

# thinkMoney/17

• random musings for traders at TD Ameritrade  
**Fall 2012**



## 10/**FOUR TRADING MYTHS... BUSTED**

18/TRADING  
GIANTS WITH  
ANY VOL

24/A NEW  
LOOK AT LEAPS

**FUTURES OPTIONS SPECIAL:**

34/YOUR BURNING  
QUESTIONS  
ANSWERED

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**p. 10**

**Four Trading  
Myths-Busted**

If you're having trouble following the advice of those who came before you, maybe you're listening to the wrong advice. Are the old rules still valid or just myths?



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cont.

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## Columns



### 16/News + Views

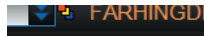
The problem with short-selling, trading platform pearls from The Suit, and a few hidden tricks on thinkorswim.

## Features



### 10/Four Trading Myths—Busted

Bromides aren't helpful when your investment stomach is queasy with financial uncertainty. And neither is trite advice. We break down four classic trading adages-turned myth to examine their relevance, and perhaps their accuracy.



### 22/Gear Head

Serving a double feature of trading treats, we break down thinkorswim's new Covered Call Rollover and how to use the new Option's Statistics feature.

## Miscellaneous



### 08/A Quick Howdy



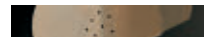
### 18/Vol for One, and One for Vol

Trading stocks over \$100 can be tricky. Even when volatility is low, plain-vanilla calls and puts can still be too rich. And high volatility? Forget about it...Or should you? With so many option spreads at your fingertips, there's a few that just might suit your needs, regardless of price and volatility.



### 29/Ask the Trader Guy

Our resident guru ponders the strategy of scalping options, beta-weighting, and how to balance trading with a needy spouse around.



### 40/Coach's Corner

A string of losses stinks, but there's hope for getting back in the game.



### 15/Love Notes



### 24/LEAPS, Longs, and Dodging Vol

What do you get when you cross a stock with an option? How about a long-term option. With LEAPS, time is on your side and capital risk can be low. And if you've never traded them, they could be worth a look.



### 31/Fearless Technician

How do you know when a consolidating market is about to trend? Consider using this little indicator to help you decide.



### 42/The Token Glossary



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FAMILIAR GROUND...SORT OF  
Yes, you can have a derivative on a derivative. But don't let that scare you. Options on futures may be easier to understand than you think. And if you're not familiar with them, you could be missing the point.

#### PLUS:

#### STRATEGY FOCUS

How to trade futures options on thinkorswim

FUTURES OPTIONS Q&A



### 32/Vol Watch

How do you confirm what volatility is really saying? With volatility, of course.

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## True Lies?

• Adages. Everybody knows at least one. You know—A bird in the hand...A stitch in time...that sort of thing. We tend to rely on such trite advice to give perspective to those we teach—particularly when we can't come up with our own way of saying things. Some adages are good. Some are bad. Some are just pure myth, and need to be revisited.

For this issue's cover feature on page 10, we thought we'd have a little fun and come up with the four of the most well-

known adages-turned-myths that need debunking—or at least revisiting. Some of them are so deeply engrained in the collective trading psyche, we universally accept them as truths. But it really depends on what you're trading, and how you're trading it.

As for what you're trading, if your vehicle of choice has been equity options thus far, and you want to spread your wings a little, be sure to read the unofficial part two of our special focus on futures. In this issue, we'll focus on trading options on futures. We'll spew the nuts, bolts, and practical application of it all, packed into six tight



## Got Feedback?

Great. Write to us at  
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You'll feel better.

pages. You decide if they're the right fit. If needed, there's even a step-by-step on how to open a futures account at TD Ameritrade on page 32.

If you're thirsty for new strategies and volatility has you

befuddled, check out "Vol for One, and One for Vol" on page 18. There's an options strategy made for every conceivable volatility backdrop. We'll start with three.

Hard to believe, but it's possible that everything we've jammed in these 44 pages may not be enough to quench your thirst for good trading content. If it's not, head over to our monthly online trading and investing newsletter, *The Ticker Tape Monthly* at tickertapemonthly.com. Part trader, part investor content, there's a longer-term slant to *Ticker* that might satiate you at last. If it doesn't, you could always kill some time coming up with new adages.

Happy trading,  
TD Ameritrade

## We Goofed

In the last issue of *thinkMoney* (Summer 2012), we mistakenly credited the wrong author for our "Gear Head" column. Proper credit should have been given to Greg Edwards. Thanks Greg, and sorry about that.





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costs. At TD Ameritrade, the standard commission for online equity orders is \$9.99, online option orders are \$9.99 + \$0.75 per contract. Orders placed by other means will have higher transaction costs. Options exercises and assignments will incur a \$19.99 commission.



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**Busting Myths**

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# FOUR TRADING MYTHS BUSTED

BROMIDES AREN'T HELPFUL WHEN YOUR INVESTMENT STOMACH IS QUEASY WITH FINANCIAL UNCERTAINTY, AND NEITHER IS TRITE ADVICE. REPLACE BOTH WITH LOGICAL APPROACHES TO MANAGING YOUR TRADES.

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

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## Busting Myths

• Photograph by  
**Fredrik Brodén**  
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If you've traded long enough, you've probably heard an old trading adage being spewed from an authority on the markets or trading. While heeding sound advice is a good thing, not all advice is equal. When adages turn to myths, it's time to bust 'em. Here's four of the biggest.

#### MYTH NO.1 — CUT YOUR LOSSES SHORT, AND LET YOUR WINNERS RUN.

**What it means.** One of the oldest ones in the book.

The idea is that your long-term trading success is determined by large winners. If you can just keep the losses on your losing trades small, the large profits from the winners will offset them, and you'll be profitable over time. You'll hear stories from investors about how they bought some high-flying stock at a much lower price, or bought some out-of-the-money calls for pennies that turned into dollars. They will likely attribute that to forgoing taking a small profit, and being patient enough to wait for the big score. You will likely not hear them utter the word "luck."

**Why it's busted.** This isn't necessarily bad advice, but it doesn't tell the whole story. Every option trade, for example, starts as a loser, simply because of the bid/ask spread. And you could also get whipsawed out of every type of trade on an intraday swing, if your only criteria is to exit on "small losses" alone.

Further, trades with huge profits don't happen very often, and this rule doesn't give any guidance about when to take profits to make sure they don't turn into losers. For example, how much should you let a winning trade "run"? The longer you hold a profitable position, there is a growing likelihood that the stock could reverse itself and turn that winning trade into a scratch, or even a loser. That's why this adage seems to be more about luck than strategy.

**Make it smarter.** Let's flip this one on its head. Instead of focusing on trying to get big wins, you may want to consider trades with smaller profits, and with fewer, smaller, losing trades. In other words, keep both your potential profits and losses small, using strategies with inherently higher probabilities of success, and lower, defined risk. That doesn't mean you should be trying to scalp stock, and run up huge commissions. For example, option-credit spread strategies can have higher

probabilities of profit, and have defined risk where the maximum loss is limited, such as vertical spreads and iron condors. They can be the foundation of building a portfolio where profits are built up slowly, over time.

#### MYTH NO.2 — ALWAYS USE STOP ORDERS

**What it means.** The "flash crash" of 2010. The financial meltdown of 2008. The collapse of the "irrational exuberance" in 2000. And the granddaddy of them all—Black Monday, 1987. These events are etched into

our financial subconscious, and woe to any trader who blithely buys stocks ignorant of history. Stop orders (or stop-loss orders) are activated when the price of a stock drops to a certain level, and routes a market order to close a position to limit the loss. The objective is to keep a small or moderate loss from turning into a monster that can wipe a trader out—particularly if he or she is trading on margin.

**Why it's busted.** Stop orders seem to make sense, but the big question is, where to place them? A stop price that's too close to the current price can keep losses small. But a long position can be stopped out as a losing trade before the stock rallies, and the position potentially becomes profitable, simply because of the stock's random up-and-down swings. A stop that's too far away means the potential loss is much greater. Either way, a stop order doesn't do much to protect you if a stock "gaps" lower—dropping to a much lower price on the open of trading (or possibly during the day)—that results in stop orders being filled at prices much lower than the stop price. And if you're using a stop-limit order, fuggedaboutit. Your stop might get triggered, but if the stock is volatile enough, you may never get executed.

**Make it smarter.** Using stops is a rudimentary way to manage risk on a stock you've bought. But a smarter way to think about it is that risk management starts at order entry. The maximum loss on a stock position is the difference in the price you pay for the stock (plus commissions and fees), and \$0. On a \$20 stock, that's \$20 max loss per share, or \$2,000 for 100 shares. But you don't really know your potential loss with a stop order. Rather, use strategies where the max loss is known when you enter the order, and is within your risk parameters. For example, certain option-spread strategies have their max potential risk defined to either the debit paid, or the difference between the long-and-short strike prices, minus the credit received. A bullish spread with a maximum possible loss of, say, \$60, would lose no more than \$60 plus commissions and fees, even if a crash takes the price of the stock to \$0. No stop needed.



#### Course Correction

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SEE  
GLOSSARY  
PAGE 42

### MYTH NO. 3 — DIVERSIFY YOUR PORTFOLIO WITH STOCK, BONDS, AND CASH.

**What it means.** Who knows which stock, sector or product will go up in the future? Instead of picking one, spread your investment dollars around to a variety of stock, bonds, funds, and leave some cash in reserve. This is diversification, and it can mean your portfolio won't see such large swings in profit or loss, and will hopefully benefit from the component assets rising over time.

**Why it's busted.** It's true you don't want to take every penny you have and buy some stock, or option, or bond, and hope it goes up. But, with an efficient market, you can't really predict which way a stock or bond will go next. Diversification doesn't change that. And traditional diversification doesn't factor in the relative risk between assets like bonds and stocks.

**Make it smarter.** Diversify, but diversify across time, strategy, and markets. Spreading your trades out over time, and using strategies like certain defined-risk, higher-probability option spreads, such as verticals, and those found on page 18, that let you take advantage of changing volatility and rates of time decay.

Also, if you use strategies that require smaller amounts of capital than buying stocks or bonds, you can have smaller amounts at risk across even more stocks, indices, or sectors, creating even more diversification. Consider using tools like the beta-weighting tools on the thinkorswim trading platform to help assess possible total risk of all your positions.

### MYTH NO. 4 — VOLATILITY IS BAD, BAD, BAD!

**What it means.** Stocks can move up and down, and volatility means how far they can move up and down. And with most people buying stocks, bigger moves to the downside are scary, and a reason to avoid investing in stocks during volatile times.

**Why it's busted.** Guess what? Volatility works both ways. A stock that has a 20% move up, is just as volatile as a stock that has a 20% move down. Those big winners some traders chase are only possible in volatile markets. Plus, volatility changes all the time. It moves up when there's a lot of fear in the market, and it moves down when there's more complacency. And complacency often sets in after a big rally. So, when you decide volatility is low enough to start investing in stocks again, volatility can spike up with a big sell off.

**Make it smarter.** High volatility that means larger potential moves in the stock price, also means potentially higher option premiums. And that can mean larger credits for strategies, like covered calls (see page 22, this issue) and certain option spreads. Those larger credits can also mean larger potential profits. Just because the credits are higher doesn't mean you wait until volatility is high to load your portfolio up with **short-option strategies**. Be aware that larger potential profit usually means larger potential loss as well. Keep your position size small, so that even if the worst case happens, whether volatility is high or low, the loss is manageable.

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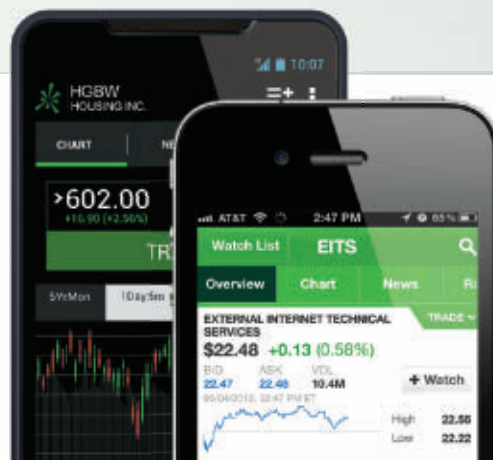
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# 15 ltrrs.

## Love Notes

Hyperbole and  
Trading Pearls  
From ... You

Photograph by  
**Fredrik Brodén**



• Exasperation...er, I mean expiration Friday...No, wait. I got that right the first time...

**Danielle**

• You're better off putting the money into dating, drinks, and clothes than in markets if you don't understand them.

**Stefan**

• Please get all the facts straight first so that they may be distorted correctly later.

**Ben**

• I told my wife if she walks out that door, I don't have enough money to change the locks...due to bad trading.

**Trey**

• Who needs astrology when you have Gann charts?

**Hector**

• Keeping my eyes open for "I'm in a coma, not dead" cross.

**Danny**

• If you look back at a 10% gain as a loss, you will never be right.

**Trevor**

• Damn, [thinkorswim] chat won't let me exclude myself.

**Luke**

• The FWIW chart...Is it a cup and handle? A rounded bottom? A double bottom? A gap fill failure? A Fib stop and reverse? It could be anything you want. Welcome to trading after the fact of course. Or else how could one take precognition credits...or 20/20 hind sight...or...well...you get the picture. Oh boy.

**Phil**

• I may have been up sick all night, but at least I didn't miss any action in the markets this morning.

**Renee**

• All I need is a 600,000 point move on my one contract to afford a \$30 mil home.

**Rick**

• October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.

**Mark Twain**

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## News+Views

A hodgepodge of stuff we thought you should know.

Photograph by  
Fredrik Brodén

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## Ask The Suit

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

**Q: What's the best new feature in thinkorswim everyone should check out?**

**A:** One feature I'd urge all you chartists out there to check out is the new custom time frame feature. Now, you can create your own aggregation period with either tick or time. The days of being forced to paint one-minute bars are over! I'd also urge you to check out the thinkorswim **Learning Center** at [tlc.thinkorswim.com](http://tlc.thinkorswim.com) to find out even more about how to create your own masterpiece with thinkorswim Charts.

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**A:** We love user feedback and take it very seriously. In fact, our product-development team reviews each and every request that our valued users submit. If you have an idea that you believe will help you or other traders make better trading decisions, we want to hear from you. You can send your ideas for Trade Architect, thinkorswim, or Mobile Trader via the following address: [thinkorswimfeedback@tdameritrade.com](mailto:thinkorswimfeedback@tdameritrade.com).

**Q: I use both thinkorswim and Trade Architect. I think Trade Architect needs more work than thinkorswim—yet new releases seem to be made more frequently on thinkorswim. Why?**

**A:** For the last six months, we've been working on a redesign of Trade Architect, and we're finally in the home stretch. This new upgrade will make the platform faster and more nimble. It will also address a lot of user feedback that will result in a more intuitive trading experience. This project was a major undertaking, and should launch before the next issue of *thinkMoney* hits your mailbox. The new version of Trade Architect will also provide the foundation that we need to begin introducing more frequent upgrades. That means you will see a similar cadence of evolution for both thinkorswim and Trade Architect.

## industry spotlight

# Is short selling still a "problem"?

Words by  
**Thomas Preston**  
Illustration by  
**Brian Cairns**

During the 2008 financial crisis, there was much discussion about how "naked" short sales—short sales of stock where the shares weren't borrowed—were exacerbating the sell-off in stocks. You may even remember back in 2006, the CEO of Overstock complaining that the poor performance of the company's stock was due to naked short selling. You don't hear much about short selling lately. Has anything changed?

Short selling is a strategy that bets on the price of a stock going down. It means selling stock you don't own, in hopes you can buy it back for a lower price in the future. Traditionally, brokers and clearing firms require you to "borrow" the stock before you short it, so it can be "deliv-

ered" to the buyer. Through the clearing process, the borrowed shares are delivered within three days. If the shares aren't delivered, a "failure to deliver" occurs.

Because of extensions for the delivery period, it's possible that multiple short sellers are allowed to borrow the same shares of stock. If that happens enough, there can be more shares short than are in the "float," or shares available for public trading. In 2008, the SEC clamped down, and prohibited

naked short selling after concerns that the failures of Bears Stearns and Lehman Brothers had been effected in part by naked short selling. Since then, there have been some large penalties assessed to firms allowing the practice.

Now, part of the reason short sellers got attention a few years ago was the money they were making. In 2007 and 2008, the sharp sell-offs in the market gave short sellers opportunities. But a rally for the past couple of years has made it tougher for short sellers. And, they're not making headlines any more.

Also, naked short selling was more of an institutional problem. Retail brokers and clearing firms weren't overriding their short stock rules.

While we can agree that prohibitions against naked short selling may make for sound trading and clearing practices, have they reduced market volatility? Tough to say. The global markets are so large and liquid, that the impact of a gang of naked short sellers is likely muted—particularly if their banks aren't letting them play that game anymore.



## toys

### Toys for Traders

Our latest trading platform faves now and later

#### HERE AND NOW

##### thinkorswim:

##### TIME & SALES FOR OPTIONS

Wondering why your order to sell 50 contracts didn't get filled. The thinkorswim Time & Sales feature might clue you in. Found at the bottom of the All Products menu, under the Trade tab, Options Time & Sales can give you trading ideas, but also how the "Big Money" is hedging their bets on say, the SPX.

##### PRODUCT DEPTH CURVE

Spreading the love to futures traders, this tool allows you to plot multiple contracts of futures on a single chart. This will be a very helpful feature for futures spread traders, displaying convergence and divergence of contract months.

##### NAME YOUR OWN TIME FRAME

Who cares if there are already 1, 5, 10, 15, 30, and 60 minute time frames. If you don't like the predefined time frames, make your own!

#### COMING SOON

##### For TD Ameritrade Mobile Trader

##### FOR iOS:

- Push Notifications
- App help overlay
- International CNBC
  - tastyrade
  - Feedback link

##### ANDROID AND iOS:

- Complex order entry
  - Reskin
- Rolling options

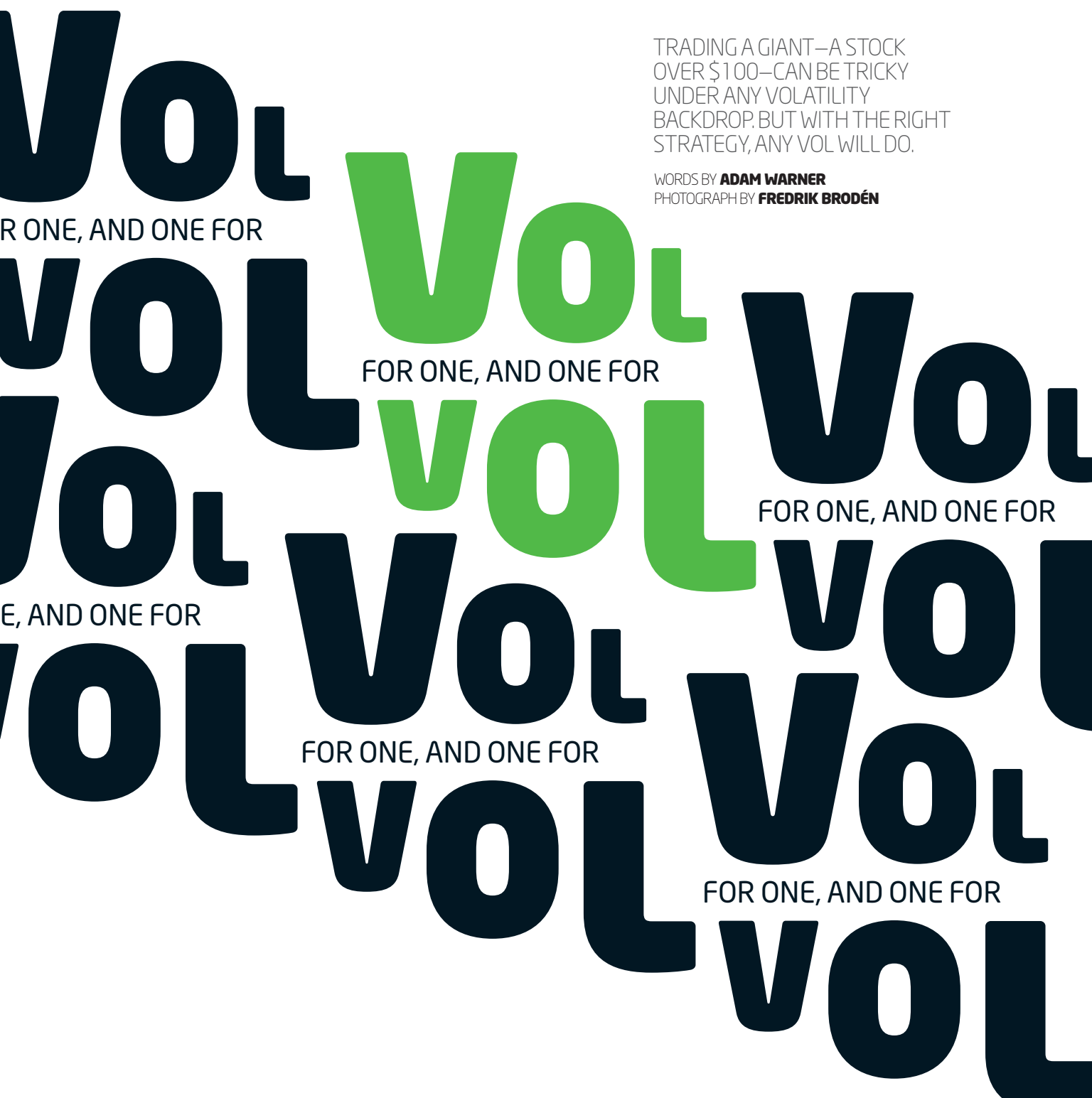
18

Volatility Trades

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TRADING A GIANT—A STOCK  
OVER \$100—CAN BE TRICKY  
UNDER ANY VOLATILITY  
BACKDROP. BUT WITH THE RIGHT  
STRATEGY, ANY VOL WILL DO.

WORDS BY **ADAM WARNER**  
PHOTOGRAPH BY **FREDRIK BRODÉN**







# 20

## Volatility Trades

Photograph by  
Fredrik Brodén

tdameritrade.com

**THE ONE CONSTANT IN THE WORLD OF OPTIONS** is that nothing's constant. And so goes volatility. But volatility, unlike a stock, doesn't typically move up without looking back. That's because it's "mean reverting," which in geek-speak means it tends to rise and fall around an average level. Trying to figure out why a stock's implied volatility is high or low, won't do you as much good as simply determining the optimal strategy to take advantage of the volatility hand you're dealt—particularly on high-priced stocks.

Generally speaking, there are three volatility environments you'll need to consider: low, mixed, and high. Here's a few trend-trade strategies designed to meet each of these.

### 1—LOW VOL — BACKSPREADS

Is the stock you're looking at \$20 or \$200? If the latter, then a simple long-option strategy may be too pricey, despite low implied volatility. An at-the-money option on the \$20 stock might be \$2, but on a \$200 stock, it could be \$20. So what if you think the stock is poised for a nice drop in price, and you want to trade that downside? Perhaps a put backspread might come in handy.

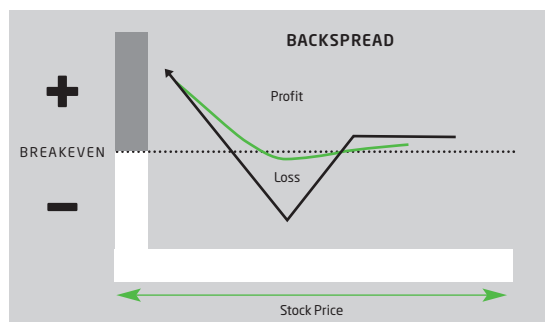
A backspread is comprised of at least one near-money, or **out-of-the money** (OTM) options series, and a greater quantity of long position, in a further OTM option series of the same class and expiration cycle. You want to try to put them on for a small credit.

What's the attraction? In addition to likely being less capital-intensive than their long-option counterparts, backspreads give you a two-pronged bet. They generally let you establish a credit in your favor, while getting you poised to take advantage of a rise in volatility. Putting them on for a credit may just provide you with a small profit, if the entire trade expires worthless. Second, you also have more long puts than short on a put backspread, and more long calls than short on a call backspread, so you could profit if the underlying moves sharply beyond your strike prices.

What's the downside? You lose in general if the underlying stock hovers near the long strike, and you lose big if you do nothing, and the stock closes right at your long strike.

Suppose stock XYZ is trading at \$225. XYZ has rallied considerably over the past six months. You suspect the uptrend is tired, and the stock may drift over the course of the next two months, or possibly even crash hard. To put on a bearish put backspread, you'd sell, say, two August 220 puts in XYZ, for \$11.50 (for a total credit of \$2,300). Against that, you could theoretically buy four August \$200 puts, for \$5.00 each (for a total debit of \$2,000). The margin you would need to put up is the difference between the short and long strikes (in this case, net-net, you take in a credit of \$300).

An upward move in the stock is pretty straightforward. Your profit maxes out at the \$300 you took in as a credit (less commissions and fees).



**FIGURE 1: The Backspread** In low-vol environments, particularly on high-priced stocks, the backspread offers an alternative to expensive calls and puts.

A downward move in the stock is trickier. If XYZ crashes, you could potentially cash in—again, thanks to owning the extra put. The lower it goes, the better.

Looking at a profit curve of the backspread in Figure 1, notice the change in the difference between the date of entry (red dash line), and trade expiration. As time passes, the potential loss increases, as time decay sets in the long options, with the greatest loss at the long-put strike.

However, the backspread's best performance comes if XYZ collapses immediately. That's because of the two additional long puts, which should benefit if XYZ declines—even if XYZ declines towards our long strike of \$200.

If XYZ doesn't move quickly enough, however, you may not be so lucky. Though you typically don't want to hold a backspread until expiration, your worst-case scenario occurs if XYZ closes exactly at \$200 on August expiration. The \$220 puts you sold at \$11.50 each expire at \$20, which produces a loss of \$1,750. What's more, the 200-strike puts you bought \$5 each go worthless. That's another \$2,000 down the drain. Since you took in a \$300 credit at the onset of the trade, your total loss would be \$3,450 (plus commissions and fees) in this scenario (\$300 - \$1,750 - \$2,000). Ouch.

### 2—MIXED VOL — LONG VERTICAL

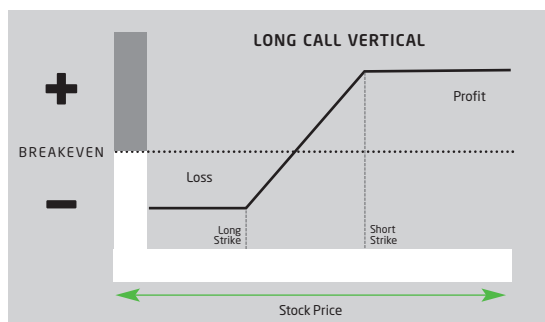
When volatility is at heightened levels, but not too extreme, a long vertical spread is a defined-risk strategy designed to profit from a directional move, while also hedging volatility. It typically requires only a small investment—you simply need to cover the debit you incur.

With a long-call vertical, you're making a bullish bet by purchasing a call, and selling a higher-strike call of the same class and expiration, in equal amounts. (See Figure 2) With a long-put vertical, you're making a bearish bet by purchasing a put and selling a lower-strike put of the same class and expiration, in equal amounts as well.

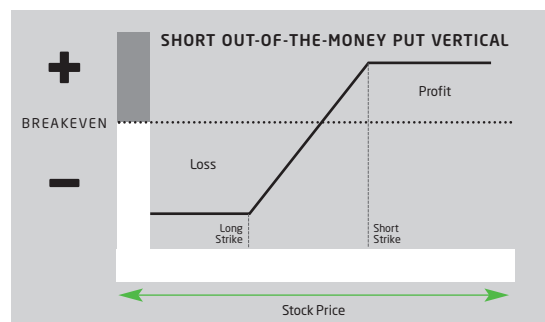
Vega—the rate at which an option changes when volatility changes—is the culprit for taking money away from you, when volatility collapses in a long position. However, in a long vertical, the reason your negative vega is hedged somewhat, is because the volatility you sell in the short option, negates some of the volatility



SEE  
GLOSSARY  
PAGE 42



**FIGURE 2: Long Call Vertical** One benefit to a long vertical spread is you're buying and selling volatility, which essentially negates it.



**FIGURE 3: Short Out-of-the-Money Put Vertical** High volatility is a killer of long option strategies. That's why short verticals are designed to profit from a drop in volatility.



### Volatility Lessons

Befuddled about volatility? You're not alone. Start from the beginning by reading the Volatility Focus in issue #12 of the **thinkMoney** archives.

Just go to [dameritrade.com/thinkmoney](http://dameritrade.com/thinkmoney) and click the cover of issue #12.

you're buying in the long option. It doesn't hedge all of it, but it helps. And you could still potentially benefit from a rise in volatility. More importantly, the long-vertical could position you to profit from the underlying stock move.

Suppose you're mildly bullish on hypothetical stock FAHN, but not interested in a big bet on option volatility. You could theoretically buy a call-vertical spread by purchasing 2 FAHN August 230 calls for, say, \$9.00 (= \$1,800), and selling 2 FAHN August 240 calls for \$6.00 (= \$1,200), for a total outlay of \$300 (plus commissions and fees). This is also your max risk. And your max reward is \$7.00 per spread (less commissions and fees).

What's next? If you do nothing, and FAHN settles anywhere below \$230, the spread goes out worthless, and you lose the entire \$300. However, on the upside, if FAHN expires above \$240, the spread is worth \$10 (\$240-\$230). Since you paid \$3.00 for it, you make the difference of \$7.00 x 2, or \$1400. Yay.

If FAHN closes anywhere in the middle of the strikes, you win or lose the difference between the intrinsic value of the spread, and the \$3.00 debit you paid. So you break even at \$233, and max out on profit potential at \$240.

### 3— HIGH VOL — SHORT VERTICAL

Suppose you're still bullish, or mildly bullish, on FAHN, but volatility is too high to purchase a long vertical spread. The risk/reward just isn't there. Instead of buying a call vertical, you sell an out-of-the-money put vertical

### Important Information

*Options involve risks and are not suitable for all investors. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. The spread strategies discussed above 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 that often involve greater risk, and more complex risk, than basic options trades. Clients must consider all relevant risk factors, including their own personal financial situations before trading. Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. For simplicity, the examples above did not include transaction costs. At TD Ameritrade, the standard commission for online equity orders is \$9.99, online option orders are \$9.99 + \$0.75 per contract. Orders placed by other means will have higher transaction costs. Options exercises and assignments will incur a \$19.99 commission.*

spread. (Figure 3) Painting broad strokes, a stock can go up, down, or stay put. With stock, or long calls, or long vertical spreads, you lose in two of those three scenarios. But a short out-of-the-money put vertical can make money if the market goes up, stays the same, or even drops a bit—just as long as the stock is above the short strike at expiration.

What does it look like? Using our FAHN example, suppose you short the August 220 puts at \$11.50, and purchase the Aug. 210 puts at \$9.50, for a credit of \$2.00 each, or \$200 per spread (less commissions and fees).

If FAHN expires anywhere above \$220, you keep the \$200 (less commissions and fees). If it closes below \$210, your maximum loss is the difference between the strikes, less the \$2.00, for a net loss of \$8.00 per spread, or \$800. If it closes in between, you lose intrinsic value, less the \$2.00. For example, if FAHN finishes at 215, you lose \$5.00 per spread, less the \$2.00 your received, for a total of \$3.00 per spread, or \$300.

In the case of a short vertical, you're counting on volatility collapsing, which helps your trade. The sooner the volatility premium is pulled out of the options, the sooner you profit. On the other hand, should volatility increase, this would hurt your trade. You only profit if you can buy the spread back cheaper than you sold it for, or it expires worthless.

Obviously, short verticals are similar to long verticals. However, they're a modest bet against volatility. It's a great alternative to its unhedged cousin, the **short-naked put**. But with a short vertical, you have a built-in stop at your long strike, should the stock go awry.

HIGH-PRICED STOCKS don't have to be intimidating, and neither does their volatility. These are just three of the many option spreads designed to mitigate your volatility risk and attempt to capitalize on the prevailing trend—without breaking the bank.

## Gear Head

Our favorite gadgets you may not have heard of

**Tool #1 Words by**  
**Nicole Sherrod**  
*Managing Director,  
Trader Group at TD Ameritrade*

**Tool #2 Words by**  
**Editorial Staff**

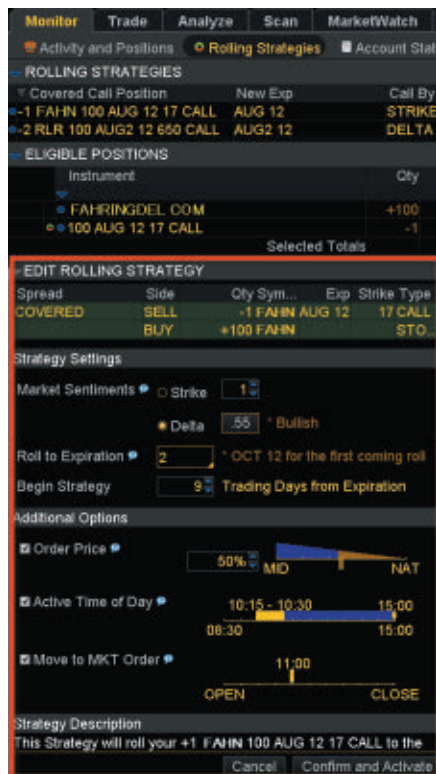
### TOOL #1

## Covered Call Roller (coming soon)

Never forget another roll again

AS A CHILD, I REMEMBER GOING TO THE library with mom and watching her comb through “Value Line” binders that were bigger than my booster seat. This was how she researched her stocks. Thanks, technology, for making our lives easier today, and well, less archaic.

But there are still some trading activities today that continue to be prehistoric. Take, for instance, the action of rolling forward on a covered call. What’s that? Say you’re long stock, and you sold short-term, out-of-the-money call options against your position to generate incremental income, and to drive down your position’s cost basis by the amount of cash you received. This is the plain-vanilla covered call. To “roll over,” you buy to close your near-term option, and sell to open a slightly further-term option at the same strike price, while leaving the long stock position alone. If you keep rolling the short option from one expiration to another (month to month), you could potentially create a consistent monthly flow of income, as long as your stock doesn’t get called away with an assignment\* and of course, transaction costs don’t cut into your profits.



**FIGURE 1: Automate Your Rolls .** The Covered Call Roller in thinkorswim allows you to customize your monthly rolls with so many levers, you’ll start to wonder what to do with all your new free time. *For illustrative purposes only.*

### CARPE COVERED CALL ROLLER

But why go through the hassle of initiating the roll each month? And what if one month you forget, and miss the opportunity? Introducing the “covered call roller.”

This new user-friendly feature recently introduced on the thinkorswim trading platform, is designed to completely automate the process of rolling forward. You can now program virtually every consideration you would normally make in rolling forward, so you can completely define your parameters for future actions. What’s more, the capability also has robust notifications so you are kept abreast of any automated adjustments made to your position for the life of your trade.

Let’s start with the overall sentiment on the position. If I’m short-term delta neutral on the position—meaning the delta of all legs in the position net out to zero—I would want to roll forward into the same, or similar, strike. But if I’m more bullish, I would want to roll out and up to a higher strike in an attempt to capture a



### A Little Extra

RedOption.com is a great way to learn more about covered calls, and they have an advisory of covered-call trade ideas. Paid subscribers are notified each time Red Option recommends a new covered call trade, makes an adjustment, or closes a position. Then, once you find the right idea, you can automate your strategy with the new Covered Call Roller. (launching in November, 2012).

profit in the stock, should it move higher. You can program this easily with the Market Sentiment slider.

The same holds true for other custom capabilities. If you’d like to get the most out of these features, the best place to turn is the thinkorswim **Learning Center** at [tlc.thinkorswim.com](http://tlc.thinkorswim.com). When the Covered Call Roller launches around November, you’ll find a video of the same name to help you better understand this exciting new feature.

### TOOL #2

## thinkorswim’s Options Statistics

Digging deep into the market mood for clues to what might be next

STOCK TRADERS, HERE’S A NEWS FLASH: You don’t actually have to trade options to potentially benefit from them.

Take implied volatility—the volatility of the price of a security that is “implied” by the price of the options. When it’s high, that’s generally a reflection of nervousness in a stock. As traders start putting on more hedges, put activity might increase, taking volatility in the options with it. When volatility goes up, option premiums tend to get inflated.

This information can benefit both the stock and options trader. As a stock trader,



market “nervousness” is hard to gauge from charts alone. And, for the option trader, when option premiums are expensive, it’s typically better to be implementing sell strategies, such as covered calls, rather than buying them. Higher premiums can erode quickly, making it difficult for long strategies to profit.

But what’s “expensive” or “cheap” anyway? After all, volatility is relative. Just because a tech company has higher volatility than a paint company, doesn’t mean its options are more expensive. The Options Statistics tool in the Trade page of the thinkorswim platform provides additional information that might be useful in helping you decide whether you want to trade tech or paint.

As you plan your next trade, take a look at a few items from Options Statistics that might help you make sense of things.

#### CURRENT IV PERCENTILE:

Most of the occurrences of implied volatility over the past 52 weeks have occurred above this number. This is key for factoring whether options are “cheap” or “expensive.” In the case of Figure 2, current volatility sits at the bottom 18% of all other instances of volatility in the past 52 weeks—pretty cheap. This might be a candidate for a position that’s net long vol (i.e., buy option strategies such as **long vertical spreads**). If it were on the high end—say, over 60%—you might want to be net short volatility (i.e., sell option strategies, such as **short vertical spreads**).

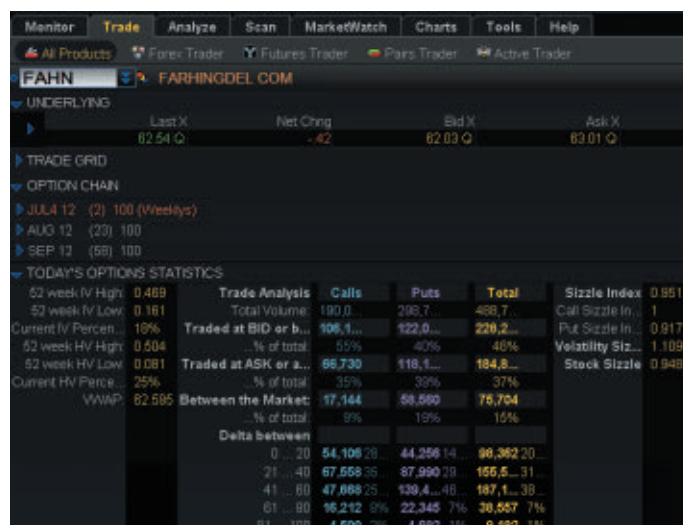
The area in the middle column of the tool under “Trade Analysis” takes it a little further, to help you determine if traders are actually buying or selling options.

#### TRADED AT THE BID:

Looks at how many traders are likely selling options, which likely indicates they are getting out of positions, or establishing **short** positions.

#### TRADED AT THE ASK:

Looks at how many traders are likely buying options, which indicates they are likely entering positions or covering shorts.



**FIGURE 1: Data Is King.** Take heed, stock traders. The **Options Statistics** tool in thinkorswim contains a bunch of information about the general mood of the market, and collectively, what other traders are thinking. *For illustrative purposes only.*

#### DELTA BETWEEN:

Traded at BID and Traded at ASK provides great info, but the challenge is, you can’t tell if the trades were previously opened positions closed at the end of the day, or they’re establishing new positions today. “Delta between” might provide clues. The delta of **at-the-money** options is typically .50. So, if a majority of options are trading in the money again, the question is, are they getting in or out? Typically (and this is anecdotal), seasoned traders will hedge with puts. If there are a lot of calls trading

in the money, this could be a bullish signal, since it would be unusual for traders to buy in-the-money calls as a hedge.

There’s always a nugget or two of information traders can pull from the options market. But, just as important as making the effort to dig a little, is understanding what you’re looking at when you find it. Options Statistics goes a little beyond your standard volatility readings, and hopefully offers some clues as to what to do next. This goes for you too, stock trader.

#### Important Information

<sup>1</sup>RED Option Advisors, Inc. and TD Ameritrade, Inc. are separate but affiliated firms. Advisory services are provided exclusively by RED Option Advisors, Inc. and brokerage services are provided exclusively by TD Ameritrade, Inc.

\*Covered call strategies can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of substantial stock price increase. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.) Please note that a monthly covered call rollover strategy will entail transaction costs (commissions and other fees) for each rollover transaction executed which may impact any potential return. Commissions and fees are important factors and should be considered when evaluating any options trade or strategy.

Information and analysis available in the Option Statistics tool cannot predict performance, and past performance is no guarantee of future results. The information contained in this article is not intended to be investment advice and is for educational purposes only. Be sure to understand all risks involved with each strategy, including transaction 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. Clients must consider all relevant risk factors, including their own personal financial situation 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. Market volatility, volume, and system availability may delay account access and trade executions.

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LEAPS

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**THERE'S NO ARGUING** that options are time-sensitive instruments. They decay, which is one of the reasons many new traders shy away from them. And long-term investors—well, forget it. Most often, buying an option with a limited life span is like racing against the clock—the stock's gotta move before time runs out. And even that doesn't guarantee a profit.

So what do you need? More time. And that's what LEAPS options are all about. LEAPS—Long-Term Equity Anticipation Securities—are options that have expiration dates ranging from nine months to nearly three years. But these long-term contracts come with their own set of questions. How do they differ from standard options? And what strategies can a trader employ to take advantage of these differences? >>

WORDS BY **ALEX MENDOZA**

PHOTOGRAPHS BY **FREDRIK BRODÉN**

# LEAPS, LONGS, AND DODGING VOL

WHAT DO YOU GET WHEN  
YOU CROSS A STOCK  
WITH AN OPTION? **HOW**  
**ABOUT A LONG-TERM**  
**OPTION. WITH LEAPS, TIME**  
**IS ON YOUR SIDE AND**  
**CAPITAL RISK IS LOW. AND**  
IF YOU'VE NEVER TRADED  
THEM, THEY COULD BE  
WORTH A LOOK.

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## LEAPS

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**Speak Greek**

Need to brush up on your option greeks? See the Token Glossary on page 42, or go to the new Learning Center at [tlic.thinkorswim.com](http://tlic.thinkorswim.com) and type in "greeks" in the search box. You'll be glad you did.

**BABY LEAPS**

First and foremost, LEAPS are as close to buying a stock as you can get—without actually buying a stock. It's not an asset like a stock, but it does qualify as a security as the name suggests.

But even if you don't intend to hold them for the long term (many traders don't), LEAPS may be useful in your portfolio, depending on your investing objectives. For example, you might want to have fair exposure to a certain sector, without tying up too much capital, or borrowing on margin. LEAPS can also run about 20% of the price of the underlying stock. So, if you only have a few thousand bucks to spare—a modest sum if many of the stocks you're looking at might be trading over, say \$100—this might help you achieve some diversification and invest in options on a few different equities.

That said, you could implement a LEAPS-based strategy on individual stocks, or broad-based indices, or you could find a happy medium and build a sector-specific portfolio. And to boot, depending on the strategy you implement, if you hold a LEAPS option for at least 12 months, it could qualify for long-term tax treatment. But that's a question for your accountant, of course.

**A DIFFERENT KIND OF GREEK**

To understand the differences between LEAPS and standard options, we have to delve into the world of option greeks. You may already be familiar with option greeks as they pertain to standard options. (See the glossary, page 42, if you need to brush up on greeks.) However, the option greeks that pertain to LEAPS options tend to have some significant differences. As a result, you may want to structure your LEAPS trades in considerably different fashion from your standard option trades. To illustrate, take a look at the following table:

| Exp.    | Delta | Gamma | Theta | Vega | Rho  | Opt. Price |
|---------|-------|-------|-------|------|------|------------|
| 1 Week  | .50   | .03   | -.51  | .28  | .05  | \$6.00     |
| 2 Years | .60   | .002  | -.08  | 2.68 | 3.57 | \$97.00    |

The table compares two at-the-money option contracts. One option has a week left until expiration. The other has two years left. More specifically, XYZ stock is trading for \$550 per share, and the table compares the one-week 550-strike call, with the two-year LEAPS 550-strike call. Even though the options share the same strike, the similarities stop there. Let's break down the difference between each greek.

**DELTA**

Notice that the delta of the LEAPS is significantly higher than that of the weekly option, even though both are at the money. You might expect delta to be about .50. However, in the real world, options are priced based on something called the "forward price of the stock." Rather than pricing the options based on a

stock price of \$550, they are priced off \$550, plus any interest on that amount, until option expiration. For the LEAPS call, the additional interest is enough, so that even though you are trading the 550-strike call, it's being priced off a value significantly higher than \$550. Because the stock price being used is higher than the strike price, the option is technically in the money, and hence, it correctly reflects the higher delta.

**GAMMA**

The longer an option has until it expires, the smaller the gamma becomes. While the reasons can get complicated, think of it this way: gamma is a measure of how much the delta changes based on a small move in the stock. Since longer-term options are big-ticket items, a small move in the stock is likely to have a negligible effect, as compared to what it would do with a shorter-term option.

**THETA**

If gamma is fairly negligible in longer-term options, it follows that theta is also negligible. Why? Not only is theta the effect of time decay on the price of an option, but it's also referred to as "the price of gamma." So, if you own LEAPS, you probably won't have to worry much about time decay until you start getting closer to its expiration day. That's what differentiates LEAPS from standard options, and is the reason they may be viable, alternative investment for certain traders to hold for months, even years, at a time.

**VEGA**

If there's one wet blanket to throw on the virtues of LEAPS, it's vega. The effect of volatility swings on an option's premium is a killer. In fact the farther out in time you go, the greater your vega. Take weekly options. The difference between a LEAPS option and an extremely short term option like a Weekly, is almost tenfold. In a nutshell, if the implied volatility level changes by so much as one percentage point, you could be looking at some fairly significant P&L swings. This is clearly something you need to address in order to successfully incorporate LEAPS into your trading arsenal.

**RHO**

Rho is typically the "forgotten" greek. In fact, you can get pretty far in an options education curriculum and never hear anyone mention rho. The reason is twofold. First, the change in the option value based on a one-percentage point change in interest rates is typically a small number. Second, interest rates don't commonly change by a full percentage point during the life of an option.

This all changes with LEAPS. Because of the lengthy period until expiration, changes in interest rates matter. Think of it like a bank loan. If you're going to borrow money for the next 30 days, then the difference between an interest rate of 4%, as compared to one of 5%, is





fairly negligible. However, in terms of a 30-year mortgage, the difference in interest between a 4% rate, and a 5% rate, is substantial. Well, that's a little primer on how rho gets factored into options.

## COVERED CALL REVISITED

Okay, so given what you now know about LEAPS, here's an example of how LEAPS could be used in a trading strategy, like selling covered calls, and how the greeks can impact your decisions.

By now, you've heard of the covered call—you know, where you buy a stock in increments of 100 shares, and sell a call against it that's slightly out of the money. While it's a common stock-trading strategy to help lower the cost of a stock, or provide cash flow from a stagnant stock, it can also benefit the LEAPS buyer in unique ways.

With a LEAPS "covered call," Instead of purchasing stock, you could purchase an at-the-money LEAPS option and sell a slightly out-of-the-money, short-term call. Though the LEAPS option isn't an asset like a stock, you're "covered" because the strike of the LEAPS option is lower than the short-term option, and the expiration is farther out in time. Should you be

assigned on the higher, short strike, you'd be short 100 shares of stock, but you're covered (hedged) by the long LEAPS option.

Trading the LEAPS covered call this way has a two-fold effect: were you to do this month after month, you could 1) offset the extrinsic value (time value) of the LEAPS option; and 2) you could reduce the overall positive vega of the position.

On the other hand, if the stock is at, or closer to, a recent high, it may revert and give back some of its gains. You could still lose the entire premium of the LEAPS, should this happen. However, remember that when the market falls, volatility typically rises. And a rise in overall volatility can have a large, positive impact on your large-vega trade.

And while we're currently in a world where interest rates have relatively little room to drop, a sudden spike in interest rates could provide an additional jolt to your LEAPS call option. So, who knows, you may find that rho could possibly become an unexpected friend.

LEAPS aren't a replacement for stock, but they can provide a few of the same benefits, without the erosive nature of short-term options. Don't get us wrong. They're still an option. So yes, you can just the same

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lose all your investment, as you can for short-term options. However, for traders with smaller accounts, who want to trade a few different securities without fear of rapid decay, LEAPS might make sense. Or, for traders who simply want exposure to sectors in which they're not comfortable tying up a lot of capital, LEAPS are a low-capital alternative. Heck, the CBOE recently listed five-year options on the SPX, known as "Super LEAPS."

That's an eternity to some traders. But, if you want longer-term exposure to the "broad market," without tying up precious trading capital, or you want to try a longer-term trading strategy, like the covered call alternative, there's no shortage of ideas.

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Ask the  
Trader Guy

Saving traders, one question at a time.

Photograph by  
**Fredrik Brodén**

trdr.

**Q: I see a number labeled “beta” on the trading platform. What is it?**

A: Beta describes how much a stock would change if an index changes 1%—typically the S&P 500. For example, if a stock had a beta of 1.25, and the S&P 500 moved up 1%, theoretically the stock would move up 1.25%.

Beta works the same way if the S&P 500 moves down. Beta is calculated by a statistical regression between the percent changes in the stock, and the percent changes in the S&P 500, over some previous number of days. On the thinkorswim trading

platform the beta is calculated for most stocks using five years of monthly data. So, beta isn’t fixed, and it can change if you use different time frames in the calculation, or if the stock and the S&P 500 move in different ways in the future.

**Q: What do you think about scalping options as a short-term strategy?**

A: Some people like the idea of buying options with the idea of selling them quickly—hopefully for a profit. This is because of the defined risk nature of long options, and their typically lower capital requirements than, say, long, or short stock, or even futures. That sounds great except for three things: bid/ask spreads, fees, and commissions.

Let’s say you were thinking about scalping an at-the-money option with a bid/ask spread of .10. If you bought the option at the ask price, then sold it on the bid price, that’s \$10 you’re losing, because of the bid/ask.

Compare that to a .01 or .02 bid/ask spread for actively traded stocks, which translates into \$1 or \$2 of slippage. Also, to get the same market exposure as 100 shares of stock, you’d probably have to buy two of those at the money

options. That means not only twice the slippage, but twice the fees and commissions, as well. Plus, commissions for options are typically a much higher percentage of the invested amount than for stock. While option strategies can make sense in different situations, they are not often used for short-term scalps.

**Q: I’ve been playing with some of the option pricing tools on the trading platform. What interest rate do they use?**

A: Most pricing models use a short-term, risk-free rate by default, like the

Fed Funds rate, for example, or a three-month T-bill rate. But if you want to see how rate changes can impact option prices, input something like the broker call rate. That’s more realistic, because it’s closer to the rate you’d pay to borrow money if you bought stock on margin. The interest rate in an option-pricing model determines the carry costs of a stock position, to create an arbitrage-free theoretical value between the stock and the call and put, at a particular strike and expiration.

**Q: Now that my husband and I are both retired, and our kids are out of the house, he wants to watch the sunrise with me. But I’m busy trading forex at that hour. How can I tell him that Mama needs to trade?**

A: Tell him that too little sleep causes heartburn, and that the early-bird specials don’t start until after the close, anyway. If that doesn’t work, lock him in the bathroom.

**Important Information**

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## Fearless Technician

Chart candy for traders

Words by  
John F. Carter

tech

• It's the eternal question. You've got a setup that you like, on an index that you follow. Now...do you go directional, or do you sell some option premium?

The first question I typically ask myself about a pending trade goes like this. Is this market consolidating or trending? If it's consolidating, then I look at selling some premium. If it's trending, and the market has just pulled back to support, then I could do either—such as buying a .70 **delta** call for an **in-the-money** directional trade, or sell an **at-the-money** put vertical spread. Both trades make sense.

But what if a market is about to make the “switch”? The switch? Yes, the switch.

The switch takes place during those moments when a market transitions from consolidating, into a full-on trending market. Although it's easy to identify in hindsight, I look at tools that can help detect when a switch might be near.

### Connect The Dots

Figure 1 shows a chart of the NDX with the TTM Squeeze indicator on the bottom. The red dots along the horizontal axis at Point 1 show a market that is “squeezing” out the last bit of consolidation from a period of sideways price action; and is now building up energy to “make the shift” to a trending market.

The first green dot at Point #2 suggests “the squeeze is on,” and this market is ready to move.

In this case, with the histogram above zero, a bullish option strategy might make sense. So, do you go directional, or sell some premium?

# Get Your Squeeze On

Is a market switch near? Use this little indicator to help you decide.



**FIGURE 1: Squeeze Me.** Markets typically break out of consolidations. The TTM Squeeze indicator (lower histogram) attempts to alert you when it may happen. *Chart from thinkorswim. For illustrative purposes only.*

At these moments, I prefer to leg into a bullish-call **vertical spread**, which essentially turns into a “poor man’s covered call.”

Initially, I will buy in-the-money calls. I prefer a delta of at least .70, in order to get price movement in the option that closely mimics the underlying.

And then I wait...and wait... for the momentum on this trade to end. And that takes place at point #3 on the chart, when the momentum on the histogram changes color, indicating that the trending price action is coming to an end.

This is where I typically like to sell some at-the-money calls close to expiration to complete the vertical spread.

A best-case scenario at this point is a market that goes back into a choppy consolidating phase. Under these circumstances, our long in-the-money calls hold mostly intrinsic value, and suffers minimal premium decay. Our short call, on the other hand, starts losing premium at a quick clip.

IN SUM, THE TTM SQUEEZE INDICATOR represents a unique moment in the life of the underlying asset. The key here is to identify that critical moment, and utilize delta in the options, to maximize the potential of the situation.

*John Carter is a recognized authority on technical analysis but is not a representative of TD Ameritrade.*

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To access the **TTM Squeeze** indicator, log in to the **thinkorswim** trading platform, and select the Charts tab. In the upper right of any chart follow click path to Studies > Quick Study > John Carter's Studies

SEE  
GLOSSARY  
PAGE 42

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**Vol Watch**

Viewing the markets through the eyes of volatility

Words by **Adam Warner**

# When Vol Meets Vol

How do you confirm what volatility is really saying? With volatility, of course.

• I bet you thought the trading world had already invented a volatility index for everything. But guess what: the CBOE has one more up its sleeve—the volatility of volatility!

That's right, CBOE VIX Volatility Index (VVIX) is the volatility of options on the CBOE VIX itself—hence, the volatility of...well, volatility. Confusing? Perhaps. Useful? Sure.

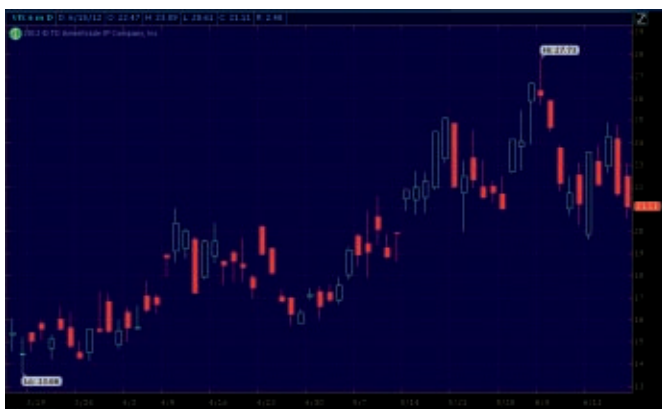
**WHEN TWO VOLS COLLIDE**

You would expect VIX and VVIX to tell a somewhat similar story. A spike in “fear” typically leads to a lift in VIX—pretty much by definition—as put activity increases during market shocks. And if VIX is spiking, it seems likely traders will pay up for options on VIX, which would in turn spike VVIX.

In fact, it's almost self-defining. VIX has a “positive skew,” which means the higher the strike price of a VIX option, the higher that option's implied volatility. Thus, even if nothing changes (volatility-wise) on the VIX options, a higher VIX will beget a higher VVIX, because the calculation will now apply greater weight to the higher-volatility, higher strikes in VIX.

Look at the top chart of VVIX in Figure 1 since its inception in March 2012.

Then look at the bottom chart of VIX itself over the same stretch in March.



**FIGURE 1: When Two Vols Collide** . If you see divergences between the VIX Volatility Index (VVIX-top) and VIX itself (bottom), the market could be telling you something. *Past performance does not guarantee future results or success.*

Notice a couple of interesting divergences? VIX basically started out this three-month stretch at its local lows. During the same period, VVIX meandered, then tanked in late April, a pretty large under-the-radar reduction of fear which VIX missed. That boded poorly for the market.

Conversely, VVIX hit its local highs in late May, about a week and half before VIX itself hit its local highs. So in that instance, we saw a “fear” bubble in VVIX first. That boded well for the market.

**HOMEGROWN VVIX**

Now, before you start viewing VVIX as a “leading indicator,” remember this is a narrow timeframe. And, divergences don't always give such clear signals in hindsight.

Even though VVIX only started trading in March 2012, we can proxy it quite easily on the thinkorswim trading platform, and go back much further. Simply pull up a VIX chart and add the Implied Volatility

indicator from Studies. The implied volatility field actually uses the VIX methodology to calculate a volatility index on any underlying stock. So by applying it to VIX, we've essentially created our own VVIX.

Now, do a side-by-side, 2011-2012 comparison of VIX and our replicated VVIX. Both peaked on August 8th, 2011, with VIX hitting 48, and VVIX at 144. VIX dipped, then surged in early October, rising as high as 45.5, before

embarking on a long fade that bottomed in March 2012 in the low teens. VVIX, however, didn't come anywhere close to the August highs—only hitting 105 in early October. Rather, it diverged, and suggested relative complacency under the surface, which in this instance, presaged a five-month market rally.

So no, VVIX won't become a Magic 8-ball anytime soon. But it's nice to have an additional volatility indicator to help support, or negate, your opinions on the overall volatility backdrop itself.

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**Special Focus:  
Futures Options**

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



**Options  
on  
Futures:**

**Familiar Ground...**

**Sort of**

YES, YOU CAN HAVE A  
DERIVATIVE ON A DERIVATIVE.  
BUT DON'T LET THAT SCARE  
YOU. OPTIONS ON FUTURES  
CERTAINLY AREN'T FOR  
EVERYONE, BUT THEY MAY BE  
EASIER TO UNDERSTAND  
THAN YOU THINK.

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## Special Focus: Futures Options

Photograph by  
**Fredrik Brodén**

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fut.

threaten to strike fear into our hearts...and stuff that sounds eerily like what nearly killed the economy back in 2008. Wasn't it derivatives on derivatives that has so far cost JP Morgan a few billion?

Rest assured, the products themselves don't kill you. It's generally how they're used. To wit: options on futures are pretty similar to the options you use to sell covered calls against your long stock. And they're the only way to establish positions with lower risk and lower capital requirements in certain markets—like physical commodities that don't have another product, such as an index or fund that tracks them. If you get to know how futures options work, you can use them to expand your universe of trading opportunities. Don't let the words scare you off. Read on and decide for yourself if you're ready to incorporate futures options into your portfolio.

## NOT YOUR FATHER'S OPTION

Buying an option gives you the right to buy (in the case of a call), or sell (in the case of a put), an underlying security at the strike price of the option. That should be pretty familiar to most people who've traded an option on a stock. That's how a future option works, too. If you buy a call option on corn futures, that gives you the right to buy a corn future at the strike price of the call. But a few nuances make futures options a little unlike stock options. And these nuances don't necessarily make it harder to trade them, but you should be familiar with the twists and turns before you start trading options on futures.

**1 — WHAT YOU GET.** This is the simplest. What does a future option deliver when you exercise it, or it's assigned?

A future option delivers one futures contract. So, let's use options on the E-mini S&P 500 future as an example. If you exercise a call option on the E-mini S&P 500 future, you'll be long one E-mini S&P 500 future. If you exercise a put option on the E-mini S&P 500 future, you'll be short one E-mini S&P 500 future. If you exercise a call option on soybean futures, you'll be long one soybean future. You won't have 5,000 bushels of soybeans in your driveway. That's why the price of the future option is driven by the price of the future that it delivers on exercise, not the "spot" price, like the SPX S&P 500 cash index, or a bushel of soybeans.

But unlike a stock option that always delivers 100 shares of the same stock, a future option delivers the future that expires at the same time, or later.

Futures have expiration dates. So you can't have an option that delivers a future that's already expired. For example, an October expiration option on the E-mini S&P500 future delivers a December E-mini future. So does a November and December expiration option. But a January expiration option on the E-mini S&P 500 delivers a March E-mini future. This is important because futures prices on the same index or commodity can have

different prices in different expirations, and can move with either greater or lower volatility than a future in a different expiration. In grains, for example, planting is done in the spring and harvesting in the fall. Futures that expire in March through September are termed "old" crop, because they would deliver grain harvested the previous fall. Futures expiring in November and December deliver grain that's just been harvested. Old crop vs. new crop futures can have different price changes. Options on futures will change in price according to the changes in the future that the options deliver.

**2 — POINT VALUE AND TICK SIZE.** A standard equity option has a point value of \$100, and changes in either .01 or .05 increments, with each .01 increment worth \$1.00. That is, if a call on a stock goes from 2.50 to 3.50, its value has increased \$100. After a 3:2 stock split, the options have a point value of \$150, but that's about as complicated as they get. The point value of futures options isn't standardized. For example, one point in an E-mini S&P 500 future option is worth \$50, and the minimum increment is .25, which is worth \$12.50. One point in a bond future option is worth \$1,000, and the minimum increment is 1/64th, which is worth \$15.625. And one point in a corn future option is worth \$50, just like the E-mini S&P option, but the minimum increment is 1/8th or .125, worth \$6.25.

Before you trade them, get familiar with the point value of the future option you like (which you can get at the website of the Chicago Mercantile Exchange at [www.cme.com](http://www.cme.com)). Risk management starts at order entry, and the dollars you put at risk on a trade depend on the options' point values. Also, you can calculate the amount of slippage, or the difference in dollar value, between an option's bid and ask prices. A bid/ask spread of .50 in an E-mini S&P 500 option is worth \$25. But a bid/ask spread of four ticks on a bond option is worth \$62.50.

**3 — EXPIRATION.** Stock options almost always expire on the Saturday after the third Friday of the month. As a stock option trader, that's handy for planning vacations. But, futures options don't always give you that freedom. The E-mini S&P 500 future options expire at the same date as the equity options. They were designed as a hedge for equity, and to make equity option portfolios easier.

But bond future options have some funky expirations. They expire on the last Friday that precedes the last business day of the month preceding the option month by at least two business days. Huh? September bond future options expire in August. December bond future options expire in November. Crude oil-futures options expire three days before the end of trading of the corresponding future, which expires in the month before the future expiration month, to accommodate delivery of crude oil. Double huh, right? Make it easy on yourself and look on the left-hand side of the Trade page of TD Ameritrade's thinkorswim platform, for the number of days until the last trading day of the options. It's the number in parentheses after the expiration month. This will help you not get surprised by expiration



### Need to open a futures account?

The process is completed in three easy steps:

- 1** You need to have Level 3 options approval prior to filling out the futures application. To apply for Level 3 options, log in to the TD Ameritrade website, click on My Profile and click Edit Option Trading. Complete and submit the Upgrade form.
- 2** After receiving your approval, log back in. Under My Profile, click on Upgrade your futures account for futures and forex. Complete the "Upgrade Agreement for Futures and Forex."
- 3** Once your account has been upgraded, (which may take about a day or two) go back under My Profile and click the Futures Apply button. Fill out the online futures application and you're on your way to trading futures.

**Contact us** at  
[support@thinkorswim.com](mailto:support@thinkorswim.com),  
or call 866-839-1100.





DON'T LET THE WORDS SCARE YOU OFF. FUTURES OPTIONS ARE PRETTY SIMILAR TO THE OPTIONS YOU USE TO SELL COVERED CALLS AGAINST YOUR LONG STOCK.

## BACK TO THE FUTURE(S)

That's pretty much it for the differences. Now let's dip into some of the most actively traded futures. Futures, future options, and index options work together in the S&P 500. You have the SPX, SPX options, E-mini S&P 500 futures, and E-Mini options, all based on the S&P 500, right? Well, sorta.

**S&P 500 index (SPX).** The SPX is the index based on the composite value of the 500 stocks in the S&P 500. You can't buy or sell the SPX itself. But it can drive the value of the E-mini S&P 500 futures, based on an arbitrage relationship between the interest cost and dividends on the 500 stocks, and the expiration of the future. So, SPX moves up, and E-mini S&P 500 futures move up. But sometimes the E-mini S&P 500 futures move up quicker, or more, than the SPX. (For more on futures trading, see our Futures Special Focus in *thinkMoney*, Summer 2012, page 34.)

You also have SPX options, which are cash-settled options that deliver the cash difference between the strike price and the SPX. You'd think SPX options are priced off of the SPX, but you'd be wrong. Why? SPX option traders can't trade the S&P 500 stocks any easier

than you can. So they typically use E-mini S&P 500 futures as their hedge. When the hedge moves, the options move. SPX option market makers factor the cost of carry and dividends out of the E-mini S&P 500 future, and use that to come up with the prices of the SPX options. Fun, no?

**E-mini S&P 500 futures.** SPX options aren't the only ones to use E-mini S&P 500 futures to price themselves.

### Important Information

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Options on the E-mini S&P 500 future do, too. The difference between E-mini and SPX options is that the E-mini S&P 500 futures options deliver the future, not cash. They don't need to factor in the cost of carry and dividends of the SPX. So, both SPX options and E-mini S&P 500 futures options are valued off the E-mini S&P 500 future.

Don't confuse SPX options with E-mini S&P 500 futures options. An S&P 500 future option is an American-style option, meaning a long option can be exercised at any time between the time it's purchased through expiration, and its futures settled. This means if you exercise a long S&P 500 futures call, you'll take delivery of one S&P 500 future. SPX options are cash-settled, and European-style. Importantly, one point in the E-

mini S&P 500 future option is worth \$50. But one point in an SPX option is worth \$100.

## PICKING FAVORITES

So, which is better—SPX options, or E-mini S&P 500 futures options? It's not a question of the best product. But, how best to use the product.

Let's look at the pros and cons of using them as a way to potentially enhance a \$100,000 stock portfolio's returns. Selling an out-of-the-money call vertical is a strategy that could be used in this way. With the SPX at 1362, a short 1390/1400 call vertical with 28 days to expiration is worth about \$3.10. If we sell 10 of them, the

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Futures Options

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maximum potential risk is \$6,900, if the SPX is above 1400 at expiration. The potential enhancement to the portfolio would be \$3,100, if the SPX is below 1390. (Breakeven on the SPX is \$1393.10.) SPX options have the widest bid/ask differential, meaning slippage is potentially higher. But you can execute the SPX vertical, and the execution price would be \$2.90, making the maximum potential risk \$7,100, and the potential return \$2,900. (Break even on the SPX is \$1392.90.)

Finally, with the E-mini S&P 500 future at 1,362, the 1390/1400 call spread with 28 days to expiration is worth \$3.25. To get an equivalent amount of risk and reward to the SPX **verticals**, we'd have to sell 20 of the E-mini future option spreads with a maximum potential loss of \$6,750, if the E-mini S&P 500 future is above 1400, and a potential enhancement of \$3,250, if the future is below 1390 at expiration. (Breakeven on the E-mini future is \$1393.25.) Factoring in slippage of one tick, or .25,

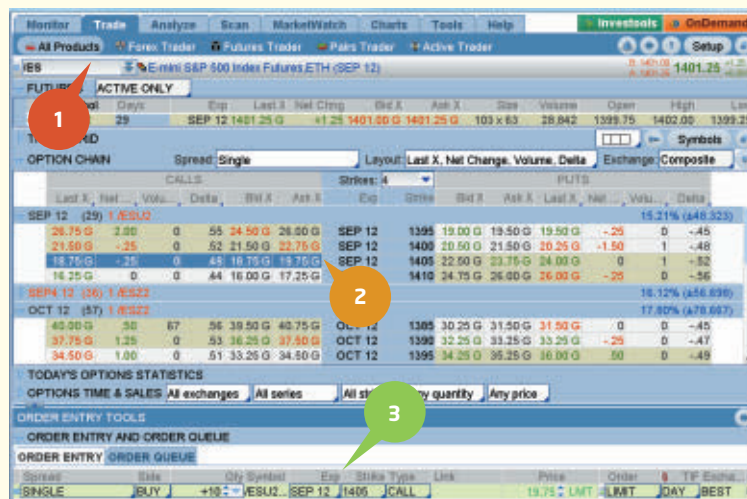
the net price of the spread might be \$3.00, which would give it a maximum potential loss of \$7,000, and an

enhancement of \$3,000. (Breakeven on the E-mini future is \$1393.00.) With E-mini S&P future options, commissions could be two times higher than with SPX options. But that could be offset by lower slippage. In this case, whether you use SPX options or E-mini S&P 500 options depends on the size of your portfolio, as well as your ability to work your orders in between the bid/ask to get better pricing.

NOW THAT YOU'VE LEARNED SOME of the basics about futures options, consider testing them out in paperMoney, found on the thinkorswim trading platform. Or if you are ready to incorporate them into your portfolio, you can apply for a futures account to trade them alongside your stocks and stock options.

# How to...Trade options on futures in thinkorswim

If you're already trading equity options, you're half way there



**FIGURE 1: Futures Options** trading on thinkorswim is pretty much like trading equity options. You can place a trade in about three steps (read the article), but bear in mind, you have to have a futures account (see sidebar, page 36). For illustrative purposes only.

## fut.

- Got the option trading blues when equity markets close at 4pm ET each day? What if you

could trade 24 hours per day? You can—in the futures options market. Yup, 24 hours a day, 5.5 days a week, you can trade E-mini S&P and E-mini Nasdaq, as well as crude oil, gold, corn, the euro currency, and many more. Just be sure to check the trading hours at tdameritrade.com. They all have their own trading hours, which can differ. (Click path tdameritrade.com > Trade > futures.)

Now, if you come from the equity option world, the notion of trading a derivative of a derivative might make you a little uneasy. But don't worry. Trading options on futures isn't that different than trading equity options. The same basic concepts—option greeks, time value, strike price, and most of the strategies you can do with equity options—also apply to

futures options. And if you're already using the thinkorswim trading platform for your equity options trading, you're probably familiar with how to place trades on futures options. You just follow the same three steps:

**1— Select your underlying futures product.** Choose a product like the E-mini S&P (/ES) under the main Trade tab. This will display the active month under the FUTURES section.

**2— Expand the OPTION CHAIN section.** By expanding this section, you can view the strike prices by month. In addition, you have access to the same great options tools you use when trading equity options. For example, you can increase the number of strikes you can view per contract, and, view different spread order types (i.e. Single, Vertical, etc), or customize your layout to show things like implied volatility, option greeks, volume, and open interest.

**3—Confirm and send your order.** Take one last moment to review your order to insure the contract, strike price and quantity are what you wanted. If so, simply click the Confirm and Send button. If not,

you can either delete the order or adjust the order in the Order Entry window.

A nice perk of using the thinkorswim platform is that you can trade multiple asset classes from the same platform, with the same look or feel, using the same log in. But before you jump off the starting block, take advantage of the education available to you to be aware of all the important nuances. Knowing things like the correct trading hours of the underlying futures product, as well as each of their respective price increments, could make a huge difference in your profit/loss if you're not paying attention.

Now, if you have a burning question about how to trade options on futures, you can always reach out to our futures Trade Desk. Click on the Support/Chat button in the trading platform to contact a futures Trade Desk representative via Live Support, or just enter one of the Chat Rooms. If you'd rather speak to a human (gasp), call us at (866) 839-1100 and we'll answer your question live.

You can learn more about options on futures by going to the CME's Option Education center located at (<http://www.cmegroup.com/education/options.html>). In addition, TD Ameritrade's education affiliate, Investools, offers a variety of educational seminars to help educate you about options trading.

If at any time you have any questions about the account opening process, please contact us [support@thinkorswim.com](mailto:support@thinkorswim.com) or call us at 866-839-1100.

#### Important Information

*Investools® does not provide financial advice and is not in the business of transacting trades.*

*Investools, Inc., and TD Ameritrade, Inc., are separate but affiliated companies that are not responsible for each other's services or policies. For details, please see disclaimer, page 9.*

#### FUTURES TRADING

## Q+A:

**Q: Do I need a futures account to trade future options, or can I use my stock account?**

**A:** You need to trade futures options in a futures account. While you can see the futures and future option positions side by side with your stocks, options and mutual funds on the thinkorswim trading platform, there are really two accounts on the back end—an equity account for the stocks, stock options and mutual funds, and a futures account for the futures and futures options.

**Q: Can I trade futures options in an IRA?**

**A:** Currently, you cannot trade options on futures in an IRA on either thinkorswim or [tdameritrade.com](http://tdameritrade.com).

REST ASSURED, THE FUTURES OPTIONS PRODUCTS THEMSELVES DON'T KILL YOU. IT'S GENERALLY HOW THEY'RE USED.

**Q: How are margin requirements determined for futures options?**

**A:** The margin requirement on futures option positions are calculated by a process known as SPAN (Standard Portfolio Analysis of Risk) SPAN calculates the loss of your future options positions in a variety of scenarios including possible changes in the underlying futures price, and changes in volatility over a one-day period. The margin for the future option position is the maximum loss identified by SPAN across that risk array.

**Q: Can I be assigned on a futures option before expiration?**

**A:** Yes, if the option has American style exercise procedure. Most futures options traded in the US are American style, which means if you're long an option, you can exercise it and take delivery of the future, or if you're short an option, you might have to take delivery of the future before expiration. Because futures don't pay dividends like stocks do, the decision whether or not to exercise a long future option depends on the amount of interest you would earn by either being long a future at a lower price or short a future at a higher price by either exercising a long call or put.

**Q: Are profits and losses on futures options credited to my account in the same way futures are?**

**A:** No. While futures options have settlement prices each day that

can be used to calculate profits and losses, the dollar value of the profit and loss isn't credited or debited from the trading account as it would with a futures position. The profit or loss is recognized when the future option position is closed.

**Q: Can I work limit orders in between the bid/ask spread?**

**A:** Absolutely. You can enter limit orders in between the published bid/ask spread as long as the limit price is in a tradable increment. For example, if an E-mini option (/ES) were quoted 8.00 bid and 8.50 ask, you could enter a limit order to buy or sell at 8.25.



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**Coach's Corner**

Pulling pearls from your favorite trading instructors.

Words by  
**Pat Mulally**  
*Investools Instructor*

• *I thought I was dancing until somebody stepped on my face...*

At some point in your trading career, you may experience the jolt of a fairly large drawdown in your equity curve—either through a string of losses, or one big one. Either way, this is every trader's cross to bear. So how you cope with the situation may not only define the depth of the loss, but also your ability to recover.

**GET OVER IT**

As a trader, drawdowns are a fact of life. Just as the market moves up and down, so goes your trading account. Feelings of regret from a large loss can beget further errors in judgment, such as rationalizing why you should continue to hold losing positions. Research by the Econometric Society shows that the second \$100 loss is easier to take than the first. And the third is easier than the second—until, at some point, the trade becomes a “buy and hold” investment regardless of your original strategy.

**SHINE YOUR DANCING SHOES**

Avoiding drawdowns is impossible. However, the negative effects both financially and psychologically can be mitigated. How?

**1/ Visualize.** Have a vision of what you're trying to accomplish over the next one-to-five years. Then define a plan for what you need your trading account to do on a weekly and monthly basis to make that happen. Having a long-term goal, and then managing positions in alignment with those goals, will keep you less myopic and more focused on the prize.

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## Dealing with Drawdowns

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A string of losses stinks, but there's hope for getting back in the game

**2/ Size your positions smartly.** Too much size and a sudden, adverse event, can be devastating. Too little size, and a favorable market barely moves the needle. Figure out the position size and risk that works for your profit/loss, and stick with that.

**3/ Get out.** There's no shame in shedding your losers. Don't let ego, hopes, or fears paralyze you. As the old saying goes, “Sell down to the sleeping level.”

**Important Information**

*Past performance of a security does not guarantee future results or success. The information contained in this article is not intended to be investment advice and is for educational purposes only. Clients must consider all relevant risk factors, including their own personal financial situation before trading. Supporting documentation for any claims, comparisons, statistics, or other technical data, will be supplied upon request. Investools® does not provide financial advice and is not in the business of transacting trades. Investools, Inc., and TD Ameritrade, Inc., are separate but affiliated companies that are not responsible for each other's services or policies. For details, please see disclaimer, page 9. PaperMoney is for educational purposes only. Successful virtual trading during one time period does not guarantee successful investing of actual funds during a later time period as market conditions change continuously.*

**\*Funny Money**

Getting back in the game is easier said than done when committing real trading dollars. With **paperMoney**, you can work on building your confidence back with a fake money/real market experience. Just pull up the log-in screen on thinkorswim, and select **paperMoney** before signing in.

**4/ Get back in (when you're ready).**

After a large drawdown, you may be afraid to get back on the dance floor. That's fine. Perhaps you paper trade using something like **paperMoney\*** on the thinkorswim trading platform until you're ready to put real dollars back to work. When you put on a smaller portion of the positions than you normally would. The first goal isn't to get

back what you lost. And, trade the amount of positions typical for you, but keep the size small until you build confidence.

**DRAWDOWNS HAPPEN. BUT SO DO PROFITS.** Accepting that things change is crucial. So after a drawdown, move on. I like to say I've given up all hope of having a better past. So, remember the lessons from the past, look to what you can do now, and build towards your future.



**THIS TOOL DOESN'T FIND OPPORTUNITY. IT HUNTS IT DOWN, TIES IT UP, AND THROWS IT AT YOUR FEET.**



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► Learn more and view a demo at [tdameritrade.com/ta](http://tdameritrade.com/ta).



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**The Token Glossary**

• Terms you might stumble across in this issue.

• [tdameritrade.com](http://tdameritrade.com)

found on pages: **12, 23 & 31**

# Vertical Spread

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

found on pages:

**31****In the money**

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

found on page:

**13 & 23**

# SHORTING

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

**12**

found on page:

# Iron Condor

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

**23, 26 & 31**

found on page:

# Delta

- A measure of an option’s sensitivity to a \$1 change in the underlying asset. All else being equal, an option with a 50 delta (also written as .50) for example, would gain or lose \$50 per \$1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying loses in value.

found on pages:

**20****Selling a naked put**

- A STRATEGY DESIGNED TO PROFIT FROM SHORTING AN UNHEDGED PUT TO COLLECT A PREMIUM. IF YOU BELIEVE THAT A STOCK WON’T DROP VERY MUCH AND HAVE A BULLISH BIAS ON IT, YOU MIGHT CONSIDER A SHORT PUT. THE MAX LOSS IS THE STRIKE PRICE MINUS THE PREMIUM PLUS TRANSACTION COSTS. THE PROBLEM: YOU HAVE NO HEDGE. HENCE, YOU’RE “NAKED”—MEANING, YOU’RE EXPOSED, WITHOUT A SAFETY NET.

**26**

found on pages:

# Theta

- A measure of an option’s sensitivity to the passing of time by one 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 page:

**26**

# VEGA

- A measure of an option’s price sensitivity to a one-percentage-point change in its implied volatility.

found on pages:

**23 & 31****At the money**

- An option whose strike is “at” the price of the underlying equity. Like out-of-the-money options, the premium of an at the money option is all “time” value.

found on pages:

**20****Out of the money**

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

found on pages:

**12****Scalp Stock**

- A trading strategy seeking to profit from incremental moves in a stock.

Awarded 5 stars from Stockbrokers.com\* ★★★★★

# Trade with your finger on the market.

Explore futures and forex trading with thinkorswim®, our award-winning, feature-packed trading platform. Use Monkey Bars, Pairs Trading, and the Active Trader Ladder to help make your strategy even stronger. Access all your trading, data, and idea-generation tools in one slick, customizable window. Or take your trading on the go with TD Ameritrade Mobile Trader.

Both platforms are free to download. And they'll change the way you trade.



**TD Ameritrade**

Find out more at [tdameritrade.com/futuresforex](http://tdameritrade.com/futuresforex)

\*The thinkorswim trading platform received 5 stars overall in the 2011 Stockbrokers.com Forex Broker Review (sharing the highest score with one other broker), as well as 5 stars in the categories of "platforms and tools" (sharing the highest score with one other broker), "investment offerings" (sharing the highest score with three other brokers), and "customer support" (sharing the highest score with one other broker). thinkorswim was evaluated among a total of 16 forex brokers and trading platforms reviewed.

Access to real-time market data is conditioned on acceptance of the exchange agreements. Professional access differs and subscription fees may apply.

Market volatility, volume, and system availability may delay account access and trade executions.

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Forex investments are subject to counter-party risk, as there is no central clearing organization for these transactions.

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