

# HOW TO PLAY THE FED'S RATE GAME

NOW THAT THE PROMISE  
OF RAISING INTEREST RATES  
HAS BEEN LIVED UP TO,  
WHAT'S THE PUNCHLINE  
FOR TRADERS?

**PAGE 16**

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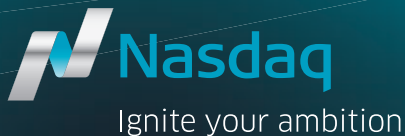
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# When it comes to options trading, ***you can never have enough options.***

If you buy and sell options in the capital markets, information is critical to your success. You not only need to know the risks, but the various ways you can execute your trades.

For two decades, NDX has been a popular hedging strategy for ambitious traders. Depending on your circumstances, it may also enjoy certain tax advantages over an investment in the underlying index. For those concerned about market volatility in the coming year, consider diversifying your portfolio by going straight to the source: The NASDAQ-100 Index Option (NDX).



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Traders love volatility. And nothing stirs the pot more than speculating on interest rates. But what do rising rates mean for the markets? What really happens when they go up? Here are four things you should know and what you can do about them.

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Cover Photograph by  
**Fredrik Brodén**

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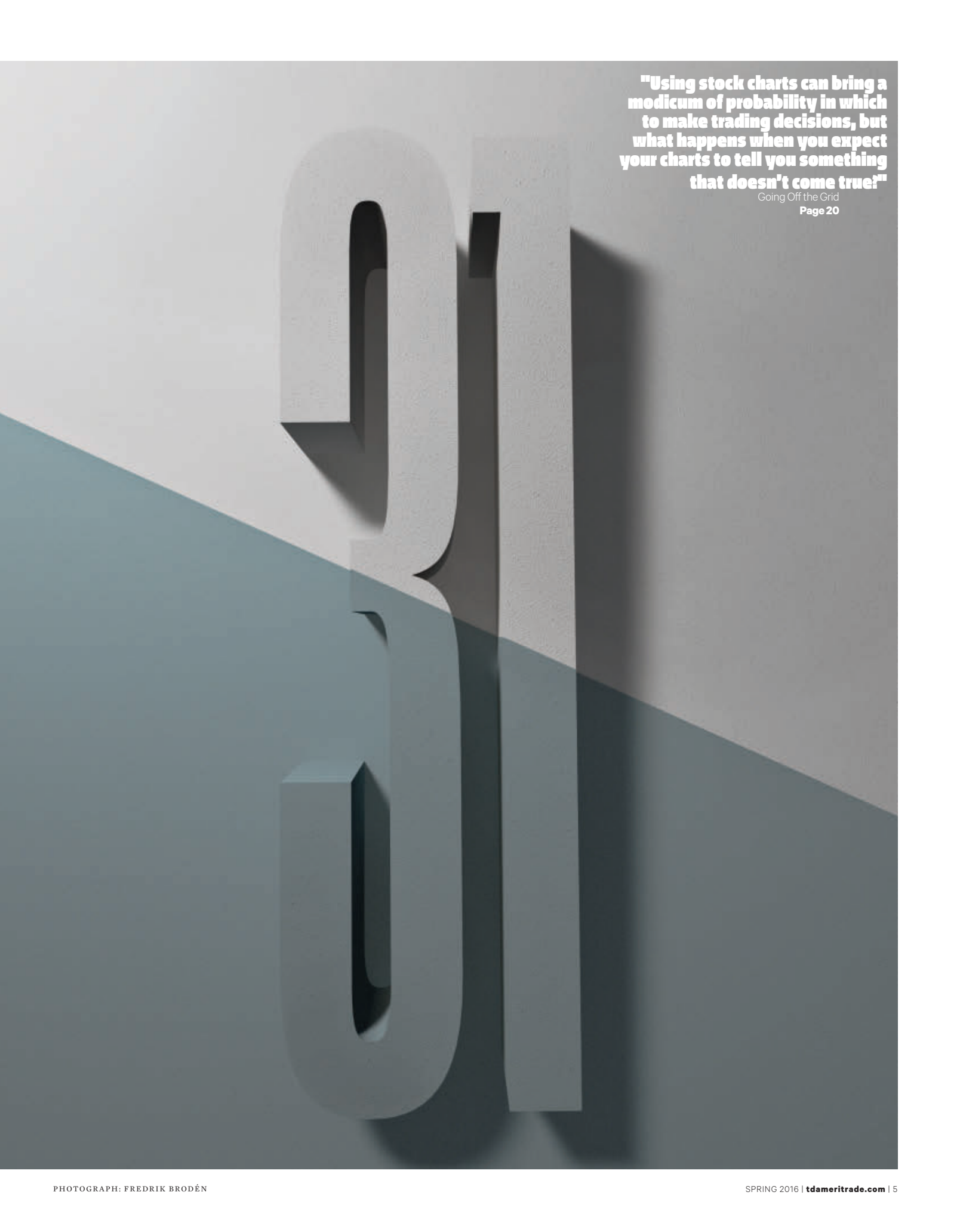
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**"Using stock charts can bring a  
modicum of probability in which  
to make trading decisions, but  
what happens when you expect  
your charts to tell you something  
that doesn't come true?"**

Going Off the Grid

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### Game on, Fed

• AS IF WE DIDN'T HAVE enough to deal with in 2016, what with a Presidential election looming, oil's debilitating nervous breakdown, and now, rumblings of a potential European shakeup as Britain threatens an EU "Brexit." And despite the newer worries, here we are still asking, "What will the Fed do?" Perhaps the question traders should be asking is, "Why should we care?"

The point is, the rate-speculation game isn't going away. And as they say, don't fight the Fed. If you've been keeping your distance from interest rate trades, time to bone up and learn something about what you've been avoiding. Our cover story, "Popping the Cork with the Fed" on page 16 starts you from the beginning and what you can do about it.

Speculation on rates aside, there's a new asset class in town that could comfortably sit right next to the traditional stock-bonds-cash portfolio—volatility. Volatility as an asset? Yup.

Consider this. In 2008 when all the other asset classes tanked at the same time—thereby blowing modern portfolio theory out of the water—volatility was one of the few things rising. And when markets recovered, volatility fell. The good news for traders and investors is that you can now invest in volatility through a multitude of "fear index" products that capitalize on these trends. For more, read "The Trader's Cure for the Volatility Blues" on page 28 and decide for yourself.

We don't have to tell you that the remainder of the year should prove to be difficult to predict. So choosing strategies carefully to accommodate many market conditions will go a long way to strengthening your skill set. Calendar spreads, in particular, are one such strategy. Not only can they be traded in neutral markets, but they can be bullish and bearish. They can be many things. So if you're a veteran trader and still confused about them, see "Beyond the Basics: Calendar Spreads 3.0" on page 28.

As rates do whatever it is they're going to do; as political candidates jockey for constituent love; and as oil, well, keeps being oily, keep your head cool. Learn some new tricks from this issue, and be ready for the one thing that's as certain as death and taxes—volatility.

Happy Trading,

**Kevin Lund**

Editor-in-Chief, *thinkMoney*



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## LOVE NOTES

LITTLE QUIPS FROM YOU TO YOURS TRULY

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

I built a Raspberry based Wi-Fi sensor to throw 50 Watts thru me, if sleeping, if ES Rate Of Change moves >.37% in any given 5M candle—Gotta stay focused. —**Mark**

\$30 oil—cheaper than a bottle of Jack Daniels. —**Fred**

Like dad used to say “Draw enough lines on a chart and price is bound to hit one.” —**Luke**

I have never been so enthusiastic about something that is losing me so much money. —**Pete**

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



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### Chat Room Pearls...

*Cleaned my glasses.  
The Monitor  
tab still doesn't  
look any better.*  
—JUSTIN

CHAT SWIMMER #1:  
*I'm still waiting for  
a TOS upgrade to  
put \$250,000 in my  
account by accident.*

CHAT SWIMMER #2:  
*That would be an  
excellent upgrade*

CHAT SWIMMER #1:  
*Do tech anal pat-  
terns work on  
TICK CHARTS?*

CHAT SWIMMER #2:  
*You'll have to ask  
a technician about  
that. Seems it'd be  
hard to get his butt  
on the screen, but  
whatever.*

*Forget VIX,  
I measure fear by  
looking at how much  
coffee splashes out  
of my cup.*  
—JON

*Swim lessons chat room  
rules: No floaties.  
No speedo's.*  
—BILLY

*It's hard to make a  
comeback when  
you haven't been  
anywhere.*  
—VANESSA

*A sign for the door:  
No pets, insects, dust,  
or more than one  
human allowed on  
the trading room.*  
—BRIAN

*Hi all...Do I need  
to worry about a red  
message on my  
account position  
screen that says  
"REGULATION-  
T CALL"?*  
—NICK

*Does AMTD accept  
EBT food stamps?*  
—BEN

*Play tomorrow in  
OnDemand to see  
the future. That'd be  
a nice feature.*  
—MARSHA

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

CHAT SWIMMER #2:  
*That's the great  
thing about the  
stock market.  
You never know.*

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The risk of loss in trading options can be substantial. Clients must consider all relevant risk factors, including their own personal financial situation, before trading.

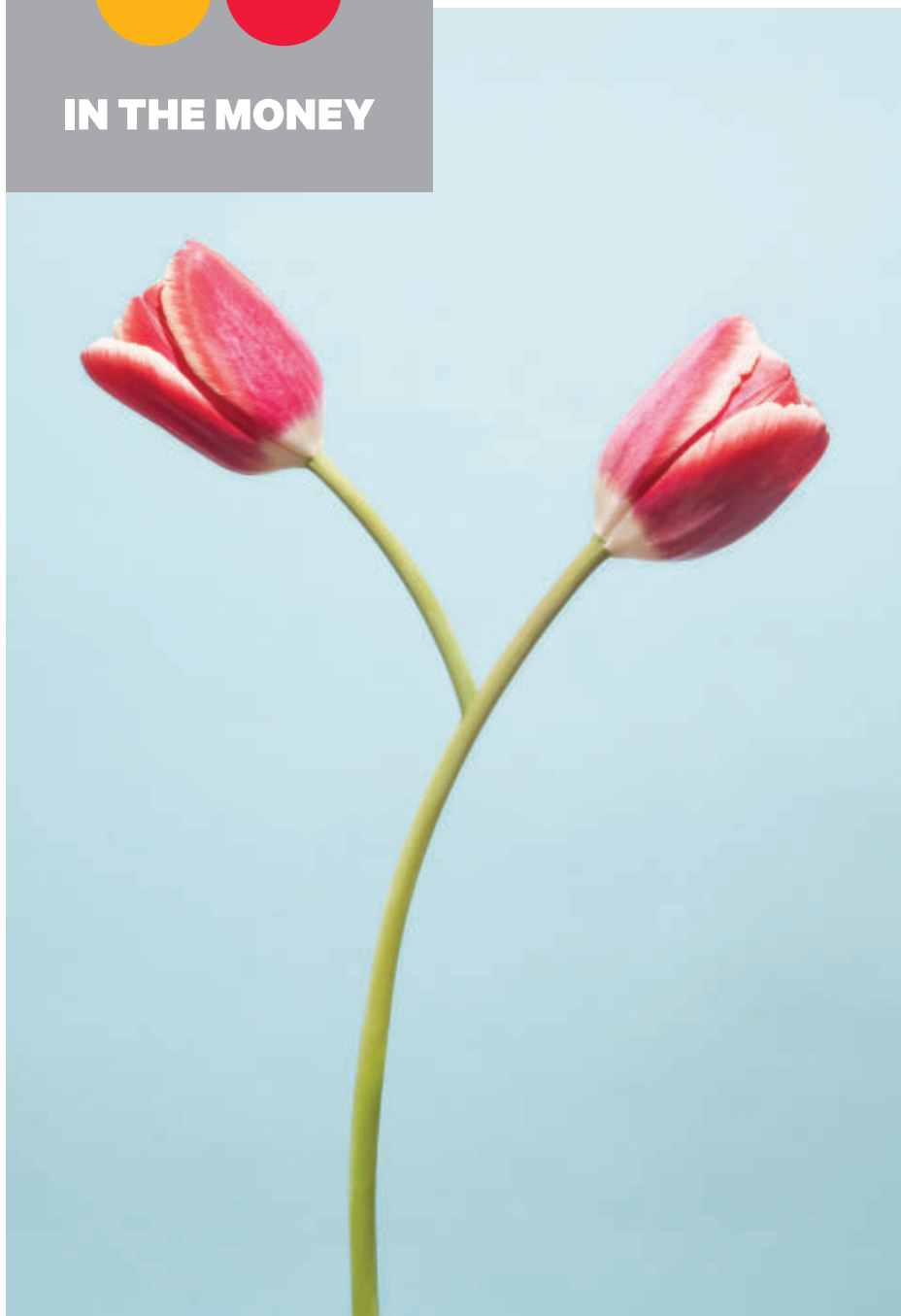
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## IN THE MONEY

A HODGEPODGE OF MARKET STUFF YOU SHOULD KNOW



CAPICHE? ● EASY

# I Just Doubled My Account. Now What?

**BIG IDEA:** IS TWICE THE CASH TWICE THE FUN?  
NOT IF YOU TAKE UTILITY INTO ACCOUNT.

• VISIONS OF SUGARPLUMS ain't just for fairytales. Maybe you've traded your way to a much bigger account size. Or Uncle Milt left you a huge chunk of change. Whatever the source, you've come into serious money. Exciting? Sure. But now what?

Some would consider doubling their trade size after doubling their account. After all, if you're willing to risk \$500 a trade with \$50,000, why not \$1,000 a trade with \$100,000? No wrong answer here. But again, perspective is crucial. Above all, consider your capital's "utility"...huh?

Simply put, utility measures how much benefit you'll get from the next dollar. One dollar to someone whose net worth is \$100 is a big deal. One dollar to a millionaire, not so much. In trading, potential reward is always tied to risk. If you want more reward, you typically need to take on more risk. The utility you have with that extra trading profit helps determine whether you would in fact take the extra risk.

Twenty-somethings have plenty of time before retirement, so their accounts have time to potentially recover from losses. In this scenario, the utility a younger investor realizes for his potential trading profit might be high enough to encourage more risk. Why? The dollar today will likely buy less tomorrow. To offset the cost of a more expensive future, a young person may take more risk with a profit "windfall." For someone closer to or already in retirement, taking extra risk could cause a loss from which it may be harder to recover. This could make that potential and incremental profit less attractive. Either way, younger or older, there are potentially smarter ways to adjust incremental risk to fit your lifestyle and trading goals.



## DOUBLE THE PLEASURE, TEMPER THE “FUN”

One possible solution suggests increasing position risk incrementally as your account grows. For example, instead of increasing risk by 100%, maybe you go, say, 25% instead, from \$500 to \$625, instead of from

\$500 to \$1,000. This could mean doing more contracts, or simply adjusting spread strikes so they're wider.

If you were, say, to sell four 100/102 put spreads for \$0.75 credit, that would have a max risk of \$500, not

including commissions (\$2 spread - \$0.75 credit = \$1.25 risk.  $\$125 \times 4 = \$500$ ). If you widened the strikes and sold three of the 99/102 put spreads for 0.95 credit, that would have a max risk of \$615, not including commissions.

If you're comfortable with a 25% increase in risk, you may consider increasing risk by another 25%, and work your way up over time to doubling your risk. If you're not comfortable with a 25% increase in risk, it's easy to back off and try to avoid larger losses. This way, your potential profit will be delivering the appropriate balance of risk and reward that makes the most sense for your personal financial situation, without throwing caution to the wind (never a good idea). —Words by THOMAS PRESTON

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**TRADER JARGON**  
TURN TO  
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### COOL TOOLS

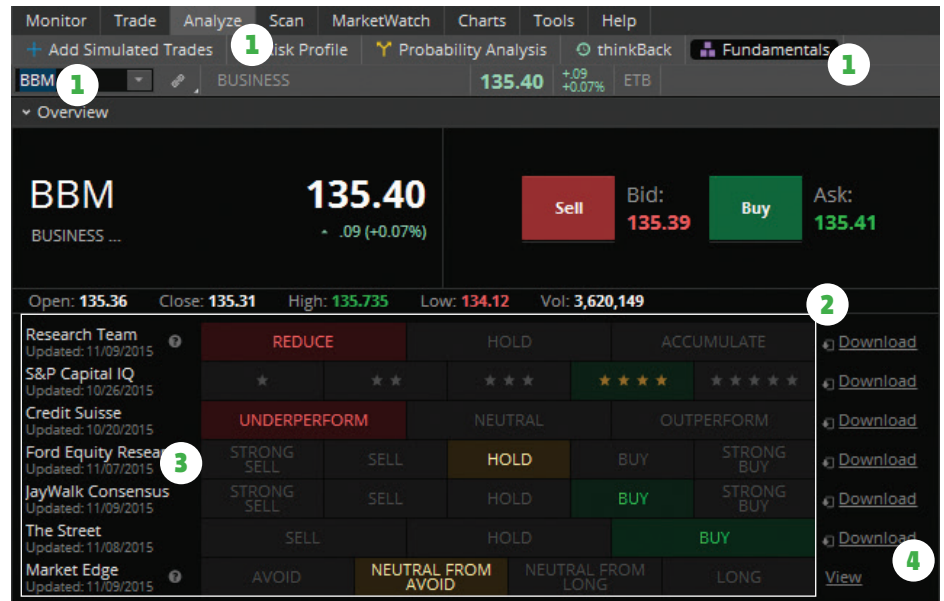
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## What are They Thinking?

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# Ask the Suit

**BIG IDEA:** A LITTLE Q&A WITH **NICOLE SHERROD**, MANAGING DIRECTOR, TRADER GROUP AT TD AMERITRADE



## • What suggestions do you have for staying informed when I'm away from my portfolio?

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**"Tech should simplify your life so that you have more time to do the things in your life that really matter."**

—NICOLE "THE SUIT" SHERROD  
@TDANSHERROD

Tech should simplify your life so that you have more time to do the things in your life that really matter. Along that same vein, in our most recent release on thinkorswim®, we added a new capability which we are calling Time and Event alerts—letting you set alerts on virtually anything on the thinkorswim calendar.

Maybe your portfolio is a little heavy in housing. Now you can set an alert for when the Mortgage Bankers Mortgage Applications number comes out. Or the Pending Home Sales Index update. And not only can you receive that alert on thinkorswim, but it can also be sent via text or push notification to your phone or Apple Watch.

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## What tools do you have to help me analyze my trading performance?

Obviously, I'd start with that little number in the upper left hand quarter of the platform that says Net Liq. Hopefully that's up from where you started the year — and not because you made your IRA contribution.

**SPOILER ALERT:** Later this year, we're releasing a host of new features designed to help you understand your successes and opportunities in trading. But for now, we recently integrated Trade History on Charts—allowing you to look at all of your buy and sell executions plotted along a historical price chart. Chartists are raving about this feature because it allows them to see if they were true to the signals that got them in their trades. To enable this feature within your thinkorswim Chart, click on the Style, then Settings. From the Chart Settings window remain on the General tab and check the Show Trades box.

## TOYS FOR TRADERS

FROM THINKORSWIM®

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### CUSTOMIZABLE QUICK TIME FRAMES

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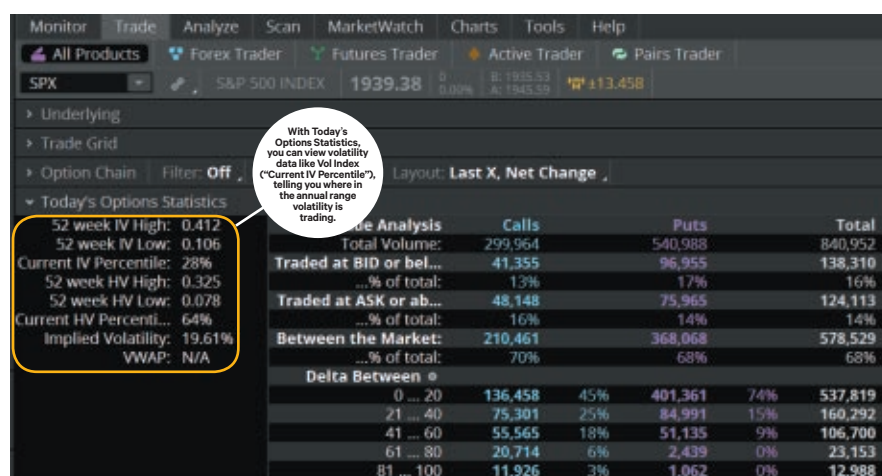


# ASK THE TRADER GUY

THE VOL WHISPERER • EASY

## The “V” Word: A Three-Minute Volatility Primer

**BIG IDEA:** EVERYTHING YOU NEED TO KNOW ABOUT VOLATILITY TO SOUND COOL AT A TRADING PARTY.



**FIGURE 1: Strategy is Key.** By viewing “Today’s Options Statistics” in thinkorswim®, you can assess the optimal strategy to use based on the current volatility against past volatility. *For illustrative purposes only.*

• **TRADERS TALK** a lot about “volatility.” What does it *really* mean? Loosely, stock or index volatility is the magnitude in which it moves. It also represents uncertainty about how much a stock or index price might change in the future. Volatility doesn’t care if a price change is higher or lower. Only if the change is big or small.

### NUTS AND BOLTS

Putting those together, the higher the volatility, the more uncertainty the market has about the future magnitude of a stock’s potential price changes. For example, 30% vol is higher than 20% vol, and 50% vol is higher than 30% vol. But let’s add some context.

Volatility is expressed as an annual percentage number. If a stock has 30% volatility, historically the stock has shown that its price might be 30% higher or 30% lower in one year. This stock price could change more or less than 30%. But volatility suggests the price within plus/minus 30% is the most likely scenario. Why? Volatility is also a standard deviation—which means if you believe a stock’s percentage price change is normally distributed, there’s about a 68% chance the price will be within plus/minus 30% in a year. (The 68% number comes from the normal distribution—think bell curve—and is the probability of the return of a stock price landing between -1 and +1 standard deviation.)

### WHEN GEEK-SPEAK = STRATEGY

We assume volatility won’t change over the year, and that returns (a price’s percentage changes) are normally distributed across a bell

curve. Translation? Most of the prices will cluster around a median price.

Those are pretty big assumptions. But they help you turn volatility into something concrete. Something you can use. Multiply a stock’s volatility by its price to get the one standard-deviation price change, then add and subtract that to the price. This will give you high-and-low stock prices that comprise the boundaries within which, in a year, the stock has a 68% probability of landing. You can then consider using these as price targets, stops, or even strike prices to sell spreads with potentially greater efficiency and genuine strategy.

For example, if stock XYZ was trading at \$50 and had a 20% volatility,

you might target \$60 and/or \$40 as your higher and lower price targets ( $50 \times .20 = 10$ ) with a 68% probability that the stock will remain within that range for the year. One item of note, this probability is theoretical in nature and stocks may move outside of their one standard deviation expectation. If qualified, you could consider selling call and put spreads with your short options strikes sold at those respective targets. If a year is too long to wait, you may use the thinkorswim probability cone on the Analyze page to help you narrow the range within the same probability.

—Words by THOMAS PRESTON

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

**Q: I know a stock’s price is supposed to drop by the amount of the dividend amount on the ex-dividend date. Sometimes it drops more, sometimes less. Why?**

**A:** A stock drops on the ex-date because on that date, you can’t buy the stock and be eligible to receive the dividend. To be eligible, you need to buy the stock before the ex-date. On the ex-date, the price drop shows you can’t get the upcoming dividend if you buy it. Otherwise, an ex-dividend date is just a regular trading day. Only part of a stock’s price change is because of a dividend. Company news, industry events, or the market moving higher or lower, can drive a stock price up or down regardless of dividends. When you see a stock price drop more or less than the dividend amount on the ex-date, you can blame the discrepancy on other influences.

**Q: I was skeptical at first. But it seems that mayonnaise holds a solid position as the #1 domestic condiment. With the 2014 avian flu having hit the poultry flock hard, I figured mayo supplies would drop. I filled my garage with 2,000 gallons expecting a rally. But it hasn’t happened. What’s a good hedge?**

**A:** Your problem is that mayo is brand-dependent, and isn’t fungible. Some brands work better with pasta salad, while others are ideally suited to tuna salad or turkey. Without knowing what brand you’re long, I can only make a general suggestion. More eggs would crash the mayonnaise price. And these eggs come from more chickens.



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1. Morningstar, as of 9/30/15. Comparison is between the Prospectus Net Expense Ratio for the average iShares Core Series ETFs (0.12%) and the average Open-End Mutual Fund (1.27%) available in the U.S. (excluding municipal bond and money market funds). 2. Based on \$4.506T in AUM as of 9/30/15. Visit [www.ishares.com](https://www.ishares.com) or [www.blackrock.com](https://www.blackrock.com) to view a prospectus, which includes investment objectives, risks, fees, expenses and other information that you should read and consider carefully before investing. Risk includes principal loss. The Funds are distributed by BlackRock Investments, LLC (together with its affiliates, "BlackRock"). ©2016 BlackRock. All rights reserved. iSHARES and BLACKROCK are registered trademarks of BlackRock. IS-17226-0116

**BIG IDEA:** WHAT REALLY HAPPENS WHEN RATES GO UP?  
HERE ARE FOUR THINGS YOU SHOULD KNOW ABOUT RISING RATES, AND WHAT  
YOU CAN DO ABOUT THEM. WORDS BY **MARK AMBROSE**  
PHOTOGRAPHS BY FREDRIK BRODÉN

# POPPING THE CORK WITH THE FED

CAN YOU THINK OF ANYTHING THE MARKET PAYS MORE ATTENTION TO THAN THE FEDERAL RESERVE TALKING ABOUT INTEREST RATES? WELL, THEY FINALLY RAISED 'EM. NOW WHAT? FOR TRADERS, THE WORK HAS JUST BEGUN.

The Fed's rate decisions can reverberate through the global economy, and the gossip usually centers around Federal Open Market Committee meetings. Here, the chair and governors hash out how best to meet the Fed's dual mandate—maximizing sustainable employment while maintaining price stability. When they release meeting minutes weeks later, the market dissects every sentence for clues about whether the Fed might raise, lower, or keep rates the same. How can that information be useful to you? ➡

● **EASY / TAKE AWAY:** *Practical trading strategies for rising interest rates.*







**TRADER  
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You can in fact react to, and approach, Fed decisions in four different arenas.

## 1. HOW BANKS BORROW

Officially, the Fed sets the discount rate. That's the rate banks pay to borrow money from the Fed. But the Federal Reserve impacts interest rates most dramatically through the Fed funds rate, for which targets must be set. Banks need to hold a certain amount of cash on hand to run their businesses. That amount, the "reserve requirement," is set by the Federal Reserve. Big banks (think Citigroup or JP Morgan) use the Fed funds rate to charge each other for overnight loans.

The Fed also uses open market operations, whereby the Fed buys and sells Treasury bonds and notes, and sets the interest it pays on bank reserves held at one of the regional

Federal Reserve banks to push Fed funds to its target. To see the Fed funds rate, look at the /ZQ future. The rate is 100 minus the futures price.

As a bank's cash moves in and out through borrowing and lending, it may find at the end of any given day it's cash short to meet its reserve requirement. No problem. It locates a bank with a cash-reserve excess for that day, and arranges an overnight loan. These Fed fund loans are "unsecured," meaning they don't require collateral. This is in part why the Fed funds rate is more influential than the discount rate. When a bank borrows money from the Fed at a discount, the loan has to be collateralized. The discount rate is also usually higher than the Fed funds rate, which is why big banks prefer working with Fed funds.

**HOW TO PROCEED:** Banks and financial companies hold lots of cash on which they earn interest. When rates are higher, banks earn more interest on that cash, and likewise earn more on loans. That's why higher interest rates can be bullish for bank stocks. And why the world pays attention to those boring committee meetings. If you think rates might rise and lift bank stocks, consider strategies like [covered calls](#) or [short puts](#).

## 2. BOND MATURITY AND DURATION

When it comes to bonds, interest rates get all the love. All things being equal, when interest rates rise, bond prices fall. When rates fall, bond prices rise. Rate and bond prices move opposite to one another. Remember that.

But here's the deal: a rate change doesn't affect all bonds equally. Bond prices with varying maturities react differently to rate changes. That unique sensitivity is called "duration." A bond's duration indicates how much its price changes if its yield (rate) changes 1%. For most investors, it's not important to know a bond's calculated duration. But you should know the more time to maturity a bond has, the higher its duration, and thus its sensitivity to rate changes.

For example, if we look at the price of Treasury notes and bonds with 5 years, 10 years, and 30 years to maturity, and expect rates will rise 1% for each of them, the price of the 30-year bond will drop the most, the 10-year note will drop less than the 30-year bond, and the 5-year note will drop the least. They'll all drop in price, but by different amounts. This also suggests the 30-year Treasury is more volatile than the 10-year, which is more volatile than the 5-year.

Now, rates don't usually change uniformly for Treasuries across the various maturities. The relationship between bond rates, or yields, and time to maturity is known as the "term structure." But that's a topic for another day.

**HOW TO PROCEED:** By way of example, if you think interest rates might rise, and Treasury prices might fall, keep in mind the 30-year Treasury future (/ZB)\*\* could drop more, or be more volatile, than the 10-year Treasury future (/ZN), which could drop more, or be more volatile, than the 5-year Treasury future (/ZF). Work to align how bearish you want to be with a product's sensitivity. If you have the appropriate

\*\*Symbols only used for illustrative purposes. Not a recommendation.



approvals, you can trade options in all these futures, so bearish option strategies like short call spreads, or long put spreads, offer you ways to speculate on rate changes by leveraging defined risk.

### 3. STOCK BUYBACKS

As the name implies, this scenario occurs when a company buys back its own stock. When a company issues stock, shares are sold to individual investors or institutions. The number of shares issued is referred to as “shares outstanding.” A company can have tens of millions of outstanding shares. To calculate the company’s market value, multiply the number of shares outstanding by the stock price. So, what does that have to do with interest rates?

When rates are low, a company can borrow, and not spend as much on interest payments. On the other hand, a company holding a lot of cash earns less interest on that cash when rates are low. If a company thinks its share price is low, it can either borrow money, or spend cash, to buy back from investors some of its outstanding shares. With less shares on the open market, the earnings per share increases, causing the stock price to increase in most cases. A company’s overall market value doesn’t change because of the buyback. But

buybacks and remove some of the market’s upward bias, you might consider a short call spread in the S&P 500 as a way to do this using a defined-risk strategy.

### 4. IMPACT ON CURRENCIES

Under capitalism, money flows to higher returns. And money thinks globally, cherry-picking which country has better returns. In practice, what does this mean?

Most industrialized countries have central banks that offer guarantees on interest and principal on certain investments like Treasury bills. These banks set or influence short-term rates in their countries. Rates can differ widely, and some guarantees are more sound than others. Germany, for instance, is more stable these days than Greece. All things being equal, the safer the investment is considered, the lower the interest rate. That’s why German short-term rates tend to be lower than Greek short-term rates. In general, investors balance higher potential returns with risk, and invest in countries they feel offer the best risk-adjusted return.

To do that, you have to buy an interest-rate product in a country’s own currency. When you convert your native currency, in effect you are selling your currency and buying the other. That activity pushes down the price

within the equity world, there are a number of exchange-traded dollar-based currency products that you could sell put spreads on. Or you could sell call spreads on an exchange-traded foreign currency product. (Please note that many of these currency products are not investment companies registered under the Investment Company Act of 1940, so be sure to carefully read the particular product’s prospectus for a more complete discussion of the applicable risk factors before investing in or trading options on these products.)

#### LEAVING THE CAVE

Think of the Fed like a bear waking up from a long slumber. With the Fed potentially in rate-hike mode now after nine years with a flat interest rate at zero, it might be time to adjust your trading strategies if you’re trying to capitalize on rising rates. When, or ultimately how much, rates change is anybody’s guess. But if rates move higher, having a strategy in place like the four discussed here might help position you to keep pace with potentially deep market shifts and emerging opportunities.



**FIGURE 1: Finding Fed Funds Rate.** To calculate the Fed funds rate, subtract the futures price (yellow circle above) from 100. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

with fewer shares outstanding, you need to multiply those shares by a higher stock price to keep the company’s market price the same.

**HOW TO PROCEED:** In recent years, a large number of buybacks is one reason the market has rallied. And a threat of higher interest rates can mean buybacks become less attractive. If you think higher rates will slow

of your currency relative to the other. In this way, higher domestic interest rates tend to mean a stronger currency. So, when the Fed signals higher U.S. rates, the dollar tends to move higher, relative to foreign currencies.

**HOW TO PROCEED:** If you think rates might rise and push the dollar higher, and you’re approved for forex trading, one option to consider is to short a currency like the euro against the dollar (EUR/USD on the thinkorswim platform). If you’d like to stay

*International investments involve special risks, including currency fluctuations and political and economic instability. Forex trading involves leverage, carries a high level of risk, and is not suitable for all investors. Please read the Forex Risk Disclosure (<http://www.nfa.futures.org/NFA-investor-information/publication-library/forex.pdf>) prior to trading forex products. Forex accounts are not protected by the Securities Investor Protection Corporation (SIPC). Forex trading services provided by TD Ameritrade Futures & Forex LLC. Trading privileges subject to review and approval. Not all clients will qualify. Forex accounts are not available to residents of Ohio or Arizona. A forex dealer can be compensated via commission and/or spread on forex trades. TD Ameritrade is subsequently compensated by the forex dealer.*

*For more information on the general risks of trading options and futures, see page 37, #1-3.*

**BIG IDEA:** UNLESS YOU'RE TRADING UNDER A ROCK, MOST CHARTISTS  
ALREADY KNOW ABOUT MOVING AVERAGES AND RSI. BUT HAVE YOU HEARD OF A  
SCHAFF TREND CYCLE? THEY MAY NOT BE AS POPULAR AS  
BOLLINGER BANDS, BUT CONSIDER THREE TRADE-WORTHY CHARTING  
INDICATORS HIDING IN PLAIN SIGHT. WORDS BY **DAVID KIER**  
PHOTOGRAPH BY FREDRIK BRODÉN

# GOING OFF THE GRID (WITH YOUR CHARTS)



● PRO / **TAKE AWAY:** *Little-known chart indicators with potentially big impacts on your analysis.*

# PEOPLE AND NATURE TEND TO BE PREDICTABLE.

Too bad the stock market isn't. Using stock charts can bring a modicum of probability in which to make trading decisions, but what happens when you expect your charts to tell you something that doesn't come true? Where do you go when your MACD and RSI indicators keep giving you false signals? You dig deep and go off the grid. • Thousands of charting studies exist, while thinkorswim® lists over 300. For our purposes, and leaving aside traditional indicators, we'll cover three that are a bit different, yet worthy of attention—the Standard Deviation Channel, Schaff Trend Cycle, and Simple Cloud. • Even if you don't use them yourself, consider this an exercise in learning to uncover hard-to-find studies, and how to use them to anticipate the potential for market moves.

## STANDARD DEVIATION CHANNEL (SDC)

**WHAT IT IS.** This statistical-analysis tool is normally overlaid on a price chart. To find it (and others in this article), click the Charts tab in thinkorswim. In the upper right corner of any chart, follow the click path to Analysis Tools > Add Study > All Studies. Choose StandDevChannel from the “R-S” menu.



### HOW TO VIEW STUDIES IN THINKORSWIM

There are two common ways to view studies on your charts. You can overlay them on the price or volume, or put them on their own graph. Each has benefits and drawbacks, mostly related to legibility. So explore what works for you.

The SDC is composed of a middle “regression” trendline that's automatically plotted for you, as well as two other lines plotted above and below it by one standard deviation (which, in statistical geek-speak, means it contains 68% of the price data). See Figure 1.

Theoretically, 68% of the price action falls into the SDC if both upper and lower lines are plotted one standard deviation above and below the trendline. If you increase that to two standard deviations, statistically you'll get 95% of the price action expected to fall into the channel.

**HOW IT WORKS.** Without getting into the mathematical complexities used to plot the middle-regression line, SDC is basically a measure of how much the price has historically tended to move from one point to the next. The study's idea is that over time, prices tend to regress toward that middle line, which represents where buyers and sellers

have agreed to a price the most amount of times. If the price moves above the top or below the bottom line, that price is now out of its statistically normal range. The thought is that the price may likely fall back into that normal range, or a new trend is being defined.

Referring again to Figure 1, the yellow line is the regression line. Notice that the price reaches the top line, which is two standard deviations above the middle line, noted with the pink arrow. Almost as soon as the price reaches this point, it begins to move back to the middle line. The price does this action again at the green arrow, and nearly again at

the purple arrow. The idea is that because price tends to regress back toward the center line, bullish and bearish potential trade opportunities may present themselves at extreme points of the channel.

## SCHAFF TREND CYCLE (STC)

**WHAT IT IS.** While the name may be foreign to you, the Schaff Trend Cycle combines two well-known indicators—MACD and Fast Stochastics. Since these two indicators are typically used together, the STC gives you the



**FIGURE 1: Standard Deviation Channel.** This indicator makes it relatively easy to spot when a stock's price action hits extremes as well as a line that is mathematically closest to all the charted prices. Source: thinkorswim from TD Ameritrade. For illustrative purposes only. Past performance is no guarantee of future results.



chance to see and learn the benefits of each study, while looking at a single output.

The main idea is to combine the benefits of trend and cycle indicators, and minimize their drawbacks, such as lags or false signals. The STC's main goal is to estimate price direction and potential market turning points.

Technically, the STC is an oscillator that moves between 0 and 100, and is calculated as a double-smoothed stochastic of the MACD. In trending markets, the STC is expected to move up if the market uptrend is accelerating. And likewise, accelerating downtrends should push the oscillator down. Likewise, during sideways markets, the STC attempts to identify potentially oversold conditions when it reverses after falling below 25. Or possibly overbought conditions, when it turns down from above 75.

**HOW IT WORKS.** In short, many chartists use the STC in trending markets to try to determine if the trend is growing or is in a sideways market, and might indicate a break-out. See *Figure 2*.

At the beginning of the chart, the price is not trending in any particular direction. But you see a pattern begin and the STC breaks below the oversold line, shown with the yellow arrow.

Once the indicator reverses and goes above the oversold line at 25, a “buy signal” is triggered (green arrows on the chart in *Figure 2*). Next, after crossing above the top line (overbought line), the indicator crosses back below that line, shown on the chart in *Figure 2* with

the first red arrow. This indicates the trending market has run out of bullish acceleration, and may be at a sell point. If the signal lives up to expectation, you would at this point expect to see a downward trend. While this chart may indicate overbought and oversold conditions, an equity can remain in these conditions for quite a while. (And bear in mind, the buy and sell signals are speculative in nature.)

## THE SIMPLE CLOUD (TSC)

**WHAT IT IS.** A relatively unknown indicator called the Simple Cloud can be overlaid directly on your price chart. As the name implies, the concept and application are, well, simple (assuming you’ve had some experience reading charts). Referring to *Figure 3*, TSC uses two separate simple moving averages to define a trend. By default, the indicator uses 20- and 50-period moving averages, with shading between the lines. The color of that shading is used to display trend direction.

**HOW IT WORKS.** You can see TSC recognized the bull trend when price closed inside the green cloud (indicated by the first green arrow). We then saw a confirmed pullback, indicated by the red arrow. If a long position would have been established after the first arrow, this red arrow might indicate that the trend could possibly be over. Then, TSC goes back to work and confirms that a new bullish trend may be beginning with the close price indicated by the second green arrow.

As an aside, when you just can’t find what

you want with traditional indicators, you can create your own using the thinkScript tool in thinkorswim. The Simple Cloud indicator was created by yours truly through this feature. Since this one isn’t available among the 300 other indicators, I can share the study with you to import into your own thinkorswim software. Just go to <http://tos.mx/NhP0sl> and follow the instructions on the page.

NATURALLY, THESE STUDIES ARE SIMPLY guides to help determine direction. They are not only theoretical and without a guarantee, but they can’t predict the future. The idea of any chart indicator is to simply help identify high-probability chart points to help you take action—i.e. enter, exit, and manage trades. The market changes constantly. So it’s worth evolving your charting chops with a mix of traditional indicators and those that challenge conventional wisdom. If these don’t fit your style, the thinkorswim platform has plenty of others to consider. Visit [tlc.thinkorswim.com](http://tlc.thinkorswim.com) for more good stuff on this.

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*While this article discusses technical analysis, other approaches, including fundamental analysis, may assert very different views. For more information on the general risks of trading, see page 37, #1.*

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**FIGURE 2: Schaff Trend Cycle.** Combining two popular indicators—MACD and Stochastics—to give you a single read on momentum.

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



**FIGURE 3: The Simple Cloud.** Taking matters into my own hands, I created this simple indicator using thinkScript on thinkorswim to generate visible buy/sell signals to consider when two moving averages cross over.

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





**BIG IDEA:** WHAT'S A HANDY CORE OPTION STRATEGY THAT LEVERAGES TIME? THE CALENDAR SPREAD. BUT EVEN IF YOU'RE SEASONED WITH THEM, YOU MAY STILL HAVE QUESTIONS. IS THIS ONLY A MARKET-NEUTRAL STRATEGY? WHERE CAN YOU EXPECT TO FIND PROFIT? AND **WHAT MATTERS MOST, TIME OR VOLATILITY?** NOT FOR BEGINNING TRADERS OR THE FAINT OF HEART, LET'S DIVE IN.

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# BEYOND THE BASICS: CALENDAR SPREADS 3.0

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WORDS BY **THOMAS PRESTON**  
PHOTO ILLUSTRATION BY MAX BRODÉN

● PRO / TAKE AWAY: *There's more to calendar spreads than buying and waiting. Your burning questions answered.*



HERE'S A QUESTION:

## WHAT DO YOU GET WHEN YOU CROSS TIME PASSING WITH A DULL MARKET? NOTHING.

And that's the point of a long calendar spread—much ado about nothing. Well, almost. While traditionally, the calendar spread is a strategy designed to profit when the market doesn't move very much, it can be as much a bullish or bearish strategy as a neutral one. And when market conditions suggest low volatility ("vol"), it can be potentially the ideal pick.

As pros know, calendar spreads in spirit only care about extrinsic (time) value.

And because a calendar spread is made up



### TRADER JARGON:

The **calendar spread** is made up of a near-month short option (call or put), and a far month long options (call or put respectively). The trade is profitable when the short option decays more rapidly than the long options.

of either calls or puts, in different expirations at the same strike price, if one option is **in the money** (ITM), the other is, too, by the same amount. In fact, any intrinsic value for the calendar's short option is offset by the same amount of the long

option's intrinsic value. But the extrinsic values of the options are in fact different.

So only extrinsic values matter when considering the value of calendar spreads. And it's this extrinsic value that's most influenced by volatility.

### PEAS IN PODS

A calendar's debit is the price of the option you're buying (i.e., June 100 put), minus the price of the option you're selling (i.e., May 100 put), plus transaction costs. The max potential loss on a long calendar spread is the debit you pay.

You may see more calendar opportunities with low vol because their debits tend to be lower. The more time to expiration, the higher an option's **vega**. For example, the June 100 put will have a higher vega than the May 100 put. When vol goes up, the June put's extrinsic value increases more than the May put, which increases the calendar's debit. When vol is lower, the June put's extrinsic value decreases more than the May put, which decreases the calendar's debit. And when the calendar's debit is lower, its maximum risk is lower.

### REDEFINING EXPIRATION

Using this May/June calendar as an example, if you pay \$0.80 debit for the spread, the max loss is \$80, plus transaction costs. That

occurs at the expiration of the near-term short option, when the stock is higher or lower than the calendar's strike price, and the extrinsic value of the options is low or zero. Let's review a long May/June 100 put calendar for an 0.80 debit.

The further the option moves away from the stock price, the lower the extrinsic value. That's true for both in- and out-of-the-money (OTM) options. If the stock is at \$150 at May expiration, the short May 100 put will expire worthless, and the long June put will be far OTM. It may have a low extrinsic value, say, 0.10, and the calendar is worth 0.10 at that point (losing trade). If you hold it through June expiration, and the stock is above \$100, the June 100 put will expire worthless, and the calendar will have a max loss of 0.80.

If the stock is at \$50 at May expiration, the short May 100 put will be deep ITM, and worth its \$50

intrinsic value. The long June 100 put will be deep ITM, too, and also have \$50 intrinsic value. The June 100 put might have some extrinsic value. As with the stock at \$150, the calendar's value would be the extrinsic value of the June 100 put. If the extrinsic of that June put is 0.10, the calendar would be worth 0.10.

In both cases, with the stock at \$150 and \$50, the extrinsic values of the options are low, which makes the calendar's value low. If its value is less than the debit you paid, it's a loser.

### CONSIDER THE GAP

Calendar spreads have the largest value when the difference between the extrinsic values of the long and short options is the highest. For any given expiration, the **at-the-money** (ATM) options have the highest extrinsic value, and the option with more time to expiration (the long June 100 put) will have a higher extrinsic value than the option with less time (the short May 100 put).

When the stock price is at \$100 at expiration, the 100 strike is ATM. The May 100 put will have zero extrinsic value because it's expiring, and the June 100 put will have more value. That makes the difference in extrinsic values (high vs. zero) higher—making the value of the calendar higher, too.

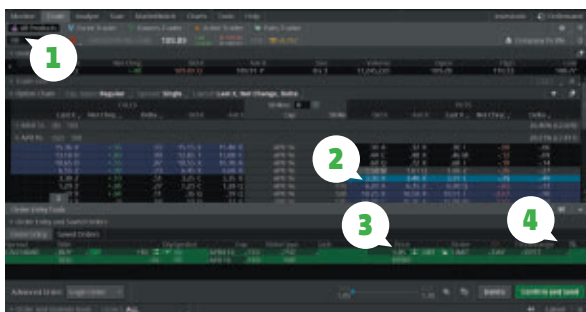
A calendar is profitable, then, when its value is greater than the debit you paid. And its



For illustrative purposes only.

**FIGURE 1: Long Calendar Spread.** The top peak of a calendar spread risk curve is the strike at which you place the trade, which can be at, above, or below the stock price, depending on where you think it will go.





For illustrative purposes only.

## PLACING A CALENDAR ON THINKORSWIM®

The easiest way to place a calendar spread order in thinkorswim is under the Trade tab.

### 1. Enter the Symbol

In the upper left of the Trade page, fill in the box with the stock symbol and press Enter.

### 2. Pick the Strategy

Next, choose the expiration you want and right-click the bid or ask of the option you want to trade. In the menu that opens up, choose "BUY," then "Calendar."

### 3. Adjust the Order

Under the Order Entry Tools screen at the bottom of the page, you can change the quantity of spreads, the strikes, expirations, etc.

### 4. Place the Order

When you're ready, click Confirm and Send.



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max value (and max profit) happens at the expiration of the short front-month option, with the stock exactly at the calendar's strike price. This makes the short option's extrinsic value zero, and maximizes the long option's extrinsic value.

## WHAT'S IT ALL WORTH?

How high can the calendar price rise? We can guess. As implied vol moves up and down, extrinsic values of options do, too. If vol is lower when the stock is near the calendar's expiration strike, the calendar will be worth less, because the long option's extrinsic value is also lower.

Even if the stock is at the calendar's strike price at expiration, its value might be lower than the debit paid. If vol is higher when the stock is near the calendar's strike at expiration, the calendar will be worth more, making the potential profit larger. Because vol can go higher and lower independently, in different expirations, and we can't pinpoint when, the max calendar spread profit is always an approximation.

## WHAT EVERY PRO SHOULD KNOW

Even the most veteran traders have inquiring minds. They take nothing for granted. But here are a couple of nuggets even the pros may not be thinking about.

### *The Question of Direction*

A good place to start—are calendars bullish, bearish, or neutral? While most learn them as market-neutral, they can be all three. Simply buy the calendar at the expected strike point—better yet, the middle of an expected range.

- If you're bullish, buy a call calendar with a strike higher than the prevailing stock price.
- If bearish, buy a put calendar at a lower

strike price.

- If neutral, buy a calendar at a strike that's close to the prevailing stock price. Naturally, it's hard to know when to use a calendar as a directional trade.

## ROLLING YOUR LOSERS

So, what's your calendar management strategy once you have one on? If the stock is close to the strike in the last week before expiration, and the calendar has a profit, consider taking whatever profits you have, even if the calendar might still expand in value at expiration. The stock might move away from the strike price and turn the profitable calendar into a loser. With less time to expiration, the stock price might not come back to the strike.

If the calendar is a losing trade, but you believe the stock could still go to the short calendar strike in the future, consider rolling the short option to the next expiration (in a multi-month calendar), when the short option has



**COOL CALENDAR INFO:**  
Need to go further back on calendar spreads. Start from the beginning by visiting the thinkMoney archives at [thetickertape.com/thinkmoney](http://thetickertape.com/thinkmoney). Open the search box and type in "calendar spreads."

little extrinsic value left, and can't deliver additional profit.

Yet, if the calendar is OTM, you can let it go through expiration, and keep the long back-month option as a speculative directional trade. If the calendar is ITM, close the trade before expiration to avoid the short option's assignment.

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

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# THE TRADER'S CURE FOR THE VOLATILITY BLUES

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WHEN MARKET VOLATILITY IS LOW, THERE'S NOTHING TO DO.  
OR IS THERE? LEARN HOW TO GENERATE A TRADER'S VERSION OF  
"YIELD" WITH A NEW ASSET CLASS. WORDS BY **THOMAS PRESTON**

PHOTO ILLUSTRATION BY MAX BRODÉN







STOCKS, BONDS, CASH. THESE ARE WHAT INVESTORS CONSIDER TRADITIONAL “ASSET CLASSES.” MORE ADVENTUROUS ONES MIGHT TOSS IN COMMODITIES LIKE PRECIOUS METALS, CRUDE OIL, OR GRAINS. AND HERE’S ONE MORE THAT MIGHT SURPRISE YOU: **VOLATILITY**.

OK. “Vol” as an asset class might sound a little esoteric, and a little hard to fit into a portfolio. But if we define an asset class as a group of products that exhibit similar market behaviors, that’s in effect what volatility is. And we have the **VIX**, the **CBOE’s volatility index**. And VIX futures. And VIX options. It’s VIX options and futures that exhibit similar market behavior.

When market temperament depresses VIX, you may find fewer equity trading opportunities. Or you might be concerned that a market drop could spike vol. Keep reading. You’ll soon understand how to treat volatility as an asset class, and find potential strategies for a low VIX. Once it’s all more familiar, you may discover potential opportunities more often—when the VIX is high, low, or in between.

In order to understand other volatility products, let’s review the VIX itself.

## THE VIX INDEX

The VIX is an index (think Dow Jones Industrial Average, or S&P 500) that’s a weighted average of **out-of-the-money** (OTM) SPX options. It measures the overall implied volatility of SPX options.

Remember that implied vol is derived from the market prices of options. And when plugged into an option pricing model, it’s the vol that makes the option’s theoretical value equal to the option’s market value. In a word,

the VIX is a single implied-volatility number that represents all SPX options. Let’s see how it works.

The VIX is calculated from live SPX option price data. So, when you see a VIX at 15, for example, it’s based on a snapshot of the option prices. What happens if traders start buying OTM calls or puts? Option prices are set by the market’s buying and selling activity. So, with more demand (buying), the price goes up. And because OTM option prices are made up entirely of extrinsic value (the value of time to expiration and volatility), as their price goes up and time to expiration stays the same, their implied volatility goes up, too.

As SPX option prices rise, that translates into a higher VIX. The traders might be buying the SPX options as a hedge against a big move in the market, or as a speculative trade. It doesn’t matter. The buying pressure

on the SPX options increases their price. That in turn increases the VIX. The VIX is sometimes called the “fear gauge” because it goes up when traders think there might be a big up-or-down change in an index.

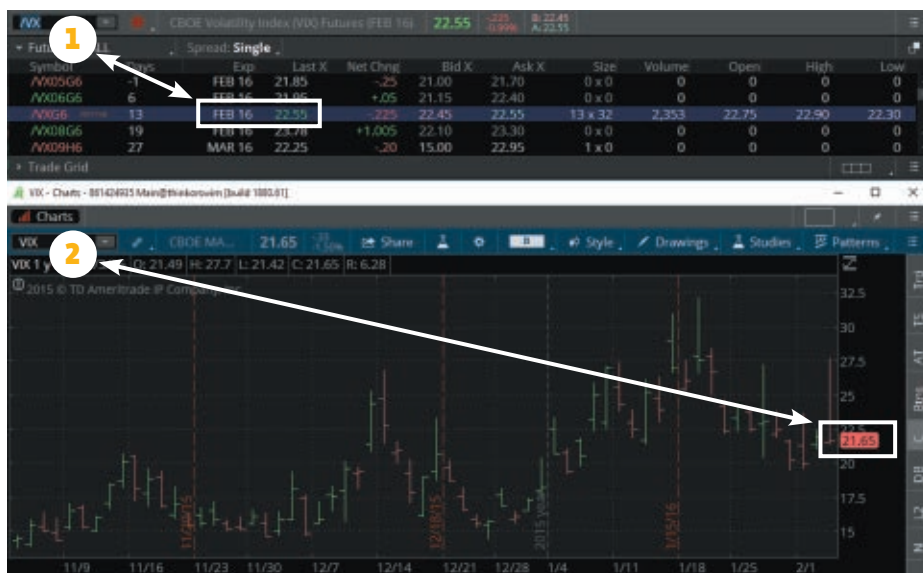
Conversely, if traders think the market might not make any large moves, they sell their hedges, or **sell options short**. That selling pressure pushes SPX prices lower, which in turn pushes the VIX lower. This is how the VIX works as a handy snapshot of the market’s expectation of the potential magnitude of SPX price changes.

But you can’t trade the VIX index itself. It’s just a number. That’s where the VIX futures come in.

## VIX FUTURES

You can see quotes and charts for VIX futures on the thinkorswim® by

**TRADER  
GLOSSARY**  
TURN TO  
PAGE 36



**FIGURE 1: Beware the VIX versus /VX.** The most common mistake trading VIX is confusing the options on VIX with the VIX itself. The options are actually based on /VX, or VIX futures (#1 above), which differs in price from the VIX (#2 above). Source: TD Ameritrade's thinkorswim platform. For illustrative purposes only.

market's future volatility. When you see the different expirations of /VX futures, the **basis** between them is the market's anticipation of where vol will be. For example, if you see the June /VX trading at 17, and the September /VX trading at 18, that's the market's way of telling you it anticipates higher vol by the time September rolls around. If the June /VX is trading at 20, and the September /VX is trading at 19, the market anticipates lower vol.

Near-term /VX futures tend to be more volatile than further-term /VX futures. And that usually means bigger, faster moves to the upside. The mechanics of the VIX and /VX can help explain why.

When the market starts to sell off quickly, traders and investors panic. The first thing they do is bid for OTM SPX puts, as either protection, or as speculation on a crash. That spikes the VIX index. The near-term /VX futures rally in anticipation the VIX

might stay higher, and that the price of the front-month /VX future will converge to a higher VIX price. Further-term /VX futures will rally, too. But not as much if the market believes it's less likely the VIX will stay at a higher price by those further /VX expirations. This explains why /VX futures can go into backwardation, with the price

of the front month /VX higher than the back-month /VX.

And don't be fooled by the relatively low prices of /VX futures. The contract size of the /VX futures is \$1,000. So if you buy a /VX future for 16, and it drops to 15, you'll be down \$1,000. The minimum tick size of /VX is 0.05, which represents \$50.

## VIX OPTIONS

VIX options are interesting. They're European-style, and cash-settled, meaning any **in-the-money** (ITM) options deliver cash equivalent to \$100 times intrinsic value at expiration. They settle to the same symbol—VRO—to which the /VX futures settle. To see VIX options, type in VIX on the Trade page of the thinkorswim by TD Ameritrade platform.

But here's the tricky part. VIX options are priced off the /VX futures, not the VIX index. (See Figure 1.) One concept in option pricing is that the options are priced off their hedge. For example, if you are short an XYZ call, you could hedge with long XYZ stock. That's because the options deliver shares in XYZ, and you can trade XYZ stock. So, you calculate the theoretical value of XYZ options with the price of XYZ.

At the closing bell, /VX basis trading isn't for the faint of heart. If you're already a proficient futures trader, consider this another tool in the strategy toolbox. But even if you're not ready to trade it, /VX basis can

TD Ameritrade platform using the symbol /VX. VIX futures are cash settled, meaning they deliver cash into your account equal to \$1,000 times the /VX settlement price at expiration. You can even see the settlement price on the platform with the symbol VRO. Basically, the /VX future, and VIX index, converge at expiration. Before expiration, though, /VX futures move up and down as traders speculate on whether vol might be higher or lower by a future's expiration.

Keep in mind there's no cost of carry for /VX futures because there is no underlying product like stocks, bonds, or commodities. So, the difference you see between the VIX index, and the /VX future is pure speculation on the



### TAKE ACTION:

**Open a Futures Account.** For qualified accounts, you'll need Level 3 options approval to trade futures. Log in to your account at [tdameritrade.com](http://tdameritrade.com). Under the Trade tab, go to Futures & Forex for more information.

certainly offer you clues as to how the market is forecasting volatility.

But you can't trade the VIX index. So, what's the hedge to a VIX option? The closest thing is the /VX future. When a trader has a short VIX call, he can hedge with long /VX futures, even though both the VIX call and /VX futures settle to cash. The key is that both VIX options and /VX futures settle the same symbol (VRO) on the same expiration date. Because the VIX and /VX converge at expiration, the /VX future can act as a hedge to VIX options, and be the underlying to calculate the "theo" value of VIX options.

When you look at VIX options prices, they may not always make sense. For example, with the VIX at 16, the 17 put with 60 days to expiration is only 0.20, and the 17 call is 1.20. The OTM 17 call is trading for more than the ITM 17 put because the 17 call only looks OTM, and that call and put aren't priced off the VIX at 16. Rather, they're priced off the /VX future that expires 60 days out and is priced at 18.

When considering VIX options, you'll also need to look at the /VX future that matches the options' expiration. If you're looking at June VIX options, you need to look at the June /VX future, because those VIX options are priced off the June /VX future. The price of the /VX future will tell you which calls and puts are ITM and OTM.

Now that you're more familiar with the VIX, /VX futures and VIX options, let's see how you can use them as a volatility asset class. If you think that vol is low at a given point, and think it might go higher, consider three strategies of varying risk and potential profit.

## VIX TRADING STRATEGIES

### STRATEGY 1:

#### BUY /VX FUTURE

This is the most aggressive strategy if you think vol will rise. It has the most risk and profit potential. And you need to choose the future expiration that matches your speculation.

Generally, the shorter term /VX future will rise and fall more than the further-term future. For example, if the S&P 500 crashes, the June /VX may rise 3 points, the September /VX may rise 2 points, and the December /VX may rise 1 point.

If you think volatility might rise sharply in the short-term, buying a near-term future might be the one to pick. If you do, compare its price to the price of the VIX. Remember, the two will converge at expiration. If the price of the near-term /VX is higher than the VIX, and if vol doesn't rise in time, the price of the /VX could drift downward toward the VIX. Longer-term /VX futures have less problems with convergence, but typically rally less should the market crash. Balancing price sensitivity and expiration is the key to trading /VX futures. (Just keep in mind that short-term trading strategies can incur high commission charges.)

### STRATEGY 2:

#### BUY VIX CALL VERTICAL

Pricing VIX options can be complex. But a long VIX call vertical spread still has risk limited to the debit you pay for it. And it's still a risk that the VIX could go higher. The same decision you have about which expirations to buy for a /VX future also applies to buying a VIX call vertical. In addition, you need to choose long and short strikes.

Take a look at the price of the /VX. That determines the at-the-money (ATM) strike in the VIX options. Buying a call one strike ITM and selling a call one strike OTM based on the price of the /VX creates a bullish strategy with less risk, but also lower profit potential than a long /VX future. This creates a more conservative strategy.

### STRATEGY 3:

#### LONG/VX, SHORT VIX COVERED CALL

Covered calls on volatility is the same type of strategy as covered calls on stock, but with important differences. When you sell an OTM call against long stock, you can collect income and reduce the effective cost basis of the long shares by the premium of the short, in exchange for limited profit potential. This can also work with a long /VX future and short VIX calls. Unlike covered calls in stock, quantity and expiration are more critical.

First, the value of the /VX future changes \$1,000 for every point. And VIX options change \$100 for every point. Because the /VX changes 10x more than the VIX option, you would sell 10 VIX calls against a single /VX future to create a covered call. If the

VIX settles above the strike price of the short VIX call, the loss on 10 of those calls would equal the profit on the long /VX future between the strike price and the settlement price.

Second, you must match the expirations of the /VX future and the VIX options. Remember, the VIX options are priced off the /VX future that expires at the same time. If you don't sell the VIX calls in the same expiration in which you're buying the /VX future, you're taking the risk of the /VX basis moving against you. For example, if you're long the September /VX future, and short 10 June VIX calls, and the market crashes, it's possible for the June /VX to rise more than the September /VX. Because your short VIX calls are in June, they're rallying along with the June /VX. But your long September /VX isn't keeping up. Your short June VIX calls can lose more than your long September VX is profiting. Keep the expirations the same to avoid the additional risk of changes in the /VX futures basis.

THESE ARE THREE IDEAS OF AMONG MANY if things are just mulling along and you think volatility might rise. As long as you understand volatility products and specific risks, you can employ many of the same strategies you'd use for index or equity options to speculate on vol going higher, lower, or staying the same.

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

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# SHIFT YOUR TRADING INTO HYPER-DRIVE.

Buckle your chin strap and get ready for cutting-edge insights and new strategies from pro speakers and fellow traders. No matter your skill level, this free event gives you everything you need to boost your trader know-how.

- Test-drive revolutionary trading platforms and learn new skills
- Get answers and insights from our TD Ameritrade platform experts
- Interact with industry visionary and veteran Tom Sosnoff, CEO of tastytrade<sup>®</sup>,\* Inc. and co-founder of thinkorswim<sup>®</sup>
- Bring a friend, because your friends are our friends



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# 3

## What makes your team special?

The majority of our team has between 10 and 30 years of derivatives experience. Many of our reps are former floor traders who worked in Chicago's three major exchanges. They bring a special combination of experience and efficiency I believe is unmatched in

the industry. As the trend continues toward complex products and strategies, having a former trader on the phone reassures clients that they're talking to an expert. This can only help the education process.

# 4

## What do you tell traders who want to be more successful?

One, you have to be disciplined and avoid letting emotion drive decisions. Two, in general there are two kinds of traders: those who love the thrill, and those who seek to slowly grind out profits and pursue success over the long term. Finally, trade what you know. If you don't understand futures, don't take them on until you learn about their potential benefits and risks. Start by paper trading. Talk to other traders.

# 5

## Skydiving, running with the bulls, what's next?

Maybe I'll get married some day?

## Doing the Math

EQUAL PARTS MATH WHIZ AND DAREDEVIL GUY, DERIVATIVES EXPERT PHILIP CARAVA AND HIS TEAM ARE ALWAYS JUST A PHONE CALL AWAY.

Interview by Kira Brecht / Illustration by Joe Morse

• SOME SAY THE SECRETS of the world are solved through a math problem. Philip Carava might agree. From learning multiplication tables at age four, to a college economics degree, Carava talked his way into his first job on the CBOE trading floor by answering—you guessed it—a battery of math questions. He joined TD Ameritrade in 2007. Carava's team in the OneTrader group are specialists in derivatives trading, and field they questions from the most active clients at TD Ameritrade Carava's claim to fame is twofold: a daredevil streak and legendary hair.

# 1

## Enlighten us about the OneTrader group.

We work with the most active traders. The market moves quickly. So we help folks understand every aspect of our platform technologies. We're also a sounding board for their trading ideas, and can talk them through various risk/reward strategies. Education is our highest priority.

Everyone has always used phones to monitor the market. But now clients are trading there. About 16% of our trades come from mobile platforms. I'm proud to say we're the industry leader.\* It's the fastest-growing part of our business, and we've spent a lot of time and resources on efficient mobile applications. When the market opens at 8:30 am CT, a lot of people are commuting. Now they can watch the market wherever they are.



**"I've hitchhiked twice in my life. First, in New Orleans and then in Paris. Both decisions proved to be among the better choices I've made."**

# 2

## Can you detail some trends you're seeing now?

There's a huge shift toward mobile. People are trading on their smartphones and tablets.

\*Mobile leadership claim based on analysis of publicly available competitor data concerning number of mobile users and daily average revenue trade levels.



# Hedging Against Tsunamis

DON'T BE CAUGHT ON THE WRONG SIDE OF A MAJOR SWING SHIFT. CONSIDER CALENDAR SPREADS TO HEDGE.

● PRO / TAKE AWAY: *How to dampen risk in futures trading with spreads*



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

• TRADERS ARE attracted to the futures market because of its fast pace, leverage, and flexibility. Yet, those benefits also come with the risk of large, directional moves that can catch unprepared traders on the wrong side of a trade. For instance, recent volatility in energy and interest-rate futures reminds us to consider using spreads as a way to keep a long-term perspective while softening short-term risk.

## FUTURES SPREADS

A futures spread is simultaneously buying one futures contract while selling a related contract. This might be the same underlying contract, but with a different delivery month. Or, it might be two different underlyings whose price movements react in similar ways to the same factors. The goal is to profit from changes in the *differential* of the contracts, rather than the outright price change in only one contract. Essentially, you're removing the directionality of the trade. You're also limiting the risk of your trade—and your profit—to the widening and narrowing of the spread. This can be a unique benefit.

## CALENDAR SPREADS

A calendar spread is the buying and selling of the same futures contract with different delivery months. Buying a calendar involves

buying a contract with a near-term expiration, and selling a second contract with a longer-dated expiration. A short calendar is the opposite. (Note: this is the opposite convention for currency and equity-index futures.)

For example, as of this writing, the difference between the Feb '16 (/CLG6 \$41.52) and Mar '16 (/CLH6 \$42.66) crude oil futures is -\$1.14. (See Figure 1, left.) This spread has been widening for several months, and is now wider than it's been over the past 12 months. If, at the time, you believed the nature of price movement in the market was mean-reverting, you might conclude from this chart that buying this spread would be appropriate. To buy the calendar spread, you'd buy the Feb '16 contract and sell Mar '16 contract against it. You profit if the spread narrows. And you'll likely lose if the spread widens.

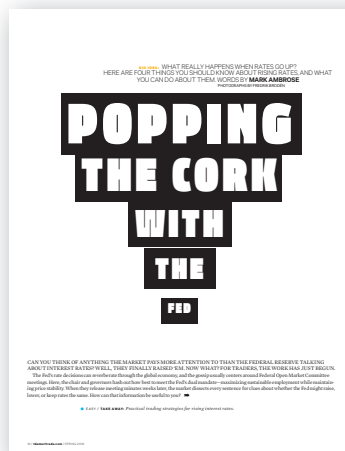
## MANAGING RISK

Although spread trading can be less risky than an outright futures position, you'll still need to be cautious. Related markets generally move in the same direction based on the same fundamental information. But there are times when spreads can be equally volatile. Positions should be monitored frequently, even if it's considered a longer-term investment or hedge. Likewise, positions should be carefully sized to avoid putting too much capital at risk. Always enter and exit both sides of the spread trade at the same time. Avoid exposing one side of the position to more risk.

Traders should always have a stop-loss point. The challenge in spread trading is that stop-loss orders become more complicated and are typically handled manually. Yet, don't be lulled into the idea that risk might be small because it's moving slowly. Be disciplined to stop yourself straight out of the trade. —Words by DEVIN EKBERG, INVESTTOOLS® CONTENT DEVELOPMENT MANAGER

### Figure 1: Calendar Spreads: Futures Style.

Not completely unlike it's equity-options brethren, there are some nuances in futures calendars to be aware of. For one, charting them in thinkorswim requires a different type of symbol. But the analysis is a simple three steps.



## Covered calls

PAGE 18

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

## Short put

PAGE 18, 30

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

## Long call vertical spread

PAGE 32

A defined-risk, directional spread strategy, composed of a long option and a short call option expiring in the same month. Long verticals are bullish and purchased for a debit. The risk of a long vertical is typically limited to the debit of the trade.

## Short put vertical spread

PAGE 12

A defined-risk, directional spread strategy, composed of an equal number of short (sold) and long (bought) puts in which the credit from the short strike is greater than the debit of the long strike, resulting in a net credit taken into the trader's account at the onset. Short put verticals are bullish. The risk in this strategy is typically limited to the difference between the strikes less the received credit. The trade is profitable when it can be closed at a debit for less than the credit received. Breakeven is calculated by subtracting the credit received from the higher (short) put strike.

## Vega

PAGE 26

A measure of an option's sensitivity to a 1% change in implied volatility. For example, if a long option has a vega of .04, a 1% increase in implied volatility will increase the option premium by \$4

## CBOE Volatility Index (VIX)

PAGE 30

The VIX measures the implied volatility (“vol”) of the S&P 500 index (SPX) option

## Basis

PAGE 31

The difference in futures prices in different expirations, or the cash (“spot”) price of the underlying product and the futures price.

## In the money (ITM)

PAGE 26, 31

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

## Out of the money (OTM)

PAGE 26, 30

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

## At the money (ATM)

PAGE 26, 32

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



## DISCLAIMERS

IMPORTANT INFORMATION YOU NEED TO KNOW

# 1

### GENERAL DISCLAIMER

*The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Past performance of a security or strategy does not guarantee future results or success.*

*Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. Options are not suitable for all investors as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options (<http://www.optionsclearing.com/about/publications/character-risks.jsp>) before investing in options.*

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

# 2

### OPTION STRATEGIES

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

*Spreads, condors, butterflies, straddles, and other complex, multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies and often involve greater risk, and more complex risk, than basic options trades. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security.*

*Maximum potential reward for a long put is limited by the amount that the underlying stock can fall. Should the long put position expire worthless, the entire cost of the put position would be lost.*

*When trading short option strategies, there is a risk in getting assigned early on the options sold, even if they go in the money by \$0.01, obligating you to deliver shares you don't own (in the case of a short call) or purchase shares (in the case of a short put).*

*The risk of loss on an uncovered short call option position is potentially unlimited since there is no limit to the price increase of the underlying security. Option writing as an investment strategy is absolutely inappropriate for anyone who does not fully understand the nature and extent of the risks involved.*

*The short naked put and cash-secured put strategies include a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.*

*Short naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance.*

*A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)*

# 3

### FUTURES

*Futures trading is not suitable for all investors as the risk of loss in trading futures is substantial. Futures trading privileges are subject to TD Ameritrade review and approval. Not all account owners will qualify. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Equity options trading involves risks and is not suitable for all investors. Spreads and other multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return.*

*Futures and futures options trading is speculative, and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products (<https://www.tdameritrade.com/retail-en-us/resources/pdf/TDA631.pdf>).*

# The Trader's Vacation Planner

**BIG IDEA:** WE'RE TRADERS, NOT TRAVEL AGENTS. BUT WHY SHOULDN'T WE TAKE ADVANTAGE OF SOME OF THE SPRING BREAK TRAVEL DEALS LIKE EVERYBODY ELSE? IF YOU'RE CONFUSED ABOUT WHICH DESTINATION IS BEST FOR YOU, TAKE THIS QUIZ TO FIND OUT.

## How long can you go without having Wi-Fi to trade while traveling?

- A** I can go a full day without trading—theoretically, that is.
- B** Is it expiration week?
- C** My longest bathroom break was 15 minutes.
- D** The same time it takes bond futures to tick up or down.

\* Answer A, B, C, or D here ➡

☐

## What would be your choice of hedge for a margarita?

- A** Hip flask of scotch.
- B** Big bowl of chips and a quart of guac.
- C** A good lawyer.
- D** Two more.

☐

## When was the last time your skin was exposed to the sun?

- A** Daily. Vitamin D gets my brain to find trades faster.
- B** I can't get sweaty. Slippery fingers make for sloppy trading.
- C** I warm myself from the glow of my trading screen.
- D** Only if lotion is involved.

☐

## Is a mostly vegetarian menu okay with you?

- A** I can suppress the gag reflex long enough to choke down tofu.
- B** Leafy greens remind me of money.
- C** If I can trade 'em, I eat 'em. Corn, soybeans, and wheat.
- D** Yes, as long as the vegetable is encased in a meatball.

☐

## How are you with crowds?

- A** I love mingling with non-traders to hear their stories about normal lives.
- B** The only crowd I like is the trading pit.
- C** Someone might see my secret charting pattern!
- D** This cheese stands alone.

☐

## What are your thoughts on indoor plumbing?

- A** I've held on to trades that stink worse than sewer gas.
- B** Commodes and put-call parity are what separate us from animals.
- C** One hand on TD Ameritrade Mobile Trader, the other taking care of business.
- D** Non-prickly bush or porcelain... six of one, half dozen of the other.

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### If you answered mostly As

**Room at the closest hotel:** Why risk a long trip? All you need for a break from the routine is to trade at a different desk and sit in a different chair in the same hotel you drive by on your way to the grocery store. Plus, there's room service and they change the sheets daily. Paradise.

### If you answered mostly Bs

**Ft. Lauderdale:** The confidence you have in trading will serve you well in the land where everyone else is one-third your age and has shoulders wider than their middles. Just make sure you max on the SPF so you don't look like a 6-foot downtick, and don't say "groovy" when you make a good scalp in /ES.

### If you answered mostly Cs

**Puerto Vallarta:** The slower pace south of the border is the perfect partner to time decay. You hit a few bids in the morning and let the clock do the work while you enjoy a bucket of beer on the beach and a little grilled mahi-mahi. Speaking of theta, if you're enterprising, you can sell calls against the ubiquitous time shares.

### If you answered mostly Ds

**Papua, New Guinea:** You're a self-directed vacationer. On this equatorial island, the probability of seeing anyone from your investment club is almost nil. But the presence of active volcanoes at this destination increases its implied volatility and boosts the odds of a hair-singeing Black Swan event.



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