Photograph by **Fredrik Brodén**

tdameritrade.com

A TWEET YOU'LL LIKELY SPOT ON TWITTER after a sharp rally: "Anyone who bought XYZ on Monday earned 25% if he bought on margin."

A tweet you'll likely never spot on Twitter two days later: "Broker closed me out on that XYZ I bought on margin on Monday ahead of selloff."

And that's the deal when you trade on margin. It can add fuel to your returns when you get it right. But it can also wipe out your account in a blink when you get it wrong.

So, what's margin? Here's the long answer straight from the TD Ameritrade handbook:

"A margin account permits investors to borrow funds from their brokerage firm to purchase marginable securities on credit and to borrow against marginable securities already in the account. The terms of a margin loan require the qualifying securities or cash that you have in your account be used as collateral to secure the loan. Interest is charged on the borrowed funds."

Here's the short answer: It allows you to borrow money from your broker to buy more marginable securities than you can afford.

Margin can increase your effective returns. It can also bankrupt you. And frankly, we tend to obsess over the latter, and for good reason. There can be benefits to trading on margin when used with care and discipline. It may allow you to take advantage of investment opportunities you would otherwise have to avoid simply because you were "priced out."

Before you get started, make sure to understand how it all works, lest you get "that call" and have to sell securities, deposit more money, or worse, be forcibly sold out by your brokerage firm before you're able to put up more money (i.e. just when your investment thesis begins to play out).

Margin Types

REGULATION T Also known as "Reg T," this type of margin typically allows you to buy a marginable stock with 50% of the money the security would cost in full. Suppose you're loving yourself some XYZ stock trading at $20. You would like to buy 1,000 shares, or $20,000 worth. You only have $10,000 you can spare to invest, however. No problem. You can buy the stock on margin. You use the $10,000 you have and borrow the other $10,000--a loan on which you pay interest.

If XYZ dips at all, you could be in trouble. Let's say it goes down $1 to $19. The value of your holding is now $19,000 (1,000 shares of a $19 stock). You've lost $1,000, so your equity in the position is only $9,000.

TD Ameritrade has various maintenance requirements for stocks, the most common being 30%. So while you needed $10,000 to initiate the purchase, you "only" need to maintain $6,000 in equity (30% of $20,000) to avoid a margin call.

Great, you have some breathing room. This can play out a couple of different ways:

On the good side, suppose XYZ lifts to $25. You now own $25,000 worth. You borrowed $10,000, so your equity stake is $15,000. Since you only actually put up $10,000, the $5,000 you earned represents a 50% return. Since you've purchased shares on margin, when the stock rose 25%, you made 50%. Sweet. Cha-Ching. BooYa. Sign me up.

On the bad side, XYZ drops to $15. You lost $5,000. You started with $10,000 in the account, so now you have $5,000 left, and you still owe $10,000 to your broker. You dropped 50% on a 25% drop in XYZ. What's more, you now have some maintenance issues. Your XYZ holding has a value of $15,000. In order to maintain that position, you need 30% equity, or $4,500. You only have $5,000 equity left in the account, so that leaves a mere $500 of leeway.

Not so sweet.

If XYZ goes any lower, you will get a margin call. At this point, you can:

1—Put up more money and maintain the position (i.e. deposit funds or marginable securities into your account).
2—Sell other securities in your account to raise cash.
3—Close out of the position.

Depending on the situation, you may never get the choice, and the position can be closed out by your brokerage firm without your consent. And none of these options factor in ancillary expenses. You owe interest on the money you borrow, same as if you borrowed it anywhere. There are also trading commissions and regulatory fees, so keep on top of it all.

There's your basics. But wait—there's more. Other types of trading activities and other stocks have different margin rules that are not always the cut-and-dry 30%. And maintenance requirements can also be raised at any time.

PATTERN DAY-TRADER If you make four or more round-trip day trades within any rolling 5-business day period, and that represents at least 6% of your total trading activity during the same period, you are now considered a Pattern Day Trader (PTD). You can open a

30% MARGIN ON STOCK??

Yup, it's true. But not all stocks qualify. There's two ways to find out:

1. The order ticket Just prior to purchasing any security, the margin requirements for any order will be displayed on the order ticket before any purchase.

2. On the web Log on to your account at tdameritrade.com and select the "Help Center" link in the upper right of the screen. In the left menu of the new window that opens, select Margin Trading > Margin Requirements. On the right column, select "Which stocks have special margin requirements?" Again, select the link "special maintenance requirements." At long last, you will arrive at a comprehensive list of equities and their related margin requirements.

MARGIN CAN INCREASE YOUR EFFECTIVE RETURNS. IT CAN ALSO BANKRUPT YOU. AND FRANKLY, WE TEND TO OBSESS OVER THE LATTER. THERE CAN BE BENEFITS TO TRADING ON MARGIN WHEN USED WITH CARE AND DISCIPLINE. IT MAY ALLOW YOU TO TAKE ADVANTAGE OF INVESTMENT OPPORTUNITIES YOU WOULD OTHERWISE HAVE TO AVOID SIMPLY BECAUSE YOU WERE "PRICED OUT."

Special Focus: Margin

SEE GLOSSARY PAGE 42

regular margin account with as little as $2,000, but Pattern Day Traders need a minimum equity balance of $25,000 in order to day trade. What does that mean for you? Specifically, four times your excess equity. In other words, if you have $25,000 in your account above and beyond any money needed to hold securities, you have access to $100,000 of day-trading buying power. But keep in mind, if your equity drops below $25,000 minimum for PTD, you may be subject to a minimum day-trading equity call.

OPTIONS Margin requirements for defined-risk options strategies, such as long puts and calls, verticals, and iron condors are pretty straightforward. It works like a cash account inside your "margin" account, meaning you simply need to put the cash up for the cost of long trades, or in the case of short strategies, such as short verticals or iron condors, you'll need to put up the amount at risk. Short verticals, for example, would require the difference between the strikes less the premium received on the sell side of the vertical. Just remember that if/when you exercise such strategies, you will need to follow the margin rules on the stock or underlying.

Selling "naked," though? As per TD Ameritrade, "The writing of uncovered puts and calls requires an initial deposit and maintenance of the greatest of the following three formulas:

A—20% of the underlying stock less the out-of-the-money amount (if any), plus 100% of the current market value of the option(s).

B—For calls, 10% of the market value of the underlying stock plus the premium value. For puts, 10% of the exercise value of the underlying stock plus the premium value.

Continue on pg. 37 (opposite)

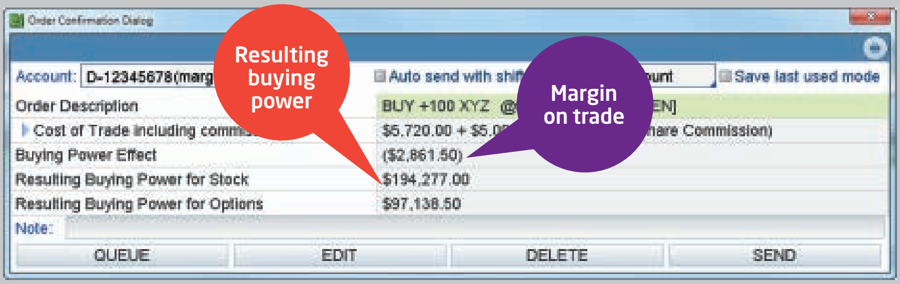

FIGURE 1: The thinkorswim order confirmation ticket will show you 1) how much margin the trade would require, and 2) the remaining buying power for both stocks and options.

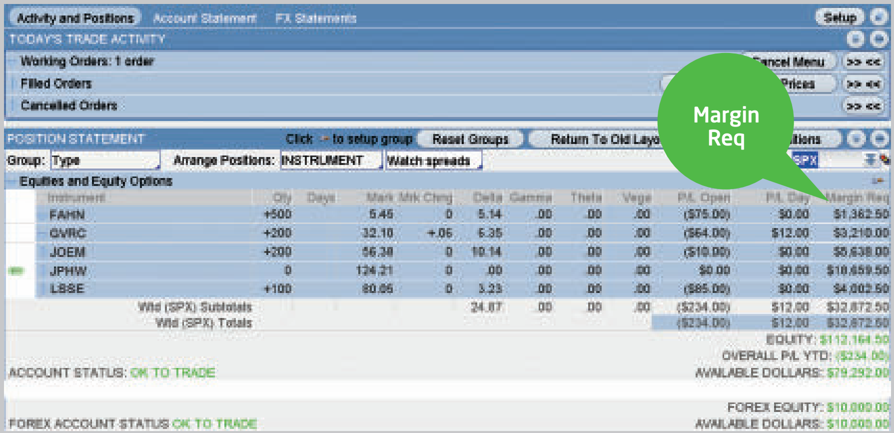

FIGURE 2: In the "Activities and Positions" page under the Monitor tab, you can see what each of your position's margin requirements are in the far rightcolumn. *For illustrative puposes only. Not a recommendation or solicitation.*

How To: Check Your Margin Balance in thinkorswim

mrgn.

• So you've read all about margin, which naturally begs the question of how this effects your portfolio. And of course, how much a proposed trade will impact your account. You can start by looking on the trade ticket, the last screen before you send in an order. Let's say you want to buy 100 shares of FAHN.

Reg T says you need 50% of cash or securities in the account in order to initiate the trade, so your order to purchase 100 shares of FAHN here reduces your buying power by $2745, after commissions (as in Figure 1).

In fact, many of the pages of the platform display BP Effect (buying power effect), which is essentially how much the position will reduce your purchasing power. However, under the General Tab in the Setup screen, you can switch this to Margin REQ (margin requirement), so you can view how much margin a position you're analyzing or about to trade would require.

Left click on "Position margin/BP Effect" and then choose "Margin REQ". Click on "OK", and you can view how much margin a position you're analyzing or about to trade would require. You can see this all over the platform, like on the Monitor page in Figure 2.

Options require 100% of the money down to purchase, so they affect buying power, but not margin. Hence the zeros in the Margin Req column. You've already paid for those positions in full.

C—$50 per contract plus 100% of the premium."

Got that? As an example, let's say you want to sell 10 uncovered puts on XYZ, which is trading at $42. The strike price is $40, and the puts are trading at $3.

With formula a), you would need 20% of $40, times 1000 shares, or $8,000, plus the market value of the options ($3,000), or $11,000.

With formula b), you would need 10% of $40 (the exercise value) plus $3,000 (the value of the puts), or $7000

With formula c), you would need $500 for the 10 contracts, plus the $3000 of premium, or $3,500.

So, in this case, the big winner is formula a), and you would need to put up $11,000.

KEEPING YOUR HEAD IS ABOUT NOT over-leveraging. Margin is like anything. Used as a tool to benefit your trading strategy, it can potentially complement returns, particularly in underperforming markets. But abuse it, and that shiny new car you rolled the dice on just became a Hot Wheel.

Important Information

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple-leg option strategies such as vertical spreads and iron condors can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. 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. Margin trading increases risk of loss and includes the possibility of a forced sale if account equity drops below required levels.

Margin is not available in all account types. Margin trading privileges subject to TD Ameritrade review and approval. Carefully review the Margin Handbook and Margin Disclosure Document for more details. Please see our Web site or contact TD Ameritrade at 800-669-3900 for copies.

MARGIN

Q+A:

MARGINS ON FUTURES ARE MUCH LOWER THAN MARGINS ON EQUITIES. IT VARIES FROM CONTRACT TO CONTRACT, MOSTLY DEPENDING ON THE VOLATILITY.

Q: How do the margin requirements for trading futures differ from those of trading equities? (i.e. marked to market each day)

A: Futures are marked to market every day. So your cash balance adjusts daily based on the closing settlement price. This differs from equities where your cash balance only adjusts when you actually buy or sell shares.Margins on futures are much lower than margins on equities. It varies from contract to contract, mostly depending on the volatility of the contract, but generally hovers between 5-15%, vs. 50% for stocks. And that's the margin to initiate the position, the maintenance margin is lower. Unlike stocks though, margins on specific futures frequently change as the volatility in the futures themselves changes.

Q: If I sell a covered call against a long stock position, is there a margin requirement on it?

A: A short call is considered "covered" if you own stock against it. There is no additional margin requirement beyond the margin requirement for owning the stock.

Q: How many days to I have to meet a margin call?

A: Immediately. If not sooner. Its in your best interests to address a margin call as promptly as possible as TD Ameritrade may close your positions during a margin call without your consent. You can meet margin calls by depositing additional funds, hedging your risk to reduce your margin requirement, or selling some securities. If you don't have any other securities, wiring funds is the fastest way to resolve the margin call.

Q: What happens to my day trading buying power if my net liquidity drops below $25,000?

A: $25,000 is the minimum balance for an identified day-trader. If you drop below, you will not be allowed to day trade. If you do execute a trade after you've dropped below $25,000, you will be restricted to closing transactions for the next 90 days (or until you bring the equity back up over $25,000).

Important Information

The risk of loss in trading futures can be substantial. Clients must consider all relevant risk factors, including their own personal financial situation, before trading.

Gear Head

gear

Lessons from a veteran floor trader.

Words by **Nicole Sherrod**
Managing Director, Trader Group at TD Ameritrade

Chat it Up!

Does trading make you lonely? Come to the thinkorswim Chat Rooms.

• Once upon a time (circa late '90s), I decided I wanted to leave the rat race of Wall Street and become … wait for it … a day-trader. I set up multiple flat-screen monitors. I installed a state-of-the-art, high-speed (56k) Internet connection. Yup, the early days were glamorous. I'd trade the market open, pop into Bergdorfs for some intra-day doldrums shopping, and then bounce back for the close. But then, things started to change.

Maybe it was the sweatpants I was wearing seven days a week. Or maybe it was the bright orange Cheetos residue on my keyboard that was calling for me to get a life. I had let myself go. Why? Trading was lonely. Back then, there was no means of interaction with other traders. The only stimulation was the endless amounts of real-time data flowing through the screen in spurts of green and red.

FINDING FRIENDS BEYOND A DOG

Thankfully, things have changed since the early days.Today, with the online chatrooms in the thinkorswim platform (Figure 1), I can connect and bond with fellow traders who actually understand that a vertical spread is not a condiment. Nice. But being able to bounce ideas off one another is just the start. What many of our clients don't realize is there are also visual and audio feeds in the chatrooms as well. You just have to click on the "watch" and "listen" buttons in order to trigger the audio and visual streams. Here are a couple of my favs.

SWIM LESSONS

Each day that the market is open, we have veteran traders who share market insights as well as platform education for hours on end each trading day. So while you're trading, you can also be learning how to sharpen your skills. These traders expose their trading desktop in the chat so you can see how they've configured their layouts and what tools and features they use to trade the market. They also talk about things to look out for and what pending news might really cause ripples or more major reverberations in the market. Best of all, there's no price of entry for this valuable education. Your swim Lessons are 100% free.

GLOBAL NEWS SQUAWK

I love this one and often have it running in the background while I'm at work. It's completely silent as long as there is no major news but the instant something major happens, the audio springs to life so I'm always in the know.

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 situation, before trading. Past performance does not guarantee future results. Supporting documentation for any claims, comparisons, statistics or other technical data, will be supplied upon request. Market volatility, volume and system availability may delay account access and trade executions.

MARKET CAST

Ben Lichtenstein is a veteran trader and he stands in the S&P futures pit in Chicago and talks to our clients through the feed to articulate what he's seeing. Best of all, it sounds like the audio call of a horse race (my other great passion), so it's music to my ears. The value in this content is immense. It's one thing to look at streaming data to try to figure out what's happening. It's quite another to hear Ben issue a cautionary warning to clients that a big-time buyer has just walked into the pits and could mean things are about to really move. Those are the things you can't see in the data on your screen.

NOW, I'M NOT KIDDING WHEN I SAY that we spend a small fortune making these cutting edge features available because we want you to have the tools that may give you information for a more informed strategy. It's how we roll. And since they're free, we just ask that you use them!

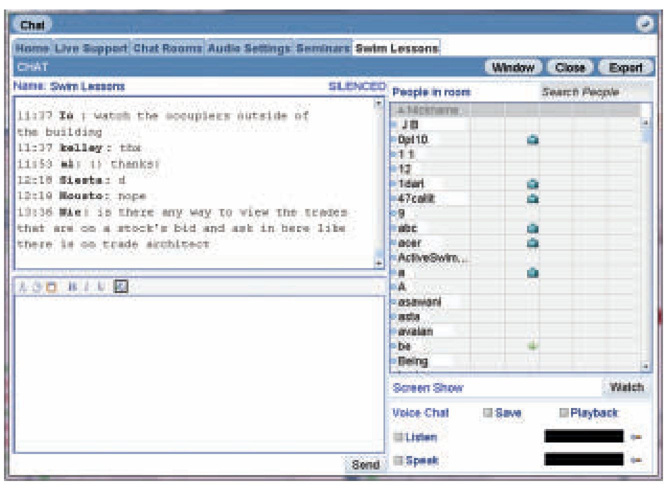

FIGURE 1: Swim Lessons. It's not a replacement for a productive social life, but connecting with other traders in the thinkorswim Chat Rooms is one way to share information and feel, well, less alone.

Capiche?

Viewing the markets through the eyes of volatility

Words by **Thomas Preston**

Photograph by **Fredrik Brodén**

To Leg or Not to Leg

One at a time could be hazardous to your wealth

• In the world of trading, the term “legging” refers to putting on the different parts of an option spread as individual transactions. For example, a put vertical spread is composed of a long put at one strike and a short put at another. The long is one “leg” of the spread, and the short is the other. You could establish a position in the put vertical as a single transaction. Or you could put an order in to buy the long put, wait for a fill, then enter an order to sell the short put.

A CAN OF WORMS

The main reason for legging is to try to get a better fill price. But this can lead to problems.

Say you want to sell a call vertical for a net 1.00 credit, with the short call at 1.50 and the long call at .50, because you think the stock might go down longer term. But intraday, you think the stock might bounce higher. So you tryto leg into the short call spread by buying the long call leg first for $0.50, then wait until the price goes up a bit before entering the order to sell the short call leg.

If the stock does go up, you might be able to sell that call at a higher price, say 1.75, and get 1.25 credit for your short call vertical. In this case, you'd be getting a higher net credit by legging into the call spread than you could have selling the call spread as a single transaction.

If the stock drops instead of rises, then the call you’re looking to sell to establish the short call vertical could be dropping in price, too. you'd be getting a worse price for your short call vertical than if you sold the spread as a single transaction.

GUIDELINES FOR GLUTTONS

If you’re very confident in your speculations, have the discipline to trade that second leg if the stock goes against you and you have assessed the risk and possible loss, then you may consider legging with a few caveats.

Do the long leg first. Imagine you tried legging into a short call vertical with the short call leg first, and the stock suddenly jumped higher. You’d have a growing loss on that short call option, and possibly a margin call, and you’d have to try to buy the long call leg at higher prices. If your first leg is a short option, the margining systems don’t know you intend to buy an option against that short, so it looks at that short option order as naked. That means the order could be rejected, or significantly reduce the buying power in your account.

Don’t leg into spreads with more than two legs. Trying to keep track of the prices and not getting legged out on complex spread is very hard, even for pros. Do the “hard” leg first. First try to get filled on the option that might have a wider bid/ask spread, or lower liquidity (as measured by volume and open interest). If you do the “easy” side first, with the option that is more actively traded, you could get filled very quickly, but then have a hard time getting the other, less actively traded leg filled.

Don’t be stubborn. If you get legged out, you must exercise discipline to get the other side of the spread on, even if the price has moved against you. Don’t be greedy or overconfident—the option might not come back to where you want to trade it. Have a price for either the stock or the option you’ll use to decide to either put the second leg on, even if it’s a worse price, or close out the first leg for a loss. That can limit potential losses while legging.

SEE GLOSSARY PAGE 42

Coach's Corner

Pulling pearls from your favorite trading instructors.

Words by
Brandon Chapman, CMT
Investools Instructor

ATR, Stops and You

Feeling out in the cold with your exits? Try cozying up to Average True Range.

A COMMON STATEMENT I get from new traders is that they feel good about their entries, but just don't know when to get out. Unfortunately, a statement like this typically has accompanied a large loss. This inevitably leads to a conversation about the No. 1 rule of the jungle—control thy risk. Easier said than done, right? Small losses can be made up, but large, uncontrolled losses really hurt. One way that might help control your losses is to use the Average True Range (ATR) indicator in your charts to assist with calculating where to put your stop losses.

Before we get down to the nitty-gritty of how some have used ATR, let's discuss some basics. At its heart, ATR is a volatility indicator, and is pretty straightforward. For a daily chart, the "True Range" of a stock is the higher of 1) the high minus the low of the day, 2) today's high minus yesterday's close, or 3) yesterday's close minus today's low.

In essence, we're trying to figure out how much movement might occur from one period to the next. Stocks may close on average one to two points a day, for example, but the range of a day/week/month typically exceeds that. Since there can be a fair amount of volatility with true range, the indicator looks at the average of the "true range" to smooth things out.

FIGURE 2: Whether you're trading long, short or somewhere in between, you can use ATR to help determine where to place your stops.

Posture	Multiplier
Investor	2-4 X Weekly ATR (5)
Trend Trader	2-4 X Daily ATR (14)
Swing Trader	10-2 X Daily ATR (5)

FIGURE 1: How you apply Average True Range as a stop depends on how long you plan to spend in your trade, which is usually marked by what type of trader you are—i.e. long-, medium-, and short-term.

Calculate Your Stop

So, how do you apply ATR? The table in Figure 1 is an example of how you can use the concept of ATR for several trading strategies. In the table, when I use the word trend I'm referring to riding the up and down swings of a stocks cycle as long as the so-called "trend" is intact. Swing trading would be exclusively trading the up or down swings within the stock's cycle.

Let's go through a trend trading example. In Figure 2 you'll see a price chart of the XYZ with an ATR (14) study applied just below the price graph. The current ATR (14) is $32.1, meaning that over the last 14 days this stock fluctuated, on average, $32.1 from one day to the next. As a result, the initial stop will be placed a minimum of $64.2 below the entry price for a trend trade, which is something you can do right from both the thinkorswim or Trade Architect trading platforms.

Seriously, that's it. No complex formulas here. So, the next time you're feeling out in the cold with your exit strategy, maybe you'll find some warmth with this simple ATR approach.

42 gls

The Token Glossa[ry]

Terms you might stumble across in this issue.

tdameritrade.com

found on pages: 16, 28, 35 & 39

Vertical Spread

• A defined-risk, directional spread strategy, composed of a long and a short option of the same type (i.e. calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the trade onset. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes, less the credit.

found on pages: 13, 16 & 21

In-the-money

• An option whose premium contains "real" value, i.e. not just time value. For calls, it refers to strikes that are lower than the price of the underlying equity. For puts, it refers to strikes that are higher.

Out- of-the-money

• An option whose premium is not only all "time" value, but whose strike is also away from the underlying equity. For calls, it refers to strikes that are higher than the underlying. For puts, it refers to strikes that are lower.

At-the-money

• An option whose strike is "at" the price of the underlying equity. Like out of the money options, the premium of an at-the-money option is all "time" value.

35 found on page:

BUTTERFLY SPREAD

• A market-neutral, defined-risk strategy composed of selling two options at one strike and buying one each of both a higher and lower strike option of the same type (either all calls or puts). The strategy assumes the underlying will remain relatively unchanged during the trade's life, and as time passes and/or volatility drops, the short option premiums decay faster than those of the long options; resulting in a profit when the spread can be sold for more than its original debit (which is its maximum loss).

found on pages: 18 & 39

Long Calendar Spread

• A DEFINED-RISK SPREAD STRATEGY, CONSTRUCTED BY SELLING A SHORT-TERM OPTION AND BUYING A LONGER-TERM OPTION OF THE SAME TYPE (I.E. CALLS OR PUTS). 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. THE RISK IS TYPICALLY LIMITED TO THE DEBIT INCURRED.

20 & 37 found on page:

Delta

• *A measure of an option's sensitivity to a $1 change in the underlying asset. All else being equal, an option with a 50 delta (also written as .50), for example, would gain or lose $50 per $1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying loses in value.*

35 found on page:

Iron Condor

• 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 trade 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 (if they are equal widths, otherwise the wider of the vertical spreads), minus the total credit received.

found on page: 20

Vega

• A measure of expected change in an option's price per 1% change in implied volatility. For example, if a long call has a vega of .07, should implied volatility increase by 1%, the optionvalue will increase by $7.00 per contract, all else equal.

found on page: 20

Theta

• A measure of an option's sensitivity to time passing one calendar day. For example, if a long put has a theta of -.02, the option value will decrease by $2.00 per contract, all else equal.

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