

# thinkMoney/18

random musings for traders at TD Ameritrade  
Winter 2013

18/BIRDS, BUGS,  
AND SIDEWAYS  
MARKETS

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24/THE TRICK  
TO CONFIRMING  
CHARTS

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**SPREAD TRADING FOCUS:**

30/FIRST UP:  
THE MIGHTY  
VERTICAL



10/TRADER  
JARGON  
FOR THE  
LAY-TRADER

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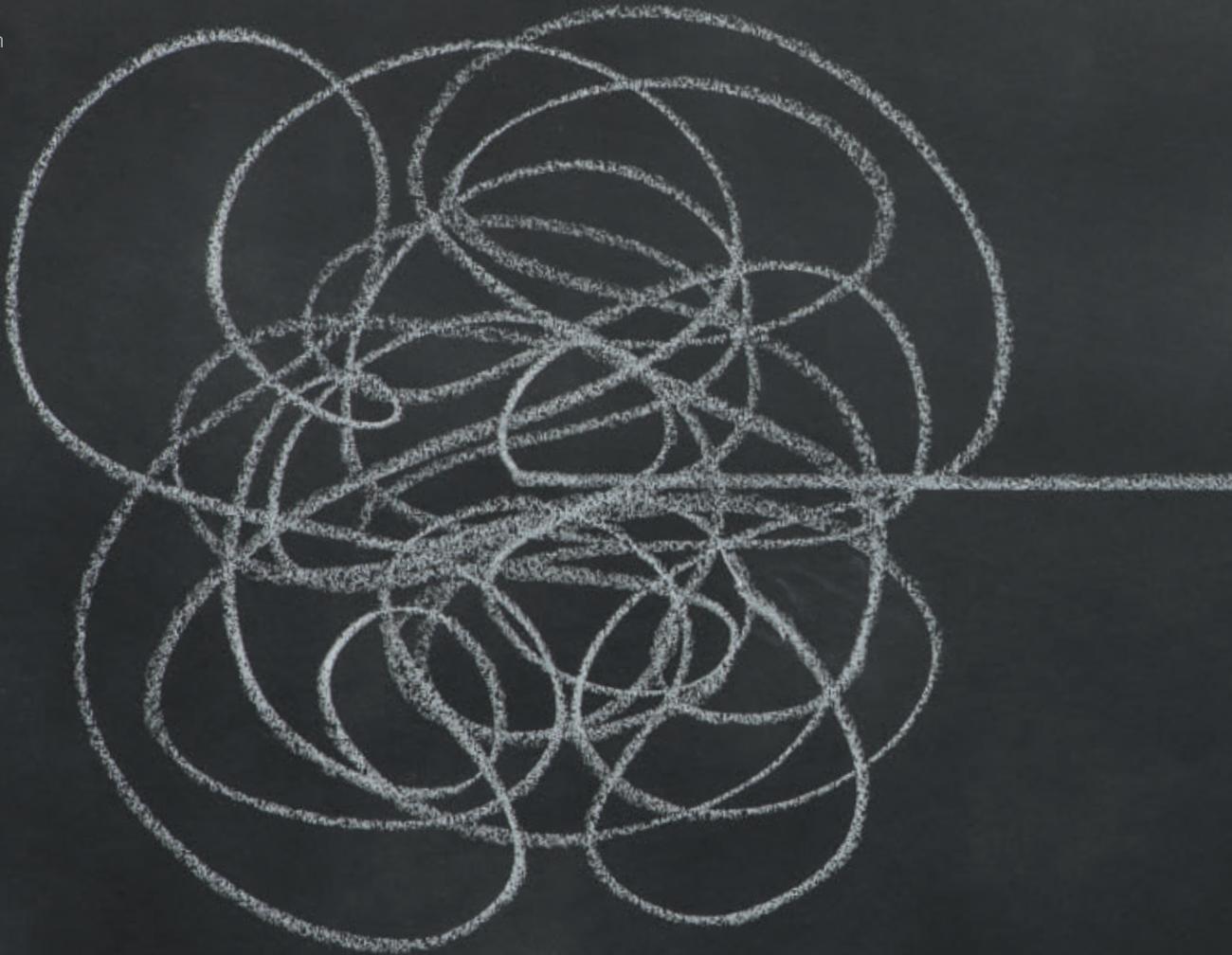
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**Fredrik Brodén**

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**Option Trader Decoder Ring**

Don't ya just want to punch the guy who speaks in jargon? We hear you. But as a trader, you ought to know at least a few common terms that could impact your bottom line.

# WHERE DIVERSIFICATION LEAPS ACROSS BORDERS.

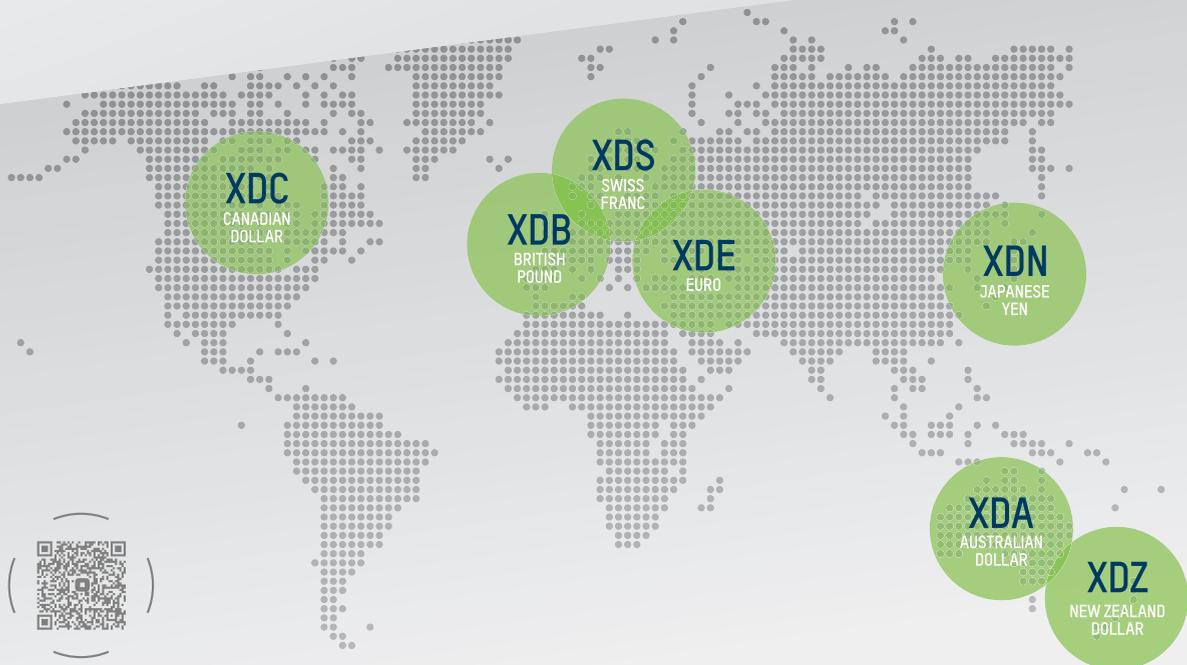
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Features



**10/** Option Trader Decoder Ring

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Todd McCarthy isn't just the manager of the trading desk at TD Ameritrade. He's on a crusade to teach you how to trade, and how to have fun doing it.

**PLUS:**  
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How to trade spreads on thinkorswim®  
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**A Quick Howdy**

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edit.

## Holiday Hangovers?

• By the time you read this, the “holidays” have already passed. But despite time taken off by leagues of investors, anchoring their rightfully-earned two-weeks’ worth of rest after a year of binge-working and tireless nights, traders know that the market never sleeps. Sure, it might doze off a little now and again, but there’s usually some fiscal goings-on or political events somewhere in the world shaking things up. Last year the U.S. alone gave the world a healthy serving of Presidential election with a side of fiscal

cliff—creating investor inertia, while traders frolicked with volatility delight.

What’s next? We don’t know. But here’s what we do know. At some point, there will be another financial or political hiccup somewhere in the world that makes the markets yin, when you thought they should yang. All we can do as traders is watch for opportunities that might happen and protect ourselves when they don’t.

Okay, that might sound a little patronizing. We don’t mean to be. But the lesson here is that the markets are largely unpredictable. We can use all the tools in the world to assess longer-term trends and attempt to predict futures, but at the end of the trading day, the markets give (or take) whatever they want.



### Got Feedback?

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[www.tdameritrade.com/tmsurvey](http://www.tdameritrade.com/tmsurvey).

You can’t help the things you can’t control, so don’t give up the things you can control. Like what, you ask? Learning how to “spread” your risk when trading options is a good start. And over the next few issues, we’ll introduce you to the world of spread trading—starting with verticals on page 30.

If you’re already a vertical genius, skip to the butterfly article on page 18. And why not? The fly is basically just two verticals in one. Consider it a post-holiday treat. It’s the least we can do.

Every year about this time, we broadcast our desire to hear from you. Perhaps it’s ego, but your input means the world to us. No, it doesn’t come with a consolation prize as a gift for your efforts, but if you love what you learn in thinkMoney, you’ll help keep this engine running with the things you want. Without you involved, all this is just words on paper. C’mon, what’s two minutes? Go to [www.tdameritrade.com/tmsurvey](http://www.tdameritrade.com/tmsurvey).

Happy trading,  
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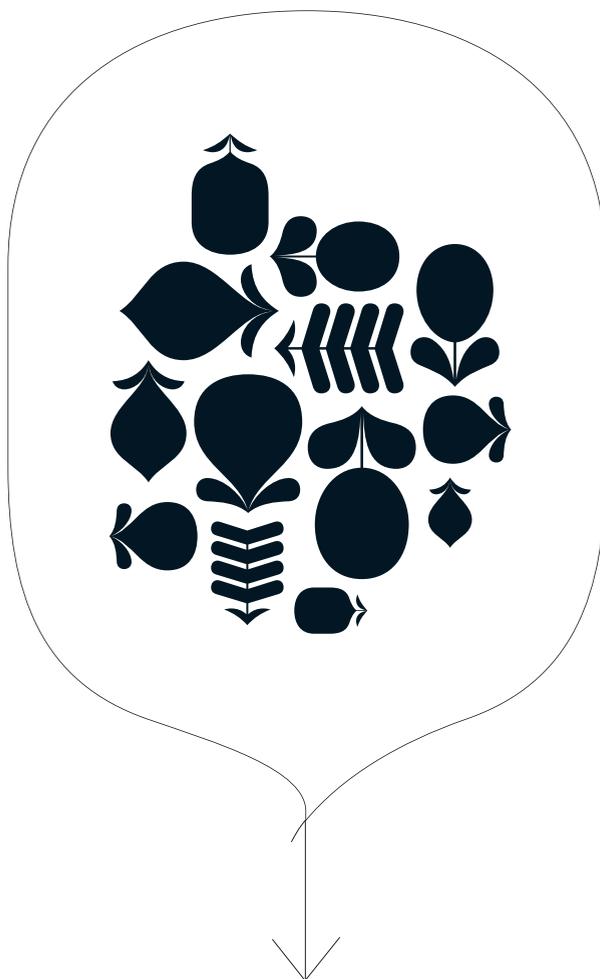
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**Trader Jargon**

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## **The Option Trader Decoder Ring**

**EVERY INDUSTRY LOVES ITS JARGON.**

AND TRADING IS NO DIFFERENT.

IF YOU'VE HUNG OUT WITH VETERAN TRADERS LONG ENOUGH, YOU'VE LIKELY COME ACROSS A FEW TERMS THAT YOU'VE MADE A MENTAL NOTE TO GOOGLE LATER. HERE ARE FIVE THAT ARE LIKELY TO MAKE THAT LIST...NO GOOGLING NECESSARY.

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WORDS BY **MARK AMBROSE**

PHOTOGRAPH BY **FREDRIK BRODÉN**

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## Trader Jargon

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Do a little research on F-stops or fly-tipping and you'll see that everyone from lizard photographers to garbage men speak in code. The market isn't any different. And the jargon of trading is notorious for creating confusion. So for the moment, let's ditch the textbooks as we decode 5 critical concepts.

### 1 – LIQUIDITY

**What a book says:** The ability to buy or sell a stock, option, future, or forex, without causing a significant price change.

**What a trader says:** Imagine a crystal-clear lake. You jump in, you swim with the fishes, you jump out. But imagine that same lake tarnished with oil. You jump in, you can hardly move, and the fish are especially unhappy.

Trading a liquid product is like swimming in the good lake. You can enter and exit your positions quickly. And with less slippage (no pun). Slippage in a word is the difference between your trade price, and the average of the bid/ask spread of the stock or option. But, when you trade a product that isn't liquid, you might get stuck in the trading goo. You might not be able to execute a trade near its current price, because there aren't enough buyers and sellers. And slippage is potentially higher, because you might have to sell the illiquid product considerably lower, or buy it considerably higher, than its current price.

You can often identify liquid trading products by high volume, open interest, and bid/ask spreads a few pennies wide. Before you place an order, check the liquidity. If you don't think a product is liquid enough to trade, look for a more liquid stock in the same sector.

**Where to find it:** In the thinkorswim® trading platform, go to the Trade page to see the bid/ask prices, and load up the Open Interest and Volume columns. For reference: .01-to-.02 wide bid/ask spreads are very tight; volume in the thousands, and open interest in the tens of thousands, are pretty high.

### 2 – VOLATILITY

**What a book says:** A measure of the dispersion of the percentage returns of a stock around a mean. (Helpful? Maybe not.)

**What a trader says:** Volatility in some sense “rates” the market's opinion of the range a stock or asset could move in time—say, a day, a week, or a month. Volatility numbers are often expressed as a percentage of the underlying stock price, and are annualized.

Theoretically, a volatility of, say, 30% means that 68% of the time, the stock could be between +30% or -30% from the current stock price in one year.

But, traders think in dollars. And, we're more likely to care about what the stock might do in the short term—i.e. the next day, week, or month, than one year. So how do you convert the “vol” number to a different time frame to dollars?

To convert annual volatility and arrive at monthly, weekly, and daily ranges, a few shortcuts\*:

Monthly: *divide by 3.5*

Weekly: *divide by 7.25*

Daily: *divide by 16*

For example, to calculate the range for one month:

$$((0.30) / (3.5)) * \$50 = \$4.28$$

$$\$50 +/- \$4.28 = \text{One month range of } \$45.72 \text{ to } \$54.28$$

**Where to find it** In thinkorswim, take a look at the Vol Index, which is the overall implied volatility of a stock's options on the Charts tab. Load the “ImpVolatility” study on a Chart, and you'll see the overall implied volatility level going back to 2003.

### 3 – PROBABILITY

**What a book says:** The likelihood of an event occurring based on a mathematically derived model that describes the distribution of the data set. (Huh?)

**What a trader says:** No doubt, there's complex math in probability. But rather than focus on formulas, consider what drives those numbers—namely, implied volatility.

All things being equal, the higher an option's price, the higher its implied volatility. This makes the probability formula generate a higher chance that the out-of-the-money option could be in the money by expiration.

Total market activity—what traders and investors believe about a given option at its expiration, and how they behave—can drive an option price up or down. Over time, price fluctuations change the implied volatility, which then affects probabilities.

Keep in mind that probability numbers can't tell you whether a stock is going up or down. But, they can attach a number to “market expectations” of a price change, and its potential magnitude. Although an option might show a low probability of being in the money, it doesn't mean it won't be. A low probability isn't a 0% probability, and also isn't impossible.

**Where to find it:** On the thinkorswim Trade page, you can see the probability of an option expiring out of the money, as well as the probability of touching, which estimates the likelihood a stock will reach a strike price before expiration.



The range of the stock price calculated from volatility changes by the square root of time. To arrive at the values for the range, you would divide the annual volatility by the square root of the number of days in a year, divided by the number of days for which you want to figure the range.

Once you divide the annual percent vol number by those factors (i.e. monthly [3.5], weekly [7.25], or daily [16]), multiply that product by the current stock price to get the 1-standard deviation range for the time period. Then, add and subtract that number from the stock price to get your range for the period.



**Where to find it:** In thinkorswim, right click on the P/L Open number on either the Position Statement of the Monitor page, or the Profits and Losses section of the Account Statement page, to see the trade prices of the positions in your account. If you're long stock, the trade price will be your cost basis.

## 5 – **RETURN ON CAPITAL**

**What a book says:** A financial ratio derived by dividing operating income by the value of an invested capital.

**What a trader says:** There's a number on the thinkorswim trading platform called "return on capital" (ROC), seen on the Trade page. It's available for short puts, and short verticals. ROC takes the mid-price of the put, or call, or put vertical, and divides it by the capital required to take the position. (To learn about the capital requirements for positions, read the Margin Handbook at [www.tdameritrade.com/forms/AMTD086.pdf](http://www.tdameritrade.com/forms/AMTD086.pdf)).

ROC shows you the percentage return if the position makes a maximum profit at expiration. (The number is not annualized, and shows only a theoretical best-case scenario.) If the position loses money, or has a profit less than the max, you won't earn that ROC. But, ROC lets you compare two strategies to see how effectively they might use capital. ROC quantifies a received credit, and compares it to the required amount of capital.

For example, if there are two out-of-the-money puts on the same stock with adjacent strike prices, the ROC lets you compare the potential return for a given probability. Even though the probability might be higher for the further out-of-the-money put, the ROC might be lower. Traders bullish on a stock might balance the probability of expiring worthless on a short put with its ROC.

Traders bullish on a stock might balance the probability of expiring worthless on a short put with its ROC.

**Where to find it:** Return on capital, and return on risk, are columns available on the Trade page of thinkorswim, where you can see them for short puts and short verticals.

## 4 – **COST BASIS**

**What a book says:** The original cost of an acquired asset, adjusted for depreciation and capital improvements.

**What a trader says:** To a trader, the cost basis is a position's breakeven price—or the price the stock has to reach for the position to be profitable. And, if a trader is long stock, or even long further-expiration calls, often the goal is to reduce the cost basis. The less a stock has to rise in order for the position to be profitable, the greater the likelihood of making a profit.

One way to reduce the cost basis of long stock, is to sell out-of-the-money calls against long stock, or long calls. You've probably heard of the covered-call strategy, where calls are sold against long stock to generate income, and/or to act as a partial hedge.

But traders don't think of it like that. A stock can't go lower than \$0. So, the lower your cost basis, the less risk. Also, with a lower cost basis, you can increase the probability of making money on a given position. To a trader, the credit realized when selling a covered call reduces the cost basis.

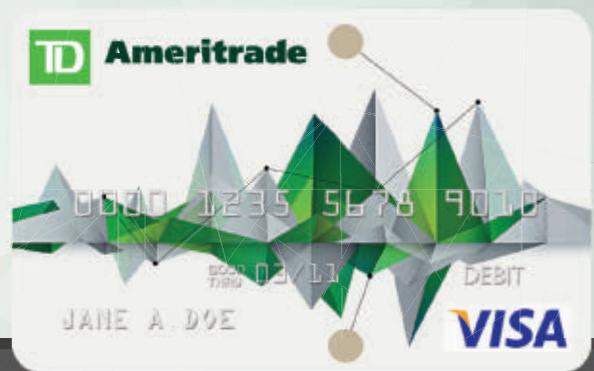
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GLOSSARY  
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# 15 Ittrs.

## Love Notes

Quips from the thinkorswim Chat Rooms

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• Volume is so light today, it would make Baumgartner's space balloon happy.  
**Rick**

• A smart bear knows when salmon are swimming upstream.  
**Fred**

• I wish my alter-ego would find a trade for me.  
**Jim**

• The Martians are already lining up in front of the Mars Rover. Somebody told them it's an iPhone5 dispenser.  
**Dustin**

• Always stay one step ahead of the technology of your spouse.  
**Betty**

• A scratch trade is when you take a trade and then scratch your head wondering why you took it.  
**Joe**



• First thing you want to do when researching a stock: learn how to pronounce it.  
**Betsey**

• I want to get chocolate wasted.  
**Stephanie**

• Just peeked at my 80-year chart. The trend looks higher.  
**Bob**

• Trading is alchemy, and alchemy comes from the heart.  
**Diane**

• Your own stupid actions should not be confused with fate.  
**Brenda**

• Can anyone explain to me why higher home prices are great news for the economy, yet higher food, energy, cars, etc. prices are bad?  
**Trish**

• A great trader once said, The market is a daily waterfall of opportunity, no need to try and capture every drop.  
**Bill**

• A Trader Sonnet  
Here I Sit broken hearted.  
Came to trade and soon departed. It's Saturday and all markets are closed. Now two days off to figure why I got hosed.  
**Steve**

• A Trader Psalm  
Oh Lord, won't you find me a contrarian trend?  
My buddies are all technicians,  
I must make new friends  
Traded hard all my lifetime,  
no help from the Yen  
So Lord, won't you find me a contrarian trend.  
**Samuel**

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Got a quip, a poem or a pearl you'd like to share? Send your best prose to [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com).

News+Views

A hodgepodge of stuff we thought you should know.

Photograph by Fredrik Brodén

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**Q: My buddy has an iPhone and his Mobile Trader app seems to have more functionality and is sleeker than my Android app. Will I ever have the same features as he has?**

A: Does your buddy also drive a better car and date hotter women? Because according to a recent study\*, iPhone users are 37% more likely to have a college degree and are 67% more likely to have an annual household income of \$200k or more than Android users. There is a lot of work involved in producing two different suites of apps for both android and iPhone so it seems like it would be a win-win for both you and for my development team if you just got an iPhone. But since that's probably not going to happen, you'll be glad to know we just recently launched our Android redesign in late November.

So most of the same features in the iPhone app are now available to Android users. That said, our iOS users will be pleased to hear that we recently launched push notifications and a help overlay in late November.

**Ask The**  
*Suit*

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

**Q: I'm a fundamental investor but I like to swing in and out of stocks that I believe in. I find myself having to do a lot of my research on tdameritrade.com because the info I'm looking for isn't in thinkorswim. Will you ever add more company fundamentals info to thinkorswim®?**

A: I'm right there with you. While all my girlfriends were reading 50 Shades of Gray, I was combing SEC filings. In fact, I almost named my newborn son Edgar. So I'm pleased to share that we very recently integrated valuation information into thinkorswim so that traders can better understand what drives the stock, particularly if a company has a lot of vertical businesses outside of their core product that you may not be aware of. This is just the beginning, though. So tune in for more fundamental data and research coming to the thinkorswim® platform.

**Q: I just received my first issue of thinkMoney and I really want to learn more about the TD Ameritrade active trading platform, thinkorswim. What's the best way to get started?**

A: Bar none, the best way to get started is to check out the thinkorswim Learning Center which is chock full of tutorial videos, articles, manuals and other handy references to help you get the most out of this powerful trading tool. We are consistently ranked as one of the top trading platforms and we feel confident that we also have the best help and support resources in the category in order to help new clients acclimate to the platform's capabilities. You can find the Learning Center on the help tab of the platform.

\*Source: Huffington Post

## industry spotlight

# Behold Sir Volcker's Rule

Words by  
**Thomas Preston**  
Illustration by  
**Joe Morse**

Paul Volcker, the ex-Fed Chairman during the '80s, came back in the news like a knight in shining armor when he made sure the 2010 Dodd-Frank legislation included measures to prevent banks from taking the types of risk that lead to their collapse 2008. In a nutshell, the eponymous Volcker Rule would prohibit banks from investing in or sponsoring hedge funds, private equity funds or trading for their own profit—the type of activity that was partly to blame for the demise of some of the biggest banks in the US.

The Volcker Rule isn't in place yet as some of its details are being hashed by an alphabet soup of government agen-



cies like the Federal Reserve, SEC, FDIC, OCC and CFTC. But it seems like some banks have already cut back their trading activity in expectation of its passage in 2013. Some banks' managers are working as if the Volcker Rule is already law. Now, we know that thinkMoney can be found in the briefcases of some of these Wall Street hot shots. But for all us non-billion dollar institutions out there—retail traders like you and me—what does the

Volcker Rule mean?

In my opinion, banks cutting back on their trading won't necessarily add to or reduce perceived market volatility. But it could reduce liquidity. Liquidity—the trading activity that makes entering and exiting positions faster—is a sort of chicken and egg situation. Do market makers make tight markets in order to attract lots of trading, or does lots of trading make tight markets? And even if banks weren't trading the specific options or strategies you and I might be, liquidity is interrelated. Liquidity in a

large index product might allow an institution to use it as a hedge while doing a trade in a smaller product or less active option, which in turn could provide liquidity to you.

While the Volcker Rule is a step in the right direction to keep banks and other large institutions from taking potentially lethal trading risks, we'll have to see if it has the unintended (and not so great) consequence of drying up liquidity.

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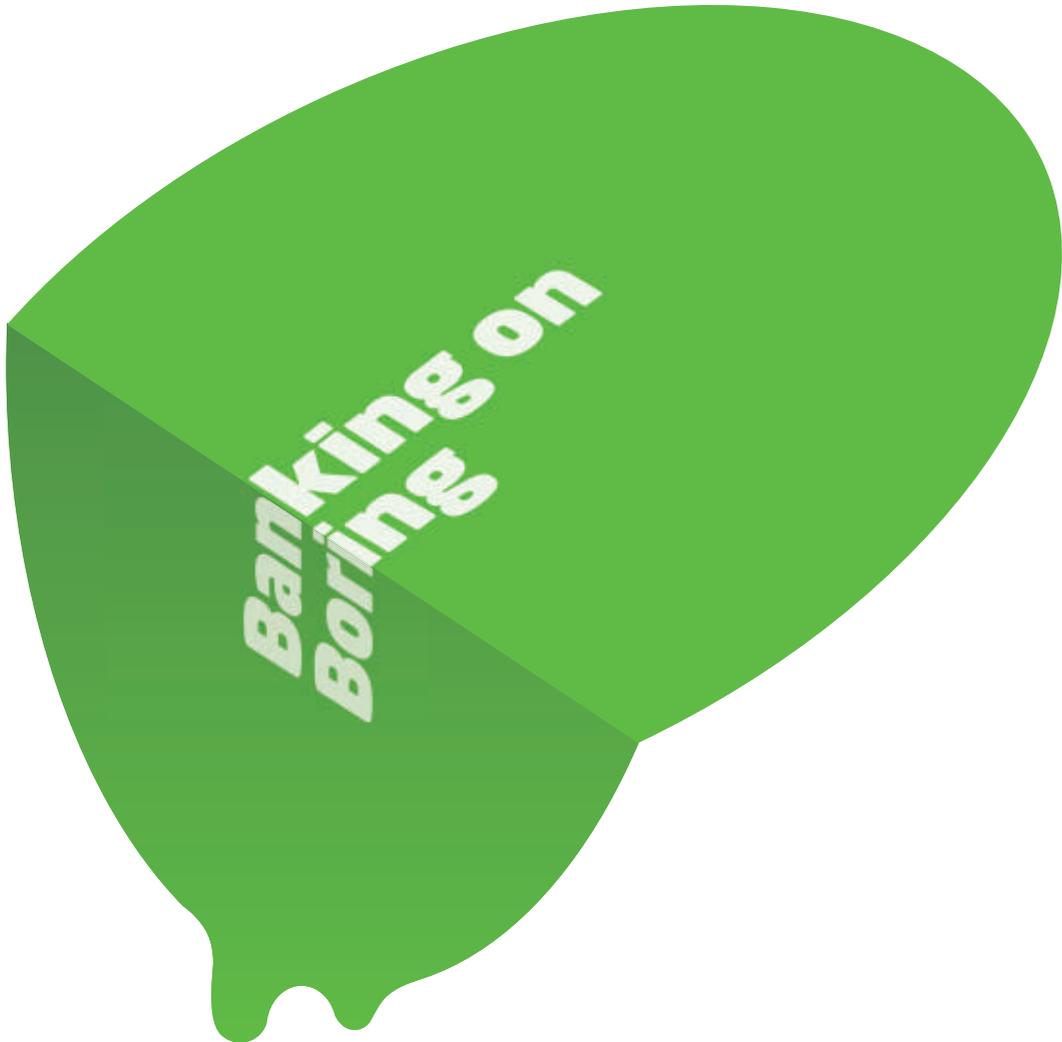
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**MAKING MOOLAH WHEN A STOCK GOES NOWHERE.**

IT'S A CONCEPT THAT MOST TRADERS DON'T THINK ABOUT EARLY ON. BUT BUTTERFLIES AND CONDORS WERE DESIGNED TO DO JUST THAT...AND THEN SOME.

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



# F

## ORGET UP AND DOWN

for a moment. There's a third direction—sideways—that can hog up more time in a stock's trend than the other two combined. Both the butterfly spread and the condor were designed to be used when stocks are "range-bound." They're flexible enough to be directional trades as well, possibly to target a key technical point on a chart. However, they can also play an extremely useful role as the end result of an adjustment of a single option position. Taking a directional trade, such as a long call or put position, and adjusting into a butterfly or condor, may not only allow you to capture some profits, but it may also allow room for future gains.

### OF BUGS AND BIRDS

Butterflies and condors alike involve the purchase of one vertical spread, and the sale of another. (Flip to the vertical spread primer on page 30 of this issue for more on verticals.) The short options of both strategies comprise the "inner" strikes (the "body"), while the long options comprise the "outer" strikes (the "wings"). Where those strikes sit makes all the difference between the two (Figure 1).

In both cases, you purchase the trades for a debit. However, the secret to making money on both butterflies and condors lies in understanding time value. Options lose time value as days go by, but some options decay faster

than others. Therefore, you want to be short the options that decay faster, and you want to be long the options that decay slower.

Which options decay faster? Those with the most time value, which happen to be those closest to the money. Since all time value has to go to zero by expiration, it also follows that the options with more time value have to get rid of it at a faster rate, than the options with less time value.

As a result, if the trading price of your stock remains close to, or between, the short strikes in your butterfly or condor, your short options would be the ones closest to the money. Since your short options would have the most time value, they would likely exhibit the most time decay. And since the options that you are short would lose more value than the options you are long, that net difference would result in your profit.

**To create a butterfly:** You buy one vertical spread, and sell another one, whose strikes are equal distances apart, such that the two spreads share the same short strike.

For example, stock XYZ in Figure 1 is trading at \$55. You could buy the 50/55 call spread, and subsequently sell the 55/60 call spread. In this case, the body of your spread would consist of the two short 55-strike calls. The wings would be the 50-call, and the 60-call.

Notice that both the long vertical spread, and the short one, are composed of strikes that are \$5 apart. Furthermore, both spreads are comprised solely of call options. Finally, both spreads have the same short strike in common.

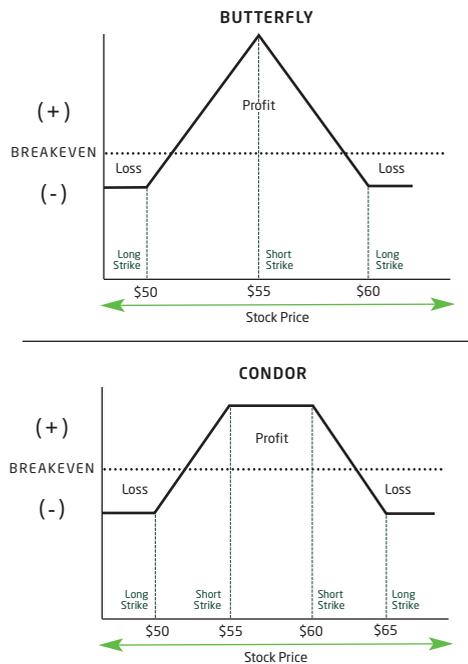
If you had this position, you would say that you are long the 50/55/60 call butterfly ("call fly" for short).

**To create a condor:** The idea is the same as the butterfly. But instead of the two verticals sharing the short strike, the trade has two different short strikes. And generally, the strikes pertaining to each vertical spread are the same distance apart.

For example, you could buy the 50/55 call spread, and subsequently sell the 60/65 call spread. In this case, the body of your spread would consist of the short 55-strike call and the short 60-strike call. The wings would be the long 50-call and the long 65-call.

### WHICH IS BETTER?

Because of its construction, a butterfly typically offers a higher potential reward than what can be achieved with a condor, and at a considerably lower debit. On the other hand, the maximum potential reward of condor trades, albeit typically lower than that of butterflies, can span a much wider range of stock prices, thereby theoretically increasing your probability for profit.



**FIGURE 1: Sideways Options** The butterfly (top) and the condor (bottom) are two ways to trade options on stocks going nowhere. The "fly" can potentially make more money, but the condor has a higher probability of profiting with its "body" strikes wider apart. For illustrative purposes only



#### Quick math:

If you add two butterflies that are one strike apart (i.e., the 20/25/30 and the 25/30/35), you get a condor (i.e., the 20/25/30/35). Then, if the first butterfly costs, say, 1.00 and the second butterfly costs 0.80, you can approximate your condor will cost 1.80.

In terms of profitability, butterflies and condors have similar properties. In a nutshell, the closer the price of your stock is to the short strikes, the more money you stand to make. For butterfly trades, this means that the closer your stock snuggles up against the short strike at expiration, the more profitable your trade can be.

By contrast, with condors (also Figure 1) there isn't just one stock price at which maximum profit resides. (See Figure 1.) Rather, there is a range of prices. And, because you get to pick the width between the short strikes in a condor, you also pick the width of the range of your potential profit area. The trade-off is that the wider you make the maximum profit range, the less your maximum potential profit will be.

The good news is that condors can make for very forgiving trades. While so many option strategies expect a certain stock-picking prowess from you, the condor typically only asks that you're "kinda right." In other words, rather than asking you to pick one stock price, or one market direction, in order to maximize profit, the condor lets you pick a range of stock prices. Depending on the underlying instrument, it allows you to make that stock range quite wide.

Suppose hypothetical stock FAHN is trading in a range between \$120 and \$130. Perhaps this has been the stock's range for several months. Let's say you looked at trading the 115/120/130/135 condor, expiring in 30 days. In order to achieve maximum profit on this trade, the stock would simply need to stay in its current stock range until expiration. In fact, even if it ventured slightly outside that range, you'd still have a chance to make a little profit.

Now suppose that due to the wide stock range, your maximum profit on this trade would only be 50 cents. For a condor in which each of the vertical spreads is \$5-wide, this means that you would be paying \$4.50 for the condor. At first glance, this may not sound terribly attractive—a "base hit" if you will.

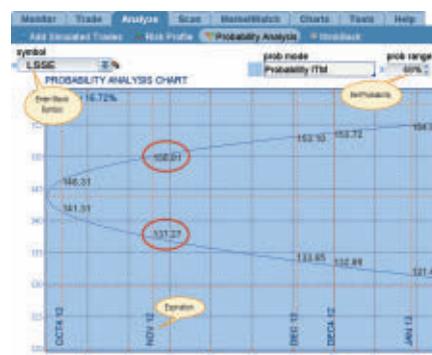
But a closer look at the math reveals that you have a 10-point range in which you can achieve this maximum profit, and all the stock has to do for the next 30 days is behave as it has for the past four months. How do you know it will perform similarly as it has for the past four months? You don't. Remember, past performance is not a guarantee of future results. It could behave completely opposite of what you expect it to. You could run a probability test on the thinkorswim platform to help assess the likelihood of the stock trading within a certain range. But keep in mind that the probability analysis

## HOME ON THE RANGE

To get a sense of the likelihood that a stock might stay in a specific range through expiration, fire up your thinkorswim software and follow these steps (see figure below):

- 1) Go to the Analyze page.
- 2) Click the Probability Analysis tab.
- 3) Type in a symbol in the upper left and hit Enter on your keyboard.

The graph that appears lets you know the likely range of prices the stock will trade in prior to expiration of the month you're looking to trade. The two prices where the expiration date intersects the upper and lower lines of the curved graph (red circles in graph below) are the highest and lowest prices in the range. By default this range has a probability of 68% (one standard deviation), but if you'd like to see a higher probability range, set the "prob range" to 95% or even 99%. It's not a perfect science, but those numbers ought to help you with your decision about where to place the strikes of your butterfly or condor.



results are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring. See the sidebar, "Home on the Range."

### SO WHY FLY?

Simply put, the fly is one way to potentially lock in a partial profit on a winning trade that you might think has more juice. So, suppose you decide to buy a call option, the stock moves to a point of resistance, and you feel that the only choice you have is to exit the position. As it turns out, if you're confident enough in your assessment of resistance, and if you are willing to take on an extra bit of risk, you may be able to squeeze more out of your original long-option position by

turning that long option into a butterfly or condor.

Using the butterfly or the condor as an adjustment strategy changes the overall pricing of the trade, and allows you as a trader to judge which of the two strategies best fits your risk tolerance.

Suppose you are bullish on hypothetical stock GVRC, which is currently trading for \$203 a share. You think it may make a sudden move to \$210, but not much higher, as you notice a lot of resistance at \$210.

So, you buy the slightly-out-of-the-money 205 call for \$1.60, in an effort to capitalize on a quick move in the stock.

A few days later, GVRC is trading for \$208 a share. The GVRC 205 call that you bought for \$1.60 can now be sold at \$3.60, potentially netting you a \$2.00 profit (less transaction costs). You could exit your trade, or you could try to do a little better by securing some of that profit, while turning the trade into a butterfly or a condor.

### Turning the trade into a butterfly:

Say you wanted to turn the 205 call into the 205/210/215 butterfly, you would need to sell two of the 210 calls, and buy one of the 215 calls (known as a 2x1 ratio spread). With the stock higher, the 210 calls are trading for \$1.40, while the 215 calls are trading for 30 cents. This means that the 210/215 ratio spread can

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## Butterflies & Condors

Photograph by  
Fredrik Brodén

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bring in a credit of \$2.50 (less transaction costs), thereby giving you a butterfly trade placed for a 90-cent credit (less transaction costs).

You now have a trade that can be worth as much as \$5.00, giving you a maximum potential profit of \$3.40, plus the 90-cent credit, for a total maximum profit of \$4.30 (less transaction costs). Furthermore, if the butterfly happens to go out worthless, you retain the 90-cent credit.

Of course, the \$3.40 maximum profit is achieved only if you happen to be lucky enough to have the stock settle exactly at \$210, at expiration. The further the stock settles from \$210, the smaller your resulting profit. You may be willing to take a smaller credit in exchange for a wider range, for your potential maximum profit.

### Turning the trade into a condor:

If you wanted to turn the 205 call into the 205/210/215/220 condor, you would need to sell one of the 210 calls, sell one of the 215 calls, and buy one of the 220 calls. With the stock higher, the 210 calls are trading for \$1.40, while the 215 calls are trading for 30 cents, and the 220 calls can be bought for five cents. This means that the 205/210/215/220 condor can be completed for a credit of \$1.65 (less transaction costs), thereby giving you a condor trade placed for a net five-cent credit (less transaction costs).

While the net credit on this trade is significantly smaller, the stock range under which you may obtain maximum profit increases from one price point (\$210), to a \$5-wide range (\$210 to \$215). This way, if XYZ happens to overshoot the resistance level by a few dollars, you retain some wiggle room where you still can obtain maximum profit.

You now have a trade that can be worth as much as \$5.00, giving you a maximum potential profit of \$3.40, plus the five-cent credit, for a total maximum profit of \$3.45. If your condor happens to expire worthless, you still keep the five-cent credit. Of course, since condors are four-legged spreads, transaction costs should be a consideration. (See page 9, #3 for more details.)

### Important Information

*Options involve risks and are not suitable for all investors. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. The spread strategies discussed above and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies that often involve greater risk, and more complex risk, than basic options trades. Clients must consider all relevant risk factors, including their own personal financial situations before trading. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Probability analysis results are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring. For more information on transaction costs at TD Ameritrade, see page 9, #3.*

WHILE SO MANY OPTION STRATEGIES EXPECT A CERTAIN STOCK-PICKING PROWESS FROM YOU, THE CONDOR TYPICALLY ONLY ASKS THAT YOU'RE "KINDA RIGHT."



### WHERE DO YOU SELL?

The resistance level can be helpful in determining which strike or strikes you want to sell, so that they comprise the short options of either your butterfly or condor. The idea is to wait until the stock is close enough to the resistance level so that you sell the options when they are at the money. This way, you would maximize the amount of time value that would work in your favor.

If you are too close to expiration, or if the volatility levels are sufficiently low, you may not be able to obtain enough premium when you sell the body of either your butterfly or your condor. In these cases, it may make sense to simply exit your long option position, and move on to a different trade.

BUTTERFLIES AND CONDORS ARE extremely flexible option strategies. You can use them as range trades by selecting short strikes that are close to the current stock price, or as target trades by selecting the short strikes close to where you think the stock will end up. If you are confident of your forecast of exactly where a stock will go, when it will get there and you understand the risks if your forecast is wrong, you can pursue the higher potential profit offered by butterflies. On the other hand, for the mere mortals who may prefer a larger margin for error, you may find comfort in a condor's potentially wider range of profit.

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## WHO CAN TELL YOU WHICH WAY A STOCK'S GOING TO GO?

A fundamental investor pores over corporate financial statements and reports, looking for some metric or ratio that will indicate a stock is ready to make its big move. On the other hand, a technician believes that all that stuff the fundamental guy looks at is built into the stock's price, and instead spends hours looking at charts, convinced that predictable market behavior reveals itself in studies and patterns. All that's great, if you want to show off how much you know about a company, or its historical price performance. But surprisingly, the price of an option can reveal as much, or even more, than all the Wall Street analysts put together.

That's a pretty gutsy thing to say about a measly option. But it's true. Because the price of an option, or more specifically, its extrinsic (time) value, is a balance of all the buying and selling pressure on it. There can be thousands of traders placing buy and sell orders on a single option, with the buyers believing that the stock might move enough to make the option in the money by expiration, and sellers believing that the stock might not move enough to make it in the money.

### TRANSLATING OPTION-SPEAK

An option's extrinsic value is the market's estimate of the probability of the stock reaching the option's strike price. (Now, bear in mind that the price of an **out-of-the-money** option is composed entirely of extrinsic [time] value.)

For example, as you look at options further and further out of the money for a given expiration—say, puts with lower and lower strike prices, or calls with higher and higher strike prices—the options have lower prices. Why? A stock is less likely to have a larger price change, than a smaller price change, given a normal distribution of stock-price returns. The further out of the money an option is, the less likely it is that the stock will have a price change large enough for that option to be **in the money**. No matter what the price of the stock is, no matter what the volatility is, further out-of-the-money options are cheaper, and have a lower probability of being in the money. An option's extrinsic value informs you of the likelihood of the potential magnitude of the price change—not the direction.

Here's a simple example, assuming the **cost of carry** is 0%. If a stock price is \$100, and the 95 put and 105 call in the same expiration are both trading at \$2.00, then the market is saying that a 5% move up is just as likely as a 5% move down. But, if the 95 put is trading at \$2.20, and the 105 call is trading at \$1.90, the market is saying that a 5% move down is more likely than a 5% move up. You can potentially quantify that likelihood by using the option's extrinsic value to derive an implied volatility, and then use that **implied volatility** as input into the probability formulas.



The math may seem complicated. But simply put, the market fears crashes. That leads to buying pressure on out-of-the-money puts, which pushes up their prices. The more fear of a larger negative price change, the more traders will buy even further out-of-the-money puts.

On the opposite side, traders often sell calls against long stock to reduce their cost basis. That leads to selling pressure on out-of-the-money calls, which pushes their prices lower. Many traders will sell the calls at the strike they think the stock has a lower probability of reaching. If they think the stock won't rise very much, they'll sell calls at strikes just out of the money.

In fairness to the technical and fundamental analysts, the option's price, or extrinsic value, contains no directional, i.e. bullish or bearish, information. "No fair!" cry the analysts. "If an option can't tell you whether a stock is going to go up or down, what good is it?" The answer? It ain't the stock. It's the strategy.

And that's the next step in the evolution of the retail trader and investor—not just deciding which way a stock might go when you trade it, but rather how you trade it. Look, there's lots of good analysis out there that can help you decide whether a stock, an index, or a commodity might go higher or lower. That's not the point here. But sometimes, the difference between profit and loss is the strategy you choose, not the choice of direction.

#### How to Run Your Own Study (Or "Do-It-Yourself" Studies)

I conducted this study using the thinkBack® tool on the thinkorswim® platform. You can access thinkBack by going to the Analyze tab, and clicking on the thinkBack sub tab. The thinkBack screen looks very much like the Trade screen except that the data is not live. After you type in the symbol, in the upper right-hand corner set the date for which you want to see option data. I used the Calendar feature on the date control to see the highlighted expiration dates for each month. I simply clicked on the date of the Monday after each expiration, to see a snapshot of the closing option prices. I then found the put in the front-month expiration, whose delta was closest to .32, then used the mid-price, or average, of the bid and ask prices, to estimate the credit received to sell that put in the experiment.

## TESTING A THEORY

Over the past five years, the S&P 500 has seen some pretty dramatic market action, what with a near meltdown of the world financial system, to strong corporate earnings in the following years.

Looking at a chart for the S&P 500 from July 2007 to July 2012, you might think you'd be profitable over that time, if you just bought and held an S&P index tracking product. Buy and hold is a long-term bullish strategy, where you're invested all the time and you're not trying to time the market.

Another bullish strategy—**selling naked puts** in the SPX—doesn't necessarily time the market either, but this approach does use the probability information that the option prices are telling you. To test the strategy, not the stock (or in this case, the S&P 500 index), we compared the returns of the S&P 500, and selling an out-of-the-money SPX put over those five years. (For details on this study, see the sidebar, "How to Run a Study.")

To test the buy-and-hold strategy, we recorded the prices of the S&P 500 on June 18, 2007, and July 20, 2012, and then added in historical dividend yields. The short-put strategy found an SPX put closest to a **.32 delta** on the first day of each expiration cycle, and held it through expiration. Both strategies were bullish, and would benefit if the S&P 500 increases, and lose if the S&P 500 drops. Since both strategies were invested at all times (there was no market timing with regard to price or volatility), the results were a bit surprising.

On average, the short-put strategy generated 215% monthly positive returns, while, on average, the buy-and-hold S&P 500 strategy lost -.19% monthly (including dividends) over those five years. (Bear in mind, the short-put strategy does not include charges for commissions, contract, exercise, and assignment fees, which would produce lower net returns.) Over the 61 months of the experiment, the short-put strategy was profitable in 45 (73.8%) of those months, while the buy and hold was profitable in 39 of those months (63.9%). If you picked a different time period, a shorter time period or a longer time period, the results might be reversed. And there's no guarantee that selling out-of-the-money SPX puts will outperform buy and hold in the future.

Using the put's delta as a proxy for the probability of expiring worthless, would let us estimate the likelihood that the short put would be out of the money at expiration. A .32 delta suggests the short put would expire worthless approximately 68% of the time. In periods of higher volatility, the relationship between volatility and delta is that the .32 delta put would be further out of the money from the current SPX price, than it would be with lower volatility. In this way, the put reflects the overall market's opinion of how much the SPX might change in one expiration cycle. Over the

study's five years, the short put expired worthless slightly more frequently than predicted by the model.

## IT'S THE STRATEGY, STUPID

Why did the bullish short SPX put outperform the bullish S&P 500 buy and hold? The information provided by the SPX put itself helped us select the out-of-the-money strike that was hopefully, far enough out of the money, so that the SPX could drop and cause losses for the buy and hold, but not drop so much that it caused losses for the short put.

### Important Information

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The downsides to the short-put strategy? Naked option strategies involve a significant amount of risk and are only appropriate for traders with the highest risk tolerance. A cash-secured SPX put would require approximately \$140,000 of trading capital. The equivalent in the buy-and-hold strategy would be to invest \$140,000 in an S&P index tracking product. However, most index tracking products (such as mutual funds or exchange-traded funds) can be purchased in much smaller amounts, making the buy and hold more accessible to investors with less capital. Also, the short-put strategy is essentially putting on a new trade every month, incurring commissions, contract fees and possible option assignment fees with each trade.

THE KEY? Reading an option price to reveal the market's collective wisdom, then using that wisdom to select the strategy. The technology to do this quickly is also at your fingertips. Who would have thought that one measly little option could help you become a smarter, more confident trader?

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TDA 6220 SS 10/12

## Ask the Trader Guy

Saving traders, one question at a time.

Photograph by  
**Fredrik Brodén**

trdr.

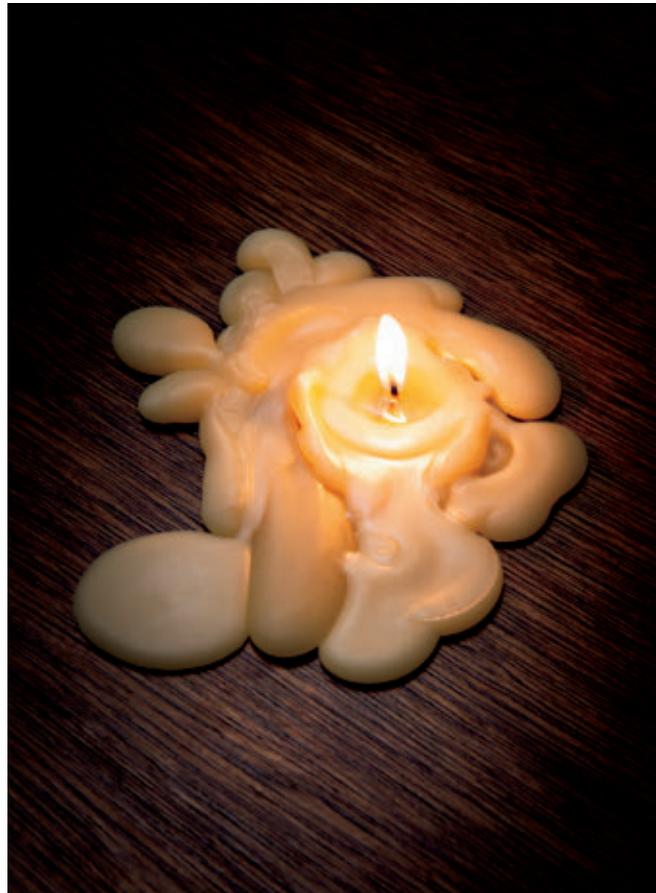
**Q: If I'm working a limit order to open an option spread position and I don't get filled, should I change my limit price to get filled?**

A: If you're working a limit order at the mid-price, or average of the bid/ask price of the spread, you could adjust it up a bit if you're buying, or down a bit if you're selling. But when you do that, you're increasing slippage—the difference between the bid/ask price. With actively traded stocks and options that have bid/ask spreads only a few pennies wide, you can often get filled .01 away from the mid-price. That's

not bad. If you have to move the limit price more than that to try to get filled, you may want to skip it, and find another product where you could get filled closer to the mid-price. If someone doesn't want to play with you, take your ball and move to another playing field.

**Q. I'm short an option that's far out of the money, and it should be getting cheaper as it approaches expiration. But my P/L isn't changing at all. What gives?**

A. You're right. Theoretically, the short out-of-the-money option should be getting cheaper as time passes, if the stock price and volatility don't change. More, the p/l of your position is based on the trade price, and the average of the current bid/ask spread. I'm guessing that far out-of-the-money



option probably has a 0.0 bid, and .05 ask, which makes the mid-price .025. If the bid/ask doesn't change, the p/l won't change. So, even if the theoretical value of the short option drops from .02 to .01, if the market makers for that option keep the bid/ask 0.0-.05, your p/l won't change. In that case, the p/l would reflect all that remaining .025 at expiration, if the option does indeed expire worthless.

**Q. I know that in general, when interest rates move up, bond prices go**

**down, and vice versa. But, is there a way to know how much the price of a bond future changes when interest rates change 1 basis point?**

A. The relationship between bond prices and interest rates is non-linear, so this approximation works when bonds and rates are at about their current levels. If the yield on the 30-year Treasury moves up or down 1 basis point (.01%), the bond future changes

about 5 ticks. If the 30-year yield changes 100 basis points (1%), the bond future changes about 17 points. To get the price of the bond future to change 1 point, the yield has to change about 6 basis points (.06%).

**Q: I'm only 13 years old, so I don't know if you'll take this question, but I was thinking about buying a put on my next math quiz score. It would be a hedge against the Wrath of Mom if things don't go my way. Care to make a market?**

A: Kid, I like the way you think. But my answer is no, for three reasons. First, it's probably illegal. Second, you could intentionally throw the quiz and drive the puts in the money. Third, I trudged through middle-school math and look what I turned out to be! You have to suffer like everybody else.

### 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.*

thinkMoney/18

•  
30  
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**Special Focus:  
Vertical Spreads**

•  
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**vert.**



# Up,

## Who Cares?

IN TRADING, THERE ARE FEW THINGS MORE FRUSTRATING THAN BEING RIGHT ON THE DIRECTION OF THE STOCK, BUT HAVING THE POSITION LOSE MONEY.

SINGLE-OPTION STRATEGIES CAN LOSE MONEY FASTER THAN YOU CAN SAY "TIME DECAY."

BUT **LEARNING A THING OR TWO ABOUT VERTICAL SPREADS** JUST MIGHT KEEP YOU FROM PULLING YOUR HAIR OUT.

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

# Down...

# 32

**Special Focus:  
Vertical Spreads**

Photograph by  
**Fredrik Brodén**

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## People often ask me

what separates successful option traders from the rest, and they think the answer is going to be some complex set of rules, or analysis, or secret handshakes. But in my opinion, a pro's positions can still be profitable even if they're wrong on the direction of the stock or index. That might not sound too special. But for me and the traders I know, choosing the right strategy trumps trend-picking skills. And choosing the right strategy requires a playbook that goes well beyond long single calls or puts.

Sure, a complete playbook might contain everything from butterflies to calendars. But there's one spread—the vertical—that underlies the bulk of all the more complex strategies combined. And, it can be profitable, even if your directional pick isn't right, and it can help insulate you from changes in time and volatility. In fact, the vertical could be the most important option strategy you ever learn.

money, and the other option is losing money. They offset each other. Not equally, but enough so that verticals can be one of the tamest positions in your option playbook. The reason? If the long and short strikes of the vertical are relatively close, say, at adjacent strikes, the greeks of the options can be pretty close to each other. (See sidebar, right.)

Take a look at the greeks of the options on the Trade page of the thinkorswim® trading platform, They're fairly equal at adjacent strikes, and less equal at further strikes. With one option long and the other short, the **gamma** and **vega**, especially of verticals, is usually much lower than an indi-

vidual option at the same strikes. Even vertical **deltas** are lower, too. But widen out the strikes, and the greeks of the vertical start to get much bigger.

Now, you can buy verticals, or sell them short. Consider the four basic versions in Figure 1.

At expiration, a vertical will always have a value between \$0 (when both options of the vertical are out of the money), and the difference between the long-and-short strikes (when both options are in the money). For example, if you're long an XYZ 49/52 bullish call vertical, it would be worth \$0 if XYZ is below \$49, or \$3.00 if XYZ is above \$52 at expiration. That defines the minimum and maximum values for the vertical, whether long or short. When one option of the vertical is in the money, and the other is out of the money at expiration, the vertical is worth the intrinsic value of the in-the-money option. The XYZ 49/52 call vertical would be worth \$1.00, if XYZ is \$50 at expiration, or \$2.50 if XYZ is at \$51.50 at expiration (not including transaction costs).

### LOCATION IS EVERYTHING

The kind of vertical you use—long or short—and its strikes, determines how it might profit. If you want a long vertical to be at its maximum value at expiration, you place the strikes at levels you think the stock will move beyond—either higher for a long-call vertical, or lower for a long-put vertical. If you want a short vertical to be at its minimum value at expiration, place the strikes at levels you don't think the stock will reach.

Looking at Figure 1, consider a bullish long-call vertical, and a bullish short vertical, both on stock XYZ at \$50. Let's say you could buy the 55/56 call vertical for .30 debit, or sell the 44/45 put vertical for .30 credit. The long 55/56 call vertical has a maximum loss of \$30, if XYZ is below \$55, and a maximum profit of \$70, if XYZ is above \$56, with a breakeven point at \$55.30. The short 44/45 put vertical has a maxi-

### THE MIGHTY VERTICAL

Here's the problem with only buying single calls and puts. In order to be profitable, three things need to happen:

- 1) The stock needs to move in the right direction
- 2) The move has to be big enough
- 3) It has to happen before expiration

By choosing the appropriate vertical:

- 1) The stock can move in the opposite way you think it will, or not at all
- 2) The stock can move a small amount
- 3) Time passing can be beneficial

If you want to pick a horse at the track, trade long options. If you want a more reliable strategy, even if a little dull, consider trading verticals. Many consider them to be building blocks of options trading, not individual calls and puts. And while describing a vertical can be pretty straightforward, where to put the vertical can be a little more difficult to decide. So, let's start with easy definitions.

### VERTICALS 101

A vertical spread is composed of two options—one long and one short—which are either both calls or puts. Both options are in the same expiration, and the same quantity.

Inside a vertical, when the stock moves one way or the other, all things being equal, one option is making



**Find Your Vertical-ness**

To help pick which vertical to trade, know your volatility.

To view volatility in **thinkorswim**, pull up a chart in the Chart tab. Go to the Studies button, upper right of chart, then Add Study >Volatility Studies >ImpVolatility.

To view volatility in **Trade Architect**, go to charts, and click the indicators icon (looks like a little chart). Select "Volatility (VLT)" in the list and click the "Add" button.

Vertical Type	Vol Bias	Debit/Credit
Long call vertical = 1 long 50 call + 1 short 51 call	Bullish	Debit
Short call vertical = 1 short 50 call + 1 long 51 call	Bearish	Credit
Long put vertical = 1 long 49 put + 1 short 48 put	Bearish	Debit
Short put vertical = 1 short 49 put + 1 long 48 put	Bullish	Credit

**FIGURE 1: The long and short of it:** Both calls and puts can be used in short verticals to create bullish or bearish strategies. The trick is to match the trend with volatility, with the optimal spread. *For illustrative purposes only.*



### Greeks in a nutshell

Just like the sun, wind, and rain are elements that can erode a home over time, volatility, time, and direction can kill an option's value pretty quickly. Option "greeks"—delta, gamma, vega, theta—are numbers that help you determine how much your option position stands to gain or lose when the elements of the market change. Bear in mind, these numbers are not part of an option's price. Rather, they tell you what might happen to the price when things change.

mum loss of \$70, if XYZ is below \$44, and a maximum profit of \$30, if XYZ is above \$45, with a breakeven point at \$44.70. Keep in mind that none of these examples include transaction costs which will affect potential profits, losses and breakeven points.

Think about it. Like a long call, you have to be right on three things, for a long-call vertical to profit: XYZ has to rally, it has to rally high enough, and it has to rally before expiration. But, for the short-put vertical to be profitable, XYZ can go up, stay the same, and even drop five points. And, as long as XYZ is above \$45 at expiration, the short-put vertical can make money. The out-of-the-money bullish short-put vertical could make money even if the price of XYZ drops a bit.

By example, this is a strategy that could make money even if you're wrong about the direction of the stock. The short-put vertical could make less money than the long out-of-the-money call vertical, but it could make money more consistently. The same is true for short-call verticals, or **at-the-money**, long call-or-put verticals, where the stock doesn't have to move up

If You Are	Vol Bias	Vertical Type to Consider
Bullish	High	Short out-of-the-money put vertical
Bullish	Low	Long at-the-money call vertical
Bearish	High	Short out-of-the-money call vertical
Bearish	Low	Long-at-the-money put vertical

**FIGURE 2: Which vertical do you trade?** Just match the direction you think the stock is going with the level of volatility. *For illustrative purposes only.*

or down as much to make them profitable.

The defined risk characteristic of verticals means they can often have less risk than a stock's bullish or bearish position. In high-priced, volatile stocks, verticals can even have less risk than buying individual options, in exchange for limited profit potentials. For example, with XYZ at \$50, and the \$49 call priced at \$1.75, and the \$51 call priced at \$.80, a bullish position would be buying 100 shares of XYZ, with a maximum risk of \$5,000, or buying a 49 call, with a maximum risk of \$175, or buying a 51 call with a maximum risk of \$80. The bullish long 49/51 call vertical would cost \$.95 debit. Its \$95 maximum risk is much lower than the long 100 shares, lower than the long 49 call, and only slightly higher than the long 51 call. Again, not including transaction costs.



### VERTICAL PLAYBOOK

The downside to verticals? They generate commissions, contract fees and possible exercise and assignment fees for two options, they have limited profit potential, and, like all options, they expire, which can make it difficult to maintain exposure in a particular stock or index, as you'll need to open and close new positions in your portfolio regularly.

But, if you decide verticals might play a role in your trading strategy, how do you decide on a long-call vertical, or short-put vertical, or long-put vertical, or short-call vertical? And how do you pick the strikes? It's not a question of which is "best," but of which one fits your bullish or bearish outlook for the stock, and if volatility is relatively high or low. Here's an elementary verticals playbook for your consideration.

This playbook is oversimplified, but generally, short out-of-the-money, call-and-put verticals are used when volatility is high, and the trader is less confident in her directional bias. The out-of-

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Special Focus:  
Vertical Spreads

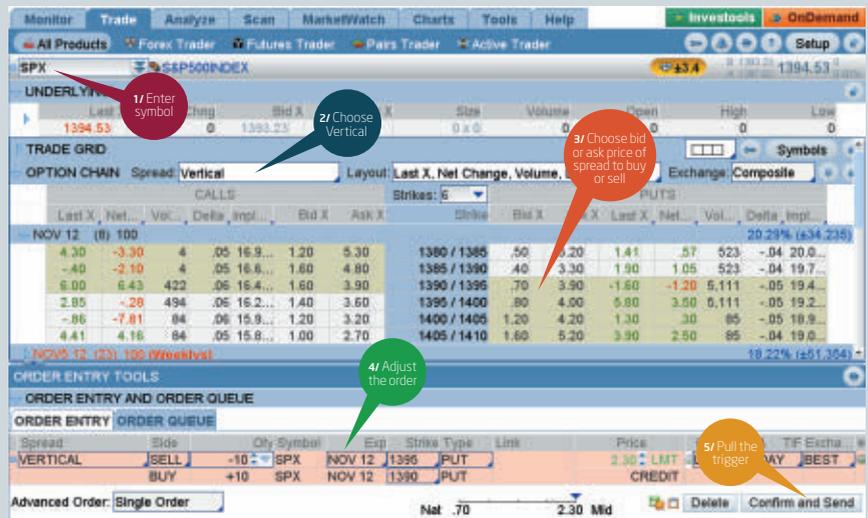
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the-money vertical gives her more “room” for the stock to move against her, and still be potentially profitable. Long at-the-money verticals are used when volatility is lower, and the trader is more confident in her directional bias. The at-the-money vertical responds more directly to a change in the stock price, because its delta is higher than that of an out-of-the-money vertical.

Of course, if the trader’s directional bias is wrong, the at-the-money vertical will lose money more quickly if the stock moves against it. Once you choose a long or short, call-or-put vertical, you can then select the long and short strikes to match how much you think the stock might move, how much risk you’re willing to take, how much sensitivity to the greeks you’re comfortable with, and how much capital is required.

The next step in your spread-trading evolution is understanding how verticals are the foundation for more complex spreads, such as combining a long-call vertical, and a short-call vertical, to get a butterfly or a condor. (See “Banking on Boring,” page 18, for more on these strategies.) Or perhaps you want to combine a short-call vertical, and a short-put vertical, to get an iron condor. Then, you can roll a short covered call up to a higher strike if you buy a vertical, or you can roll it down to a lower strike if you sell a vertical.

Right now, we’re just scratching the surface, and future articles will describe this process in greater detail. But rest assured, if you understand verticals, you’ll come to understand how complex strategies make and lose money, and how traders often use them to advantage.



**FIGURE 1:** Going vertical in five steps with thinkorswim. Just follow the pretty color bubbles above for how to sell a put vertical spread. For illustrative purposes only. Not a recommendation.

## How To...Trade Verticals in thinkorswim®

Five steps to vertical Utopia

### vert.

- One of the most important and popular features on the thinkorswim platform is the easy spread-order entry. It takes just a few clicks, and a few seconds, to create an order. So easy, our editors could do it.

#### 1—Enter Thy Symbol

Go to the Trade page. In the upper left, fill in the box (Figure 1, step 1) with the symbol of the stock or index for which you want to create a spread order. You’ll see the available expirations for the options on that underlying asset or index. And, if you expand one, you’ll also see strikes available for that expiration. Click on the “Strikes” dropdown menu at the top of the option chain, if you want to see more strikes.

#### 2—Pick Thy Strategy

Next, click the Spread dropdown box and choose “Vertical” (Figure 1, step 2). Look at the CALLS column on the left-hand side of the option chain to view the call verticals, and review the PUTS on the right, to view the put verticals. Listed are the bid/ask prices for all the spreads listed.

#### 3—Choose Thy Price

The first decision you’ll make is whether you want to buy the spread, or sell it. Choose either the bid or ask price to buy or sell a vertical, respectively (Figure 1, step 3). You’ll be able to change this before you send the order, but selecting the correct side first speeds up the process.

#### 4—Adjust Thy Order

You’ll see your order to buy or sell the vertical with those options populated in the Order Entry section at the bottom of the Trade page, below the option chain (Figure 1, step 4). You’ll see which option you are buying or selling, along with the default quantity. You can change the order

to buy or sell the spread a number of ways in the Order Entry bar. The “Side” drop down changes your buy/sell preference. The “Strike” field is where you change the strike prices of each leg. Change the quantity of options by clicking the up/down arrows under “Qty.” And change the expiration date in the “Exp” field.

The default-limit order price is the difference between the numerical average of the bid and ask prices of the options in the spread. That’s called the “mid” price. So, when you change the expiration or the strike prices, you’ll see the mid-price of the new spread that you created. If you’re fickle, you can adjust the price, or any part of the spread, such as strike, quantity of spreads, or expiration, in the Order Entry screen.

### 5—Thy End

When you’ve created the spread you want, click Confirm and Send (Figure 1, step 5). The Order Confirmation Dialog box will give you one last chance to check the details, before you click the Send button and work a live spread order.

### Important Information

*Options involve risks and are not suitable for all investors. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. The spread strategies discussed above and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies that often involve greater risk, and more complex risk, than basic options trades. A long call or put option position places the entire cost of the option position at risk. Should an individual long call or long put position expire worthless, the entire cost of the position would be lost. Clients must consider all relevant risk factors, including their own personal financial situations before trading. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. For more information on transaction costs, please see page 9, #3.*



**Q: Is it better to do two 1-point verticals, or one 2-point vertical?**

**A:** A 2-point vertical is just two 1-point verticals in a row. For example, the long 50/52 call spread is long the 50 call, and short the 52 call. You can also think of it as long the 50/51 call spread, which is long the 50 call, short the 51 call, and long the 51/52 call spread, which is long the 51 call, and short the 52 call. Gang the 50/51 and 51/52 call spreads together, and you get the long 50/52 call spread. The only advantage to buying one 2-point vertical is that the commissions would be half of buying two 1-point verticals.

CHOOSING THE RIGHT STRATEGY TRUMPS TREND-PICKING SKILLS, AND REQUIRES A PLAYBOOK THAT GOES WELL BEYOND LONG CALLS OR PUTS.

**Q: Can you trade verticals in an IRA?**

**A:** Yes, you can trade verticals in a TD Ameritrade IRA with the appropriate level of option approval. Buying put spreads or selling call spreads in an IRA is a way to have bearish exposure in a stock, without being short shares.

**Q: What happens to a vertical at expiration, if one or both of the options is in the money?**

**A:** If both options are in the money by at least \$.01, the shares of stock from the automatic

exercise of the long option will offset the shares of stock from the high likelihood of assignment of the short option. So, you wouldn’t have any position in the stock after expiration. But if the stock is in between the strikes of the vertical at expiration, the in-the-money option will deliver either long or short shares to your account, depending on whether it’s a long or short call or put. If you don’t want to have shares in your account, you’ll have to either close the in-the-money option, or the entire vertical, before the end of trading at expiration. Any option exercised or assigned incurs a \$19.99 charge.

**Q: When I trade a vertical, do I have to pay a ticket charge for each option?**

**A:** No, you only pay one ticket charge when you route the vertical as a single order. However, for each option, you do have to pay “contract fees.” Now, if you “leg” into a vertical by buying and selling the options as

separate orders, then you would incur two ticket charges. The same rules apply to closing out a vertical, or you may incur exercise and assignment fees that are applicable.

**Q: What’s the margin to trade vertical spreads?**

**A:** That depends on whether you’re long a vertical, or short a vertical. Long verticals don’t require margin. However, short verticals will require you to put up the difference between the short and long strikes. For example, if you sell a 50/55 put spread on a stock, then you would need to put up \$5.00 X \$100 per spread—or \$500—to be swept from your margin account.

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## Gear Head

Our favorite gadgets you may not have heard of

Tool #1 Words by  
Don Kaufman

Tool #2 Words by  
Ben Lichtenstein

## gear

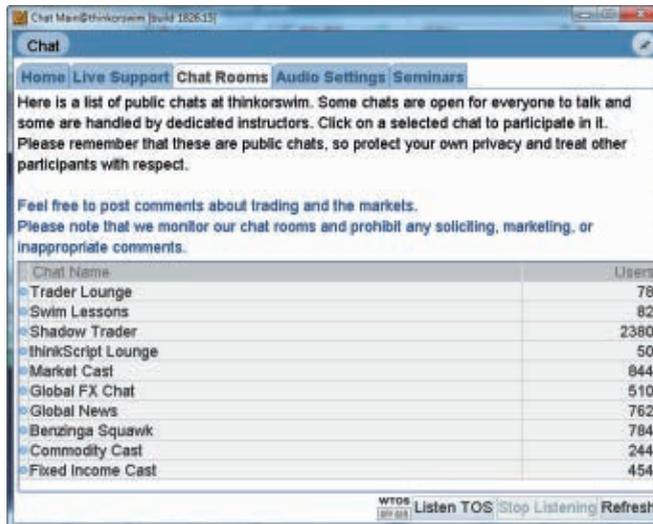
• Once upon a time, my mom watched me in the wading pool and saw an Olympic swimmer—

countless gold medals, my face gracing every Wheaties box from New York to New Delhi.

Actually, I went in search of another kind of gold and became a trader (sorry, Mom). And, I literally grew up surrounded by the insanity this business often evokes. For better or for worse, I've been "raised" my entire adult life within the bounds of thinkorswim (it's quite possible the Analyze tab is my brother, DNA tests pending!).

After years of doling out advice at live events to tens of thousands of traders about stocks, options, and futures, we decided to take it to the airwaves—well, at least to thinkorswim® online chat rooms anyway. And no flippers required.

So (drum roll please), we present **Swim Lessons**. Found in the thinkorswim Chat Rooms, Monday to Friday, 10:30 - 1:30 CST, the renowned Don "the Option Geek" Kaufman, Todd "TMAC" McCarthy, and Jeff "the Professor" Bierman, are hosting live, interactive, daily chats on everything thinkorswim, and the markets, have to offer.



**FIGURE 1: Step 1** Pick your conversation from the menu of choices under the thinkorswim Chat Rooms tab. Swim Lessons and Fixed Income Cast are a click away.

## TOOL #1

## Chat Rooms: Swim Lessons

• Three dudes talking trading. Each and every day. Cool.

And just to clarify, this isn't grandma's easy-going slow lane. Unless, of course, grandma's completely into roller derby and "beta weighting." Because we're serious about being trader geeks, and bringing you our 60+ years of insight and expertise. We pride ourselves on helping you get your feet wet, and sort out trading ideas, thinkorswim technology, and technical analysis—any excuse to unleash the full gamut of our options geekdom for your trading pleasures.

## THE BACKSTROKE IN RECORD TIME

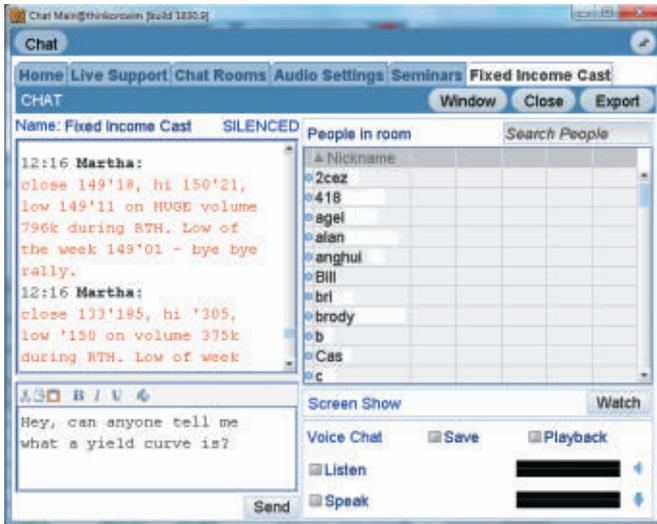
The world of trading is immense. And as you know, it can't hurt to have a lifeguard of sorts guide you through the ins and outs of the markets. Swim Lessons has recently hosted discussions on pairs trading, butterfly spreads, momentum studies, and of course, **iron condors**. Who doesn't enjoy three hours of iron condors? And for the record, we covered the subject from basic concepts to entry, exit, and deployment. With a whole three hours, why race through it?

## TAKE THE DIVE

What, you're not an options geek? Don't worry. Jeff Bierman's daily "Stock Chop" may have what you're looking for, as he covers the technicals and fundamentals of many of the stocks that might float your boat. (Ed. note: check out page 32 of thinkMoney Summer 2012 for an interview with Jeff. You'll be glad you did.)



**Imagine:** real-time market insight and sexy technology, all hosted by thinkorswim fanatics for thinkorswim fanatics. Worth the price of a Speedo? Better than that. 'Cause it's free. Just log in to thinkorswim, and click SUPPORT/CHAT in the upper left. Select the Chat Rooms tab, then Swim Lessons. You don't have to speak "trader" to enjoy Swim Lessons. But like they say about swimming caps and chlorine-free hair, can't hurt.



**FIGURE 2: Step 2** Once you found your Chat Room of choice (Fixed Income Cast shown here), banter away or just be a voyeur.

**TOOL #2**

# Chat Rooms: Fixed-Income Cast

Who says bonds are boring?

• What made James Bond the sexiest spy since the invention of flirting? Was it the fabulous suits and perfect hair? The near-death escapes? The cars? Actually, James Bond was a master at listening. And he never missed a trick.

What, you might ask, does a dry martini and good ears have to do with me? Well, maybe you've been fantasizing about trading bonds. Or a 10-year note. Or maybe you just want to get secret-agent smart about fixed-income correlations to other markets, and you're aching to drop some pretty steamy trading talk at the next cocktail bash.

You're in luck, as thinkorswim now offers a live, interactive chat room for fixed-income traders. (Like Swim Lessons, hit the SUPPORT/CHAT button top left of the platform, then Chat Rooms > Fixed Income Cast.)

Okay, it's not exactly like driving a Lamborghini off a cliff and surviving. But if you're a fixed-income nut, the real-time intensity's right there for popular futures products. Listen to authentic bids, offers, and trades, and hear the market react to news and developments—basically all the stuff a chart could tell you if a chart could talk.

### Inside the Attaché Case

We're gonna let you eavesdrop on audio quote details that include bid/offer price, and size. And, as contracts trade, you'll hear about real-time volume, and where the trade occurred in relation to the bid and the offer. Naturally, all this will give you a peek into whether buyers or

sellers are more aggressive. And, we'll follow two contracts—the 10-year U.S. Treasury Note, and the 30-year U.S. Treasury Bond futures. If the markets speed up, we'll move between the two, rather than follow each, price by price. And for the record, these contracts often move at the same moment, if not to the same extent. So you'll get a clear picture of what's happening, no matter what's being traded.

### Black-Tie Reporting

Once we're sober, we'll also have our eye on the numbers, bringing you reminders, and consensus estimates, well ahead of actual economic releases. We're especially attracted to releases tied to the cash Treasuries market...and did you know the New York Federal Reserve buys or sells US Treasuries during the same 45-minute period every business day? In our chat, you'll get those priceless daily operational details. And of course, we'll pony up the same kind of not-so-secret codes for direct Treasury auctions.

### Think Grappling Hooks

Knowledge is power. And as you know, the Treasury market is huge, more complex than it first appears, and is wildly different from equities and commodities. Our chat-room technology will help us give you even more cool data as the broadcast continues. So, whatever your level of know-how, you'll find a comfort zone. As you hear more about these major markets you may have ignored, we're here to help you negotiate trading insights, along with the secret explosives in the friendly doorman's coat pocket.

### Important Information

*TD Ameritrade does not make recommendations or determine the suitability of any security, strategy or course of action for you through your use of its trading tools. Any investment decision you make in your self-directed account is solely your responsibility. All investment involves risk, including loss of principal. The content presented in swimLessons and Fixed-Income Cast chat sessions are provided for educational purposes only and should be considered recommendations to trade any specific security or utilize any specific strategy. TD Ameritrade Inc., member FINRA/SIPC/NFA.*

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## The Spotlight

A chat with a TD Ameritrade VIP making things happen

Interview by Kevin Lund

Illustration by Joe Morse



# A Beautiful Mind?

Todd McCarthy is part chat room moderator, part Trade Desk manager. He also has really great hair.

• What's a guy who's spent 23 years on the floor of the CBOE to do when it's all over? He blabs a lot to customers about trading, of course. But not just any blabbing, mind you. For the past six years, he has manned the Trade Desk at TD Ameritrade. His alter ego co-hosts the ever-popular Swim Lessons® show every weekday afternoon in the thinkorswim® chat rooms. In his spare time, he takes the stage, speaking to adoring fans at industry tradeshow events like Traders Expos. So whether you have a question about how to unload your 20 positions, or you have a burning question about your trading platform, Todd is more than happy to help. We wanted to find out what makes this superhero's mind (and hair) tick.

**So Todd, what does the "Trade Desk" do?** We do everything from executing orders, to fielding customer-service questions, to answering all kinds of trading questions. You might have a question about how to get a better fill, or how to unwind your positions. Whatever question you have, you can ask it.

**Early on, didn't you guys have ex-floor traders running the Trade Desk?** Yeah, we were lucky. Back when thinkorswim was being built, it coincided with the burgeoning technology on trading floors. When there was a mass exodus from the floor to off-the-floor outfits, TD Ameritrade benefited big time.

Today, the vast majority of those working the Trade Desk have 20+ years' experience as floor traders, and professional market participants in equities, options, futures, bonds, you name it.

**Regarding Swim Lessons: Why does the show resonate so well with clients?** Hanging out with Donny Kaufman and Jeff Bierman is a blast. And part of the trading-floor experience that we've taken to Swim Lessons is a level of humor injected into some very serious moments. When there's that much capital on the line, this is meaningful. A lot of the guys

in the pit, even if they didn't like each other, they kept their wits about them.

**I bet you get a lot of questions about position and trade management. Give us your top three rules.**

**1) Don't be someone you're not.** Don't trade 30 lots if you should be trading three. Don't allocate capital to such a degree that you can't sleep at night.

**2) Before you click that mouse, know your max loss (and max gain).** You can do so many preventative things prior to



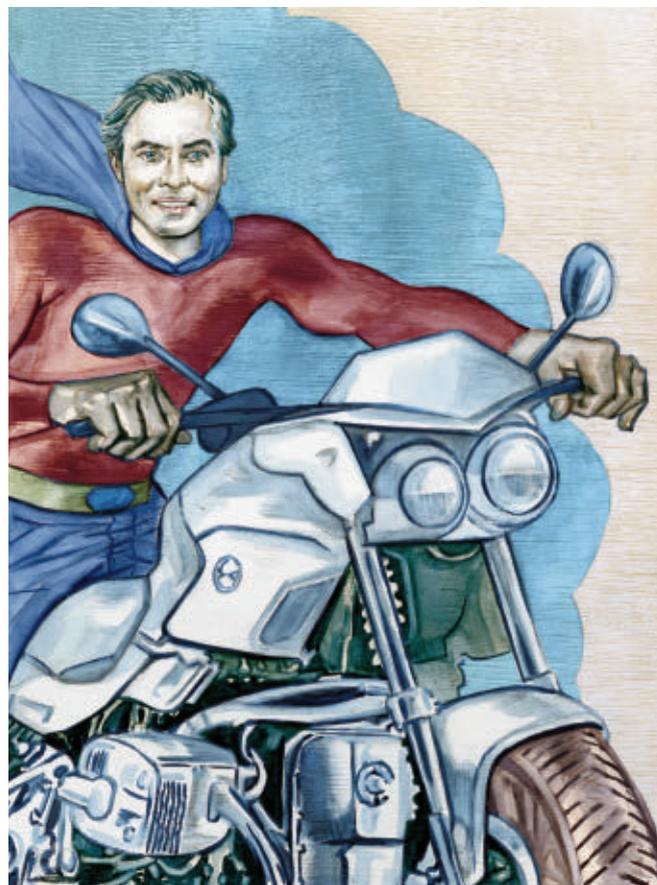
### The Doctor is In

Go ahead, get that question off your chest and call the Trade Desk anytime at 800-669-3900 between 7 a.m. and 4 p.m. CT.

a trade. Know your parameters and be comfortable. **3) Have an exit strategy.** Before entering a trade, you should also know when you're going to take a profit, and when you're going to say "uncle."

**Any remaining pearls?** Yeah, in the trading pits, if you didn't have thick skin, you wouldn't survive. But the same thing applies if you're trading at home. Keep your humility about you, and have a laugh now and again. That's the secret of success.

**So, about that hair. Barber or "stylist"?** Listen, I've been using the same girl to cut my hair for 23 years. All rumors of going to a stylist are untrue. When I started with her, she charged \$8 for a haircut. Joe Colin promotes the idea that I dye my eyebrows. That too is 100% false.



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## Coach's Corner

Pulling pearls from your favorite trading instructors.

Words by **Brandon Chapman, CMT** & **John McNichol**  
Investools Instructors

# Taking the Long (and Longer) View

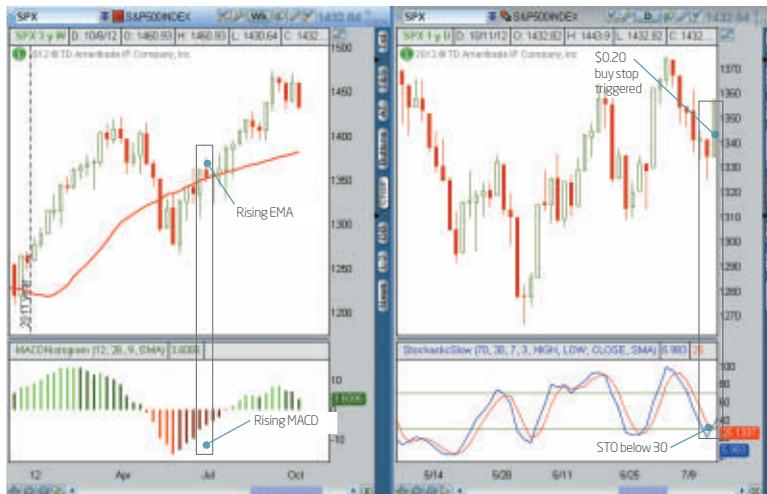
Using multiple time frames to plan entries...Smart.

• If the market were the Old West, right about now you might be “shooting from the hip,” reacting to anything that moves, and every market whim. But hold on there, trader. You now have electric can openers, as well as time to identify your target, take aim, and fire more thoughtfully. From a technician’s perspective, looking at longer-term charts may also help you zero in before you pull the trigger on shorter time frames. Let’s walk through an example of a bullish entry.

### WHAT’S ON THE WANTED POSTER?

Sometimes the best way to identify your target is to find higher ground. In technical analysis, this means looking at a longer aggregation period than the one your trading signals come from. When using a daily chart for example, by comparing to a weekly chart, you eliminate insignificant daily movements and may see the direction more clearly.

Even from this hierarchy, applying a moving average to the chart can make things clearer. For example, Figure 1 uses a thinkorswim chart, with a 26-week



**FIGURE 1: Second Opinions** When sizing up a trade, using multiple time frames to confirm a trend, such as the weekly (left) and daily (right) charts of SPX, can help time entries (and exits). Chart from thinkorswim. For illustrative purposes only.

Exponential Moving Average (EMA). Though you may have a rising EMA, indicating bullish conditions, the stock still retains its cyclical behavior. As a result, notice the momentum is turning in your favor. For this purpose, we’ll use the MACD Histogram set to the default (12,26,9) setting. A rising MACD shows the momentum is turning in the direction of the longer-term trend.

### AIM WELL

At this point, you’re really trying to zero in on which day to enter the trade, using a daily aggregation period. Assuming you’ve identified your target correctly, you’re going to key off the Slow Stochastics, using a (7,3) setting, with the “over bought” and “over sold” areas set to 70 and 30, respectively. Assuming the weekly MACD is still moving in the direction of the trade, an entry signal is based on the Slow Stochastics trading below 30 for a bullish trade, and above 70 for a bearish trade. With the long-term momentum turning bullish, and the short-term momentum at a bearish extreme, the stock may be poised for a move back in the direction of the long-term trend.

### FIRE WHEN READY

With a rising 26-week EMA, a rising MACD histogram on the weekly charts, and the slow Stochastics moving below 30 on the daily charts, the stock is in a position to

enter an order (see table). The trading trigger could be pulled using a buy-stop order of say, \$0.20 above the previous day’s high. A protective stop could be placed initially 1-3% below the low of the previous day or the entry day, whichever is lower.

IN A DUSTY BARROOM OR ON THE trading floor, the best man almost always wins. Lining up your trade using multiple time frames may help give you a clearer view of your target—making sure you’re trading in the direction of the longer-term trend.

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Direction	Weekly	Daily	Trigger
Bullish	Rising 26-week EMA Rising MACD Hist. (12,26,9)	Slow Stochastics (7,3) below 30	Buy-stop \$0.20 above previous day's high
Bearish	Falling 26-week EMA Falling MACD Hist. (12,26,9)	Slow Stochastics (7,3) above 30	Buy-stop \$0.20 below previous day's low

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## The Token Glossary

Terms you might stumble across in this issue.

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## 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 spreads can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the largest difference between the adjacent and long strikes minus the total credit received.

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**27 & 32**

## 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 cents 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 drops in value.

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## Cost of carry

- *The cost to you to hold an asset, such as an option of futures contract. In the case of options, the cost of carry relates to dividends paid out by the underlying asset and the prevailing interest rates.*

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## Implied volatility

- The market's perception of the future volatility of the underlying security, and is directly reflected in an option's premium. Implied volatility, is an annualized number expressed in percent (such as 25%), is forward-looking, and can change.

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**27**

## Selling naked puts (short put)

- A bullish, directional strategy with unlimited risk in which a put option is sold for a credit, without another option (of a different strike or expiration) or instrument used as a hedge. The strategy assumes that the stock will stay above the strike sold; in which case, as time passes and/or volatility drops, the option can be bought back cheaper or expire worthless, resulting in a profit.

**32**

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## Vega

- A measure of an option's sensitivity to a 1% change in implied volatility.

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**32**

## GAMMA

- A measure of what an option's delta is expected to change per \$1 move in the underlying.

**26**

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## In the money

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

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**26**

## 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 any strike that is higher than the underlying. For puts, it's any strike that's lower.

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found on page:

## 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.



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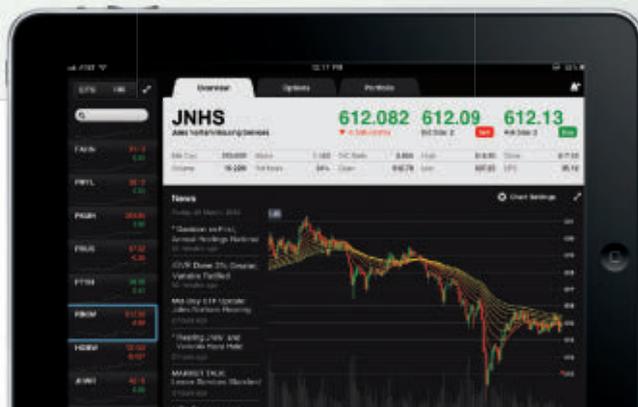
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