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random musings for traders  
at TD Ameritrade  
Fall 2010



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Photograph by  
**Fredrik Brodén**

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**p. 10**

**ARE MARKETS RANDOM?**

Thousands of traders pore through charts and balance sheets in an attempt to gain an edge. And then there are those who claim it's all blind luck. So who's right?



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Cover photograph by  
**Fredrik Brodén**

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## Features



## 10/Markets are Random, Your Portfolio Shouldn't Be

There are fundamental traders and technical traders. Then there's a third group—random walkers—who think predicting markets is tantamount to driving by looking in a rearview mirror. So, who's right? It's all about discipline.



## 22/Collars, Conversions, and Clarity

They're largely misunderstood, yet some of the savviest investors saved their derrieres using them when their stocks tanked at the beginning and end of the last decade. What are collars, how do they work, and can traders really benefit from them?

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## 08/A Quick Howdy



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Long-term investors worry about volatility. But traders relish it. And these days, it seems there are two culprits of volatility that shake up the markets daily—economic releases and the Fed. This time we take on the Fed, what the numbers mean, and how to trade them.



## 15/Love Notes



## 34/Futures Special TO HEDGE OR SPECULATE?... THAT IS THE QUESTION

Futures aren't just about hogs, logs, and orange juice anymore. They've earned their place among equity options as a legit means to speculate or protect yourself. Technology makes it easy to get started, but there are still caveats.

### PLUS:

**STRATEGY FOCUS** Tips for trading futures on your platform

**FUTURES TRADING Q&A** What we couldn't fit in the other articles, but you're probably still asking.



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## 33/Where Is It?

If spread orders have you confused on the thinkorswim from TD Ameritrade platform, we have answers.



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## 40/Gear Head

Show your colleagues what "after-hours" is really all about with new trading tools on the thinkorswim from TD Ameritrade platform.



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Our resident trading guru is back to dish advice on trading, the markets, and life's burning questions.



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## Here We Go Again

• Don't be fooled by the title. We're not going to hit you with chatter about double-dip recessions or end-of-year market postulations. We'll let the business media wrangle over those tidbits on their own. After all, this is a trading magazine! And traders, who—for the most part—are more concerned with shorter time horizons, probably care less about where the markets will be this time next year than most long-term investors. Besides, a market prediction is just a number, not a milestone. What matters more than ROI to a trader is P/L. In other words, when you count up your trades at the

end of the day, month, or year, do you win more than you lose?

Although there are thousands (maybe millions?) of opinions about how to predict where markets are going, most rely on fundamental and technical analysis to evaluate ripe opportunities for the picking. However, there's a school of thought that largely dismisses both disciplines. Loyalists of "random walk" believe that markets cannot be predicted at all, but they can be profitable—even if the odds are no better than a coin-toss. Our cover story on page 10 reveals just how.

Now, we know there's a chance you may be living a double life both as a trader and investor, and may actually own a few (gasp) long-term stock holdings. However, aside from the plain-vanilla long put, you're befuddled as to what the heck you can do to protect your stocks in the event of a market collapse, or worse, the return of another flash crash. Well, you and

your alter ego should find plenty of nuggets in "Collars, Conversions, and Clarity" on page 22.

So, as someone who thinks in hours, days, or weeks, you might scoff at the guy on TV talking about a "stock-picker's market" (duh). There's even a good chance *carpe diem* defines your philosophy. The trader's creed boils down to this: Embrace volatility, adapt quickly, and learn to love the good, the bad, and the ugly as it comes—when it comes. But if you're still looking for market advice, perhaps the random-walk guy says it best—the market has as much of a chance of moving up tomorrow as it does down. What are you going to do about it?

Happy Trading!  
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• thinkorswim, prior to joining TD Ameritrade, earned 4.9 stars, the top score, in the category "Trading Technology", and was rated #1 overall online broker in Barron's ranking of online brokers, 3/15/2010. thinkorswim was evaluated versus others in eight total categories, including trade experience, trading technology, usability, range of offerings, research amenities, portfolio analysis and reporting, customer serv-

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• TD Ameritrade ranked #3 of 17 Discount (Online) Brokers in SmartMoney Magazine's Annual Broker Survey in the publication's June 2010 issue.

TD Ameritrade was also awarded a five-star rating (the highest available) in the Mutual Fund and Investment Products category along with two other

firms, a five-star rating in the Trading Tools category along with four other firms, a five-star rating in the Research category along with two other firms, and a five-star rating in the Customer Service category along with four other firms in SmartMoney's 2010 Broker Survey. SmartMoney is a registered trademark of Dow Jones & Company, Inc.

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**Trade  
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MARKETS  
ARE *RAN-*  
*DOM,*  
YOUR  
PORTFOLIO  
SHOULD  
*NOT* **BE**

cov.  
story

WORDS BY **KEVIN LUND**  
PHOTOGRAPH BY FREDRIK BRODÉN

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THERE'S A CAMP OF TRADERS WHO THINK A STOCK'S NEXT MOVE IS ABOUT AS PREDICTABLE AS A COIN TOSS. BUT THAT DOESN'T MEAN YOU CAN'T MAKE CONSISTENT RETURNS. JUST TAKE YOUR STOCK-PICKING HAT OFF FOR A MOMENT AND FOCUS.

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## Trade Management

• Photograph by  
Fredrik Brodén

• tdameritrade.com

## THE PRICE IS RIGHT

is the perfect game show for traders. Not only is it cheap entertainment for millions of couch potatoes; it's also an exercise in pure statistics. Essentially, each pricing game leading up to the much-anticipated "Showcase Showdown" relies primarily on the fact that most contestants guess somewhere in the middle on the price of a pack of gum or a new car—what's called a *mean* in statistical terms.

One "TPiR" favorite—Plinko—is a pricing game based on the principles of "random walk," which also happens to be a popular school of thought among certain traders. This is the game where the contestant drops a hockey puck-like "chip" down on a board of nails that are evenly distributed. Each time the chip lands on the top of a nail, the odds are 50/50 that it will fall left or right before it lands on the next nail. Eventually, it hits the bottom. Once the contestant drops the chip, nothing can influence where it will go next except gravity itself, and nobody can predict where it will land. Its path is said to be completely random. Over the course of hundreds of chips dropped, they'll cluster around a mean in a shape that math geeks like to call a *bell curve*, with 50% of the chips landing to the left of the curve, and 50% to the right—essentially, a coin-toss. This is the essence of random walk.

### IT AIN'T PLINKO, BUT IT'S CLOSE

If there was ever a market moment when random-walk die-hards get to have their day in the sun, it's right now, because technically—at least for the first 10 years of this century—they've been right. On January 1, 2001, the S&P 500 was sitting at 1320. This year, it's been waffling on either side of 1100. So, it's pretty safe to say that at least the broad market *has* been random and it really *hasn't* gone anywhere. That's not to say there haven't been some fantastic bulls and bears in between, but you can't really argue with the math.

Random walkers typically disregard balance sheets and price charts altogether. They assume that because of the market's said random-ness, your best guess for where it will be tomorrow is where it is today. Yup, income statements, MACD, and volume are as reliable as a toilet-flushing indicator when it comes to predicting market direction (or so they say).

So, does this mean that all chartists and value-investors should just pack up and go home? Not exactly. There are plenty of successful chartists, money managers, and investors who are very good at using predictive tools. But if we're in for another

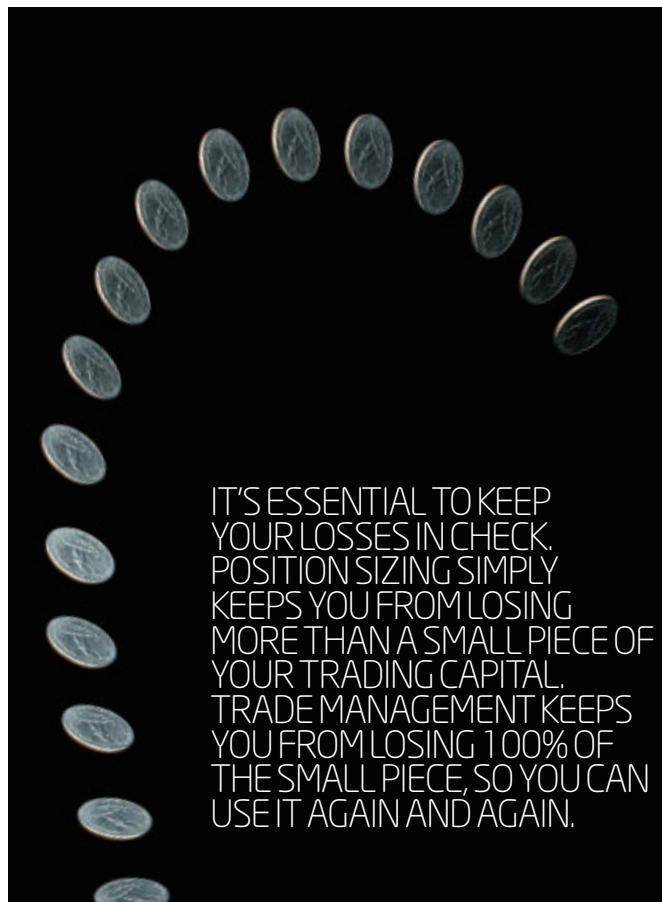
decade like the last one (not saying we are), and you haven't exactly "beat the market," you might consider adjusting your game plan and stealing a nugget or two from random-walk theory.

### WHAT'S THE EDGE ON A COIN TOSS?

Random-walk theory really borrows from another set of principles known as efficient market hypothesis (EMH), which states that market inefficiencies, anomalies, and other "ies" exist, but they do not persist. In human terms, this means that there are so many millions of market participants that any information that becomes known, which was previously unknown, immediately gets absorbed and reflected into the price of a market. Arbitrageurs close all the pricing gaps, sellers sell what they need to sell, buyers buy what they need to buy, and equilibrium is achieved. Utopia, right?

Now, let's assume for the moment the random-walk crowd is right. If so, the crux of EMH states that if markets are truly efficient, then nobody can actually beat the market because technically, you can't predict its outcome. However, random walkers have given up on the idea that you actually need to know where a market will go next to make money. How? Good old-fashioned sound money management and strategy selection, that's how. But before it starts to sound dreadfully similar to recommending (yawn) a proper diet and exercise to maintain a healthy lifestyle, let's touch on both, and give peace a chance.

**Money Management** Painting with broad strokes, if random walk assumes a 50/50 chance of being right, half of your trades will be winners, and the other half,



IT'S ESSENTIAL TO KEEP YOUR LOSSES IN CHECK. POSITION SIZING SIMPLY KEEPS YOU FROM LOSING MORE THAN A SMALL PIECE OF YOUR TRADING CAPITAL. TRADE MANAGEMENT KEEPS YOU FROM LOSING 100% OF THE SMALL PIECE, SO YOU CAN USE IT AGAIN AND AGAIN.

losers. The trick is to keep more of the dollars you win than you lose, and to do so time and time again. Here are a couple of tips:

**Position sizing (How much do you risk per trade?)—**

Develop a system for consistently allocating the same amount of risk in every trade. There's no cherry-picking here, and it doesn't matter if you have a better "gut feeling" about the next trade than the last one. Doubling down is a no-no. Stick to the plan. If, for example, you decide to risk 5% per trade, that's what you risk every time—no matter what your convictions.

**Trade management (When do you get out?)—**

If you've been trading long enough, you've probably heard the tired advice, "Cut your losses short, but let your winners run." Boring? Yes. But that's pretty much what it boils down to, and there's really no better way to put it. The idea is to create some sort of risk-to-reward scenario with each trade that looks something along the lines of risking \$1 to make, well, more than \$1—such as 1:2, 1:3, and so on—otherwise the whole 50/50 thing really doesn't work. This could mean committing to stopping out of your option trade if you lose \$1 or exiting for a profit of \$2—whichever comes first. Or, if you're trading stock, it might mean stopping out when the stock drops 2% or exiting for a profit if it earns 4%. These are oversimplifications, but you get the idea.

If you must take away only one thing from this article (you wouldn't be the first), understand that it's essential to keep your losses in check. Position sizing simply seeks to keep you from losing more than a small piece of your trading capital. Trade management seeks to keep you from losing 100% of the small piece, so you can use it again and again.

**Strategy Selection** If you're a stock trader, there isn't much selection to be had—you either buy stock or you sell it. But for option traders, it's not that black and white. Is volatility too high? You should probably consider avoiding long calls. Earnings around the corner? Maybe forget about those short puts.

Assuming you've exercised your new and brilliant money management plan, choosing the right option strategy to trade is like accessorizing your outfit before a date. You already look good, but those new jeans will make you look great... (Okay, that was awkward.) The point is that picking a good strategy doesn't innately guarantee success, but it can help to prevent bad things from happening to a good trade.

Now, this is by no means a complete list, but here are a couple of tricks:

***Consider defined-risk strategies over those for which the loss is uncertain, or worse, unlimited.***

What happens when you're short calls on a stock the day blow-out earnings are announced? What if you're short puts the morning of the next flash crash? Avoid the cowboy mentality. Slapping a hedge on your naked shorts to turn them into short put **verticals** isn't about

being unwilling to take risks, it's about preserving capital. Sure, you might win on your next 10 trades, but when lightning finally strikes, assuming you've exercised good money management, you won't blow up.

***Consider strategies where time works for you, not against you.***

Time decay is the killer of long strategies, such as buying calls and puts, or buying at- or out-of-the-money vertical spreads. Directional implications aside, strategies with positive time decay are designed to profit as time passes because the position you sell gets cheaper. Markets can go up, down, or remain the same. Long options and at- or out-of-the-money verticals lose in two out of three of those situations, whereas an out-of-the-money short put vertical, for example, can profit in at least two, if not all three situations—so long as the stock settles above the short put strike.

Strategies that follow rule #2 shouldn't break rule #1. Short puts and calls, for example, have positive time decay, but their potential losses are incalculable when things go terribly wrong. Spreads, such as short out-of-the-money verticals, **iron condors, and long butterflies** not only have defined risk; they can also profit as time passes.

IT'S IMPORTANT TO RECOGNIZE THAT THERE REALLY is no single right or wrong philosophy when it comes to trading the markets. Whether you buy into random-walk theory or not, the reality is that markets do trend, if even for just a little while. That said, if an unpredictable market is 50/50, but you have a tool or system that is designed to increase those odds, then all the more power to you.

The fact is, despite the dismal returns of the broad market over the past 10 years, there are many, many successful technicians and fundamentalists who have built predictive methods that consistently produce outstanding returns. *Your truth (and success) lies somewhere between what works for you now and how quickly you adapt when things change. But if you still want the quick answer to where the market will be tomorrow—or 10 years from now—just flip a coin and find out.*

• *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multi-legged options transactions such as spreads, straddles, iron condors, and butterflies will incur contract fees on each leg of the order, which may impact any potential return. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.*

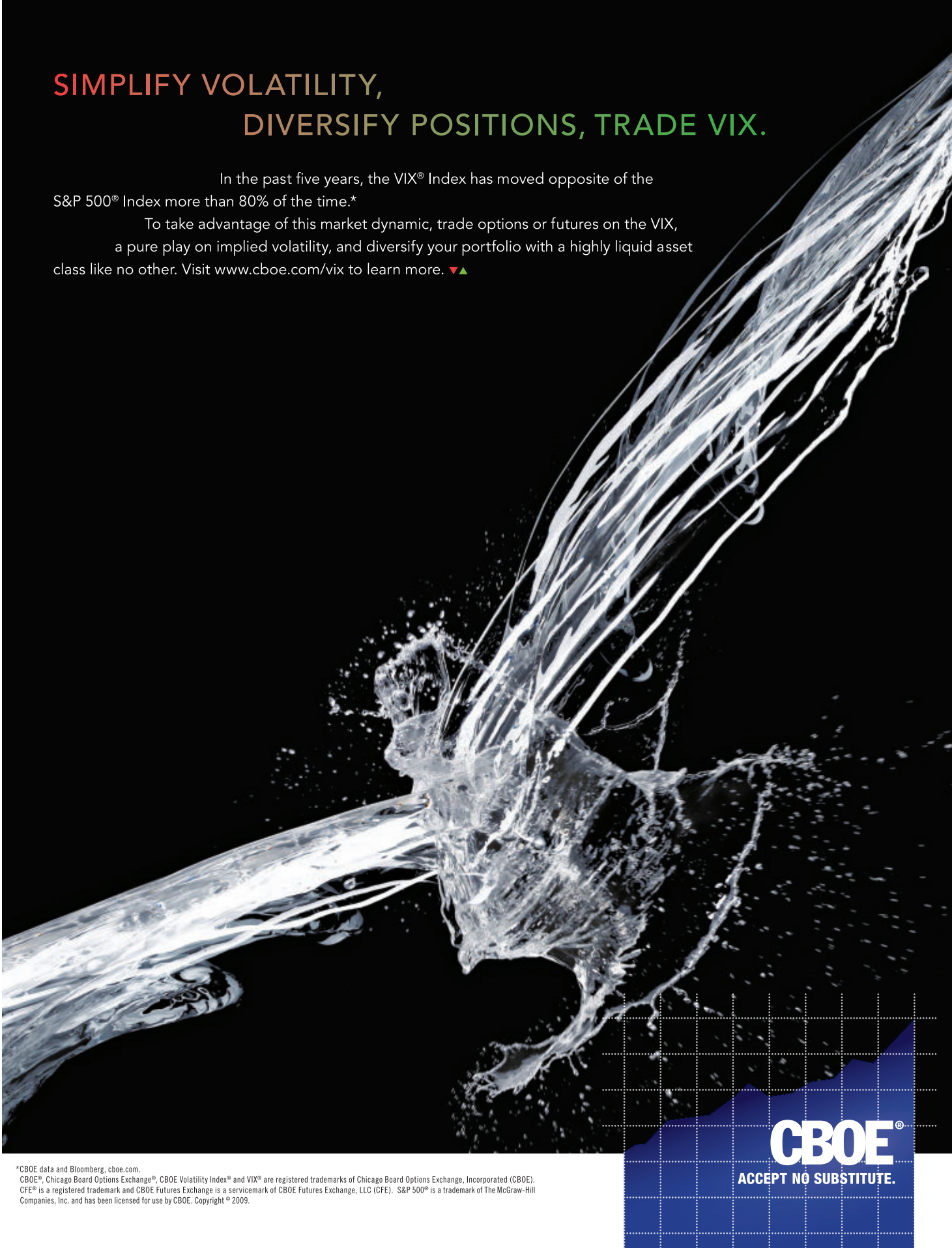
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## Love Notes

A smattering of think nothings from our readers

Photograph by  
**Fredrik Brodén**

- I only have three wishes in life—in order of importance:
  1. Options trading 24/7
  2. Be good friends with Cameron Diaz and my wife happy about me meeting new friends
  3. World peace

**Jaimie**

- CRS [Can't Remember Stuff] is a disease that affects people my age and younger. How does thinkorswim from TD Ameritrade cure CRS?

Users are all setting alerts daily, but for those of us suffering from CRS, many times when the alert fires off we might not remember why we set it in the first place.

The thinkLog tool cures CRS for good. Now, whenever I set an alert, I make sure to also make a thinkLog entry to remind me of why the alert was set in the first place. Thankfully, it dates these entries, so I am even reminded

of the date I had the epiphany. Thanks for all you do.

**Bill**

- I am in a 3-hour “Core Vision and Leadership” meeting. If there were a sharp object in this room, I might take my life. Thank God for mobile trading.

**Mike**

- I love the chats and the way thinkorswim from TD Ameritrade tries to make us a success; kudos on all topics and speakers.

I have one problem; if I hear one more person say “there is no holy grail,” I'm

Got a quip? Good, bad, and ugly, send your best to [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com)

going to jump through my computer and strangle someone. I say you outlaw the phrase.

I think there is a holy grail: a trading discipline with positive expectancy that fits your style and beliefs such that it allows you to enter and manage trades in a like manner each time.

Thank you for dropping everything to address this important matter.

**Jim**

- [In response to “Ask the Trader Guy,” Spring 2010]

Actually, the average American intake of fiber is closer to 10–15 grams per day, with recommended intake of 25 grams per day (in a 2,000 calorie diet), not 100!

So, in fact, one only needs to eat 2.2 pounds of bacon in a day to satisfy their daily fiber intake, not 8.8 pounds! Now if only eating the right amount of fiber meant we didn't have to worry about the saturated fat or cholesterol. Alas, one can dream!

**Michael**

*The comments here are excerpts from emails submitted by thinkorswim from TD Ameritrade users as their views and may not reflect those from TD Ameritrade. Testimonials may not be representative of the experience of other customers and are no guarantee of future performance or success.*

A hodgepodge of stuff we thought you should know

## Toys for Traders

The latest gadgets on thinkorswim from TD Ameritrade

**Heat map** gives you a visual overview of intraday market performance. Bigger boxes are larger stocks, and brighter colors are bigger moves. Hover the cursor to see data. Click on a box to drill down into more detail.

**Global FX chat/squawk** brings you live forex commentary all trading day long. Launch thinkorswim from TD Ameritrade, then click Support / chat (upper left) > Chat Rooms (in the new window) > Global FX Chat.

**Lovers and losers** watch lists show you current analyst upgrades and downgrades, plus pre- and post-market movers.

# news.

## INDUSTRY SPOTLIGHT

### CBOE goes public... What's in it for me?

by Thomas Preston

With most of the financial news concentrating on bank reform and a feeble economy, it was easy to overlook the Chicago Board Options Exchange's IPO this past June. Since its inception in 1973, the CBOE was and still is the largest options exchange. And, along with its nearest rival, the International Securities Exchange, it dominates the world's equity and index option transactions. But aside from Mayor Daley covered with confetti and the CBOE members getting a nice

payday, does it really mean anything for the retail trader? Here's what we'd love to see all exchanges do, with the CBOE leading the way.

- 1 Increase transparency in the way they accept and process orders, levy fees and charges on transactions, and even disseminate quotes. That's not to say that the exchanges are closed from public view, but the more people understand what happens when they hit the "send order" button on their favorite trading platform, the more confident they'll feel about the whole industry.
- 2 Put the focus on creating retail-oriented products. Weekly expiration options and penny-

wide bid/ask spreads were exchange-driven innovations that responded to what traders, both professional and retail, desired. These are the sorts of things that can increase trading activity, which is how

exchanges make money. Finding the next great trading vehicle takes a lot of swings—and misses—before you get a hit. A court upheld the CBOE's exclusive trading rights on popular stock index options. Don't squander that. Use that protection to come up with new stuff.

- 3 Finally, enhance the exchange-sided technology to deliver and receive data at ever faster, safer, and more consistent rates. Make a continuous effort to build technology that makes it easier to develop connections to the exchanges from outside, and accept the more sophisticated order types that retail traders want to route.

Hey, if it were easy, anybody could be an option exchange. But along with a few more bucks in their coffers, the CBOE is in a unique position right now to do option traders, and themselves, a lot of good.

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



To catch up on all the new toys and gadgets from thinkorswim from TD Ameritrade, go to our Release Notes archives at [tdameritrade.com/releasenotes](http://tdameritrade.com/releasenotes)

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fyi.

# Ask The Suit

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

TD Ameritrade trading platform, complex options, futures, and forex. In addition, the thinkorswim clients are seeing new tools like Widget 360 and heat-mapping from TD Ameritrade.

**The guys from thinkorswim are straight off the trading floor. What's it like working with them?**

I'm a rose among thorns. But I've learned a lot from them. In particular, they've broadened my vocabulary as I've picked up some very "colorful" new language.

**Who do you see as your biggest competitive threat?**  
Competitors? What competitors?

**What is your vision for the future of the thinkorswim from TD Ameritrade platform?**

Integrated flat racing wagering. That way, I could trade futures in the pre-market, options during the day, handicap the Santa Anita horses in the late afternoon, and bet Australia A at midnight.

**So, how is the integration between thinkorswim and TD Ameritrade progressing?**

Awesome. With the progress we've made, we're targeting an early 2011 for the final step, integrating the clearing operations, and moving forward as one better, stronger, firm. As a management team, we feel strongly that both customer bases will feel the synergies of this deal. TD Ameritrade clients are already seeing the benefits in terms of having access to new products like the thinkorswim from

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### Pot Shots

Our traders' solutions to sweaty keyboard syndrome.

#### KEY:

2 Buy Tickets =



1 Buy Ticket =



1 Sell Ticket =



2 Sell Tickets =



Perspiration. It's one of those unfortunate bodily functions that, while inconvenient at times, is necessary for survival. If your fingers keep slipping on the mouse, causing you to click "buy" when you wanted to "sell," here are some solutions, ranked from cheapest to most expensive—and inverse to their social acceptance.

#### Panting:



So cheap that even dogs use it, and so effective that it'll make you pass out. Not good if you're trading before a big Fed announcement.

#### Talc (powdered form):



Stick to no-name brands to save money, but go easy on the application. Excess gets clogged in keyboards, and can be confused for a certain contraband.

#### Botox:



More expensive, and temporary at best. Plus, you have to be in the doc's waiting room with shriveled socialites. Ick.

#### Hyperhidrosis surgery:



Very effective, and not a do-it-yourself thing, but it does give you the "you should see the other guy" scars.

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## The Fearless Technician

Brain candy for chartists.

# The Search for the End (of a Trend)

Though it is said no one can pick tops and bottoms, this could get you closer.

## tech.

- Watching the financial media for advice on when a trend is

ending is like having a smooth connecting flight at the Atlanta airport—neither is likely to happen. Analysts typically analyze what has long since passed. Once the market has fallen 40%, only then do they call it a bear market. So much for timely advice. The trick is to utilize tools that provide an objective bias for a trend change *while* it is occurring, not well after the fact.

### The Setup

Although the following method is not fool-proof by any means, it can at least give you enough information to make an informed decision. The setup involves using two indicators from the thinkor-



**FIGURE 1:** Using moving averages, such as the 8 and 21 period, with the Heikin Ashi bars can help bring you closer to realizing the end of a trend. At the top of your chart, follow the click path Style > Chart Type > Heikin Ashi. (For illustrative purposes only.)

swim from TD Ameritrade trading platform: the 8-period (yellow line) and 21-period (white line) exponential moving averages (EMA), and the Heikin Ashi bars, which are represented by the colors red and green (see Figure 1). A red bar means that the average closing price of the prior 6 bars is in the lower 50% of its range, indicating a bearish bias. The opposite is true of the green bars. What's nice about this indicator is it takes into context a group of bars—not just a single bar. A group shows a trend change, a rotation from a bullish bias to a bearish bias and vice versa. A single can be an anomaly.

### The Secret Sauce

What I'm looking for are two opposite-colored bars as my initial "heads up" that the trend is over. Next, I look to the 8- and 21-period exponential moving averages. If the 8-period starts to roll over, I'll tighten my stop to just below the current price action. For example, at point #1 in Figure 1, there is a choppy trend up and we see two red bars develop. Although there were other red bars during this move higher, this is the first time that the red bars also coincided with an 8-period EMA that has started to roll over. At this point I move up my stop to 4% below the current price action.

Once the 8- and 21-period EMAs cross to the downside, I consider the trend over. And if I haven't been stopped out at this

point, I get out. This is useful because it indicates an overall change in trend, which is not an appropriate time to add to a position or double down—it's a time to clamp down on money management techniques.

At point #2 we see a new uptrend beginning. Shortly after the 8- and 21-period EMAs cross higher, confirming a new uptrend has started, there are three red bars in succession. Is this a heads up that the trend is suddenly over? Note that during this time the 8-period EMA does not roll over, so there is no need to raise your stop.

Only at point #3 do we get multiple red bars and a rolling 8-period EMA. Again, this is where the money management techniques are initiated, and it's pretty much "rinse and repeat" from there.

John Carter is president of TradeTheMarkets.com. He can be reached at [jcarter@tradethemarkets.com](mailto:jcarter@tradethemarkets.com). TradeTheMarkets.com and TD Ameritrade are separate and unaffiliated companies.

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Hungry for more indicators? Log in to your thinkorswim from TD Ameritrade platform, and go to the Charts page under Studies.

Words by John Carter

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## thinkStart

Helping you find your way  
around thinkorswim  
from TD Ameritrade

## The Analyze Page

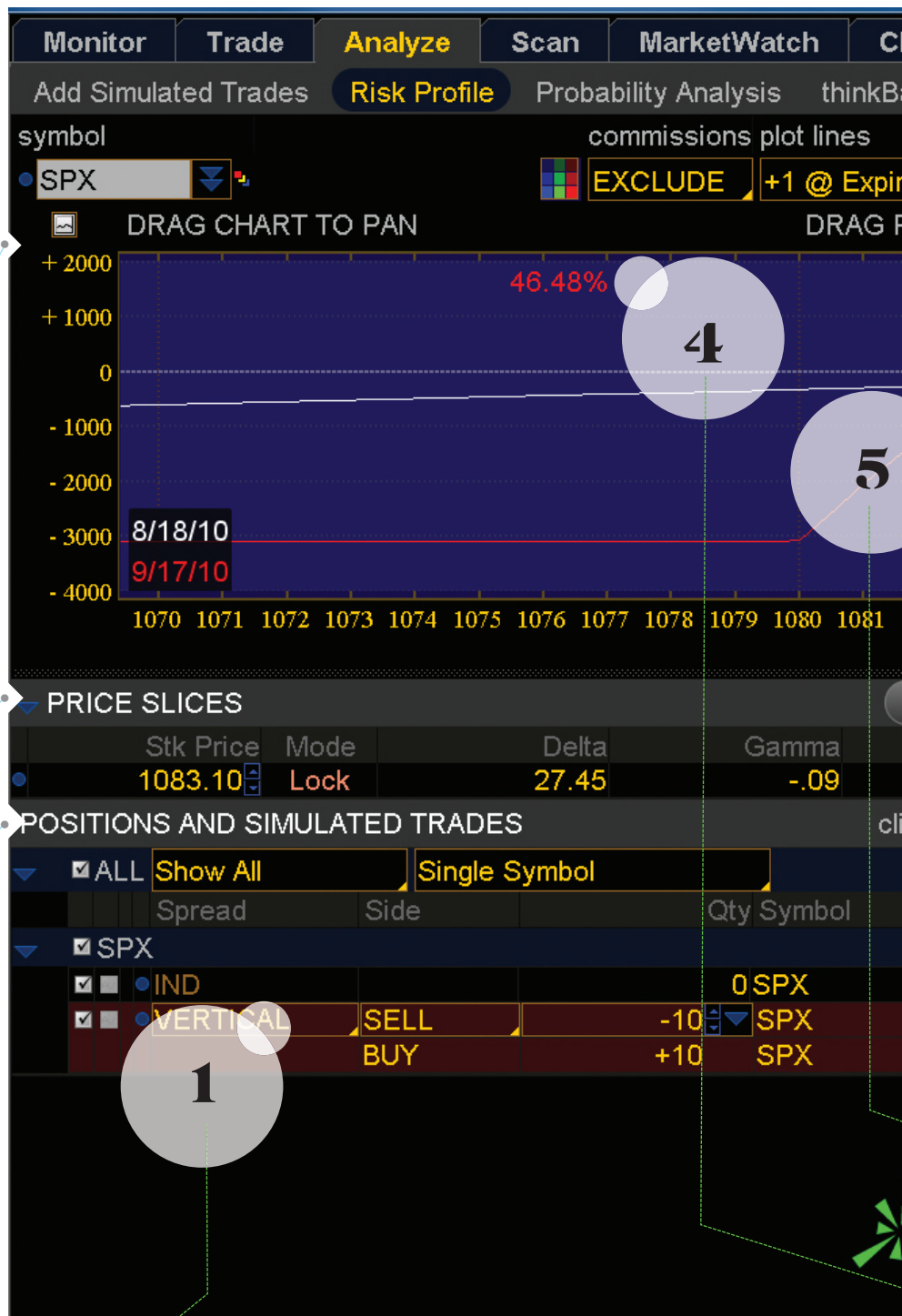
Before you build that next perfect trade, check the math and look at the pretty picture.

- You don't have to be Nostradamus to get a better sense of the potential for your trade to be profitable. Let the numbers speak for themselves. Unless you're a glutton for punishment, the Risk Profile tool on the Analyze page will do the math for you and draw a picture of all the **P/L** possibilities—including the odds of making a profit. This could be helpful for figuring out what option strikes to buy, which spreads to sell, or whether you want to take the trade at all. And don't let the cockpit-like dashboard fool you. She's a pussycat.

- CHART AREA** Lets you see a picture of your trade anytime between now and expiration. Once you've got your strategy picked out and where you want it on this page (see "How to Analyze Your Trade" below the image), you get to see the bird's eye view in the form of a risk graph.

- PRICE SLICES** Allows you to set the vertical red dash lines on the chart to view what the theoretical P/L and greeks would be at any stock price just by dragging them across your screen, without having to manually enter the prices. Also allows you to see the estimated probability of profit at expiration (see step 2 below, right).

- POSITIONS AND SIMULATED TRADES** Allows you to analyze one or more trades at once. Add positions to create a theoretical portfolio through the "Add Simulated Trades" tab and check the boxes to the left of the positions you'd like to analyze. Or better yet, check all the boxes to view a risk graph of your theoretical portfolio.



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

## 5 Steps to Analyzing Your Trade

### 1/Add Simulated Trades

Click this button in the top nav bar of the Analyze tab to create a new position. Enter the symbol in the fill-in box and right-click on any strike in the option chain. Choose the strategy in the submenu and click the Risk Profile button to get back to the screen shown above.

### 2/Set Slices

Select the click path Set Slices > Breakeven > [expiration date]. Setting the slice at breakeven on expiration allows you to view the estimated probability that the trade will make a profit.

**Hot Tip**

If you need more help, you're not alone. Just click the Help tab at the top of the page for more details and videos on using the Analyze tab.

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PAGE 42



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**3/Enter the Dates**

In the "Positions and Simulated Trades" section on the right, be sure to select today's date. Then, at the top right of the page, select the expiration of the trade.

**4/View the Probability of Profit**

The two numbers at the top of the graph to the left and right of the breakeven slice (vertical red dash) are the estimated probabilities that the trade will profit or not. In the case of the SPX vertical spread pictured, there's a 46.48% chance of losing money and a 53.52% of making money.

**5/What Do You See?**

Everything above the zero line (white dashed line) is a profit, and everything below it is a loss (the P/L numbers are to the left of the chart). The numbers running across the bottom of the chart is the stock price. So, how does that perfect trade look after all?

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Collars

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# COLLARS, SIONS, & CONVERITY & CLARITY

IF YOU OWN STOCK, AND DON'T WANT OUT, THERE ARE WAYS TO PROTECT YOURSELF  
AND STILL PROFIT ON THE UPSWINGS. BUT IF YOU'RE JUST LOOKING TO MAKE A FEW BUCKS  
WITHOUT STOCK, STICK TO SOMETHING SIMPLER.

xXx

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



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## Collars

Photograph by  
Fredrik Brodén

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# CHILI IS JUST MEAT, SPICES, AND MAYBE BEANS.

**Simple, right?** So how come some people win chili contests and the rest of us just have stains on our shirts?

In trading, if you take long stock, a short call, and a long put, what position do you have? Well, it might be a conversion, or it might be a collar. One is interesting knowledge to have in your back pocket. The other is handy in real, live trading. So, if the parts are the same, how are the conversion and collar different?

## GOOD CHILI BOILS DOWN TO STOCK

A *conversion* is long stock, a short call, and a long put. The call and the put have the same strike price and expiration. A collar is long stock, a short out-of-the-money (OTM) call, and a long out-of-the-money put. The call and put may have the same expiration, but, as we'll see later, not necessarily. The conversion is the "nice to know" trade. The collar is the one that many traders are more likely to put on.

Think about the conversion. The short call/long put combo is **synthetic** short stock, in which the position gains dollar for dollar when the stock moves down, and loses dollar for dollar to the upside. Now if you're long actual shares of stock and short synthetic stock, what do you have? A trade whose **P/L** depends less on whether the stock goes up or down, and more on interest rates and dividends.

A conversion is a "cost-of-carry" trade; interest rates and dividends determine the price of the synthetic stock. So the position is great if its purpose is strictly no-frills stock protection, but as a trade, it's not something that individual investors would have much success with. Transactions costs will more than likely eat up any profit from dividends exceeding the interest rate of holding the stock. In chili terms, it's kind of bland and not very satisfying.

## THAT COLLAR LOOKS FAMILIAR

What makes the collar more practical is that its P/L depends mainly on the direction of the stock price. The stock profits up to the strike of the short OTM call. It loses as it drops to the strike of the long OTM put, at which point, losses in the stock are offset by gains in the put. That's why a collar is a position to establish if you believe the stock might go higher.

Now, if you take the pieces of the collar—long stock, short call, long put—and match them up differently, you can see them as other synthetic positions as well. Take the long stock and match it with the long put. You get a synthetic long call. And if you have a synthetic long call and an actual short out-of-the-

money call, *voilà!* You have a long call vertical spread. Now, take the long stock and match it with the short call to get a synthetic short put. And if you have a synthetic short put and an actual long out-of-the-money put, that's a short put vertical. The long call vertical and the short put vertical make money if the stock goes up, and lose money if the stock goes down, just like the collar—same risk, same reward. If that's true, you'd be indifferent trading either the collar and long call vertical and short put vertical, right? Well, in real-world trading, no.

If you are currently long a stock position, you just might look to a collar to generate income and hedge the long stock position. Selling the out-of-the-money call generates the income, and buying the out-of-the-money put provides the hedge. These options "collar" their stock.

But if you don't already own the stock, there isn't really any reason to trade into a collar as opposed to, say, a long call vertical. The collar has three commission costs (long stock, short call, long put), while the vertical spread has only two (long call, short call). That, and the capital required for the collar, is the margin on the long stock—typically 50% of the value of the stock in a margin account. For the long call vertical, it's just the price of the vertical.

Wait! What if the stock pays a dividend? Only long stock positions are eligible to receive the dividend. Long calls get nothing. That means the collar's better on a dividend-paying stock, right? Wrong. If you own a long call, you don't get the dividend unless you exercise it before the ex-dividend date of the stock. Because the call doesn't participate in the dividend, its price is somewhat lower than it would be for a non-dividend-paying stock. A long call vertical on a dividend-paying stock is a bit less expensive, too, so it doesn't really matter whether you buy the call vertical or the collar.

## CREATING THE COLLAR

Whether you own the stock and want to collar it, or don't own the stock and want to trade a vertical, how do you select the expirations and strikes of the options? If you keep to the idea that the short call is for enhancing returns (or income) and the long put is for protection, it can help you decide which option might be right for your strategy. The two main decisions you'll have to make have to do with how far out-of-the-money (distance) and how far out in time you want to go:

**Distance** With the collar or the vertical, selling the call generates positive time decay, meaning time is working in your favor as days go by. You sell it, take cash into your account, and if it expires out of the money, you keep that cash as profit on the short call (less applicable commissions and fees, of course). The closer the



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strike price of the call is to the current stock price, the larger the credit you get when you sell it. But it also limits the potential profit on the long stock position if you're lucky and the stock goes higher. The stock's profit potential is capped at the strike price of the short call. Place the short call strike too close to the current stock price, and you'll cap the profit on the stock pretty quickly. Place the short call far away from the current stock price, and you'll take in a smaller credit. That's the trade-off.

**Time** Because the short call generates positive time decay, the choice is a balance of the rate of decay and the total amount of extrinsic value. The amount of

extrinsic value determines the maximum income you can receive for selling the call. But the rate of decay determines how quickly the position generates that income. The more time to expiration, the more extrinsic value and the higher the credit for selling the call, but the lower the rate of decay. The less time to expiration, the less extrinsic value, but the higher the rate of decay. Balancing those two things will help you determine in which expiration month to sell the call. The strike also affects the rate of decay and the extrinsic value.

## HOW MUCH INSURANCE DO I NEED?

Because they are similar with regard to risk and potential reward, your approach to determining the strikes for the options in the collar or the vertical is pretty much the same. For the put on the collar, which is also the strike of the long call in the long call vertical, you determine how much protection you want. If you buy a put further out of the money, it will be less expensive, but your stock position will lose more before the long put protection kicks in to offset the losses. Puts that are closer to the money provide more protection, but they also cost more.

One factor is how much you're willing to pay to hedge your long stock position. And, as mentioned earlier, the long put doesn't have to be in the same expiration as the short call. You may want to buy a put in a further expiration, because while it will cost more (all other things being equal), it will have lower negative time decay—as well as more **positive vega** (the measure of an option's sensitivity to changes in the volatility of the underlying asset). If **implied volatility** rises when the stock drops, that will drive the value of the higher vega long put up that much more.

Collars and verticals are interesting ways to get started in option trading; they are versatile, provide a hedge, and can provide income. Now if we could just find the perfect recipe for chili.

• *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multi-legged options transactions such as spreads, collars, and conversions will incur contract fees on each leg of the order, which may impact any potential return. Collar and conversion strategies involves the risks of both covered calls and protective puts. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.*

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**Trader Econ**  
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# HOW TO TRADE THE FED

YOU CAN'T FIGHT THE FEDERAL RESERVE,  
BUT AT THE RATE THINGS CHANGE TODAY, THAT  
DOESN'T MEAN YOU SHOULDN'T  
KEEP AN EYE ON IT.

WORDS BY **MATT BLACKMAN**  
PHOTOGRAPH BY **FREDRIK BRODÉN**

FED





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**F**ew traders would disagree that stock markets have dramatically changed in the last two years since the credit crisis began to unfold in earnest. And the rally off the March 2009 bottom that peaked in April 2010 was also very different. How so?

For starters, never before in history has so much money been pumped into global markets by central banks in the U.S. and around the globe in an effort to re-inflate economies. Stock markets have been the early major beneficiaries from this tsunami of cash.

So what factors are at work this time, and how can knowledge of what the Fed is doing help traders?

## THE NORM

Looking at the chart in Figure 1, there is an interesting inverse relationship between stocks and interest rates. In good economic times, rates generally rise as the economy gathers momentum. As it starts to overheat, rates are pushed even higher in an attempt to control inflation.

However, as it becomes clear that the higher rates are doing their job, the Fed stops increasing rates just as the business cycle is peaking—and so are stocks (see points 1 and 4).

As the economy begins to cool, the Fed lowers rates (points 2 and 5). When it overheats again, rates

are raised again (point 3). You can see that interest rate changes have had a measurable impact on stocks—albeit with a delay.

## HOW IS IT DIFFERENT THIS TIME?

But during the last recession (2001–02), the Fed decided to leave rates low (around 1%) for more than a year after the stock rally started. Their plan was to ensure the economic recovery (and stock market rally) would not be derailed by the rising cost of money.

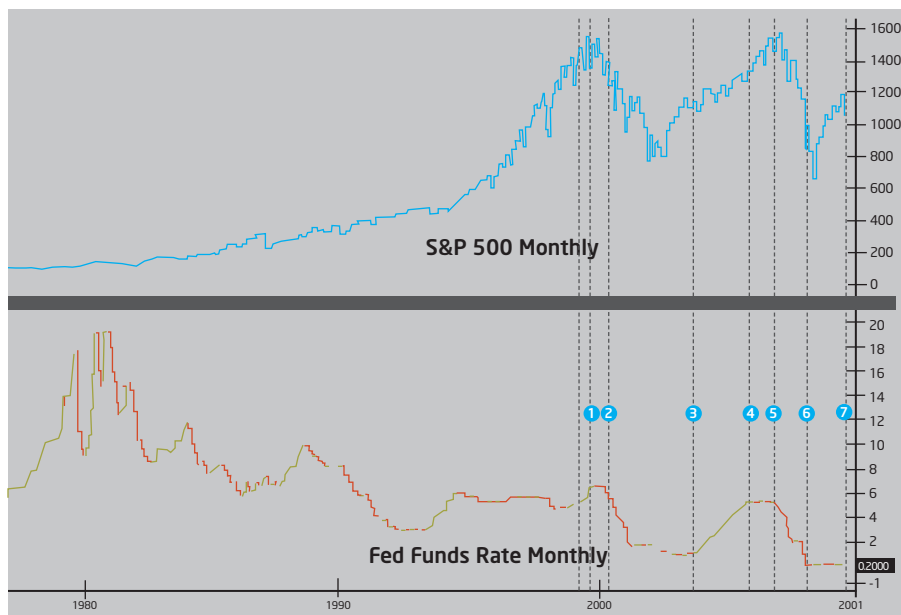
What happens when lowering interest rates doesn't have the intended effect on the economy? Even after dropping the Fed funds rate to nearly zero in November 2008 (point 6), the economy was still deteriorating (and stocks were still falling). In an attempt to counteract this drop, the Fed began pumping more money into the economy in unprecedented amounts, which caused the sum total of money in circulation (as measured by the adjusted monetary base) to more than double in a few short months (Figure 2). It was step two in what is euphemistically called the “quantitative easing program.”

What's important to understand is that quantitative easing is nothing more than money creation. And the Fed has two tools at its disposal to accomplish this: (1) One way to create money is by lowering interest rates, which makes loans cheaper and encourages investment, borrowing, and consumer spending. And (2) when this fails to work, the Fed can add more cash to the system by going to the printing press.

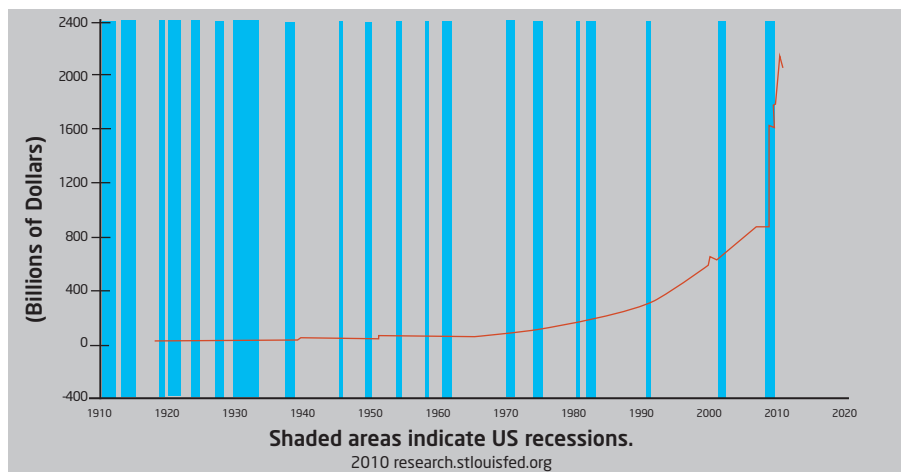
This is exactly the position in which the Fed now finds itself—stuck between a zero interest rates rock and a weak economic hard place (see point 7, Figure 1).

As Figure 2 shows, since the 1970s, the money in circulation as indicated by the adjusted monetary base (AMB) has grown at an increasing rate. In September 2008, when it became obvious that lower rates alone would not be enough to combat the problem, the Fed began to increase the AMB. By January 2009, the AMB had more than doubled on a year-over-year basis. By March 2010, it was up 146% as the Fed struggled to find new ways to boost the economy.

An overnight rate near zero and more than double the money in circulation (two powerful quantitative easing tools) are inflationary, and stocks have responded with a vengeance since March 2009. As long as the U.S. Treasury can continue to sell unprecedented amounts of bonds to pay the rapidly growing debt bills, rates could remain low for months and even years, and stocks have the potential to enjoy this powerful Fed-sponsored lift.



**FIGURE 1:** Monthly chart of the S&P 500 Index and the Fed funds rate, which remained near zero at 0.013% in March. Note numbers 1 through 6 on the lower chart, which we'll discuss in detail. It is also interesting to note that the Fed funds rate was lower in February than at any time in the last 60 years. Source: MetaStock by Thomson Reuters



**FIGURE 2:** The Federal Reserve's chart showing the adjusted monetary base (monthly). Since the beginning of 2009, the year-over-year increase in the money in circulation has averaged 76%. Since August 2008, when the adjusted money base began to expand in earnest, money in circulation has grown a whopping 146%. Source: Federal Reserve Bank of St. Louis

## EYES ON THE RESERVE

So, what indicators can traders use to help measure this push?

**1. Fed funds rate.** Otherwise known as interest rates, this is what media heads are referring to; though the Fed, through its Federal Open Market Committee (FOMC), merely sets “targets,” not the actual rate. The rate itself is determined by the open market. As long as the fed funds rate remains low, stocks will enjoy a tailwind. The Fed funds target rate changes monthly, and is published by the Fed at <http://bit.ly/fedfundstarget>. The effective Fed funds rate changes daily, and can be tracked at <http://bit.ly/fedfundsdaily>.

**2. Money supply,** and more specifically, the **adjusted monetary base.** These statistics will tell you when the Fed is increasing or decreasing the money in circulation. When more money is put into circulation, it initially can have a positive impact on stocks because there is more money out there to invest. The problem is that if this continues for too long, it begins to cause inflation, which means interest rates will eventually have to rise—a situation that is generally bad for stocks.

The Fed can also reduce the money in circulation, but this is relatively rare. Still, it should be tracked carefully, as it can warn of a weakening environment for stocks. This data is published bi-weekly at <http://bit.ly/moneysupply1>.

**3. M1 multiplier.** This statistic tells us how effectively money is circulating in the economy. It dropped below 1 in December 2008 for the first time since records have been kept thanks to the recent explosion in the adjusted monetary base. This trend is cause for concern, since it means money is not being used as effectively to power our economy (and thus the stock markets). You can track it at <http://bit.ly/m1mult>.

These indicators tell us when the Fed is raising or lowering interest rates, which may in turn have an impact on stocks. And when rates have hit rock bottom, as we're seeing right now, the Fed can still stimulate markets by printing cash and using other means of putting money into the economy, which can have the same impact on stocks as lowering interest rates.

You've probably heard the phrase, “Never fight the Fed.” As many have learned the hard way (particularly traders), stepping in front of the Federal

Reserve to trade can be a painful experience. So, until the day comes that the Fed no longer controls interest rates and money supply mechanisms, traders should follow agency actions carefully to pick up clues on where stocks may be headed.

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A forex dealer can be compensated via commission and/or spread on forex trades. TD Ameritrade is subsequently compensated by the forex dealer. Futures and forex accounts are not protected by the Securities Investor Protection Corporation (SIPC).

Diversification does not eliminate the risk of experiencing investment losses.

Futures and forex trading privileges subject to TD Ameritrade review and approval. Not all account owners will qualify.

\*thinkorswim, prior to joining TD Ameritrade, earned 4.9 stars, the top score, in the category "Trading Technology," and was rated #1 overall online broker in *Barron's* ranking of online brokers, 3/15/2010. thinkorswim was evaluated versus others in eight total categories, including trade experience, trading technology, usability, range of offerings, research amenities, portfolio analysis and reporting, customer service and education and costs. thinkorswim topped the list in 2006, 2007, 2009 and 2010 with the highest weighted-average score. *Barron's* is a registered trademark of Dow Jones & Company © 2006-2010.

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## Ask the Trader Guy

Our resident guru answers your tough questions about trading and beyond.

Photograph by  
**Fredrik Brodén**

### Q: Hey, Trader Guy! How come the options quotes stunk during the “flash crash”?

A: Anyone watching quotes during the “flash crash” on May 6 saw the bid/ask spreads of options widen out enough to drive a truck through. That made it harder to execute trades at fair value, because you didn’t really know where fair value was! The reason the market makers did this is that, contrary to popular opinion, they are not all-knowing market prognosticators. Option market makers typically don’t take a lot of directional (delta) risk. Let’s say an order comes in to sell calls. As a market maker, you’d buy those calls and sell stock to hedge them—which is the key. If the option

market maker sees a stock with a tight bid/ask spread and a lot of trading volume around the current price, he can make his bid/ask spreads tight, too, because he knows he can reliably execute his stock hedge. But in the flash crash, individual stocks were dropping sharply, and the confusion made their bid/ask spreads wider. The option market makers responded by widening out their spreads because they didn’t feel they could hedge the risk of their option trades. They needed more “edge” when they bought on their bids or sold at their ask prices because they might get a lousy fill on their stock hedge. From their perspective, they were just trying to protect themselves.

### Q: Hey, Trader Guy! My doc says I should walk my dog to lose weight, but my dog hates me! Help!

A: I shudder to think what caused your dog to feel so negatively about you, his supposed mas-

ter. But trading can be an efficient way to burn calories. Nervously bouncing your legs, ultra-fast mouse clicks, and alternating fist “pumps” with spins on your office chair from bell to bell will get your body moving, and maybe even draw your dog closer to you out of pity.

### Q: Hey, Trader Guy! Grandma says shorting is un-American. She ain’t wrong, is she?

A: Let’s face it, shorting is betting the stock is not going to do well, which means the

company isn’t doing well, which means employees aren’t doing well, etc. That’s sort of negative. (If you’re not in the know, selling a stock you don’t own is known as “shorting.”) But while a short stock position does have theoretical unlimited risk, it isn’t creating fake shares out of thin air, as some would have you believe. No, short selling is a speculative activity, just like buying stock. Active trading adds liquidity to the markets, which means all-American capitalists can get in and out of a position at a fair value quickly, and gives them confidence in

their ability to manage their risk. It’s also important to the process of “price discovery,” or figuring out what the market value of a particular security is. That’s something that was sorely missing in the mortgage debacle.

Without the ability to short stock, you could only buy shares from someone who’s closing out their long position. That could be mighty tempting to a dodgy corporate exec who can make claims to pump up the stock price and sell the stock at an inflated price before the truth gets out. Savvy short sellers can enforce a certain market discipline, which is as American as apple pie.



*Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request. The information contained in this article is for illustrative purposes only. Market volatility, volume, and system availability may delay account access and trade executions. Price can change quickly in fast market conditions, resulting in an execution price different from the quote displayed at order entry. Execution price, speed and liquidity, and account access are affected by many factors, including market volatility, size and type of order, and available market centers. The risk of loss on a short sale is potentially unlimited since there is no limit to the price increase of a security. There is no guarantee the brokerage firm can continue to maintain a short position for an unlimited time period. Your position may be closed out by the firm without regard to your profit or loss.*

## Capiche?

Lessons from a  
veteran floor trader

## Expiration Horror Stories: A.M. vs P.M.

Think you're in the clear on those short index options? Think again.

cap.

• When I started trading options way back when, the S&P 500 futures were worth \$500 a point, I could eat five of my mother's cannolis without gaining weight, and everything expired on a Friday afternoon—stock and index options, futures and futures options, everything. Simple.

When interest rates were higher, there was a lot more index arbitrage going on. Big trading firms would try to make money on cost-of-carry trades by taking positions in the underlying stocks in an index and off-setting them with index options and futures. Only trouble was, at expiration, they'd have to unwind their positions. Because they'd hold on to them until the bitter end, they'd do all of this trading on the afternoon of expiration Friday. And man, you can imagine what it was like. Order imbalances to buy or sell, wild swings in the indexes, market makers taking the other side of all the action. It was great. But what was happening was that

even though the arbs weren't really trying to guess which way the market was going—their positions were largely **delta neutral**—it could create huge changes in the prices of the underlying stocks. This was especially true at what was known as “Triple Witching,” which happened in March, June, September, and December when the index futures expired.

The exchanges eventually decided to make most cash-settled index options, like the SPX, NDX, RUT, and DJX, expire on Friday morning. In the old days, the index settlement price was based on the prices of the individual component stocks at the close of trading in the afternoon—p.m. Now, the settlement price is based on the opening prices of the component stocks on Friday morning—a.m. The idea was that some of the heavy trading activity would be transferred to Friday morning, and reduce the volatility in the market.

And that's all well and good, but it means you have to adjust a bit. Like, the S&P 500 futures are now worth \$250 a point, and I can still eat five cannolis, but then I'm not eating lunch for the next two days. The trick is that because most cash-settled index options stop trading on Thursday afternoon, and settlement isn't determined until Friday morning, there's a whole Thursday night's worth of risk if you hold those expiring options. Let's say you're short a call vertical (spread) in one of those cash-settled indexes, and it's out of the money at the close of trading on Thursday afternoon. You may think you're in good shape to keep the profit on that trade, but you might end up having that trade turn into a max loss if there's a rally overnight into Friday morning.

What happens is that the settlement price is based on the price that each stock opens with, and all stocks don't necessarily have trades at the open of trading at 8:30 a.m. Central time. Some of them take a few minutes, and in the case of the Russell 2000, some stocks don't have a trade until well past the first hour. That can delay the calculation of the settlement price, which means it can even be outside of the high or low



SEE  
GLOSSARY  
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index price on Friday morning. Holding on to that position for the one extra night can be nerve-racking and very costly.

So, just like my mother told me to wipe my face after eating cannolis, consider cleaning up your positions in those cash-settled options as they approach expiration. They represent nothing but risk, and even though you'll pay commissions, you won't be subject to any unpleasant mark-ups or mark-downs in the a.m. settlements.

• *TD Ameritrade, Inc., and its registered employee, Tony Battista, do not solicit or recommend any form of trading in the individual securities mentioned above. Please do careful, independent research before investing any money as well as weigh the possible consequences on your particular financial situation before doing so. The risk of loss may be substantial. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. The information contained in this article is not intended to be investment advice and is for illustrative purposes only.*

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

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## Where Is It?

thinkorswim from TD Ameritrade platform tips straight from the Trade Desk

Words by  
**Todd McCarthy**

## Spread Tricks & Treats

Confused about how to set up your spread orders? Sure, we can help.



| Spread | Side | Qty | Symbol | Exp    | Strike | Type |
|--------|------|-----|--------|--------|--------|------|
| CUSTOM | BUY  | +10 | BIDU   | AUG 10 | 75     | CALL |
| SE...  | SELL | -20 | BIDU   | AUG 10 | 80     | CALL |
|        | BUY  | +10 | BIDU   | AUG 10 | 85     | CALL |

**FIGURE 1:** The software is set to change all strikes when only one leg is changed. Customizing, however, is a snap.



| Instrument         | Qty | Days | Mark  | Mark Chng |
|--------------------|-----|------|-------|-----------|
| XYZ                |     |      |       |           |
| 100 AUG 10 25 CALL | -10 | 9    | 11.85 | -.20      |
| 100 AUG 10 30 CALL | -10 | 9    | 6.90  | -.30      |
| 100 AUG 10 35 CALL | 10  | 9    | 1.95  | -.35      |
| 100 AUG 10 40 CALL | 10  | 9    | .05   | 0         |

**FIGURES 2 & 3:** Since your position statement (top) automatically displays each leg of a spread, the trick is to hold down your control button to choose a spread to sell (bottom).

As a trade desk vet, I enjoy getting the calls that begin with, “I love you guys and the software, but I can’t figure out how to (fill in the blank).” Knowing that Tom Sosnoff’s mother put an extra scoop of “can do” in his oatmeal every morning as a child gives me the confidence that when a client hits a wall, we should be able to give them the boost that they need to continue on their way to successfully navigate the thinkorswim from TD Ameritrade trading platform. Here are two questions newbies have that are easy to work around.

### I brought up a spread order on the Trade tab, but how do I get different strikes than what is depicted on the quote page?

Not a problem. If we’re living in an age where you can choose your child’s eye color and whether or not they get your father’s ears (I shudder to think), customizing your spreads to your liking is a cakewalk.

First, bring up a spread with one or more of the strikes you’d like. To do this, right-click on an option in the chain on the Trade page and choose any spread in the menu (butterfly, vertical, iron condor, and so on). Then, once the order is open under order entry, on the far left, under “Spread,”

choose the dropdown and select “Custom” (Figure 1). You’ll notice that you’ll be able to manually change not only the strikes and the quantity of contracts, but also the buy and sells individually without changing the adjacent fields. As you make changes, if you leave the price unlocked, the price will automatically change to the current mid-price.

### How do I close positions as spreads when they’re not next to each other in my statement?

Suppose you’re short two vertical call spreads, say the Aug 30/40 as well as the Aug 25/35. Your position statement would appear as it does in Figure 2.

Now, if you wanted to bring up a closing order for the 25/35 call spread, you would simply hold down your control button (CTRL) while you click on the 25 strike line and then the 35 strike line. You will notice that those will be the only two lines highlighted in the position statement (Figure 3). Next, right-click on one of the lines to create a closing order, and you’ve successfully created a closing order for those specific strikes.

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 can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.

# 34

## Special Focus: Futures Trading

Photograph by  
**Fredrik Brodén**

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Having been shunned for decades by investors opting for the “safety” of buy-and-hold strategies that haven’t exactly panned out, futures’ time has come. And with it, so has the technology to trade them. If you’re new to futures, let’s start with the basics.

words by **Thomas Preston**



# M

FOCUS:  
**futures  
trading**

Maybe it's because the 1982 movie *Trading Places* still has resonance in popular culture, but futures trading still has a certain boom/bust image. It's either, "Looking good, Louis!" on the yacht, or down and out on the street. The reality is somewhere in between, and futures can be a valuable tool for any retail trader or investor in different scenarios. Futures can be used for speculating, hedging a portfolio, or just gauging the mood of the market. If you've only heard stories about futures trading—scary or otherwise—or know a bit but want to know how to incorporate them into a trading strategy, read on. You'll make Billy Ray proud.

## IT STARTS WITH A TICK

Trading futures is less an objective in and of itself than part of a larger plan of how you intend to make money trading. Do you scan the markets for trends or reversals? There are dozens of futures markets with different market characteristics and volatility. Are you a stock investor concerned about risk? Index futures can provide a fast and potent hedge. How about speculating on interest rates, physical commodities, or even environmental markets? Futures offer direct exposure to things as diverse as eurodollars and sulphur dioxide emissions.

On the other hand, futures can also wreak havoc on your **P/L** if you don't know what you're doing. So before you plunge in and start slinging, you have to understand the nuances of the futures you intend to trade. (And you thought orange juice was exotic!)

For example, what's the minimum tick size? Most stocks go up and down in penny increments. That's not



Don't have a futures account open yet? For more info, go to [tdameritrade.com/trade/futures.html](http://tdameritrade.com/trade/futures.html).

to say that stocks don't change by a full point at a time, but each \$1 is 100 pennies, or 100 minimum ticks. In contrast, different futures products have very different minimum ticks. Take the very popular e-mini S&P 500. Its future has a minimum tick size of \$0.25, so you may see it move from 1100.00 to 1100.25, but not from 1100.00 to 1100.10. And the 0.25 move in the e-mini is worth \$12.50 per contract, not \$25, as you might expect. Crude oil futures have a minimum tick size of \$0.01, and are worth \$10 per contract. Because the minimum tick size and dollar value of that tick can be so important when hedging with futures, it's worth spending a bit of time familiarizing yourself with the contract specifications. A quick check on the CME Group's website ([www.cmegroup.com](http://www.cmegroup.com)) can get you up to speed with the basics.

## HEDGING WITH FUTURES

Speaking of hedging, that's a good place to start if you're new to futures. No, you're probably not growing 5,000 acres of corn and looking to hedge the crop (although there may be a few of you out there). But you probably have a position in stocks, funds, or options,



and maybe you will lose money if the market drops. Stock index futures can be used to help reduce the loss on an underlying portfolio—but understanding how it works is critical before you actually put on the hedge.

The trick to hedging your portfolio is to estimate how much money it would lose in some drop in a benchmark index, and then how much a short futures position in that benchmark index would make in the same drop. In other words, you have positive deltas that represent risk if the market drops. Short futures have negative deltas that would make money if the market drops. To hedge your portfolio, you balance the positive deltas with the negative deltas.

Sound tricky? It doesn't have to be with the beta-weighting tools on the thinkorswim from TD Ameritrade trading platform, which weighs the deltas (a measure of an option's sensitivity to changes in the price of the underlying asset) of the individual parts of your portfolio for their different volatility and sensitivity to changes in the overall market—i.e., their beta. The beta-weighting tool adjusts the deltas of the components stocks or funds by their beta to, say, the S&P 500 Index or Nasdaq, to name two possible benchmark indexes. Checking the box for “beta weighting,” then typing in the symbol of the future (“/ES” for the e-mini S&P 500 future and “/NQ” for the e-mini Nasdaq future) converts the deltas of the parts of your portfolio

into deltas of the benchmark future. When you look at the total deltas now, you'll see your portfolio's risk in terms of the future. You're almost there!

The next step is really important, and it gets to the nuances mentioned earlier. The beta-weighted delta indicates how much money the portfolio could theoretically make or lose if the benchmark future moves up or down one point. But you need to know how many dollars that future makes as it

moves. The e-mini S&P makes or loses \$50 when its price changes \$1. If your portfolio's beta-weighted delta is equivalent to positive 250 e-mini S&P 500 futures, then selling five e-mini S&P 500 futures would theoretically give you zero overall deltas.

But selling index futures as a hedge against a stock portfolio takes discipline to execute. That includes getting out if the market starts to rally—you don't want those short futures to eat up the profits that your underlying stock or funds should be making. Give yourself

either a specific time frame (“I'm nervous about the unemployment numbers coming out tomorrow, and I'll hedge with futures, but I'll hold the short futures for no more than a fixed number of days afterward”) or a specific dollar amount, like a stop loss (“I'll hedge my portfolio with short futures, but if the market rallies, I'll buy them back if they lose more than a fixed amount”). Hedging with futures can help reduce risk, but it doesn't mean that you can put them on and forget about them. Futures have a very specific role when hedging a portfolio—and it's usually short-term. When the hedge has fulfilled its purpose, or isn't needed anymore, you should close it out.

## STOPPING OUT

Because futures prices can move fast, you need to have a trading plan in place ahead of time, whether you plan to take advantage of the price movement or to get out of a losing position. Futures are highly leveraged—you don't have to put up much money relative to the significant risk they represent.

That leverage also means that losses can mount quickly, but technology can help you manage the risk. Stop-loss orders and trailing stop orders can be entered at the same time you enter the long or short futures positions. The thinkorswim from TD Ameritrade platform lets you base stop orders a certain number of points away from the current price, a certain number of ticks away, or a percentage move away. The first is the most often used—putting a sell stop, say, 2 points lower than where you buy the futures. But the second can be handy when you're trading futures with a strategy based on the number of ticks a product moves up or down. For instance, if the e-mini S&P future rises from 1100.00 to 1101.00, it can be seen as having moved 1.00 point or 4 ticks. Some trading strategies focus more on ticks.

## THE MYTH OF CLAIRVOYANCE

One of the things you may hear is that index futures predict the price of the market. That's not entirely true, but they can “lead” the market. The price of a future is related to its underlying or cash product (as the e-mini S&P 500 to the S&P 500 Index, or Treasury bond futures to the actual 30-year Treasury bonds) by a cost-to-carry relationship known as “basis.” It's a very specific financial calculation, and the difference between the future and the underlying is kept near that basis number through arbitrage. So, when you see a futures price higher or lower than the cash product, it doesn't mean the cash product will rise or fall in the future. But because futures are faster for executing trades (as opposed to, say, all 500 stocks in the S&P 500 or a silo of grain), futures will also change their prices more quickly than you might see in the basket

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of stocks. So, if you're a "tape reader" watching the intraday up and down ticks in the market, the futures can provide a heads up to the short-term market sentiment that will be translated into individual stocks a bit later.

To trade futures, you need to open up a futures account, because these trades are cleared and executed in a different way from stocks. But thinkorswim from TD Ameritrade lets you trade futures on the same platform that you're trading your stocks and options on. Your futures account will be listed under the same login as your equities account. That lets you switch back and forth from equities and options to futures just by selecting the active account in the upper right-hand corner of the platform. This makes managing your futures positions more convenient than ever.

SO DON'T THINK OF FUTURES AS A mysterious thing in the realm of billionaire speculators or something you only hear about on TV. They're trading products that can be useful for real traders, big or small. And the better you understand them, the more useful they can be.

*The risk of loss in trading futures and forex can be substantial. Clients 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 National Futures Association Understanding the Risks of Trading in the Retail Off-Exchange Foreign Currency Market risk disclosure before considering the trading of this product.*

# Futures Trading Tips

Options aren't the only game in town on thinkorswim from TD Ameritrade. Here are three tips for trading futures with the Active Trader tool.



**FIGURE 1:** With the Active Trader screen in the Trade tab, you can (1) bracket your orders, (2) Auto Send them without confirmation screens, and (3) trade like a market maker with price ladders.

fut.

### • Tip #1: Bracket Your Orders:

If you're trading futures, the Active Trader screen under the Trade tab on the thinkorswim from TD Ameritrade platform can give you a lot of flexibility with your orders. One of the best features is the ability to create a bracket order, which is an OCO (one-cancels-other) stop and limit order, to be entered as soon as your original buy or sell is filled.

A bracket order for a long futures position, for example, would set a limit order at a higher price and a stop order at a lower price. Because it's an OCO order, either the limit order or stop order would be executed, not both. The limit price sets a point where you would take profits, and the stop price sets a point where you want to limit the loss.

Associated with those brackets are the trigger prices. The stops and limit orders

can be based on a price change in the futures price, a percentage change, or a tick change. If you click the icon next to the "link" field, you can control the order to one of these three. The "offset" field controls the number of points, percentage, or ticks that the stop and limit orders will be set away from the current price.

Once the bracket order is routed, you can see the stop and limit orders displayed on the chart, as well as the price ladder on Active Trader. If you want to change the stop or limit prices, you can simply drag and drop the order right on the chart or price ladder to the desired level, and a cancel/replace order for either, or both the stop and limit order, will be submitted.

### Tip #2: The Little Wrench Thingy

Click the wrench icon at the top (right of the "Flat" button) to see the choices for order buttons such as Auto Send (routing orders without the order confirmation dialog—fast, but potentially dangerous), flat-tan (which closes any existing positions and cancels any working orders), and

Don't have a futures account open yet? For more info, go to [tdameritrade.com/trade/futures.html](http://tdameritrade.com/trade/futures.html)

## Q + A:

reverse (which reverses the quantity of your position from long to short or short to long).

### Tip #3: Price Ladders for Cool People

Finally, trading on the price ladder is “market maker” style, where clicking on the bid price routes an order to buy, and clicking on the ask price routes an order to sell. That’s different from the “All Products” tab on the Trade page. The idea in the Active Trader tab is that you want to work your orders for the best fill price, and want to join other market participants to buy on the bid price or sell on the ask price. It’s tougher to get filled this way, but with a product that’s actively trading, you can get orders executed. Also, if you click on the bid above the current market, it creates a buy stop order, and if you click on the ask price below the current market, it creates a sell stop order. Active Trader assumes that you don’t want to pay above or sell below the current bid/ask prices.

• *Market volatility, volume, and system availability may delay access and trade executions. A stop order does not guarantee an execution at or near the activation price. A stop limit order risks missing the market altogether. Carefully review every order placed with the Auto Send feature. You are responsible for all orders entered in your account. The risk of loss in trading futures and forex can be substantial. Clients 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 National Futures Association Understanding the Risks of Trading in the Retail Off-Exchange Foreign Currency Market risk disclosure before considering the trading of this product.*

#### Q: How is a future different from stock?

**A:** A stock represents ownership in a company. A future doesn’t represent ownership in the underlying commodity, product, or index; instead, it is a legally binding contract, an agreement between the buyer and seller to accept or deliver a specified quantity of the underlying asset (orange juice, Treasury bonds, etc.) by a set expiration date.

#### Q: How are margins calculated on futures?

**A:** Margins on futures are determined by the exchanges, and are based on the likely dollar value that the futures contract may change in a single trading day. More volatile products have higher margins. The system that clearing firms and exchanges use to determine the margin on futures positions is called SPAN (standardized portfolio analysis of risk), and is stan-

dard throughout the industry.

#### Q: What does marked to market mean?

**A:** Futures are marked to market daily. That means the cash from the daily profit or loss goes into (or out of) your account at the end of each day—not just when you close the position. Contrast this with stock trades, where the initial debit for a purchase is deducted from the cash in your account, and the cash proceeds from the sale go into your account only when you close the position and sell the stock. At the end of each trading day, the exchange that the future is traded on posts an official settlement price. That determines the daily profit or loss for any positions held overnight, and that profit or loss is added or deducted from the cash in your account.

#### Q: What is the basis?

**A:** Basis is the term for the difference in price between the contract months of the futures. It is the cost of owning the underlying product—whether that’s the S&P 500 Index, Treasury bonds, gold, etc.—from one expiration date to the next. The cost is composed mainly of interest charges, but can also include insurance and storage costs for physical commodities. Things like dividends on stock indexes and interest payments on bonds reduce the cost of carry. Basis can also reflect different supply and demand relationships. Crop cycles, shortages, or excess supplies expected in the future can also affect basis. Sometimes the futures in further expirations are more expensive; other times they are less so. The basis, then, can be positive or negative.

#### Q: How do I get a quote on futures?

**A:** Each future has a root symbol, such as /ES for the e-mini S&P 500 future, or /ZB for Treasury bonds. You can see root symbols of all the futures available on the thinkorswim from TD Ameritrade platform by clicking on the double drop-down arrows on the

symbol field on the Trade page. Then click on the Futures tab to see a list of the symbols. In addition to the root symbol, each future has a month and year code. If you type in the root symbol on the Trade page, you can see the different expiration months for that future. The expiration month is indicated by a letter:

January F  
February G  
March H  
April J  
May K  
June M  
July N  
August Q  
September U  
October V  
November X  
December Z

The expiration year is indicated by 0 for 2010, 1 for 2011, 2 for 2012, and 3 for 2013.

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## Gear Head

Cool things to do with  
thinkorswim from  
TD Ameritrade

Words by **Nicole Sherrod**

## tech.

• Traders are (ahem) an odd lot. Some people perceive us to be antisocial ... introverted ... withdrawn ... socially awkward. And although we're almost never the center of attention at happy hour, we are great at exploiting an opportunistic bend to place ourselves in the spot most likely to see the highest pig-in-blanket traffic. The reality is, we'd rather be home, poring over charts, than risk social incontinence.

But that's about to change, grasshopper! Untether thyself with mobile trading, get to your local water hole, and show your buddies what "after-hours" is all about! The launch of the TD Ameritrade Mobile suite, along with the release of futures and forex trading, will undoubtedly result in the new definition of the "Renaissance Man." Picture yourself. You're the confident, dark, brooding type at the corner of the bar. With your iPhone, Android, or Web-enabled smart phone in hand, you have access to more technical studies and indicators than are offered by most other brokerage apps. But here's a short list of a few:



# After Hours Trading

Putting the "Happy" Back in Happy Hour with Mobile Trading

## After-the-Close Earnings Updates

In the middle of earnings season, you can get real-time updates of after-the-close earnings releases. You can trade equities in the after-hours market in addition to futures and forex around the clock—all right from the palm of your hand. You'll also have access to after-hours news stories from a variety of sources.

## Research Trading Opportunities

Undoubtedly, people will approach you. Remember, there is opportunity in conversation. My girlfriends all started obsessing about J.Crew in early 2009. While they started amassing "tissue tees" and "schoolboy blazers," I amassed a bull call spread as the stock took flight from \$12 to \$45. Your friends are consumers and can



Talk, text, trade. To access the **Mobile Suite**, log in to your TD Ameritrade account and go to Trading Tools>Mobile Applications.

provide a lot of insight as to concentrations of retail spending in core demographics. Exploit them! While they talk, you can research trading opportunities right from your phone.

## Alerts

Keep up with your portfolio in the after-hours by receiving earnings alerts for any of your holdings. In addition, you can receive an alert if there is a change in earnings targets for any of your holdings.

And while, sadly, options don't trade in the after-hours, you can certainly queue up some opportunities for the next trading day.

Now get out there and put the "happy" back in Happy Hour!

Nicole Sherrod, Managing Director, Trader Group at TD Ameritrade.

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



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## The Token Glossary

• Terms you might stumble across in this issue

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# Short Vertical

• A defined-risk spread constructed of a short option and a further out-of-the-money option, both calls or puts. Short verticals are put on for a credit. Short put verticals are bullish and short call verticals are bearish. As time passes, and/or volatility drops, the short options decay faster than the longs. The strategy is designed to profit when you can buy back the spread for more than you sold it for, or at expiration, the short option is at- or out-of-the-money. Risk is limited to the difference between the strikes, minus the premium received.

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# BUTTERFLY

• A defined-risk, long spread constructed of two short options at one strike, one long option at a higher strike, and one long option at a lower strike, all calls or puts. By putting on a “fly,” you assume the underlying will remain in a range during the life of the trade. As time passes, and/or volatility drops, the short legs decay faster than the longs. The strategy is designed to profit when you can sell the fly for more than you paid—which is your maximum risk.

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## Delta Neutral

• When the sum of all deltas in all legs of a trade equals zero (or practically speaking, near zero). At the moment of delta neutral, the position is said to have virtually no delta (directional) risk, providing the trader with a near-perfect hedge.

## Implied Volatility

• Affectionately referred to as “vol” by floor traders and certain authors of this magazine, it’s an estimate of the volatility of an underlying stock or index that is derived from the market value of an option. The value of implied vol is plugged into one of the inputs of an option pricing formula to determine the value of the option. Higher implied volatility typically means higher premiums, and vice versa.

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## Iron Condor

• A DEFINED-RISK, SHORT SPREAD STRATEGY, CONSTRUCTED OF A SHORT PUT VERTICAL AND A SHORT CALL VERTICAL. YOU ASSUME THE UNDERLYING WILL STAY WITHIN A CERTAIN RANGE (BETWEEN THE STRIKES OF THE SHORT OPTIONS). THE GOAL: AS TIME PASSES AND/OR VOLATILITY DROPS, THE TRADE CAN BE BOUGHT BACK FOR LESS THAN CREDIT TAKEN IN OR EXPIRE WORTHLESS, RESULTING IN A PROFIT. THE RISK IS LIMITED TO THE DIFFERENCE BETWEEN THE STRIKES, MINUS THE TOTAL CREDIT RECEIVED.

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## P/L

• Profit and loss of the aggregate total of all gains and losses over a specific period of time, e.g., day, month, year. Often confused with ROI, which of course is just the “return on investment” of a single trade or position.

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# Vega

• One of the “greeks” used to determine what will happen to an option’s price. Vega measures expected change in an option’s price per 1% change in implied volatility. For example, if a long call has a vega of .07, should the implied volatility increase by 1%, the option premium will increase by \$7.

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## Spread

• An option position or order that contains two or more option “legs” and includes at least one long and one short option.

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## SYNTHETIC

• A position that mimics the risk/reward profile of another position, typically using some combination of stock and options. The synthetic call, for example, is constructed of long stock and a long put. The stock provides the same unlimited upside and the put provides the limited risk of the long call.

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