

thinkMoney/04

• random musings
for thinkorswimmers
Fall 2008



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Do Adjustments Really Work?

The idea of "fixing" a good trade gone bad certainly appeals to one's psyche more than acquiescing to a loss, but unless said fix is a better trade than the first, beware of chasing terds.





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In option trader-speak, the adjustment is that magical elixir that revitalizes a broken trade and makes all the pain go away. But does such a thing exist? It's all about perspective and a few good ideas.

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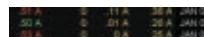
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Ever wonder what the fearless but fruitless French leader would say about the markets were he alive today? Well, in case you did...



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08

A Quick Howdy

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edit.



The last thing you want to do when new rules are being written is dwell on the past.

"Swimming Naked" for some TOS-style tips on avoiding the same mistakes so many others have made before you.

A year ago our cover feature discussed something we cheekily dubbed "umbrella trading", or how to trade a falling market. Not that we were clairvoyant or anything. We just subscribe to the idea that even a blind squirrel finds a nut now and again, so it pays to collect as many nuts as possible when the day of reckoning comes. And come it has. But whether you've profited or periled during the recent market malaise, maybe it's time to simply push the big red "Easy" button, shore up your trades and reset your plan going forward. That's what any level-headed trader would do in the midst of a sizeable drawdown; because, as they say, *Contra paratum vix fortuna vires habet* (Against the prepared man chance scarcely has power).

Happy trading!

• **We want to hear from you! Please send your thoughts and opinions to editor@thinkmoneymag.com**

Holy \$***!

Sure, the proverbial writing may have been on the wall, but this??

The obvious question on everyone's mind right now is, Where do we go from here? But, since we're not in the business of predicting the future, it's probably best to just state the obvious: Volatility is here to stay, and ain't goin' anywhere for a while. For traders, this means that those seeking out gains in a manic market ought to find solace in one of two

things: staying in cash or *carpe diem* (seize the day). After all, the last thing you want to do when new rules are being written and new opportunities abound is dwell on the past.

And while we're feeling linguistically frisky, traders might also heed the advice, *memento mori* (remember that you are mortal), which simply means don't kick yourself too hard for decisions gone awry during the market's misgivings. In fact, now might be a good time to think about how to fix your broken trades, or at least ask if there is such a thing. This issue's cover feature, "Do Adjustments Really Work?" provides some insight into the fact vs. fiction debate on this very hot option topic. And before you go diving into any naked option strategy in today's environment, be sure to check out the feature

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Feature #1

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cov.
story

**DO
ADJUSTMENTS
REALLY
WORK?**

**WHEN NOVICE
TRADERS TALK ABOUT
"ADJUSTING"**

**A POSITION, THEY'VE
USUALLY GOT A
LOSING TRADE.
BUT IS**

**THERE REALLY
SUCH A THING AS
A POSITION THAT FIXES
EVERYTHING?**

**TEXT BY
THOMAS PRESTON
PHOTOGRAPHS
BY FREDRIK BRODÉN**

Feature #1

Photograph by
Fredrik Broden

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IMAGINE THE FOLLOWING:

The underlying index has blown through the long strike of one side of an **iron condor** you have on. The stock on your position has gapped down on what was expected to be bullish news. The market's up, but your long calls are down from time decay, and volatility is getting crushed. How do you save the trade?

Rookies look for some magic bullet, some secret technique, that will turn that loser into a winner. Sorry, folks, it doesn't exist. The only thing that will help is if the stock or index makes a favorable move, or implied volatility goes your way, or if the space-time continuum starts working backward and they add some time decay back to your long options.

But if that were all there were to say, it would make for one short article. So, if you have a losing trade, what are your choices?

1. Close it and take the loss.
2. Hold onto it and keep your fingers crossed.
3. Turn it into a position that you think has a better chance of making money in the future.

In other words: The adjusting trade turns the position you currently have into the position you want to have.

Say what? OK, you have a position on (long stock, **short call vertical**, iron condor, whatever), and it might be making money or losing money. That really doesn't matter. What matters is that your current position can make money only if what you think will happen in the future actually hap-

STRATEGY BOX:

Iron Condor A market-neutral, limited risk-strategy, comprised of a short put vertical spread and a short call vertical spread. The strategy assumes the underlying will stay within a certain range (between the strikes of the short options), in which case, as time passes and/or volatility drops, the spreads can be bought back cheaper than the credit taken in or expire worthless, resulting in a profit. The two breakeven points at expiration are calculated by adding the total credit received to the call strike and subtracting the credit from the short put strike.

Short Vertical A directional spread strategy with limited risk, composed of an equal number of short (sold) and long (bought) calls or puts in which the short strike is closer to the money than the long strike of the spread, resulting in a credit taken into the trader's account at the onset. Short call verticals are bearish, while short put verticals are bullish. The risk in this strategy is typically limited to the difference between the strikes, less the credit taken in. The trade is profitable when it can be closed as a debit for less than the credit that was taken in.

Long Calendar Spread

A market-neutral, limited-risk strategy, done by selling an option (typically front-month) and buying an option with a more distant expiration date of the same class (i.e., calls or puts). The strategy assumes the underlying will remain relatively unchanged during the life of the trade, in which case, as time passes and/or volatility drops, the short option decays faster than the long option. A profit results when the spread can be sold for more than its original debit.

pens (stock goes up, stock goes down, stock stays the same, volatility goes up, etc.). So, if you are bullish on a stock, but your position won't make money unless the stock goes down, then why do you have that position on? Get out of the bearish position and put on a new, bullish position. In other words, adjust.

SO, WHAT DO YOU WANT?

For example, let's say you thought a stock that was \$48 might go down (or at least not go up), so you sold a 50/55 call vertical. If the stock rallies and you turn bullish and think the stock might go past \$60 by expiration, one adjustment would be to buy a 50/60 call vertical to turn your short 50/55 call vertical into a long 55/60 call vertical. The 50 short call in the original trade is offset by the purchase of the 50 call in the new, adjusting trade. The adjusting trade, then, is buying the 50/60 call vertical. It's the most efficient way to convert the position you have into the position you want to have. In one transaction, you turn your bearish short call vertical into a bullish long vertical. But is it easy? No. The logic demands that you know what position you want to have going forward. OK, you have some position on now, but what position do you want to have on in the future? Think of it as starting out with a new trade, not "fixing" a bad one. That forces you to think critically about each position all the time—both winners and losers.

THE NO-BRAINER

An example of a good adjustment would be buying back short options that are trading for, say, .05 or less. You might have sold an iron condor in an index or ETF, it's close to expiration, and the underlying has stayed in a range. All the options in the trade are now much cheaper—0.00 bid—.05 ask. If you are short an option that is 0.00 bid—.05 ask, it can't make you any more money beyond that last .05. Is it worth holding on to that short option, which can't generate any more profit for you than it already has, and hope that the underlying doesn't make a huge move in the last few days before expiration? I don't think so. So, you buy back the cheap call and put for .05 (or less) apiece, capture your profits, and eliminate the risk. That's a risk-averse adjustment. Still, if you don't have an opinion on what the stock or index might do next, you might be best off with no position at all. In that case, the adjusting trade is a closing trade.

ADJUSTING TIME

Taking it one step further, adjusting your current position into something else means you have to go through the trade identification process all over again. And if the new trade isn't well thought out, you're probably taking unnecessary risks. Now let's say you start with a **put calendar**, but the market moves higher, away from the strike of the calendar. You could "roll" the short month put to a higher strike to create a diagonal (i.e., buying back the lower strike while simultaneously "rolling" up, or selling the higher strike), which would increase your time decay, but also increase the risk if the index moves back down because you sold a put vertical as an adjustment. It's not that it's a bad adjustment, but you have to recognize the additional risk you're taking in exchange for a bit more potential



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FOR SOME
MAGIC BULLET
THAT WILL
TURN THAT
LOSER INTO
A WINNER.
SORRY, FOLKS,
IT DOESN'T
EXIST.

profit—in addition to any losses you've already incurred.

Also, whether the adjusted trade makes money or not, you will be paying additional commissions and slippage. Those two things can be a big drag on your trading performance. Too many adjustments just send your trading costs higher, while the adjusting trades may or may not be profitable. That's why you have to pick and choose your trades very carefully.

This article assumes that you aren't trading too big, and that you're using good risk management strategies. The adjustments are to be approached with the cool, detached intellect of a trader under control.

GETTING COMPLICATED

Let's look at a more advanced example. Going back to our index or ETF iron condor, maybe everything looks good until the market sells off sharply and the index is in between the long and short put strikes—not what you want to see. What are your choices? Assuming that you still believe that the index could rise back up into the profitable range for the iron condor, you could simply hold on to the position and keep your fingers crossed. If you think the index might rally back, but want to reduce your loss if it

stays where it is or even moves down toward the long put strike, here are two suggestions.

1. You could simply take off part of the position, say half. You would buy back half of your iron condors, lock in a partial loss on the trade, and maintain the balance going forward. If the index moves back up, you make a reduced profit. If the index moves down, you reduce your loss.

2. If you want to be more creative, you could buy a put calendar at the long put strike. Keep in mind that a calendar spread rises in value when the underlying is close to the strike price at expiration. For example, if you are short a SPY Dec 130/131/141/142 iron condor and you are concerned that the SPY might go to 130 and sit there (lousy for your iron condor), you could buy a Dec/Jan 130 put calendar. If the index moves down to 130, which is bad for the iron condor, it is simultaneously moving toward the strike of the put calendar, which is good. The profit on the put calendar would offset the loss on the iron condor. If the index rises so that the iron condor is profitable again, the put calendar could lose. To counter that, you could ratio the quantity of put calendars to iron condors. If you had 10 short iron condors, you could buy, for example, 5 put calendars. The 5 calendars would offset the loss if the index moves lower, but wouldn't reduce the profit on the iron condors as much if the index rallies. All that depends on the price of the calendar spread and your opinion of volatility—i.e., you would have to like buying that calendar spread as a trade all by itself.

IN SUM

Adjusting trades doesn't mean you have to learn all sorts of new options positions. Far from it. But it does demand discipline and the willingness to take your ego out of the picture. If a trade that you worked so hard to find and execute isn't working for you, and doesn't look like it will in the future, take it off, or replace it with something else. Use a common-sense approach. No matter how much lipstick you smear on that pig, you don't want to marry it.

• The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple-option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting Scott Garland at 773-435-3270 or 600 W. Chicago Ave. Suite 100, Chicago, IL 60610.

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15 ltrrs.

Dear Swim

Forget about letters to the Editor. Here's a few nutty ones you sent to our trading desk.

Photograph by
Fredrik Broden

• Well, I'm on day number 3 here of being stuck in Thailand, and it's not looking good. It's Sunday and all flights are canceled—protesters still on the runway. I'm going to sit tight and see how things play out until Tuesday. Tuesday I will rent a car and start driving, maybe to Kuala Lumpur ... or, I hear Vietnam is nice this time of year! Bright side is I am the one of the tallest people in this country. Downside—that's probably why they will eat me first. The natives are restless my friends!

Don Kaufman

TOS Chief Diminutive Instructor

• Can you make your main site more iPhone friendly? I literally rear-ended someone in stop-and-go traffic while trying to download a Wednesday chat.

Wes

• I have no computer. What to do?

Jonathan

• Either you guys are getting even better, or I'm finally understanding what you're talking about. You mentioned synthetics today. Next week, could you in your inim-

itable style address what to do with them? Morally (I know, I know: what does that have to do with trading), you cannot refer me to more dry reading material. That @#\$\$%^&monkey is already hanging by a literal thread desperately waiting for TOS to set up a shelter for battered critters.

Karen

• I was wondering, can't I use thinkdesktop to make omelets? You make me feel you're not brokers—strange, isn't it? Well done.

Urso

• Your letters continue to warm the cockles of our hearts and fry our minds. Keep 'em coming. Send your questions to Dear Swim at editor@thinkmoneymag.com. Go ahead—ask us anything!

• The comments above are excerpts of e-mails submitted by thinkorswim, Inc. clients as their views and may not necessarily be that of thinkorswim, Inc.

• Your piece on "Prayers Fail to Help Traders Stem Losses" reinforces something I tell Christian friends taking up the trading game, often to their consternation. Just what is G_d supposed to do when "for every buyer there is a seller" and there is someone on the opposite side of each trade wanting the stock to do just the opposite of what you want it to do? "Pray for wisdom, discernment, patience, and a healthy balance of both greed and fear, but don't expect much else unless you are on God's A-list." Sacrilege?! Perhaps.

Bob

• Thought I'd let you know that I actually made a trade today while at 40,000 feet in Mr. Perot's Wi-Fi-equipped Gulfstream! The platform works as well as the plane!

Bill

• While I was learning option strategies in 2005, intuitively I felt that option strategies provide enough mental exercise so that it is highly likely that option traders will not get Alzheimer's. I am hoping that someday, someone will do a scientific study to test this hypothesis.

Ishwar

Correction Time:

OK, every once in a while, even we screw up. On page 30 in the last issue of thinkMoney (issue 03), we incorrectly stated that long calls and short puts have negative deltas, while long puts and short calls have positive deltas. The reverse is in fact true: long calls and short puts have positive deltas, while long puts and short calls have negative deltas.

16

Volatility Watch

Analyzing the markets through the eyes of volatility, sans charts.

•OK, the world has changed. No, I'm not talking about the disappearance of certain financial firms, or the socialist-tinged government bailout of private companies that make money through free markets. I'm talking about volatility. Using the CBOE's VIX volatility index as my proxy, the implied volatility of options is high and not likely to come down anytime soon.

My contention is that the VIX is mean-reverting—up to a point. Mean reversion is a term used to describe a situation where the price of a stock, index, or volatility oscillates around some average level, or mean. When the price goes up, it tends to come back down to that average, and when the price drops, it tends to rally back to the average. You can say the VIX does that. If it spikes up, it tends to settle back down. And if it drifts lower, something causes it to shoot higher, back to the mean. Then “the world changes”, and the VIX moves up or down to a different mean, and proceeds to oscillate around that new mean. You can see this same behavior in the CBOE's VXD DJIA volatility index, the VIXN NASDAQ volatility index, and the RVX Russell 2000 volatility index.

For example, look at any chart of the VIX in January, February, and July of 2008. It spiked up over 30% on fear and market weakness. But it slipped back to the low and mid 20s after a couple days, and resumed trading around that lower average until the next spike. But this fall, when the

financials were taken lower by their mortgage-related holdings, the market collapsed, and again, the VIX jumped over 30%. The difference now is that the VIX hasn't fallen back to its previous levels. That clued me in that a new mean might have been established.

The VIX option prices seem to give a different indication of where the VIX might go, however. You can use the VIX options to calculate a synthetic VIX future, which can show you what market makers think the VIX will be at a future expiration. Pick a strike price of the VIX options in a particular expiration month, take the strike price, add in the price of the call, and subtract the price of the put. That gives you the price of a synthetic VIX future. At the time of this writing and with the cash VIX at 55%, the October VIX synthetic future is 50.7%, the November is 36.2%, December is 31.8%, and January 2009 is 30.6%. Clearly,



For more ideas on how to navigate and trade these volatile markets, go to the Trader Lounge archives by following the path to [thinkorswim.com](#) > Support > Option School > Chat Archive.

VIX traders think volatility will be lower over the next few months, and may feel that the “crash of 2008” is over. I still would wait a bit before I could decide what the new range might be, but with implied vols higher overall, credits for market-neutral, defined-risk, premium-selling strategies are all higher than they were a few weeks ago. That means that they are a bit more attractive considering their risk/reward ratio. The bigger the credit, the lower the risk, and the larger the potential profit. And if you think that volatility might drop, the credits for those strategies will fall if that happens.

Be careful if you are just getting started in option trading, when simply buying calls and puts is the most alluring strategy. When volatility is relatively high, buying options doesn't make much sense because the high volatility makes option premiums more expensive, and sensitive to a drop in volatility. Shorting options as part of defined-risk option spreads when volatility is high is a good alternative. Of course, the higher current volatility might increase the possibility of big price swings that kill the market-neutral positions. So, either way, proceed with caution!



vol.

Moving to Higher Ground

Words by **Thomas Preston**
Photograph by **Fredrik Broden**

• The keeper of volatility climbed higher to get a better view from the top. And he just might stay there awhile.



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TOS News+Views

A hodge-podge of stuff that matters to you (or so we think)

Recently Released Toys

The new Active Trader interface

- lets you trade market-maker-style with single-click sell orders on the ask price and buy orders on the bid price. In addition to being able to see the bid and ask sizes in a "ladder," you can track the live profit/loss of your position while you trade.

Reduced margins

- for intraday futures positions are available for accounts with net liquidity over \$15,000. If you are a futures day trader, and promise to close those positions out before the bell, you are eligible for substantially lower margins. If you do hold positions overnight, the standard futures margins will be applied to your account, and any margin calls that result must be met immediately.

Customizable position grouping

- on the Monitor page lets you separate trades and symbols and put them into a

group to monitor the profit/loss and risk. You can move an executed trade, or all the positions in an underlying symbol, to keep track of its performance. You can also sort positions by spread type and time of execution.

TRADER TALK

Miasisorias (my-ass-is-sÿr-i-us) noun:

The painful condition a trader develops over time in his derrière, brought on by years of being firmly planted in a seated position for 6.5 hours every trading day.



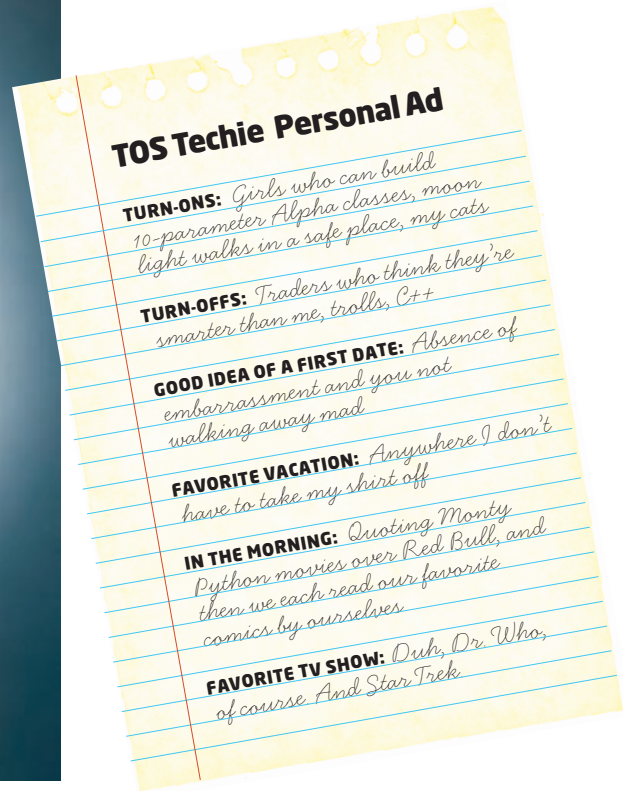
INDUSTRY SPOTLIGHT

The Year the Financials Died

It's official: The American taxpayer will be footing the bill for all the mortgages owned and guaranteed by Frannie Mac—er, Fannie Mae and Freddie Mac, now that the US Treasury has taken over these two companies. How big is the bill going to be? Not even Treasury Secretary Paulson would hazard a guess. But \$100 billion is the number being kicked around. So, what will the average American get for our collective generosity? While the mortgage crisis has been one of the heaviest burdens on the faltering US equities market, this government guarantee of FNM and FRE debt probably won't do much in the short term. Despite falling mortgage rates,

it isn't necessarily getting any easier for people to get home loans. If people aren't getting mortgages, it's hard to argue for a rebound in the housing market. And if the housing market continues to be weak ... Both FNM and FRE are sub-\$1.00 at the time of this writing, which indicates that traders think that the companies' troubles will continue for some time despite the Fed's backing. The takeover is structured so that the government will be paid back before a penny goes to the shareholders.

The question going forward is, Will banking and finance regulators will make meaningful changes to the capital and reporting requirements for these types of companies so that we can avoid a toxic mortgage market in the future? Our next President may be making that decision for us. Until then, volatility and weakness may continue in the financial sector.



fyi.

TOS TOYS COMING SOON

Time and sales artificial intelligence and machine learning to predict future stock movement • orders based on technical studies and indicators • performance graphs on thinkBack • technical scans • customizable account reports.

Pot Shots

Rating our favorite non tradable events

KEY:

2 Buy Tickets =



1 Buy Ticket =



1 Sell Ticket =



2 Sell Tickets =



Hurricane Season:



Gustav, Hanna, Ike—Who names these things, the von Trapps?

High point: None wiped out New Orleans

Low point: Did the media actually want the hurricane to hit?

Democratic Convention:



Who can name the order of the Obama's columns?

High point: Why can't Brian Schweitzer run for President?

Low point: Hillary didn't tackle Obama during his acceptance speech.

Republican Convention:



Didn't Tom Cruise play Maverick in *Top Gun*?

High point: Lipstick and pitbulls? Sounds like Saturday night at Michael Vick's

Low point: Boring white guy after boring white guy.

Fannie, Freddie, Lehman, WaMu, Merrill, AIG:



And you thought missing one mortgage payment wouldn't be a big deal?

High point: We never could get jobs at those fancy places. Now we're glad we didn't.

Low point: We're feeling in need of a personal bailout, but Paulson won't return our calls.

Carry on Luggage Fees



How much underwear do I really need for this trip?

High point: Southwest hedges fuel costs and snickers at competition.

Low point: Class warfare in the air as the rich dominate the overheads and the poor lose their bags.

WHEN IT COMES TO CURRENCIES, THE WORLD TURNS TO PHILADELPHIA



NASDAQ OMX PHLX World Currency Options® and PBOT World Currency FuturesSM are easy to understand, easy to trade, easy to manage and are specially engineered to work for individual investors. With small-sized trading units and settlements in U.S. dollars, along with fully electronic order entry and execution, they might just mesh with your trading needs today. To see if they're a good fit for you, visit www.nasdaqtrader.com/wco.

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Options and Futures involve risk and are not suitable for everyone. Prior to recommending or trading the NASDAQ OMX PHLX World Currency Options or PBOT World Currency Futures products, be sure to contact your firm's compliance department regarding registration, qualification and approval requirements at your firm

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Hey Monkey!

Got a question about anything? Ask Monkey, our resident primate.

Or visit the Monkey Brains blog at www.thinkorswim.com

Illustration by
Brian Cairns

mkly.

Q: Hey Monkey, I hear you chimps are really strong. What can you bench?

A: This monkey and sweat do not mix. But you know, my dad's first job when he got to this country was tossing drunks out of a boxing ring at a traveling carnival. He earned \$1.50 a night, which wasn't bad in those days for an ape right off the boat. That's how he met Mom. She was an extra on *Planet of the Apes* and caught Dad's act when his show went through LA.

God bless 'em. They worked so hard to save up enough money to stake my first trading account. I ran that \$500 up to \$600, then lost it all on a long bet in Qualcomm. And now I'm doing this... Mom, Dad, I'm sorry.

Q: Hey Monkey, are short sellers evil?

A: Oh, jeez. A few banks go out of business and everybody freaks out...Look, here's how it works. If I want to short stock, my clearing firm goes and borrows the stock for me to so that I can sell it. The clearing firm borrows it from someone else (usually an entity like another clearing firm) who is long the stock, and pays that person/entity some rebate amount or interest rate in exchange for the benefit of borrowing the stock. So, the long stock is simply lent to the person who is short the stock, whether that person shorted the stock as a trade by itself, or was assigned on a short call or exercised a long put. Now, if a stock can't be borrowed by the clearing firm, it's known as "hard to borrow". That means you have to ask the

clearing firm to see if it can borrow the number of shares you want to short. If it can't find any, you're out of luck and you can't short the stock. All this locating and borrowing and yada, yada has to happen by the third business day after the transaction (known as "T+3"). What the recent SEC ruling was about was "naked" short selling, where nobody bothers to locate, borrow, or deliver the stock by T+3. Some places were letting big customers get away with that. And when the market started to crap out, in particular the financials, the SEC steps in and says they can't do that anymore. If you don't deliver the stock by T+3, you're toast. I'm all for playing by the rules. But was short selling, naked or otherwise, responsible for the market's, or even a particular stock's, drop? I don't think



For more Monkey business, visit the Monkey Brains blog for daily market wraps and trading ideas at www.thinkorswim.com by going to the path Support tab > MonkeyBrains Blog.



A few banks to out of business and everybody freaks out...Look, if a company stinks, it's not because of short sellers.

so. If a company stinks, it's not because of short sellers. Let's face it — short sellers didn't force the banks to take on all that mortgage risk. And if the short seller is wrong, and gets caught in a short squeeze if the stock starts to rally, he gets creamed. So, the rules should be enforced, and as long as short sellers, and buyers, don't break the law, may the best trader win.

Q: Hey Monkey, do you wear a bathing suit at the pool?

A: First off, guys over 25 should not, I repeat NOT, be allowed to bathe in public unless they're accompanying their own, small children. They are just way too ugly. I am a guy, and I'm, well, north of 25. I stick by the pool-side bar, where any self-respecting male will find himself.

Q: Hey Monkey, I heard someone talking about "taking the weekend out" of the options. What does that mean?

A: Because you can't trade options

over the weekend, market makers will begin lowering their bid/ask prices for options on Friday to account for the time decay (theta) that theoretically occurs over the weekend. Theta is based on calendar days, so rather than allow someone to hit their bids and stay short over the weekend to collect some time decay, the market makers lower prices to reflect some time "coming out" of the options over the weekend. Hence, the term.

thinkMoney/04

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Calendar
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Icon Illustrations by
Randall Watson
•

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mmmmm....

Option Trading

Calendar 2009





25

Feature #2

thinkorswim.com

Photography by **Fredrik Broden**

Why Commissions Don't Matter

WHEN CHOOSING
A BROKER, TRADERS
TEND TO TRIP
OVER PENNIES
ON THE WAY TO
DOLLARS. MAKE SURE
YOU'RE GETTING
WHAT YOU NEED,
AND NOT JUST
"CHEAP" COMMISSIONS
THAT MIGHT
ACTUALLY COST
YOU MORE IN
THE LONG RUN.

SURE, THAT'S AN INTERESTING TITLE

coming from a broker that generates its revenues from commissions clients pay to trade on its platforms. But when you look at what makes a retail trader successful, commissions are a relatively small part of the equation. How many traders who have lost money can say that they would be profitable if it weren't for commissions? A simple mirror check would render taxi-cab confessions ranging from a lack of trading know-how and poor order execution skills, to paying expensive fees for platforms that provide tools that can usually be had for free elsewhere.

If you think about your trading as running a business, commissions are simply part of the costs. Think of them as an overhead expense necessary to keep the lights on. Now, no one can blame you for trying to get the lowest commission costs possible. That's natural. However, at the risk of sounding like a bad cliché, you get what you pay for, and trading is no exception. If the dirt-cheap commissions don't come with someone to help the next time you make a mistake entering an order, or when you don't understand why your position is losing when you thought it would be profiting, or are wondering just what implied volatility really means, then maybe they're not as cheap as you thought. While getting the lowest possible commission from a broker that offers no platform, tools, or support may work for some traders, it might be worth considering paying slightly more for a better product. Only when all of the parts are added together, along with commissions, can a trader make an informed decision about with. We thought of four that mattered.

Cost of Execution

One of the major things that new traders overlook is that with solid execution skills, you can significantly reduce your overall trading costs. Slippage is the term used to describe the difference between the fair value of a stock or option (measured by the "mid" price or average of the bid/ask spread) and the price where you actually buy or sell it. For example, if I want to sell a call against my long stock (covered call) to generate some income, and I see the bid/ask of that call is 1.05 – 1.20, the fair value of that call is 1.125. If I sell that call at 1.05, I give up .075 in slippage. That translates into \$7.50 of money that I give up to the market makers for each call that I sell. Over time, that cost can far exceed the amount of commissions.

Now, if your broker assists you in getting a better execution price, either by teaching you how or by working the order on your behalf, you can cut your slippage dramatically. If I use a limit order to sell that same option at 1.10 and get filled at that price, which is quite possible in certain circumstances, my slippage is only .025 or \$2.50 for each call that I sell. That reduces my execution costs by two-thirds. Now, just work the math that applies to you. Take the number of contracts you average per trade, divided by the number of trades you average per day/month/year, and you'll start to get a clearer picture of where your money might really be going. Unless I'm working with a very expensive broker that charges \$5 per contract, the amount of money that I can give away or save in terms of slippage can be much greater than the commissions charged.

Cost of Tools

Another pitfall for new traders is their willingness to write a check or charge a credit card to get as much information and as many tools as they can to try and make the best trading decisions. Too often, the vendors offering this information and tools charge a lot of money—

sometimes thousands of dollars per year. That money is also a trading expense, and should be viewed relative to commissions.

Companies that charge money for live quotes, option analytics, stock scanning tools, or advanced charting features may certainly be offering something of great value. But it's worth your while to see if your broker offers these things for free, and does so even if you don't trade much.



As brilliantly neutral as this article is, we thought you might like a little help with your due diligence. Just follow the path to **thinkor-swing.com** > **why thinkor-swing.**

3

Cost of Hidden Fees

When you're just in the learning phase of your trading career, you may not be trading actively, or even at all. You don't want to be surprised by any platform charges or inactivity fees that some companies charge if you don't trade enough in a given month. Ultimately, those charges eat into your potential trading profits and increase your overhead expenses. Though it's probably in micro-print somewhere, most traders are unaware that these days, more and more brokers are charging fees for canceling orders, which adds up—especially as you learn how to work orders like a professional and need to cancel and replace limit orders frequently. So, read the fine print of all the brokers and vendors you work with. Make sure that they don't lure you in with low commissions, only to make it up with hidden fees.

(The Real) Cost of Commissions

One of the interesting things going on in the trading industry is that some brokers are allowing you to pick your own commissions schedule. As crazy as that may sound, it simply reflects the fact that the differences between brokerages' commissions are, for the most part, cosmetic. With one broker it may be cheaper to buy five calls, but more expensive to sell ten iron condors when compared to another broker. It might be cheaper to buy 10,000 shares of stock with one broker or 500 shares at another. Most of us can't forecast exactly how many options or shares of stock we'll be trading, so commissions tend to average out over time. Rather than having a single, complex commissions structure that they try hard to distinguish from everyone else's, smarter brokers let you choose from any one of their direct competitors' rate plans.

WHEN YOU LOOK AT WHAT MAKES A RETAIL TRADER SUCCESSFUL, COMMISSIONS ARE A RELATIVELY SMALL PART OF THE EQUATION. HOW MANY TRADERS WHO HAVE LOST MONEY CAN SAY THAT THEY WOULD BE PROFITABLE IF IT WEREN'T FOR COMMISSIONS?

If it's the only thing keeping you from getting the tools, support, and service you require to trade, don't let commissions stand in your way.

The Sum of the "Hole"

With the explosive growth in online trading and more and more online brokers vying for your business, it seems they want you to think that cheap commissions are the most important thing in trading. But as retail traders become more experienced and sophisticated, it is likely that firms will try to differentiate themselves based on what they have to offer customers—like the range of their trading platforms for desktops, browsers, or PDAs; their support staffs' industry experience; and the breadth of the educational programs they offer, from investment basics for newbie traders all the way to advanced strategies for veterans. It's in these areas that real differences exist between brokerage firms. A retail trader can look at these and make a decision based on how much a given broker can offer her versus the commissions she'll pay. A smart choice can make the road to trading success much smoother.

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Feature #3

Photograph by
Fredrik Broden

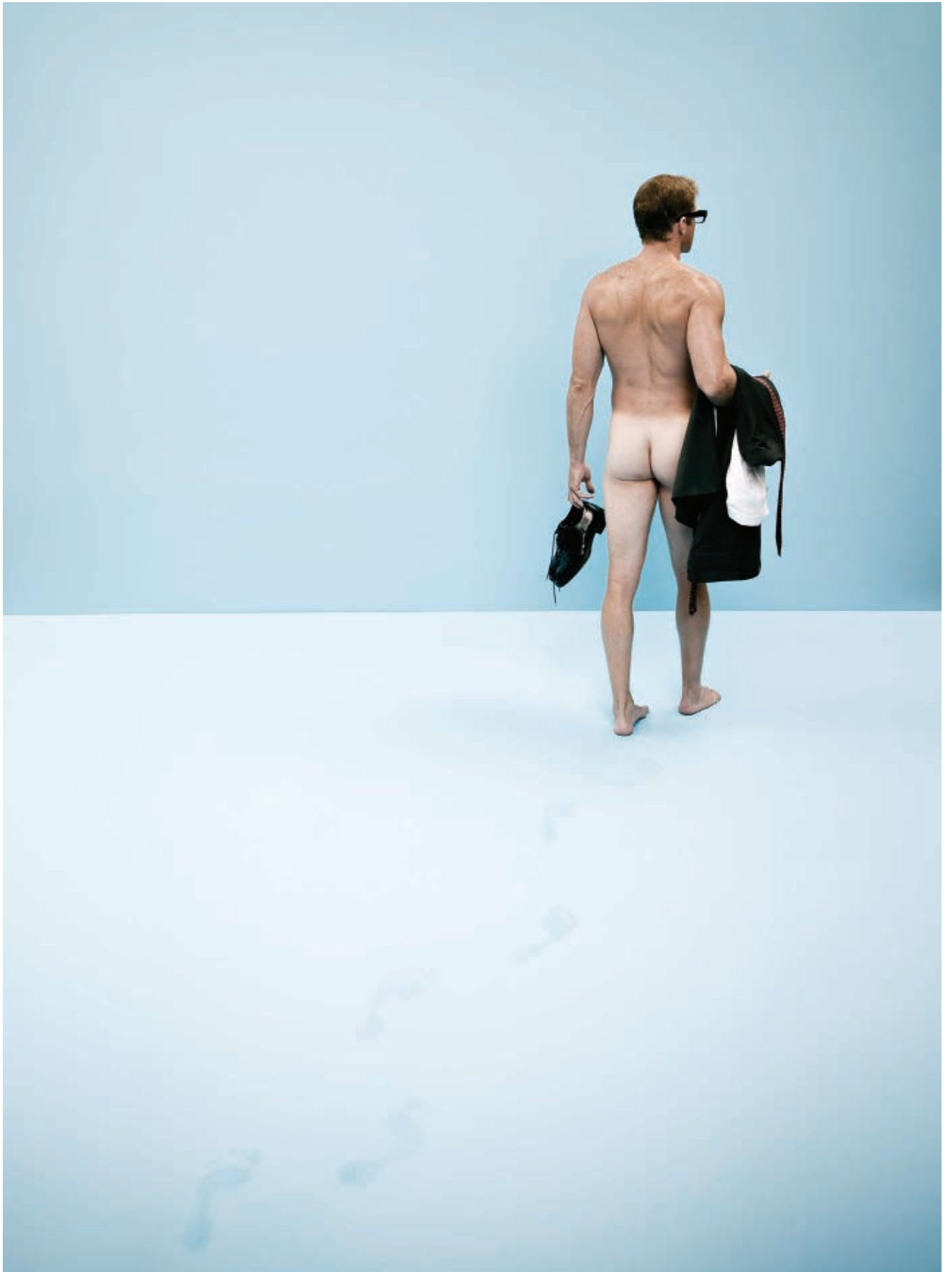
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Swimming Naked

WITHOUT LOSING YOUR SHORTS.

THERE'S A LOT OF DEBATE ON THE RISKS
OF TRADING NAKED OPTIONS.
ALL FUSSING ASIDE, HERE'S
THE SKINNY ON THE
MOST COMMON NAKED STRATEGIES TO
HELP YOU DECIDE FOR YOURSELF
WHETHER THEY'RE
SOMETHING YOU CAN REALLY
GET BEHIND
(PUN INTENDED).

words by **Bill McSheehy**

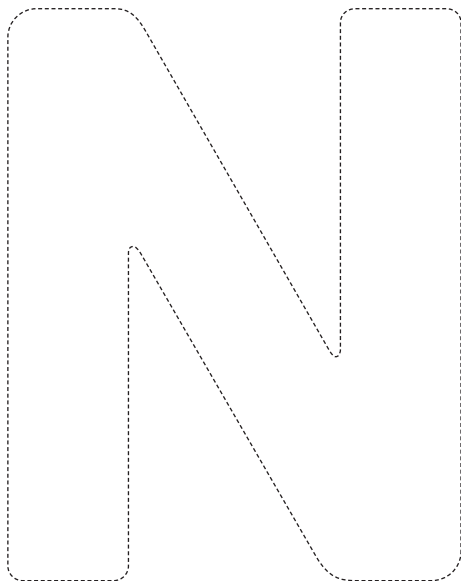


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Feature #3

Photograph by
Fredrik Broden

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aked risk.

Whether you understand trading well or not, those words tend to make a person nervous. Naked risk has the potential to lose a lot of money, maybe even enough to wipe you out financially. Images of sitting on the curb outside of the exchange, tin cup in hand, pop into mind when thinking about risk mismanaged, or a too-big trade gone wrong. But it's not quite as simple as that. Even though you may be rightfully cautious about positions with naked risk, you might not always realize just how much risk you are already taking on in your trading. On the flip side, some scary-sounding trades really have surprisingly little risk.

In a nutshell, naked risk is defined as a long (bought) or short (sold) position that is held without the hedge of another option (or other instrument) to offset some or most of the risk. Think of it as a lone option, fully exposed (naked) to risk, without a diaper on in case things get messy. But just how dangerous is naked risk? That depends on the knowledge and skill of the trader, and the size of the risk taken relative to his or her trading account.

THE (NOT SO) COVERED CALL

Let's take a look at the retiree's special—the covered call. Stock brokers since time immemorial have been recommending selling out-of-the-money calls against customers' long stock positions. The idea is that you generate some cash (the credit you receive when you sell the call), reduce the cost basis of the stock (by the amount of the credit received), and make money on the long stock position if it goes up to the strike price of the call. The problem is that most people don't recognize that if the stock goes down dramatically, say to zero, the loss can be enormous. Don't think a stock can go to zero? Ever trade Pets.com? Or Enron? If not, it's probably because they don't exist anymore—i.e. gone, done, kaput (despite Enron's shining moments of having once been the seventh largest publicly traded US company). You may argue that Granny only buys quality stocks, like Bear Stearns, Freddie Mac, or Fannie Mae. Well, if you bought shares in those companies last year and sold calls against them, you may have recently been clobbered.

The point is that the covered call is synthetically the same thing as a naked short put, meaning the two posi-

tions have the same risk and reward. Yet, while many brokers condone the former in an IRA, they condemn the latter. If you're not convinced they're one and the same, plug them both into the thinkorswim Analyze tab and check out the risk profiles. Does this mean that buying stock and selling calls is bad? Not necessarily. If you have a knack for buying stocks that don't drop too much, covered calls can be profitable. But it also means that you shouldn't be too afraid of naked short puts.

The fact is, selling puts short can be a more capital-efficient trade than covered calls. For example, if I think stock XYZ at \$50 won't drop too much, and might even go up a bit, I might sell an out-of-the-money 45 strike put. If XYZ stays at \$50, or at least above \$45 by the option's expiration, the profit is the credit I receive for selling the put. If XYZ goes up, the profit is limited to the credit, no matter how high XYZ goes. The naked short put begins to lose money if XYZ is below \$45 at expiration. The breakeven point is the strike price minus the credit. So, if I sold that 45 put for 1.00, the breakeven point is \$44. The position would lose money if XYZ were below \$44. The more it falls below \$44, the greater the loss, with the max loss achieved with the stock at zero.

The risk of simply buying XYZ at the current price of \$50 is actually greater—\$44 versus \$50. Additionally, in a margin account, the amount of capital I need to put up to enter a long stock/short call position is typically greater than what's needed for a short naked put. Reg T requires that the margin for the long stock/short call is 50% of the

IF YOU HAVE A KNACK
FOR BUYING STOCKS THAT
DON'T DROP TOO MUCH,
COVERED CALLS CAN
BE PROFITABLE.
BUT IT ALSO MEANS
THAT YOU SHOULDN'T
BE TOO AFRAID OF
NAKED SHORT PUTS.



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Feature #3

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STRATEGY BOX:

Short Straddle/Strangle

A market-neutral strategy with unlimited risk, composed of an equal number of short calls and puts of the same strike price (straddle) or two different prices (strangle), resulting in a credit taken in at the onset of the trade. The strategy assumes the underlying will stay within a certain range, in which case, as time passes and/or volatility drops, the options can be bought back cheaper than the credit taken in, or expire worthless, resulting in a profit.

value of the stock, while the margin on a short naked put is roughly 20% of the value of the stock.

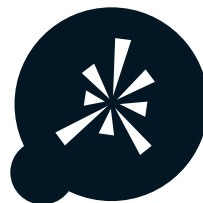
SELLING NAKED CALLS

The key to selling naked is to recognize the risk in a position and either accept or reject the potential reward for taking it. Let's take the bogeyman of risk, the naked short call, as an example. I understand that a stock or index could go infinitely high, and that the risk of a short call is limited only to the difference between the strike price of the call plus the credit and the price of the underlying stock or index. How likely, though, is the price of a stock or index to go higher, if not infinitely high? Could it go, say, high enough to cause a loss on my short naked call that would spell my financial ruin? That depends on the stock. The biggest risk on a short call is a stock that might be the target of a takeover or some other event that would cause the price to gap higher. In that scenario, I have no ability to hedge or close out the position before the price jump causes a huge loss. But barring that type of event, a short naked call position doesn't have to have any more risk than a naked short put position—if I am willing to watch the position closely and buy back the short options if the stock moves more than I think it will. In that case, I can keep my loss lower than that potential maximum.

SELLING VOLATILITY (LITERALLY)

Now, if I believe that in the short-term, a stock is as likely to fall as it is to rise, and stay in a range rather than make a big move up or down, I might even combine the naked short call and naked short put into a [Short straddle](#) (if the strikes are the same) or [Short strangle](#) (if the strikes are different). Selling a straddle when implied volatility is high and likely to fall, as before an earnings or news announcement, is a strategy used by professional traders who are looking to capture a large amount of positive time decay. These traders are not only willing to monitor the position and stock carefully, but also have the discipline to close the trade at a predefined exit point. Might the stock make a big move on the news that results in a large loss? Absolutely. If the earnings are announced after the close of trading, the stock may make a big move in the overnight markets. But if it doesn't, the rewards can be high.

A more unusual application of naked risk is selling puts in the CBOE's VIX volatility index options. If the market is going to crash, it usually crashes down. And when the market crashes down, volatility tends to rise. Selling VIX puts when the index is in the low teens has relatively low real risk. The VIX has only been below 10% twice in its history,

**WHAT DO SHORT SELLING BANS DO TO OPTION PRICES?**

• When the SEC introduced a blanket ban on everyone, including option market makers, on short selling 799 financial stocks, it created distortions in those stocks, option prices. If a market maker needs to hedge long deltas and can't short stock, where does she turn? To puts! As traders bought puts as a replacement for short stock, the puts jumped in price, and the combo (synthetic stock, or buy call/sell put at the same strike) was driven lower relative to the stock price. You calculate the synthetic stock price by adding the call price and subtracting the put price to the strike

price. Most of the time, the synthetic stock trades above the stock itself because of the cost of carry, which is built into the synthetic stock price (see p. 41). But because the puts got pushed up in value because of the ban on shorting stocks, the synthetic stock was lower than what the cost of carry would suggest. For example, right when the ban came out the Morgan Stanley (MS) October 22.5 calls were 5.20

and the 22.5 puts were 6.00 when the stock was \$22.50. The synthetic stock was \$21.70 (22.5 + 5.20 - 6.00). In cases like this, the put isn't necessarily "too" expensive. It's fairly valued because of the ban on short selling. So, don't get suckered into thinking that a put is a great thing to short simply because it looks over-priced. In this case, looks can be deceiving.

and the VIX going to zero is theoretically almost impossible. If the market drops and the VIX rises, the short put can be a profitable trade with limited risk.

GOING LONG THE NAKED BOMB

Finally, most retail traders would not see a single, long option as having naked risk. But even though the risk is confined to the debit paid for the option, most professional traders would not be comfortable with that position. Why? The single long option has negative theta (time whittles away at its value), posi-

tive vega (a drop in volatility will push its value lower), and either has a low probability of success (if it's an out-of-the-money option) or the same short-term risk that a stock position would have (if it's an in-the-money option). If I have a long option position, I try to sell another option against it to reduce the negative theta, positive vega, and delta risk.

Don't be automatically put off from a trade because of naked risk. If you have the knowledge and skill to define the risk of an unlimited, naked risk trade, then you might consider adding short naked options in carefully planned scenarios to your strategies.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting Scott Garland at 773-435-3270 or 600 W. Chicago Ave. Suite 100, Chicago, IL 60610. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security.

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An Interview with... Napoleon

A real interview with a dead French guy

Illustration by **Brian Cairns**

Q+A:

TOS: Wow, hangin' with Napoleon! So, um, where are we?

N.B.: Elba, dammit! The pantywaists in Paris shipped me here

TOS: All conquered out? Why don't you try trading?

N.B.: Trading? Perhaps. But you know what they say. Those who can, do. Those who can't do, teach. And those who can't teach, trade. It is not a suitable activity for the Emperor of France.

TOS: All sorts of grand Pooh-Bahs trade in America.

N.B.: Ah, yes, the colonists! If you want to talk about trades, my best one was selling the Americans 2 million square kilometers of New World "nothing" for 60 million francs. Yes, Louis's name is on the deal, but it was I who was calling the shots. We replenished our war treasury by selling those rubes, er—I mean freedom-loving democrats—trackless forests and beaver-infested streams. Those sorts of trades will leave the Americans penniless and without an army.

TOS: So, you're saying the Americans don't have a chance?

N.B.: The Americans aren't so bad. But their wine is fit only for farm animals. And they don't know how to trade. However, they beat the English, which is good.

TOS: Huh?

N.B.: A country is only as great as its wine. Look at Germany. Their wine tastes like piss. I crushed them at Jena. The Germans will

never amount to much. Ugggh. I also do not like beer. Hopefully, Americans will learn to drink wine, not beer, so they will be successful like the French. Not as successful as the French, mind you, because that is not possible. La Belle France makes the best wine, which is why she will make her allies stand in awe, and her enemies quake in fear and freeze at her borders for 1,000 years to come. No one will dare set foot in France! Not the English, not the Spanish, not the Germans, nobody!
TOS: I didn't know the English made wine ...

N.B.: Well, their ale is just as bad as beer.

They, too, will fall under the dominion of France.

TOS: And I thought you fought the Prussians, not the Germans?

N.B.: Do not make me angry. I have a sword, you know. Do you want me to pierce you with my sword? I think not. Although you would have the honor of being pierced by none other than Napoleon Bonaparte. Which is good. Anyway, Prussians, Germans, Austrians ... they're all the same and their wine is all bad.

TOS: OK, point taken. You seem like a pretty successful guy. If a dumb American wanted to make a couple bucks in the future, what would you suggest?

The Americans aren't so bad. But their wine is fit only for farm animals. And they don't know how to trade. However, they beat the English, which is good.

N.B.: Me, I would be investing in whaling ships. Whale oil is the only thing plentiful and powerful enough to fuel our future. France's top scientists and salon patrons are devising ways to use whale oil to run hot air balloons and as a sandwich spread for the lower classes.

TOS: Not railroads?

N.B.: The so-called "railroads" are simply a fad. There is never a train depot near a battlefield, where you really need one. And they are never on time. You could take all the iron used to make the rails, and turn them into cannon balls. I can defeat the Russians with cannon balls, not railroads.

TOS: Well, then. I can see that your ego has not diminished with your army.

N.B.: Look, I may not have my army, but my sword is still long and firm. And I am not afraid to unsheathe it!

TOS: Uhh ... yeah ... I'll be going now.



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thinkMoney/04

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Special Section

Photograph by
Fredrik Broden

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SPECIAL SECTION:

pair.

PAIRS TRADING... CONTRARIAN EXTRA- ORDINAIRE

Coke versus Pepsi. GM versus Ford. Pairs trading takes match-ups like these and bets on the relative performance between the two. Could this be the new frontier for traders?

words by **Thomas Preston**

•
Special Focus
•

Photograph by
Fredrik Broden

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P

STRATEGY BOX

Vertical Spread A directional, limited-risk spread strategy constructed of a long and a short option of the same type (i.e., calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes, less the credit. Breakevens of either put vertical are calculated by subtracting the debit/credit from the higher strike, whereas the breakeven of either call vertical is calculated by adding the debit/credit to the lower strike.

airs trading: It's contrarianism extraordinaire. Two stocks that normally move in lockstep fashion, suddenly don't. Since contrarians take the other side of an extreme move, in the case of the pairs trade, it's an extreme move in the difference (spread) between the two stocks' prices. Geek speak for this is when statistically "correlated" stocks become uncorrelated. When the spread between two such stocks widens and narrows, it can present trading opportunities.

This is a new frontier of sorts, as adventurous traders can discover new opportunities when they look beyond traditional trading strategies. Pairs trading can involve stocks, futures, and options with varying degrees of complexity.

How it Works

Essentially, a pairs trader tries to profit by buying a stock that he or she thinks will outperform a stock that she sells short. If you think that stock A will outperform stock B, by either rising more or falling less, then a possible pairs trade would be to buy shares of A and sell short shares of B.

A good example of a pairs trade came earlier this summer, when the spread between two integrated oil companies with highly correlated price moves, CVX minus COP (the price of CVX, less the price of COP) was trading at about \$5 on average. In July, the price of oil started to falter, and the prices of CVX and COP both dropped sharply. But CVX dropped more sharply than COP, pushing the spread of CVX minus COP to less than \$1 in the last week of July with both stocks trading at around \$80. To me, that signaled a very unusual situation. In the past, when that particular spread traded that low, it usually rebounded very soon after to its average level.

On July 24, I bought 1,000 shares of CVX for \$83 and sold 1,000 shares of COP at \$82. The spread hung around

Equal Shares on Pairs?

• Do you need to have equal dollar amounts in the long and short stock positions? Not necessarily. Take two oil companies, CVX and SUN, where CVX was trading at about \$95 in early July and SUN was about \$35, making the spread between them \$60. If you thought that the spread would drop from \$60 to \$50, as it did in the middle of July, you would sell CVX and buy SUN. If you used an equal number of shares in both stocks, selling 100 CVX and buying 100 SUN, you would have made \$1,000 when the spread price dropped \$10, and CVX was \$84 and SUN was \$34. But if you invested an equal monetary amount in each, say, \$9,500, which is 1,000 shares of CVX at \$95, and 271 shares of SUN at \$35, you would make only \$829 on that trade. Doing an equal dollar amount can also change the average and range of the spread. You can see that by typing "CVX - 2.71*SUN" in the Chart symbol field. While balancing the dollars invested can work in pairs trading, it adds another layer of complexity. You can even take it a step further by adjusting the cash invested by each stock's beta, where less money is allocated to the more volatile stock. However, that tends to be a refinement of the pairs trade that you can investigate after you get the basic, equal-shares technique down.

under \$1 until July 28, when it headed higher. Even though both CVX and COP were rallying, CVX was rallying more sharply. The spread continued to move up, and on August 13, I exited the positions with the spread at about \$4.10; I sold the CVX position at \$85.80 and bought back the short COP shares for \$81.70. The profit was \$4,100 on the trade. I closed the position because the spread was nearing its average level, and I was afraid it might drop back down and give back the profits.

An immediate question you may be asking: If I thought that stock A would rise, why wouldn't I simply buy stock A and forget stock B, or vice versa? Because in pairs trading, it's not the stock price or direction of the stock you're focused on, but rather the opportunity created by an "abnormal" spread between two stock prices. In the case of CVX minus COP, I wasn't focusing on the individual stock prices as much as on the spread price. Picking the direction of either CVX or COP would have been the flip of a coin. But looking at the spread, I saw an extreme situation that I could capitalize on.

The disaster scenario for a pairs trade is when the stock or index you buy goes down and the stock or index you sell short goes up in a sort of divergence. The losses in that case can be significant, and are theoretically unlimited because you have a short stock position. You can reduce (but never eliminate) the chances of this situation by using highly correlated stocks and indices for pairs trades. Highly correlated stocks tend to move up and down at the same time. Maybe they don't behave that way all the time (correlation of 1.00), but they behave that way enough of the time (say, correlation of .80 and higher) that divergence is less likely (to find the correlation values between two stocks, see the next article, "Color-by-Numbers Pairs Trading"). No matter what the correlation is between the two stocks in a pairs trade, divergence and large losses are always possible. Using our stock A and stock B trades as an example, if your long stock A goes to \$55 and your short stock B goes to \$70, you would make \$500 on stock A and lose \$2,500 on stock B, for a net \$2,000 loss on the pairs trade.

Getting Started

The most popular exchange-traded funds (ETFs) like SPY, DIA, QQQQ, and IWM, as well as e-mini futures like the S&P 500 (/ES), NASDAQ (/NQ), and DJIA (/YM), are all highly correlated, and can be a good place for the novice pairs trader to start.

Pairs trades using individual stocks, ETFs, and futures are the most straightforward. If you believe that the S&P 500 will outperform the Nasdaq, you could buy the SPY and sell short the QQQQ. Depending on whether the overall market goes up or down, the pairs trade can make money if the SPY goes up more or down less than the QQQQ. The pairs trade would lose money if the SPY goes

up less or down more than the QQQQ. You could also do that pairs trade with futures by buying one S&P 500 future and selling one Nasdaq future—betting on the longer-term strength of the S&P 500 over the Nasdaq.

You can also make more esoteric bets with pairs trades. Being long crude oil and short the S&P 500 would have worked out very well in late 2007 through the middle of 2008. That would have been more of a macroeconomic pairs trade, based on the prediction that increases in global demand and the fear of shrinking supplies would drive oil higher, and higher energy prices would in turn drive US stocks lower.

From a more technical point of view, you can look at the price of one stock minus the price of another stock to see whether that spread is high or low relative to some time frame—maybe a few months, a few weeks, or even a few days. Is there a consistent relationship between the two stocks, where the spread oscillates around an average or mean (revert to the mean), or does it drift or trend higher or lower? A pairs trader tries to guess which way that spread is going to go. If the spread between stock A and stock B has an average of \$5 (for example, stock A at \$50 minus stock B at \$45), you might sell the spread when it gets to \$7 (sell stock A at \$51, buy stock B at \$44), and buy the spread back when it gets back to its average \$5 (buy back stock A at \$53, sell to close stock B at \$48) to make \$200. Again, you're less concerned about the prices of the individual stocks, and more concerned about the spread between them.

Pairs Trading With Options

Pairs trading using options adds another level of complexity. One of the difficulties is execution. Options are, by and large, less liquid and have a wider bid-ask spread as a percentage of their price than stocks and futures do. For shorter-term pairs trading—when minutes, and even seconds, can count—you can't always afford to work options orders to get good fill prices. The other difficulty is that options are also sensitive to time decay and changes in implied volatility. To reduce those factors, longer-term pairs trading with [verticals](#) can be interesting.

Verticals typically have lower delta, gamma, theta, and vega than individual options, but they can be used as the bullish/bearish components of pairs trades. Going back to the SPY/QQQQ pairs trade, rather than buying SPY shares and selling short QQQQ shares, you could sell a SPY put vertical and sell a QQQQ call vertical. That type of trade can be profitable through positive time decay even if the SPY and QQQQ don't move at all. The risk of this trade is if the SPY drops and the QQQQ rises.

While pairs trading can take a lot of effort—finding, analyzing, and executing—it does represent an area that even most professional traders don't understand well. That leaves plenty of room for the advanced retail trader with the right tools to try to profit in uncharted territory.

• The information contained in this article is not intended to be investment advice and is for illustrative purposes only. The views in this section are those of a thinkorswim employee, but may not necessarily be that of thinkorswim, Inc. Multiple-option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade.

pair.

SCANNING FOR PAIRS

The TOS trading platform has the tools you need to find, analyze, and execute pairs trades. You can begin by searching for stocks in an industry sector that might become the components of a pairs trade. Using the Stock Hacker tab, you can scan for stocks within a sector that fit certain criteria, like price, market cap, and levels of implied volatility. Start by clicking on "All Stocks" in the "Search in" field, then choose "Industry" to see the largest S&P industry divisions. You can click on one of them, then drill down into the sectors and groups to include only stocks from that list in your scan.

To scan for ETFs and index products, choose "Public" in the "Search in" field to see the choices available.

If you want to know what industry sector a particular stock belongs to, you can do that on the Quotes tab by adding the industry division, industry sector, and industry group fields to the display. All you have to do then is type in your stock symbol to see where you can find it in the public watch lists.

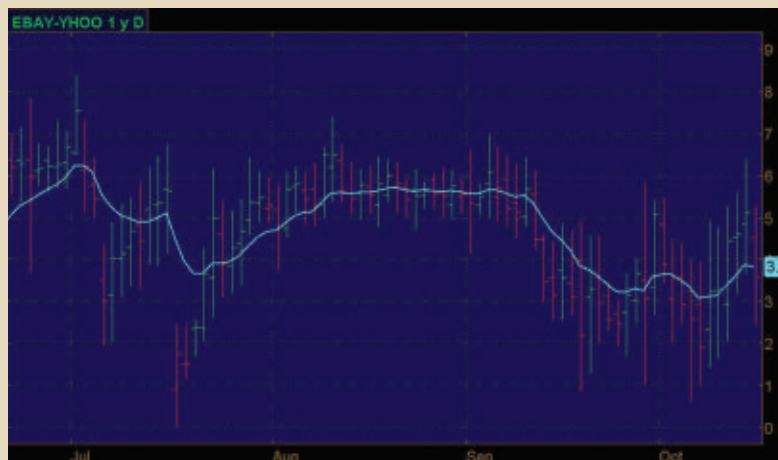


FIGURE 1: This chart of the pair EBAY-YHOO displays the net price of the two stocks subtracted from one another. Looking for stocks in the same sectors or stocks that correlate with a particular index are typically good places to start.

Source: TOS charts on thinkDesktop

Color-by-Numbers Pairs Trading

We know what you're thinking: How do I get started in pairs trading? Great question.

CHARTING THE TRADE

Seeing a chart of the spread between two stocks is easy. Simply type in one symbol minus another symbol on the symbol field, like "IBM - MSFT," or "/ES - /NQ." That will display a graph representing the difference between the prices of the two symbols. It's important that you know which symbol you're subtracting from the other when looking at the chart. If you think the line on the chart is going to go higher, then you would "buy" the pair by buying the first symbol and selling the second symbol. If you think the line on the chart is going to go lower, then you would "sell" the pair by selling the first symbol and buying the second symbol.

You can also use the same format to see the spread between multiples of stock prices. For example, "2*IBM - 5*MSFT" would show you a the value of two times the price of IBM

minus five times the price of MSFT. If you base your pairs trades on charts like that, it's important to remember that you would be buying 200 shares of the first symbol and selling 500 shares of the second symbol.

It's best to look at a line chart when analyzing pairs trades. The reason is that the line chart will use the last price of the two symbols, which occur at the same time,



Since you're in the mood, we thought you'd like to hear an extended discussion on pairs trading. For an in-depth interview with our resident expert on the subject, Tom Preston, go to www.thinkorswim.com/thinkMoney

versus an open/high/low/close (OHLC) bar chart, in which the high or low that you see for a spread between two symbols would not normally appear at the same time, and would likely have not been tradable at those prices.

CHECK FOR CORRELATION

To check the correlation between two stocks or indices, go to the Charts tab, type in your first stock symbol, then find "correlation" in the list of available studies. The default correlation will be based on the SPX. You can change that in the "Study Properties" box for correlation by typing in a new symbol in the "correlation with security" field. Typing in QQQQ will give you the correlation between the symbol on the chart and the QQQQ, for example.

Because the correlation between two symbols is based on their historical price data, you have to determine how much data you want to use. A rule of thumb is to use an amount of data equal to the length of the proposed trade. If you are looking at a short-term pairs trade using 10 days of hourly data, and you are considering a pairs trade that you might hold for 2 days, then you could look at a correlation for 14, which is the number of hourly bars for 2 trading days. The default number of days/bars is 10. To change it, go to the "Study Properties" box again and type in the number of days/bars you want in the "length" field. On a chart with daily data, a length of "30" will give you the correlation between the two symbols based on 30 days of data.

TRACKING THE PAIR

A feature recently added to the TOS platform gives you the ability to group particular trades together in the Position Statement section of the Monitor page. After you've executed the individual stocks or options of the pairs trade, open up the positions on the Position Statement, then click the blue dot at the far left of each position. Select "Move to Group," then choose "Symbol Group." Give the group a name for your pairs trade, and the first symbol will be moved to that group. Then click on the blue dot for the second position, select "Move to Group," and choose the pairs trade group name. That second position will be moved to the group with the first position. This way you can easily monitor the performance of your pairs trade.



Stock and option exchanges don't recognize pairs transactions. Thinkorswim has two features that can make pairs trading a bit simpler.

Q:
What is the margin requirement on a pairs trade?

A:
Generally speaking, there isn't any cross-margin relief for pairs trades. The margin for a pairs trade, then, is the margin on both positions. If you're pairs trading with stocks, it's going to be 50% of the value of both the long and short positions. If you're pairs trading with futures, it will be both futures margins. And if you're pairs trading with options, the margin will be that of the separate option positions in each underlying.

Q:
How do I execute a pairs trade?

A:
Stock and option exchanges don't recognize pairs transactions. That's why you can't route a pairs trade as one order

and have it execute both sides. Thinkorswim has two features that can make executing pairs trades a bit simpler. The first is the "Blast All" order type (found on the advanced order menu in the order entry panel), which allows you to submit multiple, separate orders with a single push of a button. The second is the Active Trader interface on the Trade page. That allows you to watch two or more stocks or futures, their bid and ask prices, as well as the size of the bid and ask, on one screen. Then you can rapidly click on the price to route an order in one, then click to route an order in the second when the spread of the pair reaches your desired price.

Q:
How do I do a pairs trade if the prices of the stocks are very different?

A:
It is not essential that the prices of the underlying

stocks be the same for a pairs trade. If you are looking at the spread price between two stocks, you can buy and sell the same number of shares in each stock and hopefully profit if the spread price moves in the desired direction. But if you are looking at the spread between, say, two times one stock minus three times another, then you would trade 200 shares of the first stock and 300 shares of the second to have the trade profit or lose based on the change in that 2-by-3 spread.

When you are looking to hedge one stock position with another, then you may want to have equal dollar amounts, adjusted

for beta, in the two stocks. That way, the dollar amount of the profit or loss in one stock will be offset by the dollar profit or loss in the other. That is like a pairs trade, but is more of a hedging strategy than a speculation.

Q:
How do I create a stop loss or limit order to close out a pairs trade?

A:
Just as you can't execute a pairs trade in one transaction, you can't set stop prices for a pairs trade either. Because you are focusing on the spread between two stocks, not necessarily the prices of the stocks themselves, you can't set stops for the individual stocks, because the spread price can have the same value with very different stock prices. In pairs trading, you must watch closely so that you can act on a "mental" stop if you see the pairs trade going against you. That's why pairs trading requires proven risk management discipline.

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Gear Head

Cool things to do with what we've got.

Now Trading FROs

Not to be confused with the hairstyle of the same name, the moniker stands for fixed return options—a fresh alternative for options investors

Amex FRO Settlement Index MSFT									
UNDERLYING									
LAST X NET CHNG	BID X	ASK X	SIZE	VOLUME	OPEN	HIGH	LOW		
23.39 A	-1.04	23.39	23.39	0 x 0	0	23.79	23.81	23.39	
OPTIONS									
CALLS					PUTS				
LAST X NET CH...	BID X	ASK X	EXP	STRIKE	BID X	ASK X	LAST X NET CH...		
OCT 08 (2) 100 (US\$ 100) 93.03%									
NOV 08 (37) 100 (US\$ 100) 32.56%									
JAN 09 (93) 100 (US\$ 100) 19.89%									
0	0	.62 A	.87 A	JAN 09	20	.12 A	.37 A	0	0
0	0	.51 A	.76 A	JAN 09	21	.23 A	.48 A	0	0
0	0	.39 A	.64 A	JAN 09	22	.35 A	.60 A	0	0
.68 A	0	.41 A	.66 A	JAN 09	23	.44 A	.69 A	0	0
0	0	.33 A	.58 A	JAN 09	24	.51 A	.76 A	0	0
0	0	.17 A	.42 A	JAN 09	25	.62 A	.87 A	.25 A	0
.51 A	0	.11 A	.36 A	JAN 09	26	.68 A	.93 A	.31 A	0
.50 A	0	.01 A	.26 A	JAN 09	27	.73 A	.98 A	0	0
.63 A	0	0 A	.25 A	JAN 09	28	.75 A	1.00 A	0	0
0	0	0 A	.25 A	JAN 09	29	.80 A	1.05 A	0	0
0	0	0 A	.25 A	JAN 09	30	.82 A	1.07 A	0	0
.01 A	0	.05 A	.25 A	JAN 09	31	.85 A	1.10 A	.84 A	0

FIGURE 1: FRO chain of MSFT (symbol RIS). Typically, you can calculate the probability of the option expiring in-the-money by taking the midpoint between the bid/ask. **Source:** thinkDesktop

tech.

• Maybe you've seen them on an options quote page: AXO, TBA, TSB, RIS. They're attached to AAPL, GOOG, IBM, and MSFT options quotes, but they're different. Have no fear: those are just fixed return options. When the American Stock Exchange listed them earlier this year, they were mixed in with the "regular" options, and to the unwary trader, they looked cheap. And in fact, most FROs are less expensive than the standard equity option on the same stock, the same expiration, and same strike price. Let's see why.

An FRO is a European-style, cash-settled binary or "cash-or-nothing" option, which means that it has either one of two values at expiration. An FRO is worth either \$100 if the option is in-the-money at expiration, or nothing if it is not. The value of the FRO, then, reflects the probability that the option will be in-the-money at expiration. An FRO with a strike price that is far out-of-the-

money and without much time to expiration will have a low price because the probability that the option will be in-the-money at expiration is small. An FRO that is deep in-the-money will have a price close to 1.00 (which translates into a value of \$100) because of its high probability of being in-the-money at expiration.

Of course, when you think about probabilities and trading, you think about thinkorswim. You can see the probability of an option expiring in the money right on the Trade page. Wait a minute...if you can see what the probability of expiring is, you could determine the price of the FRO, right? Right! With MSFT trading at \$22.50 at the time of this writing, the probability of expiring in the money for the Jan 09 25 calls is 30.8%. Now look at the bid/ask of the RIS (the MSFT FRO symbol) Jan 09 25 calls. They're .17 - .42! Wrapped around the 30.8% probability! Armed with the thinkorswim tools, you can estimate the value of an FRO by looking at the probability of expiring in the money for the "regular" options. Hey, maybe the FRO market makers have the thinkorswim platform running on one of their screens. Nah, they'd rather spend \$5,000 a month on some "professional" option software.



To learn about all the latest and greatest new tools on our platform, view the archived Release Notes at thinkorswim.com and follow the path Support > Software Support.

Now, just because you know how an FRO is priced doesn't necessarily mean you want to trade them. That same RIS Jan 09 25 call had zero open interest, and that bid/ask spread is wide enough to drive a truck through. Because of that lack of liquidity, I would avoid trading them. That's why we separated them from the regular options on the Trade page, and make you find them under their FRO symbol. But at least now their prices should make more sense to you, and any time you understand more about options, the more confident you'll be when you trade them.

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Capiche?

Lessons from a veteran floor trader

A Costly Carry

There could be more to an option price than meets the eye. Sellers, beware of the cost of carry.

I was trading one day around lunchtime, eating a meatball sub while watching my positions. They were good meatballs, but not great. I was thinking about what makes a great meatball, when it dawned on me that options are a lot like meatballs. There's a lot of stuff in there that makes them delicious, especially Mom's meatballs (the best in the world); but you don't always see the ingredients.

The price of an option is made up of a bunch of ingredients as well. Whether it's a call or a put, the obvious are stock price, strike price, time to expiration, and volatility. But the ingredient that most people never think about is the cost of carry.

Did I always know this? I wish. I was just learning how to be a market maker when I saw some big combo (buy call, sell put) orders come into the pit. I knew enough that the price of the call minus the price of the put plus the strike price was the price of the synthetic stock. I did the math and saw that they were trying to buy an at-the-money combo with one month to expiration for a synthetic price of 25 3/16 while the stock itself was trading for 25 1/8. I figured they didn't know what they were doing, so I sold the combos and bought the stock as a hedge (see sidebar for more), figuring that I made a 1/16 (pre-deci-

malization) guaranteed, which would be over \$10,000 on the position. Things were going fine until I saw the statement from my clearing firm for an interest charge of \$15,000. Huh? I called my rep at the firm and began to gripe, but she stopped me with the words "cost of carry."

The cost of carry is all about interest rates and, for stocks and some ETFs, dividends. It has to do with how much you have to pay in interest borrowing when you own the stock, and whether or not you would earn a dividend if you held that stock until the option's expiration. Say I buy 100 shares of stock for \$75 per share. I have to come up with \$7,500 to pay for it. If I have the cash in my account to pay for it, I use that cash. But I'll stop earning interest on that cash. That's an interest expense. And if I don't have the cash in my account, I have to borrow the money from the clearing firm, for which I'll have to pay interest on that loan. If the stock pays a dividend, and you own the stock on the ex-dividend date, then you'll take money in for it, which will offset your interest expense.

cap.

The combo described here is known as a conversion, and is not sensitive to changes in the stock price because the negative 100 deltas of the short combo are offset by positive 100 deltas of the long stock. Whether the conversion makes or loses money depends on how much interest I pay and dividends I receive holding the stock, and how much I sell the combo for over the stock price. The breakeven combo price is the stock price plus the net interest I pay minus the dividends I receive. In this trade, the interest minus dividends was about .25. With the stock at 25 1/8, the breakeven combo price was 25 3/8.

When you buy stock, you can calculate the interest charged each day that you own the stock: cash value of stock purchase * interest rate * 1 day / 360 days.

So, if the interest rate is 2% and I bought 100 shares for \$75, the interest per day would be $\$7,500 * .02 * 1 / 360 = .416$ or about \$0.42 per day. I can multiply that by 30 to get a monthly number, by 7 for a weekly number, etc. Could I avoid that interest cost by buying calls instead of stock? Nope. Calls include that interest expense in their price to avoid an arbitrage situation, which makes them a little more expensive. And puts? Well, if instead of

buying stock I sell stock short, cash goes into my account. If I buy a put, I don't get that cash in my account, and I don't earn interest on it. So, a put is worth a little less to a professional trader, and interest rates make puts a little cheaper.

This is called "put-call parity," and ensures that if you buy a call and sell a put at the same strike price to get long synthetic stock, that synthetic stock price is a little bit more expensive than the plain old stock price because of that interest rate and the cost of carry. I lost \$5,000 because I didn't factor in the interest rates. If the stock paid a divi-

dend, I wouldn't have lost as much. And if I had sold those combos high enough, say 25 3/8, I might have made money on them. But I didn't, and I learned my lesson: Know what's in the meatball before you take a bite.

Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade.

Words by **Tony Battista**
Photograph by **Fredrik Broden**

The Last Page

Photograph by
Fredrik Broden

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end

Top 10 Rejected Halloween Costumes:

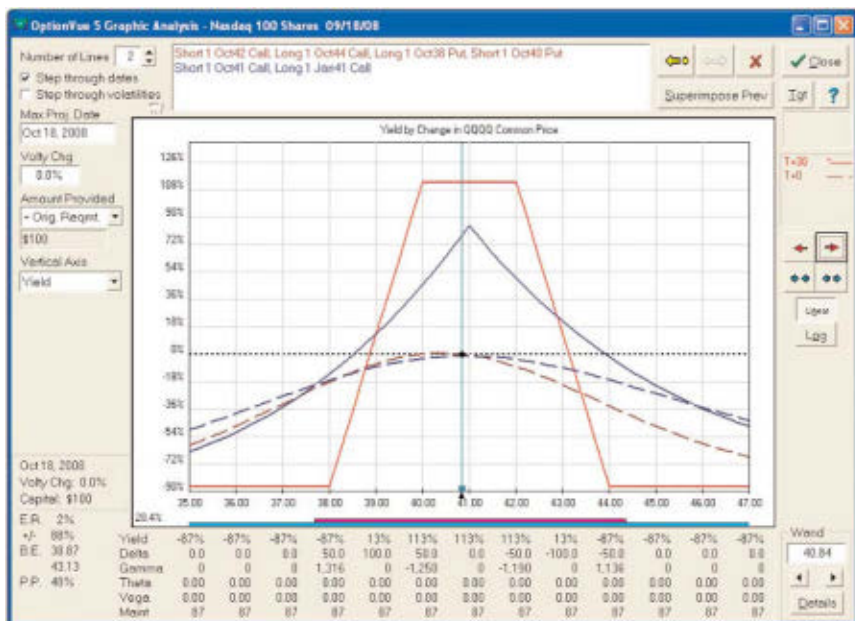
1. Bloodsucking
FINRA auditor
2. Delta, the dorky
robot from Planet Vega
3. **Permanently
stained, faded
floral print ghost**
4. Negative time
decaying corpse
5. Poorly executed
criminal
6. Mentally unbal-
anced iron shackled
condor
7. Zombie Bear tears
trader (oops, that's no
costume)
8. Sexy margin clerk
9. Sparkly princess
volatility fairy with
light-up wings
10. Tickle Me Hell-mo!



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