

# thinkMoney/13

random musings for traders  
at TD Ameritrade  
Fall 2011



10/**BEATING THE MACHINES**

18/**NAKED SHORTS AND DIRTY SECRETS**

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**ETF SPECIAL:**  
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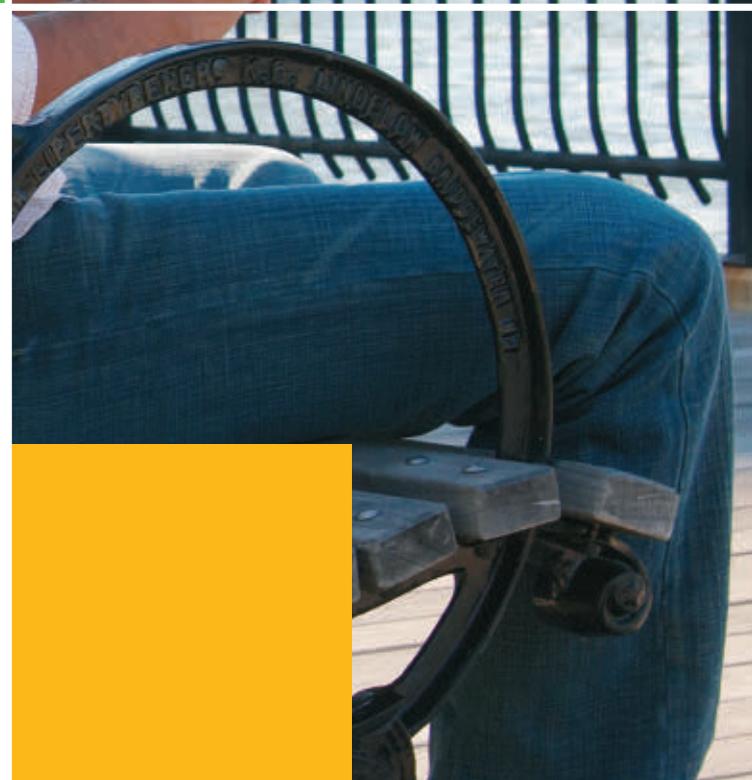


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Photograph by  
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**Stickin' It to the Nerds**

Despite the argument that quants rule the day, the key is how your own trading system holds up. If you don't have one, we have a few pointers.





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cont.

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### Features



#### 10/Stickin' It to the Nerds

Who would've thought that geeks would someday reign over Wall Street? These days, it seems that the "quants" are making all the money with high-frequency trading algorithms and black boxes. So, what's it gonna take to compete? Beat them at their own game.



#### 18/Naked Short Dos and Don'ts

Papa always said there was a right way and a wrong way to do things. If you're already trading naked short options without much thought about risk or probabilities, here are a few pointers papa would be proud of.

### Columns



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Pondering the value of social trading, a word from The Suit, and the five best trading shows that never made it to the telly.



#### 23/Vol Watch

Volatility may have spiked this summer. But when it's low again (don't worry, it will be), you'll want to be ready to pounce.

### Miscellaneous



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#### 26/How to Trade the Government

Traders and investors alike watch for market signals to time their entries and exits. With all eyes on the state of the U.S. economy, which government (and private) economic reports are the most relevant to the stock market?



#### 24/thinkStart

If thinkorswim Charts have you scratching your head with all of their awesomeness, we'll walk you through a few pointers to help you get started.



#### 44/Coach's Corner

Who said fibbing is bad? If you're looking for a fresh idea on picking stock targets, check out Fibonacci retracements.



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Traders may balk at buy-and-hold investor logic, but many still have stock portfolios. They just don't care much for the "long term." Whatever your time frame, if you're hedging stock positions with options, it's good to know a few tricks about how to size things up.



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The world of exchange-traded funds is huge. But that doesn't mean you should be trading all of them. With ETFs, less is more, but it helps to understand the essentials as well as the caveats.

#### PLUS: STRATEGY FOCUS

Scanning for ETFs on thinkorswim  
ETF Q&A

### TD Ameritrade Contact Info You Could Use

Client Services Representative: 800-669-3900  
New Accounts: 800-454-9272

#### thinkorswim Support:

800-672-2098  
thinkorswim@tdameritrade.com

#### Platform Feedback:

thinkorswimfeedback@tdameritrade.com

#### Tech Support:

thinkorswimtechsupport@tdameritrade.com

**paperMoney Support:** thinkorswimpapermoney@tdameritrade.com

#### For all other inquiries:

tdameritrade.com/contact

#### General Mailing Address

PO Box 229  
Omaha, NE 68103

**A Quick Howdy**

tdameritrade.com

**thinkMoney®**

EDITORIAL DIRECTOR  
**Kevin Lund**

EDITOR  
**Thomas Preston**

TECHNICAL EDITOR  
**Alex Mendoza**

ART DIRECTOR  
**Tom Brown**

ASSISTANT EDITOR  
**Jennifer Agee**

DESIGNER  
**Jennifer Roberts**

CONTRIBUTING WRITERS

**Nicole Sherrod**  
**Frederic Ruffly**  
**Matt Blackman**  
**Michael Turvey**  
**Adam Warner**

CHIEF PHOTOGRAPHER  
**Fredrik Brodén**

CONTRIBUTING ILLUSTRATORS  
**Brian Cairns, Evonrude**

PUBLISHER

**T3 Publishing**  
Email: info@t3publishing.com  
www.t3publishing.com



ADVERTISING CONTACT  
sales@t3publishing.com

edit.

**Nerd Bashing**

•Viva la quants! ...

Or is it revile the quants? We're not sure. But what we are sure of is that there's a lot of blame for this past summer's unusual (and sudden) volatility being attributed to high-frequency trading, or should we say the machines that trade HFT and the geeks—er, quants who programmed them. But hey, we're not here to accuse and abuse one way or another. What we do know is that you don't need a HFT firm or a genius IQ to take on the market. You just need some

common sense, a little less emotion, and more than likely, a little structure. In a word, you need a system—a simple one. If you don't have a system (astrology aside, please), maybe our cover feature "Stickin' It to the Nerds" (p. 10) will help.

Now, if you're like a lot of traders, "data creep" is setting in by way of talking heads discussing this and that about the latest super-important economic report that's going to move the markets. The real question is, which ones matter the most to you as a trader, or perhaps to your long-term portfolio? In "How to Trade the Government" (p. 26), we'll pick apart the five most widely followed reports to see how they measure up.

Speaking of portfolios, if you have one, you may have picked up on the fact that we really don't live in a "set it and forget it" world anymore. So if you have any positions for the long haul



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(we realize this is a relevant term), then you might want to learn just how to size up your hedge by reading "Hedge ... Not a Four-Letter Word" (p. 32).

As you can see, there's a lot of stuff we pack into each issue of *thinkMoney*. But how will we know if we're pushing the right buttons unless you speak up? We won't. So, if you can take three minutes to answer seven questions right now, head on over to [tdameritrade.com/tmsurvey](http://tdameritrade.com/tmsurvey). You'd sure make our editors happy, and we'd surely be grateful.

Happy trading!  
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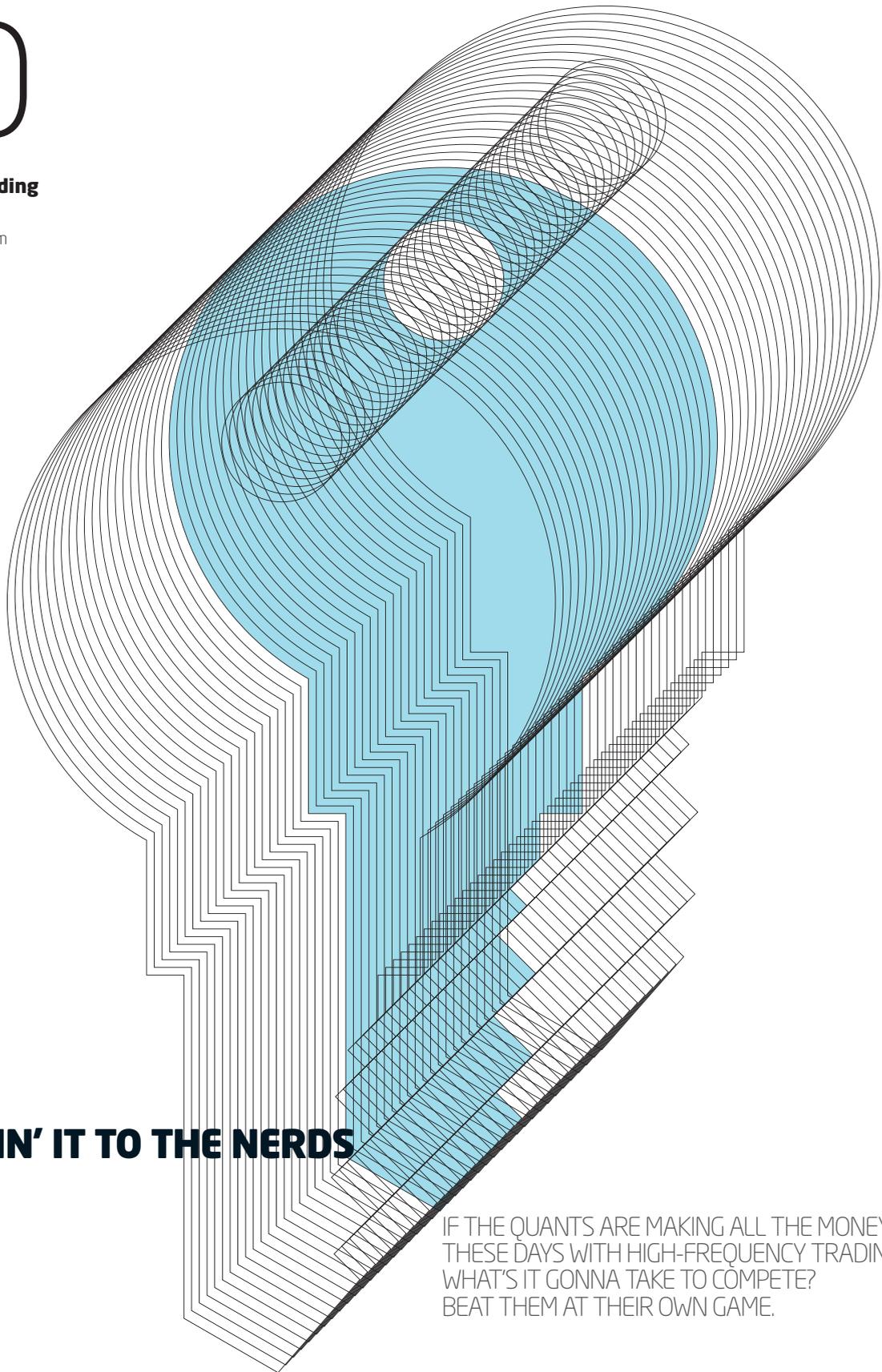
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**System Trading**

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## **STICKIN' IT TO THE NERDS**

IF THE QUANTS ARE MAKING ALL THE MONEY THESE DAYS WITH HIGH-FREQUENCY TRADING, WHAT'S IT GONNA TAKE TO COMPETE? BEAT THEM AT THEIR OWN GAME.



WORDS BY **MARK AMBROSE**  
PHOTOGRAPH BY FREDRIK BRODÉN



## System Trading

Photograph by **Fredrik Brodén**

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SEE GLOSSARY PAGE 46

AS A KID, DID YOU EVER DREAM of becoming a nerd? I didn't think so. But over the past couple of years, how many grinning people did you see in the financial news who looked like, well, nerds? Schooled in computer theory, math, physics, whatever, these nerds were in the headlines for making a lot of money with computerized trading: high-volume, split-second, machine-driven buys and sells that netted maybe \$0.05 per 100 shares. That doesn't sound like a lot of money, but multiply that by hundreds of thousands of shares across thousands of trades a day, and it starts to add up. In fact, it accounts for the majority of today's stock trading volume. And as you switch on your underpowered laptop, you might wonder, is that what I have to do to make money trading?

Short answer: No.

Longer answer: Absolutely no.

### NERD REPELLENT

What those stories haven't told you is that the recent sharp swings in volatility have forced many who develop computerized trading to rethink their strategies. The short-term, back-and-forth price movements that computerized trading is supposed to capture have been more uni-directional, and have left some traders with large losing positions.

Okay then, you ask, if not high-frequency, computerized trading, then what? You need a strategy-based approach to trading, so that regardless of the stock or index, regardless of the market environment, you have an approach to finding and executing trades that makes sense. In other words, a system. This means you need to create a set of rules that you follow for getting in and out of trades every time, rather than simply shooting from the hip. Your system may not always turn out as you expected, or always make money, but you'll have a plan for placing trades. You may not get your picture in the financial news, but maybe you'll pay your bills and still have time to be a normal person.

### BUILD A 1-2-3 SYSTEM

So, how do you do it? Well, for starters, if you already have the thinkorswim platform loaded on your laptop, you have tools at your disposal that are designed to offer more than what most of the Wall Street nerds have. Seriously. And you're going to use those tools to find trades that meet the following three criteria:

1. *Defined risk*
2. *Positive time decay*
3. *Favorable odds*

Let's break each one down.

#### 1. Defined Risk

This means no matter what the stock or index does, whether it goes up big, down big, or nowhere at all, your maximum potential loss is known before you even do the trade. For example, a short call vertical has defined risk. A short naked call does not. With the short vertical, the max loss is the difference between the strike prices minus the credit received. That's it. With a naked short call, you don't really know what your maximum loss might be. Even if you think you'll use a stop order to buy the short call back if the loss gets too great, what if the stock gaps up overnight, when you can't trade? Stick with defined-risk trades.

#### 2. Positive Time Decay

Besides death and taxes, the only other thing you can count on is time passing. And if it doesn't, we've all got bigger problems. Because of that inevitability, you want time passing on your side. That means you want your positions to have positive time decay, so that all other things being equal, one day passing means your position is worth a little bit more. Positive time decay generally comes from having a short option somewhere in the position. It doesn't have to be a naked short (see criterion #1), but as part of a spread like a **short vertical, long calendar, or short iron condor**, a short option will put time on your side.

#### 3. Favorable odds

No matter how much research you do, the probability of a stock or index moving up or down is 50%. But you don't want your trading to depend on the flip of a coin. The way to tip the odds in your favor is with smarter strategy selection. That begins by searching the option chain for a shorter-term expiration and a high probability of expiring worthless. This will let you create spreads that depend less on being right on direction and more on premium decay.

### OKAY, NOW WHAT?

Not too nerdy, is it? But how about a couple of real-life examples for both the stock and options trader that you won't find anywhere in those stories from Wall Street?



**FIGURE 1:** In thinkorswim, view the probability of an option expiring in-the-money (ITM). Here, a call with a 34% probability of expiring ITM is the same as saying it has a 66% probability of expiring worthless.



## The Options Trader

You're raring to get going with options, but you're not sure whether you should be bullish or bearish on a particular stock or index. Don't sweat the direction of the stock. Using the three criteria, you can find a strategy that may still make money even if you're wrong on your directional bet. Let's see how.

First, start with some directional bias for the stock or index. Maybe it's based on technical or fundamental analysis, or maybe your favorite talking head on TV suggested it. We're going to create a short vertical spread (criteria #1 and #2)—a short call vertical if you have a bearish bias, or a short put vertical if you have a bullish bias. Start by finding the expiration ranging from 25 to 45 days.

For criteria #3, if you're bearish, find the out-of-the-money short call that has a 60% to 70% probability of expiring worthless. If you're bullish, consider finding the out-of-the-money short put that has a probability of expiring worthless of between 60% and 70%. To create a short call vertical, consider buying the call option that's one strike further out-of-the-money than your short call. To create a short put vertical, consider buying the put option that's one strike further out-of-the-money than your short put.

Now, here's what can happen. With the short out-of-the-money call vertical, if the stock moves down by expiration, you make money. If the stock stays the same by expiration, you make money. If the stock moves up past the short strike of the short call vertical, you'll probably lose money. But if it only goes up a little, not as high as the short strike of the short call vertical, you can still make money. The short put option works the same way, but loses money if the stock moves down past the short strike of the short put vertical.

THIS IS NOT A FOOL-PROOF, GUARANTEED WAY OF making money trading. But it is better than sitting on the sidelines, frustrated and confused by not being able to trade the way you think the Wall Street pros do it. Each trade you make based on these criteria will have reasoning behind it. And even if the trade loses money, you'll know exactly how much and why. That's being an educated trader. Instead of a nerd.

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## The Stock Trader

You're a stock trader. Maybe you're not quite ready for all the option spread stuff. So how do the three criteria work for you? If you're long stock, you already know your maximum potential loss if the stock goes to zero. Even though that risk might be a very large number, I'll argue that it is defined in its own way. That's criterion #1.

For #2, you look to create a short covered call against that long stock to give you some positive time decay. When you're short a call against your long stock, for each day that the stock price doesn't move, that short call is going to get cheaper and cheaper and make you a little bit of money.

For #3, getting the odds on your side means selling an **out-of-the-money** call that has a probability of expiring worthless of about 60%, which you can do from both thinkorswim (Figure 1) or Trade Architect (sidebar, left). The stock can rise up to the strike price of the short call by expiration, and the call will still expire worthless. That reduces the cost basis of your long stock, which also lowers its breakeven point. That means the stock can make a larger move down, and you still might not lose money.



### TIPPING THE ODDS

There are two ways to look up the odds of an option expiring worthless: thinkorswim (see Figure 1, left) and **Trade Architect**. In Trade Architect, select the Quote page. Pull up an option chain and select one of the left column headers under Calls to customize the column. Select "Probability of Exp."

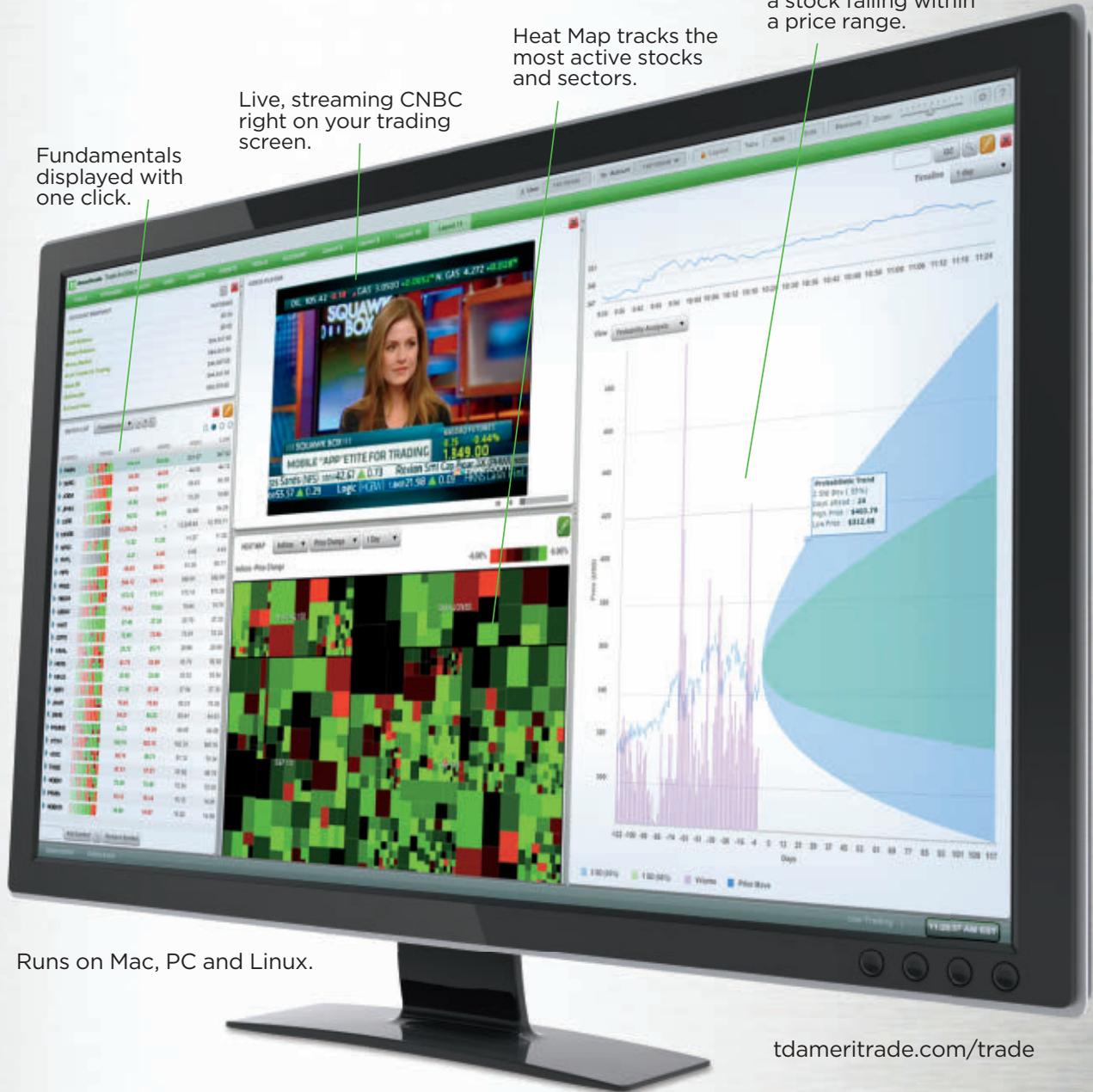
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**Love Notes**

Hyperbole and trading pearls from you and yours truly

Photograph by **Fredrik Brodén**

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• **CLIENT 1:** Once you decide on the number you want, type it into the empty box beneath “length” and click the Enter button on your keyboard.  
**CLIENT 2:** What’s a keyboard?

• This market is acting weird for a reason. I doubt it is because of anything I said.  
**Amy**

• A narcissist is a person who is foolishly infatuated with himself. With me, it’s true love.  
**Bret**

• I can’t give you a formula for success, but I can give you a formula for failure. Try to please everybody.  
**Herbert**

• Preconceived notions will be dealt with by the full extent of the market.  
**Grant**

• My problem is I don’t know if I’m a good trader or if I have extra-divine help from above.  
**Herbert**

• I trade best when I’m hung over enough to be miserable but not so much that I fall asleep under the desk.  
**Dan**

• How can you not love the guy who invented calculus?  
**Don**

• From my experience, going back 10 years is like looking at Mars ... You know it’s there, but you can’t use it for anything but as a point of light.  
**Al**

• If you want to make a living at this, better get more than one golf club ... just saying.  
**Pat**



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

• Her husband has done nothing but look through the window all day, moaning on and on about the horrible weather. She says that if it gets much worse, she may have to let him back in.  
**Beth**

• If you cannot make money with one monitor, you cannot do it with ten.  
**Dennis**

• You will not be punished for your anger. You will be punished by your anger.  
**Buddha**

## News+Views

A hodgepodge of stuff we thought you should know.

## Coming Soon to Trade Architect

Our favorite new gadgets

### Stock Screener

We're starting with 21 real-time scans that will update every 15 minutes, with more to be added soon. And the results come with the "Strength Meter" showing if the trend is up, down, or flat for the prior three weeks.

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### Column

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# nws.

## INDUSTRY SPOTLIGHT

# Is There Value in Social Investing?

by Adam Warner

CNBC would say—not so much. A recent interview began like this:

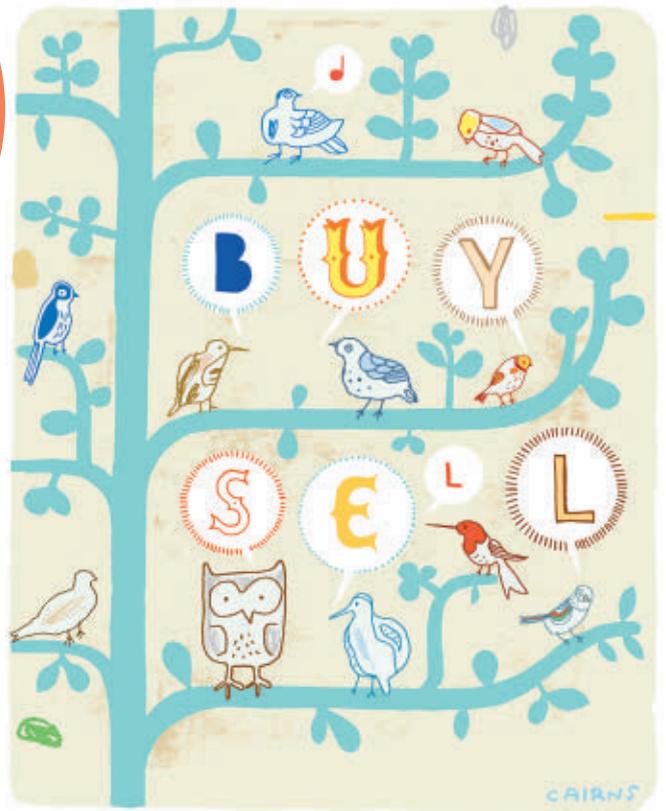
"Every day 155 million tweets get posted on Twitter. [...] Tweeting before thinking can get you in a whole lot of trouble. And so can believing everything you read on Twitter; it's becoming an even bigger problem for investors." It didn't get much better from there.

But it's simplistic to treat Twitter, and by extension, myTRADE, as if they were Yahoo! chat rooms in the late 1990s. Anyone who blindly jumps into trades following a random observation or "news break" he sees on myTrade or Twitter deserves his/her

fate.

Twitter is just a medium. If it existed in 1775, you can bet Paul Revere would have dispensed with riding around on horseback, warning folks to ring them church bells and make a lot of noise. He would have fired up his Twitter app on his iPhone and issued his warning. Since @PaulRevere had built a reputation over time, his followers would have attached some credibility to his warnings. If it came from @TheRealBenedict Arnold or @RandomAngryColonist, maybe not.

All Twitter has done since then is improve the communication mechanism. We still choose who we lis-



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ten to. We self-curate. myTRADE and Twitter expand on that. They segment your information into one major topic (finance) and then segment even further via ticker symbol. And yes,

they can curate by individual via suggested streams, or by topic, such as an options stream, a currency stream, and so on. No, they don't always make perfect choices. It's a process, like everything else in life. Does CNBC have the absolute perfect mix of guests on TV? Um, no.

Sites like myTRADE can be helpful ways to crowdsource market news and the markets' reaction to market news. And they may help you make more informed decisions. I emphasize the word "help." These sites shouldn't make the decisions for you—and neither should a guy on TV.

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# Ask The Suit

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



**TD Ameritrade bought my account and all I got was this monkey in a lousy T-shirt. What gives?**

That's right! It's mass pandemonium. Dogs and cats ... living together. Former thinkorswim clients are now officially living under the same roof with TD Ameritrade clients. And we couldn't be happier to have them as a part of the family. So maybe we didn't send you anything tangible, but my team of product development elves have been hard at work assembling a whole host of new toys for traders that we will be rolling out in late fall and early winter—just in time for the holidays. We've received no shortage of notes from clients who have informed us that we are on the naughty list because we haven't been delivering new features as regularly as we used to. The reality of the situation is that we've been hard at work gluing these two companies together. The effort was nothing short of MacGyverian. We used more bubble gum, duct tape, and pipe cleaners than you could ever imagine, but the heavy lifting is done and we are now very much focused on getting back to our normally scheduled software releases. Stay tuned...

**I recently became a new father and wanted to let you know that I sometimes read the thinkorswim User Manual to help the baby fall to sleep.**

Oh yeah? It also works wonders for potty training puppies and lining bird cages. But I get your point. Our old User Manual had ... how should I say ... a few opportunities. To that end, if you visit the help tab, you'll see that we worked with the talented staff that produces *thinkMoney* to create a new user manual in the same look, feel, and voice. It's even scratch and sniff and has popups! Okay, not really, but I'm sure you will find that it will delight all of your trading senses and will help make you a power user of our fantastic desktop trading software.

**I have accounts at other firms and no one sends me anything like *thinkMoney*. What can I do to thank you for brightening my day once a quarter?**

Transfer the accounts at the "other firms" to TD Ameritrade! No, really. Do that. I beg of you.

## Pot Shots

Reality Trading Shows that Didn't Make the Fall Network Lineup

### KEY:

2 Buy Tickets =



1 Buy Ticket =



1 Sell Ticket =



2 Sell Tickets =



### Trader Wife Swap



A new tech integration that lets you run all your trading decisions by another person's wife.

### Theta Hunter



Somehow, even rampant market volatility and three-legged spreads don't conjure images of living life on the edge.

### Extreme Position Makeover



It starts with a simple call option that somehow fell off a cliff. Watch as a team of floor traders puts it back together, one delta at a time.

### Chicago Shore



Can a clan of unemployed market specialists who once stood in the pits together survive 30 days and 30 nights under one roof?

### Pimp My Iron Condor



If you thought selling naked puts was sexy, imagine putting on two verticals.

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**Naked Short**

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**NAKED  
SHORT  
DOS  
AND  
DON'TS**

PAPA ALWAYS SAID THERE WAS A RIGHT WAY AND A WRONG WAY TO DO THINGS. IF YOU'RE ALREADY TRADING NAKED OPTIONS (OR POSITIONS LIKE THEM) WITHOUT MUCH THOUGHT ABOUT RISK OR PROBABILITIES, HERE ARE A FEW POINTERS PAPA WOULD BE PROUD OF.

BY **ADAM WARNER**  
PHOTOGRAPH BY  
**FREDRIK BRODÉN**



**Naked Short**Photograph by  
**Fredrik Brodén**

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**\*SELLING NAKED  
(SHORTING OPTIONS)**

All snickering aside, selling a naked option is simply shorting a call or put to collect a premium. If you believe that a stock won't drop very much and have a bullish bias on it, you might consider a short put, where the max loss is the strike price minus the premium plus transaction costs. If you believe the stock won't rise very much and have a bearish bias, you might consider a short call—the breakeven is the strike plus the credit. However, max loss is unlimited regardless of the strike or the credit. The problem: you have no hedge. Hence, the "naked" part—meaning you're exposed, without a safety net.

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**S**horting options\* always sounds tempting, if for no other reason than the allure of getting something for nothing—or shall we say, profiting from the passage of time, rather than speculating on direction. If nothing happens, the option you sold has less value today than it did yesterday, and will have less value tomorrow than today. You might say in the case of short options that you have the wind at your back.

The catch, of course, is that you have open and potentially unlimited risk shorting options. And the magnitude of losses for the average trader tends to dwarf the magnitude of the winners—such that the expected gain of a net-shortening strategy ultimately equals the expected gain from a net-buying strategy. But that's not to say shorting options is a bad idea. In fact, hordes of traders swear by it. Like any other trading strategy, you just need to understand the risks and follow a set of rules. If you don't have any of your own, think about the following.

**THE "SHORT" LIST****1. BEWARE OF NAKED CALLS.**

Wait, you probably thought this article would provide unbiased tips for shorting both puts and calls, right? Sorry. Shorting calls just has a lousy risk/reward profile. Period. Enter at your own risk, because the most you can "win" is the premium on the calls less commissions and fees, and your losses can run to the moon and back.

So let's say you sell an at-the-money call for \$2. You get the direction in the stock completely right and it gets slammed, say down \$10. Your win? Excluding commissions and fees, \$2. And if the stock really gets plastered, down \$20, you win ... the same \$2. On the flip side, with naked calls, you have unlimited risk. If the stock goes up \$10, you lose at least \$8 plus commissions and fees, and probably more, depending on how much time you have until expiration. As Larry David might say—pretty, pretty bad. And who wants to tie up all that precious capital, anyway? Or worse, trigger a margin call.

A different alternative?—Selling call vertical spreads. **Short verticals** contain a built-in hedge. Instead of, say, selling the XYZ January 50 calls

at \$2, consider selling the XYZ January 50–55 call spread at something like \$1.50. If XYZ drops, or even just expires below \$50, you still earn the premium you generated, minus commissions and fees, whether via a naked call or a call spread. But with the latter, your risk is capped at the long call. Sure, you generate less premium selling a spread as opposed to a naked call. But you can sell a greater quantity of spreads than you would naked calls. Why? Because you now have defined upside risk, and typically, your friendly broker (wink, wink) will require you to put up less capital on margin. This call spread maxes out at \$5, the difference between the two strikes in the spread (\$55–\$50). Since you took in \$1.50 of premium, you can actually only lose \$3.50 (plus commissions and fees) per spread.

**2. BEWARE OF SELLING NAKED PUTS AFTER A BIG RALLY WHEN EVERYONE'S BULLISH.**

Covered calls sometimes get defined as "income." At least the sold call part. The idea is that the premium received from selling the call against a long stock position is "income." That of course assumes you don't end up buying the call back at a higher price than you sold it for. But a covered call position carries nearly the same risk/reward characteristics as a naked short put. And we all know naked put shorting carries rather large risk. Namely, the stock might actually go lower and you



Only qualified accounts can trade short puts—“Level 3” trading. If you’re only approved for Level 2 trading, you’ll need to apply to upgrade your account to obtain the green light to do so. Log into your TD Ameritrade account and click on My Profile under the Home tab...

Under Elections & Routing, go to Option Trading and click on the Edit button to apply for an **Options Upgrade**.

could end up buying the stock at the put’s strike price, which may be significantly higher than where the stock is trading. There’s nothing wrong with using a naked short put or covered call strategy—just know the risks attached.

**3. CONSIDER SELLING NAKED PUTS AFTER A SELLOFF WHEN VOLATILITY IS HIGHER AND THERE’S A HIGHER PROBABILITY OF AN UPSIDE MOVE.**

It’s the reverse of point 2. Naked put shorting is an out-and-out bullish strategy. You are not only betting on the stock to go higher; you’re also betting on volatility to go lower. And since volatility tends to move opposite the stock, it’s almost like making a double bet. So you really want to time it well.

**4. BEWARE OF SELLING TOO FAR INTO THE FUTURE.**

Options lose value every day by virtue of time ticking away—this decay is known as *theta*. However, options don’t decay in a straight line. The closer to expiration they get, the faster they decay. In greek terms, the closer to expiration, the higher the theta.

In general, the farther expiration options (say, three months) trade at higher absolute premiums compared to shorter term-options (say, two months). But on the other hand, theta is higher for the shorter-term options. So as an options seller, you want to have it work both ways. You want to sell enough time value that you get a reasonable premium, in absolute dollars, for the options you sold. But you don’t want to go too far and not earn any money on time decay.

What’s a good risk/reward in terms of time until expiration? There are a lot of variables. All things being equal, selling options in the one- to two-month range can usually generate enough premium to be worthwhile, and also sets you up to earn some time decay.

**5. CONSIDER SELLING NAKED PUTS ON LOW-PRICED STOCKS THAT HAVE BEEN BEATEN UP.**

It’s tough to get too injured jumping out of a first-floor window. In that same vein, there’s relatively light downside risk selling puts in already low-priced stocks (under \$10, for example). The stock itself can only go to zero. Put buyers obviously know this, so they won’t pay you an enormous premium when they can see the floor, too. But low-priced names around the \$5 to \$10 price range do tend to see some high implied volatilities, so it may be worth checking for potential opportunities.

**WHICH OPTION DO I CHOOSE?**

So, now that you know a little more about the risks of trading naked puts, which options should you choose if you decide to proceed? In the spirit of this issue’s cover story (“Stickin’ It to the Nerds”), create a simple system to follow. Don’t make it complicated. For example:

1. Consider puts expiring in less than 40 days.
2. Consider options that have a greater than 60% probability of expiring worthless.\*

With step 1, you take care of rule 4 in the previous section. With step 2, you’re trying to stack the odds in your favor from the get-go in an attempt to win on more trades than you lose. You can find both criteria on the Trade page in the thinkorswim platform (see Figure 1, or for Trade Architect users, see sidebar at left). We can’t guarantee success, but it doesn’t hurt to put a well-thought-out method into place that you follow consistently. Trading short puts isn’t for every trader. But avoiding them out of a sense of fear may not be appropriate, either.

• *\*Probability analysis results available in the thinkorswim and Trade Architect platforms are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring.*

*Past performance of a security or strategy is no guarantee of future results or success. Naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance. The special risks inherent to naked options trading may expose traders to potentially rapid and substantial losses. The information contained in this article is not intended to be investment advice and is for educational purposes only. All applicable 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.*



**Trade Architect Tip**

To locate probabilities, select the Quote page. Pull up an option chain and select one of the left column headers under Calls to customize the column. Select “Probability of Exp.”



**FIGURE 1: Consider the odds.** Using a thinkorswim option chain, you can (1) check the days to expiration to ensure that there are 40 days or less, and (2) look for a greater than 60% probability of expiring worthless.\* In the chain pictured here, the 52 strike put has a 37.03% chance of expiring in the money—or a 62.97% chance of expiring worthless.



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**Vol Watch**

Viewing the markets through the eyes of volatility

vol.

• Now you see it, now you don't. Market volatility (measured by CBOE's VIX volatility index) stubbornly persisted under 20% for several months until it broke out in July of this year. By August, it spiked as high as 48%. Could you have known what expected future volatility was when the VIX was only about 16% in early July? Well, using VIX option prices to estimate the market's expectation of its future value, at that time, the October VIX was at 22%, the November VIX was at 22.8%, and December was at 23%—indicating a possibility of higher future implied volatility.

**GOING VERTICAL**

One strategy with positive vega is the long **at-the-money** vertical spread. When volatility is lower, the extrinsic value of the first **in-the-money** option is lower, too. Creating **long vertical spreads** by buying that first in-the-money option and selling an **out-of-the-money** option one or two strikes away can have a debit that is less than the intrinsic value of the long option at expiration. What does that mean?

Look at the intrinsic value of the option that is one strike in-the-money. Now compare it to the price of the option, which is the sum of the intrinsic and extrinsic value. If you can sell the out-of-the money option

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

**Low Vol... Yum, Yum**

• Volatility, like a spring, will recoil again. When it does, be ready.

for close to the extrinsic value of the long option, then you are establishing the long vertical for close to the intrinsic value of the long option. That means that if the stock stays right where it is, the spread won't lose much money. It's harder to establish long at-the-money verticals at these prices during periods of higher volatility.

**WHEN VOL KEEPS FALLING**

The question is, though, when volatility is low, and you establish a position that has positive vega, aren't you at risk if volatility falls? Sure. But how much risk is there that the VIX would fall from 16% to, say, 12%, and how great a loss would that create for a long vega position? For example, if the vega in a two-month vertical spread in S&P 500 options is approximately +0.10, that means a long vertical spread worth, say, 2.00 with volatility at 16% today could drop to 1.60 if volatility drops to 12%.

In ten years, the VIX has not dropped below 9%, and it has rarely dropped below 14% (source: thinkorswim Charts).

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Volatility is often low during the summer months, only to historically rise in the fall. While there is risk in a long vega position if the VIX goes from 16% to 14%, it's not as great as when volatility is 30% and drops to 20%.

WITH VOL ALL OVER the map this year, who knows where it will be by the time you read this. But when the VIX eventually comes down from its perch, and you believe that there is support for the VIX at a certain level (look at your charts), you could use dips in volatility to establish long vega positions. Keep in mind that an increase in implied volatility does not have to be accompanied by an increase in the magni-

tude of percentage price changes in an index or stock. That's one reason to possibly avoid simply buying calls and puts, even though they would have positive vega.

• *The information contained in this article is not intended to be investment advice and is for educational purposes only. Multi-legged 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 transaction 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.*

thinkStart

Finding your way around your favorite trading platforms

# thinkorswim Charts Page

If pictures could speak a thousand words, this one is guilty as charged.

• Surely you've seen those magical chart programs on TV? You know, the ones being peddled as crystal balls that tell you exactly where any stock is headed for only \$3,995? Uh-huh—well, they don't exist. Sorry, we can't promise to show you the future, but we do have thinkorswim Charts. And they're free. So flexible, they perform yoga, and contain more indicators than any other broker/dealer to help you find that perfect setup. Here's the high-level view.

- **PRICE CHART** Customize your colors and chart type. If it's Candlesticks, bars, or heck, Heikin Ashi that you want, it's there. As far as trading goes, this really is the "big picture." Pretty, isn't it?
- **UPPER INDICATOR AREA** Drop all kinds of drawings and studies over the price chart. From the **Drawings** menu (upper right button), you can add trendlines, Fibonacci retracements, and even regression channels. From the **Studies** menu (next to Drawings button) add all flavors of moving averages, Bollinger Bands (pictured here), price channels, or plot all the places where certain in study "crossovers" occur as potential entry/exit points.
- **LOWER INDICATOR AREA** If it doesn't belong in the upper chart area, it probably lives in the lower sub-graph. The default is volume, but this is not only other old favorites live—i.e. MACD histograms and Stochastics—but also the lesser-known as well, such as volatility studies, ADX, and the ever-ironic Random Walk Index (no, not kidding).



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

## 5 Treats for Chart Nerds

### 1/Expiration Friday

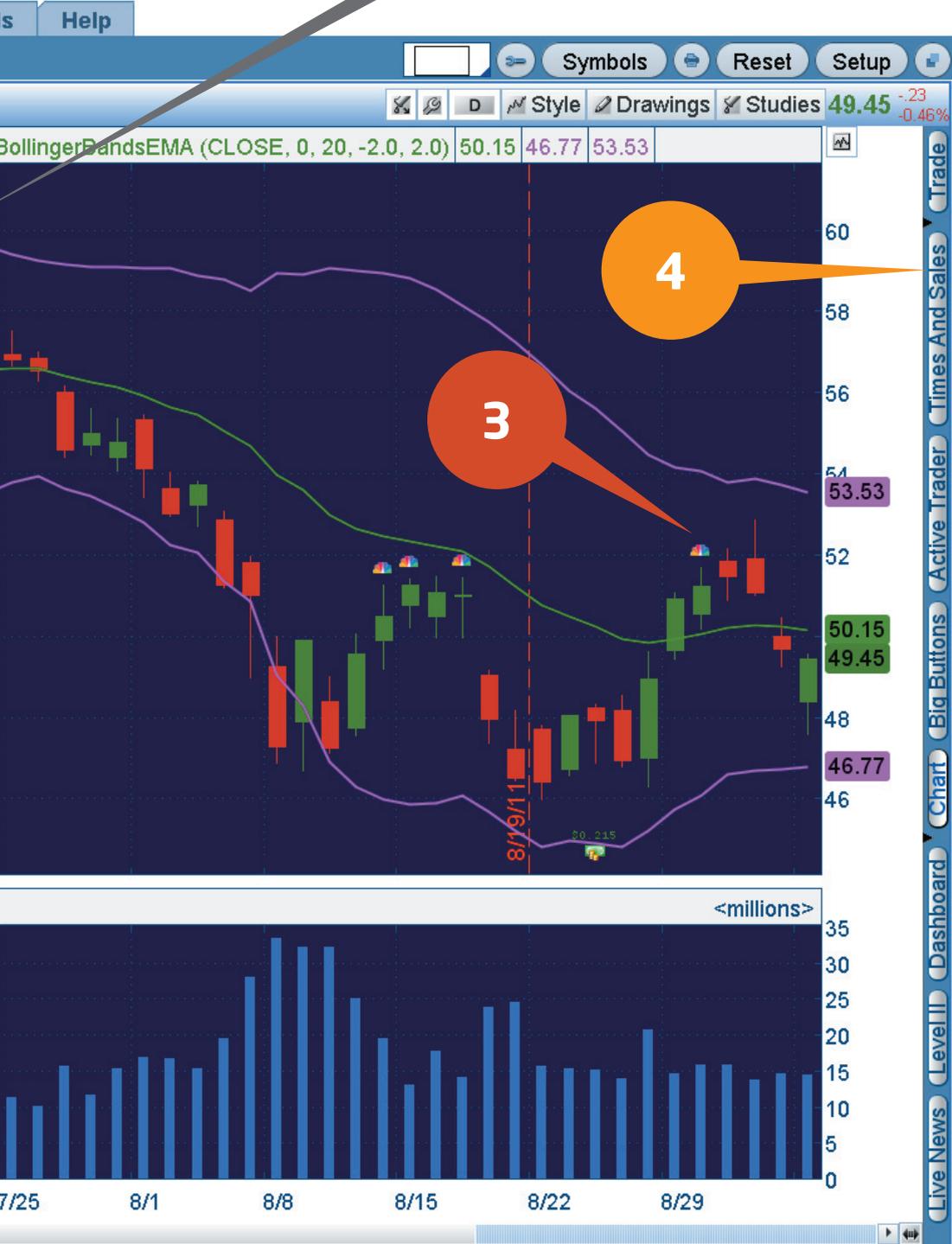
It might be a good idea to check out how the stock you're looking at fared at prior options expirations before trying out your next new options strategy. The little dashed-lines running vertically up your screen tell the date of expiration on the bottom.

### 2/Earnings and Dividends

Hover your cursor over these little icons to get the past numbers. Right click and choose "Read Press Release" to get the details. Can't see them? Click the Style button (upper right) and choose "Settings." Choose Equities and check the box next to "Corporate Actions."

**Hot Tip**

To delete a study from the chart, right-click on the indicator, choose "Delete," and watch it disappear.



Haven't downloaded thinkorswim yet? What are you waiting for? Watch the demo at [tdameritrade.com/demo](http://tdameritrade.com/demo), or just log onto your TD Ameritrade account and click on the Trading Tools tab to download the software.

Options involve risk 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 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.

**3/CNBC Stock Vids**

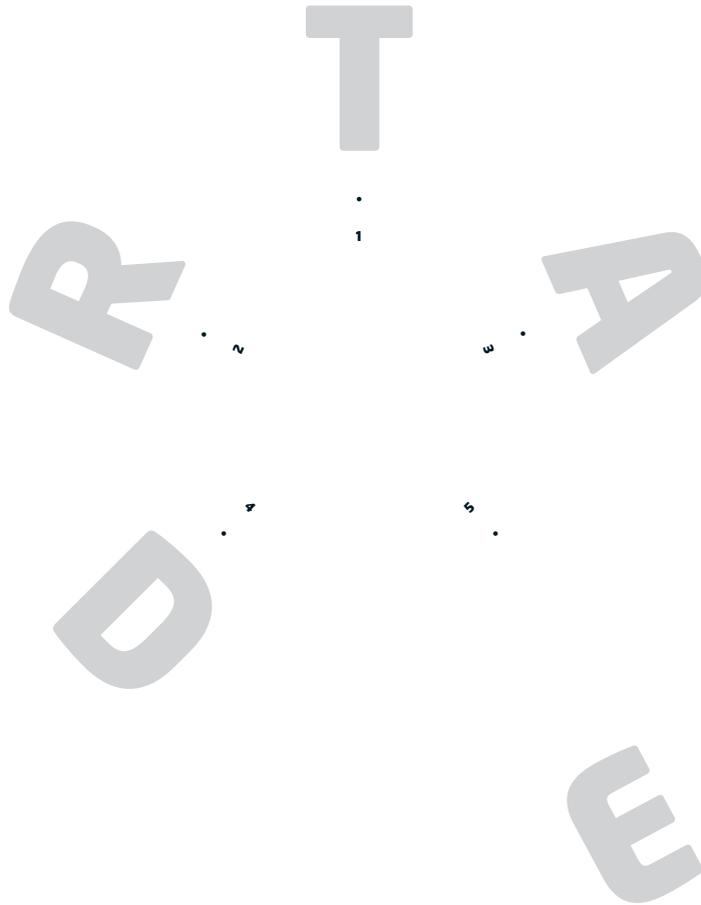
If you've ever tried to recall a video bit that you watched on CNBC that mentions your favorite stock, right-click on the "Peacock" icon. Choose "Show News" and watch the video. No more needle in a haystack.

**4/Control Panel**

Each button turns on a feature that lets you see the live markets and place trades all without ever having to navigate away from the Chart screen. You'll have to turn your head 90° to read them, but go ahead and press each one to see what comes up.

**5/Extended Session (Not pictured)**

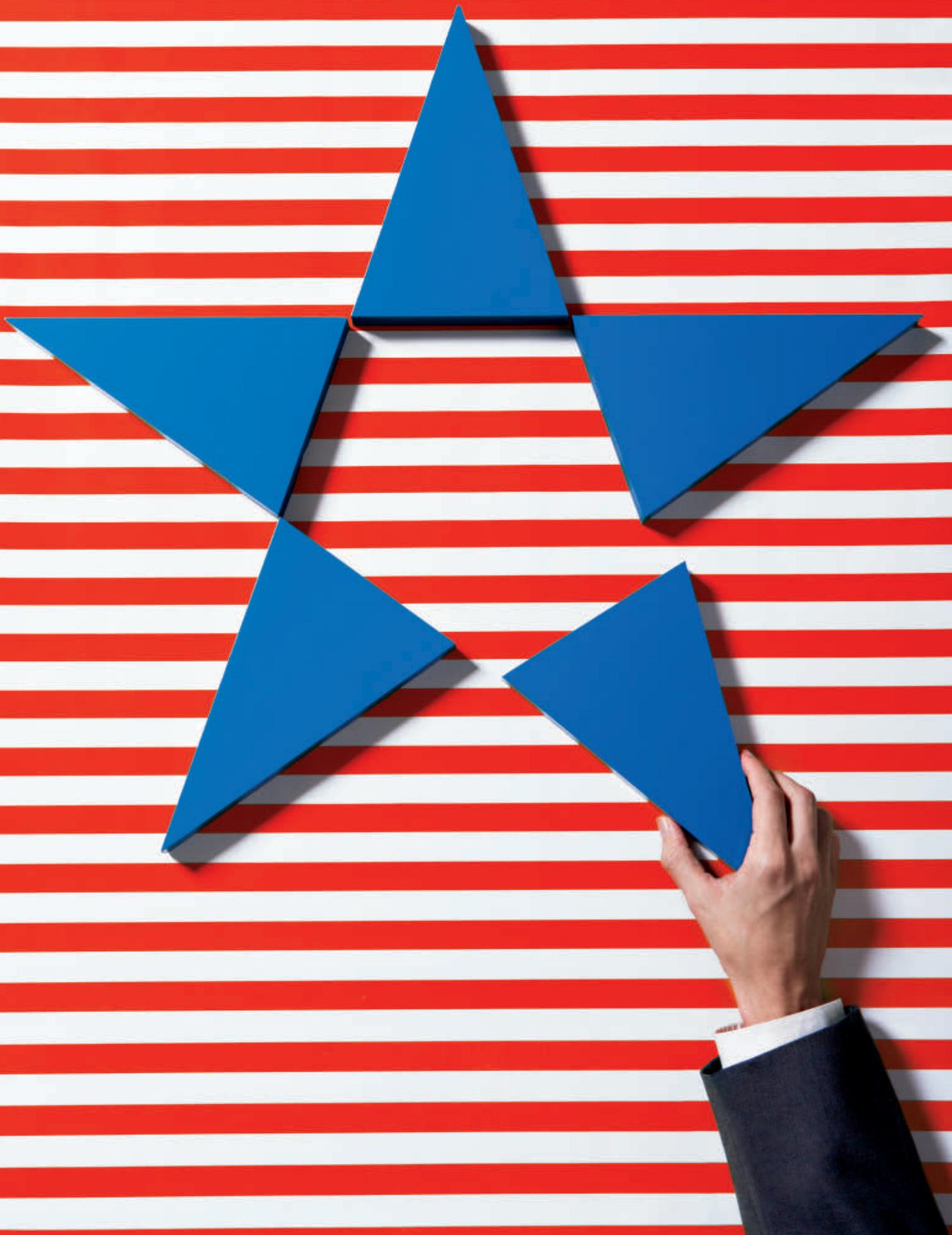
Worth an honorable mention is the ability to see the "pre-market" and "after-hours" movement of a stock, available for intraday charts. To turn on/off, go to "Settings" in the Style menu and choose "Equities." Toggle "Show Extended Session."



## HOW TO **TRADE** THE GOVERNMENT

TRADERS AND INVESTORS WATCH FOR MARKET SIGNALS TO TIME THEIR ENTRIES AND EXITS. WITH ALL EYES ON THE STATE OF THE U.S. ECONOMY, WHICH GOVERNMENT (AND PRIVATE) ECONOMIC REPORTS ARE THE MOST RELEVANT TO THE STOCK MARKET?

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



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Trader Econ

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*“Every investor is a market timer. Some people buy when they have money and sell when they need money. Others use methods that are more sophisticated.”*

MARIAN MCCLELLAN, 1934–2003



INVESTORS AND TRADERS HAVE DEBATED THE value of economic indicators in timing trades as long as stock markets have been around. Do they provide valuable trading signals, or are they just noise? Whatever your opinion, there is little doubt that the following five economic indicators are among the most highly followed:

- 1 — Unemployment
- 2 — Gross domestic product (GDP)
- 3 — Housing
- 4 — Manufacturing
- 5 — Retail sales/consumer confidence

Surprises in any one of these indicators have the potential to impact short-term stock prices. But how useful are they to traders and investors over the longer haul?

## EYES ON THE ECONOMY

Let’s examine the merits of each of the “big five” and score them for relevance as short-term and longer-term stock market indicators. We’ll grade them from “A” (important) to “F” (irrelevant).

### 1) Unemployment

One of the most popular economic indicators tracked by the financial media is the Bureau of Labor Statistics (BLS) non-farm payrolls, new jobs, and unemployment

rate report, published on the first Friday of every month. Big surprises, whether positive or negative, have the potential to move stock prices in the very short term.

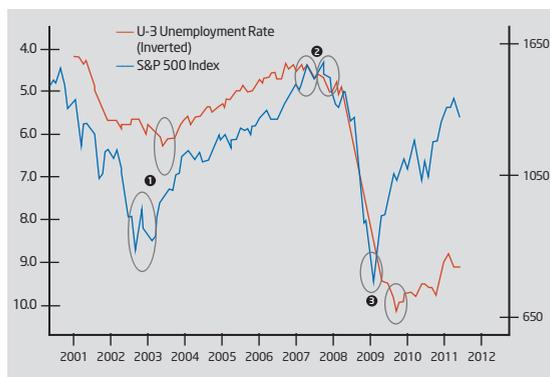
But how useful an indicator is unemployment for generating buy and sell signals? From a glance at Figure 1, we can see two challenges. First, unemployment tends to lag stock prices. The second challenge isn’t as obvious. The unemployment rate is the result of many revisions—some of which happen a year or more after the fact. In other words, this information was not available to the average retail trader (you) at the time.

How important is this factor? Just before stock prices collapsed in September 2007, the BLS reported that 110,000 new jobs were created. However, they ultimately reported many months later than only 44,000 jobs were actually generated—a difference of 60% from the initial report! They later learned and reported that November jobs were also originally reported as 36% higher than reality. For 2008, after the BLS reported that 1,882,000 non-farm jobs were lost, we later learned (well into 2009) that the number was actually 2,759,000—a difference of 47% from the original report.

If investors have no idea whether the data will be revised (or by how much), what is its value at the time? Unlike the initial reports, revisions are not widely followed. So although revisions can significantly change the overall picture, they generally have little impact on stock prices.

SCORE:

Short-term indicator: **B**  
 Long-term indicator: **D**



**FIGURE 1:** The U-3 unemployment rate (inverted) versus the S&P 500 Index. Unemployment lagged the SPX in the 2002–03 economic bottom by nine months (1), led slightly at the top in fall 2007 (2), and lagged the 2009 bottom in stocks by seven months (3). What this chart doesn’t show is that unemployment was revised up to a year (or more) later—data that was not available to market participants when they really needed it. *Source: MetaStock.com, July 2011*

### 2) Gross Domestic Product (GDP)

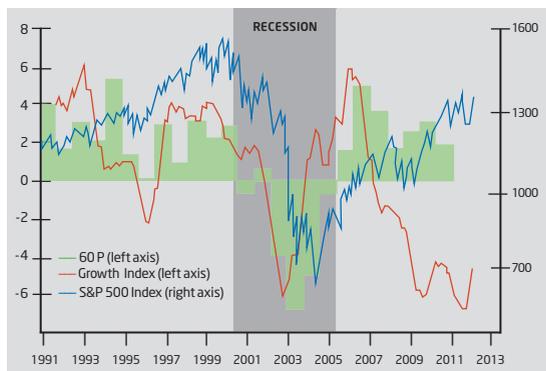
GDP is the dollar sum of the value of all goods and services produced in the U.S. It is calculated from data collected from a wide variety of sources by the Bureau of Economic Analysis and reported quarterly in the last week of the month following the reported quarter. Data

is revised in the following months, with annual revisions occurring in July. So what you see at the time is generally not what is shown in historical data or charts.

Similar to unemployment data, surprises have the potential to impact stock prices in the short term, but this data is of limited value to active investors due to revisions and the fact that GDP tends to lag stock prices.

Score:

Short-term indicator: **C**  
 Long-term indicator: **D**



**FIGURE 2:** The Consumer Metrics Institute's (CMI) 91-day "Trailing Quarter" Growth Index versus the Bureau of Economic Analysis's (BEA) Quarterly GDP Growth Rates and the S&P 500 over the past six years. *Chart courtesy DShort.com*

### 3) Housing

A number of housing-related data reports are published. Government-produced reports include the house price index (HPI). This quarterly report uses home sales price data from Fannie Mae and Freddie Mac-acquired mortgages by the Federal Housing Finance Agency (FHFA), formerly the Office of Federal Housing Enterprise Oversight (OFHEO). This is a lagging indicator published nearly two months after each quarter. It includes only homes with conventional mortgages within the conforming amount limits.

The FHFA data is also subject to revisions, making it less useful for making investment or trading decisions. Housing data is also collected by the Census Bureau, called the Constant Quality House Price Index, but this index is based on a relatively small sample size of about 14,000 new and existing home transactions annually, according to the FHFA.

Better known is the National Association of Realtors (NAR) existing home sales price index. There are two drawbacks to this index. First, the data is produced by the NAR, whose job is to promote the benefits of home ownership on behalf of its member realtors—which means it is prone to bias. Second, this data is also subject to revisions, making it less useful to stock market traders and investors.

Next is the Case-Shiller Home Price Index, which is a value-weighted index employing purchase prices to calculate changing home prices monthly. Revisions are rare, and the data is valued by market participants—in

part because the Case-Shiller Home Price Indices are futures and options derivatives traded on the Chicago Mercantile Exchange to manage U.S. housing risk.

Indexes that track the new residential housing market include, but are not limited to, instruments such as the Philadelphia Housing Sector Index (HGX), which consists of companies that are primarily involved in new home construction, development, support, and sales. This allows market participants to track the health of the new home market.

The U.S. Commerce Department also publishes new housing permit and start data monthly, which are two metrics that can help market participants measure the strength of the new housing market. Housing permits tend to lead housing starts by one to two months. But like many government-produced statistics, they are subject to revisions, making them less reliable for timing stock market entries and exits.

Score:

Short-term indicator: **C**  
 Long-term indicator: **D**

*The National Association of Home Builders Housing Market Index also tracks the new home market, but in a different way. Each month the NAHB polls builders for their sentiment regarding the health and outlook for their industry. Revisions are rare.*

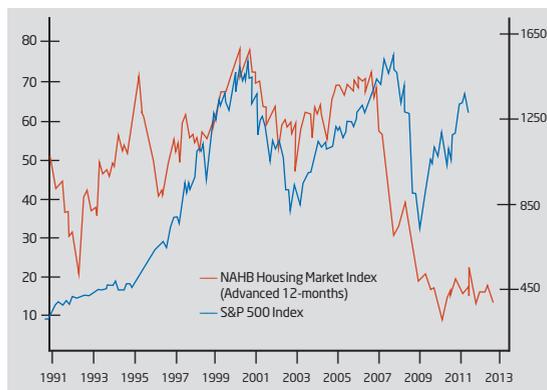
Score:

#### Case-Shiller Home Price Index

Short-term indicator: **C**  
 Long-term indicator: **B**

#### NAHB Housing Market Index

Short-term indicator: **B**  
 Long-term indicator: **B**



**FIGURE 3:** Monthly chart of the NAHB HMI (red) advanced 12 months (shifted to the right) versus the S&P 500 Index (blue), showing the relationship between the two. Note the different impact that the Federal Reserve and government quantitative easing (QE1 and 2) had on both. As this chart shows, the NAHB Index has tended to lead stock prices by 12 to 18 months over the last 15 years. *Source: MetaStock.com, July 2011*

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## Trader Econ

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### ECON RECON

Wanna know when these numbers are coming? Log onto the **thinkorswim** platform and under the MarketWatch tab, click "Calendar" in the upper menu. Click on the event and at the bottom of the page you can grab the details. Heck, while you're at it, check out upcoming earnings, dividends, and stock splits, too.

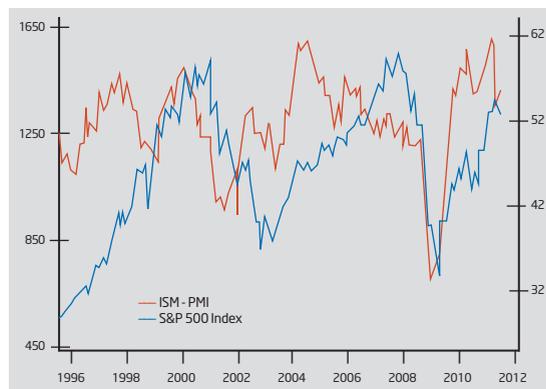
#### 4) Manufacturing

Undoubtedly, the most widely followed manufacturing index is the Purchasing Managers Index (PMI) published by the Institute of Supply Management (ISM), a non-governmental organization. It is a national index based on data compiled from purchasing and supply executives and covers a wide range of manufacturing businesses. A reading above 50 indicates an expanding economy; below 50 indicates economic contraction. It is published on the first business day of the following month. Revisions are rare.

Although the relationship is not lockstep, the ISM PMI tends to lead stock prices, as Figure 4 shows. It also puts in a respectable showing as a stock trading indicator.

Score:

Short-term indicator: **B**  
 Long-term indicator: **B**



**FIGURE 4:** Monthly chart of the S&P 500 Index versus the ISM Purchasing Managers Index, showing how the ISM has led stocks. The PMI has been fairly accurate at warning about impending tops and bottoms, with the exception of the 2007 peak, which came nearly three years after the PMI peak. The latest PMI peak reading occurred in February 2011, two months before stocks peaked in April. *Source: MetaStock.com, July 2011*

#### 5) Retail Sales/Consumer Confidence

Retail sales data is based on spending surveys collected from retailers across the nation by the U.S. Census Bureau. Revisions are published monthly, two weeks following the report month. Data are revised two months later, and final adjustments made every March, making this indicator of little value to stock investors except in the very short term.

Score:

Short-term indicator: **C**  
 Long-term indicator: **D**

There are two widely followed consumer sentiment indexes, namely the Conference Board Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index. The University of Michigan index scored respectably in long-term testing as a trading tool, while the Conference Board indicator was not

tested (as we'll explain in the next section).

Revisions for both indexes are rare. Surprises have the potential to impact stock prices in the short term.

Score:

Short-term indicator: **C**  
 Long-term indicator: **C**

As you can see in Figure 2, the Consumer Metrics Institute Daily Growth Index has done a respectable job of anticipating changes to GDP, so although it may not be as helpful for timing the stock market, it is quite useful in anticipating economic growth.

### INDICATOR PUDDING

A new book titled *Timing the Markets: Using Technical Analysis to Interpret Economic Data* by Charles Kirkpatrick (due to be published in 2012 by FT Press) tests a number of these indicators plus a host of other economic and fundamental corporate indicators and compares them to a simple buy-and-hold strategy. Buy and sell signals are generated by a filtered moving average crossover system over a 500-month period between 1969 and 2010. Many indicators failed the robustness test—results between in-sample and out-of-sample tests were either unreliable or not enough historical data was available.

Of the five discussed here, the ISM Purchasing Managers Index scored best, returning more than three times the returns of a buy-and-hold strategy that stayed in the market 81 % of the time.

The University of Michigan Consumer Sentiment Index was the next best performing indicator, although it underperformed the buy-and-hold approach. Not surprisingly, unemployment and housing starts failed the robustness test. The NAHB HMI, GDP, and retail sales were not tested; there are not 50 years of data required to qualify for testing.

SO WHETHER YOU'RE A SHORT-TERM TRADER seizing the moment or a long-term investor looking to time your entries for new holdings, you may (or may not) want to pay attention to some of the "big five" indicators described here. This certainly isn't an exhaustive list by any means, but since these seem to make the biggest headlines of late, perhaps you can now decide if they're useful to you or just noise.

**Matt Blackman** is a Chartered Market Technician (CMT).

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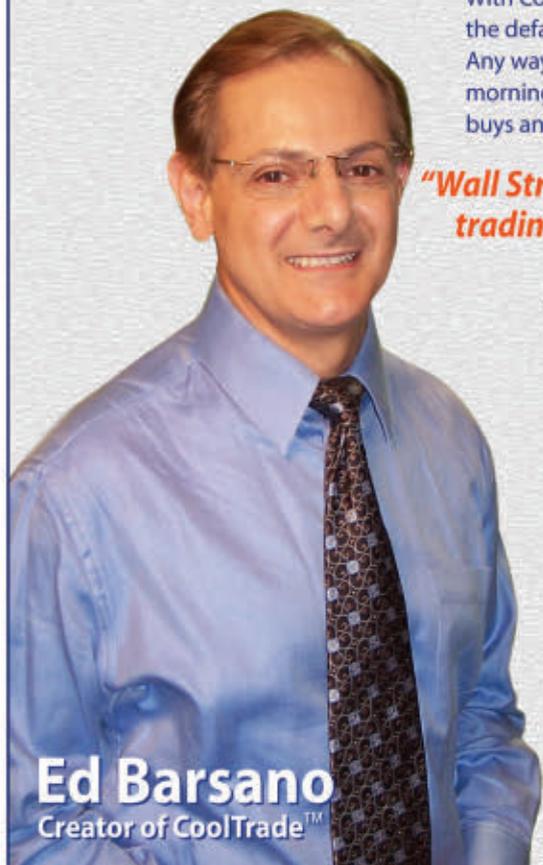
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**Ed Barsano**  
Creator of CoolTrade™



# HEDGE

## ... NOT A FOUR-LETTER WORD

TRADERS MAY BALK AT BUY-AND-HOLD INVESTOR LOGIC, BUT MANY STILL HAVE STOCK PORTFOLIOS. THEY JUST DON'T CARE MUCH FOR "THE LONG TERM." WHATEVER YOUR TIME FRAME, IF YOU'RE HEDGING WITH OPTIONS, IT'S GOOD TO KNOW A FEW TRICKS ABOUT HOW TO SIZE THINGS UP.

## Hedging with Options

Photograph by  
Fredrik Brodén

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LUNCH? LUNCH IS FOR WIMPS. Hedging, though? Not so much, especially with options. Risk is risk. So whether you're an investor or a trader, everyone needs to protect against the downside—no matter what time frame is involved. • Traders (particularly stock traders) may not want to be compared to “investors,” but at any given time, whether you hold one stock or ten stocks, it's still a “portfolio,” even if only for a short while. So you still need to protect your basket—particularly if you're timing market swings.

For investors, hedging a typical buy-and-hold strategy might look complete with a healthy mix of stocks across different industries. The logic is that if industry #1 goes down, the other, entirely different industry 2 is immune to whatever plagued industry 1. If, for example, gaming companies suddenly fall out of favor because a recession hits, broke consumers aren't likely to stop buying toothpaste and soap. In fact, money might come out of gaming and go into “safer” stocks such as consumer staples. But what happens if another black swan hits again and everything comes crumbling down at once, despite your best efforts to “hedge” in the traditional sense?

Fortunately, the hedging tricks with options are designed to protect both camps. And when it comes to an options hedge, the simplest choice is usually the preferred one. This is not to say that just because you have a hedge, you're not going to have any losses. In the following three hedges, you're buying options, which means you're paying for premium to protect against your downside. It's merely a matter of picking the right class of option with the right strike and the right duration.

But the question is ... how?

### HOW MUCH TIME DO YOU NEED?

All three methods require you to decide how much

time you think you'll need for your long hedge. The shorter the time, the cheaper the options. But go too short in duration and your hedge decays too quickly. On the other hand, go too far and it just costs too much in dollar terms. If you're swing-trading stocks (holding longer than a day, but less than two months), you could look at options that expire anywhere from one week (if weekly options are available) to two months out. This will give you enough time to provide an effective hedge, but not so much time that it costs an arm and a leg. And you can always buy another hedge if you find you need more time.

### PICKING THE RIGHT HEDGE

The following three strategies involve buying options, but by no means is this a complete list—you can experiment with option spreads that might work better under certain conditions, such as when volatility is extremely high and long option prices are inflated.

• **EYEBALLING THE OPTION STRIKES** If you want to hedge each stock individually, deciding on which puts to buy can be a bit of a trick since options don't appreciate in a straight line. If you're starting with **at-the-money** puts, for example, and your **delta** is 50, all things being equal, you'll earn \$50 on your put if the stock moves one dollar. But if you start with an out-of-the-money put with a delta of 25, you'll only earn \$25 on the same dollar move in the underlying.

Option greeks aside, there's a way to calculate how much an option hedge will protect you without making things complicated: eyeball the option prices of two adjacent strikes in an option chain. In other words, look at the difference in price between the one you want to buy and another that's one strike deeper **in-the-money**. Here's how it works:

*Assume stock XYZ is trading at \$50  
The two-month 50-strike put hedge is \$5.30  
The two-month 45-strike put is \$3.60*

Subtract the hedge premium from the next strike premium ( $\$5.30 - \$3.60 = \$1.70$ , or \$170 per contract). Should the stock suddenly fall the distance between



#### DIVERSIFICATION, TRADER-STYLE

Hedging against directional risk is one aspect of trader diversification. But what about hedging time and volatility? Read “Not Your Daddy’s Diversification,” *thinkMoney*, Winter 2011 by going to the [thinkMoney archives](http://thinkMoney.archives.tdameritrade.com/thinkmoney) at [tdameritrade.com/thinkmoney](http://tdameritrade.com/thinkmoney).

strikes (\$5 in the example), you’ll offset your position by approximately that amount (\$170).

At this point, you simply calculate how much of a hedge you think you need. The trade-off is as follows:

**Scenario 1:** You buy the 50 put and pay \$5.30 to hedge every dollar that the stock drops below its current price of \$50. This is the more expensive of the two choices, resulting in a higher break-even if the stock goes up, but you obtain full protection with every cent that the stock drops.

**Scenario 2:** You buy the 45 put, pay \$3.60, and hedge every dollar from \$45 on down. This choice is less expensive up front, but costs more if the stock drops lower than \$44.70.

- **INDEX OPTIONS** Rather than buy protective puts on every holding, sometimes it makes more sense to simply buy them on an index that closely follows the performance of your portfolio. First, you’ll need to decide which index is the most appropriate, of course, but for the moment, let’s assume your portfolio reflects a “diversified” mix of stock positions that can be found in the S&P 500 Index—in which case, you might use SPX puts to hedge your long portfolio.

Next you need to figure out how many options to use, and there are a few moving parts to work through before determining that.

#### STEP 1: Determine the cash value of the index

Let’s say SPX is 1300. The value of a play that gets you short 100 “shares” of SPX gets you short \$130,000 worth of the market. You can get that by multiplying the price of the index (1,300) by 100.

#### STEP 2: Calculate the number of puts you’ll need

Say you’re looking to hedge \$250,000 worth of longs. That’s a little less than twice the value of 100 “shares” of SPX, but let’s call it 2X. Essentially, you need to get short 200 shares of SPX. A put option on the SPX represents 100 “shares” of the index. Hence, in order to control 200 short shares of SPX via put options, you would need to buy two puts—provided, of course, you weight your portfolio equally to how you would weight an index. (It also depends on the “beta” of what’s in your portfolio, which we’ll get to next.) And don’t forget to factor in transaction costs or fees that could affect your net hedge.

A tip on how much time to buy for index options: Unlike single stock options, the volatility term structure in index options tends to be pretty smooth. Single-stock options see blips of volatility strength along the way as news events pop up. If we happen to be in a market environment where index option volatility levels are higher for longer-term options than for shorter-term ones, then we have to give serious consideration to just how far out in time we want to go in order to obtain our hedge. That’s of course on top of

the higher dollar price to begin with thanks to the value of having longer to wait until expiration. So you really don’t want to go too far out. Again, like a single stock, something in the first two expiration cycles that sits in the three- to six-week range usually works best.

- **BETA-WEIGHTING** Instead of calculating math, what if you could just push a button that tells you exactly how many index puts to buy as a hedge? Or perhaps your portfolio is weighted too heavily in one sector—say, energy—and you’re looking to hedge with puts on the sector ETF.

In the thinkorswim platform, you can “beta weight” your portfolio against any stock or index. The beta-weighting tool converts the deltas of the individual positions into stock-equivalent deltas for you. It also converts the sum portfolio deltas into the stock-equivalent portfolio.

Suppose, for example, you wanted to beta-weight your portfolio to NDX:

**STEP 1:** Go to your Position Statement on the Monitor page.

**STEP 2:** In the upper right portion of the position statement, check the box next to “beta weighting,” type in the symbol “NDX,” then hit Enter.

**STEP 3:** The index-equivalent deltas for each holding and total portfolio will display. The portfolio delta is the number you would use to determine how many puts to buy to “neutralize” the positive delta number to zero.

## LAST THOUGHTS

So far we’ve only discussed puts, but all the same logic applies to calls—just in reverse. In other words, if you have a short portfolio and wanted to create a hedge, you’d consider buying calls. You could take it a step further and hedge with [long vertical spreads](#), too (for more on verticals, see “Down and Dirty with Verticals,” *thinkMoney*, Summer 2011). Hopefully you pick up some tips for hedging here. You might be a trader, or you might be an investor. Either way, you share at least one interest—preserving your capital. As always, these are just guidelines, and personal preferences can vary. Just remember, it’s about finding the best fit for your own situation.

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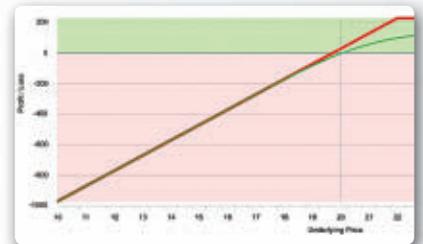
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## 37

**Ask the  
Trader Guy**

• Saving traders, one question at a time.

• Photograph by  
**Fredrik Brodén**

trdr.

**Q: Do you ever decide to trade the stock itself instead of its options?**

A: Assuming that the stock has options (not all of them do), the answer is yes. There are two circumstances where I trade the stock and not the options, assuming that I'm speculating on the stock's direction. The first is when the options have very little trading activity and/or very wide bid/ask spreads, meaning it's tough to enter and exit positions at close to fair value. When there's very little trading activity,

you're at the mercy of the market maker. When there is lots of activity, there's a better chance to get filled at a price in between the bid/ask spread. I like to see a good level of option volume and open interest before I enter, because I know I might have to exit, and I want to get good executions on both sides.

The second is when the stock is trading at, say, less than \$2. Now, that's a somewhat arbitrary number, but if you buy 100 shares of stock for \$200, your max potential loss is \$200. One of the reasons I like to use options, and option spreads in particular, is to reduce my maximum potential loss. In higher-priced stocks, option spreads can have a lot less risk than an outright position in the stock. But if the stock itself has a very low price, there's not much more risk in buying 100 shares of stock for \$2 a share than some option spread for \$150. And that's assuming that there are enough actively traded options in that low-priced

stock to even do a spread. Plus, the stock doesn't have an expiration date. You can hang on to that low-priced stock as long as you want in the hopes that it will go up someday. You can't do that with options.

**Q: How do I start to work option trading in with my stock portfolio?**

A: You might be a stock investor looking to generate extra income on your portfolio, or hedge it, or establish new positions using less capital. Once you've educated yourself on the strategies and tactics and their benefits and risks, start small. Really small. Smaller. No matter how big your account is, start with two spreads, two options. No more. Why? When you start out, you're likely to make mistakes that cost you money, and you'll learn from those mistakes whether you trade a 2-lot or a 200-lot. So keep the "tuition" low. If two's too much, you could start with one. But why two instead of one? You might want to try closing half of a position—whether to lock in a profit or a loss, or take off risk. You



can't do that with one contract.

Now if one contract is too much, then start with paperMoney on thinkorswim. By trading fake money on the real platform (it's virtually identical), during market hours, you'll get a sense of how you might react when you have real money on the line.

Only when you've gained experience with winning and losing trades, and have built confidence in your ability to execute trades efficiently and manage positions and risk effectively, should you start to increase the size of your option positions—very slowly.

**Q: Bacon has become too "public." What's the next meat, cured or otherwise?**

A: I have to confess I agree with you. When bacon started popping up in all the magazines at the supermarket checkout, I quietly put five of the six packages back on the shelf. I'm thinking the next thing is ham steaks. They're pork. They cook up quick. They're versatile. You can fold them around other ingredients like a tortilla. Get the napkins ready ...

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## Coach's Corner

Pulling pearls from your favorite trading instructors.

Words by  
**Michael Turvey, CFP, CMT**  
Investools Instructor

# Sometimes It's Good to Fib

Need help with setting targets for trades? Try Fibonacci retracements.

ern.

Let's face it: trading the markets would be a whole lot easier if you knew what was going to happen tomorrow (or next week, or next year). Of course, nothing can predict the future, but you might consider using a charting tool called Fibonacci retracements in your pursuit of a consistent trading strategy.

Leonardo Fibonacci was an Italian mathematician in the Middle Ages who used his brilliance to, among other things, help solve a problem about rabbit population growth. (It can't be proved that he also opened a ristorante to solve it.) The solution was a sequence that later became known as Fibonacci numbers. Starting with 0 and 1, each number is the sum of the two previous numbers, so the



**FIGURE 1:** In January 2011, SPX was in the midst of a strong uptrend. The index pulled back on January 28, and then the trend resumed. In the thinkorswim chart shown, the Fibs are drawn from the January 28 high to the January 20 low, and the 161.8% retracement line indicates the target near \$1,322. The SPX made it to the target on February 7 and 8. **Source:** thinkorswim Charts



**SWEET ALTERNATIVE**  
You can draw Fib retracements on **Trade Architect**, also. Just click on the Charts tab at the top. In the upper left of the chart, click the "drawing tools" icon, then the "Fibonacci Retracement" icon. Then follow the same logic as thinkorswim Charts.

sequence goes 0, 1, 1, 2, 3, 5, 8, 13, 21, and so on. As the sequence gets higher and higher, dividing two consecutive numbers by each other keeps getting closer to the "golden ratio" of 1:1.618 (or 0.618:1). The golden ratio appears frequently in nature and has been used in architecture for centuries.

### Rabbits and Trading

So now you're wondering how this applies to trading, right? Well, it just so happens that a lot of math geeks like trading, too. So they started applying Fibonacci numbers and the golden ratio to stock prices and, presto! Fibonacci retracements (we'll call them Fibs) were born. Fibs are based on the idea that stocks tend to retrace part of a move before continuing in the original direction. One of the ways you can use them is to set target exits for "swing" trades—short-term momentum trades that typically last from a few days to a few weeks. After all, getting into a trade is the easy part, but it's the exits that can make or break you.

Here's how it works: find a stock that's been trending fairly strongly up or down. For an up-trending stock, draw the Fibs from the most recent high to the low point where the move began (for a down-trending stock, draw the Fibs from low to high). Enter the trade on a pullback from the high point, and set your target at the 161.8% Fib level (there's that golden ratio again).

Now, the trade isn't going to work

every single time, of course, so make sure you manage your risk with a stop-loss, too (1% to 3% below the entry price is a popular choice). You may find that setting up the orders ahead of time helps you manage your trading emotions better.

One of the keys to trading success is finding a regular, repeatable strategy. It's not about predicting the future; it's about finding a consistent approach to taking profits. Fibonacci retracements can help.

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## The Token Glossary

• Terms you might stumble across in this issue.

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found on pages:

12, 20, 23, & 41

# Vertical Spread

- A defined-risk, directional spread strategy composed of a long and a short option of the same type (i.e., calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes, less the credit.

found on pages:

13, 23, 34, & 41

### In the money

- AN OPTION WHOSE PREMIUM CONTAINS "REAL" VALUE, NOT JUST TIME VALUE. FOR CALLS, IT'S ANY STRIKE THAT IS LOWER THAN THE PRICE OF THE UNDERLYING EQUITY. FOR PUTS, IT'S ANY STRIKE THAT IS HIGHER.

### Out of the money

- AN OPTION WHOSE PREMIUM IS NOT ONLY ALL TIME VALUE, BUT THE STRIKE IS ALSO AWAY FROM THE UNDERLYING EQUITY. FOR CALLS, IT'S ANY STRIKE THAT IS HIGHER THAN THE UNDERLYING. FOR PUTS, IT'S ANY STRIKE THAT'S LOWER.

### At the money

- AN OPTION WHOSE STRIKE IS "AT" THE PRICE OF THE UNDERLYING EQUITY. LIKE OUT-OF-THE-MONEY OPTIONS, THE PREMIUM OF AN-AT-THE-MONEY OPTION IS ALL TIME VALUE.

found on pages:

12 & 41

## Long Calendar Spread

- A defined-risk spread strategy constructed by selling a short-term option and buying a longer-term option of the same type (i.e., calls or puts). The goal: as time passes, the shorter-term option typically decays faster than the longer-term option, and profits when the spread can be sold for more than you paid for it. The risk is typically limited to the debit incurred.

# BUTTERFLY SPREAD

- A market-neutral, defined-risk strategy created by selling two options at one strike and buying one each of both a higher- and lower-strike option of the same type (either all calls or puts). The strategy assumes the underlying will remain relatively unchanged during the life of the trade, in which case, as time passes and/or volatility drops, the combined short option premiums exhibit more decay than the combined long option premiums, resulting in a profit when the spread can be sold for more than its original debit (which is its maximum loss).

found on pages:

12 & 41

## Iron Condor

- A defined-risk, short spread strategy constructed of a short put vertical and a short call vertical. You assume the underlying will stay within a certain range (between the strikes of the short options). The goal: As time passes and/or volatility drops, the trade can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the largest difference between adjacent long and short strikes, minus the total credit received.

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34 & 41

found on pages:

## Delta

- A measure of an option's sensitivity to a \$1 change in the underlying asset. All else being equal, an option with a 50 delta (also written as 0.50) would gain or lose 50 cents per \$1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (-) deltas, meaning they gain as the underlying drops in value.

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