

# thinkMoney/19

random musings for traders at TD Ameritrade  
Spring 2013

18/THE EXCITING  
WORLD OF  
BONDS,  
SERIOUSLY

24/FUNDAMENTALS  
EVEN A TRADER  
COULD DIG

SPREAD TRADING FOCUS:

34/KILLING  
TIME WITH  
CALENDARS



## 10/FOUR BIG MISTAKES YOU KEEP MAKING

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(See page 9 for details)

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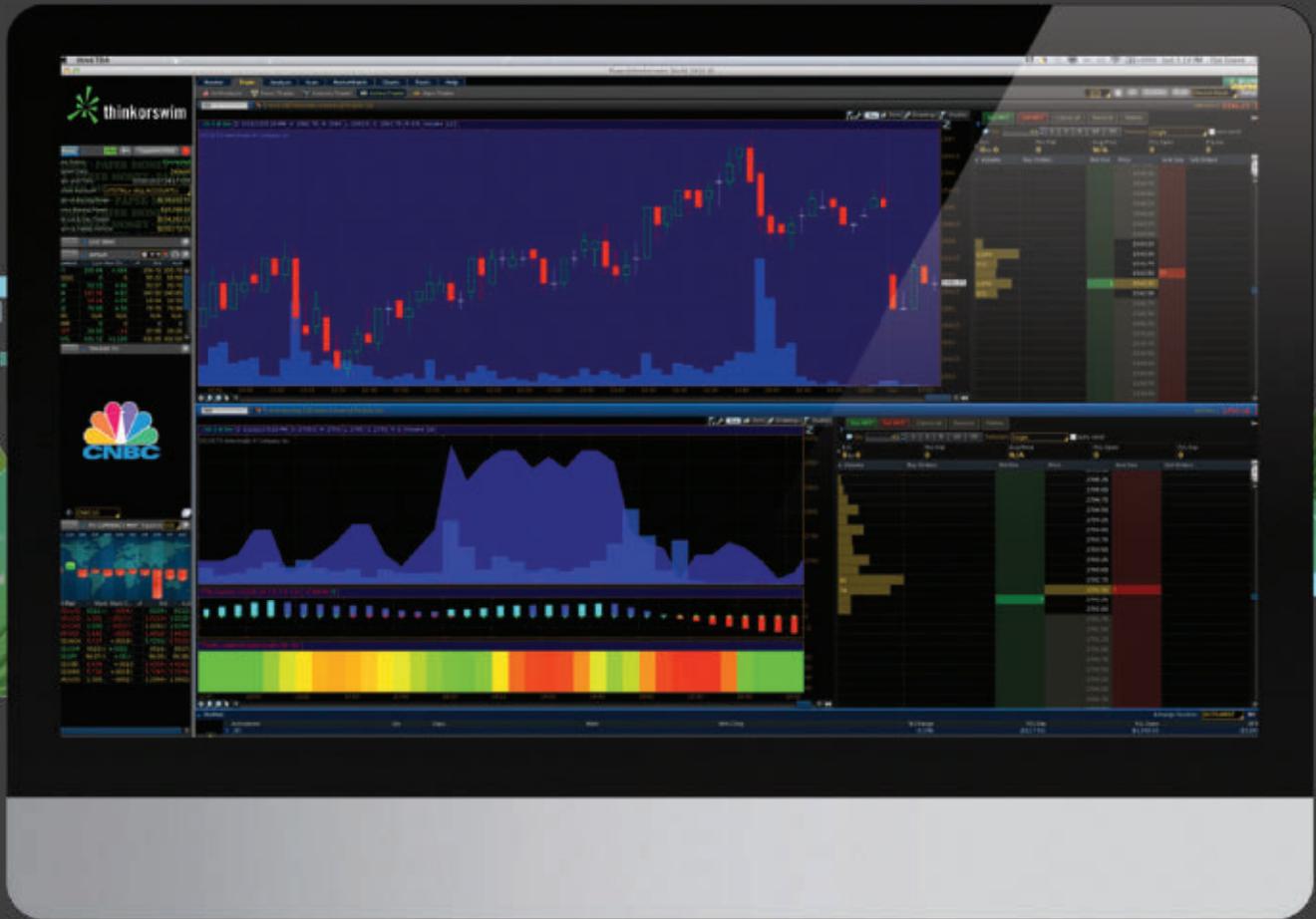
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**Fredrik Brodén**

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### **Unwarping Your Mind**

There's no excuse for traders to keep making the same mistakes. Here's four common blunders you'll probably recognize, and what to do about them.

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#### 33/The Spotlight

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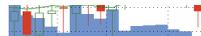
#### 18/ Bonds! Bonds! Bonds!

Bonds are boring, right? Wrong. For traders, they represent a market that can be bigger than equities. Complex? Perhaps at first. But peel back the layers, and bonds represent another trading opportunity you might be missing out on while chasing stocks.



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Our resident guru has a few thoughts on what to do with your worthless short options, and how to tempt contrarian fate.



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#### 30/Gear Head

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##### KILLING TIME

The calendar spread is another building block that you'll need to know to trade spreads. Though it's designed to profit when a stock goes nowhere, there's more to it than just watching time pass.

##### PLUS:

##### STRATEGY FOCUS

How to analyze and trade a calendar spread.

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#### 32/Vol Watch

Instead of micro-analyzing the VIX and judging the market's next direction based on the last tick, take the long-term view.

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A Quick Howdy

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## Head Games

• By now, you’ve probably heard the layman’s definition of insanity—the propensity to keep making the same mistake, thinking the next outcome will be different. If that’s true, then traders the world over are doomed to strait jackets and white-padded rooms. It seems that no matter how many times we think we’re not going to chase a stock or throw good money after bad, well, we wind up doing exactly that...over and over again.

So what are you going to do about it? For one, you could stop making the same mistakes. But surely that voice in your head will fall on deaf ears. After all,

you’re as smart as they come. And you’ve got the greatest trading tools at your fingertips to help with that soft landing when you make your next mistake. The problem is that you’re not really using those tools correctly, now are you?

Whether you’re choking on the entry, or going all in when you should be staying out, there’s probably a better way to solve the problem than engaging in self-flagellation. And by using the tools you get for free on our trading platforms, you might find yourself staying out of trouble more (and out of those pesky padded rooms). Our cover feature, “Unwarping Your Mind,” on page 10 not only highlights four of the



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biggest no-nos in trading, but also suggests a mechanical solution to each that might prevent you from making your next big mistake—again.

Speaking of head trips, it’s a misnomer to believe the market moves in only two directions. While we dutifully respect up and down, there’s a third direction—sideways—which is ripe with potential opportunity as well. In Part 2 of our four-part series on spread trading (page 36), we’ll focus on calendar spreads, i.e. analyzing, trading, and “rolling” them. Calendars, along with vertical spreads discussed in Part 1 of this series (*thinkMoney*, Winter 2013), is a critical, must-know strategy if you’re truly going to master spread trading.

And lastly, for those of you who’ve been crying for bond-trading lessons since the birth of this magazine, you can now have your cake, and eat it too—on page 18. We wouldn’t want to neglect the needs of traders of all shapes and sizes. And for this issue, bonds are a welcome addition.

Happy Trading,  
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Lessons Learned

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# Un- warp- ing Your Mind

**It's true.** Trading can play tricks on your mind. The key is to control as much as you can to reduce the risk of what you can't. How do you control bad decisions driven by emotion? Ditch the head games and trust your technology. Here's four common mistakes traders make and what to do about them with the tools you already have.



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## Lessons Learned

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**Fredrik Brodén**

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**Some people** want to believe that trading is about a proverbial mental path up an imaginary mountain to some skinny guru in a loincloth. If you could just get your mind right, the trading profits would appear through some benevolent market karma. Maybe that's the way it works for some. Personally, I have to work hard for my trades and you probably do, too. In fact, hard work is way easier to figure out than mapping a meditation path to your very own private jet.

If you're a novice, you're likely to get tripped up by one or more of the following four things. If you're a veteran and haven't gotten snagged, consider yourself lucky. Avoiding future pit falls will be less about you chanting your way through the process, and more about using the right tools and resources that exist in the real world.



### 1/CHOKING ON ENTRY

When the signals or conditions to do a trade are there, but you don't act.

**The lesson:** I remember most of my trades, in the same way a lot of baseball fans know every batting statistic for the last 40 years. By September 1997, I was off the trading floor and running a futures-and-options trading fund. On the morning of September 15, I didn't have any S&P 500 positions on, and I was looking to get long on a sell off below \$900 as a contrarian bet. The S&P 500 futures sold off sharply, below \$900. But I couldn't bring myself to buy any. The market was dropping much faster and sharper than I thought. Pick your metaphor—I had visions of catching falling knives, stepping in front of a train. I didn't implement my strategy and didn't do the trade. Of course, the S&P 500 rallied the next day without me, and I missed out on what could have been one of the best trades of the year.

**The wisdom:** Forget trying to figure out why you get scared. You choke because you think you could lose a lot of money. How do you tame those demons? Stress test your strategy on the Analyze page of the thinkorswim® platform before you route the order, and well before your signal is met. See what the loss might be with a different stock price, volatility, and days-to-expiration scenario. If you can't handle the potential loss on that trade, consider a lower risk strategy.

### 2/RIGHT CALL, WRONG STRATEGY

Your directional bias proves to be correct but your position loses money.

**The lesson:** Back in the early '90s, I was calling in orders and working as a clerk. I hadn't been trading options for very long. But the shop I was working for

had a Schwatratron—one of the first electronic-quote delivery systems. It let me pull up what passed for option quotes from time to time. At \$430, I had a hunch that the S&P 500 might go higher. So, I bought a 460 call with three weeks to expiration as my bullish strategy. As the S&P 500 went down, it took my call with it. But lo and behold, the market rallied and took the S&P 500 up to \$455 soon after. I pulled up the options on the Schwatratron, expecting to see my call up significantly. I had my broker on speed dial, ready to sell and take profits. But wait a second—the 460 call was lower. The S&P 500 was up, and my call was down? Yup, time decay and a vol crush took the value out of my option and cost me about two weeks of a meager salary.

**The wisdom:** You probably won't learn about how time decay, volatility, and stock or index-price movement all happen simultaneously in your M.B.A. program. But you should take advantage of the educational resources that TD Ameritrade offers. Daily presentations in the Chat Rooms is one such place. Three hours of live trading banter, five days a week, with guys in the trenches could help you avoid some of the rookie mistakes I made.

### 3/GOING ALL IN

A position looks like it can't lose and you take it way too big.

**The lesson:** A trader I once knew did this. A reversal is an arbitrage position of short stock vs. synthetic long stock (long call/**short put**). You try to buy the synthetic long stock for less than the price for which you sell the actual stock. Because it doesn't have much market risk, the margin requirement—especially for institutional traders—is pretty low. They mostly trade for debits. So when this trader saw a reversal set up for a \$.15 credit



SEE  
GLOSSARY  
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in a stock close to expiration, he bought 2,000 contracts, thinking he could make at least \$.15 per spread in a couple of days. He figured it was a lock. He showed it to me on expiration when the stock dropped by \$.30 and it looked like a profitable trade. “Did you check for dividends?” I asked. “Huh?” he answered. He hadn’t investigated why the reversal was trading for a credit. He took what little he knew about reversals and figured he’d found a position that couldn’t lose. Turns out, the stock was going ex-dividend the day after which he put on the position. A few weeks later, when the dividend payment date came up, he saw a huge debit for the dividends he owed in his account that wiped out his \$.15 per spread credit. All of it ate up a couple years of profit.

**The wisdom:** Avail yourself of the TD Ameritrade Trade Desk at 800-669-3900 the next time you think you’ve found something too good to be true. It’s staffed with associates who have seen just about every kind of trade and strategy ever done. They can help you spot the potential risks and rewards of your trade ideas. It’s not that your idea is necessarily bad, but it doesn’t hurt to have an experienced pro take a look at it. And, for the love of Pete, do it small.

#### 4/IGNORING INTERNAL BIASES

Starting your market analysis with the answer already in your head and shutting out results to the contrary.

**The lesson:** One of the tasks I had at my first trading job was to build an index-arbitrage system for the S&P 100

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and S&P 500 indices. The idea was to trade the synthetic index (long call/short put) vs. the stocks in the index. But it was hard executing 100 stocks trades at once, let alone 500. So I looked for subsets of the stocks to see which ones had the highest correlation. If I could find, say, 30 stocks of the S&P 100 that mimicked most of the price movement in the index, we could trade those 30 stocks instead of 100. If you include all the stocks in the index you get 100% correlation. If you use less than all the stock, you get something less than 100% correlation. Theoretically, 95% or even 90% correlation might sound good. But I had seen some divergence in the historical performance between the high correlation subset and the index. I chose to ignore the basis risk inherent in doing a subset of the index and went ahead because I believed that the historical correlations would continue in the future. One expiration’s worth of a losing index arbitrage system disabused me of that notion. And I went back to the drawing board.

**The wisdom:** You might not be doing index arb, but whatever strategies you do use, numbers don’t lie. You can test various entry and exit signals using the Strategies feature found in Edit Studies function of thinkorswim® Charts (in the upper right of any chart follow click path **Studies > Edit Studies > Strategies**). Then you can click to see a report of the potential profit and loss for that strategy. Don’t kid yourself like I did, and figure that the risk that the data showed wouldn’t happen in real life.

I MAY BE SHOWING MY AGE when I say, “if I had the tools when I was young that you have now...” but it’s true. TD Ameritrade’s thinkorswim trading platform is packed with functionality that can help you avoid the mistakes I made, and speed up your learning process. And best of all, it’s just a few clicks away.

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# 15 **1ttrs.**

## Love Notes

Quips from the thinkorswim Chat Rooms

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**This issue, we extracted sage advice from our Chat Room junkies on a variety of trader-isms...**

### On broken markets:

Gimme some ball bearings, a pack of Twizzlers and some Cheez Whiz and we'll have this fixed by 3 p.m.

**Irwin**

### On retirement planning:

I'm retiring now before I hit 30. Not because I've made money trading. But because my wife is a doctor.

**Stu**

### On market advice:

I'm seeing it get worse every year. Enjoy yourself today, forget about stocks, and go to the mall.

**Sandi**

### On charts (cup empty):

Every ship that ever sank had charts on board.

**CJ**

### On charts (cup full):

A weekend without a histogram is a weekend wasted.

**Diane**

### On trading gurus:

Don't believe everything you pay to hear. Real good traders have fancy cars and stables full of raccoons.

**Billy**

### On strategy selection:

If a simple strategy won't work, then a complex one doesn't stand a chance.

**Jack**

### On chutzpa:

My courage is directly proportional to the time remaining before the bell divided by my P/L.

**Stan**



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

### On trading psychology:

I am a contrarian in theory and trend player in practice, which I think means I am close to a psychotic break.

**Jenn**

### On aiming low:

I only hope to make enough today for a juicy, tasty burger and a can of beer.

**Jed**

### On life:

Life is like a roll of toilet paper, the closer you get to the end, the faster it spins.

**Jonny**

**...Not from the Chat Rooms, but still dang funny.**

• Just got off the phone with Ms. Cleo. She said it was a record volume day in the Nasdaq. Worth every \$9 per minute of conversation.

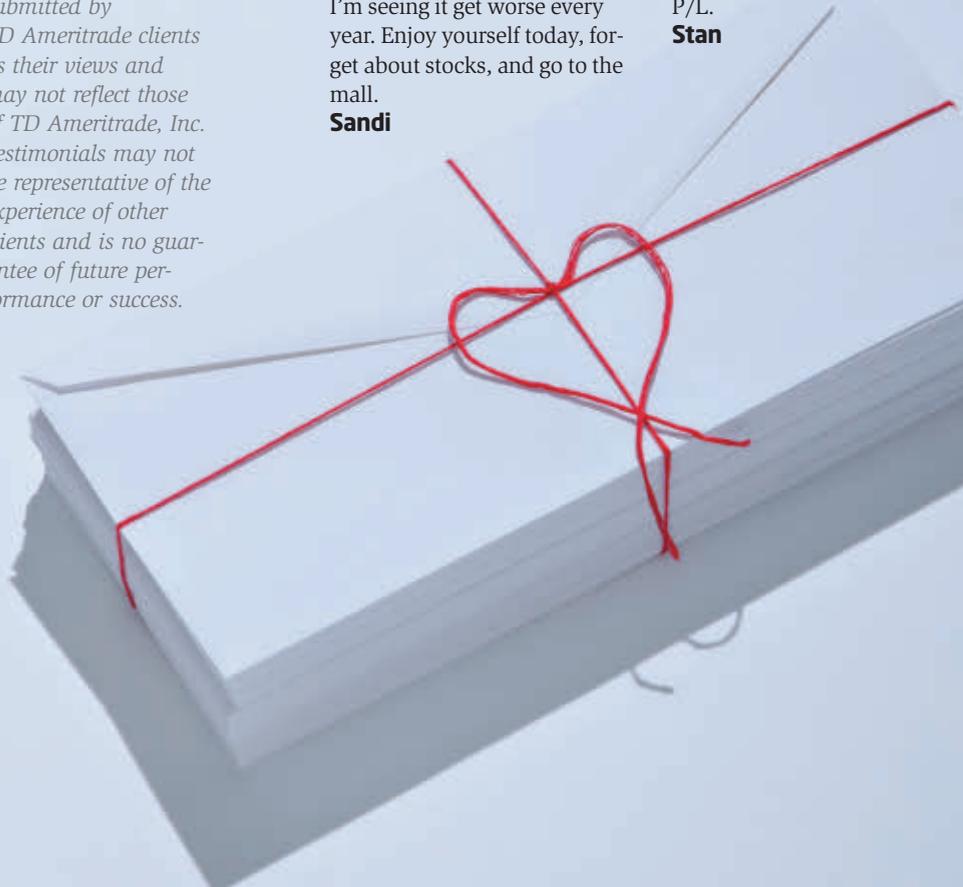
**Patrick**

• A move doesn't necessarily have to be "false" because it retraces. That move before the move is still valid, if that later move happens. But not before it doesn't.

**Roger**

• We are getting more efficient faster than you might think.

**Edgar**



News+Views

A hodgepodge of stuff we thought you should know.

Photograph by Fredrik Brodén

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**Q: Suit, I love trading story stocks like AAPL and GOOG, but these days, they're so expensive. And the options! Any other way to play those bad boys?**

A: Until now, even spread trading on monster stocks could still cost a pretty penny. But on March 18, 2013, the ISE exchange launched a new contract called the "mini-option." Available on APPL, GOOG, and three other high-priced securities\* mini-options represent a deliverable of 10 shares of the

**Ask The**  
*Suit*

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

**Q: Dearest Suit, I wish I could hear from you more often than just once a quarter when my new issue of thinkMoney arrives.**

A: OK, first of all, that's a statement, not a question. And second of all, I'm suspect of the flattery which I heard once before. That time, it was my mom. And I told her the same thing I'll tell you. You can hear from me daily. Just follow me on twitter! I'm @TDANsherrod. You can also find me on Facebook. Be sure to also follow my colleague JJ Kinahan— @TDAJJKinahan. What's in it for you? JJ and I will be providing insight on the markets, new technology releases, witty repertoire, and much more.

underlying security. So they are 1/10 the size of the standard contract but the strikes and expirations are the same as standard 100 share options as well as the commission, contract and exercise/assignment fees.

**Q: Hey, Suit! Now that we're really getting it stuck to us with capital-gains tax increases, any suggestions as to how to maximize returns?**

A: Trade more profitably, maybe? And when you figure out how to do that, give me a ring. Seriously, you may have noticed that we recently rolled out a new feature in thinkorswim® which allows you to specify your preferred default method of tax-lot selection for sales. In addition, it used to be that you were stuck with "first in, first out" on lot sales. Now you can select the lot you want to sell when placing your sell order. More than ever before, you really need to think about how you are offsetting your gains. We don't provide tax advice so be sure to consult a tax professional.

\*Security symbols displayed for informational purposes only. This is not a recommendation to trade any specific security.

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## industry spotlight

# Fiscal Cliffs & Sequesters, Oh My!

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

In case you've been living under a rock, the term "fiscal cliff" refers to the potentially toxic combination of increased tax rates, the end of certain monetary stimuli, blanket spending cuts by the Federal government, and bumping up against the debt ceiling. The idea is that if all these things happen at once, the U.S. economy could nosedive. Thing of the past right? And what about the most recent political wrangling around the "sequester"? Old news. Yet, as Washington lurches along with one patch or another, no one really knows what the impact

on the economy will be. But traders can typically see the impact on the markets.

Take the fiscal cliff. Though conversations about falling off said cliff seem to have subsided—not to diminish the disruption and pain that a fiscal cliff could have caused (and may still)—to a trader, all the uncertainty is played out in the S&P 500, Treasury bonds, the dollar, gold, and the VIX, to name a few. This translates to increased volatility in each of these benchmarks, which



is the name of the game for many traders.

When we first encountered the fiscal-cliff specter that ended up with the US losing its AAA rating back in the summer of 2011, actual price volatility in the S&P 500 futures was twice as high as it had been in the previous three months. Treasury bond futures were nearly twice as volatile, as were gold futures. The dollar and oil volatility rose as well, but not quite as much. Just as important, trading

activity and liquidity also increased.

While fiscal cliffs and the associated market volatility can often scare the public from investing, it's the efficiency that comes from increased liquidity that should be getting traders' attention. When things are too calm, the market can offer fewer entry and exit points, and fewer participants mean fewer people to keep bid/ask spreads tight. So far, the market sell-offs from the facts and fears of the fis-

cal cliff haven't been permanent—stocks rebounded quite nicely.

For traders, then, the harder question is what will keep a certain minimum volatility in the market without having to go through another debacle in Washington. Yet, when it comes to trading, volatility isn't the enemy. But rather, it creates the opportunity.

# 18

## Bond Trading

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BONDS ARE BORING, RIGHT? WRONG. FOR TRADERS, THEY REPRESENT A MARKET THAT CAN BE EVEN BIGGER THAN EQUITIES. COMPLEX? PERHAPS AT FIRST. BUT PEEL BACK THE LAYERS, AND YOU'LL DISCOVER ANOTHER POTENTIAL TRADING OPPORTUNITY YOU MIGHT BE MISSING WHILE CHASING STOCKS.

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



## Bond Trading

Photograph by  
Fredrik Brodén

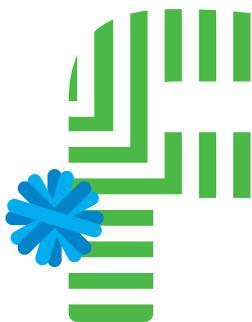
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## BONDS 101—NOT THE TRADING STUFF, YET

First things first. A bond represents debt, unlike a stock that represents ownership. When you buy a bond, whether it's from the U.S. Treasury, a corporation, state or municipality, that entity is borrowing money from you and promises to pay you a fixed rate of return, plus your money back at some future maturity date. How likely that entity is to pay you that money is reflected in the bond issuer's credit rating. Remember when the U.S. lost its AAA rating a couple years ago? That happened because people thought the U.S. was a little less likely to pay its promised bond payments. (Those rating stinkers.) Anyway, a rating naturally impacts a bond's price and volatility.

Because the rate of return is fixed when the bond is issued, bond prices and interest rates move inversely to each other. Interest rates go up, bond prices go down, and vice versa. If a bond pays some coupon rate, say, 5%, and interest rates drop



OR SOME PEOPLE, bonds evoke images of Mortimer and Randolph sipping brandy in smoking jackets, or maybe retirees waiting patiently for their bi-annual coupon payments. Dull, right? But then there are some traders, for whom bonds represent the biggest, baddest market of them all—the only one that makes the S&P 500 seem like a pipsqueak. You. Me.

We're the latter. Or maybe you aren't yet, but you want to be. Or at least you want to take a peek behind the curtain to see what all the excitement is about.

In point of fact, bonds don't have to be just a placeholder for your money. For many traders, bonds are just another trading instrument. Period. And for some investors, they're a default choice for the money you wouldn't, or don't, invest in stocks. Cookie-cutter financial plans often suggest you allocate some percentage of your investments into bonds as a "safe" place for your money, no matter the bond market's condition. As a person who's seen bond futures trading limit down on more than a few occasions, I guess my take on "safe" is a little different than most financial planners.

to 4%, that 5% bond becomes more attractive and people will pay more for it. Remember this inverse relationship between interest rates and bond prices. It's important because expectations of changes to interest rates can have a big impact on bond prices. And small, incremental changes in bond prices can have a large impact on the yield of a bond. Yield is the bond's coupon rate divided by the bond's price.

Bonds also have different times to maturity, ranging from CDs and T-bills maturing in a few months, to 30-year Treasury bonds. A bond's maturity not only affects the rate it offers but also its price volatility. In simple terms, a bond with a shorter amount of time to maturity—like a 90-day T-bill—will have a lower coupon rate than a 30-year bond because people generally require less return to take a risk over a shorter amount of time. A somewhat more complex concept is the relationship between a bond's time to maturity and its price volatility. Without getting into all the joys of bond math with modified duration and convexity, suffice it to say that the price of a bond with more time to maturity will be more sensitive to changes in interest rates than a bond with less time. You can see that reflected in the **implied volatility (IV)** of options on futures for bonds of different maturities. For example, at the time of this writing, overall IV in options on the

30-year Treasury bond future was 9.4%, and the overall IV in options on the 10-year Treasury-note future was 4.8%. They both have the same credit rating of the U.S. government, but the greater time to maturity of the 30-year bond means larger potential price changes, which can translate into higher IV in options on bond futures. When IV is higher, option premiums become more expensive.

## OKAY, WHICH BONDS?

With a basic understanding of how bond prices work, you now have to sift through the range of bond and debt products. Most traders and investors generally consider four types:

1. Government and agency bonds
2. Municipal bonds (or “munis”)
3. Corporate bonds
4. Short-term debt

All of these promise to pay interest and return on capital, but they can have different ratings, yields, and maturities. Some are more actively traded than others, and offer traders more flexibility. Foreign bonds aren’t easily traded in the U.S. by retail investors, and they involve currency and political risks that are beyond the scope of this article.

**Government and agency bonds** are things like U.S. Treasuries and GNMA (Ginnie Mae) mortgage-backed securities that have high credit ratings and are actively traded. Why? The backing of the U.S. government make them attractive to a wide range of investors.

**Municipal bonds** are issued by entities like cities and states that use taxes and other revenue to pay back the bonds. Munis are popular with some investors because of certain tax advantages, but specific muni bonds may not be actively traded and some may be subject to the alternative minimum tax.

**Corporate bonds** use a company’s revenues to pay the bonds, and offer a much wider range of credit ratings and yields—from relatively safe names, to high-yield “junk” bonds. While bond traders might not trade corporate bonds themselves, they’ll sometimes look at the difference in the yields between corporates and Treasuries to see if one may be overbought or oversold relative to the other.

**Short-term debt instruments** are typically things like T-bills, CDs, and money markets. They have different levels of credit ratings, and are more likely to be offered at a discount with principal and interest paid at maturity.

You can actually buy any one of these bonds in your TD Ameritrade account. With TD Ameritrade’s CD Center and Bond Wizard, you’re able to filter through all the bond offerings to find one that meets your criteria for rating, maturity, and yield, and buy it with a few clicks.

As a trader, one potential strategy is to use T-bills as collateral in your margin accounts. T-bills usually have very stable prices because of their short time to maturity, and the timely payment of principal and interest is backed by the full faith and credit of the U.S. government. So, you can borrow against a much higher percentage of the value of T-bills than you can stocks. With most marginable stocks, you can borrow on 30% to purchase them—meaning you would only need to put up \$0.30 for each \$1.00 it costs. But depending on your broker/dealer, for T-bills under 20 years in duration, you can typically borrow up to 95% of their value (i.e. put up \$0.05 for each \$1.00 it costs). For T-bills over 20 years in duration, it’s typically up to 90% (i.e. put up \$0.10 for each \$1.00 it costs). The percentage of the T-bill’s value that’s not available for collateral is called the “haircut.” Traders looking to earn a potentially higher rate on cash in their account, but not take much principal risk and not reduce their available trading capital too much, may buy T-bills. Longer-term Treasury bonds and notes can be used as collateral as well. But they have a bigger “haircut” because of their higher-price volatility.

## AS FOR TRADING THEM...

If you ask a trader how bonds are doing today, she’ll likely answer with only one thing—30-year, Treasury-bond futures. T-Bond futures and their options (and I’ll toss in 10-year T-Note futures and options too) are the most actively traded bond products for retail investors and traders. Munis and CDs are nice, but when traders trade “bonds,” they’re mostly trading bond futures and futures options. If you want to trade bond futures, you’ll need a futures account, which can be set up easily at TD Ameritrade. See sidebar, left. [Please note that certain qualifications and permissions are required to trade futures or options on futures.] But any TD Ameritrade client can see futures quotes on the thinkorswim® platform. For example, type the



### Open a Futures Account in 3 Steps

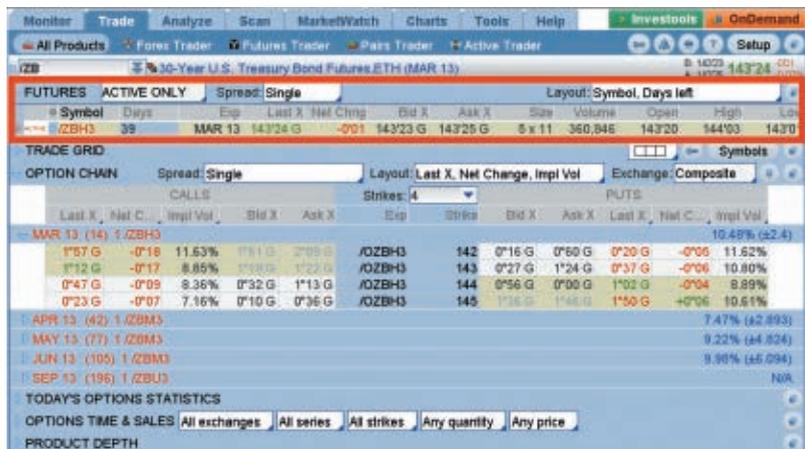
**1/** You need to have Level 3 options approval prior to filling out the futures application. To apply for Level 3 options, log in to the TD Ameritrade website, click on **My Profile** and click **Edit Option Trading**. Complete and submit the **Upgrade** form.

**2/** After receiving your approval, log back in. Under **My Profile**, click on **Upgrade** your futures account for futures and forex. Complete the “Upgrade Agreement for Futures and Forex.”

**3/** Once your account has been upgraded, (which may take about a day or two) go back under **My Profile** and click the **Futures Apply** button. Fill out the online futures application and you’re on your way to trading futures.

**Contact us at**  
support@thinkorswim.com,  
or call 866-839-1100.

SEE  
GLOSSARY  
PAGE 42



**FIGURE 1: Pulling bond quotes** on thinkorswim is easy. Just go to the Trade page and type in the symbol (e.g. “ZB” shown here). The quote you see is the most “active” future trading. *For illustrative purposes only*

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22•  
**Bond Trading**•  
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root symbol /ZB for the 30-year bond future, and /ZN for the 10-year note future, into a symbol field to see quotes, charts and options.

**Pulling quotes:** Pull up /ZB in the Trade page of thinkorswim®, and it pulls in the quotes for all the bond-future expirations, which are always in either March, June, September and/or December. There is one most-actively traded future, and it's usually the one with the shortest amount of time to expiration. It's conveniently marked "Active" on the thinkorswim Trade page. The most active future "rolls" to the next expiration when the near-term future gets into its delivery period, as traders with short futures positions can deliver actual Treasury bonds to traders with long futures positions. This isn't something retail traders get into, so keep an eye on that "Active" future indicator and roll positions as needed.

When you pull up /ZB on the Trade page, you'll also see plenty of T bond-futures options. The options in the different expirations deliver, and are priced off, futures with corresponding expirations. For example, April, May, and June T bond-futures options deliver June T bond futures. September options deliver September T bond futures. The options' expirations are a little funky. Their final trading day is the last Friday that precedes by at least two business days the last business day of the month before the stated expiration month of the option. So, June options stop trading on the third Friday of May. Bond futures options are also American-style, meaning they can be exercised at any time before, and including, expiration, and are futures settled—meaning you take or make delivery of one bond futures contract for each option that's exercised or assigned.

One main difference between bond futures, and futures options, and stock options is point value. You'll see bond futures quoted in 1/32nd increments and options in 1/64th increments. If /ZB has a price of 145'20, that means the price of the future is 145 and 20/32nds. An option on /ZB might be "58 bid and "60 ask. That's 58/64ths bid and 60/64ths ask. You multiply each of those by \$1,000 to get the full point value. A one-point change in the bond future or option is worth \$1,000. To clarify further, if you sold a 147 call and bought a 148 call to create a vertical spread in /ZB for a net credit of "22, that credit is 22/64, and would generate \$343.75 cash in your account. The max potential loss on the trade is the difference between the strikes of 1.00 point, which is worth \$1,000, minus the credit. By example,  $\$1,000 - \$343.75 = \$656.25$ . That's also  $42/64\text{ths} \times \$1,000$ . So, selling a one-point vertical in bond futures with a max profit of 22/64 has a max potential loss of 42/64 (before commissions).

**Trading on margin:** The current margin requirement on each bond future is approximately \$3,800, and is based on the estimated likely maximum one-day price change. It can be changed by the CME Group if the estimated risk of the future increases or decreases. Bond-futures options positions are margined according to the SPAN method (Standard Portfolio Analysis of Risk),

which determines the potential loss of the position, based on different scenarios in the bond-future price, time, and volatility. It's similar to portfolio margin for equity accounts.

**Picking strategies:**

The strategies you use for bond futures and options can be based on probability and volatility, just as you might use with your equity option strategies. Bonds just offer a trader additional trading opportunities, particularly around economic events like Fed meetings and employment reports. You may be long-term bullish or bearish on bonds if you expect interest rates to decrease or increase over time, based on U.S. economic activity, but the 30-year future typically makes enough large price changes up and down daily and weekly to accommodate scalpers and swing traders looking to capture shorter-term moves. But of course, past performance is not a guarantee of future performance. Option traders often use defined-risk strategies like verticals and iron condors to speculate on bonds going up, down, or sideways. It's not possible to enter spread orders for bond-futures options yet, so you'll have to leg into them which will trigger additional transactions costs. Keep your position size small while you're learning to trade bond-futures options. They're actively traded with tight bid/ask spreads, but bonds can move sharply in a matter of minutes, and you don't want to be caught legged out on a position.

Whether you're ready to start trading in the bond arena, or just want to first be a spectator, get familiar with the bond trading tools on the TD Ameritrade platforms, and you might be teaching your financial planner a thing or two at your next meeting.

**Important Information**

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Trading options, futures and options on futures involves speculation, and the risk of loss can be substantial. These products are not suitable for all investors. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies and often involve greater risk, and more complex risk, than basic options trades. Investments in fixed income products are subject to liquidity (or market) risk, interest rate risk (bonds ordinarily decline in price when interest rates rise and rise in price when interest rates fall), financial (or credit) risk, inflation (or purchasing power) risk and special tax liabilities. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*

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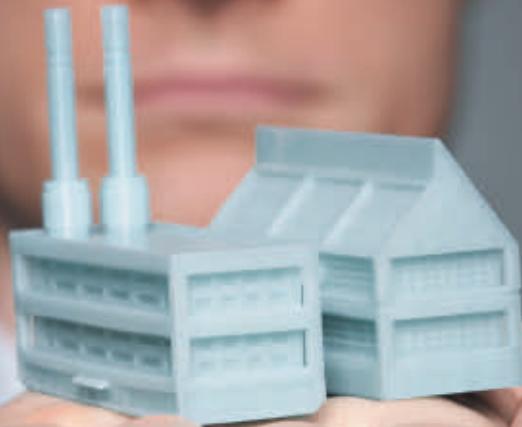
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TRADER TOOLS

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# FINALLY, NUMBERS THAT MATTER

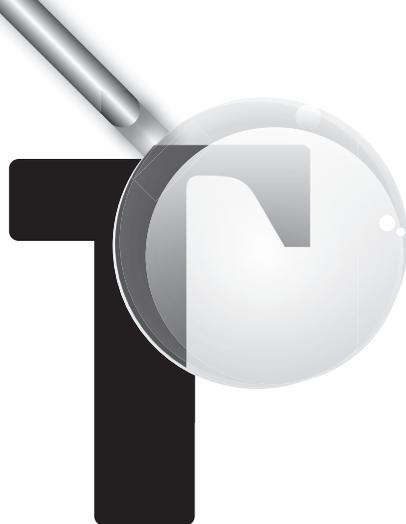
NO TRADER WORTH HIS SALT LOOKS AT BALANCE SHEETS AND INCOME STATEMENTS, RIGHT? NOT SO FAST. IF THERE WAS A TOOL THAT CAN TELL YOU SOMETHING YOUR CHARTS CAN'T, IT MIGHT BE WORTH A LOOK. FUNDAMENTAL ANALYSIS ISN'T JUST ABOUT BETTING ON THE JOCKEY. IT'S ALSO ABOUT WHAT MAKES HIM GO.

WORDS BY **NICOLE SHERROD**,  
MANAGING DIRECTOR, TRADER GROUP AT TD AMERITRADE  
PHOTOGRAPH BY **FREDRIK BRODÉN**

TRADER TOOLS

Photograph by  
Fredrik Brodén

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TECHNICIANS HAVE FOREVER RESISTED THE NOTION that fundamental analysis matters—you know, poring over those pesky income statements and balance sheets. “It’s already built into the charts!” they cry. A trader myself, I tend to agree with my technical brethren. But I also know there may be useful fundamental nuggets that complement my, ahem, charting prowess. And that’s why, after 14 years, I’m pleased to announce we’ve developed the first fundamental gadget for the thinkorswim® platform—the company profile tool.

**FIGURE 1:**  
**The Company Profile tool** Studying the business divisions of a company can tell a story about a company you may not have heard. Just type in a symbol, and click a business division in the left bar. Select a forecast measure in the right column and view the data, or slide the levers to see what your forecasts will reveal. For illustrative purposes only.

BE ONE WITH THE ANALYST

If Warren Buffet and Peter Lynch were techno-geeks and had hashed out an idea for a trading tool, it might have been the **company profile tool** (“tool”), which delivers two key things—valuating and researching companies you already know a little bit about. And why not? After all, Buffet looks for great companies that trade at a fair price. And Lynch believes in researching the companies whose products you already enjoy. The tool not only marries these two con-

cepts but takes it to the next level—allowing you to be your own analyst without pouring over dense financial statements and mountains of data.

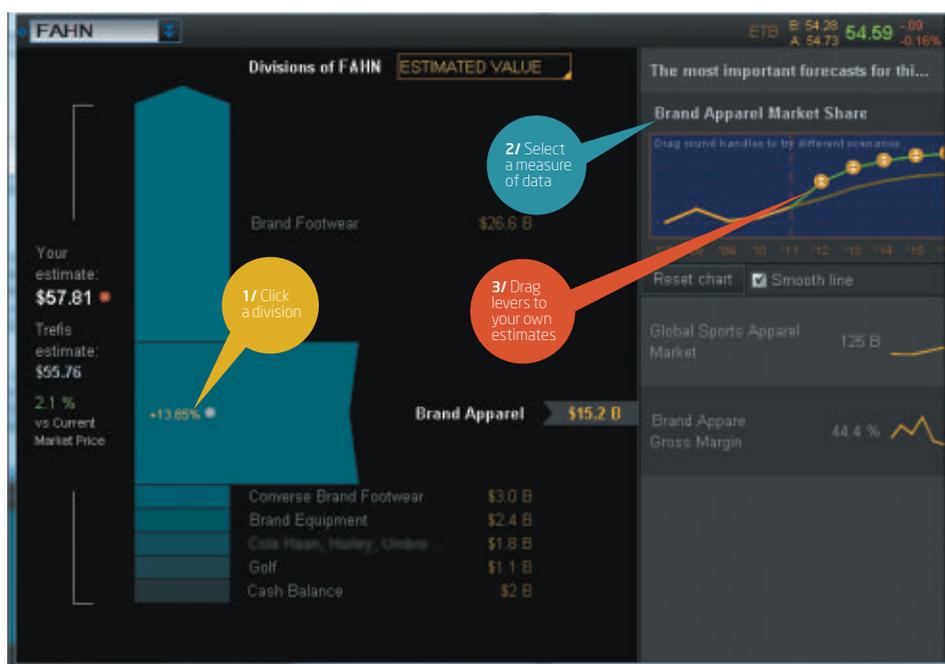
Historically, traders haven’t cared too much about what a company does. Why bother projecting a five-year growth rate when you may only care about tomorrow, next week, or next month? But truth be told, I don’t remember the last time I bought a symbol for a company I didn’t know, or at least, didn’t know what it made. For me, I feel more comfortable trading something familiar. So, on some level, certain fundamentals do in fact matter. Let’s look at how you might benefit from studying them with the help of the tool.

TOP DOWN, TRADER STYLE

Fundamental investors approach markets in two ways—top down, and bottom up. I prefer top down for investments and bottom up for martinis. With top down, you might start with global economics, make your way to industry analysis, then to sector analysis, and finally to a couple of stock picks.

At this point in your research fire up the tool to make a side-by-side comparison of each stock candidate to see which one is favorable. The first question is, what are you looking for? To answer that, grab your analyst hat.

Stock analysts are notorious for building out complex equity models that let them adjust a company’s valuation based on pulling certain levers. For instance, sales of widget “X” are up 10%, advertising pricing is decreasing by 1%, and operating margins are increasing by 2%—this is the basket of levers that could impact overall valuation. The tool lets you automatically adjust these “levers” to make your own projections. (See Figure 1.) After all, momentum is everything to a chart reader. You may want to know if there’s anything about the company (or companies) you’re about to trade that could give you an edge.



HYPOTHETICALLY SPEAKING...

For example, imagine it’s the start of the new year—new year, new you. We all promise to hit the gym, and with that, you figure millions of wishful thinkers will not only be going for six-pack abs, they’ll be shopping for new workout clothes. So, you look for a company that specializes in “performance apparel.” You’ve narrowed your selection to two companies. Both have diversified businesses, so out of the gate, you’re looking for one where there is a higher concentration of revenue in performance apparel. In addition, you’re looking for the brand that’s squeezing out higher margins in its apparel business. Finally, you’re looking for the company that’s trading at a discount to its valuation. In about 45 seconds, you should be able to zero in on what you think looks like the better opportunity. How?

IF WARREN BUFFET AND PETER LYNCH WERE TECHNO-GEEKS AND HAD HASHED OUT AN IDEA FOR A TRADING TOOL, IT MIGHT HAVE BEEN THE COMPANY PROFILE TOOL.



**Pulling the levers:** To use the tool, start from the Trade page of thinkorswim.

- 1—Type a stock symbol in the upper left box. If the tool is available for that stock, the “Company Profile” button will appear top right of the page. Click to bring up the tool (Figure 1, p. 26).
- 2—On the blue vertical bar in the left of the tool window, click the division of business you’d like to analyze.
- 3—Notice right column of “Most important forecasts for this division.”
- 4—Drag estimates of these forecasts (the “levers”) based on your own findings. Say you believe that with increased demand for performance apparel, there’ll be a near-term sales spike resulting in a greater market share. By moving that lever up slightly, you can see the impact it would have on the valuation estimate.

**Finding divergence:** When there’s a difference between your projections (which you adjusted with the levers), analyst estimates (which you can find on [tdameritrade.com](http://tdameritrade.com)), and the current market price, you have found what’s called divergence. And divergence is where you can often discover some great directional-trading potential—both to the upside and downside.

## DOES IT REALLY MATTER?

As a trader you might not care. Because you don’t feel qualified to pull levers and pretend to understand fundamentals. I hear you. Yet, there are still plenty of ways fundamentals—along with the tool—can help.

**1— Before Betting the Farm.** Say you discover an exciting new product. You research the company and everything checks out. The technicals seem to indicate that the time is right for entry so you pull the trigger—only to learn that the product you adore only adds 3% to the company’s bottom line. In this scenario, the tool

can help you validate or disprove your assumptions. It can help you better understand how much revenue is attributable to the bottom line from the company’s combined revenue drivers.

**2— Pairs trades.** When two companies trend in lock step, they’re said to be “correlated.” You’ll typically find correlated stocks easiest among a pair of stocks in the same sector. When one of the stocks diverges in price from the other, and correlation breaks up, you might pairs trade by buying one stock and shorting the other, with the hopes that the stocks will again converge and resume normal correlation. (See our “Pairs Trading Special,” *thinkMoney*, Spring 2012.)

In this case, to help you assess correlation, use the tool to validate the pair itself. In other words, a chart may show that a pairs trade looks great, but the tool could help you understand if there’s too much risk in one business over the other. For example, you may have two giant energy companies that appear to be in the same business. But you favor one over the other for technical reasons. By digging deeper into their business divisions, you may find there’s a high amount of natural-gas drilling that could either threaten the correlation, or simply tell you it’s a lousy pairs trade to start with.

**3— Finding Soldiers.** In longer-term position trades, the tool lets you compare “generals to soldiers.” First-

### Important Information

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tier companies (generals) that serve as sector proxies tend to have lower volatility and might not offer the ideal opportunity.

However, if you’re anxious to be in this sector, you might look for the 2nd- and 3rd-tier companies (soldiers) that have room to grow. Do they have similar business units than the generals, and a similar makeup of those units? Are the growth projections of those units what you’d expect?

The tool is your secret weapon and can help keep you armed and battle ready.

## HIT THE “BOOKS” GLADLY

Remember in high school when Cliff Notes were your BFF? With so much great technology in the trading world these days, the idea of market research and informed decisions no longer have to provoke anxiety attacks and extreme dread. Think of the company profile tool as the Cliff Notes of the trading world that can easily turn you into a poor man’s fundamentalist. You’ll save yourself countless hours wading through beefy analyst reports, and quickly get the insights you need to trade a whole lot of companies whose products and services make you want to profile with joy.

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## Ask the Trader Guy

Rescuing traders,  
one question at a time.

Photograph by  
**Fredrik Brodén**



trdr.

**Q: Hey, Trader Guy! If one standard deviation covers 68% of the potential changes in a stock price, is the option that has a 68% probability of expiring worthless at a strike that's one standard deviation away?**

A: Not quite. The stock is going to be somewhere between \$0 and infinity 100% of the time, and one standard deviation up and down from the current price theoretically covers

68% of the possible price changes. That leaves 32% of the price changes outside that one standard-deviation range. If those 32% of price changes are equally distributed above and below the one-standard deviation levels, that means 16% are below minus-one standard deviation from the current price, and 16% are above plus-one standard deviation from the current price. That means you'd look for an option with an 84% probability of expiring worthless (100% - 16%) to find the strike that's theoretically one

standard deviation away from the current price.

**Q: Hey, Trader Guy! My wife and I trade across from each other at our desks. I forgot our anniversary or something, and I heard her mutter my name and "leptokurtic" when she was on the phone with her sister. Should I be offended?**

A: Well, as we all know, context is everything. Let's try to keep this civil

and assume your better half was talking to her sister about trading. "Leptokurtic" refers to a probability distribution where the peak in the middle is higher than a normal distribution. Some traders think stocks, and stock indices, exhibit this behavior. Of course, she might have been talking about your head, but you are the one that forgot the anniversary.

**Q: Hey, Trader Guy! If I'm short an out-of-the-money option with expiration coming up, and it's really cheap, should I**

**just let it expire worthless, or spend the commissions and premium to buy it back?**

A: I know exactly how you feel because I short options as part of my trading strategy, too. It seems like there's a very low probability that the stock or index will move enough in one or two days to threaten the short option, but expiration week can be full of surprises. Think of it this way—if you're short an option that's nearly worthless, you've probably captured a majority of the potential premium already. In this scenario, buying back the short option does three things: takes profit, reduces risk, frees up trading capital. The downside is that you may have to pay the ask price to buy it back, and you have to pay commission on the trade.

**Q: Hey, Trader Guy! I think there's a setting on the trading platform to make all the green numbers turn red and vice versa. I'm getting whacked on some contrarian trades, and I could use some price reversals. How do I do that?**

A: 3-D glasses and a barf bag.

### Important Information

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*

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gear

## Gear Head

Our favorite gadgets you may not have heard of

Words by **Nicole Sherrod**

Managing Director,  
Trader Group at TD Ameritrade

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• There's been a notion out there for a long time that "the little people," retail investors, are somehow not all that savvy. CNBC Executive Producer John Melloy debunks the myth, "On Wall Street, the retail investor is often seen as the dumb money. By the time Main Street has caught into a bullish or bearish trend, it's time for the so-called smart money—the professionals—to do the opposite." But, as Melloy goes on to say, those days may be over.

In creating the Investor Movement Index<sup>SM</sup> (IMX), TD Ameritrade has leveraged one of the largest individual-investor databases in the country representing data from over six million clients to show how regular investors—like you and me—are positioning themselves in the market. While it cannot predict the direction of the market, insights from the IMX data, when viewed over time, can be used to suggest a bullish or bearish sentiment on the part of retail investors and might help investors gauge a range of trading decisions for both the present and the future. [Just remember that no single indicator or study tells all. It's a good idea to monitor a variety of indicators and studies when considering an investing decision.]

### THE ULTIMATE SENTIMENT INDICATOR

The calculated value of the IMX is based on a complex formula in which the holdings and positions of TD Ameritrade account holders are evaluated monthly to arrive at an individual score. The median of

# Investor Movement Index<sup>SM</sup>

For those who want to know how "the little guy" is really investing.



**FIGURE 1: As close as it gets** Get a feel for the sentiment of retail investors' portfolios, by tracking what the little guys are doing with TD Ameritrade's Index Movement Index (IMX). For illustrative purposes only.

these individual scores represents the IMX, whose first purpose is to show, over time, how one of the largest active-investor populations in the United States reacts to, and adjusts for, unexpected events.

The IMX score is best viewed each month relevant to its prior levels. So a score that moves up from one month to the next could be interpreted as TD Ameritrade clients becoming more bullish. Likewise, a score that moves down from one month to the next could be interpreted as TD Ameritrade clients becoming more bearish. Keep in mind that this is not a mean-reverting index like the **CBOE's Volatility Index (VIX)**, so there are no bullish or bearish "thresholds."

Preliminary results have proven interesting. In December of 2012, during the "fiscal cliff" doom-and-gloom headlines, the IMX rose to its highest level since January 2012.

### Important Information

*Past performance of a security, strategy or index is no guarantee of future results or investment success. Historical data should not be used alone when making investment decisions. Please consult other sources of information and consider your individual financial position and goals before making an independent investment decision. The IMX is not a tradable index. The IMX should not be used as an indicator or predictor of future client trading volume or financial performance for TD Ameritrade.*

Despite all the market uncertainty, the "unsavvy" Main Street investor appeared to be dialing up risk, buying equities, increasing margin, and trading options. Ultimately, the S&P 500 index rose, just as an end-of-year deal prevented any real government catastrophes. Yet, that increase in the S&P 500 index has continued well into January.

### FANCY TOOLS FOR PLAIN FOLK

You might wonder how this differs from VIX, which also measures market sentiment. Whereas, VIX analyzes implied volatility on S&P 500 index options, IMX goes a bit farther. As a precise tool, it pulls institutional traders out of the equation to laser in on the temperature of individual investors (you and me)—giving you a truer sense of what us little people are thinking, on the whole. But unlike the VIX, it updates once a month, not on a tick-by-tick basis.

### Easy Access

Access IMX at [tdameritrade.com/IMX](http://tdameritrade.com/IMX) to get charts, commentary, and to sign up for email alerts each month the IMX is updated. Or fire up your thinkorswim® Charts and type \$IMX in the symbol field. You can overlay studies, or compare IMX to other symbols.

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Futures trading is not suitable for all investors, and involves the risk of loss. Futures are a leveraged investment, and because only a percentage of a contract's value is required to trade, it is possible to lose more than the amount of money deposited for a futures position. Therefore, traders should only use funds that they can afford to lose without affecting their lifestyles. And only a portion of those funds should be devoted to any one trade because they cannot expect to profit on every trade. All references to options refer to options on futures. CME Group is a trademark of CME Group Inc. The Globe logo, CME, Chicago Mercantile Exchange, E-mini and Globex are trademarks of Chicago Mercantile Exchange Inc. CBOT and Chicago Board of Trade are trademarks of the Board of Trade of the City of Chicago. NYMEX, New York Mercantile Exchange and ClearPort are trademarks of New York Mercantile Exchange Inc. COMEX is a trademark of Commodity Exchange Inc. S&P 500 is a trademark of The McGraw-Hill Companies, Inc., and has been licensed for use by Chicago Mercantile Exchange Inc. Copyright © 2012 CME Group. All rights reserved.



## Vol Watch

Viewing the markets through the eyes of volatility

Words by **Adam Warner**

• It seems that ever since the **CBOE Volatility Index (VIX)** first achieved notoriety about a decade ago, a cottage industry of over-analysis has grown up around it. We parse every little tweak as if it bears some sort of predictive power. “VIX is up too much.” “VIX isn’t up enough.” “Why isn’t there more fear out there?” “Why do I keep asking rhetorical questions about an index?” And while I’ve overhyped and overanalyzed the small moves as much as anyone, it’s worth stepping back and seeing the bigger picture through a new criterion—regime.

### HORIZONS ARE MORE THAN SUNSETS...

Volatility moves tend to produce more “noise” than signal in the short term. But expand your time horizons and you might see clearer trends. VIX tends to move within “high” and “low” regimes—ranges across larger subsets of time—that last between 4 and 6 years. Right now, you could make a case that we’re about two years into a low VIX regime. But, at the end the day, what does that mean?

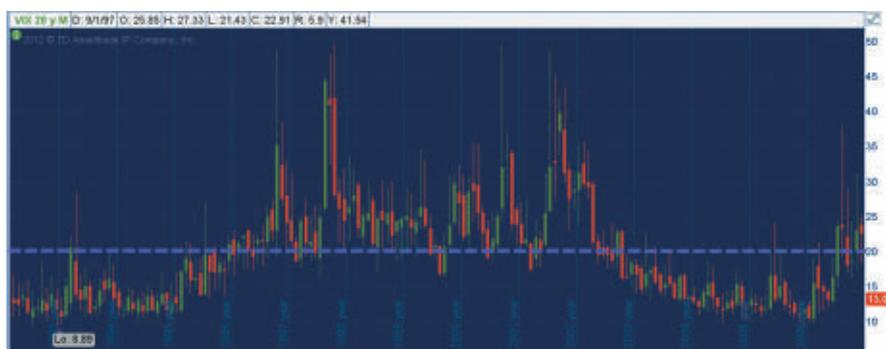
Look at the monthly chart of VIX from 1993 through the end of 2008 in Figure 1.

The horizontal line in the chart is drawn at 20 because that’s more or less the average level of VIX over the course of time. Prior to 1997, VIX broke above 20 infrequently. Back then, no one talked about the VIX. But we did follow volatility trends. Since the markets went up pretty much every year in the ‘90s, we treated implied volatility as a stable variable. If it got a little elevated, you sold more options. If it got cheap, you bought them back. Mean reversion within a small range was the name of the game.

# Volatility. It’s all relative.

Think you know what VIX is saying? Maybe not in the short term.

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**FIGURE 1: The big VIX** Looking at the VIX over the long term, in regimes, versus days or weeks, can help you understand current market-sentiment bias, relative to its current backdrop. Chart from the thinkorswim® platform. For illustrative purposes only. Past performance is no guarantee of future results.

We’ll call this Down Regime 1, lorded over by Sir Alan Greenspan and Sir Eddie Vedder.

By 1997 though, implied volatility started to trend up. And so did the market—the only time in the last 20 years that the VIX and the equity market seemed to move in the same direction. It was the dawn of the tech bubble, day trading, and eye-popping rallies in stocks that either don’t exist anymore (anyone remember eToys?) or are a shell of their once high-flying selves. (Here’s looking at you, JDSU.)

That legendary stock rally may have ended in March 2000, but the volatility rally persisted until mid-2003. The 20 line that served as a ceiling in the ‘90s now looks more like a floor, as the millennium turned over.

We’ll call this Up Regime 2, patron Saints of Jeff Bezos and Derek Jeter.

From mid-2003 to early 2007, VIX troughed again, thanks mainly to a persistent and non-volatile market rally, followed by the persistently strong VIX that started in roughly February of 2008 and ended, well, we don’t know for sure yet, though a new “low” regime likely started around the beginning of 2012.

### HEED YOUR DEFINITIONS

What does it all mean?

Well, nothing. And everything. Remem-

ber that the VIX reverts to its mean. However, the trick is to define “mean”—hence the need to look at regimes. Yes, 20 may be the long-term average VIX, as you can see from the charts. But a trader can go broke waiting for it to revert back. The true mean is more local.

If we’re truly in a “down” VIX regime, then we have to recalibrate expectations. Whereas 20 VIX maybe was cheap a couple years ago, it’s now on the high side. Readings in the low-to-mid teens may prove to be our “new” normal. This doesn’t mean we won’t see 25 VIX again, and watch it stay there for a couple of years. But seeing as how we’re at historical lows, keep your eyes peeled for a rise to a new regime.

### Important Information

*Options trading involves unique risks and is not suitable for all investors. The views in the article above are not intended to be specific investment advice. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Clients must consider all relevant risk factors, including their own personal financial situation before trading. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Investors cannot invest directly in an unmanaged index. Past performance is no guarantee of future results or success.*

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## Associate Spotlight

A chat with a TD Ameritrade VIP making waves

Interview by **Kevin Lund**

Illustration by **Joe Morse**

### spot

When you're Don Kaufman, you don't really need an excuse to talk options. It's in his blood. Having started working for his uncle's firm, O'Conner and Associates, right out of college, he soon went from trading-floor runner to upstairs risk manager. Eventually, he became an integral part of the Trader Group at TD Ameritrade.

Not only can you now find him out on the road at most major trade shows and TD Ameritrade's Market Drive events in cities throughout the country. But he also cohosts the popular daily chat show "Swim Lessons" with Jeff Bierman and Todd McCarthy.

### So Don—um, Mr. "Option Geek"—you were there in the early days of thinkorswim, right?

Yeah, I built Option Planet for thinkorswim, back when it was an independent broker out of Chicago, not just a highly-regarded trading platform. Option Planet led the education model for Investools®, which paved the way for us to eventually merge with TD Ameritrade. They knew that they were buying a highly innovative brokerage firm in thinkorswim, but the acquisition also allowed TD Ameritrade to take their education strategy to the next level.

### What makes the TD Ameritrade education from Trader Group so important?

We try to bring the reality of trading to everyone. It's not "get rich quick". It's often



## The King of Content

Swim Lesson's<sup>SM</sup> Don "The Option Geek" Kaufman reveals himself and his trading rules to live by.

a grind. We show the real side of trading—the pitfalls. What not to do, rather than what works, really. We also provide a lot of insight into the world of professional trading, such as risk management, and specific criteria for strategies.

### Give me three trading rules to live by.

1/ Sell premium and manage risk. I don't like directional trading, and I don't use charts. Always know your risk—how much do you stand to lose? Run your portfolio through the Analyze tab in thinkorswim.

2/ Pare down what you look at and know those products really well. For example, I primarily trade only a handful of indexes I

### Important Information

*TD Ameritrade does not make recommendations or determine the suitability of any security, strategy or course of action, for you through your use of its trading tools. Any investment decision you make in your self-directed account is solely your responsibility. All investments involve risk, including loss of principal. The content presented in the Trade Architect and Swim Lessons chat sessions are provided for educational purposes only and should not be considered recommendations to trade any specific security or utilize any specific trading strategy.*



### Listen to the Geek Speak

Listen to Don and his crew yammer about trading, every weekday, 11:30 a.m. - 2:30 p.m. ET in the thinkorswim Chat Rooms. Just click the Support/Chat button in the upper left of the platform and follow the path to Chat Rooms > Swim Lessons. Then follow click path Chat Rooms > Swim Lessons.

know well because I don't like equities as much.

3/ Allow the market to tell you what's next. For all the predictions of where things will go, most don't think much about what the market is doing now. But it's telling you more than you think.

### Any other pearls?

It's not about quick hits. It's about longevity as a trader. Markets change, but strategies don't. What works now may not work two months from now. Which is why tuning into Swim Lessons frequently as well as attending our live events more than once is important.

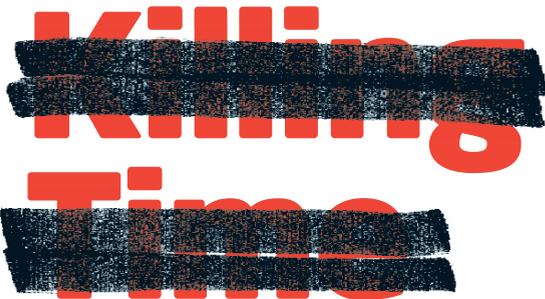
### So what's with the Hugh Hefner smoking jacket there, bud?

I have no life. My "celebrity" image on the road is a ruse. When I'm home, it's daddy day care, so the jacket safely takes me to a different time. One can reminisce, right?... (sigh).

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**Special Focus:  
Spreads Part 2  
Calendars**

•  
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THE CALENDAR SPREAD IS ANOTHER BUILDING BLOCK THAT YOU'LL NEED TO KNOW SHOULD YOU DECIDE TO TRADE SPREADS. THOUGH IT'S DESIGNED TO PROFIT WHEN A STOCK GOES NOWHERE, THERE'S MORE TO IT THAN JUST WATCHING TIME PASS. THE FIRST STEP IS REVIEWING THE BASICS. THE NEXT STEP IS LEARNING WHEN AND HOW TO TRADE THEM.

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



April

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Thursday

## Time for a pop quiz.

Q: When is a volatility trade not about volatility?

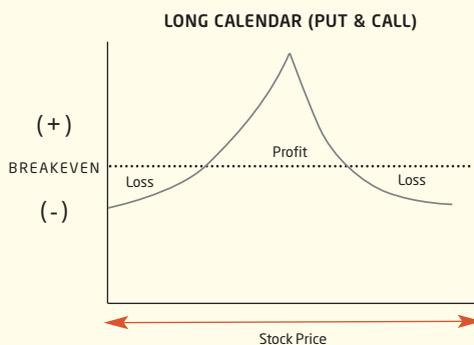
A: When it's a calendar spread.

Typically, traders think about two things when you mention calendar spreads: sideways trends and low volatility ("vol"). Also known as "time spreads," calendars have been popular in the past year due to the low volatility backdrop. Now, advanced traders have learned that long calendars have **positive vega** (i.e., buying vol), and that lower vol typically means lower-priced calendars. But what they haven't learned is that an increase in volatility won't necessarily save a calendar gone bad. And when it comes to calendars, vol might not be telling them what they think they hear.

### LET'S BACK UP

Calendars are designed to profit from the passing of time, not stock movement. So generally, you want the underlying to trade in a relatively flat range over the life of the trade. As in other range trades, the zone of potential profit generally looks like a "tent" in the risk/reward profile (Figure 1).

Calendars are created using any two options of the same stock, strike and type (either two calls or two puts), but with different expirations. For example, if stock XYZ is \$50, and you think it will trade in a tight range around \$50 for a while, you might buy one July \$50 call for \$2.00 and sell one June \$50 call for \$1.25--also your max risk. You'd then own a long June/July



**FIGURE 1:** The basic calendar "tent" shape of a risk/reward profile. The curves versus hard lines are largely influenced by the expiration date of the short option, and changes with every "roll" of the short strike. For illustrative purposes only

calendar for \$0.75 debit (not including commissions and fees).

How do you profit? If as expected, the shorter-term option decays at a faster rate than the longer-term option, the spread "widens" and you may be able to close out the spread for a profit. All things being equal, were XYZ to finish at \$50 at expiration of the short option, your short option would be worth \$0.00, while the long option might now be \$1.25. Since your long spread has "widened" from 0.75 to \$1.25, your profit is \$0.50 (less commissions and fees). It's not always this perfect, but you get the idea.

### PITCHING TENTS

Several different option strategies give you that "tent" risk/reward profile that may profit from a stock price landing in a range by expiration. **Butterflies, short straddles,** and calendars (Figure 1) are designed to maximize their profits when the stock is right at the short strike price. Of those three strategies, only calendars can look more attractive when vol is low. In that environment, long butterflies are theoretically more expensive and short straddles have lower credits.

Using calendars in your strategy is more than knowing that you're buying and selling options in different expirations, and looking for low volatility, or certain intermonth vol differentials. Low vol doesn't automatically mean long calendars are good opportunities. And volatility isn't the whole story behind them. Let's go beyond the basics, and talk about tools that can help.

### ROLLING—THE SECRET SAUCE

While calendars are an essential building block to spread trading, if you're trading them by themselves, their profit potential may increase with "rolling." The roll is buying back the short front-month option, and shorting the same strike option in the next expiration. Because the option with more time to expiration has greater extrinsic value, the roll should generate a credit of some amount. Buying a calendar incurs a debit, and the credits from the roll(s) have to be at least as large as the debit. If the rolls aren't high enough to cover the debit and transaction costs for buying the calendar, the trade won't make money. Consider the value of the roll and three of its various moving parts.

**Time to expiration:** When you decide to roll is the only aspect you can control. All things being equal, a roll will achieve its maximum credit when the short option is almost fully expired. This makes sense because time decay is reducing the extrinsic value of the option most quickly approaching expiration. And you buy the short option back for almost zero extrinsic value, and take in the extrinsic value of the next-month option as credit. The less you have to pay to buy the short option back, the better.

So, why wouldn't you just let every calendar go to expiration? Because the stock price and volatility may be at better levels for the roll before expiration, and waiting until expiration means you're risking the



## HOW TO CALENDAR

Watch a short vid on how to trade calendars with thinkorswim® in the **Learning Center**. Just follow the click path to [www.tlc.thinkorswim.com](http://www.tlc.thinkorswim.com) > tutorials > trade. Locate the "Strategy: Calendars" video and click for three minutes of bona fide enlightenment.

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stock moving away from the strike price and/or volatility shifting.

**Volatility:** While volatility is something you can't control, you can have an idea of what might cause it to go higher or lower. When uncertainty in the market is high, implied vol (the market's future price projection of the stock, as priced in the options) can be high. When there's more complacency, implied vol can be lower.

So, you'll often see implied vol rise ahead of news or earnings announcements when there is uncertainty about how they might impact the price of the stock. Implied vol often drops right after the announcement when the news is out and digested, and the uncertainty subsides. This is tied to options expirations cycles, when news scheduled after an expiration does not affect the implied vol of the options in that expiration. The news will likely have a greater impact on the volatility of the options that expire in the nearest expiration after the news. Which is why you'll see different implied volatilities—and thus, different roll values—in options with different expirations.

This is important because as the front month expiration approaches, the value of the roll depends a lot more on the vol of the back-month option, the one you're rolling the short front-month option to. That's because the vega (a measure of an option's sensitivity to changes in the volatility of the underlying asset) of that back-month option is higher than the vega of the front-month option, and why changes in the implied vol of the back-month option can have a much bigger impact on the value of the roll than changes in the vol of the front-month option.

Pay closer attention to that back-month option's volatility. If it moves higher, or you believe it might move higher because of news that would impact options in that expiration, you may get more credit for the roll. Alternatively, if vol has dropped in that back-month option, its value will probably have dropped more than the front-month option. This is also important when initiating calendar trades. More later.

**Stock price:** Where the stock is, in relation to the strike price, either close to it or further away, usually has a bigger impact on the roll value than either the approach of expiration, or volatility. For a given number of days to expiration and volatility, the roll value is going to be maximized when the stock is very close to the strike of the calendar. That's because the at-the-money option has the highest extrinsic value, regardless of its expiration. You'll see calendar spreads/roll values peak at the at-the-money strike. As you watch successive **out-of-the-money** strikes, the calendars/rolls are worth less. This is more pronounced close to expiration. If the stock is close to the strike price in the days before expiration, that could be the most opportune time to roll, and you don't want to lose it if the stock moves from the strike.

You can see this on the thinkorswim® platform. On the Trade tab, load up the "Calendars" from the Spread dropdown menu and select "Mark" as a column

choice. You'll see the prices of the calendars for adjacent months. It doesn't matter which months are available. Calendars are most valuable for the at-the-money strikes, and the values fall away more quickly from the at-the-money the closer the options are to expiration. For the calendars in further months, the drop from the at-the-money is shallower. The difference in the value of the calendars reveal how much value the roll might lose if the stock moves away from the strike price.

## ROLLING IT ALL TOGETHER

OK. So you understand how rolls are affected by time, vol, and stock price. And you know that credits from the rolls are key to profits in calendars. But how do you put it together to find a potential calendar-spread trading opportunity?

**First: consider the option price**, as well as its implied vol. Don't get suckered by high front-month vol in a wide, intermonth vol skew—vol levels of the same strike with different expirations—that doesn't give you much premium for the short option. When building a calendar, start by looking for the short front-month option. I start with the options that have between 25 and 35 days to expiration, and I look at the strikes that are 2 to 4 strikes out of the money. That may help to balance the probability of an option expiring worthless, time decay, and actual option premium.

Then, look at the next consecutive expiration for the long option. If the debit of the calendar is less than, or about equal to, the price of the short front-month option, it may be a calendar to consider further.

**Second: consider if you can break** even on the calendar if the stock doesn't move in the right direction. Calendars are directional to the extent that the strike is at, or away from, the money. Remember that the calendar/roll maximizes its value when the stock is at the strike price. So, a put calendar at a strike below the current stock price is bearish, and a call calendar at a strike above the current stock price is bullish.

But I like to find calendars that have a chance at even a small profit if the stock stays where it is, or even moves away from the strike. That's related to the first step. Why? At the time the short front-month option is approaching expiration, the long back-month option will have about the same number of days to expiration that the short front-month option has now—about 30. So, the price of the short front-month option can be used to approximate the price of the calendar/roll in one month. With the price of the front-month short option at least as high as the debit of the calendar, it's possible for the calendar to be profitable, even if the stock stays at its current price until expiration.

Go one step further by looking at the successive out-of-the-money, front-month options. Those indicate the price of the calendar/roll if the stock moves away from the calendar's strike by that many points. So, if the stock is at \$50 and the 48 put is .60 and the 47 call is .50, the calendar roll might be worth .60 if the stock stays at \$50, or .50 if the stock moves up to \$51.

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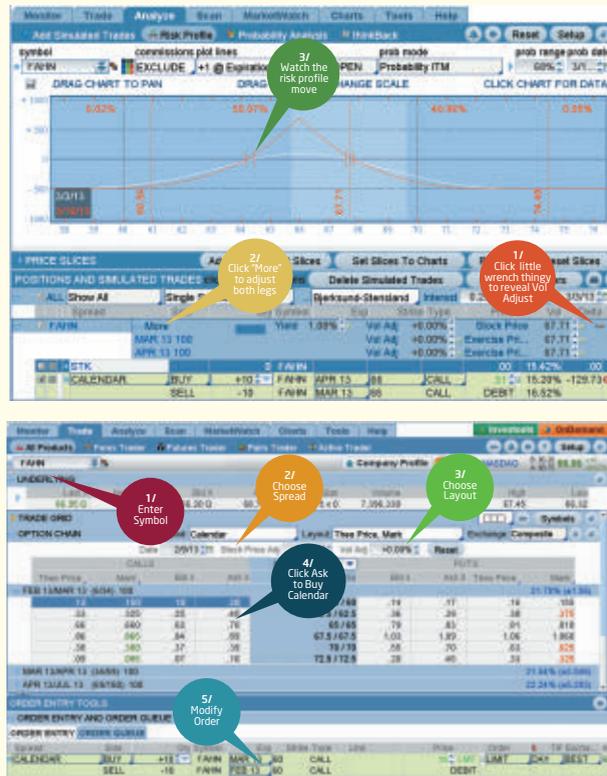
## Special Focus: Spreads Part 2 Calendars

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**Third: realize your potential.** Make sure you get a high enough potential profit if you're right, and the stock does move to the calendar's strike price. Look at the current at-the-money option in the same expiration as the short option of the calendar. That's the approximate value of the calendar/roll if the stock is close to the strike price near the front-month expiration. If the price of that option is only slightly higher than the calendar debit, the potential profit wouldn't be that high, compared to the risk I'm taking on the calendar. I like the potential profit to be at least as great as the risk—defined as the debit of the calendar, and preferably about 1.5x greater than the risk.

THIS APPROACH TO CALENDAR SPREADS is price-based. Don't ignore implied volatility. But, look at the overall implied vol difference between expirations as a place to begin looking for price-based calendars. But not as the sole criterion. When the front-month implied vol is slightly higher than the back-month vol, calendars tend to meet the price criteria I want. When the back-month vol is higher, it's tougher to find them. And when the front-month vol is much higher, that can indicate large potential price swings in the stock price that could drive it away from the calendar's strike.

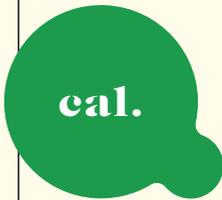
If you decide to use calendars in your portfolio, use the functionality available in the thinkorswim platform to make the job easier—from checking vol differentials and prices, to roll values and trade entry.



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**FIGURE 1 (top) & 2 (bottom):** A two-screen process to analyzing and trading a calendar spread on thinkorswim. One to analyze volatility scenarios, and the other to place the trade. For illustrative purposes only. Not a recommendation.

## PART 2 How To...Trade Calendars in thinkorswim®



• Even though you might be basing your calendar trades on price, taking a look at how changes in the volatilities in different expirations can be helpful if you're considering calendars around news announcements that could cause vol to first rise then fall. Typically, the front-month vol drops more than the back-month vol, but the back-month option has more **vega**. It's hard to assess in your head how these changes impact calendars. So we built the volatility tools on the Analyze page of thinkorswim. You can do this for actual calendar spreads in your account, or simulated calendar positions before you do the trade.

### ANALYZING VOL

Go to the Trade tab on the Analyze page, and click the little wrench icon to the right under "Positions and Simulated Trades." (Fig. 1, Step 1) You'll then see "Yield", "Vol Adjust," and "Stock Price." We'll focus on the Vol Adjust. When you move that up and down, it takes the implied vol of every option up and down the same number of points. If you set the Vol Adjust to + 2.00%, that would push an implied vol of 20% to 22%, and use that 22% to calculate the option's greeks and theoretical value.

But with calendars, you don't want one Vol Adjust for all the expirations. Go a couple inches left of the "Yield" control to the word "More" and click on the arrow (Fig. 1, Step 2). That opens up further controls with a Vol Adjust for each expiration. That lets you take the front-month implied volatility down 15%, for example, and the back-month volatility down 5%. You can set the vol changes to any combination you want. The resulting adjusted volatility is used to calculate the options' theoretical values, and will be reflected in different potential profits and losses on the Risk Profile of the calendar spread (Fig. 1, Step 3).

## PLACING THE ORDER

Once you feel comfortable with the calendar you're looking at and the volatility backdrop, it's time to place the trade. The easiest way to do this from the page (See Figure 2):

1. Enter the stock symbol in the symbol box upper left of the page.
2. Select "Calendar" in the Spread dropdown in the center.
3. Select "Theo Price, Mark" to get the last price traded on each calendar.
4. In the Strike column (middle of page), you'll see the different calendar spreads already put together for you. Select the Ask for any one of the spreads to populate a long calendar in the Order screen below. (Selecting the Bid will populate a short calendar.)
5. Adjust the trade in the lower Order Entry screen and hit Confirm and Send to place the order.

### Important Information

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**Q: What about calendars with more than one month between expirations?**

**A:** For multi-month calendars, divide the total debit by the number of expirations to see how much you have to get for each one-month roll to offset the debit of the calendar and begin to generate profit.

**Q: Can you trade calendars in IRA accounts?**

**A:** Yes, as long as the long option is in a further expiration than the short option. So, long calendars are allowed. Short-call calendars are prohibited in IRAs because the short call is considered naked. Short-put calendars would have a margin requirement equal to the strike of the

SHORT  
OPTIONS IN A  
CALENDAR  
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BE ASSIGNED  
AT ANY  
TIME UP TO  
EXPIRATION  
REGARDLESS  
OF THE IN-  
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AMOUNT.

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**Q: How much buying power does it take to buy a calendar spread?**

**A:** You only need option buying power in your account high enough to cover the debit of the long calendar. When you roll the short front-month option to the next month as a single trade, the margin requirement does not increase.

**Q: Do I have to do anything with a calendar at expiration?**

**A:** It depends on where the stock price is relative to the strike price of the calendar's options. There are three scenarios for the short front-month option at expiration: 1) it's out of the money, 2) it's in the money, 3) it's at the money.

If the short option is out of the money, you can let it expire worthless and leave the long back-month option on. If you do that, you have the directional delta of that long option, as well as negative time decay and positive vega. If the short option is in the money, it will likely be assigned and you'll have a synthetic position with the long back-month option with the delta, negative theta (a measure of an option's sensitivity to time decay), and positive vega, as well as the margin requirement on the stock position. If the option is exactly at the money, you can't be sure of what you'll have at expiration. Generally, you should consider either rolling the short

option to the next expiration, or close the calendar before the short option expires.

**Q: What if I'm assigned on the short option before expiration?**

**A:** That can certainly happen, especially with short-call calendars on stocks that pay dividends. If you're assigned on a short call, you'll end up with a short stock position in your account and the long back-month option of the calendar. The margin would be the margin on the short stock, and would be prohibited in an IRA. The choice you would have is to either buy the stock back and sell the long back-month option to close the position, or exercise the long back-month option. Get in touch with your broker to help you evaluate the better choice. Remember, short options can be assigned at any time up to expiration regardless of the in-the-money amount.



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## Coach's Corner

Pulling pearls from your favorite trading instructors.

Words by  
**Brandon Chapman, CMT**  
Investools Instructor

# Who Cares About Trend?

If picking direction isn't your game, futures pairs trading may suffice

DID YOU EVER LOOK AT A RUNAWAY stock or index and say to yourself, "that can't go on forever?" You may not have been a perma-bear, but you may have felt that order would eventually need to be restored. If so, then listen up. Futures pairs trading may be a strategy to consider.

Pairs trading is market neutral—meaning you don't care where the stock or index is going, you're just trying to profit from the relationship between highly correlated securities. (i.e. they move together in tandem.) The idea is when two stocks that are highly correlated, and one suddenly starts diverting from that "normal," you sell the higher-priced security, and buy the lower-priced security, and profit as they revert to historical norms. (For more, see our "Pairs Trading Special" in *thinkMoney*, Spring 2012.)

## THE TRADE

**First:** find a pair to trade. A common product to use is index futures because of their close correlation, leverage, and the liquidity of these markets.

**Second:** identify when correlations break down, which you can do from the Pairs Trader feature on thinkorswim®, (Figure 1). The tool is prebuilt with a 10-period correlation study and a chart of the spread—the difference—between the two securities entered.



**FIGURE 1: Back to the Mean** When one security outperforms another highly correlated security, placing a pairs trade is a bet that things will return to "normal" again soon. For illustrative purposes only.

**Third:** figure out how many contracts of each security to trade. Failing to size the position appropriately will result in different outcomes if one security moves in a particular direction. One method that addresses this issue is to trade similar dollar values or to achieve "dollar neutrality." For example, if /ES is trading at \$1,460 and has a contract value of \$50, the dollar value of the trade would be 1,460 times 50—or \$73,000. In order to be dollar neutral, you would need to trade enough /NQ contracts that it comes close to equaling \$73,000.

## THE TRIGGER

During bullish times, small caps and tech tend to take a leadership role in the markets. However, in the spring of 2012 small caps (/TF) were struggling and tech (/NQ) was soaring due to the extreme weight of Apple Inc.'s market cap. Notice in Figure 1, that in early April, the high correlation of these two indices turned negative. The chart of the spread (or /NQ minus /TF) showed that /NQ was solidly outperforming. This kind of market distortion presents opportunity for those betting on a restoration of market order. The way to capitalize

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## Pick a Pair

Analyzing and placing a pairs trade is a piece of cake in thinkorswim®. Just select the Trade tab, and click "Pairs Trader" in the submenu below the tab. At the top of one of the pairs trading screens, enter the symbol on the left you want to buy, and the symbol on the right you want to sell. Look at the chart, and click "Buy Pair" or "Sell Pair."

on the anticipated reversion would be to short /NQ and buy /TF. Of course, your risk in this trade is that the correlation continues to break down.

## HOW MANY?

So, how many contracts do you trade? On April 6, 2012, /NQ closed at \$2,725 and /TF closed at \$799. The dollar value of one /NQ contract is \$20 times the price of \$2,725, or \$54,500. The dollar value of one /TF contract is \$100 times the price of \$799, or \$79,900. In order to figure out the ratio, you'll divide the contract value of /TF by the contact value of /NQ, or \$79,900/\$54,500. The ratio of /NQ contracts to /TF is 1.47. For this trade, you would short three /NQ contracts and buy two /TF contracts. The exit for this type of trade could be when the correlation nears historic norms.

Futures-pairs trading provides you with the opportunity to trade based on the relationship between two securities, not trend. While it's always possible for a correlation to break down longer than capital would permit, you may find pairs trading to be a refreshing approach to trading the markets—particularly when you can't tell where the market is going.

42 **gls****The Token  
Glossary**

Terms you might  
stumble across in  
this issue.

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# Implied volatility

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

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**37 & 39****In the  
money**

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

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## BUTTERFLY SPREAD

• Typically a market-neutral, defined-risk strategy, composed of 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).

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## POSITIVE VEGA

• Long options have positive vega—or long vega—such that when volatility increases, option premiums typically rise, and can enhance the trader's profit. Short options have negative vega because as volatility drops, so do their option premiums, which can enhance the profitability of the short option as well.

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## CBOE Volatility Index (VIX)

• The de facto market volatility index used to measure the overall implied volatility of S&P 500 index options, and by extension the broader market itself. Otherwise known to the public as the "fear index," it is often used to gauge the level of fear or complacency in the market at any given time. Typically, the more fearful traders are, the more they buy out of the money S&P 500 options as a hedge. That buying pressure increases option prices, which translates into a higher VIX. When traders are complacent, and don't think the price of the S&P 500 will move up or down much, they sell options. That selling pressure pushes option prices lower, which translates into a lower VIX.

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## Short Straddle/Strangle

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

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## Short Put

### (a.k.a. Selling a Naked Put)

• A BULLISH, DIRECTIONAL STRATEGY WITH UNLIMITED RISK IN WHICH A PUT OPTION IS SOLD FOR A CREDIT, WITHOUT ANOTHER OPTION (OF A DIFFERENT STRIKE OR EXPIRATION) OR INSTRUMENT USED AS A HEDGE. THE STRATEGY ASSUMES THAT THE STOCK WILL STAY ABOVE THE STRIKE SOLD; IN WHICH CASE, AS TIME PASSES AND/OR VOLATILITY DROPS, THE OPTION CAN BE BOUGHT BACK CHEAPER OR EXPIRE WORTHLESS, RESULTING IN A PROFIT.

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## Delta

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

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## Out of the money

• An option whose premium is not only all "time" value, but the strike is away from the underlying equity. For calls, it's any strike that is higher than the underlying. For puts, it's any strike that's lower.

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## At the money

• An option whose strike is "at" the price of the underlying equity. Like out of the money options, the premium of an at the money option is all "time" value.

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## VEGA

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



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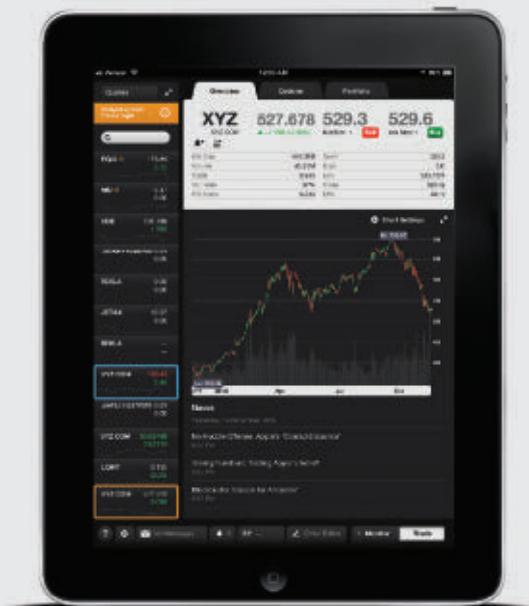
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