

Strategies, analysis, and news for futures and options traders

# Futures & Options TRADER

December 2007 • Volume 1, Issue 9

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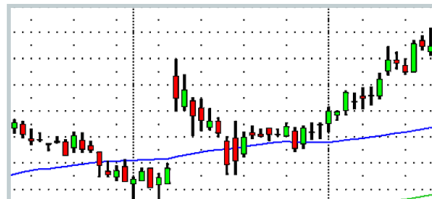
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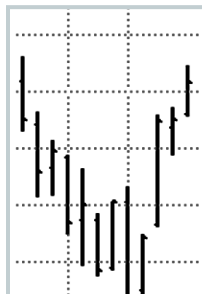
*By FOT Staff*

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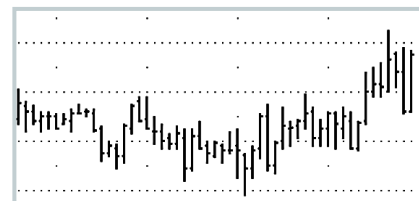
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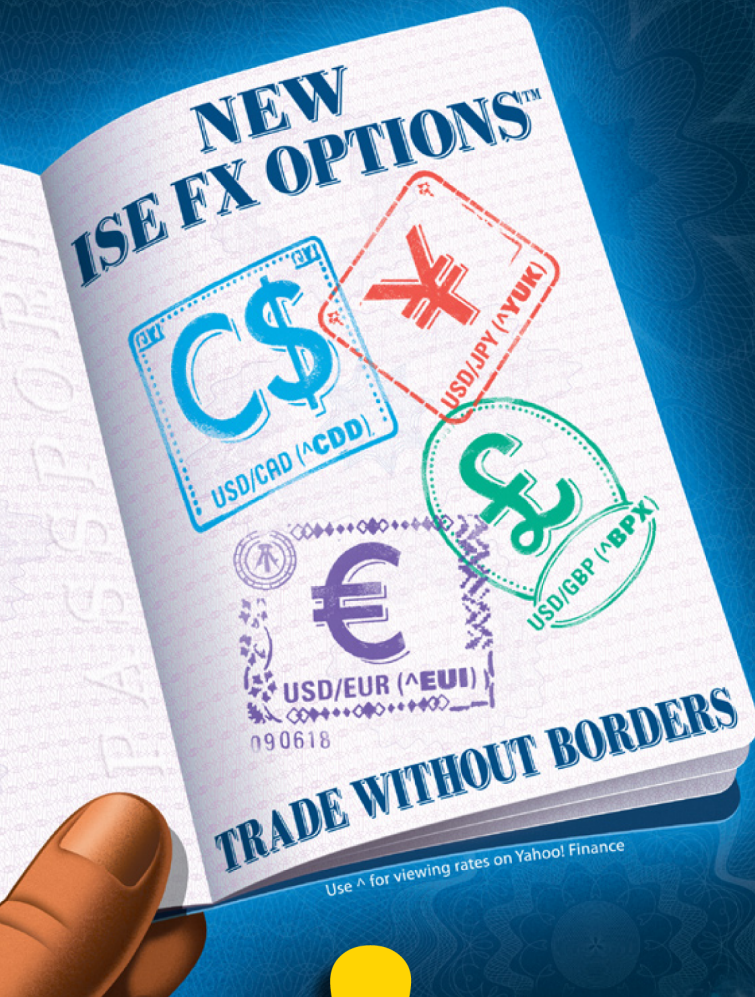
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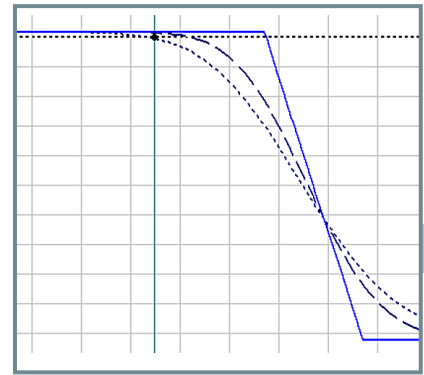
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**For all subscriber services:**  
www.futuresandoptionstrader.com

**Editor-in-chief:** Mark Etzkorn  
metzkorn@futuresandoptionstrader.com

**Managing editor:** Molly Flynn  
mflynn@futuresandoptionstrader.com

**Senior editor:** David Bukey  
dbukey@futuresandoptionstrader.com

**Contributing editors:**  
Jeff Ponczak  
jponczak@futuresandoptionstrader.com,  
Keith Schap

**Editorial assistant and  
Webmaster:** Kesha Green  
kgreen@futuresandoptionstrader.com

**Art director:** Laura Coyle  
lcoyle@futuresandoptionstrader.com

**President:** Phil Dorman  
pdorman@futuresandoptionstrader.com

**Publisher,  
Ad sales East Coast and Midwest:**  
Bob Dorman  
bdorman@futuresandoptionstrader.com

**Ad sales  
West Coast and Southwest only:**  
Allison Ellis  
aellis@futuresandoptionstrader.com

**Classified ad sales:** Mark Seger  
mseger@futuresandoptionstrader.com

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▼ **Marc Allaire** is a consultant to the Chicago Board Options Exchange, the Montreal Exchange, and other options industry firms. He also teaches finance at the University of Indianapolis and investments and derivatives at the Ningbo Institute of Technology in China. A former senior staff instructor at the Chicago Board Options Exchange's Options Institute, Allaire was a featured contributor to the CBOE's book *Options: Fundamental Concepts and Trading Strategies*, co-authored *Understanding LEAPS*, and is a regular contributor to professional publications on options, LEAPS, and trading strategies. His latest publication is *The Options Strategist*. He can be reached at [optionstrategist@aol.com](mailto:optionstrategist@aol.com).



▼ **AJ Monte** is part of The Market Guys, Inc. team, which is the exclusive education provider for E\*Trade's five million accounts worldwide. He has more than 25 years experience in the financial industry. Monte is the cohost of *Wealth & Wisdom*, a weekly financial show on WXEL PBS television in south Florida. He is also a chartered market technician and member of the Market Technicians Association.



▼ **Rick Swope** is also part of The Market Guys, Inc. team. His business background has allowed him to create and develop premier consultant teams across America. Swope is the cohost of The Market Guys' podcast, which is available on Apple iTunes. He is also the cohost of *Wealth & Wisdom*, a weekly financial show on WXEL PBS television in south Florida.



▼ **Jim Graham** ([advisor@optionvue.com](mailto:advisor@optionvue.com)) is the product manager for OptionVue Systems and a registered investment advisor for OptionVue Research.



▼ **Steve Lentz** ([advisor@optionvue.com](mailto:advisor@optionvue.com)) is executive vice president of OptionVue Research, a risk-management consulting company. He also heads education and research programs for OptionVue Systems, including one-on-one mentoring for intermediate and advanced traders.

▼ **Jim Kharouf** is a business writer and editor with more than 10 years of experience covering stocks, futures, and options worldwide. He has written extensively on equities, indices, commodities, currencies, and bonds in the U.S., Europe, and Asia. Kharouf has covered international derivatives exchanges, money managers, and traders for a variety of publications.





In the last two issues of *Futures & Options Trader* there have been articles by Steve Lentz and Jim Graham looking at two options strategies. These have both involved picking strike prices “*n*” standard deviations away from the underlying price, where the standard deviation was calculated by “using the implied volatility (IV) of the at-the-money (ATM) option.”

How does one use the IV of an option to get a standard deviation? I can’t seem to find an answer to this question.

— Brandon Wilhite

### Jim Graham responds:

When creating a lognormal distribution for an asset, you need to input a number of variables: the underlying price, the number of days ahead you are projecting to, dividend yield, interest rates, and future volatility. It is this last variable we are talking about. What the volatility will be in the future is unknown, so we use the current implied volatility (IV) of the ATM call option (in the appropriate expiration month) for this variable.

Most brokerage sites now offer IV as an available calculated field to be displayed with the option chain (we actually use the mid-point IV — between the IV calculated using the bid and ask prices).

There is a free probability calculator on our educational Web

site, <http://www.DiscoverOptions.com>. Given these variables, the calculator shows the underlying price one, two, and three standard deviations both above and below the market.

You need to register to access this tool, but it is free. I also like Larry McMillan’s *Option Strategist* newsletter and Web site (<http://www.optionstrategist.com>), but (if I recall correctly) his probability calculator only shows the probability of hitting a certain target price and does not display one, two, and three standard deviations of the lognormal distribution.

### Correction

“Adjusting your collar” (*Futures & Options Trader*, November 2007, p. 20) contained an error. Figure 3’s risk-profile graph showed the entire position’s risk and reward at the second expiration (April 2008), including the long 160 put on Apple Inc. that would have expired back in January.

As a result, the position’s total risk equals its debit of \$16,213 — not \$213 as Figure 3 and Table 2 stated. We fixed the article and reposted it on our Web site. If you’d like to read the corrected version, you can follow the original link and download the PDF file again.

*Futures & Options Trader* regrets the error.

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# The DEMA smoothing technique

Combining two exponential moving average (EMA) calculations helps create a trend indicator with less lag. Inserting it into a trading system shows how it compares to a standard EMA.

BY FOT STAFF

**M**oving averages are the most popular tool for smoothing price action and identifying the trend. The two most commonly used averages are the simple moving average (SMA) and the exponential moving average (EMA), which is a specific type of weighted moving average that emphasizes the most recent price data with the goal of creating a more responsive indicator.

Here, we look at a lesser-known way to smooth price data — the double exponential moving average (DEMA), which uses two calculations involving the EMA to reduce lag (the tendency for moving averages to trail price action).

Figure 1 shows a daily chart of the EuroFX futures (EC) with three moving averages, each of which has a 13-bar look-back period or smoothing technique. Let's review each of the calculations.

First, there's the 13-bar SMA (blue line), which is the sum of the 13 most-recent closing prices divided by 13.

Next is the 13-period EMA (red line), which uses a "smoothing constant" (SC) to give more weight to the most recent closing price. This weighted closing price is then added to yesterday's EMA value, which is also weighted (1 minus the smoothing constant):

$$EMA_{\text{Today}} = SC * \text{Close}_{\text{Today}} + (1-SC) * EMA_{\text{Yesterday}}$$

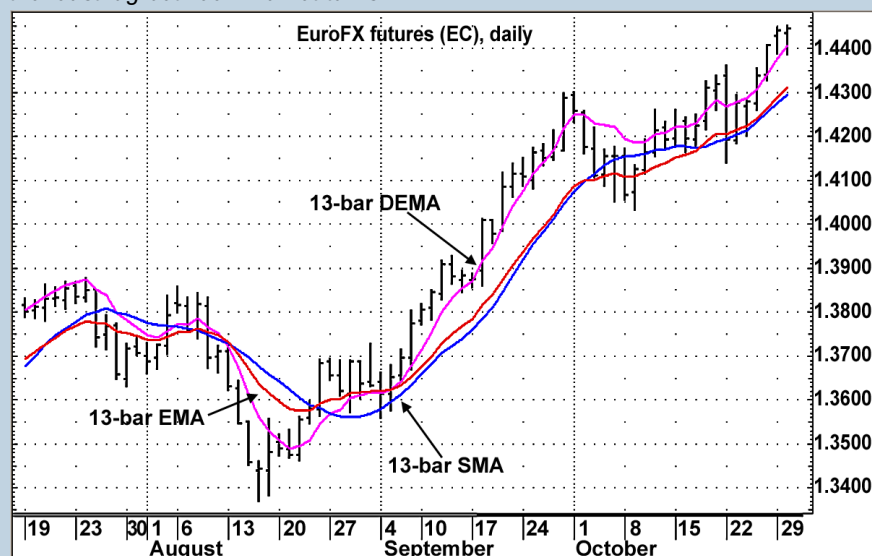
The smoothing constant (which ranges between 0 and 1) equates to an SMA look-period according to the following formula:

$$SC = 2/(n+1)$$

where  $n$  is the number of periods in an equivalent SMA's look-back period.

**FIGURE 1 — MOVING AVERAGE COMPARISON**

*The simple moving average lagged the market turns the most. The DEMA had the least lag between market turns.*



Source: CQG Integrated Client

For example, the smoothing constant to calculate a "13-period" EMA is  $2/(13+1) = 0.14$ . The larger  $n$  is, the smaller the smoothing constant, and the smaller the smoothing constant, the less impact the most recent price action will have on the EMA.

Because each bar's weighted closing price is added to the previous EMA value, one unique feature of the EMA is that the average changes direction as soon as price closes above or below it: If price closes above the EMA, the EMA will climb; if price closes below it, the EMA will drop. As a result, there is no lag when the closing price initially crosses the EMA.

The third average in Figure 1 is the double exponential moving average (DEMA), which was introduced by Patrick G. Mulloy in 1994.

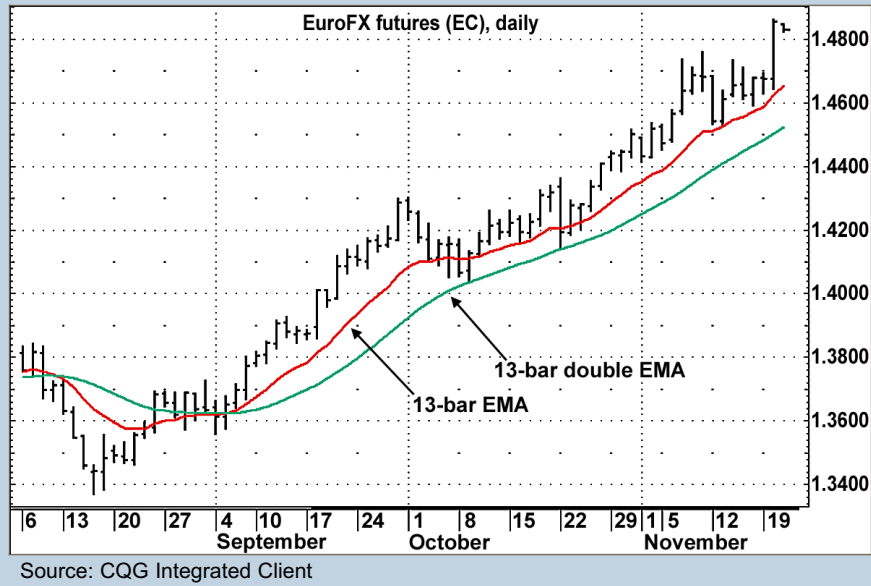
### Reducing lag with the DEMA

The DEMA calculates the difference between two components: a doubling of the basic EMA value and a "double smoothing" of the EMA value — that is, an EMA smoothed by a second EMA:



**FIGURE 2 — STANDARD EMA VS. DOUBLE SMOOTHED EMA**

Double smoothing creates a smoother average but also trails price more than the single EMA.



$DEMA = 2 * EMA - \text{double-smoothed EMA}$

For example, on Nov. 16, the 13-bar EMA value was 1.4574 and the double-smoothed EMA value was 1.4465, which makes the 13-bar DEMA value:

$$DEMA = 2 * 1.4574 - 1.4465 = 2.9148 - 1.4465 = 1.4683$$

One attribute of all moving averages is the tradeoff between smoothing and lag: The longer the average, the more it will smooth the data, but the more it will lag the data as well. The same is true for double-smoothing.

Figure 2 compares a single- and double-smoothed EMA (the latter being the second component of the DEMA calculation). Both averages smooth the price data, but the double-smoothed EMA smooths it more — and lags the price action more, as well. The 13-bar EMA turns up five days after the low bar in August, while the 13-bar double-smoothed EMA turns up eight days after that.

To counter this increased lag of the double-smoothed EMA, the DEMA calculation doubles the EMA in the calculation and subtracts the double-smoothed EMA from it.

In Figure 1, notice in the aftermath of the August bottom how the SMA was still declining even while prices were closing above it; it did not turn up to follow the uptrend until 10 bars after the August low. The EMA turned up five bars after the low bar and the DEMA turned up only four bars after it.

It is apparent how much more closely the DEMA tracks price compared to the SMA and EMA. This reduction in lag is a result of the difference between the two components.

**Comparing trading systems**

To illustrate the difference between the DEMA and the standard EMA, two simple systems were created and applied to EuroFX continuous contract data. The test period spanned January 2004 to Nov. 19, 2007.

The two systems use the [moving average convergence-divergence \(MACD\)](#) indicator, which in this case uses the difference between 26- and 13-period EMAs, plus a nine-period EMA of the primary MACD line, which is called the *continued on p. 10*

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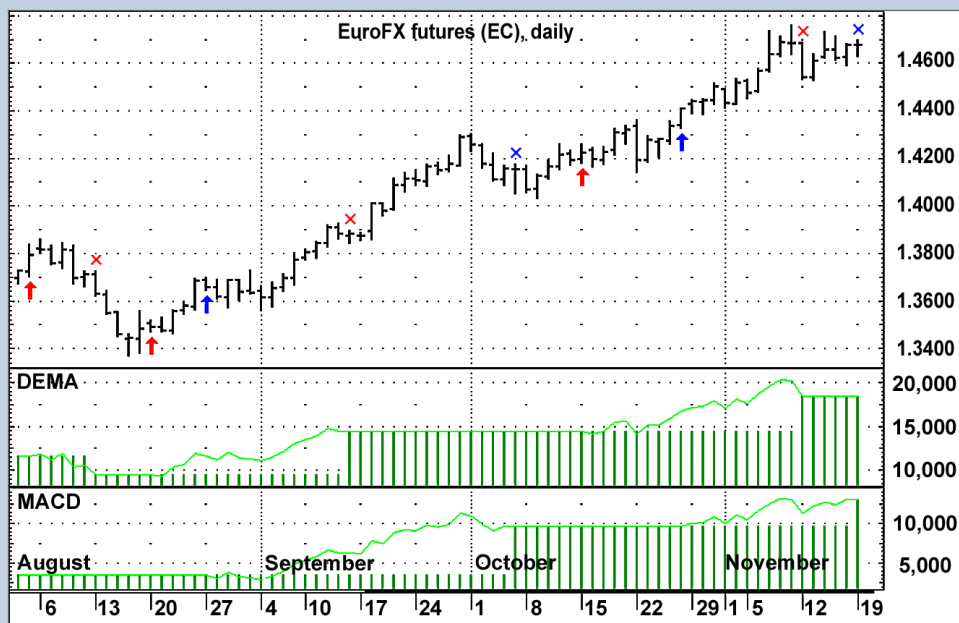
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**FIGURE 3 — TRADE SIGNAL COMPARISON**

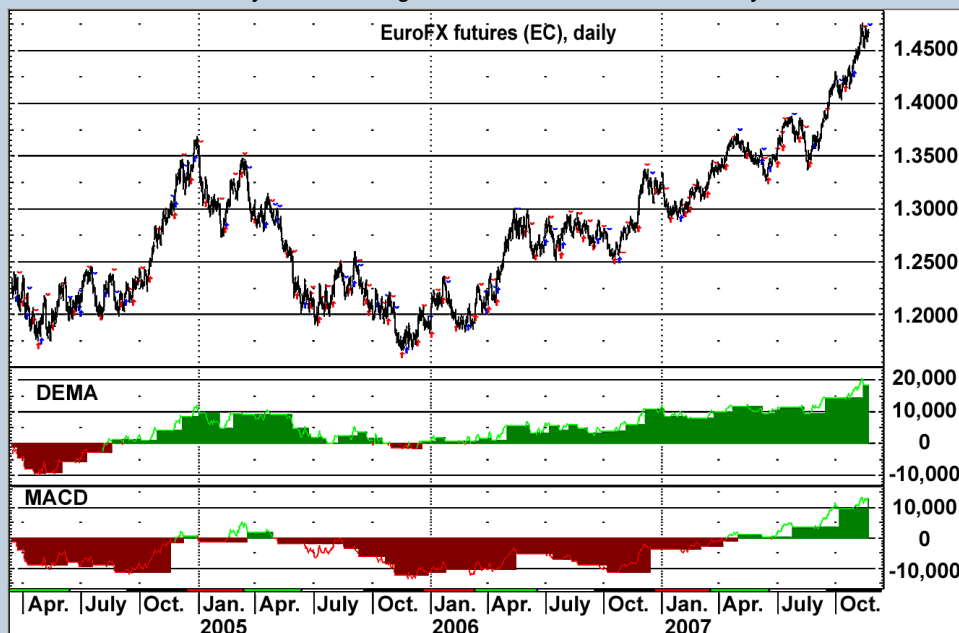
The DEMA system (red) has shorter trade lengths and tends to enter the market sooner than the standard system (blue).



Source: CQG Integrated Client

**FIGURE 4 — LONGER-TERM VIEW**

The green histogram represents closed profits and the red histogram represents closed losses. The standard system had larger drawdowns than the DEMA system.



Source: CQG Integrated Client

closing price on the day a signal is triggered.

The difference between the two systems is one uses the standard EMA calculation for the MACD while the other uses the DEMA calculation. Both use the default MACD moving average lengths of 26, 13, and 9.

Figure 3 shows some trade signals from August to November. On the chart, trades generated by the DEMA version of the system have red arrows at the entry bars and red Xs at the exit bars. Blue arrows mark the standard MACD trade entries and blue Xs mark the exits.

In Figure 4, the two panes below the price display the systems' realized profits and losses (green histograms and red histograms, respectively) as well as open profits (green line). The bottom pane shows the standard MACD version of the system and the middle pane contains the DEMA version of the system.

Figure 3 illustrates the aggressive nature of the DEMA smoothing. First, there is the much earlier entry signal after the August bottom. On the other hand, the DEMA system exited the first trade well before the market had stopped rallying. The standard system stayed in the trend longer, but exited after it had peaked. The DEMA system then re-entered the market earlier than the standard system.

Figure 4 is a longer-term view showing the two systems' performance from April 2004 to Nov. 19, 2007. This chart shows the standard system had deeper and longer drawdowns compared than the DEMA system.

Table 1 contains the performance details for the two systems. The DEMA system had a larger net profit (\$18,437 vs. \$13,037) and, more importantly, a smaller maximum drawdown (-\$13,612 vs. -\$18,325). Also, the DEMA system had 50 percent winning trades vs. 41.18 percent for the standard system.

"signal line."

The system trades only on the long side. A buy signal occurs when the MACD line first closes above the signal line (i.e., subsequent buy signals are ignored until an exit signal is triggered). An exit occurs when the MACD line first closes below the signal line. Trades are executed at the



**TABLE 1 — DEMA MACD VS. STANDARD MACD**

The DEMA version of the system had a larger net profit and smaller maximum drawdown than the standard version.

Test period: 1/1/04-11/19/07	DEMA	Standard	DEMA	Standard
Total net profit	\$18,437	\$13,037	Max consecutive wins	4
Closed net profit	\$18,437	\$13,037	Current consecutive wins	2
Total trade count	60	36	Maximum consecutive losses	5
Open position	1	1	Profit to max drawdown	1.35
Percent long	100%	100%	Profit loss ratio	1.38
Average duration	9	16	Percent winners	50.00%
Average profit	307	362	Average loss	-\$1,637
Average win	\$2,251	\$2,920	Maximum loss	-\$4,925
Maximum win	\$4,925	\$9,800	Maximum drawdown duration	504 days
Maximum closed drawdown	-8,862	-13,925	Maximum drawdown amount	-\$13,612

## Related reading

### “Weighted and exponential moving averages”

*Currency Trader*, January 2005. Weighted and exponential moving averages are designed to be more responsive to price changes than the simple moving average. But there are advantages and disadvantages to this sensitivity. This article includes a historical test comparison of simple, weighted, and exponential moving averages.

### “Trading System Lab: Anti-Trend EMA”

*Active Trader*, November 2006. The Anti-Trend EMA system inverts a short-term moving average crossover system to buy stocks on a down-scaled basis. Note: This article is also part of the “Trading System Labs, Vol. 2: Countertrend Trading” discounted article collection.

### “Trading System Lab: The weighted moving average system”

*Active Trader*, November 2004. Analysis of a trading system designed to catch longer trends using 30- and 60-day WMAs.

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On the other hand, the standard system’s largest win was \$9,800 vs. \$4,925 for the DEMA system. Other details in the table — including the number of trades — reflect the more aggressive nature of the DEMA compared to the standard EMA smoothing.

### The battle against lag

There are a number of ways to smooth data including various moving aver-

ages, such as simple, exponential, and weighted. The DEMA calculation uses a unique calculation that includes both double exponential smoothing and a differencing calculation.

Double smoothing can introduce lag while calculating differences can reduce lag. The DEMA technique can be used as a substitute for other moving averages when working with studies. 📌

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## Trading the plunge

As the year draws to a close, traders are still debating whether the stock market will rebound from the October-November sell-off or if it's just the beginning of a larger decline and recession.

This price-forecast model shows some interesting results.

BY FOT STAFF

**B**ear market. Recession. *Deep* recession.

These are just a few of the cheerful words that have been thrown around recently as the S&P 500 index dropped approximately 10 percent for the second time in three months. The seemingly endless reverberations of the housing collapse and uncertainty over a Fed that seems to have painted itself into a corner turned many days into wild roller-coaster rides as stocks kept trying, day after day, to mount a comeback — only to collapse in late trading. Just when the market seemed to be out of the woods for a day or two, sellers came rushing back in.

From the Oct. 11 high of 1,576.09 to the Nov. 26 low of 1,406.10, the S&P 500 index dropped 10.8 percent in a 31-day period (Figure 1).

### The pattern

The price model was designed to reflect the S&P 500's condition as of the end of trading on Nov. 27. The previous day the index had completed a 10.78-percent drop from the Oct. 11 high and made a new 20-day low. On Nov. 27 it made a higher low (and a higher close, although that was not included in the definition).

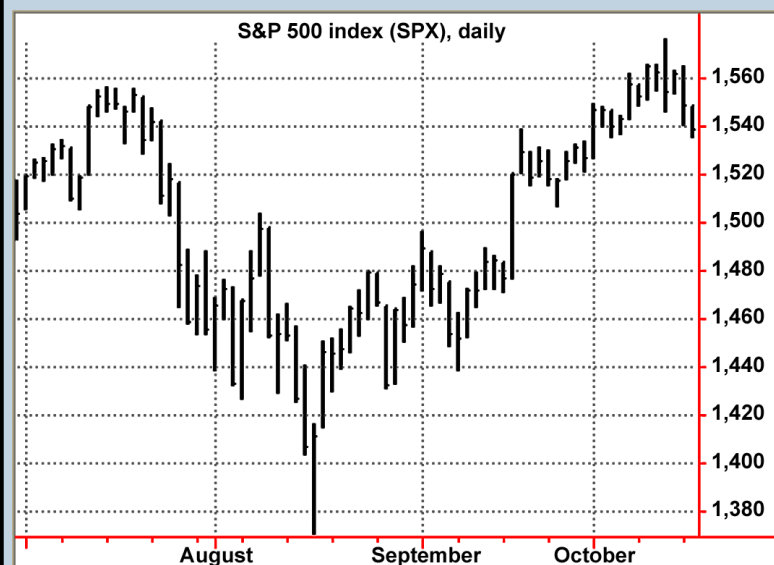
Ten percent corrections are relatively rare, and even rarer when additional criteria (such as requiring the low of the move to be a 20-day low followed by a higher low) are added to them; to get a more statistically reliable number of examples, the size of the sell-off was decreased to 8 percent (still quite large). The pattern rules were:

1. The decline from the highest high of 10 to 31 days ago to yesterday's low is greater than or equal to 8 percent.
2. The highest high of 10 to 31 days ago is higher than the highest high of 32 to 51 days ago.
3. Yesterday's low is below the preceding 20 lows.
4. Today's low is above yesterday's low.

The second rule is particularly important because it requires the high from which the 8-percent sell-off is measured.

**FIGURE 1 — JULY-AUGUST SELL-OFF**

*The S&P 500 fell more than 10 percent from the July high to the August low — only to rally strongly to the index's all-time high on Oct. 11.*



Source: TradeStation

ured to be above the high of the preceding 20 days. This is designed to avoid patterns that formed on the heels of a previous big sell-off or extended downtrend. As a formula, the rules are:

1.  $(\text{MAX}(H_{10}:H_{31}) - H_1) / \text{MAX}(H_{10}:H_{31}) \geq 0.08$
2.  $\text{MAX}(H_{10}:H_{31}) > \text{MAX}(H_{32}:H_{52})$
3.  $L_1 < \text{MIN}(L_2:L_{22})$
4.  $L_0 > L_1$

where

H = daily high  
 L = daily low  
 MAX – maximum  
 MIN = minimum  
 Subscripts<sub>0, 1, 2, etc.</sub>, refer to today, one day ago, two days ago, etc.

There were 42 previous sell-offs that met these criteria since October 1982, the first one occurring in February 1984 and the most recent forming in August 2007 (Figure 2).

Figure 3 compares the median returns after these patterns (one to 10 days and 15, 20, 40, and 60 days) to the median returns for same-length moves over the entire 25-year analysis period. Each day represents the percentage gain from the close of the last day of the pattern to the close that day. The percentage of gains (“%>0”) for each day, which represents how often the close on a given day was higher than the close of the pattern’s last day, are also shown.

The results are interesting. After an initial downturn the first two days,  
*continued on p. 14*

**FIGURE 2 — OCTOBER-NOVEMBER SELL-OFF**

Despite the recent correction in July-August, the S&P took another tumble from the October high, falling 10.78 percent to the Nov. 26 low.



Source: TradeStation

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the post-pattern gains jumped above the S&P's median gains from days 3 to 6 (peaking at day 4). From there the post-pattern returns essentially followed the S&P's typical performance, and slightly underperformed it after 20, 40, and 60 days.

Most analysis shows outsized returns after big sell-offs — i.e., the market usually tends to outdo its typical performance after taking a hard fall. This model shows the market was slightly weaker than its historical tendencies after the kind of correction that occurred in October and November.

Figure 4 shows the actual S&P closing price (blue) through Dec. 3, followed by the pattern model's projected prices (the prices after 15, 20, 40, and 60 days are simply connected by lines that do not represent interim price action). It is important to note that, even if the market does slightly underperform in the next few months, the model has the S&P 500 making a new all-time high sometime between Dec. 27 and Jan. 25.

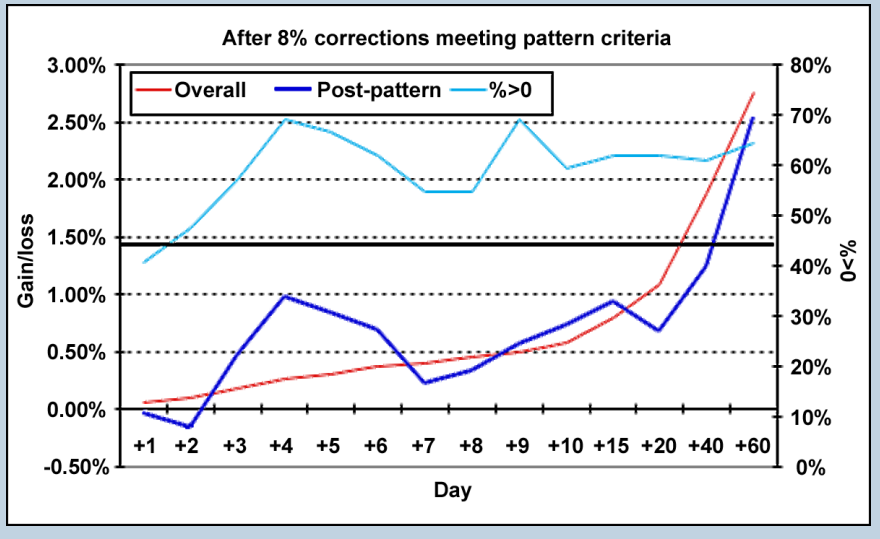
### Unquantifiable factors

As of Dec. 3, the S&P was inline with the model's estimates (and the S&P's overall historical median returns). However, as this represents only the fourth day into the post-pattern projection, it is still too early to determine whether the market is likely to do better or worse than the forecast. Which is always the rub with this kind of trading model: What inputs do you use to gauge whether the market — in this one instance — is likely to underperform or outperform a model which, after all, is a middle-of-the-road depiction of the market's possible course?

Also, this is certainly not the only pattern definition that could define the October-November downturn. It is possible some aspect of the price action (which other traders may notice) is absent from the model used here. In fact, this is not the only model that was analyzed for this article; this one happened to

**FIGURE 3 — 8%-PULLBACK PATTERN PERFORMANCE**

*Although the market has a strong tendency to outperform after big sell-offs, this price-pattern model shows the S&P to trade a shade weaker than its historical median performance.*

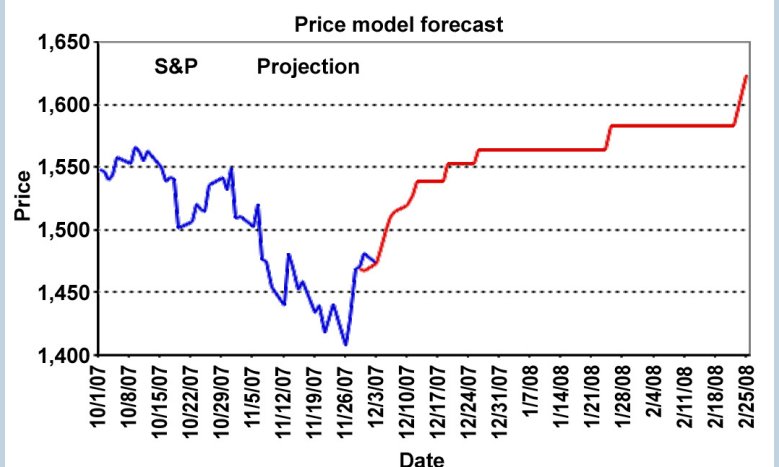


be the most robust and provide the most examples, however.

With the holiday season kicking into high gear, many traders are no doubt leaning toward an optimistic view. However, November is typically one of the strongest months of the year for the stock market, and that obviously was not the case this year. Ⓜ

**FIGURE 4 — POST-PATTERN PRICE PROJECTION**

*Will the market outperform or underperform the model's forecast?*



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# VIX options

Despite appearances, VIX options behave differently from other options.

BY MARC ALLAIRE

In February 2006 the Chicago Board Options Exchange (CBOE) listed options on its S&P 500 volatility index (VIX). The VIX tracks the implied volatility (IV) of selected S&P 500 options and measures the market's volatility forecast over the next 30 days.

VIX options represent a fairly abstract concept — options on an index that tracks the implied volatility of S&P 500 index (SPX) options. Despite their complexity, though, VIX options have become popular instruments among retail traders. In October 2006, VIX option average daily volume was only 27,574, a figure that jumped to 119,630 a year later.

However, the VIX doesn't behave like a standard stock index or futures contract, and its options are also somewhat counterintuitive.

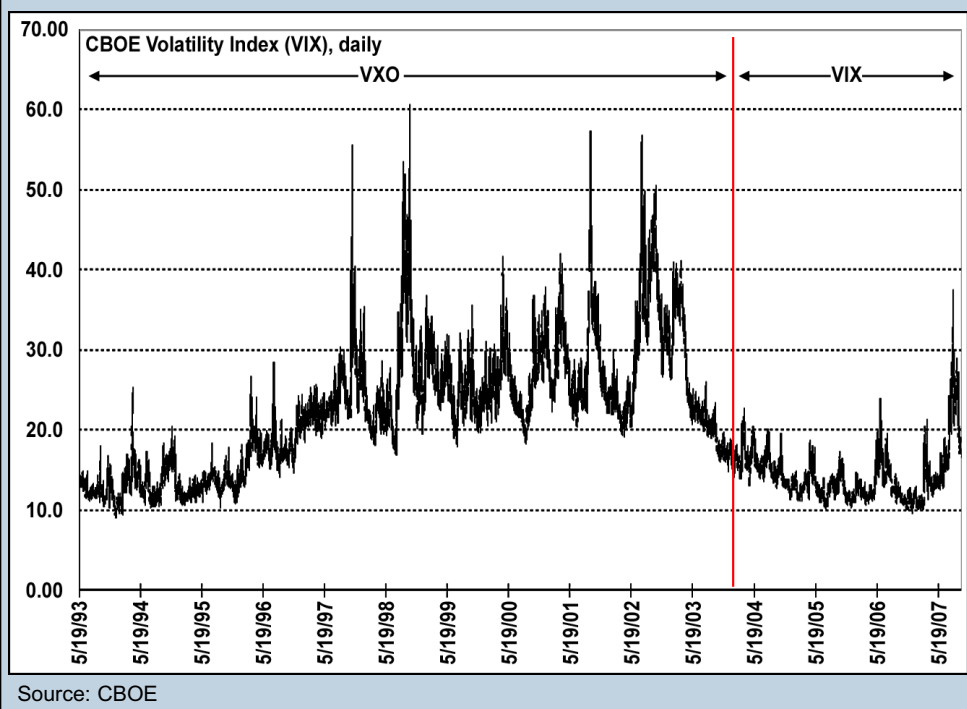
## Historical VIX patterns

Figure 1 shows a weekly VIX chart since May 19, 1993 and combines two symbols: The original volatility index (VXO), which was revised in September 2003 to become the current VIX. The original volatility index, which the CBOE still calculates, tracks the IV of eight at-the-money (ATM) options on the S&P 100 (OEX), while the current one measures the IV of various options on the S&P 500. For a detailed discussion of the VIX and this change, see "The volatility index" (p. 17).

The VIX dropped below 10 just a few times, and it spiked sharply (albeit briefly) much more often. Let's quantify these moves more precisely. Table 1 lists all the days in which the VIX fell below 10, either intraday or on a closing basis. Single-digit VIX readings were quite rare, as the volatility index stayed above 10 for more than 12 years from

FIGURE 1 — VXO AND VIX, 1993-2007

The VIX has dropped below 10 just a few times since 1993, and it spiked sharply much more often.



February 1994 to November 2006.

But what about those frequent spikes? Table 2 lists all 40+ VIX readings and shows the index rose above that level 17 times since 1993, seven of which were only intraday moves. Table 2 also suggests the VIX's highest close and its intraday high may have occurred on two different days.

## S&P 500 vs. VIX

The S&P 500 index and the VIX are mostly negatively correlated, which means when stocks climb, volatility tends to fall and vice versa. Figure 2's daily chart juxtaposes the S&P 500 and the VIX from January 2006 to mid-March 2007. The S&P 500 rose about 12 percent from early August through December, while the VIX declined from 15 to around 11. Similarly, when the S&P fell 3 percent in May 2006, the VIX spiked from about 12 to nearly 20.

This phenomenon is easily explained by the concept of options as insurance. When the market rallies every day, the demand for options (e.g., insurance) dries up; and when



buyers disappear, prices and IVs fall. If a market's decline seems dire, buying some insurance against further declines appears prudent.

### Interpreting the VIX

There are two ways to interpret the VIX: as a barometer that predicts where the S&P 500 could be headed or as a thermometer that shows how "hot" the S&P is. Traders who view the VIX as a barometer see VIX extremes as possible market turning points (see "Related reading"). This discussion, however, is limited to interpreting the VIX as a thermometer.

Because the VIX measures the temperature of S&P 500 options, it is most useful to SPX options traders. According to Figure 2, the S&P 500 dropped 4 percent in the first half of 2006, pushing the VIX up from 15 to the low 20s. At this point, let's assume you thought, "I've seen this before. The market has overreacted and will bounce back." If you are bullish, you could use the most basic bullish option strategy: buying calls on the S&P 500.

What's wrong with this scenario? Your explicit market forecast is bullish, but your implicit IV forecast is bearish, assuming you believe the historical inverse relationship between the S&P 500 and VIX will continue. If the market does rise, call values will climb, but they will also be hurt by a drop in implied volatility.

Buying calls may be profitable, but another strategy may offer a better return on investment (ROI). The solution: Enter a position that will benefit from both a rallying market and lower volatility. At the very least, make sure a bullish trade won't be hurt by an IV drop.

Strategies that fit these criteria include selling **puts**, **bull call spreads** (long call, short higher-strike call in same month), and **bull put spreads** (short put, long lower-strike put in same month). For these spreads, the short option's time premium should equal or exceed the long option's time premium.

### Look to the future(s)

An underlying security's price is one of the variables needed to calculate an option's price. (Other pricing variables include time until expiration, volatility, interest rates, and dividends.) If you trade options on stocks, indices, or futures, that variable is the current price or value. Stocks and indices can be bought or sold at their current prices, even if buying or selling the 500 stocks in the S&P 500 index is impractical for most retail traders.

But what about the VIX? It cannot be traded because it is just a number, not a true underlying security. Therefore, it can be neither bought nor sold. VIX futures (VX), on the other hand, can easily be traded. So the true underlying of VIX options is the VIX futures, which makes a big difference.

Consider the S&P 500 futures (SP). To calculate the

**TABLE 1 — LOW-VOLATILITY DAYS**

*Over the past 15 years the VIX has dropped below 10 on just 25 days. It remained above this level from Feb. 4, 1994 to Nov. 20, 2006.*

Dates	Days VIX below 10	Intraday basis	Closing basis
Dec. 20-29, 1993	8	1	7
Jan. 27-Feb. 4, 1994	7	5	2
Nov. 20-22, 2006	3	1	2
Dec. 14-15, 2006	2	1	1
Jan. 24-25, 2007	2	1	1
Feb. 2, 14, & 16, 2007	3	3	0

futures' theoretical price from the S&P 500 cash index, you should include **carrying costs** such as the risk-free interest rate and the index's dividend yield. Also the futures price doesn't stray too far from its theoretical value, because if it did, traders could profit from **arbitrage** techniques such as buying the S&P's component stocks and selling the corresponding futures contract.

It's a completely different situation with the VIX futures. Because no tradable underlying exists, VIX futures have no theoretical value, and arbitrage isn't possible. In other

*continued on p. 18*

## The volatility index (VIX)

The Volatility Index (VIX) measures the implied volatility of S&P 500 index options traded on the Chicago Board Option Exchange (CBOE). The VIX is designed to reflect the market expectation of near-term (in this case, 30-day) volatility and is a commonly referenced gauge of the stock market's "fear level."

The original VIX, launched in 1990, was derived from eight near-term at-the-money S&P 100 (OEX) options (calls and puts) using the Black-Scholes options pricing model.

The VIX underwent a major transformation in late 2003. The current index is derived from both at-the-money and out-of-the-money S&P 500 (SPX) calls and puts to make the index better represent the full range of volatility. At the same time the CBOE applied the new calculation method to the CBOE NDX Volatility Index (VXN), which reflects the volatility of the Nasdaq 100 index.

The exchange still publishes the original VIX calculation, which can be found under the ticker symbol VXO. Figure 1 shows both indices: the VXO from May 19, 1993 to Sept 19, 2003 and the new VIX over the next four years.

For more information about the VIX and its calculation, visit <http://www.cboe.com/vix>.



**TABLE 2 — HIGH-VOLATILITY DAYS**

*The VIX exceeded 40 more than a dozen times since 1993 and stayed above this level for 105 days overall.*

Dates	Days VIX above 40	Highest close	Intraday high
Oct. 27-28, 1997	2	39.96	55.48
Nov. 13, 1997	1	36.98	40.40
Aug. 27-Sept. 14, 1998	13	48.33	53.43
Sept. 17-21, 1998	3	42.33	46.82
Sept. 30-Oct. 15, 1998	12	48.56	60.63
April 14, 2000	1	39.33	41.53
March 22, 2001	1	39.70	41.99
April 3-4, 2001	2	39.33	40.77
Sept. 17-25, 2001	7	49.04	57.31
July 11-26, 2002	12	50.48	56.74
Aug. 1-15, 2002	10	49.31	49.83
Sept. 3-9, 2002	5	43.86	44.87
Sept. 12-Oct. 25, 2002	32	49.48	50.48
Jan. 27, 2003	1	39.77	40.89
Feb. 10, 2003	1	37.70	40.48
Feb. 13, 2003	1	38.48	40.68
March 12, 2003	1	38.99	41.16

**Where is the money?**

VIX options use VIX futures instead of the cash VIX as the underlying. VIX options are based on the futures' expected, or forward, VIX value at expiration, which differs from current VIX values because options in later-expiring months often have different IVs.

When VIX futures trade significantly above or below the cash level, the terms *in-*, *at-*, and *out-of-the-money* take on a slightly different meaning. Assume, for example, that VIX is 16.00, but the futures, which expire in three months, trade at 18.00. This suggests the market expects higher volatility, because the futures price is driven by expectations, not arbitrage opportunities.

If you buy a 16-strike VIX call, you may think it is ATM, but, in reality, that call is priced as if it is 2 points in-the-money. And if you buy a 16-strike put, it will be priced as if it is 2 points out-of-the-money, not ATM as it appears. In this scenario, the

call appears expensive and the put seems cheap.

Although VIX put buyers may be duped by this discrepancy, they still have an inherent advantage, because VIX options settle to the VIX cash index, not VIX futures. The VIX cash index represents the market's volatility expectations

within 30 days, so as VIX options near expiration, the actual VIX becomes more accurate as an underlying security. As expiration approaches, both VIX options and the VIX index are based on the S&P 500 options in the same month.

Suppose you buy a 17-strike VIX put when the cash VIX is 16 and the VIX futures trade at 18. When you enter the trade, the put is priced one point OTM, but it will expire one point ITM if the VIX remains unchanged.

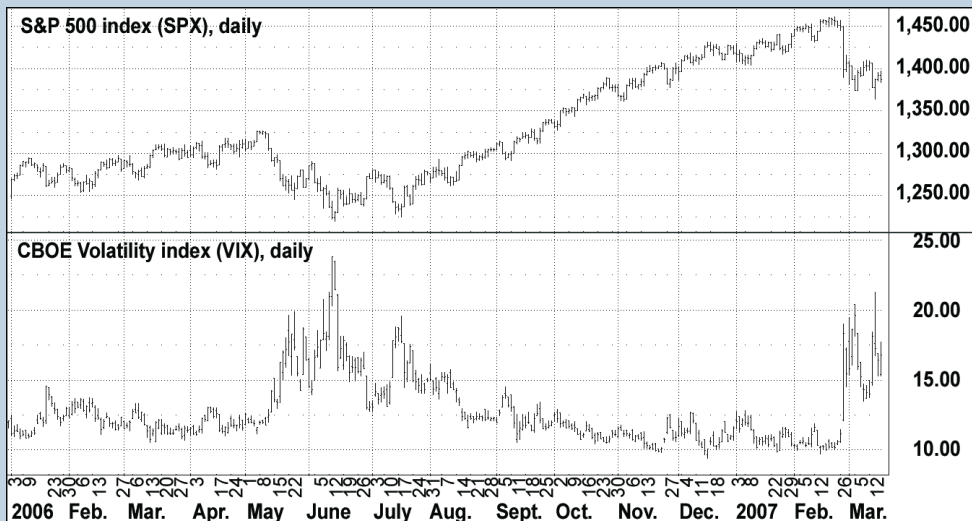
**Strategy implications**

You should also remember the VIX index behaves differently from stocks and other indices. For example, a stock can jump from \$100 to \$400 and never

words, no buy programs kick in if VIX futures seem overpriced and no sell programs are triggered by seemingly underpriced futures. The cash and futures VIX prices can diverge significantly from one another, and the gap can remain for extended periods of time.

**FIGURE 2 — S&P 500 AND VIX**

*The S&P 500 and VIX are negatively correlated, which means one tends to fall as the other rises and vice versa. Notice how the VIX climbed to 20 as the S&P 500 fell in May 2006 but slipped below 10 as the S&P rallied in November.*



Source: eSignal

trade at \$400 again (think Google, at least so far). But if VIX jumps from 10 to 40, the odds are fairly good that it will drop below 40 again. Table 2 shows the VIX has never stayed above 40 for more than 32 days. This historical pattern has implications for strategies such as selling naked calls.

When you sell an uncovered call, you collect premium in exchange for the obligation to sell stock to the call's holder at the strike price, which translates to theoretically unlimited risk. Although you can debate whether this upside risk is really unlimited, you can easily get wiped out if the market rallies and get caught on the wrong side of a short naked call.

For VIX, the risk of selling naked calls is running out of money before the market proves you right. In other words, naked call sellers need to hold a great deal of capital so that if they get caught by one of the VIX's unexpected spikes, they will have enough staying power to outlast margin calls.

Selling naked puts could be a portfolio-hedging strategy. A market correction could hurt you, but if you sell VIX puts as a hedge, the premium you collect will help offset those losses. However, this strategy is risky if the market either goes nowhere or rallies consistently. In these situations, the VIX will probably drop.

### **Six degrees of separation**

If the VIX index acts as a thermometer and shows how "hot" SPX options are, how can you gauge the temperature of VIX options themselves? The answer is the implied volatility of VIX options. A note of caution here: You might generate some bizarre results if you calculate VIX options' implied volatility with option-pricing software designed for stock or index options.

One of the assumptions behind these models is that an underlying's returns are normally distributed, which means there is an equal possibility of a positive or negative return, and that most returns will be relatively small with few very high or low returns. But the VIX is a mean-reverting index, so this assumption is inaccurate. In other words, the VIX has a long-term tendency to move back toward its mean, which is about 16 percent.

Expect unusual IV values when the VIX trades at extreme lows or highs. If VIX is above 40, then it is more likely to drop than climb — the odds of it going in either direction are no longer even. An accurate implied volatility estimate would have to take into account this mean-reverting phenomenon. 📍

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For information on the author see p. 6.

## **Related reading**

### **Marc Allaire articles**

#### **"Putting put-call parity to work"**

*Futures and Options Trader*, August 2007.

Theories don't pay the bills. This analysis focuses on the practical side of the put-call parity equation.

#### **"Rolling profitable covered calls"**

*Futures and Options Trader*, April 2007.

Taking profits on a winning covered call is tempting, but extending the trade another month could generate additional profits. This first installment of a two-part series examines the benefits and drawbacks of rolling a profitable covered call position as expiration nears.

#### **"Repairing a losing covered call"**

*Futures and Options Trader*, May 2007.

This sequel to the first article on covered calls shows how several repair strategies can help minimize a covered call's losses — and can occasionally even turn a loser into a winner.

#### **"Straddles vs. strangles, round two"**

*Options Trader*, January 2007.

Neither strategy always outperforms the other. However, having a clear price forecast makes it easier to select the best position.

#### **"Selecting calls based on ROI"**

*Options Trader*, October 2006.

Traders seem drawn to complex options strategies, but sometimes simply buying calls is the best way to catch an up move. Learn how to weigh the possibilities by comparing various calls' return on investment.

### **Other articles**

#### **"Getting a grip on implied volatility"**

*Options Trader*, February 2006.

Implied volatility is a crucial, but often misunderstood, concept. We explain what it means and how you can use it to improve a trade's chance of success.

#### **"VIX-based system"**

*Active Trader*, January 2006.

This test uses a system described by Larry Connors in the TradingMarkets.com blog on Sept. 16. The system tries to find oversold situations in the S&P by identifying VIX spikes.

#### **"Forecasting the VIX"**

*Active Trader*, June 2005.

A novel approach to analyzing the VIX results in a volatility forecasting technique and countertrend volatility trading method.

#### **"The volatility market connection"**

*Active Trader*, March 2004.

Is everything you know about volatility wrong? Find out what history says about the volatility-market relationship — and what the VIX is saying about the stock market's 2004 prospects.

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# Options and risk management

A simple adjustment allows you to apply traditional risk-control techniques to options trades.

BY RICK SWOPE AND A.J. MONTE

One of the biggest challenges traders face is keeping their emotions out of trade decisions. Professional traders often rely on colleagues to help them control risk, but most traders are on their own. No one is reminding you to exit trades or reduce risk before the close each day, so you are more likely to hold losing positions overnight.

Managing risk is fairly straightforward for stock and futures traders, who can simply set stop-loss orders and exit trades without too much slippage. If you trade highly liquid stocks, for instance, you can often exit trades within pennies of your stop price.

For options traders, however, controlling risk is more dif-

ficult because of wider bid-ask spreads, **time decay**, and complex, multi-leg positions that take time to unwind. The following example illustrates how to limit a trade's risk to one percent of account value using standard money management techniques, such as position sizing (e.g., determining how many shares of stock to trade by calculating per-share risk). This approach is translated to option positions by using each option's **delta** to determine how many contracts to trade.

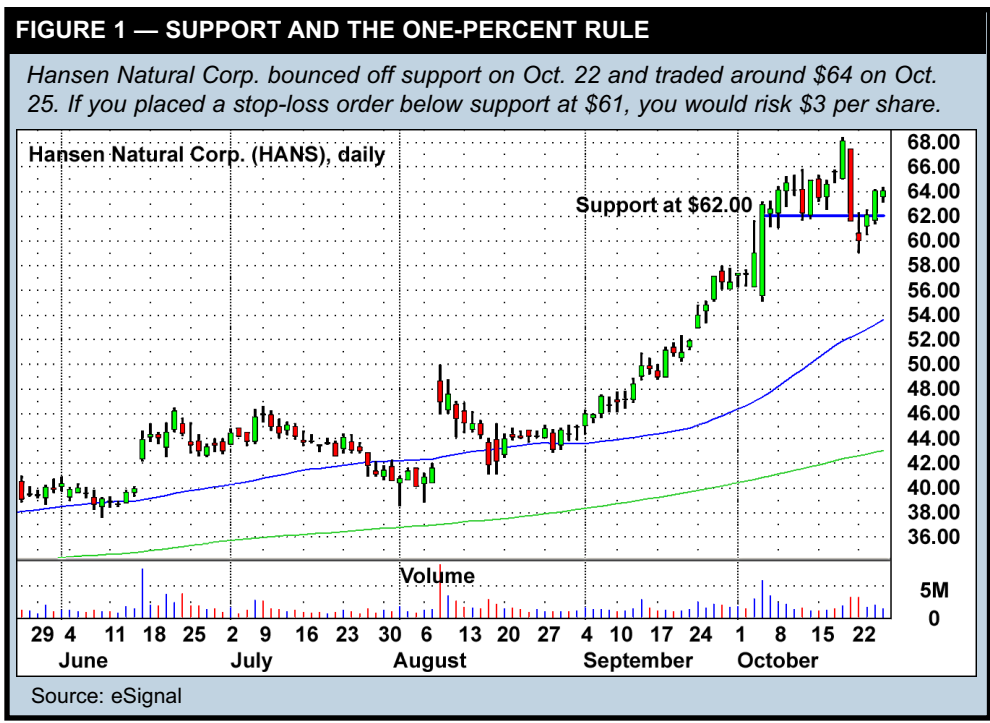
### The one-percent rule

The one-percent rule for managing risk limits your loss on a trade to one percent of total account value. This rule is

especially helpful when you apply it to an entire portfolio. If, for example, you are holding five positions and are stopped out of all of them, your entire portfolio won't lose more than five percent.

It's not always possible to limit risk to one percent because markets sometimes open much higher or lower than their previous closing price. Such large opening gaps typically appear after surprising (good or bad) news hits the Street; they can hurt a trade before you get a chance to exit.

Despite this caveat, the one-percent rule allows you to set a predetermined exit point for each position. Consider an example of how to use this rule when trading stocks and futures. To calculate the risk



amount based on a \$100,000 account:

Risk amount = 1 percent  
of account value = 0.01 \*  
\$100,000 = \$1,000

Notice you do not know anything about the actual trade at this point. This is an important point, because many new traders mistakenly believe they should exit after a position moves against them by one percent. However, the one-percent rule is only applied to account equity and is just a first step.

The second step is to identify the risk per share. Figure 1 shows Hansen Natural Corp. (HANS) fell in late October before rising from the \$62 support level that began to form earlier that month.

Suppose you bought HANS at \$64 on Oct. 25. Because there is support around \$62, you might place a sell stop at \$61, just below that level. The risk per share would be:

Risk per share = entry price  
(\$64) - stop price  
(\$61) = \$3 per share

The final step is determining position size to calculate how many shares to trade by dividing the risk amount by the risk per share:

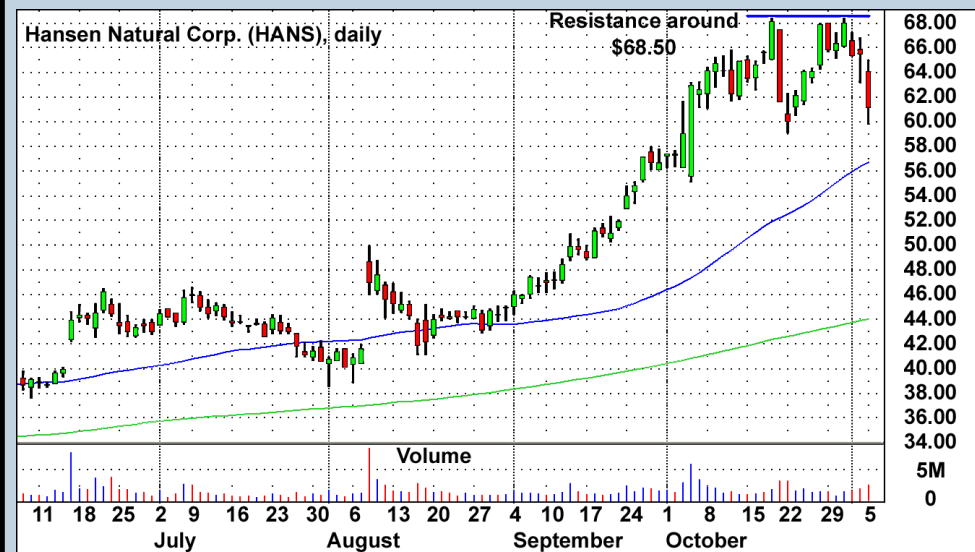
Position size = risk amount  
(\$1,000)/risk per share (\$3) =  
333 shares

This means you could trade up to 333 shares of Hansen Natural, assuming you had a \$100,000 account and risked \$3 per share.

Figure 2 shows HANS rallied toward a resistance level around \$68.50 on Oct. 31 and failed to break above it. Price then fell 10.9 percent to \$61 and triggered the sell-stop order at

**FIGURE 2 — TRIGGERING THE STOP-LOSS**

*Hansen Natural failed to break above resistance around \$68.50 and fell 10.9 percent to the \$61 stop-loss by Nov. 5.*



Source: eSignal

1:50 p.m. ET on Nov. 5. Ideally, you should have exited this trade when Hansen Natural failed to break above resistance — a bearish sign. But even if you held HANS when it tanked in early November, your loss would have been capped at \$1,000.

**Applying the rule to options**

You can use this same risk-management approach with options by using delta to adjust the per-share risk.

Instead of buying HANS at \$64 on Oct. 25, you could have bought one June 2008 55 call option. The call cost \$16.20, included about \$9 of intrinsic value, and expired in eight months.

Table 1 shows the trade’s details. To apply the one-percent rule to this trade, multiply the call’s 0.70 delta by the \$3 risk per share amount. (It is more precise to account for delta’s change [gamma] as HANS price falls, but the “static” delta value of 0.70 provides an adequate estimate.) If HANS dropped from \$64 to \$61, the call’s bid should decline from \$15.70 to \$13.60, because a \$3 per-share drop should

*continued on p. 22*

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roughly equal a \$2.10 decrease (0.70 delta \* \$3) in the call's bid. Based on an exit price of \$13.60, the call's risk is \$2.60, and you could buy up to 385 shares or four calls and still limit your total loss to \$1,000.

Alternately, you could have bought a (front-month) November 2007 55 call option for \$10.90 (Table 2). This option had a delta of 0.85. To apply the one-percent rule, first calculate the exit price of \$7.95 (\$10.50 bid - [0.85 delta \* \$3 risk]). Based on this exit price, the option's risk is \$2.95, and you could buy up to 339 shares, or just three calls.

Notice the November call's risk and position size make it nearly identical to an outright stock position because its bid-ask spread is tighter than the June call's by \$0.10 and its delta is larger.

Instead of simply buying a call, you could enter a **diagonal call spread** by buying one June 55 call for \$16.20 and selling one **out-of-the-money (OTM)** November 70 call for \$2.25. Selling the OTM front-month call lowers the overall cost to \$13.95 (and also reduces the risk), although it caps the maximum gain (at the first expiration).

**TABLE 1 — LIMITING RISK ON OPTIONS**

*You could buy up to four June 2008 55 calls on HANS for \$16.20 each and still limit risk to 1 percent of total assets.*

Component	Long/short	Bid-ask	Delta	Per-share credit/debit	Dollar cost
1 June 2008 55 call	Long	\$15.70-\$16.20	0.70	-\$16.20	-\$1,620.00
<b>Exit price:</b> \$13.60 = \$15.70 - (0.70 delta * \$3 risk amount)					
<b>Risk per share:</b> \$2.60 = \$16.20 - \$13.60					
<b>Position size:</b> 385 shares = \$1,000 risk amount / \$2.60 risk per share					

**TABLE 2 — LIMITING RISK ON SHORTER-TERM OPTIONS**

*Buying up to three November 2007 55 calls for \$10.90 each limited risk to 1 percent of total assets.*

Component	Long/short	Bid-ask	Delta	Per-share credit/debit	Dollar cost
1 November 2007 55 call	Long	\$10.50-\$10.90	0.85	\$10.90	-\$1,090
<b>Exit price:</b> \$7.95 = \$10.50 - (0.85 delta * \$3 risk amount)					
<b>Risk per share:</b> \$2.95 = \$10.90 - \$7.95					
<b>Position size:</b> 339 shares = \$1,000 risk amount / \$2.95 risk per share					

**TABLE 3 — DIAGONAL CALL SPREAD**

*You could buy up to four June/November call diagonal spreads for \$13.95 each without risking more 1 percent of total assets.*

Components	Long/short	Bid-ask	Delta	Per-share credit/debit	Dollar cost
1 June 2008 55 call	Long	\$15.70-\$16.20	0.70	-\$16.20	-\$1,620.00
1 November 2007 70 call	Short	\$2.25-\$2.50	0.10	\$2.25	\$225.00
<b>Net debit at entry:</b> \$13.95					
<b>Exit price of June 2008 55 call:</b> \$13.60 = \$15.70 - (0.70 delta * \$3 risk amount)					
<b>Exit price of November 2007 70 call:</b> \$2.20 = \$2.50 - (0.10 delta * \$3 risk amount)					
<b>Net credit at exit:</b> \$11.40 = \$13.60 - \$2.20					
<b>Risk per share:</b> \$2.55 = \$13.95 - \$11.40					
<b>Position size:</b> 392 shares (4 options contracts) = \$1,000 risk amount / \$2.55 risk per share					



Table 3 shows how to apply the one-percent rule to this diagonal spread. If HANS broke below support at \$62 and you unwound the spread at \$61, the spread's exit price would be \$11.40. Based on this price, the spread's risk per share is \$2.55 (\$13.95 cost - \$11.40 exit). Accordingly, you can trade up to 392 "shares" (\$1,000 / \$2.55) or four contracts per leg.

### The elephant in the room

You can modify the one-percent rule several ways, including accounting for gamma if the stop level is significantly different from the entry price. If your stock's stop level is several dollars and your option has a high gamma, then focusing on a fixed delta may not be the best way to estimate premium at the stop-loss. Although there are countless ways to manage risk, the point is to have a system and stick to it.

When managing risk, we must constantly battle our skewed perception of the risks we face. In his book *Against the Gods: The Remarkable Story of Risk*, Peter Bernstein relates this story:

*One winter night during one of the many German air raids on Moscow in World War II, a distinguished Soviet professor of statistics showed up in his local air-raid shelter. He had never appeared there before. "There are seven million people in Moscow," he used to say. "Why should I expect them to hit me?" His friends were astonished to see him and asked what had happened to change his mind. "Look," he explained, "there are seven million people in Moscow and one elephant. Last night they got the elephant."*

Ultimately, if you manage risk at some level, you will accept small losses and move on to the next trade instead of letting those losses threaten your livelihood. 📍

For information on the authors see p. 6.

## Related reading

### **Risk control and money management articles:**

#### **"Principles of risk control and money management"**

*Active Trader*, January 2003.

While some traders argue various aspects of trading are more art than science, that's not the case with basic risk control and money management concepts. Learn three rules of position sizing, capital allocation, and stop placement that illustrate the principles of objective trading.

#### **"Putting stops to the test,"** *Active Trader*, March 2002.

Placing stops effectively requires understanding how your strategy, trade size and account equity interact. Here's an approach that allows you to systematically find the best stop for your trading system.

#### **"No such thing as bad luck,"** *Active Trader*, January 2002.

Ideally, you should risk the same percentage of your capital on every trade. But determining that figure isn't as straightforward as it sounds. Here's how to find the right amount to risk for your strategy and how you can increase your odds of success.

#### **"Finding the right amount,"** *Active Trader*, December 2001.

Luck plays a role in even the best trader's career. But limiting the role of luck — especially bad luck — means controlling as many risk factors as possible. Sizing your trades appropriately is one way to do it.

#### **"Reining in risk,"** *Active Trader*, July 2000.

A look at fundamental money-management concepts, tools, and ideas on how to implement them.

### **Options articles:**

#### **"Long-term diagonal call spreads"**

*Futures and Options Trader*, November 2007.

This detailed look at diagonal spreads shows how to trade them with a long-term perspective.

#### **"Delta for the rest of us,"** *Options Trader*, October 2006.

A few simple concepts shed light on delta and how option prices change.

#### **"Selecting calls based on ROI,"** *Options Trader*, October 2006.

Traders seem drawn to complex options strategies, but sometimes simply buying calls is the best way to catch an up move. Learn how to weigh the possibilities by comparing various calls' return on investment.

#### **"Speculating with stock options,"** *Options Trader*, April 2006.

Many option traders scoff at the notion of buying calls instead of simply going long the underlying market, but in the right circumstances, options can offer distinct advantages.

Several of these articles are included in the **"Risk Control and Money Management"** collection of 22 articles that offer a variety of strategies for limiting risk, maximizing profit, and managing trades — regardless of your particular trading approach. Topics range from nuts-and-bolts discussions about the number of shares or contracts to trade and stop placement to more advanced concepts such as diversification between multiple trading systems, MAE-MFE analysis, Optimal f, and Monte Carlo simulations.

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[http://www.activetradermag.com/purchase\\_articles.htm](http://www.activetradermag.com/purchase_articles.htm).



# Trading credit spreads with the MACD

**Market:** Options on the S&P 500 futures (SP). This system could also be applied to other stock-index futures, indices, and exchange-traded funds (ETFs) with liquid options contracts.

**System concept:** Vertical credit spreads are popular because they limit risk and allow you to make money even if your directional forecast is imprecise. Past Options Labs have entered credit spreads based on a variety of technical indicators, including moving averages, *stochastics*, and the *Average Directional Movement Index (ADX)*.

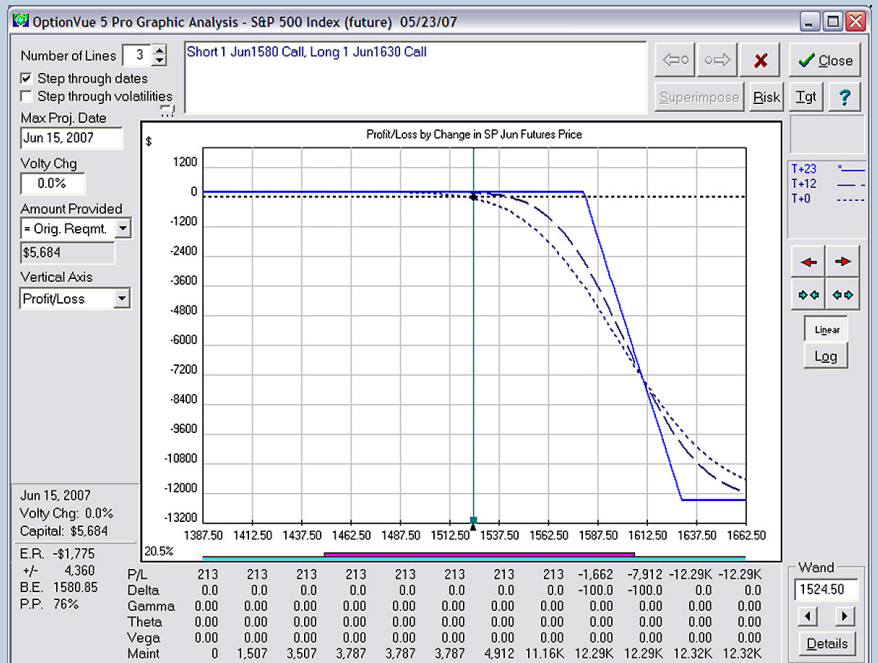
This system compares new 20-day highs and lows with *Moving Average Convergence Divergence (MACD)* readings to identify bullish or bearish signals. A bullish divergence signal occurs when price drops as the MACD rises, while a bearish divergence signal appears when price climbs as the MACD declines. Standard parameters (12-26-9) were used.

After a signal triggers, the system enters a credit spread by first selling an option one standard deviation *out-of-the-money (OTM)*. Then the system buys a farther OTM option of the same type. The market would need to reverse direction by more than a full standard deviation before the trade is stopped out — a relatively unlikely event.

Figure 1 shows possible gains and losses of a June 1,580/1,630 call credit spread entered on May 23, 2007. The trade would be profitable as long as the S&P 500 futures trade below 1,580.85 by the June 15 expiration date. The spread has a 76-percent chance of capturing the maximum potential gain of \$213, but it also has a very poor risk-reward ratio: If the S&P 500 jumps dramatically, the trade could lose up to \$12,287 if it isn't stopped out.

**FIGURE 1 — RISK PROFILE — BEAR CALL SPREAD**

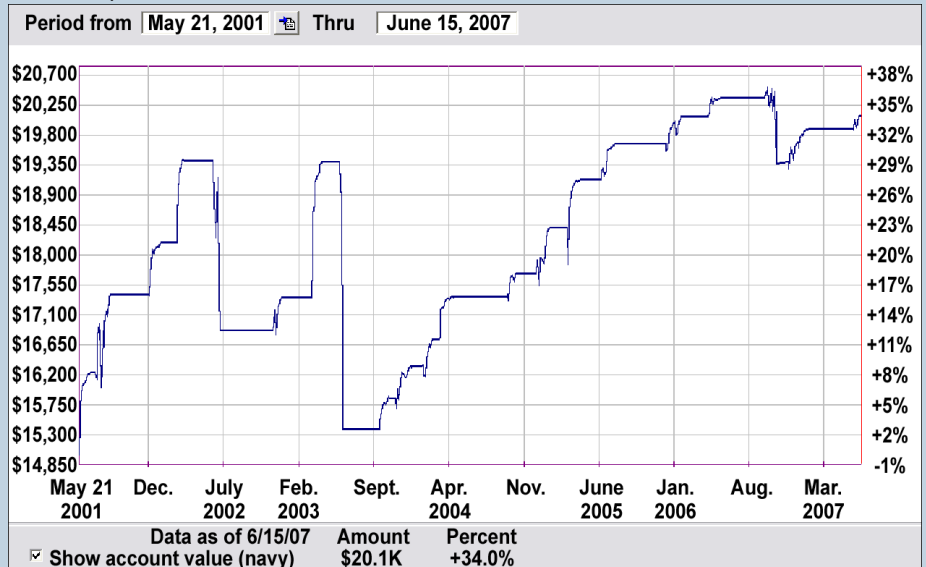
*This bear call spread included a short June 1,580 OTM call and a long June 1,630 call. To be profitable, the June S&P 500 futures contract must close below 1,580.85 at expiration on June 15.*



Source: OptionVue

**FIGURE 2 — PERFORMANCE**

*This system was consistently profitable, but each losing trade meant a substantial loss of capital.*



Source: OptionVue

## STRATEGY SUMMARY

<b>Net gain:</b>	\$5,100.00
<b>Percentage return:</b>	34.0%
<b>Annualized return:</b>	5.6%
<b>No. of trades:</b>	22
<b>Winning/losing trades:</b>	19/3
<b>Win/loss:</b>	86%
<b>Avg. trade:</b>	\$231.82
<b>Largest winning trade:</b>	\$2,038.00
<b>Largest losing trade:</b>	-\$4,011.50
<b>Avg. profit (winners):</b>	\$666.29
<b>Avg. loss (losers):</b>	-\$2,519.83
<b>Avg. hold time (winners):</b>	37
<b>Avg. hold time (losers):</b>	20
<b>Max consec. win/loss :</b>	10/1

### Trade rules:

1. Enter an OTM bull put spread on the first up close after price drops to a new 20-day low and the MACD fails to fall to a new 20-day low.
2. Enter an OTM bear call spread on the first down close after price climbs to a new 20-day high and the MACD fails to rise to a new 20-day high.
3. Construct each credit spread with options in the first expiration month that don't expire for at least 21 days by:
  - a. Selling an OTM option that lies one strike beyond the first standard deviation. This is determined with a probability calculator and the implied volatility of the at-the-money (ATM) call as an input.
  - b. Buying a same-type option with a strike that is 50 points farther OTM. (Although this system followed strict rules, you don't have to use the same point spread each time; just ensure the net credit is sufficient.)
4. Exit the spread if the S&P 500 futures touches the short option's strike. Otherwise, let the credit spread expire worthless.

### Test details:

- The test account began with \$15,000 in capital.
- One-lot spreads were traded each time.
- Daily closing prices were used. Trades were executed between the bid and ask, when possible. Otherwise, theoretical prices were used.
- Multiple signals: Bullish signals were ignored if a bull put spread was already open. Bearish signals were ignored if a bear call spread was already open.
- Commissions were \$6 per option.

**Test data:** The system was tested using options on the S&P 500 futures (SP) at the CME.

**Test period:** May 21, 2001 to June 15, 2007.

**Test results:** Figure 2 shows the strategy gained \$5,100 (34 percent) in the six-year test period. This trading system's win-loss ratio was 86 percent, so it had a definite edge in that department.

However, the average losing trade (\$2,519.83) was nearly four times as large as the average winner (\$666.29) — a poor risk-reward ratio that would concern any trader. The system tended to enter bear call spreads that often collected far less premium than its put spreads. In short, each of those

bear call spreads had a very small potential reward relative to the risk.

Instead of trading both types of spreads, you might want to focus on bull put spreads because they can deliver larger gains. Another idea is to exit a spread after a set percentage loss rather than waiting for the market to hit the short strike.

Note: This test included minimal commissions, but large fees and bad fills will likely reduce performance.

— Steve Lentz and Jim Graham of OptionVue

### LEGEND:

**Net gain/loss** – Gain or loss at end of test period, less commission.

**Percentage return** – Gain or loss on a percentage basis.

**Annualized return** – Gain or loss on an annualized percentage basis.

**No. of trades** – Number of trades generated by the system.

**Winning/losing trades** – Number of winners/losers generated by the system.

**Win/loss (%)** – The percentage of trades that were profitable.

**Avg. trade** – The average profit for all trades.

**Largest winning trade** – Biggest individual profit generated by the system.

**Largest losing trade** – Biggest individual loss generated by the system.

**Avg. profit (winners)** – The average profit for winning trades.

**Avg. loss (losers)** – The average loss for losing trades.

**Avg. hold time (winners)** – The average holding time for winning trades.

**Avg. hold time (losers)** – The average holding time for losing trades.

**Max consec. win/loss** – The maximum number of consecutive winning and losing trades.

Option System Analysis strategies are tested using OptionVue's BackTrader module (unless otherwise noted).

If you have a trading idea or strategy that you'd like to see tested, please send the trading and money-management rules to [Advisor@OptionVue.com](mailto:Advisor@OptionVue.com).





# Options exercise and assignment

If you are new to options, you need to learn the rules behind exercise and assignment.

This guide explains how to avoid mistakes on expiration day.

BY FOT STAFF

**W**henever you hold an option just before it expires, you face a dilemma: Should you close it or exercise it?

Options holders can exercise and options sellers are subject to their actions. If you buy an option, you can exercise that right and convert it into an underlying position. But if you sell an option, you can be assigned, which means you are obligated to either buy or sell the underlying if a call or put holder exercises before expiration.

Most traders prefer to close trades by selling long options or buying back short ones. Indeed, only 10 percent of all options are exercised and converted into underlying positions, according to the Chicago Board Options Exchange

Table 1 shows the mechanics of exercise and assignment. If you buy a call, you can exercise it and purchase the underlying at the strike price; but if you sell it, you may be forced to sell the underlying at the strike, which could be expensive if the strike is well below market value.

The first step is to determine whether an option is **in-the-money** (ITM), which represents the difference between its strike and the underlying's current price. A call is ITM if its strike is below the market.

For example, Adobe Systems (ADBE) closed at \$42.13 on Nov. 16 — the day before November options expired. The November 40 calls were ITM, because you could exercise them to buy ADBE at \$40, sell shares at \$42.13, and capture \$2.13 in value. By contrast, the November 42.50 calls were **out-of-the-money** (OTM) and expired worthless. You would have lost money if you exercised them to buy ADBE at \$42.50 and then sold shares at \$42.13.

On the other hand, if you sold November 40 calls short and held them until Nov. 16, they would be assigned, forcing you to sell Adobe at \$40 and buy it back at \$42.13 — a loss of \$2.13 per share.

Table 1 shows that puts reverse the exercise and assignment process. When ADBE closed at \$42.13 on Nov. 16, the November 40 puts were OTM and expired worthless; exercising those puts to sell Adobe at \$40 — below the market price of \$42.13 — doesn't make sense.

However, the November 42.50 puts were ITM, so you could have exercised them to sell ADBE at \$42.50, buy shares back at \$42.13, and capture \$0.37. Put sellers lost the same amount when November \$42.50 puts were assigned, because they had to buy Adobe at the \$42.50 strike, or \$0.37 above its Nov. 16 price.

The same concepts apply to index options, but they are

**TABLE 1 — EXERCISE AND ASSIGNMENT**

*Buying an option gives you the right to buy or sell the underlying instrument for a specific period, while selling one may force you to take the opposite position in the underlying instrument.*

	<b>Calls</b>	<b>Puts</b>
<b>Exercise</b>	Buy underlying at strike	Sell underlying at strike
<b>Assignment</b>	Sell underlying at strike	Buy underlying at strike

(CBOE). But although traders rarely exercise options, you still need to understand how the exercise and assignment process works, because it has opportunities and risks that could make or break your trade.

### Exercising your rights

A call option offers the right to buy the underlying instrument at the **strike price** before it expires. By contrast, a put option includes the right to **sell** the underlying at the strike price before it expires.

cash-settled, so you receive a payment when exercising a long option, and you owe money if you are assigned on a short option position (see Table 2).

Stock options have **American-style exercise**, which means they can be exercised or assigned anytime before expiration. However, index options can also have **European-style exercise**, whereby options are only exercised or assigned on expiration day. Many option sellers prefer European-style options because there's no risk of assignment — i.e., option holders can't exercise their options until expiration day.

### Intrinsic vs. time value

An option's **premium** has two main parts: **Intrinsic value**, which represents the amount it is ITM, and **time value**, which is often used to describe a combination of its other pricing variables (i.e., time to expiration, **implied volatility**, interest rates, and dividends).

If an option still has time value, traders typically don't exercise it because that value will disappear. For instance, E\*Trade Financial Corp (ETFC) closed at \$5.33 on Nov. 23,

**TABLE 2 — CASH-SETTLED INDEX OPTIONS**

*Index options are settled in cash, so you collect money when you exercise one but you pay it when assigned.*

Cash-settled index options (calls or puts)	
<b>Exercise</b>	Receive cash
<b>Assignment</b>	Pay cash

and its December 5 call, expiring Dec. 15, cost \$1.15. If you exercise E\*Trade's 5 call, you will buy ETFC at the \$5 strike price and capture \$0.33. But you lose the call's time value of \$0.82 (\$1.15 - \$0.33 intrinsic value), so selling the call for \$1.15 is more profitable.

Options probably won't be assigned before expiration unless they are ITM and their time value is close to zero. But holders of American-style options can exercise them at any time, so options sellers are always at risk of assignment, especially put sellers.

Traders will exercise an option early if this step adds value or saves money. For example, DuPont (DD) closed at \$44.69 on Nov. 23, and its December 50 put's bid was \$5.30.

*continued on p. 28*

# Trade Options

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**TABLE 3 — AUTOMATIC EXERCISE AMOUNTS**

*Any stock option that is slightly ITM at expiration Friday's close is automatically exercised by the OCC, which can be a hassle if you want it to expire worthless. Remember to tell your broker if you don't want to exercise an option.*

	In-the-money amount
<b>Stocks</b>	<b>\$0.05 or more</b>
<b>Cash-settled index options</b>	<b>\$0.01 or more</b>

This ITM put traded near its intrinsic value, so if you held a short 50 put, it might have been assigned even though it wouldn't expire for three weeks. If the put's owner also held shares of DuPont, they could exercise that put, sell DD at 50, and pay just one commission instead of two (sell put, sell underlying).

Another reason to exercise early is to capture a dividend. If an ITM call contains no time value the day before a stock pays dividends, call holders will sell it before it opens lower the next day by the dividend's amount.

**Exercise and assignment costs**

Exercising an option requires additional capital, which is why some traders avoid it. Suppose a stock trades at \$50, and you buy a 55 call that expires in two months for \$0.50. If the stock climbs to \$56 and the 55 call moves ITM, you need an additional \$5,000 to exercise it and buy 100 shares.

Moreover, exercising a put to sell 100 shares can be a hassle if you don't already own them, because your broker must find shares to borrow first.

Capital requirements are even more troublesome for options sellers if they get assigned. For example, you might have enough cash to sell a call (or put), but not enough to sell (or buy) stock if it's assigned. If this happens, your broker will charge commissions and margin interest.

**Expiration day and automatic exercise**

Holding an options position on the Friday before expiration can be risky, even if you bought options that are set to expire worthless. There are two rules you need to know: Traders can exercise options up to 90 minutes after the close on expiration Friday, and the Options Clearing Corporation will automatically exercise any stock options that are ITM by as little as \$0.05 (see Table 3).

Most brokers let you exercise options up to an hour after the close on expiration Friday (5 p.m. ET). Ignoring this detail can lead to trouble, because any news that happens between the close and this deadline can affect your position.

Suppose you sold 100-strike puts on a stock that closed at \$110, and the company released disappointing earnings at

**Related reading**

**Articles:**

**"Short selling basics"**

*Active Trader*, December 2007.

Short selling allows you to profit when the market is going down, but traders who use margin need to be especially aware of the potential drawbacks.

**"Options margin explained"**

*Options Trader*, September 2005.

Options margin requirements vary widely across the industry and can affect a trade's profitability. Find out how to limit the capital needed to place a trade.

The options margin article is included in the Options Basics collection, Volume 1, a discounted, nine-article set of past *Options Trader* and *Active Trader* articles that encompasses options terminology, fundamental trading concepts and simple strategies, as well as practical considerations such as margin. This is a collection designed for those new to options trading, whether in stock or futures.

*You can purchase and download past articles at [http://www.activetradermag.com/purchase\\_articles.htm](http://www.activetradermag.com/purchase_articles.htm).*

**Book:**

*McMillan on Options* by Lawrence G. McMillan (John Wiley & Sons, 2004).

**Webcast:**

**"The ins and outs of exercise and assignment"**

<http://www.cboe.com/LearnCenter/webcast/archive.aspx>

4:30 p.m. ET. Although your short puts seem poised to expire worthless, a trader who held those puts could exercise them at 4:45 p.m. to sell shares at \$100. Instead of just keeping the short put's premium, you would be assigned and forced to buy shares at \$100 on Monday morning, which could be painful if the stock tanked at the open.

Finally, don't simply assume near-the-money long options will expire worthless. If you bought November 105 puts on International Business Machines (IBM), and they were priced at \$0.20 at 3:45 p.m. on expiration Friday, you might decide it's not worthwhile to buy them back (after commissions).

However, IBM closed at \$104.79 on Nov. 16, so those 105 puts were ITM by \$0.21, and the OCC would have exercised them and sold 100 shares at \$105 automatically. Luckily, avoiding automatic exercise is easy — just tell your broker to let them expire worthless. ☹



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*A longer whip, a larger purse*

# CFTC wants to beef up

BY JEFF PONCZAK AND JIM KHAROUF

**T**he Commodity Futures Trading Commission (CFTC) has long been the ignored stepchild of U.S. regulators. The Securities and Exchange Commission (SEC) has a bigger budget, a bigger staff, and greater authority from Congress.

Because the SEC has always had jurisdiction over stocks and options and the CFTC has overseen futures (although it is trying to expand its sphere of influence to include forex), the inequity was understandable. Until relatively recently, the U.S.'s financial world has been dominated by companies and individuals who owned stock, and futures were something left to farmers and traders who had doctorates in applied mathematics.

However, the advent of financial futures — and particularly interest-rate futures and stock-index futures — changed that. Futures became more mainstream, and long-time stock traders ditched the moribund stock market to participate in futures.

Also, over the past few years, increased interest in energy futures — particularly crude oil and natural gas — has brought those markets to the forefront, and institutional use of futures has never been greater.

However, the SEC still gets the bulk of the attention from Congress, and the CFTC is often left to make due with inadequate resources.

How much of the 2006 collapse of the Amaranth Advisors hedge fund, which lost \$6 billion, could have been avoided if the CFTC had more authority in that area is unclear. Nonetheless, the CFTC wants to make sure it doesn't happen again.

In late October the CFTC asked

Congress to increase its clout in handling energy trades, whether they occur at a regulated exchange or not.

A congressional study on the Amaranth collapse found that over-the-counter trades made on the IntercontinentalExchange (ICE) — which expedited Amaranth's demise — had a significant impact on prices at the regulated New York Mercantile Exchange (NYMEX).

Amaranth switched its trading from the NYMEX to the ICE when it reached volume limits on the NYMEX. The ICE had no volume restrictions, but the CFTC wants that to change.

"Changes to the Commodities Exchange Act (*the bill that actually reauthorizes the CFTC*) are necessary in order for the commission to detect and prevent manipulation in these mar-

kets," CFTC Chairman Walt Lukken told Congress.

Lukken also wants the CFTC to have the authority to disrupt cash or physical settlement of futures contracts in emergency situations, and wants to ensure that non-regulated exchanges have a self-regulation plan in place.

The CFTC boss believes the changes will give his group greater oversight while not being overly restrictive to electronic exchanges to the point of driving them overseas.

Over-the-counter transactions are exempt from CFTC regulation because of a rule known as the "Enron Loophole." The loophole exists because lobbying on the part of Enron — before it collapsed — convinced lawmakers these markets needed to be

## MANAGED MONEY

Top 10 option strategy traders ranked by October 2007 return.  
(Managing at least \$1 million as of Oct. 31, 2007.)

Rank	Trading advisor	September return	2007 YTD return	\$ under mgmt.
1.	Parrot Trading Partners	14.75	26.69	12.4M
2.	Ascendant Asset Adv. (Strategic2)	10.86	45.80	36.3M
3.	Singleton Fund	9.62	52.35	17.0M
4.	Aksel Capital Mgmt (Growth & Income)	8.46	-22.36	3.9M
5.	Ascendant Asset Adv. (JLDeVore)	7.17	75.81	7.3M
6.	Solaris Market Neutral Fund LP	6.76	23.71	1.7M
7.	ACE Investment Strat. (SIPC INST)	5.58	-10.70	29.5M
8.	Welton Investment (Alpha Leveraged)	5.23	1.96	4.0M
9.	LJM Partners (Neutral S&P Option)	4.02	7.48	119.9M
10.	BC Capital Management	3.96	-0.04	9.8M

Source: Barclay Hedge (<http://www.barclayhedge.com>)

Based on estimates of the composite of all accounts or the fully funded subset method.

Does not reflect the performance of any single account.

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exempt from regulation.

The U.S. Senate and the U.S. House already have bills submitted that would close the loophole.

The NYMEX and the ICE are both in favor of market reforms and increased CFTC power. The NYMEX says it's important that regulated products aren't in direct competition with similar or identical products on unregulated markets, while the ICE says it has always believed some sort of regulatory certainty for over-the-counter markets was a good thing.

### SEC-CFTC merger talk heats up

As the CFTC attempts to solidify its future, momentum is building among market participants for a major overhaul of the entire U.S. securities and futures regulatory structure.

This topic has been bandied about for years, with many calling for a merger of the SEC and the CFTC. Frustration for exchanges, firms, and customers has grown because they are often faced with overlapping and sometimes conflicting regulation, as well as the practical problem of separating securities and futures accounts.

This comes at a time when trading is getting more international and more traders are trading across multiple asset classes. The short answer has always been to merge the SEC and the CFTC.

But in the wake of the U.S. Treasury Department's summer study on streamlining the U.S. regulatory structure and its request for comments on the topic in November, firms, exchanges, and regulators appear to be taking a different approach. Now many are calling for the SEC to adopt the CFTC's method of oversight, called "principles-based regulation," which allows for more flexible, case-by-case rule interpretation.

Lukken cautioned Congress about

potential consolidation of the CFTC and SEC just for consolidation's sake.

"While all ideas should be thoughtfully considered, in my view, policy-makers should first focus on how we regulate rather than who is regulating," Lukken said at the Futures Industry Association (FIA) Expo in Chicago in November. "No matter the Washington zip code, our agencies have differing public missions and approaches to regulation. Although not as eye-grabbing as discussions of a merger, reconciling these differences in how we regulate should be the first focus of our attention."

Lukken and others have said that principles-based regulation for both agencies at some level is the right way to go. Whether the SEC and Congress are able to make that switch from set rules to more flexible rule making and oversight is a big issue and is fraught with several challenges. Changing the SEC culture of rather slow and distant interaction with exchanges may be even harder, says Bill Brodsky, chairman and CEO of the Chicago Board Options Exchange.

"I'm for principles-based regulation," Brodsky says. "But principles-based regulation doesn't solve the issues between the two agencies. I'm not advocating a merger of the two agencies. There should be a fresh look at the whole thing, which goes way beyond the merger."


John Damgard, president of the FIA, agrees.

"There are Congressional turf issues and attitudinal problems at the various committees — banking and agriculture — [that oversee the SEC and CFTC, respectively]," he says.

Chris Hehmeyer, CEO of securities and futures broker Penson GHCO, calls for a merger of the CFTC and SEC under a proposed "Twin Peaks" structure, bringing the two under one roof but separating their duties. On one

hand, Penson calls for a division that would focus on capital formation that includes regulation of public companies using rules-based principles. The other division would focus on market participation, conduct, and market integrity, using principles-based rules.

Variations of this structure, Hehmeyer points out, are already in use in Australia and the Netherlands.

While the issue has more traction than it has in years, most expect it to be discussed for at least a couple of more years before any significant changes are brought by Congress. In the end, traders could benefit from this regulatory change by being able to trade stocks, futures, and options from a single account; portfolio margining of positions; and a faster rollout of new contracts from exchanges. 

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Some afraid of the dark

# Nasdaq options pricing sparks debate

BY JIM KHAROUF

The issue of Nasdaq's options pricing sparked debate among long-time options exchange leaders at the November Futures Industry Association Expo in Chicago.

The Nasdaq, which planned to launch its exchange in December pending regulatory approval, will introduce a price-time order book and allow customers to enter option prices in penny increments, even though trades will be filled in nickel and dime increments.

For example, customers theoretically will be able to enter a bid at \$1.02 for an offer of \$1.05. That order will be displayed at \$1.00 even though the bid is \$1.02. If the offer falls to \$1.00, the trade is executed and the seller gets a two-cent price improvement.

The Nasdaq refers to this as "Price Improving Orders" and considers it a different approach to the Price Improvement Period (PIP) offered at the Boston Options Exchange and the Price Improvement Mechanism at the International Securities Exchange (ISE), both of which also improve orders using penny-pricing auctions.

"I think you can separate a PIP type of liquidity from a display order," says Adam Nunes, Nasdaq vice president of transaction services. "And on those [display orders], we've seen them in equities. What they have done is provide a tool for institutions to get size done without showing their hand."

That sparked a strong rebuke from David Krell, CEO of the ISE who will retire and assume the role of ISE chairman

## Options Watch: High-volume stocks (as of Nov. 27)

Compiled by Tristan Yates

The following table summarizes the expiration months available for 15 stocks with the largest options volume. It also shows each index's average bid-ask spread for at-the-money (ATM) December options. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of potential slippage in each option market.

Index	Sym	Exchange	Option contracts traded										Bid-ask spreads				
			2007		2008					2009	2010	Closing price	Call	Put	Bid-ask spread as % of underlying price		
			Dec.	Jan.	Feb.	March	April	May	June	July	Jan.					Jan.	
Google	GOOG	NA	X	X		X			X			X	X	673.57	0.35	0.63	0.07%
Goldman Sachs Group	GS	NA	X	X			X				X	X	X	213.33	0.33	0.28	0.14%
Bank of America	BAC	NA	X	X	X			X			X	X	X	42.94	0.09	0.08	0.19%
Baidu.com	BIDU	NA	X	X		X			X		X	X	X	341.34	0.63	0.75	0.20%
McDonald's	MCD	NA	X	X		X			X		X	X	X	57.46	0.14	0.11	0.22%
Freeport-McMoRan C&G	FCX	NA	X	X	X			X			X	X	X	89.28	0.23	0.21	0.25%
Lehman Bros Holdings	LEH	NA	X	X			X				X	X	X	59.90	0.18	0.15	0.27%
Merrill Lynch	MER	NA	X	X			X			X	X	X	X	53.07	0.14	0.16	0.28%
America Movil	AMX	NA	X	X	X			X			X	X	X	56.27	0.09	0.24	0.29%
EMC Corp	EMC	NA	X	X			X			X	X	X	X	18.19	0.06	0.06	0.34%
American Intl Group	AIG	NA	X	X	X			X			X	X	X	54.49	0.20	0.20	0.37%
Comp Vale do Rio Doce	RIO	NA	X	X		X			X		X	X	X	31.20	0.13	0.11	0.38%
Crocs	CROX	NA	X	X		X			X		X	X	X	36.87	0.20	0.18	0.51%
Washington Mutual	WM	NA	X	X			X			X	X	X	X	17.20	0.11	0.09	0.58%
Countrywide Financial	CFC	NA	X	X			X			X	X	X	X	8.97	0.06	0.08	0.77%

Legend:

Call: Four-day average difference between bid and ask prices for the front-month ATM call.

Put: Four-day average difference between bid and ask prices for the front-month ATM put.

Bid-ask spread as % of underlying price: Average difference between bid and ask prices for front-month, ATM call and put divided by the underlying's closing price.

at year-end. Krell believes that placing an order for \$1.02 but displaying the price as \$1.00 is misleading to market participants and takes away price transparency from the market.

"We think that's absolutely the wrong way to go," Krell says. "We have been trying for the past 30 years as an industry to have the most liquid markets, the best displayed size, and greatest transparency. They are moving to make the markets more opaque, [and] we think that's the wrong direction."

Some exchange leaders are concerned the Nasdaq's moves are creating an environment for liquidity "dark pools" to emerge in options. The debate over dark pools is ongoing. Some market participants believe such pools in the options market will never reach the same level as those found in the equities market because option orders still have to be executed on an options exchange and cleared by the Options Clearing Corporation.


Critics say dark pools are being created through pricing

displays such as Nasdaq's, since such penny displays will not be available to all customers.

"Hidden liquidity opens up opportunities for gaming, internalizing, and being exposed to things they didn't see," says Mike Bickford, AMEX vice president, who adds that Nasdaq's proposed market model will increase quote traffic.

Sandy Frucher, CEO of the Philadelphia Stock Exchange, which was recently purchased by the Nasdaq, says dark pools are a concern for the industry and called on the Securities and Exchange Commission (SEC) to step in.

"The fact is markets have evolved and technology is a big part of that evolution," Frucher says. "Dark pools are a train wreck waiting to happen and we need guidance from the SEC. I don't think *laissez faire* is the way to go."

The SEC is still analyzing the Nasdaq's market model and some sources say the regulator has some reservations about the Price Improving Orders model. That could delay the launch of the new exchange, the seventh U.S. equity options exchange. 



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# FUTURES SNAPSHOT (as of Nov. 28)

The following table summarizes the trading activity in the most actively traded futures contracts. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields. Volume figures are for the most active contract month in a particular market and may not reflect total volume for all contract months.

Note: Average volume and open-interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity for CME futures is based on pit-traded contracts, while price activity for CBOT futures is based on the highest-volume contract (pit or electronic).

Market	E-sym	Pit sym	Exch	Vol	OI	10-day move	% rank	20-day move	% rank	60-day move	% rank	Volatility ratio/rank
E-Mini S&P 500	ES		CME	2.10 M	2.02 M	-0.86%	17%	-4.26%	56%	-1.28%	13%	.41 / 54%
10-yr. T-note	ZN	TY	CBOT	1.37 M	2.35 M	1.71%	65%	2.65%	79%	3.78%	68%	.29 / 58%
5-yr. T-note	ZF	FV	CBOT	718.4	1.72 M	1.01%	45%	1.91%	80%	2.90%	68%	.27 / 53%
E-Mini Nasdaq 100	NQ		CME	504.1	435.8	1.39%	29%	-5.51%	29%	3.49%	22%	.26 / 29%
Corn	ZC	C	CBOT	435.5	408.2	3.36%	69%	4.59%	35%	15.03%	68%	.18 / 3%
Eurodollar*	GE	ED	CME	394.6	1.37 M	-0.09%	53%	-0.17%	38%	0.78%	100%	.12 / 0%
30-yr. T-bond	ZB	US	CBOT	383.3	947.1	1.90%	68%	2.75%	66%	4.61%	66%	.37 / 65%
Crude oil		CL	NYMEX	296.9	344.1	-0.60%	75%	0.27%	0%	20.70%	78%	.27 / 48%
2-yr. T-note	ZT	TU	CBOT	281.7	1.01 M	0.17%	20%	0.97%	73%	1.19%	43%	.25 / 53%
E-Mini Russell 2000	ER		CME	269.7	614.1	-2.27%	11%	-5.75%	52%	-3.69%	38%	.43 / 54%
Mini Dow	YM		CBOT	216.6	105.3	-0.17%	0%	-3.73%	53%	-1.11%	30%	.43 / 49%
Eurocurrency	6E	EC	CME	171.9	211.0	1.77%	60%	2.90%	52%	8.92%	100%	.24 / 37%
Japanese yen	6J	JY	CME	137.6	186.6	0.46%	6%	4.08%	68%	5.43%	65%	.37 / 68%
Gold 100 oz.		GC	NYMEX	128.0	273.4	0.16%	0%	1.59%	3%	16.80%	76%	.28 / 37%
British pound	6B	BP	CME	83.0	128.4	0.66%	18%	0.73%	35%	3.17%	92%	.42 / 41%
Soybeans	ZS	S	CBOT	58.9	164.0	3.83%	32%	10.54%	68%	22.88%	86%	.12 / 7%
Australian dollar	6A	AD	CME	56.2	83.1	-0.02%	0%	-2.95%	47%	9.12%	91%	.25 / 10%
Natural gas		NG	NYMEX	55.7	68.3	-5.82%	82%	-6.67%	27%	32.99%	80%	.20 / 13%
Canadian dollar	6C	CD	CME	55.1	125.1	-2.07%	27%	-3.21%	90%	7.06%	52%	.21 / 20%
Swiss franc	6S	SF	CME	49.9	77.8	1.42%	10%	4.32%	75%	8.75%	96%	.31 / 41%
Sugar		SB	ICE	46.0	435.9	-0.20%	6%	-1.29%	10%	4.85%	46%	.27 / 50%
S&P 500 index		SP	CME	44.0	569.2	-0.86%	17%	-4.26%	56%	-1.28%	15%	.41 / 53%
Wheat	ZW	W	CBOT	43.7	135.8	14.84%	100%	5.53%	20%	6.44%	3%	.36 / 87%
E-Mini S&P MidCap 400	ME		CME	33.2	101.8	-1.68%	17%	-4.62%	52%	-2.05%	32%	.41 / 60%
Silver 5,000 oz.		SI	NYMEX	32.8	68.2	-1.88%	29%	0.05%	0%	15.16%	72%	.19 / 0%
Heating oil		HO	NYMEX	31.1	56.9	2.87%	30%	6.15%	29%	23.77%	83%	.24 / 13%
RBOB gasoline		RB	NYMEX	30.7	49.8	-1.77%	60%	0.82%	5%	14.30%	56%	.34 / 65%
Gold 100 oz.		ZG	CBOT	30.5	16.2	0.16%	0%	1.57%	3%	16.83%	76%	.27 / 31%
Soybean oil	ZL	BO	CBOT	29.0	87.4	4.30%	20%	10.68%	71%	24.04%	89%	.23 / 15%
Soybean meal	ZM	SM	CBOT	26.3	75.4	2.53%	38%	6.37%	56%	17.87%	56%	.09 / 3%
Fed Funds	ZQ	FF	CBOT	24.7	129.7	0.17%	53%	0.22%	36%	0.70%	93%	.22 / 52%
Mexican peso	6M	MP	CME	19.7	92.4	-0.44%	8%	-1.69%	90%	0.72%	8%	.20 / 12%
Crude oil e-miNY	QM		NYMEX	18.7	9.0	-0.60%	50%	0.27%	0%	20.70%	78%	.29 / 50%
Coffee		KC	ICE	12.5	64.5	5.91%	100%	5.39%	22%	11.31%	77%	.27 / 32%
Nikkei 225 index		NK	CME	12.3	70.2	0.65%	50%	-6.67%	58%	-6.13%	52%	.32 / 50%
Lean hogs	HE	LH	CME	11.9	72.9	1.53%	38%	1.81%	50%	-18.19%	65%	.18 / 32%
Live cattle	LE	LC	CME	11.7	62.0	-0.60%	67%	-0.76%	35%	-2.69%	36%	.33 / 62%
Copper		HG	NYMEX	11.1	40.5	-3.25%	0%	-13.66%	73%	-9.53%	91%	.34 / 32%
Mini-sized gold	YG		CBOT	7.1	6.0	0.16%	0%	1.57%	3%	16.83%	76%	.27 / 30%
Cocoa		CC	ICE	6.3	41.1	3.03%	25%	-0.46%	15%	7.86%	65%	.27 / 48%
Silver 5,000 oz.	ZI		CBOT	6.1	5.2	-1.81%	14%	0.11%	2%	15.13%	72%	.18 / 0%
Nasdaq 100		ND	CME	5.9	53.6	1.39%	29%	-5.51%	29%	3.49%	22%	.27 / 28%
Dow Jones Ind. Avg.	ZD	DJ	CBOT	4.2	34.2	-0.17%	0%	-3.73%	53%	-1.11%	30%	.46 / 53%
Natural gas e-miNY	QG		NYMEX	3.9	3.1	-5.82%	82%	-6.67%	47%	32.99%	81%	.21 / 13%
U.S. dollar index		DX	ICE	3.4	36.4	-1.05%	35%	-2.12%	40%	-7.11%	97%	.20 / 23%
New Zealand dollar	6N	NE	CME	2.6	26.0	2.81%	50%	1.59%	26%	10.87%	100%	.24 / 23%
LIBOR		EM	CME	2.4	31.2	-0.44%	100%	-0.42%	79%	0.68%	92%	.15 / 22%

\*Average volume and open interest based on highest-volume contract (December 2008).

## Legend

**Vol:** 30-day average daily volume, in thousands (unless otherwise indicated).

**OI:** Open interest, in thousands (unless otherwise indicated).

**10-day move:** The percentage price move from the close 10 days ago to today's close.

**20-day move:** The percentage price move from the close 20 days ago to today's close.

**60-day move:** The percentage price move from the close 60 days ago to today's close.

The "% rank" fields for each time window

(10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the "% rank" for 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the "% rank" field shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, the "% rank" field shows how the most recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100

percent means the current reading is larger than all the past readings, while a reading of 0 percent means the current reading is smaller than the previous readings. These figures provide perspective for determining how relatively large or small the most recent price move is compared to past price moves.

**Volatility ratio/rank:** The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The rank is the percentile rank of the volatility ratio over the past 60 days.

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## MOST-LIQUID OPTIONS\*

Indices	Symbol	Exchange	Options volume	Open interest	10-day move	% rank	20-day move	% rank	IV/SV ratio	IV/SV ratio — 20 days ago
S&P 500 index	SPX	CBOE	264.4	1.75 M	-0.81%	18%	-4.05%	56%	23.6% / 20.8%	19.7% / 15.6%
S&P 500 volatility index	VIX	CBOE	152.5	1.46 M	0.04%	0%	14.43%	29%	86.7% / 154.8%	96.2% / 128.1%
Russell 2000 index	RUT	CBOE	79.8	773.3	-2.42%	16%	-5.65%	54%	29.4% / 26.2%	26.8% / 21.5%
S&P 100 index	OEX	CBOE	44.2	121.2	0.17%	33%	-5.17%	71%	22.8% / 20.5%	19.1% / 14.9%
Nasdaq 100 index	NDX	CBOE	43.7	278.2	1.42%	29%	-5.08%	29%	27.5% / 27%	25% / 20.4%

Stocks										
Apple Inc	AAPL		317.9	1.27 M	6.04%	33%	-3.63%	18%	42.5% / 59.7%	35.5% / 40.1%
Citigroup	C		309.5	2.67 M	-10.06%	30%	-23.32%	75%	49.4% / 65.6%	37.2% / 37.5%
Microsoft	MSFT		165.2	3.12 M	-2.21%	17%	-5.26%	86%	29.3% / 31.6%	25.2% / 24%
Research in Motion	RIMM		145.5	420.9	7.82%	44%	0.12%	0%	67.1% / 89.3%	59.3% / 67.9%
Cisco Systems	CSCO		141.4	1.58 M	-6.93%	36%	-13.98%	96%	36.2% / 39.6%	35.4% / 29.1%

Futures										
Eurodollar	ED-GE	CME	422.7	10.80 M	-0.06%	13%	-0.12%	29%	23.3% / 12.7%	17.2% / 14.8%
10-year T-notes	TY-ZN	CBOT	72.7	654.4	1.75%	75%	2.85%	90%	6.8% / 5.2%	5.3% / 5.3%
Crude oil	CL	NYMEX	48.6	297.0	-3.69%	100%	-4.14%	100%	31.5% / 37%	32.4% / 32.4%
5-year T-notes	FV-ZF	CBOT	40.8	274.0	1.03%	55%	2.05%	90%	NA	4% / 3.8%
Corn	C-ZC	CBOT	36.8	687.1	1.10%	29%	3.14%	22%	24.6% / 21.1%	29.7% / 26.9%

## VOLATILITY EXTREMES\*\*

Indices — High IV/SV ratio										
Euro index	XDE	PHLX	4.2	42.5	1.61%	55%	2.78%	49%	9.8% / 5.4%	8.1% / 6.2%
S&P 500 futures	SP	CME	9.7	78.6	-0.51%	6%	-5.42%	64%	23.5% / 20%	19.1% / 16.1%
S&P 500 index	SPX	CBOE	264.4	1.75 M	-0.81%	18%	-4.05%	56%	23.6% / 20.8%	19.7% / 15.6%
Russell 2000 index	RUT	CBOE	79.8	773.3	-2.42%	16%	-5.65%	54%	29.4% / 26.2%	26.8% / 21.5%
Dow Jones index	DJX	CBOE	25.3	291.9	-0.14%	6%	-3.65%	59%	21.3% / 19%	18.1% / 14.9%

Indices — Low IV/SV ratio										
S&P 500 volatility index	VIX	CBOE	152.5	1.46 M	0.04%	0%	14.43%	29%	86.7% / 154.8%	96.2% / 128.1%
Banking index	BKX	PHLX	6.5	104.1	-4.13%	45%	-7.36%	62%	36.9% / 46.2%	31.2% / 25.2%
Gold/silver index	XAU	PHLX	8.3	98.5	-1.30%	0%	-3.72%	50%	41.8% / 47%	42.5% / 35.9%
Mini-Nasdaq 100 Index	MINX	CBOE	32.0	799.6	1.42%	29%	-5.08%	29%	27.3% / 28.8%	24.5% / 21%
Oil service index	OSX	PHLX	2.0	28.3	0.50%	0%	-1.25%	17%	36.8% / 38.1%	36.4% / 32.4%

Stocks — High IV/SV ratio										
Savient Pharms	SVNT		3.2	54.4	14.01%	100%	1.20%	3%	175% / 55.7%	136.2% / 48.9%
Neurocrine Biosciences	NBIX		4.1	127.9	7.30%	78%	17.65%	100%	125.5% / 56.9%	88% / 43.9%
Medarex	MEDX		38.3	1.31 M	-0.89%	0%	3.36%	33%	113.9% / 59.4%	75.4% / 48.1%
Rite Aid	RAD		1.7	313.5	-7.81%	85%	-8.29%	26%	63% / 35.9%	45.8% / 36.4%
Tivo Inc	TIVO		1.7	56.1	-13.46%	81%	-13.71%	74%	75.9% / 46.8%	70.6% / 62%

Stocks — Low IV/SV ratio										
Crocs	CROX		52.9	244.0	1.85%	0%	-44.97%	91%	59.9% / 108.6%	75.8% / 56.5%
Diana Shipping	DSX		10.7	78.7	-4.66%	7%	-19.24%	57%	68.7% / 120.3%	84.7% / 83.2%
Suntech Power Holdings	STP		14.4	125.7	24.51%	76%	25.98%	62%	72.3% / 116.5%	66.8% / 71.5%
PMI Group	PMI		8.2	101.9	-23.94%	47%	-31.26%	21%	117.2% / 184.1%	91% / 126.6%
Lehman Bros Holdings	LEH		48.6	693.5	2.14%	27%	5.69%	22%	49.1% / 76.1%	44% / 50.9%

Futures — High IV/SV ratio										
Eurodollar	ED-GE	CME	422.7	10.80 M	-0.06%	13%	-0.12%	29%	23.3% / 12.7%	17.2% / 14.8%
Eurocurrency	EC-6E	CME	5.2	47.63	1.77%	60%	2.90%	52%	8.6% / 5%	8.4% / 6.6%
British pound	BP-6B	CME	1.1	10.06	0.66%	18%	0.73%	35%	8.9% / 5.7%	7.6% / 5.3%
Japanese yen	JY-6J	CME	5.3	47.28	0.46%	6%	4.08%	68%	12.8% / 8.2%	10.1% / 6.8%
30-year T-bonds	US-ZB	CBOT	27.5	326.01	1.90%	79%	3.66%	87%	9.7% / 6.6%	7.7% / 7.4%

Futures — Low IV/SV ratio										
Gold 100 oz.	GC	NYMEX	10.2	86.3	-1.77%	29%	0.63%	0%	22.7% / 27.5%	19.4% / 20.3%
Silver 5,000 oz.	SI	NYMEX	6.3	51.6	-4.85%	43%	-0.71%	20%	34.7% / 29.2%	28.7% / 31%
Crude oil	CL	NYMEX	48.6	297.0	-3.69%	100%	-4.14%	100%	31.5% / 21.4%	32.4% / 32.4%
Australian dollar	AD-6A	CME	1.2	3.8	-0.02%	0%	-2.95%	47%	10.6% / 59.7%	14% / 11.8%
Heating oil	HO	NYMEX	1.5	3.8	0.02%	0%	1.76%	5%	29.4% / 65.6%	28.7% / 28.1%

\* Ranked by volume

\*\* Ranked based on high or low IV/SV values.

### LEGEND:

**Options volume:** 20-day average daily options volume (in thousands unless otherwise indicated).

**Open interest:** 20-day average daily options open interest (in thousands unless otherwise indicated).

**IV/SV ratio:** Overall average implied volatility of all options divided by statistical volatility of underlying instrument.

**10-day move:** The underlying's percentage price move from the close 10 days ago to today's close.

**20-day move:** The underlying's percentage price move from the close 20 days ago to today's close. The "% rank" fields for each time window (10-day moves, 20-day moves) show the percentile rank of the most recent move to a certain number of previous moves of the same size and in the same direction. For example, the "% rank" for 10-day moves shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the "% rank" field shows how the most recent 20-day move compares to the past sixty 20-day moves.





**Event:** Opportunity Finance Network  
2007 Annual Conference

**Date:** Dec. 11-14

**Location:** Miami, Fla.

**For more information:**

<http://www.opportunityfinance.net>

**Event:** MTA Mid-Winter Retreat

**Date:** Jan. 24-26

**Location:** Don CeSar Beach Resort at St. Pete Beach  
(outside Tampa, Fla.)

**For more information:** Call (646) 652-3300

**Event:** The World Money Show

**Date:** Feb. 6-9

**Location:** Gaylord Palms Resort and Convention Center,  
Kissimmee, Fla.

**For more information:**

<http://www.worldmoneyshow.com>

**Event:** Traders Expo New York

**Date:** Feb. 16-19

**Location:** Marriott Marquis Hotel, New York

**For more information:** <http://www.tradersexpo.com>

**Event:** 24th Annual Risk Management Conference

**Date:** March 9-11

**Location:** Hyatt Regency Coconut Point Resort and Spa,  
Bonita Springs, Fla.

**For more information:** <http://www.cboe.com/rmc>

**Event:** Day Trading Seminar: Presented by Joe Ross  
and Rogerio Kirchbaum

**Date:** March 23-24

**Location:** Sao Paulo, Brazil

**For more information:** E-mail  
[info@tradingeducators.com.br](mailto:info@tradingeducators.com.br)

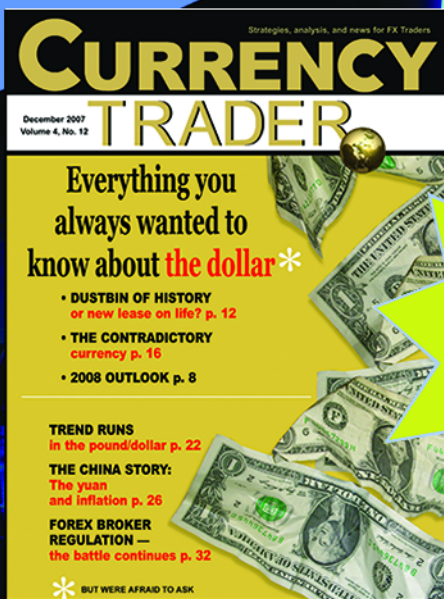
**Event:** Traders Expo Los Angeles

**Date:** June 23-26

**Location:** Ontario Convention Center

**For more information:** <http://www.tradersexpo.com>

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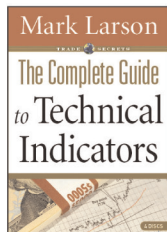
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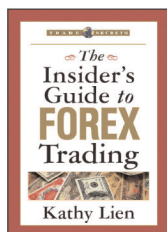
## DVD Trading Courses



### The Complete Guide to Technical Indicators

Mark Larson  
Length: 6 hours  
Item #5197572 Price \$795

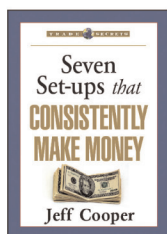
6+ hours on 4 DVDs! Now you can easily carve through the hundreds of indicators and get right to the ones that make money most often and help you achieve success in trading in this comprehensive guide to cracking the code of technical indicators.



### The Insider's Guide to Forex Trading

Kathy Lien  
Length: 90 min  
Item #5197573 Price \$99

This course that gives you the tools, tactics and expertise you need to tap into the huge potential forex trading offers—from the return boosting advantage of interest paid out on currencies to the flexibility of the 24/7 markets.



### Seven Set-ups that Consistently Make Money

Jeff Cooper  
Length: 90 min  
Item #5197574 Price: \$129

A reliable trading set-up can be worth a fortune in winning trades. Jeff Cooper, hands over his seven most consistently profitable set-ups that will work in a wide variety of market conditions.



### Predicting Market Trends

Alan Farley  
Length: 90 min  
Item #5197575 Price: \$99

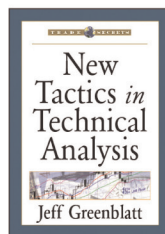
To master the complexity of our modern financial markets, traders need innovative timing techniques and sound trade management in order to profit. In this 90-minute presentation, the Master Swing Trader, Alan Farley, shows you how to incorporate market trends and timing into every single trade you make.



### Proven Candlestick Patterns

Steve Palmquist  
Length: 90 min  
Item #5197576 Price: \$99

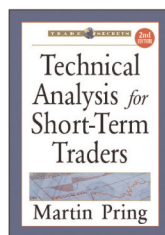
After testing every known candlestick pattern, Steve Palmquist has determined which candlesticks are the most effective and gives you extensive data and techniques for how to best incorporate them into your trading strategy.



### New Tactics in Technical Analysis

Jeff Greenblatt  
Length 90 min  
Item #5197586 Price: \$99

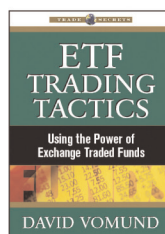
In this innovative DVD course, Jeff Greenblatt brings you new tactics to see the big moves before they happen, so you are ready to make big trades time after time again like a machine.



### Technical Analysis for Short-Term Traders, 2nd Ed.

Marting Pring  
Length 90 min  
Item #5197587 Price: \$99

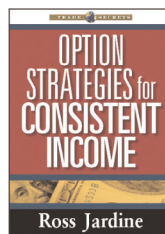
One of the greatest technicians in the industry has taken one of his best courses and made it even better with new tactics, new examples and his sharp and straight-forward insights. Traders' Hall of Fame Award Winner, Martin Pring, walks you through how to identify the trend, confirm the trends and then apply short term tactics to exploit the trend.



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David Vomund  
Length: 90 min  
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Ross Jardine  
Length 90 min  
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2007 Trading FORUM





**American style:** An option that can be exercised at any time until expiration.

**Arbitrage:** The simultaneous purchase and sale of similar or identical instruments (often in different geographical locations) to take advantage of short-term price discrepancies.

For example, gold trades in several major financial centers around the world — New York, London, Paris, Hong Kong, and Tokyo. If gold were trading in New York for \$780 per ounce and \$782 per ounce in London, you could, in effect, buy gold in New York and immediately sell an equal amount in the London market and profit \$2 per ounce.

Why would the metal be \$2 higher in London? Short-term supply and demand fluctuations: Perhaps a European jeweler or metal fabricator placed a large order in the London market. This short-term demand may cause the price to rise in London relative to New York or other financial centers.

**Assign(ment):** When an option seller (or “writer”) is obligated to assume a long position (if he or she sold a put) or short position (if he or she sold a call) in the underlying stock or futures contract because an option buyer exercised the same option.

**At the money (ATM):** An option whose strike price is identical (or very close) to the current underlying stock (or futures) price.

**Average directional movement index (ADX):** Measures trend strength, regardless of direction. The higher the ADX value, the stronger the trend, whether the market is going up or down. The indicator can be applied to any time frame, although it is typically used on daily charts.

Although the ADX concept is straightforward, its calculation is rather lengthy. The indicator was designed by Welles Wilder and is described in detail in his book *New Concepts in Technical Trading Systems* (Trend Research 1978).

### Calculation:

1. Calculate the positive or negative directional movement (+DM and -DM) for each bar in the desired lookback period. Bars that make higher highs and higher lows than the previous bar have positive directional movement. Bars that make lower highs and lower lows than the previous bar have negative directional movement.

If a bar has both a higher high and a lower low than the previous bar, it has positive directional movement if its high is above the previous high more than its low is below the previous low. Reverse this criterion for negative directional movement. An inside bar (a bar that trades within the range of the previous bar) has no directional movement, and neither does a bar whose high is above the previous high by the same amount its low is below the previous low.

2. If a bar has positive (negative) directional movement, the absolute value of the distance between today's high (low) and yesterday's high (low) is added to the running totals of +DM (-DM) calculated over a given lookback period (i.e., 20 bars, 30 bars, etc.). The

## The option “Greeks”

**Delta:** The ratio of the movement in the option price for every point move in the underlying. An option with a delta of 0.5 would move a half-point for every 1-point move in the underlying stock; an option with a delta of 1.00 would move 1 point for every 1-point move in the underlying stock.

**Gamma:** The change in delta relative to a change in the underlying market. Unlike delta, which is highest for deep ITM options, gamma is highest for ATM options and lowest for deep ITM and OTM options.

**Rho:** The change in option price relative to the change in the interest rate.

**Theta:** The rate at which an option loses value each day (the rate of time decay). Theta is relatively larger for OTM than ITM options, and increases as the option gets closer to its expiration date.

**Vega:** How much an option's price changes per a one-percent change in volatility.

absolute value is used so both +DM and -DM are positive values.

3. Calculate the sum of the true ranges for all bars in the lookback period.

4. Calculate the Directional Indicator (+DI and -DI) by dividing the running totals of +DM and -DM by the sum of the true ranges.

5. Calculate the directional index (DX) by taking the absolute value of the difference between the +DI value and the -DI value, dividing that by the sum of the +DI and -DI values, and multiplying by 100.

6. To create the ADX, calculate a moving average of the DX over the same period as the lookback period used throughout the other calculations.

**Bear call spread:** A vertical credit spread that consists of a short call and a higher-strike, further OTM long call in the same expiration month. The spread's largest potential gain is the premium collected, and its maximum loss is limited to the point difference between the strikes minus that premium.

**Bear put spread:** A bear debit spread that contains puts with the same expiration date but different strike prices. You buy the higher-strike put, which costs more, and sell the cheaper, lower-strike put.

**Beta:** Measures the volatility of an investment compared to the overall market. Instruments with a beta of one move in line with the market. A beta value below one means the instrument is less affected by market moves and a beta value greater than one means it is more volatile than the overall market. A beta of zero implies no market risk.

**Bull call ladder:** A variation of the bull call debit spread

that profits if the underlying market doesn't rally too far. To enter a bull call ladder, buy an ATM or ITM long call and sell two calls at different, higher strike prices. The goal is to profit from a moderately bullish outlook without too much upside risk. Ideally, the market will rally and close between the two short strikes at expiration. But if the market jumps far above the highest short strike, potential losses could be unlimited.

**Bull call spread:** A bull debit spread that contains calls with the same expiration date but different strike prices. You buy the lower-strike call, which has more value, and sell the less-expensive, higher-strike call.

**Bull put spread (put credit spread):** A bull credit spread that contains puts with the same expiration date, but different strike prices. You sell an OTM put and buy a less-expensive, lower-strike put.

**Calendar spread:** A position with one short-term short option and one long same-strike option with more time until expiration. If the spread uses ATM options, it is market-neutral and tries to profit from time decay. However, OTM options can be used to profit from both a directional move and time decay.

**Call option:** An option that gives the owner the right, but not the obligation, to buy a stock (or futures contract) at a fixed price.

**Carrying costs:** The costs associated with holding an investment that include interest, dividends, and the opportunity costs of entering the trade.

**Correlation:** The correlation coefficient can tell us the type and strength of the relationship between two data series. The correlation coefficient ranges from +1, which indicates perfect, positive correlation between two data sets (i.e., they move in the same direction, in tandem) and -1, which indicates the sets are directly inverted; zero indicates no discernible relationship between the two data sets.

**Covered call:** Shorting an out-of-the-money call option against a long position in the underlying market. An example would be purchasing a stock for \$50 and selling a call option with a strike price of \$55. The goal is for the market to move sideways or slightly higher and for the call option to expire worthless, in which case you keep the premium.

**Credit spread:** A position that collects more premium from short options than you pay for long options. A credit spread using calls is bearish, while a credit spread using puts is bullish.

**Debit:** A cost you must pay to enter any position if the components you buy are more expensive than the ones you sell. For instance, you must pay a debit to buy any option, and a spread (long one option, short another) requires a debit if the premium you collect from the short option doesn't offset the long option's cost.

**Deep (e.g., deep in-the-money option or deep out-of-the-money option):** Call options with strike prices that are very far above the current price of the underlying asset and put options with strike prices that are very

far below the current price of the underlying asset.

**Delta-neutral:** An options position that has an overall delta of zero, which means it's unaffected by underlying price movement. However, delta will change as the underlying moves up or down, so you must buy or sell shares/contracts to adjust delta back to zero.

**Diagonal spread:** A position consisting of options with different expiration dates and different strike prices — e.g., a December 50 call and a January 60 call.

**Double diagonal spread:** A double diagonal resembles an iron condor (call credit spread + put credit spread), but the long side of each spread expires in a later month. This position combines two diagonal spreads on either side of the market and tries to exploit the time decay of the short, near-term options. It collects the most profit if the market trades sideways by expiration.

To construct a double diagonal, enter two spreads simultaneously: a call spread, which consists of a short out-of-the-money call and a long, higher-strike call in a further month; and a put spread, which consists of a short OTM put and a long, lower-strike put in a more-distant month. Both spread's short options share the same expiration month, and the long options expire together at least one month later.

**European style:** An option that can only be exercised at expiration, not before.

**Exercise:** To exchange an option for the underlying instrument.

**Expiration:** The last day on which an option can be exercised and exchanged for the underlying instrument (usually the last trading day or one day after).

**Intermonth (futures) spread:** A trade consisting of long and short positions in different contract months in the same market — e.g., July and November soybeans or September and December crude oil. Also referred to as a futures "calendar spread."

**In the money (ITM):** A call option with a strike price below the price of the underlying instrument, or a put option with a strike price above the underlying instrument's price.

**Intrinsic value:** The difference between the strike price of an in-the-money option and the underlying asset price. A call option with a strike price of 22 has 2 points of intrinsic value if the underlying market is trading at 24.

**Leverage:** An amount of "buying power" that increases exposure to underlying market moves. For example, if you buy 100 shares of stock, that investment will gain or lose \$100 for each \$1 (one-point) move in the stock.

But if you invest half as much and borrow the other half from your broker as margin, then you control those 100 shares with half as much capital (i.e., 2-to-1 buying power). At that point, if the stock moves \$1, you will gain or lose \$100 even though you only invested \$50 — a double-edged sword.

*continued on p. 40*





**Limit up (down):** The maximum amount that a futures contract is allowed to move up (down) in one trading session.

**Lock-limit:** The maximum amount that a futures contract is allowed to move (up or down) in one trading session.

**Long call condor:** A market-neutral position structured with calls only. It combines a bear call spread (short call, long higher-strike further OTM call) above the market and a bull call spread (long call, short higher-strike call). Unlike an iron condor, which contains two credit spreads, a call condor includes two types of spreads: debit and credit.

**Long-Term Equity Anticipation Securities (LEAPS):** Options contracts with much more distant expiration dates — in some cases as far as two years and eight months away — than regular options.

**Market makers:** Provide liquidity by attempting to profit from trading their own accounts. They supply bids when there may be no other buyers and supply offers when there are no other sellers. In return, they have an edge in buying and selling at more favorable prices.

**Moving average convergence-divergence (MACD):** Although it is often grouped with oscillators, the MACD is more of an intermediate-term trend indicator (although it can reflect overbought and oversold conditions).

The default MACD line (which can also be plotted as a histogram, as is the case in the accompanying article) is created by subtracting a 26-period exponential moving average (EMA) of closing prices from a 12-period EMA of closing prices; a nine-period EMA is then applied to the MACD line to create a “signal line.”

$$\text{MACD} = \text{EMA}(C,12) - \text{EMA}(C,26)$$

$$\text{Signal line} = \text{EMA}(\text{MACD},9)$$

**Naked (uncovered) puts:** Selling put options to collect premium that contains risk. If the market drops below the short put's strike price, the holder may exercise it, requiring you to buy stock at the strike price (i.e., above the market).

**Open interest:** The number of options that have not been exercised in a specific contract that has not yet expired.

**Opportunity cost:** The value of any other investment you might have made if your capital wasn't already in the markets

**Outlier:** An anomalous data point or reading that is not representative of the majority of a data set.

**Out of the money (OTM):** A call option with a strike price above the price of the underlying instrument, or a put option with a strike price below the underlying instrument's price.

**Parity:** An option trading at its intrinsic value.

**Pivot points:** Calculations some traders use to determine

supposed support and resistance levels derived from the high, low, and closing prices of the previous price bar. The pivot point value is added to and subtracted from the previous bars' reference points to determine support and resistance levels for future trading.

The pivot point (PP) formula is:

1.  $PP = (H + L + C)/3$
2. First resistance level (R1) =  $(PP * 2) - L$
3. Second resistance level (R2) =  $PP + (H - L)$
4. First support level (S1) =  $(PP * 2) - H$
5. Second support level (S2) =  $PP - (H + L)$

A typical pivot point application is to cover any short positions and go long at either of the two support levels, or sell any long positions and go short at the projected resistance levels. Pivot points are often attributed to a tradition passed down among floor traders. Like any tool, pivot points should be tested to verify their potential before trading.

**Premium:** The price of an option.

**Put option:** An option that gives the owner the right, but not the obligation, to sell a stock (or futures contract) at a fixed price.

**Put ratio backspread:** A bearish ratio spread that contains more long puts than short ones. The short strikes are closer to the money and the long strikes are further from the money.

For example if a stock trades at \$50, you could sell one \$45 put and buy two \$40 puts in the same expiration month. If the stock drops, the short \$45 put might move into the money, but the long lower-strike puts will hedge some (or all) of those losses. If the stock drops well below \$40, potential gains are unlimited until it reaches zero.

**Put spreads:** Vertical spreads with puts sharing the same expiration date but different strike prices. A bull put spread contains short, higher-strike puts and long, lower-strike puts. A bear put spread is structured differently: Its long puts have higher strikes than the short puts.

**Ratio spread:** A ratio spread can contain calls or puts and includes a long option and multiple short options of the same type that are further out-of-the-money, usually in a ratio of 1:2 or 1:3 (long to short options). For example, if a stock trades at \$60, you could buy one \$60 call and sell two same-month \$65 calls. Basically, the trade is a bull call spread (long call, short higher-strike call) with the sale of additional calls at the short strike.

Overall, these positions are neutral, but they can have a directional bias, depending on the strike prices you select. Because you sell more options than you buy, the short options usually cover the cost of the long one or provide a net credit. However, the spread contains uncovered, or “naked” options, which add upside or downside risk.

**Straddle:** A non-directional option spread that typically consists of an at-the-money call and at-the-money put with the same expiration. For example, with the underlying

instrument trading at 25, a standard long straddle would consist of buying a 25 call and a 25 put. Long straddles are designed to profit from an increase in volatility; short straddles are intended to capitalize on declining volatility. The strangle is a related strategy.

**Strangle:** A non-directional option spread that consists of an out-of-the-money call and out-of-the-money put with the same expiration. For example, with the underlying instrument trading at 25, a long strangle could consist of buying a 27.5 call and a 22.5 put. Long strangles are designed to profit from an increase in volatility; short strangles are intended to capitalize on declining volatility. The straddle is a related strategy.

**Stochastic oscillator:** A technical tool designed to highlight shorter-term momentum and “overbought” and “oversold” levels (points at which a price move has, theoretically at least, temporarily exhausted itself and is ripe for a correction or reversal).

**Calculation:** The stochastic oscillator consists of two lines: %K and a moving average of %K called %D. The basic stochastic calculation compares the most recent close to the price range (high of the range - low of the range) over a particular period.

For example, a 10-day stochastic calculation (%K) would be the difference between today’s close and the lowest low of the last 10 days divided by the difference between the highest high and the lowest low of the last 10 days; the result is multiplied by 100. The formula is:

$$\%K = 100 * \{(C_t - L_n) / (H_n - L_n)\}$$

where

$C_t$  is today’s closing price

$H_n$  is the highest price of the most recent  $n$  days (the default value is five days)

$L_n$  is the lowest price of the most recent  $n$  days

The second line, %D, is a three-period simple moving average of %K. The resulting indicator fluctuates between 0 and 100.

**Fast vs. slow:** The formula above is sometimes referred to as “fast” stochastics. Because it is very volatile, an additionally smoothed version of the indicator — where the original %D line becomes a new %K line and a three-period average of this line becomes the new %D line — is more commonly used (and referred to as “slow” stochastics, or simply “stochastics”).

Any of the parameters — either the number of periods used in the basic calculation or the length of the moving averages used to smooth the %K and %D lines — can be adjusted to make the indicator more or less sensitive to price action.

Horizontal lines are used to mark overbought and oversold stochastic readings. These levels are discretionary; readings of 80 and 20 or 70 and 30 are common, but different market conditions and indicator lengths will dictate different levels.

**Strike (“exercise”) price:** The price at which an underlying instrument is exchanged upon exercise of an option.

**Time decay:** The tendency of time value to decrease at an

accelerated rate as an option approaches expiration.

**Time spread:** Any type of spread that contains short near-term options and long options that expire later. Both options can share a strike price (calendar spread) or have different strikes (diagonal spread).

**Time value (premium):** The amount of an option’s value that is a function of the time remaining until expiration. As expiration approaches, time value decreases at an accelerated rate, a phenomenon known as “time decay.”

**Vertical spread:** A position consisting of options with the same expiration date but different strike prices (e.g., a September 40 call option and a September 50 call option).

**VIX:** measures the implied volatility of S&P 500 index options traded on the Chicago Board Option Exchange (CBOE). The index reflects the market expectation of near-term (i.e., 30-day) volatility. The VIX has been around since 1990, but underwent a major transformation in late 2003. It is a commonly referenced gauge of the stock market’s “fear level.”

When the CBOE overhauled the VIX in September 2003, it changed it from a volatility measurement based on the S&P 100 (OEX) to one based on the S&P 500 (SPX).

The old VIX formula used the Black-Scholes pricing model that looked at eight near-term at-the-money OEX options (calls and puts). The new VIX is derived from near-term at-the-money SPX options as well as out-of-the-money puts and calls (so the index reflects the full range of volatility).

The new calculation derives the VIX from the prices of options themselves rather than from a formula. The CBOE also applied the new calculation method to the CBOE NDX Volatility Index (VXN), which reflects the volatility of the Nasdaq 100 index. The exchange still publishes the original VIX calculation, which can be found under the ticker symbol VXO. For more information about the VIX and its calculation, visit [www.cboe.com/vix](http://www.cboe.com/vix).

**Volatility:** The level of price movement in a market. Historical (“statistical”) volatility measures the price fluctuations (usually calculated as the standard deviation of closing prices) over a certain time period — e.g., the past 20 days. Implied volatility is the current market estimate of future volatility as reflected in the level of option premiums. The higher the implied volatility, the higher the option premium.

**Volatility skew:** The tendency of implied option volatility to vary by strike price. Although, it might seem logical that all options on the same underlying instrument with the same expiration would have identical (or nearly identical) implied volatilities. For example, deeper in-the-money and out-of-the-money options often have higher volatilities than at-the-money options. This type of skew is often referred to as the “volatility smile” because a chart of these implied volatilities would resemble a line curving upward at both ends. Volatility skews can take other forms than the volatility smile, though.



## Legend

**CPI:** Consumer Price Index

**ECI:** Employment cost index

### First delivery day (FDD):

The first day on which delivery of a commodity in fulfillment of a futures contract can take place.

### First notice day (FND):

Also known as first intent day, this is the first day a clearinghouse can give notice to a buyer of a futures contract that it intends to deliver a commodity in fulfillment of a futures contract. The clearinghouse also informs the seller.

**FOMC:** Federal Open Market Committee

**GDP:** Gross domestic product

**ISM:** Institute for supply management

**LTD:** Last trading day; the first day a contract may trade or be closed out before the delivery of the underlying asset may occur.

**PPI:** Producer price index

### Quadruple witching Friday:

A day where equity options, equity futures, index options, and index futures all expire.

## DECEMBER 2007

26	27	28	29	30	31	1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31	1	2	3	4	5

## JANUARY 2008

30	31	1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31	1	2

The information on this page is subject to change. Futures & Options Trader is not responsible for the accuracy of calendar dates beyond press time.

## December

**1 FDD:** December coal, natural gas, and crude oil futures (NYMEX)

**2**

**3 ISM report on business**  
**FDD:** December T-bond futures (CBOT); December aluminum, copper, platinum, palladium, silver, and gold futures (NYMEX); December oats, wheat, corn, and soybean products futures (CBOT); December coffee, cocoa, and cotton futures (ICE)

**4 FND:** December propane, gasoline, and heating oil futures (NYMEX)

**5**

**6 LTD:** December cotton futures (ICE)  
**FDD:** December propane futures (NYMEX)

**7 Unemployment**  
**LTD:** December currency options (CME); December U.S. dollar index options (ICE); January cocoa options (ICE)

**8 FDD:** December gasoline and heating oil futures (NYMEX)

**9**

**10 FND:** December live cattle futures (CME)

**11 FOMC meeting**

**12**

**13 PPI**  
 Retail sales  
**LTD:** January crude oil options (NYMEX); December cocoa futures (ICE)  
**FDD:** December live cattle futures (CME)

**14 CPI**  
**LTD:** December oats, rice, wheat, corn, and soybean product futures (CBOT); December lean hog futures (CME); January sugar and coffee options (ICE)

**15**

**16**

**17 LTD:** December currency futures (CME); December U.S. dollar index futures (ICE); December Goldman Sachs commodity index futures and options (CME)

**18 LTD:** December coffee futures (ICE)

**19 LTD:** December T-bond futures (CBOT); January crude oil futures (NYMEX); January platinum options (NYMEX)

**20 GDP**

**LTD:** All December equity options and futures; S&P options and futures (CME); Nasdaq options and futures (CME); Russell options and futures (CME); Dow Jones options and futures (CBOT)

**21 Quadruple witching Friday**

**LTD:** January T-bond options (CBOT); January soybean and soybean products options (CBOT); January orange juice options (ICE)

**22**

**23**

**24**

**25 Markets closed — Christmas Day**

**26 LTD:** January natural gas, gasoline, and heating oil options (NYMEX); January coal futures (NYMEX); January aluminum, copper, silver, and gold options (NYMEX)

**27 Durable goods**

**LTD:** January natural gas futures (NYMEX); December aluminum, palladium, copper, platinum, silver, and gold futures (NYMEX)  
**FND:** December coal futures (NYMEX)

**28 FND:** January natural gas futures (NYMEX)

**29**

**30**

**31 LTD:** January propane, gasoline, and heating oil futures (NYMEX); December live cattle futures (CME)  
**FND:** January aluminum, copper, platinum, palladium, silver, and gold futures (NYMEX); January soybean products futures (CBOT)

## January

**1 Markets closed — New Year's Day**  
**FDD:** January natural gas, gasoline, and crude oil futures (NYMEX)

**2 ISM report on business**  
**FND:** January orange juice futures (ICE)  
**FDD:** January aluminum, copper, platinum, palladium, silver, and gold futures (NYMEX); January rice, soybean products, and soybean futures (CBOT)

**3 LTD:** December milk futures and options (CME)  
**FND:** January propane and heating oil futures (NYMEX)

**4 Unemployment**

**LTD:** January currency options (CME); January U.S. dollar index options (ICE); February cocoa options (ICE)





Using a mental stop works — this time — but are we being rewarded for doing the wrong thing?

## TRADE

**Date:** Friday, Nov. 23, 2007.

**Entry:** Long the December 2007 E-Mini Russell 2000 futures at 757.00.

**Reasons for trade/setup:** The Russell 200 index lost a whopping 14 percent from Oct. 11 through Nov. 20. After getting battered in a long position during the first part of that sell-off, we remained out of the market for more than two weeks.

There is plenty of analysis showing the tendency for stocks to rebound after such large down moves (“Navigating market shocks,” *Active Trader*, November 2006 and “Stock market pullbacks: Know the odds” *Active Trader*, August 2007) and, despite (actually, because of) all the negative news regarding the economy, it seems a good time to get back in the market.

On Nov. 23, the market failed to make a lower low for the second straight day. Also, it was apparent the market was going to reverse the previous day’s price action (high open and low close). Testing indicated favorable odds for an up move.

**Initial stop:** 733.60, which is 3.10 below the Nov. 20 low. This is a wide stop, but the market is, and will likely continue to be, very volatile. This is intended to be a longer-term trade, so we don’t want to get shaken out of the market unnecessarily.

**Initial target:** 788.90, which is the approximate midpoint of the Nov. 14 bar and 1.10 below a round-number target price (790).

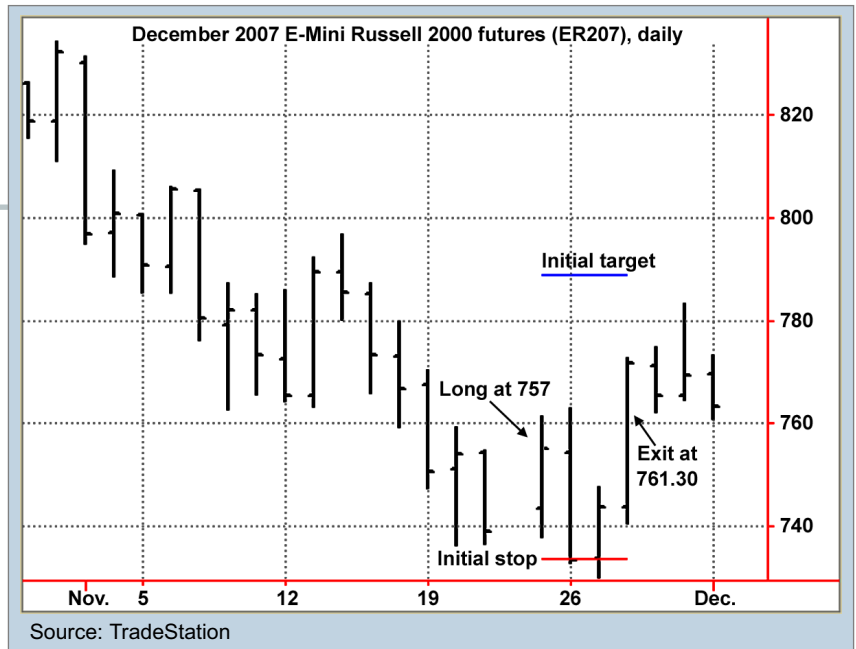
## RESULT

**Exit:** 761.30.

**Profit/loss:** +4.30 (0.6 percent).

**Trade executed according to plan?** No.

**Outcome:** The day after entry was explosive — the market rallied to a higher high before collapsing and making a



sharply lower low and lower close. The mood was very, very bearish. We pulled the stop because the market was swinging up and down so sharply, we were afraid of getting knocked out of the market only to watch it go back in our favor. The contract closed 0.50 points below the stop level and we carried the trade into the next day (Nov. 26).

The market then extended the slide, falling as far as 730.00. We were just about to get out when price turned back up, closing the day above 743.00

Ignoring the stop to this extent could be viewed as a fairly significant breach of the trade plan, but the market’s volatility made it difficult for any reasonably close stop-loss level not to get triggered. We decided the storm had to be weathered a little more. A dangerous rationalization or an adjustment to changing conditions? Even now it’s still difficult to tell.

The next day, Nov. 28, turned out to be a big up day that put the trade back in the black. Having let the position extend beyond the initial stop point made us exit the trade sooner than planned. Holding the position until the close would have tripled the percentage gain, but to be fair, we added on to what was an overall long position in the stock market using Nasdaq 100 futures (NQ) just prior to exiting this trade. ☹

*Note: Initial targets for trades are typically based on things such as the historical performance of a price pattern or trading system signal. However, individual trades are a function of immediate market behavior; initial price targets are flexible and are most often used as points at which a portion of the trade is liquidated to reduce the position’s open risk. As a result, the initial (pre-trade) reward-risk ratios are conjectural by nature.*

## TRADE SUMMARY

Date	Contract	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Trade length
11/23/07	ER207	757.00	733.60	788.90	1.36	761.30	11/28/07	+4.3 (+0.6%)	15.80	27	3 days

Legend: IRR — initial reward/risk ratio (initial target amount/initial stop amount); LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade).



## Buying in-the-money calls before Dominion Resources' stock split captures a bullish overnight move.

### TRADE

**Date:** Monday, Nov. 19.

**Market:** Options on Dominion Resources (D).

**Entry:** Buy 1 December 85 put for \$6.50.

**Reasons for trade/setup:** Dominion Resources (D) announced a two-for-one (2:1) stock split before Oct. 29's open, and its stock rallied 1.67 percent by the close. D then gained as much as 3.79 percent in the next two weeks as the S&P 500 plunged 5.66 percent during the same period (Figure 1).

When a company splits its stock, management gives investors additional shares and cuts the stock's price. As a result, a shareholder's dollar investment doesn't change. However, investors tend to view a stock split as bullish, because they receive more shares.

Companies sometimes announce stock splits up to six months in advance, but Dominion Resources planned to split its stock within three weeks. Historical testing in the past seven years shows S&P 500 stocks have tended to climb after stock splits are announced until the shares actually split.

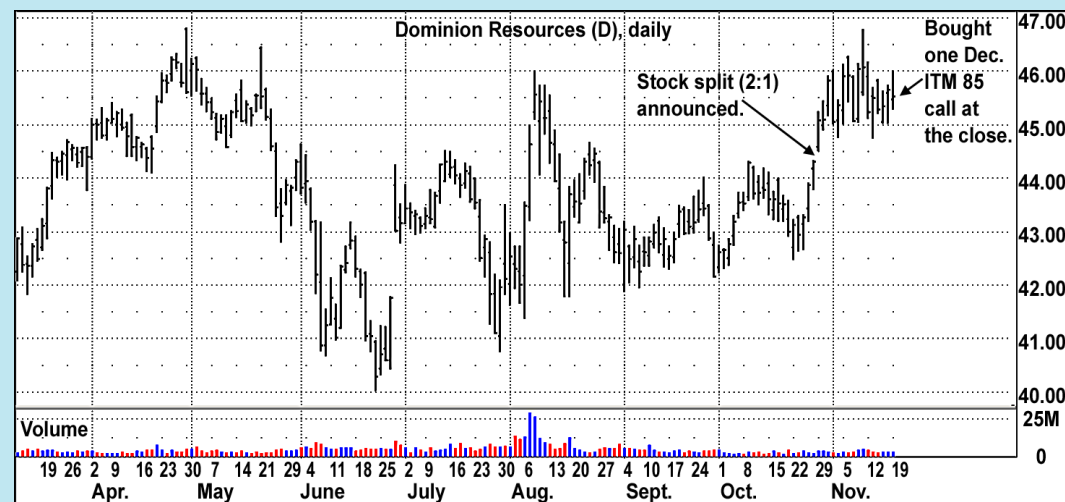
Stock-split candidates gained roughly 3.4 percent, on average, from split announcements to the day before the split, the so-called payable date. Stocks then fell an average

0.28 percent on the payable date before rebounding 0.49 percent overnight on the split day, also known as the ex-date.

Although this pattern suggested Dominion Resources would continue to advance until its stock split on Nov. 20, we hesitated to enter a bullish trade because of the sharp decline in U.S. stocks. However, Dominion's behavior followed historical patterns fairly closely — it even declined 0.30 percent

**FIGURE 1 — BEFORE THE SPLIT**

*Dominion Resources gained 2.70 percent from its stock-split announcement on Oct. 29 to Nov. 19 — the day before the split. Historical testing suggests D may jump overnight.*



Source: eSignal

on its Nov. 19 payable date.

When D traded at \$91.03 just before the Nov. 19 close, we bought a December 85 call for \$6.50. Buying an *in-the-money* (ITM) call is a simple directional trade, because it has a fairly large *delta* (89.10) and a small *time value* (\$0.47). Ideally, Dominion will climb at least 0.50 percent when it splits two-for-one at tomorrow's open.

**Initial stop:** None.

**Initial target:** Hold trade overnight and exit at tomorrow's open.

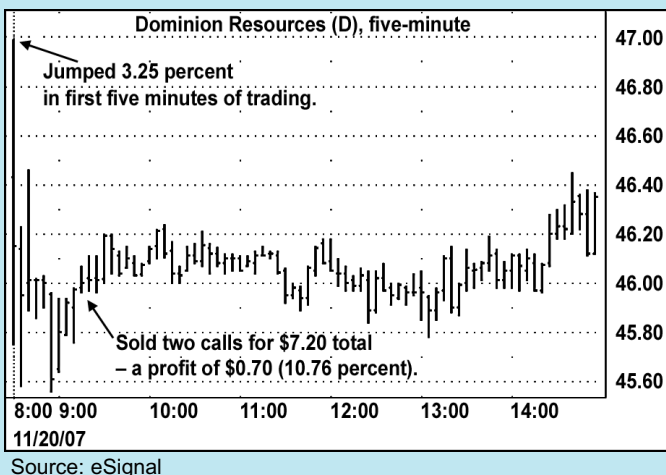
**Outcome:** Figure 2 shows Dominion Resources surged 3.25 percent at Nov. 20's open to reach an all-time, split-adjusted high of \$46.99. The December 85 call was immediately profitable, but several logistical problems kept us from exiting quickly.

First, we assumed our broker would exchange one December 85 call for two 42.5-strike calls, but this process wasn't automatic. Instead of selling at least one call at the open, we waited 20 minutes until we received the second 42.5 call. By that point Dominion had declined 1.89 percent, which hurt the position.

Moreover, the new 42.5 call was illiquid, with an opening bid-ask spread of \$0.60 (\$3.40 bid-\$4.00 asked). After D fell to \$46.10, we exited at \$3.60 (\$7.20 total) — an overall profit of \$0.70 (10.76 percent). In hindsight, we should have sold first and asked questions later. 📌

**FIGURE 2 — AFTER THE SPLIT**

*Dominion Resources spiked 3.25 percent shortly after the open, but we didn't sell the ITM call until 20 minutes later. The trade gained \$0.70 (10.76 percent) overnight.*



**TRADE SUMMARY**

<b>Entry date:</b>	Nov. 19, 2007
<b>Underlying security:</b>	Dominion Resources (D)
<b>Position:</b>	Long call
<b>Initial capital required:</b>	\$650
<b>Initial stop:</b>	None
<b>Initial target:</b>	Exit at next day's open
<b>Initial daily time decay:</b>	\$3.16
<b>Trade length (in days):</b>	1
<b>P/L:</b>	\$70 (10.76 percent)
<b>LOP:</b>	N/A
<b>LOL:</b>	N/A

LOP — largest open profit (maximum available profit during life of trade).  
LOL — largest open loss (maximum potential loss during life of trade).

**TRADE STATISTICS**

Date	Nov. 19	Nov. 20
<b>Delta</b>	89.10	99.70
<b>Gamma</b>	2.83	0.66
<b>Theta</b>	-3.16	0
<b>Vega</b>	6.34	0
<b>Probability of profit</b>	48 percent	52 percent
<b>Breakeven point</b>	\$45.75 (split price)	\$45.75 (split price)





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