

# thinkMoney®/36

Random musings for traders at TD Ameritrade—SUMMER 2017



# 3

## CLICKS FROM DATA TO TRADE

YUP, FUNDAMENTALS  
EVEN TRADERS CAN USE

PAGE 16

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See page 7 for details



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COVER STORY

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## Three Clicks from Data to Trade

Traders anxiously await the release of economic data, but some economic indicators create more noise than others. Here are four to get you started. Know them, love them, consider incorporating them into your routine.

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## A Short-Term Fling or Puttin' On the Ring?

You have a trade idea but you can't decide how long you want to commit. Should it be a short-term position or a long-term one? Here's how you can align trade duration with your attraction.

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## Are You Missing the Forest for the Trades?

Are you overthinking that one trade and potentially missing the big picture? Instead of hyper-focusing on one position at a time, look at your entire portfolio and try to figure out a better hedge. Here are some tips that'll keep your head in check.

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Do you know what you're getting into before putting on that option trade? Nobody wants to be forced into buying an asset they didn't want or can't afford. Be aware of the oddities of assignment.



Cover Photograph by  
**Fredrik Brodén**

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**SKILLS  
BAROMETER:**

See a dot. Read or pass. If you've ever been frustrated spending your precious few minutes reading articles that aren't for you, these little color dots at the beginning of each article will help you skip to the stuff that matters most to you.

- EASY
- SEASONED
- PRO

**"Every day, a myriad of market and trading data info bites can drag markets up or down."**

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## The First 100 Days...

• FORGET THE PRESIDENT'S first trimester. How'd you do on your first 100 days—of trading, that is?

If you haven't done so already, it's time to give yourself a midyear review. The nice thing about being a trader is that you're your own boss and you don't have to worry about getting fired or your feelings hurt. But you still need to be fair to yourself—and honest. Analyze your winners and losers. Why did your winners win? Was it luck or was it your stellar trading skills? And did your losers lose because they were good trades gone bad or was it your own lack of discipline?

Self-reflection isn't always easy. But when you peel back the trading onion, you may discover you might be hanging on a bit too tight to your trades. Or maybe not long enough. In love or trading, knowing how long you should stick around isn't always obvious. Consider some matchmaking tips in "A Short-Term Fling or Puttin' On the Ring?" on page 20 to align direction and time with your trading needs.

Remember, it's more than the individual trades you have to look at. Each of those trades are a part of something bigger—your portfolio. When you look at it from the perspective of your portfolio, it may just open doors to creative ways to manage your positions. In "Are You Missing the Forest for the Trades?" on page 24, you'll learn that knowing your portfolio's beta-weighted greeks can take risk analysis to a new level. And the view from that higher level is eye-opening.

And it gets even more eye-opening when you go beyond your portfolio and look at fundamental data such as GDP, jobs, housing, and consumer spending. Getting comfy with Fed data may not have been on your radar, but the reality is the "dismal science" of economic data can have an impact on how certain sectors or stocks move. In our cover feature "Three Clicks from Data to Trade" on page 16,

you'll raise your awareness a notch and see things from a different view.

All told, by the time you read this, your first 100 days will be a distant memory. But by taking the time to reflect on your midyear P/L, taking a bigger-picture approach to trading portfolio analysis, and adding economic data to your bag of tricks, you could be in a better position for the rest of the year.

Happy trading,  
**Kevin Lund**  
Editor-in-Chief, *thinkMoney*



**TAKE ACTION:**

Ask a question, tell us a joke, or just give us your feedback on *thinkMoney*. Write to us at [thinkmoney@tdameritrade.com](mailto:thinkmoney@tdameritrade.com).

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**thinkMoney Back Issues:**

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# 1

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# 3

• Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. For simplicity, the examples in these articles do not include transaction costs. At TD Ameritrade, the standard commission for online equity orders is \$6.95; online option orders are \$6.95 + \$0.75 per contract. Orders placed by other means will have higher transaction costs. Options exercises and assignments will incur a \$19.99 commission.

# 4

• TD Ameritrade was ranked #1 overall out of 16 online brokers evaluated in the StockBrokers.com Online Broker Review 2017. We also rated #1 in several categories, including "Offering of Investments," "Platform & Tools," "Customer Service" "Education" "New Investors," and "Mobile Trading." Read the full article at [www.stockbrokers.com/annual-broker-review](http://www.stockbrokers.com/annual-broker-review).



Turns out, when it comes to your money,  
it's okay to be a know-it-all.

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## LOVE NOTES

LITTLE QUIPS FROM YOU TO YOURS TRULY



## Best in Show ... (To Our Inbox)

Putting money under your mattress may make it very lumpy, and that violates the rule about trading only stuff that lets you sleep at night. —**Bob**

I just taped over the camera on my laptop. I feel like I'm crazy, but I walk out of the room for exactly 60 seconds and I'm suddenly down when I had been up! 60 seconds! They're watching meeee!!! Black tape over camera is working ... account is back green. —**Tony**

A bought iron condor should be renamed an iron maiden because you're sure going to get stuck. —**Moby**

*The comments from Chat Room Pearls, right, are excerpts from chat rooms, emails, and tweets submitted by TD Ameritrade clients, and are their views and may not reflect those of TD Ameritrade. Testimonials may not be representative of the experience of other clients and are no guarantee of future performance or success. TD Ameritrade reserves the right to modify Love Notes for grammar, consistency, and similar purposes.*

## Chat Room Pearls...

*This is a wholesome family chat room. We don't get naked.*  
—JIM

*Trading on Jack D is not a bad setup as long as you don't start before 10:00 am ;)*  
—TOMMY

CHAT SWIMMER #1:  
*One thing I hate about the stock market is, "You never know."*

CHAT SWIMMER #2:  
*But that's the great thing about the stock market, "You never know."*

*Now I understand theta. I just needed to relate daily theta decay to the cost of a cup of coffee every day.*  
—SPENCER

*If I write you a check for \$1 billion and you write me a check for \$1 billion, we'd both be billionaires ... until the checks clear.*  
—JOE

*I finally figured out what that beaker icon is on top of the TOS charts. It's a libations decanter!*  
—ROD

*Walking dead has much more life than this market.*  
—SUSAN

*If you want to lose, make it spectacular ... something folks can talk about for years to come.*  
—DINA

*Maybe I got lucky. I've been totally satisfied with my losing trades. I've never had to add to one.*  
—CHARLIE

*Psst ... here's the best hot tip. There're no hot tips.*  
—PASCAL

*Trading on news is like shooting an arrow at a moving target in a hurricane!*  
—WADE

*Keep plotting lines and fibs. There're lies and there're lines. Some may be worth trading, and some aren't worth the paper they're on.*  
—YVETTE

*No more buying for me today. I can't pucker any tighter.*  
—AARON

*Sometimes you're the bug and sometimes you're the windshield.*  
—SARAH

### GET CHATTING

Head over to the thinkorswim® Chat Rooms for trading education or to cure boredom. In thinkorswim, at the top left select Support/Chat > Chat Rooms. Then join the party.



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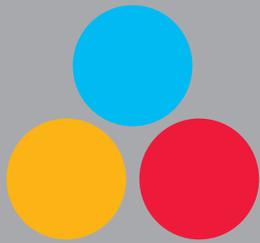
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## IN THE MONEY

A HODGEPODGE OF MARKET STUFF YOU SHOULD KNOW



• **BELL-BOTTOMS** may be a thing of the past. But they reemerged with a different name—boot-cut jeans. Very likely they'll be on their way out soon enough, only to reappear in a slightly different style with a completely different name. Just as fashion trends come and go, so do market trends.

A new trend you may have heard about is smart beta, i.e., strategies that select securities based on familiar ideas like value, growth, or volatility, as opposed to traditional index products that invest in proportion to company size. Investors and market pundits may be quick to call smart beta the hot new trend, but looking under the hood of these strategies may prove a different conclusion. In fact, the idea of smart beta or factor investing isn't a trend. It's been around as long as other ideas active managers have sought to capture for decades, such as value investing, but today the availability of technology and data makes these investment ideas available at your fingertips.

### What's Old Is New Again

When you think of diversification, you think about allocating your assets across assets like equities, bonds, commodities, or currencies. But what about understanding the forces that may drive the risk and returns of performance within asset classes and diversifying to those exposures?

As an example, within equities are factors such as value, growth, volatility, and momentum that help to drive risk, returns, and correlation—the so-called “building blocks” of asset classes.

BlackRock is a leader in factor investing, which they offer via smart beta exchange-traded funds (ETFs), among other product structures. Factors may be selected based on their different performance depending on the market cycle's phases. When markets trend up, some factors may move up, while others may move down.

“While the terminology of factor investing might seem new, the economic concepts behind them are not. Innovation in the asset management industry—made possible by advances in data and technology—has provided investors with greater access to factors, including the development of factor ETFs,” says Sara Shores, Global Head of Smart Beta at BlackRock.

INDUSTRY SPOTLIGHT • EASY

# Diversification's New Look

**BIG IDEA:** SPREAD YOUR WEALTH BY ALLOCATING IT IN DIFFERENT FACTORS.



How does factor investing fit into your particular trading world? Here are three factors that could help you ponder.

• **Momentum.** A stable economy with sustained trends means you might stick with what's trendy, until it changes. Momentum tends to be favorable when an economic cycle is expanding, and one measure of momentum is relative strength. When relative strength is strong, the current trend still has room to grow.

• **Minimum volatility.** When growth is slow and you need to play defense, get your minimum volatility gloves on. You'll need them to protect you from downside moves that could surprise you in a future crisis. Think of this factor as similar to investing in bonds—i.e., more defensive and somewhat more predictable.

• **Value.** Don your value shoes when the economy seems relatively "great." Push aside recession fears and be prepared to take on more risk. Don't confuse this kind of value with a traditional "value" fund, which is more like finding last year's trends at a bargain price. In factor investing, value means you might look to get in during a new trend's early stages. "Factor ETFs allow investors to be deliberate about these exposures and may be used to express views, complement exposures, and diversify portfolios," says Shores.

### Pay Attention

Above all, work harder to stay on top of market pace—whether the markets are in slow mode or growing quickly. Factors can help you tilt your portfolio to take advantage of opportunities in the market.

When your wardrobe—er, portfolio isn't looking so great, it may be time to try something different. It's best to be aware of and use all the tools available to help you potentially seek a positive return. —Words by JAYANTHI GOPALAKRISHNAN

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GEAR HEAD ● SEASONED

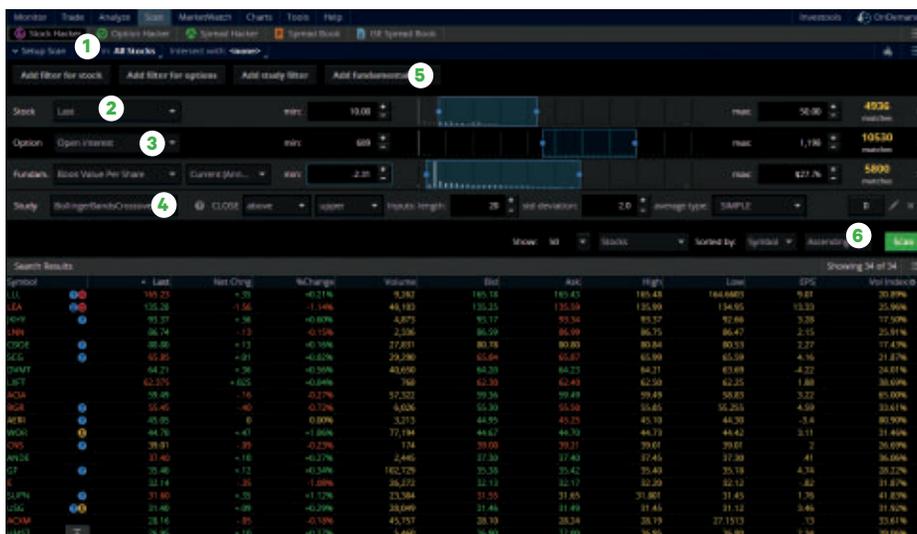
## Find New Trades

**BIG IDEA:** FINDING NEW TRADING OPPORTUNITIES DOESN'T HAVE TO BE LIKE LOOKING FOR A NEEDLE IN A HAYSTACK. GET CREATIVE WITH YOUR FILTERING TOOLS AND FOCUS ON THOSE THAT MATTER.

• It all starts at the **Scan** tab. The thinkorswim® Scan tab is a powerful and diverse tool. It allows you to scan for complex historical price analysis, make precise balance sheet queries, look for stocks that are trading at a specific price, and include option contracts that have specific number of days till expiration. There's plenty more. Here's a look at what the scan tool can do for you. It may be just a peek, but you'll get the idea, and pretty soon you'll get cozy with it. And once you've come up with your scans, you can save them, use them to auto-update watchlists, sort your scan outputs by fancy columns, and create alerts when something is added to or deleted from your scans. What are you waiting for? Gear up and start scanning.



**COOL TOOLS:** For the latest release notes and thinkorswim how-to videos, go to [tlic.thinkorswim.com](http://tlic.thinkorswim.com).



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### TAKE THE PLUNGE

The best place to begin your scan is to first filter through all the products you are looking at. This is where the Stock Hacker comes in. It's found under the thinkorswim Scan tab.

- 1 – Click the dropdown menu under "Scan in:" and select either a group of symbols or a watchlist.
- 2 – Stock filters can be added based on price, volume, and derivatives of those data points.
- 3 – Option filters are used to filter out single options. You can scan

based on any of the available columns in an option chain.

- 4 – Study filters are a technical analyst's dream. This is where charts meet the scanner. You can add any available study or one you have come up with as a filter criteria.

- 5 – Fundamental filters allow you to scan based on balance sheet queries. You can open up balance sheets for all equities that report earnings.
- 6 – Once you have selected all your filtering criteria, hit the Scan button!



# Ask the Geek

**BIG IDEA:** A LITTLE Q&A WITH **JOHN HART**, MANAGING DIRECTOR,  
TRADER PRODUCT DEVELOPMENT AT TD AMERITRADE



• **I trade earnings on companies that have a history of profitability and a market potential for moving soon. How can I stay on top of all of the companies that I might be interested in and not waste my time with hundreds of charts and hours of research?**

Here's the executive summary: Add this watchlist to your thinkorswim® platform to find the data you are looking for: <http://bit.ly/TM36earnings>.

Let's look at this in more detail. You've loaded the watchlist into your thinkorswim platform, and it's now time to tear it apart. Because this is a scan, it'll first scan all the optionable symbols. Second, it uses a fundamental filter to look at only companies that've reported positive net profit margins. Third, it limits the scan to only companies that will announce earnings in the next

**"We've focused on making the earnings trader's life simpler with a new feature that you need to check out."**

—JOHN HART  
@JOHNHART\_TDA

five days. And last, to satisfy the criteria of stocks that have a market potential for moving, the scan is limited to companies that have a market maker move (MMM) over \$1. MMM is an indicator that figures out the expected magnitude of price movement based on market volatility. It uses the stock's price, volatility differential, and time to expiration in its calculation. To make that watchlist work for you, you'll need to set up an alert so you get a push notification, text message, or email whenever a new symbol is added to that watchlist.

As luck would have it, we've focused on making the earnings trader's life simpler with a new feature that you need to check out. It's a whole new analysis mode. Take a look at the Analyze tab. You'll see a new "lightbulb" icon called Earnings. Earnings is a detailed view into a unique data set from Estimote®, a third-party company whose crowd-sourced earnings estimates tend to be pretty accurate. With this feature you can view earnings per share (EPS) and revenue estimates over the last eight quarters and track how Wall Street and the crowd have fared against the actuals. We added options volatility and stock pricing data for five days leading up to and five days past each earnings event. So, as you're picking your potential trade, whether it's a stock, risk-defined option strategy, or something more directional, you have more relevant data indexed and immediately available.

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## TICK CHARTS

Tick charts show you intraday price action in terms of the number of trades: a new bar (or candlestick, line section, etc.) is plotted after a certain number of trades (ticks) are completed. This aggregation type can be used on intraday charts. For example, the 2d 133t bar chart plots the price action for two days, defining open, high, low, and close every time the number of trades equals 133. You can specify any number from one through 10,000 for tick aggregation.

## THINKORSWIM STRATEGIES

Strategies are thinkorswim Charts' backtesting tool. They consist of systems of conditions that, when fulfilled, trigger signals to enter or exit the market. To add or build strategies, click on the Studies menu on the top right of your chart and select Edit Studies. Under the Strategies tab you will see a list of common studies you can test. To backtest the performance of selected strategies, right-click on the generated signal and select Show Report from the popup menu. This will bring up the strategy report.

## VOLUME PROFILE

The Volume Profile study shows trading activity over a time period at specified price levels. Depending upon the input-defined aggregation period, Volume Profile plots a histogram that shows price distribution and the dominant price values in terms of volume. The width of the histogram's row represents the number of actual transactions made within the price interval defined by the row's height.

CAPICHE? ● PRO

## PORTFOLIO MARGIN PART 3: Profit, Loss, and Expiration

**BIG IDEA:** EVENTUALLY, YOUR OPTION POSITION WILL EXPIRE. KNOW WHAT TO EXPECT AT EXPIRATION.



**COOL INFO:**  
To learn more about portfolio margin, watch the video at <http://bit.ly/2somW2K>

### FIGURING IT OUT

Here's an example to help explain P/L. Say you buy one share of XYZ at \$50. If the price rises to \$51, you can make a \$1 profit. If the price drops to \$49, you lose \$1. Multiply that profit or loss by the number of shares you own, and you have the total P/L.

Now, PM tests the P/L if the underlying changes. In other words, what's the P/L if XYZ drops 15%? If you're long 100 shares of XYZ at \$50, and XYZ drops 15%, the price of XYZ drops by \$7.50 ( $50 \times 15\%$ ) and goes from \$50 to \$42.50. The loss on 100 shares would be \$750.

P/L for options works the same way, except that for most equity options, when the option price changes \$1, the P/L changes \$100 because of the option's 100 contract multiplier. So if you buy one 50-strike call on XYZ for \$3, and the value of the option drops to \$2, the loss is  $1 \times 100$ , or \$100. If the call option rises from \$3 to \$3.50, the profit would be \$50.

### REALITY AT EXPIRATION

The PM algorithm calculates the theoretical value for the options in the account positions. It comes up with a theoretical P/L based on changes in the underlying price

and volatility. You don't need to figure this out, but you should know that at expiration, an option will either be **out of the money** (OTM) and worthless, or **in the money** (ITM) and worth its intrinsic value (difference between stock price and option's strike price).

Remember, the intrinsic value of a call is the prevailing stock price minus the call's stock price. The intrinsic value of a put is the put's strike price minus the prevailing stock price.

For example, if you buy a 50-strike call for \$3, and the stock is \$49 at expiration, the 50-strike call is OTM, which means it's worthless at that time. The P/L would be  $(\$0 - \$3) \times 100 = \$300$  loss.

If you buy a 50-strike call for \$3 and the stock is \$52 at expiration, the call will have \$2 of intrinsic value. The P/L on the long call would be  $(\$2 - \$3) \times 100 = \$100$  loss. If the stock is \$55 at expiration, the call will have \$5 of intrinsic value. The P/L on the long call would be  $(\$5 - \$3) \times 100 = \$200$  profit.

### EXERCISED OR ASSIGNED?

These P/L calculations assume you close the ITM option position at expiration. If an option is ITM at expiration, and is not closed before the close of trading, it will likely be exercised or assigned and turned into stock. ITM long calls and short puts turn into long stock, while ITM short calls and long puts turn into short stock. If the stock is exactly at the strike price at expiration, it's not automatically exercised or assigned. In this case, if you're long that option, you'll have to notify your broker of the intention to exercise it. And the person who's short that option doesn't know if it will be assigned because it depends on whether or not the long option holder exercises it.

Now that you have some idea of how theoretical P/L is calculated in a PM account, you'll know what to keep an eye on as your option approaches expiration. Don't end up owning something you didn't want.

*Please note that the examples above do not account for transaction costs or dividends.*

*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 increases the risk of involuntary liquidation. Client, account, and position eligibility requirements exist and approval is not guaranteed.*

*Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

• CONTINUING OUR portfolio margin (PM) series, let's look at how profit and loss are calculated, and what can be expected at option expiration.

In a PM account, a position's margin requirement is based on two things. One, how much the position might lose if the price of its underlying changes by some percentage. And two, whether volatility, that is, uncertainty about changes in a stock's value, moves. This is a stress test, which is why knowing how to calculate profit and loss (P/L), and understanding what happens to an option position at expiration, are important.

# Add performance to your portfolio

NASDAQ-100<sup>®</sup> Index Options (NDX) are  
now available for trading on Nasdaq PHLX,  
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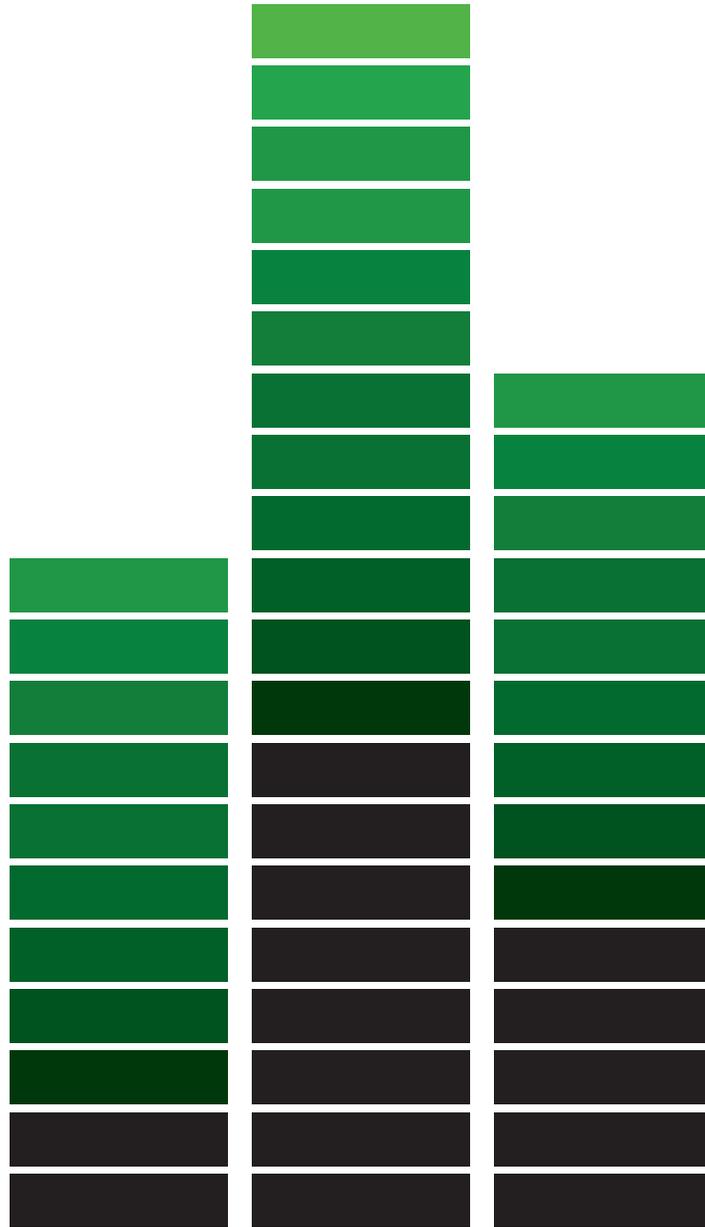
NASDAQ-100<sup>®</sup> Index Options (NDX) have been a valuable hedging  
strategy for ambitious traders over the last two decades. Why?

- NDX Options provide exposure to the most active non-financial domestic and international issuers with the largest market capitalization listed on The Nasdaq Stock Market
- Easy Profit and Loss Calculation: One index point equals \$100 (.01 equals \$1.00)
- European Style Expiration means the option can only be exercised on the Expiration date
- Cash Settlement eliminates need for delivery of underlying stock components



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# THREE CLICKS FROM DATA TO TRADE

**BIG IDEA:** TRADERS ANXIOUSLY AWAIT THE RELEASE OF ECONOMIC DATA, BUT SOME ECONOMIC INDICATORS CREATE MORE NOISE THAN OTHERS. HERE ARE FOUR TO GET YOU STARTED. KNOW THEM, LOVE THEM, CONSIDER INCORPORATING THEM INTO YOUR ROUTINE.  
WORDS BY **JAYANTHI GOPALAKRISHNAN**

PHOTOGRAPHS BY **FREDRIK BRODÉN**

● **EASY/ TAKE AWAY:** *Learn to create trading strategies based on how markets might react to economic data.*





## INNOCENTLY, YOU GO ONLINE.

You browse, you surf, you scan. Before you know it, you're lost deep in cyberspace. Just like Tom Hanks stranded in an uninhabited island in the movie *Cast Away*, with nothing but remnants of a crashed plane and what's left of the packages in the plane's cargo. Where am I? How did I get here? And more important, how do I get out of here? You try to send out flare signals, you attempt to build a raft, but nothing works and you end up feeling lost and helpless.

The markets aren't all that different. There're so many data points that you don't know which ones to use. You're confident

about when earnings and economic data will be released, but you have no idea how the markets will react to that data. The markets can feel random, and finding your way in that randomness can be a challenge. Add in all the competing opinions about how to beat the markets, and you can find yourself tangled in the "unknowing," where any trade at all gets confusing, and staring at the screen becomes a popular pastime. But escaping from the market's daily chaos is possible and desirable. All you need is a plan. And a review of a few trusted indicators.

### JUST ASK FRED

Every day, a myriad of market and trading data info bites can drag markets up or down. The good news? For a wealth of information, you can access the Federal Reserve Bank's massive economic database called "FRED" on the thinkorswim® platform from TD Ameritrade. But with so many factoids in one place, it's easy to feel lost and not know how to get back home. Go in with a plan. Above all, used properly, FRED can help you create a strategy to tackle the market with a tad more certainty. Some economic indicators are more important than others. Let's start off with four that will keep you engaged with the market, help you find possible trading opportunities, and get you to back to familiar territory sooner rather than later.

**Gross domestic product (GDP).** This is an important number that gives you a snapshot of the health of the economy. GDP can reveal the pace at which the economy is growing.

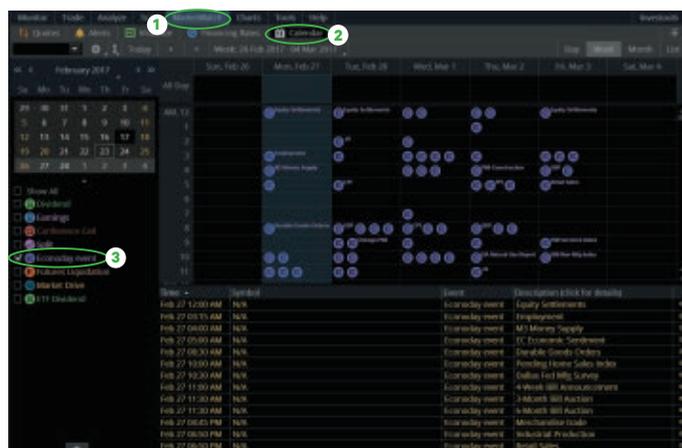
**TRADER GLOSSARY**  
TURN TO  
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Simply put, if GDP is up, people often feel good, they spend more, and that can be positive for equities. With a lower GDP, traders tend to move to bonds. Typically, GDP data affects broad market indices and blue-chip stocks, especially in

the manufacturing and transportation sectors. Keep in mind that GDP is revised constantly, so by the time you get the data, it's most likely going to lag the price movement of stocks.

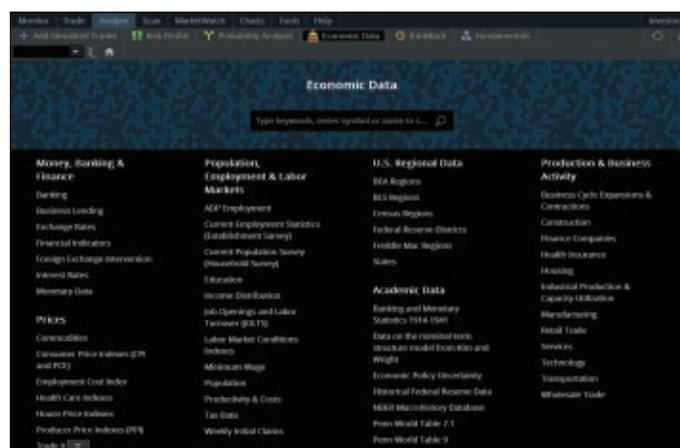
**Housing data.** Here you'll get a handle on whether consumer confidence, which churns the economy, is strong. Housing data comes in lots of shapes and sizes. You can review existing home sales, the S&P Case-Shiller U.S. National Home Price Index, the FHFA House Price Index, new home sales, and more. So, for instance, if existing home sales are up, especially if they're higher than what Wall Street expected, it's possible broader markets will move to the upside. Stocks of building-material companies, construction companies, and homebuilders are likely to be impacted by housing data.

**Jobs data.** This one's a no-brainer—strong jobs numbers are generally a good indicator of a healthy economy. Important jobs data includes total employment figures and the unemployment rate. In this category, the monthly employment report for non-farm payroll is essential. A big surprise in any of these numbers could move prices up or down. Small-caps, banks, and financial stocks are often affected by jobs data.



**FIGURE 1: Pencil it in.** When will retail sales be released? Employment data? Housing starts? Three clicks will get you there.

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



**FIGURE 2: Oh, so organized.** With so much available data, it's a good idea to have a game plan. Figure out which information is important to you and go from there.

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

**Consumer spending and retail sales.** It all comes down to how much people spend, and that's a huge giveaway on how the economy is doing. For the most part, if people spend more, it's good for the economy in the simplest terms. The University of Michigan's Consumer Sentiment Index, the Consumer Price Index, and retail sales data are some of the data points you can use to figure out if consumers are spending more.

### THE THREE-CLICK PLAN

Once you know the kind of data you're after, you can create watchlists of optionable indices, exchange-traded funds (ETFs), or equities that, historically speaking, tend to move before and after the release of economic data. Once you've got the watchlists in place, you can then apply FRED to your analysis. Let's take retail sales as an example.

#### 1. Economic Event

On your thinkorswim platform, go to the **MarketWatch** tab and select **Calendar**

(Figure 1). You'll see a list of things you can display on the calendar. Select **Econoday event** and you'll see all the economic data that will be released by day, week, or month.



**TAKE ACTION:**  
**Data at your fingertips.**  
You can find out more about the Economic Data feature by watching the video at <http://bit.ly/2rmCGmt>

#### 2. All That Data

Let's say you notice that retail sales will be released soon. Head over to the **Analyze** tab and select **Economic Data**. You'll see a list of several types of data, organized by categories (Figure 2). Browse through the list and find **Retail Trade**. Click on it and you'll find more choices.

#### 3. Pick Your Category

Say you're after e-commerce retail sales data. You'll find a chart that shows the overall movement of this number for the past 15 years (Figure 3). Notice that ecommerce retail sales have been trending higher since 2000. At a broad level, this suggests that things, for now, are looking good in the ecommerce sector.

### LET DATA BE YOUR LIFE RAFT

After all this data-crunching, let's assume you know when retail sales are going to be announced, and you know the market forecast for retail sales. But you don't know how

the market will actually react. Economic data releases, just like earnings, are binary events—either something happens or it doesn't. If you're looking to trade on this information, you open a position based on what you anticipate the price movement will be. Pull up your watchlist of ecommerce retailers prior to retail sales releases. Review the **implied volatility (IV)** of those stocks, ETFs, or indices, so you're well prepared before the release.

For example, you may find that before a data release, front-month contracts will tend to have higher IV. This could offer an opportunity to collect some premium. The number of days to expiration could be low, so you'll have to worry about **gamma risk** since **delta** could become larger in the wrong direction. You may consider keeping your position small to reduce your gamma risk, or you may want to think about going further out and sacrificing the higher premium.

You may also find from your research that IV tends to decrease after data releases and you might open a position based on how large you believe the decrease will be. Engaging neutral strategies such as **straddles** could be a possibility. Another way to trade economic events is by making short-term directional plays using weekly options. Because weeklys have short life spans, consider contracts with expirations that coincide with data release dates. Yet, always be mindful of **theta**, since expiration will come pretty quickly on those weeklys and they can be subject to significant volatility. Profits on short options can disappear quickly and can even turn into losses with a very small movement of the underlying asset.

### SIGNAL FIRES GOOD

Markets are uncertain, and there's no hard proof that studying economic indicators improves your ability to anticipate price movements. That said, information naturally makes you more aware of the bigger picture at critical points in time. Using FRED and other resources, you can more easily track the moving parts that can impact a stock's direction and behavior.

NOTHING GUARANTEES a perfect trade. But you can perfect your research abilities every day you crank up your computer and feel empowered. Then you're free to fire those signals and flag down that rescue plane. Trading can be a fascinating engagement, and life's too short to get stuck in the middle of nowhere.

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*Jayanthi Gopalakrishnan is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

*For more information on the general risks of trading and trading options, see page 37, #1-2.*

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*Past performance is no guarantee of future results.*

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**FIGURE 3: How're you trending?** Select the ecommerce retail sales indicator and you'll get a big picture of its overall historical trend.

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

● SEASONED / TAKE AWAY: *Short term versus long term—which way should you go? Here's one way to figure it out.*

# A SHORT- TERM FLING OR PUTTIN' ON THE RING?

**BIG IDEA:**

SO YOU HAVE A TRADE IDEA, BUT YOU CAN'T DECIDE HOW LONG YOU WANT TO COMMIT. HERE'S HOW YOU CAN ALIGN TRADE DURATION WITH YOUR ATTRACTION.

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



# A

cross a noisy market, crowded with symbols, your eyes meet—well, metaphorically, anyway. With a flushed face and beating heart, you discover it: that one stock or index or ETF that rises above all the others. It piques your interest and beckons with potential opportunity. Come to think of it, trading and love have a lot in common. Both involve potential risk and potential joy. Just as in romance, you might wonder how long the relationship will last. With a trade, you have to start by applying the right strategy.

## THE FIRST DATE

Option strategies, like people, are never one size fits all, and there's no one "best" approach. You can be right on a directional call, but not make as much profit as you expected. Why? You probably could have chosen a better strategy. A bullish long call **vertical** might work in one scenario where the stock goes up quickly, but not work in another where the stock rises over a longer period of time. The wrong strategy with the right stock might not yield the desired results. When you trade, first decide whether the stock might go up or down, and how long it might take to do so. Next, decide which strategy might yield the best results if you're right on direction and timing.

Just as we each have our own opinions about who makes a good life partner, two traders can look at the same stock and see different realities. You may both consider the same news,

financial data, and charts. Yet, one may see a short-term opportunity, while another sees a long-term investment. So, the first decision—direction and time—is up to you.

## GETTING TO KNOW YOU

If your first decision is about what you're going to trade, your second decision concerns how. From the start, understanding strategy mechanics will help you match trading decisions to your outlook for a stock, and give you a better idea of how the stock might respond

to changes in price and other factors.

You can use this thought process for just about any option strategy: **short calls, iron condors, straddles**, and so on. Here we'll focus on **verticals**—specifically, long verticals as a bullish or bearish speculative strategy. Verticals are a popular strategy for directional trading. They cost less than buying or shorting a stock outright, they have defined risk, and they can be flexible, letting you select strikes and expirations to suit a stock's outlook. But all verticals don't act the same thanks to different expiration times.

Consider this example. Suppose stock XYZ is trading at \$135. Earnings are coming up within a few days. You're bullish on the stock, and believe it might go up in the next week. Using theoretical values, compare a long 134/136 call vertical with seven days to expiration (DTE), trading at \$0.99, with a long 134/136 call vertical with 45 DTE, trading at \$0.98.

Assuming no change in implied vols, if the stock rallies up to \$136 in six days, the 134/136 call vertical that had seven DTE would have a theoretical value of about \$1.48. The call vertical that had 45 DTE would have a theoretical value of about \$1.07.

The stock went up \$1 in six days; the short-term vertical rose about 49%, and the long-term vertical rose about 9%.

If the stock falls \$1 in six days, the theoretical value of the short-term 134/136 call vertical drops to \$0.51, and the theoretical value of the long-term 134/136 call vertical drops to \$0.90. The short-term vertical that had seven DTE when established dropped about 48%, and the longer-term vertical that had 45 DTE when established dropped about 8%.

In both cases—stock goes up \$1 and stock goes down \$1 after six days pass—the short-term vertical had larger percentage gains and

losses. In other words, it's more volatile and gives you a larger profit when you're right (stock goes up), but a larger loss when you're wrong (stock goes down).

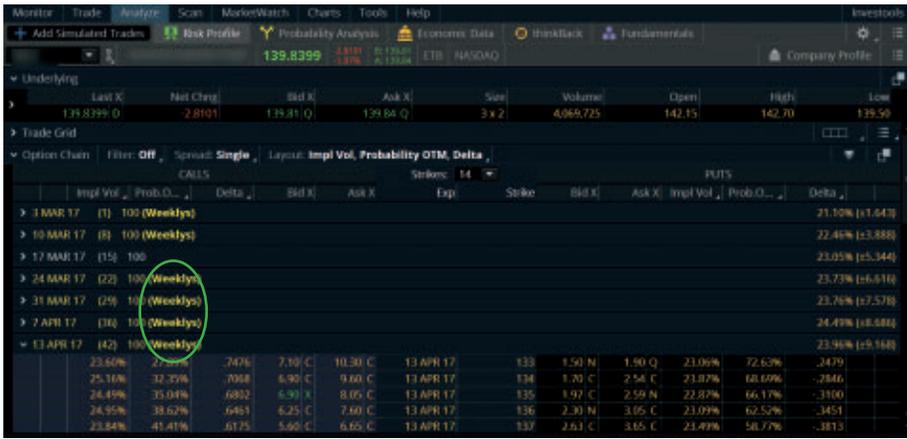
What if the stock's price is at \$135 after six days? The theoretical value of the short-term 134/136 call vertical is \$1, and the theoretical value of the long-term 134/136 call vertical is \$0.99. Both are basically unchanged. This is important when thinking about a longer-term strategy.

On the other hand, say you're bullish on XYZ, and you think it might take more than a month to rally. Neither the short- or long-term 134/136 call vertical changes theoretical value much over a week. Are you any worse off buying the short-term call vertical for a longer-term trade? Possibly so. Even though the theoretical values don't change much if the stock price doesn't change, you'd have to reestablish the short-term call vertical maybe five more times to extend the duration of the trade to match that of the vertical that has 45 DTE. That can mean five times more commissions and slippage.

The price of a vertical that's closer to expiration will respond more to a change in the stock's price, all things being equal, than a vertical that's further from expiration. This is true for verticals that are **at the money** (ATM), where one option is **in the money** (ITM) and the other option is **out of the money** (OTM), as well as OTM verticals, where both options are OTM; and finally for ITM verticals, where both options are ITM. Keep in mind the vol of a vertical's price is often higher the closer it is to expiration. That volatility works both ways, of course. Say you're bullish on a stock in the short term and you buy a call vertical with a few days to expiration. If the stock goes down, that short-term vertical will lose value more quickly.

With verticals, the greater the potential reward, the greater the potential risk. Think of that first perfect date with a globetrotter who lives half the year in another country. The ensuing relationship isn't always smooth sailing.

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**FIGURE 1: A really short-term fling.** Many stocks offer weekly options, which means you have more choices when it comes to finding an expiration to match your interest.

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

## THE FIRST FIGHT

The difference between the theoretical values of a short- and long-term vertical depends on how likely they are to be ITM at expiration. At expiration, a vertical will be worth zero if it's OTM. If both options are ITM, the vertical will be worth its full value of the difference between the strikes. And if the stock is in between the strikes of the vertical, it'll be worth the **intrinsic value\*** of the long ITM option. If you're long a vertical, you'll potentially realize the most profit if both options are ITM at expiration.

The likelihood that a vertical is ITM at expiration depends on where the stock's price is in relation to the vertical's strikes and time to expiration. For the 134/136 call vertical with one DTE with the stock price at \$136, it's ITM. And the likelihood that the stock will stay at \$136 or above over the next day is fairly high. Over those 39 days, there's a chance the stock could drop back down from \$136 to \$134 or below, to make that 134/136 call vertical OTM. That's why the 134/136 call vertical with one DTE has a higher theoretical price with the stock at \$136 than the vertical with 39 days to expiration.

Alternatively, with the stock at \$134, it's less likely the stock will rally to \$136 in one day versus 39 days. It's not impossible, it's just not as likely. That's why the 134/136 call vertical with 39 DTE has a higher theoretical price with the stock at \$134 than the vertical with one day to expiration.

Think of it this way: in most cases, the maximum value a vertical can theoretically



## UNDERSTANDING STRATEGY MECHANICS WILL HELP YOU MATCH TRADING DECISIONS TO YOUR OUTLOOK FOR A STOCK.

get to is the difference between its strikes, which happens if both options of the vertical are ITM at expiration. Before expiration, an ITM vertical will usually trade under its full value, because with some time remaining until expiration, there's a chance the stock price could change and turn that ITM vertical into an OTM vertical. The more time to expiration, the more time the stock has to do that. With less time to expiration, there's less time for the stock to move to a price that would make the vertical OTM.

The opposite is true for OTM verticals. With less time to expiration, there's less chance for the stock to move enough to make that OTM vertical ITM. With more time, there's more of a chance. The prices of verticals, then, reflect the likelihood of them being ITM or OTM at expiration, with OTM verticals with more time to expiration having higher theoretical values than OTM verticals with less time to expiration, all things being equal.

## TIME TO MOVE ON

It makes sense to match the expiration of the options to your opinion of when a stock



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might move. Many stocks now have weekly expiration options, in addition to standard expirations (see Figure 1)\*. This lets you tailor a strategy to match your risk tolerance by choosing certain strikes, while matching your market expectation by choosing a certain duration for a trade.

As always, consider the information at hand. Are earnings coming up in a few days?



**TAKE ACTION:**  
Itching to find out more on trading weeklys? Read **"Weekly Options: Stretch Them Out"** on the *thinkMoney* archives online at [tickertape.tdameritrade.com/thinkmoney/33](http://tickertape.tdameritrade.com/thinkmoney/33).

Is the Fed making an announcement the following week? Is there a significant election in the months ahead that might call for speculation? Gather up the data. Find an expiration that comes close to these col-

lective events, then match your interest to a reasonable level of commitment. Above all, analyze with clarity and trust your instincts. And don't tell the wrong jokes when you finally meet the parents.

*Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc. For more on the general risks of trading and trading options, see page 37, #1-2.*

*\*Because they are short-lived instruments, weekly options positions require close monitoring, as they can be subject to significant volatility. Profits can disappear quickly and can even turn into losses with a very small movement of the underlying asset.*



ARE YOU  
MISSING THE  
FOREST FOR  
THE  
TRADES?

MISSING

**BIG IDEA:** ARE YOU OVERTHINKING THAT ONE TRADE AND POTENTIALLY MISSING THE BIG PICTURE? INSTEAD OF HYPER-FOCUSING ON ONE POSITION AT A TIME, LOOK AT YOUR ENTIRE PORTFOLIO AND TRY TO FIGURE OUT A BETTER HEDGE. HERE ARE SOME TIPS THAT'LL KEEP YOUR HEAD IN CHECK. WORDS BY **THOMAS PRESTON**

PHOTOGRAPHS BY FREDRIK BRODÉN

**ASSUME YOU'VE ACHIEVED THE EXPERTISE OF A TRADING MACHINE. YOU KNOW THE STRATEGIES. YOU'RE ON TOP OF THE MARKET. YOU SEE A STOCK MOVE, CHECK ITS VOL, PUT ON A TRADE. YOU MANAGE YOUR CAPITAL AND RISK EFFICIENTLY ON EACH ONE, AND HAVE A SOLID REASON FOR EVERY DECISION. THAT PRETTY MUCH DEFINES AN EXPERIENCED, ENGAGED TRADER. BUT THERE'S ONE THING EVEN VETERANS CAN MISS. IN THE DAILY PROCESS OF FINDING AND PLACING TRADES, SOMETIMES THE TRADER FORGETS THAT ALL THOSE TRADES ADD UP TO SOMETHING UNIQUE. THEY CREATE A PORTFOLIO.**

#### SEE THE BIG PICTURE

Long-term investors often create portfolios around different ratios of asset classes. An option trader doesn't necessarily think about asset classes, but rather a series of **verticals**, **calendars**, **straddles**, and so on, in whatever stock or index presents potential opportunities. Each strategy, for example, might be used within certain parameters for risk, probability, **theta**, and **implied vol**. And even though each of those strategies may make sense on an individual basis, an option trader should step back and take a look at the entire portfolio she's created. Because quietly, in the background, the portfolio itself might be building up **delta**, **vega**, or even theta to undesirable levels. In a word, the sum of the parts creates a whole with its own rules.

Sounds a little like Frankenstein's monster, right? Well, stay away from the percolating chemicals and lightning rods and use the tools

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that the thinkorswim® platform by TD Ameritrade provides, like the **beta-weighting** tools on the **Position Statement** section of the **Monitor** tab. Why? Because that's where all your current positions along with various parameters are visible.

First, look at beta-weighted greeks. Click on the "Beta Weighting" box and enter the symbol for an index that roughly covers most of the symbols in your position. For example, are most of your trades in large-cap stocks? Then S&P 500 Index (SPX) might be a good beta-weighting symbol. Small-cap stocks? Russell 2000 Index (RUT) might be a better choice.

#### FLATTEN DELTA

The first thing to review is your portfolio's beta-weighted delta. That reveals how many deltas your portfolio theoretically has in terms of the beta-weighting index. For example, suppose a portfolio shows a beta-weighted delta of -127 (see Figure 1). Theoretically, the portfolio would lose \$127 if the SPX rose \$1, and it would make \$127 if the SPX fell \$1.

Assume the SPX might move up or down 20 points or more, and the short 127 deltas might be more risk than you'd like. So, how to reduce it? There are a couple of potential approaches using index options. Long delta strategies like long call verticals and short put verticals in SPX would potentially reduce the short portfolio deltas. To what degree depends on which vertical you choose, and how many were traded. You can simulate adding long delta SPX positions to your portfolio on the **Analyze** page to see how much a particular SPX strategy would help reduce deltas. This is more of a longer-term delta reduction—meaning you may not want to reduce your portfolio deltas to zero, but just flatten them somewhat while still maintaining most of your bearish, negative-delta stance.

On the other hand, consider an index option strategy that would neutralize the portfolio delta more aggressively ahead of a major event. In that case, you might choose to take on greater risk on the index side—

short naked puts, for example—where one trade could add enough positive deltas to take the portfolio delta from -127 to zero. It's a short-term event and you're on top of your positions. No naps allowed!

This is a tactic floor traders often use when they don't want risk to get in the way of new potential opportunities that a big event might provide. And most feel it has to be a simple trade to execute—no complex spreads. The cool thing is that you can do this analysis the night before, and if you decide to, you can quickly incorporate it the next trading day if needed.

What if you look at the market and all you see are bearish opportunities? If you put on bearish trades, you would potentially only increase your portfolio's negative deltas. Maybe you could try to find some bullish strategies by using scanning tools like **Stock Hacker** and **Option Hacker** to find stocks you might not be currently following. If you're a contrarian trader, for example, you might try to find a stock near its 52-week low to investigate a bullish strategy. Or you could find positive delta trades with certain vol or stock-price parameters.

#### DRILL DOWN

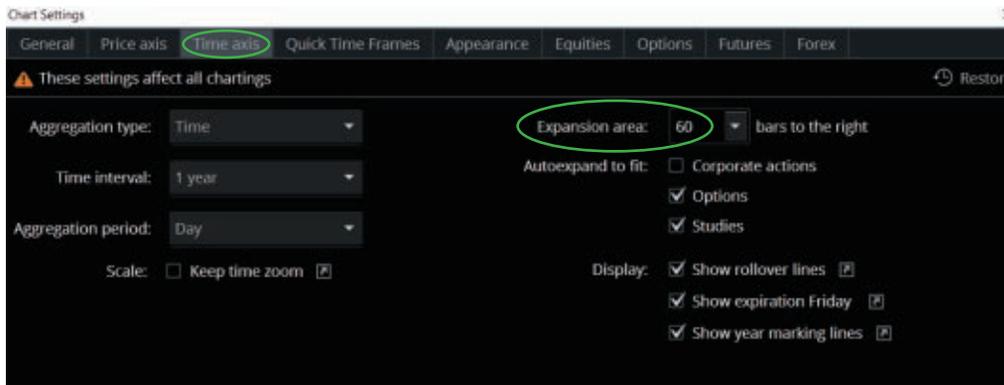
Maybe you don't want to open any more positions. We've talked about balancing risk between individual positions—that is, keeping the beta-weighted deltas of individual positions roughly the same. Here's another way to look at them. Sort your positions by their trade time, and think about taking off those you've held the longest—meaning, first in, first out.

Why? As time passes, the conditions on which you based the trade might have changed. You may not want to hold a position that you wouldn't want to establish as a new trade. Arranging positions by time, which you can do on the **Position Statement**, lets you take a hard look at the positions you've had the longest. Even if you decide not to close a position, you'll want to at least review it and reassess the logic of the trade. Again,

Instrument	Qty	Delta	Theta	Vega
Wtd (SPX) Subtotals		-127.43	212.60	-938.50
Wtd (SPX) Totals				

**FIGURE 1: What's your risk?** If your portfolio has a delta of -127, it may be more risk than you want. Figure out what strategies will flatten that delta.

Source: TD Ameritrade. For illustrative purposes only.



**FIGURE 2: Any announcements ahead?** You can tell your charts to display upcoming earnings releases by setting the expansion area to a specific number of days.  
 Source: TD Ameritrade. For illustrative purposes only.

you can do this type of analysis outside of trading hours so it can become a potential plan for the next trading day.

### CRUSH TIME DECAY

Speaking of time, that's where the next step—portfolio theta—comes into play. The nice thing about portfolio theta is that anyone can add them together and not weight them. That's because one day passing is the same no matter what's being traded. And theta is a dollar term that measures the decay in the

**extrinsic value\*** of a portfolio's options. Theta, then, is in the same scale for all products, so it's kind of self-weighting. All things being equal, the theta of an option in a higher-priced stock will most likely be higher than that of an option on a lower-priced stock. That's why you

can compare theta directly between trades without adjusting them again for underlying price, like you would do for delta.

For portfolio theta, what's key is time to expiration. If the portfolio's theta is \$212, the portfolio would theoretically make \$212 over the next day due to time decay, if nothing else changes. Generally, theta is highest the closer an option is to expiration. Is that positive theta high because most options in the portfolio are expiring in the coming days? Or are the options diversified over time, with some close to expiration with very high theoretical theta, and others further from expiration with lower theoretical theta?

By balancing theta over time, you avoid big theta swings as expiration approaches and passes, while attempting to diversify across events. If you see most of your positive theta positions clustered around one expiration, or around a significant news event, your



**QUICK TERMS**  
TURN TO PAGE 31

short options might all go against you at the same time and wipe out your theta. You could attempt to roll short options to nearer or further expirations to spread theta out. Rolling those short

options out to further expirations can preserve the same trading logic of the original position, while maintaining a steadier theta for your account.

A quick way to check for earnings events on a symbol is to project future dates on **Charts**. Click on the **Style** button on the Chart, then choose **Settings** from the drop-down menu. Next, click on **Time axis**, and find the **Expansion area** (Figure 2). Set it to 60, for example. That will expand the right-hand side of the chart and let you see any event announcements coming up.

### NEUTRALIZE VOL

Finally, check your portfolio's vega. If it's negative 938, that means your portfolio would theoretically lose \$938 all else equal, if the implied vol of each option in your portfolio rose by exactly one percentage point. Vegas are added together, just like theta. The only warning is that the implied vols of the stocks and indices in your portfolio may not always move up and down at the same time. So, portfolio vega is typically a rough estimate. But if the market crashes and sends **VIX** through the roof, it's possible that the implied volatilities of all symbols in your portfolio might go up, too.

If you have a lot of short vega, see where the VIX is. If it's low, ask yourself if you want to be short volatility when the risk of a spike may be high. To reduce short vega, consider adding long options in further expirations to create **calendars** out of some short options. On the other hand, long delta trades in VIX

options, like **long call verticals**, could also help offset losses if vol rises and hurts your short vega positions.

Just like hedging delta risk, identify the one trade—whether it's a positive vega index trade or a VIX trade—that will potentially neutralize the short vegas if necessary.

### COMBAT RISK

Keep in mind that all these adjustments incur commissions, so making a lot of them can drive commissions higher. But the goal of this exercise is to get you to step back, look at the aggregate delta, theta, and vega risks of your total portfolio, and create a plan to bring them back to where you're comfortable. When you need the hedge, chances are the markets will be moving, and you'll want to focus on that.

Tear a page from the market maker's playbook. Do your homework the night before, and take action to attempt to manage risk and stop the bleeding when needed. Above all, consider all the moving parts of your book. Frankenstein's shinbone connected to his knee bone, so he was careful to nurture them both.

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*Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

*Naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance. Examples presented in this piece are for educational and illustrative purposes only.*

*Investors cannot directly invest in an index.*

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# LOOK

**BIG IDEA:** DO YOU KNOW WHAT YOU'RE GETTING INTO BEFORE PUTTING ON THAT OPTION TRADE? NOBODY WANTS TO BE FORCED INTO BUYING AN ASSET THEY DON'T WANT OR CAN'T AFFORD. BE AWARE OF THE ODDITIES OF ASSIGNMENT. WORDS BY **KEVIN LUND**  
PHOTOGRAPHS BY FREDRIK BRODÉN

● **PRO / TAKE AWAY:** *Educate yourself about the risks of getting assigned and avoid surprises.*



**BEFORE YOU...GET ASSIGNED**

# Fortune cookie says, “Pay close attention.”

Maybe your hairdresser was drunk, but you ignore the results. Or, half asleep, you buy a case of tube socks on TV even though shipping fees cost more than the product. Or you bravely concoct Alfredo sauce with no recipe ('cause your mom could). In the long run, ignorance can be tricky. Like getting assigned on a short option. If you’ve ever held a short option position through a **covered call\***, or **iron condor**, you know there’s a risk of early assignment—i.e., you could be forced to buy or sell stock when the short option you sold is **exercised**. Instead of guessing when you might get assigned on a short option position, let’s explore the science behind “early exercise” so you can potentially get ahead of the unexpected. (And learn to put down the remote.)

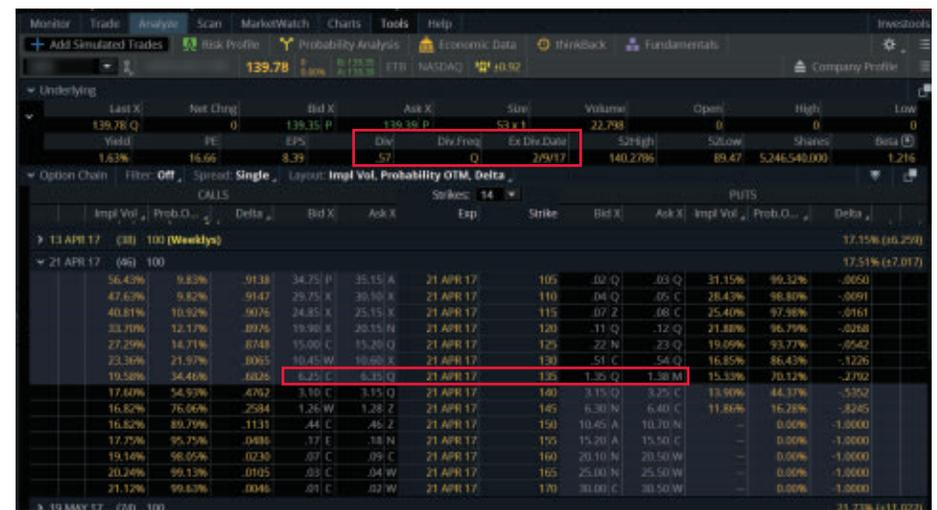
## WHAT’S REALLY IN THE BOX?

You know that an option gives you the right but not the obligation to buy or sell stock at a set price. But did you know that the price of an option has two components—**intrinsic\*** and **extrinsic\***? In the case of exercising an **in-the-money (ITM)** long call, you buy the stock at the strike price, which is lower than its prevailing price. In the case of a long put that isn’t being used as a hedge for a long stock position, you short the stock for a price higher than its prevailing price. You’ll only capture an (ITM) option’s intrinsic value if you sell the stock (after exercising a long call) or buy the stock (after exercising a long put) immediately upon exercise. If you don’t, you take on all of the risks associated with holding a long or short stock position. So, the question of whether a short option might be assigned depends on if there’s some perceived benefit to another trader exercising a long option that you happen to be short.

Fortunately, there’s a method to the madness.

## SYNTHETICS: BEHIND THE CURTAIN

When you’re short an option, you need to put yourself in the shoes of the person who’s long that option. Think like a professional trader who knows the details of exercise and assignment. If you’re short an option that’s ITM, the other trader who’s long the option might exercise it. If it’s **out of the money (OTM)**, it’s less likely. By exercising an option, the trader converts a defined-risk call or put into long or short stock, which could



**FIGURE 1: What if you get assigned?** Check out the value of an OTM put and ITM call of the same strike price. If you’re trying to see whether your short ITM call might be assigned, compare the price of the OTM put to the expected dividend.

Source: TD Ameritrade. For illustrative purposes only.

carry more risk. So, the other trader will likely want to hedge that stock by creating a synthetic. In the options world, synthetics are constructed from a short list of elements: calls, puts, and stock.

Say a trader exercises a long call and takes delivery of long stock. Let’s say he then buys a put at the same strike as the call he just exercised to create a **synthetic long call\***. If a trader exercises a long put, he creates a short position, i.e., deliver stock you don’t own. He’ll likely buy a call at the same strike as the long put he just exercised to create a **synthetic long put\***. If you want to see if an ITM short option might be assigned, you have to look at the corresponding OTM option at the same strike (Figure 1).

Because the synthetic option contains long or short stock, capital requirements for the synthetic position could be considerably

greater than those for the long call or put option.

Let’s look at the cash flows around exercise and synthetics. If you exercise a long call, you have to pay for the stock with cash from your account. Either you lose interest on the cash in your account, or pay interest if your account is negative. For example, if you exercise a long 30-strike call with 10 days to expiration and the interest rate is 2%, the interest would be  $(\$30 \times 0.02 \times 10) / 365 = \$0.0164$ . Note that the interest isn’t calculated on the \$3,000 the strike represents. That’s because you want that interest number to be in terms of the option’s price.

Next, look at the price of the 30-strike put with 10 days to expiration. To create the synthetic long call, you'd have to buy that put. If the 30-strike put is trading for \$0.20, you'd pay \$20 for it. But like interest, you'd use only the \$0.20 put price in your analysis. Add the cost of the interest to the cost of the put to get the cost of exercising that call, which in this case is  $(\$0.0164 + 0.20 = \$0.2164)$ .

Say the 30-strike call is trading for \$2.25 with the stock trading at \$32. If the trader exercises that call, he's giving up that \$0.25 of extrinsic value. And if you add in the \$0.2164 to create the synthetic equivalent call, it means exercising that call doesn't make much financial sense.

Hang in there, because life gets interesting when stocks pay a dividend. If the dividend is greater than the cost of the interest plus the cost of the 30 put plus the cost of any lost extrinsic value, then there may be a financial advantage to exercising the call. This usually happens close to the ex-dividend date.

A trader would have to exercise that long call on the day before (or earlier than) the ex-dividend date to be eligible to receive the dividend. You should monitor your short calls closely, especially as the dividend date approaches. Know how much the dividend is, how much extrinsic value your short calls still have, and the premium value of the corresponding OTM put.

You can do it all on the **Trade** page of the thinkorswim® platform from TD Ameritrade. You can see past dividends, the price of your short call, and the price of the put at the call's strike price. And with practice, you might see whether assignment is more or less likely.

### STORM THE FINE PRINT

If you have a covered call that's ITM and it's assigned, you'll deliver the long stock out of your account to cover the assignment. And you'll have to pay the assignment fee.

If you have a call vertical where both options are ITM and the ex-dividend date is approaching, you may want to exercise the long option component before the ex-dividend date to have long stock to deliver against the potential assignment of the short call. You may end up paying two exercise/assignment

fees. Or you could close the ITM call vertical before the ex-date. It might be cheaper to pay the commission to close the trade.

If you have a **call vertical** where the ITM option is short and the OTM option is long, you may want to consider closing the position or rolling it to a further expiration before the ex-date. You'd do this to avoid having short stock on the ex-date and being liable for the dividend.

So, if you're long an ITM call, it may be better to close it ahead of the ex-date rather than exercise and create the synthetic. That's because on the ex-date, the price of the stock drops by the amount of the dividend. The drop in the stock price offsets what you'd earn on the dividend, and you'd still have to pay commissions and fees on top of the price of the put.

### GET SMART: EARLIER

Make every attempt to get nerdy and shrewd about early exercise. And avoid potential surprises like "European-style options"—they're typically associated with indices and can only be exercised at expiration. As you know, you can't own an index. So an index option can only settle to cash, not a tangible product. Going further, cash settlement means that if you own an option that expires ITM, you get the difference in cash between the stock and strike price. If you're short the option, you must pay the difference. Most indices trade European-style options and are cash settled. One exception is the OEX (index options traded on the Standard & Poor's 100 Index), which has its own rules.

### PROBE THE RISK

When your option is converted to stock through exercise or assignment, your position's risk profile naturally changes. This could increase your margin requirements, or you may be subject to a **margin call\***, or both. This can happen at or before expiration during early assignment. Ironically, exercise of a long option position can be more likely to

## QUICK TERMS\*

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

**Covered Calls** - A limited-reward strategy constructed of long stock and a short call. Ideally, you want the stock to finish at or above the call strike at expiration, in which case, you'd have your stock "called away" at the short call strike. In this case, you would keep your original credit from the sale of the call as well as any gain in the stock up to the strike. Breakeven on the trade is the stock price you paid minus the credit from the call.

**Extrinsic Value** - Difference between market price and intrinsic value.

**Intrinsic Value** - Difference between the stock price and option's strike price.

**Margin Call** - A margin call is issued when your account value drops below the maintenance requirements on a security or securities due to a drop in the market value of a security or when you exceed your buying power. Margin calls may be met by depositing funds, selling stock, or depositing securities. TD Ameritrade may forcibly liquidate all or part of your account without prior notice, regardless of your intent to satisfy a margin call in the interests of both parties.

trigger a margin call, since naked short option trades typically carry substantial margin requirements.

Early exercise can be tricky, and you can still be assigned on a short option any time prior to the option's expiration, even if you think there's no financial benefit for doing so. Educate yourself fully about "early" anything. And never wear those tube socks first thing in the morning. Tube socks should only be assigned after hurricanes and nasty basement floods.

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*For the sake of simplicity, transaction costs are not included in the examples above but should be considered before placing any trade. Transaction costs for trades placed online at TD Ameritrade are \$6.95 for stock orders, \$6.95 for option orders plus a \$0.75 fee per contract. Options exercise and assignment fees are \$19.99.*

*Examples presented are provided for illustrative and educational use only and are not a recommendation or solicitation to purchase, sell or hold any specific security or utilize any specific strategy.*

*Rolling strategies, 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.*

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## It's the "Klinker" and He's Got Your Back

SOMEONE'S WATCHING HOW YOU PLAY WITH RISK. SO RESIST THE TEMPTATION TO TOY WITH EVERYTHING ON YOUR PLATE.

Illustration by Joe Morse

• YOU CAN SPOT Peter Klink from a mile away. He walks tall, literally, and chances are he'll be wearing his "dress for the day" outfit. With his years of experience as a floor trader at the CBOE and CBOT, he brings a lot to the table, especially when it comes to risk. He took on the role of Risk Manager at TD Ameritrade in 2008, and is now Director of Exposure Management and Modeling. In option-speak, that means he makes sure traders don't over-leverage themselves. He's also played a role in developing, marketing, and portfolio margin trader education. —Interview by JAYANTHI GOPALAKRISHNAN

# 1

**Your title sounds heavy-duty. What does it involve?**

I'm part of the Financial Risk Management (FRM) and my team provides the firm's overall markets exposure tests for all products that're traded on our trading platform. In part, we provide stress tests for customers' exposure to the products they trade. We have to make sure there's enough collateral in the customer's account to handle their exposure. We want our customers to be long-term traders and not be wiped out on a one-day market event.

I'm proud to say we have a solid team of quants who develop models to

measure and monitor risk and financial exposure

We also continue to enhance our market exposure models as we analyze trading products and provide risk tools to optimize risk mitigation.

# 2

**How does this touch the self-directed trader?**

There's a lot more to risk than the margin requirement of positions based on traditional fixed percentages or strategy rules that don't incorporate option pricing models with implied volatility. We provide our customers with the same exposure models in real-time as we use for the firm stress test and provide a range of

risk tools across the thinkorswim® platform. This allows traders to move stock or vol around so they can see what type of loss could occur.

We make sure our quants sit next to the thinkorswim trade desk. This way they can see what's going on with our traders so they understand how it all works.

# 3

**Speaking of floor trading, what's with the pumpkins on your trading jacket?**

I used to trade futures, and my acronym was PKP. The futures clerk would call me "pumpkin," so a couple of guys got me a pumpkin jacket. It worked

out. I still have the jacket and wear it during Halloween for fun.

# 4

**Give us three golden rules for trading.**

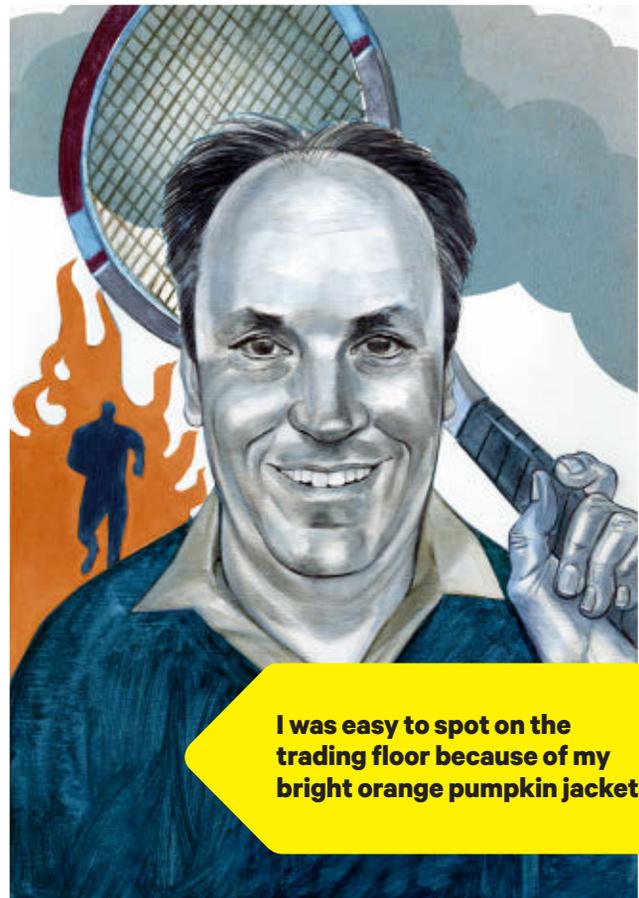
First, don't risk your whole account on one trade or position. Every day brings new challenges and adventures. Second, make sure your market exposure using margin and leverage strategies are small enough to take advantage of market opportunities. You want enough ammo in reserve. And third, know what you're trad-

ing. One nice thing thinkorswim users can do is always ask questions. We have a lot of experienced traders on our team. They're happy to help.

# 5

**Playing tennis is one thing, but completing a tough mudder is quite a feat. What possessed you to do that?**

I remember thinking the morning of the competition that it was a bad idea—12 miles and 22 obstacle courses—but somehow, I finished it.



**I was easy to spot on the trading floor because of my bright orange pumpkin jacket.**



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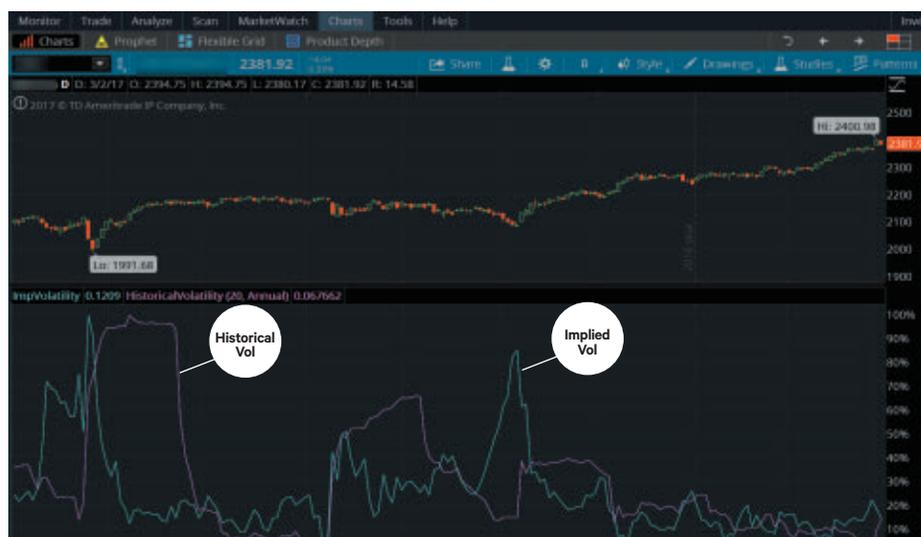
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## Historical or Implied—What's the Diff?

LOOKING AT BOTH MAY HELP YOU DECIDE IF THE MARKET'S EXPECTATIONS ARE REALISTIC OR WAY OFF BASE.

● **PRO / TAKE AWAY:** Figure out if volatility is on track or has veered off course.



**FIGURE 1: Historical and implied vol overlay.** Place one on top of the other so you can see when and how the two move together or differently. Source: TD Ameritrade. For illustrative purposes only.

• **VOLATILITY IS LIKE A SUNSET.** You've seen one, you've seen 'em all, right? Well, yes and no. Sure, volatility ("vol") means how much the price of a stock or index might change. High vol suggests the market anticipates bigger potential future price changes. Low vol means the market anticipates smaller future price changes. Simple enough. But there are in fact two main volatilities you'll typically encounter—historical and implied. And although they both refer to a price change's potential magnitude, they're calculated and employed differently.

Whether historical or implied, vol is always a percentage, and usually an annualized number. If vol is 20%, for example, a stock or index might be 20% higher or 20% lower in a year's time. Further, vol is a standard deviation of price changes. So theoretically, in one year, the stock will be within +20% and -20% of its prevailing price approximately 68% of the time. The stock will theoretically be within +40% and -40% approximately 95% of the time, and within

+60% and -60% approximately 99% of the time. Statistically, vol is one standard deviation. But that's about as much as historical and implied vols have in common.

### IT'S HISTORY. OR IS IT?

Historical vol is based on price changes for a stock or index over a period of time. That time can be a year, 10 days, or any time period. It doesn't change for a given set of data, because a stock's past price changes are what they are.

To calculate historical vol, you'll have to do some mathematical calculations, but don't sweat the heavy stuff. Historical vol is available on the thinkorswim® platform by TD Ameritrade as a study on the **Charts** tab. Select **Studies > Add Study > All Studies** and find **Historical Volatility**.

### THE PRE-CHECK

Implied vol or IV is a tad more complicated to calculate. It still uses the stock price in its calculation. Unlike historical vol, though, IV

is always changing because option prices shift constantly, depending on how the market anticipates future price moves.

If you think a stock might make bigger price changes, option prices increase, which in turn increases implied vols. Conversely, if you don't anticipate big changes, option prices decrease, which decreases implied vols.

Analyze historical vol to see how volatile a stock or index has been in the past, and implied vol to see how volatile the market anticipates a stock or index might be in the future. Compare the two to determine if one is higher than the other. For example, if you believe historical and implied vols should follow each other up and down, but you notice that implied vol is higher than historical, that could suggest implied vol overstates a stock's potential price change. If implied vol is lower than its historical counterpart, that could suggest implied vol is understating potential price changes.

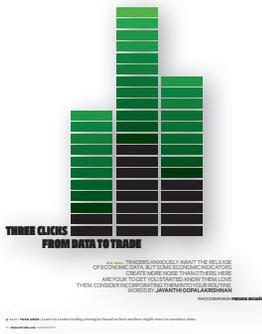
Getting your mind around vol isn't a trading strategy per se, and you shouldn't base decisions solely on the movement and relationship of historical and implied vols. But comparing them may help you peer into how the market feels.

For a fuller picture of historical and implied vols, add them on **Charts** (see Figure 1). By default, the two studies appear on separate panels. But if you go to the **Edit** studies section and click on the up-facing arrow on the lower study, it'll move it to the same panel as the upper study. This overlays historical and implied vol data.

With a little practice, you can mine vol territory fairly quickly for potential insights. Again, use implied vol to see what the market might be thinking, but turn to historical vol to see if the market may have veered off track. Think of it as checking the weather before you leave the house. You can't control a downpour. But you can grab an umbrella and be a little more prepared. —Words by THOMAS PRESTON

*Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.*

## TRADER JARGON



### Iron condor

- A defined-risk, short spread strategy, constructed of a short put vertical and a short call vertical. You assume the underlying will stay within a certain range (between the strikes of the short options). The goal: as time passes and/or volatility drops, the 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.

### At the money (ATM)

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.

### Calendars

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

### Delta

A measure of an option’s sensitivity to a \$1 change in the underlying asset. All else being equal, an option with a 0.50 delta (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.

### Gamma

A measure of what an option’s delta is expected to change per \$1 move in the underlying.

### Implied volatility

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

### In the money (ITM)

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.

### Out of the money (OTM)

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.

### Exercise

When the holder of an option exercises their right to buy or sell as stated in their contract.

### Short calls

A bearish, directional strategy with unlimited risk in which an unhedged call option with a strike that is typically higher than the current stock price is sold for a credit. The strategy assumes that the stock will stay below the strike sold; in which case, as time passes and/or volatility drops, the call option can be bought back cheaper or expire worthless, resulting in a profit.

### Straddle

A trading position involving puts and calls on a one-to-one basis in which the puts and calls have the same strike price, expiration, and underlying asset. When both options are owned, it’s a long straddle. When both options are written, it’s a short straddle.

### Beta weighting

Standardizing a portfolio’s positions into one unit.

### Theta

A measure of an option’s sensitivity to time passing one calendar day. For example, if a long put has a theta of -0.02, the option premium will decrease by \$2 per option contract.

### Vega

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

### Vertical, Call Vertical, Long Call Vertical

A vertical is an option position composed of either all calls or all puts, with long options and short options at two different strikes. The options are all on the same stock and of the same expiration. Long call verticals are bullish and composed of call options. Call verticals are composed of call options.

### VIX (CBOE Volatility Index)

The de facto market volatility index used to measure the implied volatility of S&P 500 index options. Otherwise known to the public as the “fear index,” it is most often used to gauge the level of fear or complacency in a market over a specified period of time. Typically, as the VIX rises, option buying activity increases, and option premiums on the S&P 500 Index increase as well. As the VIX declines, option buying activity decreases. The assumption is that greater option activity means the market is buying up hedges in anticipation of a correction. However, the market can move higher or lower, despite a rising VIX.

## 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 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* (<http://www.optionsclearing.com/about/publications/character-risks.jsp>) before investing in options.*

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

# 2

### OPTION STRATEGIES

*Trading options involves unique risks and is not suitable for all investors.*

*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 a 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

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# Surviving a ROAD TRIP with non-traders

• It's summer, and time to jump in the SUV for that classic road trip—the stuff of movies and serious bonding. Unless, of course, you're a trader. In which case, the prospect of facing endless highways with no one to talk greeks to and no warp-speed access to futures prices is a form of torture that should be outlawed by the Geneva Conventions. But if you're strong-armed into the experience, consider this road map of handy strategies to survive the ordeal.



## FAKE A LITTLE GASTROENTERITIS

• Study the symptoms. Practice a worried look. The night before you set out, set the stage with comments like, "Can't wait to go! Just hope this infection clears up in time!" So when you need to complete a trade on the go, your buds will sympathetically pull over so you can presumably "take care of business" at the rest stop with the finest Wi-Fi.

## THROW AROUND THE WORD STOCHASTIC

• The full explanation of Brownian motion quiets even the most talkative companions. Naturally, traders find the reasons why we subtract volatility squared, divided by two, from the risk-free rate to model asset-price behavior fascinating. But most non-traders respond with "sleepy toddler" face.

## COLONIZE THE BACK SEAT

• Claim your hideaway. Remind your pals that, statistically, the front seat is the most dangerous, and you'd prefer that the odds of survival be on your side. Plus, there's only so much eye contact the driver can make through the rearview mirror.

## MAKE ROADSIDE ATTRACTIONS YOUR FRIEND

• Time your visits to gift shops and scenic cliffs around key trading times and scheduled Fed announcements. Local attractions can have the best Internet service as well as comfortable seating. Stretch these stops by urging companions to snap hundreds of vista pics.

## AVOID BEVERAGES AND SALTY SNACKS

• Balancing a soda while typing a symbol with one hand is a recipe for disaster. Thirst discouraged. Stick to creamy fillings. You can drip the goo from cheap pastries on your lap or laptop without doing serious damage. Load up on the stuff with a shelf life of 1,000 years. Trader's orders.

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