

# thinkMoney/15

random musings for traders  
at TD Ameritrade  
Spring 2012



## 10/ TRADING SECRETS FOR THE REST OF US

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SPX HANGOVERS

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PARTY BE A DUD?

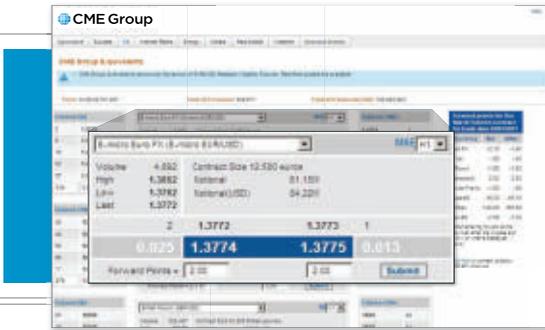
PAIRS TRADING SPECIAL:

34/ DIRECTION IS  
OVERRATED

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**DAN GRAMZA**

President, Gramza Capital Management



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**Fredrik Brodén**

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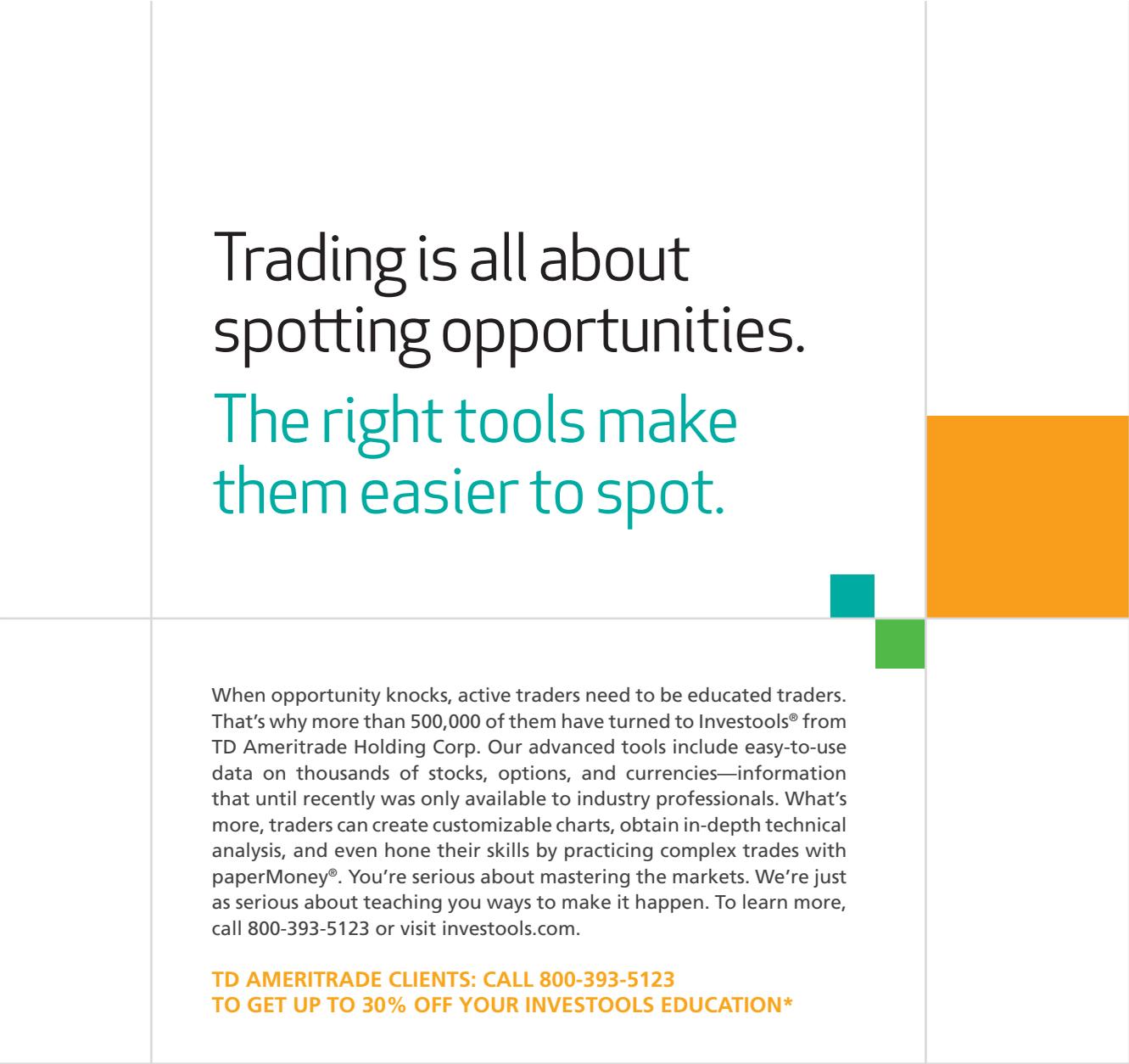
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**Trading for the 99%**

There are Wall Street fat cats, and the rest of us. If you think trading is a zero-sum game, working against the little guy, think again. Here's how to join the 1%.





A decorative grid with vertical and horizontal lines. A large orange square is in the top right. A teal square is in the middle right. A green square is in the middle right, below the teal one. A teal square is in the middle left. An orange square is in the bottom left. A teal square is in the bottom left, below the orange one.

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cont.

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Cover photograph by **Fredrik Brodén**

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How to pairs trade on thinkorswim

PAIRS TRADING Q&A



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Our resident guru tackles your questions about probabilities, stubborn call options, and when to schedule your personal trainer.

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## A Quick Howdy

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## Trends? Who Needs Trends?

• Should it go without saying that the rest of 2012 will be, shall we say, politically interesting? Probably, but there... we said it anyway. Thankfully, this isn't a political rag, and while personally, you may care about the outcome of the Presidential race, the market doesn't. Bridges will get built, and roads will get paved. Or maybe not. Who knows? Your focus as a trader is to try to position the wind at your back, whichever way it blows.

But what if there was a way to trade without trying to pick a direction at all? Huh? There is. This month,

our Special Focus on pairs trading (p.34) explores a totally different way of trading the market—that of speculating on price discrepancies. Think of it as a “battle of two stocks,” but you don't care which one wins, just as long as when prices are out of line, they eventually find common ground. Like choosing between chocolate and vanilla—without any egos at stake. And with the Pairs Trader tool—one of our newest features on the thinkorswim trading platform we've simplified the process of placing pairs trades.

Of course, some will suggest that no matter which direction the market goes, it's a zero-sum game—i.e. for every dollar made in the market, another dollar is lost somewhere. If you believe that, then you may also likely buy into the idea that only the “top 1%” makes all the money. These are just the types of myths we like to debunk, and our cover feature on page 10 takes on that debate mercilessly. We're all capable of blaming someone or something else for a loss. But if you're trading like 99% of the rookies, expect the same results. Read the article for more.

So enjoy, and tell us what you think. If you haven't had a chance to fill out our reader survey, help us keep a good thing going so we know we're pushing the right buttons. Just go to [tdameritrade.com/tmsurvey](http://tdameritrade.com/tmsurvey).

Happy trading!  
TD Ameritrade



If you want to shoot us an email, we could always use some good feedback. Good, bad, or ugly, we read every letter. Write to us at [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com). Heck, if it's funny enough, it just might be worthy of a spot in our “Love Notes” on page 15.

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**Trader  
Psychology**

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YOU MAY HAVE HEARD  
THAT TRADING IS  
A ZERO-SUM GAME.  
IT'S A GIANT CONSPIRACY  
BY THE 1% OF THE  
INVESTING POPULACE  
THAT SEEM TO MAKE  
ALL THE MONEY.  
YOUR DOLLAR LOST  
IS THEIR DOLLAR GAINED.  
IN TRUTH, THE MARKET  
DOESN'T CARE, SO  
WHAT YOU'RE LEFT  
WITH IS A FEW SIMPLE  
RULES OF THUMB.

WORDS BY **THOMAS PRESTON**



**TRADING  
FOR THE  
99%**

PHOTOGRAPH BY **FREDRIK BRODÉN**





**TRADING FOR THE 99%?**  
What the heck does that mean? Well, it doesn't mean doing what 99% of investors do, which tends to be the same old thing. You know, trying to time the market and missing it. Try-

ing to find the next hot stock but finding that it doesn't outperform the broader market. Watching interest rates on savings or cash sit at near zero.

Lately, the news has been filled with stories about the "99%"—shorthand for everybody that isn't a billionaire. As a professional trader for the past 20-plus years, the 99% to me isn't about the "haves" versus the "have nots." It's about the people who are building a logical, strategy-based portfolio, designed with the goal of having a higher chance of being profitable over time, versus those that aren't. And the only thing likely separating these two camps is knowledge.

If you're in the 99%, it may be time to challenge yourself to do better. To take control. Don't just hand your financial destiny over to Wall Street. It might mean learning about the potential benefits and risks of incorporating a variety of stocks, ETFs, options, and maybe even futures and forex into your portfolio. Ultimately, it could mean getting smarter.

So, how do most investors get stuck in this 99% rut to begin with? Think monkeys and evolution.

## CRO-MAGNON TRADER

Your evolution might look like this:

**You start out buying stocks.** Maybe you buy your first stock for its low price. Or it's a company or product you like. Or you've done your homework, or taken a class, and some technical indicator or fundamental metric provided the rationale. Maybe you like an analyst's opinion. What happens? Well, most of the time, the stock price moves up and down. Maybe you take a profit when it rallies, or suffer a loss when it drops. Maybe you start to learn about risk (i.e. losing money), and volatility (i.e. swinging stock prices). But you can't wrap your head around those realities just yet. And you sense—or you hope—there might be an easier way.

**You discover the "stop loss."** The next evolutionary step might be adding a stop-loss order to a stock position to help protect it from a drop in price. But, at some point you place a stop too close to the current price, and the position gets stopped out for a small loss before the stock heads higher. Or, even if the stop were placed further away, you get whipsawed out of a position because of a volatile market, and the stock heads higher anyway.

**You learn other strategies.** Little by little, you begin to walk upright. Maybe you start to learn about more

advanced trading strategies, including the use of options. Maybe you add a short call to a long stock position (a.k.a. a covered call). You might be using this as a hedge, or as a way to generate income from a stock position. That's fine, but what that short call also does is reduce the cost basis of the stock position, and increase the probability of profit of the overall position. How? By reducing the cost basis of the stock position, the stock could actually drop a small amount and the covered call position could still be profitable—the stock doesn't have to rally in order to be profitable. One potential problem? The short call on long stock limits the position's upside potential. That is, in exchange for lower cost basis, the potential profit is capped. And you may not like that if you're hoping your \$10 stock will be the next \$400 stock. You may be right, but the odds are against you, while you're still yearning to leave the cave once and for all.

**You feel the need for something more.** There may come a time where you're feeling friskier, and tempted to take on new, more complex challenges. Maybe futures or forex trading. You're tempted to try what the pros are doing—the 1%. But perhaps you realize you're not ready...it's intimidating.

**So, you go back to school.** A few of you hit the books and learn about options—and the various types of options strategies that have bullish, bearish, or neutral biases. You learn about volatility, potential risks and rewards, and theoretical concepts like "the greeks" and probabilities. At this point, you are evolving. You use real matches to start your fires, and you start incorporating different option strategies into your portfolio based on potential risk, potential return, and probability.

One catch: if you start to use defined-risk strategies like **butterflies**, **verticals**, and **calendars**, where the maximum possible loss is known at the onset of the trade, you might wonder if it becomes a zero-sum game. Sure, your palette of strategies has gotten bigger, but you're still just skating by. The trick is to stop trading like you're still part of the 99%.

## THE SECRET SAUCE

If you're still reading, you're probably somewhere along this evolutionary ladder. But no matter where you stand, the rules are the same for creating portfolios where risk is theoretically controlled:

- 1—*Understand the strategy.*
- 2—*Manage the winners, not the losers.*
- 3—*Control your position size and risk.*

Let's see how this works in practice.

### 1—Understand the Strategy

Stocks are unpredictable. Sure, you might think a stock could go higher, but if the broader market is sinking, it would have to be an unusual stock to buck the trend. Consistently picking the direction for any stock or market is impossible. That's why strategy selection is so crucial. With options, there are other variables—i.e.

time decay and volatility—that can work against you, even if the direction of the underlying is working in your favor. Choosing strategies that are designed to profit under more of such circumstances doesn't guarantee success, but it makes sense to start on the right foot.

For example, you might be bullish on a stock that's trading for \$50. If you buy 100 shares, and the stock drops to \$49, you'd be down \$100 (plus commissions). But if you sold the 46 strike put, and bought the 45 strike put for a net .40 credit, that short-put vertical position can be profitable if the stock stays above \$46 until expiration. The maximum loss would be .60 per spread (plus all commissions, contract and exercise/assignment fees\*), if the stock drops below \$45 prior to expiration. But that would compare to a \$500 loss on 100 shares of stock without a hedge. And the profit is capped at .40 per spread (less commissions and fees) if the stock is anywhere above \$46. If the stock is at \$60, for example, the profit is still only .40 per spread (less commissions and fees\*), compared to \$1,000 (less commissions) profit for 100 shares. But is it likely the stock will reach \$60 during the life of the options? There's no way to know.

## 2—Manage the Winners, Not Your Losers

How many times have you had a small gain in a trade, only to exit at a loss because you were trying to cut your losses short and let your winners run? “Letting your winners run” sounds great in theory, but stocks go up and down every day. Not just up.

The market moves up and down in cycles, like a sine wave. So, on any given day after you put on trades you could show a profit or loss or you could be breaking even.

One useful approach: take profits when the market presents them rather than hanging on too long. This may fly in the face of the “let your winners run” mantra, but for certain types of strategies, it starts to make sense.

To start, if you're trading option spreads like verticals, and a position has made nearly as much money as it can, don't try to squeeze out the last few pennies. For example, if you sold a put vertical for .50 credit, and now it's trading at .05, you've made 90% of its max profit before commissions and fees. Does it make sense to hold the position to try to get that last .05? If the stock drops sharply, your gain could disappear.

Now, if the stock moves favorably to the position, it's more likely the profit will be something less than 90% of the max due to time premium left in the options. In that case, when do you take it off, if at all? It's a judgment call. But, consider why you put the trade on in the first place. Was it a speculation on price? On volatility? On a Fed meeting or earnings headline? Should the event you anticipate happen, consider capturing the profit.

In markets where volatility is higher, both beneficial and adverse price moves can happen quickly. Have a profit target in mind that takes into account all factors, including commissions and fees. When the stock or index price moves

IF YOU'RE IN THE 99%, DON'T JUST HAND YOUR FINANCIAL DESTINY OVER TO WALL STREET. ULTIMATELY, IT MEANS GETTING SMARTER. HOW DO MOST INVESTORS GET STUCK IN THIS 99% RUT TO BEGIN WITH? THINK MONKEYS AND EVOLUTION.

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### GET OUT OF YOUR HEAD

And into the minds of those that trade every day. Chat now with traders of all kinds in the Swim Lessons chat room. Log in to thinkorswim and select Support/Chat, then Swim Lessons tab.



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## Trader Psychology

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“your” way, and the position hits its profit target, consider taking it.

In the case of the stock moving against you, if you’re using defined-risk spreads, the max risk is known. But let’s say you have that long put vertical and the stock rallies. The trade is likely going to be losing money, and maybe it’s worth only .10 now, down 80% of its original .50 purchase price. In this case, take a look at the time to expiration. The position has lost nearly as much money as it can. The additional percentage loss isn’t that great. If you have some time before expiration (maybe two or three weeks, for example), and your situation will allow the additional loss, you may consider holding the position a little longer to see if market cycles drive that stock lower again, to make the loss on the long vertical less, or potentially turn it into a profitable trade. Of course, there is that risk that the stock price stays there or moves higher and you suffer the maximum possible loss for the strategy.

### 3—Control Your Position Size and Risk

Here’s a hard fact: Every trade you take will start out at a loss. If you buy at the ask, the best you can hope for at that moment if you want out is to sell at the bid; and thus, a loss. This means that no matter what, once you place a trade, any type of profit you might realize will take time. So regardless of the strategy you choose, you need to hold a position long enough for it to benefit from what it was designed to do, without having it create a margin call or large loss. That’s known as risk and capital management, and that’s why knowing the margin requirements of a position is important. You can see the margin requirements for different positions using the thinkorswim platform. (For a step by step of just how to do this, see the Margin Special Focus in the previous issue of thinkMoney, Winter 2012.)

THE 99% ISN'T ABOUT THE "HAVES" VERSUS THE "HAVE NOTS." IT'S ABOUT THE PEOPLE WHO ARE BUILDING A LOGICAL, STRATEGY-BASED PORTFOLIO, DESIGNED WITH THE GOAL OF HAVING A HIGHER CHANCE OF BEING PROFITABLE OVER TIME, VERSUS THOSE THAT AREN'T.

Allocating small, consistent, amounts of risk per trade, even when your convictions strong, and keeping capital requirements low, lets you put on more, and smaller, positions. Even if a single trade has the same capital requirement and risk as a series of smaller trades, that trade could become a 100% loser and take you out of business. You can certainly lose 100% on a more, smaller trades, but before you blow out your account, you can stop the bleeding and preserve your capital by not placing the next trade. Bear in mind all the commissions and fees for each trade as well. Depending on the size of your account, these costs could compound your losses dramatically.

Defined-risk option strategies like **verticals, calendars, butterflies,** and **iron condors** provide a maximum possible loss before you trade for better risk manage-

ment. Just make sure the aggregate maximum loss of all your positions doesn’t exceed your comfort level. When you can “handle” the loss, you give a losing position time to recover. But again, there’s no guarantee that it will.

AS YOU BUILD A PORTFOLIO, focus on strategies designed with a higher probability of success, with capital allocated more or less equally across positions—so any one position couldn’t have excessive impact on your p/l.

Think about longevity in trading because you’re not going to join the 1% overnight. Trading well takes practice. Choosing trades based on defined risk, potential reward, low capital and margin requirements, combined with high success probabilities and taking profits when they present themselves, is a way for the rest of us to compete with the 1% by playing our own game.

### Important Information

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. 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.*

*A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. Keep in mind that short equity options can be assigned at any time up to expiration regardless of the in-the-money amount.*

*\* Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. TD Ameritrade standard commission charge is \$9.99 for online equity and options orders plus a \$0.75 per contract fee for options. Orders placed by other means may have higher transaction costs. Options exercises and assignments will incur a \$19.99 commission.*

*Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Investors should also consider contacting a tax advisor regarding the tax treatment applicable to multiple-leg transactions.*

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**1ttrs.**



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

### Love Notes

Hyperbole and Trading Pearls From ...You

Photograph by **Fredrik Brodén**

### Important Information

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• Take some profits at least in partials. As a little old trader told me once, sell half and hope you are wrong.

**Jim**

• My wife and I cannot even agree on finances. How the heck are multiple countries supposed to?

**Jack**

• The old Drakeman would go long here and lose his shirt. The new Drakeman will stay short here and still lose his shirt.

**Drakeman**

• Can there be a dead catfish bounce?

**Jenny**

• I'm 40 pounds lighter when I beta weight.

**Tom**

Down does not equal bad. It's neither good nor bad. It just is what it is. Today the market is down and the trade is short.

**Dan**

• My first novel is going to be titled "Trading Out of My Hole."

**Stephen**

• Adding a new metric to my trading system...praying.

**Scott**

• "Help! Europe has fallen into a liquidity trap and it can't get up!" This message was brought to you by Final Financial Alert, a Greek enterprise with partners in Italy, Spain and France, but apparently not Germany.

**Buster**

• I just got my Amex bill, forget about selling calls/puts. I may sell an organ.

**Frank**

• I see dead stocks. They don't even know they are dead.

**Bud**

• Chat Room banter:  
Client 1: Do they have a "Beige Book For Dummies" yet?  
Client 2: The original beige book is for dummies.

• I never know why people talk about the weather when they can talk about trading :)

**Shaundra**

• I beg you to show me another macro indicator that nails time of turn like solar-lunar correlations and apogee.

**Juliana**

• Jedi trader axiom: In the market there is no try, only never or always.

**Ben**

• I don't know why we bother with all of these charts and fundamentals with all these great rating agencies giving one so much of an edge.

**Doug**

News+Views

A hodgepodge of stuff we thought you should know.

Photograph by Fredrik Brodén

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Ask The Suit

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

Q: I'm obsessed with the new features you guys recently rolled out for futures. I can't stop trading! Is there anything else that's new that I should know about?

A: Sometimes I worry about you futures traders. And lately? I worry about your personal lives. Last year we saw a tremendous growth in futures trading between the hours of 3am and 6am Eastern. And some of you are just reaching for your iPhones—a new phenomenon I like to call “bedside table trading”. Despite the potential domestic conflict we might be causing, the capitalist on my shoulder always wins. So be sure to check out our new CNBC International feed. Global economic news has never been more important and this feed will keep you company during those early morning trading sessions.

Q: I'm new to TD Ameritrade. What's the best way for me to get started on the thinkorswim platform?

A: We get this question a lot. Daily. Hourly. It's for that reason that we've been focused on producing better help resources. A few months ago, you may have noticed that we rolled out thinkManual, the new user manual for thinkorswim. This month, we launched the new thinkorswim Learning Center, which contains FAQ's, videos, manuals, release notes, a program guide to all education events, and much more. You can access the new Learning Center from the upper right hand corner of the platform.

Q: I really like the new look of the iPad app. Will we start seeing more features soon?

A: Yes, soon! Our mobile apps recently went through a major face lift. But they're not just prettier, they're smarter too—which benefits future development. So while our competitors are bragging about new mobile features which allow you to bypass snail mail to get a check in faster, we're going to urge you to continue to ACH your deposits. We'd rather focus on delivering features that allow you to outperform the market, not the mailman.

Toys for Traders

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You can now get your RSI fix in 3D. Well, almost. Just fire up the Charts page and plot your favorite study. If it's “eligible” for Thermo Mode, you'll see a check box in the Edit Studies function and can look at the various gradients of color to determine high and low readings. Beats those boring old lines, huh?

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industry  
spotlight

## What's the Real Cost of a "Trader Tax"?

Words by  
**Thomas Preston**  
Illustration by  
**Ulla Pugaard**

There's been an increasing call for a financial transaction tax (FTT). This would be a fixed percentage charge on each stock, option, future, and ETF trade. The goal is two-fold: after the financial crisis of 2008, regulators and pundits looked at the derivatives trading of the Wall Street banks and decided it was part of what caused the crisis, and increased the volatility of not only the financial markets, but also the global economy. Likewise, and perhaps more interesting to all politicians, the FTT could generate billions of dollars of tax revenue each year.

Now, while all the talk might be how FTT impacts Wall Street, the tax also hits retail investors and traders. And even though the rate might seem small—I've seen numbers around .025%-.003% of the cash value of the transaction.

There are some supposed protections for retail investors, like no tax on the first \$100,000 of transactions

in a year. The thinking is that retail investors don't do the types of transactions that would exceed that. Let's say I buy a call **vertical** in a \$100 stock, where I buy the \$100 call and sell the \$105 call for say, \$2.00 premium, or \$200 cash. The tax on that might be \$.05. Not much, right? Now let's say the stock goes up, and both options are **in the money** at expiration. The long 100 call would buy 100 shares of stock for \$10,000, and the short 105 call would sell 100 shares of stock for \$10,500. That's \$20,500 of taxable transactions according to some of the proposed legislation. Even if you trade only option strategies with small premiums, exercise and assignment could push you over that \$100,000 max quickly.

Now, suppose you place an option trade for \$200. The tax might be \$.05. That doesn't seem like a lot, but when options are often traded in .01 increments, which represents a \$1.00 difference between the bid/ask prices, that's a 5% increase on the execution price. Tack that on to both the buy and the sell, and it can start to add up over time. In the past 10 years, better technology has benefited retail traders to be able to execute orders closer to fair value; thereby reducing slippage. A transaction tax would turn that progress back.

Would that extra tax reduce market volatility? It might, or that tax might just be a blip on a Wall Street bank's income statement, and might not slow them down at all. If politicians prefer to see financial securities transactions as a new source of tax revenue that wouldn't impact "regular" investors and traders, they'd be wrong.

### Important Information

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

### pit talk

Every vocation has its jargon. So if you want to be a real trader, you're gonna have to learn to speak like one

## Airport trade

Placing a very speculative trade which will either send you on a world cruise or dashing out of the country to avoid the authorities.

## PUKING

Exiting all positions quickly.

## 95 Delta on that

Used when something is a sure-fire event.

## THE SIX-MONTH PUT

A way of saying that you would buy that time frame on one of the guys in the pit getting married.

## Buying the "stupid" spread

Buying a call and rather than selling a call against it, buying another call at a different strike.

### COMING SOON FROM TD AMERITRADE

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SPXPM options

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HEDGE

GAPS

AND

PARTY

HATS

WORDS BY **ALEX MENDOZA** PHOTOGRAPH BY **FREDRIK BRODÉN**

A FAVORITE HEDGE AMONG  
OPTION TRADERS, SPX OPTIONS  
HAVE ONE MAJOR BLEMISH—  
THEY SETTLE THE DAY AFTER  
THEY STOP TRADING.  
SAY GOODBYE TO THE OLD, AND  
SAY HELLO TO SPXPM.

## 20

## SPXPM options

Photograph by  
Fredrik Brodén

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TRADERS HAVE HAD A LOVE AFFAIR WITH INDEX options ever since the Chicago Board Options Exchange® (CBOE) introduced the S&P 100 options (OEX) in 1982. However, among index products, arguably the most popular is still that of the S&P 500 (SPX), particularly when it comes to using its options to help hedge portfolios. But, for the past three decades, a problem unique to “a.m. settled” options, such as those on SPX, has challenged investors who rely on SPX options as a hedge. The cries have been heard. A new product, the CBOE SPXpm (SPXPM), could potentially bridge the “hedge gap” between index products and their respective equities.

### FIRST, WHY INDEX OPTIONS?

Before getting into the hedge gap conundrum, let’s take a look at why index options have become popular hedging instruments. If you hold just one or two stocks, you could certainly hedge with the options on those stocks. Yet, for more complex portfolios, it might make sense to hedge with index options. Here’s why:

**1—One product for the entire portfolio.** If you’re truly diversified, chances are your portfolio moves in similar fashion to a major index—what we call “correlation.” So, trading options in one product (the index) is simpler (and less commission-intensive) than trying to trade options on every security in your portfolio.

**2—Size matters.** Indices are typically big products. The S&P 500 cash index is currently priced well over \$1,000. While this may sound intimidating, because of the product size, you may not need to buy as many options to get the same hedge for your portfolio.

**3—Most index options are cash-settled.** Cash settlement means easy math. **In-the-money** equity options settle to the corresponding equity. For example, assume you own the 50-strike put in XYZ stock, and the stock closes at \$44 at expiration. If you don’t sell the put and you don’t have the underlying stock in your account, you will be **short stock** at \$50 per share. To make money, you must then buy the underlying stock for a value lower than \$50 per share. And just because the stock closed at \$44 on expiration Friday, there’s no guarantee you’ll be able to buy the stock for less than \$50 per share come Monday morning—cash-settled options don’t come with this headache. If

you’re long a 50-strike put in a cash-settled index, and the index settles at \$44 at expiration, you get the six bucks (less what you spent on the put, of course). Simple.

**4—Broad-based index options can be very liquid.** A diversified portfolio will often hold both liquid and illiquid stocks. Trying to hedge individual illiquid stock positions can be costly because you might have to give up a substantial amount through wide bid-ask spreads. Making use of a liquid index to hedge—such as SPX—can potentially alleviate this concern. (Keep in mind, though, that there is no guarantee that a secondary market will be available for any given option contract.)

**5—Some of your stocks may not be optionable.** Just because a particular stock doesn’t have options, doesn’t mean you have to live unhedged. Index options might still offer you some measure of protection, even if some of your stocks don’t have options associated with them.

### THE HEDGE GAP CONUNDRUM

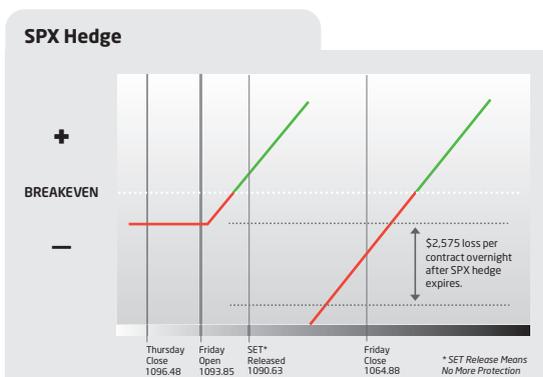
Often, traders resist using index options to hedge equities. After all, most cash-settled indices settle to an opening print on expiration Friday—otherwise known as “a.m. settlement.” This means that the last day you can trade their options is Thursday. Further, in order to calculate the settlement price of an a.m.-settled index, you need the opening print of every stock in the index. Some stocks invariably open later than others. On a day



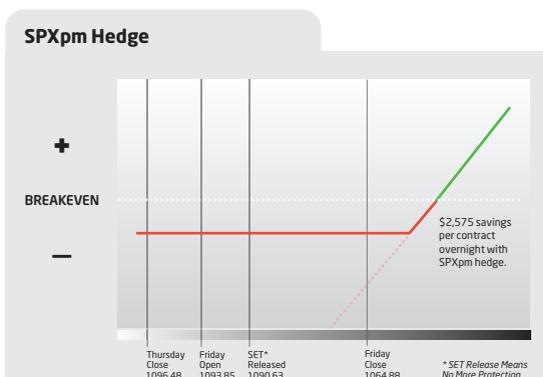
SEE  
GLOSSARY  
PAGE 42

#### INDEX OPTION HAVEN

Trade index options, or your favorite products in the thinkorswim platform by logging in and going straight to the Trade tab. Heck, analyze some hypothetical trades first by throwing them up on a risk graph in the Analyze tab before trading them with real capital.



**FIGURE 1:** Hedging with SPX options can actually leave you unprotected between Thursday, the last day of trading, and the opening settlement price (SET) on Friday the following morning.



**FIGURE 2:** On the other hand, SPXpm options stop trading and settle with equities, so you can potentially have a hedge on your stocks until the end of trading on expiration Friday.

when the market is moving quickly and some stocks open late, it's possible the settlement price of the index equals a value outside the trading range of the index for that day. Naturally, that's a lot of uncertainty. In theory, your hands would be tied unless you chose to close your trades out early.

## THE SPXPM SOLUTION

CBOE, along with its partner exchange C2, launched the S&P 500 p.m.-Settled Options (symbol SPXPM). Compared to the original flagship SPX product, with SPXpm, options settle with your equities. So you can potentially have a hedge on your equity positions in place until the end of trading on expiration Friday.

You always have the freedom to exit, roll, or otherwise adjust your index option positions earlier than expiration Friday. But, SPXpm options now let you maintain positions through the end of trading on Friday. As you know, many companies tend to release earnings headlines on expiration Friday near the close of business. So of course, protecting yourself should be top of mind. However, because SPX options leave you exposed at the moment at which you may need protection the most, SPXpm options may help resolve the conundrum by filling the gap.

## HOW TO USE 'EM

In recent years, we've seen the value of even the most diversified portfolios plunge in response to world events. So, the average investor can feel like nothing can be done to hedge market catastrophes. On the contrary. When diversity can't eliminate risk, again, this is where index options might come in handy. So if you're afraid some shoe will drop in the coming month, and take your portfolio with it, what can you do?

Suppose your portfolio is worth \$25,000, and follows the S&P 500 index. You're concerned about a possible drop in the stock market. To hedge, you could buy put options on each of your holdings, assuming three things—that each one of your stocks has options; that you own at least 100 shares of each stock in your portfolio; and that if you own more than 100 shares, you own them in multiples of 100. That's a lot to assume just to hedge a position.

An alternative approach would be to simply buy options in the index—in this case, the S&P 500.

And, now that there are SPXpm options, a long put position can potentially protect you even if disaster strikes on expiration Friday. (To calculate a hedge using SPX and SPXpm options, see "Hedge ... Not a Four-Letter Word," *thinkMoney*, Fall 2011.)

## PROTECTION 'TIL THE VERY END

The beauty of p.m.-settlement is that the index takes its value from the closing prints of each stock. So, at the end of the day on expiration Friday, you'll know exactly which stock value will be used to calculate the settlement price of the index. Yes, it's possible that you could lose your entire investment in the put you purchase. However, you don't have to deal with the possibility of a mid-morning surprise for the value of your hedge. In volatile times, this added protection may be well worth your investment.

HEDGING WITH INDEX OPTIONS MAY HAVE advantages over hedging with equity options. While there are certainly the similar risks with S&P 500 index options as there are with the other types of options, what it comes down to is flexibility. And that flexibility has been recently enhanced with the introduction of the SPXpm options. The SPX indices are big-dollar products. But for larger, diversified portfolios, they can help keep commissions low because, when compared to lower-dollar products, it takes fewer options to implement the same hedge.

### Important Information

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. 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. Investors considering options should consult their tax advisor as to how taxes may affect the outcome of contemplated options transactions.*

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## Coach's Corner

Pulling pearls from your favorite trading instructors.

Words by  
**Brandon Chapman, CMT**  
Investools Instructor

ern.

PATTERNS. PEOPLE TEND to gravitate to them. Why?

Because they're familiar. If you do something long enough you might recognize that certain patterns of behavior may lead to certain results. The "bull flag" is a continuation-price pattern and is common in a bullish trending environment. It's important to understand the pattern's formation and how some investors measure a potential target. When the bulls hoist a flag, it could be a signal to charge ahead.

The flag pattern is divided into three parts:  
1/ The flagpole  
2/ The flag  
3/ The move after the flag

Think of the pattern as the bulls waving a flag before the next charge, because a bull flag is often a brief pause in the middle of a strong market move. Let's dig into the psychology behind the flag pattern.

### Anatomy of a Flagpole

Phase one. Imagine you're watching the stock of a cell-phone company. Good news comes out that the phone's artificial intelligence can now call your mother-in-law and carry on the conversation for you. Clearly, traders are excited by this company's prospects, and suddenly, they start buying more of its stock than selling it. As such, the stock price rises and volume increases, confirming greater trading activity. This is the formation of the flagpole.

Phase two. The price movement eventually starts to stall as buyers bank profits. Now there appears to be better equilibrium

# Leading the Charge with Bull Flags

Pretty pictures come in all shapes—especially this little pattern



**FIGURE 1: Bullish Flag on the S&P 100 Index.** The flagpole begins with a resistance breakout and ends where the bull flag begins. This distance is added to the flag breakout to come up with a target. Chart from TD Ameritrade's thinkorswim. For illustrative purposes only.

between buyers and sellers. The trading volume begins to slow down and price action moves sideways, to slightly down. We sometimes say the market is "catching its breath." This is the formation of the flag.

Phase three. Knowing demand for a smart phone that automatically talks to mother-in-laws isn't over, traders want more, and buying starts up again. An imbalance in supply and demand once again encourages the price to rise on high volume. This is the movement after the flag.

### Bringing it Together

The flag formation itself has a parallel level of support and resistance sloping slightly downwards, that may last three-to-fifteen trading periods. (See the chart in Figure 1.) It's sort of like a downward-tilted rectangle. After price action moves upward again, it often moves roughly the same distance as

### Important Information

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WHAT IF THE FED THREW A BOND AUCTION AND NOBODY SHOWED? COULD  
WHAT HAPPENED IN GREECE AND ICELAND HAPPEN HERE? THOUGH IT'S NOT LIKELY  
TO HAPPEN ANY TIME SOON, TRADERS SHOULD PAY ATTENTION TO THE SIGNPOSTS.

**THE FRIENDLESS BOND**



IT WAS A TIME THAT WILL BE FOREVER ETCHED into the minds of those who lived through it. Inflation had soared north of 13%. The U.S. economy was in stagflation, mired in financial purgatory somewhere between anemic growth and falling wages on one side, and soaring commodity prices on the other. At its peak in July 1981, the Fed funds rate, which commercial banks charge each other for overnight loans, hit a punishing 22.36%. Mortgage rates surged passed 20% and in the process pushed thousands of homeowners into foreclosure.

Today, with the Fed funds rate hovering near all-time lows, between zero and 0.25%, the sovereign default threat looms large as crises in Greece, Iceland, Portugal, Spain, and Italy are pushing bond rates to new highs. These are painful reminders of what can happen when economies come unglued and investor confidence plummets.

But, could what happened in 1980s America, or worse, in Iceland 2008 and Greece 2010-11, when lack of investor interest pushed bond yields into the stratosphere, occur here? If so, how can you see it coming and what's the punchline for traders?

### SAFETY IN NUMBERS

Such scenarios seem far-fetched today, given the apparent popularity of U.S. Treasury bonds as safe capital. Arguably, even a downgrade of the U.S. debt rating in 2011 failed to shake confidence in government bonds. At the time of this writing, according to Bloomberg, U.S. 30 year T-bonds (US-057) hovered near all-time highs of 145 with yields under 3%. It's a long way indeed from the low of 46 in 1981, when yields were closing in on 15%.

Challenges in Europe have seemed only to increase the attractiveness of Treasuries and other bonds due to their perceived safety. The December 19, 2011 Treasury auction saw 30-year bonds drawing more than three times the bids than normal to sell them all. Bonds earned record prices, despite the record low yield of 2.925%. According to Bloomberg, it was also the highest level of investor interest since August 2000.

This auction stood in stark contrast to the November 23, 2011 German auction that failed to attract sufficient bids to sell all the 10-year bonds. Bloomberg also cites that this failure quickly pushed yields up 15 basis points to 2.06%. Germany is the strongest euro zone member and the auction failure is a concern. But yields remain low in Germany, which is a positive sign. This is in stark contrast to Greece, where yields hit 116.59% recently on two-year notes.

The rising probability, and various predictions of, recessions in both Europe and the U.S. could help keep interest rates and yields low, a contention supported by a number of leading indicators. The Economic Cycle Research Institute's (ECRI) weekly leading growth index first turned negative in September 2011, prompting the institute to warn clients that the U.S. economy was tipping toward another recession. ECRI registered a bearish reading of -7.6 in December. This indicator has successfully called the last three recessions without any false alarms, according to its website.

It is not alone. The Aruoba-Diebold-Scotti (ADS) Business Conditions Index, and the Chicago Fed National Activity Index (CFNAI), were also both in negative territory at the time of this writing. These indicators, along with the ECRI, accurately warned of the 2001 and 2008 recessions.

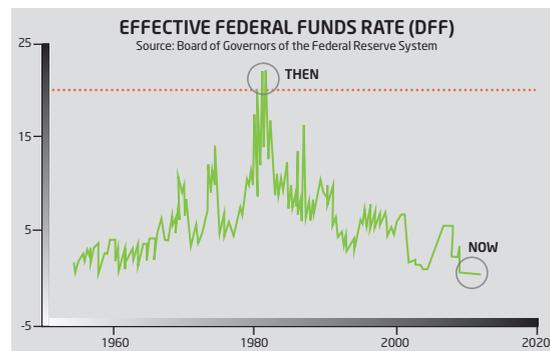
### THE LONG VIEW

Economist Dr. Gary Shilling, author of *The Age of Deleveraging*, sees a number of years of economic headwinds ahead, including extended periods of deflation.

"Before we have to start worrying about rates increasing substantially, we need to see sustainable economic growth, jobs creation, and a pick-up in the housing market. Behind that, we'd have to be rid of the excess housing inventory, and we think that's going to take another five years," Shilling said in a telephone interview on December 16.

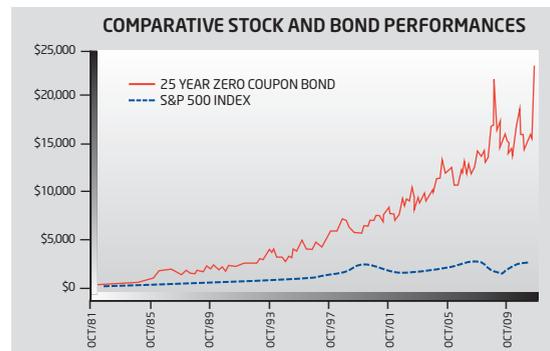
Other signs that rates may rise could come in the form of a weakening dollar. Before that can happen, Dr. Shilling believes we'd need to see significant strengthening in Europe, which he sees as unlikely anytime soon.

In his book, Shilling outlines a bond strategy that has handily outperformed the stock market over the last thirty years. His "favorite all-time graph" (Figure 2) shows the difference \$100 invested in a 25-year, zero-coupon bond at its all-time yield high, and rolling into



**FIGURE 1: Daily effective Fed funds** rate over the last 50 years, showing the historic range from its all-time high of 22.36% in July 1981, to its all-time low today.

Source: Federal Reserve Bank of St. Louis.



**FIGURE 2: Chart from Age of Deleveraging** by Gary Shilling showing the difference between his strategy of buying a \$100 zero-coupon, 25-year Treasury bond in 1981, versus the same investment in the S&P 500. For illustrative purposes only. Past performance is not a guarantee of future results or success.

Source: Bianco Research & Haver Analytics. Chart courtesy of agaryshilling.com.

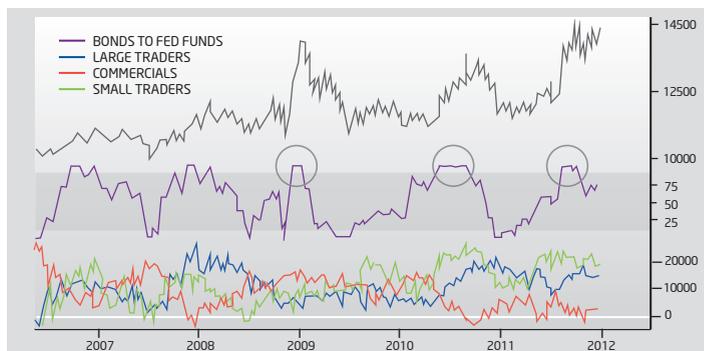


COULD WHAT  
HAPPENED IN 1980S  
AMERICA, OR  
WORSE, IN ICELAND  
AND GREECE, WHEN  
LACK OF INVESTOR  
INTEREST PUSHED  
BOND YIELDS INTO  
THE STRATOSPHERE,  
OCCUR HERE?  
IF SO, HOW COULD  
YOU SEE IT COMING?



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**FIGURE 3: Weekly chart of the US-057, 30-year Treasury bonds** showing Larry Williams Bonds to Fed Funds Valuation (upper graph), showing past peaks (middle graph), and the commitment-of-traders positions of small speculator (green) at high levels, as well as commercials (red) and large speculators (blue).  
For illustrative purposes only. Chart courtesy of GenesisFT.com and ireallytrade.com.

a new 25-year bond every year, versus the same investment in the S&P 500 Index.

“My target rate on the 25-year bond is 2.5%. At 2.5%, I don’t see much more upside in bonds. From then on, the trade would be driven by real yield,” Shilling says. “But if we do have chronic deflation of 2%, and bond yields stay around 3.5%, that means a real return of 5.5%, which is quite respectable.”

### THE SHORTER VIEW

Gary Shilling’s long-term strategy is macro-economic lasting decades, so we contacted commodity trader Larry Williams, who has a shorter technical trading horizon. We asked him what he sees ahead for bonds in the near term.

“The recent commitment-of-traders report (COT) shows small speculators are aggressively long bonds. Commercial interests have not been buying. What I believe will kick off a down move in the bond market is a very strong seasonal trend to decline that starts right after the first of the year. I see no reason why this year will be different.”

The chart in Figure 3 of the U.S. 30-year Treasury bond (US-057), shows the combination of higher-than-average commitment of traders and small speculator (retail) contracts, and the low number of commercial contracts. Note what happened in October 2010, after which bond prices dropped nearly 15%. In 2008, the seasonal drop was even more pronounced at more than 20%.

What happens longer term however, could depend more on sovereign default and deflation risk than on technical or seasonal factors.

### AND THE PARTY RAGES ON?

With the exception of periodic seasonal weakness, bonds are still considered by some to have the potential to be one place to park money for the foreseeable future. If experts like Gary Shilling, Nouriel Roubini, and Peter Schiff are correct, the global economy will experience headwinds—not the least of which are continued problems in Europe as leaders grapple with a flawed euro. And it remains to be seen whether the monetary union of nations with such pronounced political and fiscal differences can survive the strain. If

these problems can be solved quickly and economic growth exceeds current expectations however, look for interest rates and bond yields to rise at the expense of bond prices.

Plus, there is growing evidence that both China and India—significant contributors to the global economic growth over the last decade—like western nations, are now struggling under crushing debt loads. While there are risks of bank and sovereign defaults in a deflationary environment, it’s possible investors will continue to put a higher priority on safety rather than on returns. But again, if these economic

challenges prove to be less severe and real growth in these economies rebounds, bond prices will suffer in the face of rising inflationary pressure.

What’s the punchline for traders in all this? For a buyers’ strike of U.S. debt to occur, it would likely require a dramatic event or shift in perceptions that we can pay back our debt (i.e. unexpected global downturn, downgrade in U.S. debt). As long as the current environment exists, the probability of a Greek style meltdown in U.S. Treasury markets remains

low. If the U.S. economy continues to improve, and shows signs that the Fed policy of printing more money is working, inflation may start to creep in, and send bond prices lower. If that happens, keep an eye on the reactions of the equities and commodities markets to get a sense of whether institutional traders feel the inflation will actually benefit stocks. And listen closely to chatter about precious metals. When inflation appears, that’s about the time precious metals start to get a lot of attention as well. But given the massive amounts of debt worldwide, the risk of a default happening somewhere in an industrialized, or large emerging nation, certainly remains a real threat. In this kind of uncertain world, a thoughtful bond strategy—short and long term—could make sense.

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## Vol Watch

Viewing the markets through the eyes of volatility

Words by Adam Warner

vol

“This time it’s different.”  
How often do you hear that?

Yes, the world may change, but not the behavior of volatility. Volatility generally moves up and down. It can spike every once in a while due to macro events, but then eventually trades in a new range. The trick is understanding when the new range has been formed.

Let’s take a look at the CBOE Volatility Index (VIX). The VIX proxies volatility of an SPX option with 30 days to expiration. Since the mid-1990s, VIX has traded around a mean of 20. But break it down a bit, and it tends to fluctuate between strong and weak three-to-five year regimes. For example, VIX hovered in the teens in the early-to-mid 90s—a weak regime. When the tech bubble came in the late 90s, VIX generally traded in the 20s—a strong regime. In 2003-2007, VIX weakened and traded mostly under 20. Recent years—strong. And so on.

### CHARTING THE NEW NORMAL

So how do you know when VIX has left one regime and begun another? We don’t know. Nobody knows. But we do know that over time, VIX is a mean-reverting instrument. So the real trick is finding a fair mean in the here and now. This is where charts can come in handy.

Bollinger Bands is a tool you can use to help define “new” normals. Figure 1 shows a six-month thinkorswim chart of VIX, with Bollinger Bands.

The green line in the center is the 20-

# Where it Stops, Nobody Knows

Future volatility may be unpredictable. But what about range?



**FIGURE 1: One-Year VIX.** Between March and August, 2011, VIX traded between 15-21. After breaking out in early August, it found a new range until October between 30-45. Each new range helps define your strategy. Chart from thinkorswim. For illustrative purpose only and is not a recommendation.



#### Trade Architect Users!

There’s Bollinger Band love for you too. Pull up the Charts page and click the Indicators button in the top left of a chart. In the drop down menu, you’ll find Bollinger Bands.

“normals.” From April to July, 2011 VIX fluctuated in the 15-21 range. Then came the fears around a European collapse in August, 2011 and the ensuing VIX pop. Afterward, a new range formed, from the low 30s to the high 40s.

#### BE FLEXIBLE

A couple things should stand out. First, in short time frames, VIX has previously tended to bounce around the moving average, unlike stocks that can trend and trend. And this mean reversion can happen during

day simple moving average, and the two outer bands (pink lines) are set two standard deviations up and down (i.e. 95% of the price action). The chart covers a six-month stretch that really encompassed two “mini-

periods when VIX is both strong and weak. Second, the moving average hasn’t always sat in one area for long. It can get comfortable in one range then—wham!—it moves into another.

It’s easy to lean against a range, like the one from April to August, 2011. And it’s even easier to get caught leaning against the top of that range, then watching it go far beyond that. Flexibility is the key here. VIX has no “fair” value. It’s forever worth the price the market places on insuring a portfolio, and the aggregate investor sentiment regarding future market risk. So when the notion of a price changes over time, you might be wise to change your notion of that price, too.

Even if you’re not trading options, being flexible still applies. Consider adjusting your stop losses, widening your targets, and reducing your position sizing as market volatility increases. It’s less about guessing when “facts on the ground” will change, and more about adapting swiftly as it happens.

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**Gear Head**

Our favorite gadgets you may not have heard of

# Two for One

See the world at a glance (currencies, anyway), and option data from a bird's eyes.

**FX CURRENCY MAP**

Trying to get a quick beat on the currency markets used to be a challenge. With the FX Currency Map in thinkorswim, you can now get the high-level view of your favorite currency against other currencies of its traded pairs. In a tight little widget, the FX Currency Map displays the hard data for all personality types (Currency pair lists for type As. Pretty pictures for type Bs).

Where do you find it? In the left sidebar of the thinkorswim platform, click on Gadgets in the left sidebar and choose FX Currency Map from the menu. Once there, you can compare the currency of your choice to all currencies of the traded pairs.

The lower stacked column comparisons in the list give you a better look at a currency's overall performance. In the upper



**FIGURE 1: FX Currency Map** Your favorite currency pairs at a glance. Found in the Gadgets menu of thinkorswim.



**FIGURE 2: Widget 360.** Options data at a high level. Found under the Tools tab of thinkorswim.

animated graph (it's the one with the world map behind it), just place your cursor over any one of the columns to get the day's skinny on price action. If the upside of your currency comes on the downside of a given pair, the quote is inverted to keep everything consistent—no, make that pretty. Sigh.

**WIDGET 360**

This little thinkorswim tool displays a world of option data in a visually intuitive format. You can see implied volatility, open interest, gamma—and just about anything else option-related that's plottable. Switch fields in a click, look at different strikes and expiration cycles, and so on.

Suppose you need help picking a strike for your trade. And you're looking for analytics on volatility and the probability of dif-

ferent outcomes.

- 1) Enter your symbol.
- 2) Choose the options you want to plot. You can see everything by clicking on "All", just view either Calls or Puts, or only out of the money options.
- 3) Pick your Expiration Cycles. Between Weeklys, Quarterlies, LEAPS and all the regular options, you might have as many as 16 expirations to choose from.
- 4) Pick your strikes. You can view everything that trades, or narrow the field down to as few as one strike.
- 5) Choose what you want to see in the charts—greeks, Implied volatility, and so on.

Widget 360 is a customizable analytic tool. Take it all in and let it help you pick a strike and expiration for your trade. So go on, pick a name out and get started.

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Awarded 5 stars from Stockbrokers.com\* ★★★★★

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\*The thinkorswim trading platform received 5 stars overall in the 2011 Stockbrokers.com Forex Broker Review (sharing the highest score with one other broker), as well as 5 stars in the categories of "platforms and tools" (sharing the highest score with one other broker), "investment offerings" (sharing the highest score with three other brokers), and "customer support" (sharing the highest score with one other broker). thinkorswim was evaluated among a total of 16 forex brokers and trading platforms reviewed.

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**Ask the  
Trader Guy**

Saving traders, one question at a time.

Photograph by  
**Fredrik Brodén**



trdr.

**Q: Hey, Trader! I see probability numbers on your platform. What's the difference between the 'probability of expiring' and the 'probability of touching?'**

A: Here's a quick explanation without getting into all the math. The probability numbers are calculated with statistical confidence formulas that use the current stock price, the strike price of the

option, time to expiration, cost of carry, and a volatility estimate. The vol estimate is the implied vol based on the current price of the option. There's a difference between the probability of expiring and the probability of touching: the expiring number considers whether the stock is above or below the strike price only at expiration. It doesn't consider where the stock has been between now and expiration. The probability of touching considers the possibility of the stock hitting that strike price any time between now and expiration.

**Q: Hey, Trader! I bought an out-of-the-money call on a stock, thinking the stock would go higher. Well, the stock went up, but my call lost value. What happened?**

A: Option prices are affected by several factors, one of which is the price of the stock. But time passing and changes in volatility can have a big impact, too. If volatility dropped as the stock went up, and time went by (as it always does), then

the negative impact on the option price due to those factors could have exceeded the positive impact of the price increase of the stock. If the stock doesn't move high enough, fast enough, then a drop in volatility and time passing can turn a long call position into a loser.

**Q: Hey, Trader! People are talking about the relationship of the dollar to oil. How does that work?**

A: Oil is one of the few dollar-denominated commodities in the world. No matter where you

are, oil is quoted in US dollars. Now, let's say you're a Russian oil producer that hopes to make a certain amount of rubles from a barrel of oil. You need to convert into rubles the dollars you receive from selling that oil. If the US dollar rises relative to the ruble, you could convert those dollars into more rubles. Therefore, you're willing to sell oil at a lower price when the US dollar is higher, because the high dollar lets you turn the lower oil price into the same number of rubles. The opposite is true if the dollar is weak. You'd need to sell your oil for a higher price in US dollars to make the same number of rubles.

**Q: Hey Trader! My New Year's resolution was to lose weight, but the missus set me up with a trainer who can only meet me near the close of trading. What should I do?**

A: Being able to see your knees is highly overrated. Rest your troubled mind. Trade right up to the close, and have another burrito.

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*The probability projections on the Analyze page assume the underlying stocks follow a log-normal distribution. The results are derived using the Black-Scholes formula for delta, consisting of the current stock price, number of days in the future, current volatility of the stock, and the risk-free rate of return. Probability analysis results are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring.*

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**Special Focus:  
Pairs Trading**

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WORDS  
BY **THOMAS  
PRESTON**

OPPO  
SIT  
ES

A  
TTR  
ACT

Two stocks from the same sector walk into a bar. One is up, the other is down. Which one do you buy a dirty martini? How about both. Confused? To "pairs trade," you need a firm grasp of the strategy, the right tools, and the right temperament. Soon you could be on your way to using an interesting and overlooked strategy.

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**Special Focus:  
Pairs Trading**Photograph by  
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**THINK  
CHEVY  
VS FORD.  
COKE  
VS PEPSI.  
KETCHUP  
VS MUSTARD.**

You like one, and don't like the other. Pairs trading is similar: you buy one stock while **shorting** another. On purpose. At the same time. In a pairs trade, you're long, say, 100 shares of one stock and short 100 shares of another. To get the price of a pairs trade, what we'll call the "pair difference," take one stock price (usually the more expensive of the two), and subtract the other. If you're buying a pair, you want the pair difference to go up. If you're shorting the pair, you want the pair difference to go down. When you do a pairs trade, you want the stock you bought to outperform the one you shorted. This can happen in three ways, as we'll see using two stocks.

*Stock A (long) = \$50*

*Stock B (short) = \$49*

At these prices, the pair difference is \$1.00 (\$50 minus \$49). The pair difference could move higher, from \$1.00 to, say, \$3.00, in a couple of ways.

First, if stock A moves to \$54, and stock B moves to \$51, the pair difference moves to \$3.00 (\$54 minus \$51). Both stocks move up, and the pair difference moves up as well.

Or, stock A could drop to \$48, and stock B could drop to \$45. The pair difference moves up to \$3.00 (\$48 minus \$45). Both stocks move down in this case, but the pair difference moves up. Either way, if you had bought 100 shares of stock A, and sold short 100 shares of stock B, the position would have profited \$200 before commissions.

Now, if stock A rises to \$55, and stock B rises to \$60, the pair difference moves down to -\$5.00 (\$55 minus \$60). If you had bought 100 shares of stock A and sold short 100 shares of stock B, the position would have lost \$600 before commissions.

Calculate profit and loss by tracking the change in the price of the pair. This is straightforward if the pairs trade consists of long 100 shares and short 100 shares. In one case, the pair difference went from \$1.00 to \$3.00, and the trade made \$200. In the other, the pair difference went from \$1.00 to -\$5.00, and the trade lost \$600.

Now, this hypothetical example uses long and short stock positions. But, you can also pair trade using options. Instead of buying stock, you could use **positive delta** spreads, like **short-put verticals** or **long-call verticals**. Instead of shorting stock, you could use negative delta option spreads, like short-call verticals or long-put verticals. Even though you're using options, the underlying premise behind trading pairs is the same: you

want the stock in which you have the positive delta option position to outperform the stock in which you have the negative delta option position.

**WHY PAIRS TRADING?**

When trading pairs, you might have more confidence in the direction of the pair difference than you do in individual stocks or indices. Stocks can exhibit random patterns. But, certain pairs trades tend to oscillate—their price difference goes up and down around an average level or mean—though this behavior is by no means guaranteed. When it's above the level, it has a tendency to go back down to the level. When it's below the level, it has a tendency to go back up to it. Thus, pairs trades would seem attractive at one extreme or another of a trading range, when they can be seen as an "overbought" or "oversold" condition.

Let's consider different time frames. For shorter-term trades, maybe intraday out to one week, pairs that exhibit wide oscillating price movement can move away, and back to an average level, quickly. If you wanted to pursue this strategy, you have to be nimble and sometimes aggressive—ready to take profits, or cut a losing position at any time. Short-term pairs trades require the greatest engagement. For short-term trades, stocks are typically the product used. The short-term pairs trades usually have smaller price targets, maybe only three or four points. When trying to capitalize on



those short-term, smaller moves, stock is typically more responsive to changes in the pair difference. The stock pairs position profit and loss changes dollar for dollar with the change in the pairs difference.

Longer-term pairs trades could be considered when there might be divergence between two stocks, or, more typically, between broad indices or industry sectors. For example, pairs trades speculating on the divergence between large-cap and small-cap stocks could be longer-term pairs trades lasting weeks or months. Rather than tracking oscillating price behavior, traders typically base longer-term pairs on fundamental or economic rationale.

For longer-term trades, you might consider options. With stocks, when a pair difference changes price, the response is generally 1:1. With option spreads, the response is often slower. With option spreads, you could have defined risk and lower capital-requirement positions for a pairs trade. But you have to understand options, and their specific risks, and how those risks are affected in a pairs-trade scenario.

## HOW DO YOU FIND THEM?

**1. Look for sector pairs.** Search industry groups, like large oil stocks, or pharmaceuticals, or retail stocks. Review charts of different pairs to analyze whether the pair oscillates around a mean. If it does, do more analysis. But, start by looking at a chart to see if the oscillation is faster, i.e. more short term, or slower, covering weeks or months. You may have to go through a dozen sets of stocks before you find one you believe worth considering. Finding a good pairs trade takes time. Save them in a watch list in the thinkorswim software. If you find a pair of stocks whose pair-difference price exhibits the behavior you like, move to more analysis.

**2. Check the correlation.** Correlation measures how often stock A goes up when stock B goes up. You can measure correlation right from the Pairs Trading feature in the Trade page of thinkorswim (See Figure 1, page 38). If the two stocks always go up (or down) at the same time, the correlation between them is going to be 1.00. If stock A always drops when stock B goes up, and vice versa, the correlation is going to be -1.00. If stock A goes up or down without any measurable relation to when stock B goes up or down, the correlation is close to 0.00.

Remember that correlation results represent past performance, and as we all know, past performance does not guarantee future results. So while correlation may be valuable in evaluation of potential trades, it doesn't mean the two stocks will always cooperate. For pairs trades, you want to see correlations as close to 1.00 as possible. Now, 1.00 is pretty rare. So, look for correlations that are at least, say, .80. Why?

With a pairs trade, you're getting long one stock and short another, speculating that the stock you're long will rise faster, or fall less, than the stock you're short. So, if both stocks move up at the same time, or down at the same time, the spread difference between the stock prices tends to increase or decrease within a certain range. But if one stock heads higher and the other stock

heads lower, you're hoping it's the stock you're long that's going higher and the stock you're short that's going lower.

Hope isn't a strategy. When stocks are uncorrelated, their pair difference can be much more unpredictable. In this case, you're speculating more on individual stock prices, and it isn't really a pairs trade. When stocks are correlated, and they more frequently move up together when the market's rallying, or down together when the market's falling, their spread differences tend to be more predictable, generating that oscillating price movement. If the correlation is low, it's more likely the pair difference will break down and start to move less predictably. You'll want to check the correlation frequently while you have a pairs trade on to see if it's dropping. If it is, you may want to exit the pairs trade for whatever profit or loss it has at that time.

**3. Consider time frames.** As previously mentioned, look at a couple different time frames for the pair. For example, look at a daily chart for a year, then look at a 20-minute chart for 20 days. The daily data will show whether the oscillation is a recent event, or has been with that pair for some time. The 20-minute data can provide a glimpse into how much that pair might swing intraday. This becomes important if you're only holding a pair for a few days.

**4. Check implied volatility.** Look at the implied options volatility on the stocks in the pair, particularly if you're looking at a longer-term pairs trade. If the two

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stocks are correlated and have betas—a measure of relative volatility comparing how much a stock moves up or down relative to a benchmark, such as an index—that are close to each other, if one stock's options have a higher implied volatility than the other stock's options, pairs trading theory would lean toward shorting a call or put vertical in the stock whose options have the higher volatility, and buying a call or put vertical in the

stock whose options have the lower volatility. (Check implied volatility in thinkorswim by pulling up a stock's chart in the Charts page. In the Studies menu, select Quick Study > Volatility Studies > ImpVolatility.)

**5. Pick your exits.** Choose the ideal exit points for profits and losses. These mental stops can help prevent a losing pairs trade from potentially creating even larger losses when using stock positions. You may want to set a stop loss at a point just outside the recent range of the

SEE  
GLOSSARY  
PAGE 42



Pairs trading on the thinkorswim platform just got a face lift. Make than a major overhaul. Just log on to thinkorswim and click the Trade tab, then Pairs Trader in the submenu. Need more help? Call the Trade Desk at 800-672-2098.

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**Special Focus:  
Pairs Trading**

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pair, to make sure the position doesn't get stopped out in a predicted oscillation. Look to take profits if the pair gets close to the average level.

**PUTTING IT ALL TOGETHER**

Looking at a daily chart of stock A minus stock B, the pair difference between them seems to oscillate around an average of \$3 for the past couple of months. The low end of the oscillation takes it down to \$1 before it bounces back to around \$3. The high end of the oscillation takes it up to \$5 before it drops down to around \$3. So, check the correlation and see that it's .85 for the past three months. Good.

Now look at the daily chart for the A/B pair, maybe the 20-minute/20-day chart. Hopefully you'll see pretty much the same oscillating behavior even in the shorter time frame. If not, reevaluate. The current pair difference is \$1—the low end of the range. If you believe in the strategy, and think it will bounce back up to \$3, you buy 100 shares of A and short 100 shares of B. Maybe set a stop at \$-1, which would be a \$200 loss for the pairs trade. If the pair difference rallies from \$1 to \$3, take the \$200 profit by selling the long 100 shares of A, and buying back the short 100 shares of B. Now, if you see that pair difference continue to rally up to \$5, and you think it will drop back down to \$3, short the pair by shorting 100 shares of stock A and buying 100 shares of stock B. And place a stop to buy it back for, say, \$7, for a \$200 loss, or buy it back when it reaches \$3, for a \$200 profit. Just remember that the strategy generates multiple commissions, which you'll need to factor in when calculating overall profit or loss.

Wrapping your head around pairs trading isn't easy. But if you can't find what you like in your favorite stocks or indices, the strategy could provide new potential opportunities for those who understand it.

# How To: Trade Pairs in thinkorswim

Ready to analyze and place a pairs trade? No problem.



**FIGURE 2: Chart, Analyze, Trade** Don't be shy. Pull up a pairs trade in the new Pairs Trader feature on thinkorswim, by entering the long position on the Left Side, and the short position on the Right Side. The chart displays the history of the pair's price. From there, treat it like any other chart. **Chart from thinkorswim.** For illustrative purposes only.

pairs

Once you're comfortable with the concept of pairs trading, and it's time to test the waters, the thinkorswim platform has a lot of the tools you need to find, analyze and place pairs trades.

**SCANNING FOR PAIRS**

You can begin by searching for stocks in an industry sector that might become the components of a pairs trade. Using the Stock Hacker tab, you can scan for stocks within a sector that fit certain criteria you determine, like price, market cap, and levels of implied volatility. Start by clicking on "All Stocks" in the "Search in" field, then choose "Industry" to see the largest S&P industry divisions. You can click on one of them, then drill down into the sectors and groups to include only stocks from that list in your scan.

**PLACING THE TRADE****Pairs Trader Page**

Select the Trade tab at the top of thinkorswim and then choose the new Pairs Trader page in the submenu. Then follow three steps:

## 1 CHART A PAIR OF STOCKS OR INDICES

If you're looking to trade a pair of stocks, say FAHN and CVRC, you can see a chart of the pair by entering the symbols in each of the "Left Side" and "Right Side" input boxes. Then select the time period at the top of the chart to hourly, daily, weekly, etc. (Alternatively, you can chart pairs in the Charts page of thinkorswim by simply entering the pair [i.e. FAHN-GVRC] in the symbol field above one of the charts.)

## 2 CHECK CORRELATION

After you enter the pair symbols in the chart, you can add in the "PairCorrelation" study at the bottom of each pair screen in the Pairs Trader tool to see the correlation between the two symbols. By default, the PairCorrelation study uses 10 bars of data, but you can edit that to match the time frame you want to analyze.

## 3 ENTER A PAIRS TRADE ORDER

Once you've entered the two symbols that comprise your pairs trade, you can adjust the quantities that you want to buy or sell, set the trigger price at which you want to execute the pair, then click on the Buy Pair or Sell Pair to route the order.

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**Q:** What's the margin requirement on a pairs trade?

**A:** In regular margin accounts, the margin for a pairs trade is the sum of the margins of the individual positions. There's no offset. If you're pairs trading with stocks, it could be as low as 30% of the value of both the long and short positions, but could be higher, depending on the individual stocks. If you're pairs trading with options, the margin will be that of the separate option positions in each underlying. (For more on margin requirements, see the Special Focus on Margin, "Now You See It, Now You Don't," thinkMoney, Winter, 2012.)

STOCK AND OPTION EXCHANGES DON'T RECOGNIZE PAIRS TRANSACTIONS, SO YOU CAN'T ROUTE A PAIRS TRADE AS ONE ORDER AND HAVE IT EXECUTE BOTH SIDES SIMULTANEOUSLY.

**Q:** Can I do pairs trades in IRAs?

**A:** Because you cannot short stock in an IRA, you would not be able to do pairs trades using only stock. If the IRA is allowed to trade option spreads, then a pairs trade could be constructed with them.

**Q:** Are pairs trades executed as a single transaction?

**A:** No. The two halves of a pairs trade are executed as individual orders on the exchanges.

**Q:** Can I place a pairs trade with different amounts of shares for each side?

**A:** Yes. You're not limited to an equal number of shares in a pairs trade, such as 100 long one stock, and 100 short another. You can choose a different ratio based on if you'd prefer to invest in more equal dollar amount in each stock. Take two stocks, FAHN at \$60, and XYZ at \$40, making the spread between them \$20. If you want to invest an equal dollar amount in each, say, \$1,200, which is 200 shares of FAHN at \$60, and 300 shares of XYZ at \$40, you can do that as well. The number of shares can be changed in the Pairs Trading screen in the quantity boxes of both the "Left Side" and the "Right Side" of each pairs trading screen.

**Q:** When looking at a pairs chart, should I use a bar chart, candlesticks, or line?

**A:** Generally, you would look at a line chart for a pair. The reason is that bar and candlesticks show daily high-

and-low prices, but those are not necessarily accurate for a pair. The chart calculates the high and low for a bar or candle by taking the high and low for the individual stocks of the pair. But because the highs and lows for the two stocks are not necessarily concurrent, i.e., they don't occur at exactly the same time, the highs and lows on a bar or candle would not be meaningful.

**Q:** Does a pairs trade get executed at the same time?

**A:** Stock and option exchanges don't recognize pairs transactions. So you can't route a pairs trade as one order and have it execute both sides simultaneously. However, when sending in an order from the Pairs Trader feature on thinkorswim, the software will send in the trade as a special order type called a "Blast All" (found on the advanced order menu in the order entry panel), which allows you to submit a pairs trade with a single push of a button.



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# 41 fun

## Futures 4 Fun

Futures trading nuggets, one dollar at a time

Words by  
**Michael Atkinson**  
Investools Instructor

• Any day of the week traders can tackle a mountain of futures reports. The downside? You risk being buried under an avalanche of data. The following reports are known for timely info. They just might keep you efficient (and sane), while potentially energizing your trading.

### 1) Oil's Petroleum Status Report

Every Wednesday, 10:30 EST, the U.S. Energy Information Administration releases the Weekly Petroleum Status Report (<http://tinyurl.com/petroreport>). The report details how refinery production, inventories and prices, affect oil and stock futures. It also details the effects on currencies like the British pound (nearly 20% of U.K.GDP is from British Petroleum). And it reveals the impact on bonds and interest rates due to inflation. Pay special attention to oil inventories, because greater-than-expected supply tends to hurt oil prices while helping stocks (the opposite is often true for smaller supplies). An honorable mention for monitoring oil goes to the dollar (/DX), which can have a significant impact on the price of oil.

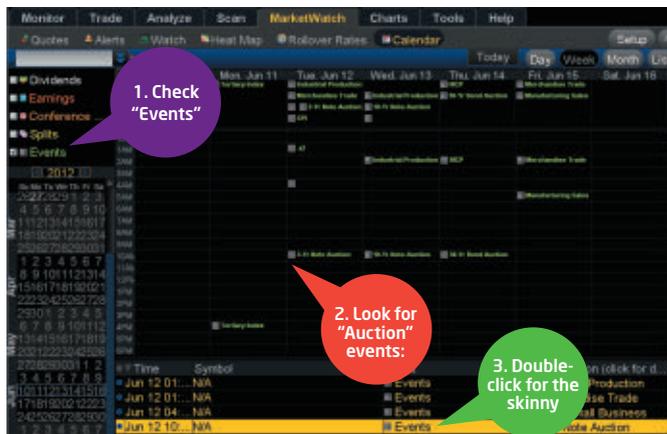
### 2) US Treasury Auctions

US debt is issued through auctions by the US Treasury, according to a complex schedule that you can find in the Economic Calendar on thinkorswim's MarketWatch page (Figure 1).

If you're trading both treasury and dollar futures, this insight is important. In these auctions, no one knows exactly what the yields will be. So like with oil, the difference between guesses, expectations, and reality can impact treasury futures. There's also the scary possibility of a failed auction. This

# Three Must-See Reports for Futures Traders

If you're new to trading futures, here's a few things to keep an eye on



**FIGURE 1:** Treasury auction events in thinkorswim's MarketWatch calendar.

rare, market-moving hurricane occurs when investors don't step up to buy debt. It can catalyze an economic crisis, and immediately causes waves in the futures market. (For more on this, See "The Friendless Bond," this issue, page 24.)

### 3) USDA Crop Reports

Crazy rain in South America, demand in Beijing, farmer planting intentions, and a thousand other things contribute to supply, demand, and price in the USDA's crop reports (<http://tinyurl.com/cropsreportw>). These reports are bread-and-butter data for grains traders. They include an annual Crop Production report, and a monthly World Agricultural Supply and Demand report. The context is blue skies and corn fields, but the information is just as essential as oil

and treasury reports.

## MAKING SENSE OF IT ALL

Like most economic announcements, each report reveals the stand-off between expectation and reality. And there can easily be information overload. Make a habit of tuning in every time these reports roll out and make every effort to take the time necessary to stay up to date on any other resources that can assist your analysis. The more you read, the more you analyze, the more you'll learn what to look for in your futures trades and related "inter-market" futures. Your analysis and knowledge can help you see the bigger picture and progress as a trader. Over time, you might start to make better decisions and save time while you learn to mine the data gems from the stones.

### Important Information

*Past performance of a security does not guarantee future results or success. The information contained in this article is not intended to be investment advice and is for educational purposes only. The risk of loss in trading futures can be substantial. Clients must consider all relevant risk factors, including their own personal financial situations before trading. Please read the National Futures Association's Understanding the Risks of Trading in the Retail Off-Exchange Foreign Currency Market risk disclosure before considering the trading of this product. Supporting documentation for any claims, comparisons, statistics, or other technical data, will be supplied upon request. Investools® 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. Futures and forex accounts are not protected by the Securities Investor Protection Corporation (SIPC). For details, please see disclaimer, page 9.*



Want to get started trading futures? For more info, go to [tdameritrade.com/trade/futures.html](http://tdameritrade.com/trade/futures.html)

# 42 **gls**

## The Token Glossary

Terms you might stumble across in this issue.

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found on pages: **12, 17 & 36**

# 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 onset of the trade. 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:

**17 & 20**

### In the money

- An option whose premium contains “real” value, i.e. not just time value. For calls, it’s the strike that is lower than the price of the underlying equity. For puts, it’s the strike that is higher.

**12**

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 class (either all calls or puts). The strategy assumes the underlying will remain relatively unchanged during the life of the trade, in which case, 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:

**12**

### Long Calendar Spread

- 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). 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.

found on pages:

**20 & 33**

### 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.

**17 & 36**

found on page:

# Short Stock

- *Short-selling stock is to sell a stock that you don't already own, and is the direct opposite of being long stock. Whereas the long stock holder profits when the stock price rises, the short-seller profits when the stock price goes down. Both apply the principal tenet of “buy low, sell high.” The difference is that the short seller sells at the higher value first, and buys back (“covers”) the short stock at the lower value.*

found on page:

**14**

# 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, minus the total credit received.

found on pages:

**17 & 36**

# 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.

found on pages:

**20 & 33**

### Out of the money

- An option whose premium is not only all “time” value, but the strike is away from the underlying equity. For calls, it’s the strike that is higher than the underlying. For puts, it’s the strike that’s lower.

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