

thinkMoney/11

random musings
for thinkorswimmers
Winter 2011

INSIDE THIS ISSUE

DIVERSIFICATION,
TRADER-STYLE/10

WEEKLYS FOR THE
ATTENTION DEFICIENT/24

STEPPING UP
TO VERTICALS/20

FOREX SPECIAL:
NOT JUST FOR THE BIG
BOYS ANYMORE/38



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•
04
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Contents

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Fredrik Brodén

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p. 10

NOT YOUR DADDY'S DIVERSIFICATION

There are investors, and there are traders. And while a diversified mix of stocks, bonds, and cash may define the former, the latter has a different set of needs.





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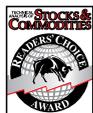


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07

Contents

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Features



10/Not Your Daddy's Diversification

Stocks, bonds, and cash—three things you might find in a “diversified” long-term portfolio. That’s fine if your time horizon is measured in years. But what if your timeline is months, weeks, or even days? Today, traders have a different set of needs, and options can help.

Columns



16/TOS News & Views

Trader opinions, favorite new tools, top five trading muscle-builders, and of course, “The Suit.”



23/Hey, Monkey!

Our resident primate is back to dishing tips on trading, the markets, and living green.

Miscellaneous



08/A Quick Howdy



18/Down and Dirty with Verticals

Before buying or selling calls and puts, you may want to check the alternatives. The vertical spread is a simple solution to many of the problems naked options pose. But before you put your hand in the cookie jar, understand what you’re trading.



29/Capiche?

Ever wonder why your SPX options settle at a different price than what you anticipated? Now you’ll know.



31/Where Is It?

More TOS tips from one of our favorite trading desk jockeys.



15/Dear Swim



24/Trading in the Red Zone

There’s been a lot of hype lately about weekly options. And for good reason: Volume is swelling, and traders with short attention spans are using them to speculate on very short-term moves, or simply as a hedge. So what exactly are weekly options, and why trade them?



30/Forex for Fun

You know times have changed when you can bet against a country’s stock market with its own currency. It’s a good thing you can do both from one trading platform.



38/The Token Glossary

If you see a big word highlighted that you don’t understand, look here for the answer to the question, “Huh?”



32/Forex Special STOCK TRADER, MEET FOREX

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A Quick Howdy

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Broken Promises

• Now that the egg and Aunt Bessie have worn out their holiday welcome, it's time to dust off the 2010 book of trading resolutions (most of which we're sure you've conveniently forgotten) and make some new ones. But in case you have writer's block, we thought we'd help you through your creative impasse by doling out a few unsolicited 2011 resolutions of our own:

1. Think beyond the long call.
2. Learn at least half of what you hope to learn.
3. Don't judge an asset by its past reputation.

As in trading, too many rules can lead to indecision and confusion. And the point of this annual exercise isn't to make you feel guilty for not following through on last year's resolutions. We're givers. So, we've crafted this issue of *thinkMoney* to help you live up to your promises—or, if nothing else, to make us feel better about having done our job.

If speculating with options means buying calls and puts to you, then you're kind of missing the point. Not that there's anything wrong with them, but there's usually a better alternative. If you're not using vertical spreads yet, be sure to read "Down and Dirty with Verticals" on page 18, and cross off Resolution #1.

Trading, like other skill sets, requires the ability to recognize changes a-comin' and to be able to shift gears before it's too late. That's the point of diversification in the traditional sense. However, for traders, diversifying a portfolio means more than simply mixing



We want to hear your pros and cons! Please send your comments to editor@thinkmoneymag.com.

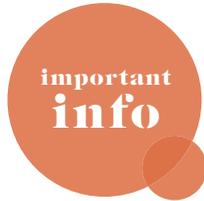
asset classes. "Not Your Daddy's Diversification" on page 10 ought to help with Resolution #2.

And what about Resolution #3? The doors to currency trading have swung wide open in the last 10 years. If you haven't dipped your toes in the water, be sure to read this issue's Special Focus on forex trading.

There, see? Not only did we help you come up with new resolutions, but over the next 45 minutes or so, we'll help you cross them off your list. Please, no applause.

Happy trading in 2011!
TOS

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10

Portfolio Management

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**NOT
YOUR
DADDY'S**

**DIVER-
SIFICA-
TION**

LONG-TERM INVESTORS HAVE BEEN TOLD AD NAUSEAM NOT TO PUT ALL OF THEIR EGGS IN ONE BASKET. BUT WHAT ABOUT ACTIVE TRADERS? SAME CONCEPT. DIFFERENT ANIMAL.

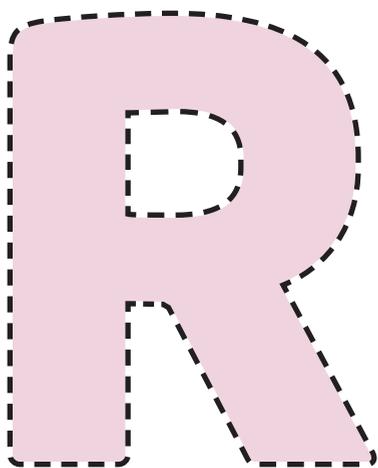


WORDS BY
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PRESTON**
PHOTOGRAPH BY
FREDRIK BRODÉN

Portfolio Management

Photograph by
Fredrik Brodén

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REMEMBER THE BAD OLD DAYS, WHEN INVESTORS just bought a single stock and hoped for the best? Then came the '80s, when star mutual fund managers sold us on the benefits of “diversification”—particularly the diversification that came from their funds. So then investors bought a couple funds and, once again, hoped for the best.

Diversification for a stock portfolio is a way to reduce “non-systematic” risk. Systematic risk is the danger of the whole market dropping and all stock prices falling along with it. Non-systematic risk is the danger that is unique to a specific stock, such as management skill, products, legal rulings, and so on. The idea is if you have enough different stocks in your portfolio, all those company-specific risks offset each other, and no single risk will dominate your portfolio.

All that’s fine. But when you’re a floor trader standing in a trading pit that’s only trading options on one index or stock or future, diversification across different underlying securities isn’t really possible. So, you think about diversification in a different way. Different spreads have different risks—some lose money when the stock goes up; others, when the stock goes down. Some lose money when volatility goes up; others, when volatility goes down. Retail option traders and investors can trade any stock or index they like, but they can still benefit from thinking about how an option trader might diversify. Let’s look at a few different approaches.

HEDGING DIRECTION

First, let’s look at the net risk of your positions. Right now, go ahead and launch your TOS trading platform and look at the Position Statement section of the Monitor page. You can see that each symbol’s net position greeks are displayed. (You can do this exercise whether or not you have option positions, because even stocks and mutual funds have **delta**.)

Are the net deltas all positive? That means you want them all to rise—at least a little bit. What happens if the market falls?

If you beta-weight the positions to a common index, is there a particular symbol that has a much bigger delta than the others? That means that your portfolio’s risk is concentrated in that one symbol. (See sidebar, “Bet Your Bottom Beta.”) It’s okay to have a stronger bullish bias on a particular stock, but make sure you understand the risk it presents to your portfolio. If that one stock crashes, it can wipe out all your other gains.

HEDGING TIME AND VOL

If you do have any options in your positions, you’ll notice other greeks in addition to deltas—**theta** and **vega** in particular. While stock trading is somewhat one-dimensional—stocks only go up and down—option trading has to contend not only with the stock’s movement (delta), but also with changes in volatility (vega) and time passing (theta). An option trader can be right in picking the direction of a stock, but be wrong on time and volatility—and lose money. That means that the trader who ignores all the factors that affect options could be blind-sided by any one of them.

Earlier, you looked at delta. Now look at vega—do all your positions have either positive or negative vega? Negative vega means your positions are losing money as **implied volatility** drops, assuming no change in the stock price or theta. If every position has positive vega, what happens if volatility drops? You should look at theta in the same way as well. Are all your positions negative theta, which means your option positions are losing money as each day passes (assuming no change in the stock price or volatility)?

Just because all the deltas, vegas, and thetas are “pointing” the same way isn’t necessarily bad, as long as you understand the risks. If you are very confident in the direction of stock prices or volatility, then perhaps your portfolio is appropriate. But if you’re not too confident, and I don’t know many traders who are, then you might want to diversify a bit. Different option strategies such as **verticals**, **calendar spreads**, and **iron condors** have different delta, vega, and theta characteristics, so it’s a good idea to learn more about them. (See “Five Strategies under \$1,000,” *thinkMoney*, Summer 2009.) Diversification with options comes from mixing them so that the portfolio has the delta, vega, and theta risk that you’re comfortable with. No single risk should dominate your portfolio.

BE A NIMBLE STRATEGIST

As a market maker, I didn’t diversify with a particular trade in mind. Rather, as orders would come into the pit, I would think of them as either increasing or decreasing the risk of my position. If I wanted to decrease the risk, then I might be a little more aggressive in making a market for an order that would do that. I was willing to give up a bit of theoretical edge to get my risk in line. For example, if my position was overall positive or long vega, and I wanted to make it less positive, then when an order came in to buy a calendar spread, I would make my offer a bit lower to try to sell it. A short calendar has negative vega, so if I sold it, my overall vega would become less positive.

As a retail trader, you can’t really do that because



Use the Analyze page on thinkorswim from TD Ameritrade to stress-test your hedge ideas. Click the wrench icon in the Positions and Simulated Trades section to adjust the price of the underlying or option volatility to view various “what if” scenarios.

SEE
GLOSSARY
PAGE 38

you can’t make markets and you don’t see the order flow coming into the pit. But what you can do is bias your trades a bit. Let’s say you have positive or long vega in your portfolio because you’re long a bunch of calendar spreads. If volatility is lower, calendar spreads would be less expensive. That might fit your trade criteria, but if you bought more calendar spreads and your vega became more positive, then you’d be adding to your risk if volatility dropped. You might want to pass on buying more calendars. Instead, maybe you’d look to sell iron condors that have a low delta and negative vega. At lower volatility, the credit for iron condors would be lower, so you might not do too many of them, but they would partially offset your portfolio’s positive vega. If you were going to make a directional speculation, you could sell a vertical—call or put, depending on your bullish or bearish bias—which would create deltas and negative vega. Alternatively, you could roll some of the short front-month options in your calendar spreads to a further expiration. That would reduce the amount of positive vega in your port-

folio. (For more on how to roll a calendar spread, see “Lip-Smackin’ Good Rolls,” also in *thinkMoney*, Summer 2009.)

If you have a stock portfolio in that same low-volatility environment, you’re at risk if the market goes down. If that happens, it’s also possible that volatility would rise. As a way to reduce some of your portfolio’s positive deltas and get positive vega, buying long out-of-the-money puts would generate some negative deltas along with positive vega. Long out-of-the-money put verticals could be less expensive than long puts, but would generate fewer negative deltas and positive vega. Long out-of-the-money put calendars would generate even fewer negative deltas, but could generate more positive vega. There’s no “right” answer. There are only choices that affect your portfolio in different ways.

DIVERSIFICATION HAS A SIMILAR MEANING FOR BOTH traders and investors. Either way, what you’re really doing is keeping your portfolio nimble. However, “investing” for the short term, as traders do, requires a different set of skills than simply understanding correlation between stocks, bonds, and cash products to weather a storm. With practice, you can finely tune the risk of your options portfolio to match your risk tolerance and any speculative bias you have. This will also let you structure your portfolios with more discipline. Rather than entering trades as discrete speculations, you see any individual trades as pieces of a broader portfolio. Any new trades would fit into and change the portfolio a certain way.

• *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Diversification does not eliminate the risk of experiencing investment losses. Spreads, straddles, iron condors and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies and often involve greater risk, and more complex risk, than basic options trades. 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. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*

BET YOUR BOTTOM BETA

Hey, how much risk do you have in your trading portfolio, and how will you hedge it? Don’t know? A slick little tool traders have with TOS is the beta-weighting feature. This tool takes the total delta of your portfolio and converts it into individual positions on a stock or index that’s optionable, such as DJX or NDX. That number will tell you how many deltas are needed to buy or sell to hedge your portfolio. Cool, huh?

To find the beta-weighting feature, go to the Monitor page > left side, under Position Statement, click the blue dot to the left of Not Weighted > check box next to Beta Weighting. Type in the symbol of an optionable stock or index. The numbers in the delta column are the hypothetical equivalent of the stock or index you entered. To hedge this, if the number is positive, you would short deltas in the stock or index. If it’s negative, you would buy deltas.



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15

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Dear Swim

A smattering of think nothings to our beloved Trade Desk

Photograph by **Fredrik Brodén**



• Thanks for the paper version of *thinkMoney*. It's the perfect weight, not too light, not too heavy, to whack my cat out of the way when he climbs on my trading keyboard. Now when he approaches, I just whisper "thinkMoney" and he takes a wide detour.

Louisa

• Is there a singles night in the Trader Lounge chat room?

Stephan

• I love your new trade show booth! I hope it's portable. I already booked my ticket to see you again at the Orlando show.

Mike

• Where do I submit a demo tape to be on a TD Ameritrade commercial?

Charity

• I heard TOS outsources their coding to a Chinese prison in Tibet and QA to roaming Peruvian shepherders ... Don't quote me on this though.

Dan

• Dear VIX ... please go to 50. ;) lol

Scotty

• When TOS sent me a monkey, I thought it was a mascot, not their production test team.

Bill

• 90 minutes to go in the session ... What can happen?

Jon

Preconceived notions will be dealt with by the full extent of the market.

Larry

The sword of leverage is the same for companies as it is for traders: Wield it well, and you can be the victor. Wield it poorly, and you become lunch meat.

Kerry

• *The comments here are excerpts from emails submitted by TD Ameritrade clients as their views and may not reflect those of TD Ameritrade. Testimonials may not be representative of the experience of other customers and are no guarantee of future performance or success.*



Got a quip? Good, bad, and ugly, send your best to editor @thinkmoneymag.com.

And one from a respected trading dude:

Ask yourself how it is that a flock of birds or a school of fish can change direction simultaneously. There must be a way in which they are linked to one another. ... Traders who have experienced being tapped into the collective consciousness of the market can anticipate a change in direction just as a bird in the middle of a flock will turn at the precise moment that all of the others turn.

Mark Douglas

(Trading in the Zone)

TOS News+Views

A hodgepodge of stuff we thought you should know

Toys for TOS

Our favorite new gadgets

The ISE Spread Book

on the Scan tab shows you actual orders working on the International Securities Exchange. Unlike the “regular” spread book, which shows only orders working on the TD Ameritrade platform, the ISE spread book shows you all the option spread orders that are working on the entire exchange.

The Strength Meter

is a new column for any watch list. It calculates the change in price for a security over the previous three weeks. A green uptrend means $> 10\%$. A red downtrend means $< 10\%$. And a yellow range-bound means the change is between $+/-10\%$.

INDUSTRY SPOTLIGHT

QE2. What's in It for Me?

by Thomas Preston

You've seen the headlines: Two years after the crash and financial near-meltdown, the economy is still sluggish, and unemployment is discouragingly high. The volatile mix of economic and political hopes and fears fuels hours of TV programming. Since the Federal Reserve embarked on a policy of quantitative easing, it, too, has become a topic of heated discussion.

Quantitative easing is a technique that a nation's central bank (e.g., the Federal Reserve) uses to increase the supply of money by buying its own bonds back. This is supposed to raise or stabilize their prices

and lower or stabilize interest rates. Whoever owns the bonds—banks, for instance—increases their cash when they sell them to the Fed, and that is supposed to give them incentive to lend that money out. That increases the amount of money in the economy. It's not really printing money, as some commentators suggest. Rather, it's a transfer of cash for assets from the bank to the Fed. Does it work to stimulate an economy? The global record is mixed. But while any effort that lowers interest rates and increases the money supply can lead to inflation, what happens to an economy in deflation can be much scarier. The bet by the Fed is that inflation is the lesser of two evils.

From a trader's perspective, though,



To catch up on all the new TOS toys and gadgets, go to our Release Notes archives at thinkorswim.com > Support > Software Support. Select the link at the top: “Looking for Release Notes.”

what does this all mean? It's possible that the recent quantitative easing by the Fed will put inflation back into the news. It really hasn't been discussed much in the recent past, mainly because it's relatively low. Inflation talk translates into rates talk for

traders. Interest rate products, whether bonds or interest rate derivatives, are affected not only by the current inflation rate, but also by the expectation of what inflation will be in the future. Higher inflation usually means higher interest rates. Of course, that could trigger another round of Fed actions. Sure, gold and other precious metals are sometimes considered inflation hedges, but that's more qualitative than quantitative.

Watching the yield curve—whether it goes up, down, steepens, or flattens—could be the story of 2011. And instead of getting mad at the talking heads and politicians on TV, a savvy trader who

synthesizes and analyzes the data could possibly use it to her advantage.

- *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. Spreads option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. Spread option strategies can involve greater and more complex risk, than basic options trades.*

IRAS N' SPREADS: YA GOTTA LUV IT!
DID YOU KNOW THAT CUSTOMERS WHO QUALIFY CAN TRADE QUALIFIED SPREADS IN THEIR IRAS? YUP, IRAS ARE NOT JUST FOR STOCK TRADERS AND COVERED CALL PLAYERS. SO SPREADERS REJOICE!... OF COURSE, YOU'LL HAVE TO PUT UP THE CAPITAL THAT'S AT RISK, SO THERE'S NO BORROWING ON MARGIN. BUT HEY, WHO'S COMPLAINING?



Ask The Suit

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

How do you prioritize customer requests for changes to the TOS platform?

We keep a database of all feedback so we have an accurate sense of demand for each item. For each software release, we try to strike a balance of frequently requested items and new features that help support more successful traders. In the event there is disagreement among team members around prioritization, we relegate decision-making authority to the Magic 8-Ball. (If you have a suggestion, don't be shy. Send it to thinkorswimfeedback@tdameritrade.com.)

If you could be granted just one wish, what would it be?

I'm a giver, so I'd wish for all profits that we made from paper-Money trades to be credited to our live trading accounts.

With all the great features on the platform, could you suggest one thing that all clients should be looking at?

myTRADE*. I love this feature. I love seeing how other individual investors are taking action in the market. I've found some really sharp traders in the community whom I follow on a daily basis. We're all in the fight to outperform the markets together. We might as well get acquainted!

What's on deck for 2011?

thinkOnDemand will be reformat- ted. Instead of replaying a historical market, it will allow you to see how the market plays out in the future. (Just kidding.)

*myTRADE, Inc. and TD Ameritrade, Inc. are separate but affiliated companies and not responsible for each others products or services.

fyi.

COMING SOON!

• Synchronize chart cross-hairs • Market Maker Move (to estimate one-day price changes) • New indicators for TOS charts from John Carter of Trading Markets.com • Single-ticket futures spread orders • Dynamic watch lists

Pot Shots

The Trading Desk Rates the Top 5 Muscle-Builders for Traders

KEY:

2 Buy Tickets = 

1 Buy Ticket = 

1 Sell Ticket = 

2 Sell Tickets = 

Creatine



A legal, safe way for every trader to drive the monkey genes from his body.

Steroids



The ability to lift the entire yield curve with one arm is reward enough for the kidney failure and pimples.

More Food



Recent studies show that it's not the quality of the food as much as the quantity. A calorie is a calorie. Praise the Lord and pass the fries!

Whey



Provides the protein Miss Muffet needs to build enough hard muscle mass to squeeze the juice out of the Spiders every expiration.

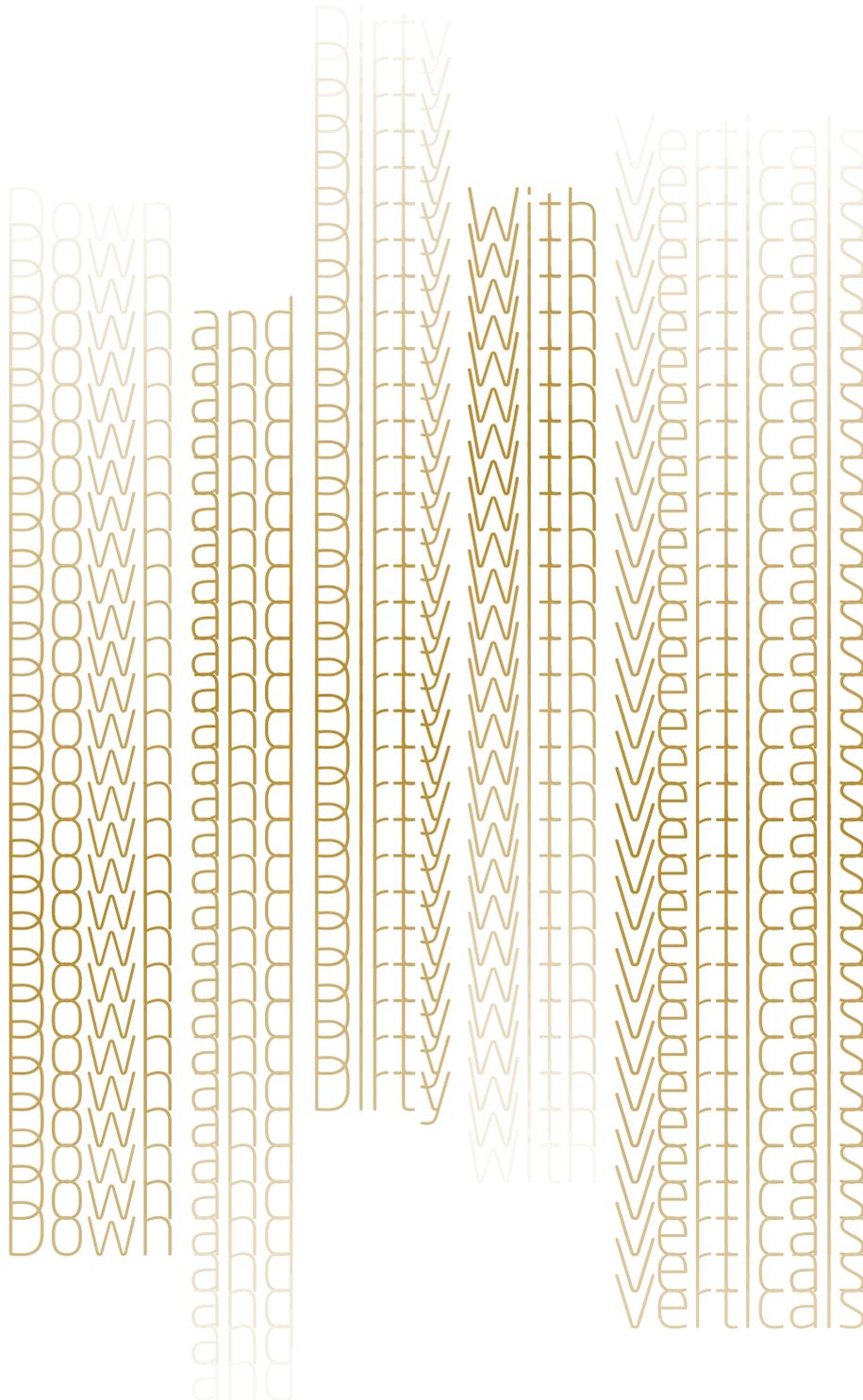
Nitric Oxide Boosters



Doesn't really affect your metabolism, but carrying that big tank on your back when you drag race that '73 'Cuda gives you a full-body workout.

18

Verticals



EVOLVING TO PRO TRADER STATUS MEANS MORE THAN BUYING CALLS AND PUTS. THE VERTICAL IS THE FIRST SPREAD OPTION TRADERS TYPICALLY LEARN. BUT SINCE YOU CAN TRADE BOTH LONG AND SHORT VERTICALS, THERE ARE STILL SOME TOUGH CHOICES TO MAKE.

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

vertical vertical

20

Verticals

Photograph by
Fredrik Brodén

thinkorswim.com

VERTICALS
ARE THE
SIMPLEST
OPTION
POSITION

There, I said it. Now I hear the chorus: “But it’s a spread! It’s two options instead of one! How can it be the simplest?” With all due respect for the individual call and put, with whom I have a long history and many fond memories, I stand by my statement. Why? Depending on how far apart or “wide” the strikes of the vertical are, it can be a lot more manageable than single options and even plain stock. Verticals can be much less sensitive than individual calls or puts. They can even have less risk than long stock.

In contrast to a single call or put, verticals—often just called call spreads or put spreads—are made up of a long call and a short call, or a long put and a short put, at different strikes, in the same expiration and same underlying stock or index. The long and short options in the vertical are called “legs” of the spread. Because the vertical has long and short option legs, whatever the stock price does, volatility does; or, as time passes, they affect the long and short legs in opposite ways. Think of it this way: A long call makes money if the stock price goes up, all other things being equal. A short call loses money when the stock price goes up. If you combine them into a spread, when the stock price goes up, and volatility and time do not change, one part of the spread makes money and the other part loses money (to different degrees). This means that verticals, or spreads, can be less sensitive to changes in the stock price (and volatility and time, as well) than a single option. That is the heart of their manageability for traders.

GREEKS MATTER

While this isn’t an article about option “greeks,” comparing the greeks of a vertical with those of a single option, and even those of other verticals, is a convenient way to measure their sensitivities. The greeks that are typically used when talking about verticals are (1) **delta**, which measures an option’s sensitivity to changes in the price of the underlying asset; (2) **theta**,

which measures an option’s sensitivity to time decay; and (3) **vega**, which measures an option’s sensitivity to changes in the volatility of the underlying asset.

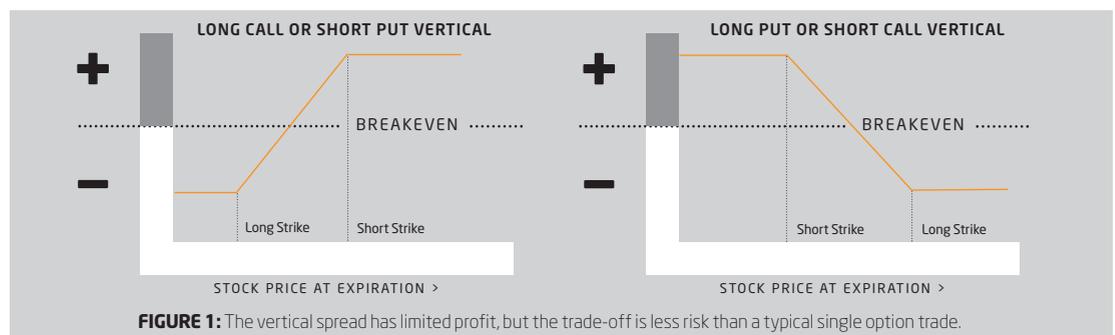
The greeks of the vertical are the net difference of the greeks of the single options. Just take the delta of the long leg of the spread and subtract the delta of the short leg of the spread. For example, if you have a 100 strike call with a delta of 0.60 and a 105 strike call with a delta of 0.45, then a vertical that’s long the 100 call and short the 105 call would have a delta of 0.15 (short calls have a negative delta, so $0.60 - 0.45 = 0.15$). In this example, the delta of the vertical is much smaller than the delta of either of the component options. That’s because the strikes are close to each other. To continue the example, if the 130 strike call has a delta of 0.05, then a vertical that’s long the 100 call and short the 130 call would have a delta of 0.55—not significantly less than the delta of the 100 call by itself.

You can do the same exercise with theta and vega. Look at the theta and vega numbers on the Trade page of the thinkorswim from TD Ameritrade platform, and you’ll see that they’re often pretty close in value at adjacent strikes—that is, the vega of the 100 call is probably going to be pretty close to the vega of the 105 call. The vega, or sensitivity to changes in volatility, of the 100/105 vertical is going to be pretty small. Just like delta, verticals whose strikes are close to one another can have much lower sensitivity to changes in time and volatility than the individual options in the spread.

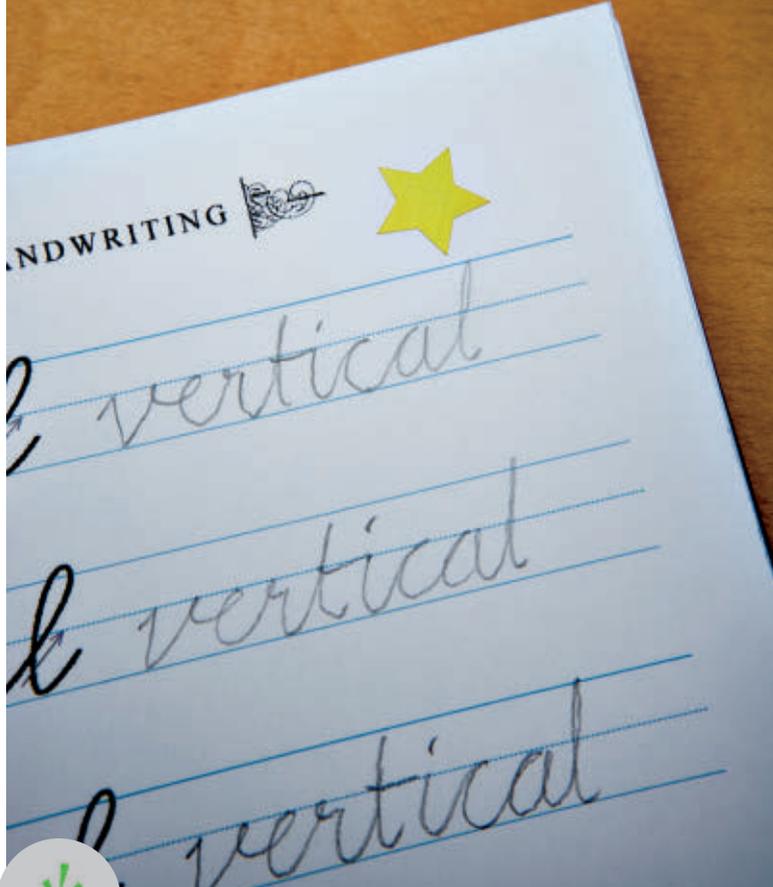
The lesson here is that the magnitude of the greeks of a vertical depend on how far apart the strikes are. The further apart they are, the larger the greeks of the vertical. The closer the strikes, the smaller the greeks. The smaller the greeks, the smaller the sensitivity of the position to the given change in the underlying. Here, I have to emphasize that verticals can have less sensitivity than single options. It’s not the case in all scenarios, but it is more likely when the strikes of the legs are close.

MULTITASKING WITH VERTICALS

So, what does all this mean to a trader? Trading options can sometimes feel like you’re spinning plates on poles. You start with one, then move to the second, then move to the third, but then you have to go back to the first to keep that going, then you move to the fourth, then back to the third, and so on. Monitoring how the changes in the stock price, volatility, and time are affecting your position can feel like keeping all the plates spinning on the poles. The fewer the poles, the easier it is. Have you ever been long an out-of-the-



VERTICALS CAN GIVE YOU MORE BREATHING ROOM TO THINK ABOUT A TRADE. THEY SLOW THINGS DOWN A BIT, AND CAN REQUIRE LESS IMMEDIATE ATTENTION.



Want more vertical know-how? Follow the click path at thinkorswim.com:

Support > Option School > Chat Archives

Type in "verticals" in the fill-in box and select "Search."

money call and had the stock go up, and still lost money as time passed (because of negative theta) and volatility dropped (because of positive vega)? Yes, a vertical still can have delta, theta, and vega, but the poles are a little lower and closer together.

Going back to the earlier example, look at the 100/105 call vertical with the delta of 0.15 versus the 100 call with the delta of 0.60. If the stock drops 1.00, the value of that call vertical would theoretically drop \$15 and the 100 call would drop \$60. If the stock moves against your position, the vertical can lose less money than the single option. And if it's losing less money, you're probably going to be less stressed, and better able to figure out why the stock is dropping and what you think the stock might do from here on out. Verticals can give you more breathing room to think about a trade. They slow things down a bit, and can require less immediate attention.

The main downside of verticals is that they have larger commissions than single options (because there are two options in the trade). But what really increases

commissions is that verticals don't have much delta. So, for example, in order to get the same risk exposure as 100 shares of stock or some single options, you might have to do many times the number of verticals. If a vertical has a delta of 0.10, you'd need to do 10 verticals to have the same delta risk as 100 shares of stock. That would require the commission of 20 options.

THINGS TO THINK ABOUT

Now, while I still stand by my opinion that verticals are the simplest options position, they are not suitable for everyone. But if you are thinking about trading verticals, here are three pointers I would offer up for your consideration:

(1) **Use limit orders.** When you're opening a position in a vertical, consider using limit orders. They give you control over the price where you trade the spread, but there's no guarantee that the order will be filled. Of course, market orders will seek to fill your orders at the next available prices, but you risk getting terrible fill prices on two options, not just one, which compounds the problem.

(2) **Don't "leg in" to the trade.** Buying one option and selling the other should be done with a single order. When you try to do them in separate orders, it's called legging, and it exposes you to more risk if you only get one "leg" order filled and the market moves against it before you get the other side done.

(3) **Never set it and forget it.** Even though verticals might not be as sensitive, don't just forget about them. At expiration, be aware that if the stock price is in between the strikes of the options, you could automatically exercise or be assigned on one of the options—not both. That would leave you with a stock position after expiration, and expose you to unwanted risk.

Verticals are the "gateway" trade. Once you figure them out, you might combine them into more complex trades such as butterflies and **iron condors**. Those increase your trading flexibility and choices even more.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Spreads, butterflies, iron condors, and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. 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. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.

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23

Hey, Monkey!

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

Photograph by **Brent Humphreys**

Q: Hey, Monkey! I've already broken all of my New Year's trading resolutions, and it's only been a week! Can I be redeemed?

A: You think you're bad, just ask my gut about that latest box of Twinkies. Anyhoo, it's safe to assume that just like the varying degrees of debauchery that spur New Year's resolutions, it's trading losses that prompted you to create your trading resolutions. Discipline in sticking to a trading game plan is tough to get and challenging to keep. Even the best traders falter. But sometimes they bend the rules to come up with even better ones. If you keep losing money when you break your rules, stop it. But if you keep losing money and you're following your rules, a review might be in order. Also, consistently

breaking the rules might mean you've learned something new, and need to change them. Redemption? You've got the rest of the year. As for me, I swear not to eat anything that has a fat content of more than 20%. But if I end up sucking on a stick of butter in a time of weakness, I'll just hit the treadmill. My doc gives me a year, too.

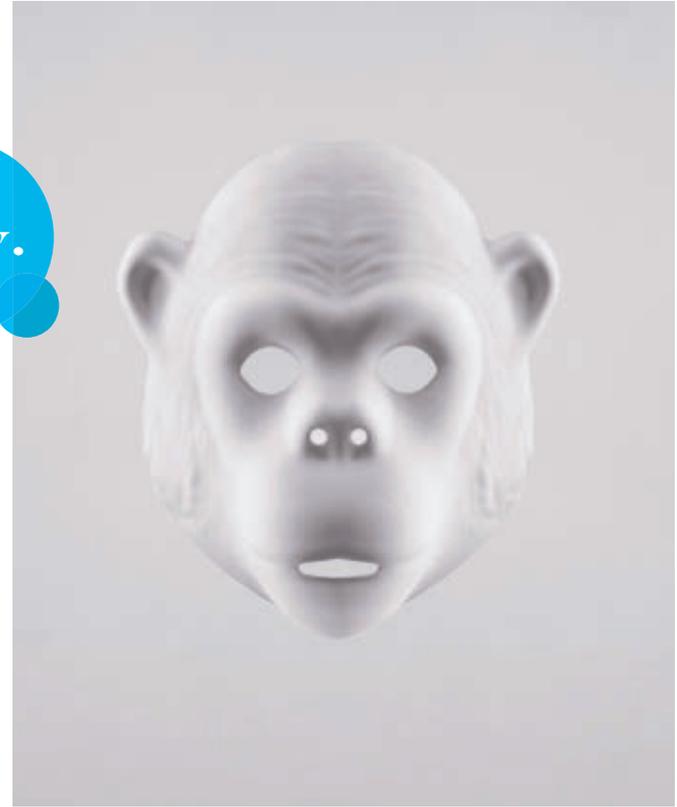
Q: Hey, Monkey! I read that when a stock has a dividend, its calls are cheaper. Why?

A: The simplest way I know to explain this is to think of calls as alternative to stock. It's not exact, but if the stock goes up, assuming they're not too far out-of-the-money, calls tend to go up, too (all other things being equal). If a stock pays a dividend, then the cost of owning that stock goes down. You're either borrowing money to buy the stock, or you're using cash that would otherwise earn interest. Those interest costs

are reduced when the stock pays a dividend. So if it costs less to own the stock, then it's less advantageous to buy the call as an alternative. The call, then, is cheaper.

A fuller explanation is that the put is worth more when there's a dividend. A long call that's cheaper and a short put that's more expensive means the synthetic stock (long call, short put, same strike and expiration) is cheaper. The price of the synthetic stock is based on the cost to own the stock for a certain amount of time. The dividend reduces that cost, so the synthetic is cheaper. That can happen when either the call is cheaper or the put is more expensive.

Q: Hey, Monkey! In light of my recent trading performance, I'm weighing some of my housing options at the moment, and have decided to "go



green." What's my carbon footprint if I live in my car?

A: So much of environmental friendliness is about multi-use, meet-your-needs, replicable lifestyle choices. Once the housing of upscale vagrants, car-living is poised to become the easy, fast way to get LEED certification in the future. It's like a battery-powered, mobile greenhouse. I applaud you for your pioneering spirit. And if your trading turns around, all you'll need for a home makeover is some air fresheners and fuzzy dice.

Just like the varying degrees of debauchery that spur New Year's resolutions, it's trading losses that prompt you to create your trading resolutions.

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



TRADING IN THE RED ZONE

IN FOOTBALL, MAKE OR BREAK MIGHT BE THE FINAL FEW YARDS. IN TRADING, IT COULD BE OPTIONS THAT EXPIRE IN THE FINAL FEW DAYS. BUT IF YOU'RE TOO SCRAWNY FOR THE NFL, WEEKLY OPTIONS LET YOU PLAY IN THE RED ZONE.

WORDS BY **MARK AMBROSE**

PHOTOGRAPH BY FREDRIK BRODÉN



THE

"RED ZONE" IS FOOTBALL'S UNOFFICIAL SPACE BETWEEN THE GOAL LINE AND THE 20-YARD LINE. IT CAN BE THE SPACE OF THE FINAL DRIVE OF THE OFFENSE—OR THE FINAL STAND OF THE DEFENSE. THE RED ZONE TESTS A TEAM'S METTLE. IN FACT, IT'S A LITTLE LIKE EXPIRATION WEEK FOR OPTIONS. THINGS CAN GET MORE ACTIVE—EVEN CRAZY.

Decisions are a little more pressing. And just as with football, the way you perform in the red zone can determine your success. Some teams thrive there, and some traders love those few days before expiration. The product that lets them play there is known as "Weeklys"—exchange-traded options on stocks that expire in just

one week. Weeklys are created on Thursdays and they expire the following Friday. Set! Hike!

Weekly expiration options were introduced a few years ago, and their popularity among traders is expanding rapidly. The reason? Weeklys offer the ability to make very tailored speculations on short-term price moves in the stock. With fewer days to expiration, they're less expensive than other options at the same strike price in further expirations. And they give you a lot of bang for the buck, because if the underlying stock or index makes a big move, Weekly prices can change by a much larger percentage than further-dated options. That's what makes them "red zone" trades. If the trade in the weekly options goes wrong, there's no "it'll come back someday"—unless "someday" is this coming Friday.

What do I mean? Let's use an option pricing formula to arrive at some theoretical values. (The option pricing model we're using Bjerksund-Stensland. All theoretical values in the following example were derived using the

SEE
GLOSSARY
PAGE 38

theoretical pricing tool found in the Trade page of the thinkorswim from TD Ameritrade platform. See callout, left.) Let's assume we're looking at a \$100 stock with a volatility of 35%.

If the stock price moves from \$100 to \$101 (assuming no change in volatility), the 100 strike Weekly calls with seven days to expiration theoretically would go from .90 to 1.44. Meanwhile, the 100 strike calls with 21 days to expiration would go from 2.23 to 2.76. The Weekly options rose 0.54, or about 60%. The 21-day options rose 0.53, or about 24%. Thus, Weekly options have the potential to increase by a greater percentage for the same price change in the stock.

BIG BANG, SMALL BUCK

What makes the Weeklys move so much? The short time to expiration means that Weekly options have relatively high **gamma**. That high gamma means that their prices respond very quickly when the stock or index price changes, whether up or down. Gamma measures how much an option's **delta** moves when the stock price changes; delta measures how much the price of the option changes.

A good way to think about delta is how much the option "acts" like stock. When gamma is high, a small change in the stock price increases the delta, pushing the option to act more like stock as it changes closer and closer to parity (dollar for dollar). That's what accounts for the very high percentage appreciation you can see in Weekly options. The high gamma makes them interesting trades for earnings announcements or other news releases. Let's say you believe the stock will have a big price change when the news comes out. It's the Weekly options that will have the largest percentage changes if you're right.

If that's the case, why wouldn't you just buy Weekly options all the time? Well, the less time there is to expiration, the less likely it is that a big move is going to occur. A longer-dated option gives the stock more opportunity to rise. The short amount of time with Weeklys means that their decay, or **theta**, whittles their extrinsic values down very quickly. Along with the high gamma, Weeklys have commensurately high theta. If the stock does not make the price move you're hoping for, that Weekly option's price will go from cheap to cheaper thanks to time decay, and much of the time, there's no turning back. That works in favor of short options positions, but your longs are likely to toast.

A CASE FOR BUYING

You might be asking yourself, "But if you're speculating on a short-term change in the stock, why use the Weeklys instead of trading the stock?" It's true that



To access the theoretical pricing tool in the thinkorswim from TD Ameritrade platform, simply select the Trade tab > enter symbol in fill-in box > in the dropdown menu next to "layout", select "Theo Price, Mark" Under each of the calls and puts columns, you'll see the theoretical price column to the left and the "mark" or current price to the right. Just above the chain, you can change the theoretical days, as well as price and volatility of the underlying, to see the theoretical price where each option in the chain might go.

stock doesn't expire and doesn't suffer from time decay, but it uses a lot more trading capital than a Weekly option, and it can have a lot more risk. If you were going to buy 100 shares of that \$100 stock in the example, the margin requirement would be \$5,000. But the weekly 100 strike call would cost you only \$110. And let's say the stock drops in price. The max loss on the long Weekly call is \$110—as opposed to \$10,000 on the long stock. While the stock position has advantages, it also has greater risk.

So how about just buying options with a further expiration date? You could buy more to get the gamma equal to the Weekly position, and the time decay would still probably be lower. The risk here is that the larger position in options with a further expiration date has a much higher **vega**, or sensitivity to changes in **implied volatility**. Remember when I said that Weeklys let you tailor the speculation? Weekly options have low vega, and don't move as much when volatility goes up or down. That means that you can focus more on what the stock price is doing. With longer-dated options, you have to be aware of what volatility is doing as well.

A CASE AGAINST SELLING

Now, the reason that every trader doesn't just go out and short Weekly options to take advantage of the steep time decay is that the lower price of the Weeklys makes the absolute amount of decay relatively lower. Sure, the rate is high, but the overall amount is smaller. Just as an offense has a running game and a passing game, each with its own particular risk and potential reward, buyers of Weekly options take the risk of that big move in the stock not happening while they battle negative time decay. Sellers have to decide whether the smaller credit they get from shorting the Weekly is worth taking the risk of a big move in the stock that would create a huge loss in that position.

GETTING IN THE GAME

So, ready to start trading Weeklys as part of your game plan? Here are some things to consider during the huddle:

1. **CURRENTLY A SMALL BASKET** Weeklys are available on more than 15 different stocks. Individual stocks sometimes have their biggest price swings around earnings numbers. If you're buying Weekly options to speculate on a big price move on earnings, double-check to make sure the earnings are announced before the Weeklys expire (see callout, left). Keep in mind that if you guess wrong and the position moves against you, you could lose the entire investment amount spent on the option.

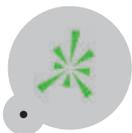
WEEKLYS ALLOW YOU TO MAKE VERY TAILORED SPECULATIONS ON SHORT-TERM MOVES IN THE STOCK. WITH FEWER DAYS TO EXPIRATION, THEY'RE LESS EXPENSIVE THAN OTHER OPTIONS AT THE SAME STRIKE. AND THEY GIVE A LOT OF BANG FOR THE BUCK.

2. **HOW TO SHORT** If you want to try to take advantage of the Weeklys' time decay, you could consider shorting Weekly option spreads in the index products. You can see those symbols on the public watchlist as well. The index products tend to be less volatile than individual stocks, and can be a way to test out short option strategies. Bear in mind that some short strategies can carry unlimited risk. So be sure to understand all relevant risk factors and whether such strategies are suitable for your portfolio.

3. **WATCH FOR EARLY SETTLEMENT** Some Weekly options are based on cash-settled indexes such as the OEX, XEO, DJX, and SPX. The DJX and SPX Weekly options stop trading on Thursday afternoon and settle on Friday morning. For more information, check the Weekly option specifications on the Chicago Board Options Exchange website at www.cboe.com.

What should be clear from the advent of Weekly options is that equity markets are no longer targeted to just long-term investors. As options are becoming increasingly popular with traders, the industry is scrambling to find ways to quench their thirst for capitalizing on short-term events that move markets. Heck, recently, the CBOE petitioned the SEC to include options that expire *daily* in its arsenal of products! Who knows if that'll happen, but if "Dailys" are on the horizon, so much for the red zone—you're literally at the goal line.

• *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. 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. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*



To find the list of Weeklys options currently trading, log on to the TOS platform, look on the Market Watch tab of the trading software, and choose "Weeklys" from the "public watchlist". If you're looking for earnings plays, the icons next to the symbol indicate upcoming earnings announcements.

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29

Capiche?Lessons from a
veteran floor trader

Do the Numbers Lie?

How the opening price of the SPX differs from its settlement price—and how it screws traders up.

• Trading is great if you like to stare. There are so many numbers flashing red and green and yellow, it's like the Feast of San Gennaro. Hey, if you haven't eaten zeppole in Little Italy, you haven't lived. When you have a position on, sometimes you can't help but stare at the trading screen. Sure, if you have some options on that have weeks until expiration and they're not moving around very much, you stare at something else. Like TV. But fast-forward to expiration, and you can't pry your eyes away from the monitor with a crowbar.

One of the most interesting things to watch if you're an old index option trader like me is the settlement price of the S&P 500 Index (SPX). As you probably know, SPX options stop trading on the Thursday before the third Saturday of the month, and the SPX settlement price, which determines if the options are in- or out-of-the-money, is determined on Friday morning. If you have expiring SPX options, you have to wait and see what happens from the close on Thursday to the open on Friday. And you wonder why I have a few gray hairs? Anything can happen overnight!

Words by **Tony Battista**
Photograph by **Fredrik Brodén**



cap.

WHAT YOU SEE ISN'T WHAT YOU GET

So you wake up extra early on Friday and watch the S&P 500 futures to see whether there was a big move overnight. And you stare really hard at the SPX price at 8:30 a.m. CT to see how your positions might fare. The opening price of the SPX looks good for your positions, but only a rookie would breathe a sigh of relief. You see, even though the settlement price of the SPX is determined by the opening price, it's really the composite of all the opening prices of all 500 stocks in the index. That means the settlement price of the SPX can be significantly different from the opening price of the SPX itself. So what gives?

The SPX quote you see is the weighted average of all the last prices of the 500 component stocks. If a stock changes price, the SPX price changes a little, too. While most of the 500 stocks are trading pretty actively in the middle of the trading day, that's not necessarily the case at 8:30 in the morning. Just before the open, the price of the SPX is being calculated off the last prices of the 500 component stocks from the night before. At 8:30, some, but not all, the stocks start trading, and the SPX starts to change. The open price you see for the SPX is based on some current and some old data. The current data is for the stocks that are trading at 8:30. The old data is for the stocks that

haven't traded yet, and is from yesterday's close. That's crucial, because the settlement price of the SPX can be determined only when all 500 stocks have traded with an opening price. As I said, some have their opening price at 8:30, but others might not open until 8:45. If the overall market moves in those 15 minutes, the SPX settlement price has some of its data from before the move and some from after the move.

Because you have to wait until all 500 component stocks have opening prices, you won't know what the settlement price of the SPX will be until a couple hours after the open. That gives the

exchanges time to verify the opening prices, calculate the settlement price, double-check it, and then broadcast it to the world under the symbol SET. The NDX and RUT settlement prices can take even longer.

Generally, if I have any expiring short out-of-the-money options in the SPX, for example, I'll try to close those positions before they stop trading on Thursday. Too much can happen in a market between Thursday night and Friday morning. Because the index settlement price can be such a wild card, to me, it's not worth taking the risk leaving those positions open.

And the gray hair? Nah, it's just a little powdered sugar.

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30

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Looking for bears in a bull market? Try using correlation.

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Many traders find they are able to spot the top of the market or a bearish trend in equities, but are not willing to pull the trigger on the bearish trade. For one reason or another, most people are wired to look for bullish opportunities, and quite frankly, they can miss the forest for the trees. But what if there were a way to spot bearish opportunities while bullish trends are occurring elsewhere, and vice versa? That's what inverse correlation is all about, and it tends to happen frequently in the forex markets—particularly when comparing price action between equities and the dollar (USD) in recent years.

WHERE THERE'S A BULL, THERE'S A BEAR

In trading geek-speak, correlation has to do with how assets move in relation to one another. In the world of stocks, two companies in the same sector—say, automakers—

Words by **Kevin Lund**



FIGURE 1: Opposites Attract. Using the correlation indicator on the TOS charts, you can start to gauge whether one asset tracks another in its movement, or in the case of the U.S. dollar vs. the S&P 500, they tended to move opposite of one another for most of 2010. For illustrative purposes only. Source: thinkorswim from TD Ameritrade

often tend to be highly correlated (i.e., have positive correlation) and move together. Though, over the long term, the dollar and US equities have been highly correlated, recently, that trend has reversed. In other words, as the dollar has moved lower, stocks have moved higher. When stocks crashed in 2008, for example, the dollar finally broke its multi-year downtrend. Perhaps coincidentally, when traders started piling in on equities in March of 2009, we saw the dollar take another tumble until the equities peaked in April 2010. Could this mean the dollar/equity relationship is primarily due to traders running to cash at the first sign of fear?

Correlation values vary from -1 to +1. A negative value indicates a negative or inverse correlation. A positive value is a positive correlation. The calculation simply compares relative price moves between two instruments over a specific time. If they move up together point by point, the value will be 1, or 100% correlated. If they move opposite to each other (one moving up and one moving down point by point), the value would be -1, or 100% inversely correlated.

Based on data between January and early December of last year (see chart in Figure 1), the S&P futures (/ES) was inversely correlated (below the zero line) to the dollar index (/DX) for most of the year. Extreme readings above 0.5 have strong positive correlation and below -0.5 have strong negative correlation, respectively. Readings between 0.50 and -0.50 are relatively weak correlations. However, specific readings at certain points in time aren't as important as the overall trend for a period of time, such as the whole of 2010. How can a trader use this to his or her advantage? The

trade might be to buy dollars when equities are falling, and sell dollars and buy equities when they are rising.

If the inverse correlation continues to hold true, buying dollars at resistance levels in equities and exiting dollar-long trades at equity support levels could be one opportunity. And if the U.S. economy does see the dreaded “double-dip” recession after all, what kind of returns might be made on the dollar while others flee the sinking ship of the equity markets? Are equities setting up for that next drop? Time will tell.

Trading forex involves speculation, and the risk of loss can be substantial. Investors must consider all relevant risk factors, including their own personal financial situations, before trading. Trading foreign exchange on margin carries a high level of risk, as well as its own unique risk factors. Forex investments are subject to counterparty risk, as there is no central clearing organization for these transactions. Before considering the trading of this product, please read the Forex Risk Disclosure available at <http://www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf>. A forex dealer can be compensated via commission and/or spread on forex trades. TD Ameritrade is subsequently compensated by the forex dealer. Forex accounts are not protected by the Securities Investor Protection Corporation (SIPC).

Wanna trade forex at TOS? To open an account, just follow the click path online at thinkorswim.com > Why thinkorswim? > Order Types & Products > Currency Trading

Where Is It?

Platform tips from
the TOS Trade Desk

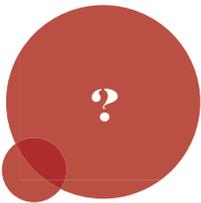
Words by
Todd McGarthy

Custom Template Orders for That Someone Special

Tired of building the same trade? No problem.



FIGURE 1: Custom Template Order. Fire up an order from TOS (1), click the custom template icon (2), give your template a name, and save it (3).



• What do you get that special person who has everything? It's a question most of us ask ourselves this time of year (guys, in case you forgot, Valentine's Day is around the corner). And if you're single, this can be one of the most daunting tasks you'll face. It once forced me to break up with a girl before the holidays and make up with her after Valentine's Day. Here's a slightly better idea.

Customized Order Template

This is the gift that keeps giving, and they'll have it for many expirations to come. It's particularly useful for the sweet-heart who loves trading skewed butterflies.

If you're someone who gets annoyed every time you want to place an order for that wild long trade on the SPX with the

four legs, a stop-limit price, good for the day, on the CBOE, saving a custom order template is now your best friend. And the best thing about custom order templates is that it's a one-time deal and it only takes three steps.

1. Create an order.
2. Click the icon that looks like a little puzzle piece on top of an old-school floppy disc (Figure 1, step 2) in the lower right-hand corner to the left of the Delete/Confirm/Send buttons. (Work with us here.)
3. When the "Save Custom Order Template" window pops up, name your template (Figure 1, step 3)—perhaps "Honey Bunny's Butterfly," or "Pookie Bear's Back/Ratio." You get the idea.

The great thing about custom templates is that the next time you need that setup, you simply right-click on a bid/ask in an option chain and you'll see your customized order template option below the standard ones—i.e., Stop and Stoplimit. Click on it to adjust your strikes, quantity, and price, and you're off to the races.

Okay, so isn't really a gift to your loved one in the traditional sense, but you could

always recommend to that special someone that they open up a TOS account and give him/her this article!

• *The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multiple-leg 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. Supporting documentation for any claims, comparisons, statistics, or other technical data will be supplied upon request.*

Special Focus:
Forex Trading

Photograph by
Fredrik Brodén

thinkorswim.com

STOCK TRADER, MEET FOREX

Familiarity breeds comfort, and though a chart's a chart, there are some differences between trading currencies and equities you ought to know before diving in.

words by **Frederic Ruffy**

FOCUS:
**forex
trading**

YOU DON'T HAVE TO BE A BIG FISH to swim in the pool of currency trading anymore. It's certainly not shrouded in the mystique it once was, and advances in technology have helped to level the playing field by bringing it to the masses. But let's be clear. It's not for everyone, and we'll cover some of the specific risks a little later.

Also known as forex (or FX), currency trading is a vibrant marketplace. If you haven't looked at FX yet, perhaps it's because you were too afraid of it, or just didn't quite understand it. But the pool of currency to trade is expansive, and you don't have to be a rocket scientist to figure things out. In fact, when trading FX, you can rely on many of the same tools available on the TOS trading platform that you already know and love. And if you understand what makes a stock tick, you more than likely understand what makes FX—ahem, pip. >



34

Special Focus:
Forex TradingPhotograph by
Fredrik Brodén

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WHAT MAKES THE DOLLAR MOVE?

One way to think of a country's currency is the same way equity investors think of stocks. Higher stock prices typically reflect investor confidence in a company's future. Likewise, higher currency values typically reflect investor sentiment in the health of that country's economy relative to other countries. Earlier in 2010, when word spread that the U.S. Federal Reserve was planning to buy back Treasury bonds, the U.S. dollar (USD) sank. By October 2010, the greenback had buckled to new 15-year lows against the Japanese yen. By buying bonds, the Fed signaled to investors that it was taking serious action to keep interest rates in check. Lower rates in the U.S. make the dollar less interesting relative to other currencies. That is, as rates or yields fall, banks and other investors will move money into financial systems that offer higher rates. For instance, if rates are low in the U.S., investors might move money into Australia and invest in higher-yielding Australian bonds.

Capital movements across borders are like tides that flow in the ocean. These shifts of assets are powerful forces that drive currencies higher and lower. Economic data and interest rates are the key fundamental drivers for this capital movement. As a result, trends can last months or even years and provide both short- and long-term profit opportunities in the currency markets.

FIRST, THE NUTS AND BOLTS

Trading FX is essentially pairs trading. You are buying one currency and selling another. If you buy the EUR/USD pair, for example, you are long the euro and short the US dollar. Some of the more actively traded pairs today include the USD/JPY, GBP/USD, and EUR/JPY. Major currency pairs consist of any pair with two of the currencies listed below. All other pairs are considered "exotic."

| | |
|-----|---------------------------|
| USD | <i>U.S. dollar</i> |
| JPY | <i>Japanese yen</i> |
| EUR | <i>Euro</i> |
| AUD | <i>Australian dollar</i> |
| CAD | <i>Canadian dollar</i> |
| GBP | <i>British pound</i> |
| CHF | <i>Swiss franc</i> |
| DKK | <i>Danish krone</i> |
| NZD | <i>New Zealand dollar</i> |
| NOK | <i>Norwegian krone</i> |
| SEK | <i>Swedish krona</i> |

The minimum price movement in a currency market is called a *pip* or *tick*. For example, let's say the quote for EUR/USD is 1.4165 bid to 1.4175 ask. Since one pip is 0.0001, this means that the difference in price between the bid and ask is ten pips, which is another way of saying that the difference in price for €10,000 (euros) is \$100 (U.S. dollars). Just as with stocks, investors can buy at the ask and sell on the bid.

For many currencies, the pip is equal to 1/100 of a cent, or 0.0001. This seems like a small amount, but a standard trade is \$100,000, so a 0.0001 pip equals \$10. If you capture 10 pips on a trade, you've made \$100.

fx.



IT'S ALL ABOUT THE LEVERAGE

Forex trading at TD Ameritrade offers a fixed leverage of 50 to 1 on major pairs and 20 to 1 on exotic pairs. The rules surrounding leverage on FX are a bit different than margin on equities. Let's consider an example: Suppose the EUR/USD currency pair is trading at 1.41750 bid to 1.41850 ask, and you buy the pair on the 1.41850 ask. You are now long the euro and short the dollar. You're anticipating the euro will bounce higher against the dollar. Assume the euro gains against the dollar, and the quote is now 1.42050 bid to 1.42150 ask. You sell the position at the 1.42050 bid price. On a \$100,000 transaction size, you net 20 pips, or a \$200 profit. If you're trading on TD Ameritrade's non-commission feed, your transaction costs are included in the quotes.

$$(\$1.42050 - \$1.41850) \times 100,000 \\ = 0.002 = 20 \text{ pips} = \$200$$

On the other hand, if the euro loses against the dollar, and the quote is lower, say 1.41650 bid to 1.41750 ask, on a \$100,000 transaction size, you're down 20 pips, or a \$200 loss.

$$(\$1.41650 - \$1.41850) \times 100,000 \\ = -0.002 = -20 \text{ pips} = -\$200$$

What's important to understand about FX leverage is that you don't need to put up the entire \$100,000 to trade EUR/USD. The leverage varies by firm, but it's not uncommon to see leverage rates of 5 to 1 or even 50 to 1 (as with TD Ameritrade). If, for example, you've put down \$2,000 (50 to 1) and capture 20 pips

on a currency trade, you've made \$200 or 10% on your investment. However, leverage like this is a double-edged sword: The more you have, the higher the potential rewards, and the greater the risk of hefty percentage losses.

THE OTHER BITS

FX has some unique features that appeal to equity and options traders, in particular. The following is a short list.

Same Board, Different Game. Adding FX to your game plan gives you another product to trade, but it's not like you'll be starting from scratch. You can use many of the same analysis techniques that you do for equities. After all, a chart is a chart. Chances are, many of the indicators that you use to trade stocks, futures, or options can be applied to FX charts as well. In Figure 1, notice the trend in the USD/JPY currency pair from May to November 2010. Even simple trendlines can be useful when looking for the next major trend in a currency pair.

Trading currencies can also provide some portfolio diversification. It's another asset class and another opportunity to initiate positions to build a portfolio. If, for example, your stock portfolio isn't doing well, some of those losses might be offset by positive results from a profitable currency position. There's a lot to be said for trading asset groups that do not have a high degree of correlation.

The Long and Short of It. Since currency markets tend to move in trends, they can offer both short- and long-term trading opportunities. For example, the investor focused on fundamental factors such as interest rates and economic data can trade on information from news releases in search of short-term profits, or even intraday moves. Economic news releases tend to cause very short bursts of activity in financial markets, including volatile moves in currency pairs. The idea is to capture a few pips here and there. Remem-

ber, hit for singles, not home runs.

Some currencies trend nicely over time and are sometimes used for longer-term positions. For example, an investor who expects the dollar to rebound against the yen through 2012 might initiate a long position in the USD/JPY and place a stop-loss above a recent low that is a predetermined price designed to get him out of the trade when that price is reached—something you can program right into the TOS trading platform. A long-term, trend-following approach can be just as useful in trading currency pairs as it is in equities. Frequently, the key is to correctly assess longer-term macro trends by reading the news and economic reports, just as you would equities.

Rock and Roll Around the Clock. Since international currency markets overlap, you can trade currencies day and night. For the week, markets are normally open from 6:00 p.m. Sunday to 4:00 p.m. Friday (Central time). The continuous trading helps to ensure that there are no "speed bumps" or big moves when markets are closed. The largest volume and most liquid markets exist when multiple international markets are trading.

Because there is no daily close for the currency market, the value of any open FX position is calculated at 2:00 p.m. Central time every day and adjusted due to rollover rates. The rollover is simply the interest rate differential between the currency you're long versus the currency you're short. If you pay more than you earn, the rollover will result in a debit. If you earn more than you pay, you get a credit. So, the daily adjustment is a net debit or credit to the position. Essentially, automatically and behind the scenes, at the end of the day (2:00 p.m.), one position is closed and a new one is opened reflecting the debit or credit. This process is sometimes called the overnight roll or the Tom-next procedure. (See page 36 for more on the overnight roll.)

Finally, it's worth mentioning that although every investment involves some risk, the risk of loss in trading off-exchange forex contracts can be substantial. So before jumping in with both feet, understand that the only funds that should ever be used to speculate in foreign currency trading are funds that represent risk capital—i.e., funds you can afford to lose without affecting your financial situation. The reality is that no one can predict which way exchange rates will go, and the forex market is volatile. Leverage can produce large losses in relation to your initial deposit. In fact, even a small move against your position may result in a large loss, including the loss of your entire deposit. And, depending on your agreement with your dealer, you could also be required to pay additional losses.

UNDERSTANDING THE RISKS of trading FX is key, and if it's a new concept for you, sure, it will take a little time and educa-



For more information on opening a forex account with TOS, go to click path: thinkorswim.com > Why thinkorswim > Order Types & Products



FIGURE 1: A chart is a chart. Does this chart look familiar? Most of the technical indicators that stock and options traders use are shared by FX as well. This chart happens to show the dollar/yen (USD/JPY), but it could just as well be SPX. For illustrative purposes only. **Source:** thinkorswim.

36

Special Focus: Forex Trading

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tion to learn the ins and outs. Yet, for many investors, FX is an exciting and liquid market to trade. The key drivers—economic data and changes in interest rates—are easy to follow. Just as we've seen with the U.S. dollar, currency prices can trend over time and provide both long-term and short-term trading opportunities. If you're already trading equities, you don't need to reinvent the wheel. You can use many of the TOS platform tools that you already know and love.

Trading forex involves speculation, and the risk of loss can be substantial. Investors must consider all relevant risk factors, including their own personal financial situations, before trading. Trading foreign exchange on margin carries a high level of risk, as well as its own unique risk factors. Forex investments are subject to counter-party risk, as there is no central clearing organization for these transactions. Before considering the trading of this product, please read the Forex Risk Disclosure available at <http://www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf>. A forex dealer can be compensated via commission and/or spread on forex trades. TD Ameritrade is subsequently compensated by the forex dealer. Forex accounts are not protected by the Securities Investor Protection Corporation (SIPC). Diversification does not eliminate the risk of experiencing investment losses.

FX Tips and the Overnight Roll

If you made money on your currency pair while sleeping but didn't know why, here's your answer.

| Symbol | Close Price | Long Open | Long Swap | Long P/L | Short Open | Short Swap | Short P/L |
|---------|-------------|-----------|-----------|----------|------------|------------|-----------|
| USD/JPY | 83.75 | 83.7479 | 21.00 | \$0.25 | 83.7425 | -75.00 | (\$0.69) |
| USD/KWD | 283 | 282988 | 0.12 | \$0.42 | 282965 | -0.35 | (\$1.24) |
| USD/MXN | 12.3733 | 12.3754 | -21.00 | (\$1.70) | 12.3743 | 10.00 | \$0.81 |
| USD/NOK | 5.988 | 5.98914 | -11.40 | (\$1.90) | 5.98805 | 0.50 | \$0.08 |
| USD/PLN | 3.0567 | 3.057009 | -3.09 | (\$1.01) | 3.05675 | 0.50 | \$0.16 |
| USD/RON | 3.2751 | 3.275437 | -3.37 | (\$1.03) | 3.27515 | 0.50 | \$0.15 |
| USD/SAR | 3.7504 | 3.750471 | -0.71 | (\$0.19) | 3.750291 | -1.09 | (\$0.29) |
| USD/SEK | 6.8484 | 6.8493 | -9.00 | (\$1.31) | 6.84845 | 0.50 | \$0.07 |
| USD/SGD | 1.3129 | 1.312955 | -0.55 | (\$0.42) | 1.312823 | -0.77 | (\$0.59) |
| USD/THB | 30.17 | 30.1913 | -213.00 | (\$7.05) | 30.1505 | -195.00 | (\$6.45) |
| USD/TRY | 1.5593 | 1.559704 | -4.04 | (\$2.59) | 1.55935 | 0.50 | \$0.32 |
| USD/ZAR | 6.8313 | 6.832589 | -12.89 | (\$1.89) | 6.83135 | 0.50 | |

FIGURE 1: Forex rollover rates. To calculate how much interest your long or short currency pair is making or costing you per night, go to the click path MarketWatch > Rollover Rates > "Long P/L" or "Short P/L" columns. For illustrative purposes only. Source: thinkorswim from TD Ameritrade.

fx.

- As with stocks or futures, to trade forex (FX), you need to open up a separate forex account with

TD Ameritrade. Once open, your FX account will be listed under the same login as your other thinkorswim accounts. This allows you to switch back and forth from, say, equities and options to FX just by selecting the active account in the upper left-hand corner of the platform. Nice.

Practice Makes Perfect

Once you've opened a FX account, you might want to practice a trade or two before committing real capital. To do this, select the paperMoney platform at the thinkorswim login screen. With paperMoney, you can familiarize yourself with all of the trading platform's features and how to place an order. Once you've got the hang of things, if you're planning on hold-

ing any currency pairs overnight, you should understand how interest rates could impact your P/L.

Checking Your Rollover Rates

Jumping ahead a little, an important consideration when trading FX is the payout on overnight interest rates. Each country pays out some interest for holding its currency. In the U.S., for example, it's the Fed funds rate. You earn that rate if you're long the U.S. dollar (USD), and you pay that rate if you're short it. That's important, because every FX trade is a pairs trade, where you're buying one currency and shorting another. For example, if you buy the USD/JPY and hold that overnight, you're buying the U.S. dollar and shorting the Japanese yen.

Because you're long the dollar, you receive the dollar interest rate. Because you're short the yen, you pay the yen interest rate. If you hold a currency pair overnight, the net difference between the rate you're paid and that which you pay,



For more information on opening a forex account with thinkorswim, go to thinkorswim.com and follow the click path to **Why Thinkorswim > Order Types & Products**.

FOREX TRADING

Q + A:



and the method that the interest is debited or credited, is called the rollover (or overnight roll). This is not something you have to worry about doing yourself. It's all done automatically behind the scenes at 2 p.m. CT, and posted at 4 p.m. CT.

You'll find the "Rollover Rates" page on the MarketWatch tab in the submenu. That gives you an idea of the debit or credit for overnight FX positions. There are seven fields for each pair: close price, long open, long swap, long P/L, short open, short swap, and short P/L. For example, take a look at the USD/JPY in Figure 1: The close price was 83.75, the long open was 83.7479, the long swap was 21.00 yen, the long P/L was \$0.25, the short open was 83.7425, the short swap was -75.00 yen, and the short P/L was -\$0.89. Notice how the long open is lower than the close price. With U.S. interest rates higher than Japanese interest rates, you would earn more interest being long USD than the interest you pay being short JPY. The net interest on an overnight long USD/JPY position is credited to your account by closing your long USD/JPY position at 83.75 and reopening it at a lower price of 83.7479. That difference is 21 yen, which is the long swap. The value of the 21 yen is \$0.25, which is the amount credited to your account.

If you were short the USD/JPY, you'd look at the short rates. In that case, a short position would be closed at 83.75 and reopened at 83.7425. That difference represents 75 yen, which is the short swap. The value of the 75 yen is \$0.80, and is the amount you're paying in interest by holding the short USD/JPY position overnight.

•
Forex trading privileges are subject to TD Ameritrade review and approval. Not all account owners will qualify.

Q: Can I trade FX in an IRA?

A: Not at this time. FX trading is available only in margin accounts.

Q: Can I just start trading FX in my account?

A: You need to open a FX account with us before you can route forex orders, and it's easy to do. Go to thinkorswim.com and log in to the accounts services center. Click on the button to apply for FX trading on eligible accounts. That will take you to a page that shows your margin accounts, and another button to request forex trading. Click on that, and you're on your way to FX trading.

ONCE YOUR ACCOUNT IS SET UP, YOU CAN TRADE FX RIGHT ALONGSIDE YOUR STOCKS, OPTIONS, FUTURES, AND FUNDS AND SEE THE POSITIONS ON THE TRADING PLATFORM.

Now, even though you opened a forex account, that's only on the back end. You'll be able to trade FX right alongside your stocks, options, futures, and funds and see the positions on the trading platform. You also don't have to fund your FX account separately.

Q: What is the commission on FX trading?

A: If you choose the non-commission option for your FX trades, there isn't a commission, but it isn't free. Since mid-market trades do not occur you can only buy on the offer and sell on the bid all of the transaction fees are implicitly priced in

to the quoted markets. Should you choose the commission-based option, FX trades are subject to a fixed-commission structure based in counter-currency units (the second symbol of a pair). For example, the commission from a 1,000-lot EUR/USD trade would be USD \$1 (\$1 minimum and/or \$0.10 per 1,000 units). The commission from a USD/JPY trade of 5,000 units would be JPY ¥90.

Q: When do FX traders sleep?

A: Not often. The FX market is open continuously from Sunday at 4 p.m. CT to Friday at 4 p.m. CT. Because the FX market doesn't really have a close during that time, the value and profit/loss on any position you hold is calculated at 2 p.m. CT every day.

Q: How much money do I need to trade FX?

A: There's no minimum account size, but there are margins for FX positions based on the leverage allowed for the currency. For pairs between major currencies such as the U.S. dollar, Australian

dollar, British pound, Canadian dollar, Danish krone, euro, Japanese yen, New Zealand dollar, Norwegian krone, Swedish krona, and Swiss franc, the leverage is 50 to 1. For all other pairs, the leverage is 20 to 1. That means for a position that's long 10,000 USD/JPY, the margin requirement is \$200. For 10,000 EUR/USD, the margin is 200 euros. The margin requirement is based on the first currency of the pair.

38

gls

found on pages:

Short Vertical **12 & 18**

- A defined-risk spread constructed of a short option and a further out-of-the-money option, both calls or puts. Short verticals are put on for a credit. Short put verticals are bullish and short call verticals are bearish. As time passes, and/or volatility drops, the short options decay faster than the longs. The strategy is designed to profit when you can buy back the spread for less than you sold it for, or at expiration, the short option is at- or out-of-the-money. The risk is typically limited to the difference between the strikes, minus the premium received.

The Token Glossary

• Terms you might stumble across in this issue

• thinkorswim.com

found on page:

12**Spread**

- An option position or order that contains two or more option "legs" and includes at least one long and one short option.

found on page:

12**Calendar Spread**

- A DEFINED-RISK, LONG SPREAD STRATEGY, CONSTRUCTED BY SELLING A SHORT-TERM OPTION AND BUYING A LONGER-TERM OPTION OF THE SAME CLASS (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.

found on page:

12, 20, & 26**THETA**

- A measure of an option's sensitivity to the passing of time by each calendar day. Positive theta refers to option positions that gain in value as time passes, whereas negative theta refers to positions that decay as time passes.

found on pages:

12 & 21**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 (typically between the strikes of the short options). The goal: As time passes and/or volatility drops, the trade 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 difference between the strikes, minus the total credit received.

found on page:

20 & 26**Delta**

- A measure of an option's sensitivity to a \$1 change in the price of the underlying asset. All else being equal, an option with a 50 delta (also written as 0.50), for example, would gain or lose \$50 per \$1 move up in the underlying. An option's delta ranges between 0 and 100. Long calls and short puts have positive (+) deltas, whereas long puts and short calls have negative (-) deltas.

found on pages:

12 & 27**Implied Volatility**

- The market's forecast of the future volatility of the underlying security; directly reflected in an option's premium. Implied volatility, expressed as an annualized number, is forward-looking and can change.

We goofed!

- *In the Fall 2010 issue of thinkMoney, our editor put his glasses on backwards and stated that a short vertical profits when the spread is bought back for more than you sold it for. In the real world, this doesn't work. The spread profits when you can buy back the position for less than you sold it for.*

found on page:

26**Gamma**

- The velocity of an option's move is measured by a measure of delta's sensitivity to a change of \$1 in the price of the underlying asset. Gamma is highest for at-the-money options (those at the same strike as the underlying's price), and approaches zero as the option moves further in- or out-of-the-money.

found on pages:

12, 20, & 27**Vega**

- A measure of an options's sensitivity to a 1% change in the volatility of the underlying asset.

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Multi-legged options transactions such as spreads, straddles, iron condors, and butterflies will incur contract fees on each leg of the order, which may impact any potential return. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Customers must consider all relevant risk factors, including their own personal financial situations, before trading. Options involve risks and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request.

TRADING IS ALL ABOUT
SPOTTING OPPORTUNITIES.

THE RIGHT TOOLS MAKE
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