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Random musings for traders at TD Ameritrade—FALL 2018

3 THREE INDICATORS

TO CHECK BEFORE THE TRADE

USE THEM FOR TRENDS, MOMENTUM, AND REVERSALS

PAGE 16

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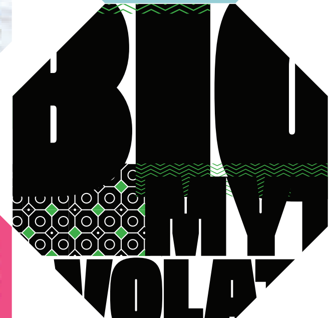

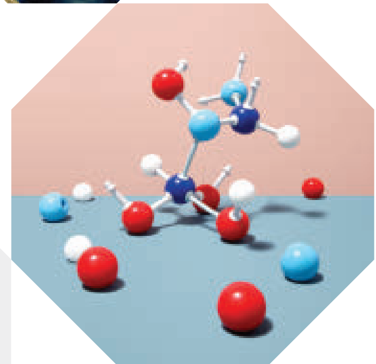

"As with all financial instruments, it's worth putting in the time to understand how margin and leverage work."

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SKILLS BAROMETER
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- EASY
- SEASONED
- PRO

A picture is worth a thousand words ...

• DON'T YOU HATE the days you're staring endlessly at your screen and have no clue what to trade? To get ideas, you visit your favorite chat room, and you listen and read as much as you can to see if anything gets you excited, but still, nothing.

We all go through this from time to time. And since you can't predict the future, there must be something out there that brings clarity to your trading mind. Lucky for you, you have charts. They may not be able to show you what a stock will do, but they're good at capturing all that information you hear and read about into one price bar, like a snapshot in time. And that price bar could reflect any time period—a minute, an hour, a year.

Think of charts as silent storytellers. As you watch them unfold during the trading day, they have a lot to say as they evolve and reveal things you didn't know before the last tick. You can see where price is relative to past highs or lows, past support or resistance levels, and what's trending or stagnant. You can add a ton of things to charts—indicators, trendlines, arcs, patterns with strange names, and more. And with the right amount of information, charts can be great visual tools for traders.

TALK TO US!

Ask a question, tell us a joke, or just give us your feedback on *thinkMoney*. Write to us at **thinkmoney@tdameritrade.com**

Our cover feature, "Three Indicators to Check Before the Trade" (page 16), shows you one way to choose the right mix of indicators that'll indicate a trend's direction and momentum. Yes, there is a method to the madness!

Once you've figured out which way and how quickly prices are moving, your next step is to figure out what type of strategies to trade. You have several choices there as well, some simpler than others. If you've been trading options for a while, you may want to venture into something new. In "Pile On With Multi-Spread Organic Trading" on page 24, find out how you can turn a strategy you often use into something else by overlaying another strategy.

Trying new things can be nerve-racking, but it could make your trading life more interesting, too. The next time you're stuck not knowing what to trade, try something different with your charts.

Happy trading,
Kevin Lund
Editor-in-Chief, *thinkMoney*

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Best in Show ... (To Our Inbox)

What's a strike? When the ball passes between the batter's armpits and knees. **—Jeremy**

As a trader, the only shopping I talk about is market related. Lol! **— Rick**

I've never seen a cat bounce this high! Is that a trampoline cat? **—Alycia**

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Chat Room Pearls...

Algebra is a see-saw. Put the same amount on both sides to keep it balanced. Calculus is a picket fence. Fill the missing picket.
—NICK

CHAT SWIMMER #1
I had at least a dozen alerts go off, some while I was in the pool at the resort next door early this morning.
CHAT SWIMMER #2
Shut off volume—too many alerts.

I got my haircut. I sure hope I'm still adorable.
—ANDY

When my account grows up (after weeds pop, I hope), I want to do butterflies and double calendars.
—DAVE

All I want for my birthday is a spell checker.
—JO

CHAT SWIMMER #1
How would you trade this?
CHAT SWIMMER #2
I would sell it on an online auction as artwork.

When I have my own currency, I'm gonna name it the sugar.
—ROB

Oh! There goes my lotta play for tomorrow.
—RYAN

I'd like to become adept enough at my full-time job or at trading so I don't have two full-time jobs.
—TRINA

Fair trade is when you break a candy bar in half and I get to choose which half I want.
—YVETTE

CHAT SWIMMER #1
Oh darn! Beans and rice again today.
CHAT SWIMMER #2
Too expensive. Tofu will get cheaper now that we can't export beans.

I'm going to wean myself off bad posts. Should only take a couple of weeks.
—KIM

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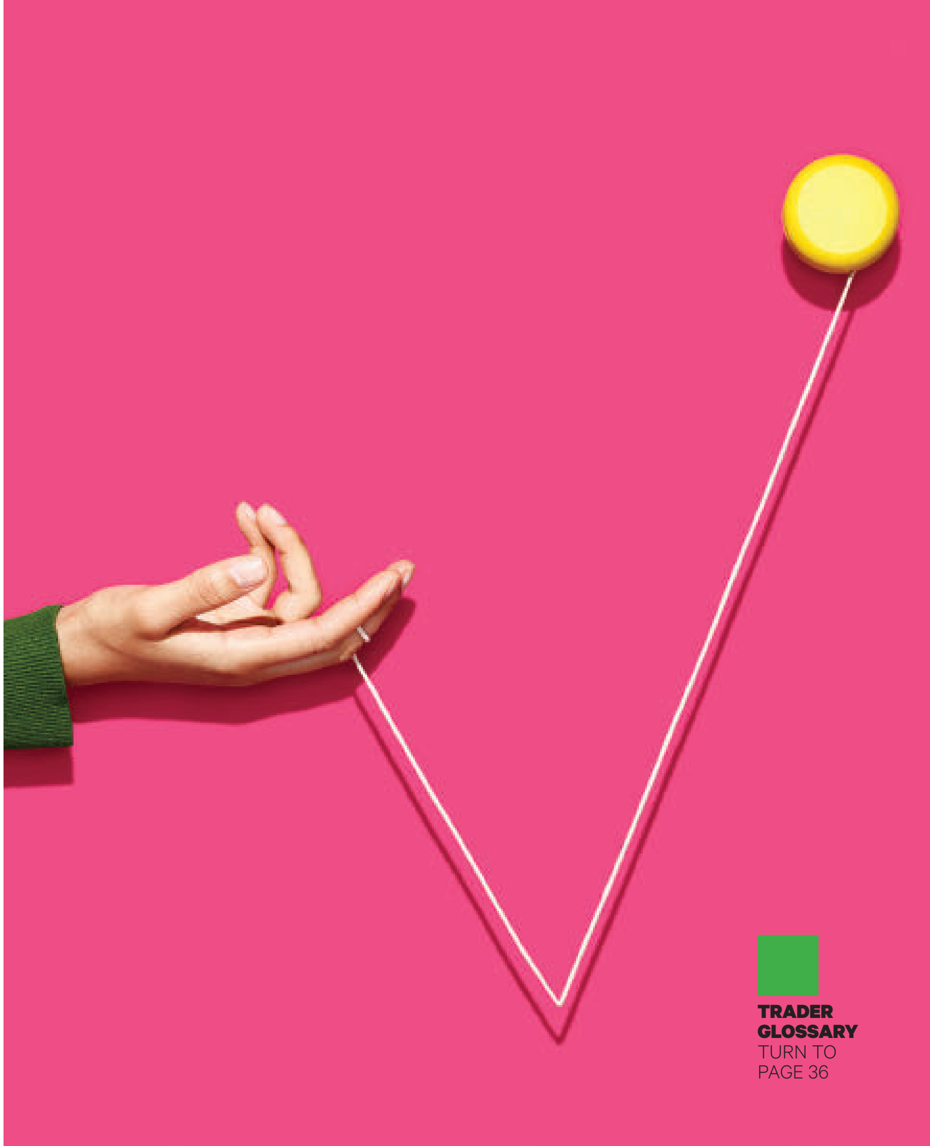
IN THE MONEY



TRADER GLOSSARY
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VOL WHISPERER ● SEASONED

Volatility Watch

BIG IDEA: WHEN THE VIX MAKES EXPLOSIVE MOVES, WHAT'S IT TELLING YOU?

• RIGHT OFF THE BAT, 2018 saw the widest range of the CBOE Volatility Index (VIX) since 2015—from a low of 8.92 at the start of the year, to a high of 50.3 in early February. That's almost a 500% change in about a month. Is there something going on in the market? Or is the VIX overly sensitive?

Consider this a cautionary tale about how you may trade the VIX. The risk in the VIX tends to be asymmetrical. When it's low (low teens), the risk tends to be on the upside, historically. The VIX can go lower. But unlike a stock that can go to zero, the VIX could go to zero only if global finance discovers there's no more uncertainty in the market. Could that happen? In theory, yes. But in practice, the VIX at 12, for example, is generally less likely to drop by half its value than it is to double in value.

That's why shorting the VIX can be risky. Just as the market may crash faster and further than it can rally, the VIX, which tends to move in the opposite direction of the stock market, can have large increases in a short time frame. So, if you believe the VIX might drop, and you decide to short it, you may want to consider defined-risk strategies. And keeping your position size small.

It's all about uncertainty

The VIX makes these moves in part because its calculation uses the average of SPX options' bid and ask prices, and not executed options trades. When market makers change their bid and ask prices to respond to the risk perception in the SPX, the VIX changes, too. And as bid and ask prices can change in milliseconds, the VIX can change almost as fast.

For example, if an SPX option is 0.40 bid and 0.70 ask, the 0.55 average price is used in the VIX calculation. Yet, if an economic number is scheduled to come out, or there's some news that spooks SPX market makers, that option's bid/ask might widen to 0.40 bid and 0.80 ask without a change in the SPX price. The market maker widens out

PHOTOGRAPH: DAN SAELINGER

the bid/ask when uncertainty increases to give herself more room for error. The average changes to 0.60. And that 0.05 increase in the option's average price percolates through the VIX calculation and pushes it up. When this happens across all SPX strikes, the impact on the VIX can be large. That's why the VIX is so sensitive to the market's mood.

When the VIX goes up, but SPX doesn't move, it can seem nonsensical. Why is volatility ("vol") increasing when the market isn't doing anything? It's market makers signaling increased uncertainty. Or the SPX and VIX might drop a bit, too. That's just market makers "taking their bids and making them offers," as traders used to say once fear dissipated.

Now the huge VIX swings in the first six weeks of 2018 start to make more sense. After the tax reform bill in late 2017, the market felt good. SPX market makers believed there'd be less uncertainty and lowered their bid/ask prices to entice traders. In February 2018, increasing bond yields threatened inflation and sent stocks lower. This spooked market makers, so they increased the bid/ask prices of the out-of-the-money (OTM) SPX options and widened the spreads. That combination increased the average SPX option prices and sent the VIX soaring. In the end, the market took a deep breath, stopped falling, SPX options dropped, and that pulled the VIX back down.

Watch SPX options closely, along with the VIX, and you can see this behavior in live, streaming data. Believe it or not, it's fun! —Words by THOMAS PRESTON

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For more on the risks of trading and trading options, see page 37, #1–2.

THINK TANK ● EASY

New, Old, or Different—It's All Good

BIG IDEA: FROM BASIC TRADING IDEAS TO MORE ESOTERIC ONES, CHANCES ARE THERE'S A FEATURE FOR THAT. HERE ARE SOME COOL TOOLS THAT COULD BUMP YOUR TECHNICAL ANALYSIS SKILLS UP A NOTCH.

PARABOLIC SAR

Wanna know the short-term momentum of a stock? The parabolic SAR "stop and reverse" indicator may provide a clue. If you bring up a price chart on thinkorswim® and overlay the parabolic SAR on the chart, you'll see a series of dots above or below the price bars. These dots trail price movement

One popular use of the parabolic SAR is to use it as a trailing stop-loss level. In an uptrend, parabolic SAR will continue to rise along with prices. Once the trend reverses and price falls below SAR, it indicates the start of a downtrend and the dots will be above the price bars.

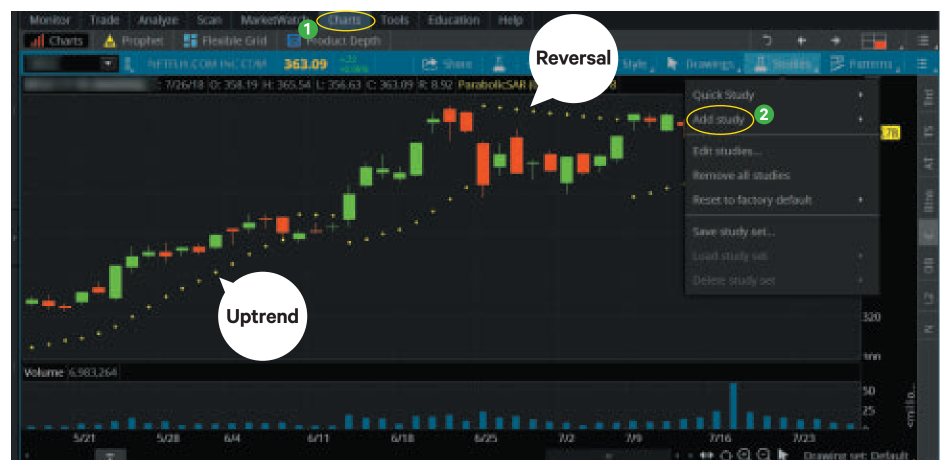

FIGURE 1: Parabolic SAR. *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

HERE'S HOW TO FIND IT (FIGURE 1).

1 – From the **Charts** tab, enter a symbol and bring up a price chart.
2 – Select Studies, and from the dropdown menu, select Add Study, then All Studies, and find Parabolic SAR. You'll see the dots displayed on the price chart.
3 – Observe how the dots are below the price bar in uptrends and above them in downtrends.

HIGH/LOW GRAPH

When prices continue to move in one direction consecutively, it could be telling you something. If you see a stock trading at a specific price, it doesn't tell you much. But if you know where that price is relative to its high or low, there may be something there. How far do you look back? If you're a short-term trader, you may want to look at an intraday time frame—one, five, or fifteen minutes. Or if you're a longer-term trader, maybe you prefer to look back as far as a month or by option expirations. You can do that by adding the High/Low Graph column on the Watchlist on the left sidebar on your thinkorswim platform.

FIGURE 2: High/low graph.
Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

HERE'S HOW (FIGURE 2).

1 – Right-click on a column header on a Watchlist and select Customize.
2 – Scroll down through the Available Items list and select High/Low Graph.
3 – Add it to the current set.
4 – Scroll the horizontal slider bar to the extreme right of the Current Set window, select the dropdown menu, and choose the aggregation period you prefer and the inputs for that period.

ANALYZE FUTURES CALENDAR SPREADS

If you've stepped into the world of futures trading or are even just thinking about it, there are some tools and features tucked away that could open up many possibilities. Ever thought of scoping out a futures calendar spread? They're a little different from trading options calendar spreads. When you analyze a futures calendar spread, you're looking at two contracts of the same product but with different expirations. So, you're really speculating on the relationship between the nearby and distant contracts, and not on whether the price of the underlying is increasing or decreasing.

FIGURE 3: Futures spreads.
Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

HERE'S HOW TO LOOK THEM UP (FIGURE 3).

1 – From the **Analyze** tab, type in the futures symbol.
2 – Select Futures, and from the dropdown, select All.
3 – Select Calendar from the Spread dropdown menu.
4 – Choose any contract you're interested in to see all the listed spreads for your selected symbol.

You can take this one step further and look at the chart of the spread. This helps to see if the spread between the nearby and distant contract is widening or narrowing. The relationship between the two contracts in the same commodity could indicate something about the strength or weakness of the underlying future. Charting the spread between two contracts helps to identify this more clearly.

FIGURE 4: Futures spreads, charted.
Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

HOW TO CHART THE SPREAD (FIGURE 4).

1 –To bring up the chart, right-click on any of the listed spreads (Figure 3).
2 – Select More Info, and then Charts.

COOL TOOLS
Is it better to trade single options or spreads? The ROC column on the option chain could tell you which is a better bet.

CAPICHE? ● PRO

Return On Capital: The Great Decider

BIG IDEA: FOR THE SELF-DIRECTED TRADER, RELYING ON DEFINED-RISK STRATEGIES MAY BRING MORE CONFIDENCE. HERE'S WHY.

• The nerd-speak of options trading means every moving part of your trading life has a handy phrase to describe it. Naturally, you trade with the intent to make a profit. So "return on capital" (ROC) is the technical phrase that describes the yacht you one day hope to buy from all your hard work. But let's take a deeper look at this term.

LITTLE-KNOWN FACTS

Naturally, you enter a trade with the idea of making a return. It may not always work out that way. But you consider your capital investment and the trade's maximum (max) profit potential. These two pieces of data comprise ROC. To wit: ROC = max profit ÷ capital used (buying power reduction).

ROC gives you the percentage return if your position makes max profit at expiration. If your position loses money, or the profit is less than max—such as if you close out the position before expiration—you're not necessarily going to make that percentage return. That's why ROC doesn't measure your profit. Instead, it's a tool that lets you compare two strategies to gauge how efficiently your capital is being used.

WHICH STRATEGY IS BEST?

Say you compare two out-of-the-money (OTM) puts on the same stock with adjacent strike prices. The ROC of these puts lets you compare the potential return for a given probability. So even though the probability of profit (POP) may be higher for the further OTM put, the ROC might be lower.

Likewise, an undefined-risk strategy (versus a defined-risk strategy) will likely have a higher POP. But keep in mind: that undefined-risk strategy could have a lower ROC. Usually, the POP and ROC are related inversely.

To see ROC on the thinkorswim® platform from TD Ameritrade, from the **Trade** page, bring up the options chain. Click on the columns and select Layout. From the dropdown menu, choose Customize, and add "Return on Capital" for one of the columns. The ROC value on your platform takes the midprice of the option or vertical and divides it by the capital required to take the position. (To learn more about capital requirements for positions, read the Margin Handbook at https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD086.pdf.)

TRADER JARGON
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If you compare the ROC of single options and verticals, you may find the ROC on the verticals is higher. That doesn't necessarily mean the spread is a better trade than the single option. It just means that given the amount of capital investment, that's the ROC you could potentially make if you're right.

IN A SMALL ACCOUNT where you may want diversification across several positions, ROC can illustrate how defined-risk strategies aren't something to shy away from. Use this tool to compare similar strategies like a naked option to a vertical, or a straddle to an iron condor. Which one gives you the best possible bang for your buck? —Words by JAYANTHI GOPALAKRISHNAN

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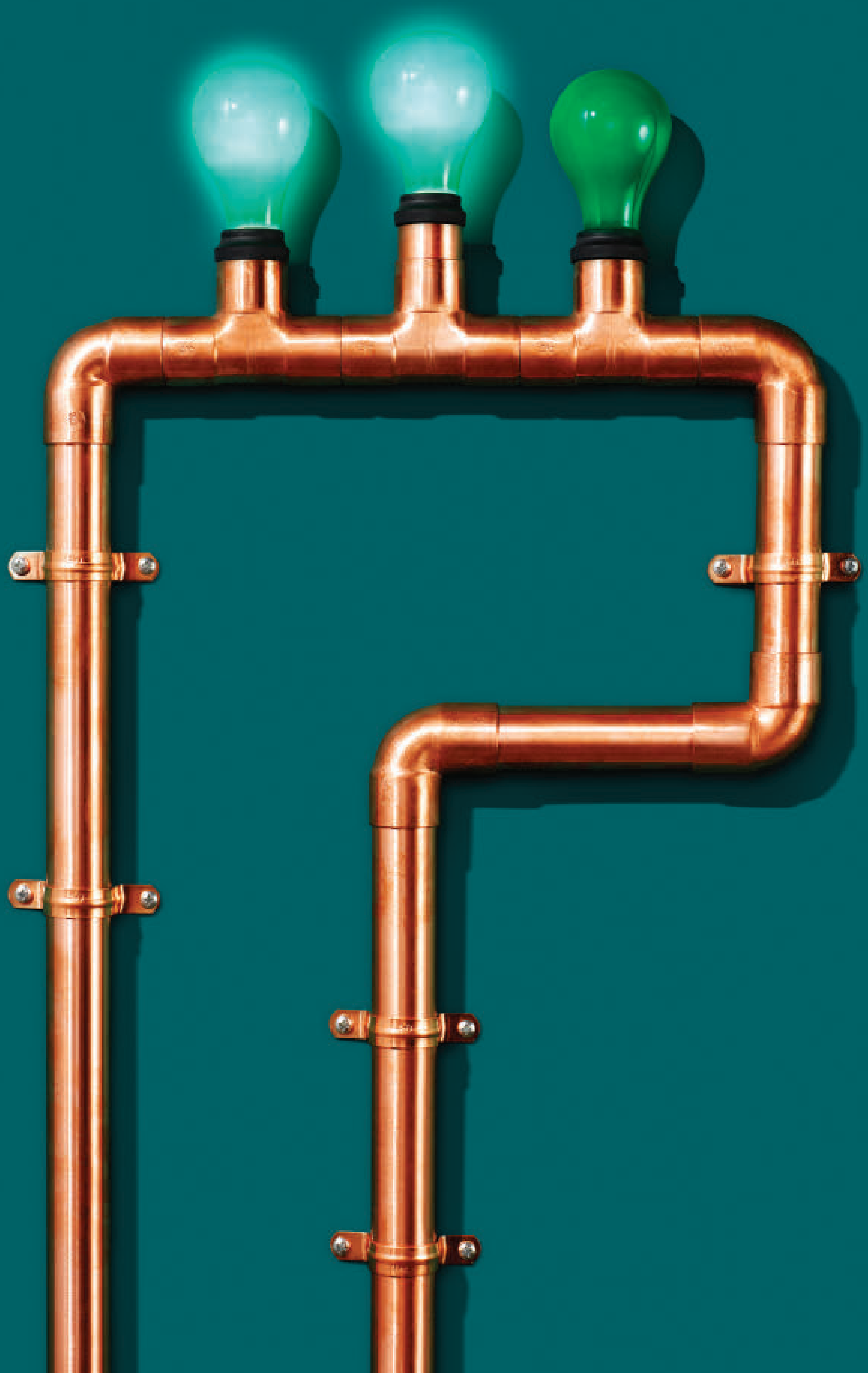
EASY/ **TAKE AWAY:** *Choosing the right mix of indicators could potentially yield clues to direction and volatility.*

1 2 THREE INDICATORS TO CHECK BEFORE THE TRADE 3

WORDS BY
JAYANTHI GOPALAKRISHNAN

PHOTOGRAPHS BY
DAN SAELINGER

BIG IDEA: YOU RELY ON TRENDS AND VOLATILITY TO COME UP WITH TRADING STRATEGIES. SO HOW DO YOU DETERMINE A TREND'S DIRECTION AND MOMENTUM? THERE'S NO ONE PERFECT WAY, BUT TECHNICAL INDICATORS MAY PROVE USEFUL. WITH SO MANY INDICATORS TO CHOOSE FROM, HOW DO YOU PICK THE RIGHT ONES? HERE'S ONE STRATEGY.



They say too many cooks spoil the broth. You can think of indicators the same way. Too many on a chart, and you won't be able to make any sense of potential price direction. So which indicators should you consider adding to your charts?

Option contracts have a limited lifespan. So the challenge is to figure out which options will move within the lifespan of the options contract.

Options traders generally focus on volatility (vol) and trend. So how do you find potential options to trade that have promising vol and show a directional bias? This is where indicators may help.

NOT JUST FOR CHART GEEKS

No one indicator has all the answers. But throw a few together on a chart, and they may "indicate" if a stock is trending, which direction it's trending, and with how much momentum.

Fire up your thinkorswim® platform from TD Ameritrade, select the **Charts** tab, pull up any chart, choose the **Studies** option, then **Add Study**, and finally **All Studies**. You'll see a long list. But you don't need to know all about every single indicator. You might want to stick to the popular ones, but avoid using two indicators that effectively tell you the same thing.

Where to start? Keeping vol and directional bias in mind, let's divide the indicators into categories.

1 TREND-FOLLOWING INDICATORS

Moving averages. When you think "trend-following," the first indicator that usually comes to mind is the moving average. It's the line that goes through prices to show the general price movement. And there are different types: simple, exponential, weighted. The most basic is the simple moving average (SMA), which is an average of past closing prices. So, if you use a 50-day SMA, you're looking at the average of the past 50 days. If you use a 20-week SMA, you're seeing the average of the last 20 weeks.

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The SMA's main objective is to identify if price is in a possible trend and the trend's direction. A quick glance at a chart can help answer those questions. In Figure 1, it's clear when a trend is going up or down. Remember, a trend can reverse at any time without notice.

Moving average convergence/divergence (MACD). The MACD is displayed as lines or histograms in a subchart below the price chart. We'll focus on the line display, which is made up of two lines—the MACD line and signal line (see Figure 1). These two lines oscillate around the zero line. The MACD line, by default, is the difference between the 12- and 26-period exponential moving average (EMA) of the close. The signal line, by default, is the 9-period EMA of the MACD. You can change these parameters.

The MACD provides three signals—a trend signal, divergence signal, and timing signal. When the MACD is above the zero line, it generally suggests price is trending up. When it's below the zero line, it suggests a downtrend. Crossovers can also be used to indicate uptrends and downtrends. When the MACD crosses above its signal line, prices are in an uptrend. The opposite is true for downtrends.

There's another way you might use MACD—for divergence signals. That's when price moves in one direction, but MACD moves in the opposite direction. A divergence could signal a potential trend change. But when will that change happen, and will it be a correction or a reversal? You may never get a perfect answer. But to get a possible idea, use the SMA and MACD together.

In Figure 1, notice how price reacts to the SMA after the MACD divergence. Price broke through the SMA, after which a bearish trend started. Usually, you won't see a divergence early in an uptrend. Instead, price, SMA, and MACD will probably move up. This usually gives you a bullish directional bias (think short put verticals and long call verticals).

Once a trend starts, watch it, as it may continue or change. Where are prices in the trend? How much steam does the trend have left? This is where momentum indicators come in.

2 MOMENTUM INDICATORS

To measure price momentum, you can examine where a stock's price closed relative to previous closes or price ranges. Two common momentum indicators are stochastics and the Relative Strength Index (RSI).

Stochastics. This is an oscillator that moves from zero to 100 and goes up and down with price. It's derived from the closing price relative to the price range. If price rises and pushes the stochastic above 80, which is the "overbought" level, it suggests the trend may be losing steam, and prices could fall. In the same way, when price falls and the stochastic goes below 20, which is the oversold level, it suggests that selling may have dried up and price may rise.

Relative Strength Index (RSI). RSI looks at the strength of price relative to its closing price. It measures a security's speed and the change in its price movements. A 10-period RSI will look at the prevailing closing price relative to the closing price of the prior 10 days. Like stochastics, RSI has overbought/oversold threshold levels—70 and 30, by default.

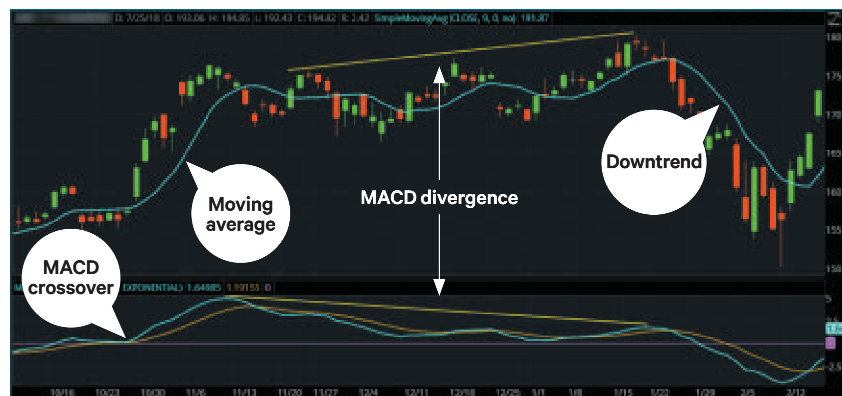


FIGURE 1: SMA and MACD. **On your chart, try inserting the SimpleMovingAvg and MACDTwoLines studies. Here, the MACD divergence indicates a trend reversal may be coming.** *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

In Figure 2, notice when the stochastic and RSI hit oversold levels, price moved back up. But both these momentum indicators can remain in overbought/oversold areas for extended time periods. So, how do you know when the trend could reverse?

3 TREND-REVERSAL INDICATORS

There's no single indicator that can tell you a trend will reverse. But some have a combination of trend, momentum, and trend-reversal characteristics. The Bollinger Bands indicator falls into that category.

Bollinger Bands. These bands can indicate a stock's volatility. Bollinger Bands drape around prices like a channel, with an upper band and a lower band. Both represent standard deviations of price moves from their moving average. So a one-standard-deviation Bollinger Band means the bands cover 68% of price bars. Bollinger Bands of two standard deviations cover 95% of price bars, and so on. When you overlay two-standard-deviation Bollinger Bands on price bars, it means if price falls outside the bands, statistically they should stay outside the bands only about 5% of the time.

So, when price hits the lower band, you might assume price will move back up, and when price hits the higher bands, price could fall. But the stock's price might move outside of the bands (see Figure 3).

Sometimes you'll see the bands contract or "squeeze." When you see that happening, consider it a warning of a potential impending reversal. When price breaks out of the bands and it leads to an uptrend, prices may trade along the upper band. The opposite happens in a downtrend.

Bollinger Bands may also signal the slowing of a trend's momentum. When a bullish trend slows down, the upper band starts to round out. But it's what price does after the rounding out that could confirm it. If price approaches the mid-band, then moves toward the lower band, then moves along it, the trend has likely reversed.

FINDING THE RIGHT MIX

To see how this all works, suppose you select an indicator from each category—MACD for trend, RSI for momentum, and Bollinger Bands for trend reversal.

From the **Charts** tab, pull up a chart and enter a symbol, then add RSI, MACDTwoLines, and BollingerBands studies to your chart.

FIGURE 2: FINDING MOMENTUM. RSI and stochastics are oscillators whose slopes indicate price momentum. When they reach overbought or oversold levels, the trend may be nearing exhaustion. *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

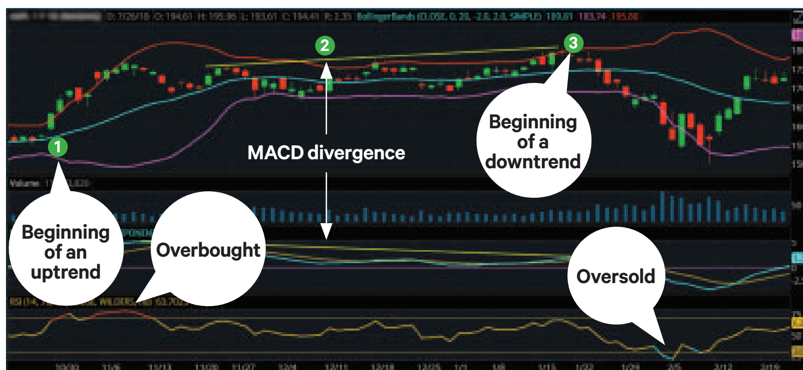


FIGURE 3: MACD, RSI, and Bollinger Bands. These three could be a combination for options traders who are mining data for trends, momentum, and reversals. *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

WHAT DO THE INDICATORS REVEAL IN FIGURE 3?

1. Bollinger Bands squeeze, bullish crossover in MACD, and RSI rapidly moving into overbought territory. Maybe it's time to think about directional trades with a bullish bias.

2. Bollinger Bands start narrowing—upward trend could change. While prices are moving higher, MACD and RSI are moving lower. Momentum is slowing. Prices move within a tight range within the Bollinger Bands, and divergence between MACD and price suggests uptrend could reverse.

3. Bollinger Bands round out, price breaks through middle band toward the lower band, and breaks through it. Notice how prices move back to the lower band. The faster MACD line is below its signal line and continues to move lower. RSI also moves lower and hits "oversold" territory. All indicators confirm a downtrend with a lot of steam. Perhaps it's time to consider putting on directional trades with a bearish bias, such as long put verticals or short call verticals.

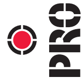
NOT BLAND, NOT SPICY

It's easy to see how indicators work on a chart in hindsight. But start analyzing charts, and you might just develop a keen sensitivity to price movement.

The market has a life of its own. And taken together, indicators may not be the secret sauce. But they can sometimes offer just the right amount of information to help you recognize and leverage directional bias and momentum.

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

For more on the risks of trading and trading options, see page 37, #1–2.



PRO **TAKE AWAY:** *Don't be lured into strategies that seem like a sure thing. Consider the alternatives.*

LOADED FRAGILE

PUTTING "TOO GOOD TO BE TRUE" TO USE

WORDS BY **THOMAS PRESTON**
PHOTOGRAPHS BY DAN SAELINGER

LOT 527

BIG IDEA TRADERS SOMETIMES TALK GLOWINGLY ABOUT THRILLING STRATEGIES WITHOUT CONSIDERING THE RISKS. LET'S TAKE A LOOK AT ALTERNATIVES THAT CAN HELP YOU BETTER MANAGE POTENTIAL DANGER.

WHO HASN'T

LOT 527

Who hasn't seen ads promoting a trading strategy that will magically make you rich? Or read an online article about a secret technique to squeeze money out of the market? Here are a couple such "secrets" you may have heard of. But we'll show you how to turn that too-good-to-be-true strategy into something with more realistic risk and return.

SECRET 1

BUY CHEAP OUT-OF-THE-MONEY OPTIONS FOR GIANT PROFITS! TURN PENNIES INTO DOLLARS!

What could be better than turning a small investment into a mountain of money in just a few months? Maybe buying that out-of-the-money (OTM) call option for $0.20—that's a mere $20 investment, not including commissions. And if its price goes to $10, that's a $980 profit. Do that a few times, and you'll be driving a golden Bentley around your private island!

Truth be told, if it were that easy, everyone would be a bajillionaire. The story of buying cheap OTM options and selling them for some large multiple of the purchase price as a means to strike it rich is naturally too good to be true.

First off, the prices of OTM options don't always grow dramatically compared to earlier prices, if at all. Sure, there are some OTM options that can be $0.20 one day, and $2 when the stock moves favorably. If the stock is $100, that $107 strike call might be $0.20, for example. And if the stock goes from $100 to $109—a 9% increase—that 107 call could be worth more than $2. It can happen, but it's not likely. For that cheap OTM option to be a huge winner, two things need to happen: the stock has to move big, and it has to move in the right direction.

Take a look at some OTM options on the SPX on the thinkorswim® platform from TD Ameritrade (Figure 1). Yes, the 2845 strike call is less than $2 (affordable, by SPX standards). But with the SPX at $2,704, there's a theoretical 4.22% probability that the call will be in the money (ITM) at expiration. That suggests a theoretical 95% probability it'll expire worthless. Not so great.

Further, the SPX price needs to move before the option's expiration. You may be able to do that one time when you buy a cheap OTM option. But two times? Three times? Can you make a trading career out of that?

That's your decision. But a more sensible strategy that might also have a small capital requirement and not require perfect market conditions to be potentially profitable is a short OTM vertical—a short put vertical if you're bullish, or a short call vertical if you're bearish.

With the stock at $100, a short put vertical might be long the 96 strike put and short the 97 put. If you took in a $0.35 credit, the capital requirement is $65 (the difference between the strikes minus the credit), which is also its max potential loss. If the stock rises 9%, that short put vertical could have a max profit of $35 (the credit received), not including commissions. That's not as big a profit as you could get on that long OTM call. But that short put vertical can be profitable even if the stock drops a bit, so long as it stays above $97 through expiration. The long OTM call doesn't have that advantage. So, consider the long OTM option as a potential lottery ticket (high risk, low potential reward), and the short vertical as a kind of plain-vanilla trade.

SECRET 2

GAMMA SCALP YOUR WAY TO VICTORY! HOW ABOUT A STRATEGY THAT MAKES MONEY WHEN A STOCK GOES UP OR DOWN, AND YOU DON'T LOSE ON TIME DECAY?

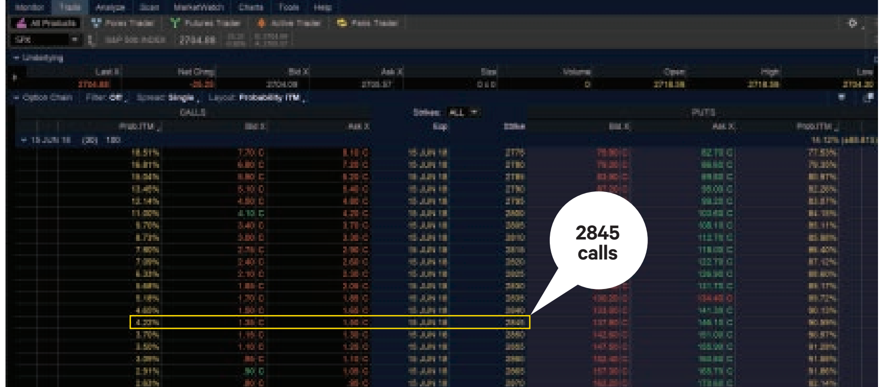


FIGURE 1: The lure of cheap OTM options. **On the Trade page of your thinkorswim® platform, bring up the option chain. Although the options may be cheap, the probability of the option being in the money at expiration could be very low.** *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

What's not to love about the gamma scalp? Turns out, plenty.

Gamma scalping is a semi-complex strategy that continuously hedges the deltas of a long straddle using—in its simplest form—stock. As a stock price moves up and down, the deltas of a straddle can go from positive to negative. The stock trades become (hopefully) profitable scalps, and they offset the losses from negative time decay.

But let's look at the numbers. Say the stock is $100, and you buy the 100 strike put and 100 call. Assume the delta of that straddle is close to zero, while gamma is 0.80. If the stock price goes up $1, the delta theoretically increases by 80. If the stock price goes down $1, the delta theoretically drops by 80.

If the stock goes from $100 to $101, the delta of the 100 straddle goes from zero to 80. The gamma scalper sells short 80 shares of stock, and the position (straddle plus short stock) goes back to zero. Say the stock drops from $101 back to $100, and the position's delta goes from zero to -80. The gamma scalper buys 80 shares of stock to get the position delta back to zero. The gamma scalper is left with the long 100 straddle (the original position). She made $80 selling stock at $101 and buying it back at $100. If the long 100 straddle had theta (time decay) of -20 per day, the $80 scalp more than offset it. The gamma scalper "defended" the long straddle with the scalps, and was able to hold that straddle to wait for the big move. That's how it's supposed to work, and what makes gamma scalping sound appealing.

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But there are problems. First, commission costs can get high with so many stock trades. Second, if the stock price doesn't change, and the long gamma doesn't "manufacture" any deltas to scalp, the time decay still eats away at the straddle's value. Third, the long straddle has long vega. And if implied vol drops, it can take the straddle's value down, all else being equal. That means the stock scalps have to offset theta and vega risks. Finally, successful gamma scalping means you're buying and selling stock at relative tops and bottoms. If the stock went from $100 to $101 and the gamma scalper sold 80 shares, who's to say it wouldn't continue higher in the "big move" that would make the original straddle position profitable? You don't want any short stock in that case.

For gamma scalping to be profitable, too many things have to go just right. Sometimes large institutions do a version of gamma scalping across all the firm's positions. But that's a different case.

Consider a long iron condor. It's an alternative to gamma scalping around a long straddle if you think a stock might have a big move up or down. A long iron condor might be short the 98 strike put, long the 99 strike put, long the 101 strike call, and short the 102 strike call. It's a long put vertical plus a long call vertical, and you pay a debit for it—which is also the strategy's max loss (not including commissions). That max profit occurs if the stock is below $98 or above $102 at expiration, and the max loss occurs if the stock is between $99 and $101 at expiration, with breakeven points at $99 (minus the debit paid) and $101 (plus the debit paid). Like a long straddle, the long iron condor is profitable if the stock has a big move up or down, yet loses if it doesn't.

There are also other alternatives to the long iron condor. And although they also have commissions, they may be less than with gamma scalping. Also, the long iron condor and its cousins may not require constant trade adjustments, as with gamma scalping, and might carry less risk.

SO IT MAKES SENSE TO SEND THE snake-oil salesmen packing. Always bring a healthy dose of skepticism to "can't lose" trading strategies. Consider the basic premise and leverage a smarter strategy.

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

For more on the risks of trading and trading options, see page 37, #1–2.

PRO/ **TAKE AWAY:** *Layer strategies to offset or reduce risks.*

WORDS BY **THOMAS PRESTON**
PHOTOGRAPHS BY DAN SAELINGER

WITH MULTI-SPREAD ORGANIC TRADING

BIG IDEA: IT'S ONE THING TO KNOW WHICH OPTIONS SPREAD IS POSSIBLY IDEAL FOR CURRENT VOLATILITY CONDITIONS AND TRENDS. BUT HOW DO YOU POSITION YOURSELF FOR SOMETHING THAT HASN'T YET HAPPENED?

here's always something new to learn in the options world. That's what makes it fun. Sure, you can stick with covered calls and iron condors and perhaps lead a long, successful trading career. But if you're curious, you can dip into option pricing formulas, probability theory, or even option strategies that don't yet have names. Even assuming a finite number of calls and puts, there's still a lot of them. And you can always add one more call, or one more put, or one more spread to a strategy to generate more time decay, widen out breakeven points, or reduce risk. Who knows? Your nice little iron condor might turn into a fire-breathing titanium archaeopteryx.

ORGANIC GROWTH

Most seasoned traders—retail or professional—don't pursue complexity for complexity's sake. A strategy that starts out as an eight-legged monster may also have high execution and commission costs. Plus, how are you going to manage that trade relative to profit or loss? The more complex a strategy, the more work it can be. And that can take time away from finding new potential opportunities. Yes, some positions are complex, with long and short options occurring at many strikes, and over many expirations. But they don't necessarily start out that way. Positions for seasoned traders can grow over time—organically, if you will—when the stock and volatility ("vol") move up and down.

TRADER GLOSSARY
TURN TO PAGE 36

Consider starting out with the simplest strategy that can be profitable if your underlying assumption actually happens. Then, you might add other simple strategies over time to either reduce risk or possibly realize a profit, while still maintaining the basic speculative strategy.

In a word, there's often a short-term, and longer-term, view. Can you have the best of both worlds?

KNOW YOUR OPTIONS

Market makers manage positions by overlaying strategies—layers of options from their daily buying and selling activity. Let's consider some of those lessons. Take note of how overlaying strategies can be combined so that one offsets, or reduces, the risk of another speculation, with each position having a specific purpose.

1 WHEN VOL IS LOW, AND YOU BELIEVE A BREAKOUT IS IMMINENT, BUT YOU DON'T KNOW WHICH DIRECTION

POSSIBLE STRATEGY: A LONG BACK-MONTH STRANGLE WITH A LONG FRONT-MONTH BUTTERFLY OVERLAY

Timing a market is tough. But as they say, you have to be at the table when dinner is served. So, rather than try to pick the exact time when the stock might rally or drop, or vol might increase or decrease, you could enter a trade now, but layer a short option or option spread on top of it to collect a credit and reduce its effective cost if the event you're hoping for doesn't happen. For example, if you buy a stock, selling an OTM call can reduce the stock's cost.

If vol is low, and you think it might rise with a big move in a stock price, you might want to buy a strangle. That's an out-of-the-money (OTM) call and OTM put. And if you're speculating on vol, buying a strangle in a further expiration could give the trade higher vega, all other things being equal.

But what if vol doesn't rise, and the stock doesn't move? One trade you could layer on top of the long strangle in the further expiration is a long, at-the-money (ATM) butterfly in a closer expiration. A butterfly maximizes its profit if the stock is at its center strike at expiration. If you place the butterfly's short strike in between the strangle's strikes, then it might profit when the stock price is at the least ideal for that strangle.

For example, with the stock at $50, say you buy two long strangles at the 48 strike put and 52 strike call with 60 days to expiration for $0.85 debit each. Then you add a butterfly that's long the 48 strike call, short two of the 50 strike calls, and long the 52 strike call in an expiration with, say, 30 days to go, and pay $0.60 debit. If the stock is at $49 in 30 days, that's not so great for the long 48/52 strangle. Maybe it's worth about $0.65 now, and has lost $40 ($0.20 x 2). But the 48/50/52 call butterfly could have a profit of $40, which is the butterfly's value ($1), minus the $0.60 debit. The strangles lost $40, but the butterfly made $40. So, the profit on the butterfly offset the loss on the strangles. That's how an overlapped position can help.

Or say the stock drops to $48 in 30 days. The 48/50/52 butterfly is worth zero, so it loses $60. But the 48/52 strangle might be worth $1.20, and be up $70 ($0.35 x 2). Yes, the butterfly hurt. But the lower stock price that hurt the butterfly helped the strangle. The overall strategy would still be up $10. That's one downside to overlapped strategies. The other downside, of course, is commissions. Overlaying a butterfly and long strangle means five legs and six options. There can naturally be extra expense when using overlapped strategies.

But you'd still own two of the long 48/52 strangles. And if the stock continued to

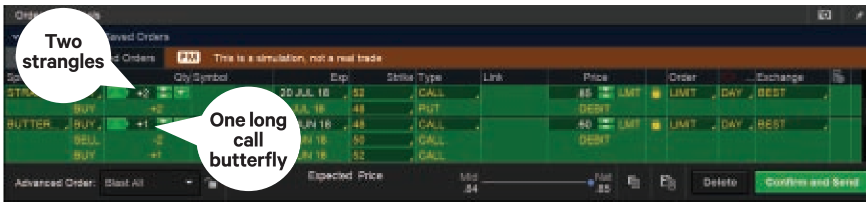

FIGURE 1: Strangles overlapped with a butterfly. **From the Trade page on thinkorswim, select the expiration and strike price to place strangles and a butterfly.** *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

FIGURE 2: Two long put verticals overlapped with a short put vertical. **Right-click on the strike prices to buy and sell two put verticals.** *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

move down, the strategy could potentially become profitable.

Keep in mind the overlapped positions maintained your original speculation. The strategy is long vega because the long two strangles in the back month can have a higher vega than the long butterfly in the near month. And the strategy may be profitable if the stock has a very large price move.

Figure 1 shows how two long strangles and one overlapping long call butterfly might look.

2 WHEN MARKETS ARE HIGH, BUT YOU DON'T KNOW WHEN THEY MIGHT FALL BACK

POSSIBLE STRATEGY: A LONG BACK-MONTH VERTICAL WITH SHORT FRONT-MONTH VERTICAL OVERLAY

Consider a case when the market has had a big rally and you're bearish. Again, you're not trying to time the market. So you may buy a put vertical in a further expiration. But what if the market rallies a bit, or even just sits there for a while? Neither could be good for that long put vertical. So, you might overlay a short put vertical in a closer expiration that would have narrower strikes.

You may want to ratio these overlapped verticals with two debit spreads to one credit spread, for example. This gives you more negative deltas in the back month, and fewer positive deltas in the front month, to keep the overall strategy bearish. But the bullish, short, front-month vertical can chip away at the breakeven point of the back-month bearish long verticals.

For example, with the stock at $50, maybe you buy two of the long put verticals, long the 51 strike put and short the 48 strike put in an expiration 60 days out for $1.20 debit. On top of that, you sell one put vertical that might be short the 50 strike put and long the 49 strike put, with an expiration 30 days out, for $0.45 credit.

If the stock rallies from $50 to $52 in 30 days, that's not good for the long 51/48 put verticals, which might be $0.80 now, and may have lost $80 ($0.40 x 2). But the short 50/49 put vertical would have its max profit of $45, and reduce the overall position's loss to $35.

On the other hand, if the stock is down to $48 in 30 days, the long 51/48 put verticals might be worth $2.20, and be up $200 ($1 x 2), while the 50/49 put vertical has its max loss of $55 ($1 – $0.45 credit). Overall, the strategy is up $145, not including commissions.

Figure 2 shows how two long put verticals and one overlapping short put vertical might look. The short put vertical overlay has its downside. But its purpose is to offset the loss on the long put verticals if the stock continues to climb.

Overlaying verticals gives you a lot of flexibility. If the stock continues to rally, you could attempt to roll the long put vertical to higher strikes—potentially taking a loss—but also sell a higher-strike put vertical in a closer expiration (possibly a weekly expiration) to offset the loss.

OVERLAPPING STRATEGIES IS NO MAGIC formula to guaranteed profits. The goal is to potentially reduce the risk of a longer-term or core position. And each part of the overlapped strategy plays a specific role that you should understand. Again, keep in mind that a potentially helpful strategy in one scenario can hurt in another. But why the overall strategy might make or lose money can be easier to figure out if each position has a clear purpose in relation to the other, and can be analyzed as its own, separate trade.

The point isn't to get super complex in your trading life to wow your friends, but to fine-tune a speculation that could potentially be more profitable with less risk.

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For more on the risks of trading and trading options, see page 37, #1–2.

TRADER JARGON

Butterfly
Typically a market-neutral, defined-risk strategy, composed of selling two options at one strike and buying one each of both a higher- and lower-strike option of the same type (either all calls or puts). The strategy assumes the underlying will remain relatively unchanged during the life of the trade, in which case, as time passes, and/or volatility drops, the combined short option premiums exhibit more decay than the combined long option premiums, resulting in a profit when the spread can be sold for more than its original debit (which is its maximum loss).

Strangle
A trading position involving puts and calls on a one-to-one basis in which the puts and calls have the same expiration and underlying asset, but different strike prices. When both options are owned, it's a long strangle. When both options are written, it's a short strangle.

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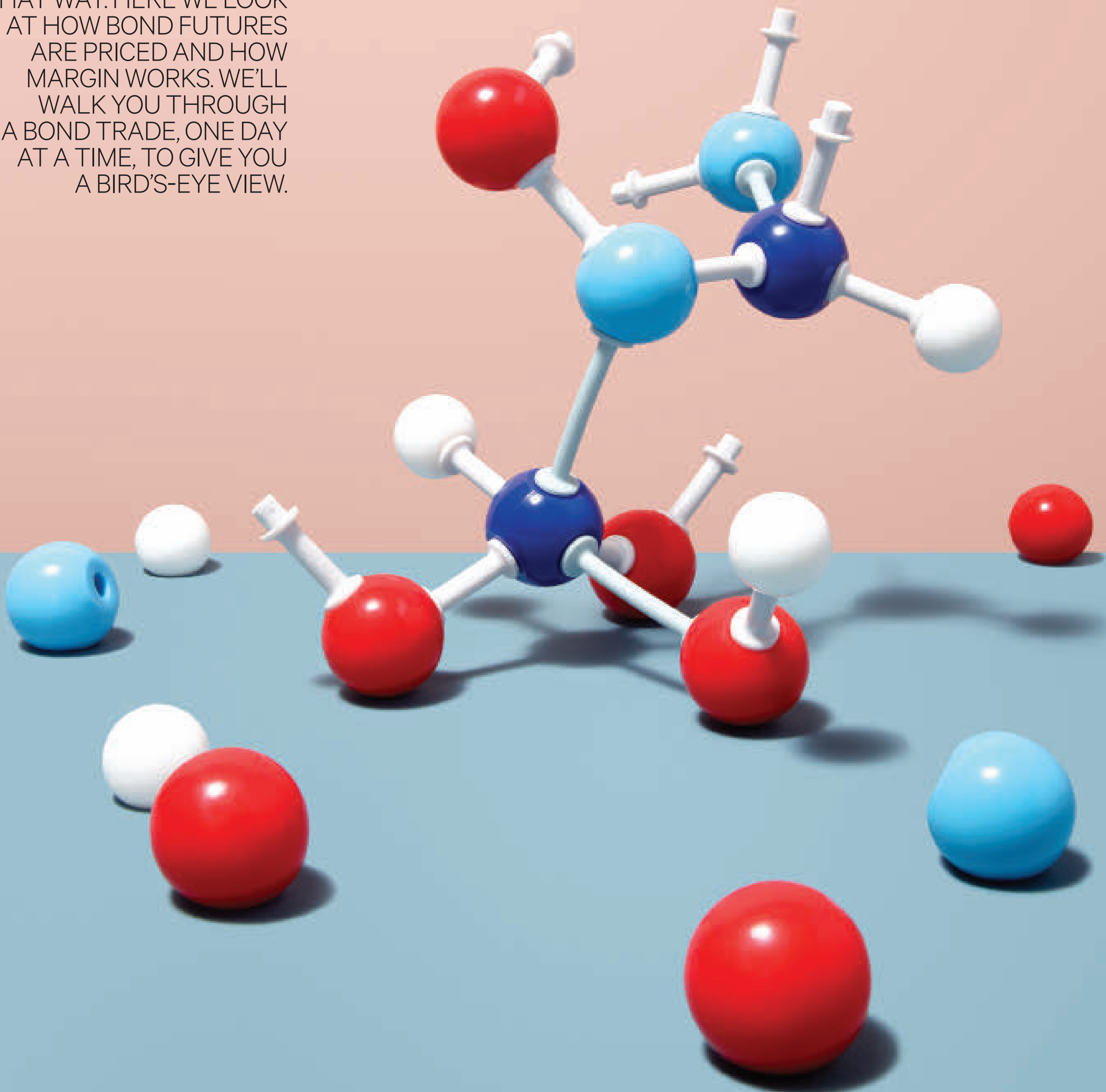
SEASONED / **TAKE AWAY:**
What are bond futures, and how can you trade them?

A DAY IN THE LIFE OF A BOND TRADE

WORDS BY **JAYANTHI GOPALAKRISHNAN**

PHOTOGRAPHS BY DAN SAELINGER

BIG IDEA: BOND FUTURES HAVE A REPUTATION FOR BEING TOUGH TO UNDERSTAND. BUT IT DOESN'T HAVE TO BE THAT WAY. HERE WE LOOK AT HOW BOND FUTURES ARE PRICED AND HOW MARGIN WORKS. WE'LL WALK YOU THROUGH A BOND TRADE, ONE DAY AT A TIME, TO GIVE YOU A BIRD'S-EYE VIEW.



PERCEPTION IS TRICKY.

Reality is better. If you believe bonds are boring, risky, and complex, you've got a ton of company among retail traders. In reality, bond futures markets are actively traded, very liquid, have narrow bid/ask spreads, and provide a direct way to speculate on the bond market. Better yet, the value of the bond futures markets equals, or surpasses, equity markets. Great characteristics, all. Since reality is way more fun, let's unravel the bond market mysteries and some of the mechanics behind Treasury futures.

WHAT ARE THEY?

A Treasury futures contract, like any futures contract, is an agreement between a buyer and seller to buy or sell an underlying at a certain price for delivery and payment at a specific date in the future. With Treasury futures, the underlying asset is a U.S. government–issued coupon security: bonds, notes, or bills.

The T-bond or "long bond" refers to the long-term, 30-year bond (symbol: /ZB on the thinkorswim® platform from TD Ameritrade). Treasury notes can have 10-year (/ZN), 5-year (/ZF), or 2-year (/ZT) maturities. Treasury bills have shorter maturities of one year or less, but they're not widely traded.

THINKING ABOUT TRADING FUTURES?

To apply for futures trading at TD Ameritrade, your account must be enabled for margin, have Tier 2 or Tier 3 options trading approval, and have Advanced Features enabled. Log in to your account at tdameritrade.com, and under the Trade tab, go to Futures & Forex for more information.

Interest rates directly affect bond markets, which can likewise affect forex, commodity, and equity markets. For this reason, it's a good idea to keep interest rates on your radar. And, bond prices and interest rates are inversely related. When interest rates or yields rise, bond prices fall. Why?

To understand this relationship, consider the nature of a bond, which is made up of a face value, an interest rate (coupon), and a maturity date. The interest rate is fixed. So, when expectations change, price is the only thing that moves. If interest rates rise, your fixed-rate bond is now yielding relatively less, so its price has to fall. But this price movement isn't consistent across different contracts—which can make a bond future complex.

THE VALUE OF PRICE MOVES

Treasury futures contracts come in five flavors with different maturities. Figure 1 shows these products and their price movement values. Think of it as a cheat sheet.

Most bond futures contracts have a $100,000 face value. One exception is /ZT, whose face value is twice as much. It has the shortest duration, which means those contracts won't generally be impacted by interest rate movement. In other words, /ZT doesn't move as much as the others. On the other hand, /ZB, /ZN, and /ZF are more actively traded. If you bring up /ZB on your thinkorswim® platform from TD Ameritrade, and choose to display **Active Only**, the active contract will be identified.

WHAT'S YOUR EXPOSURE?

Bonds are quoted in terms of their $1,000 multiplier. If the June /ZB contract is trading at 144'04, its value is (144 + 4/32), which works out to 144.125. Your exposure would be the contract multiplier $1,000, multiplied by $144.125, which works out to $144,125. But you don't need

	2-YEAR NOTES (/ZT)	5-YEAR NOTES (/ZF)	10-YEAR NOTES (/ZN)	30-YEAR T-BOND FUTURES (/ZB)	ULTRA T-BOND FUTURES (/UB)
Face value	200,000	100,000	100,000	100,000	100,000
Multiplier or one-point move	$2,000	$1,000	$1,000	$1,000	$1,000
Minimum tick	1/4 of 1/32 of a point	1/4 of 1/32 of a point	1/2 of 1/32 of a point	1/32 of a point	1/32 of a point
Minimum tick value	$15.625	$7.815	$15.625	$31.25	$31.25

Note: Treasury futures contract months occur on a quarterly cycle: March, June, September, December.

FIGURE 1: Treasury futures contract specs. They're all a bit different, but if you know the point values and tick values of each, price movements become easier to digest. *For illustrative purposes only.*

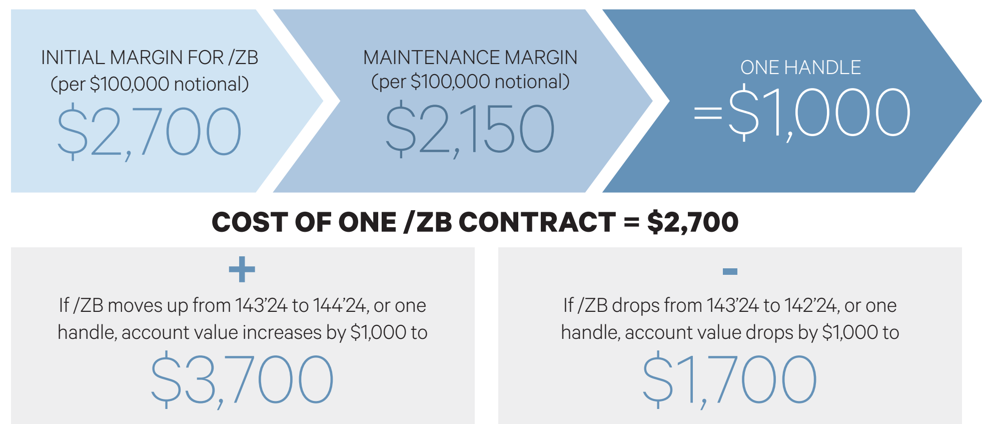


FIGURE 2: Bond future margins, explained. *For illustrative purposes only.*

to put up that entire amount. Instead, you put up a marginal amount, known as the initial margin requirement.

Many traders are drawn to trading futures because of leverage—the ability to commit a small amount of capital to control a large position. And that means small changes in an underlying future's price could turn into large gains or losses. As with all financial instruments, it's worth putting in the time to understand how margin and leverage work.

Leverage for futures is different than for stocks. Many traders will let cash-settled futures settle to cash. For physically settled contracts, such as crude oil (/CL), a trader must be out of the position before the settlement date or else a broker like TD Ameritrade, which doesn't allow physical delivery, will trade out of the contract for you. Futures traders open and close positions before a contract's settlement date, so they don't need the contract's full value in order to trade. (See Figure 2 for an illustration of a bond future's margin mechanics.) Keep in mind: margin requirements are subject to change. So check with the exchange, and/or your broker, before you trade.

For $2,700 you're getting exposure to $100,000 of the 30-year Treasury bond. Now that you know how bonds are priced and how margin works, take a look at Figure 3 to see an example of day-to-day action in bond prices. Calculating P/L is simple math. Say you buy one/ZB contract at 143'26 and sell one /ZB at 144'28. Your profit would be $1,062.50. On your thinkorswim platform, head over to the **Analyze tab**, thinkBack, Underlying & P/L Graph. Go back in time to see how bonds move. With initial capital of $2,700, it's possible to trade bond futures and potentially earn a profit. But remember, things could go the other way. Which is why you should have a risk management strategy in place to prevent your account value from dropping below its maintenance margin.

BOND TRADER JARGON

Coupon or interest rate The interest that's due and the date it needs to be paid.

Face value (or par) The actual value of the bond, i.e., principal, maturity, or value. Not the market value.

Handle A full-point price movement. For /ZB, this would be $1,000.

Initial margin The amount you need in your trading account to enter the trade.

Maintenance margin The amount you must maintain in your account at the close of trading to hold a futures contract.

Maturity date The date the bond's principal amount is due and paid.

Yield Annual percentage rate of return earned from the bond.

SEE DAY TO DAY PRICE ACTION. Go back in time and explore how bond prices move using the thinkBack tool on thinkorswim.

BIG DOESN'T HAVE TO BE SCARY

Some may think bonds are complex, scary financial instruments that should be avoided. In point of fact, you don't always need a huge capital outlay to trade bond futures—just a strong understanding of the pricing dynamics. And make sure you're prudent about your trading account. Get to know bonds in your paperMoney® account. The reality may surprise you.

10-DAY BOND TRADE

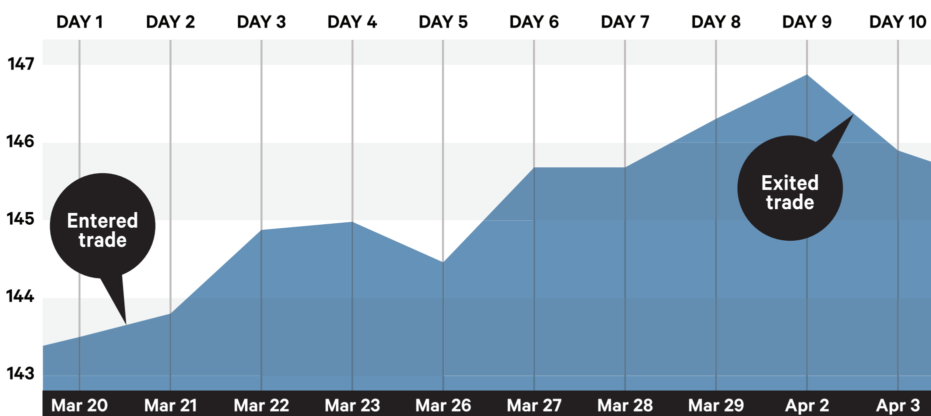


FIGURE 3: Watch bond prices move. Here you see how /ZB moved between March 20, 2018, to April 3, 2018.
For illustrative purposes only.

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

Futures and futures option trading is speculative and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Futures and futures options trading services provided by TD Ameritrade Futures & Forex LLC. Trading privileges subject to review and approval. Not all clients will qualify.

For more information on the risks of trading and futures, please see page 37, #1 & 3.

FOUR BIG MYTHS ABOUT VOLATILITY (AND HOW TO DEBUNK THEM)

WORDS BY THOMAS PRESTON

PRO / **TAKE AWAY:** *The truth about volatility and what it may really tell a trader.*

BIG IDEA: WHEN THE POPULARITY OF ANY MARKET GAUGE CATCHES THE ATTENTION OF THE MEDIA, YOU'LL HEAR LOTS OF STORIES ABOUT IT. BUT THEY MAY NOT ALL BE ACCURATE. CONSIDER A FEW THINGS ABOUT VOLATILITY THAT MAY NOT BE TRUE.

WHAT'S WORSE than being talked about? Not being talked about! That double-edged popularity sword is true for teenagers, celebrities, and you guessed it—volatility ("vol"). For years, vol was something you read about in dry financial textbooks or heard about from crusty old traders. And that was unfortunate. Because "vol" has always been an important tool when it comes to trading, especially for options traders.

Yet, as vol became more popular, particularly the CBOE Volatility Index (VIX), and more people gossiped about it, sure enough, mean rumors started circulating. TV pundits were saying things like, "The VIX didn't tell me when the market would crash! It's useless!" Or articles warned investors to shun the VIX, which apparently was to blame for market selloffs.

NOT SO FAST

Though it seems like vol can't catch any good press, there's hope. Consider four things you might hear about vol that aren't necessarily true—myths, if you will, that should be debunked and replaced with facts.

1

MYTH The VIX drives the market.

FACT The market drives volatility.

Selloffs are bad when you're long stocks. Those who complain about the VIX often have a vested interest in the market always going up.

When the market drops, uninformed pundits may blame the VIX. True, it can be hard to understand just what the VIX is. The formula is a bit complex. But conceptually, the VIX is fairly simple. It's a weighted average of the implied volatility of out-of-the-money (OTM) S&P 500 index options (SPX).

Because VIX derives its value from SPX options, saying the VIX drove the market down, for example, would be blaming SPX options. As market participants (you, me, hedge funds, etc.) buy and sell SPX options based on how big or small potential SPX price changes might be in the future, it pushes the values of those OTM SPX options up and down. When prices go up, all things being equal, the VIX goes up. When price goes down, the VIX goes down. So, the VIX is a kind of indicator as to how much traders are pushing the SPX options prices up or down in expectation of what might happen in the future.

2

MYTH Vol tells you where the market is going.

FACT Vol may help you choose a trading strategy.

FIGURE 1: Vol Index. On the Analyze tab of your thinkorswim platform, add Vol Index into the Watchlist. *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

TAKE ACTION. To get to know /VX futures, read "You're so VIXed" on the *thinkMoney* archives online at tickertape.tdameritrade.com/thinkMoney/37.

Financial talking heads may say the VIX is low. So the market is due for a selloff. Or the VIX is high and the market is going to bounce. If it doesn't happen their way, they blame vol.

In point of fact, vol doesn't reliably predict market direction. Sometimes the market crashes when the VIX is low. Sometimes the market rallies after the VIX spikes higher—but not all the time. That inconsistency makes the VIX a not-so-great directional indicator, which leads some traders to suggest the VIX is useless. And that's just plain wrong.

The VIX may help you choose a strategy once you've determined your bullish, bearish, or neutral market opinion. Remember: the VIX is just a measure of the implied vols and, by extension, the extrinsic values of SPX options. When vol is relatively low, it means the extrinsic value of SPX options is relatively low, too. If you're bearish, for example, and VIX is low, you may decide to choose a strategy that benefits from low extrinsic values, like a long put vertical or a long put calendar spread. If you're bearish and VIX is high, you may decide on a strategy that takes advantage of the higher extrinsic values, like a short OTM call vertical.

Those strategies are bearish. But each tries to take advantage of how high or low the extrinsic values of options might be. Whether the VIX at 17 or 25 is considered high or low, as a trader, you'll still need to make a judgment call. But use that judgment to inform your strategy, not your directional bias. That's how you potentially derive value from the VIX, which can move rapidly and because of that, can quickly move against a position.

TRADER GLOSSARY TURN TO PAGE 36

3

MYTH Sometimes the VIX is wrong.

FACT It's math.

The VIX itself is never "wrong." Saying the VIX is wrong is like saying SPX options prices are wrong. And that statement can be tough, if not impossible, to prove. Above all, it's how you interpret VIX that matters. It might indicate over-complacency in market participants on one hand, or too much fear on the other. Keep in mind the VIX is not taking the pulse of the market. It's taking the pulse of market participants. Are traders complacent or fearful? If traders expect a quiet market, they may sell SPX options and push prices lower. The VIX goes down, indicating complacency. If traders expect drama, they may buy SPX options and drive prices higher. The VIX goes up, indicating some measure of fear or uncertainty. The VIX tells you what the people trading the markets are thinking. Do you want to join them, or not?

As a trader, what's key is your judgment as to how you'll respond to movements in the VIX.

4

MYTH Overall vol is just on the S&P 500.

FACT TD Ameritrade has an overall vol for most stocks.

Strictly speaking, the VIX index represents only SPX options. But the thinkorswim® platform from TD Ameritrade also has a Vol Index that displays similar information on any stock or index with options. Find it on the Watchlist gadget (Figure 1). The Vol Index uses the same type of formula as the VIX, so you may interpret it in much the same way.

Beyond our myth-busting, consider this bonus fact! VIX options aren't based on the VIX; they're based on /VX futures.

Before the cool kids start bad-mouthing VIX options, let's head them off with some facts about how they're priced. When you look at VIX options and compare them to the VIX's price, a put with a strike that's, say, two points below the VIX looks less expensive than a call that's two points above the VIX. Why?

A key concept in option pricing suggests options are priced off their hedge. Stock options are hedged with their stocks and are priced off the stock's price. But the VIX itself is a cash index that isn't tradable. If you're trading VIX options, what's your hedge? VIX market makers use /VX VIX futures—specifically the /VX future that expires at the same time as the VIX options.

If you type in the root futures symbol /VX in the **Trade** page of the thinkorswim platform, you'll see all the /VX futures, along with their days to expiration. You won't see any VIX options listed. And if you type in VIX, you'll see VIX options, but not futures. But if you note the price of a particular /VX future, say the September /VXU8, and compare it to the Sep VIX options, suddenly the VIX option prices make sense. The call and put at the strike closest to the price of the /VX future will have roughly the same price. The intrinsic value of the in-the-money (ITM) calls and puts will match the difference between the strike price and /VX future's price. And the OTM options will make a lot more sense if you compare them to the /VX price rather than the VIX itself.

Now, go spread the facts about volatility!

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

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The Go-Getter

KATIE RYAN'S KNOWN TO BE RESILIENT, LASER-FOCUSED, AND A JUGGLER OF MANY TASKS. AND NOW SHE'S HAPPY TO HELP LAUNCH THE TD AMERITRADE NETWORK.

Illustration by Joe Morse

• TRADERS DON'T CUT CORNERS. This is a kind of mantra. Likewise, a handful of people are passionate and determined to master the tasks before them. Katie Ryan, director of our media company affiliate, TD Ameritrade Network, is one such person. Throughout her career, she has worn many hats—from the trading floor, to operations, and now she's coordinating the technology behind television production.

1

What motivated you to get involved with the TD Ameritrade Network?
I had been on the product side for some time, yet was curious about the overall trading ecosystem. TV is new for me. I don't have all the answers. My secret? I hired really smart people! I also get a lot of support from the production executives and the entire team. It's our extended family—marketing, social media teams, and technology. Truly a group effort.

"Travel is a great way to disconnect from work and learn to live without your phone."

2

How do you feel you're contributing to the overall trading ecosystem?
On the new media company network, we're able to remove a lot of the noise and focus on financial markets—we break down financial news so viewers can apply it to their trading strategies. You won't hear much about politics or human interest. And we plan to add more shows so we can present content 24 hours a day, five to seven days a week.

3

How do you decide which content will be the most valuable to viewers?
Say housing sales are up by 3%. What could that mean for an individual trader? It could mean stocks of home-buying-related businesses will benefit. Another topic might be interest rate hikes. How might they affect the overall economy and individual traders? Our goal is to educate our viewers through live TV so they become more informed and engaged with the markets.

4

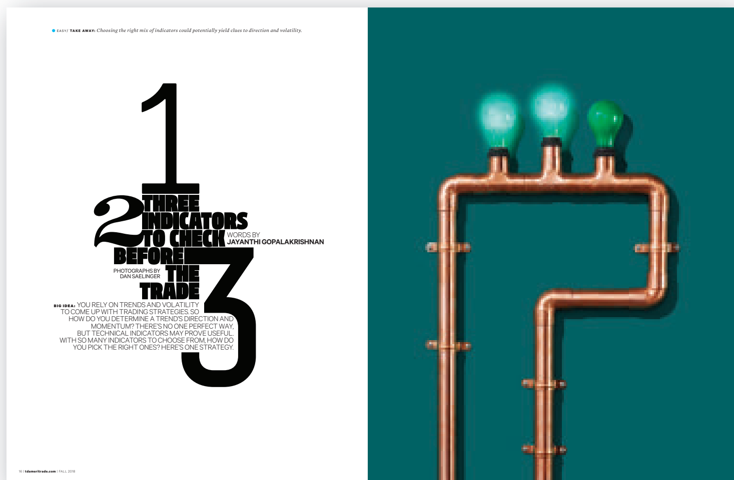
Why is user engagement important?
Our viewers benefit from seeing platform demonstrations as the markets unfold. It elevates their market awareness. So even if they aren't actively trading each day, they're still actively involved with the markets. They become more in tune with what goes on in the markets, globally.

5

Tell us about your European biking trip.
My family went on a bike ride from Paris to London and we navigated our way with "old school" map reading. Just like in a trading day, sometimes we found ourselves off the beaten path!

TD Ameritrade Network is brought to you by TD Ameritrade Media Productions Company. TD Ameritrade Media Productions Company and TD Ameritrade, Inc., are separate but affiliated subsidiaries of TD Ameritrade Holding Corporation.

TRADER JARGON


EASY/ TAKE AWAY: *Choosing the right mix of indicators could potentially yield clues to direction and volatility.*

1 2 THREE INDICATORS TO CHECK BEFORE THE TRADE 3

WORDS BY **JAYANTHI GOPALAKRISHNAN**

PHOTOGRAPHS BY DAN SAELINGER

BIG IDEA: YOU RELY ON TRENDS AND VOLATILITY TO COME UP WITH TRADING STRATEGIES. SO HOW DO YOU DETERMINE A TREND'S DIRECTION AND MOMENTUM? THERE'S NO ONE PERFECT WAY, BUT TECHNICAL INDICATORS MAY PROVE USEFUL. WITH SO MANY INDICATORS TO CHOOSE FROM, HOW DO YOU PICK THE RIGHT ONES? HERE'S ONE STRATEGY.

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Long call vertical spread

• A defined-risk, bullish spread strategy composed of a long and short option of the same type (i.e., calls). Long verticals are purchased for a debit at the onset of the trade. The risk of a long vertical is typically limited to the debit of the trade.

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

Delta — A measure of an option's sensitivity to a $1 change in the underlying asset. All else being equal, an option with a 0.50 delta (for example) would gain 50 cents per $1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying drops in value.

Gamma — A measure of how much an option's delta is expected to change per $1 move in the underlying.

In the money (ITM) — An option whose premium contains "real" value, i.e., not just time value. For calls, it's any strike lower than the price of the underlying equity. For puts, it's any strike that's higher.

Iron condor — A defined-risk, short spread strategy, constructed of a short put vertical and a short call vertical. You assume the underlying will stay within a certain range (between the strikes of the short options). The goal: as time passes and/or volatility drops, the spreads can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the largest difference between the adjacent and long strikes minus the total credit received.

Long put calendar spread — A defined-risk spread strategy, constructed by selling a short-term put option and buying a longer-term put option. The goal: as time passes, the shorter-term option typically decays faster than the longer-term option, and profits when the spread can be sold for more than you paid for it. The risk is typically limited to the debit incurred.

Long put vertical — The simultaneous purchase of one put option and sale of another put option at a different strike price, in the same underlying, in the same expiration month.

Out of the money (OTM) — An option whose premium is not only all "time" value, but the strike is away from the underlying equity. For calls, it's any strike higher than the underlying. For puts, it's any strike that's lower.

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

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

Straddle — A trading position involving puts and calls on a one-to-one basis in which the puts and calls have the same strike price, expiration, and underlying asset. When both options are owned, it's a long straddle. When both options are written, it's a short straddle.

Theta — A measure of an option's sensitivity to time passing one calendar day. For example, if a long put has a theta of -0.02, the option premium will decrease by $2.

Vega — A measure of an option's sensitivity to a one-percentage-point change in implied volatility. For example, if a long option has a vega of 0.04, a one-percentage-point increase in implied volatility will increase the option premium by $4 per contract.

CBOE Volatility Index (VIX) — Index that measures the implied volatility of S&P 500 index options. Otherwise known to the public as the "fear index," it is most often used to gauge the level of fear or complacency in a market over a specified period of time. Typically, as the VIX rises, option buying activity increases, and option premiums on the S&P 500 index increase as well. As the VIX declines, option buying activity decreases. The assumption is that greater option activity means the market is buying up hedges, in anticipation of a correction. However, the market can move higher or lower, despite a rising VIX.

DISCLAIMERS

IMPORTANT INFORMATION YOU NEED TO KNOW

1

GENERAL DISCLAIMER

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

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

It is not possible to invest directly in an index.

2

OPTION STRATEGIES

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

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

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

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

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

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

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

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

3

FUTURES

Futures trading is not suitable for all investors as the risk of loss in trading futures is substantial. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Futures and futures options trading services provided by TD Ameritrade Futures & Forex LLC. Trading privileges subject to review and approval. Not all clients will qualify.

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

The Trader Proficiency Test: What Kind of Trader Are You?

• After interviewing dozens of scientists, traders, and other dysfunctional personality types, we've developed this proficiency test to identify your trading profile. Just answer the following questions and match your answers to the profiles below.

AND... BEGIN:

–01–

The music of which artist compels you to stare longingly at the moon?

- ○ **A.** Taylor Swift
- ○ **B.** The Weekend
- ○ **C.** Frank Sinatra
- ○ **D.** Megadeth

–02–

If you look down and notice a rash, do you:

- ○ **A.** Scratch it
- ○ **B.** Consult a trained professional, like a doctor
- ○ **C.** Call a fortune teller
- ○ **D.** Call the TD Ameritrade Client Service Desk

–03–

For a weekend getaway, what's always in your suitcase?

- ○ **A.** Encased meats
- ○ **B.** Eye drops
- ○ **C.** Spare kidney
- ○ **D.** Teacup chihuahua

–04–

What's your favorite form of cheap entertainment?

- ○ **A.** Shorting index options at expiration
- ○ **B.** Hypnotic tick charts
- ○ **C.** Chugging curdled milk
- ○ **D.** Crank calling your spouse

–05–

If you could take delivery of any futures contract, which would it be?

- ○ **A.** Savory lean hogs
- ○ **B.** Fragrant Class IV milk
- ○ **C.** Sensuous soybean oil
- ○ **D.** Darknet convertible cryptocurrencies

–06–

For what are you most grateful?

- ○ **A.** The trade you did do
- ○ **B.** The trade you didn't do
- ○ **C.** Spouse's trust fund
- ○ **D.** Kind TD Ameritrade trade desk staff

–07–

Which of the following would you choose for a band name?

- ○ **A.** The Margin Callers
- ○ **B.** Carpe Diem
- ○ **C.** Shorty's End
- ○ **D.** Gamma Ramma

–08–

When the market goes down:

- ○ **A.** Your long puts go down
- ○ **B.** Your short calls don't budge
- ○ **C.** It's the day after you gave up on your short S&Ps
- ○ **D.** Markets go down?

SO WHAT KIND OF TRADER ARE YOU?

IF YOU ANSWERED MOSTLY: As

The Speculator
Has a much better ring to it than "daytrader."

IF YOU ANSWERED MOSTLY: Bs

The Arbitrageur
When the marks come back in line I'll be rich! You'll see! You'll ALL see!!

IF YOU ANSWERED MOSTLY: Cs

The Risk Manager
If it weren't for those stupid traders, I'd have had a bonus last year.

IF YOU ANSWERED MOSTLY: Ds

The Newsletter Guru
Hey, even a blind squirrel finds a nut here and there. Can you say "upsell"?

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