

thinkMoney/03

• random musings
for thinkorswimmers
Summer 2008

INSIDE THIS ISSUE

• GOT GUTS? GO PRO/10

• THE UGLY BUTTERFLY/24

• TRADING LESSONS
FROM MOMMA/32

• **FUTURES SPECIAL:**
YUP, YOU CAN TRADE THEM
HERE, TOO/35



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04

Contents

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p. 10

Got Guts? Go Pro

Like many professions, trading requires a cool head, calculated risks and a dose of gumption. Find out if you have what it takes.

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07

Contents

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Features



10/Got Guts? Go Pro

So you wanna go pro, but do you have what it takes? There is certainly more to trading for a living than meets the eye; but if you can take your punches, tame your fears and recognize opportunity, you just might have a bright career ahead of you after all, kid!

Miscellaneous



08/A Quick Howdy



24/The Ugly Butterfly

Because of its lower risk, high reward potential, the butterfly spread is a favorite amongst floor and retail traders alike. But unless you can throw darts with pinpoint accuracy or just happen to be clairvoyant, the "fly" isn't always what it's cracked up to be. With a couple of tweaks, perhaps there is another way.



15/Dear Swim

Wacky letters from you
to yours truly



28/Risk Management: A Trader's Least Fun Job

Show us a trader who doesn't manage his risk and we'll show you a broke trader. But with volumes of material on the subject, which rules should you follow? With a few simple tips to put you on the right track, you'll keep your powder dry and stay in the game.



35/Futures Special THE DECOUPLING THEORY-FACT OR FANTASY?

An new school of thought is discredits the mantra, "As the US markets go, so goes the rest of the world." But is this just a bunch of hooley?

PLUS:

STRATEGY FOCUS Before you go diving into trading calls on crude, understand the differences between options on futures versus stocks.

Q&A Tackling the tough questions on futures trading as well as our platform.

Columns



16/Volatility Watch

What is the volatility of the markets telling us about where the market is headed? Let's see if our resident volatility expert can shine a little light on the subject.



18/T.O.S. News & Views

Check out what's coming and going at TOS, along with some other tidbits and relatively useless opinions about the state of the markets.



33/An Interview with... Rasta Lou

Cross Lou Dobbs with a Rastafarian and what do you get? One mellow radical with a new plan to save the American workforce.



21/Gear Head

Gadget junkies rejoice! Our latest releases let you "thinkBack" and test your best option theories, or save your coolest custom orders.



40/Getting Technical

Revisiting an old favorite of technicians, the moving average crossover can provide a few clues on direction in an otherwise unpredictable market.



42/The Last Page

When the going gets tough, even the power of prayer can't seem to help the helpless.



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08

A Quick Howdy

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Having Fun Yet?

edit.

If there was one word that could surmise the first six months of '08 it would be volatility. And since we're about to jump the hump and head into the second half of what has proven to be one of the more volatile years of the decade, it may not be a bad idea to do a little reflection as we watch history unfold through the year.

Don't worry, we're not going to waste your time jabbering about the Presidential election, the credit crunch, or the looming world food shortage as cars start eating more corn than people do. But what we do want to focus on this issue is

how to keep your cool during uncertain times and make some money under these circumstances (or any for that matter), regardless of which way the wind blows in your world.

So, if you've ever contemplated sticking it to the man and becoming a professional trader, be sure to read the cover feature "Got Guts? Go Pro". It's a good place to start if you're looking for perspective from someone who's already been there, done that.

Now, if you're just starting out as a new trader, or perhaps you've hit a dry spell in your trading career, it doesn't hurt to go back to the basics of discipline. Traders who blow out tend to do so because they spend so much time searching for the Holy Grail, they don't understand that when it comes to trading, it's mostly the jockey, not the horse that wins in the end. Though it ain't glamorous (and at times pretty dang boring), risk management is crucial to staying in the game and eventually going pro. So we thought it was worth revisiting this topic from our perspective

Where there's a market, there's volatility, otherwise there'd be no market.

in this issue's "Money Management: A Trader's Least Fun Job"; condensing the really important stuff in plain English, rather than complicated formulas.

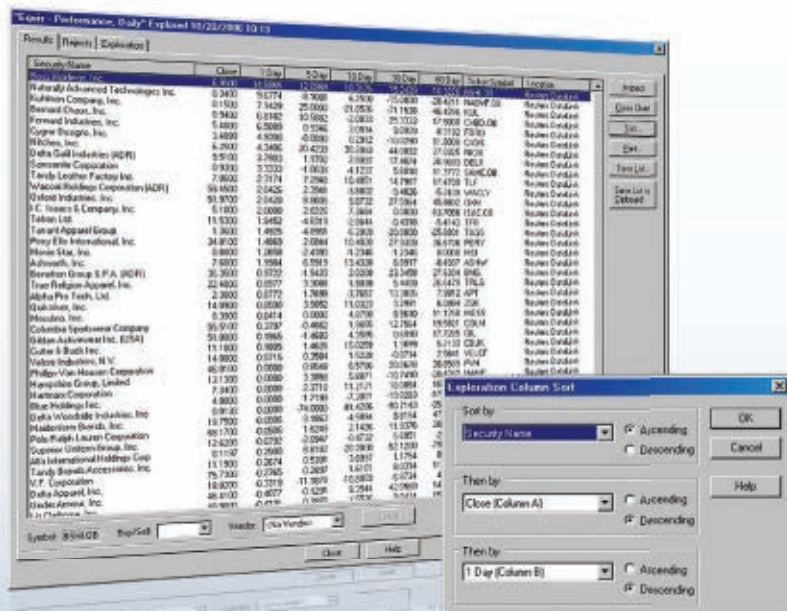
All in all, though we can't tell the future, we can say this with certainty - Where there's a market, there's volatility, otherwise there'd be no market. And as volatility goes, so goes opportunity.

Happy Trading

We want to hear from you!
Please send your thoughts and opinions to
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10

Feature #1

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GOT GUTS? GO PRO

cov.
story

SO YOU WANNA TRADE FOR A LIVING...

BUT DO YOU HAVE WHAT IT TAKES? TURNING YOUR HOBBY INTO A FULL-TIME VENTURE COULD MEAN MANY THINGS TO DIFFERENT PEOPLE. NO MATTER WHICH SIDE OF THE BORN-OR-BRED ARGUMENT YOU SIT ON, ONCE YOU'VE GRASPED THE BASIC MECHANICS OF ANY MARKET, THE LITMUS TEST FOR BIG SUCCESS AS A TRADER MAY NOT BE WHAT YOU THINK AT ALL. LET'S SEE IF YOU HAVE WHAT IT TAKES.

words by **Mark Ambrose**

12

Feature #1

Photograph by
Fredrik Broden

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YOU KNOW WHAT THE DREAM IS. You quit your day job. You work when you want to. You answer to yourself. You make more money than you know what to do with. That's why you're learning how to trade. You want to be a pro.

But what's the difference between a retail trader, even an advanced retail trader, and a professional? What is a professional trader anyway? Let's define it simply as a trader who makes his or her living from trading. There's no "day job." No other income than what you can earn on your trading capital. What you'll find is that being a professional trader is a lot like starting your own business. It takes the same hard work and the same drive. So, the main differences between the pro and the retail trader can be boiled down to a few points. It's not inventing wild new option spreads. Maybe it's not even better trading tools (plenty of professional traders use the thinkorswim platform). It's more about attitude and nerve, because the difference in know-how and trading technology between the pro and the retail trader is smaller than it has ever been.

MINE'S BIGGER

One of the main things that professional traders do is risk a larger percentage of their capital to trades. Each trade may require a larger capital requirement than most retail customers should consider, or even be comfortable with. For example, if I have \$1 million to trade with, I may have margin requirements that are about 80% or 90% of that. But I believe that my trading skills are the best way to expand my capital. If I am confident in my abilities, I can increase the returns by allocating more capital to the trades I find.

The math is simple: If my profit target is 15% a year on the trades I find and I allocate \$900,000 to those trades, I can try to make \$135,000; if I allocate \$200,000 to the trades, I can try to make \$30,000. On the flip side, I can effectively lose the same \$135,000 and \$30,000 or more respectively, but that's something I'm okay with prior to getting in the trade. My risk is relative (for more on this, read "Risk Management: A Trader's Least Fun Job" in this issue). My tolerance for pain may involve more zeros than yours, but it's how we react when the wounds hurt that makes the difference between a pro, and well, not-so-pro.

I know that allocating more capital means that I'll see bigger swings in the value of my account. Bigger trades generate a bigger p/l. But again, because I am confident, I know I can see those fluctuations (i.e. losses) and continue to trade. That confidence comes from allocating smaller amounts when I was starting out, and learning how I

responded to losses. Professional traders don't go into shock at a losing trade. They push on and continue to trade, believing that the next trades could be profitable.

These days, though, the new portfolio margining rules available to a retail trader with an account of at least \$100,000 mean that you can put on larger positions with less capital. That's both good and bad. When you put on bigger positions, you have to be ready for larger potential losses. But portfolio margining can be used as a step toward becoming a professional.

Now, one of the reasons that the trades a professional trader may put on require a lot of capital is that they often have undefined risk. That is, they may have naked short options or outright long and short positions in an underlying stock or future. All those positions typically have large margin requirements relative to defined-risk positions. For example, I sold a straddle in AMZN for 12.00 ahead of earnings to try to capture a lot of time decay because I was willing to speculate that the stock wouldn't move much on the announcement and implied volatility would drop. Does a short straddle have unlimited risk? Absolutely—if the stock goes to zero or \$150, I'm toast. But I expect that I'll have an opportunity to close that trade out before that happens. That demands a lot of discipline to be able to accept a loss if my speculation is wrong and I need to exit the trade. If you don't have that discipline, then the style of trading that takes on a lot of risk isn't for you.

NO PLACE FOR A DEER IN HEADLIGHTS

Of course, if I'm taking all that risk, it means that I don't hesitate to take action when I stop liking a trade I have on. What makes me not like a trade? Let me give you an example. I was short some XLF call verticals in early March. I was bearish on the financials, with the continued fallout of the subprime loans and recession fears. Bear Stearns was crashing, and I was liking the trade. Then the Fed made it easier for the banks to get credit. They cut the discount rate again. A couple of big banks fessed up to some final big write-offs. And the XLF stopped dropping. OK, maybe it won't go down any more. Maybe it won't rally sharply, but I realize I wouldn't necessarily make an opening trade to sell

STRATEGY BOX:

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

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



A LOT OF
RETAIL
TRADERS
THINK THAT
THE PROFES-
SIONALS
KNOW SOME-
THING THEY
DON'T. THEY
DO, BUT IT'S
PROBABLY
NOT WHAT
THE NEWBIES
THINK.

a call vertical. So, I buy my short call vertical back for a small profit. It could have been a loss, but I would have closed it anyway. I re-evaluated what I thought the XLF would do, and I changed my mind. The analysis wasn't complicated or particularly sophisticated. But the point is I wasn't emotional about it, and I didn't second-guess myself.

As a professional, if you have a bad trade, you move on. Conversely, you don't let a winning trade go to your head. The losing trades don't necessarily mean you're a bad trader, and the winners don't mean you're a genius. They're both part of the business of trading.

LESS IS THE NEW MORE...REALLY

Professional traders also tend to trade a relatively small universe of products. Sure, I might trade a range of index options, futures products, and the occasional stock, but they're all very liquid. And there just aren't that many very liquid products out there where there is open interest in the options of tens of thousands of contracts. But when it comes to the size of a position, I will only do as many as I can get out of. That's why liquidity is so important. I don't want to get stuck with a position—whether it's a winner or a loser. If you can't exit a profitable position when you

want to, you risk having that winner turn into a loser. And if you can't exit a losing position when you need to, you could go out of business. When I was trading on the floor, a big order came into the 10-year note pit for a vertical versus futures at a good price. I called my boss upstairs to see how many I should do. His reply? "Do as many as you can get out of." That has stuck with me ever since.

THE ILLUSION OF TIME

Finally, for me personally, being a professional trader is a full-time job. I watch my positions all the time. Not some of the time. All the time. I don't put a position on, dutifully enter my stop or contingent orders, and just "set it and forget it." Certainly, we can accommodate just about every complex order under the sun at thinkorswim, but that's not necessarily my style of trading. I do this for a living. When you are running a business, you need to be worried. You put in 16-hour days sometimes (at least I do) because there is always something that you have to do, and if you don't do it, your business might not succeed. For most "pros," that's trading. When I was trading a futures fund, I had a big position ahead of a Bank of Japan announcement. I watched the yen all night, and called my broker at 2 am when it had reached a certain point so I could sell a few futures there. I could have put in resting orders because I had all my prices worked out, but I wanted as much control over my position and orders as I could get.

Is it glamorous? No. Fun? Sometimes. Profitable? Hopefully. But a lot of retail traders think that the professionals know something they don't. They do, but it's probably not what the newbies think. Certainly, your education is very important to your success (as with any specialization), and you should always take your learning as far as you can with those who are most qualified to teach you. But to turn pro requires skills that don't necessarily come packaged neatly in a box. For pros, it comes down to a few basic principles: Know that you're only as good as your last trade, that you'll never divorce reward from risk, and that your mother will never understand what you do for a living.

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15

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Dear Swim

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

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Fredrik Broden

- TOS should have a monkey delivered to people that were in the BSC trade. The monkey should have a T-shirt that says, "I survived BSC... But my account did not!"

Greg

- Long-term trades in this market seem to be bowel movement to bowel movement.

Al

- The video tutorials for using the TOS software are incredibly helpful, but I beg on my hands and knees that someone would revise the videos or edit them to take out all the sounds of Don Kaufman smacking his lips every third word he said. I just wanted to shut it down and run from my computer, but I couldn't because I needed to learn what he was teaching. Ha!

Lee

- I'm happy to see expansion with BC (Canada) now online, but I live in Calgary, Alberta... Is the delay due to elections? I'm like a fat kid at the candy shop—money in my pocket and the store is closed.

Mel

- Is that a thinkorswim screen on the computer of the character Zoe on Wednesday night ABC television series *Cashmere Mafia*?

Theo

- I'm sorry. I know you don't need comments from the peanut gallery. I've convinced some of my friends to give TOS a try. They were blown away by the complex order entries. Then I showed one of them how you can duplicate the complex trades made by other TOS customers. Luckily we have full medical at my work... he started hyperventilating.

Derek

- I just left the office. My number is 773.xxx-xxxx in case you ever need to reach me on the week-end. Go ahead and program that number into your cell phone. Usually I only give it out to girls, but for you I can make the exception.

Bob

- I've proved to myself I have no business trading. Please stop all auto trading in my account. Convert everything to cash. Close my account and send me a check for the balance. I cannot trust myself to do this anymore. Thanks for your help.

Ronald

- I listened to the first 3–4 minutes of your first training video "Left Side Bar." The presenter used the word "actually" about 480 times. "I'm actually going to go ahead and actually click on this button, and that will actually open up a window that will actually show us the actual prices." I got so sick of it I stopped the video. Perhaps you could consider redoing the video with a little attention to some of the other 200,000+ words in the English language.

Steve

- When will you put your software on the iPhone, so I can lose money trading in the car?

Bill

- Last week, my boyfriend talked about your chat session over and over... he was sooo impressed with your session. Even when we talked about our relationship, he changed the subject and talked about you again!

Alice

For the next issue's Dear Swim column, let's change things up a little. In addition to the nutty comments, send us your thoughts or questions about the markets and trading. Go on... Ask us anything. Send to: editor@thinkmoney.com.

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Volatility Watch

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

vol.

• It looks like the CBOE's Volatility Index, the VIX, pretty much stayed in the range that we thought it would from the last issue. We suggested that the VIX would stay in a range between the low 20s to low 30s, and that's what we saw. In early 2008 the VIX reached the low 30s a couple of times (and up to 37% intraday) when the stocks in the financial sector sold off so sharply on the continued sub-prime loan mess. But what about the future? My guess is that there will be enough fundamental bullish factors (low interest rates, for example) and bearish factors (like high oil) to combine with the typical summer doldrums to make the market somewhat range-bound. That's why I think the VIX will trade in a slightly lower range than we've seen. Maybe the mid teens to the upper 20s on a scare.

But to expand the volatility horizons a bit, the CBOE has some other volatility indices worth looking at. There's the VXN (NASDAQ 100 volatility), VXD (DJIA volatility), RVX (Russell 2000 volatility) and VXO (S&P 100 volatility). They all use the same calculation, based on weighting the out-of-the-money options with non-zero bids in the first two expiration months. So, they capture the volatility information in the skews of the underlying index product, as opposed to simpler methods that just look at the at-the-money implied vol. Of those, only the VXN and RVX have options on them (in addition to the VIX, which is S&P 500 volatility). The VXN and RVX options have markets wide enough to drive a truck through, and very low open interest. So, I don't think

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



More of the Same

• Low interest rates, high oil prices, and the summer doldrums should make for a relatively predictable market...going nowhere.

they make for great trading vehicles. But is there a way to look at those volatility measures as indicators of fear or complacency?

Those volatility measures have the same inverse relationship with their indices, just as the VIX has with the SPX. For example, when the RUT drops, the RVX tends to rise, and vice versa. On a daily basis, you can see both the index and the volatility rise a bit, or both of them fall a bit. But when the index is moving higher over time, the volatility tends to drop. Some sophisticated traders use those VIX options as a hedge for long stock portfolios. When the market rallies, and the VIX moves lower, you can create a hedge of sorts by selling a short put vertical on the VIX. The idea is that if the market drops, the VIX will rally, and your short VIX puts will make money as your long stock portfolio loses. It's not a perfect hedge, and offsets only a portion of the possible losses on the long stocks. Also, it is possible for stocks to drift lower, and the VIX not rally much at all. So, you could have losses both with the stock portfolio and the VIX hedge. It's not for the faint of heart.

For option traders, looking at one of the volatility indices can be used to inform

STRATEGY BOX:

Vertical Spread A directional, limited-risk spread strategy constructed of a long and a short option of the same type (i.e. calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. 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. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish.

whether you would want to buy or sell a vertical as a directional speculation. Low volatility market environments tend to make **vertical spreads**, which have limited risk and limited profit potential, relatively cheaper. If a trader were bearish and volatility were low, long put verticals might make sense. Low volatility would reduce the cost of the vertical, and might suggest that the market could drop. Buying a bearish put vertical would be positioned to make money if the market dropped and volatility increased. If volatility were high making verticals more expensive, selling them might be a better choice. If a trader were bullish and volatility were high, short put verticals would be trades that take advantage of a rising market and falling volatility. Beware that trading vertical option spreads entails risk, and can incur significant trading losses and generate substantial commissions.



TOS Chart Tip:

To view a pairs trade, in the symbol field simply type in the two symbols subtracted from one another, such as **VIX-VXN**.

• So, if you're only trading the S&P 500, maybe the VIX is enough. But if you trade other ETFs, take a look at some of the other volatility indices. You might find some useful information.

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

Options Traders: How Do You Find Your Best Profits?

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TOS News+Views

A hodgepodge of stuff that matters to you (or so we think)

Recently Released TOS Toys

Sizzle Index

- Shows you the stocks whose options are trading more actively. Select the "Quotes" tab, or search for stocks using it as a criteria in the Stock Hacker tab. The Sizzle index takes the current volume for either calls, puts or calls and puts both, and divides it by the average volume of that stock's options for the last 5 days. Greater or less than 1.00 indicates higher or lower than average volume respectively.

thinkPod

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thinkBack Charts

- You can now see the theoretical value of an option as a study on TOS charts. This is

much more informative than traditional option charts that only show the last option trade. Because most options trade infrequently, a chart of trades alone doesn't tell you much. The theoretical value can be calculated whenever there is a stock trade, so you can compare how the value of the option changed when the stock moved.

TRADER TALK

Ohnosphere :
noun (ō-no-sfeer)

The catatonic state an option trader falls into after disaster strikes the markets and sends their position reeling through a black hole within minutes, rendering him frozen and motionless.

INDUSTRY SPOTLIGHT

Regulator Reorg?

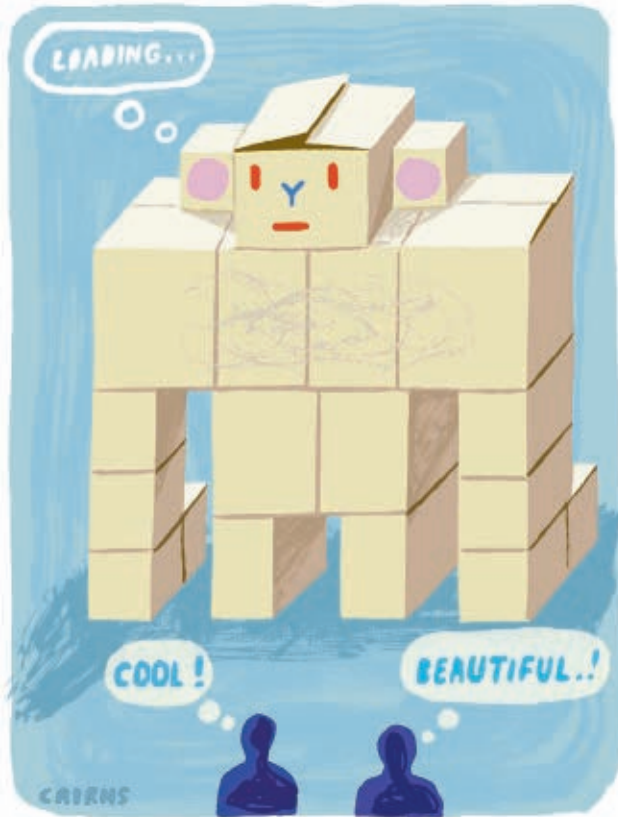
Contained in Treasury Secretary Henry Paulson's call for new regulatory agencies with wide-ranging powers over the banking and securities industries and how the latter conduct business is an idea to merge the SEC (equities regulator) and CFTC (futures regulator). Given the scares in the sub-prime lending business and the failed investments in securitized loans, it would seem prudent to overhaul the watchdog system that currently oversees these activities.

But haven't we seen this before? Junk bonds and the S&L crisis in the '80s, overvalued stocks and the dot-com bubble in the '90s, to name a few. Anytime people get hurt or lose money, there is much hand-wringing and cries for more laws to prevent further calamity and prevent this from happening in the future. The cycle

repeats itself: innovation, excess, collapse. The fact is, though, that there were calls to apply existing regulations to the aggressive lending tactics two or three years ago. No one listened then because the lenders and bankers were making too much money. Who's to say the regulators or Congress will listen in the future?

It all comes down to risk management, which the Paulson report *didn't* spend much time on. The fact is, it will likely take years for any of these changes to take place. Maybe new methods to identify the risk of positions, and corresponding capital requirements to hold them, would be a faster and more efficient way to head off future disaster, rather than more "suits" in Washington trying to figure it out. It wasn't the futures and option traders that caused the current problem. Instead of creating a new agency, maybe Paulson could take some risk management lessons from those guys.





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key; so, it pays to have fast hands. The simple activity frees your mind to explore new creative thoughts. Why, you might even finally think of a trading strategy that is actually profitable, and let you turn all those dimes into quarters! Who needs college, anyway? Build your future, one monkey at a time!

STUFF COMING SOON AT TOS: Charts: incorporate bid/ask prices of stock, enter complex orders directly from chart, show user notes on chart, integrate thinkBack with charts • FX: full integration of FX positions and order entry into thinkorswim platform • Alerts: based on technical indicators and studies

Pot Shots

Rating our favorite non tradable events

•

KEY:

2 Buy Tickets =



1 Buy Ticket =



1 Sell Ticket =



2 Sell Tickets =



Eliot Spitzer resigns over call girl flap:



Why do you think you become governor in the first place? But you'd think he would have been smarter paying for it. Maybe Mrs. Spitzer was the one who normally handled the bills.

Hillary vs Obama is finally over



The people have spoken and now we can finally go back to what we really care about - Lindsay Lohan's new floss size. But if we're going to have to watch one of these people for the next four years, McCain definitely has the hottest spouse.

Steroids in baseball:



How much fun is it for Red Sox fans to see Clemens twisting in the breeze? That's what you get for taking yourself out of a Game 6 because of a blister.

Bear Stearns goes kaput:



How many investment bankers does it take to run a credit check? One more than it takes to miscalculate the risk of a bunch of mortgage derivatives. So, does this mean we don't have to meet their margin calls?

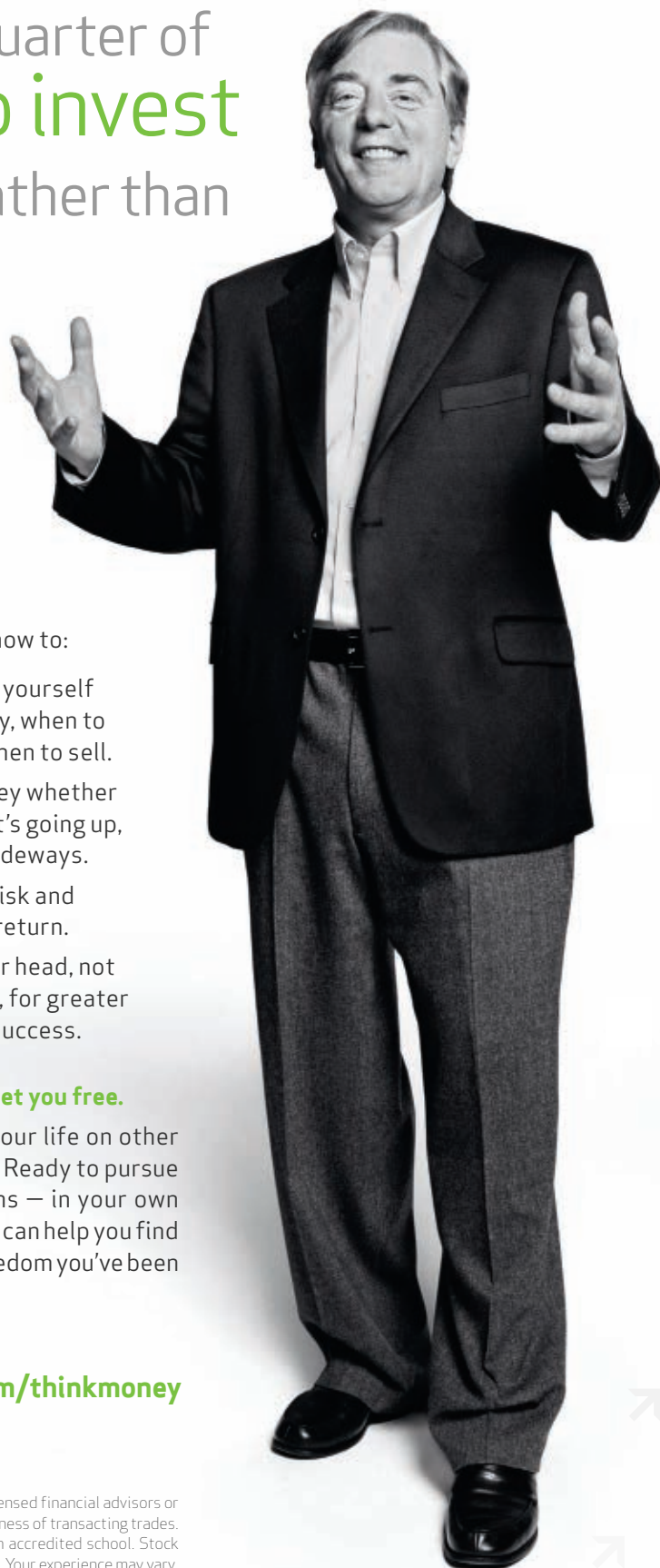
Yahoo! + Microsoft:



According to Yahoo!, less is more. The company can't impress its investors enough to lift its stock past the low \$20s, but cries "Foul" when Bill and Co. offer up a \$33 handle, stating they have unlocked value that can't be seen yet. Unless we missed the memo about the benefits of phantom value, our advice to Yahoo! - Hug it out.

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Gear Head

Cool things to do with what we've got.

tech

Saved Custom Orders

Are you addicted to a particular set of OCO rules, and get tired of recreating them every time you want to do that trade? That's what that new little "floppy disc" icon is for in the order entry panel.

You can now save your favorite order type as a custom order. To do this, (1) create the order you want to save on the Trade page. It could be an OCO, or a stop order with a particular set of trigger rules, or a set of GTC orders you want entered if a first order is filled. (2) Next, look for a green floppy disc with an orange puzzle piece (hey, it made sense to the programmers) on the right-hand side of the order entry panel. If you click that, (3) you can create a name for your order and save it. Once you've done that, if you right-click on the bid or ask of the stock or an option, you can select "Buy Custom" or "Sell Custom" and choose your saved order from the menu. This will load up that order type in the order entry panel. Always double-check the details and look at the order confirmation box to make sure it's still the order you want to route.



Figure 1 (top): 3 steps to saving a custom order. Figure 2 (bottom): Simple back-testing in 4 steps with thinkBack.

Dynamic Duo

Back-test your theories and cut down time placing extravagant orders with two of our newest tools. Please, no applause necessary.

Back-Testing with thinkBack

thinkBack is thinkorswim's new option back-testing feature. thinkBack lets you see option quotes up to five years back, enter simulated orders using those quotes, then advance the date and see how that trade fared over time.

For example, how would that short put spread have done in BSC right before March expiration? Or how about a short call vertical in the VIX at about the same time, when the volatility index spiked to 35%?

Simply (1) go to the thinkBack tab on the thinkorswim software, (2) type in the underlying symbol in the upper left-hand corner

and hit the Enter key. (3) You'll see the current quotes by default, but if you go to "Quote Date" in the upper right-hand corner, you can use the arrow keys to scroll back through time and (4) see the stock and option prices change. You can enter a simulated order in thinkBack the same way you would a real trade. Click on the bid or ask to buy or sell, or right-click to create a spread order. Then, go to "P/L Date" on the lower right-hand side and change the date to see how much money that position would have made or lost.



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

OPTIONS



Did you know that Options can be a conservative investor's greatest ally in managing risk? So when the proverbial storm hits, you can be ready. To learn how, go to **OptionsEducation.org** or contact your Financial Advisor.

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Hey Monkey!

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

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

Illustration by
Brian Cairns

Q: I need some money fast or they're shutting down the convent! The nuns need a good trade!

A: Ah, desperation. That's the one emotion shared by every species in the animal kingdom. If I knew what the next great trade was, do you think I'd be doing this? I've been short the euro since 1.35. Damned Frenchies. I'm the perfect counter-indicator. Just have the sisters take the other side of my trades, and they'll have more money than Oprah.

Q: I bought a RIMM April 120 call on April Fools' Day, and the stock rallied right after earnings. My call dropped in value! What gives?

A: Were you watching the volatility? Obviously not. Right before earnings, the volatility of options can get pumped up. RIMM April options had 80% vol ahead of earnings. Once the earnings came out, the volatility dropped to 50% because the uncertainty of the earnings was over. And even though the stock rallied, that drop in volatility, along with time decay, reduced the value of your call by more than what it gained because the stock went higher. That's why verticals are nice. Sure you don't get the huge wins, but you're more insulated against time decay and changes in volatility.

Q: With gas prices so high, I'm thinking about getting a hybrid car. Any thoughts on that?

A: Wow, what's it like to be castrated? Look, you drive one of those, you have no chance, and I mean ZERO CHANCE, with the ladies. OK? Do you want to be green, or do you want to be happy? But if you're running low on gas money, look at other areas where you can save. Switch from Dunhill to Merits, for example. [Ed. Disclosure: While Monkey makes a

good point, the editor does in fact own a hybrid, with mixed results. But since he is married, the whole happiness thing is a moot point.]

Q: What's the deal with early exercise? I have a short call that's in the money. Am I going to get assigned or not? I asked my other broker, and he told me he'd get back to me on that.

A: You have another broker? Ewww. I feel sick. OK, your tough question is worthy of my answer though. That's why you've come to the Monkey; so I won't make you feel like yesterday's banana peel for asking. Whether or not an American-style option is a candidate for early exercise depends on dividends and interest rates. It's mostly calls that get assigned early. An in-the-money call might be exercised if the out-of-the-money put at the same strike is less than the dividend minus the interest rate on carrying the stock at that strike. The idea is that the person who is long the call exercises it, collects the dividend, pays interest until expiration, and buys the put for protection. The long stock and long put is synthetically the long call the trader had. If



that dividend is big enough to cover the interest and the cost of the put, then that call is more likely to be exercised.

Q: It's summertime, and I'm invited to a lot of BBQs where they ask me to bring a dish. What's a good one?

A: First, this monkey handles all the food at his parties. I don't need some Emeril wannabe screwing up my well-orchestrated symphony of encased meats. But if you feel you must

bring a dish to someone else's party, bring a pile of my Mom's potato salad. Trust me, it's good. But for the love of God, keep it cold so you aren't playing bacterial roulette by the pool. Combine 2 pounds boiled potatoes, 1/2 cup celery, 1/4 cup parsley, 2 diced hard-boiled eggs, 1 cup mayonnaise, 4 tablespoons chopped red onion, 2 tablespoons red wine vinegar, 1 tablespoon mustard, and a dash of salt to taste.

Q: How DO you do it?

A: Hair gel and lots of naps.



Visit the Monkey Brains blog for daily market wraps and trading ideas at www.thinkorswim.com by following the path - Support tab > Monkey-Brains Blog.

the ugly butterfly

Is it cruel to call a butterfly “ugly” when it’s a colorful favorite of children and novice option traders around the world? Well, while the kids are chasing after the insects, the parents are buying butterfly option positions and looking for a big win with low

risk. And although the insects might be pretty, those option positions all too often expire worthless, and cause a slow drain on your trading account. Let’s see why and what can be done about it.

Words by **Thomas Preston**





Feature #2

Photograph by
Fredrik Broden

thinkorswim.com

FIRST THE BASICS



A butterfly is an option spread—that is, it means buying a lower strike option, selling two middle strike options, and buying one higher strike option. For example, with SPY at \$133, a long call butterfly could be a long 135 call, short two 136 calls, and long one 137 call. With 30 days to expiration and depending on volatility, you might be able to buy that butterfly for .10. That would be buying the 135 call for 2.90, selling two 136 calls for 2.40 each, and buying one 137 call for 2.00. The max risk of that butterfly is .10, the debit that you paid for it, and occurs at expiration if SPY is below 135 or above 137.

The butterfly has a maximum profit of .90 if SPY is right at 136 at expiration. That's a good illustration of the option trader's maxim: you want the stock to go to the short strike! The butterfly still makes money, but less than the max, if the stock lands in between the breakeven points, which are .10 point above the lower strike (135.10) and .10 point below the higher strike (136.90). The butterfly loses money if the SPY is outside of those break even points. On the face of it, a butterfly looks like it's a great trade. But the main problem with butterflies is that they typically have very low probabilities of success. The reason is that the butterfly needs the stock to be in a very narrow range at expiration. If the stock is too low, the butterfly loses. If the stock is too high, the butterfly loses. So, yes, it does have defined risk and a much higher potential reward than risk, but more often than not, the butterflies lose money because the stock doesn't cooperate. Between the times a butterfly expires worthless and the times it makes only a small profit, those max profits when you "nail" that short strike at expiration are few and far between. That's where the "ugly" comes from. For example, that 135/136/137 call butterfly that we buy for .10 debit only has about a 10% chance of making any money at all, let alone its max profit. You can calculate that on the thinkorswim Analyze page by setting the price slices to the position's breakeven points at expiration.

GETTING UGLY

So, can a butterfly be changed in some way to give it a higher probability of success? Yes, if you're willing to add some directional risk to the trade. The way we do this is by combining a higher probability trade with the butterfly. A short vertical can be a great match with a butterfly. (For

more details on the short vertical, see the Strategy Box on p. 12). A short vertical has a few things going for it that it shares with a butterfly—greater risk, positive time decay—and a couple things it doesn't—less targeted profit range and higher probability of success. Those last two points turn an "ugly" butterfly into a "skewed" or "unbalanced" butterfly.

OK, maybe "skewed" or "unbalanced" aren't flattering descriptions, but they can make a butterfly a more attractive trade if you are willing to increase the risk of the position. Let's say we buy that 135/136/137 call butterfly for .10 debit, and then we sell a 137/138 call vertical at .40 credit. That creates a position that is a long a 135 call, short two 136 calls, and long one 138 call that is established for a .30 credit. If you look at it as two positions, a butterfly and a short vertical, the butterfly is long one 137 call, and the short vertical is short one 137 call. The long and short 137 calls net out to zero, which is why there is no position at the 137 strike in the unbalanced butterfly.

As for the name, "unbalanced" refers to the strikes not being equidistant (one point between 135 and 136, and

STYLING: JULIE WHITMIRE





For an extended discussion on the Ugly Butterfly, go to www.thinkorswim.com and follow the path – Home>Support>Options School>Chat Archive.



two points between 136 and 138), as they would be in a regular butterfly. But the unbalanced butterfly has more risk than the regular butterfly. While the 135/136/137 butterfly has a max loss of \$10 if the SPY is above 137 at expiration, the unbalanced butterfly has a max loss of \$70 with the SPY above 138 and a breakeven of 137.30 because of that “embedded” short 137/138 call vertical. You calculate the max loss by subtracting the credit of the unbalanced butterfly from the difference in the strikes of the embedded vertical. (See Figure 1 for a profit curve of another SPY position.) The extra risk of an unbalanced butterfly means that it should only be considered by more experienced traders because the loss on such positions can be substantial.

But in exchange for the greater risk, you get two things: higher max profit and virtually zero risk on a downside move in the underlying (One exception is cash-settled, American style options. For more on why, see p. 32 for details.). If you think about the unbalanced butterfly as a long butterfly and short vertical, it's easier to figure it out. If the SPY is right at 136 at expiration, the

135/136/137 butterfly has a max profit of .90, and the short 137/138 call vertical expires worthless and has a max profit of .40. The two positions combine to give a max profit to the unbalanced butterfly of 1.30—.40 greater than the regular butterfly. And interestingly, if the SPY is below 135 or lower at expiration, the 135/136/137 butterfly loses .10. But the short 137/138 call vertical expires worthless and keeps its .40 credit as profit. The net profit for the unbalanced butterfly is .30 anywhere below 135. That's why this unbalanced butterfly is still profitable no matter how low the SPY goes. This is due to

the credit of the vertical being greater than the debit of the butterfly. If the credit of the vertical is lower than the debit of the butterfly, the position can lose money if the stock goes up or down.

Because of its unique risk profile, not only is the unbalanced butterfly profitable with SPY anywhere below 137.30 (the unbalanced butterfly's breakeven point); its probability of making money is about 65%, which you can determine using the TOS Analyze page. That's why the unbalanced butterfly exchanges higher risk for greater profit potential, reduced or eliminated downside risk, and significantly higher probability of profit. That's why the unbalanced butterfly exchanges higher risk for greater profit potential and higher probability of profit.

This example of an unbalanced butterfly combined a call butterfly and a short out-of-the-money call spread, but you could also create one with a put butterfly and a short out-of-the-money put spread. The difference is that the put unbalanced butterfly has its risk reduced or eliminated on the upside.

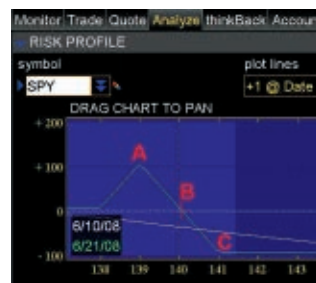


Figure 1: Profit Curve of the Ugly Butterfly.

With the SPY at \$136, this 138/139/141 unbalanced call fly sold for .07. Maximum profit (A) is \$107 per spread if at expiration, SPY finishes at 139. Anything under break-even (B) of 140.07 is a profit. Maximum loss (C) is \$93 at 141.

Source: TOS Charts (Analyze tab)

THE HOW AND WHY

The rationale for putting on an unbalanced butterfly is that you think a stock or index might trade in a narrow range, or move to a certain range and stay there. You select the short middle strike of the unbalanced butterfly where you think the underlying will be close to expiration. Then, you can buy the lower strike option one strike away from the short, and the higher strike option two strikes away from the short.

Alternatively, you can start by thinking about which vertical you would sell. One way is to look at options with roughly one month to expiration. Then look for the strike that has approximately 30% to 35% probability of being in-the-money at expiration. The easy way to do that is to look at the “Probability of Expiring” on the TOS Trade page. If that strike has a 35% probability of being in the money at expiration, it will have a 65% probability of expiring worthless. Then, you buy the strike above that as the long higher strike of the unbalanced butterfly, and sell the strike below as the short middle of the unbalanced, and buy the strike just below the short strike as the lower long strike.

When volatility is high, unbalanced butterflies can be attractive because the embedded verticals are worth more, and the butterfly component is cheaper. That means the unbalanced butterfly can be bought for a higher credit, which reduces its maximum loss.

You can enter an order for an unbalanced butterfly as a single trade using TOS. The easiest way is to right-click on the option that you will sell as the middle strike, then select “Buy,” then “Butterfly.” That will create an order to buy a regular butterfly in the order entry panel. To make it unbalanced, click on the strike price that you need to change to a higher strike (call unbalanced) or lower strike (put unbalanced) to create that embedded short vertical. (Be aware that multiple option strategies may incur large commission charges! Since the ugly butterfly has three legs, it has three commissions per side of the trade due to the three strikes purchased.)

Examples contained in this article are for illustrative purposes only. Customers must consider all relevant risk factors including their own personal financial situation before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting: Scott Garland at 773-435-3270 or 600 W. Chicago Ave. Suite 100, Chicago IL 60610.

thinkMoney/03

28

Feature #3

Photograph by
Fredrik Broden

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YOU'VE HEARD ALL THE STORIES ABOUT WHAT HAPPENS WHEN YOU DON'T FOLLOW A TRADING PLAN. YOU MAY EVEN HAVE A LIST OF PERSONAL RULES STASHED SOMEWHERE BENEATH THE STACK OF UNREAD TRADING BOOKS ON YOUR DESK THAT YOU'VE BEEN MEANING TO GET TO. LIKE IT OR NOT, YOUR RISK MANAGEMENT STRATEGY COULD MAKE ALL THE DIFFERENCE BETWEEN SURVIVING THE NEXT MARKET TURN—OR NOT.

words by **Bill McSheehy**

30

Feature #3

Photograph by
Fredrik Broden

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STRATEGY BOX:

Iron Condor A market-neutral, limited risk strategy, comprised of a short put vertical spread and a short call vertical spread (For vertical spreads, see "Strategy Box" on page 16). The strategy assumes the underlying will stay within a certain range (between the strikes of the short options), in which case, as time passes and/or volatility drops, the spreads can be bought back cheaper than the credit taken in or expire worthless, resulting in a profit.

Naked Short Options A directional strategy with unlimited risk in which an option is sold for a credit, without another option of a different strike or expiration as a hedge. The strategy assumes that the stock will stay above (in the case of a short put) or below (in the case of a short call) the strike sold; in which case, as time passes and/or volatility drops, the option can be bought back cheaper or expire worthless, resulting in a profit. Short puts are bullish and short calls are bearish.

Delta The value an option will move for each \$1 move in the underlying. Long calls and short puts have negative (-) deltas, while long puts and short calls have positive (+) deltas. The total sum of all positions in a portfolio is the portfolio's delta.

Short Straddle See "Strategy Box" on page 12

What do the subprime loan crisis, the fall of Soc Gen, and retail traders who lose everything have in common? Risk management, or more precisely, the lack of risk management know-how and techniques. You can read thick books on risk management and you can even hire mathematical geniuses to write algorithms as long as your arm. That's what the big financial institutions did. And where did it get them? Billions of dollars of losses and the prize of being part of causing an economic slowdown.

But that doesn't have to be you. Managing the risk of your positions doesn't have to be all that hard. And most of it is simple common sense. Let's define risk management simply as making sure that one trade, or a series of trades in a month, a quarter, or a year, doesn't create a loss so great that you cannot continue to trade. Consider it the financial equivalent of not getting hit by a bus when you cross the street.

RISK IS
RELATIVE
—SORT OF

So, what constitutes getting hit by a bus? That can be different things for different traders. For example, if I have \$10,000 in my trading account, how would I feel if I lost \$8,000 in a month? Would it prevent me from continuing to trade? If I have a job where I earn a lot of money, and can replace that \$8,000 easily, maybe that loss isn't a big deal. But if that \$8,000 can only be replaced by making winning trades with the remaining \$2,000, then that could be a more significant negative financial event for someone with limited resources.

Where do you fit in? Let's look at the coin flip game. I give you a choice. You can guess heads or tails, and if you're right, you win \$1.00. If you are wrong, you get \$0. Or, you can take \$0.50 (the expected value of that coin flip game) and walk away. The vast majority of adults would probably choose to flip the coin. Why? Whether you make \$1.00, \$0.50, or \$0 would hardly make a material difference to most people. It's the cost of a candy bar. But now let's change the numbers of the game to \$10 million if you guess right, \$0 if you guess wrong, or walk away with \$5 million. Hmmm. Most people will choose to walk away with the \$5 million because, well—that's a lot of

candy bars. As a trader, only you can decide what loss is too great for you to bear. That can be tough for some people, but that choice will make the rest of your risk management decisions much easier.

DEFINED
RISK
(MADE EZ)

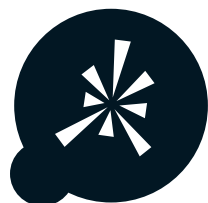
As a general rule for traders just starting out, I suggest not risking more than about 20% of your capital at any time. What that means is that if all your trades lose their maximum amount, you'll lose about 20% of your capital, leaving 80% of your base to continue trading to make up the losses. Survival in trading is key because it takes time to learn how to be successful. The other rule of thumb would be to not risk more than 5% of your trading capital on any one trade. That means you could do about four trades, each risking 5% of your capital, and have a max overall risk of 20%.

Of course, setting a maximum loss for your account assumes that you can identify what the maximum loss of your trade is. For defined risk trades, like verticals, iron condors, butterflies, calendar spreads, and so on, that's easy. You can load them up on the thinkorswim Analyze page and see what the max loss would be even before you do the trade. A straightforward process is to take 5% of your trading capital and divide it by the max loss of the position. That would be a target number of spreads to do.

For example, if I have \$10,000 in my trading account, 5% of that is \$500. A 128/129/135/136 **iron condor** in SPY that I sell for .40 has break even points of 128.60 and 135.40, and a max risk of \$60; \$500 divided by \$60 is 8.33. If I sell eight of those iron condors, the max risk of that position is \$480, which is less than the 5% ceiling. Now, you're always free to do less of any trade. If the decision is to take more risk or less risk, beginning and intermediate traders should choose less risk. If 5% of your trading capital per trade seems like too much, then make it a 3% ceiling. *(Trading in these types of strategies can incur significant losses and generate substantial commissions, so keep this in mind when evaluating any strategy.)*

IF TRADING
IS ABOUT ODDS,
THEN USE 'EM

If you're trading positions with non-defined risk, like stock, mutual funds, or **naked short options**, determining how much you can do of any one trade is a little trickier. You might argue that you always use stops and that defines your risk. But if the stock or index gaps up or down, you might not exit your position at a price anywhere near your stop. A more conservative approach would be to look at a likely move in the stock or index over some period, say one day or one week. You can use the Probability Analysis page on thinkorswim to see what a 99% likely range is for a stock or index. You might not think a three standard deviation move will come while you're holding your favorite stock, or short some naked premium right before expiration, but those "black swan" moves can come out of nowhere. Remember Bear Stearns (BSC)?



A COOL TIP FOR PORTFOLIO MANAGEMENT

• A quick little trick for assessing and managing portfolio risk is to count your deltas. Fortunately, you don't have to suffer doing this by hand. Using the beta-weighting portfolio tools on thinkorswim, you can measure the delta risk of your entire portfolio in a single underlying index's terms, like SPY or e-mini S&P 500 futures. This is a useful technique if you tend to hold many stock positions for longer periods of time. By looking at the overall risk in S&P futures terms, for example, I can see what the loss might be if the S&P makes a large move in a short period of time.

The time frame you use when looking at the potential loss of a trade with undefined risk should match the time you expect to hold the position. If you're day-trading stock, you can look at a one-day potential price range. But if you think you might hold positions longer, like a week or a month, you need to account for the greater risk that entails. With more time, there is more risk of a big price move.

Factoring in the potential loss if the underlying stock or index does make a large move against you, keeping the total risk of all your positions under that 20% maximum risk ceiling can help prevent catastrophic losses.

IT'S HOW MUCH YOU CAN LOSE THAT COUNTS



A side benefit of managing risk this way is that it smooths out your trading results. When you risk a smaller percentage of your trading capital, you tend not to have big winners or big losers relative to your total trading account. One trade may have a max profit or loss, but combined with other trades that might make or lose some smaller amount, the effect on your account is reduced. That's bad if you make nothing but winning trades, but I don't know anyone who does that. In the real world, minimizing the effects of losing trades can be smarter when you're a beginning trader than maximizing the winners.

On top of that, you may want to keep the risk of all your different positions basically equal. That is, one trade shouldn't represent dramatically more risk than any of the others. The rationale for this is that if you are using a set of criteria to identify the trades you want to do, whether they're based on probabilities and volatility or technical or fundamental analysis, each trade has about the same potential to make or lose money as the others. If you start to have a "favorite," and you decide to risk twice as much money on that trade as the others, that favorite can end up breaking your heart (and trading account) if it turns out to be a loser. You generally don't want one position to have

If that risk is greater than what I'm comfortable with, then I can reduce the portfolio's deltas by selling (if my portfolio is long deltas) S&P futures, SPY shares, or even doing short delta option spreads like short call verticals or long put verticals.

You can hedge with futures as long as you watch them closely and exit the position if the market moves

higher. You don't want a hedge to cause a greater loss in your account than the rest of the portfolio (that you're trying to hedge) can make. That's why I'm not in favor of using futures to hedge defined-risk positions like iron condors and calendar spreads. Those spreads have

limited profit potential, and the loss created by a hedge in an undefined-risk instrument (like futures) can be too great. That's why in those cases I would prefer to use defined-risk option spreads (verticals, for example) to reduce delta risk.

risk that's disproportionate to the others.

Now, the 20% rule is good if you tend to put your positions on and not pay much attention to them after that. But if you can monitor what's going on in the markets, and your positions in particular through the trading day, and you have the discipline to exit or hedge positions that are going against you, then increasing the percentage of your trading capital to risk might make sense. How high do you want to go? That depends on the confidence you have that you will have the discipline necessary to "pull the trigger" if a trade goes bad. Also, I may not look at the maximum loss of a position, but rather the maximum loss I am willing to take when I figure in the number of contracts I do.

For example, I may sell straddles ahead of an earnings or news announcement when implied volatilities have been pushed higher. A short straddle has a potentially unlimited loss. But that occurs if the stock goes to zero or infinitely high, and both those events are somewhat unlikely. So, I may look at the volatility, determine a likely price range, and see what my losses will be at certain prices (the Analyze page is really useful here). Because the loss at the points where I would exit the trade might be less than the maximum potential loss, and because I have enough experience trading these scenarios that I am quite sure I will exit when I have to, I may do a bigger trade than the max loss method would indicate. But I am watching what the stock is doing tick by tick. If that position reaches a loss that I have determined is too much, I exit the whole position or parts of it without question.

NOT YOUR DADDY'S RISK MANAGEMENT



Failure to manage risk is possibly the single most important aspect of trading that retail traders and investors often overlook. It's not necessarily fun, and it certainly isn't the first thing that springs to mind when you think about trading. Risk management? That's for the suits and their reports and green lampshades. Boring. But when you realize why you are trading—to make money—then you need to take the steps that can help make you more successful. One of those steps is to make sure that you don't get knocked out of the game before you even learn how to play. Employing even the simplest risk management techniques, like those presented here, can work for just about every trader and market condition. And it makes your trading much safer than having no risk management at all.

• Customers must consider all relevant risk factors including their own personal financial situation before trading. Options involve risk and are not suitable for all investors. A copy of Characteristics and Risks of Standardized Options can be obtained by contacting Scott Garland at 773-435-3270 or 600 W. Chicago Ave., Suite 100, Chicago, IL 60610.

• Examples contained in this article are for illustrative purposes only. Multiple option strategies such as those discussed in this article will have additional costs due to the additional strikes traded. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Beware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security.

32

Capiche?

Lessons from a
veteran floor trader

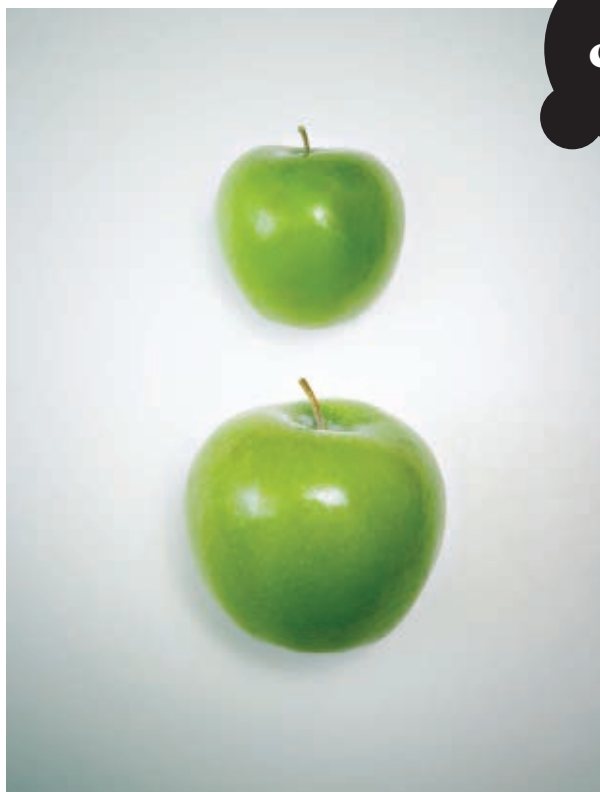
• You know, I was born cool. I was cool as a kid, in school, had the cool car, had the cool girlfriend. So, when I landed in Chicago and became a trader, where did I start? The OEX of course. That's where the hot shots traded. And even though I might not have been the biggest trader in that pit, I was definitely one of the coolest. But when my Mama wanted to place some bets in index options, I almost cried when she brought up the OEX. Let me tell you why.

It's the mid '80s and I'm trading the "O", making some money, and feeling like I know how to play this game. I'm spitting out bids and asks, doing the fraction math fast, and starting to trade some size. And I was hedging a little bit with the SPUs, but not much. It was a few days to expiration and the market looked like it was going to drop, so I had on a short call spread, among other equally cool positions. How do you hedge cool?

So I'm short the 150/155 call spread for a 3.50 credit and it's looking good with the OEX index at 157. Remember, that's a short 150 call and a long 155 call. I was watching the SPUs trading around 3:05, right after the index settled for the day. They trade until 3:15 and I see them start to sell off—Nice. Tomorrow might be ugly, and that's good for my short call spread, right? Eh... wrong.

I come in the next morning and what do I see? I was assigned on my short 150 call. My account was debited \$700 for each short 150 call that was assigned, which is the difference between 150 and the prior day's OEX settlement of 157. Even though I knew the OEX was cash-settled (you get the cash difference between the option's strike price and the index settlement price, not stock), I didn't fully

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



cap.

Good Boys Make Their Mamas Trade XEO

• Sometimes ignorance is bliss. But for the unsuspecting spread trader, it pays to be aware of the hidden risks of American-style, cash-settled options.

realize what was going to happen until the markets opened at 8:30. When the SPUs open down 5 points on the open, the OEX opens down 3. After my 150 call hedge is gone from assignment, I'm long the 155s naked, which are 2.00 bid at 2.50. I finally sell my 155s at 1.50 after the market dropped some. That means I'm down \$200 on a short call vertical that I thought had a max risk of \$150. And I thought the position would make money if the market dropped. Definitely not cool.

What happened? Someone who understood the game a little better than I did was on the other side of that trade. He bought that call spread from me, and sold SPUs as a delta hedge. The devilish detail is that because the other trader was long that 150 call, he could exercise it on any day and receive the difference between the strike price and the index settlement. He'll do that if he sees the index

settle high, and the SPUs drop in between 3:00 and 3:15. Figuring that the OEX will drop tomorrow morning along with the SPUs, he exercises the long 150 and collects the \$700. That's the money I paid out. Then, he buys back his short SPUs, which are dropping! To cap it off, the next morning, when the OEX opens down (following the SPUs from the day before), he buys back the short 155s he's left with for a lower price. I was out-cooled on that one.

That was a fast lesson that I learned about the OEX. It's one of the few American-style cash-settled index options. That means you can exercise a long option (or be assigned on a short option) at any time before expiration, but you receive (if you exercise a long option) or pay (if you are assigned on a short option) cash. Unlike an equity option, which is stock-settled, exercise

or assignment of a cash-settled option doesn't give you anything with any hedging power, i.e. stock! If you're assigned on a short option that's part of a spread, your remaining long option of the spread doesn't have any protection. That's what happened to me.

Did I stop trading the OEX because of that? No, because the XEO hadn't been invented yet. But I did watch the SPUs like a hawk. And when the CBOE introduced the XEO options in 2001, which are the European-style S&P 100 options, I was all over them. No early exercise, no getting nicked because of some cool guy on the other side of the trade gets the game better than you. So please, Mama, be cool and trade the XEO.

33

An interview with...

Rasta Lou "Dobba"

(Not necessarily) a real interview with a market VIP

Illustration by **Evonrude**

Q + A:

TOS: Hi Lou, thanks for (cough, cough) meeting me here tonight.

R.L.: Tha' pleasure be all mine mon.

TOS: I just didn't recognize you at first, with the dreds and the beard and the Army surplus jacket.

R.L.: Naa' worry 'bout it. They think I'm deliverin' da' lunch when I walk into CNN.

TOS: So, you've gone from profiling CEOs to being something of an America-first demagogue to being a Rastafarian? I thought you grew up in Idaho?

R.L.: Those white bread days are over mon. You lookin' at da' real Lou right here.

TOS: But isn't this a radical departure? I mean, the last time I watched your show you were all about protecting American jobs and fighting corporate injustice.

R.L.: That was all about ratings. I've made m' pile. Now it's time to take my career to the next logical step. Standing up to da man. Throwing off the shackles. Power to the people, baby. I'm the new Bob Marley!



TOS: I guess. Are the dreds real or extensions?

R.L.: When I would go out and do my interviews with people all over the country, I saw good people without jobs, losing their houses. You know those billions of dollars lost in the sub-prime mess? It all went to the fat cats.

TOS: I see.

R.L.: But did the American people just sit there? No! Instead of waiting for big business or the government to bail them out, they're sticking it to the man by partying like it's 1999! Foreclose on the house if you want, we've got booze and ganja!

TOS: Uhh, interesting... So, for the traders out there, is there some investment play?

R.L.: Absolutely! This is the growth industry of the 21st century! Who's going to win? All the companies that make stuff that people turn to in bad times. Think consumer non-durables. Liquor, fatty foods, ammunition, high-intensity lights and fertilizer.

TOS: Lights? For what? And what happened to the Jamaican accent?

Suffice to say, we did not actually interview Lou Dobbs for this article. And although rumors are floating around that he's been spotted wearing a wig, we have not been able to validate the claim that they are in fact dreadlocks.

act natural. Don' admit ta' nuthin'.

TOS: I see your accent has come back... Well, I should be going anyway. It's been fun, uh, Rasta Lou!

R.L.: Maybe you and me will hook up agin'. I got a nice place near Negril.

TOS: Err, maybe not.

R.L.: Everyday Americans are turning their spare bedrooms into grow rooms!

How about that for American ingenuity? And what do they need? Grow lights! Pumps! Organic fertilizers! The stores can't keep the stuff on the shelves. And at \$100 bucks a pop, those lights mean big money.

TOS: Because everyone is growing "green"?

R.L.: Everybody has to make ends meet somehow.

TOS: Even though it's a Federal crime? Don't these people get busted?

R.L.: Who's going to bust them? The cops are growing too! Do you know how little a cop makes these days? Now that's a crime!

TOS: Wow. Speaking of cops, it looks like those two over there are watching you pretty closely.

R.L.: Oooh. Den' we bes' be movin' on. Jus'



“Never let risk restrain your potential.”

GERRARD KATZ

Head of FX Trading, North East Asia,
Standard Chartered Bank

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35
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SPECIAL SECTION:
futures

THE DECOUPLING THEORY **FACT OR FANTASY?**

With the recent decline in US economic strength, a new school of thought suggests ending the mantra, "As the US markets go, so goes the rest of the world." But is this just a fool's theory?

Words by **Matt Blackman**



Special Focus

Photograph by
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In late 2007, as U.S. economic strength waned and the probability of recession increased, economies around the globe continued to soar, prompting many to declare the traditionally inexorable link between global and U.S. markets extinct. But to paraphrase Samuel Clemens, had rumors of this long-term relationship's death been greatly exaggerated?

As evidence of a slowing U.S. economy mounted, bullish pundits increasingly hung optimistic forecasts on the hope that American weakness would have limited global impact. Since the size of the U.S. economy relative to global output had declined, they argued, global and U.S. markets had effectively decoupled. In other words, any domestic slowdown would not have the same negative effect on global markets as it had in the past.

While U.S. fourth quarter 2007 gross domestic product estimates tentatively hovered above zero, China was forecasting economic growth above 11 percent and India was still expanding near 9 percent. Wasn't this convincing evidence that while Americans were catching cold, consumers in these powerhouse emerging nations had become immune?

THE LAST TIME AROUND

In March 2000, the most recent bear market officially began. Over the next 30 months, the S&P 500 dropped 50.5%, the Value Line Index dropped 57%, and the Nasdaq Composite Index dropped more than 80%. More resilient, the Dow Jones Industrial Average fell "just" 38.7%. Many traders and investors learned the hard way that by the time the U.S. recession that began in Q1, 2001, was officially confirmed in late November 2001, the SPX had already lost more than 25%. And the bear market was a long way from being over.

How did this compare with other major global markets? As we see from Table 1, only one national index, the Russian Moscow Times, missed the major drop. Thanks to gut-wrenching drops in 1998 during the Ruble Crisis, stocks had already taken their medicine. By the time the bear market



hit the rest of the world, prices were already on the mend.

The important takeaway is that even though not all countries experienced recession in 2001–02 (Canada's GDP dropped to a low of +0.7%), every international stock market experienced a serious bear market. It is also interesting to note that the S&P 500 index was the third least severely hit of the group. Nine indexes—including the Value Line Index—lost more ground, with the German DAX being the hardest hit.

So why did Toronto's TSX drop 50.2% even though Canada never officially had a recession? Canadian markets are closely linked to the U.S. through strong trade and economic ties, so the coupling between the two markets is understandable. But since the economies of other nations are less closely linked to the U.S., it would be logical to assume they would be less affected. Yet history tells a different story, as Table 1 shows—where stock prices go in the U.S., so go the world markets.

However, the overriding question remained. Is it different this time—as many analysts have postulated—and have global and U.S. markets truly decoupled?

BACK TO THE FUTURE

If the decoupling theory were correct, we should expect to see global market strength during recent periods of U.S. weakness. But as we see from Table 2, that was certainly not the case in the stock meltdown between late October 2007 and the third week of January 2008. Before recovering, the Dow Jones Industrial Average, S&P 500, Nasdaq, and Russell 2000 indexes had dropped an average 18.7% by the third week of January. But with the sole exception of the Chinese Shanghai Composite Index, which dropped 10%, the peak-to-

INDEX	DATE HIGH ◆	DATE LOW ◆	HIGH ◆	LOW ◆	DECLINE ◆
German DAX	Mar-00	Mar-03	8,136	2,189	-73.1%
French CAC 40	Sep-00	Mar-03	6,945	2,401	-65.4%
Japan Nikkei 225	Mar-00	Apr-03	20,810	7,604	-63.5%
India BSE 30	Feb-00	Sep-01	6,151	2,595	-57.8%
Value Line	Apr-98	Oct-02	509	218	-57.2%
Brazil Bovespa	Mar-00	Oct-02	19,047	8,245	-56.7%
Shanghai Comp	Jun-01	Jun-05	2,245	998	-55.5%
Hong Kong Hang Seng	Mar-00	Apr-03	18,398	8,332	-54.7%
UKFTSE 100	Nov-99	Mar-03	6,950	3,277	-52.8%
S&P 500	Mar-00	Oct-02	1,553	769	-50.5%
Toronto TSX Comp	Sep-00	Oct-02	11,402	5,678	-50.2%
Sydney All Ords	Jul-01	Mar-03	3,425	2,666	-22.2%
Russia Moscow Times	Jan-00	No low	1,689	No low	NA

Table 1: Summary of international market declines in the recession of 2001–02 compared to those in the United States. Only the Russian Moscow Times market avoided a downturn.
Data Source: MetaStock by Thomson Reuters

The US and Japan—a Loyal “Couple”

• As can be seen from Tables 1 and 2,, no matter what U.S. stocks have done, the Nikkei 225 has underperformed them even though Japan has been suffering through a long-term recession for the better part of the last two decades. In other words, even an overdue rally would likely catch a cold if the US market even sneezes.

Since Japan's Nikkei 225 Index (/NK) had its bear market rally from 7,600 in 2003 to over 18,000 in 2007, it's dropped more than 30% since. As the U.S. economy continues to slow and the U.S. enters a recession as some indicators suggest, if history repeats, a further fall to old support levels is certainly realistic.

Unless you have the unique gift of foresight, it is impossible to know what the future holds, but given the bearish leading market indicators and strong historic ties between global markets, where U.S. markets go, the world does in fact, seem to follow. And those who appreciate this historic reality have a distinct advantage over the rest who buy into the statement that “this time is different.”

INDEX	HIGH	DATE HIGH	22JAN08	DECLINE	31DEC07	31JAN08	CHANGE
Hong Kong Hang Seng	31,638	10-30-07	21,758	-31.2%	27,813	23,456	-15.7%
Japan Nikkei 225	18,262	7-9-07	12,573	-31.2%	15,308	13,245	-13.5%
French CAC 40	6,168	6-1-07	4,637	-24.8%	5,614	4,870	-13.3%
Value Line	508	7-13-07	385	-24.2%	440	413	-6.2%
Dow Transports	5,446	7-19-07	4,140	-24.0%	4,571	4,752	4.0%
Sydney All Ords	6,854	11-1-07	5,222	-23.8%	6,421	5,697	-11.3%
Russell 2000	856	7-13-07	672	-21.5%	766	713	-6.9%
German DAX	8,106	7-16-07	6,439	-20.6%	8,067	6,852	-15.1%
India BSE 30	20,873	1-8-08	16,730	-19.8%	20,287	17,649	-13.0%
Nasdaq Composite	2,859	10-31-07	2,292	-19.8%	2,652	2,390	-9.9%
Brazil Bovespa	65,791	12-6-07	53,709	-18.4%	63,886	59,490	-6.9%
Russia Moscow Times	25,808	1-14-08	21,285	-17.5%	25,199	21,106	-16.2%
UKFTSE 100	6,732	6-15-07	5,578	-17.1%	6,457	5,880	-8.9%
Toronto TSX Comp	14,626	7-19-07	12,132	-17.1%	13,833	13,155	-4.9%
NYSE Index	10,312	10-31-07	8,661	-16.0%	9,740	9,126	-6.3%
Dow Industrials	14,165	10-9-07	11,971	-15.5%	13,265	12,650	-4.6%
S&P500	1,565	10-9-07	1,325	-15.3%	1,468	1,379	-6.1%
Shanghai Comp	6,092	10-16-07	5,460	-10.4%	5,261	4,383	-16.7%

Table 2: Table comparing index drops between the 2007–08 highs and January lows. It also shows index changes in January, which is a fore-caster for the rest of 2008, if history is any guide. **Data Source:** Meta-Stock by Thomson Reuters

trough decline in every other global market we tracked suffered a greater decline than the S&P 500. The worst performers were the Japanese Nikkei 225 and Hong Kong Hang Seng, which dropped more than 31%. Even the powerhouse Chinese and Indian indexes, which peaked later in October 2007 and January 2008 respectively, didn't escape the carnage.

As a group, not only did global markets feel the U.S. downdraft, but with few exceptions, stocks in other markets were even more seriously impacted than their American counterparts. So whether we look at peak-to-trough losses or January performance, global markets were even harder hit than their U.S. counterparts by the stock meltdown.

So much for the decoupling myth!

LOOKING AHEAD

How have global markets performed since the late January bottom? As the first U.S. index to feel the downdraft, the Dow Jones Transport Index has been the star performer, gaining more than 13% in the two months between January 22 and March 20. This is curious given the fact that oil prices rallied over the same period.

Next was the Hong Kong Hang Seng index, which gained nearly 12% over the same period. At the other end of the scale were both the Shanghai Composite and India Bombay Stock Exchange 30 indexes, the latter of which was in the early stages of a correction in January.

Is this evidence of decoupling with the U.S? Stock indexes in “Chindia” had experienced more dramatic parabolic run-ups and blow-off tops, making the corrections more severe as opposed to being examples of markets out

of sync. Any significant rallies in the U.S. will most likely exert upward pressure on these markets.

JANUARY BAROMETER—CRYSTAL BALL VIEW OF THE FUTURE?

Finally, let's get another perspective on where markets may be headed in 2008. As Januaries go, this one will go down as among the worst for the S&P 500 since World War II, with the index dropping more than 6%. Only five Januaries in the last seventy-odd years have been worse. In only one case—1978—did the S&P manage a positive gain for the year (+6.5%), and interestingly enough, it was in the middle of the 1968 to 1982 bear market. So what does this mean for 2008?

Without a doubt, the best early-year warning indicator is the January Barometer. Devised by Yale Hirsch in 1972, it says that as January goes, the rest of the year follows for the S&P 500. According to the Stock Trader's Almanac 2008, the indicator has only registered five major errors (most of which occurred in times of war) since 1950, for an accuracy of 91.2%. Given that 2008 is an election year, it is worth noting that January losses preceded down years in 10 of the last 14 election years, for a 71.4% accuracy rate since 1950.

As we see from the right-hand side of Table 2, global indexes were very much in sympathy with those of the U.S.—except that many were even harder hit. If someone were looking for evidence of decoupling in January, they wouldn't find it here either. Unless this year proves atypical, given the strong historic link between U.S. and global markets, January weakness implies a challenging year picking direction for stocks around the world in 2008.

• Data contained here are obtained from what are considered reliable sources; however, their accuracy, completeness or reliability cannot be guaranteed. Past performance does not guarantee future results.

fut.

• Futures options. To the uninitiated, combining those two words sounds pretty intimidating. A derivative of a derivative? Don't let the term send you running for the hills. In most respects, they work just like stock options.

There are many significant differences between futures options and stock options, not the least of which is the fact that with a futures option, you're trading a derivative of a derivative, which can pose substantial risks if you're not aware of the nuances between futures versus stocks. Another main difference is the cost of carry. The cost of carry is the interest expense that you incur when you buy something. When you buy stock, you spend cash. If you don't have the cash, and you need to borrow it, you would incur an interest charge for borrowing the money. Even if you do have the cash to cover the cost of buying the stock, you stop earning interest on the cash that you spent.

For example, if I have \$100,000 in my account, and I am earning, say, 2% interest on it, I would make \$2,000 per year just from interest alone. If I buy \$25,000 worth of stock, I only have \$75,000 cash left in my

Crossing Over to Futures Options

If options on futures have you scratching your head, here's a primer on how they stand apart from their stock option counterparts.

account, and I would earn only \$1,500 per year from interest on that amount. If I have only \$25,000 in my account, I can buy \$50,000 worth of stock under Reg T margin rules. If I do that, I spend my \$25,000 cash and borrow another \$25,000. Not only do I stop earning interest—I pay interest on the borrowed money. On a positive note, if the stock pays a dividend, that reduces the interest expense of the cost of carry.

That said, cost of carry is built into equity options. It makes calls more expensive relative to puts at the same strike price. That's why the combo (call, minus put, plus strike) is higher than the price of the stock. With SPY at 135 and 80 days to go to expiration, the 135 call is 6.10 and the 135 put is 5.70. The combo is 135.40 (6.10 - 5.70 + 135). That .40 difference is the cost of carrying the SPY for 80 days, which is interest minus dividends.

But if you look at futures options, the combos look cheap. With the e-mini S&P future

with 80 days to expiration at 1360, the 1360 call with 80 days to expiration is 57.00, and the 1360 put is 57.00. Why are they the same? It's because in futures, there is no interest expense and there are no dividends. So, they're somewhat simpler to price than equity options. When you buy a future, you don't actually spend cash. The cash needed to cover the margin required to hold the futures



To open a futures account, log in to your account at www.thinkorswim.com and follow the path to the Account Services page from the My Account tab. Scroll to the bottom of the page under Account Summary.

The risk of loss in trading futures can be substantial. Customers must consider all relevant risk factors including their own personal financial situation before trading. Trading foreign exchange on margin carries a high level of risk as well as its own unique risk factors. Please read the National Futures Association Understanding the Risks of Trading in the Retail Off-Exchange Foreign Currency Market risk disclosure before considering the trading of this product at www.thinkorswim.com.



FUTURES

Q + A:



position is set aside so you can't use it to trade something else, but you don't "spend" it. Your cash balance stays the same until the end of the day when the futures positions are "marked to market," which is when the profit or loss on the futures position is added or subtracted from the cash in your account.

But even though you don't see it in the options, the cost of carry is already built into the futures price. When the e-mini S&P 500 future was 1360, the SPX, which is the "cash" S&P 500 index, was 1358. That 8.00 is the approximate cost of carrying the portfolio of stocks in the S&P 500 index for 80 days.

Other differences between futures options and equity options include different margin requirements, with futures options using the SPAN system. SPAN basically sets the margin for a futures option position by looking at the potential loss at various futures prices and volatility levels. It is very similar to the risk-based margin system that was introduced last year for equity option accounts with assets above \$100,000.

Futures options also need to be traded in a futures account and require filling out a futures account application you can find on our Web site. You can link your futures account with your equity account so that you can trade and see your stock, stock options, futures, and futures options positions under one login name. However, there is no cross-margining between equity and futures positions. That is, a position in a stock that might offset the risk of a future, or vice versa, does not reduce the margin requirement of either the stock or futures position.

Be sure to check the expiration dates of the options on futures, as they will vary depending on the commodity or product. Most equity option traders are accustomed to the majority of their options expiring on the third Friday of each month, which is convenient. But if you're trading hogs or soybean futures options, you might find yourself taking delivery on a heck of a lot of bacon if you wait to close your short by the Friday #3 when those futures settle on Friday #2. All expirations for futures options tradable on the thinkorswim platform can be found in the Trade tab under the Options chains for each symbol you enter in the symbol box.

Q: What futures can I trade at thinkorswim?

A: Right now, you can trade futures products in stock indexes including the E-Mini S&P 500, S&P MidCap 400, S&P MidCap 600, S&P SmallCap 600, Nasdaq 100, Russell 2000, mini Dow Jones Industrial Average, and Nikkei 225, physical commodities including mini gold, mini silver, 100 oz gold, 5000 oz silver, corn, soybeans, soy oil, soy meal, oats, and wheat, and financials including 30-day Fed funds, LIBOR, Eurodollars, and Euro FX.

Q: How can I see a futures chain?

A: On the Trade page, you can type in the futures root symbol (for S&P 500, it's /ES) in the field in the upper left-hand corner to see all the futures months. If you don't know the futures root symbol, click on the double

drop-down arrows and click on the Futures tab at the top of the Symbol Table box. You'll see a list of all the futures available to trade on thinkorswim, as well as their root symbols. Click on the root symbol to select it and have the different futures months displayed.

Q: What does a futures chain represent?

A: If you type in /ZC, for example, to see corn futures in the Trade page, you will see several different futures prices at the top, and one with an "Active" indicator next to it. Those different futures prices are for the futures at various expirations. For example, you may see /ZCK8, which is the May 08 corn future. /ZCN8 is the July 08 corn future. /ZCU8 is the September 08 corn future. The future symbol is made up of the root (/ZC), a month code (e.g., N is for July) and a year code (08). The dif-

ference between the prices of the futures in different months is known as the basis. Some futures are more actively traded than others, and the one that has the most trading activity and is used by most speculators is known as the "active" month. It is usually, but not always, the future that has the fewest days to expiration. On thinkorswim, the active future month is labeled for you.

Q: How do I get a chart on a future?

A: You can get a "continuous" futures chart by typing in the root symbol in the Charts page. Because a future has a date when it first begins trading and an expiration, no single future exists long enough to see a chart of, say, five years of data. So, a continuous futures chart links the futures from past expirations into one series of data.

Q: Can I trade futures in my stock account?

A:

Even though you need a specific futures account to trade futures, you can link that account to your thinkorswim login name. That will let you trade futures and have the executions and positions held in the futures account, but you will see those transactions and positions alongside your stock and option trades, and log in with your regular username and password. There is a purple link at the bottom of the page that lets you request futures trading for eligible accounts (we don't support futures trading in IRAs yet).

Q: What are the margin requirements on futures?

A: The margin requirements differ from one future to another based on the risk and size of the futures contract. Go to thinkorswim.com, and under "Why thinkorswim" select "Order Types and Products" to see the list of futures and their margin requirements.

40

Getting Technical

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• When I teach technical analysis at the Options School at thinkorswim, I typically start out by asking my class, "Would you fly an airplane without instruments?" After a

pause I ask, "Then why would you trade securities without charts?" Breaking it down to its most simple concept, technical analysis shows me where a security's price has been, where it lies now, and where it could be going.

One of the most fundamental technical studies is the simple moving average (SMA), which you can easily find in the thinkorswim platform by selecting the "Charts" tab. A SMA represents the average stock price over a given period of time, such as 50 or 200 days. Short-term averages (i.e. 10-day SMA) respond quickly to changes in the price of the underlying, while long-term averages (i.e. 200-day SMA) are slow to react. The basic premise behind moving averages is to identify

Words by **Jeffrey Bierman**,
thinkorswim Instructor



MOVING AVERAGE CROSSOVER: The premise of a bearish crossover is when the faster moving average (blue) crosses below the slow moving average (red) at point A, a trade is entered. The exit is not made until the fast line crosses back above the slow at point B.

key resistance and support levels of the underlying security to determine the likely continuation of a price trend or trend reversal.

Though moving averages are vital for some technicians, they're limiting in that they lag current events. For example, by the time a 20-bar average curves upward to confirm a trend, the move is already underway and may be over. While faster moving averages (such as exponential averages) will speed up signals, all of them ring the trading bell way too late. To overcome this problem, multiple moving averages may be used at the same time.

Try this out: Pick a long-term and a short-term average and watch the price action when they turn toward each other and cross over (hence the name, "moving average crossover" - see chart). This event may trigger a good trading signal, especially when it converges with a key support or resistance level.

Crossovers mark important shifts in momentum and identifying support/resistance regardless of the holding period. Many traders can therefore just stick with the major averages and find out most of what they need to know. The most popular settings draw charts with a 20-day MA for the short-term trend, a 50-day MA for the intermediate trend, and a 200-day MA for the big picture. Long-term crossovers carry more weight than short-term events. For instance, when the 50-day average breaks above the 200-day

average, it triggers a potential "buy" signal, as it represents a major change from a bearish to a bullish trend as the 200-day average turns into major support. Conversely, when the 50-day average falls back beneath the 200-day average, it

triggers a potential "sell" signal as the 200-day average becomes major resistance after the 50-day average drops below it. When price gets trapped between the 50-day and 200-day averages, it can whipsaw repeatedly between their price extremes. This pinball action can mark a zone of opportunity for swing trades.

TOS CHART TIP:

To apply the MA Crossover study in TOS Charts, just click on the Studies tab > click Add Studies > hold your cursor over the Moving Averages sub-category selection from the drop-down menu > scroll down and select "MovingAvgTwoLines." Remember: 1) don't forget to add the symbol of the underlying before you add the study, and 2) you can change the periods from the 9- and 18-day default to your desired duration via the Edit Studies function (just change the "length" and click Apply).

While MA Crossovers can be very powerful trading tools, I caution that they can sometimes give false signals when they are the only technical indicator used. Typically, it's best to use them in concert with price oscillators such as stochastics or Williams%R to build a stronger case for their signals. Wayne Gretzky, arguably the greatest hockey player of all time, when asked how he compiled so many goals once remarked, "It's not where the puck is—it's where it's

going." In other words, technical traders don't try to "guess" where a stock is going, they employ charting tools to guide their decisions. The moving average crossover is worth placing in the toolbox.

• The information contained in this article is not intended to be investment advice and is for illustrative purposes only.



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TOS

Prayers Fail to Help Traders Stem Losses

thinkorswim press

CHICAGO, IL — With recent market volatility hitting stock and option traders with loss after loss, many are leaning away from advanced education and professional-style tools, and turning to prayer as a means of resurrecting their trading accounts. Most, however, are not seeing positive results.

Wendy Barnes, a 49-year-old trader from San Diego explained her predicament. "When I was 10, my kitty Peppers disappeared for two days. I prayed and prayed that she would come back. And what happened? She shows up in the backyard again the next day. I have been a believer in prayer ever since. So, what do I do when I strap on some Bear Stearns calls last February and the stock kept dropping? I pray. But did that do anything to help my calls? Apparently God listens to institutional investors before little traders like me."

"Lord Ganesha, why have you forsaken me?" cried Ravi Gupta of South Bend, IN, as he got stopped out of a long E-mini S&P 500 futures position only to see the market bounce back and rally past his original purchase price. That would mark his fourth losing trade of the day. "Is my incense not fragrant enough? Are my garlands not lovely enough? The lady down the block worships Shiva. She's had good luck with her iron condors lately. Maybe I will look into praying to the wondrous three-eyed god of grace and light in the universe."

Aaron Millstein, a trader from Larchmont, NY, complained about a recent trade. "Selling straddles ahead of earnings on AMZN was a little too risky for me. So I bought an at the money butterfly instead. Defined risk, positive time decay. I was feeling good about the trade. The number comes out and what does the stock do? It moves up 5 points, kills my butterfly, and my account. Maybe it's because I ate the kung pao pork at the Chinese buffet. I thought you got a pass for Chinese food! My rabbi was right, I am a bad Jew!"

Rick Spears, professor of Theology at San Diego State, is studying this renewed interest in prayer and spirituality. "The public's level of praying ebbs and flows with various events, like hurricanes, terrorist attacks, etc. But the intensity of prayer in trading exceeds even the level you see for high school math tests. It's unbelievable. I mean, traders are trying anything to stop the bleeding."

Some see this new interest in the divine's influence on what is a rather profane undertaking as somewhat blasphemous. The Reverend Cecil Scruggs of the Search for New Zion congregation of Pine Bluff, AK put the current market situation in perspective. "It used to be plagues of locusts, hail, unsightly boils and various kinds of scourges. Now it's trading. In God's eyes, a lot of people have this coming. Have you seen what's on TV?" The Reverend refused to comment on the trading performance of his own flock.

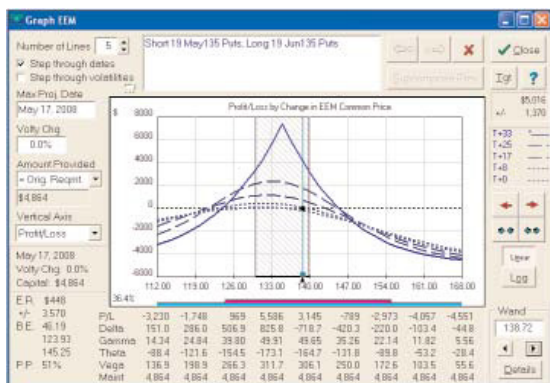
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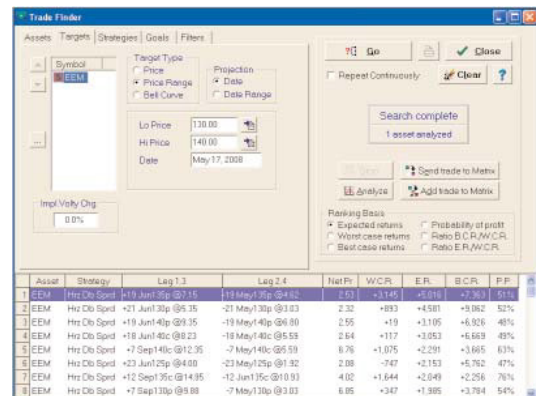
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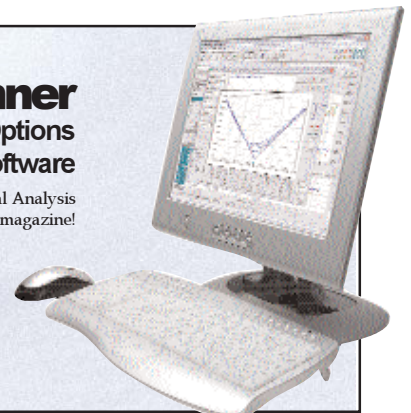
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