

# thinkMoney<sup>®</sup>/30

Random musings for traders at TD Ameritrade — WINTER 2016



## **TRICKS OF THE TRADE FUND MANAGERS CAN'T TOUCH**

THE PLAYING FIELD FOR  
TRADERS IS MORE LEVEL  
THAN YOU THINK

**PAGE 16**

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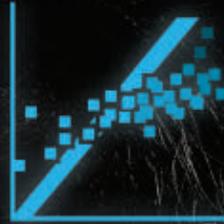
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COVER STORY

### Tricks Fund Managers Only Dream Of

There are never guarantees where your portfolio ends up at the end of the year. But as a trader, you have some wind at your back that makes your job a little easier than the average mutual fund manager.

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### Long Tooth, Busted Jaw (Three Signs A Trend May End)

Guessing market tops is, as they say, a fool's game. But that doesn't mean you shouldn't prepare for the worst. There are a few chart indicators that make spotting the potential warning signs a little easier.

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### How To Resuscitate Your Dead Investments

When your stock portfolio doesn't have a pulse, there's a way to generate "income" from those investments, even if they aren't optionable. What can you do? Think like a trader and explore your options.

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### Trading Futures In 3-D

Outside of scalping futures and riding trends, there's a third dimension open to aspiring futures traders called "basis trading" that, until now, has largely been known only to the pros. And it works with the gamut of futures products.



Cover Photograph by  
Fredrik Brodén

## MISCELLANEOUS

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**Capiche?** Want to trade VIX options? There's something you should know before you do.

**Gear Head** Looking for the next big thing? Follow the big money with this gadget.

**Ask the Suit** Trading ideas come and go. And our own Nicole Sherrod has three places to look.

**Toys for Traders** The newest, funnest tools a trading platform can offer.

**Industry Spotlight** The thinkerswim "reskin" arrived as promised. Here are a few of our favorite things.

**Ask the Trader Guy** Neutral market spreads and rock 'n' roll. Our resident guru dives in.

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You're a trader, not a poet. Don't stress. We've got your Valentine's poem to your sweetie covered.

**"A trader can look for early warning signs that a market could break down. With certain charting indicators, in some sense, you become a "market weatherman" looking for storms on the horizon."**

Long Tooth, Busted Jaw  
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**SKILLS BAROMETER:** See a dot. Read or pass. If you've ever been frustrated spending your precious few minutes reading articles that are too hot or too cold, these little color dots at the beginning of each article will help you skip to just the right temperature.

- EASY
- SEASONED
- PRO

## Let's Have A Little Mutual Fun(d)

• YOU'D HAVE TO GO back to the invention of the wheel to pinpoint when the first financial advisor touted the virtues of a long-term managed approach using mutual funds. Kidding aside, there's no arguing that this has been a successful strategy for many during certain periods over the years when there were fewer choices. But in recent years, being an individual trader or investor has gotten easier, cheaper, and with the ability to trade options in appropriately approved retirement accounts, much more diverse.

Today, for many fund managers, outperforming indexes and individual stock portfolios can be a crapshoot. And there are a few truths of mutual fund investing left out of all the marketing malaise that have led traders and investors to conclude mutual fund managers have some sort of upper hand.

As a trader, you might be asking how this applies to you. Despite your lightning-speed trigger fingers and short-term strategies, there's a high likelihood that some of your profits wind up in longer term investments like, well, mutual funds. So in the spirit of an "eyes wide open" approach, what we're suggesting is that you continue to think like a trader while acting like an investor. For some of these insights, see our cover story on page 16.

And if you do happen to own mutual funds or some other asset that you can't trade options on, but you'd like to implement a strategy designed to generate income or set up a hedge, there's a technique that can help you that we discuss in "How to Resuscitate Your Dead Investments" on page 24.

Mutual funds aside, traders ride trends, period. And one of the toughest struggles a trader has is to figure out when a trend is about to break a leg. Of course, no one can predict the future, and unless your name is Nostradamus, you're most likely just guessing when this might happen. The good news is there are a few chart indicators that you could pay closer attention to that might help make your analysis a bit less subjective. For more, read "Long Tooth, Busted Jaw" on page 20.

By the time this 30th issue of thinkMoney is out, 2016 interest rate mania and election year smear campaigns will be in full force. And while we don't know where the market's going, now might be a good time to bone up on the options strategies and hedging techniques that we've covered since the bull market began in 2009. For the best of the best, check out our archives at [tickertape.tdameritrade.com/thinkmoney](http://tickertape.tdameritrade.com/thinkmoney).

Happy Trading,  
**Kevin Lund**  
Editor-in-Chief, *thinkMoney*



**TAKE ACTION:**

Ask a question, tell us a joke, or just give us your feedback on *thinkMoney*. Write to us at [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com)

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# 1

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# 3

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## LOVE NOTES

LITTLE QUIPS FROM YOU TO YOURS TRULY



### Socially Speaking... with the Suit

**Nicole Sherrod, @TDANSherrrod, 2:12 PM – 8 Nov 2015**  
With amazing products like an \$84 waffle iron that makes “keyboard” waffles, I’m shocked Skymall is struggling.

**Nicole Sherrod, @TDANSherrrod, 1:32 PM – 28 Oct 2015**  
Nicole’s Halloween costume should be:  
-76% Sexy Janet Yellen  
-24% JJ Kinahan

**Nicole Sherrod, @TDANSherrrod, 5:41 AM – 23 Oct 2015**  
I’m spending the day with the Board of Directors. If this account goes dark later, you’ll know it didn’t go well.

*The comments from Chat Room Pearls, right, are excerpts from chat rooms, emails, and tweets submitted by TD Ameritrade clients, and their views and may not reflect those of TD Ameritrade. Testimonials may not be representative of the experience of other clients and are no guarantee of future performance or success. TD Ameritrade reserves the right to modify Love Notes for grammar, consistency, and similar purposes.*



#### JOIN THE FUN

Tweeting Nicole “the Suit” Sherrod is drinking a cup of trader humor any time of day. Play a part. **@TDANSherrrod.**

### Chat Room Pearls...

*Why do I have to give my daughter \$50 for her hair? Mine only costs \$10. Can't I just tell her it was a bad day in the market?*  
—KENDALL

*Someone on the trading floor said, “What is this button for?”*  
—JENNY

*I guess being long today was a bad idea.*  
—NATE

*Yellen to announce joining Van Halen after raising the Fed funds rate.*  
—LUKE

*Just randomly press things on your keyboard until your p/l turns green.*  
—PETE

*So we should wear garlic bulbs around our necks tomorrow?*  
—IRENE

*Why is advice so cheap? Because supply always exceeds demand.*  
—CALVIN

*Only dead fish flow with the current.*  
—KIM

*Better to be a bad luck winner than a good luck loser.*  
—STEPHANIE

*I use 100 indicators. I am confused.*  
—DEKLIN

*Logic is a systematic method of coming to the wrong conclusion with confidence.*  
—EDGAR

*Be like a postage stamp—stick to one thing until you get there.*  
—JENNY

*“While money can't buy happiness, it certainly lets you choose your form of misery.”*  
—GROUCHO MARX

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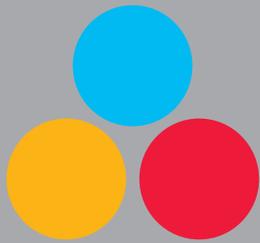
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## IN THE MONEY

A HODGEPODGE OF MARKET STUFF YOU SHOULD KNOW



**TRADER  
JARGON**  
TURN TO  
PAGE 36

- MOST OF THE TIME traders turn to the **CBOE Volatility Index (VIX)** to check the pulse of the market. And many option traders naturally gravitate to VIX options to trade their opinion on volatility. But buyers (and sellers) beware—there's a chance you're watching apples to trade oranges.

Options traders know that options prices are based, in part, on the current price of the underlying. But options prices are also partially based on the anticipated future value of an underlying until expiration, once interest rates and dividends are factored in. Yet, even though the VIX is just a number or a kind of benchmark that can't be traded (and certainly doesn't pay dividends), the same idea applies here. But, with a twist.

### THE FUTURE IS NOW

The VIX measures volatility of the S&P 500 (SPX) options. And volatility is something that's known as "mean-reverting." That's a fancy way of saying the VIX is likely reverting to its normal range. Not always. But much of the time.

But here's the twist: the VIX represents the current "cash" value of its options, similar to the current price of a stock. But options aren't priced off the cash market, right? They're priced off where the VIX is projected to be at option expiration, which is the *future* value.

So notice what happens when an event spooks the market. The VIX itself pops because it represents a "right this minute" level of fear. Sooner or later, though, things typically return to normal. How soon? Enter: VIX futures.

In this instance, a cash value of VIX is higher than a future value. This difference in the two numbers represents

CAPICHE? ● EASY

# What You See Isn't Always What You Get

**BIG IDEA:** WHEN IS THE VIX REALLY NOT THE VIX? WHEN IT COMES TO VIX OPTIONS.



**COOL INFO:** You can also easily decipher the current value of the futures by looking at the option chain in thinkorswim®. Just find the strike where the call value is roughly the same as the put value. That's where the combo is at or closest to zero.



the market's way of handicapping the likelihood of things settling down. The greater the disparity, the more likely it is that the VIX will be back to normal by expiration.

As expiration gets closer, the cash and futures converge. By expiration, they're the same. So as time passes, something has to give. Either the VIX starts to settle down, or, if market fear remains elevated, the price of the futures has to rise to meet it.

Look for yourself. You can explore the chart of VIX futures on the thinkorswim® platform by TD Ameritrade using the symbol /VX. If the jump in volatility is expected to be short-lived, VIX futures won't go up that much. If VIX futures don't go up, neither do VIX call options. This explains why there can be a disconnect between a spiking VIX and call options that might not move.

### MANAGE EXPECTATIONS

How can this affect your trading? First, don't expect a point-for-point move in the futures. Second, shorter-term options are impacted more, and longer-term options are affected less because there's more time for things to settle down. And third, if your VIX call options have profited, keep in mind your calls are likely to collapse once there's any hint of safety.

Remember: with VIX options, you're not trading current volatility. You're trading the expectation of *future* volatility levels.

—Words by KEVIN LUND

For more information on the general risks of trading, as well as trading options and futures, see page 37, #1-3.

GEAR HEAD ● SEASONED

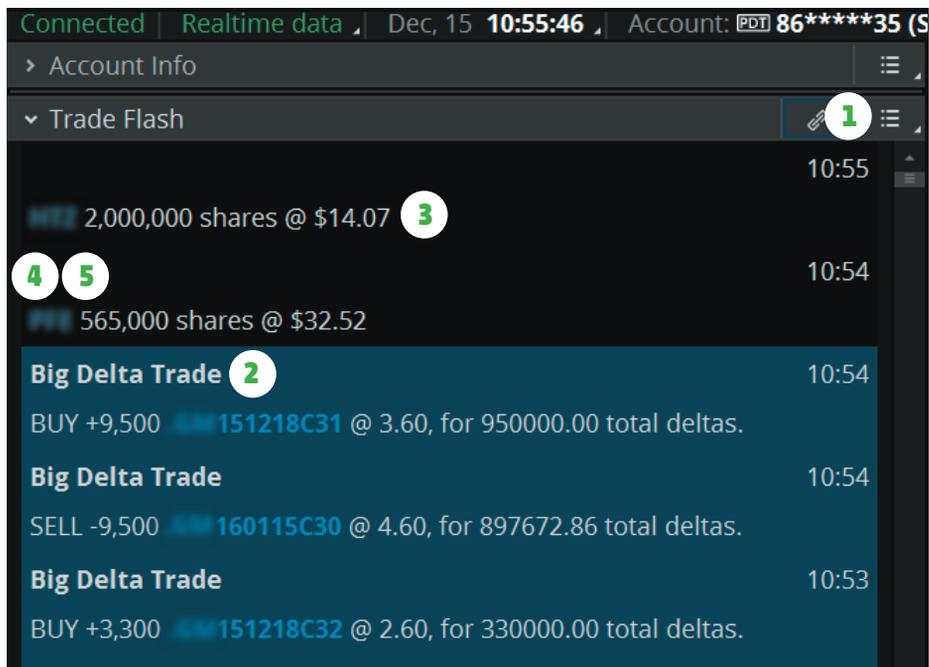
# Trading with the Big Money

**BIG IDEA:** LOOKING FOR THE NEXT BIG THING? FOLLOW THE MONEY WITH TRADE FLASH.

• Whether you are brand new to trading or you have been standing in the pits since the '80's often the hardest part of the trade is finding it. With thinkorswim® there are many ways to do this—charts, scanner, MyTrade, spread book, etc. But our newest gadget, Trade Flash is found on the left side bar of thinkorswim and streams all kinds of information about what the large traders are doing and important trading action throughout the day.



**COOL INFO:**  
For the latest release notes and thinkorswim how-to videos, go to [tlc.thinkorswim.com](http://tlc.thinkorswim.com)



For illustrative purposes only.

### How To Do It

Five top things to know about looking at institutional trades in real time with Trade Flash.

**1-** Click on the Menu button of any Gadget window, choose Switch Gadget, and select Trade Flash.

**2 -** Trade Flash reveals high-quantity trades as well as trades that result in a large delta.

**3 -** There is also information about substantial price moves with concisely written context.

**4 -** Symbols that are highlighted in blue are clickable, so if you see a symbol you're interested in, you can promptly take action on it.

**5 -** All of these highlighted symbols support thinkorswim full right click menu functionality, in case you would like to quickly create an alert or chart the symbol.



# Ask the Suit

**BIG IDEA:** A LITTLE Q&A WITH **NICOLE SHERROD**, MANAGING DIRECTOR, TRADER GROUP AT TD AMERITRADE

When an institutional level investor places a large trade, it demonstrates that the pros have conviction. It doesn't mean the stock is going up or down for sure, but having a tool to look at recent large trades can help me build more conviction as well. Here are a couple of tools in thinkorswim® that help monitor block trades:

**Trade Flash.** This tool provides real time, intraday commentary from a network of over 500 professional traders. Throughout the day, it's populated with market-related observations that call your attention to underlying equities that are in play. Recently, we added an execution scanner which displays unusual trades in the market. The notion of "unusual" can take many forms so it's much more than just trade size—such as different combinations of price, volume, volatility, and liquidity to uncover opportunities worthy of a second glance. For a Trade Flash step-by-step, see "Gear Head," left, page 12.

**Option Time and Sales.** I'm amazed at how few brokers have integrated this "must have" capability which offers the ability to see the price of every option execution, and where the market was at that time. I often use this in concert with Trade Flash. As soon as I see an unusual trade in Trade Flash, I'll jump over to Option Time and Sales to see other executions around the same time.

## What's the latest in thinkorswim Mobile?

We spent a lot of time thinking about how mobile and desktop and function together as an ecosystem as opposed to being two completely separate platforms. Even when I'm at my desk sitting on conference calls, I always have my iPad and iPhone right next to me. So why can't these screens all work together to immerse the trader even more deeply into the markets? Now, they can.

thinkorswim Mobile now uses the same "chain" icons on your thinkorswim iOS mobile apps that thinkorswim desktop uses to link various capabilities together. By tapping any of the symbols in your mobile watchlist, you can populate charts on the desktop, and vice versa. Also, saved orders now coexist in both mobile and desktop.

This is just the beginning. You can anticipate much more symbiotic development between desktop and mobile in the months to come.

## SWIM LESSONS

Swim Lessons is a daily live broadcast on the thinkorswim and Mobile Trader from 10:30–12:00 CT. The hosts, Scott Connor and Kevin Hincks, use a combined 50+ years of floor trading experience to educate clients on trade identification and strategy ideas as well as trade entry, exit, and adjustments. Swim Lessons is found in Support/Chat under the Chat Rooms tab.

## SECOND LEVEL OF MARKET DEPTH

thinkorswim has two types of full order books plugged into our Level II gadget platform: NASDAQ TotalView and BATS Depth of Book. This functionality gives you the ability to see the entire depth of book for all equity orders outstanding from market participants for either of these exchanges.

## OPTION CHAIN FILTERS

Trying to find the perfect option to trade can become a bit cumbersome when looking at an option chain with a dozen series and hundreds of strikes. thinkorswim has the capability to filter out the series and options that you want to see from the ones you don't right at the top of the option chain.



## • What are some of the ways that I can keep an eye on what the "big fish" are trading?

One of my favorite questions! Our mission is to level the playing field between what's available to the professionals and you, the individual investor. Wall Street is like an elitist, members-only club filled with people who are in the know. But guess what? They're not sharing their insights outside of the shiny polished brass doors of the club. So while I can't tell you what they're saying, I can try to show you what they're trading.

Keeping it simple, markets are driven by supply and demand, which means they go higher when there are more buyers than sellers and vice versa. The majority of the volume is driven by institutional players so it behooves you to follow large trades so you can track capital flow as it enters and exits the stocks that you care about.

**"When an institutional level investor places a large trade, it demonstrates that the pros have conviction. So looking at recent large trades can help me build more conviction as well."**

—NICOLE "THE SUIT" SHERROD  
@TDANSHERROD



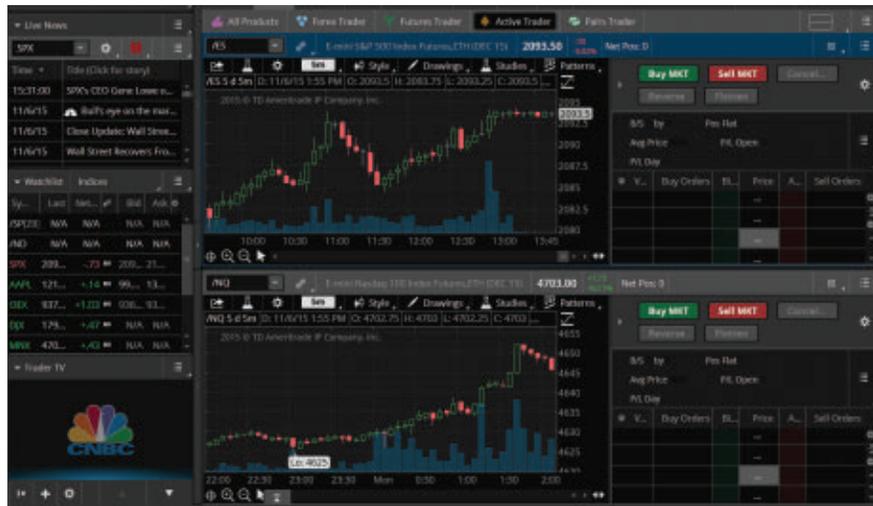
# ASK THE TRADER GUY

**Q: Hey, Trader Guy! I know that long at-the-money butterflies can have smaller debits, and short iron condors can have larger credits when volatility is higher. But how do I choose between them if I want to use them as a market-neutral strategy?**

**A:** Butterflies typically give you a larger potential profit relative to their cost. But because they have their max profit when the stock is at the short middle strike at expiration, they don't necessarily have a high chance of making that profit. Iron condors typically have smaller potential profit relative to their risk, but because they have their max profit as long as the stock is in between the short strikes at expiration, they have a higher chance of making it. You'll have to choose between a higher profit that's less likely, and a lower profit that's more likely.

**Q: Hey, Trader Guy! You ever think of getting the band back together?**

**A:** What, and give up my childhood dream of calculating the odds of a short put spread making money in my head? Seriously, the whole rock star thing is overrated. You can't eat too much or you won't fit into the leather pants. Groupies at late night parties distract from European markets. And the backstage interviews that focus on upcoming movie roles instead of talking about volatility? No thanks.



INDUSTRY SPOTLIGHT ● EASY

## Our Favorite Makeover Tips

**BIG IDEA:** THE NEW THINKORSWIM® “RESKIN” MAY BE OLD NEWS, BUT WE HAVE A FEW THINGS TO SHARE.

• WHILE THE SWAN-LIKE facelift we just gave to the thinkorswim® trading platform is no longer news, we thought since you've likely been playing with it awhile, you might need a few highlights, tips, and answers to some of your “What the...?” or “Where did the little blue thingy go?” questions. Here are our three new things.

### Beautification

Out with the black, white, and metal color schemes. In with a cool new trio: Dark, Bright, and Old School. The Dark and Bright themes also come with a high-contrast mode for maximized readability. This mode also shifts the hues most affected by red/green colorblindness. If you want to kick it old school, select that color option for the classic thinkorswim color scheme.

And have you noticed the overall calmer look and feel? The default chart and study colors have all been updated to be consistent with these new color schemes. These can all still be customized to your individual preferences. The control style on the trade ticket has been updated. Brightly colored items are static (to differentiate between editable and non-editable fields). Muted items can be edited via a drop-down menu. Items with a black/white background can be clicked to type in a value. All of the icons in the platform have been updated, and they now

scale properly with any changes to font size. And to boot, they glisten on Retina/HiDPI displays.

### Usability

The left-hand sidebar can now be resized to any width. Just click and drag its inside edge to your preferred width to make the change.

You can now change between color schemes and high-contrast modes, as well as change the size of the font, within the platform without restarting.

We have updated to a new font, Open Sans, which is anti-aliased (fancy tech talk for having smoothed edges) for a smoother look and better readability.

You can also switch to your system default font

if you prefer it. And you can now change the spacing given to all portions of the platform to either maximize the amount of data displayed or make the data easier to read. Your choice. To access all of these, go to Setup >Application Settings >Look and Feel.

There is now better distinction drawing in the platform between paperMoney®, OnDemand, and Live Trading.

### Modernization

The entire codebase of the UI was rewritten essentially from scratch to allow for more consistent performance and easier development of new features. Various components within the platform, such as the Dashboard gadget, now resize themselves adaptively to allow for proper representation no matter their dimensions.

Oh, and if you're wondering what happened to the little blue dot thingy that launches menus—it's been phased out. All of its functions are available either in the Actions menu (marked with a gear in the column header on the right-hand column) or via the right-click menu. —Words by thinkMoney Editors

*Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return.*

*For more information on the risks of trading and options, see page 37, #1-2.*

# X MARKS

# THE SPOT

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TRADE SPOT FX OPTIONS

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AVAILABLE CURRENCIES



**XDA**

AUSTRALIAN  
DOLLAR

**XDB**

BRITISH  
POUND

**XDC**

CANADIAN  
DOLLAR

**XDE**

EURO

**XDN**

JAPANESE  
YEN

**XDS**

SWISS  
FRANC

**XDZ**

NEW ZEALAND  
DOLLAR







## SOMETIMES, THE EASIEST WAY TO START INVESTING IS WITH A MUTUAL

**FUND.** You can invest almost any amount, and you have choices for investing in big caps, small caps, bonds, Europe, Asia, industry sectors, and specialty funds. And there are benefits to investing in mutual funds, such as **dollar-cost averaging**, the ability to have exposure to different sectors, and reducing non-systematic risk through broad diversification.

But fund managers face some challenges that you, as a trader, don't.

**1. Costs.** Funds may have a lot of overhead they need to pay for to cover expenses.

**2. Risk Adjustments.** Depending on the terms of the fund, the manager may be required to be fully invested at all times and may not, for example, be able to sell some of their portfolio if they think the market might drop.

**3. Strategies.** Most funds don't allow the manager to use options either to manage risk or potentially enhance returns. Let's explore.

### 1/COSTS

**The Fund Manager.** Mutual funds can wind up underperforming their benchmark index simply through fees. Sales or redemption charges may be taken off your principal when you buy or sell a fund depending on the share class. Management and certain fees to pay for the costs of running a mutual fund, like legal, marketing, transaction costs, distribution and investment advisor expenses get charged every year. The percentages may not seem like a lot when you read them in the fund prospectus, but they may cause a fund to underperform its benchmark over time.\*\*

\*\*Please keep in mind that you cannot invest directly in an index.



**The Trader.** As a self-directed trader, you have to pay commissions when you trade. But let's compare commissions to fees. If you had \$50,000 invested in an S&P 500 benchmark fund that had a 0.25% management fee, for example, that's \$125 every year that would come out of the fund's returns. If you bought \$50,000 of an S&P 500 ETF, you'd pay \$9.99 in commissions (for an online order through TD Ameritrade), which is about 0.02%. (And

to boot, TD Ameritrade offers a commission-free trading program for many ETFs.) ETFs have management fees, too. On average, ETFs have a 0.44% expense ratio. According to the 2015 Fee Study by Morningstar, the asset-weighted expense ratio of all mutual funds and ETFs combined was 0.64% in 2014. (Be sure to read the ETF's or fund's prospectus carefully to understand all the fees involved.)

Of course if you trade more and generate

more commissions, you can erode your returns significantly, too. But your level of trading is something you can control. And you have to compare the costs apples-to-apples. Mutual fund investments are usually long-term, buy-and-hold. If you bought and held a portfolio of individual stocks that tracked an index, you would pay commissions when you enter and exit the positions. The commissions may or may not be lower than the fees on a similar investment in funds or ETFs held over some amount of time. But commissions on individual stock positions are only charged once if you don't make any changes to your portfolio, while fees on funds and ETFs are charged on a continual basis.

## 2/ RISK ADJUSTMENTS

**The Fund Manager.** When you buy shares of a mutual fund, you own a proportion of all the stocks in that fund, just like all the other people who bought that mutual fund do. The

fund manager manages the portfolio for all the investors, and can't adjust the risk of the fund for the benefit of one specific investor. In other words, aside from the dollar amount of the investment, the risk you have in a fund is the same the same as for everyone else who bought that fund.

Now, if you want to ride out market volatility, you can hold your fund for the long term. But if you want to tailor the risk of your investments, like adjusting risk if you anticipate potentially adverse market conditions, you have to do it yourself. The fund manager doesn't do it for you. If you're invested 100% in a stock fund and want to reduce your risk, you may consider redeeming some or all of your shares, or allocate them to a money market fund or a bond fund or a different equity fund that may be less risky. You go online or call the fund company or your broker and make the adjustments. It's not hard, but that's why a mutual fund isn't necessarily a hands-off investment if you want to actively adjust your risk based on your market opinion.

**The Trader.** As a trader, you may have the same risk tolerance and expectation of market

volatility as the mutual fund investor to make the same types of adjustments to a portfolio, but you can be more precise. For example, you can look at the **delta** of your long market portfolio and consider buying index puts or selling call spreads to reduce the overall delta number to a level you're more comfortable with.

These types of trades can be done ahead of events that might make volatility higher, like Fed meetings or releases of government data such as unemployment. You might consider reducing your portfolio's delta before these events, and restore the delta to previous levels after them—maybe on the same day.

Now, you can redeem (i.e., close) part of the fund position if you want to reduce your risk exposure. But the price you get for your fund shares is their net asset value for that day, which might be lower or higher due to the news event. The major downsides to an active approach like this are that with frequent trading and repositioning comes increased transaction costs, and you could potentially experience more losses or missed opportunities due to volatility or trying to forecast the market. So, use this approach with those risks in mind.

## 3/ STRATEGIES

**The Fund Manager.** Some fund managers can only buy shares of stock to build a portfolio that tracks an index.

**The Trader.** If you're approved to trade options, you may choose to use a variety of option strategies to help manage risk and/or potentially generate income on stocks in your portfolio. Just keep in mind as you read the following list that options trading is subject to significant risks and is not suitable for everyone.

**1. Sell calls.** Selling **covered calls** against each stock in your portfolio can potentially reduce their cost basis and enhance returns in exchange for the obligation to sell the underlying stock positions at the strike price of the option. Mutual fund managers typically can't do that.

**2. Short puts.** You may be able to short out-of-the-money puts instead of buying stock,

to take advantage of time decay in exchange for taking on the obligation to purchase the stock at the option's strike price if the stock price drops.\*\*\*

**3. Collars.** An option trader may also collar the stocks with long **out-of-the-money** puts financed by short out-of-the-money calls. Collaring provides some short-term downside protection for reduced upside potential, but can be a useful strategy if you believe the market might drop in the short term. Note that multiple-leg option strategies can entail substantial transaction costs, including multiple commissions.

**4. Vertical spreads.** You can make bearish speculations on the market with **long put verticals** or **short call verticals**, for example, both of which may be allowed in qualified IRAs.

**5. Volatility options.** You may even trade options in volatility products like the **CBOE VIX**, which can rally if the market sells off. Your average mutual fund manager can't do any of that.

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*Carefully consider the investment objectives, risks, charges and expenses before investing. A prospectus, obtained by calling 800-669-3900, contains this and other important information about an investment company. Read carefully before investing.*

*\*\*\*Note that the short put strategy includes a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.*

*Spreads, straddles, and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance. Options are not suitable for all investors as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options before investing in options. You cannot invest directly in an index.*

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**LONG  
TOOTH,  
BUSTED  
JAW**  
**THREE  
SIGNS  
A TREND  
MAY  
END**

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**BIG IDEA:**

GUESSING MARKET  
TOPS IS, AS THEY SAY,  
A FOOL'S GAME.  
BUT THAT DOESN'T  
MEAN YOU SHOULDN'T  
PREPARE FOR THE  
WORST WHEN WARNING  
SIGNS SURFACE. THE  
TRICK IS KNOWING  
WHERE TO LOOK.

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WORDS BY  
**KIRA BRECHT**  
PHOTOGRAPHS BY  
**FREDRIK BRODÉN**

● **EASY / TAKE AWAY:** *Tools that give early warning signs of possible trouble ahead*



**LONG BEFORE A HURRICANE** ever hits land, there's fair warning it's on the way via satellite radar and forecasting programs. If you're a trader who monitors chart and technical indicators, you can in some sense become a "market weatherman"—tuning in to market signals and alerts that better prepare you for what may be on the horizon. So how do you recognize when a bull might be breaking down? Stock charts can offer clues. Let's zoom in on three warning signs.

# 3

## VOLUME CLUES

Volume, or the number of stock shares traded each day, is a third avenue by which to gauge a trend's strength or weakness. Think of volume as the fuel behind a market's move. Do you have a full tank and your engine is raring to go? Or is your "empty" light flashing and you're running on fumes?

Newton's first law of motion states that an object in motion will stay in motion unless acted upon by an unbalanced force. Coming back to confirmation, typically a stock's healthy uptrend will be accompanied by rising volume on up days, or a bullish confirmation signal. Contracting volume on down days during an uptrend is considered normal.

Be on the lookout for an exception to the rule. A stock rising on light volume signals an uptrend may be losing steam. When volume increases and price goes down, that's often a sign the trend is breaking down.

To organize your thoughts, monitor raw volume numbers shown in daily bars below the stock price charts. Or use an indicator that smooths out the data and can also signal divergences, such as on-balance volume.

Like volume, On Balance Volume (OBV) is a momentum indicator. However, it more or less calculates the difference between two volume periods of a stock. When the stock settles higher than a previous day's close, the day's volume counts it as up volume. But, when a stock closes lower, the day's volume chalks it up as down volume. A rising OBV

**TRADER  
JARGON**  
TURN TO  
PAGE 36

# 1

## PRICE ACTION

The study of charting is rooted in three major premises: market action discounts all known news; stock prices move in trends; and history repeats itself. At the heart of these tenets is price. And many technical traders will tell you stock price is king. After all, the goal is to buy low and sell high, right?

Yet, how do we analyze price? We consider the trend—up, down, or sideways. It's fairly easy to spot a trend on a chart (though the analysis is a bit more tricky). It's all about looking at the right pictures and connecting the right dots.

Technically, an uptrend is a series of higher price highs and higher price lows. As long as that pattern continues, a stock's uptrend is intact. Looking at Figure 1, you can connect the dots and draw a rising bull trendline along the price lows from late November to June when the chart peaked. The lower peaks become support for the market, or important swing lows. These same patterns can be applied for any time frame—i.e., hourly charts for the more active trader; weekly or monthly charts for the longer-term investor; and so on.

Just like hemlines rise and fall with fashion trends, technical indicators come and go. The Relative Strength Index (RSI) below the price chart in Figure 1 has proved popular over time. Originally developed in the late 1970s by J. Welles Wilder, Jr., the RSI is still widely used

today, as it offers traders a quick-read cheat sheet on the strength of the underlying market momentum.

If a stock is climbing, a strengthening or rising RSI line may confirm a price trend. But if the RSI climbs above the 70 line that is considered "overbought" territory, that becomes a warning signal that a "top" could be near. Like a weatherman's tracking devices, the RSI can potentially be an early-warning system. For a declining stock, an RSI reading that falls below 30 is generally considered "oversold," and suggests price may soon bottom out.

Not all tropical storms turn into hurricanes. And not all overbought markets turn into bears. Consider the concept of divergence—when an indicator fails to confirm price action—as a strong alert or red flag warning for a market storm that may be brewing.

**Warning signal:** *Beware once a swing-low support point is violated. The trend has been compromised and may be starting to break down. Stay alert and consider using stop-loss points, as a correction may be on the way.*

## CONFIRMATION AND DIVERGENCE

The principle of confirmation is widely used as trading strategies are developing. If one indicator flashes a buy signal, that's a start. If three indicators confirm that positive signal, a high-odds trade may be in the works. On the flip side, divergence can be an early alert that a trend is breaking down, such as in Figure 1 when RSI diverged from the market making all-time highs.

**Warning signal:** *When a stock price hits a new high, but the RSI doesn't confirm that with a new high momentum reading, be careful. It could be warning that market turmoil is coming.*

# 2



**FIGURE 1: Divergence whispers.** As the S&P 500 hits an all-time high in May 2015, the RSI indicator revealed a bearish divergence, or non-confirmation, at the new high. In late May, the RSI hit 59% as the SPX made new price highs—well below the 75% level registered in November 2014—indicating that bullish momentum was fading.

Source: thinkorswim from TD Ameritrade. For illustrative purposes only.



**FIGURE 2: Volume clues.** As this stock hit new highs, lackluster volume bars below the price chart revealed a lack of accumulation going into those highs—a “red flag” alert. Further, the on-balance volume indicator (OBV) revealed a bearish divergence compared to November of the prior year. Weak volume warned that the bulls were losing control of the trend. Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

line is often confirmation of an uptrend. If a stock price gains, but is not confirmed by an increase in OBV, a potential divergence may be in the works. An OBV moving sideways can indicate a neutral market.

**Warning signal:** When rising prices aren't accompanied by rising volume, this is often one more sign that an uptrend may be breaking down, such as in Figure 2.

## DON'T DISMISS THE NEWS

Consider market action in the first two quarters of 2015. The S&P 500 had shifted into a large consolidative range when the Fed became hawkish. The first hiccup was the Greek crisis, and soon after concerns about China reverberated through global markets. This kind of pattern often precedes a correction. Naturally, Wall Street doesn't like uncertainty. And while headlines are

not necessarily reflected in underlying fundamentals, news reports can dramatically impact the charts.

Chart reading relies on the premise that markets discount all known information. As the saying goes, “it's all in the charts.” Bull markets climb a so-called “wall of worry”—lots of uncertainty and potential “bad” news, but prices keep climbing. In the end, how a market reacts to news may be more important than the news itself. If a market shrugs off bad news and keeps rallying, that may be a sign of a strong trend. Does a market sell off or fail to advance on good news? That could signal that a bull market is getting tired.

## OKAY, YOU'VE CONFIRMED: WHAT NOW?

Once you decide a trend change is near, you may consider a defined-risk option strategy based on your outlook and expected scenario.

If you're bullish, consider a short, out-of-the-money put vertical spread. You'll be selling puts and buying lower-strike puts of the same expiration. If you're bearish, consider a short out-of-the-money call vertical spread. You'll sell calls and buy higher-strike



**COOL INFO:** For the most comprehensive information on all of the chart studies on thinkorswim, visit the thinkorswim Learning Center at [tlc.thinkorswim.com](http://tlc.thinkorswim.com).

calls of the same expiration. If you're neutral, consider an iron condor. You'll sell lower-strike put verticals, and sell higher-strike call verticals. The distance between the long and short strikes will be the same.

Get your finger in the air and study the wind. Once you learn to read market signals, you might glean a bit more about the kind of potential market storms headed your way. Whether it happens or not, observing price action, divergences, and volume can help you batten down the hatches long before a correction comes to shore.

While this article discusses technical analysis, other approaches, including fundamental analysis, may assert very different views. For more information on the general risks of trading, and trading options, see page 37, #1-2.





For the sake of simplicity, the examples below do not take transaction costs (commissions and other fees) into account. For information on TD Ameritrade transaction costs and fees, see page 7.



REMEMBER THE OLD CERTS COMMERCIAL? Two mints in one? In today's market, sometimes a trader is also an investor. And as an investor, you may hold some core positions longer term, maybe even for years (gasp). Nothing wrong with that. For a lot of investors, core positions are mutual funds.

Perhaps you've tried options strategies with the intent of generating income or reducing the cost basis of core positions. If they're comprised of individual stocks, you might sell calls against them. For example, if your core position was long shares in AAPL, GM, and XOM\*\*, you could sell calls in AAPL, GM, and XOM, respectively. This, of course, is a covered call strategy, which limits the upside potential of the underlying stock positions in exchange for selling the right to call your shares away.

Unfortunately, options aren't traded on mutual funds. And mutual funds don't always move higher. So since selling calls against mutual funds isn't possible, how can you generate income on them?

\*\*Stock symbols mentioned are not a recommendation and are for illustrative purposes only.

## WHEN SELLING CALLS IS NOT AN OPTION

Many big mutual funds have high "positive correlations" to big equity indices like the S&P 500, NASDAQ 100, or Russell 2000—so when the index price goes up, the mutual fund price goes up, too. And when the index goes down, the fund price goes down, too. Which makes sense. Because most big mutual funds contain many of the same stocks in the larger indices, particularly if the fund's objective is to track a particular index.

Conveniently, there are options on the big indices whose symbols are SPX (S&P 500), NDX (NASDAQ 100), and RUT (Russell 2000). Since selling a call on an index like SPX isn't "covered," if you're a qualified options trader, you may consider selling **out-of-the-money (OTM) call verticals** in those index options, in combination with your mutual fund, to mimic what you do when you sell calls against stocks.

With OTM short call verticals on SPX, you have defined risk equal to the difference between the long and short strikes, minus the credit received. Therefore, the cash requirement can be low. And if your fund is in an appropriately approved IRA, you can typically sell call verticals. There are generally three steps to this process:

1. Check the correlation between your fund and the index;
2. Determine the quantity of call spreads to sell;
3. Choose where to place the call spread.

## CHECK CORRELATION

Correlation reveals the strength of the price relationship between two symbols (e.g., an index and a mutual fund) for a certain

amount of time. Explore the correlation by firing up the Charts tab in the thinkorswim® trading platform by TD Ameritrade, and refer to Figure 1.

First, go to Charts and type in the fund symbol, minus the symbol of the index it's most closely tracking—such as SPX (if the fund tracks the S&P 500). For example, "MNKYX SPX".

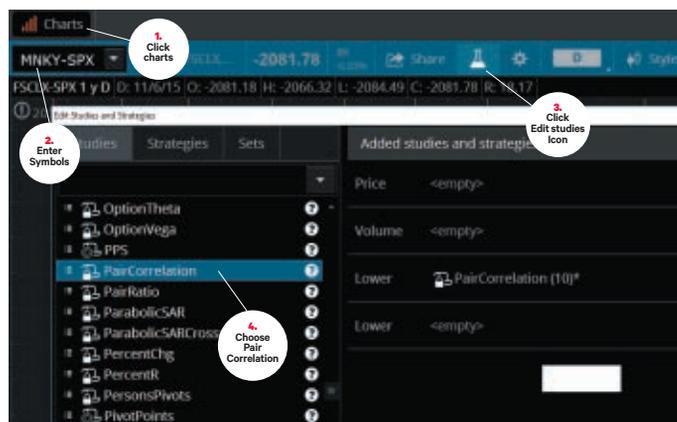
Next, go to the Edit Studies menu and select "Pair Correlation" from the studies list. This adds a study to the chart that shows correlation between your two symbols, MNKYX and SPX.

The default amount of time for the Pair Correlation study is 10 days, which you can edit. The strongest correlations are high no matter what time frame you look at.

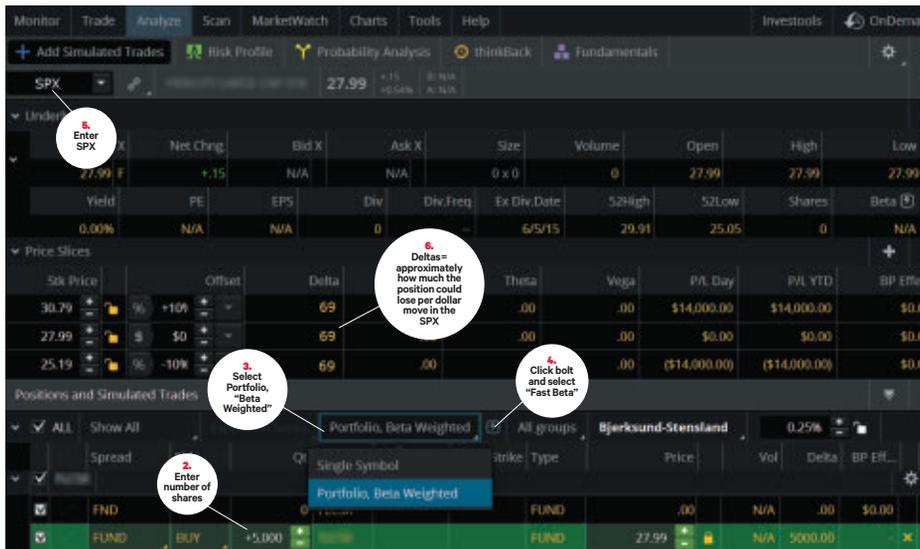
Correlation is measured between +1 (the fund and the SPX always move up and down together), and -1 (the fund and the SPX always move in opposite directions). A correlation of +1.00 is strong. But I would consider anything above 0.80 as a high correlation. For example, if you see that the correlation between your fund and the SPX is +0.99 for 10 days, but only +0.50 for 30 days, the correlation may not be stable or strong, and you may not want to be mixing SPX options with that fund. Maybe try another index, like NDX or RUT. But if the correlation is +0.99 for both 10 days and 30 days, the correlation is more reliable, and that index might be considered a good candidate in which to sell call spreads.

Now, it's possible to lose money on both the mutual fund and short index call spread if the correlation turns negative and the fund

price drops while the index rises. As long as the fund holds similar stocks to those in the index, the correlation should stay positive. But be aware there are no guarantees with this strategy. (Keep in mind also that spreads strategies can entail substantial transaction costs, including multiple commissions, which may impact potential returns.)



**FIGURE 1: Finding correlation.** To correlate a fund against an index, follow the steps above in the Charts tab of thinkorswim. Source: thinkorswim by TD Ameritrade. For illustrative purposes only.



**FIGURE 2: How many spreads do I sell?** Once you've determined which index is most correlated to your mutual fund, beta-weight your fund against that index to determine the number of spreads to sell. Source: thinkorswim by TD Ameritrade. For illustrative purposes only.

## DETERMINE THE QUANTITY OF SPREADS

Once you've identified the index correlated to your fund, how many call spreads do you need to sell? For that, determine how many SPX deltas your fund position represents, which can be found under the Analyze tab of thinkorswim.

Type in the fund's symbol on the Analyze page. If the fund is held in your TD Ameritrade account, you'll see it in the Positions and Simulated Trades section. If not, you can enter a simulated trade that's the same as your actual position by clicking on the "Ask" field on the Add Simulated Trades sub-tab.

Even though the Ask price is "N/A," you can still create a simulated long position in the fund.

Figure 2 shows a simulation of being long 5,000 shares of the fund. To determine the number of spreads to sell:

**1.** Enter the fund symbol in the symbol box at top. Change the price in the Positions and Simulated Trades section to the last price of the fund.

**2.** In the Price Slices section, you'll see that the fund position has 5,000 deltas. With 5,000 shares of the fund, if the price of the fund goes

up \$1, the value of the fund position will rise by \$5,000. Now, click on "Single Symbol," and select "Portfolio, Beta Weighted." Then click the little lightning bolt icon to the right of the dropdown and select "Fast Beta."

**3.** Type in any symbol, such as SPX, in the symbol field, to beta weight against that stock. In the case of our example in Figure 2, watch how the deltas of the fund position go in this scenario from 5,000 to 69. Beta weighting the fund's deltas tells you that if the SPX goes up or down \$1, the fund position could theoretically make or lose \$69. If the SPX goes up or down \$20, the fund position could theoretically make or lose \$1,380.

To determine how many short OTM call spreads you'll need, let's assume the max risk of a single, short SPX call spread is \$500. If you sold three of those call spreads and the market goes up, you could potentially lose a max of \$1,500. Of course, it depends on how far OTM you sell that call spread (we'll consider that next). But if you sell call spreads less than 10 points OTM, and the SPX goes up 20 points, you would lose \$1,500 and your fund would only theoretically make \$1,380. If the market goes even higher, the loss on the three short call spreads is limited to \$1,500, and your fund might continue to make money.

## CHOOSE WHERE TO PLACE THE CALL SPREAD

Selling a nearer OTM call spread will give you a larger credit, but it takes a smaller move in the index for it to lose money. Selling a

further OTM call spread takes in a smaller credit, but gives the index more room to move higher before the trade loses money. And you take in more credit when you choose a call spread in a further expiration, but that gives the index more time to move higher and create a loss.

**1.** Start by choosing an expiration with about 60 days. That's where the options still have relatively high extrinsic value, and their time decay is slowly starting to increase.

**2.** Then look for the call spread where the short and long strikes are adjacent to each other (e.g., a short SPX 2010 call and long SPX 2015 call) that nets a credit near one-third of the width of the strikes (about \$1.65 for a 5-point spread). That makes the max loss of the 5-point spread \$335.

**3.** Now determine how many points the SPX would have to rally to hit that long strike price and create the max loss. Multiply the beta-weighted delta of your fund position by that number of SPX points to see how much it would theoretically make. Does the profit on the fund offset the loss of the vertical? If not, maybe move the short call vertical to a higher strike. If it does, consider moving the vertical to a lower strike to collect a larger credit.

Overall, be patient with this strategy. The goal is for the credits from the short index call verticals to slowly accumulate and generate extra income, and/or indirectly reduce the fund's cost basis. The credit you receive for selling the call spread is the amount your fund's cost basis decreases with this strategy. Conversely, any loss on the verticals would increase it.

FINALLY, you'll need buying power in your account to cover the margin requirement for the short call spreads. If all you have is the mutual fund, you'll need to deposit cash. Now, go take a look at your mutual funds with a whole new perspective.

*Tom Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

*For more information on the risks of trading and options, see page 37, #1-2.*

# HOW TO TRADE

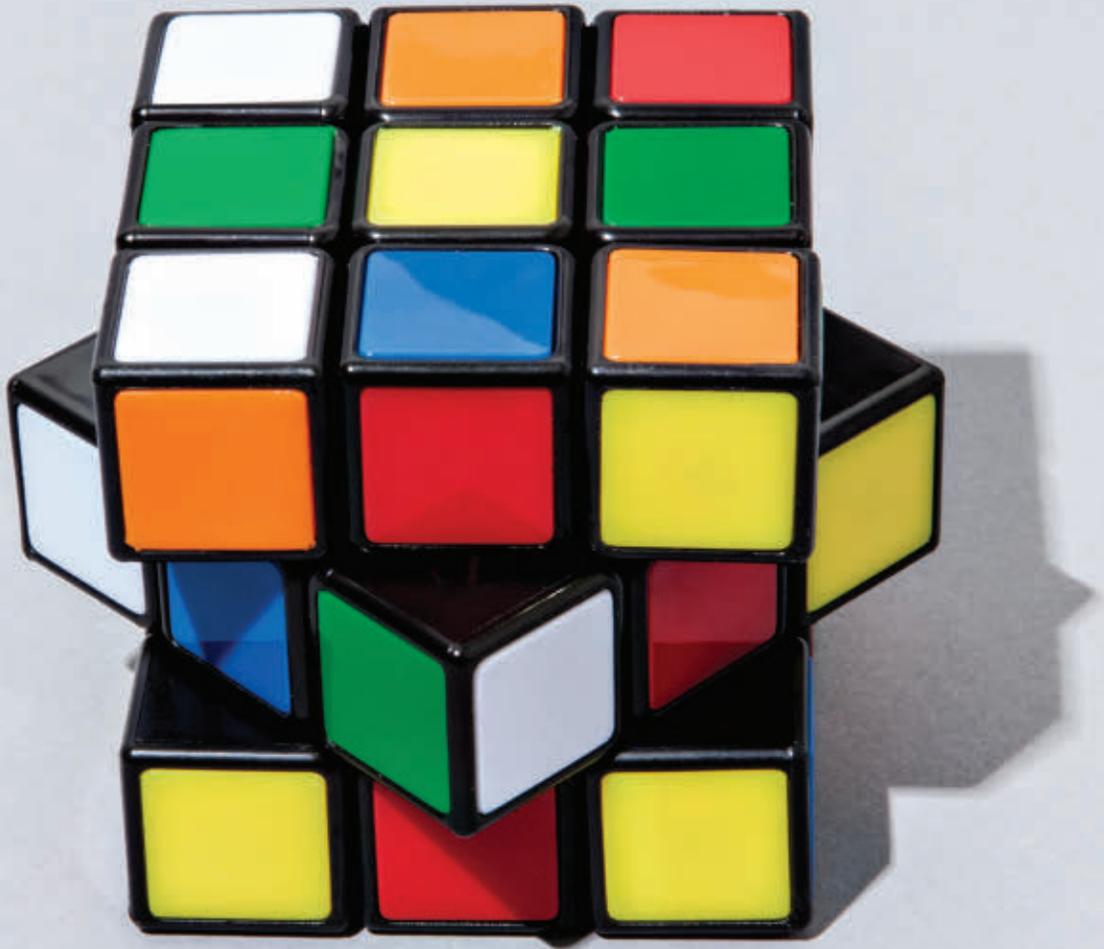
**BIG IDEA:** OUTSIDE OF SCALPING FUTURES AND RIDING TRENDS, THERE'S A THIRD UNIVERSE OPEN TO ASPIRING FUTURES TRADERS CALLED "BASIS TRADING" THAT, UNTIL NOW, HAS LARGELY BEEN KNOWN ONLY TO THE PROS. AND IT WORKS WITH THE GAMUT OF FUTURES PRODUCTS.

WORDS BY **THOMAS PRESTON**

PHOTOGRAPHS BY FREDRIK BRODÉN



**IN  
3-D**





FUTURES CAN BE A STRAIGHTFORWARD and capital-efficient way to either speculate or hedge. You think the price of corn is going higher? Buying a /ZC corn futures contract is an easier way to lay a bet than buying a corn farm and growing your own. How about a short-term hedge on a big S&P 500 stock portfolio, just ahead of a Fed announcement? /ES S&P 500 futures fit that bill. Just like stocks, futures can be long-term trades or quick scalps. But unlike stocks, futures can also offer different trading opportunities because of their basis, which few novice individual traders know about.

## BASIS 101

“Basis” is the term for the difference in futures prices in different expirations, or the cash (“spot”) price of the underlying product and the futures price. Futures prices in the various expirations are different from each other and the spot price because of the cost of carry, and the impact of supply and demand. That difference represents the basis. /ES futures, for example, have contracts that expire in March, June, September, and December. /ZC corn futures have contracts that expire in March, May, July, September, and December. /ZB bonds, /GC gold and, /CL crude oil futures have their own set of expirations.

## TRADING BASIS

In a word, basis trading is buying a future in one expiration month, and selling it in a different expiration month—like selling the

March /ES and buying the June /ES. It’s sort of like intermarket **pairs trading**, but with near 100% **correlation**. You’re speculating on the basis increasing and widening, or decreasing and narrowing. Because the two futures are based on the same underlying (e.g. S&P 500, Treasury bonds, crude oil, etc.), they are highly correlated. They tend to move up and down at the same time. But when they don’t move at the same time, or by the same amount, the basis changes.

Because the basis can be negative, where the price of the further expiration future is lower than the price of the nearer expiration future (also known as “backwardation”), it’s important to know which way you think the near-term future may move, relative to the back-month future. Some futures like /ES are regularly in backwardation, so the basis widening means it becomes more negative. If you thought it would widen, you might consider buying the near-term future and shorting the back-month future (e.g., you’d buy March /ES and short June /ES).

When the price of further expiration futures are higher than nearer expiration futures, that’s called “contango.” In contango, the basis is positive. If /CL futures are in contango, and you thought the basis would widen, you might consider shorting the near-month /CL future, and buying the back-month /CL future.

## BASIS TRADING IN THE REAL WORLD

You may consider the futures basis because they can be trades by themselves, kind of like stocks pairs trades. For example, maybe you don’t have a bullish or bearish bias on the futures’ underlying product itself. But considering the futures basis, you think it might move higher or lower.

Trading the futures basis also has potential advantages over stock pairs trading. First, the contract and tick size are the same for a given future. You don’t need to adjust the quantities of the trade to account for different contract specifications. Second, the margin requirement for basis trades can be lower than for a single long or short future because the basis trade is simultaneously long and short futures. The basis tends to have smaller price changes than the individual future would. So the margin requirement is also smaller.

4

STEPS TO GETTING BASIS

To trade basis, you have to see basis. With that, thinkorswim® has you covered.

- 1.** On the Trade tab of thinkorswim®, you can see the available futures expirations by typing the root symbol (e.g. /ES) and selecting “All” from the drop-down menu.
- 2.** To see the basis price between consecutive futures expirations, click the “Spread” drop-down menu and select “Calendar.”
- 3.** Click the arrow next to one of the futures to

expand the basis price, which is the further (or back) expiration, minus the nearer expiration.

- 4.** From the basis price you just opened up, you can chart basis by right-clicking the “=” before the futures symbol, and following the click path “More info...” > TOS Charts > upper-left square in the chart grid menu.

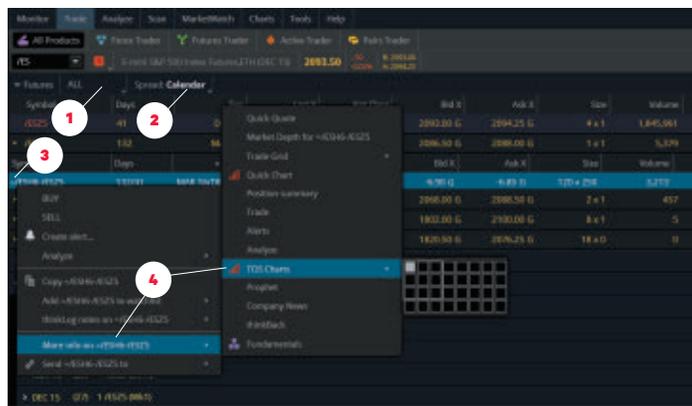


FIGURE 1: Source: thinkorswim by TD Ameritrade. For illustrative purposes only.

Let's look at three futures basis trading scenarios.

### Crude Oil (/CL)

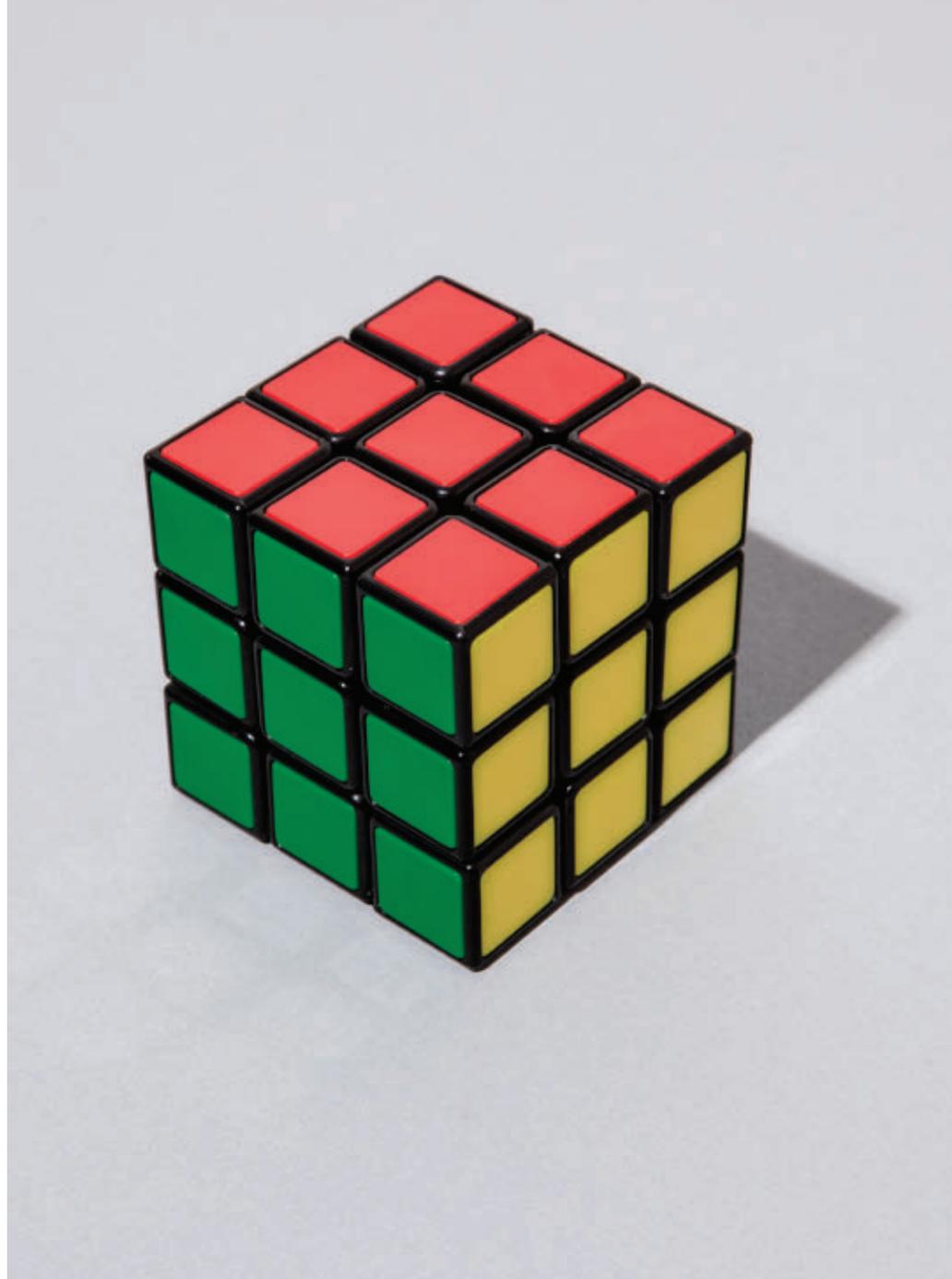
Crude oil futures contracts typically go out a couple of years. They're one of the most liquid, actively traded futures contracts, and the basis can move around a lot. To understand why, think about how crude oil gets turned into gasoline and other "stuff." It gets pumped out of the ground and transported to a refinery, and that costs money. If the oil is stored, there are insurance and storage fees, as well as interest charges if you're borrowing money to buy it. All those things go into the basis of /CL futures, and would make the further-term futures more expensive than near-term futures because

those costs are built into the futures' prices. But with the futures basis, there's also the expectation of over- or under-supply in the coming months and years. You can see that when you look at /CL futures prices.

**TRADER  
JARGON**  
TURN TO  
PAGE 36

Backwardation in /CL can happen when the market sees a shortage in crude oil, and where near-term demand outstrips immediate supply. The price of the near expiration /CL future is pushed higher than the back month. But /CL is more often in "contango," where the carry costs make the back months slightly higher than the near months, and there is equilibrium between supply and demand.

If you see /CL in backwardation and you think the causes are temporary, and that /CL will move back to contango, you could consider shorting the near-expiration /CL and buy the further-expiration /CL. The risk of course is that /CL could move further in backwardation, resulting in a loss on the trade. And there's never a guarantee that contango has to happen in the future. But the trade could be profitable if the futures move back to contango before the expiration of the near-term future.



### S&P 500 Index (/ES)

One of the most widely watched and actively traded futures is the /ES contract based on the S&P 500 stock index. /ES trades until 3:15 p.m. CT during "regular" market hours. The price of /ES is based on the value of the stocks in the S&P 500 (which is the SPX index), and the cost to carry the portfolio of those stocks.

There is an interest charge to borrow money to buy shares. The interest is offset by dividends that are paid by the S&P 500 stocks. The net impact of interest and dividends determines the basis between the /ES and the SPX. Nowadays with interest rates low relative to dividends, /ES futures are usually in backwardation, and the basis

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BASIS TRADING  
IS LIKE INTERMARKET  
PAIRS TRADING,  
BUT WITH NEAR 100%  
CORRELATION.  
IT'S BUYING A  
FUTURE IN ONE  
EXPIRATION MONTH,  
AND SELLING IT  
IN ANOTHER.

doesn't fluctuate much. But because S&P 500 stocks stop trading at 3:00 p.m. CT, so, too, does the price of the SPX stop updating. And in the 15 minutes between 3:00 p.m. and 3:15 p.m., when the /ES continues to trade, it can move higher or lower than what the basis calculation would suggest based on news that arrives after 3:00 p.m., or on the opening of large positions in /ES in the last 15 minutes of trading that anticipate the next day's price movement.

If the /ES to SPX basis is \$-10, when the /ES moves up relative to where SPX closed and makes the basis \$-8, for example, that can signal a stronger open the next day. If /ES moves down relative to the SPX closing price to make the basis \$-12, that can signal a weaker open the next day. Looking at the /ES to SPX basis before and after 3:00 pm can give you a clue as to the next day's opening price action. This may impact stop orders, and even technical indicators you might be tracking.

### CBOE Volatility Index (/VX)

Volatility futures might be the trickiest to understand. But they might offer the most interesting opportunities. The CBOE Volatility Index (VIX) is derived from the **out-of-the-money** SPX option prices. When traders anticipate larger price changes in the SPX (i.e. more volatility), the out-of-the-money SPX option prices can increase in price. That, in turn, pushes up the VIX. When traders anticipate smaller price changes in the SPX (i.e., lower volatility), the out-of-the-money SPX prices can drop, which in turn drives the VIX lower.

You can't trade the VIX directly, and /VX futures are a way to speculate on the direction of volatility. But /VX futures are only modestly tied to the VIX. "Modestly" because /VX settles to the VIX settlement value at their expiration. But there isn't any cost of carry between the VIX and /VX futures because you can't buy the VIX like you can buy

**TAKE ACTION:**  
**Open a Futures Account.** For qualified accounts, you'll need Level 3 options approval to trade futures. Log in to your account at [tdameritrade.com](http://tdameritrade.com). Under the Trade tab, go to Futures & Forex for more information.



**FIGURE 2: Negative basis.** To view basis on /VX, you have to enter it manually as a pair (i.e., longer-term future minus shorter-term future, or /VXX5-/VXV5 as shown above). Most of the time, /VX futures are in contango, as was the case prior to August in the chart. Source: thinkorswim by TD Ameritrade. For illustrative purposes only.

crude oil or a stock portfolio. That makes /VX futures pure indications of how much future volatility the market anticipates. The basis you see between the near and further month in /VX futures reflects whether the market sees more volatility near term or longer term.

Most of the time, /VX futures are in contango—where the market expects more volatility the further into the future you look. But when the market panics and drops, generally the VIX rallies the most, the closest expiration /VX future rallies a bit less, and further expiration /VX futures rally a little less than those. That can push /VX futures into backwardation, and make the basis negative.

Figure 2 charts just this scenario, when a market dropped and pushed volatility higher, and the /VX basis became negative.

Most of the time, the price of the back-month /VX future is higher than the price of the near-month /VX future, and the basis is positive. When the market became more volatile, the basis became negative. If you believe the market will calm down, and the front-month /VX will drop relative to the back month, and the basis will go from negative to positive, you could consider shorting the front-month /VX future and buy the back-month /VX future. That trade could be profitable if the basis goes from negative to positive. But the trade would lose money if the basis became more negative—which is something that happened in the 2008 market crisis.

AT THE CLOSING BELL, /VX basis trading isn't for the faint of heart. If you're already a proficient futures trader, consider this another

tool in the strategy toolbox. But even if you're not ready to trade it, /VX basis can certainly offer you clues as to how the market is forecasting volatility.

*Tom Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

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*For more information on the risks of trading and futures, please see page 37, #1 & 3.*

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Spreads, straddles, 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 and often involve greater risk, and more complex risk, than basic options trades.

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## Meet Your Go-To Guy

PART PLATFORM GENIUS, PART PRIVATE TUTOR, MIKE YING CAN ALSO LIGHT UP THE ROOM WITH HIS TRUMPET.

Interview by Kira Brecht / Illustration by Joe Morse

• **WHAT'S YOUR PATH** to the top of the trading mountain? For every 10 traders there are 11 approaches. In a word, much creativity in the work. A computer scientist by training and a classically trained jazz-turned-jazz trumpet player, TD Ameritrade Trading Solutions Specialist Mike Ying knows well the heights and depths of thinkorswim® and Trade Architect®. And he uses that expertise to optimize, customize, and tweak platforms for every individual trader's best starting point.

Think of him as tech support on steroids. Rumor has it he pursues an answer for everything. No matter how obscure a thinkscript request, Mike is the go-to guy who makes it happen.

**1**  
**Mike, what's special about the Trading Solutions team?**

I don't know of another firm that offers free coaching sessions like what we do with our Trading Solutions Group. Our first priority is education on technology and platform functions for active traders. We offer a dedicated 30 to 60 minutes to demonstrate anything clients need to explore. We listen carefully to client strategies, and can remote in and customize their platforms for what they want to do. We love to help traders through the initial learning curve and show what's possible.

**2**  
**What's hot in the platform features arena?**

I personally find the Trade Flash gadget very cool. It's a real-time stream of unusual things happening in the market. If a stock falls 13% at the open, that information appears. Or if someone puts in an order on a large options position on a stock, that shows up. In effect it's a real-time feed, but without the filter of opinions. All you see is pure market-related information.

Another hot feature is the ability to customize and link your symbols to multiple charts, or to other areas of the platform. With a process called linking, you click one symbol to see multiple charts at once, all with differing time frames.

**3**

**You trade too. What are a few trading rules you live by?**

Top of the list, I only trade what I know. I'm not delving into the

corn or wheat markets for instance because I don't know them as well. I also trust my gut to tell me how and when to proceed. Finally, I define my risk. I know exactly how much I can lose before I put on a trade.

**4**

**The market can be a bear. How can traders calm the beast?**

I'm also a musician, having started in classical and moved to jazz for the freedom. Musicians have their own style and their own way of expression. Just like trading, different styles and strategies take dedicated time and practice to learn. There are no right or wrong ways. It's best to dive in. Total immersion. In my case, I moved to the States from Hong Kong when I was seven and learned English watching *The Simpsons* on TV. Immersion models are everywhere.



**Trading is just like music. Everyone has their own style, everyone has their own way to play it. The easiest way to learn is to just dive in.**

## Two Steps Forward, Three Steps Higher

AS AN OPTION'S VOLATILITY INCREASES, VOL PREMIUM DOESN'T JUST GO UP TOO, IT DOES SO EXPONENTIALLY.

● **PRO / TAKEAWAY:** *Option prices can go much higher than vol increases would suggest*



• **YOU LISTEN TO THE NEWS.** You hear that market volatility is higher than normal. Talking heads see volatility as a “fear gauge,” with the implication that it’s a tougher investor environment. You get it. Higher volatility (“vol”) can mean stock and index prices move a lot in various directions. It’s not easy when prices don’t rise or fall in a predictable way. It gets scary. And scary equals fear. So, volatility becomes a marker for fear. But consider these numbers.

For example, a stock price is \$100, its vol is 15%, and the 95 put with 50 days to expiration has a theoretical value of \$0.50. Likewise, a stock price is \$100, its vol is 30%, and the 95 put with 50 days to expiration has a **Black-Scholes** theoretical value of \$2.22. Same stock price, same strike price, same days to expiration.

### THE SAME, BUT NOT REALLY

But when vol is 2x higher, the option’s theoretical price, in this example, is more than 2x higher. In fact, it’s over 4x higher. You know that higher volatility can mean higher option prices, all things being equal. But option prices don’t increase in a linear way with higher vol. They increase exponentially because according to theory, an option’s “vega” (how much price changes with a change in vol) increases as volatility increases. So, higher vol means higher vega, which can mean greater

*For the sake of simplicity, these examples do not take transaction costs (commissions and other fees) into account. Please see page 7 for more information.*

increases in an option’s price as volatility increases.

In a practical way, higher vol suggests more uncertainty about how much the price of a stock could change. So, traders who want to buy downside protection in the form of a put have to pay up for that protection. It’s the same reason car insurance is higher for 18-year-olds than for those so-called old folks who statistically are safer drivers.

On the other hand, for example, in a margin account, let’s say the requirement for a short put is either 20% of the stock price minus the out-of-the-money amount, or 10% of the strike price, whichever is larger. Options volatility doesn’t have anything to do with it. And even though a broker may increase margin requirements in times of extreme volatility, the requirements don’t go up and down daily as volatility goes up and down. In this example, for a 95 put on a \$100 stock, the requirement in a margin account would be \$1,500.

Think of it this way: with \$1,500 in capital, you can short the put in low vol and have a max theoretical profit of \$50. Or short the put in high vol and have a max theoretical profit of \$222. Also, the max risk if the stock goes to 0 is \$9,450 when vol is 15%, and \$9,278 when vol is 30%.

### WHEN VOL SPELLS OPPORTUNITY

Rather than a “fear gauge,” volatility can also be an important “opportunity gauge.”

Naturally there’s no guarantee of making money when volatility is high, while higher volatility can in fact signal larger potential future price changes that could create bigger losses on a short put than with low vol.

But here’s the catch: big price changes when a stock, or the market broadly, gets surprised can happen at any time, whether vol is high or low. Yet, when volatility is higher, your potential reward and maximum risk is higher, too. So when everyone’s buzzing about the market going haywire and vol going through the roof, step back and think about these numbers. And decide for yourself whether it’s time to sit on your hands or get in a trade.

*Naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance. For more information on the risks of trading options, see page 37, #1-2.*

## TRADER JARGON



### Vertical Spread

PAGE 19, 23

• 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.

### CBOE Volatility Index (VIX)

PAGE 11, 19

The VIX measures the implied volatility (“vol”) of the S&P 500 index (SPX) options.

### Iron Condor

PAGE 14, 23

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.

### Covered Call

PAGE 19, 26

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

### Correlation

PAGE 30

Used to measure how closely two assets move relative to one another. A correlation of +1 means both assets tend to move in tandem, while -1 means both assets move opposite of each other.

### -Delta

PAGE 19, 27

A measure of an option’s sensitivity to a \$1 change in the underlying asset. All else being equal, an option with a 0.50 delta, for example, would gain 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.

### In-the-Money

PAGE 17, 27

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

### Out-of-the-Money

PAGE 19, 26, 32

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 higher than the underlying. For puts, it’s any strike that’s lower.

### Black Scholes

PAGE 35

The option-pricing formula published by Fischer Black and Myron Scholes, which requires five inputs (stock price, options strike, interest rate, time to expiration, and volatility) to arrive at a price.

### Pairs Trading

PAGE 30

Buying one asset and selling another in the hopes that either the long asset outperforms the short asset or vice versa. This is usually done on two correlating assets that suddenly become uncorrelated.

### Dollar-Cost Averaging

PAGE 18

Investing a fixed dollar amount in a fund on a regular basis such that more fund shares are bought when the price is lower and fewer are bought when the price is higher. The goal is to have a lower average purchase price than would be available on any specific day.

## DISCLAIMERS

IMPORTANT INFORMATION YOU NEED TO KNOW

# 1

### GENERAL DISCLAIMER

*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. Past performance of a security or strategy does not guarantee future results or success.*

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*It is not possible to invest directly in an index.*

# 2

### OPTION STRATEGIES

*Trading options involves unique risks and is not suitable for all investors.*

*Spreads, condors, butterflies, straddles, and other complex, multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies and often involve greater risk, and more complex risk, than basic options trades. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security.*

*Maximum potential reward for a long put is limited by the amount that the underlying stock can fall. Should the long put position expire worthless, the entire cost of the put position would be lost.*

*When trading short option strategies, there is a risk in getting assigned early on the options sold, even if they go in the money by \$0.01, obligating you to deliver shares you don't own (in the case of a short call) or purchase shares (in the case of a short put).*

*The risk of loss on an uncovered short call option position is potentially unlimited since there is no limit to the price increase of the underlying security. Option writing as an investment strategy is absolutely inappropriate for anyone who does not fully understand the nature and extent of the risks involved.*

*The short naked put and cash-secured put strategies include a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.*

*Short naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance.*

*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 a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)*

# 3

### FUTURES

*Futures trading is not suitable for all investors as the risk of loss in trading futures is substantial. Futures trading privileges are subject to TD Ameritrade review and approval. Not all account owners will qualify. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Equity options trading involves risks and is not suitable for all investors. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return.*

*Futures and futures options trading is speculative, and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products ([https://www.tdameritrade.com/retail-en\\_us/resources/pdf/TDA631.pdf](https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA631.pdf)).*

# Valentine's Day Cards For Traders

• Let's face it, we're traders. By the time the market closes on Valentine's Day, it doesn't leave us much time to run to the drugstore to get our sweetie a card. And all the decent ones will be gone by then. So to avoid an awkward evening (or worse), we wrote your next Valentine's sentiments to let the special people in our lives know how much we love them. Trader style. Simply copy the most appropriate one onto a blank card, seal it with a kiss, and get back to trading the overnight markets...You're welcome.

## VALENTINE FOR YOUR BOYFRIEND/GIRLFRIEND

*Let's spend Valentine's Day together, just you, me and the SPUs.*

• If I were afraid of commitment, would I be holding this trade for so long? The Federal Reserve Governors couldn't drag me away. I'd even swap my second-best trade today for just one kiss from you!

## VALENTINE FOR FIANCÉ/FIANCÉE

*All I ask is that you be my personal VIX, I mean Valentine, forever!*

• To the love of my life, I give you these pledges—I promise to keep the probability of success of our relationship above 70%. I promise to work to get comfortable with a joint trading account. I promise to not endlessly compare our net liqs every evening before bed.

## VALENTINE FOR NEWLYWEDS

*We're like the two highly-correlated parts of a pairs trade!*

• You're the best non-market thing that's ever happened to me! Your laugh is as happy as the opening bell. Your kisses are as sweet as when I bought corn on its low. Our love is almost as rich as a strangle ahead of earnings.

## VALENTINE FOR SOMEONE MARRIED 20 YEARS

*You're the best trading clerk ever!*

• Over the expirations, we've held hands through margin calls, market crashes, Fed meetings and whatever it is that happens to you. I couldn't imagine being as great a trader as I am without you by my side.

## VALENTINE FOR SOMEONE MARRIED 50 YEARS

*Happy Valentine's Day, my theta!*

• To my special trading partner, You hand me my pills while I wait for my fills. You log me in to my mobile trading at the doctor's office. You check my heart monitor when you hear the trade alerts. I owe my trading success to you and time decay.



Kyle S.  
thinkorswim® user

Nicole "The Suit" Sherrod  
@TDANSherrod  
Managing Director, Trading

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Get an exclusive look into how "The Suit" uses thinkorswim.

With the new sharing feature in thinkorswim, you'll discover how our experts use the platform and which tools they rely on most. You can also generate new ideas and share your platform setup with friends, followers, and the myTrade® community.



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