

thinkMoney/08

• random musings
for thinkorswimmers
Winter 2010

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The Last Order Standing

The idea of creating a “fool-proof” system using the endless order types available is certainly alluring. But ultimately, there’s no substitute for human intervention.



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There are probably more order types available today than there are letters in the alphabet. And just because we have 'em doesn't necessarily mean you should use 'em—at least, not as a surrogate for managing your trades. To be an active trader, you need to be a less passive one.

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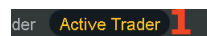


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Options provide a seemingly endless supply of strategies for taking advantage of markets in trading ranges. Not that the markets have been boring this year, but when things start to slow down (and eventually they will), you might want to try on a Double D for size.



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Forever the consummate realist, our simian spokesman doles out his pearls of wisdom on early assignment, option pricing models, and bad Jell-O.



Contact Info You Could Use

Main Office 866-839-1100
Technical Support 866-839-1100 ext. 3290
Forex Support 866-839-1100 ext. 3400

• **General Help:** help@thinkorswim.com
Getting Started: account@thinkorswim.com
Retirement Account: iraaccounts@thinkorswim.com
Account Transfer Help: acats@thinkorswim.com
Account Funding Help: funding@thinkorswim.com
ACH Transfer Help: ACHTeam@thinkorswim.com
Trading Help: tradedesk@thinkorswim.com
Forex-related Questions: fx@thinkorswim.com

General Mailing Address

thinkorswim, Inc.
600 W. Chicago Ave., Suite 100
Chicago, IL 60654-2597

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A Quick Howdy

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thinkMoney®

EDITORIAL DIRECTOR

Kevin Lund

EDITOR

Thomas Preston

ART DIRECTOR

Tom Brown

ASSISTANT EDITOR

Jennifer Agee

DESIGNER

Jennifer Roberts

CONTRIBUTING WRITERS

Tony Battista, Steve Quirk, Blake Young, Matt Blackman, John Carter

CHIEF PHOTOGRAPHER

Fredrik Brodén

CONTRIBUTING ILLUSTRATORS

Brian Cairns, Evonrude

PUBLISHER

T3 Publishing, LLC

Email: info@t3publishing.com

www.t3publishing.com



ADVERTISING CONTACT

sales@t3publishing.com

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Just Kidding

Hey, did you hear the one about the Great Recession?

Assuming we don't get the dreaded "double dip," that one-liner is likely to become the financial equivalent of "So a guy walks into a bar" for years to come by jesters waxing comedic about the first decade of the new millennium. But if 401(K)s turned 201(K)s turned 301(K)s keep rocking in lieu of rolling, such jokes will certainly

be lost on the next generation of traders and investors, while this generation suffers the same fate as the last remaining survivor of the Titanic—saying things like "I was once on a really big ship that sunk when it hit an iceberg."

Lest we forget the lessons learned when we first started trading, we thought it appropriate to go back to basics this issue, starting with our cover feature, "The Last Order Standing." It serves as a reference guide to most of the order types you'll find on our trading platform, along with a few pearls on why you shouldn't use them as a surrogate for human intervention.

Next, and this may come as a shock to many, we've devoted this issue's entire Special Focus to (gaspl) technical analysis. What the heck, right?

Ah, well, there've been plenty of requests by readers to discuss the subject, but our motto has always been to give you something that nobody else will. So, instead of rehashing what you can already get in, ahem, other magazines, it hit us—why not tell you what NOT to do with your charts in "Five No-Nos of Technical Analysis."

Don't worry, we wouldn't think of giving you the yin without the yang. There's still plenty of brain candy in this issue for even our most advanced swimmers (double diagonals, anyone?).

Despite the distant memory of falling markets, if we've learned nothing else from 2009, it's that bad things happen to good money. With that, this issue of *thinkMoney* could serve as the "what not to do" issue going into 2010. Having lived through (and survived, thank you) a market shellacking of seismic proportions, we like to think we can impart some wisdom about what to do if (and when) we hit another iceberg.

Happy Trading!
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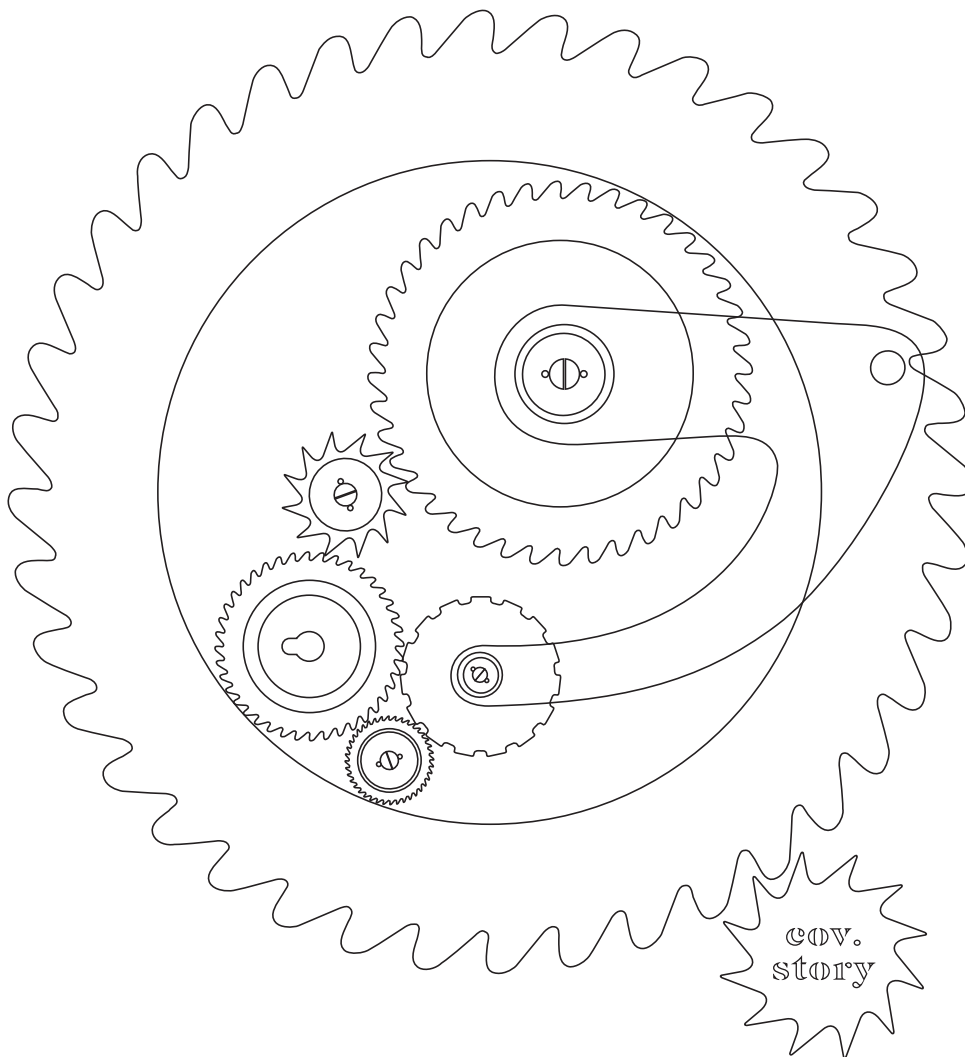
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THE LAST ORDER STANDING

THERE ARE ALL SORTS OF WAYS TO OPEN AND
CLOSE POSITIONS, BUT THEY MAY NOT ALL BE WHAT
THE UNSUSPECTING TRADER ORDERED.



Order Types

Photograph by
Fredrik Brodén

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STOP

Trailing stop limit. Market on close. Contingent orders. There are over 20 different order types available on the thinkorswim platform. Some are more complex than others, and you might believe that the more complex the order, the more “professional” or useful it is. Right? Well, sometimes yes. Sometimes no. The key is to understand how these orders work before you use them in live trading.

All orders, however complex, can be seen as variations on two basic themes: market and limit orders. A market order guarantees a fill but not a price. A limit order guarantees a price but not a fill. Period. The other 18 order types attempt to make your life a little easier, but they’re not meant to replace a real person monitoring positions (read: you). Let’s dive into the world of order types and learn how to manage them properly.

THE BUILDING BLOCKS

• **MARKET ORDER** • With a market order, the broker is allowed to execute the order without regard to price or time. The broker will fill the order. But in exchange for that certainty, you have no idea what price you’ll get, or what time the order will be executed. In the world of electronic trading, the time until execution will likely be measured in milliseconds after you route the order. But the rule is that the broker isn’t held to anything but getting you a fill.

Be warned: Unless you’re dealing with extremely liquid issues, such as QQQQ or SPY, market orders are like writing blank checks to the floor—rarely a good idea (more on this later). A few other familiar order types that turn into market orders when they’re triggered include stops, trailing stops, and market on close.

• **LIMIT ORDER** • With a limit order, the broker can’t fill at a price that’s worse than your limit price. That is, you won’t pay more than your limit price when you’re buying, and you won’t sell lower than your limit price when you’re selling. That’s good because it gives you control over the price where you execute the order. But the downside is that you might not get filled if a market maker doesn’t want to take the other side of your order. A few other familiar order types that turn into limit orders when they’re triggered include stop limit, trailing stop limit, and limit on close.

The bottom line is, whether they’re market or limit, there is no order that guarantees both a fill and a price. You can have one or the other, but not both.

• **STOP ORDER** • Beyond the standard market and limit order, probably the most well-known is the stop order, aka “stop loss.” A stop order is used mainly to protect against an adverse move in the stock price, and can be either a buy stop (used if you have a short stock position) or a sell stop (used if you have a long stock position). If I were long 100 shares of XYZ with a price of \$50, I could enter a sell stop order at \$48. The way it works is if XYZ drops to \$48, the stop is triggered and routes a market order to sell 100 shares of XYZ. Because it’s a market order, there’s no guarantee of price, and if XYZ gaps below \$48, the stop order will be triggered, but the price where I sell XYZ could be much lower than \$48.

An extension of the stop order is the stop limit order, which triggers a limit order when the stop price is hit. If I set a stop limit order for my 100 shares of XYZ with a \$48 stop and a \$48 limit, and XYZ drops below \$48, the limit order to sell the 100 shares at \$48 will be routed. Because it’s a limit order, there’s no guarantee I’ll be filled, and XYZ could keep dropping and dropping. In practice, I might set the limit part a bit away from the stop order. With a stop price of \$48, I might make the limit price \$47.90. That way, I have a somewhat better chance of getting filled on my limit order when the stop is triggered.

While stops and stop limits can reduce losses, they can’t really protect profits if the stock goes up and comes back down. That’s where trailing stops come in.

• **TRAILING STOP ORDER** • Trailing stop orders behave like a ratchet: they move in one direction but not the other. The stop price is set at a certain number of pennies or points away from the current stock price. As the stock moves higher, so does the trailing stop, following the price of the stock but staying the same number of pennies away. Once the trailing stop ratchets up, it doesn’t ratchet back down if the stock moves down. If I set a trailing stop of 0.20 for my 100 shares of XYZ at \$50, the initial stop is set at \$49.80. If XYZ drops that 0.20 to \$49.80, the trailing stop is triggered and a market order to sell the 100 shares of XYZ gets routed. But if XYZ goes up to \$51, the trailing stop follows it higher. The 0.20 trailing stop will be set at \$50.80. If XYZ goes higher still to \$51.50, the trailing stop moves up to \$51.30, which is 0.20 away from the stock price. Now, if XYZ drops to \$51.30, the trailing stop is activated and routes a market order. In this way, a trailing stop can help protect profits.

TAKING IT UP A NOTCH

• **CONDITIONAL ORDER** • Conditional orders have to be triggered by an event before the order is actually routed: a stock hits a certain price, or volatility reaches a certain level, or a study gets to some value. Also known as

I KNOW YOUR TRADING FANTASY. NO, NOT THE ONE WHERE YOU HAVE NEXT YEAR'S NEWSPAPER TODAY. IT'S THE ONE WHERE YOU DEVISE A TRADING PLAN SO BRILLIANT AND SO WELL STRUCTURED THAT ALL YOU HAVE TO DO TO MAKE A FORTUNE IS ROLL OUT OF BED, HIT THE "ENTER" BUTTON, AND WATCH ALL THE WINNING TRADES TUMBLE IN. THAT JUST ISN'T REALITY, AND LIKELY NEVER WILL BE.



the trade on, whether far from or close to expiration. This could all depend on the type of whipsawing action often seen in stocks (as opposed to true reversals), and it can take you out of trades prematurely. If the move happens far from expiration, you might still have some time for the stock to move back your way. Close to expiration, that's less likely. So, you may want to enhance your conditional order strategy by placing a trading alert to notify you when the stock is getting close to your exit point. Being alerted when the stock is 0.50 away from that price gives you a chance to check your account, your positions, and the stock. It gives you time to think about the trade clearly, and exit it with perhaps a better plan. (For information on setting up alerts, go to thinkorswim.com >Support>Software Support, and type "Alerts" in the fill-in box).

Of course, that all assumes that you haven't done too many of these in the first place. How many risk management articles have we printed in this space? If the position is too big for your account, giving a trade "more room" can eventually kill you. That's why prudent position sizing is so important.

• **OCO AND BRACKET ORDER** • Beyond the specific order types are the OCOs and first-triggers orders, which are combinations of different limit, market, stop, trailing stop, and so on orders. OCO stands for "one cancels other," and means that if one of the orders in the group is filled, the others will be canceled.

Bracket orders are what you call a limit order and stop order that are combined in an OCO group. You can create an order to buy 100 shares of stock, and simultaneously create an OCO that will trigger when you execute the buy. That's what we call a "first triggers OCO," because the execution of the first order (the buy) triggers that OCO with the limit order to sell and the sell stop. The OCO contains a limit order to sell the shares at a higher price to take a profit, and a stop order to sell them at a lower price to limit losses. If the limit order to sell is filled, it cancels the stop order. If the stop order is filled, it cancels the limit order. Often, the bracket orders are set to GTC if the position isn't being day traded. GTC, or "good 'til cancelled," is an order that doesn't expire at the end of the day as "DAY" orders do, but rather when it is either filled or you cancel it. Active

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contingency orders, these can be particularly useful when you're trading options as a stock replacement.

Let me elaborate. If you're selling a put vertical because you think the stock is going higher (or at least not down very much), then the speculation is really on the stock price itself. Sure, the vertical might meet your risk and potential reward criteria, but whether the trade makes money or not depends mainly on the stock price. So, it would stand to reason that you might want to exit the trade based on the price of the stock, particularly if the stock moves against you. If you are short an out-of-the-money put vertical on XYZ, which is trading at \$50, you could enter a conditional order to buy that put spread back if XYZ drops to \$47. You can choose for that conditional order to route a limit order or a market order when that condition is met. The TOS platform gives you a lot of flexibility here. You can have the conditional order route a limit order that is a certain price, or a certain number of pennies above or below the spread's average price. Used properly, that can help you get the order filled.

Now, suppose you want to give yourself a little more room when using a conditional order to close your defined-risk, positive-time-decay trades if the stock starts to move against you. If you set a conditional order based on the stock price, it might get triggered at any time after you put

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Order Types

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day traders sometimes use bracket orders if they have to step away from their trading screens or if they're trading multiple stocks or futures and can't concentrate on all of them all the time. (See Gear Head, page 21, for a discussion on customizing multi-level bracket orders.)

• **FIRST TRIGGERS ORDERS** • First triggers sequence and first triggers orders all work a bit like the first triggers OCO. The execution of the first order in the list either sends all the other orders in at once, or sends them sequentially: If the first is executed, it routes the second, and if the second is executed, it routes the third, etc.

First triggers sequence orders can be used when you're

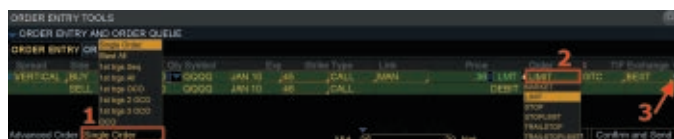


FIGURE 1: PLACING THE ORDER. From the Order Entry Tools screen, choose your advanced order type (1) on the left, the simple order type (2) on the right. But if you're really feeling frisky, select the barely visible gear wheel thingy (3) to the right to enter a conditional order (Figure 2).

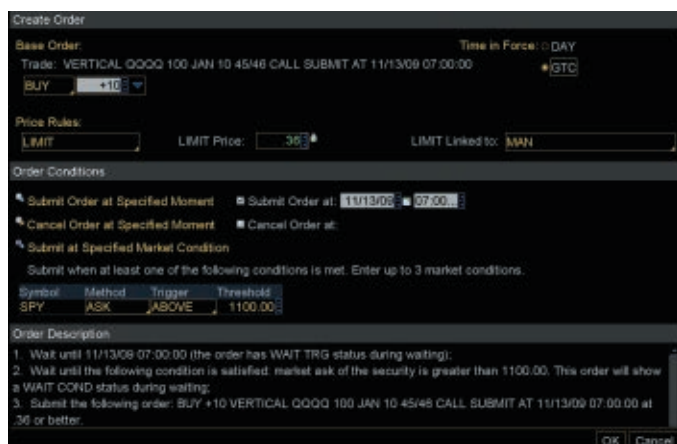


FIGURE 2: CONDITIONAL ORDER. Activate your trade on a future date and time; e.g., at 10:30 a.m., next Monday, and up to three market conditions, e.g., SPX above 1200, GOOG trading above 600, and the pope just gave his blessing (maybe not that last one). Tip: to enter conditions, click just below the word "Symbol."

managing a long stock plus short covered call, for example. As time passes and if the stock doesn't move higher, the short call drops in value. You may want to have an order in that would buy that short call back. Then, if the order to buy the short call back is filled, it routes a stop-loss order for the long stock position. Or maybe it routes an order to sell a call at either a different expiration or different strike price.

• **LOC OR MOC ORDER** • LOC and MOC stand for limit on close and market on close. Simply, they route either a limit or a market order near the close of trading, approximately two minutes before. These orders were created mainly for institutional traders and fund managers who needed to execute orders close to the end-of-day settlement price for accounting purposes. Retail traders (that's you) can use them, but they're not really that useful. There's no magic to

the price of a stock, index, or option closer or further away from the close of trading. A trade that meets your criteria can pop up anytime during trading hours. When you spot one, don't use an LOC or MOC and risk having a good trade get away from you between now and the close. Just trade it.

• **THE STEPFORD TRADE** • So now that you're armed with this information, which orders do the professionals use? Here's something I tell every class I teach when we cover order types: I know what each of your trading fantasies is. No, not the one where you have next year's newspaper today. It's the one where you devise a trading plan so brilliant and so well structured that all you have to do to make a fortune is roll out of bed, hit the "enter" button on your keyboard, and watch all the winning trades tumble in. That's what you think professional traders do, but that just isn't reality, and likely never will be. Sorry, Charlie. The fact is that professional traders are fully engaged in their trading. They work limit orders trying to get a better fill. They cancel orders and put in new ones. And they almost always use limit orders because it gives them more control. As such, limit day orders make up the majority of the effective option trader's executions.

The only time I consider using market orders is the rare occasion when I need to exit a position at all costs. Never use market orders to open positions. There is no reason to enter a new position, accepting the risk of a trade, while giving up control over the price of the order. There is never any guarantee that a trade is going to make money, no matter how convinced you are of your analysis or "hot tip." Because I'm not a fan of market orders, that means I don't use stops, trailing stops, etc. And because I personally like to keep a close eye on my positions, I don't have to rely too much on conditional orders or OCOs.

There's really no such thing as a "perfect" trade, nor is there any substitute for actively monitoring your positions. It's right about the time when you think you've outsmarted the market that your fool-proof, fully automated system will likely fail. I'm not saying you shouldn't use these order types, but what I am saying is that if you're using them to save you the trouble of checking your positions and monitoring prices every day, then you might find yourself in a whole different type of trouble when the next crash comes.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting thinkorswim at support@thinkorswim.com.

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Dear Swim

A collection of your best quips to the Trading Desk

Photograph by
Fredrik Brodén

11trs.

• My wife destroyed my TOS monkey last night. She ripped it limb from limb and gutted it out of anger. He's dead. I would have rather she destroyed something replaceable. If I ever get another TOS monkey, I'm taking it straight to my office where it will be safe. That being said, what would I have to do to get another monkey sent to me? I would be glad to pay for it.

Yours truly,

Paul

[With no time to lose, TOS Customer Service quickly responded.]

• Hello Paul,
Sorry to hear of the monkey murder. We will see what we can do to help you replace your monkey and send one out to you. Feel free to follow up anytime.

Best regards,

Andrew Hartnett

TOS Customer Service

• If ShadowTrader ever goes off the air, I will move to a cave in the middle of the Amazon, drink Ayahuasca, and stick myself with tranquilizer darts until I am comatose.

Dave

• Please reconsider your choice of guests on the Friday Market Wrap show. Tom Sosnoff has been wrong so many sessions of late that I am beginning to wonder how he makes money trading. One or two more sessions with Tom and I will be outside playing with my dog on Friday afternoons!

Claude

[We had an overwhelming response to the thinkMoney survey in our Summer 2009 issue and just had to share. If you'd still like to participate, go to thinkorswim.com/thinkMoney. We'll leave the lights on.]

The Good

• I love *thinkMoney*! I look forward to it coming in the mail, and have even stood outside my mailbox for days on end just waiting for it to show up!

• No more pictures of rolls with butter on them. I completely fell off my diet, thanks to you.

• *thinkMoney* is great—a prized collection resides in the library of the porcelain perch. Our guests don't get to read about cars and vixens, they read about calls and the VIX.



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

The Bad

• I have to admit most topics you cover are written in a manner that is over my head. I would like to follow your advice, but most of the time I don't even understand what you are talking about.

The Ugly

• Some of the irreverent humor has crossed over the line into the area of offense.

• *The comments above are excerpts from e-mails submitted by thinkorswim, Inc., clients as their views and may not reflect those of thinkorswim, Inc. Testimonials may not be representative of the experience of other clients and are no guarantee of future performance or success.*



Vol Watch

Analyzing the markets through the eyes of volatility—sans charts.

vol.

• The CBOE Volatility Index (VIX) is a measure of fear versus complacency, plain and simple. Are traders afraid of what's coming? The VIX goes up as out-of-the-money SPX options get bid higher. Are traders thinking that the market's going to be a snooze? The VIX goes down as the SPX option prices get offered lower. Although the perception is that the VIX moves higher when markets move lower, the important thing to realize is that option values are based on the expected magnitude of future price changes. If big changes are expected, then option prices get pushed up in both calls and puts, because it's not the direction of the price change that's important, but its size. Traders see risk on both up and down moves.

Over the past two years, the average expiration-to-expiration absolute percent change in the S&P 500 (SPY) was about 6%*. That's pretty typical—maybe a bit on the high side. Of course, October 2008 came in with a 25%* change, skewing the results a bit. (*Source: thinkorswim.) If you base a trading strategy on expecting no more than a 6% monthly price change on average, up or down, it might work most of the time, but you'll get crushed by those occasional massive moves (usually lower). The question is, can the VIX help tip you off to when those events might occur?

Fear of Deviation

I did a simple test to see whether that happened. Using the past two years of data, I looked at where the SPX was at the end of each expiration, took the value of the VIX on

Words by **Thomas Preston**
Photograph by **Fredrik Brodén**



Can the VIX Predict the Future?

Using history as its guide, the famed volatility index has a story to tell.

that day, and estimated the one- and two-standard-deviation price changes for the next expiration date. Then I looked at where the SPX settled on that next expiration, and whether it landed inside or outside that estimated range.

With only 25 data points, this is not an exhaustive study of SPX price movement and volatility. But it's certainly enough to get you thinking.

When I used the VIX to calculate the one-standard-deviation range of the SPX on expiration forward, the SPX settled within those upper and lower bounds 19 out of 25 times. That's 76%, higher than the theoretical 68% that you'd expect for one standard deviation. It's close, indicating that the VIX is a pretty good estimator of how much the SPX will move up or down.

What the VIX didn't do was foresee the

crash in October 2008. It was hovering around 32%, and the SPX fell 100 points through its projected range on the downside. And it failed again, but just barely, in November 2008. The VIX had jumped to over 70% by that time, and projected a very wide range. While the SPX dropped just 1 point below the lower projected boundary, close only counts in horseshoes.

Interestingly, too, when I looked at two standard deviations, the SPX settled within that range 100% of the time. Theoretically, it should be only about 95% of the time.

What's more interesting from a trading standpoint is that because the SPX settles within the projected range a bit more often than expected, it suggests that the VIX, and therefore out-of-the-money option prices, overestimate the likelihood of the big price changes. Sure, they happen. We all saw that last year. It suggests, though, that while past performance is certainly no indicator of the future, and the big price moves can happen at any time, the VIX seems to think they happen a little

more frequently. That pushes up the value of out-of-the-money options, which pushes up the value of credits for selling out-of-the-money verticals. Maybe that will give you something to think about in 2010.

• *The views in this section are those of the author, but are not necessarily those of thinkorswim, Inc., and are not intended to be specific investment advice. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade.*



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A blue-outlined thought bubble with a white background, containing the text "Do I own the right stocks?".

***Do I own the
right stocks?***

A close-up photograph of a middle-aged man with grey hair, looking thoughtful with his hand on his chin.

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INDUSTRY SPOTLIGHT

The Guts of Cap and Trade

The term *cap and trade* describes a set of environmental laws and regulations that aim to reduce greenhouse gasses and other pollutants. They combine a "cap" on emissions with the ability to "trade" emissions permits. The idea is to give companies a certain amount of flexibility: You can invest in new, energy-efficient technology, and you won't get fined for exceeding the cap. Or, you can buy permits on the open market and keep right on emitting as much as you want.

Forget the pro versus con arguments—cleaner air, lost jobs, higher heating bills, sticking it to OPEC. Take your pick and bring it to the next election. But what about us traders? How can we make a couple bucks off this?

Alternative energy companies (solar, wind) are the obvious picks to benefit from cap and trade if you believe that their products will be more attractive as pollutants from traditional

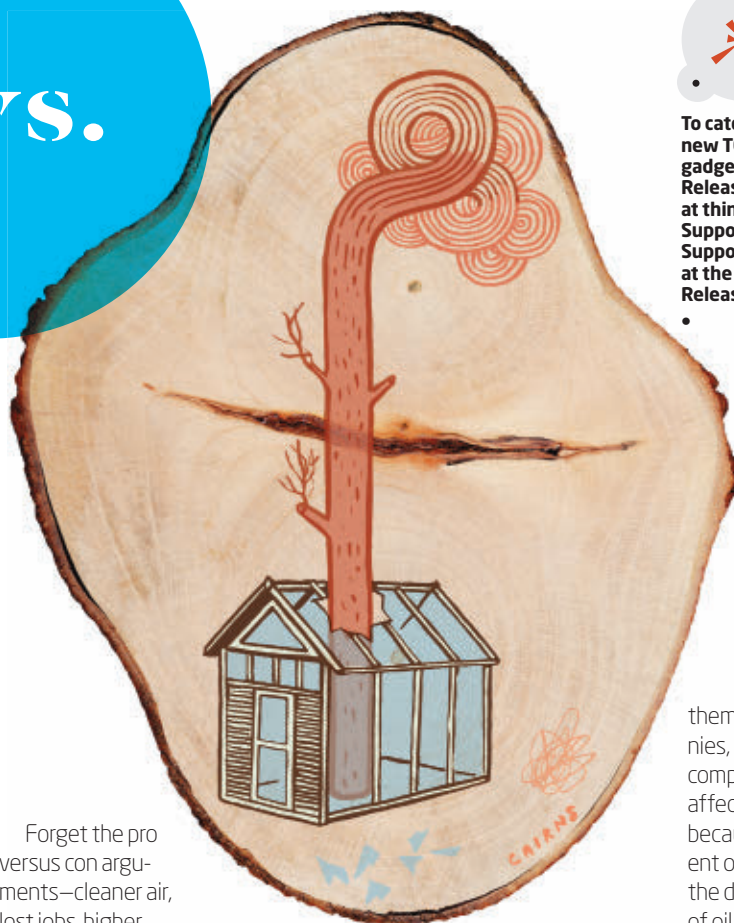
sources (oil, coal, natural gas) become more costly. But the whole solar thing depends heavily on the cost of alternatives. The dollar per watt of a solar panel has to make economic sense to individuals and larger users. And cap and trade won't necessarily affect the price of oil and coal. The technology that utili-

ties, for example, may use to clean their emissions to slide under the cap probably won't have anything to do with solar. The big engineering firms could get some contracts out of this. And if the utilities become more efficient at producing power, they'll use less coal, for example, and the price could come down.

How about the big, consolidated oil companies? Cap and trade is tougher to analyze there. Under the plans being discussed, the government will hand out permits to companies that produce the emissions, but not evenly. Utilities will get more of

them; the oil companies, much less. Each company will be affected differently because of its different operations and the different sources of oil. Companies whose operations are concentrated in the U.S. will likely be hit hardest by the regulations.

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TUNE IN AND TRADE 'EM UP
A BLEND OF RADIO, Q&A, AND LIVE VIDEO INSTRUCTION, RED OPTION'S SWIMCOACH PROVIDES IN-DEPTH EDUCATION FROM SOME OF THE MOST VENERATED TRADERS. LIVE FROM 10:30 A.M. TO 12 P.M. CT DAILY, WATCH US FIND, ANALYZE, AND EXECUTE TRADES. LEARN MORE AT WWW.REDOPTION.COM/SWIMCOACH



Trading Advice from Dick Cheney

I heard you were fading the rally this year. How's it going?

My belief is that the bearish positions will, in fact, become profitable trades when the appropriate forces take control of this market. The positive news is that we appear to be making progress.

Do you use a technical or fundamental or volatility-based approach?

We have analysts from key agencies embedded in the trading structure. This is a multi-faceted

strategy that can respond rapidly to any contingency, anywhere in the world at a moment's notice to deliver a swift, decisive blow.

How are you managing the risk of your positions?

Trading is more than tough talk. The gathering danger must be confronted and dealt with, using force if necessary. The record speaks for itself. Our advance toward reduced risk and higher profitability is all but inevitable. We will persevere and prevail and are willing to take extraordinary measures to achieve the desired results.

Are you doing any actual trades? You sound a bit detached from the process?

Security! Get this down out of here before I crush him!

• This is the part where we make the lawyers happy by disclosing that Dick didn't really talk to us for this interview.

fyi.

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Pot Shots

Top 5 trading ailments not covered by insurance.

KEY:

2 Buy Tickets =



1 Buy Ticket =



1 Sell Ticket =



2 Sell Tickets =



Deltomaceous Transplant



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Gammitis Inflatus



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Hemorhoectomy



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Volorectal Purge




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Gear Head

Cool things to do with what we've got.

tech.

As the markets have taken on a more volatile tone over the past couple of years, more retail traders are looking to either try to take advantage of short-term price movement or to better manage the risk exposure on their medium- and long-term stock and futures trades. We built the new multi-level order bracketing with point, tick, and percent execution points to give these traders more control. The new tools live on the Active Trader section of the Trade page. Let's take a look at them.

Bracketing is the term we use for an OCO order to close a position with a limit order or a stop order (see "The Last Order Standing," page 10, for more information on bracket orders). If I am long 100 shares of XYZ, I could put in a bracket order to sell 100 shares at a higher price with a limit order or sell 100 shares at a lower price with a stop order. But the new multi-level brackets give you a lot more flexibility. If I choose one level, I can create a simple OCO group. If I choose two or three levels, I can set different quantities for different OCO groups that are all tied together. So, if I'm long 300 shares of XYZ, I can create three different OCO groups for, say, 100 shares each. For example, if XYZ is \$50, I could create a multi-level bracket to sell 100 shares at \$51 limit OCO sell 100 shares at \$48 stop, and another to sell 100 shares at \$52 limit OCO sell 100 shares at \$47, and finally sell 100 shares at \$53 OCO



FIGURE 1: To access custom bracket orders for your stock and futures OCOs, click the "Trade" tab, then "Active Trader" in the submenu. Next to "Bracketing" in the upper left, you can choose up to three custom OCOs for your trade.

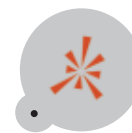
[Profits in Brackets]

Customizing your bracket orders gives you more flexibility than ever.

sell 100 shares at \$46. Or I could set the stop price for all the brackets to \$48, and set the limit orders at successively higher prices. The multi-level brackets let you scale out of positions with combinations of limit, stop, and trailing stop orders. This is helpful if you're trading stocks or futures and want to capture profits as the position moves your way, but have stop orders in place to exit the remaining position if it moves against you.

The ability to customize trigger price for the limit and stop orders in the multi-level brackets expands the functionality to different products. For example, most stock traders think about setting limits and stops in terms of dollars or points in stock, such as selling XYZ at a limit price 1.00 point higher and a stop price 2.00 points lower. But futures traders sometimes like to think in terms of ticks. For example, the CME's E-mini S&P 500 contract, /ES, trades in 0.25 increments, or ticks, in price. Each tick represents \$12.50, and many traders like to base their exit points in terms of ticks of profit or loss. So, a 3-tick stop would exit the position if the price of the /ES future dropped 0.75, which would be a loss of \$37.50. When you're using ticks, it's critical to know how many dollars each tick represents. You don't want to be surprised by a big loss if the tick value of a particular future is larger than you thought.

The percent offset for the bracket orders



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is more often used by stock traders or investors, who want to exit a position if it loses, say, 5% or gains 10%. Using the percent bracket saves you the trouble of having to calculate the price of the stock after that percent change. Keep in mind that the percent offset

rounds to the "nearer" increment because the order has to be sent to the exchange with an actual price, not a percentage, and a percent change could give a price that is in a smaller increment than what the stock or future trades in. For a stop price below, it rounds up to the next higher tradable increment, and for a limit above, it rounds down to the next lower tradable increment.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by emailing thinkorswim@support@thinkorswim.com.

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The Fearless Technician

When technical analysis meets random walk

Fibbing Your Exits

Keep your emotions in check with Fibonacci extensions.

tech.

• My neighbor gets nervous anytime the markets make a new 52-week low.

And, of course, he gets giddy when the markets make a new 52-week high. He's one of the main indicators I use in my own trading. When he gets too excited, I know it's nearly time to get out. But when should I pull the trigger?

One of my favorite tools for exiting trades that are making new 52-week highs or lows are the Fibonacci extensions at 1.272 and 1.618. They help to keep my emotions in check while at the same time providing reasonable targets in what can be a chaotic price-action environment.

While the Getting's Good

On the daily chart of the DIA, we see the markets retesting their prior lows near the end of February. Once they break the lows,



FIGURE 1: FIBONACCI FIX. To set up your Fib extensions, select "Drawings" in the upper right, above the chart, then choose your favorite Fibonacci tools from the list.

the exit strategy is engaged. Just as it's foolish to think a market will rise to infinity, it's also problematic to think that every market breakdown is going to result in price action that goes straight to zero. Yet around this time, pundits were talking about the end of the world. While many people rushed out to buy bullets, gold, and whiskey, others were using an exit-based trading system to capture profits. A solid exit strategy is a key component of consistent trading.

As the markets take out the lows, I draw Fibonacci levels from the prior test of this level in December and retrace it back to its swing high made at the beginning of 2009. From here I derive the 1.272 extension, which comes in around \$69.81, and the 1.618 extension, which prints around \$64.10 (you can add these in using the Edit function). Now, 1.272 may not be a familiar Fib level to some, but I've found that the 1.272 extension has a good probability of getting hit. If that level is reached, I close out half my position and move my stop to my entry level. I then either get out of the rest of my trade at the 1.618 extension (remember, the stock is probably not going to zero) or at my breakeven stop loss.

Hint: other people are also watching these levels. Place your orders out in front so you'll be first in line if and when price action approaches.

A Solid Average

One way to trade shorter time frames with this strategy when the market makes a new high, for example, is to take the move from the low of the day to the breakout point, plot

far between—just ask Joe Torre. It's better to keep going for base hits. I've found that using these Fibonacci extensions keeps me focused on my exits and I don't get too carried away with dreams of shorting a market straight into the ground. Such markets often have the power to bounce back.

John Carter is president of TradeTheMarkets.com. He can be reached at jcarter@tradethemarkets.com.

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the extensions, and pick your targets accordingly.

Many traders make the mistake of trying to turn every trade into a home run. In reality, home runs are few and

Need more Fibonacci? Go to our chat archives at thinkorswim.com, then Support > Options School > Chat Archives. From there type in "Fibonacci."

23

Hey Monkey!

A spattering of our resident primate waxing philosophical and answering your trading questions.

Illustration by
Maxwell Brodén

mky.

Q: Hey, Monkey! How come there are so many different option pricing models?

A: You've heard of them: Black-Scholes, Whaley, Cox-Ross-Rubinstein, Bjerk-sund-Stensland. There are dozens of different option pricing models. And it's not unreasonable to ask, why does the world need more than one? The whole point of a model is that it can tell you the value of an option given some set of inputs like stock price, time to expiration, etc. This is different from some-

thing like put-call parity, which gives you the value of the call if you know the value of the put, and vice versa. The pricing models come in when you don't have either the call or the put to work with. Exchange-traded options come in two styles: American and European. The Black-Scholes model came pretty close to nailing the value of European-style options, and later variants and new models try to fix its issues of discrete dividends, non-constant volatility, and discontinuous asset pricing, to name a few. American-style options, with their possibility of early exercise, are trickier to value. Most of the option pricing models try to estimate the likelihood of early exercise and build this into the value. That's where the math gets hard, and financial engineering types are still working on it. Now, the problem is that some genius may come up with a pricing model that's theoretically really, really good. But the formula is 14 pages long and requires the hand of God to get all the parameters right. (Mortgage derivatives, anyone?) And

even if you do get it right, it translates into a difference of about 0.03 in the value of an option. That makes it very impractical. Trading is nothing if not about practicality. So, even though some models like the Bjerk-sund-Stensland may not be perfect, they're relatively easy to program and very efficient when you have to perform the calculation thousands of times on your advanced options trading platform (ahem, TOS). The final results are pretty damn close. 'Nuff said.

Q: Oh, Monkey. Progress is good, right?

A: Not always, son. I remember the sticky summer night my Mama learned that they switched making gelatin out of ox hooves to pigs' hides. You could hear the wailin' clear to the next county. They called it progress. But Jell-O ain't tasted the same since.

Q: Hey, Monkey! Is it true that short options are unlikely to be assigned before expiration if there is significant time premium left?

A: That is, indeed, the rule of thumb. If you do a search on the



For more Monkey business, daily market wraps, and trading ideas, visit the **MonkeyBrains** blog at thinkorswim.com. Select the top Support tab, then **Monkey-Brains Blog**.

There are dozens of different option pricing models. And it's not unreasonable to ask, why does the world need more than one?

thinkorswim site, you'll find beaucoup info in the archives. But it's mainly an issue of—what else?—cost of carry, and whether the trader who's long an in-the-money option gets an economic benefit from exercising it. The less extrinsic value that in-the-money option has, the more likely it is to be a candidate for early exercise. So, if you're short an in-the-money option, check out the corresponding out-of-the-money option at the same strike. If

that out-of-the-money option is trading at \$0.10 or so, you might be looking at getting hit, as we say, on that short option. With calls, early exercise is a lot more likely when there's a dividend coming up. Don't be scared by this stuff. Just learn as much as you can and go into it with your eyes wide open.

Fortunately, no primates were harmed in the production of this article. The information contained in this article is not intended to be investment advice and is for illustrative purposes only.

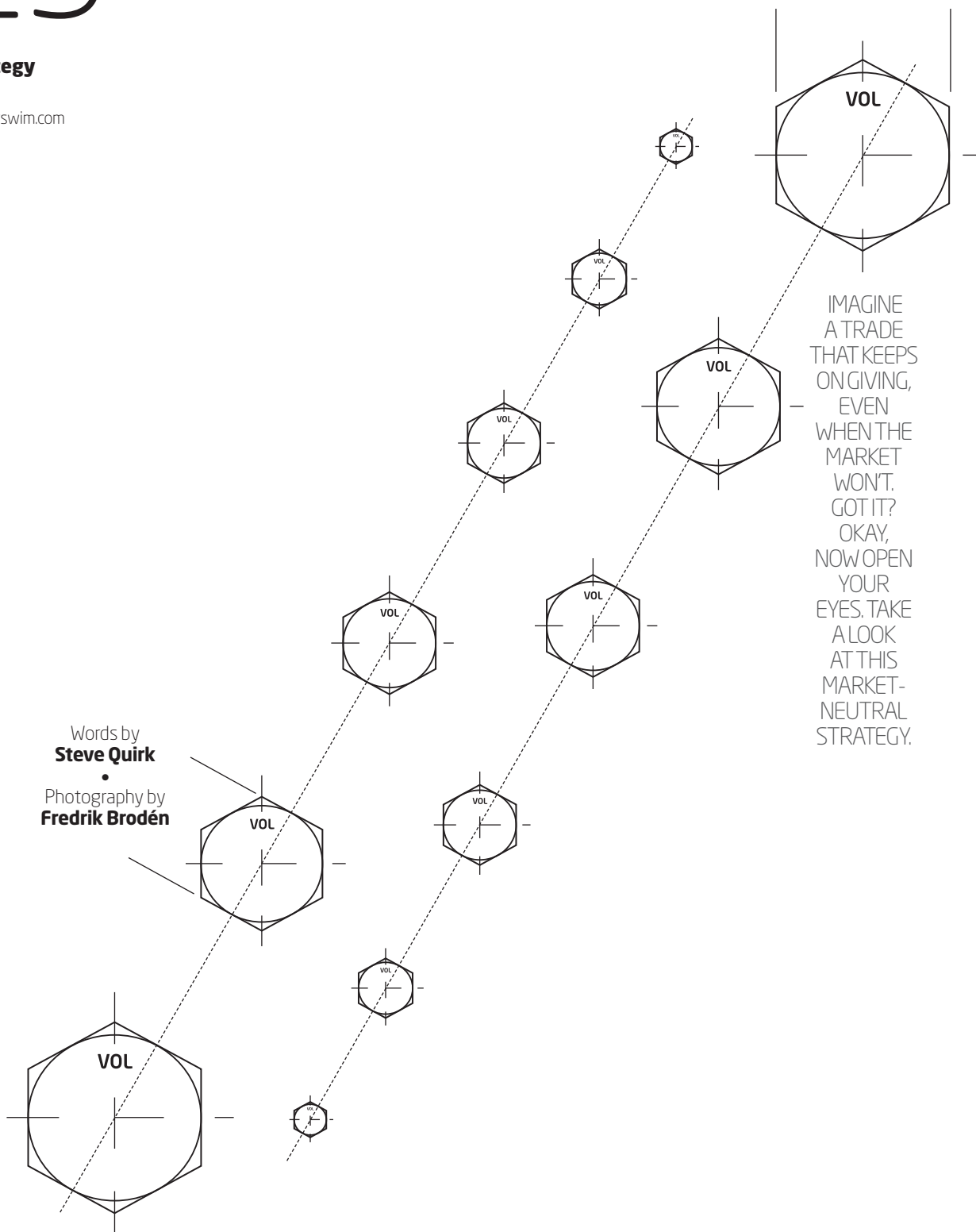


25

Strategy

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KILLING TIME WITH THE DOUBLE DIAGONAL



IMAGINE
A TRADE
THAT KEEPS
ON GIVING,
EVEN
WHEN THE
MARKET
WON'T.
GOT IT?
OKAY,
NOW OPEN
YOUR
EYES. TAKE
A LOOK
AT THIS
MARKET-
NEUTRAL
STRATEGY.

Words by
Steve Quirk

Photography by
Fredrik Brodén

**STRATEGY BOX:**

Short Strangle A market-neutral strategy with unlimited risk, composed of an equal number of short calls and puts of two different strikes, resulting in a credit taken in at the onset of the trade. The strategy assumes the underlying will stay within a certain range, in which case, as time passes and/or volatility drops, the options can be bought back cheaper than the credit taken in, or expire worthless, resulting in a profit. Breakeven points at expiration are calculated by adding the total credit received to the call strike and subtracting the total credit received from the put strike.

Long Strangle A market-neutral, defined-risk position, composed of an equal number of long calls and puts with different strike prices. The strategy assumes the market will break out one way or another, in which case, a profit occurs when one side of the trade gains more than the other side loses. Breakeven points are calculated by adding and subtracting the total debit to and from the strike prices of the options.

Vega The rate of change in the option for each 1% change in implied volatility. The formula is:

$$v = \frac{\partial V}{\partial \sigma}$$

MOST OPTIONS TRADERS START OUT TRADING the markets directionally, enticed by the high-leverage trades for minimal capital. Thus begins a love affair with buying puts or calls, and little thought is given to anything else. Then comes heartbreak when the market doesn't make a big enough move to offset the negative time decay of these trades. With the vengeance of a scorned heart, a trader who lacks the right education might decide to take the opposite approach and start selling naked options. But the risks of that type of trading will soon open the trader's eyes when the crash or unrelenting rally happens.

Properly chastened, the trader may make his way into learning about vertical spreads. And there he sits, wondering whether there is something else. Maybe a trade that doesn't have the crushing negative time decay, or the dramatic swings in profit/loss, and just a little more versatility. The trader who seeks out creative and dynamic ways to harness more of what the market can give (besides going up and down) might eventually discover flexible market-neutral strategies. The double diagonal is one such strategy.

THE BASICS

Double diagonals are a type of trade you can use if you think a stock, index, or ETF will stay in a range. Like other "market-neutral" trades, a double diagonal typically loses money if the stock makes a big move up or down. But if that's the case, what's so special about a double diagonal?

You sometimes hear double diagonals called something else, like a strangle swap, and that can clue you in to how they're set up. A double diagonal is made up of a **short strangle** in a front-month expiration and a **long strangle** in a back-month expiration. Simply put, you sell a strangle in the front month to generate positive time decay, and you buy a strangle (at wider strikes) in the

back month for protection.

Why do you buy the protection in the back month as opposed to the same month that the short options are in? Well, the more time to expiration an option has, the higher the option's **vega**, or sensitivity to changes in implied volatility. If you think that volatility might rise during the life of the trade, then having the positive vega of a double diagonal could be beneficial.

The other point is that if you buy the options in a further expiration, you only have to buy your hedge once. Let's explain that. The short front-month options of a double diagonal provide the positive time decay, which comprises much of the potential profits of the position. When those options get close to expiration, and assuming that the stock price hasn't made a big move up or down, you might be able to buy those short options back for less than you sold them, and "roll" them to the next month. That is, you buy back the short front-month options, and sell the same strike options in the next expiration. Because you need protection for those new, short options, the long options that you bought in that further expiration are already in place. You can save transaction costs in this way.

So, the setup for the double diagonal is that you have to believe that the stock is going to stay in a relatively narrow range between now and the expiration of the long back-month options, and that the volatility of those options is unlikely to drop. ETFs and indices can be candidates for double diagonals because their diversified nature means they are less likely (though there is no guarantee) to have the large price changes that are the enemy of double diagonals.

We generally like to execute double diagonals for credits or small debits. By selling a call and a put in the front month closer to the current price of the stock, ETF, or index, we can accomplish that. The reason is that the bigger the debit of the double diagonal, the more "correct" we have to be in our speculation that the underlying won't move much, and that implied volatility will actually rise. A big debit just makes it harder to trade successfully.

THE SECRET SAUCE

Strike selection for double diagonals is key. The long back-month options are more expensive than the short front-month options, so you try to push the back-month options to further out-of-the-money strikes. But the further away you push the strikes from the strike prices of the short front-month options, the more risk the trade has. That's why you have to balance how close to the money you sell your short strangle and how far away from the money you buy your long strangle. Start by selling options that have a probability of expiring out-of-the-money of between 60% and 70%, then buy the options in



Feeling giddy about the possibilities with double diagonals? For more on this strategy, check out the *thinkMoney* exclusive video at thinkorswim.com/thinkMoney

the back month that are one or two strikes further out.

Let's look at an example of XYZ trading at \$42.50, which we believe will trade in a relatively tight range for two months and whose implied volatility we don't think will drop much. If the January front-month options have about 30 days to expiration, I could sell the 41 put and the 44 call for a \$1.40 credit. That gives me a "window" of about 7% for XYZ to trade in. For a hedge, I'll look to the February options, and would consider either buying the 40 puts and 45 calls, or 39 puts and 46 calls. Whether I go one or two strikes away depends on how much those strangles cost. If the 40/45 strangle were \$1.65, that would mean I would be putting the double diagonal on for a 0.25 debit. That's a little high. If the 39/46 strangle were trading for \$1.20, I could put the double diagonal on for a 0.20 credit. That's a bit more

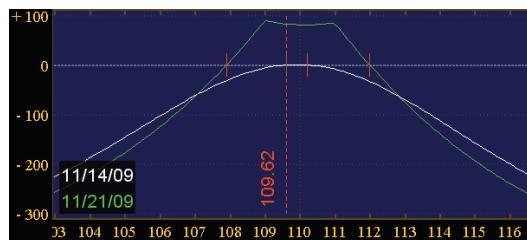


FIGURE 1: DOUBLE DIPPIN'. Risk curve showing the profit potential at expiration of the short options. From there, you can exit the trade, roll out to the next month's options, or let the long strangle you have left just ride.

attractive. But what about the risk?

A double diagonal loses money when the stock moves higher or lower past the strike prices of the long options. In this example, if XYZ is below \$39 or above \$46 at the expiration of the back-month options, the loss will be the difference between the long and short strikes, minus any credit or plus any debit. The max risk of the short 41/44, long 39/45 for a 0.20 credit is \$1.80, or \$180 per spread. Your own risk tolerance versus desire for a larger credit will help you determine the strikes for your double diagonals.

On the face of it, you're probably wondering why a trade with a 0.20 credit and a max risk of \$1.80 makes sense. The breakeven points would be \$40.25 and \$44.50. If XYZ doesn't move much in the next 30 days and stays in between \$41 and \$45, I'll be able to buy back the short front-month strangle and sell the same strikes at the next expiration for a credit. And that credit from the "roll," along with the initial credit of 0.10, makes up the potential profit of the double diagonal.

But a double diagonal can give me a bit of flexibility here. If my opinion of XYZ changes between now and the front-month expiration, I could let the short strangle expire worthless and just hold on to the long back-month strangle if I think XYZ might have a big price change. Or I could roll the short strangle to wider or narrower strikes

ONCE YOU'RE EXPERIENCED WITH DOUBLE DIAGONALS, YOU CAN ADJUST THE STRIKES FOR A BULLISH OR BEARISH BIAS, OR EVEN DO A FEW MORE BACK-MONTH STRANGLES. THIS CAN INCREASE THE RISK, BUT IT ALSO SHOWS YOU HOW VERSATILE DOUBLE DIAGONALS CAN BE.

in the back month. If I thought XYZ might trade in a wider range, I would roll to further out-of-the-money strikes, like the \$40 put and \$45 call. Or if I thought XYZ might trade in a very narrow range, I could roll to the \$42 put and \$43 call. My strike selection determines the credit I receive as well as the max risk. So, I have to analyze the different scenarios very carefully. And keep in mind that trading complex option strategies such as this can generate high commission expenses.

ONCE YOU'RE EXPERIENCED with double diagonals, you can adjust the strikes for a bullish or bearish bias, or even do a few more back-month strangles. A double diagonal typically has the same quantity of short strangles to long strangles, but if I think that the stock, ETF, or index could move dramatically higher or lower, I might do 12 long strangles to 10 short strangles, or something like that. This can increase the overall risk of the position, which is why the technique is for more experienced traders. But it also shows you just how versatile double diagonals can be.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by emailing [thinkorswim at support@thinkorswim.com](mailto:thinkorswim@support@thinkorswim.com).



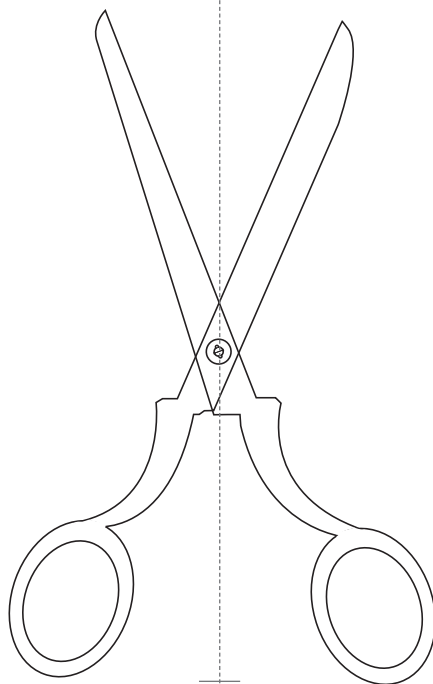
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Analysis

Photograph by
Fredrik Brodén

thinkorswim.com

words by **Thomas Preston**



2
OF A
KIND

IF IT LOOKS LIKE A
DUCK AND QUACKS
LIKE A DUCK,
IT'S PROBABLY A DUCK.
BUT WHAT IF IT
LOOKS LIKE A STOCK
AND TRADES
LIKE ONE, TOO?
YOU MIGHT
BE LOOKING AT A
SYNTHETIC OPTION
POSITION.

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Photograph by
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synthetics, go to the
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From the menu,
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Option School>
Chat Archive,
then type in
"synthetic."

SYNTHETICS.

To some of us, the word conjures up pastel disco suits. Nice. To others, high-performance exercise duds. That's nice, too. But traders can all agree that synthetics are also combinations of options and/or stock that replicate some other position. For example, buying stock and selling a covered call is synthetically equivalent to a naked short put. Buying stock and buying a protective put is equivalent to buying a long call. Buying a call and selling a put is equivalent to buying stock. (For a detailed explanation, visit our Support page at www.thinkorswim.com.)

You may already understand synthetic relationships, and if you're into "book learning," you might realize that there ain't no arbs any more. You may have relegated synthetics into the "thanks, but no thanks" category. This article will show you why synthetics might be worth a second look.

STOCK SURROGATE

Let's start with the most basic trade of all, buying stock. Say you buy 100 shares of XYZ stock for \$120 per share. The total value of that stock is \$12,000. In a regular margin account, you'd need at least \$6,000 of available dollars to put on that position. And if you don't have the cash in your account to cover the \$12K, you'll have to borrow \$6,000 from your broker. Even if you do have the cash, you'll stop earning interest on that money because you spent it buying the stock.

Now let's look at synthetic long stock, which is a long call and a short put at the same strike price and the same expiration and has a risk/reward profile just like long stock itself. Don't believe me? Load it up as a simulated trade on the Analyze page and see for yourself. You can buy the March 120 call for \$2.25 and sell the March 120 put for \$1.75 and make money if XYZ goes up, and lose money if XYZ goes down. But why would you want to do this?

First, you bought the call and sold the put (known as buying the "combo") for a \$0.50 debit. Not including commissions, \$50 came out of your cash balance. With the stock trade? \$12,000. You're either not borrowing money, or you're still earning interest on that cash.

Second, although you know that Reg-T margin requirements won't let you have the same risk exposure as \$12,000 worth of stock and hold only \$50 in your account, the margin requirement for the combo is less. The margin on the combo is the margin on the short put, which in this case is 20% of the underlying stock value minus any out-of-the-money amount. That comes to \$2,400.



SYNTHETICS ARE COMBINATIONS OF OPTIONS AND/OR STOCK THAT REPLICATE SOME OTHER POSITION. YOU MAY HAVE RELEGATED SYNTHETICS INTO THE "THANKS, BUT NO THANKS" CATEGORY, BUT HERE'S WHY SYNTHETICS MIGHT BE WORTH A SECOND LOOK.

So, \$50 versus \$12,000 cash. And \$2,400 versus \$6,000 margin requirement. The combo is 2-for-2 so far. But the commission on the combo is two option orders, which in this case would be about \$5.90, compared to \$5.00 to buy the stock. And the combo won't receive any dividends that the stock might pay. If the combo is now 2-for-4, how do you weigh the pros and cons?

The commissions on the combo trade can be much higher, depending on your commission structure. But as a percentage of the risk of the position, the commissions represent a small fraction of the risk and potential reward you're getting. In this case, commissions aren't likely to make or break the trade.

And dividends? They're nice because they can offset the interest expense when you buy the stock. But you have to hold it through the ex-dividend date, which you may or may not want to do, and the interest you are charged is often greater than the dividend you might get.

FINANCIAL ADVANTAGE?

You're smart, though, and you realize that the combo is priced in such a way as to incorporate the interest you pay and the dividends you receive on long stock. That's why there's no arb to trade the combo versus the stock. In a purely academic world, there's no financial benefit to trading the combo over the stock. That's true, but only in the academic world are every trader's borrowing and lending rates equal. In the hyper-real world of trading, your borrowing rates as a retail trader are typically much higher than a market maker's rates. The combo is priced in the open market, based largely on the market maker's rates. That's the rate you would be paying if you buy the combo. But your borrowing rate as a retail trader is a broker call. In the XYZ example, your interest cost if you buy the combo is that \$0.50 debit. But if broker call is 8%, for example, and you hold the stock for three months, you would pay \$240 in interest. In this case, the combo would make more financial sense.

In addition to that, you have to consider the benefit of the reduced amount of capital you have to allocate to get that long stock exposure using the combo. Don't make the risk management mistake of thinking that you should now put on more combos because they use less capital. Each combo has the same amount of risk that 100 shares has. Put on only as many combos as you would buy stock. But the capital you don't use to buy stock can be used to either hold in reserve, or to buy combos in other stock to diversify. (Diversification can be good, but understand that you are taking on more risk.)

ADDED FLEXIBILITY

Speaking of risk, you can even manage the synthetic stock as you would regular stock with stop or conditional orders. But you actually have more flexibility with the combo. If the stock drops and you're sucking wind on your long combo but think the stock might move back up, you

can buy back some of your short puts to reduce the risk of the position. You'll still have the long out-of-the-money calls that could benefit if the stock rallies back.

If the stock rallies, you can look for an opportunity to buy the short puts back for less than you sold them for. Doing that frees up capital, because it's the short put that creates the margin requirement on the syn-

thetic stock. That would leave your in-the-money call, which you could also hedge in a number of ways. But the short put isn't a hedge to long calls, so it would be prudent to buy that short put back if it's far out-of-the-money and can't really provide much benefit for the risk that it presents. If that happens, you can basically be left with the long calls for a small price. If you establish the combo for a small debit, the call and the put will have roughly equal prices. If you buy the short put back for a small debit, that's capturing profit on the short put. Any profit offsets the risk of that long call.

WHAT ABOUT COST OF CARRY?

You can take the cost-of-carry analysis of synthetics even further. If I wanted to buy an out-of-the-money call to hedge a position, I could buy one for 0.10 if the bid/ask of the option was 0.05 – 0.10. If the stock stayed where it was and I wanted to take the hedge off, I could probably sell it at 0.05 and lose \$5.00 per contract, plus commissions. But if the stock dropped, the bid of that call might go to 0.00, and I would basically lose the full 0.10, or \$10 per contract. But if I could buy the in-the-money put for parity (when the option trades at the stock's intrinsic value) and buy the stock, I'd have on the long call synthetically. Sure, I'd have to pay interest on that long stock position, and I'd need the capital to be able to put it on.

Why would I do it, then? The interest is charged daily, so if I don't hold the synthetic until expiration, I won't pay the full cost of carry. Let's say carry is 0.01 per day. If I hold the synthetic call for 5 days, that's 0.05 or \$5.00. If the stock moves up at that time, my synthetic long call could go up in value. If the stock drops, I can exercise my long put and close the position. If I do that, I lose the \$5.00 in interest that I paid to hold it. But my long call is 0.00 bid, even with some time left to expiration! Here, the long call loses \$10.00, and the synthetic loses \$5.00. This isn't something most retail traders would ever do, and I used to do it only once in a while as a floor trader. But I think it's fun being able to think about options this way, and you never know when that knowledge might come in handy.

Synthetics aren't magic, and the success of synthetic stock in particular is determined mainly by your ability to pick the stock's direction. Academically speaking, while there may not be a financial advantage to trading synthetic stock, there still may be other rewards for doing so. Being smarter about synthetics can help you trade smarter. And that's never a bad thing.

- *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting thinkorswim at support@thinkorswim.com.*

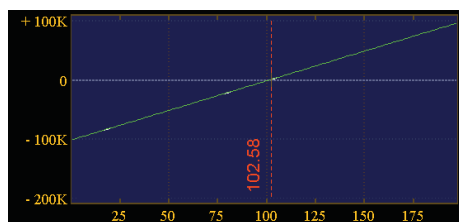


FIGURE 1: Is it a duck? Though this may look like the risk graph of 1,000 shares of long stock position (risk to zero with unlimited reward), it happens to be a combo (long call, short put) on a stock at \$102.58. Notice the difference? Probably not.

Data source: thinkorswim

OPTIONS



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Q + A:

Lunch with...

Tom Sosnoff's Mom

(Not necessarily) a real interview with a market VIP

Illustration by **Evonrude**

TOS: Wow, Mrs. S., thanks for taking the time to meet! I can see the family resemblance.

TM: Oh, you're being too nice. Tommy has such lovely curls. I wish he'd stop hiding them under that beret. Or wash the thing once in a while, you know?! Is he reading this?

TOS: Not sure. I see you're using iSwim. How long have you been trading?

TM: Only forever. I remember trading in the old days. Calling my broker on the phone. Stale quotes. Waiting and waiting for a damn fill.

Thank God for 3G and smart programmers.

TOS: So your son has trading in his blood! Was he making market calls as a toddler?

TM: Hardly. It was all I could do to keep his finger out of his nose. But once, when Tommy was little, I was trading GE. Size, mind you. And I'm out walking Tommy in the stroller, and I have a hunch that I should lighten up the position, so I look for a pay phone. I find one, but Tommy starts screaming bloody murder, so I pick him up and I'm making the call. And I'm working orders with my broker and I needed to write something down and I'm trying to find a pen in my purse, and what happens? I drop the kid. Tommy slips right out and falls on the pavement. His head bounced right off it. And I'm thinking, Oh God! I killed my baby! But then I'm thinking, I'm making a fortune in GE! I was, as they say, conflicted. He stopped crying, though.

TOS: That would explain a few things. But you must have encouraged trading in him at some point, no?

TM: Oh, no. I wanted an intellectual in the family! Someone to lighten up the parties. Art

camp in summer. A subscription to the *New Yorker*. Dance lessons. I did everything I could. And what does he do? Moves to the Midwest and gets into trading. Why do you have to break your own mother's heart? Would it kill you to read a book once in a while?

TOS: Dance lessons?

TM: Oh, sure. Jazz and tap. He's so lithe. Beautiful form.

TOS: Tom Sosnoff ... lithe? ... I'll take your word for it.

TM: Hang on ... they're pumping vol ahead of the number ... do I fade this? Ah, hell. Why not.

TOS: But trading clicked for him eventually, right?

TM: Believe me, it was a long road. Back in '81 Tommy calls me up and he's kind of whimpering. And he says, "Mama, I don't know if I can do this. All the numbers and the prices and the up and the down ..." So I ask, "Tommy, do you know what a bid is?" and he says, "Um, yeah ..." and I ask, "Do you know what do to with a bid?" and he's kind of sniffing and he says, "Um, no ..." and I say, "Tommy, when you see a bid, you HIT IT!!" And the next week he calls me and he's so happy with himself. He tells me

For the record, the interview that took place here was actually between the writer and his twisted alter ego, not really Tom's mom. But had one taken place, we're pretty sure it would have been worse. Much worse.

he's been hitting the bids and was actually up a couple bucks. And I just sigh. Does this mean I don't have to send him any more checks to help with the rent?

TOS: Well, have you?

TM: Funny you should ask. He's been getting shellacked in this rally. Poor kid. He calls me up the other day, with that same kind of sniffle. "You still short?" I ask. And he says, "Um, yeah." And I say, "Do you need a little something this month?" and he says, "I guess so." A mother knows. So, I send the kid a check. I just hope he uses a little of it to buy himself a clean shirt.

TOS: So he calls you regularly?

TM: He's a good boy. But I make sure he keeps his nose clean. When Wall Street melted down, all I could think about was how horrible it would be to see my baby's face on the evening news. Can Katie Couric even pronounce "Sosnoff"? What a mother goes through ...

TOS: You have our sympathies.

TM: Okay, shoo. I have to trade now.



thinkMoney/08

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FOCUS:
**technical
analysis**

Special Focus:
Technical Analysis

Photograph by
Fredrik Brodén

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FIVE NO-NOS in TECHNICAL ANALYSIS

It's never too late to learn what
not to do when it comes to
reading charts.

words by **Matt Blackman**





Special Focus: Technical Analysis

Photograph by
Fredrik Brodén

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• Few will dispute that the credit crisis has changed markets forever. Many investors were forced to learn the painful lesson that in times of trouble, a carefully diversified portfolio can suffer the same fate as one concentrated in several indexes or exchange-traded funds (ETFs). When the correlation of various sectors and assets classes moves toward a value of one, and the proverbial manure hits the fan, everything drops together.

The crisis reduced household wealth by 15%, or \$13 trillion*. It also significantly affected investment holding periods—which is one of the ways we measure risk. Gone are the days of buying an index or ETF and forgetting about it for months or even years.

PLAYING HOT POTATO

In 1960, the average stock position holding time (or time-in-trade) on the New York Stock Exchange was 100 months based on a 12% stock turnover rate annually, according to the NYSE Group Factbook. Today, the annual turnover rate is 141%, which translates to an average holding period of 9 months**. History shows that with each new bear market, the average times-in-trade shrink. The more severe the correction, the further they decline.

Interestingly, and contrary to the advice we continually hear from investment money managers to hold for the long haul, brokerage houses have shorter time horizons than their clients. According to the latest data from NYSE, the holding periods of *brokerage firms* ranged from a high of 9.4 months to a low of just 2.5 months for failed broker Lehman Brothers just before it collapsed.

Since the 1990s, when the average retail client held his investments for 26 months, the time-in-trade has been cut by two-thirds. Increasing volatility is one big reason; it has proven to be a real game-changer, and investment strategies are the game it changed. Gone, it would seem, is the fundamentals-based, buy-and-hold approach. Welcome to the brave new technical trading world.

The time horizon is the key difference between fundamental investing, which relies on earnings reports and financial statements, and technical trading, which relies strictly on price movement and momentum with the help of technical indicators (e.g., charts).

Fundamentals tend to lag the market, so they often

require years and long-term trends to make money. Technical trades generally last from a few minutes to a few weeks, but rarely longer. A trader stays in a trade as long as it is profitable and sticks to a specific trading envelope. Once that envelope is broken and the trend changes direction, the trader beats a hasty exit. Ignore an exit signal or “stop-loss,” and the trade can quickly turn into a loser. Discipline and a strict adherence to a written trading plan with a set of rules are absolutely essential for staying in the game.

FIVE NO-NOS

We put together a list of five mistakes that traders new to technical analysis commonly make. If you can avoid them, they should increase your chances of success. Remember that technical-based trading systems take advantage of small market inefficiencies. These efficiencies only generate profits as long as they exist.

No-No 1: Applying the wrong strategy at the wrong time.

There are two major types of markets: trending and trading ranges. In a trending market, trendline analysis combined with a moving average crossover system can work well. The trader buys when prices weaken and fall to the trendline (buys on dips) and stays in the trade as long as trendline support holds and prices are moving up. In a trading-range market, however, a better system might rely on entering and exiting the markets at short-term extremes through the use of momentum indicators or oscillators, such as those measuring relative strength. Depending on your time horizon, markets trend between 25% and 35% of the time. The rest of the time they are trading range-bound, vacillating up and down and exhibiting little apparent overall direction. Techniques that work in one will usually fail miserably in the other. For example, using a moving-average crossover system in a trading-range-bound market can be an expensive mistake, regularly whipsawing the trader in and out of losing trades. Likewise, using a mean-reversion system that gets you into or out of the market at short-term extremes can be equally costly in a trending market, as it will get you out too early and in too late.

No-No 2: Relying on a single indicator.

In technical trading, confirmation is key. Relying on one indicator, or indicators that use the same set of data points, to make a trading decision can be risky. Confirmation from two or more different indicators is a requirement—not a luxury. For example, the Relative Strength Index (RSI) relies on the relationship of an issue's high, low, open, and close over a specific period. When the index moves above 30, a buy signal is issued, and when it moves below 70, it's time to sell. The stochastic indicator looks at these same data points (high, low, open, and close) differently, but it uses

FIGURE 1: KISS. Using one indicator may not provide enough information to make critical trading decisions, but use too many, and you'll die on the vine with analysis paralysis. Finding the right balance may take time, but as they say, practice makes perfect. **Data sources:** TOS Charts, thinkorswim





using a written trading plan. Experienced traders use real money only when the probability for success is known and risks for loss are considered acceptable.

No-No 4: Ignoring the effect of volume (and trading low-volume issues).

Another common mistake both traders and investors make is focusing on the next big home run instead of concentrating their search on high-probability trades.

Imagine a game in which players are given 20 pennies and asked to throw them in a bucket. The rules: Sink the penny from one foot and get one penny plus your original penny back. Sink it from two feet and get two pennies, three feet and get three pennies, and so on. Those lucky (or skilled) enough to sink a penny from 20 feet earn twenty cents. When we saw this test conducted in a seminar room full of traders a while back, the vast majority started at two or three feet out, then moved back with each successful throw. The problem was that they *did not step closer* each time they missed. Some started from 20 feet and quickly lost all their money. However, a few stood at one foot and threw all 20 pennies from there, doubling their money in twenty throws. They were the winners.

Think of the lottery. The idea of investing a few dollars and making millions is always compelling. But investing or trading a new speculative stock touting a new technology, product, or service that trades for cheap is like trying to sink your pennies into a bucket

20 feet away. As with the probability of winning a lottery, the chances of finding a stock that's cheap and that ultimately zooms into the stratosphere are slim indeed.

But ignoring the fact that this approach has a snowball's chance in a hot tub of success for a moment, the major problem from a technical trading perspective is that *low-volume issues make poor trading candidates*. Technical analysis rarely works on speculative, low-volume issues. It works best on indexes, exchange-traded funds (ETFs), futures, or currencies that experience high trading volumes. High volume minimizes the spread between bid and ask prices and make entering and exiting trades faster and less expensive (minimum slippage).

No-No 5: Assuming what works on an index, ETF, or commodity will also work on a stock.

This point is a continuation of the last one. Technical trading relies on having wide participation from a cross-section of people with different opinions, strategies, and time horizons. Domination of a market by a minority of investors, market makers, or "big hands" reduces the effectiveness of a technical trading system. The higher the volume, the better the chance that the issue has wide participation by a disparate crowd of traders and investors and is therefore a good trading candidate. If you're only trading stocks using a technically based system, you're probably missing the bigger picture.

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For mountains of info on technical analysis, visit the Option School at thinkorswim.com > Support > Option School > Chat Archives. Type in "technical analysis," and you're golden.

the same data points nonetheless. A system that uses the RSI and stochastic indicator to confirm a trading decision really isn't confirmation at all, since they rely on similar information. Using the RSI together with a volume-based indicator like the Money Flow Index, for example, provides a more complete picture of what is going on.

No-No 3: Going too big, too soon.

In trading, patience is not only a luxury but a requirement. Jumping in with both feet and trading real money or taking large positions is a common "newbie" mistake.

Discovering a new trading system or indicator can be an exciting prospect. The first impulse is to apply it in the market and start making a bundle, but this can be costly. Any new strategy (which includes one that's new to you) should be thoroughly tested first on a set of historic data (in-sample) and then re-tested on a different set of data (out-of-sample) using a simulated trading account such as paperMoney®. (See "So You Wanna Be a Trader," thinkMoney/07). Too many neophyte traders start trading real money before sufficiently testing and re-testing a system and fully understanding its risks. The results can be disastrous, especially when the trader plays the game without

Special Focus: Technical Analysis

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PROTECT YOUR CASH, NOT YOUR EGO

(Continued from page 37) If recent history has taught us anything, it is the value of avoiding major market drops. Those who suffered a 50% drop in the value of their portfolios will need to generate a return of 100% just to get back to breakeven, and that takes considerable time and involves a fair degree of risk. It is critical to cut your losses quickly when stocks drop so as not to suffer a catastrophic setback while holding a position at all costs. In trading, there's no such thing as selling too soon.

Although this list is by no means complete, and avoiding these five mistakes does not guarantee success, it is a good start. But one thing seems clear: Highly volatile markets could be here to stay, rendering the traditional buy-and-hold strategy a relic of the past. This new environment requires a carefully disciplined and methodical approach. If you're implementing technical analysis in your trading system, avoiding these five mistakes is an important step in your journey to becoming a successful investor in the face of a new set of rules.

See Also

***Willis, Bob** [2009]. "Gain in U.S. Household Wealth Will Help Ease Strain on Spending," Bloomberg (www.bloomberg.com), September 18.

****Moscovitz, Ilan** [2009]. "The Coming Financial Time Bomb," The Motley Fool (www.fool.com), September 19.

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How to TA in TOS



FIGURE 1: Charting Your Course. Starting from the top right, you can create hundreds of combinations of charts using all the various indicators, drawing tools, and chart types. Source: TOS Charts, thinkDesktop.

tos.

- Every trader has her own way of finding opportunities. For some, technical analysis is

everything. Others dig through balance sheets and income statements. And perhaps even farther down the food chain, there are those who "watch the tape" and just trade from their gut. Whatever you choose, as long as you follow a consistent set of rules and don't cherry-pick your system each time, there's no "right" or "wrong" way. But if you choose to chart your course, there's an easy way to do so using your TOS Charts, with a seemingly endless combination of indicators. Let's do a simple 1-2-3:

1. Pick Your Chart Type

TOS Charts are loaded with a ton of indicators to suit even the most discerning tastes. The first step is to click the Charts tab in your trading platform. Enter the symbol of the stock you want to chart in the fill-in box on the left. By default, the basic chart includes the price and volume charts. To choose your preferred chart style (bars, candles, and so on), click the Style tab on the top right side of the TOS platform window. Chart style is the fourth option. Click it to open and choose your preferred chart type. At the same time you can add the information you'd like included on the chart, as well as your preferred background, volume, and

price bar colors. When you're finished, click Apply to close the option window.

2. Pick Your Indicators

To add an indicator (see point 1 on the chart), click the Studies tab to the right of the Style tab. (Hint: you can also access any of these tabs by right-clicking anywhere on the chart and left-clicking the appropriate option in the drop-down menu.) Now move your mouse over either the Quick Study or Add Study options (2). For our purposes, we'll choose Momentum Studies (3) from the Add Study option and choose the RSI (Relative Strength Index) indicator. Move your mouse over the R-W drop-down, and another drop box will open with the choices in alphabetical order. Next we choose the RSI Wilder Legacy. You will see the indicator open in the bottom sub-graph (4).

To change colors and parameters such as the top (sell) and bottom (buy) trigger lines, click Edit Studies from the Studies drop-down box. Then click the RSI Wilder Legacy option in the top right side of the window and you will see the various parameters on the indicator. Default settings can be changed to your setting preference.

3. Pick Your Trigger Points

So how do you know when the charts are telling you to get in and out? That, of course, is the million-dollar question. While we can give you bells and whistles, you still have to figure out how to interpret them on your own. And you can believe that in the world of trading, one trader's entry is another's exit. Hopefully, with a little practice (and patience), you'll find a chart setup that works well with your personal trading style and risk tolerance. But when you do, don't make the mistake of thinking you've found the magic bullet. As the markets are forever changing, so go the rules.

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TECHNICAL ANALYSIS

Q + A:



Q:

What are the key differences between trending and range-bound markets, and why don't the same indicators work in both?

A:

Trends are what investors hope for when buying or short-selling indexes, exchange-traded funds (ETFs), options, futures, or currencies. They are betting that prices will either continue in the same direction (trend) or that a reversal (change of trend) is in the cards. Short-term traders require shorter-term trends, but a majority of systems are trend-based for one reason: they are better for making money. And depending on your time horizon, markets trend between 25% and 35% of the time. The rest of the time, prices fluctuate between interim highs and lows known as trading-range or "neutral" markets. This opens

up a lot of opportunities for option spread traders.

Technical indicators can be broken down into two basic groups—those that work best in trends and those that work better in trading-range markets. If trendlines and moving averages are used to trade range-bound markets, whipsaws (quick up-and-down moves) create losses that build up the longer you remain in the market. Likewise, if you try to use trading-range indicators (or oscillators) such as the RSI or stochastics in a strongly trending market, you may tend to exit the markets too soon and enter too late.

Q:

Why does technical analysis work better on indexes than individual stocks?

A:

Pure technical analysts don't generally care about fundamentals or news. They are strictly concerned with price and volume movement, from which they

draw their own conclusions on whether to trade. Technical analysis relies on measuring crowd behavior. In other words, the technical trader focuses his or her efforts on watching how the "crowd" is reacting to news or fundamentals at a point in time, as opposed to the news itself. Indexes and ETFs generally have a large number of participants that include many disparate groups. The more diverse the participants, the better technical analysis works—at least in theory.

Q:

What is the minimum trading volume an index should have before it can be considered a reasonable trading candidate?

A:

There is no magic amount of volume recommended. That depends on the index and whether its traders and investors are diverse or specialized, highly knowledgeable, and capable of pushing prices in a direction based on "inside" or specialized information not available to the crowd. The general rule here is the higher the average daily volume, the better.

Q:

You say that technical trading systems take advantage of small market inefficiencies. But the efficient market hypothesis (EMH) says that all markets are efficient. Can you explain the inconsistency between these two statements?

A:

To put it briefly, the EMH says that markets are efficient and that all the factors that influence price are "known" at a given time. It also implies that emotions and opinions (which are not necessarily based on facts) are a minor factor and thus unimportant. This flies in the face of technical analysis theory, which says that markets are highly affected by fear, greed, hope, and hype. It is clear that markets cannot be both efficient and highly emotional (emotions are anything but efficient) at the same time. Another problem with the EMH is that it does not explain bubbles and busts, which would not occur in efficient markets. This is one of its biggest flaws. Successful technical traders will see the EMH as a theory that's not supported by market reality.

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Capiche?

Lessons from a veteran floor trader

• So, I finish up what I consider one of my better classes, showing a bunch of customers how an old pro used to do it. Now, a “Bat” option class isn’t like other option classes. No. My lessons stick. That’s because I tell people how it really is. And I let people know that market makers don’t make mistakes.

Options are fairly priced. If you think you see money lying on the floor, don’t pick it up. Chances are you’re getting into a trade that you understand a lot less than a market maker does.

So, I ask if there are any questions. One hand pops up. One hand. And this guy asks if all these smart market makers are making money, and they’re taking the other side of customers’ trades, how can the customer possibly make money? Trading is a zero-sum game, right? Well, no. Most retail traders think that if I buy something and you sell something, one of us will make money and one of us will lose money. The stock or option or future or whatever will go up or down, and only one of us can be right. But that assumes that each of us doesn’t do something else on the side. Here are a few scenarios:

Myth Buster One Say you buy a call, which means the market maker sells the call to you. If the stock goes up, you make money and the market maker loses money, right? That’s where the theory starts to fall apart. When a market maker sells you that call, he or she hedges it immediately. She’s short a call? She buys stock as a hedge. Now, you’re still long the call, but the market maker is short the call and long the stock. Let’s assume the stock goes up, and your call goes up in value as well. The market maker who’s short that call is losing money on it, but is making money on the

long stock. It’s possible for the profit on the long stock to exceed the loss on the short call. In that case, you make money on your position, and the market maker makes money on her position, too.

Myth Buster Two Let’s say the stock goes down. She’s short a call, and makes money on that, but she’s long stock, too, and loses money on that—probably more than what she made on the short call. You own that long call, and you lose when the stock goes down. You both lose! The difference is that she started out with the opposite of the trade you had, but she changed it into something else.

Myth Buster Three Now say you actually listened during class and get some fills in between the bid/ask spread, maybe trading against another retail trader who’s trying to sell in the middle of the spread when you’re trying to buy. That customer is closing out a long call for a profit, and you’re buying it from

him. If it goes up, you can sell it for a profit, too. And if there was a market maker who sold the call originally to the first customer? If she hedges the short call with long stock, she can minimize her losses even after she buys it from you when you close out your long call!

On the Other Hand So, the markets aren’t really a zero-sum game when you look at two independent traders taking opposite sides of a trade. Each can hedge or adjust the position without the other trader doing anything.

Now, if you look at *all* the traders and investors out there in aggregate, trading is a zero-sum game, minus commissions and fees and all that. When the market maker buys the stock as a hedge against her short call, someone else is selling that stock to her. If the stock goes up, the person who sold the stock misses out on the profits. So, the zero-sum

theory works in the grand scheme of the markets, but not necessarily on the trader-versus-trader level.

Where does this leave you? Pick your trades carefully and make sure they make sense to you. Let the other guys worry about their own profit/loss ratios. You just have to worry about yours.

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The Myth of Zero Sum

cap.

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

Is one trader’s gain another’s loss? Maybe not.

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Forex for Fun

And you thought we were just for option traders.

fun.

• Among traders, technical (charts) and fundamental (economics) analysis are typically considered as separate as church and state. However, in all markets there are both technical and fundamental factors that can be used to identify trading opportunities. Despite the technical slant that most short-term forex traders prefer, the forex market happens to be one of the most transparent where fundamentals are concerned. Fundamental announcements are planned months in advance, are generated by government entities without ulterior motives (wink), and are based on huge macroeconomic events that are almost impossible to manipulate.

Now, whether or not you believe those last few statements, believe this: both news events and price action are highly correlated in the forex markets and can be mutually beneficial. This can be shown mathematically, especially in intermarket correlations where one asset class directly affects the price of another.

Here is a quick list of some of the intermarket correlations that are universally accepted as consistent and relevant: banking and the Swiss franc; oil prices (and oil companies) and the British pound; the Nikkei and the Japanese yen; commodity prices and the Canadian dollar; and gold and the Australian dollar (aussie). Historically speaking, as these intermarkets have done well, the demand and price for the

Words by **Blake Young**,
INVESTools Instructor



FIGURE 1: To set up a correlation study, at the top right of the chart, click "Studies," then "Edit Studies." Select Correlation from the left menu. Select it in the list of Added Studies and change your inputs in the Properties box below.

Charts and News: An Unlikely Match

When two trading philosophies disagree, let the math decide.

related currencies have also done well.

This is all well and good, but how do we know when it's appropriate to include these intermarket correlations in trade setups and when not to? Here's where the charts can help.

Do the Math

Figure 1 is a chart that correlates the AUD/USD to gold prices (/GC). In the past six months, gold and the aussie have seen a 50% or better correlation 72% of the time. (This basically means when gold moves, the aussie usually does, too.) We can use this to our advantage to not only look for trends in gold to support the aussie, but also to find overextensions of gold prices and pullbacks to similarly affect the currency.

When do we pay attention to rising and falling gold price for our aussie-sensitive trades? When the correlation reading is 50% or higher. Our chart shows that the correlation is currently higher than 94%. Based on this, now is a good time to make fundamentals an integral part of our analysis. If gold continues to run, it's highly likely we can expect to see



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the AUD/USD to continue to run as well. And likewise, a sell-off in gold will likely mean a drop in the AUD/USD at a relatively equal move to gold.

The closer the correlation is to the zero line, the less impact the intermarket correlation is having on the currencies. When the correlation doesn't exist, the intermarket moves will have about as much impact on your trade results as your fantasy football team's recent victory will on your dating prospects.

The risk of loss in trading forex can be substantial. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Trading foreign exchange on margin carries a high level of risk, as well as its own unique risk factors. Please read the following risk disclosure before considering the trading of this product: Forex Risk Disclosure (www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf). Forex investments are subject to counter-party risk, as there is no central clearing organization for forex trades. thinkorswim is compensated through a portion of the forex dealing spread. Funds deposited into an account with a broker-dealer for investment in any currency, or which are the proceeds of a currency position, or any currency in an account with a broker-dealer, are not protected by the Securities Investor Protection Corporation (SIPC).

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The Last Page

Photograph by
Fredrik Brodén

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MONKEY! NO!

Trader see, Monkey do...
How NOT to lighten up the
company holiday party.

- Attempt an intellectual debate with drunks to prove that humans are more evolved than apes, and slap them when they fail.

- Swing from the chandelier to show off your Brazilian wax job.

- Ask the marketing manager's husband if he's ever been "interested" in monkeys.

- Make an over/under market on how many apple-tinis it will take to put the CFO under the table.

- Sift through the "Toys for Tots" basket for a gift you forgot to buy for your mom.

- Give Santa a lap dance.

(Warning: Don't try these at your own party unless you can trade like the Monkey.)



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