thinkMoney/09

random musings
for thinkorswimmers
Spring 2010

INSIDE THIS ISSUE

WINNER, WINNER, CHICKEN DINNER!

#1 broker in BARRON'S 2010 BROKERAGE SCORECARD
(Details, page 9.)

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Photograph by
Fredrik Brodén

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VIRTUES OF RETAIL TRADING

If you want to trade options, gone are the days when being a pro was the only game in town. Nowadays, the super-trader beneath the suit could very well be ... you.

COMMODITIES \ INTEREST RATES \ EQUITIES \ FX \ ENERGY \ METALS \ WEATHER

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A Quick Howdy

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Something for Everyone

• The first thing you might notice as you're reading this is that something feels different. No, it's not that tingling sensation in your belly. But if you're finding these words a bit easier to read than in previous issues, it's probably because we made the magazine, well, easier to read. As our following has grown, it seems many of you prefer to get your *thinkMoney* fix while running on the treadmill or driving down the highway (okay, not really). So sure, why not? We hope the new and improved typeface helps make your 45 minutes of editorial bliss more enjoyable.

The markets have certainly come a long way from the bottom we fell to early last year. But interestingly, as they spring back and new traders are opening options trading accounts for the first time, some are not actually trading them. It seems that some people still believe that "professional" traders still have the upper hand (largely untrue), and their practices are shrouded in such mystique (probably true), that it's best to not get involved at all (mostly untrue). If you're not trading options because you're scared for the wrong reasons, be sure to read our cover story, "If Not Now, When?"

Now, if you're in the other camp of traders not using options for reasons other than fear (perhaps you're just a stock guy at heart), you'll want to read this issue's Special Focus on options analysis, including the feature, "Options … Worth More Than You Think." Ignore options altogether, and you might be missing out on some mucho important info that might actually help your trading—and doesn't require you to actually trade options.

So you see, there's something for everyone in this issue. Call it the Giving Issue. Of course, we haven't forgotten about our advanced options traders as well. There's some brain candy for you, too, with "On Beyond Condors" highlighting a few strategies for those in search of a bold, new frontier—beyond the world of defined risk that we normally focus on. If you try them, just don't forget to fasten your seat belt … particularly if you're reading this while driving.

Happy Trading!
TOS

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

PHOTOGRAPH: FREDRIK BRODÉN

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important info

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• thinkorswim earned 4.9 stars, the top score, in the category "trading technology," and was rated #1 overall online broker and "best for options traders" in Barron's ranking of online brokers, 3/15/2010; thinkorswim was evaluated versus others in eight total categories, including trade experience, trading technology, usability, range of offerings, research amenities, portfolio analysis and reporting, customer service and education, and costs. thinkorswim topped the list in 2006, 2007, 2009, and 2010 with the highest weighted-average score and was runner-up in 2008. thinkorswim was also noted "best software-based online broker" and "best for options traders," 3/6/2006 and 3/5/2007.

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cov. story

IF NOT NOW, WHEN

THERE'S NEVER BEEN A BETTER TIME TO CONSIDER ADDING OPTIONS TO YOUR TRADING PLAN... AND THINGS ARE ONLY GETTIN' BETTER.

WORDS BY **FREDERIC RUFFY**
PHOTOGRAPH BY **FREDRIK BRODÉN**

Photograph by
Fredrik Brodén
•
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Excited about options? Yeah, we are, too. Learn more about them each week on our live Trader's Lounge chats on Wednesdays at 3:15 CT. Or, visit the chat archives at **thinkorswim> Support>Option School >Chat Archives**
•

THIS AIN'T YOUR GRAMPAPPY'S OPTION MARKET.

Back in the day, only a privileged few could take advantage of things like streaming quotes and real-time option chains. Options were shrouded in mystique and deemed too complex for the average Joe—to be traded only by "sophisticated," professional investors. Since then, however, seismic changes in the options world have leveled the playing field for individual traders and investors. Thanks to advances in technology, innovative trading tools, and better access to what was once privileged information, the little guy is now in the same position as the Wall Street fat cats were during their heyday—just a few short years ago.

GETTIN' OFF THE FLOOR

In the mid-1990s, a number of new trading software applications were developed to help investors do things like create charts, get quotes, and track portfolios. Even though a good program still cost thousands of dollars, for the individual investor (aka "the little guy"), it changed things forever. Quotes, charts, and news were no longer proprietary tools of Wall Street trading firms and their favorite clients. They were there for the taking—by anyone.

Since then, online brokerage firms have followed suit by offering customers Web-based and software-based trading platforms to find, analyze, and place trades. Today, sophisticated trading platforms are no longer a barrier to entry, but rather, in most cases, a free benefit to traders. So in the modern trading world, you can now chart your favorite stock, check its fundamentals, view an options chain, analyze a spread, and place the order using just one trading platform (for more on how, read "4 Stumbles and 1 Step" in this issue).

On a larger scale, there has also been an ongoing shift away from trading floors altogether and toward pure electronic trading. In fact, one of the largest options exchanges—the International Securities Exchange—is all electronic. While exchange floors still exist, they are mere shells of their former selves. That's why fewer and fewer people actually take a big chunk of change and set up shop on the exchange floor. It's expensive to do, and realistically, the odds of success aren't much better.

These days, once your order has been filled, the report hits your account within seconds. In fact, most of us are probably in a better position at home in front of our monitors today than a trader on the exchange floor was a decade ago.

MORE TOOLS THAN UNCLE NED'S WOODSHED

Fast execution and free tools aren't the only factors that have leveled the playing field. There are plenty of reasons that have little to do with online brokers and cool toys. Let's take a look at a few more of the majors:

1) Multiple Listing. Because there are now eight different option exchanges, and individual options contracts are listed on multiple exchanges, you can route your orders directly to the exchange where you think the best price currently exists, such as with thinkorswim. However, if you want to buy a call option on your favorite stock, and it's listed on eight different exchanges, your broker will usually direct the order to the exchange with the best price, taking into consideration the cost of execution and current market conditions, such as the National Best Bid and Offer (NBBO), volume, and liquidity.

2) Penny Pricing. On January 26, 2007, the options exchanges kicked off a penny pricing pilot program that included 13 stocks and exchange-traded funds with options listed at one-cent increments. Since that time, the list has been expanded to more than 100. These one-cent increments are another important trend that has put more power into the hands of individual investors. No longer are we fighting 5-, 10-, or 25-cent spreads between bid and ask prices; the spread on many of the most actively traded names is often just one or two pennies. This may not sound like much, but if you're trading 10 contracts at a time and can save just 5 cents per order, over 100 round trips per year that will save you $10,000 in "slippage." Not bad.

3) The "Minis." New products targeted toward individual investors have proliferated. Examples include the mini-indexes and mini-exchange-traded funds. Say I want to trade the Dow Jones Industrial Average. I can trade an index called the Dow Jones Industrial Index (symbol: DJX) or its related ETF (exchange-traded fund). The DJX and most of its related ETFs are designed to trade at 1/100th of the Dow Jones Industrial Average. So, if the Dow is trading at 10,000, these two instruments will trade at around 100. This smaller value means the options premiums are much lower, which also makes it much easier for individual investors to play the Dow. These are just two of many innovative products that benefit the individual investor.

4) Portfolio Margin. In December 2006, the Securities Exchange Commission (SEC) approved a rule change that would allow margin to be based on the true risks of a portfolio rather than on the risks associated with a specific strategy. For example, the capital required for a protective put position (buying shares of stock and buying an equivalent number of puts) under portfolio margin is a fraction of the margin required under a strategy-based margin account. Many institutions had already been using similar types of portfolio margin requirements prior to the SEC rule change. Only now, it's possible (assuming you meet strict requirements) for well-capitalized individual traders to enjoy the same advantage. See "Capiche," page 24, for more information.

WHEN IT COMES TO ACTIVE INVESTING AND TRADING, INFORMATION TRULY IS POWER, AND INDIVIDUAL INVESTORS HAVE NEVER HAD SO MUCH NEWS, RESEARCH, AND DATA. INVESTORS NOW HAVE EASY ACCESS TO VIRTUALLY ANY MARKET-RELATED INFORMATION THEY MIGHT NEED. NOT TO MENTION EDUCATION, TOOLS, PRODUCTS, EXCHANGES, MARGIN OPTIONS ...

5) Speed of Information. When it comes to active investing and trading, information truly is power, and individual investors have never had so much news, research, and data. Through brokerage firms, news services, and fee-based Web information sites, investors now have easy access to virtually any market-related information they might need. Streaming quotes and news means the delivery is also faster than ever.

6) Options Education. Finally, the free educational resources available today are almost overwhelming. Just by virtue of reading this, clearly you're pretty smart, but there's much, much more. In addition to these types of magazines and the dozens of options trading books you can buy (or check out at your local library), some private companies offer seminars and courses for a fee. And, of course, check out the online resources that thinkorswim can offer you. There are plenty of free online education and live events opportunities for anyone who just wants to learn more about options.

GRAB THE WHEEL!

Volume in the industry continues to grow as increasing numbers of investors add puts and calls to their trading plans. According to the Options Clearing Corporation, an average of 14.385 million contracts traded each day in 2009—another record year.

Obviously, not everyone uses options in the same way. For example, while I might trade call spreads to play my favorite tech stock, you might buy index puts to hedge a stock portfolio. Someone else might sell puts on stocks they want to own, while another investor might trade only covered calls. There's no right strategy for every kind of investor.

The important point is this: A major shift has taken place in the world of retail options trading, and the changes that can potentially benefit the little guy are the very reasons many professional traders have taken their operations "off the floor." Now is an ideal time to educate yourself about what options can do for your trading plan. Don't be intimidated or fooled by popular misconceptions that options are too risky or too complex. We're not saying they're a walk in the park; but with a little time and effort, most can probably take the next step. Thanks to evolving improvements like better technology, easy access to information, and innovative tools, the time has never been better. Really. If not now, when?

Frederick Ruffy *is an options strategist and cofounder of WhatsTrading.com.*

lttrs.

Dear Swim

A collection of your best quips to the Trading Desk

Photograph by **Fredrik Brodén**

The comments below are excerpts from emails submitted by thinkorswim, Inc., customers as their views and may not reflect those of thinkorswim, Inc. Testimonials may not be representative of the experience of other customers and are no guarantee of future performance or success.

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

• I was shocked that you would have used my interview to paint my darling son in an unflattering light. A mother's thoughts and feelings should be kept private. And as much as I would love to tell you to shove it, your trading software is just too handy. I'll keep trading with you, but I won't like it!
Mrs. Sosnoff

• There once was a young options trader,
who thought to be tough as Darth Vader.
Account blown on corn,
trying not to mourn,
is serving up fries as a waiter.
Trish

• Have you ever considered releasing *thinkMoney* on a more regular basis? It is truly one of my favorite publications to get and I would gladly pay $3 an issue. Thanks so much,
Robert
[Ed: Hmm . . . only $3?]

• I saw in the Contents the number to call if I prefer NOT to receive this publication. Where is the number if I prefer to receive it MONTHLY?
Greg

• Dear thinkorswim, I would first like to thank you for a awesome trading platform and customer service. I would also like to thank you for the monkey. However, my wife and I have funded two accounts and she was upset that they match. She was wondering if there was a female monkey available and how she could exchange it. Please let me know one way or the other.
Michael
[Ed: Michael, while we don't like to say this in front of the Monkey, he's, uhh . . . "gender neutral."]

• Make a note in your PDA to ask me in a year how well TOS is doing. It will only take one engineer/trader who takes the time to build a better mouse trap and you guys will all be polishing resumes. And, if I have to pick up the phone, I am likely to not pick up this tool again, until I have prepared myself emotionally for the strain of running down another rabbit trail.
Gordon

Dear Editor:
I am looking for crow recipes! Tom Sosnoff finally got a forecast of the market right. Yeah, it went into the tank in January - finally—just as he had been saying it would—like forever—on the Market Wrap! I had criticized him [*Winter 2009 issue*] for missing his forecasts, so I must eat crow. Now he says he is confused and doesn't know where the market is going! Well, what the heck, who really does! By the way, I think I like my crow baked. Sorry, Tom!
Claude

TOS News+Views

A hodgepodge of stuff we thought you'd like to know

nws.

INDUSTRY SPOTLIGHT

Retail Options: They're Not What's Broken

by Thomas Preston

As Washington struggles to create new regulations to prevent the economic crisis in the fall of 2008 from happening again, and as the economy still struggles to create jobs, it's not surprising that many Americans are suspicious of the financial industry in general and trading in particular. But what isn't widely known outside of the option trading business is that the Options Clearing Corporation reported a record number of transactions in 2009, and the beginning of 2010 saw record monthly transactions as well (source: optionsclearing.com). That might be interesting, but what does it mean to the retail trader?

That derivatives contributed to the collapse of many financial institutions in 2008 can't be argued. AIG, Bear Stearns, Lehman, and many others put on huge positions with unlimited downside risk, and borrowed more money against inaccurate but favorable "mark" prices to put on more (in this writer's educated opinion). But they did all this outside of exchanges and capital requirements that they and regulators impose. Instead, the parties involved in these "over the counter" derivative transactions were the supposedly sophisticated banks, insurance companies, hedge funds, and so on that "didn't need" that sort of oversight.

And while I agree wholeheartedly that it wasn't capitalism that failed, neither is the unregulated OTC derivative market blameless for our current economic doldrums. What is rarely acknowledged is that while many retail traders lost money in the Crash of '08, no broker dealers went out of business, no clearing firms failed, no exchanges ceased functioning. Margin calls were made when necessary, and most were met. The rules and the systems worked. Unlike the OTC market, prices for stocks, options, and futures are disseminated live, and for most, free to see. All transactions must occur on an exchange, and be brokered and cleared by firms that must meet strict financial, compliance, and supervisory requirements. This highly regulated version of a market where prices move as freely as any in the world (intraday price limits and short-sale rules, for example, don't really impede the market from determining the fair price of a stock, future, or option) proved to be a safe place to do business. That means as a retail trader working with exchange-traded products, you can focus your attention on trading, and worry a lot less about whether the "game" is rigged or the playing field is tilted against you.

The views in the section above are those of the author. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. The example above and its historical data cannot be construed as predicting future results. Customers must consider all relevant risk factors, including their own personal financial situations, before trading.

Toys for TOS

Widget 360 Click on the column header on the Trade page and select "Widget 360" to display data such as open interest, implied volatility, or extrinsic value in a visually intuitive format.

Hot key controls are visible by clicking the Ctrl or Alt keys, and let you move between tabs and features on the software faster than ever. Click on the Setup button and go to the Hot Keys tab to customize them.

Custom study sets Create custom study sets on charts to group similar study types together, including customized technical indicators.

Market Cast This live squawk box from the floor of the CME gives live market intelligence throughout the trading day.

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

TRADER OBSERVATIONS

To Golf...or to Trade

I LOVE GOLF BECAUSE	I TRADE FROM HOME BECAUSE
I can show individuality with corporate logos embroidered on shirt	Shirts are optional
I can pretend beverage cart staff flirts with me because of charm, not tips	Warehouse-sized boxes of candy, snack cakes, and jerky always within easy reach
I can pursue an activity that won't ruin my knees, back, or fragile beer belly	I can still look busy even when staring glassy-eyed at streaming quotes
I get to bond with other boring people	The dog is keenly interested in my personal market commentary

fyi.

TOS TOYS COMING SOON

- 3-D heat map / volume by price on charts / scanning on custom studies / more David Elliot studies

Pot Shots

Top 5 Cuts of Beef: What a Trader Really Wants

KEY:

2 Buy Tickets =

1 Buy Ticket =

1 Sell Ticket =

2 Sell Tickets =

Tenderloin

Soft and mild for the trader whose teeth have been kicked in and whose stomach was wrenched by a cruel market.

Tartare

For the trader who likes to brag about how much risk she takes, and doesn't really care how she'll feel in the morning.

Rib-eye

Dripping with fat and suitable for when options premiums are so high, they leave grease stains on your screen.

Hanger

A lesser-known steak appealing to the trader too busy eating to clean up his short, worthless options that leave him dangling at the end of expiration day.

Flank

Tough, but flavorful for the trader looking to replace a chewing gum habit with something that has a little more protein.

ON BEYOND CONDORS

WHAT LIES BEYOND DEFINED-RISK TRADES THAT PROFIT WHEN TIME PASSES? IF YOU'RE WELL CAPITALIZED AND FEELING FRISKY, THERE ARE A FEW STRATEGIES THAT MIGHT BE RIGHT UP YOUR ALLEY.

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

How do you turn a nice, sweet little option strategy—one that has a maximum loss that can be calculated and identified—and turn it into pure poison? Easy. Take a deep breath and take off the protection. It's collecting positive time decay and NOT sleeping at night. What's that mondo-delicious fish that they eat in Japan, that if it's not prepared perfectly can kill you? Yeah, kind of like that. What do I mean?

These are the types of positions that many firms had in 2008—the firms that blew up. Take your eye off 'em, and you might as well be speeding through a red light at a busy intersection. Scared yet? Good. Go ahead and walk away. There's no shame. But if you're curious, read on.

Do you like short put verticals?—The higher risk trade is the short naked put.

Like the long butterfly?—Take off the protection and you have a short straddle.

Short iron condor?—Next of kin is a short strangle.

Long unbalanced butterfly?—How about a put ratio spread.

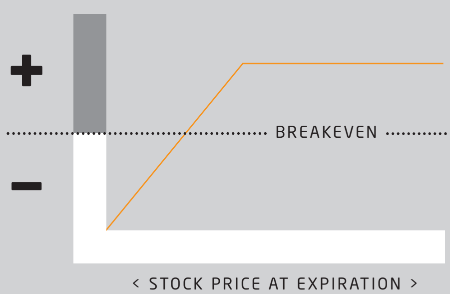
The idea with each of these is that you're still collecting positive time decay by selling options, and you're still speculating that the stock or index won't make a big move either up or down. But remember, you can't separate risk and reward. If you want less risk, you have to hedge those short options and eat into that positive time decay. And if you are willing to accept more risk? Then you exchange the hedging long option for constant attention and more risk for higher potential profits. That, in a nutshell, is the appeal. Remember that any of these complex option strategies can incur high commission charges.

SHORT NAKED PUT

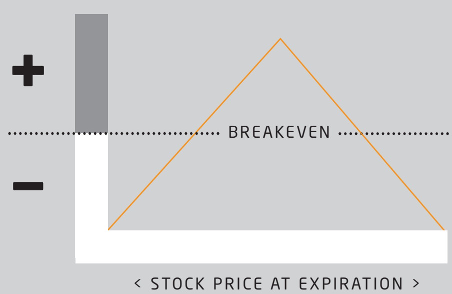
If you believe that a stock won't drop very much and have a bullish bias on it, you could consider the defined risk short put vertical, or the undefined risk short naked put. The short put vertical is selling an out-of-the-money put and buying a further out-of-the-money put. The short naked put is just selling the out-of-the-money put. The long put limits the risk of the short put vertical to the difference between the strike minus the premium received, and also reduces the total credit for the trade, which is its max profit. The breakeven point is the short strike price minus the premium.

Compare that to a short naked put, which has a much higher max loss that is the strike price minus the premium. But because the total credit received on the short put is higher, its max profit is higher, and the breakeven point is lower because it's the short put strike minus the larger premium. It's that larger credit that is tempting if you're willing to accept much larger risk and margin requirements. And if you don't think

BEYOND THE CONDOR



SHORT NAKED PUT: A short vertical put (credit spread) without the long hedge is a short naked put, and might be used when you believe a stock will trade higher or sideways until expiration.



SHORT STRADDLE: A butterfly without protective "wings" is a short straddle, and might be used when you think the stock will trade in a certain range up to the expiration of the options.

that max risk on a short put is possible, the past couple of years contains a veritable who's who of once-mighty companies with double-digit stock prices that are now either worthless or just plain bankrupt.

SHORT STRADDLE

Think you can hit 'em right between the eyes? Or at least the short strike price? If you believe that a stock is going to stay in a very narrow range, the defined risk trade is a long butterfly, which is long a lower strike option, long a higher strike option, and short two options at a strike in the middle. Its max profit occurs if the stock is right at the middle strike price at expiration, and has a max loss limited to the debit paid. The breakeven points are the lower strike plus the debit and the higher strike minus the debit.

The much riskier version of this trade is a short straddle, which is short a naked call and naked put at the same strike price. Like the long butterfly, it loses money if the stock rises or drops beyond the breakeven points, which are the strike price plus and minus the credit received. But unlike the long butterfly, the maximum loss on a short straddle is not definable because a stock can theoretically go higher and higher without end, or to zero. The credit for a short straddle can be very high, and that large credit comprises the max profit, which can be much greater than the max profit on the long butterfly if the stock does land at the strike price of the short options at expiration.

When would you consider a short straddle? One scenario is when a stock has some major news announcement, like earnings, coming up. Because of the uncertainty of whether the stock might go up or down on the news, and whether that move might be big or small, the implied volatility in the stock's options increases. When that happens, the premium received for selling the straddle can be very high. Of course, the high volatility can also mean that the stock could make a huge move either up or down, and cause major losses in a short straddle. But if the news comes out and the stock doesn't move as much as the market expected or feared, then the short straddle may drop in a lot of value and profit.

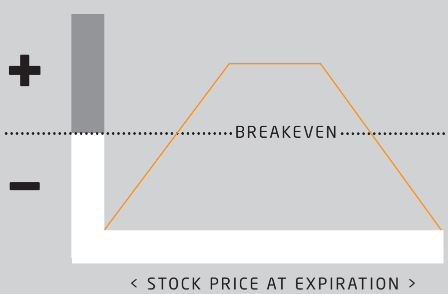
SHORT STRANGLE

Similar to a long butterfly, an iron condor is a trade that profits if the stock stays in a somewhat wider price range than what would work for a long butterfly (for more on the iron condor, see "5 Trades Under $1,000," *thinkMoney,* Summer 2009). It's a long out-of-the-money put, a short closer-to-the-money put, a long out-of-the-money call, and a short closer-to-the-money call. Its max loss is limited to the difference between the strike prices of the long and short options, and the profit is limited to the credit received. The breakeven points are the short put strike minus the credit and the short call strike plus the credit.

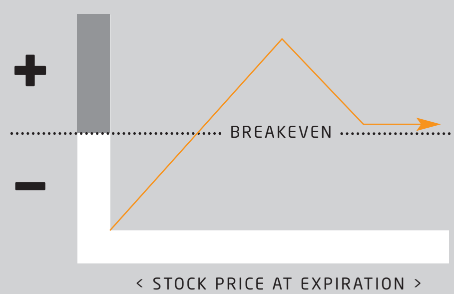
The scary version is to sell the short put and the short call without the long options to limit the risk. This is a short strangle, and because it takes in a larger

YOU CAN'T SEPARATE RISK AND REWARD. IF YOU WANT LESS RISK, YOU HAVE TO HEDGE THOSE SHORT OPTIONS AND EAT INTO THAT POSITIVE TIME DECAY. WANT MORE RISK, FOR HIGHER POTENTIAL PROFITS? THEN YOU'D BETTER PAY CONSTANT ATTENTION.

TAKING OFF THE LONG HEDGES IN EACH OF THESE TRADES CAN RESULT IN HIGHER POTENTIAL PROFITS, BUT THE TRADE-OFF IS TAKING ON THE HIGHER RISK.



SHORT STRANGLE: An iron condor without protective "wings" is a short strangle, and might be used when you think the stock will trade in a wider range up to the expiration of the options.



CALL RATIO SPREAD: An unbalanced butterfly without the lower long call hedge is a call ratio spread, and might be used when you believe a stock will trade sideways, with a possible upside breakout before expiration.

credit than an iron condor, the max profit is larger, and the breakeven points are wider at the short put strike minus the credit and the short call strike plus the credit. But the risk of a short strangle is much higher than for an iron condor. Like a short straddle, if the stock makes a big move up or down, the short strangle loses money. The max risk is undefinable if the stock goes infinitely high, or to zero.

Of course, the further out of the money the short options are, the more the stock can move before either the iron condor or the short strangle lose money. That also reduces the credit for both trades. Just as long as

NOT ONLY DO YOU HAVE TO BE READY TO CLOSE THE TRADE IN THE EVENT THAT THE STOCK MOVES AGAINST IT, BUT YOU ALSO HAVE TO BE READY TO CLOSE IT TO TAKE PROFITS. HOW MUCH PROFIT IS UP TO EACH TRADER, BUT IT'S NOT WORTH BEING GREEDY.

the stock doesn't move above the short call strike or below the short put strike, you're OK. And when it gets close, you're white-knuckled or you ain't alive. That's why you may want to employ short strangles in index products, where inherent diversification keeps event risk down and makes big moves somewhat less likely. But tell that to anyone who was short strangles in 2008.

RATIO SPREAD

When you combine short out-of-the-money options with a long out-of-the-money vertical, don't think that you're hedged—but the trade has interesting characteristics. A ratio spread is made up of some quantity of long out-of-the-money options and a larger quantity of short further-out-of-the-money options, sometimes at different strike prices. These types of positions are typically established for a net credit, where the premium received from the short options exceeds that paid for the long options. The breakeven point is the short strike price minus the net credit for puts, and plus the net credit for calls. The max potential loss of a ratio spread can be very high. For puts, the max risk number of short puts over the number of long puts times the short put's strike price minus the net credit. For calls, the max risk is infinitely high, like a short straddle or strangle.

What's the appeal, then? If the stock stays right where it is, your profit is the net credit of the ratio spread. And if the stock moves up in the case of a put ratio spread or down in the case of a call ratio spread, the profit is still the net credit. If the stock moves toward the short strike, the position can reach its max profit of the difference between the long and short strikes plus the net credit. In this way, the ratio spread can profit over a wide range of stock prices. But if the stock has a large move past your short options, the long options provide only a partial hedge. If implied volatility increases along with the price change, the long vertical component will have its value reduced, and the short options will see their value rise. Ouch.

WITH ALL THESE WARNINGS, THEN, WHY would a trader ever use these strategies? They can collect more positive time decay faster, and so you can take these trades off sooner and potentially capture an equal profit as holding trades with limited risk longer. That's why you have to monitor these trades at all times. Not only do you have to be ready to close the trade in the event that the stock moves against it, but you also have to be ready to close the trade to take profits. How much profit you want is up to each trader, but I don't think it's worth being greedy with these strategies. Holding out for that extra couple of pennies of time decay can leave you open to the wild swings the market can have as expiration approaches. These strategies aren't for novice traders. In the same way that you can build up a resistance to a toxin, you need to build the discipline to exit these trades if the losses reach a certain point, and build the respect for the losses they can dish out to the unwary. *Bon appétit!*

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Gear Head

Cool things to do with what we've got.

Buckets of Trades

Which strategies are working for you? Track your performance with subaccounts.

tech.

• Has your calendar spread trading outperformed your iron condors? Have your calls in big cap stocks matched the performance of an index? Or how about the trading performance of a paid advisor versus your own? These are some of the questions you can answer with the TOS trade grouping functionality. It lets you segregate transactions in just about any way you want into bins that will show the profit and loss, the greeks, and the margin requirements for positions in them.

To get started, you need to create one of these "bins" by going to the Trade page, and looking at the left-hand side of the order entry panel for "Subaccount." Click on the dropdown menu and select "Create New." That lets you come up with a name for the bin you want to put certain trades into. You could name one for the stock symbol that you do a lot of trades in, or maybe a certain option strategy, or the name of a trading advisor. You can also attach a colored icon to that bin for easy identification on the Position Statement of the Monitor page where the bins are displayed.

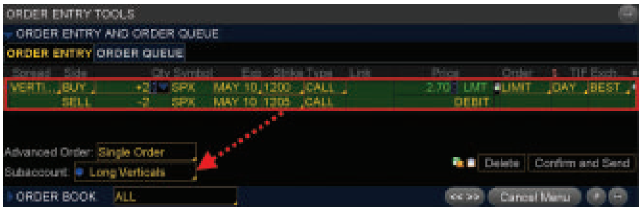

FIGURE 1: Once you've created your subaccount "bins," you can select the appropriate one to store your trades in. *For illustrative purposes only. Not a recommendation.*

FIGURE 2: After your trades are executed, you can track the performance of your open positions by strategy, based on the subaccounts you've created. *For illustrative purposes only. Not a recommendation.*

THE STEP-BY-STEP

When you want to put on a particular trade, like a purchase of stock or the sale of an option spread, there are a couple ways to do it:

FROM THE TRADE PAGE If you are creating the order on the Trade page, you can specify which bin that transaction, if executed, will be stored in (Figure 1). Here are the steps:

1. Go to the same "Subaccount" menu in the lower left-hand corner of the order entry section and select the bin from the names in the menu.

2. Go to the Position Statement section of the Monitor page and select "Subaccount" from the "Group" dropdown menu in the upper left hand corner. The positions will be sorted into the bins that you've created, and if that order that you just sent is filled, it will appear in the bin that you designated.

FROM THE MONITOR PAGE If the trade has already been executed, go to the Position Statement on the Monitor page and follow these steps:

1. Click on the blue dot to the left of the position in the Position Statement and select "Transfer" from the dropdown menu.

2. Select the bin that you want to put that position in.

3. Finally, you can put a transaction into a bin from the Trade History section in the Account Statement page.

For each position in a bin, you can see the greeks, profit and loss numbers, and margin requirements. The p/l open number in particular, which is the profit or loss on a position based on the execution price of the trade and the current price of the security, lets you see which positions, and in turn which bins, are making or losing money (Figure 2). This can be very helpful as you learn to find your own trading style, and your own comfort level with risk versus profit and loss. What's more, this functionality is available in paperMoney, which means you can test out an advisor's recommendations without risking real dollars. Remember, you can't hide from P&L.

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

Capiche?

Lessons from a veteran floor trader

cap.

Going Pro with Portfolio Margining

There's leverage, and then there's this.

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

• When I'm out on the road, spreading the good word about how to become a smarter trader, I get a lot of questions. One of the frequent ones is, "Tony, what's the difference between us retail traders and you professional traders?" Even as little as five years ago, the pro still had a couple of advantages—one being that they didn't need as much capital to put on positions as a retail trader would have to put up.

See, when I started trading on the floor, I couldn't get a backer to give me much money to trade with. Hey, I was a risk, like any new trader. But even though I didn't have much to work with, the exchange rules let me leverage my small amount of capital so that I could trade bigger size. Why'd they do that? Well, if our traders could trade more contracts, we could take the other side of the big institutions that needed our options to hedge their positions. It was Wall Street versus LaSalle Street, and it was a key factor in creating liquidity in the market.

The ability to leverage like that was a pretty big advantage to the market maker. But all that changed in 2007 when portfolio margining for retail accounts was introduced. Now, you may have heard that term mentioned here and there. So what is portfolio margining, anyway?

Instead of applying a fixed percentage or dollar amount as the margin requirement of a stock or option position, portfolio margining uses the potential risk of a position for the margin requirement. It moves the underlying stock or index up and down a predetermined percentage to see how much the position loses. The max loss across that price range is the portfolio margin requirement.

Thus, PM is based on an estimate of how much a position might lose in one day, and that can be a lot less than the standard "Reg T" margin requirement.

Now, you have to apply for this. They don't just let any schmo with a couple of bucks give it a try. Your account has to have net liquids of at least $125,000. It can't fall below $100,000 while on the program, or else you will be dropped from PM. If the shortfall can't be met within two business days, you're toast, and you'll be barred from the program. Not only do you get your lollipop taken away, but most likely you'll be subject to a large margin call due to the Reg T requirements. You have to have trading experience: three years of derivatives trading with no exceptions. And finally, you need a solid understanding of risk—you have to pass a test with a score of at least 16 out of 18. And all that's just so you can be considered by our clearing firm.

Yikes. Basically, this ain't no matter to be taken lightly, and not everybody should rush to ask for an application like we're giving away free money.

So, what does that mean for you?

Well, PM is good and bad. On one hand, you can borrow more money than Reg T margins. On the other hand, you're taking on much bigger risk. So don't act like a college kid with his first credit card.

If you qualify and you're comfortable with the risk, portfolio margining means you can use option strategies that create credits rather than debits with less money than the maximum possible risk of the trades. Be aware that assignment on short option strategies could lead to an unwanted long or short position in the underlying security. Because of this and other reasons, you have to monitor a PM account very closely to avoid any margin calls on large positions that are moving against you.

A nice thing about PM is that it considers hedges in positions in different underlying indexes. So, you might have positions in different indexes that have offsetting market exposure—bullish in one and bearish on another. PM can give you a margin requirement on the two positions as a package, and that will be lower than it would be if the positions were considered individually.

But don't get overconfident. Just because PM lets you put up less money for a position doesn't mean the risk of the position is reduced. Capiche?

25

Q+A:

Lunch with...

Spartacus

(Not necessarily) a real interview with a market VIP

Illustration by **Evonrude**

TOS: **Wow! Spartacus! I thought you'd be bringing a trident and net!**
SPAR: Hah! I'm a trader now! You know, Spartacus, the Mighty Mercator!
TOS: **I thought the gladiator stuff was a pretty good gig? And then the whole rebellion thing?**
SPAR: I had enough battling smelly Celts and Ethiopian lions. A guy could get hurt that way. And leading a bunch of rebellious slaves? They wouldn't do anything I told them to. A couple years ago, I bought some grain from around the Black Sea, traded it for some Falernian wine, sold that in Capua, and *ka-ching,* I was able to say "Vale" to the gladiator business.
TOS: **You had "ka-ching" in those days?**
SPAR: Ka-ching? Of course we had ka-ching. A ram sack filled with coins has a nice jingle.
TOS: **Do you have any insight on the current crisis in Greece?**
SPAR: Tell me when there's NOT a crisis in Greece. Just shows you where that democracy and scroll-learnin' will get you.
TOS: **You have the advantage of a couple thousand years of experience, what trading strategies do you use?**
SPAR: One of my techniques is to use my nose. I wake up in the morning, take a good whiff of the open sewage in Rome, and can tell which commodities everybody's using—I get long those—and short everything else as a kind of pairs trade. I'm getting long fermented fish paste big time.
TOS: **But how do you buy and sell stuff? Do you have limit orders? Stops?**
SPAR: I go down to the docks and squeeze those vendors, man, both literally and figuratively. You could drive an ox cart through some of their markets, and all the purple-toga types just hit the bids and lift the offers—ha!—they're too good to work 'em. And if some guy doesn't want to play, I know just how to grab his neck to bring him around to my way of doing things.
TOS: **Well, that would be kind of illegal here.**
SPAR: No, you're just too skinny.
TOS: **Yeah, well, at least I have a computer that I can trade online with! I don't need a bodyguard when I buy or sell something.**
SPAR: See, that makes no sense to me. Nothing you do is face to face, man to man. I mean, when I do a trade with someone, that guy knows that if he reneges on a deal, he's gotta deal with Spartacus. Go ahead and walk out on a Crassus or a Pompey. But not me. You have to know who you're dealing with. And on the way over here another skinny guy's telling me how your economy stinks because of a bunch of other skinny guys trading and not having to own up on the losses. I could have told you that would happen. But who asks an old gladiator who happens to be sitting on a pile of talents of gold as tall as your faceless statue of Ceres? Yes, I climbed up and looked for myself.
TOS: **You're just in love with yourself, aren't you?**
SPAR: Well, I did crush a bunch of Roman legions and made enough trading to have party villas ringing the Mediterranean. I stared out as a slave, I kicked butt, and now I'm huge. You have a problem with that? I don't.
TOS: **Heck no … Thanks Sparty …**

For the record, despite our technological prowess, we were not able to travel through time to actually conduct this interview with Spartacus himself. Any accuracy or resemblance to Spartacus or his descendants is purely coincidental and a figment of the writer's overactive imagination.

5 STEPS TO THE TRADE

xxxxxxxxxxxxxxxx 4 stumbles and 1 step xxxxxxxx

WHILE IT MAY NOT BE PERFECT, YOUR TRADING PLATFORM SHOULD NOT ONLY BE ABLE TO EXECUTE TRADES, BUT ALSO PROVIDE YOU THE ABILITY TO RESEARCH THEM METHODICALLY FROM ONE PLACE. EVEN IF YOU HAVE TO STUMBLE YOUR WAY THROUGH IT.

WORDS BY MARK AMBROSE
PHOTOGRAPH BY FREDRIK BRODÉN

STUMBLE ONE: **LOOKIN' FOR LOVE**

xx one xxx

If you're going to trade, you need to have a worldview. Not like Henry Kissinger. Rather, are you looking for a stock, index, or future that trends? Are you a contrarian who likes to bet against popular wisdom? Do you think that the best guess about where a stock will be tomorrow is right where it is today? And speaking of time, do you think the stock will stay in a range for a week or a month? Or might it trend for the next month or year?
Without some frame of reference, one symbol is no different from any other symbol. Without a defined perspective, you won't be able to create any sort of directional or range-bound bias. And without that, a trade might as well be a flip of a coin. But don't think that you have to be 100% confident in your bias. No trader ever is. You'll deal with that later.

Whether you pick your stocks by watching the news, working with technical indicators, studying fundamentals, or analyzing economics, what you're trying to do is find some underlying asset that you can make a trading judgment on. You may have already narrowed that down to a few stocks and indexes that you've traded or studied before. That can speed the process up dramatically, but it's not enough to have the bias. You need a good trading product. That means liquidity and tight bid/ask spreads.

Look for high open interest in the options. A few dozen contracts here and there means it's pretty much you against the market maker—not good. But thousands of contracts at many different strikes means you're a small fish in a big pond. Believe it or not, that's what many traders want to be when they're trading. If you're a small fraction of a large total trading volume, there's a better chance you'll find someone to trade with when you want or need to.

Bid/ask spreads measured in pennies in the options means you're trading closer to theoretical value: your slippage can be lower. Slippage is the difference between the listed price and the price at which your trade executes. The difference can be substantial when placing market orders.

Generally, there's enough of an overlap between the group of stocks you have a bias in, and the group of stocks that have potentially higher liquidity. In my opinion, liquidity trumps bias. How so? If you have a bias on a stock but its options have relatively low open interest, look for another stock in the sector that may have higher "liquidity." I don't want to get into a trade that I may not be able to get out of, no matter how much confidence I have in my bias.

STUMBLE TWO: **KILL IT ON PAPER**

xx two xxx

Assume the worst. If your bias turns out to be dead wrong, how much can you lose and still not go out of business? That determines the max loss you're willing to take on that particular trade. If you don't know that, stop. Do not pass go.

Look at the size of your trading account. Your bank account. Your income. Will this loss alter your lifestyle? That number is different for every trader, but you need to figure it out. Spending the time it takes to do that can save a lot of heartache later.

The next step is to figure out how much a particular strategy can possibly lose. Short uncovered call? Unlimited loss potential. Short vertical spread? Loss limited to the difference between the strikes minus the premium received. Long calendar spread? Loss limited to the cost of the trade. With all the educational material out there, you should be pretty confident about this stuff before you do a trade. You may not know for certain which way a stock will go, but you should know how much damage a trade can potentially inflict upon you.

Finally, figure out how many different trades you can take on that each have a certain amount of risk. Assume that each one will hit you with a max loss. That's not being pessimistic. That's being realistic with your money. If the max loss on all of your trades would ruin you financially, you're trading too many contracts.

[Caution: Multi-legged options transactions such as spreads, straddles, iron condors, and butterflies discussed in this section will incur contract fees on each leg of the order, which may impact any potential return. Ancillary costs such as commissions, carrying costs, and fees should be evaluated when considering any advanced option strategy. Be aware that assignment on short options strategies could lead to an unwanted long or short position in the underlying security.]

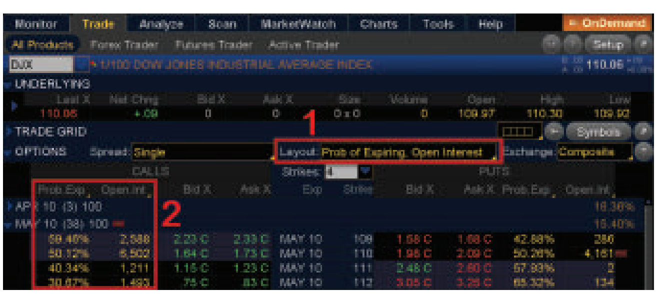

FIGURE 1: Stumble around the Layout functionality (1) of the Trade page and you can customize your column option data to get your open interest data as well as probability of expiring in the money (2). *For illustrative purposes only.*

xx three xx

STUMBLE THREE: **TWO FROM COLUMN A, ONE FROM COLUMN B…**

The fun part is finding the trade, right? Umm, maybe. Ideally, though, this is a pretty mechanical step. You should have some basic criteria, and technology can narrow down the choices pretty quickly. Consider picking your option contract month by looking at each one's number of days until expiration. That should have some relationship to the time frame of your bias in step one.

If you're looking to create positive time decay (i.e. using short strategies), you may want to consider selling an option that has a comfortable probability of expiring out of the money. So what's comfortable for you? Is it 50%, 60%, 70%? Thinkorswim's option chains make it easy to find the number you want, but remember that probability is no guarantee. That's why you may want to hedge that short option with a long option to help limit the potential loss—consider either a further out-of-the-money option in the same expiration to create a short vertical (aka "credit spread"), or possibly the same strike price in a further expiration month to create a calendar spread. Or maybe two short verticals to create an iron condor. You get the idea.

Make sure that the option trade you find conforms to your outlook on the stock. In other words, you may not want to have a range-bound position for a stock you're confidently bullish on. And if you're bearish on a stock, you likely don't want to put on a trade that would have a max loss if the underlying drops. Consider using this as a speed bump. This is the part that catches a lot of rookie traders. Rookie: "You mean I shouldn't buy an out-of-the-money put calendar if I'm bullish on the stock?" Veteran: "No."

xxx four xx

STUMBLE FOUR: **SQUEEZE 'EM!**

Consider working your order with a limit price somewhere in between the bid/ask spread. Sure, you might not get filled, but you don't have to do an opening trade at a price you don't want. No one's holding a gun to your head. Be patient. Saving pennies in your order execution is a skill that you can develop. And those pennies you save can make a big difference over your trading career. For example, let's say you're working to sell a vertical. Start with a limit price in the middle of the bid/ask. Assuming the stock doesn't move much after a few minutes, you might want to take your limit price down a little. No fill? Maybe take it down another a little more. But if you're not filled then, and if you're trading options with relatively high open interest, you might want to walk away. No trade is so good that you should give up too much slippage to the market makers. If the market makers don't want to play, you can take your ball somewhere else. There is always another trade.

xx five xxx

STEP FIVE: **KEEP YOUR FINGER ON THE PULSE**

This isn't dollar-cost-averaging with a mutual fund that you hope will rise in 20 years. Traders tend to monitor their positions and most have an exit plan in place. Will you get out of the trade if it hits a certain loss, or if it reaches some amount of profit? Or maybe if the stock behaves in such a way as to make you think your original bias is no longer valid? Be aware of what the overall market is doing and how your specific trades are faring.

FIGURE 2: Every penny counts when working a trade. When using limit orders properly, you're essentially haggling with the market to get the best price. *For illustrative purposes only.*

Again, the technology can make it easy. Real-time streaming prices, live profit/loss calculations, single-click order entry, complex technical studies, alerts sent to your mobile phone, sophisticated risk metrics—all these tools are available in one platform to help you turn the stumbles into steps. If you keep your first trades small, you'll potentially (and hopefully) only get a stubbed toe, not a fracture. When in doubt, call us. We can help you get up to speed!

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Options involve risk and are not suitable for all investors. Supporting documentation for any claims, comparison, statistics, or other technical data will be supplied upon request. Professional access and fees differ. The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Customers must consider all relevant risk factors, including their own personal financial situations, before trading.

The Fearless Technician

Brain candy for chartists.

tech.

FIGURE 1: Using specific signals to generate entry and exit points in the Milk Money trade.
Source: Prophet charts. *For illustrative purposes only.*

The Milk Money Trade

When you're looking for small opportunities, you don't have to wait until the cows come home.

Words by **John Carter**

• Traders normally have two main end goals: capital appreciation and cash flow. Capital appreciation trading is geared toward compounding gains over the long haul in order to increase wealth. The intent of cash flow trading is to attempt to capture numerous small moves within larger trends—what I call "milk money" trading.

If you're going to attempt to trade for cash flow, that generally means you're trying to grab incremental profits in short time frames. For this type of trade, I use Prophet charts with a 20-period exponential moving average (EMA), denoted by the green line on Figure 1. Next I add a moving average envelope (MAE) set to a period of 20 and a percent shift of 4%. These are the purple lines above and below the price action. Below the chart I have the Awesome Oscillator (AO) set to 5 and 21. And finally I have an average true range (ATR) set to 14. Let's take a look at the setup.

Milking the Trade

This trade revolves around the idea of prices reverting to the mean. We aren't looking to trip all over ourselves chasing momentum. We aren't trying to guess how high prices will go or how low they'll fall. We are just looking for the price action to revert back to the mean, which in this case is the green 20-period EMA.

My signal is twofold: First I wait for price action to test the upper or lower purple MAEs. Once that happens, I wait for the AO to change colors. When it does, I take the trade.

At point number 1 (Figure 1) we get a test of the upper MAE. But hold on: patience is a virtue here. Remember, we need to wait for the AO to change colors, which it does at point 2. I buy at point 3 and hold on until point 4, where my target is hit.

We get another test of the upper MAE at point 5. I wait for the momentum to change, which it does at point 6, and my entry is at point 7. Once again, I take the trade, and in this case, the target is hit the next day. As you can see on this chart, the same scenario is repeated at points 8, 9, and 10.

To access **Prophet Charts**, from the TOS platform, go to Charts > Prophet.

Word of Caution

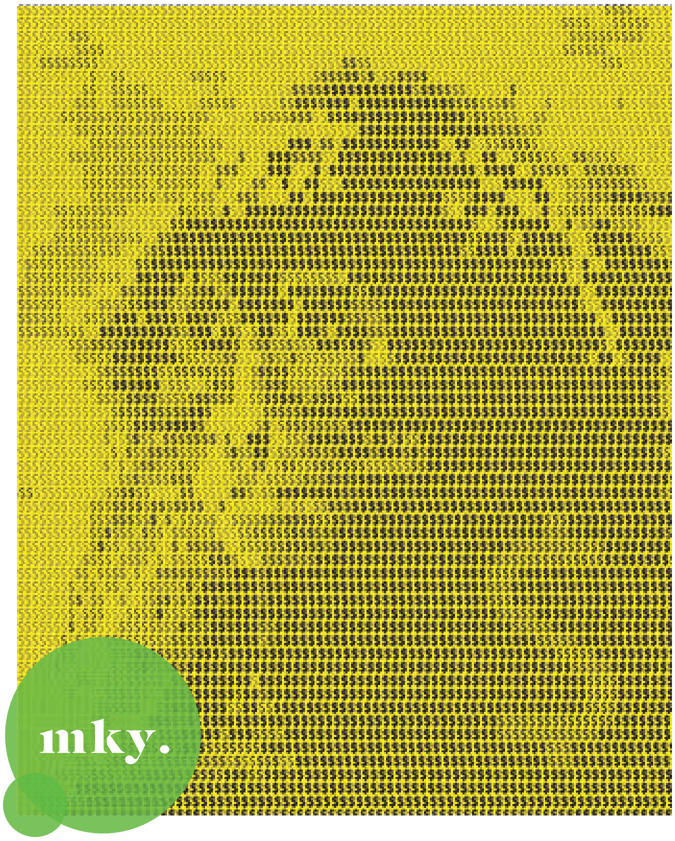
Remember, this trade is an attempt to time the market action for small gains—in an effort to pay for your Starbucks habit. The downside is that if the markets run away to the upside or downside, there isn't much to do but wait, and you can miss out on a lot of the price moves. And things don't always work out as planned. Just because the intent is to generate cash flow, doesn't mean that it will happen. You could just as easily lose more milk money than you make, so always remember to trade only with money you can afford to lose.

John Carter *is president of TradeTheMarkets.com. He can be reached at jcarter@tradethemarkets.com*

Hey, Monkey!

A spattering of our resident primate waxing philosophical on trading and life.

Illustration by **TBA+D**



Q: Hey, Monkey! Do you use the greeks when you trade?
A: A long time ago, on an exchange far, far away… option greeks existed as formulas that people way smarter than me programmed into software I couldn't get my hands on. So, most of us traded without knowing the greeks of a trade or position, but with a very strong understanding of "if the index goes to this price, and volatility drops a bit, tomorrow morning these options will probably be trading around this other price." We could do that because we looked at option quotes and traded all day, every day. So, while I might take a look at the overall greeks of my portfolio—which can be done using the nifty portfolio beta-weighting tools—to see how much risk I have overall, on any particular trade I'm much more likely to just look at option prices relative to their days to expiration, volatility, and any news or events coming up that might impact the stock or index. It's not so much art as it is the application of years of trading experience.

Q: Hey, Monkey! What happens when I hit the "send" button on an order?
A: The first thing that happens is that it's sent from your computer to our servers, which have multiple redundancies and are housed in top secret locations. When the order arrives, it hits our order validation and margining algorithms to make sure that you have enough money in your account to cover the margin requirements of the trade. If you do, the order is routed to one of the exchanges. All this happens in milliseconds. The quote you see on the platform is the NBBO (national best bid/offer) from all the exchanges, and if you try to hit a bid or lift an offer at the NBBO, it will go to an exchange that will honor that price. If the limit price is in between the NBBO, where that order gets routed to is based on price and liquidity, although you can choose which exchange your order will get sent to. At that point, the order sits as a working order, waiting for someone else, either a market maker or another retail trader, to come in and take the other side. One of the key points is that we do not internalize, or act as a market maker, on any of our customers' orders. We work to get you the best fill price and any price improvements that we can without any conflict.

Q: Hey, Monkey! I'm trying to get more fiber in my diet. Can bacon play a role in that?
A: Of course! Bacon can play a role in just about every part of your life. The USDA suggests that the average adult requires about 100 grams of fiber a day. Bacon, according to a cursory Internet search, has about 2.5 grams of fiber per 100 grams. According to my math, to get to 100 grams of fiber, you'd need to eat about 4,000 grams of bacon, give or take depending on how crispy you make it. That 4,000 grams translates into about 8.8 pounds of bacon. Now, I wouldn't suggest you eat 8.8 pounds of bacon at one time unless you have proper training. But it's easy to spread that 8.8 pounds of bacon fiber out over a day, in the same way that you might sprinkle, say, flax seeds, on food at different meals. You could start the day with two pounds of bacon for breakfast, followed by a mid-morning pick-me-up of one pound, two pounds for lunch, one pound for a late afternoon snack, two pounds at dinnertime, and a soul-warming pound before bed. That gives you your 100 grams of fiber, and you'll be beating the average American in your fiber health in a deliciously satisfying way!

The information contained in this article is not intended to be actual dietary or investment advice and is for illustrative purposes only. thinkorswim is obligated to seek the best price available for your order, taking into consideration the cost of execution and current market conditions, such as the NBBO, volume, and liquidity. Price improvement is not guaranteed and will not occur in all situations. Market volatility, volume, and system availability may delay account access and trade executions. Price can change quickly in fast market conditions, resulting in an execution price different from the quote displayed at order entry. Execution price, speed, and liquidity and account access are affected by many factors, including market volatility, size, and type of order and available market centers.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Special Focus:
Options Analytics

Photograph by
Fredrik Brodén

thinkorswim.com

FOCUS:
options analytics

OPTIONS... WORTH MORE THAN YOU THINK

If you're purely a stock trader, you may think you don't need options. Think again. Even if you don't trade them, you could learn a thing or two about stocks by watching what their options are doing.

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Special Focus: Options Analytics

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FOCUS:

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• You hear about them on TV. Your friends ask you about them. You see the online ads. Options? No time for them. You're a stock trader, not a geek. You have to trade the actual stock to feel human! Yeah, baby!

Okay, I'll admit that when option traders start arguing the finer points of intraday theta, they can get, as they say in Latin, *dorkus malorcus majoris.* And I'm not going to try to convince you to trade options. In trading, as in pudding, the proof is in the taste, er ... profits. At the end of the day, if your account is up money, it doesn't really matter what product you traded. So why are we killing precious ink trees with this article? Stock traders can use the data that option markets provide to help them make more informed trading decisions. Here's how.

OPEN INTEREST AND VOLUME

Open interest is an options term that refers to the number of option contracts that are still open and not yet closed. When an option is first listed on an exchange and no one has traded it, it has zero open interest. As soon as one trader buys one from another trader, the open interest goes up to 1. And if there are no other transactions in the option, and if the trader who bought the option sold it to the other trader (who is short that option, and in buying it back now has no position) the open interest drops to zero. Open interest, then, is the number of option contracts that are still "outstanding," or held as positions in a trader's (or your) account.

For option traders, large open interest can indicate high liquidity, and that's a good thing. After all, a stock with higher open interest usually translates to higher volume, which makes it easier to get in and out of trades at better prices. For stock traders, though, increasing open interest can indicate increasing speculative interest in a stock. I don't think heavy trading volume in options is a reliable indicator of future stock price direction. But an increase in open interest can mean that traders are establishing larger speculative positions or that institutions are hedging their positions in a stock.

There's also what some people call the "Maximum Pain Theory," which suggests that stocks gravitate, or get "pinned," to the strike with the highest open interest at expiration. It's not universally applicable, and is usually most evident in low-volatility environments when there isn't much else going on in the market. But stock traders might use it as an ultra short-term indicator.

Put/call ratios simply compare all the put trading volume in a stock versus all the call trading volume in a stock. Some traders use it as a contrarian indicator because they believe that the public is generally wrong. When there is more put volume relative to call volume, the contrarian could see that as the stock being oversold. When there is less put volume relative to call volume, it could be an indicator that the stock is overbought.

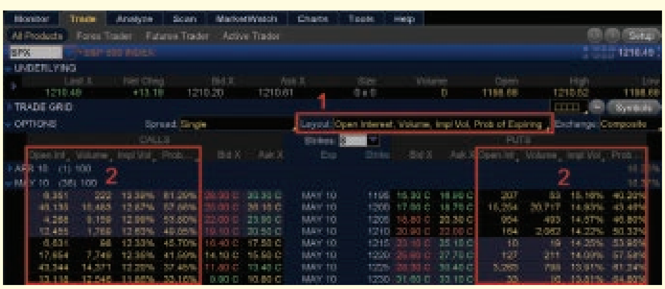

FIGURE 1: Stock junkies can glean a lot from options data to make more informed decisions. In the "Layout" dropdown (1) on the Trade screen, you can pull up all of your open interest, volume, volatility, and probability data in the option chain, right on one screen (2). *For illustrative purposes only.*

VOLATILITY

Option traders stare at it, sweat over it, and darn near pray to it. But to stock traders, volatility typically refers to the general condition when their stock position is losing money—fast. The implied volatility of options and the extrinsic value of the options themselves go up when there is increased uncertainty (read "fear") and go down when there is less uncertainty (read "I saw it coming a mile away").

The textbook definition of implied volatility is that it's the number you plug into a theoretical option pricing model to make the theoretical value of an option equal to its market value. In practice, it indicates how big a move the market thinks a stock might make. And it's big both up *and* down—not just down. Think of it this way: let's say some biotech stock is going to make an announcement next week on the FDA's test results of the company's wonder drug. If the results are good, the stock could rise dramatically. If the results are poor, the stock could crash. Either way, the stock could see a significant percentage change in its price. In that scenario, the options are likely to see an increase in their implied volatilities. But you already know about that announcement for that stock. So, as a stock trader, why should you care about implied volatility?

First, you probably don't know as much as the collective market knows about a stock. And even if you've done your research and think that there's nothing exceptional about an earnings announcement, news release, government report, etc., an increase in the implied volatility of the options suggests that the market thinks that the stock might move a bit more than usual. It indicates uncertainty. And if the market, which is all about uncertainty,

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thinks that there might be a bit more uncertainty than usual, then you should probably think about how you're going to handle a potentially large price move. Do you have your stops in place, or are you prepared to act on mental stops? Are you prepared for a potentially large loss? Maybe you need to reduce your position.

Second, the implied volatility can be used to estimate a price range for the stock price itself.

1 standard deviation price move (up or down) = *stock price* x *implied volatility* x *square root (days/365)*

Volatility is expressed in annual terms. But you can back that down to a shorter time frame using the square root of days / 365 (where "days" is equal to whatever number of days you're trying to calculate the approximate move). That gives you a theoretical 1 standard deviation move. And the range you get when you add and subtract that one standard deviation move to the current stock price theoretically covers 68% of the price range of the stock. Two standard deviations covers 95% of the price range of the stock. And while implied volatility is not a perfect indication of future stock price volatility, it can give you an indication of what might happen. Are your stops within that 1 standard deviation range? Are you prepared to be stopped out sooner than you might have expected? Do you want to adjust your stops to wider levels and accept more risk if you think the stock might move up and down in the short term before moving higher in the longer term? How you use volatility in your stock trading is up to you. But knowing what it measures and what it can indicate can be a valuable skill.

PROBABILITY

I'll spare you the comment about death and taxes. But in life, everything else may or may not happen. And in options, the probability of a stock reaching a certain price above or below where it is currently can be estimated using some fancy shmancy math. When you look at the probability that an option at a particular strike price might be in the money at expiration, that can tell the stock trader whether the market thinks the stock might reach your profit target price or your stop price. You might be convinced that a stock is going to rally 10% in the next month. But if the options suggest that the probability of that happening is 5%, then you might want to temper your expectations a bit. Probability is closely related to volatility. The higher the implied volatility of the options, the higher the probability that the option at a particular strike will be in the money. You don't have to calculate any of this by hand—it's available for free on the thinkorswim platform, and there's even a probability cone built into the chart studies. At a glance, it can show you the theoretical projected price range in the future based on current volatility.

Now, did I make any mention of option trading strategies, or come down on stock trading? Nope. I sincerely hope that your stock trading is profitable. I'm rooting for you. But I will suggest that a quick scan of some basic option information might help you with position size, profit or stop loss targets, or avoiding volatile situations. Options themselves may not be part of your trading strategy, but they can help you be a more confident stock trader.

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How to Analyze on TOS

Even stock traders can learn a thing or two from the options market. Here are four tips to get you started.

FIGURE 1: With Widget 360, you can immediately view the option strikes with the highest open interest.

FIGURE 2: Using the Probability Cone study will show you the range the stock price is expected to trade in the future. *For illustrative purposes only.*

tos.

• **OPEN INTEREST** Want to see a quick display of where open interest is highest for a stock's options? Try the Widget 360 tool on the Trade page (Figure 1). The outside columns are customizable (strikes and bid/ask prices are always there) if you click on the column heading and select the data you want to see from the menu. Look for Open Interest in the Basic Price and Quote menu. That will change the column to show the open interest for each option. Now, click on the column heading again and select Widget 360 at the bottom of the menu. A box will open up that shows you the open interest displayed versus strike price for all available expiration months. To make the graph a bit easier to interpret, you can uncheck some of the expirations in the Series dropdown menu at the top, or reduce the number of strikes visible to those closer to the money with the Strikes dropdown menu. You can use the Widget 360 tool to display most of the other data on the Trade page, such as volume, extrinsic value, or implied volatility.

PUT/CALL VOLUME RATIOS If you want to see the put/call volume ratios for different market sectors, go to the Market Watch tab and look in the Index Watch and Index Details sections. In the upper right-hand corner, you can see the put/call ratio (total put volume divided by total call volume) for all the options of the component stocks in an index or sector of your choosing. Click on the Select Watch List dropdown menu to select an index or sector, or even one of your own custom Watch Lists.

IMPLIED VS. HISTORICAL VOL Many traders are interested in comparing current implied volatility with historical stock price volatility. You can see the two volatilities overlaid on each other on the Charts tab; the studies you'll want to add are ImpVolatility and HistoricalVolatility. But here's the secret to getting them scaled properly to each other: three lines of thinkScript code. Don't worry, you don't need to be a programmer. From the top right of any chart, select STUDIES > EDIT STUDIES > STRATEGIES, and look for the "NEW" button in the lower left-hand corner. Type the following code into the NEW SCRIPT box, hit the OK button, and then APPLY:

```
declare lower;
plot data = impvolatility();
plot data2 = historicalvolatility();
```

The default number of days in the historical volatility calculation is 20. To change that in the code to, say, 40, use this:

```
plot data2 = historicalvolatility
(shortlength = 40);
```

The "ImpVolatility" study is the Vol Index for the options on a particular stock. It weights the out-of-the-money options for the front two expirations into an overall implied volatility.

PROBABILITY A handy probability feature that is right on the Charts is the Probability Cone study (Figure 2), which displays a theoretical projected range of the stock price based on the current implied volatility of its options. It's listed as the Probability of Expiring Cone in the list of available studies. The option expiration dates are also shown, with two prices for each one—the higher defining the top of the theoretical range and the lower defining the bottom of the theoretical range. By default, the range covers 68% of the theoretical price movements. You can change that to any number you want in the Edit Studies box. Incidentally, 68% is the theoretical one standard deviation range, and if you change the percentage to 95%, that is the theoretical two standard deviation range, while 99% will show you the theoretical three standard deviation range. You can even add the study two or three times to the chart, change the percentage range to, for example, 95% and 99%, and set different colors for each one. Doing that will show you the one, two, and three standard deviation theoretical price ranges simultaneously.

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Q+A:

THE CURRENT IMPLIED VOLATILITY IS THE MARKET'S BEST GUESS AS TO THE POTENTIAL MAGNITUDE OF THE PRICE CHANGES IN THE STOCK FOR A CERTAIN AMOUNT OF TIME.

Q:

How are the probability numbers calculated?

A:

The probability numbers use the current stock price, days to expiration (or some other date in the future), current interest rate, any dividend yield, and the current implied volatility of the stocks options. Because the probability numbers depend heavily on volatility and time, they are only as reliable as the estimate of future volatility of the stock and the time frame that you're looking at. The current implied volatility is the market's best guess as to the potential magnitude of the price changes in the stock for a certain amount of time. It is by no means perfect, though, which means that the probability numbers are far from guaranteed. Even though the one standard deviation range looks pretty wide, it's still entirely possible for a stock to move outside the theoretical projections.

Q:

How is implied volatility calculated?

A:

Implied volatility is that volatility which, when input as a parameter into a theoretical option pricing model, makes the theoretical value equal to the current market value of the option. TOS uses the Bjerksund-Stensland model, and a recursive approach to find the actual implied volatility. The key is to realize that implied volatility is determined by the price of the option, which is determined by the overall buying and selling in that option. When more people want to buy the option, its price goes up, and therefore its implied volatility goes up as well.

What can cause people to want to buy an option? Maybe they fear that the stock might make a big move and they need to hedge their positions. Or, maybe they hope that a stock will make a big move and generate a profit for a long option. Either way, increasing implied volatility indicates rising expectations that the stock might have large price swings in the future.

Q:

What's the difference between historical volatility and implied volatility?

A:

While implied volatility is generated from the option prices, historical volatility is calculated from the daily percentage changes in the stock price. Implied volatility is forward looking—it's sensitive to the fear and uncertainty about the future that the market has. Historical volatility looks back. Everyone knows what the stock has already done.

Some traders believe that historical and implied volatility converge, and they use historical volatility as a measure to indicate whether implied volatility might be "too" high or low. But use this sort of comparison with caution. Even if implied volatility is higher than historical volatility, the higher implied vol could indicate the possibility of bigger price changes to come in the stock. If that happens, implied vol could go up, and historical volatility based on those price changes could go up, too.

Photograph by
Fredrik Brodén

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thinkorswim #1 Ranking by Barron's Sparks Outrage, Protests

CHICAGO— With the 2010 Barron's annual review of online brokers placing thinkorswim at the top of the pack for the second year in a row, and for the fourth time in five years*, feelings of happiness gave way to dismay as protesters ring the company's headquarters.

A veritable who's-who of agitators and demonstrators hurl insults and the occasional piece of fruit as TOS staff enters and exits. PETA was in strong force, throwing buckets of red paint at TOS-ers, red being the metaphorical opposite of market neutrality. Even when they learned that TOS developers were not being slaughtered for their glossy coats, they turned their rage to the plight of the kittens used to lubricate the TOS quote servers. A counter-protest emerged across the street by another "peta" -- People Eating Tasty Animals -- celebrating the truckload of BBQ that was sent to TOS at lunch time.

Flat Earth Society members carried signs claiming that volatility skews were a myth. The Brady Campaign was fuming against so much technological "firepower" in the hands of unlicensed, unregistered TOS traders. And the local Tea Party affiliate showed up in Betsy Ross outfits demanding smaller trading platforms and an end to runaway spending on features and enhancements.

Bewildered TOS developers watched from office windows. "What will these people think when we launch our new web-based platform?", wondered one. "What's 'Barron's' anyway?", asked another. Then it was back to work, hammering out more groundbreaking code.

• *thinkorswim earned 4.9 stars, the top score, in the category "trading technology," and was rated #1 overall online broker and "best for options traders" in Barron's ranking of online brokers, 3/15/2010; thinkorswim was evaluated versus others in eight total categories, including trade experience, trading technology, usability, range of offerings, research amenities, portfolio analysis & reporting, customer service & education and costs. thinkorswim topped the list in 2006, 2007, 2009 and 2010 with the highest weighted-average score and was runner-up in 2008. thinkorswim was also noted "best software-based online broker" and "best for options traders," 3/6/2006 and 3/5/2007. Barron's is a registered trademark of Dow Jones & Company © 2006-2010.*

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