thinkMoney® 53

Random musings for traders at TD Ameritrade—FALL 2021

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Cover photograph by **Dan Saelinger**

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Change, Adapt, Repeat

• FALL IS HERE, but we may not be operating at pre-pandemic levels like we thought we would be. People are starting to go back to the office, venture out to restaurants, and meet up with friends and family. But not like we used to.

Though we resist at first, we eventually adapt to change and get used to the new way of doing things. Look at stocks. The market evolved from floor trading to all-electronic trading, the rise of algo traders to an upsurge of meme stock retail traders. More companies went public, crypto became a household name, and, overall, companies had strong earnings. All this in the midst of a pandemic.

It's great when optimism is high,but it also pays to be cautious. Healthy portfolios breed complacency, and the thought of losing may not cross your mind. But remember—markets correct. You just don't know when. As a trader, it's best to expect the worst and be prepared with strategies to protect your profits—especially with monster stocks priced in triple and quadruple digits. In "Big Stock Trading with a Parachute" on page 16, you'll discover three defined-risk options strategies you could apply to trading these stocks that are designed to keep you in the party, yet minimize your losses, just in case things change.

If things don't change much and the market continues to rally, discipline is key. Whether you're trading meme stocks or post-earnings rallies, it's tempting to jump into stocks with seemingly freight-train momentum.

But take a step back and think hard about it. Momentum can be short-lived, so find stocks that look to have longer runs. In"The Nuts and Bolts of MOMO Trading" on page 24, we walk you through a charting approach to help identify potential momentum stocks.

Change happens. And the most nimble, adaptive traders typically have a better chance of staying in the long game when things turn the wrong way. They stick to core money management strategies that keep them out of trouble and adapt new trading tactics that meet the market where it is.

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

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Transaction costs are important factors and should be considered when evaluating any options trade. For simplicity, the examples in these articles do not include transaction costs. At TD Ameritrade, online options orders are $0.65 per contract. Orders placed by other means will have higher transaction costs.

Micro Bitcoin futures

Micro-sized contracts Major possibilities

Micro Bitcoin futures (MBT) from CME Group provides an efficient, cost-effective new way to fine-tune bitcoin exposure and enhance your trading strategies. Gain more precision to manage price risk in your portfolio with an innovative contract that is 1/10 the size of one bitcoin.

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IN THE MONEY

INDUSTRY SPOTLIGHT

Ready for a Crypto Nibble? Try Micro Bitcoin futures.

They're 1/50th the notional value of full-size bitcoin futures.

• WHEN STOCK PRICES GET OUT OF reach for the retail crowd, you might see a stock split. When the notional value of a stock index gets too big, you might see new futures products with smaller multipliers. So, when bitcoin and other cryptocurrencies surged, you could say the time was right for the CME Group to introduce Micro Bitcoin futures.

Sometimes investors, traders, and market makers are slow to embrace a new futures product. Not so in the case of these smaller bitcoin futures. Volume quickly outpaced the daily volume of the full-sized contracts. For the retail trading crowd, it's easy to see why:

• **Lower notional = Lower margin.** With futures, you don't post the full notional value of the contract. You post a fraction of it in the form of margin, which can help you be more capital efficient. For example, when bitcoin surged past $60,000 per coin, the margin on one full-size (five-coin) contract topped six figures. And margin is leverage, which means the gains and losses are magnified, meaning a small amount of market movement can have a large effect—positive or negative—on an account's profit and loss. Because each micro contract is one-tenth of one coin, it might put bitcoin futures within the smaller trader's reach. Please note that micro futures are not suitable for everyone and have the same risks as the full-sized contracts.

• **Get long or short.** Similar to shorting stocks, getting short crypto exposure can require jumping through hoops. When trading futures, you should be comfortable with the ins and outs of margin before executing your trades.

PHOTOGRAPH: DAN SAELINGER

• **Futures = Regulatory certainty and mark-to-market settlement.** Like all futures in the United States, positions are cleared with a central counterparty backstop, marked to market daily, and regulated by the Commodity Futures Trading Commission. Plus, futures contracts generally offer a favorable (60/40) tax treatment under Section 1256 of the tax code. But be sure to consult a qualified tax professional with regard to your personal circumstances.

STRATEGIES FOR THE CRYPTO NIBBLER

Bitcoin and other cryptocurrencies have been moving toward a seat at the mainstream finance table. A liquid, viable derivatives market is seen by many as one of the legs of that table. What might futures traders want to consider before including Micro Bitcoin futures in their overall trading strategy?

• **Look at the technicals.** Like many chart watchers, you want to look for products that have sufficient volume, liquidity, price action, and volatility. Bitcoin futures check all the boxes. Fire up the thinkorswim® platform, pull up a chart of Micro Bitcoin futures (/MBT), add your favorite studies and drawings, and follow the action.

• **Hedge a crypto basket.** There may be times when you want to lighten your crypto exposure. Bitcoin—the largest cryptocurrency—tends to correlate highly with the overall crypto market. Shorting bitcoin futures could help you lighten your notional exposure. It's important to note that currently, TD Ameritrade does not provide the ability to trade or hold bitcoin or other cryptocurrencies directly in TD Ameritrade accounts.

• **Trade inflation.** Depending on your perspective, bitcoin can be seen as a potential hedge against government spending and central bank expansion, as well as a digital version of a commodity like gold or crude oil. With inflation making the news these days, Micro Bitcoin futures might be a way to play the ebb and flow of inflation expectations.

Micro bitcoin futures—and futures in general—are dynamic, risky, and not for everybody. But if the contract size is what's been holding you back, this 1/50th size might be the answer.

—Words by DOUG ASHBURN

Doug Ashburn 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 futures, see page 35, #1 & 3.

Virtual currencies including bitcoin experience significant price volatility, and fluctuations in the underlying virtual currency's value between the time you place a trade for a virtual currency futures contract and the time you attempt to liquidate it will affect the value of your futures contract and the potential profit and losses related to it. Be very cautious and monitor any investment that you make. Like all futures products, speculating in these markets should be considered a high-risk transaction.

Please note that virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value, but it does not have legal tender status. Virtual currencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not currently backed nor supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies. Profits and losses related to this volatility are amplified in margined futures contracts.

THINKTANK

Think Outside the Box

When you look beneath the surface of the Analyze tab on thinkorswim®, you may find some features you didn't know about.

How often do you analyze the risk/reward trade-off for a potential options trade, then second-guess your decision and end up not placing the trade? It happens. Trading gives rise to anxiety and, as a result, when it's crunch time, you may look for anything to procrastinate placing the trade—munch on snacks, watch cat videos, play with your phone, and so on.

Fortunately, there are some tools you could apply that might help reduce the pre-trading anxiety. Let's focus on the **Analyze** tab on thinkorswim. There are many features that can be found on this tab, but traders often stick to the default settings. Here are three others to consider.

Custom layouts for the Option Chain. There's virtually no limit to how you can customize the **Option Chain** on thinkorswim (see Figure 1).

1 – Filter based on parameters such as side (puts, calls, or both), expiration type (regular, quarterly, or weekly), days to expiration, and strike price. You can also choose to display the Option Chain by spreads. Select the **Spread** menu to see all your choices. You can also select the number of strikes to display.

2 – Suppose you choose to display four

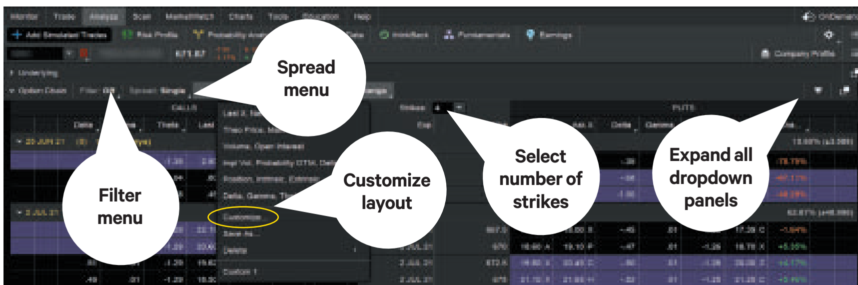

FIGURE 1: CREATING A CUSTOM LAYOUT IN THE OPTION CHAIN. There's a lot of flexibility when it comes to displaying relevant information in the **Option Chain.** *Source: thinkorswim. For illustrative purposes only.*

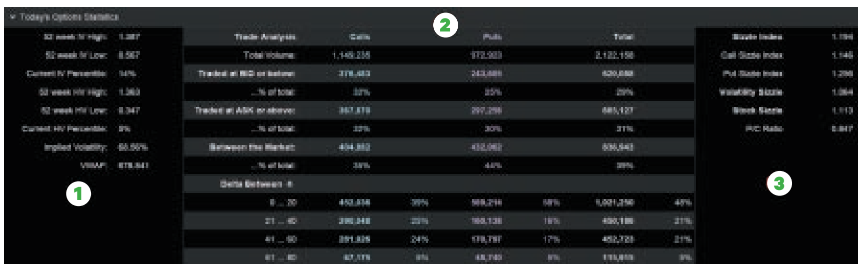

FIGURE 2: VIEWING THE STATS. Get an overall view of a security's vol, call and put activity, and any unusual options activity. *Source: thinkorswim. For illustrative purposes only.*

FIGURE 3: VIEWING VOL SKEW. Product Depth displays the volatility skew for an underlying asset. Explore different ways to view the skew. The shape of the skew and comparing the skew of calls and puts could help you identify unusual options activity. *Source: thinkorswim. For illustrative purposes only.*

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strikes. You can select the **Expand all dropdown panels** on the far right of the Option Chain. This displays the strikes for all the options in the chain.
3 – To customize the column layout, select the **Layout** menu. Here, you'll find a bunch of customized layouts. You can also create your own from the **Customize**... menu.
4 – Select the variables you want in your layout from the **Available Items** column and add them to the **Current Set**. To save this layout, again, select **Layout**, then **Save As**..., and give it a name. It'll be listed at the bottom of the menu. You could also select the column title and, from the menu, select what you want displayed.

Options Statistics. Want to break down volatility (vol) and know more about the options order flow? That's where **Today's Options Statistics** could help. Note it's divided into three sections (see Figure 2). On the left is the vol breakdown; the middle section looks into the order flow; and the section on the right breaks down the **Sizzle Index**.

1 – The vol section gives you an idea of whether vol is on the low or high side. You can see where implied volatility and historical volatility are relative to where they've been in the past year.
2 – The order flow displays volume on calls, puts, and the total. As an example, if more calls are trading, you'll be able to figure out if there's greater emphasis at the bid, ask, or somewhere in between. You'll see what percentage of the total volume took place at the bid. The section titled **Delta Between** gives you an idea of the options trading activity for an underlying.
3 – The **Sizzle Index** indicates if more traders are buying or selling calls or puts. In a nutshell, a Sizzle Index of 0.5 suggests prevailing volume is around half the average for a specific security. Think of the Sizzle Index as a scanner of potential unusual options activity.

Product depth. Speaking of unusual options activity, let's move on to vol skew. Skew indicates if the markets are behaving normally. Typically puts are more expensive than calls, but sometimes the skew can be reversed or flat. **Product Depth**, found below **Today's Options Statistics**, is a graphical representation of the skew (see Figure 3).

1 – Select **Product Depth** (make sure to select it from the settings on the top right).
2 – Select **Options** (you could select Futures also), then from the **Show** menu, select the type of options you wish to see (All, Calls, Puts, OTM, Average).
3 – Select any number of expirations you want to visualize.
4 – Select the number of strikes.
5 – From the **Value** menu, select **Impl Vol** (there are other choices available).

Knowing the skew could help strategy and strike price selections.

IT'S A GOOD IDEA TO EXPLORE THE many features available on the thinkorswim platform. Knowing your tool choices could help you make more confident decisions when placing trades.

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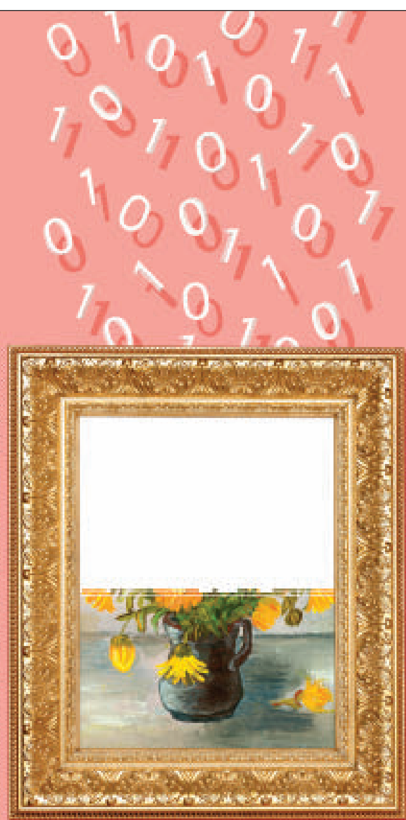

A Heat Map on Steroids

Ready for a virtual stock market experience? Check out Bookmap, a new tool on the thinkorswim® platform.

• You may be one of the lucky few who's already checked out Bookmap on the thinkorswim platform. For the rest of you, get ready to experience a tool that gives you a different perspective on market activity.

Why add Bookmap to thinkorswim? "We thought it was a unique way to allow users to see level 2 in a graphical manner, which could help traders identify trends that they may be able to act on," said Chad Cocco, part of the Active Trader Group at TD Ameritrade. "The level 2 chart view of Bookmap lets traders see where large orders are sitting and if they get pulled down before the price reaches those orders. This isn't easily seen in any other way," he added.

All in all, it's another tool to help traders "see" what's going on in the market. And it's not just limited to the orders that are filling. There are orders that are placed and/or canceled that could potentially move the price of a security. Bookmap helps you see those orders as well.

HOW CAN TRADERS APPLY IT?
Traders are always looking for liquidity, and Bookmap helps identify it. You get to see the price action—volume, last trade, order book, bid/ask numbers, and so on—evolve right in front of your eyes. It's streaming, so the data is constantly updated. The benefit of seeing the entire order flow and activity is that it could help traders analyze the market. For example, you could identify support and resistance levels, breakouts, or other chart patterns.

TRADER GLOSSARY
TURN TO PAGE 33

Another cool aspect of Bookmap is that traders can overlay price charts on the heatmap view. This could help you visualize price action and order book activity in one glance. Throw aggregate volume into the mix and you have a pretty thorough picture of trading activity. Seeing all this data unfold in real time may be too much to absorb, but you can always zoom in and view market activity on a longer time frame.

There are several adjustments available that may make it easier to identify orders. For example, every order is color-coded based on its relative size. And there are vertical lines that divide the timeline so you can clearly differentiate between historical and current data.

Bookmap is a sophisticated tool that takes charting to the next level. It doesn't tell you when to trade, but it does provide information about what market participants are doing. There may be a learning curve, especially when it comes to configuring the appearance of the tool. It's a lot of data to pack into one screen, but once you get it to display the way you want, you probably won't be able to live without it.

What Are the Odds?

Setting your options strategy is all about the numbers. And more. Brent Moors, Education Coach at TD Ameritrade, takes it to the next level in his weekly webcast, "Probability-Based Options Strategies."

Q: That's quite a lofty webcast title. Is it geared toward the advanced option trader?

Yes and no. I do believe it's a topic that attracts the advanced set, because we sometimes get in pretty deep with the options greeks and other measures that could be a bit intimidating to newbie option traders. Basically, we show ways that option traders can assess probabilities when considering a trade or strategy. And this is something that should be useful to most option traders.

So, in our classes, we'll often discuss simple options trades, such as a covered call or a cash-secured put. But we'll also discuss layering in additional legs to the trade, and that can get more complex. Regardless of your experience, though, options trading shouldn't be left to chance. There are a lot of uncertainties in the market and knowing the statistical probabilities—the odds that a trade will work out or not—can help.

LEARN MORE

WANT TO UP YOUR OPTIONS KNOWLEDGE?

Check out the different webcasts available on the **Education** tab on the thinkorswim® platform.

Q: Can you give us an example?

To help illustrate these concepts during classes, we'll try to find realistic trading opportunities given a certain event, such as earnings, or maybe another assumption, such as a trending stock that might continue.

When it comes to earnings, we might consider a calendar spread and investigate the potential effects that changes in implied volatility might have on the trade. In the case of a trending stock, we might consider a vertical spread. We look at scenarios that could result in a max gain, max loss, or breakeven for the example trade.

And then we might get into a discussion about trade-management decisions that every option trader needs to make, like when to take your profits and when to cut your losses. We use a full range of thinkorswim® tools—from a simple look at the options deltas and thetas, to a deep dive into the **Risk Profile** tab. So, again, these topics can be useful for novice and advanced option traders alike.

Traders can't control what the option does after the trade's been placed. But they can make an informed decision about whether it's a good trade to enter in the first place.

Probability analysis results available in the thinkorswim platform are theoretical in nature, not guaranteed, and do not reflect any degree of certainty of an event occurring.

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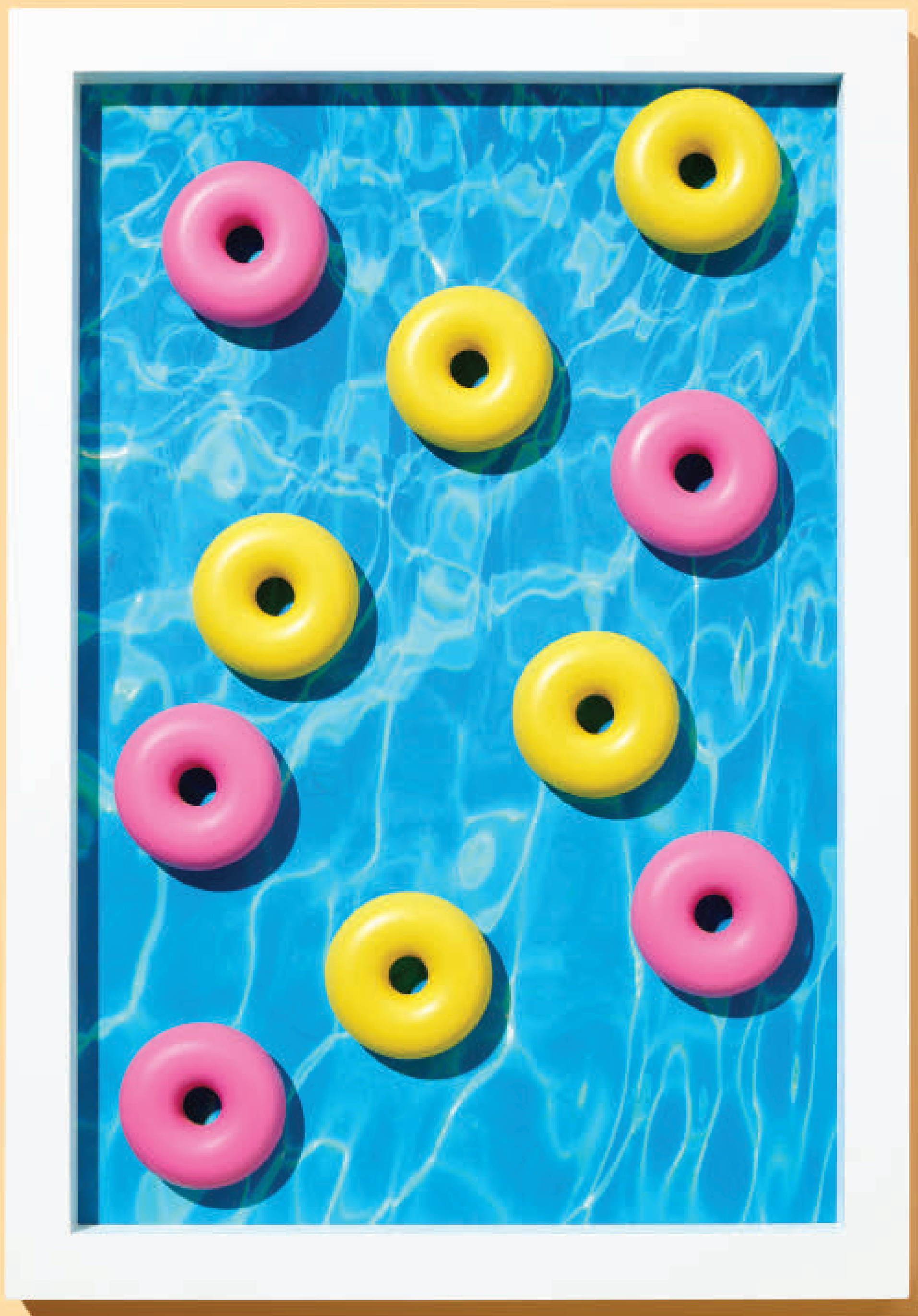
Three options strategies designed to help protect large positions.



BIG-STOCK TRADING WITH A PARACHUTE

BIG IDEA: STOCKS TO THE MOON TEND TO COME BACK TO EARTH. THE PROBLEM? WE DON'T KNOW WHEN. IF YOU'RE TRADING STOCKS WITH BIG PRICE TAGS BUT NOT SURE WHEN IT WILL ALL END, YOU MIGHT WANT TO DUST OFF A COUPLE OLD IDEAS WITH A FRESH LOOK.

3 Strategies for Trading Market Vertigo

WORDS BY **KEVIN LUND** • PHOTOGRAPH BY **DAN SAELINGER**

Vertigo (n.): *A feeling of dizziness associated with extreme heights.*

Physical heights aren't the only thing that causes vertigo. Traders get vertigo when they worry that a bull market has gone parabolic or is long in the tooth. They don't want to be left behind as a rally rages on, but the fear of missing out can mess with your head. Luckily, there are options strategies that can help you remain long and strong with defined risk built in if things don't hold up.

A seasoned option trader can look at existing market conditions, mash familiar strategies together, or use old strategies in a fresh way to take advantage of what the market is offering. Consider three approaches to get you started.

TIME STRANGLE

(Medium-term bullish, short-term skittish)

Backdrop. You expect an imminent move higher in a stock but feel a strong pullback or correction might be around the corner. You want the immediate unlimited upside potential of a call but with defined risk or potential profit from a downside move if the market suddenly reverses.

Setup. A traditional long strangle has an equal number of long calls and puts (typically both out of the money, or OTM) on a stock with the same expiration. For example, with a big stock trading at approximately $500, a traditional strangle might look like:

Buy one 90-day 510 call for $27
Buy one 90-day 490 put for $27
Cost = $5,400 per strangle (also your maximum risk)

With a time strangle, you're also buying an equal number of short-term puts and calls, but they expire on different days. Maybe you buy longer-term calls that have 90 days to expire and buy puts that expire in one week to 30 days. Here's what it might look like:

Buy one 90-day 510 call for $27
Buy one 30-day 490 put for $9
Cost = $3,600 per strangle (also your maximum risk)

What happens next? Looking at Figure 1, with a stock trading just under $500, notice that if the stock moves higher right away (pink line), theoretically the trade makes a profit when it crosses above $503. However, if the stock collapses, a plunge of about 4% below $478 theoretically produces a profit as well, while the loss in between is nominal.

The intention is to stay in this trade for as little time as possible. The blue line in Figure 1 represents the profit curve of the shorter-term put (30 days) as shown on the thinkorswim® platform. Should the breakout (or breakdown) not happen within three to five trading days, time decay (theta) sets in.

BACK/RATIO SPREAD

(For cautious optimism)

Backdrop. The shakiness of a bull market gives you pause. You're looking to maximize your returns with unlimited upside potential, but in a way that if the market reverses, you see only a small loss or even a small profit.

Setup. A call back/ratio spread combines a long call with a short call vertical spread. Simpler still, you can buy two OTM calls and sell one near- or at-the-money call with the same expiration. The goal is to set up the trade so the short call pays for both long calls and possibly nets a credit.

See Figure 2 for an example. With the stock trading at nearly $500, a call back/ratio spread might look like this:

Buy two 90-day 550 calls for $13.05 each
Sell one 90-day 505 call for $34.65
Credit = $855 per spread (max risk is $3,645)

This position is opened with a credit, meaning the options you sell generate more cash than the cost of the long options. This eliminates downside risk as long as the stock price stays below the short strike through expiration—which some traders might consider attractive when markets feel toppy. If the stock moves lower, and if both options expire worthless, the credit becomes the profit.

It's crucial to recognize that back/ratio spreads come with significant theta (time decay) risk, because the options rapidly lose value as each day passes.

What happens next? In Figure 2, the stock is trading at $497. If the stock moves higher right away (pink line), all else being equal, the trade theoretically makes a profit. If the stock collapses, the loss is relatively nominal. But what if you decide to hold on to the trade through expiration? If you took in a net credit at the onset of the trade and the stock finishes below the short strike, you could keep the entire credit, minus fees. Keep in mind, there's the risk of early assignment if the stock price rises above $505. So it may be a good idea to be aware of ex-dividend dates and manage your trade when the stock price is between $505 and $550, especially if the expiration date is approaching.

TRADER GLOSSARY
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The blue line in Figure 2 represents the profit curve of the strategy. The intention is to stay in this trade for as little time as possible. The Achilles' heel for this strategy? If the stock doesn't move at all. Beyond a couple of weeks, if the stock sits still or rises slightly, time decay (theta) will start to produce greater losses. So, it's a good idea to take price and time into account for your exit strategy.

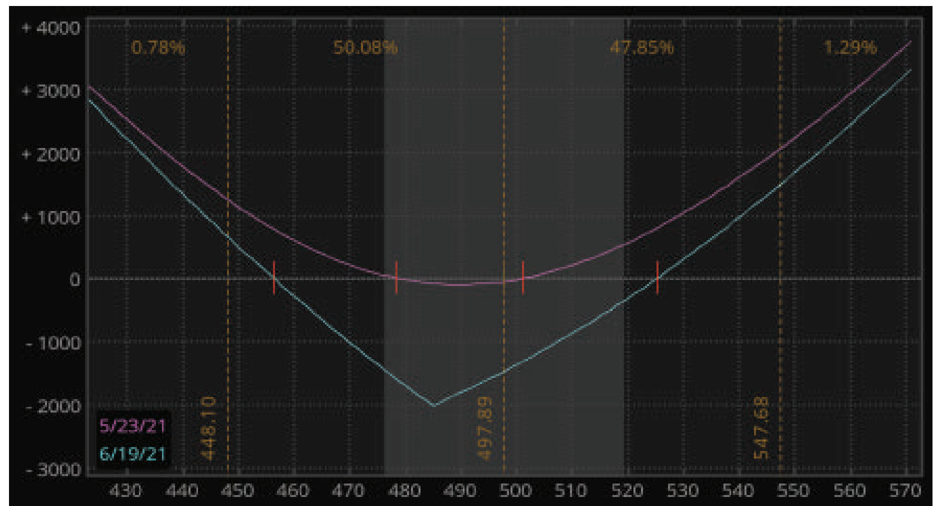


FIGURE 1: TIME STRANGLE. Enter your trade on the Analyze tab and view the Risk Profile to see the theoretical profit and loss of the strategy. *Source: thinkorswim. For illustrative purposes only.*

ROLLING COLLARS

(The movable stock hedge)

Backdrop. The collar is a conservative, slightly bullish options strategy that allows some limited upside potential while providing some protection against losses below a specific price of your choosing. Most often, the options "collar" can be placed around your stock without any further investment, excluding fees.

Consider two primary reasons you might want to place a collar trade:

1. You have a healthy gain in a stock you don't want to sell, but you need to protect your investment in the near term.

2. You'd like to squeeze a bit more out of a stock but are willing to compromise the upside for the protection of a nearly cost-free hedge.

Setup. To create a collar, for every 100 shares of stock you own, you'd buy one protective OTM put and sell one OTM call (of the same expiration), approximately equal distances from the current stock price.

For example, placing this collar involves the following:

You own 100 shares of XYZ @ $500
Sell one 550 call for $13
Buy one 450 put for $13
Cost = $0 (plus transaction fees)

In this example, the $13 put is paid for by the $13 credit received from the sale of the call, netting you a zero-cost hedge (except for fees). In exchange for this, you've capped your upside to 10% from here.

What happens next? From the profit curve of the collar in Figure 3, notice that as the stock moves higher, you won't make the same dollar-for-dollar profit as the stock anymore (see pink line). That ship sailed when you locked in a max loss of 10% with your collar hedge. Instead, your profit-and-loss curve basically resembles a long call vertical spread. If the stock suddenly jumps to $550, time decay works in your favor and you get closer to $5,000 of profit with each passing day.

To "roll" a collar, if the stock moves higher toward the short call strike or soon after, you could consider taking off the put/call combo and placing a new one around the higher stock price. You'd repeat this until either the stock collapses or you've achieved your profit target.

You want to reset the collar as the stock moves higher to avoid assignment of the short call prior to expiration, in which case you'd be forced to sell your shares. With a lot of time left in the call, assignment isn't likely; however, short options can be assigned at any time up until expiration. It would cost more for the owner of the option to exercise than to simply sell, because by exercising, the own-

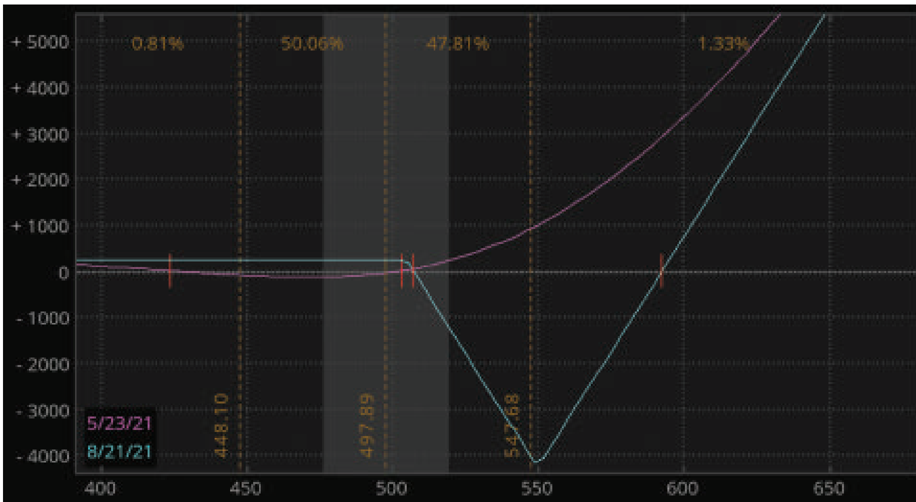


FIGURE 2: CALL BACK/RATIO SPREAD. From the **Option Chain**, select **Back/Ratio** from the **Spread** menu, select your strikes, then use the **Risk Profile** to analyze the trade. *Source: thinkorswim. For illustrative purposes only.*

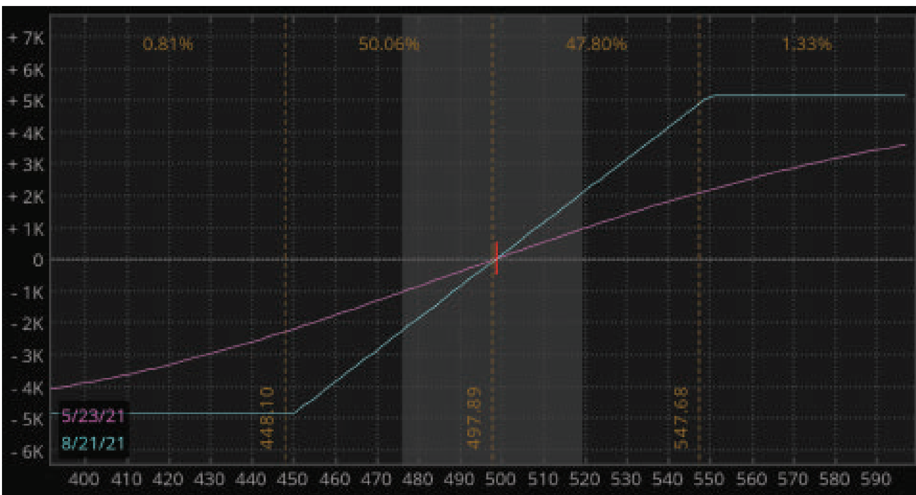
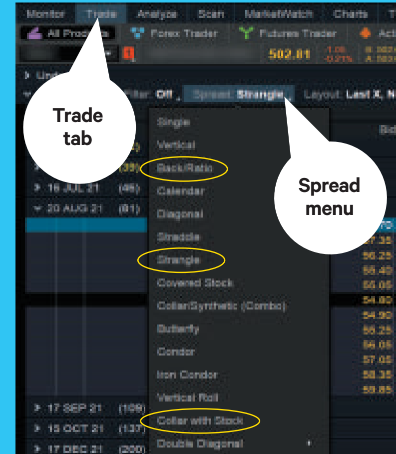


FIGURE 3: ROLLING COLLARS. Select **Collar with Stock** when selecting your strikes, adjust your strike prices in the **Positions and Simulated Trades** window, and then analyze the **Risk Profile.** *Source: thinkorswim. For illustrative purposes only.*

er would lose any time value in the option. (However, the owner may have other reasons for exercising the option, like an upcoming dividend or to cover another position.)

But this doesn't mean assignment can't happen to you. As the stock rises such that the call is further in the money (ITM), the time value of the call decreases further, posing a greater risk of assignment. Once the stock goes ITM on the short call, at some point you'd simply roll the collar by purchasing the short call back, selling the put, and resetting the collar around the new higher price of the stock. Keep in mind that rolling strategies can entail additional transaction costs, including multiple contract fees, which may impact any potential return.

BIG STOCKS CAN GET BIGGER. BUT when they do, they have further to fall. When you understand the language of options, you can start to stitch together multiple strategies and concepts using different types, expirations, and strikes, depending on market conditions. So when everything seems to be going up, you can consider engaging various strategies to potentially create defined risk profiles when things change without compromising too much upside when they don't.



PLACING STRATEGY ORDERS

Itching to try out these strategies? Entering spread orders on the thinkorswim platform is pretty straightforward. It may be a good idea to try them out in your paperMoney® account before placing the trades in your real money account.

From the **Trade** tab, enter the symbol of the underlying, expand the **Option Chain**, and select the **Spread** menu that's along the top (see image above).

To place time strangles:

- Select **Strangle** from the menu.
- From the **Option Chain**, select the strangle you're considering.
- Select **Buy custom** and one of the stop types. The order will populate in the **Order Entry** window.
- Change the put expiration, strike, and any other parameters in the **Order Entry** window.
- Select **Confirm and Send**.

To place back/ratios and collars:

- Select **Back/Ratio** or **Collar with Stock** from the menu.
- From the **Option Chain**, select the spread you're considering.
- Select **Buy** from the menu, then **Back/Ratio** or **Collar with Stock**. The order will populate in the **Order Entry** window.
- Adjust the parameters in the **Order Entry** window.
- Select **Confirm and Send**.

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

For more information on the risks of trading and trading options, see page 35, #1, 2, & 4.

SKILL LEVEL **PRO**

TAKE AWAY:
When diversifying an options portfolio, think in terms of price, time, and volatility.

PHOTOGRAPH BY
DAN SAELINGER

PORTFOLIO X DIVERSIFICATION X REDUX: X THINK X LIKE X A X TRADER X

BIG IDEA:

DIVERSIFICATION ISN'T JUST ABOUT STOCKS, BONDS, AND CASH. WHEN HEDGING RISK FOR AN OPTIONS PORTFOLIO, THINK PRICE, TIME, AND VOLATILITY. WORDS BY **KEVIN LUND**

LONG-TERM X

investors know better than to put all their eggs in one basket. Option traders, on the other hand, tend to break eggs. If you don't break more than you keep, you come out ahead. That's the idea, anyway.

Eggs and baskets are just a simple way of saying don't load up on too many stocks from one sector in case said sector should collapse. This, as you know, is the most basic tenet of diversification.

As an option trader, you're likely trading momentum stocks that you track or that pop up on your daily scans. There's probably not a lot of sector diversification going on because you're thinking less about a company's balance sheet or future earnings potential versus what a price chart tells you about tomorrow's action on a given stock. For shorter-term option traders, the lens of diversification focuses on price, time, and volatility (vol).

IS HEDGING THE NEW DIVERSIFICATION?

Diversification is typically characterized as a strategy designed to reduce your overall risk. But it's really meant to smooth out the gains when things go right. You could be diversified with bullish investments across a spectrum of stocks, sectors, or even indices. But if the market drops, you could still lose, because most stocks tend to correlate when the market crashes.

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TURN TO PAGE 33

This is called "systematic risk"—the risk that the whole market, or at least the sector you're invested in, could move against you. For option traders, it's not enough to diversify across different sectors, especially when you're trading options that feature other risks besides the directional (price) risk of stocks. Now, this doesn't mean you forego diversification altogether. But for option traders, hedging should be an integral part of your trading plan because on one hand, you have the systematic price risk of the market and, on the other, you have the risks of time decay and changes to implied volatility (IV).

So, what's the difference between diversification and hedging? In short, diversification is sharing the love and spreading your investments across different stock sectors or asset groups (like stocks, bonds, and cash). Hedging is taking an "offsetting" trade in hopes of reducing risk—basically putting on another trade in the opposite direction. When hedging with options, price, time, and vol are usually top of mind.

HEDGE LIKE A PRO

Because market makers (who typically take the other side of your trade) hedge every trade, let's start by taking a peek at their playbook. Let's go through a typical market-maker hedging progression using the May 135 call option in Figure 1 as an example.

If a market maker buys the May 135 call option at the bid price of $5 (they buy at the bid where you, the retail trader, are selling), they need to address three main risks: price (delta), time decay (theta), and changes to IV (vega). These are the same risks the retail option trader needs to manage.

Typically when you buy an option, a market maker on the other side of the trade sells it to you and turns around and buys it back from someone else for a perfect hedge, while pocketing the spread between the bid and ask. When that doesn't work, they'll rely on synthetic relationships between options to construct their hedges, such as creating "synthetic stock" to offset the risk. (See "Level Up Your Options Knowledge: Synthetics and Beyond" in *thinkMoney* 52.)

If you understand synthetics, you know the market maker could sell the 135 call synthetically through a combination of selling the 135 put and selling the stock. This would hedge the trifecta of main risks but could also expose the position to early exercise, dividend risk, and pin risk.

An alternative hedging opportunity would be to sell another May call option with a strike as close to 135 as possible, such as a 140 or 130 call. The trade would become either a short or long vertical spread depending on the strike. The further away this trade is from the 135 strike, the less risk reduction it's likely to provide.

Selling another 135 call in a different, shorter-term expiration would turn the trade into a calendar spread and likely reduce the delta risk, theta risk, and vega risk. In fact, any additional trade that reduces any of these risks can be considered a hedge. Yet, keep in mind, you're not looking to completely eliminate risk because

Strike	Bid	Ask	Delta	Theta	Vega
135	5.00	5.10	0.50	0.10	0.20

FIGURE 1: BID/ASK AND GREEK VALUES FOR MAY 135 CALL. *For illustrative purposes only.*

without it you likely won't make any money.

How do you apply all this to your real-world options trades?

Price

It's tempting to fill your portfolio with bullish trades when the market is going up. But even if you're "diversified" across different sectors, you'll likely lose money if the market drops. Even in a bull market, not all stocks move up at the same time. When a stock does move up, it might rest and retrace some of the time, or it may trade sideways as it consolidates its gains. The same is true when the market is going down, so you can consider layering in some bullish trades as part of an overall bearish strategy.

You can also reduce directional risk by turning existing long call or long put positions into long verticals by adding a short option at a further strike. You'll still have your directional trade on but with less risk. Before adding another long call to a portfolio that already has long calls in other stocks, see if those other positions might be ripe for this type of hedge.

Time decay

Turning long options into long verticals hedges your directional risk and pares down your time decay (and vol) risk. You can also reduce your overall time decay risk before you put on the trade by buying more time than you need.

Buying "more" time might sound like the opposite of hedging, but longer-term options don't decay as quickly as shorter-term counterparts. Over a given time frame, you'll likely give up less money to time decay with longer-term options. If you expect to be in a trade for 30 days, you'll cut your time decay by buying options that expire in 60 or 90 days.

Volatility

If your trades tend to be long options strategies or have longer time horizons, you're probably going to be long vega as well. Calendar spreads, for example, are vega-positive trades that can suffer when IV drops. But you don't have to ignore this strategy when vol is high. You might consider a butterfly spread. This risk profile has positive theta similar to the calendar, but it comes with short vega rather than the calendar's long vega risk.

WORTH REMEMBERING

From a directional standpoint, if you're bullish (or bearish), starting with a long vertical spread rather than a straight long option is a strategy designed to weather a vol crush—that is, when IV drops in an instant, such as after earnings announcements or other expected news releases.

Another risk to watch is the market's overall vol. The IV of one option may not correlate with the IV of another. But if the Cboe Volatility Index (VIX) is high, then IVs across the board will mostly likely also be high, and this may not be the time to load up on long vega trades. Conversely, if the VIX is low, you might avoid being short a bunch of iron condors. (For more on hedging, see the sidebar "What About Hedging with the VIX?".)

Of course, what's high and what's low can be subject to debate. For a long time, a VIX at 20 was considered high, and it would bottom out around 11 or 12. Sometimes highs have been around 30 to 40 with occasional spikes even higher, with 20 at the low end. But in 2021, we saw that low cracking and giving way to a VIX in the high teens. Is the "normal" range shifting again? Anything is possible (see "How to Spot a New Volatility Regime" on page 32).

OVERALL, DIVERSIFICATION IS AN important tool, but it's just one of many at your disposal. When markets sell off, assets tend to correlate and diversification becomes less effective. When you hedge, you engage offsetting trades that can augment diversification and can also be risk-reduction tools.

WHAT ABOUT HEDGING WITH THE VIX?

It may sound strange, but because the vol premiums of options rise and fall separately from the price of the underlying assets, you could think of vol as an asset class as you diversify. But can vol, like the VIX, be used to hedge your portfolio? The simple answer is yes. And no.

If you're short iron condors, for example, and want to hedge against a pop in market vol (rising vol hurts short positions), buying VIX call options might do the trick if you think the VIX could rise while you're in the position. But be cautious. VIX options aren't priced off the current, or spot, VIX value. Rather, they're priced off the forward value (based on VIX futures), so the call options may not jump as you expect when the VIX chart pops.

Still, if you time it right, buying VIX calls can work as part of an "asset diversification" strategy. Just don't expect to hold the trade for long. VIX options are geared to be a short-term hedge, not a long-term investment.

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

For more information on the risks of trading and trading options, see page 35, #1 & 2.

SKILL LEVEL **EASY**

TAKE AWAY: *A three-step process to identify potential momentum.*

THE NUTS & BOLTS OF MOMO TRADING

BIG IDEA: WHEN EVERYONE'S PILING INTO A BREAKOUT STOCK, SHOULD YOU JUMP IN TOO? WELL, MAYBE NOT. INSTEAD, STOP, PAUSE, REFLECT, AND FOLLOW A METHODICAL APPROACH TO TRADING MOMENTUM.
WORDS BY **JAYANTHI GOPALAKRISHNAN**

PHOTOGRAPH BY **DAN SAELINGER**

Warren Buffett once said, “Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble.” That’s sage advice for the meme-stock-trading crowd that emerged in 2020.

This new group of traders introduced a type of momentum that’s been atypical in the financial markets. First, traders hear about a stock that’s getting a lot of buzz from an online trading group. The FOMO (fear of missing out) and YOLO (you only live once) crowds decide to go for it. A bunch of traders band together, jump into the stock, and push prices higher. This continues until enough sellers show up to reverse the price move.

Mashed together, FOMO and YOLO can create momentum or MOMO—but it’s not the typical kind. When you jump into a trade based on rumors or chatroom gossip, it’s usually not a viable momentum-based trading strategy. It’s just herd-mentality guessing.

FIGURE 1: SHORT AND SWEET. It may be tempting to trade sharp breakouts on heavy volume (center), but they tend to be short-lived. If you’re lucky, you may capture some profit. But there’s no guarantee.

MAKE A PLAN

In theory, MOMO trading can be a long- or short-term strategy. If there’s enough juice for a price move to continue, it could be worth jumping in. Momentum traders typically start following a trend when a stock shows signs of strength, and they exit the trade when momentum starts to slow. How is this different from the momentum behind a FOMO trade?

Well, MOMO trading isn’t about buying low and selling high—nor about jumping into a trade on a price move that has no fundamental basis. It’s more about looking at how strong a trend is, waiting for a setup, and getting in to take advantage of that strength.

If you feel tempted to jump into a trade that’s seemingly fueled primarily by internet rumors, first take a step back and figure out whether the price move may still have room to run. It’s no fun getting into a trade at the tail end of its move.

A FOMO or YOLO trade is likely to look like the chart in Figure 1—short and quick. Sure, it’s easy to see in hindsight. But in real-time trading, it might look like any momentum trade. How do you know the difference? The real test lies in the sustainability of a price movement, and that means waiting for a setup to appear on the charts. Yes, you may have to be patient. But you’ll be grateful in the long run.

MARKET, SECTOR, GENERALS, SOLDIERS

Figuring out whether a trend is sustainable is a challenge if you’re also juggling fear and greed. Consider a three-tiered, top-down approach to help you view momentum more strategically. It all starts with asking three questions.

1 — What do you want to trade?

Before placing a trade, get an overall view of the market. Here’s a good place to start:

- Fire up the thinkorswim® platform.
- Select the **MarketWatch** tab.
- Select **Visualize** in the submenu to get a heat map of the broader market.
- Select **Indices** (listed under **All Watchlists**).
- Expand each index to see how sectors are performing.

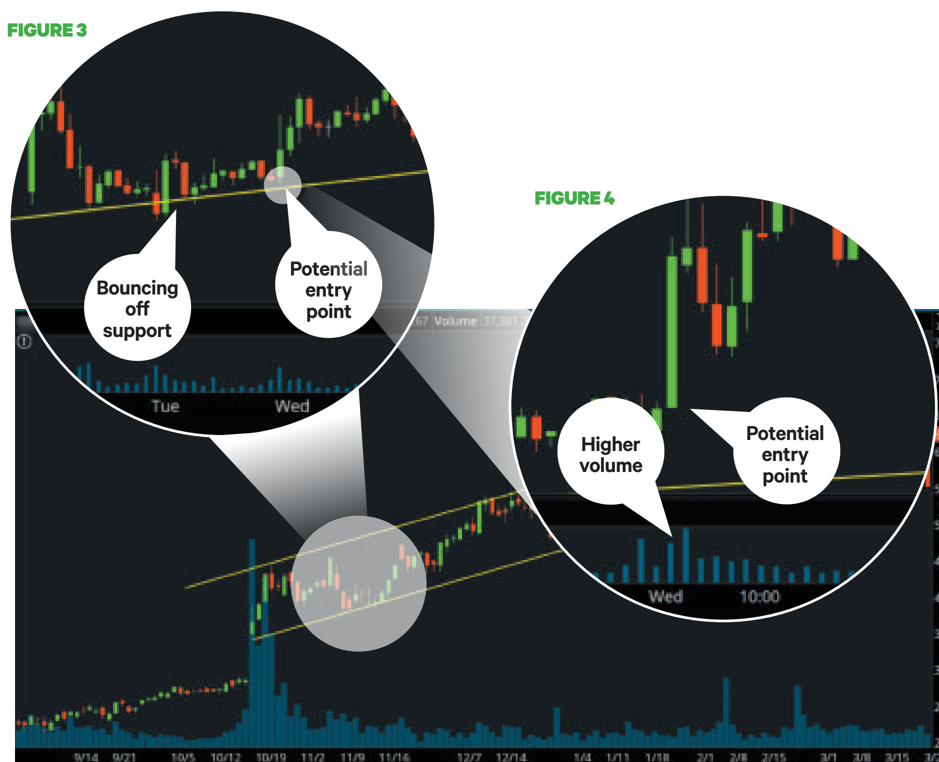
This gives you a visual idea of which sectors might be outperforming or underperforming on any given trading day.

Once you’ve figured out which sectors you might want to trade, identify a handful of stocks that are potential trading candidates. If a specific sector is outperforming, you want to look for individual stocks within the sectors that are moving in sync. Think of them as the generals.

While still in the heat map, do a quick analysis to see if any key stocks are showing signs of momentum and are likely in the early

FIGURE 3

FIGURE 4



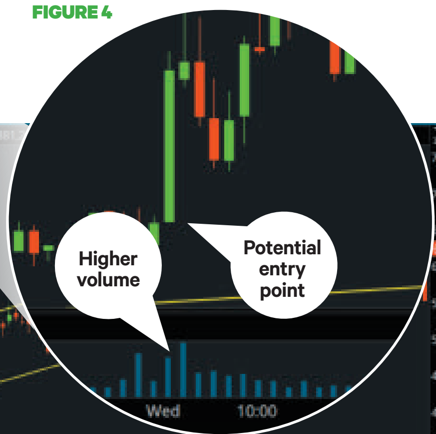


FIGURE 2 : MOMENTUM FOR REAL? When you see a gap on high volume, how do you determine if this momentum move might sustain? It's time to sharpen those drawing tools and identify potential support and resistance levels.

FIGURE 3: FOCUS ON A SHORTER TIME FRAME. On thinkorswim, change the time frame on the chart from **Daily** to **Intraday**. Then set the aggregation time period to **30m**.

FIGURE 4: PINPOINTING YOUR ENTRY. Price can always move in either direction, so use an even shorter time frame to provide more confirmation. By setting the aggregation period to **5m**, you may identify price points with more trading interest.

Figures 1–4 source: thinkorswim platform. For illustrative purposes only.

stages of a trend. Then select any of the symbols and go to **More info on symbol** > **Quick Chart**. These are the stocks you might add to your watchlist. Think of them as the soldiers.

2 — Where in the trend are you?

There's no right or wrong way to identify a trend. But there are different tools that can help you figure out if the trend is beginning, developing, or maturing. Some drawing tools to consider include price channels, support and resistance levels, and volume. You can find all these on the **Charts** tab on thinkorswim under **Drawings** > **Drawing Tools**.

It's best to start with a longer-term chart that goes back six months or a year. Figure 2 is a one-year chart that clearly shows an upward channel. Let's walk through the early stages of this channel to determine when you might potentially enter a trade.

3 — When do you get in?

There's no perfect time to enter a trade; however, using multiple time frames for your charts can help you choose. First, start with a longer-term chart. The starting time frame depends on whether you're a short- or long-term trader. It should go back just far enough to see which way prices are trending and if they're doing so with enough momentum.

Going back to Figure 2, in mid-October, the gap up on heavy volume would've been the first indication of a momentum opportunity. But to avoid false signals, don't jump in at the first sign. Instead, dig deeper to see if this is likely to be a short-term move or if it signals longer-term momentum by zooming in on shorter-term charts.

Figure 3 zooms in on a 30-minute chart for the day price bounced off support, plus the following few days. Does the trend coincide with what you saw on the daily chart? In this case, it does. But let's take it one chart further to confirm.

Pull up an even shorter time frame, such as a five-minute chart (see Figure 4). Notice that when price bounced off the trendline, it did so on higher-than-average volume—a good sign confirming the trend's momentum. From this point, bounces off support levels, high-volume price spikes, and so on may be entry points to consider.

WHEN DO YOU GET OUT?

That all depends on how price progresses. At some point, you may be able to extend your channel to the right. The upper-channel line could function as a resistance level, or there may be other resistance levels (such as previous highs) that you might use to help decide when to exit the trade. In this example, price moved in an upward channel. A breakout above the upper channel on high volume could potentially be an exit point.

Of course, it's always wise to consider setting a stop order below significant support levels. That way, if price should move in the opposite direction, you're better prepared to reduce downside risk.

FOLLOWING THIS THREE-STEP, multi-time-frame approach when planning your trades could help prevent you from making hasty decisions. And analyzing price movement from different perspectives may give you a more objective view. This, in turn, could help you trade more logically and ultimately help prevent you from following the wrong crowd.

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.

A trailing stop or stop order will not guarantee an execution at or near the activation price. Once activated, they compete with other incoming market orders.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

SKILL
LEVEL
SAVVY

TAKE AWAY:
Develop a mathematical mindset to approach trading.

OPTION TRADER'S *Guide to the Markets (and Life)*

PHOTOGRAPHS BY **DAN SAELINGER**

BIG IDEA: TRADING OPTIONS MEANS THINKING (AND ACTING) WITH THE INNER QUANT BRAIN. ONCE YOU GET INTO THE MINDSET, THAT ANALYTICAL THINKING MIGHT SHOW UP AS YOU ASSESS OTHER INVESTMENTS—AND OTHER LIFE DECISIONS.
WORDS BY **DOUG ASHBURN**

The
Options
Manifesto

IT REMAINS

a powerful phrase: "How you do anything is how you do everything."

For an option trader, the how-you-do-it part involves checking the max payoff, max risk, potential return on capital, and the probabilities of each possible outcome at every point along the way. And then you make a decision.

Trading and life are not often mutually exclusive. Many traders find that as their options knowledge grows, those insights begin to shape everyday choices. Let's consider a trader's take on a few routine decisions.

LIFE THROUGH AN OPTIONS LENS

There was a study a few years ago that suggested humans make 35,000 decisions per day. Although some have called that statistic overblown, let's agree that we all make a lot of (mostly low-stakes) choices. And the option trader's brain might send those decisions through the same cognitive process. A sampling:

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• You're out of milk, and Junior offers to run to the store, so you toss him $20. You've been on both sides of this trade—first as a kid, and now as a parent. "What's the probability or delta that I'm ever going to see change?" you mutter to yourself.

• You do a favor for a friend. It was a kindness—it didn't cost you anything, so in a way, it's a free call that might or might not pay off someday should you ever be in need.

• You're late for an important meeting, and the busy street you're about to cross has started its 10-second "don't walk" countdown. As an option trader, you're weighing the gamma (speed) of an approaching car against the theta of the walk signal against the max payoff and risk (getting to your meeting or getting hit by a car).

You get the idea.

But looking at life through the options lens is more than just the language of greeks and lingo of strategy. It's about taking those daily decisions and running them through the same cognitive process you do with an options trade.

FOUR REASONS TO ADAPT THE ANALYTICAL MINDSET

You can always quantify an options trade. The thinkorswim® platform is chock full of metrics—from the theoretical values and greeks under the **Trade** tab, to the "what-if" risk profiles and probability analysis tools under the **Analyze** tab, and much more (see Figure 1). In other words, you assess and then decide.

As a trader, you might use that mathematical mindset to approach other areas of investing (and life) because you're running it all through that same options filter. Let's look at four reasons that may be a good idea.

CHECK IT OUT

MANAGE YOUR ODDS

How do you identify high-probability trades? Read **https://bit.ly/TTOdds**

PRACTICE, PRACTICE, PRACTICE

Test your trading strategies on thinkorswim using paperMoney®: **https://bit.ly/TTPprMny**

1 You won't stay married to a trade.

The options clock is always ticking toward expiration. But your other investments have theta too: opportunity cost. Is a trade not panning out as you thought? How much time should you allow? More importantly, what opportunities are you leaving on the table because your risk capital is deployed in this trade?

Look at the decisions in your investments (and beyond) and consider giving them an expiration date. Giving them an end point gives them a theta. You might find you've become nimbler and less emotional while making decisions.

2 You'll give yourself better odds.

Options are all about uncertainty. The ebb and flow of volatility—along with the passage of time—changes the amount of uncertainty in the equation and thus affects the delta of an option. There's always uncertainty—even, at times, an hour before expiration. So, you assess the risk and reward, give yourself good odds, and do your best to manage the uncertainty.

With a non-options trade, education and assessment are the keys to managing what's unknown. "What's the delta?" becomes a question you repeatedly ask yourself. You check the charts, compare the fundamental ratios, and keep an eye on the news. Trading on momentum becomes an exercise not of following the herd but of following the math (see "The Nuts and Bolts of MOMO Trading," page 24).

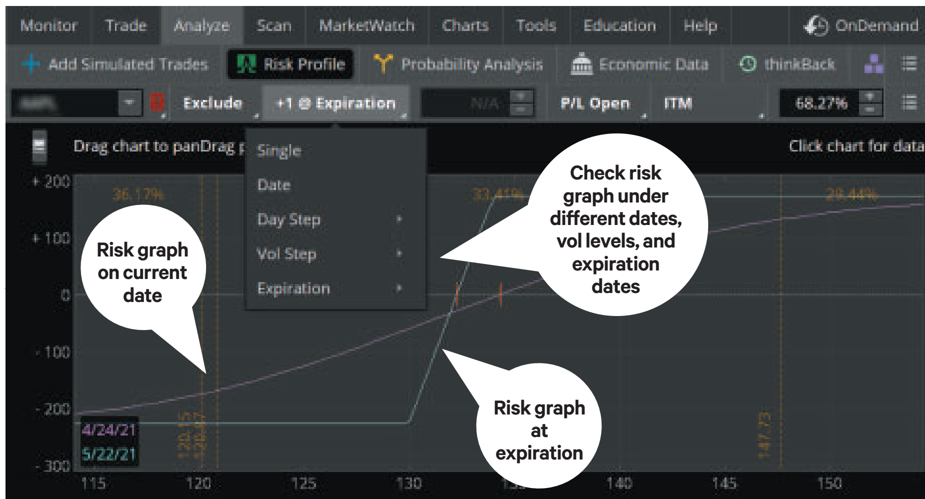

FIGURE 1: PUT A NUMBER ON IT. Fire up the thinkorswim platform, punch up an order ticket (real or simulated), and see the risk and potential reward up and down the price chart. Play with different volatility levels, roll ahead to any date, or even fast-forward to the next expiration date. *Source: thinkorswim. For illustrative purposes only. Probability analysis data in thinkorswim is theoretical in nature, not guaranteed, and does not reflect any degree of certainty of an event occurring.*

3 You'll stop chasing trades.

Every golfer knows (although some choose to ignore) that when deciding that next shot, you should go with the most likely outcome, not the best-case outcome. Trying to decide between a 200-yard carry over a pond and a layup in front of it? Don't think about that one time you pulled it off pro-style. Think about the nine times you splashed it short.

Traders should consider looking at every trade, investment, and most everyday decisions as a risk graph with the worst-case scenario drawn right in (see Figure 1). Basically, you're looking for reasons not to choose a certain course of action. If you can eliminate those reasons so the odds are tilted more in your favor, you can stop chasing trades.

4 You'll accept the bad with the good.

One of the first lessons an option trader learns is that things don't always go as planned. The good-odds trade sometimes plays out the bad way. Even a 90% success rate—which is technically achievable by options standards but hard to duplicate in the real world—still loses one out of 10 times, statistically speaking.

The trader brain knows you don't have to "win 'em all." Instead, you can try to manage the odds such that your goal is to have your winners outpace your losers—from a money standpoint, not necessarily in terms of percentages.

And you can't learn everything from a book; sometimes you have to live it. It's like the old adage about plans versus planning and how plans go out the window when the bullets start flying. In effect, you learn from practice. And paperMoney on thinkorswim can help you simulate that "skin in the game" as you test strategies and ideas in a virtual trading environment.

TUNE IN

CHOICEOLOGY PODCAST

Join in and listen: **https://www.schwab.com/resource-center/insights/podcast**

BEHAVIORAL ECON 101

Making decisions is never as easy as textbooks would have you believe. For one thing, they assume all investors have equal access to information and that they act with the same degree of rationality. Instinctively, the option trader knows that's not the real world. Money can play tricks on the mind.

In fact, Charles Schwab has an entire podcast series—Choiceology—that explores the lessons of behavioral economics to help traders and investors make decisions with their eyes wide open.

It's another piece of that same puzzle—making sense of the decisions we make. Option traders generally look at risk, potential payoff, and the odds at every stage of the game, while letting the math guide them.

And if that's how you do that one thing—thinking and acting with a trading brain—you might find it's how you do everything.

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For more information on the risks of trading and trading options, see page 35, #1 & 2.

How to Spot a New Volatility Regime

A shock to the financial system can bring about a new volatility (vol) regime, but for how long?

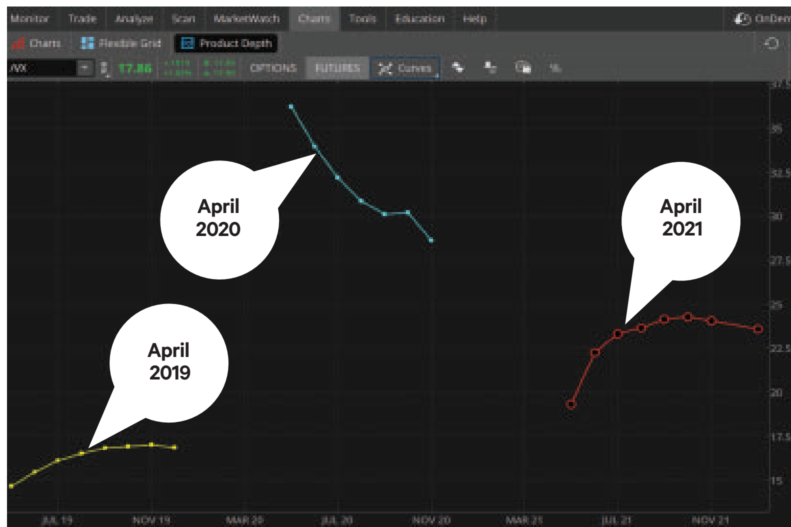

FIGURE 1: THREE YEARS, THREE REGIMES. **VIX futures (/VX) are listed monthly, out to seven months in the future—one way to identify your regime. On the thinkorswim® platform, under the Charts tab, type in the symbol and select Product Depth > Futures.** *Source: thinkorswim platform. For illustrative purposes only.*

• There's an old joke that says economists can't predict a recession, but afterward, they can identify it and tell you why it happened. As a trader, you don't look for potential opportunity in the rearview mirror but down the road.

Whenever the underlying fundamentals experience a drastic change, it can take a while to revert back. And sometimes things don't fully revert but settle in to a "new normal." It's like muscle memory—a new regime might be taking hold, but the market is still focused on the last one.

If you understand the nature of vol regimes—and recognize when one's changing—you might unlock some hidden trading potential.

REGIME ID USING VIX FUTURES CURVES

If you look at the Cboe Volatility Index futures (/VX) curve from this past April and the two Aprils before that (see Figure 1), you'll find three different vol regimes. In 2019's pre-pandemic world, the VIX had settled in to a classic low-vol regime—the curve was in slight contango (upward-sloping), with the front month in the low teens and deferred months in the 17s.

Then COVID-19 hit, sending vol higher. The curve in April 2020 was in steep backwardation—downward-sloping with the front month near historic highs. That reflected deep market uncertainty. But one year later, well after the market fully recovered and forged ahead to new highs, with the front-month /VX below 20, back-month /VX contracts were still hovering in the mid-20s in a steep contango-term structure.

OPPORTUNITY VS. HISTORIC VOL

How and when do regimes shift? It might help to look at the past and compare implied vol—up and down the futures curve—to the current historical vol (HV). Unlike implied vol (which is the market's expectation of future vol), historical or "realized" vol measures the actual price movement over a period such as 20, 30, or 90 days.

On the thinkorswim® platform, you can see how current HV ranks against the HV over the past year (HV percentile). Check it out for the VIX—or any stock—under the **Trade** tab > **Today's Options Statistics**.

Is there a mismatch between the vol implied by the market and the actual observed price movement? If so, that could create potential opportunities—or at least a reason to sidestep certain strategies. For example, note the red curve in Figure 1. That steep contango means, all else being equal, that options could lose extra vol steam from the two-months-out point. It's called riding the curve, and if you've ever hit the slopes, you know the downhill run is easier than the uphill climb.

A FINAL KEY TO SPOTTING A VOL regime change as it happens: Follow the real-time action. Tune in to programming from our media affiliate, the TD Ameritrade Network*, for up-to-the-minute market insights. —Words by DOUG ASHBURN

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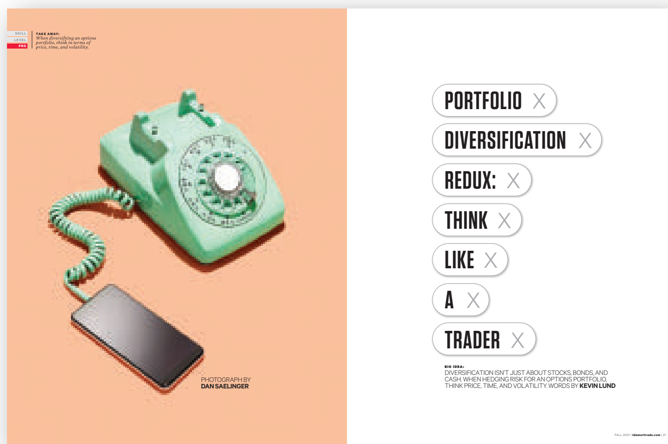

Implied volatility—The market's perception of the future volatility of the underlying security and is directly reflected in the premium of an option. Implied volatility is an annualized number expressed as a percentage (such as 25%), is forward-looking, and can change.

At the money (ATM)
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.

Butterfly spread
Typically a market-neutral, defined-risk strategy composed of selling two options at one strike and buying one each of both higher- and lower-strike options 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 options premiums exhibit more decay than the combined long options premiums, resulting in a profit when the spread can be sold for more than its original debit (which is its maximum loss).

Calendar spread (long)
A defined-risk spread strategy constructed by selling a short-term option and buying a longer-term option of the same type (i.e., calls or puts). The goal: As time passes, the shorter-term options typically decay faster than the longer-term options and profit when the spread can be sold for more than you paid for it. The risk is typically limited to the debit incurred.

Cash-secured put (short)
A cash-secured short put means that you need cash in your account equal to the strike price of the put so you have enough money to buy the stock at the strike price without borrowing money on margin.

Covered call
A limited-reward strategy constructed of long stock and a short call. Ideally, you want the stock to finish at or below the call strike at expiration. If stock price settled above strike price, you'd have your stock "called away" at the short call strike. You would keep your original credit from the sale of the call as well as any gain in the stock up to the strike. Break-even on the trade is the stock price you paid minus the credit from the call and transaction costs.

Delta
A measure of the sensitivity of an option to a $1 change in the underlying asset. All else being equal, an option with a 0.50 delta (for example) would gain $0.50 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 what an options contract's delta is expected to change per $1 move in the underlying.

In the money
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.

Out of the money
An option whose premium is not only all "time" value, but its 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.

Theta
A measure of the sensitivity of options to time passing one calendar day. For example, if a long put has a theta of -0.02, the options premium will decrease by $2 per contract.

Vega
A measure of the sensitivity of options 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 options premium by $4 per contract.

Vertical spread (long and short)
A defined-risk, directional spread strategy composed of a long and a short option of the same type (that is, calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes minus the credit.

Cboe Volatility Index (VIX)
This index is the de facto market volatility index investors use to measure the implied volatility of S&P 500 Index options. Otherwise known to the public as the "fear index," it's 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, options buying activity increases, and options premiums on the S&P 500 Index increase as well. As the VIX declines, options buying activity decreases. The assumption is that greater options 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.

The Perils of Trading with Ego

If you hang on to losing trades hoping for a big move, it could be your ego playing games. It's hard to dodge, but a few steps could help minimize the effects.

• Do you enter trades with a strong bias, then change course after placing them? Every trader wrestles with internal debates. Often, it's our ego that gets us to overvalue our own ideas about what the market should do. And it's normal—your ego wants to justify your successes, yet it doesn't want to admit to, or face, losses.

Actually, any trade you make is based on some measure of ego, because you start with a directional bias. But how can you minimize the role ego plays over the long term?

YOUR MENTAL GAME

Phase one is becoming more mindful and aware. If your losses build after placing a trade, are you losing because something went wrong in the market, or is a fear of losing generating poor decisions?

If your trading system is failing because of the market, you may be able to rectify these failures. It could be a stock going through a pullback, or overall fundamentals aren't that great, or perhaps you didn't tighten your stops as circumstances were changing. Read about ideas to fix a failing system in "Time for an Options Strategy Change?" in *thinkMoney* 47.

BATTLING FEAR

If you're holding on to a trade that went sour because you're afraid of failure, it may be time to take stock, no pun intended. Accepting losses is part of trading, but they can be hard to face. As such, you may end up holding trades longer than you need to. Face it: Drawdowns are frustrating and can make us more anxious.

If you think you're trading on the fumes of ego, consider four steps:

1 – Stop trading. Work to analyze your trading from the perspective of learning how to lose instead of win. Once you accept that trading is about probabilities and that losing is part of the game, you may become less attached to results.

2 – Reassess. Compare your strategies by reviewing different scenarios and how you'd play them out. Plan how much you're comfortable losing on a trade so when you see a trade is going sour, you already have a plan in place to exit at a point you've sketched out in your mind. A lot has to do with position sizing and trade management, so that when a trade goes against you, it won't take you out of the game. Even if you have several losses in a row, your bankroll should be healthy enough to weather it.

3 – Trade without risking real money. Before putting real money in, use a trading simulator like paperMoney® on the thinkorswim® platform to help build your confidence without risking your capital.

4 – Take small bites. Start small when you return, with modest contracts and trade sizes. You may still want to get some skin in the game, and smaller sizes are naturally more manageable from a risk perspective.

You may never be able to completely eliminate ego from trading, but you might be able to control it. Being aware of the existence of ego and knowing how it influences you can go a long way. —Words by JAYANTHI GOPALAKRISHNAN

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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 is 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

OPTIONS STRATEGIES

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

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

The 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 options strategies, there is a risk of 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 options position is potentially unlimited because 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 options 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

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4

SPREAD DISCLOSURES

Options collar: *The collar position involves the risks of both covered calls and protective puts.*

Options covered call: *The 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.)*

Options long put: *The maximum potential reward for a long put is limited by the amount that the underlying stock can fall. This strategy provides only temporary protection from a decline in the price of the corresponding stock. Should the long put position expire worthless, the entire cost of the put position would be lost.*

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