

# HOW TO: TRADE INTEREST RATES

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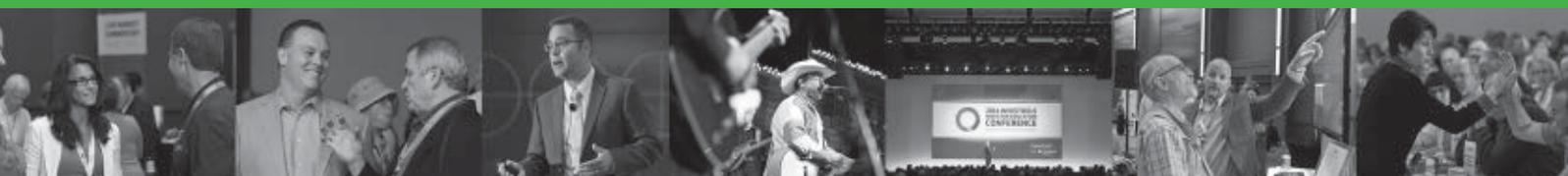
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Cover Photograph by **Fredrik Brodén**

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COVER STORY

## Dick and Jane Party with the Fed

Only pros care about interest-rate trading, and bonds are boring, right? Not so fast. There's more to them than meets the eye. Pros shouldn't be the only ones who get to have all the fun. You can, too.



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**A Cure for Trading Vertigo** No doubt the now six-year-old rally has produced some monster stocks. So how do you get involved when the altitude makes your stomach quiver? Ratio spreads might be the antidote.

MISCELLANEOUS

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**Ask the Trader Guy**

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**Toys for Traders** The latest and greatest you're not aware of.

**Ask the Suit** Pearls and nuggets from Nicole Sherrod.

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**Big Margin for the Masses** Spending one dollar to control two dollars of stock isn't a new concept. Margin trading has been around forever. But for qualified traders, there's another category—portfolio margin—that could take your leverage to a place once reserved for the pro club.



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SPECIAL FOCUS: RISK

**Don't Get Roasted** Ironically, today's obsession with the short term has created a new paradigm stemming from long-term risk factors. Since traders are investors, too (sort of), it might be helpful to put a trading spin on the long-term view when tracking portfolio risk.

**"When it comes to trading interest rates, you have lots of choices beyond simply buying bonds outright. So, rather than be scared of the Fed, you can likely find a place in the bond market that suits your trading and investment objectives.**

Dick and Jane Party with the Fed  
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”



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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 color dots at the beginning of each article will help you skip to just the right temperature.

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## Brown Bag Investing for Traders?

• QUICK, WHAT'S THE first thing you think of when you hear “interest-rate investing?” Slow. Conservative. For the nearly retired? Or perhaps you think it's confusing, complex, and best left for Wall Streeters to deal with. After all, you're a trader. So there're no opportunities here, right? Not true.

In a nutshell, when you invest in bonds, you're investing in interest rates. And it's the volatility in interest rates that provides traders with ample opportunities—mostly brought on by anticipation of what the Fed plans on doing with them now and into the future.

Perhaps bonds got their slow and steady reputation from the ones we used to get from Grammy and Grampy each birthday when we were kids. Or maybe it's because they're talked about by nearly every financial advisor as part of a “balanced portfolio” approach for long-term investors.

Since volatility brings opportunity, it's worth learning the basics as well as the products that capitalize on interest rate volatility. In this issue's cover feature, “Dick and Jane Party with the Fed,” we break it all down to help you decide if you want to dabble in this world.

Of course, with volatility comes risk—whether you're trading bonds, stocks, options, or any other financial product, for that matter. And although risk may appear in many forms, for traders, there are two primary types you should be concerned with. In our special feature, “Don't Get Roasted,” you'll learn how to analyze risk using the tools at your disposal. As for the risk in trading lofty stocks in a bull market that's long in the tooth, “A Cure for Trading Vertigo” introduces a strategy that might help you sleep better at night if you're still eyeing that \$300 stock.

As a trader, what keeps you up at night? Which tools and strategies have you wanted to learn more about, and what have you been hoping you'll find in these pages? Hit us up at [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com).

Happy Trading,

**Kevin Lund**

Editor-in-Chief, *thinkMoney*



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# With Central Bank stimulus, wise to put your focus on Europe?

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**Insight: European stocks may benefit from the European Central Bank's stimulus and a currency tailwind.**

- The ECB's massive bond-buying may continue to encourage bond investors to move into stocks.<sup>1</sup>
- A weaker euro is expected to help boost dollar-based earnings for the region's exporters.
- Germany's strong, export-oriented economy may be well-positioned to benefit from these trends.<sup>2</sup>

**Action: Consider hedged exposure to German stocks as an entryway to potential European momentum.**

**Insight into action.**  
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1. European Central Bank, as of 1/22/15. Bond-buying program expected to exceed \$1.1T. 2. Bloomberg, as of 3/20/15; as measured in size and contribution to eurozone GDP. 3. Based on \$4.774T in AUM as of 3/31/15. Visit [www.iShares.com](http://www.iShares.com) or [www.BlackRock.com](http://www.BlackRock.com) to view a prospectus, which includes investment objectives, risks, fees, expenses and other information that you should read and consider carefully before investing. Risk includes principal loss. International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. ■ These risks often are heightened for investments in concentrations of single countries. ■ The Fund's use of derivatives may reduce returns and/or increase volatility and subject the Fund to counterparty risk, which is the risk that the other party in the transaction will not fulfill its contractual obligation. The Fund could suffer losses related to its derivative positions because of a possible lack of liquidity in the secondary market and as a result of unanticipated market movements. Such losses are potentially unlimited. There can be no assurance that the Fund's hedging transactions will be effective. ■ This material represents an assessment of the market environment as of 5/13/15 and is not intended to be a forecast of future events or a guarantee of future results. ■ This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular. Funds distributed by BlackRock Investments, LLC (BRIL). The iShares Funds are not sponsored, endorsed, issued, sold or promoted by MSCI Inc., nor does this company make any representation regarding the advisability of investing in the Funds. BRIL is not affiliated with MSCI Inc. ©2015 BlackRock, Inc. All rights reserved. iSHARES and BLACKROCK are registered trademarks of BlackRock, Inc., or its subsidiaries. iS-15213-0515

## LOVE NOTES

LITTLE QUIPS FROM YOU TO YOURS TRULY



## To Our Inbox...

I am so short, I could break my knees jumping off a dime.  
—Sarah

This trader mentality is killing me. I went to buy sandals, and thought that the price was \$30 too high. Guess what happened.  
—Jeff

Money is fungible. I don't have to lose it the same way each time.  
—Christine

I'm TUI...trading under the influence. —Steve

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## Chat Room Pearls...

*"The farther backward you can look, the farther forward you are likely to see."*  
—JENNIFER

*I'm not French but I like the fries and toast.*  
—NICOLE

*Gaussian distribution applies to nearly everything.*  
—GEORGE

*Last boxing match I went to was billed as a hockey game.*  
—CHRIS

*I just tattooed my trading rules in my forearm.*  
—RUSS

*I've never been wrong in direction. Just time.* —KATHY

*Is anyone else bored out of their mind.*  
—JOE

*Assuming fetal position and sucking thumb, now.*  
—SCOTTY

*Has the interior of Tesla cars been tested for indoor air quality?*  
—DOC

*Nothing says civilized like leaping over house furniture with a beer in your hand.*  
—RICK

*Better to lose the leaves than the fig.*  
—FRANK

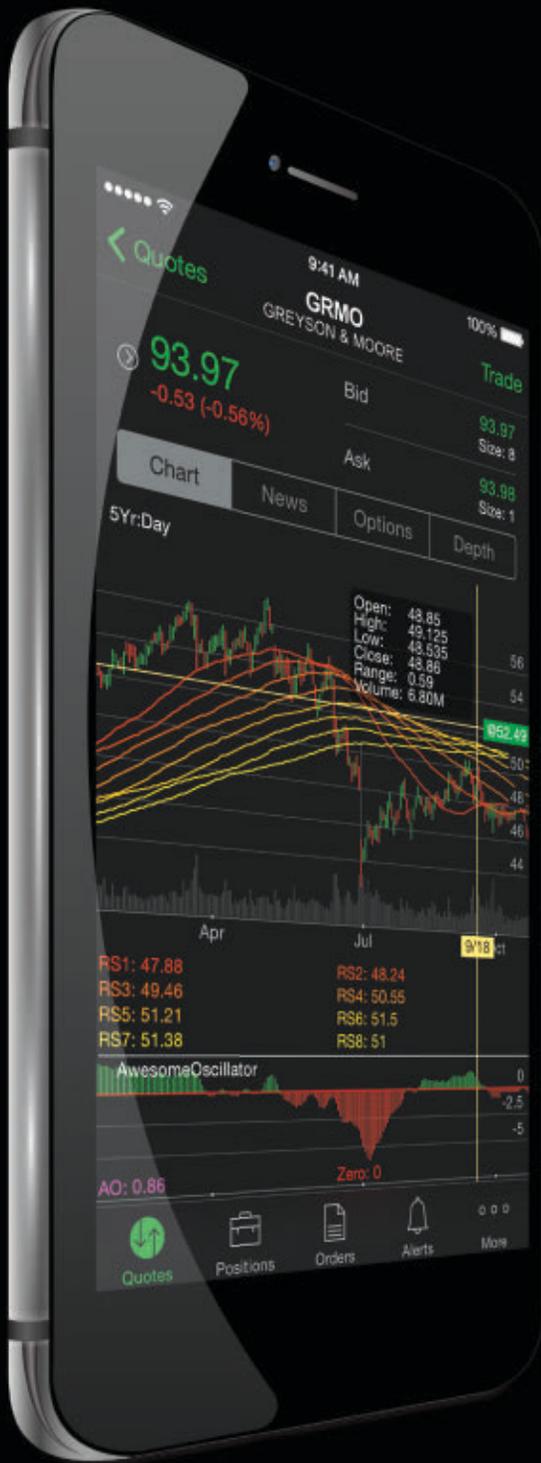
*Now I know what "Fracking" means ... My fracking portfolio is taking a fracking beating!* —SUSAN

*Making decisions with partial information is hard.*  
—BETHANY

*Is there a fund that fades Cramer as its main strategy?*  
—ADAM

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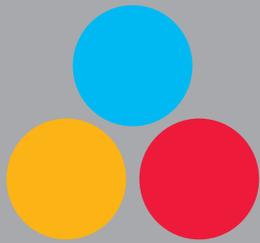
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## IN THE MONEY

A HODGEPODGE OF MARKET STUFF WE THOUGHT YOU SHOULD KNOW



• IF THE EURO/DOLLAR hits parity this year, as many investment banks predict, it will be the first time the market has seen a one-to-one exchange rate since November 2002. And we're close. As I pen this, the euro is fetching \$1.10, having bounced off a 12-year low of \$1.0457 set on March 16. In a recent global-outlook presentation, Barclays analysts said they expect the euro to fall below parity with the dollar by Q3 instead of Q4 2015, as previously forecast. The post-recession U.S. economy may have hit a few snags, but it's still the star among industrialized giants. Europe, by contrast, is facing divergence in the ranks. Germany is humming along pretty well, while Greece is trying to survive a debt crush, and begging Germany and others for more time.

### Not Like the Others

The potential dollar/euro shift is big news. But the bigger headline is dollar brawn. Period. The boost comes from expectations for higher U.S. interest rates at the same time that Europe, Japan, China, and other strong players are trying to fight an economic stall by cutting rates or supporting growth with unconventional stimulus packages. In Europe, that could mean pumping even more euros into the system, and ultimately cutting the buying power of all those notes.

Closer to home, Federal Reserve Chair Janet Yellen has signaled the U.S. central bank will likely raise rates in late 2015. That could strengthen the dollar's buying power. Yellen said a move is possible even before inflation and strong wage growth are fully realized—the Fed funds' futures market signals an October hike, based on where the market stood in March 2015. Still, Yellen emphasized a return to

INDUSTRY SPOTLIGHT • EASY

# It's Raining Euros. And You Know What That Means

**BIG IDEA:** INTEREST-RATE DIVERGENCE COULD PUT EUROPE'S SHARED CURRENCY ON PAR WITH THE BUCK



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“normal” interest rates will be gradual, which means foreign exchange traders could soon argue that gradual rate hikes are already accounted for in dollar values. And, talking about a major euro/dollar support line—parity would be it. Still, there’s little expected change in the global economic outlook that will reverse dollar dominance any time soon.

**The Long Fingers of Forex**

Consumer takeaways? First, that dollars are buying more than a few years ago. But for traders, opportunities and challenges come with dollar muscle. In reality, the currency market touches all markets. Case in point: Moody’s Analytics estimates that appreciation of the U.S. dollar accounts for about 15% of the decline in crude oil prices.

What’s more, executives across several multinational industries have warned compromised overseas profits could hurt their bottom line later in 2015 if not sooner. Can the U.S. stock market take another few quarters of lukewarm earnings? Of course, U.S. consumers can scoop up more foreign-made goods. And because the euro is becoming less valuable, and has less purchasing power abroad, it’s not seen as a lucrative way to hold assets. So people may dump euro-denominated assets in exchange for assets with more return, essentially propping up U.S. stocks.

Cheers and jeers for parity. Just be ready for the impact. —Words by RACHEL KONING-BEALS

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GEAR HEAD ● SEASONED

# In With the Tick, Out With the Tock

**BIG IDEA:** USE TICK CHARTS INSTEAD OF TIME CHARTS IN THINKORSWIM® FOR A FRESH VIEW OF MARKET ACTIVITY

• There’s more than one way to skin a cat, or so they say. One would imagine that most people’s feline de-furring experience is limited to the theoretical. That aside, the metaphor is relevant to stock charting. While traditional charts aggregate price movement over a given period of time, tick charts are based on a given number of trades per bar. This provides several advantages. Tick charts compress time when there is little trade activity (such as after-hours sessions), allowing you to see the volume associated with price shifts, or identify price cycles moving independently of time.



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- 3 - To change the number of ticks per bar (default is 133), click on the “Style” button again and hover over “Intraday” on this menu. Then choose your preferred length (in days) and number of ticks.
- 4 - If you do not see the tick value you want, select “Custom” at the bottom of this list and you can enter a custom number of ticks for each bar to use, anything from 1 to 10,000 ticks.



TOYS  
FOR  
TRADERS  
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# Two Different Histories of Volatility

**BIG IDEA:** THE TRADER GUY WAXES PHILOSOPHICAL ON VOLATILITY, ETFS, AND TRADING WITH GERBILS



• **Hey, Trader Guy! What's the difference between historical volatility and historical implied volatility?**

Historical volatility is based on changes in the price of the underlying for some number of previous days. You can see a chart of historical volatility on thinkorswim Charts with the historical volatility study. By contrast, implied volatility is based on the options' price, and is calculated via an option-pricing model. No historical data is used to calculate implied volatility. However, TD Ameritrade's thinkorswim® platform

**“No historical data is used to calculate implied volatility. However, using options prices, it's possible to calculate implied volatility for each of those dates.”**

—THE TRADER GUY

has a database of past options prices, and it's possible to calculate the implied volatility of the options for those dates. That's historical implied volatility. You can see a chart of implied volatility for past dates using the ImpVolatility study.

**When I look at an index-based ETF, sometimes the daily percent changes are different. If they're not the same, is that an arbitrage?**

No arb there. While an ETF and the corresponding index have the same component stocks, the ETF has actual shares that are bought and sold independently, whereas the index is just a sum of the prices of the component stocks that don't trade. At 3:00 p.m. Central, stocks stop trading, and the index price stops changing. But ETFs can still trade between 3:00 and 3:15 p.m. Central. If there's a price change in those 15 minutes, a closing price can be different from the closing price of the index. The next day, the net change for the ETF and index is based on those different closing prices, with the index “catching up.”

**I'm concerned about a massive power failure during trading hours. How can I keep on top of my positions and the markets if disaster strikes?**

It's good to hear you have your priorities straight in times of crisis. The most straightforward solution is a gas-powered generator into which you can plug your computer. But a more affordable option that doesn't rely on fossil fuels would be 10,000 gerbils in a turbine.

*Carefully consider the investment objectives, risks, charges and expenses of an exchange traded fund before investing. A prospectus, obtained by calling 800-669-3900, contains this and other important information about an investment company. Read carefully before investing.*

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Trying to find the perfect option to trade can become a bit cumbersome when looking at an option chain with a dozen series and hundreds of strikes. thinkorswim now has the capability to filter out the series and options that you want to see from the ones you don't. The filter is found just above the option. Click on the filter drop down and manage the criteria from the easy to use menu.

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CAPICHE? ● SEASONED

# When the VIX Finds a New Normal

**BIG IDEA:** MARKET VOLATILITY TRADES IN A RANGE...UNTIL IT DOESN'T. WHEN SHIFTS OCCUR, WHAT'S A TRADER TO DO?

• STRETCH A RUBBER BAND and what does it do? It either pulls back, or snaps back, then your fingers get stung. Because rubber bands move fast. Like the **CBOE VIX**. The VIX tends to oscillate above and below some average or mean, then spike higher or dip lower for a few days before pulling back again. That's what traders describe as "mean reversion." And the VIX does that until, "snap!" it does something unexpected. You can't predict when that will happen. You can only prepare for it and act on it. Let's look at two scenarios.

**VIX trading below the mean.** This typically indicates overconfidence and expectation of a strong or stable market in the future. Traders let their guard down a bit and aren't buying SPX puts as a hedge. That lack of buying pressure pushes the VIX lower. In this type of market, a small sell off can take people by surprise, and lead to a larger sell-off—leading to a spike higher in the VIX. (As it did between June and September '14 in the chart in Figure 1, right.) When the VIX is low, consider buying volatility and using VIX options to look at bullish trades like long-call verticals.

**VIX trading above the mean.** This typically indicates panic during a sharp drop in the market. This is not the time to lose your cool. Think about the spring of '10 or late summer of '11. The market was selling off, and traders bought SPX puts as a hedge, driving the VIX higher. But it didn't last, as the market turned around and the VIX dropped. When the VIX is higher, consider selling volatility since the SPX option premiums are generally higher. You might consider shorting put verticals in stocks or indices whose prices have dropped, or even selling defined risk call verticals in VIX options. You're collecting that option premium while it—and the VIX—are high.

Even if you're not trading options, savvy traders keep an eye on the VIX. —Words by THOMAS PRESTON



Source: thinkorswim® by TD Ameritrade. For illustrative purposes only.

**GLOSSARY OF TRADER JARGON**  
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## ASK THE SUIT

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

**Q: You've been tweeting about TD Ameritrade U a lot lately. What the hell is it?**

**A:** Back when dinosaurs roamed the Earth, and I was in college, I learned about the stock market via a textbook. My professor was a genius who turned the markets into poetry for me. But even he could only carry it so far. The markets are living. Breathing. You can't immerse yourself in them just by reading a book. TD Ameritrade U is a suite of tools for professors that allow them to breathe life into the markets. To inspire young people and, with all hope, cultivate the next generation of investors who are even better than my generation. It's all built on the backbone of the thinkorswim® platform's paperMoney® application. So young people can learn how to trade on the best-simulated trading technology in the category. And I get to visit college campuses.

**Q: How can my kids get involved?**

**A:** The best way to get started is by participating in our thinkorswim Challenge, which kicks off this fall. Last year, over 900 students competed in 36 states. Team Go Mean Green from the University of North Texas brought home \$30k to their school and each team member was awarded \$3,500 in a funded TD Ameritrade account and an iPad Air®.

**Q: Is it true Helicopter Moms were tweeting at you when their kids missed registration?**

**A:** Yes. It turns out college students are procrastinators. Who knew? Registration will kick off early fall. Keep an eye on [www.thinkorswimchallenge.com](http://www.thinkorswimchallenge.com) and my Twitter feed (@tdansherrod) to remain in the know. I will be posting well in advance this year to make sure parents can let their kids know, and the helicopter moms will not be left disappointed.

**FOLLOW THE SUIT** We double dare you to find someone who can quip, trade, and manage a team of trader-brains like Nicole can. Follow her on Twitter. @TDANSherrod

*The paperMoney software application is for educational purposes only. Successful virtual trading during one time period does not guarantee successful investing of actual funds during a later time period as market conditions change continuously.*

*Multiple-leg option strategies can entail greater risk and transaction costs. See page 38, #2.*



Kyle S.  
thinkorswim® user

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

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# DICK & JANNE PARTY WITH THE FED

**BIG IDEA:** ONLY BANKS CARE ABOUT INTEREST RATES, AND BONDS ARE BORING, RIGHT? NOT SO FAST. THERE'S MORE TO BONDS THAN MEETS THE EYE. PROS SHOULDN'T BE THE ONLY ONES WHO GET TO HAVE ALL THE FUN. YOU CAN, TOO.

WORDS BY **MARK AMBROSE**

PHOTOGRAPHS BY FREDRIK BRODÉN



# LET'S DO FREE ASSOCIATION WITH THE WORD **BOND.** WHAT IDEAS COME TO MIND?

FOR STARTERS, slow, low returns, and complicated. And the bond market (aka “fixed income”) is where the Fed and central banks meet giant financial institutions, like investment banks and insurance companies, to argue weighty matters like interest rates, inflation, and money supply. Ugh. Too scary for us little folk, right? Wrong. There’s no reason to be intimidated by the Fed. If you’re savvy, you can play the bond market in several ways that are trader friendly—like futures, ETFs, as well as certain stocks. And, if you are an options trader, you can employ some of your favorite options strategies.

When it comes to trading interest rates, you have lots of choices beyond simply buying bonds outright. So, rather than be scared of the Fed, you can likely find a place in the bond market that suits your trading and investment objectives.

## **TREASURY BONDS**

### THE BEAUTY OF SEESAWS

First things first. You need to understand how bond prices change relative to changes in interest rates. When interest rates go up, bond prices go down. When interest rates go down, bond prices go up. Bond prices and interest rates are inversely related. Commit this to memory.

A bond is like a loan. When you buy a U.S. Treasury bond, you’re loaning the U.S. Treasury money for a period of time specified by the bond’s maturity date. Like any loan, you expect your principal or loan amount to be paid back, and to receive interest that represents the return on your investment from that loan.



*“THERE’S NO REASON TO BE INTIMIDATED BY THE FED. IF YOU’RE SAVVY, YOU CAN PLAY THE BOND MARKET IN SEVERAL WAYS THAT ARE FRIENDLY—LIKE FUTURES, ETFs, AND CERTAIN STOCKS.*

”

Say you buy a \$1,000 Treasury bond at market price that pays 5% interest yearly and matures in 30 years. In 30 years, you’ll get your \$1,000 for the value of the bond, and every year you will have been paid \$50 in interest. Fast-forward six months. You buy a second \$1,000 Treasury bond that pays 6% annual interest for 30 years. Now, you have two bonds—one that pays 5% interest, and one that pays 6% interest. All things being equal, you’d rather have the bond paying the higher interest, because the bond that pays 5% is less desirable. When interest rates went up from 5% to 6% in those six months, the value of that bond paying 5% went down. So if you went to sell that bond now, you would likely get less for it than you paid.

Now, in reality, what moves bond prices can be the expectation of future interest rates

rising and falling. That’s why the price of Treasury bonds can move so much in response to Fed announcements. The Fed makes a comment about quantitative easing, or inflation, and the market expects interest rates to rally. Accordingly, bond prices will fall.

Bond prices can also change when the ability of a bond’s issuer (i.e., a country, a state, a city, a country, or a corporation) to make interest payments or even pay the principal back becomes stronger or weaker. In the third quarter of 2014, the market value of Greek bonds dropped sharply when the world thought Greece couldn’t pay interest

on its bonds. The “quality rating,” which refers to the issuer’s ability to meet its interest obligations, or some other protections built into the bond, of Greek bonds went down, and so did their prices.

## BOND FUTURES

### TRADERS SPOUTING OFF

Now, on to the bonds themselves. While you can trade all sorts of municipal, corporate, and government non-Treasury bonds, traders generally trade Treasuries—specifically, 30-year bonds and 10-year notes. And, while you can buy a physical bond or note from the U.S. Treasury, many traders use futures on those Treasuries to express bullish or bearish opinions on the bond market.

For instance, /ZB (the 30-year Treasury bond future) and /ZN (the 10-year Treasury note future), along with their options, are generally quite liquid with tight bid/ask spreads. Their prices also tend to respond directly to interest rate changes. When the

Fed makes an announcement, or there’s some important economic news, it’s often /ZB and /ZN that react first. Traders buy and sell them because they can typically execute those trades quickly—much faster than if they had to buy the actual Treasury bond.

Of course, /ZB and /ZN are futures contracts. And you need a **futures account\*** to trade them, along with their options.

Going a step further, /ZB and /ZN are also big contracts. A one-point price change is worth \$1,000. That’s 10x bigger than a one point move in 100 shares of stock. These contracts are also highly leveraged. The margin required to buy or short one /ZB future is about \$4,400. But the value of the /ZB contract at the time of this writing is \$160,000. Profits and losses can grow quickly with /ZB and /ZN futures. It may be possible to use options on /ZB and /ZN to create defined-risk spread positions that have lower margin requirements.

Quick note: if you look at /ZB and /ZN quotes, you’ll see expirations for the futures in March, June, September, and December. Those are not the maturity dates of the un-

derlying Treasury bonds. They are the expiration dates of the futures contracts, by which time physical Treasury bonds and notes can be delivered against the futures.

But what’s the difference between /ZB for a 30-year Treasury future, and /ZN the 10-year Treasury future? For one thing, 20 years between maturities. That makes /ZB and the 30-year Treasury bond more sensitive to changes in interest rates than /ZN and the 10-year note. This concept is called “duration,” which describes a bond price’s sensitivity to interest rate changes. Other things being equal, bonds with longer maturity dates have more duration, and their prices will change more when interest rates fluctuate.

## EXCHANGE-TRADED FUNDS

### BONDS CLOSER THAN YOU THINK

If you’re looking to trade the bond market but prefer equities instead of futures contracts, and still have actively traded options, consider ETFs—exchange-traded funds—in the bond space. They typically don’t have a principal guarantee like a Treasury bond, but may be bought and sold like a stock in an equity account. No futures account required.

A few bond ETFs have single points between strikes, meaning option strategies like **vertical spreads** and **iron condors** can be created with lower capital requirements. And each point between bond-ETF strikes represents only \$100, not \$1,000, as is the case for /ZB and /ZN options. (Bear in mind the ETF is different than actual cash, so it will mirror but not be exactly the same.) For smaller accounts, or for investors who like to keep risk lower than futures, bond ETFs can be another choice for trading the bond market, if you understand the differences between ETFs, futures, and Treasury bonds themselves.

## STOCKS

### INTEREST RATE OPPORTUNITIES ABOUND

To take the bond market a step further, some like bank stocks, which can be interest-rate sensitive. Banks, as you know hold a lot of money. And they make money by lending out that money. With higher interest rates, bank stocks can rally because they can earn more on the money they lend. If the broader market crashes, it could take banks down

with them, regardless of what interests rates do. On the other hand, stocks that typically pay high dividend yields, like utilities, can tend to drop when interest rates rise as investors choose higher-yielding bonds. Housing stocks, too, can tend to drop when interest rates rise, as it becomes more expensive to borrow money to buy homes.

Sure, the Fed can surprise us at any moment. But choosing the right bond, or interest-rate-sensitive product, combined with a trading strategy aligned with your risk tolerance, means you can position your portfolio to better handle those surprises and potentially leverage them to your advantage.

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**Carefully consider the investment objectives, risks, charges, and expenses before investing. A prospectus, obtained by calling 800-669-3900, contains this and other important information about an investment company. Read carefully before investing.**

*ETFs can entail risks similar to direct stock ownership, including market, sector, or industry risks. Some ETFs may involve international risk, currency risk, commodity risk, and interest rate risk. Trading prices may not reflect the net asset value of the underlying securities. Commission fees typically apply.*

*Options are not suitable for all investors as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options before investing in options. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*

*Futures and futures options trading is speculative, and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options [https://www.tdameritrade.com/retail-en\\_us/resources/pdf/TDA631.pdf](https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA631.pdf) prior to trading futures products. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Futures and futures options trading services provided by TD Ameritrade Futures & Forex LLC. Trading privileges subject to review and approval. Not all clients will qualify.*

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**\* You may apply to trade futures and options on futures through your TD Ameritrade account. Trading futures and options on futures is speculative, and not suitable for all investors. Not all accounts will qualify.**

● SEASONED / **TAKEAWAY:** *How to trade pricey stocks*

# A CURE FOR VERTIGO TRADING

**BIG IDEA:** NO DOUBT THE SIX-YEAR-OLD RALLY HAS PRODUCED SOME MONSTER STOCKS. SO HOW DO YOU GET INVOLVED WHEN THE ALTITUDE MAKES YOUR STOMACH QUIVER?

RATIO SPREADS MIGHT BE THE ANTIDOTE.

WORDS BY **GREG LOEHR**

PHOTOGRAPH BY FREDRIK BRODÉN





**BIG MONSTER STOCKS** in Wall Street's pantheon—i.e., Google, Priceline\*, any company trading over \$200 a share—can create huge transactions and large spreads. In volatile markets, these stocks can whipsaw you out of a trade because point swings can be large as well. Yet, you can be creative with option spreads using ratios of short and long options and customize a strategy, while at the same time hedging volatility and price. In a word, scale the monster-stock mountain with more confidence. (And fabulous grappling hooks.)

### IS TWO A FAIR FIGHT?

Sometimes. This is where option ratios come into play. Ratio spreads, and ratio backspreads, are complex trades that certainly have their own share of risk. But what these strategies can potentially offer goes way beyond more basic approaches.

As a spread, each trade pits one option against another, but in a one-versus-two ratio.

Ideally, trades are done for a net credit—where the credit from the short option(s) covers the cost of the long option. The first strategy—the ratio backspread—combines one short option, whose credit “pays for” two long options that are further out of the money (OTM), but are in the same month.

### RATIO BACKSPREADS

Placing a ratio backspread with put options takes advantage of those times when you think stocks are acting “toppy,” implied volatility is low, and the market feels due for a pullback. (See Figure 1.) It feels like something more than just another down day.

Consider XYZ stock trading around \$105. And let's say you could sell the May 100 put for \$1.60, and buy twice as many May 95 puts for \$0.70 each, for a net credit of \$0.20 for one spread. Just because you enter into the trade for a credit doesn't mean the trade

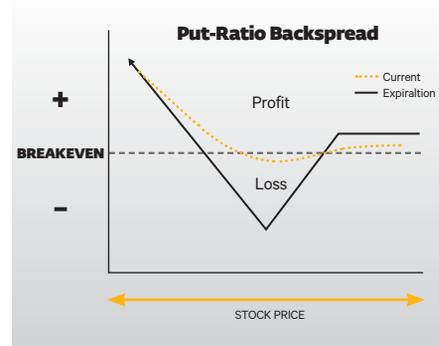
doesn't have risk. Far from it.

If XYZ drops below \$100 prior to expiration, then you'd lose dollar for dollar as the stock moves lower. But that pain stops at \$95, when the long puts kick in. The first of those long puts offsets the losses from the short put. That caps your risk at the difference between the strikes, less the initial trade premium. So, in this case, the net risk is \$4.80.

From another direction, consider your run-of-the-mill short-put spread. Shorting the 100

puts and buying the 95 puts, in a ratio of one to one, gives you a neutral-to-bullish trade, where you'd keep the credit of \$0.90 (\$1.60 credit from the 100 put, less the \$0.70 debit from the 95 put), if XYZ remains above \$100. In exchange, you'd be shouldering a \$4.10 potential loss if the stock pins at \$95 at expiration.

With the ratio backspread you're “spending” part of that 90-cent credit to buy another 95 put. You're still left with the \$5 maximum risk of the short put spread, but now your credit has been whittled down to only \$0.20, potentially leaving you on the hook for \$4.80. But you still have that second long put, and this is where things get interesting. As XYZ continues to move below \$95, you now win dollar for dollar.



**FIGURE 1: PUT-RATIO BACKSPREAD.** For monster stocks in toppy markets you suspect will pull back. For illustrative purposes only.

That's at expiration. In real-world trading, you'd probably want to be out of the trade prior to expiry if the stock is anywhere near \$95 (or whatever your long strike is) or below. By looking at the risk graph in Figure 1, you can see why. Waiting until expiration means you run the risk of taking the full hit of the short put spread, without being able to cash in on the remaining long put.

Also, if there's time left before expiration, volatility can be a big part of the trade. And if the market is selling off, chances are the low volatility you identified at the trade's outset is now pumping up, and that's good news. You own twice as many long options as short options, and those long options are now closer to the money. So they're more affected by a rise in implied vol. Pretty stealthy, right? Of course, the maximum profit occurs if XYZ goes to \$0. But nobody expects that.

Maybe you've owned puts before, only to see them disintegrate under a market that refused to move lower. This is the beauty of the trade.

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\*Companies mentioned are for illustrative purposes only and not a recommendation to buy, sell, or hold any specific security.

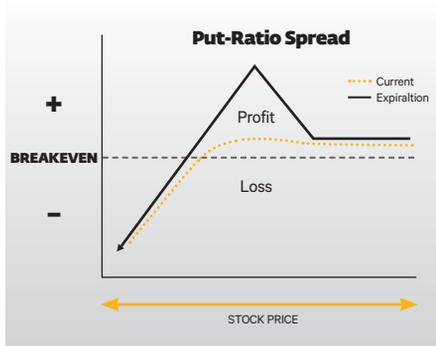
Examples do not take transaction costs (commissions and other fees) into account. Please see page 7 for more information.

If you're wrong about the market heading south, you don't necessarily lose, because all the options expire worthless with XYZ above \$100 and you keep the credit.

## RATIO SPREADS

While the put ratio backspread pertains to a market you think could move lower, what about a market you think is only going to drift a little this way or that? Basic long option and long spread strategies probably need at least some amount of movement in the right direction to make them worthwhile. And, if the market doesn't move in your direction at all, you'll likely lose.

This is where the flip side of the ratio backspread could make sense. If we stick with XYZ trading around \$105, but now assume the stock won't make any big downward moves, you could buy one of the 100 puts and sell two of the 95 puts—instant ratio spread. But let's tweak the prices so the long option costs \$1.50, and the short option collects \$0.80 each, for a net trade credit of \$0.10.



**FIGURE 2: PUT-RATIO SPREAD.** For maximizing gains when you suspect the stock will drift. For illustrative purposes only.

A look at the risk graph in Figure 2 suggests this is a horse of a different color since you're short an extra put at the 95 strike. If XYZ at expiration moves below \$100, the 100 put is in the money (ITM) and you profit, until the stock breaks below \$95. That's when the first of the short puts kicks in, and caps the profit at \$5, which is the difference between the strikes. This part of the trade is really just a long put spread, for which you paid a net debit of \$0.70. Ideally, a slow grind down to the short strike is what you're after.

The second-short put, which brings in

another 80 cent credit, is where you need to focus.

Why? The risk of being assigned and thus obligated to buy stock at \$95 from the second put isn't covered. So if XYZ drops below \$95 like the Titanic slipping into the North Atlantic, it's a long way to \$0. But that doesn't have to be bad news if you're mentally and financially prepared to pay \$95 a share (see **"Short Strategy Primer: Shut Up and Sell" in thinkMoney #23, Spring 2014**). In fact, if you consider a ratio spread as an alternative stock-accumulation strategy to a single short put, the \$5 maximum profit from the put spread portion of the ratio (along with the initial credit) could potentially represent a bigger credit than just selling one of the 95 puts alone.

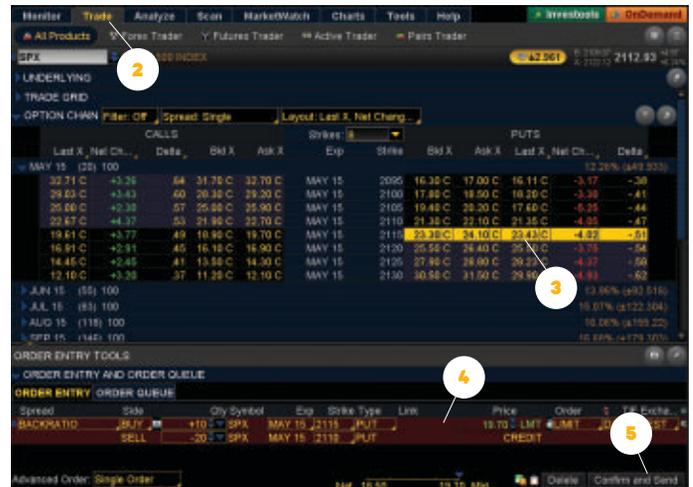
And since the risk is defined, don't count out your IRA for this one. If your account carries the right level of options trading approval, you would just put up the cash to cover the cost of buying the stock at the strike price, and you can potentially add ratio spreads to your IRA trading toolbox.

## FEAR NOT THE NORTH FACE

Whatever your strategy for big stocks, big price tags, and potentially slippery slopes, ratio spreads and backspreads are best understood and managed by thinking of trades as a combination of a regular vertical spread and a single option. The ratio backspread is a short OTM vertical spread with an extra option added to the long strike, while the ratio spread is a long vertical spread with an extra option thrown in at the short strike. While more complex, and certainly not suitable for everyone, both strategies provide a chance not to lose big if you're wrong. Something about which many other strategies simply can't brag.

# PLACING A RATIO SPREAD ORDER IN THINKORSWIM®

1. Fire up and log in to the **thinkorswim** trading platform.
2. Open the **Trade** tab and enter a symbol.
3. Right-click on an option in the chain below and in the submenu choose **SELL > Back/Ratio**.
4. Adjust your strikes and prices in the **Order Entry** box
5. Select **Confirm** and **Send**



Source: thinkorswim by TD Ameritrade. For illustrative purposes only.

Keep in mind that transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. Spreads and other multiple-leg option strategies such as those discussed here can entail substantial transaction costs, including multiple commissions, which may impact any potential returns.

Options involve risks and are not suitable for all investors. Before trading options, carefully read *Characteristics and Risks of Standardized Options*. Contact TD Ameritrade at 800-669-3900 for a copy.

Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.

# BIG MARGIN FOR THE MASSES

**BIG IDEA:** SPENDING ONE DOLLAR TO CONTROL TWO DOLLARS OF STOCK IS NOT A NEW CONCEPT. MARGIN TRADING HAS BEEN AROUND FOREVER. BUT FOR QUALIFIED TRADERS, THERE'S ANOTHER CATEGORY—PORTFOLIO MARGIN—THAT COULD TAKE YOUR LEVERAGE TO A PLACE ONCE RESERVED FOR THE PRO CLUB.

BEING A SNOB IS SO LAST CENTURY. Especially in a trading context. Today, it's about equality. Designer sneakers and super-high-tech sing-you-to-sleep watches for everyone who's got the green. So what separates us retail traders from the pros? After all, we often trade the same strategies. We both have access to real-time data. We both have lightning-fast trade execution. In a word, we both have margin, which is nothing more than a difference in leverage.

Traditionally, for a given position in stocks and/or options, the professional trader usually has a lower margin requirement than a retail trader and thus, more leverage. The rationale for the retail trader's higher margin requirement is that he or she doesn't have the knowledge or ability to manage risk as skillfully as a pro. While that might have been true 10 years ago, retail traders are quickly closing the knowledge gap. That's why "portfolio margin" was introduced in 2007 to let retail investors get closer to professional-grade margins.

## RETAIL TRADERS ARE PEOPLE TOO

Portfolio margin (PM) calculates the margin requirements of strategies like long stock, short puts, straddles, etc., that can be applied to single accounts whose net liquidity exceeds \$125,000 (a TD Ameritrade requirement). This criterion is different from a "regular" margin account. And there are rules—i.e., the Federal Reserve Board's "Reg T"—that determine the margin requirements for positions in margin, cash, and IRA accounts. FINRA also applies strategy-based rules for margin, cash, and IRA accounts, meaning each particular strategy has specific



WORDS BY  
**THOMAS PRESTON**  
PHOTOGRAPHS BY  
FREDRIK BRODÉN

requirements. For example, the minimum to buy stock in a margin account is 50% of the value of the stock shares. To buy 100 shares of a \$50 stock, for example, the Reg T margin requirement would be \$2,500.

PM is different. With PM, the margin on the long stock would be based on what its largest theoretical loss would be if the stock rose or dropped 15%. That 15% is the minimum percent change for equities, but can be adjusted to a larger percent change if the risk of the stock or position warrants it. For example, a long stock position would have its largest loss over that +/- 15% range if the price dropped 15%. For the same long 100 shares of a \$50 stock, a 15% drop would cause a \$750 loss (15% x \$5,000). So, the PM requirement would be \$750. Portfolio margins are determined by a “stress test,” where the theoretical profit or loss is calculated if and when the price of a stock or index drops or rises, and volatility drops and rises, by percentages determined by PM rules. The PM requirement is the largest theoretical loss across those various “stress test” scenarios. In some cases, the PM can be much lower than the Reg T margin.

PM might sound complicated. But it's actually pretty straightforward. Rather than saying the margin requirement for a vertical in stock XYZ is \$A, a short strangle is \$B, a long stock and covered call are \$C, PM evaluates all the positions together in its test. If some of the positions in XYZ have a theoretical profit when XYZ is down, they can offset theoretical losses on other positions in XYZ, and the PM requirement as a result can be lower. Having a lower margin requirement for a position may sound great. But it also means being able to put on more, or larger, positions in your account. The downside of that, of course, is the risk of loss will increase with the additional leverage. And that might not fit your trading or investing style. So, if your account is above that \$125k threshold, and you're thinking about applying for PM, you need to go toward it with both eyes open.

## FINANCIAL DEMOCRACY: PM IN ACTION

Before getting into the dirty details of PM, you may be wondering how it all works. Let's look at a couple of popular strategies and the difference between traditional margin and PM.



### PM on a Short Put

In the world of traditional margin, say you were to sell short a naked 120 put for \$0.80 credit on XYZ stock trading at \$125. The **Reg T margin** would be approximately \$2,000. Yet, in a PM account, the margin would be approximately \$1,350. Let's break down how that's calculated.

For equities, the PM calculation theoretically moves the price of the stock up and down 15%, and divides that range into 10 equidistant points. For each price point in that range of scenarios, PM calculates the position's theoretical value, and determines the position's profit or loss at those theoretical values. The largest theoretical loss across these scenarios is the PM requirement. So, with the price of the shares down 15%, from

\$125 to \$106.25, the put would have its largest theoretical loss of \$1,350—thus, the PM requirement.

*Margin Recap on Short Put:*

Reg T = \$2,000

PM = \$1,350

### PM on a Covered Call

How about a covered call with long stock and a short **out-of-the-money** call? Let's say you want to buy 100 shares of a stock at \$41.35, and short a 44 call at \$0.35. In a margin account, the Reg T requirement would be 50% of the value of the stock—100 shares at \$41.35 x 50%—minus the credit for selling the call. That's \$2,067.50 - \$35 = \$2,032.50. In a PM account, the loss when the stock is down 15%

would be about \$590. So, in a PM account, that would be the margin required to do that covered call.

#### Margin Recap on Covered Call:

Reg T = \$2,032.50

PM = \$590

## CALCULATING PM BLINDFOLDED

The PM requirement for stock and equity option positions is based on the +/- 15% stress test. But for options in small-cap, broad-based indices like NDX, the PM requirement is based on a +/-10% stress test. And for options in large-cap, broad-based indices like SPX, the PM requirement is based on a -8%/+6% stress test. There are different percentage ranges because some products are historically less volatile, and thus less risky, than others. Diversified indices tend to have lower volatility than individual stocks. Also, if your account has most of its risk concentrated in a single stock, a larger percentage range is used to determine the PM requirement. (Note that TD Ameritrade reserves the ability to hold higher margin requirements based on internal risk metrics.)

While it's possible to calculate a Reg T margin for a simple position in your head, that's not necessarily true for PM. Fortunately, you

don't have to. You can get an estimate of what the PM requirement might be for a position even if your account isn't yet approved for PM. The Analyze tab on thinkorswim® lets you see the daily loss of a position across the range of PM percent changes in the underlying stock or index. That will give you an estimate of what the PM requirement might be.

For example, suppose you're looking to short a put on the SPX in a PM account. You can use the Analyze page to simulate a short SPX put. Referring to Figure 1, set the price slices on the Risk Profile to -8%/+6% to see the range for the SPX price on the Risk Profile. Then move your cursor between the -8%/+6% range to find the largest p/l loss possible for that day. PM could reduce the margin requirement of those short SPX puts because of the way the algorithm computes a maximum theoretical loss. PM thus can give you more flexibility in strategy, in addition to lower requirements.

## THE 99%: WHO "QUALIFIES"?

So how do you get PM? First, you must have an account with a net liquidation value of at least \$125,000. Now, you don't have to close all your positions to have a PM account. You can simply have PM rules applied to an existing margin account (sorry, PM isn't available for retirement accounts like IRAs). But your PM account needs to have at least \$125K net liq for starters.

Second, your account has to be approved for Level 3 trading (naked option selling).

Last, take an online test—20 questions that explore risk and option strategies to let TD Ameritrade know you understand enough about trading to feel comfortable granting you PM. With PM, it's possible to put on

large positions whose maximum risk is much greater than the value of your account. If a loss of that magnitude happens, it's bad for everyone. And that's why PM isn't for everyone.

NOW THAT YOU HAVE a better idea of how PM works, is it right for you? Just because you have a PM account doesn't mean you have to put on larger, or even more, trades. You naturally have the extra capacity to do so. But there's no

obligation. In that sense, having PM doesn't hurt. And it may even be useful someday.

So, take a look at your portfolio and trading styles. PM may give you some advantages you previously overlooked. And if it's a tool you find beneficial over time, send the Founding Fathers a huge dividend check. Freedom for all means pro traders no longer get to hog the good stuff.

*For the sake of simplicity, the examples above do not take transaction costs (commissions and other fees) into account. For more information on commissions, see page 7, #3. You cannot directly invest in an index. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request. For more information on the risks of trading options, see page 39, #1-2.*

*Portfolio margining involves a great deal more risk than cash accounts and is not suitable for all investors. Minimum qualification requirements apply. Portfolio margining is not available in all account types. Portfolio margining privileges subject to TD Ameritrade review and approval. Not all clients will qualify. Please consider your financial resources, investment objectives, and tolerance for risk to determine if it makes sense for your individual circumstances. Carefully read the Portfolio Margin Risk Disclosure Statement, Margin Handbook and Margin Disclosure Document for specific disclosures and more details. You may also contact TD Ameritrade at 800-669-3900 for copies.*

### Important points to keep in mind:

- To be eligible for portfolio margining, clients must be approved for writing uncovered options.
- A margin deficiency in the portfolio margin account or sub-account, regardless of whether due to new commitments or the effect of adverse market movements on existing positions, must be met within three business days.
- Any shortfall in aggregate equity across accounts, when required, must be met within three business days.
- Portfolio margining generally permits greater leverage in an account, and greater leverage creates greater losses in the event of adverse market movements.
- Because the maximum time limit for meeting a margin deficiency is shorter than in a standard margin account, there is increased risk that a client's portfolio margin account will be liquidated involuntarily, possibly causing losses to the client.



**FIGURE 1: Calculating PM.** Before you trade a strategy (naked put shown here), you can use the Analyze page of thinkorswim to calculate what your PM might be. Just open the Price Slices menu, set the slice range, and look for the largest loss based on. For illustrative purposes only.

**TRADER GLOSSARY**  
TURN TO  
PAGE 36

SPECIAL  
FOCUS:  
**RISK**



● SEASONED / **TAKEAWAY:** *Understanding the different types of risk and what to do about them.*

**DON'T GET**

# STAY

**BIG IDEA:** IRONICALLY, TODAY'S OBSESSION WITH THE "SHORT TERM" HAS CREATED A NEW PARADIGM FOR "LONG-TERM" INVESTING. SINCE TRADERS ARE INVESTORS, TOO (SORT OF), IT MIGHT BE HELPFUL TO PUT A TRADING SPIN ON THE LONG-TERM VIEW WHEN TRACKING PORTFOLIO RISK.

WORDS BY **THOMAS PRESTON**

PHOTOGRAPHS BY FREDRIK BRODÉN

# LONG TERM.

In the financial world, the phrase is usually teamed with “investor” to describe a person who buys stock and patiently holds it for a “long” time, maybe years or decades. No taking of profits. No stop losses. Maybe the occasional re-allocation or re-investing of dividends. Above all, the goal is to have steady, compounding returns over time—the hallmark of a successful, albeit traditional, investing career.

Long-term investors often have a “set-it-and-forget-it” approach to their positions. But investments aren’t rotisserie chickens. The consequences for overcooked chicken aren’t quite as serious as assuming your investments will take care of themselves. That kind of mistake can mean overlooking risk—something professional traders have a deeper understanding of. Here we’ll explore three kinds of risks you’ll need to understand if you’re a long-term investor hoping to think more like a trader: systematic risk, non-systematic risk, and, well, let’s just save the third until the end.

## RISK 1: SYSTEMATIC RISK

Systematic risk, or market risk, describes what happens when all stocks rise or fall based on some external factor—like a change in interest rates, problems with European debt, or unemployment numbers. This is risk for the market overall, not just a particular industry. For example, bank stocks, tech stocks, and energy stocks represent very different industries. But think about what happened in 2008. Based on the fears of a global financial meltdown, all stocks dropped, regardless of industry or sector. That’s a straight shot of systematic risk. But surprisingly, this kind of risk doesn’t affect all stocks equally. In 2008, as it played out, some stocks dropped a larger percentage than others. How do you account for this disparity when assessing portfolio risk? Think like a trader.

## Beta for assessing longer-term risk.

We use “beta” to measure how much systematic risk a stock has. Let’s explore that. The S&P 500 is a large, diversified stock index reflecting a wide range of industries and sectors. That’s why the S&P 500 is considered a performance benchmark. Now, for example, when the S&P 500 moves up 1%, a bank stock moves up 0.75%, and an energy stock moves up 1.5%, the bank stock has a beta of 0.75 (i.e., less risk than the S&P 500), and the energy stock is said to have a beta of 1.5 (i.e., more risk than the S&P 500). A stock beta indicates how much the price of the stock might change (in percentage terms) when the S&P 500 (or another benchmark) changes by 1%. Beta, in other words, is a measure of the stock’s volatility—its risk—relative to a benchmark.

You can see a stock’s beta in TD Ameritrade’s thinkorswim® trading platform by going to the Trade page (see sidebar below, “How to Get Better Beta”). By default, the beta in thinkorswim uses five years of data to calculate systematic risk. For a shorter term of one year, you may want to switch to “Fast Beta,” which can be found in the Applications Settings box (Figure 1), which you’ll find under the application’s Setup menu in the upper right of the platform. Switching the beta method sets the beta you’ll see on the Trade page, as well as sets the beta used in the beta-weighting tool on the Monitor page.

## Beta-weighting for a “truer” measure.

This tool adjusts your position’s **delta** (the amount your position moves—typically an option) by the stock’s beta so you can

compare the deltas in terms of a benchmark like SPX.

Say you’re long 200 shares of XOM\*, 100 shares of AAPL, 300 shares of MSFT, etc., with your position deltas equal to their number of shares. While delta is a measure of risk, you can’t really compare position deltas directly because each stock has a different level of systematic risk. When you apply the beta-weighting tool with, say, SPX as the benchmark, you might see that XOM has a beta-weighted delta of 50, AAPL 75, and MSFT 20. So in S&P 500 terms, your portfolio theoretically has more risk in AAPL than it does in either XOM or MSFT.

## How to Reduce Systematic Risk.

So as a trader, what do you do with this information? In the case of individual positions,



**FIGURE 1: GETTING A FASTER BETA.** To get a one-year beta (instead of the default five) in thinkorswim, go to the Application Settings in the Setup menu of the platform.

*For illustrative purposes only.*

unless you’re more confident in your bullish opinion of say, AAPL, you might want to bring its beta-weighted delta down closer to the others by reducing the number of shares, or purchasing a put, for example. For your portfolio with too much systematic risk, you might reduce the portfolio deltas with defined-risk, **negative-delta** strategies, such as

## HOW TO GET BETTER BETA

To get your position or portfolio beta using a different benchmark other than the S&P 500, use the beta-weighting tool in thinkorswim:

1. On the Monitor page, look in the Position Statement section.
2. Display delta in one of the columns. Access by clicking the gear icon on the far right-hand side and add it to the display.
3. In the upper right, click the “Beta Weighting” box and enter the symbol you want to use as the beta-weighting benchmark of your choice. Stick to something that matches your book, like SPX for a large-cap portfolio, or NDX for a smaller-cap portfolio.
4. You’ll immediately see your individual position and portfolio deltas change. Those shifts represent the profit or loss your position would have if the benchmark of your choice moved \$1.00.

short call spreads, long put spreads, or others in the benchmark product.

Taking the beta-weighted delta one step further, you can see the portfolio's total delta at the bottom in terms of the benchmark. It gives you your portfolio's systematic risk, which is the dollar amount of profit or loss that would theoretically occur if the benchmark moved \$1.00. Are you comfortable with that amount of risk? A set-it-and-forget-it investor wouldn't think about it. But keeping track of your systematic risk can potentially help you avoid a nasty loss in another crash.



**FIGURE 2: CHECK YOUR CALENDAR.** Look at the "Calendar" feature in the MarketWatch tab of thinkorswim to be aware of potential non-systematic risk that could be lurking in the future. For illustrative purposes only.

**RISK 2: NON-SYSTEMATIC RISK**

Non-systematic risk, or industry- or sector-sensitive risk, is stock risk not predicted by its beta. For example, if a stock has a beta of 1.5, and the S&P 500 moves up 1%, theoretically the stock price would go up 1.5%. But if it goes up 1.4%, that 0.1% difference can be accounted

for by non-systematic risk. Non-systematic risk is what happens when one stock is dropping sharply while the rest of the market is up. This often happens around earnings announcements, industry news, or other corporate events—effects that don't always show up through the lens of the beta tool.

**How to reduce non-systematic risk.**

Theoretically, you can diversify to help reduce non-systematic risk. The S&P 500, for example, doesn't have a lot of non-systematic risk because the impact of one stock, or even one sector, on the index as a whole isn't that large. So, the long-term investor can seek to reduce non-systematic risk with index products, or a portfolio of individual stocks, from a broad range of sectors.

By contrast, a trader hunts down the very things that might cause non-systematic risk. The Calendar tab on the MarketWatch page of thinkorswim shows upcoming earnings events, for instance (see Figure 2). Knowing when news is arriving for a specific stock, or housing numbers, or petroleum data that could impact whole sectors, could let you hedge the stock before the news comes out. In this way, the long-term investor can potentially reduce non-systematic risk more directly.

**RISK 3: YOU, THE TRADER**

You can't predict systematic or non-systematic risk very well at all. You can try to mitigate them, but can't control them. But there's a third kind of risk that financial theory doesn't cover, and which is entirely under your control. You. How can you be a

risk to your own portfolio, you might ask? In a word, position size. Or more specifically, having a position in a single stock significantly larger than any other. If that stock has a correction, could it create an unrecoverable loss in your account? A "too-big" position in a long-term investor's account could reflect an unlucky combination of systematic and non-systematic risk with potentially significant downsides.

**How to save you from yourself.**

Be objective. No matter how attractive and tempting one stock's shares might be, your analysis may be imperfect, and remember that money doesn't pick favorites. In a word, take your bias out of the equation. Keep the risk of any new trade roughly the same size as the others. And that will free you up to better manage systematic and non-systematic risks, while not burning down your house trying to perfect a rustic galette with turkey sausage, eggplant, tomato, and ricotta.

*\*The symbols shown in this article are for illustrative purposes only and not a recommendation to buy, sell, or hold any security.*

*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. Investors should also consider contacting a tax advisor regarding the tax treatment applicable to multiple-leg transactions.*

Instrument	Mrk Chng	Delta	Theta	P/L Day	P/L Open	BP Effect
AAPL		18.12	6.02	\$0.00	\$0.00	(\$1,004.75)
MSFT		16.84	2.42	(\$32.00)	\$267.50	\$4,009.89
SPY		4.30	5.79	\$0.00	\$46.00	(\$1,463.74)
TLT		-49.49	4.76	\$5.00	\$46.50	(\$13,685.31)
USO		66.90	4.54	(\$20.00)	\$221.00	\$3,325.65
VXX		199.12	1.59	\$1,965.00	\$1,332.50	\$3,528.62
Subtotals		248.79	25.11	\$1,918.00	\$1,913.50	(\$5,289.64)
Overall Totals				\$1,918.00	\$1,913.50	(\$5,289.64)

**FIGURE 3: Portfolio Delta without Beta-Weighting.** For illustrative purposes only.

Instrument	Mrk Chng	Delta	Theta	P/L Day	P/L Open	BP Effect
AAPL		.95	6.02	\$0.00	\$0.00	(\$1,005.20)
MSFT		.41	2.42	(\$32.00)	\$267.50	\$4,009.89
SPY		.43	5.79	\$0.00	\$46.00	(\$1,464.88)
TLT		2.18	4.72	\$8.00	\$49.50	(\$13,680.53)
USO		.75	4.54	(\$20.00)	\$221.00	\$3,325.65
VXX		-7.46	1.59	\$1,965.00	\$1,332.50	\$3,528.62
Wtd (SPX) Subtotals		-2.74	25.07	\$1,921.00	\$1,916.50	(\$5,286.24)
Wtd (SPX) Totals				\$1,921.00	\$1,916.50	(\$5,286.24)

**FIGURE 4: Portfolio Delta with Beta-Weighting to SPX.** For illustrative purposes only.

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## The Numbers Whisperer

RACHEL CRAWFORD KNOWS WHAT TRADERS WANT. IT'S ALL IN THE NUMBERS.

Interview by Kira Brecht / Illustration by Joe Morse

• TD AMERITRADE'S RACHEL CRAWFORD dives into numbers each day to find out what traders are doing, from what part of the thinkorswim® platform they're doing it, and what their needs are for the future. She corrals and interprets this data so tech developers can prioritize new bells and whistles that align with what traders need. Through a summer job while in college, Crawford got a taste of the thinkorswim culture and was hooked. She joined TD Ameritrade full time in July 2008. As a senior business-data analyst in the Trader Group, she's built a data empire from the ground up.

In her down time she's after non-numerical adventures like mountain biking, sky diving, zip-lining, and snowboarding. And she's got one little-known secret: Crawford uses Excel at work, and for nearly every aspect of her life, including tracking the stats for her volleyball league. She even dreams about spreadsheets. If there's a number that needs corralling, she's your gal. We were pleased to have a few minutes with Rachel.

# 1

### What's a typical day for you?

I have numbers all over my screen. I'm constantly doing analytics on our trading platforms—thinkorswim, Trade Architect®, and Mobile Trader. I pull those numbers and look at what our clients are using. I get to know their trading habits, and this helps us determine what and where to improve. Where the opportunities are to make trading easier. Numbers are important, but it's the way you organize

them that counts. You can pull down mountains of data, but if your logic is incorrect, the numbers aren't telling the story correctly.

# 2

### Tell us about some new trends.

Our clients continue to trade more derivatives. In the last quarter, derivatives accounted for 41% of daily trades. Some traders are using mobile devices exclusively. Our mobile trades are about 14% of total daily trades, up 28% year over year. We used to think of mobile as a supplement traders would

use when away from their desks. Increasingly, people are trusting the mobile platform.

# 3

### How does TD Ameritrade leverage this data?

It helps us stay very connected to what our clients need. Because mobile trading is on the rise, we naturally prioritize new technology developments. We just released Market Depth for TD Ameritrade

Mobile Trader on the iOS platform, which includes Level 2 quotes. This also helps those who don't trade exclusively on mobile and only use it for a quick check-in. Another example is prioritizing projects. For example, we closely monitor exactly where on our platform people trade. On thinkorswim, for instance, the "Trade all Products" tab is one of the most popular. If that tab develops a bug, we fix that first.

# 4

### Outside of work, what's your next adventure?

I want to run a Tough Mudder—a team-style obstacle race. They're all over the country. It's a lot of running through mud pits and going over walls and swinging across monkey bars. There's even some crazy obstacle with hanging cords that zap you if you mess up.



Rachel has to do lists and a routine for everything—what she does when she gets up in the morning, what to do before she goes to bed.



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## What a Cluster!

SPOTTING POTENTIAL TOPS AND BOTTOMS GOT A LITTLE EASIER WITH THE MARKET FORECAST TOOL.

● SEASONED / **TAKEAWAY:** A tool for getting closer to tops and bottoms



For illustrative purposes only. Past performance does not guarantee future results.

• Traders yearn for that magical moment when indicators line up to deliver a crisp buy signal. There's nothing better than when the trading gods proclaim, "Back up the truck." Once or twice a year this could happen with the Market Forecast indicator in thinkorswim<sup>®</sup> applied to the broader stock market.

Fire up a chart in the thinkorswim trading platform. Under the Studies menu, select Market Forecast. This indicator is designed to help you identify buy-and-sell opportunities based on proprietary analysis across time. Looking at Figure 1, notice three time frames, represented by the Momentum (red), Near-Term (blue), and Intermediate (green) lines. Think of these lines as cycles across days, weeks, and months.

Like other oscillators, the Market Forecast has extreme values that define "oversold" and "overbought." Each line oscillates between 0 and 100. Values below 20 are oversold, and values above 80 are overbought. These oversold and overbought values apply to all three lines.

**Figure 1:** Using the thinkorswim Market Forecast indicator, notice an October 2014 bullish cluster followed a rally in the S&P 500 e-Mini (/ES) from 1850 to 2075.



**TAKE ACTION:** To access Market Forecast, log in to thinkorswim, then click Charts Tab > Studies > Edit Studies. Then type in MarketForecast.

### READING TOPS AND BOTTOMS

Stars align when all three lines of the Market Forecast are in oversold or overbought territory. These signals are known as clusters. And clusters can be powerful entry signals.

**Bullish clusters.** Looking again at the one-year, daily chart of the S&P 500 e-Mini (/ES), notice all three indicator lines "clustering" together well below a reading of 20, indicating a bullish cluster. This is where you'd look to consider bullish trades.

Short-term bottoms in the stock market tend to be events, and tops tend to be a process. When a bottom forms, it's usually within a day or two, and the subsequent rally off the bottom is fast. Such is the case with bullish clusters. When a bullish cluster appears, the market can often respond quickly.

**Bearish clusters.** Yet, tops take time to form. And it usually takes several days, or even weeks, before the market responds to bearish clusters. Bearish clusters form when all three lines of the Market Forecast are above 80. Notice the bearish clusters in November and March in Figure 1, and the time it took before the /ES eventually rolled over.

Bullish and bearish clusters are just one of several signals generated by the Market Forecast indicator. There are other ways to apply this proprietary indicator to your trading. —Words by THINKMONEY EDITORS

Nothing presented by the Market Forecast indicator should be considered advice or a recommendation. TD Ameritrade does not guarantee that the forecasts will be accurate or generate profits. TD Ameritrade is not responsible for any losses that may result from the use of the Market Forecast indicator. Results are based on historical data, theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring. Past performance does not guarantee future results.

## GLOSSARY



### Iron Condors

PAGE 19

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

### Reg T margin

PAGE 26

Formally known as “Regulation T,” it’s the initial margin requirement set by the Federal Reserve Board. According to Reg T requirements, you may borrow up to 50% of securities that can be purchased on margin.

### Naked option selling

PAGE 27

A high-risk, directional strategy in which an unhedged option is sold for a credit. The strategy assumes that the stock will stay above the strike sold if a put, or below the strike sold if a call. As time passes and/or volatility drops, the option can be bought back cheaper or expire worthless, resulting in a profit.

### Out-of-the-money

PAGE 31

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.

### In-the-money

PAGE 23

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.

### Delta

PAGE 30

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 for example, would gain 50 cents per \$1 move up in the underlying.

### Negative delta

PAGE 31

The notation of an option’s delta with a negative sign (-). Negative deltas reflect the idea that the option position will increase in value as the underlying falls in price, as would be the case of a long put or short call.

### CBOE VIX

PAGE 14

The VIX is a proprietary index of the Chicago Board Options Exchange, which measures the implied volatility (“vol”) of the S&P 500 Index (SPX) options.

### Implied volatility

PAGE 18

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.

### Vertical spreads

PAGES 19, 31

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 at 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.

# X MARKS

# THE SPOT

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TRADE SPOT FX OPTIONS

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AVAILABLE CURRENCIES



**XDA**

AUSTRALIAN  
DOLLAR

**XDB**

BRITISH  
POUND

**XDC**

CANADIAN  
DOLLAR

**XDE**

EURO

**XDN**

JAPANESE  
YEN

**XDS**

SWISS  
FRANC

**XDZ**

NEW ZEALAND  
DOLLAR



# The Trader's Guide to Summer Camps

• Look, it's not that we don't love them, but when school's out for the summer and the kids are home, sometimes they can demand attention right when you're working an order. Remember, "When a trader ain't happy, nobody's happy." So, the smart trader-parent chooses the right summer camp, not only to keep trading interruptions to a minimum, but also to give little Jill and Johnny a competitive edge for their financial future. With that, we give you this little "Trader's Guide to Summer Camps" with something to fit everyone's trading style and comfort level. *Illustration by Joe Morse*



**CAMP VOLAWAYUP**

*Discovering Volatility Camp*

• It's not enough for your kids to understand volatility, they need to live and breathe it. Your kids will be taken on an exciting emotional roller coaster where random midnight distributions of candy will be balanced by wheat-grass smoothies and meditation. And movie nights will have kids separated into the latest *Fast & Furious* offering, or a foreign-language version of *The English Patient*. This camp will leave your kids craving volatility and prepare them for trading the VIX.

**CAMP SWEATMONEY**

*Commodity Cost Basis Camp*

• Being rotated in shifts through hands-on work in feedlots, soybean fields, and silver mines, your child will learn exactly how the costs of producing physical commodities are factored into the basis for futures. Liability waivers for stampedes, fertilizer explosions, and mine collapses must accompany deposit to secure a spot.

**CAMP BITSBYTESBUX**

*Greedy Trading Robot Camp*

• Let all those other kids build friendly robots that dance to hip hop. Your kids will learn how to devise automated trading algorithms that execute arbs in pico-seconds. They'll spot mispriced securities so fast the current crop of 25-year-old Wall St. whizzes won't know what hit 'em. Securities attorney retainer included in camp fees.

**CAMP PITMONKEY**

*Pit Trading Cultural Immersion*

• Boys and girls aged 13–18 are plopped into the middle of Chicago's trading pits for the experience of a lifetime. While they learn to price seven-way option spreads in their heads, they'll be cursed at, shoved, and spit on in the ultimate trading camp experience. They'll come home with steely nerves, a surly attitude, and an extra 25 stress pounds from too much coping sugar. Looks great on college apps (weight lost by then).

**CAMP CHEBYSHEV**

*Professor Primrose's Probability Playground*

• Before they can get comfortable using trading probabilities, kids need to see them in action. Professor Primrose shows your tikesters how to figure the odds of a canoe tipping into ice-cold water. Or the odds of a wedgie happening in their lives between 8:00 and 11:00 p.m. Or the probability of 30% of the kids crying for their parents after the chin-up contest. Your child will never look at finance, or humanity, the same way again.

## 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.*

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