

# thinkMoney/26

Random musings for traders at TD Ameritrade — WINTER 2015



**BULL.  
BEAR.  
WHO  
CARES?**

HOW TO  
KEEP THE  
PARTY GOING

PAGE 16



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If you've ever been frustrated spending your precious few minutes reading articles that are too hot or too cold, these little buggers at the beginning of each article will help you skip to just right the right temperature.

● EASY  
● SEASONED  
● PRO





# 16

## How To Keep The Party Going

Bulls don't last forever. Consider some smart money management strategies to help keep the good times going when the party ends.

Cover Photograph by Fredrik Broden

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## Stop Signs, Schmop Signs

Trade options in an IRA? Yup. But there are tighter rules around what you can and can't do because you can't trade on borrowed money (read: margin). So what can you do? Consider the workarounds.

## SPECIAL FOCUS: Building a Trading System

# 26

## Part 1: Testing Your Strategy

**Courting Your Inner Quant**—Your latest “sure-thing” strategy seems like a no-brainer. But will it work? Well, to know it is to trade it. But before you put real money into a single trade, put it to the smell test with hard numbers.

## Part 2: Testing Your Trade

**Speed Dating For Traders**—When you're seduced by a trade, you should be able to size up whether it's worthy in less than 60 seconds. How? Tools, baby. Tools.

PLUS: Q+A

## SPECIAL INSERT: Trading Tarot

These little pull-em out cards may not tell fortunes, but if your future holds a high-volatility monkey with a cautious bull, there's an optimal strategy. Perfect for quizzing you or your peers at the next BBQ

### MISCELLANEOUS

#### 11 **IN THE MONEY** Industry Spotlight

Options reporting is going to look different this year. And easier, too.

**Gear Head** Finding the needle in the haystack with Pattern Finder on thinkorswim®

**Cool Scripts** You've never seen moving averages quite like this. Here's the code.

**Ask the Trader Guy** Our resident trading guru chats about broken butterfly secrets and colon cleansing. Yum.

**Toys for Traders** A slew of our newest, and most favorite gadgets.

### REGULAR COLUMNS

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Using Volume Profile and Average True Range to wake the dead...currencies, that is.

37 **Associate Spotlight**  
Tech guru or master chef? A question that plagues us. Trader Group's John Hart is both.

## Whoa. Something is different...

• IF THIS IS YOUR FIRST ISSUE OF *thinkMoney*, welcome to the club. If it's not, you probably noticed that we got a facelift. Yup, after seven years, we decided it was time to invoke a new normal. Die-hard fans may want to know why.

Well, since the first issue was published in the Fall of 2007, collectively, the way we absorb and disseminate information is markedly different than at the height of the market peak in 2007.

Since then, we as traders, survived the Great Recession, saw stock markets get cut in half (only to roar back to new all-time highs), witnessed the birth of the iPad, and tweeted, friended, and shared our way into a new social trading paradigm. In a word, things have changed—and we thought it was time we did, too. We needed to organize the same great education you've been able to count on all these years in a new, fresh way.

Enter: the new and improved *thinkMoney*!

One of the greatest values of a magazine like this is to talk about the things you may not have thought about, so you can explore them further, or try them out for yourself. And with new devices like the "Skills Barometer" (See page 4) you'll find it easier to assess whether the information is important to you, depending on your skill level.

As for the stories this issue, there comes a time when a trend gets long in the tooth. If you're like most, you can't predict the future, and you typically want to ride it out as long as you can. You may even ignore the buzz about the end being near from all the talking heads. That's cool. But if you're going to stay late at the party, there are a few tricks in our cover feature, "How to Keep the Party Going" (Page 16) that might help you make it to another day.

But before you can survive the long term, you need to develop a system of solid strategies and reliable stock-picking techniques. Our two-part Special Focus -- Building a Trading System -- starts on page 26. Not only will you learn how to test and validate your strategy of choice, but your trade ideas as well—in less than 60 seconds—before you put real money into it. It's speed dating for traders.

So there you have it—brand new package, same great taste. And while we know it will be tempting to gawk at the shiny new object, as always, trade safely. Don't read and drive.

Happy Trading,

**Kevin Lund,**

*Editor-in-Chief, thinkMoney*



**TAKE ACTION:**

Talk to us about this issue of *thinkMoney*! Take our survey and you'll qualify for infinite brownie points. [tdameritrade.com/tmsurvey](http://tdameritrade.com/tmsurvey) or write to us at: [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com)



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EDITOR-IN-CHIEF  
**Kevin Lund**  
EDITOR  
**Thomas Preston**  
ASSISTANT EDITOR  
**Eileen Sutton**  
ART DIRECTOR  
**Tom Brown**  
DESIGNER  
**Jennifer Roberts**

CONTRIBUTING WRITERS  
**Hudson Lund**  
**Nicole Sherrod**  
**John Brodemus**  
**Chesley Spencer**  
**Eric Utley**  
**David Kier**

CHIEF PHOTOGRAPHER  
**Fredrik Brodén**  
ILLUSTRATOR  
**Joe Morse**

PUBLISHER  
**T3 Custom**  
[www.t3custom.com](http://www.t3custom.com)  
[info@t3publishing.com](mailto:info@t3publishing.com)



**TD Ameritrade Contact  
Info You Could Use**  
Client Services Rep:  
800-669-3900  
New Accounts:  
800-454-9272

**thinkorswim Support:**  
800-672-2098  
[thinkorswim@tdameritrade.com](mailto:thinkorswim@tdameritrade.com)  
**Platform Feedback:**  
[thinkorswimfeedback@tdameritrade.com](mailto:thinkorswimfeedback@tdameritrade.com)  
**Tech Support:**  
[thinkorswimtechsupport@tdameritrade.com](mailto:thinkorswimtechsupport@tdameritrade.com)  
**paperMoney Support:**  
[thinkorswimpapermoney@tdameritrade.com](mailto:thinkorswimpapermoney@tdameritrade.com)  
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200 S. 108th Ave  
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At TD Ameritrade, the standard commission for online equity orders is \$9.99, online option orders are \$9.99 + \$0.75 per contract. Orders placed by other means will have higher transaction costs. Options exercises and assignments will incur a \$19.99 commission.



Kyle S.  
thinkorswim® user

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

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## LOVE NOTES

LITTLE QUIPS FROM YOU TO YOURS TRULY



## Socially Speaking...

**reg\_Nosar**, @SouthernRambler, 2:03PM – Sep. 25, 2014  
@TDANSherrrod had my first butt trade. Phone in my pocket, walking around heard a DING! Butt bought 100 shares at market of QQQ.

**Sasha Towfigh**, @SashaTofiq, 2:13PM – Nov. 3, 2014  
After the microeconomics exam today, I'll accept the job as the new CEO of @TDAmeritrade.

**Matney VilleTM**, @matny, 12:18PM – Aug. 2, 2014  
@TDAmeritrade my daughter is one and I've taught her how to trade her doll for her bottle.



### TAKE ACTION:

Follow the "experts" on Twitter for all things markets, trading, and thinkorswim?

@TDANSherrrod  
@TDAJJKinahan  
@thinkorswim

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## Chat Room Pearls...

*It is amazing how much smarter you think you are when the stock you are trading is going your way.*  
—DANNY

*I hope all my stocks go up today. I need to buy my engagement ring tomorrow night.* —FRANK

*There are two absolutes in this world—theta and transaction costs.* —BRENT

*Where's the big stupid guy trade?*—MACK

*Hold on, my dart board fell off my wall...How am I going to trade now?* —BART

*People come up to me, concerned, that I might reproduce.* —SCOTTY

*Louis Pasteur said in the end the Microbes would be victorious. He may have been on to something.*—DOUGLAS

*You know the market is quiet when this room (thinkScript) shifts to talking relativism.* —SAMMY

*I'm a profitable idiot.*  
—DWAYNE

*If you are obsessive-compulsive, press 1 repeatedly. If you are co-dependent, ask someone to press 2 for you. If you have multiple personalities, press 3, 4, 5 and 6.* —DAVID

*I love the smell of greed in the last half hour* —MISSY

*A battle not fought is a battle not lost.*  
—SUN TZU  
*Then again, you miss 100% of the shots that you do not take*  
—WAYNE GRETZKY

### GET CHATTING

Join the thinkorswim Chat Rooms for trading education or to cure boredom. In thinkorswim, in the top left select Support/Chat > Chat Rooms. Then pick your poison.

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## IN THE MONEY

A HODGEPODGE OF MARKET STUFF WE THOUGHT YOU SHOULD KNOW



**TAKE ACTION:** To access **GainsKeeper**, log on at [tdameritrade.com](http://tdameritrade.com), and select Gain/Loss under My Account.

- **NEW RULES FOR 2014** changed how brokerage firms report options trading activity and other transactions to their customers on yearend filings. It's not as boring as it sounds (really). Because if you're trading options, the changes affect you.

The new rules dealing with options are part of multi-year roll out of updated broker reporting requirements that have already been applied to other investments like stocks and mutual funds. Phase III for 2014 also includes cost basis numbers on some less complex debt instruments. The final phase will expand in 2016 to include more complex debt.

So in early-2015 you might see new information on your 1099. Specifically, the 2014 statement will include a section with all options trades, along with the cost basis for each transaction. The new information is designed to better align broker reports with tax reporting requirements. Of course, options transactions have always been reportable. For the IRS, the changes help ensure that investors are reporting their options trades correctly. For the investor, it means better and more detailed information for preparing yearend taxes. That's the good news.

### The Caveat

The bad news is that the new rules only require reporting the information from the year 2014 forward. So, you're going to need some help finding the information for positions opened in 2013 and prior. Fortunately, as a TD Ameritrade client, you have access to GainsKeeper®, which already produces similar reports, which will not only help you gather up your prior years' information, but keep tabs on results throughout the coming year(s) as well.

INDUSTRY SPOTLIGHT • EASY

# Options Tax Man is Looking Out for You

**BIG IDEA:** THERE'S GOOD NEWS, BAD NEWS, AND MORE GOOD NEWS FOR (YAWN) OPTIONS TAX REPORTING.

*TD Ameritrade does not provide tax advice. We suggest that you seek the advice of a qualified tax-planning professional with regard to your personal circumstances. For important information on GainsKeeper, see page 39.*



ASK THE TRADER GUY ● SEASONED

# Ask the Trader Guy

**BIG IDEA:** THE DEAL WITH HARD-TO-BORROW STOCKS, SHORT TERM BUTTERFLIES, AND (AHEM) “CLEANSING” TECHNIQUES.



• I bought a butterfly with just a few days to expiration, speculating that the stock would go to the middle strike, and it did. But the butterfly barely increased in value. What’s going on?

Think of butterflies as bets on a roulette table where there’s one “winning” butterfly at expiration. That butterfly is the one where the stock (the ball on the roulette table) lands on its middle—the short strike—at expiration. A butterfly’s value depends on the likelihood of the stock landing on the middle strike, making it the “winning” butterfly. The more time until expiration, the less certain where the stock price will land, and the lower the butterfly’s price. Close to expiration, there’s less uncertainty where the stock will land, and butterflies whose strikes are close to the stock price begin to have higher prices. It’s possible you just paid too much relative to its maximum payout value, due to buying too close to expiration.

**“Think of butterflies as bets on a roulette table where the’s one “winner” at expiration.”**

—THE TRADER GUY

**On some stocks that are hard to borrow, I see out-of-the-money puts with really high prices. Why does that happen, and is there an arbitrage opportunity?**

In order to short a stock (sell a stock that you don’t already own), you, or more specifically your brokerage and clearing firm, need to borrow it from someone that does own it. Sometimes there isn’t any stock in the market to borrow, so a stock becomes “hard to borrow,” and therefore, you may or may not be able to short it. A trader that wants to short the stock and who can’t, might look to buy puts instead. That buying pressure on the puts drives their price up. But there isn’t any arbitrage opportunity. If you think puts are expensive the “arb” would be a reversal, selling the put, buying the call and shorting the stock. Uh-oh, you can’t short the stock either. You can do the first two legs of the arb, but not the third. So, no arb.

**I’ve been learning more about pairs trades and have read about equalizing the notional value of the two underlying assets. What does that mean?**

Notional value is the price times the dollar value of one point. For example, in the e-Mini NASDAQ future, /NQ one point equals \$20. If the price of /NQ is 4,000, its notional value is \$80,000. In the e-Mini S&P 500 future, /ES one point equals \$50. If the price of /ES is 2,000, its notional value is \$100,000. If you wanted a /ES vs. /NQ pairs trade, where the notional values were equivalent, you’d do 4 /ES futures for every 5 /NQ futures. The notional value of a stock position is simply \$1, times the number of shares, times the stock price.

**My nutritionist has suggested a cleanse, but I’m afraid I might become “indisposed,” if you get my drift, during the trading day. Any suggestions?**

Cleanse? Kill two birds with one stone. Put on about 1,000 short gamma in expiring SPX options and don’t take your eyes off the screen until the settlement comes out. That should do the trick.

## TOYS FOR TRADERS

FROM THINKORSWIM®

### TRADE FLASH

Trade Flash is a new gadget that displays trade-related events as they happen. Events include analyst up/downgrades, block trades, trade imbalances, events on the trading floor, and more. If you want to take action on a Flash, just click on the symbol in the “Trade Flash” feed and you will be directed to the Trade tab.

### OPTION HACKER IMPROVEMENTS

We have added more than a dozen additional filter types to the Option Hacker to help you narrow down your search for trade ideas. Now you can filter your option scan results by any column that is available to add on the option chain.

### WATCH LIST NOTES

Make a note on a trade, an order, an alert, or any way you want to make a note on a symbol and display those notes as a column in your watch list. The notes can be set to expire from a symbol after a certain amount of time and all option notes roll up to the underlying symbol.

*The risk of loss on a short sale is potentially unlimited since there is no limit to the price increase of a security. Equity pairs trading requires active monitoring and management and is not suitable for all investors. For more information on the general risks of trading and options, see page 39, #1 & 2*





**SCRIPT IT!** If you want to skip to the punchline, just copy and paste the following sharing link into your browser and follow the instructions.  
<http://tos.mx/onok5p>

COOL SCRIPTS ● SEASONED

# Plotting Mo-Mo with a Twist

**BIG IDEA:** LOOKING AT SIMPLE MOVING AVERAGE FROM A DIFFERENT VIEW TO CATCH A TURNING POINT



• **WHAT'S A TREND?** To some it's a resurgence of bell bottoms and big 80's hair—both of which can be found on my colleagues here on a daily basis. To me, it's something that happens in a similar way enough times so that one can, with a fairly low level of analysis, predict the general details of the next occurrence. Trends in the market work the same way. But like bell bottoms, what is a trend to me may not be a trend to you. With the following script, let's look at price trends from a slightly different angle.

The idea is simple (pun intended)—Rather than a traditional simple moving average (SMA) superimposed over the price action in the chart, let's plot the SMA's slope as a lower indicator in a thinkorswim® chart to look at it in a different light.

## THE SCRIPT

From the **thinkScript Editor** in thinkorswim enter the following code exactly as you see here, including all spaces and characters. To locate the thinkScript Editor, go to Charts >Studies >Edit studies >New > thinkScript Editor.

```
1 declare lower;
2 input length = 20;
3 input price = close;
4 input averageType = AverageType.SIMPLE;
5 def avg = MovingAverage(averageType, price, length);
6 def height = avg - avg[1];
7 plot "Angle, deg" = Atan(height/length) * 180 / Double.Pi;
8 "Angle, deg".AssignValueColor (if "Angle, deg" >=0 then color
  ORANGE else color.BLUE);
```

**Figure 1**

Simple Moving Average on Its Head. With this script in thinkorswim®, you can view a simple moving average below the chart, in its own subgraph, giving you a different view of what the trend is, and perhaps a new type of confirming indicator. **1**—With the SMA below the chart, you may be able to see extremes in the price action more clearly, indicating possible turning points.

## WHAT IT ALL MEANS

**Line 1.** Start by telling the Editor that this script should be displayed on the lower subgraph below a chart.

**Line 2.** The number of bars needed to build your average. In general you can think of the length as the amount of time you want to your trade to be active for, the longer the time accounted for in your average, the longer the trade may need to work.

**Line 3.** This allows the user of the script to choose which data point she wants to calculate her moving average, based on the stock price bar (i.e. high, low, open, close). We use close by default since we want the average of the closing price.

**Line 4.** Your favorite type of average. For newbies, start with a simple moving average since it's the most straightforward.

**Line 5.** This function does the average math for us. Depending on your length, price, and average type the MovingAverage function will calculate the average.

**Line 6.** To create a slope you need to know a height and distance. Recall middle school geometry: Rise over Run. In this case our rise is the difference between one average point to the next.

**Line 7.** Next class, Trigonometry 101. The Atan function is short for arctangent, giving us the angle of height over the length used to calculate the moving average. The second half of this line converts the angle into degrees. Adding quotations around the variable "Angle, deg" creates a variable name with a space.

**Line 8.** Lastly we make it pretty. As in previous scripts we use the AssignValueColor function to show differences in a positive slope and a negative slope.

**For Some Really Geeky Fun.** Try adding this script as a Study Filter in the thinkorswim Stock Hacker and adding a line to plot the slope that you want to scan. If that sounds like Greek, call the Trading Desk at 800-669-3900. —Words by DAVID "MR. SCRIPT" KIER





## ASK THE SUIT

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

**Q: Apple says the Watch will be launching in early 2015. Will I be able to access my accounts on the watch?**

**A:** We've tested our notifications on the Watch simulator and it's seamless—meaning if you have your iPhone or iPad app configured to "Allow Notifications" in Settings, you'll get them on your Watch, too. At first launch of the Watch, you won't be able to access your portfolio or balances, and you'll still have to trade through your phone. As soon as the new device launches, we need to spend time with it before we can develop a plan for client adoption. We need to wear it to the gym. To the office. To bed. Will you be able to roll your condors on it? We shall see...

**Q: What are some good ways to stay tuned to the markets when I'm away from my desk?**

**A:** Trust me, I've done a lot of "informal research" into this as I'm often in meetings and traveling for business. First and foremost, make sure you're using TD Ameritrade has the #1 mobile trading app in the App Store. Second, alerts. Configure them in thinkorswim® or Mobile Trader. I set up alerts that route to my iPhone to notify me when certain conditions I'm waiting for are met. When I get them, I log into mobile to place my trade. Oh, and you can use complex order types, like OCO (one cancels other) to help manage positions. manage your risk or take profits depending on whether the markets move with you or against you.

**Q: My corporate overlords won't let me install thinkorswim at work. How can I trade?**

**A:** Duh, get a new job. Kidding. Although, denying the proletariat access to the thinkorswim platform is the very definition of economic oppression! But hey, if feudal serfdom is your gig, try Trade Architect®—our web-based trading platform. It's easy to use and totally accessible, even underneath the boot of the oligarchy.



### TAKE ACTION:

Wanna know more about chart patterns and charting? Go to the **thinkorswim Learning Center** at [tlc.thinkorswim.com](http://tlc.thinkorswim.com). From the menu at the top, click Charting>>Patterns>>Chart Patterns.

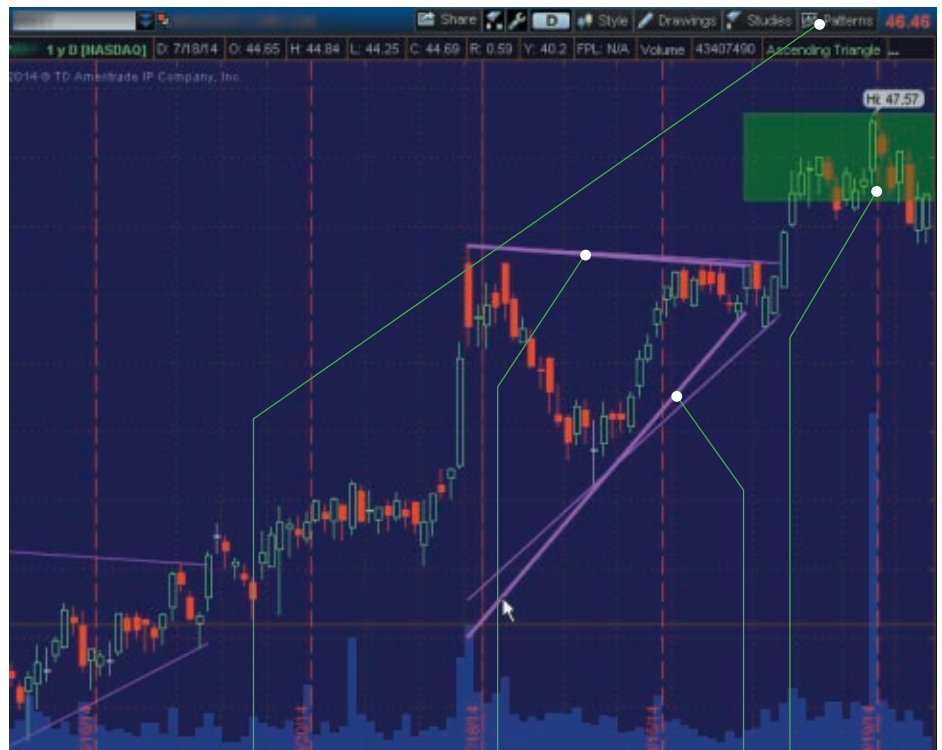
## IN THE MONEY

GEAR HEAD ● SEASONED

## The Pattern Finder

**BIG IDEA:** A COOL PATTERN-MATCHING ENGINE TO IDENTIFY PRICE TREND NEEDLES IN THE MARKET HAYSTACK.

• In the many books on technical analysis, visible chart patterns seem to jump right off the page. Such is the power of selective editing. In the real world though, finding a charting pattern with a clean signal and imminent breakout is more like playing connect the dots on television static. To help sort through the haystack, the pattern-matching function in **thinkorswim charts** is a direct, clear way to identify 16 different patterns, past and present. —Words by CHESLEY SPENCER



For illustrative purposes only

### How To Do It

To evaluate the patterns on one of your daily charts:

- 1 - Click the "Patterns" button in the upper right, of a chart, next to Studies. Choose Select Patterns to bring up the pattern-selection menu, (not shown here) where you can add any of the available pattern types.
- 2 - In the new window, double-click your desired pattern to add it to the chart. The first option you'll see is Ascending Triangles, which we'll choose for our chart here. Double click and click "OK."
- 3 - If the price action qualifies, the study will appear in the chart. Here the pink lines highlight the ascending triangles that have already formed, while the green shaded area on the right is a possible pattern formation.

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# HOW TO KEEP THE PARTY GOING

● EASY / **TAKE AWAY:** *Position sizing, trade management, when to walk*

**BIG IDEA:** BULLS DON'T LAST FOREVER. CONSIDER SOME SMART MONEY-MANAGEMENT STRATEGIES TO HELP KEEP THE GOOD TIMES GOING WHEN THE PARTY ENDS.

WORDS BY **MARK AMBROSE**

PHOTOGRAPHS BY FREDRIK BRODEN



# What

does a wicked, strange-colored punch and ear-shattering heavy metal have to do with bull markets? Everything and nothing. Great parties don't last forever. And unlike the night you wore the hula skirt on your head in the pic that somehow got to your mother-in-law, in the real world you don't overindulge. You pace yourself.

Over the past few years, major U.S. indices have had strong rallies. If you bought an index fund five years ago you might be seeing strong returns. Profits are fun, right? But markets go down as easily as they go up. If you're not ready for it, it can be a hard, nasty, punctured-balloon, torn-streamer kind of crash. The trick is arriving at the party dressed like a seasoned trader and knowing how to temper your investments. Consider three principals that could potentially help you let the good times roll no matter the market conditions.

## 1

### **KEGS ARE FUNNER FULLER**

When the beverages run dry, guests head for the door. When it comes to your investments, keep money flowing in your brokerage account to make new trades or meet expenses. To buy a stock, call, or put, for example, you'll need to cover margin requirements. If you use up all your funds on one or two trades that can mean two things. One, you won't be able to take advantage of new trading opportunities. And two, you're potentially putting your entire account value at risk.

For example, if you have \$5,000 in a brokerage account and you buy 50 call options for \$1.00 each, plus transaction costs, you've used up all available funds. If the stock or index moves lower by the options' expiration, they might expire worthless. Your account is

now worth \$0. And that's true of any trading or investment strategy. If you invest all or nothing on any one trade, you put your entire account at risk. No more fun. No more dancing under starlight and falling in the pool with your clothes on.

**PARTY TIP:** A smarter approach might be diversifying—trader style—by spreading a percentage of your trading capital over a variety of trades across sectors. That way no single trade can potentially wipe you out. And even if all your trades lose, you'll still have money left over. Break it down like this. If you don't want to risk more than 20% of a \$10,000 trading account, then the total risk of all current trades shouldn't exceed \$2,000. Now, diversify that risk over many trades on stocks in different sectors, and possibly even different asset classes. If you expect to be managing 10 trades, each trade should carry less than \$200 maximum risk. That way, if all 10 trades

lose the maximum, you're only potentially losing \$2,000 plus transaction costs. So you'll still have approximately \$8,000 left over to trade with or blow on a lot of guacamole and party favors.

Once you evolve your trading method, and begin to feel more comfortable with putting more of your capital at risk, you might think about implementing various types of margin trading in your account. You may even qualify for portfolio margining (see sidebar, "Portfolio margins made clear.") Now, using margin isn't an excuse to binge. It's just another tool, like anything else. Use it wisely.





# 2

## KNOW WHEN TO CUT YOURSELF OFF

While everyone's guzzling exotic concoctions and slamming down hot wings, know your limit. The trading equivalent to passed-out-in-the-corner party fever can take a few forms. Like trading too big or sticking with a bad strategy.

Trading too big can happen even to veterans. You wake up one day and decide a trade is unusually attractive. You say to yourself, "this stock's so low it can't go lower." Or, "the market keeps going up, it's never gonna drop." And countless other fantasies.

So you risk 2 or 3 times a typical trade allocation because you're so confident. Pin the tail on the stumbling host, anyone? You know how this bloated party ends. The stock does go lower, or the market does crash, and turns your big trade into a big loss-

er that that leaves you with empty pockets and a strange tattoo.

**PARTY TIP:** In addition to rule number one—keeping trades smaller—at a certain point, you may have to cut off a trading strategy altogether. If you're using a certain logic to identify good spots that turn out not so good, put simply, reevaluate. You may be using a set of technical studies or fundamental indicators predicated on the market moving higher. No matter how well-researched or planned, if your research is yielding nothing but losses when the market stops rallying, it might be time to walk away.

Every strategy can have losing trades. But how many are you willing to take before you find a new one? That answer can depend on how big the losses are, and how big your account size. As a rule of thumb, if you've lost more than the max loss you identified in rule 1, say more than 20% of your account size, and haven't had any winning trades in a while, it might be time to get that strategy into a Hefty bag with the soggy Twinkies and lukewarm pizza.

"IF YOU INVEST ALL OR NOTHING ON ANY ONE TRADE, YOU PUT YOUR ENTIRE ACCOUNT AT RISK. NO MORE FUN. NO MORE DANCING UNDER STARLIGHT AND FALLING IN THE POOL WITH YOUR CLOTHES ON

”

your bullish strategies aren't working, it might be time to admit you're in a bear, or a trading funk. To handle that, you'll want to stay small in your trades, active, and engaged.

A TRADING CAREER isn't built in one expiration or in one earnings cycle. Successful traders look at longer horizons and rely on fundamental rules like these to make sure the end of a trading hangover is just a power walk and a kale smoothie away.

## PORTFOLIO MARGINS MADE CLEAR

If your margin account is worth \$125K or more, you might be eligible for portfolio margin\* requirements—in a word, more leverage. Portfolio margin requirements are typically anywhere from 25% to 60% lower than standard margin. While standard margin is based on fixed percentages or dollar values for each strategy, portfolio margin looks at a strategy's theoretical risk, which is often lower than fixed percentages.

Portfolio margin looks at the theoretical profit and loss on your positions across a wide range of stock prices in one day, while identifying the max theoretical loss and setting that as the margin. Put simply, strategies use up less capital in a portfolio margin account. So, you can get more leverage, more diversification, and apply complex

hedges like selling index options against a stock portfolio, all the while having a larger percent of your capital available to potentially take advantage of other market opportunities.

But at the end of happy hour, don't consider it a free buffet. Portfolio margin can potentially lead to greater returns, but significantly greater losses, too. Leveraging portfolio margining should be an evolution in your trading career. It's a strategy like anything else. So engage it when you're comfortable and understand how to use it as a way of reducing capital expenses per trade.\*



**TAKE ACTION:** For more information on portfolio margin accounts, go to: [tdameritrade.com/portfolioMargin.call](https://tdameritrade.com/portfolioMargin.call).

# 3

## THERE'S ALWAYS ANOTHER BASH

Ask anyone on the A-list. No matter how fantastic a given market extravaganza, there's always tomorrow. So don't try to cram a year's worth of fun into one night. You need patience, a daily dose of responding sensibly to fast-changing market conditions, and

make sure you have enough gas in the tank to make it to the next one.

**PARTY TIP:** If the market doesn't rise, you'll need to adjust long term because the market will naturally fluctuate. You already know the market doesn't always go up, so what works today might not work tomorrow. What works in one set of conditions doesn't always work in the next. If you only know how to trade a bullish market, but

Margin trading increases risk of loss and includes the possibility of a forced sale if account equity drops below required levels. Margin is not available in all account types. Margin trading privileges subject to TD Ameritrade review and approval. Carefully review the Margin Handbook and Margin Disclosure Document for more details. Please see our website or contact TD Ameritrade at 800-669-3900 for copies.

\*Portfolio Margin will only be approved for accounts of qualified traders who can support the risks associated with greater leverage ability. Use of Portfolio Margin involves unique and significant risks, including increased leverage, which increases the amount of potential loss, and shortened and stricter time frames for meeting deficiencies, which increase the risk of involuntary liquidation. Client, account, and position eligibility requirements exist and approval is not guaranteed. Carefully read the Portfolio Margin Risk Disclosure Statement, Margin Handbook, and Margin Disclosure Document for more details.

For more on the general risks of trading and investing, see page 39, #1.

# X MARKS THE SPOT

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TRADE SPOT FX OPTIONS

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# STOP SIGNS,

**BIG IDEA:** SOME WOULD SAY A STOP SIGN IS JUST A SUGGESTION. WHILE WE DON'T RECOMMEND THIS STRATEGY, THERE ARE OTHER FORMS OF SLOWING DOWN—LIKE YIELDING OR AT LEAST HOVERING OVER YOUR BRAKE PEDAL. IN THE WORLD OF IRAS, THERE ARE PLENTY OF STOP SIGNS TELLING YOU WHAT YOU CAN AND CAN'T DO WITH OPTIONS. FOR QUALIFIED IRAS AT TD AMERITRADE, THERE MAY BE SOME POSSIBLE WORKAROUNDS. **WORDS BY KEVIN LUND**

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● INTERMEDIATE / **TAKE AWAY:** *Options for IRAs, stock replacement, option spreads*

# SCHMOP SIGNS



**START**



WHO KNEW THAT a nasty “good for you” food like raw spinach made great breakfast smoothies? In the land of reinvention squared, “no” is not a word American investors cozy up to. Like spinach, IRAs (individual retirement accounts) are consumed by millions without too much thought. They’re considered hearty, reliable, and often financially nutritious. Whether it’s you or your boss forking over the dough, IRAs can be used to provide wholesome tax-deferred growth for your future yoga-class budget and are often self-directed—meaning you call the investing shots. One caveat? IRAs and margins don’t typically mix. Considered too restrictive, the accounts are often shunned by active investors and options traders.

But like your excellent downward dog, self-directed IRAs can be more flexible than you think. Let’s review some popular and creative workaround trading strategies that can be used in a TD Ameritrade IRA. They have similar profit-and-loss traits to the strategies that aren’t allowed, while potentially helping you invest for retirement on your terms.

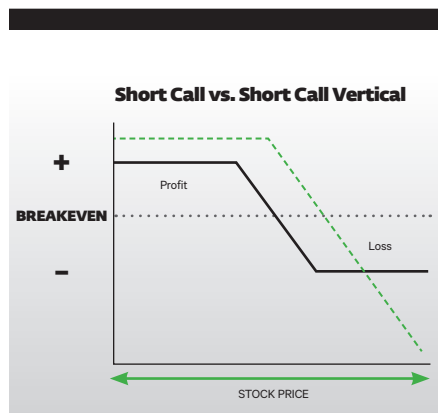
### NO-NO STRATEGY #1: **The Short Naked Call**

An unlimited-risk strategy like selling uncovered calls (“naked”) requires a margin account and the highest level of options trading approval—something not allowed in an IRA. But wait.

XYZ stock is trading near \$100 per share, but every technical indicator under the sun is telling you that the stock is top-heavy and may be slated to go any which way but up. Option premiums seem fairly rich, and you see that the XYZ 100-strike call with 28 days to expiration can be sold for \$4.00. You’d love to sell the call option uncovered but, well, you can’t. At least not in an IRA.

### **Workaround: Sell a Call Vertical Spread**

While the 100-strike call may be trading for a significant premium, the call option trading 20% out of the money may be far enough out that it could literally be picked up for pennies on the dollar. Assuming you were looking at January options and are approved to trade spreads in your IRA, your trade might be to sell the XYZ January 100-strike call and buy the XYZ January 120-strike call to create a **short-call vertical**.



**Short-Call Vertical vs. Short Call.** By replacing the short-naked call position (dash line in graph) with the short-call vertical, you limit your risk and may come close to the same credit received on the short-naked call. For illustrative purposes only. Not a recommendation of a specific investment strategy.

This trade could be placed for a net credit (minus transaction costs) much like the naked-call trade you originally had your heart set on. However, by creating a short 100/120 vertical-call spread, you accomplish several things:

1. You’re able to sell the 100-strike call that you wanted to sell in your IRA.
2. By purchasing the distant 120-strike call at the same time, you create a defined-risk position that takes in nearly the same amount of premium as the unlimited risk position. In

fact, you get the same premium for selling the 100-strike call, while only giving back a few cents for the purchase of the 120-strike call, (plus transaction costs).

3. You reduce the potential trade risk from the theoretically unlimited, to just the distance between the strikes (20, or \$2,000), less the credit received and transaction costs. In the case of a short spread, the maximum risk is the distance between the strikes—the maintenance requirement you’d need to put up in a TD Ameritrade IRA. In this case, the risk/maintenance requirement is \$2,000.

One caveat to consider with the short call vertical is since the short call is **at the money** there’s a risk you could get assigned should the short call go **in the money** prior to expiration. This means you would be obligated to deliver shares of the underlying stock that you don’t currently own in the account.

### NO-NO STRATEGY #2: **The Short-Naked Put**

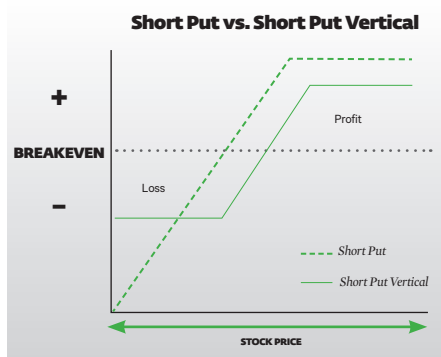
You wonder: can I really trade uncovered **short puts** without a margin account so long as I secure the sale with cash? Yes. But it’s the amount of cash that may be hard to come by, especially for some of the more expensive stocks out there. Suppose XYZ stock is trading just over \$500 per share and you think there’s significant support around \$500. Selling just one at-the-money put option contract on a \$500 stock, even at an attractive price of say, \$25, can set you back nearly \$50,000 in requirements.

### **Workaround: Sell a Put-Vertical Spread**

While selling the 500-strike put may bring you a worthwhile premium, it can hurt to have to pay up, in case the stock goes to zero. One way to limit the required funds to sell a cash-secured put is to help out the position by also purchasing a deep out-of-the-money put—something like a 400-strike put. Assuming you were looking at January options, your trade might be to sell the XYZ January 500-strike put; and buy the XYZ January 400-strike put to create a **short-put vertical**.



**TAKE ACTION:** With \$2,000, qualified applicants can open an IRA with option-trading capabilities. If you have a margin account, and don’t have an IRA, consider opening one. Go to: [www.tdameritrade.com/rollover](http://www.tdameritrade.com/rollover)



**Short-Put Vertical vs. Short Put.** Though short puts (dashed line) are allowed in IRAs if cash secured, putting up the cash for a \$500 stock may not be all that attractive. Turning the short put into a short-put vertical gives you a similar bang for a smaller buck. For illustrative purposes only. Not a recommendation of a specific investment strategy.

Being so far out of the money, the 400-strike put is likely to be trading for a dollar or less. Given the hefty potential premium fetched via the sale of the 500-strike put, having to pony up about a buck, for the 400-strike put (plus transaction costs) seems like a small price to pay, to make the sale of the 500-strike put more affordable. While the sale of a cash-secured 500-strike put at \$25 can set you back around \$47,500 per contract, by comparison, the sale of a 500/400 put spread at \$24 sets you back about \$7,600 per contract. This translates,

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.

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

The cash secured put strategy risks purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.

While options trading is subject to unique and often significant risks and is not suitable for everyone, with an appropriately funded and approved IRA at TD Ameritrade, an options trader can implement the defined-risk strategies described here. For more information on the risks of options and the options strategies covered in this article, see page 39, #1 & 2.

among other things, into either lowering the requirement by about \$40,000 per contract, or the ability to enter into a position that is roughly six times larger than what you could afford with just a cash-secured put strategy. Similar to the short call example, since the short put is "at the money" there's a risk you could get assigned should it go in the money prior to expiration.

### NO-NO STRATEGY #3:

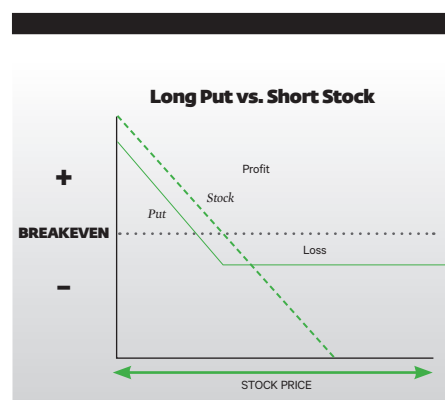
#### Short Stock

This one is fairly clear cut. You need a standard margin account to **sell stock short**—a strategy that makes money as the stock goes down in price—and an IRA does not allow trading on margin or selling stock short. So how can you take advantage of a stock that you think could be heading lower for a sustained period of time?

You could buy a put option. But as you may know, options don't always change in value at a one-to-one clip with the underlying stock. The average at-the-money option moves at about half the speed of its corresponding stock.

#### Workaround: Buy Two At-the-Money Puts

If one of something gives you half of what you want, buy two to get the desired result, right? Huh? This is a "math doesn't lie" scenario at its best. An at-the-money option moves at half the speed of stock because it generally has a 50 **delta**, meaning it tends to change in value at about half the pace of its underlying stock. That being the case, two



**Long Put vs. Short Stock.** With nearly the same profit curve at a fraction of the cost of shorting stock, buying puts are allowed in your TD Ameritrade IRA when you want to bet a stock will fall. For illustrative purposes only. Not a recommendation of a specific investment strategy.

“

IRAs AND MARGINS DON'T TYPICALLY MIX. CONSIDERED TOO RESTRICTIVE, THE ACCOUNTS ARE OFTEN SHUNNED BY ACTIVE INVESTORS AND OPTIONS TRADERS. THANKFULLY, THERE ARE SOME CREATIVE WORKAROUNDS THAT CAN BE USED.

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at-the-money options would theoretically combine for a delta of 100, thereby creating a position that should hypothetically move one-to-one with the stock.

What's better? All other things being equal, because of a put option's "convexity," (curved p/l) profits tend to accelerate as the underlying moves lower (with you), while the losses decelerate as the underlying moves higher (against you).

#### Fear Not Your Vegetables

Trading in an IRA naturally has pros and cons. While you can actively manage your portfolio and it allows for earnings to grow on a tax-deferred basis, strategies can be limited by various margin restrictions on certain positions. Fortunately, you can utilize some basic option trades that come close to accomplishing what you need with the strategies discussed here. In an IRA, keep in mind creative options strategies exist if you qualify. And when they're executed right, concerns may be outweighed by other factors like greater flexibility and new opportunities. If it feels right, consider taking your retirement portfolio beyond its current breakfast menu and trade it outside the (cereal) box.



SPECIAL  
FOCUS:

**BUILDING  
A TRADING  
SYSTEM**

1

VALIDATING  
YOUR  
STRATEGY

● PRO / TAKE AWAY: *Strategy testing*

# Courting Your Inner Quant

**BIG IDEA:** DEVELOPING A GOOD TRADING SYSTEM CAN BE A LESSON IN FUTILITY. MARKETS AND CONDITIONS CHANGE, VOLATILITY FLUCTUATES, AND WHAT WORKED YESTERDAY MIGHT NOT WORK TOMORROW. FROM THE STRATEGY YOU EMPLOY TO THE FIRST TRADE YOU PLACE THIS TWO-PART SERIES ON BUILDING A TRADING SYSTEM WILL HELP YOU DECIDE IF YOUR INSTINCTS/JUDGEMENTS/IDEAS ARE WORTHY.

WORDS BY **THOMAS PRESTON**  
PHOTOGRAPH BY **FREDRIK BRODEN**

● YOU'RE AT A FANCY FRENCH JOINT. The sommelier recommends three Bordeaux wines, each a great match for your dinner. "Gimme the middle one," you say without much thought. After all, they're red, about the same price, and will taste more or less like wine. Who cares, right? • One quick wine pick won't make or break you. But if you choose a trading strategy like that you could be in for some bitter financial surprises. • For example, consider three strategies, each of which had a 10% return in the previous year. They all involved buying and selling stock, and using technical analysis, as well as using stop losses. But they were nowhere near the same. Because all three might have had different risks, and had arrived at that 10% return along different paths.



Maybe one earned just under 1% return per month, every month, for the year. Maybe another was up 40% until a few weeks prior, and then gave back most of the profit very quickly. And maybe the last oscillated up and down 10% every month, and you're now just seeing the up-10% oscillation before the next down 10%. Wouldn't it be nice to anticipate and plan for potential variations with actual data and not with a bunch of guesses before committing to a strategy? There is.

## TAKING ACTIONS: SWIRL, SMELL, SIP

Three metrics can help you see the various possible paths and make more informed choices.

1. Max drawdown
2. Winning trades/losing trades
3. Sharpe ratio

No guarantees, but using these metrics is another smart way of strategy testing before committing real dollars and getting waiters used to large tips. Let's lean on thinkorswim® and a spreadsheet to test the strategies.

### STEP 1: mine the data

1. First, fire up your thinkorswim platform and go to the Charts tab. Click the Studies button/icon in the upper-right-hand corner. Then select Edit Studies to get the "Edit Studies and Strategies" box.

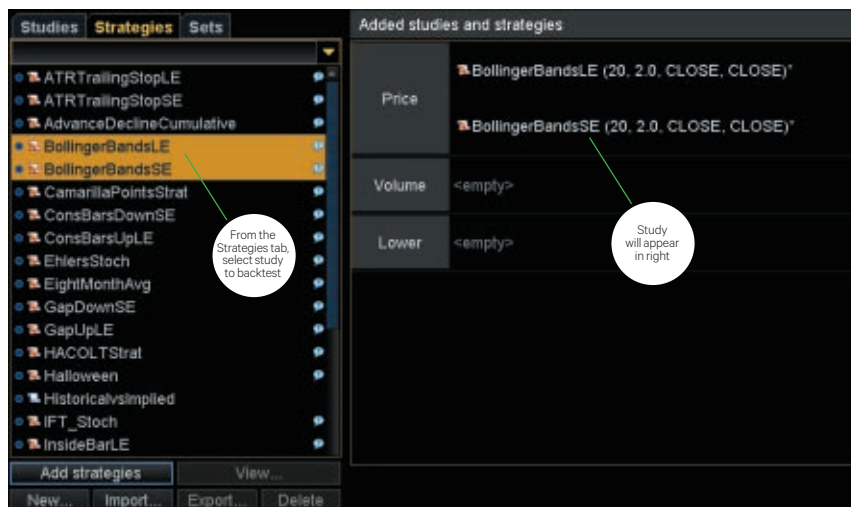
2. Click the Strategies tab in the upper-left-hand corner of that box. You'll see pre-programmed technical studies you can backtest. (See Figure 1.)

3. For this article, load up "BollingerBandsLE" and "BollingerBandsSE" by double-clicking their names and hitting the Apply button in the lower-right-hand corner. You should see both buy-and-sell signals that follow the rules set up in those Bollinger Band studies.

4. Refer to Figure 2 and hover your cursor directly over a buy-or-sell signal on the chart. You should see "Show report" in the drop-down menu.

5. A "Strategy Report" box displays the buy-and-sell signals from that strategy along with P/L information we'll be using in the following metrics.

6. You'll also see a "Total P/L" number for that strategy. Of course, there's no guarantee that its past performance will deliver the



**Figure 1: Find the Strategy.** Using the strategy testing tool from thinkorswim takes you the first half of the way to determining if a strategy has what you're looking for. For illustrative purposes only



**Figure 2: Test the Strategy** Once you've plotted the strategy on a chart, the next step is to send its data to a spreadsheet to size it up more carefully with a few "go-to" metrics. For illustrative purposes only

same future results, but if the P/L is positive, some will use that strategy to signal live trades with real money. At that point, click the "Export file" button in the lower-right-hand corner to dump this strategy data into a spreadsheet for detailed analysis.

Beyond that, you can't see a lot of information about a strategy just by looking at its total P/L. But at this point, pull out your favorite spreadsheet program to analyze the following three metrics.

### STEP 2: work the spreadsheet

Once you've exported the data from Step 1 into your favorite spreadsheet, you're ready to tackle the metrics.

## METRIC 1: MAX DRAWDOWN

Losing money in a trade is like wine that's turned sour. Unpleasant and gut-scratching at best. But what's really sorta awful is realizing a nice profit, then giving it all back and more.

Max drawdown is the term that describes loss from the peak value of your account to its lowest subsequent value. For example, your account starts out at \$10,000 and a trading strategy earns you \$4,000. That takes your account value to \$14,000. But the trading strategy has some losing trades equaling \$8,000. That takes your account from \$14,000 to \$6,000. That \$8,000 drop is your drawdown, and the max drawdown is the loss in value



from the peak to the trough.

Generally, smaller max drawdowns are better than larger max drawdowns. The larger the max drawdown, the more dramatically the value of your account can change.

To reduce drawdown, you may consider experimenting with closer stop-loss prices or profit targets that would cut losses and take in profits more quickly. Doing so, however, might also reduce return.

**HOW TO FIND IT:** To locate a strategy's max drawdown, export the data file we created into a spreadsheet. Calculate a running total for the Trade P/L column, which will show the impact of each new trade. Search for the highest value of that running total, then the lowest value after that. The difference is the strategy's max drawdown.

## METRIC 2: WINNING TRADES/ LOSING TRADES

Think about the P/L of two series of five trades. The first series has +\$100, +\$100, +\$100, +\$100, -\$300, for a total of +\$100 (less transaction costs). The second series has -\$50, -\$50, -\$50, -\$50, +\$300, for a total of +\$100 (less transaction costs). The total profit of the two series of trades is the same. But they get there differently.

The first series has four profitable trades and one big losing trade. The second series has four smaller losing trades, and one big winning trade. With the second series, you could face a lot of losing trades, which eats up your trading capital, until you hopefully get a winning trade large enough to offset losses. What if that winner doesn't come for a long time?

The first series, on the other hand, is more manageable. Of course you don't want one large loser to wipe out your profits. But you can analyze the strategy to see if something can be improved to avoid a large loss. It can be easier to solve a strategy problem with a few large losing trades, than one with a lot of losing trades and few winners. For example, adding a stop loss to the strategy might reduce the magnitude of the losses.

**HOW TO FIND IT:** To compare winning to losing trades, count the positive and negative numbers in the Trade P/L column of the spreadsheet you created from Metric 1. Consider the ratio of winners to losers, or the ratio of winners to total trades.

## METRIC 3: SHARPE RATIO

Created by Nobel laureate William Sharpe, the Sharpe ratio is used by professional money managers to evaluate funds because it lets them compare strategies with a single number. The Sharpe ratio takes the return of the strategy, subtracts off the risk-free rate, and divides it by the standard deviation of the strategy's returns. A higher Sharpe ratio can be better than a lower Sharpe ratio. When returns are high and their standard deviation (i.e. risk) is low, the Sharpe ratio is high. So, two strategies might have had the same return. But if strategy A has a standard deviation of returns (risk) that's half the standard deviation of returns for strategy B, strategy A will have a Sharpe ratio twice as high.

Sharpe lets you compare two strategies, risk adjusted. In other words, for an equal level of risk, how much more return did one strategy provide? A high Sharpe ratio can mean returns were relatively stable—they didn't fluctuate much from an average level. That can also mean drawdowns were smaller, and the ratio of winning to losing trades was higher.

**HOW TO FIND IT:** To calculate a simple Sharpe ratio for a strategy in the same spreadsheet, refer to the sidebar, right ("How to... Create a Sharpe Ratio"), for details on each of the following four steps.

1. Divide the Trade P/L number by the stock price of the opening trade to get the trade's return.
2. Calculate the average trade returns by adding up all the returns and dividing by the number of trades.
3. Then calculate the standard deviation of returns.
4. To get the Sharpe ratio, divide the average by the standard deviation.

ONCE YOU'VE GOT ALL THREE metrics—max drawdown, winning/losing trades, and Sharpe ratio—you'll have more of a complete picture. Now, each of these numbers has limitations, so looking at all of them gives you a much fuller picture of the strategy. And one number isn't necessarily better than another. So you don't want to change the strategy to improve one metric at the expense of the others.

---

*For more on the risks of investing, see page 39, #1. Backtesting is the evaluation of a particular trading strategy using historical data. Results presented are hypothetical, they did not actually occur and they may not take into consideration all transaction fees or taxes you would incur in an actual transaction*

# HOW TO CREATE A SHARPE RATIO

## 1.

**To calculate the return on a trade,** if the Trade P/L number is in say, cell H9 and the trade price of the stock is in cell F8, type the formula  $=H9/(F8*100)$  in an empty cell to the right of the data. The reason you multiply the trade price by 100 is that you want to divide the P/L by the total cost of the trade. Multiplying the stock price by 100 gives you the cost for 100 shares of stock. [Note: Theoretically, you'd subtract the risk-free rate over the life of the trade, but with interest rates as low as they are now, we'll skip that step for the sake of simplicity.] Do this for every Trade P/L number, with the return on trade cells in the same column.

## 2.

**To calculate the average return per trade,** add up the return numbers and divide by the number of your Trade P/Ls. You can use a formula  $=average(K8:K30)$  if all the return numbers are in column K, from cells 8 to 30.

## 3.

**The standard deviation of returns** measures how far individual returns range from the average return. You derive it (you have a mix of voices in this graph) and by subtracting the average return from each of the individual returns. Then square that difference (multiply the difference by itself) to make all the numbers positive. Then add up all the squared differences and divide that sum by the number of Trade P/Ls. Finally, take the square root of the average of the squared differences to get the standard deviation. The formula would be  $=stdev(K8:K30)$  in a spreadsheet.


## 4.

**To get the Sharpe ratio,** divide the average return by the standard deviation of returns. If the average return was in cell K32 and the standard deviation was in cell K34, type  $=K32/K34$  to see the Sharpe ratio.

# Speed Dating for Traders

**BIG IDEA:** ONCE YOU’VE FOUND YOUR STRATEGY, WHEN YOU START TO FEEL SEDUCED BY AN OPTIONS TRADE, YOU SHOULD BE ABLE TO SIZE UP ITS WORTHINESS IN LESS THAN 60 SECONDS. HOW? TOOLS, BABY. TOOLS.

WORDS BY **THOMAS PRESTON**  
PHOTOGRAPH BY **FREDRIK BRODEN**

 IF YOU THINK ABOUT IT, trading can, and arguably should, be like speed dating. When you’re sizing up a particular trade, you’re really asking, “Are you worthy?” In less than a minute, a few numbers can tell you what you need to know. They can help you determine whether to engage, whether to pass, whether to hold, whether to close. Today, trading is about speed. And it’s not like the pros are getting any slower. In fact, you need to get faster. Think about this: in less than a minute, are you able to answer these questions?

- How much can this trade lose if the stock goes against me?
- How much can this trade make if the stock goes my way?
- How does a change in time or volatility impact this trade?

If you’re a retail investor or trader, this one-minute exercise turns arbitrary stop-loss points or profit targets on options trades into quantifiable numbers. So, less guessing. In fact, stop loss and profit targets are easy to determine with stocks whose prices have less to do with volatility and more to do with supply and demand. Some simple subtraction and multiplication can give you the potential profit or loss on different stock prices.

gg



2

SPECIAL  
FOCUS:  
**BUILDING  
A TRADING  
SYSTEM**

VALIDATING  
YOUR  
STRATEGY

But options prices are determined by the stock price, time to expiration, and volatility, among other things. There are more moving parts, especially with options spreads.

Lucky for you, thinkorswim® figures out the math. Specifically, the tools on the Trade page and Analyze page help you answer critical questions.

### TINDER FOR STOCKS: HOT OR NOT?

Consider stock XYZ trading at \$240. You're bullish on it. And you think that a short out-of-the-money put might be a possible strategy cause you're confident the stock won't drop and you're willing to buy the stock at the put's strike price. So, you discover that the puts on XYZ have 45 days to expiration and find that the 230 puts are trading at \$12.17. Armed with this data, you can quickly size up a potential trade to sell these **puts short**. You can also use the following logic to determine whether you should get out of any trade (To wit: how to get out of a date gone awry.)

## TRADE PAGE: SIZING UP A SINGLE OPTION

Fire up the thinkorswim Trade page to analyze the theoretical effect when changes in price, time, and volatility occur, before placing single options trades.

### VIEWING PRICE CHANGES

So, how much could the trade lose if XYZ drops in price? Sure, you know the max loss is the strike price minus the price of the put goes to \$0, plus transaction costs. But what about \$230 or \$220? The tool that can answer that is Theo Pricing on the Trade page.

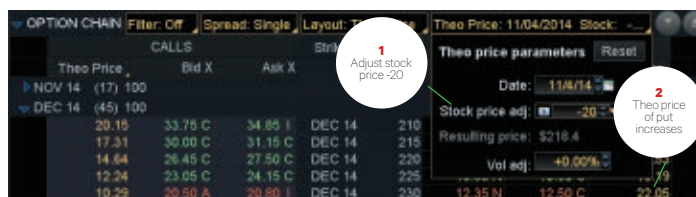
1. On the Trade page, click the Layout drop-down menu at the top of the Option Chain, then click "Theo Price, Mark." (See Figure 1.)

2. A drop-down menu to the right of the Layout menu will appear. Click that to open a set of controls to change the date, stock price, and volatility. (See Figure 2.)



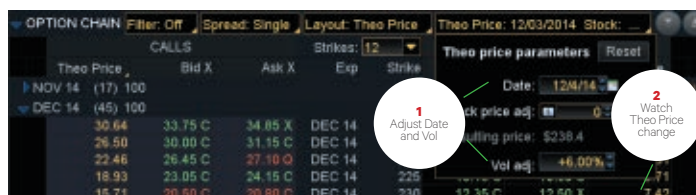
**Figure 1:** Accessing Theoretical Price of a single put option in the thinkorswim Option Chain.

For illustrative purposes only.



**Figure 2:** Adjust the stock price to see the theoretical price of the put change. In this case, a \$20 drop in price would increase the put value from \$12.17 to \$22.05.

For illustrative purposes only.



**Figure 3:** Adjust Date and Vol to see theoretical price change as time passes or volatility changes.

For illustrative purposes only.

3. Set the Stock Price Adj field to -20. What that does is use \$220 (current stock price \$240 minus \$20) as the underlying price in the option-pricing model. You'll see the Theo Price column for the 230 puts jump from 12.17 to 22.05, or a loss of \$988 plus transaction costs.

### VIEWING TIME & VOL CHANGES

Next, by changing the Date and Vol Adj fields, you can see the theoretical option value at some point in the future, and/or as volatility changes. (See Figure 3.) Let's say the stock price doesn't change (set Stock Price Adj back to 0), but one month goes by and volatility drops by 6 points. Now the theoretical price is 7.42, which would give the short put \$475 theoretical profit (less transaction costs) if the stock price doesn't change, time passes, and vol drops.

With these three controls, you can click through various scenarios of stock price, time, and volatility and see what an individual option might be worth. But how about a spread? Or what if you don't want to figure out the p/l yourself?

## ANALYZE PAGE: SIZING UP AN OPTION SPREAD

As we wrote about in a previous issue ("Trade Analysis Focus," issue #23, Spring 2014), the Analyze page has a lot of functionality that lets you drill down into all sorts of trade details. But it can also answer the three questions from the in just a few clicks.

Refer to Figures 4 and 5 for the following spread example. Instead of a short 230 put on XYZ as we just did, let's look at 10 short 220/230 **put verticals** (buying the 220 put, selling the 230 put).

### VIEWING PRICE CHANGES

To calculate how much the trade might make or lose depending on where the underlying stock goes, locate the Price Slices feature located on the page. (See Figure 4.) A "Price Slice" is just a stock price at which you want to see the theoretical P/L.

1. On the Add Simulated Trades tab of the Analyze page, enter a simulated put vertical the same way you might enter a real order.

2. You'll see three slices by default. Enter +15% in the top slice and -15% in the bottom slice. That'll get you the theoretical P/L of the short-put vertical at the current stockprice (the base), 15% lower, and +15% higher. 15% lower and +15% higher. Or, you could manually change the slices' default price to see what the P/L would look like if the stock rose or fell by say, \$20.

3. You can type in another number for the price slice, or click on Add Slice. That will add a new price slice where you can enter another stock price.

With XYZ down 15% (about \$203), the put spread has a \$3,536 theoretical loss (plus transaction costs). With XYZ up 15% (about \$275), the put spread has a \$2,333 theoretical gain (minus transaction costs).



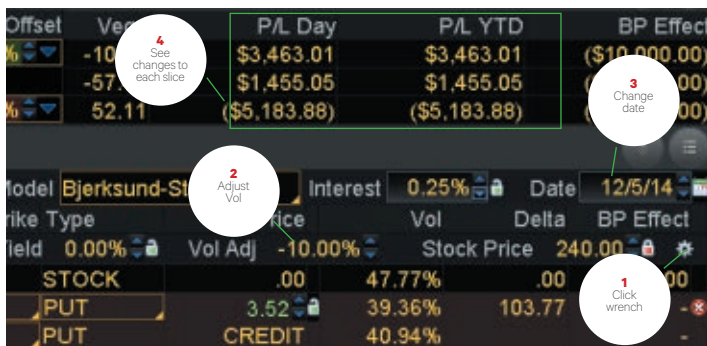
**Figure 4:** Use Price Slices in the Analyze Page to see how prices might change in your option spread when the stock price changes.

For illustrative purposes only.



**Figure 5:** Then view how prices change in your spread when time passes or volatility changes.

For illustrative purposes only.



## VIEWING TIME & VOL CHANGES

Now, let's see how time and volatility changes affect the P/L. (See Figure 5.)

1. Locate the controls on the right-hand side of the Position and Simulated Trades section of the Analyze page.

2. Click on the little gear icon on the far right to open up the Vol Adj field.

3. The Date and Vol Adj field here work just as they do on the Trade page. Set the date to one month in the future, and Vol Adj down 2 points, and look at the p/l open to see the theoretical profit and loss at the different price slices.

Want to see what happens if volatility increases as the stock price drops? Set the Vol Adj to +10, for example, to simulate **implied volatility** going up 10 points.

You'll quickly see that the theoretical loss on the short put vertical could be -\$265 plus transaction costs if the stock drops to \$170 and volatility increases by 10 points. The p/l numbers are updated immediately with each change in stock price, date, and vol, so you don't have to wait for the program to chug through the calculations and slow you down. With a little practice, you can do this sort of analysis in less than 60 seconds. Of course you can do more. But here we're weeding out possible trades so you can find the ones you really want to date. (Dinners and movies and flowers add up.)

THIS MAY ALL SEEM a little heavy on the numbers, but doing this type of analysis takes just a minute or two once you get the hang of

it. And it provides so much information about how to manage a trade beyond simply knowing max profit and loss. Rather than "guess-timating" what an option might be worth in the future on the back of a napkin, you can attach a theoretical value to it.

Now, there's no excuse for not knowing the impact of stock price, time, and vol on your trading decisions, or for being slow. Or for not knowing that your date likes milk chocolate instead of dark. Or that her mother will never like you anyway cause you're a trader.

*Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance. For more information on the general risks of investing, trading, options, and naked option strategies, see page 39, #1 & 2.*

# FAQ:

SOME LINGERING QUESTIONS YOU MAY HAVE ON SIZING UP A POSITION.

**Why is the p/l open of my positions different on the Analyze page than what I see on the Monitor page?**

The p/l open on the Monitor page compares the execution price of the trade to the current mark price, or average of the option's current bid/ask prices. On the Analyze page, p/l open compares the execution price to the theoretical value of the options. Discrepancies can occur when implied volatilities, which are used to calculate the theoretical values, are rounded and create theoretical values a bit different than the current mark price. Also, the Analyze page will use the last stock price to calculate the theoretical option prices, which updates overnight when the average of the bid/ask, used on the Monitor page, is closed.

**The Vol Adj numbers are in percentages. Is the change a percent of the current volatility or points?**

The Vol Adj numbers are points, and raise or lower all volatilities by the same amount. For example, if you set the Vol Adj to +5.00, that would make an implied volatility of 17% go up to 22%. If another option in that stock had an implied vol of 19%, it would take that vol up to 24%.

**Where should I set the Vol Adj?**

While implied volatilities can move unpredictably, you can use the 52-week high-and-low values of the implied vols. You can see those in the "Today's Option Statistics" section of the Trade page. You may want to use the Vol Adj field to increase the volatility to the 52-week high, then the 52-week low to see how it impacts your trades.

**If my theoretical loss at some point before expiration is less than the max loss, should I increase my position size?**

While it might seem logical to increase the contract numbers to make total trade risk you might take off before expiration equal to the max loss of fewer contracts at expiration, you can never be certain what the loss will be. And though you may believe you've stress-tested a position at extreme levels of stock price and volatility, you could still be surprised with larger-than-expected losses. This is where years of trading experience come in handy. If you don't have them, using the max loss to help determine position size is a good rule of thumb.



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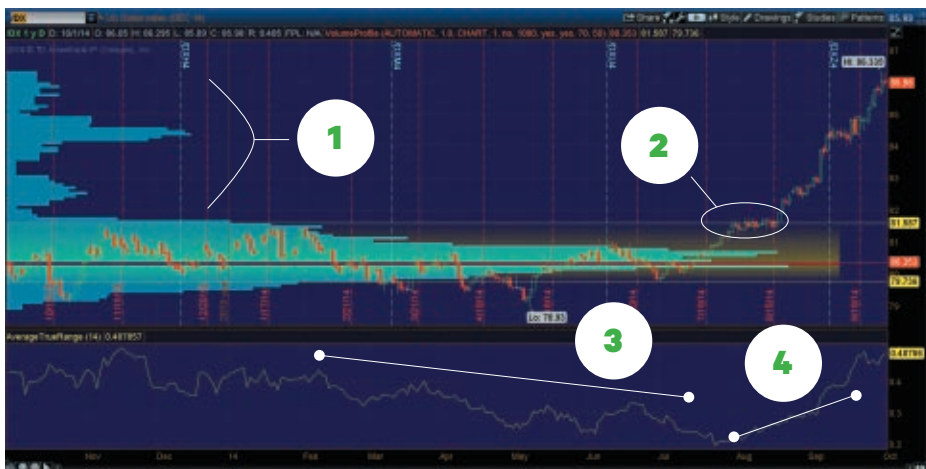


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## Currencies Aren't Dead, So Says Volume

ASLEEP FOREVER OR JUST DORMANT? THAT'S THE QUESTION FOR CURRENCIES OF LATE. THANKS TO A COUPLE OF LESSER-KNOWN INDICATORS, MAYBE NOT.

● PRO / **TAKE AWAY:** Using volatility indicators to measure currency momentum



• Vampires need love, too. Many traders regarded currencies as dead capital for most of 2014 because global central banks were printing more and more money. From the Federal Reserve's latest iteration of quantitative easing (QE), to the Bank of Japan's (BoJ) pedal-to-the-metal approach to monetary policy, the result was compression in currency volatility going back to Q4 2013. But as of late 2014, currencies have come back to life in a big way thanks in part to a structural set-up in the U.S. Dollar Index Futures (/DX), and a run on black capes.

The /DX is an example of a useful futures contract because it's a basket of six foreign currencies weighted against the U.S. dollar. These six foreign currencies include the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. Think of the /DX as the Dow Jones of the currency market.

### Blood transfusions all the rage

Currency volatility compression can be seen on a daily chart of the U.S. Dollar Index Futures (/DX) using a simple measure of volatility—Average True Range (ATR). The chart in Figure 1 uses a 14-day ATR to show the steady decline in volatility through August 2014.

A falling ATR can sometimes signal that a market is in a range-bound mode, meaning the market is likely to trade sideways between well-defined support and resistance levels. In contrast, a rising ATR tends to signal a market that is in trending mode. In the case of currencies, these trending modes can be up or down trends, and can last for a long time. The chart in Figure 1 reflects these signals in the ATR as the /DX transitioned from range-bound mode

to up-trending mode in Q4 2014.

The Volume Profile indicator plots volume totals at specific prices over the time period specified on the chart. For example, the price at which the most volume traded in Figure 1 was 80.35. Volume totals for each price are plotted horizontally and typically form a bell curve rotated on its side. This view gives traders a new perspective on support and resistance and where breakouts might occur.

You can see in Figure 1 the /DX broke out above its year-long trading range in late August with a move above 81.50. Note that the Volume Profile was thin above 81.50 and this is the structural set-up that set the stage for a return of volatility and trends in the currency market. By "thin," I mean there was minimal resistance because there was little historical volume above this price. This structural set-up cleared the way for the /DX to shift into trending mode. And trend it did.

### Transylvania: great in the summer

When looking for potential breakouts in currency futures, take a look at the Volume Profile. Whether it's in the /DX or in any of the individual currency futures examples like the euro (/6E), pound (/6B), or yen (/6J), checking traditional support and resistance levels against the Volume Profile can help you determine if a breakout might have follow through. Look for thin Volume Profiles beyond breakout points and match these moments with a rising ATR in your search for trending bliss. —Words by ERIC UTLEY, CONTENT MANAGER, INVESTTOOLS

### Back From the Dead?

Along with the ATR, this chart uses the Volume Profile of the /DX. One benefit of looking at currency futures instead of spot forex is volume data. Spot forex trades typically don't include volume data. Currency futures do. This additional data point can add valuable information for currency traders, particularly when analyzing volume by price with the Volume Profile indicator on thinkorswim.

- 1-Thin profile above 81.50
- 2-Breakout above 81.50
- 3-Compressing Volatility
- 4-Expanding Volatility.

For illustrative purposes only

*Futures and futures options trading is speculative, and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products. International investments involve special risks, including currency fluctuations and political and economic instability. For more information on the general risks of trading, options, and futures, please see 39, #1-3.*

# Go ahead, pick their brains.



*thinkorswim Swim Lessons team*

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## Dinner Is Served

PART COMPUTER WHIZ, PART TRADING-TOOLS DEVELOPER, JOHN HART CAN ALSO COOK CIRCLES AROUND YOU

Interview by Kira Brecht / Illustration by Joe Morse

• LIKE THE BEST TECHNOLOGY, great cooking means both art and science make it into the blender. Too much salt and your guests aren't returning any time soon. TD Ameritrade's John Hart knows what today's traders want and need, and he's just the guy to give it to them.

After making his first trade at 10, John set up a major university's network system at 11. And when he joined TD Ameritrade in 2006, he built the thinkorswim® forex business from the ground up. Today, as Managing Director of Trading Products, he's responsible for the design, development, and strategy behind TD Ameritrade's next-generation tools and trading platforms.

Outside the job, Hart is a wunderkind chef, proficient in several international cuisines. His is a love of fancy foods, fine wines, and the right gadget, for, well, anything. His little known secret: Hart carries a dongle multipack so he has the right-sized tool for any situation. If something must be plugged in, he's your man.

# 1

### John, what's on your current hot list of new stuff?

thinkorswim sharing is a great new technology launched in 2014. This enables our users to share a chart and click on it to get the exact settings, even if it uses a custom script. On the old trading floor, there was a community. You could observe the techniques a trader used. There was a social aspect that was lost during the move to the internet. This sharing tool gives users the ability to once again have that conversation.

# 2

### What makes TD Ameritrade technology so special?

We're listening. We saw sharing as a behavioral need because people were already doing it, and we knew we could create something better than what they were using. We are intensely focused on what clients request. Fortunately thinkorswim is agile. It lets us quickly change direction based on customer feedback. As a trader, I spend a lot of time studying



financial instruments. I always strive to understand what the client wants to see. First, you have to know your audience intimately and what's possible in terms of product development.

# 3

### What are your group's bigger goals?

We're focused on delivering more and faster market data, along with better tools to help our clients visualize and contextualize the market. Our whole group truly gets development. We push our teams hard to stay ahead of the curve.

# 4

### You trade, too. Share some market wisdom you live by.

Buy low, sell high. Do that over and over again and you'll be ok. I always look at historical and implied volatility before I get involved with a trade.

# 5

### So, the kitchen. What's your latest passion?

Naturally I don't follow recipes. I create them. Last week I made a spherified pineapple sauce for a ceviche. It formed a membrane around the liquid to allow the sphere to explode in your mouth. A little off the beaten track but it came out great.

**"John has the right tool for any situation. Just ask him about the summer he fixed his boat engine with duct tape and dental floss."**

# Speed Dating for Traders



## Implied volatility

PAGE 33

• 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.

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

## Spread

PAGE 24

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

## Short

PAGE 25

To short is to sell an asset, such as an option or stock that you don't own in order to collect a premium. The idea being that if you believe the price of the asset will decline, you can “borrow” the stock from your broker at a certain price, and buy back (“cover”) to close the position at a lower price later. Your potential profit would be the difference between the higher price you shorted at and the lower price you covered.

## Vertical spread (long and short)

PAGE 24

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

## Short put (selling naked put)

PAGES 24, 32

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.

## Delta

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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 50 cents per \$1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying drops in value.

## In the money (ITM)

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

## At the money (ATM)

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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.

## Out of the money (OTM)

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



## DISCLAIMERS

IMPORTANT INFORMATION YOU NEED TO KNOW

# 1

### GENERAL DISCLAIMER

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Past performance of a security or strategy does not guarantee future results or success.*

*Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. 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.*

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

# 2

### OPTIONS STRATEGIES

*Trading options involves unique risks and is not suitable for all investors. Mini-options do not reduce the per share cost or price of options.*

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

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

*When trading short option strategies,*

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

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

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

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

*A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)*

# 3

### FUTURES

*Futures trading is not suitable for all investors as the risk of loss in trading futures is substantial. Futures trading privileges are subject to TD Ameritrade review and approval. Not all account owners will qualify. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Equity options trading involves risks and 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.*

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

*Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC).*

# 4

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200 S. 108th Ave  
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