thinkMoney®/50

Random musings for traders at TD Ameritrade—WINTER 2021

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HITTING THE RESET BUTTON

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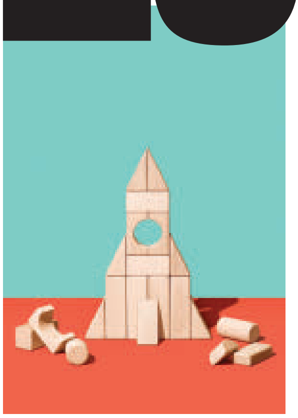
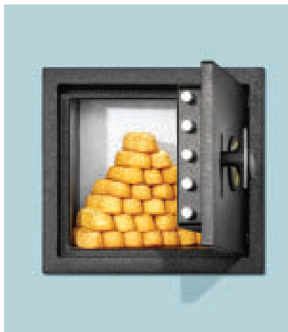


Cover photograph by
Dan Saelinger

COVER STORY

New Year, New You: Hitting the Reset Button

Goodbye 2020. Hello future. Starting the new year fresh seems like a great idea, considering what we just left behind. Despite the drop and pop we saw, perhaps it's time to think about resetting your trading strategy.



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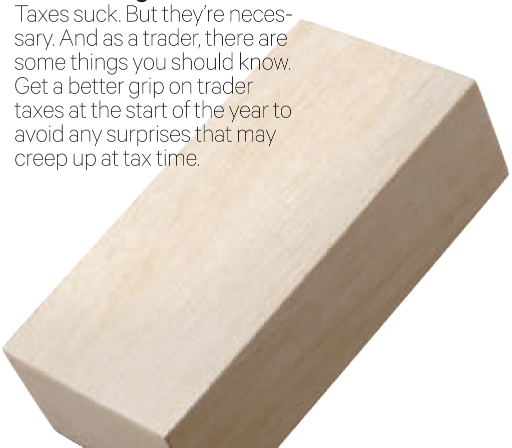

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Happy 50th!

• FIFTY ISSUES OF *thinkMoney*—wow! It's hard to believe it was all the way back in the summer of 2007 when we published our first issue and forever changed the way trading conversations take place. We've seen a lot of change over the last 14 years, but one thing remains constant: there are always trading opportunities.

Take 2020. It was certainly a year to remember—the pandemic, the social unrest, and a tumultuous U.S. presidential election. What started out as a strong year for the markets swiftly changed when the COVID-19 reality hit. The markets plunged, but then quickly recovered, with the major indices hitting record highs. Can you say "volatility"? And now, the question on traders' minds: Can we expect to see volatility continue?

Here's another certainty—a new U.S. president means things will look different in the new year. But that doesn't necessarily mean the markets will be complacent. Even though full-scale distribution of a COVID-19 vaccine could be around the corner, life might not return to "normal" for a while. In some cases, a new normal has emerged, permanently. And if we have a divided Congress, which Wall Street seems to favor, "gridlock trading" could be back in vogue. As we've always said, uncertainty equals volatility, which equals opportunity. And that, at least, could be good news for traders.

How can you prepare for volatility? A good place to start is to ask yourself what lessons you've learned from 2020 and how they can help shape your trading strategies moving forward. Take a moment and think about what hurt or helped you last year (this is good advice for any year). Did emotions influence your trading decisions? Did your analytical tools fail your system? Did you have trouble managing your trades? This issue's cover feature, "New Year, New You: Hitting the Reset Button" (page 16), lays out some different paths you could follow to give your trading strategies a recharge. It's a new year, and if you want to trade the long game, you need to adapt as conditions change.

Another long-game tactic is adding tax planning to your to-do list. Nope, taxes aren't fun, but staying on top of them can go a long way toward easing the pain of Tax Day. You'll find helpful tips and strategies in "The Business of Running Your Trading Business" on page 28. Getting a head start on tax planning could take a lot of weight off your shoulders and free up more time to engage with the markets. And that's a great resolution to make for the new year.

Wishing you all the best for 2021.

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

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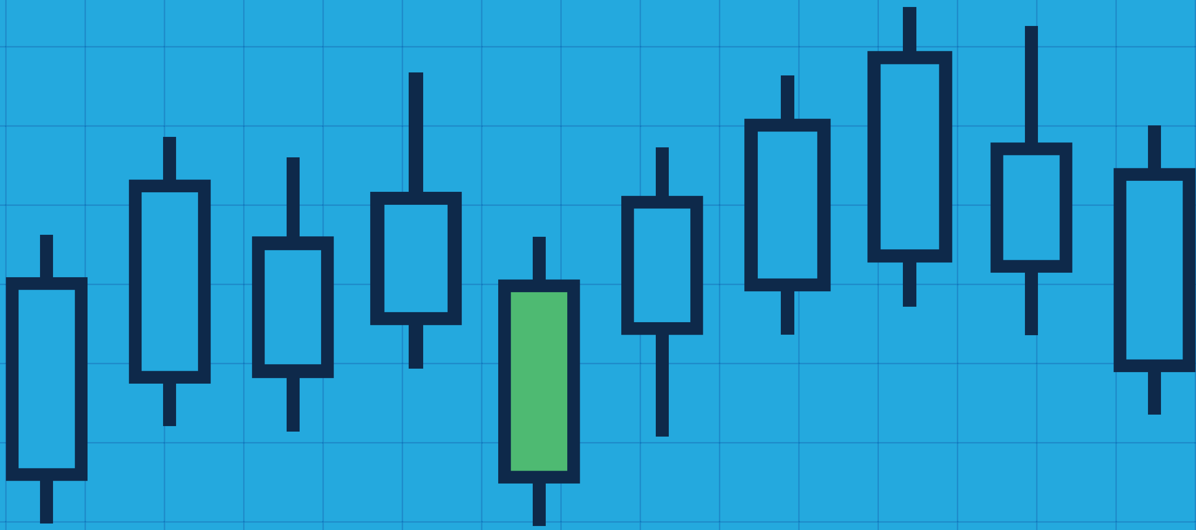
2

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.



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INDUSTRY SPOTLIGHT

Options on Micro E-mini Futures: Portion Control for Your Trading Plate

Think of them as a tasting menu for those with smaller options appetites. Tapas, not smörgåsbord.

• IF YOU'VE EVER GONE ON A DIET, YOU KNOW the drill: Watch your portion sizes and take smaller bites. That holds true for trading as well.

Maybe a trading strategy's gotten a bit sedentary, or stale, and there's a desire to add something new, like options on futures. Either way, micro e-mini options allow traders to take a nibble—with contracts that are 1/10 the size of e-mini options.

Here's the skinny: CME Group launched Micro E-mini Futures in May 2019, and by the following year, the suite was averaging more than 1.5 million contracts per day.

Last August, CME rolled out options on its most liquid micro futures—the S&P 500 Micro E-minis (/MES) and Nasdaq-100 Micro E-minis (/MNQ). The contracts are 1/10 the size of the e-mini options (one point is $5 for /MES and $2 for /MNQ).

This is welcome news for anyone looking for bite-size pieces because, remember, as the value of these indices doubled/tripled/quadrupled over the years, so did the notional value of each contract. Micros—and micro options—put the indices back within reach for many traders. And for aspiring futures and option traders, micros can be a stepping stone between the paperMoney® platform and the e-mini futures.

STRATEGIES TO WHET YOUR APPETITE

An equity option trader who wants to venture into the futures markets for the first time is already pretty close. The contract specs might look a little different, and then there's futures margin—yes, micro futures and options use leverage—but otherwise they trade similar to the e-mini futures. Strategies are strategies, and options greeks are, well, greeks.

Here are some ways micro options could tempt a trader's palate.

Basic options strategies with a twist. If a trader wants exposure to big-name tech

PHOTOGRAPH: DAN SAELINGER

stocks, but the price may place the standard 100-share options contracts beyond their scope, they could consider the /MNQ. It's made up of several big-tech stocks, and with a notional value of $2 times the index (and margin requirements that are a fraction of notional), approved account owners can take smaller portions of various options strategies.

Beta weighting a smaller portfolio. Do you beta weight your portfolio—that is, convert your positions to a standard unit for viewing (and maybe hedging) them against a benchmark such as the S&P 500? Micro options can allow traders to hedge or trade around an event such as earnings or a big economic report. From protective puts and collars, to wrapping an iron condor around the current price ahead of earnings, micros and beta weighting can be like peas and carrots on a plate.

Strategy scaling. When volatility reigns, it can be daunting to go all in or all out at one price. Micros can help there too. Consider layering orders above and below the price target, for example. And if trying to decide between two strikes, or whether to liquidate, roll, or hang on, it may be possible to try a little of each.

MICRO E-MINI OPTIONS HAVE BEEN officially added to the futures trader's buffet. But a buffet doesn't have to be about gorging till you're stuffed. It can mean an opportunity to nibble at different things until you find what you like. —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 options, see page 35, #1 & 2.

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THINKTANK

Three Steps to Fun-damentally Picking Your Next Trade

Traders often get wrapped up in chasing specific stocks, mainly because of the fear of missing out. But instead of using charts and indicators, what if there were another way?

Here's a crazy idea: Instead of cramming charts and chasing trades, how about trying a top-down, fundamental-first approach in three steps? (1) Start with the big picture, then (2) narrow your choices by focusing on industries or sectors, and finally (3) zero in on specific stocks or options. This adds some logic to the decision-making process. And you've already got all the tools you need.

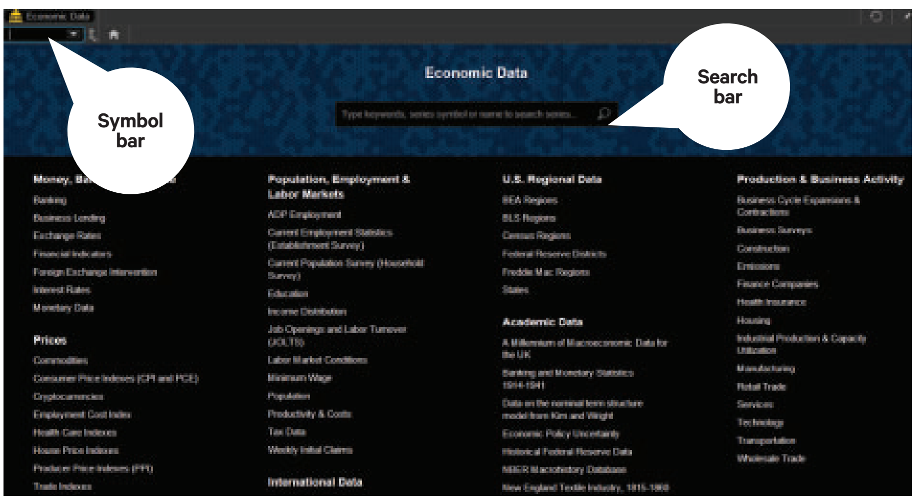

FIGURE 1: ECONOMIC DATA. There's plenty of information to choose from. Select any category to take a deeper dive. *Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.*

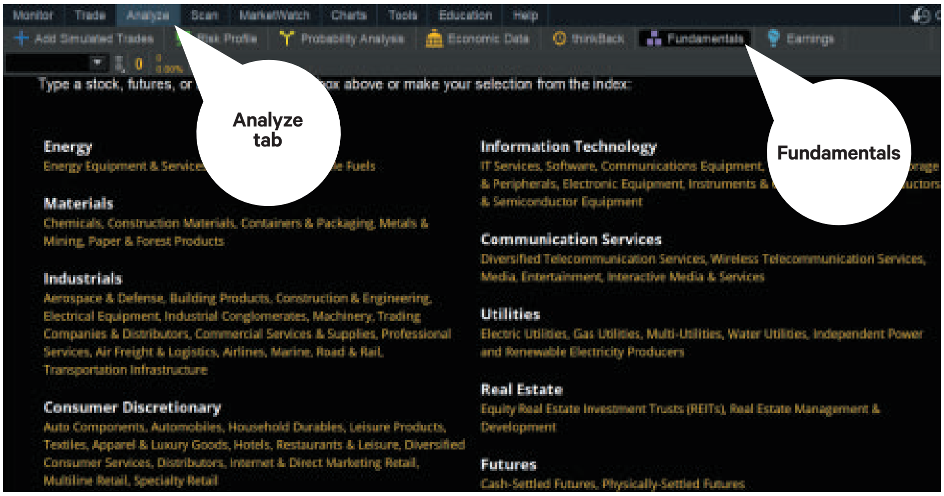

FIGURE 2: DRILLING DOWN ON SPECIFIC FUNDAMENTAL DATA. **The Fundamentals page is also organized into different categories. You can look up specific companies or select from the various sectors listed on the page.** *Source: thinkorswim from TD Ameritrade. For illustrative purposes only.*

To start, fire up the thinkorswim® platform by TD Ameritrade and choose the **Analyze** tab.

Step 1: The Macro View

How's the overall market doing? Select the **Economic Data** subtab and you'll see a long list of info organized into categories (see Figure 1). If you want to find something specific, just type it into the search box. If there's a symbol you're interested in, put it in the symbol box at the top left. Want to know where inflation is? How about jobs numbers or housing data? It's all there. Browse all the choices, and when you find something that intrigues you, select and view the chart.

Suppose you want to get a better idea of how the housing market is performing. Select **Housing**, listed under **Production & Business Activity**. From there, drill down on housing data such as housing starts, how many housing units have been completed, and how many have been sold.

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Curious about how new single-family homes have been doing? You could select **New Residential Sales**, then zoom in on the number of single-family homes sold. You may see a chart that shows sales have been increasing. Does that mean housing stocks might be worth a look? To learn more, you can drill down into sector or company fundamentals.

Step 2: Homing the Industry

Select **Fundamentals**, and again, the information is organized by categories (see Figure 2). If you have a specific company in mind, enter the stock symbol in the symbol box. Otherwise, look through the categories and select those related to your research. Home builders are listed under **Consumer Discretionary** > **Household Durables**. Pick a company you're familiar with or are considering and get information on the stock, industry, company profile, and analyst ratings. You could continue following this process for several stocks, analyzing each one in greater depth by looking at earnings data, analyzing price charts, and viewing company news releases. There's a lot to go through, so look at what's most important for your decision-making criteria. If you like what you find, add symbols to your watchlist or set an alert to get notified when a stock reaches a certain price level.

Step 3. Check the News for Stock Ideas

You snooze, you lose. That's how it is with the markets. So, to keep from missing important news events that could impact what you're trading, tune in to programming from our affiliate, TD Ameritrade Network,* either through thinkorswim (via the Trader TV gadget) or by visiting tdameritradenetwork.com, to stay current on what's going down as the trading day unfolds.

Also, subscribe to the Daily Market Update with JJ Kinahan, available on tickertape.tdameritrade.com. As a subscriber, you'll get updates in your inbox when they publish. Soon, you may know more than any of your friends about the relationship between market news and price action.

You see? It doesn't have to be all about charts. Sometimes, finding your next trade might just be fundamental.

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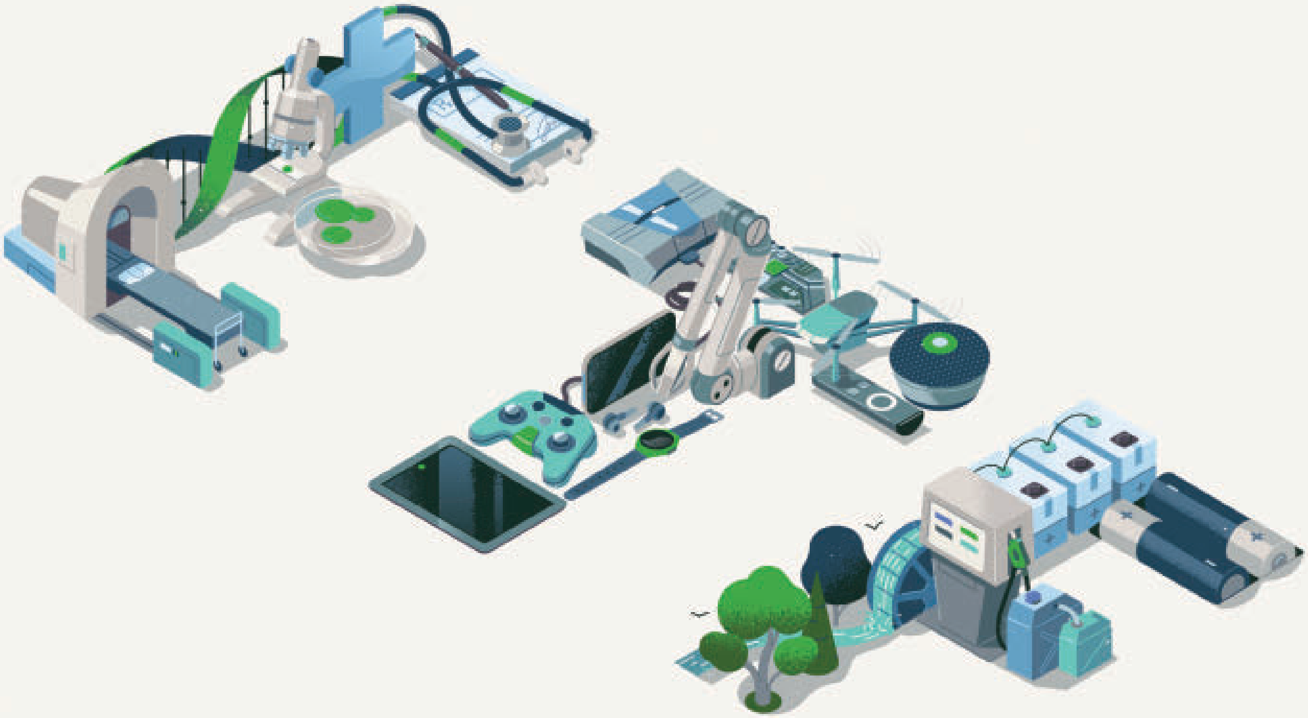

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KEN ROSE
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Education Coach, TD Ameritrade
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• Sure, there are lots of charting studies and tools at your disposal, but what if you want something that mimics a trading system you read about, or a new indicator or pattern you just can't find? You may need to build it yourself.

The thinkorswim® platform from TD Ameritrade lets traders create their own indicators, scans, alerts, and trading systems using thinkScript. And you don't need to be a computer programming whiz. To get your feet wet, you can use the **Condition Wizard** and start with something simple, like scanning for a moving average crossover.

To get started building your own indicator or system, I recommend following these six steps:

1 – Identify a goal
2 – Determine if thinkScript can meet that goal
3 – Outline the steps to script
4 – Apply thinkScript tools
5 – Write custom scripts if needed
6 – Test your script against your goal

GETTING STARTED WITH SCRIPTING

Suppose your goal is to be alerted when there's a simple moving average (SMA) crossover. Instead of checking the charts for a crossover continuously throughout the day, you could create a script that alerts you when the crossover occurs.

APPLYING THINKSCRIPT

Let's try creating a script that'll alert you when a 10-period SMA crosses above a 20-period SMA.

Fire up thinkorswim and:

1 – Select the **MarketWatch** tab, then **Alerts**.
2 – Enter the stock symbol and select **Study Alert**.
3 – In the new window, select **Condition Wizard**, then **Edit**.
4 – In the **Edit Condition** window, select **10** as the length of the first SMA and **crosses above**.
5 – Select **Study** from the **Select a Condition** menu.
6 – Scroll down and select **SimpleMovingAvg**, then change length to 20.

In the **thinkScript Editor**, you'll see the thinkScript code for the SMA following crossover:

SimpleMovingAvg ("length"= 10) crosses above SimpleMovingAvg ("length" = 20). "SMA" and MovingAvgCrossover ("length1" = 10, "length2"= 20) is true

Now set up an alert to notify you via text message or onscreen when the condition is met by selecting **Create Alert**. You can also set up **Scans & Custom Columns** to find stocks with crossovers.

You've created your first thinkScript code. You can always go into the thinkScript Editor and make changes, which will help you learn and advance your new coding career. You can also use links from other thinkorswim users and paste them into the platform.

NOW THAT YOU'VE HAD A TASTE OF thinkScript, you can take it further. Some of the more complex scripts can be used as investing strategies and backtested. Just keep in mind that good backtesting results don't provide any guarantees for future performance.

WRITE YOUR OWN THINKSCRIPT. Check out the webinar series at www.youtube.com/watch?v=8QNdRHIUaYY

Implied Volatility and Vega: How're They Related?

Well, they're similar but have some differences. Let's ask an education coach at TD Ameritrade.

Hey Coach! I'm trying to analyze different options strategies by looking at implied volatility and vega. What's the difference between the two, and how can I use them to decide which options to trade?

Both implied volatility (IV) and vega are important when analyzing an options position, but their differences may not be obvious. Simply put, both provide information about how a given option or options position may react in the future, and both are products of an options pricing model. Let's start with IV.

When a set of variables like underlying price, strike price, days to expiration, interest rates, and dividends are crunched through an options pricing model like Black-Scholes, one value that can be backsolved is IV. The math is complex, but ultimately the IV value that comes out of this formula estimates how much the underlying asset could potentially move in the future.

IV also tells you how much time premium is built into the price of a given option. And with that information, you can compare the current level of IV to the historical range of volatility for that security to determine if the options price is "cheap" (more suited to buying premium) or "expensive" (more suited to selling premium).

Now, while IV tells you how much a stock might move in the future, vega tells you how much the options price may change as IV changes. For example, let's suppose that:

(1) An option is trading at $5 per contract,
(2) IV is currently 40%, and
(3) vega is 0.01, or $1.

Because the value of the option is $500 ($5 x 100 shares per option), if IV rises from 40% to 50%, the value of the option would be expected to rise by $10 (vega of $1 times a 10-percentage-point increase in IV) to $510. If IV declines from 40% to 30%, the value of the option would be expected to decline to $490.

IDEALLY YOU WOULD BUY PREMIUM when IV is low and vega is positive. If IV rises after you enter the trade, the value of your position increases because of vega (higher volatility). Conversely, you'd ideally sell premium when IV is high and vega is negative. A subsequent decline in IV would then work in your favor.

VEGA AND FRIENDS

Vega doesn't exist in a vacuum. When volatility changes, it's usually working in concert with changes in the stock price and time itself, each with their own greeks (delta and theta). For more on the interplay of the greeks during the life of a trade, turn to page 20.

TRADER GLOSSARY
TURN TO PAGE 33

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SKILL LEVEL EASY

TAKE AWAY:
Know when it's time to reset your trading strategies.

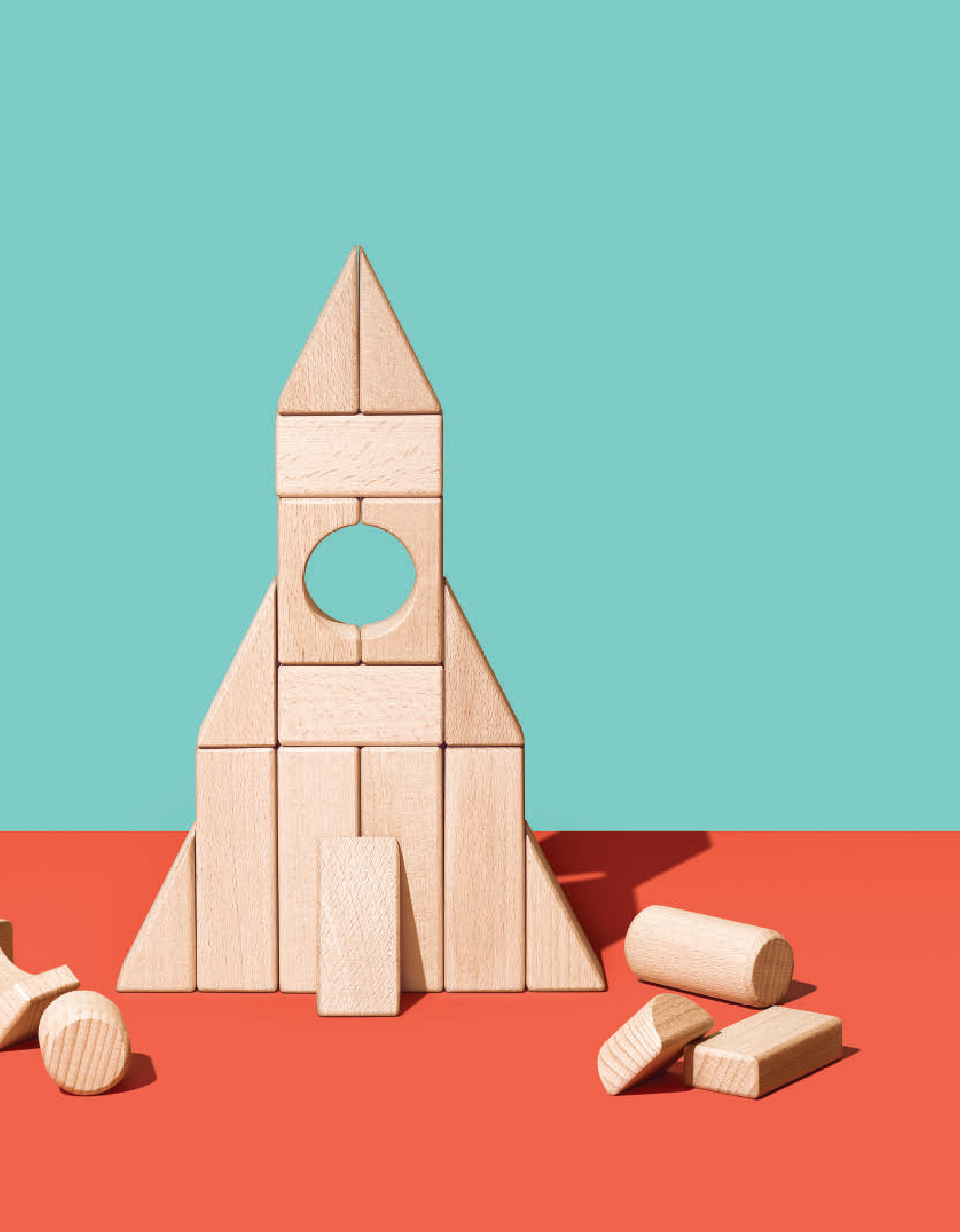
NEW YEAR, NEW YOU

WORDS BY
DOUG ASHBURN

PHOTOGRAPHS BY
DAN SAELINGER

HITTING THE RESET BUTTON

BIG IDEA:
NO MATTER HOW YOU SLICE IT, 2020 WAS ONE FOR THE RECORD BOOKS. IF YOU'RE LIKE MANY TRADERS, YOU'RE READY TO HIT THAT BIG RED BUTTON AND GET A FRESH START.



LET'S FACE IT

2020 was a big year. Unprecedented circumstances created unprecedented volatility (vol), which likely tested your trading strategies and psyche. Did the swoon, recovery, and election-year vol leave you scratching your head or licking your wounds? However you landed, it may be time to take a step back and reassess.

Think of hitting the reset button as a realignment of head, hands, and heart back to their default settings. If you do it right, you might even get a free upgrade to a new optimized operating system.

Your head—actually, your mind—contains the psychology of trading. It's about the mental game—keeping your emotions, cognitive biases, and lapses in logic and reasoning in check. Your hands are in charge of the taps, click-and-drags, and selections you make as you set up and monitor your charts and fundamentals. And the heart? That would be how you manage trades—from entry to exit. It's what pumps the blood to your hands and head and keeps your trading strategy alive. Ready to hit reset?

YOUR MIND

GET IT BACK IN THE GAME

A year like 2020 was probably tough on the mind. But it wasn't just about the markets. Many of us had to deal with the stressful realities of illness in our families, kids home from school, and the transition to a socially distanced life. How did anyone manage it all and still have mental capital left for trading? For the future, consider some of these helpful strategies:

1 – Stick to routines. Some people approach trades with a disciplined approach, but then abandon the plan mid-trade due to fear, greed, or boredom. If you have a profit target and a stop order all set, don't obsess. Of course, you don't want to "set it and forget it," but you don't need to watch every tick, either.

2 – Don't fight stress; manage it. Markets are uncertain. Uncertainty is risky. Risk is stressful. But that's not necessarily a bad thing—stress is a natural mechanism that lets us know when to be alert and focused. Fighting it can amplify discomfort and create distraction. What's your response? Get up from the computer, get some exercise, practice mindfulness. If you're still stressed out, that might be a sign your risk is outside your comfort zone. So, consider dialing it back.

3 – Consider cognitive bias. Psychologists can point to a dozen or more biases and fallacies that humans fall prey to when making decisions. Here are a few common ones:

- **Confirmation bias:** Ignoring data that doesn't support your view.
- **Recency:** Assuming a coin that's flipped heads three times in a row is more likely to flip tails the next time.
- **Overconfidence:** Thinking three winners in a row means you have the Midas touch.
- **Spurious relationships:** Assuming correlation implies causation, like linking market returns to the winner of a football game.

We're all human, but that doesn't mean we need to fall for these and other lapses in thinking. Recognize them for what they are. Work to keep them out of your trading decisions.

YOUR HANDS

FINE-TUNE YOUR CHARTING

How are your chart setups doing these days? Did 2020 blow a hole in your strategy? Did a spate of vol cause you to monkey around with your parameters? If so, it may be time to reassess and potentially revert.

For example, when the COVID-19 pandemic first hit, the markets reacted violently—on the downside and upside—and much of the chartist's tool kit went out the window. Support and resistance levels, crossovers, overbought and oversold measures, and vol overlays (the Cboe Volatility Index [VIX] went from the mid-teens to the mid-80s in about three weeks) are just a few of the metrics that didn't display much certainty.

Did you make adjustments? Are you ready to revert back to your old strategies? Maybe you want to consider something new. **Chart Describer** is a newer tool on the thinkorswim® platform from TD Ameritrade. It scans the universe of technical indicators and shows you which ones are in play. If an indicator flashes potentially significant results, the platform will ask if you want to add it to your chart (see Figure 1).

TRADER GLOSSARY
TURN TO PAGE 33

If you decide to try something new, you can always do so without risking a dime with the paperMoney® simulator. Test out new strategies and indicators. Experiment with position sizes or entry/exit points (more on that next). And when you're done,

FIGURE 1: CHART DESCRIBER HAS YOUR BACK. **On the Charts tab in thinkorswim, type in a symbol and hit that box with the little "i" (right next to the Edit studies beaker). In this example, Chart Describer identified three indicators—exponential moving average crossover, a standard deviation channel, and the nine-day moving average—to keep an eye on.** *Source: thinkorswim from TD Ameritrade. For illustrative purposes only.*

you can literally hit the reset button. Just select an account, and under the **Monitor** tab > **Activity and Positions** > **Adjust Account**, select **Reset All Balances and Positions**.

It's too bad the real world doesn't work like this.

YOUR HEART

MANAGING YOUR TRADES

The trade life cycle: It's the entry, exit, and everything in between. So, all that stuff about trading psychology and checking those charts—the head and the hands—comes down to pulling the trigger on the way in and the way out. That's the beating heart of every trade.

Does this scenario remind you of volatile years? Suppose all your go-to indicators converge on one entry point, so you place a trade. Then the market hits a pocket of illiquidity—common during vol spikes—that blows through your limit order straight to your stop order, then sharply reverses. Your instincts were right, but on this trade, you lost money and a potential opportunity.

If 2020 taught us one thing, it's that going all in or all out at one price can potentially be a disadvantaged way to trade. But there are a couple of alternatives.

Scaling orders. Instead of putting your entire unit size at one price, consider dividing it by two or three, and place orders above and below your target level. That way you can participate even if you "just missed it" and average your entry point if the market overshoots your level by a bit. In other words, scaling can help to spread out your risk. You can also potentially scale your exit points. Zero commissions for online stock, exchange-traded funds (ETFs), and options orders have changed the math behind order scaling. This applies to U.S. exchange listed stocks, ETFs, and options. A $0.65 per contract fee applies for options trades.

Options for protection. In the scenario just described, instead of a stop order, what if you had bought a put option at a strike price at or near your stop? Consider weekly options to get short-term protection. If there's a sharp move and reversal, you can participate in the upside, minus the cost of the option.

At its heart, trade management is really about managing your objectives and adjusting as needed.

THE FLOW OF YOUR TRADING LIFE IS often at its best when your mind, heart, and hands work in sync. As market conditions evolve, check in with yourself and occasionally reset if necessary.

NEED A MENTAL BREAK?

Monitor the markets brain-free with **Alerts** on the thinkorswim platform from TD Ameritrade. Under the **MarketWatch** tab, select **Alerts**, enter a ticker symbol, and set alerts based on whatever criteria you want: price or vol levels, crossovers or other technical signals, or even fundamental triggers such as dividend or earnings information. They'll pop up on the screen when you're logged in, and you can also set up email or text alerts.

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

The paperMoney® software application is for educational purposes only. Successful virtual trading during one time period does not guarantee successful investing of actual funds during a later time period, as market conditions change continuously.

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

Because they are short-lived instruments, weekly options positions require close monitoring, as they can be subject to significant volatility. Profits can disappear quickly and can even turn into losses with a very small movement of the underlying asset.

SKILL LEVEL PRO

TAKE AWAY:
Understand how options greeks move together through the life of a trade.

Don't Follow the Money

(Follow the Greeks)

BIG IDEA:
WHEN TRADING STOCKS, WINNERS AND LOSERS ARE BASED ON HOW MUCH YOUR STOCK MOVES AFTER YOU GET IN THE TRADE. WITH OPTIONS, YOU NEED TO CONSIDER PRICE, TIME, AND VOLATILITY—ALL AT THE SAME TIME. TO DO THAT, YOU'LL NEED TO UNDERSTAND THE INTERPLAY OF A FEW OPTIONS GREEKS AND HOW, WHEN COMBINED, THEY PLAY OFF ONE ANOTHER.

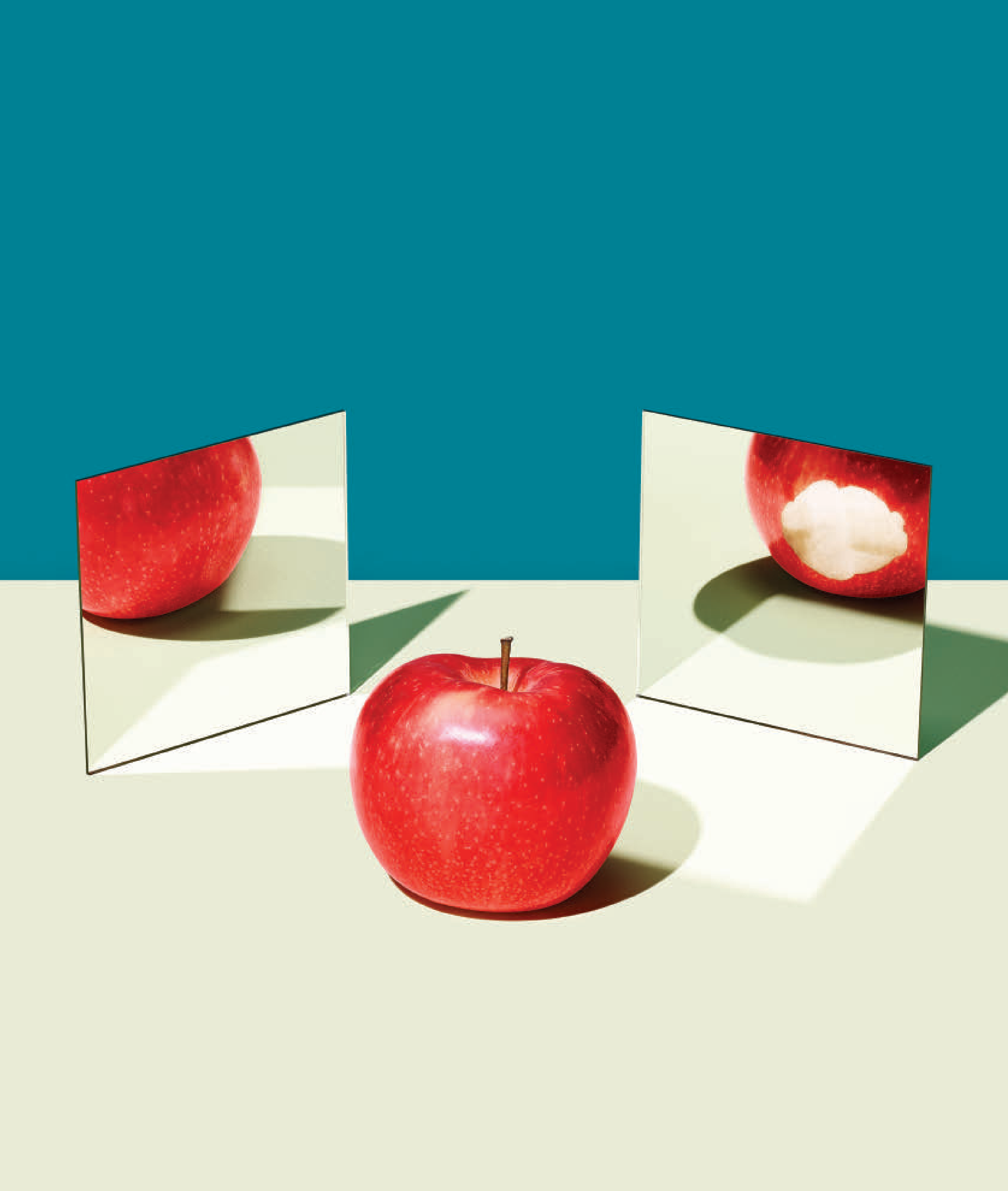
WORDS BY **KEVIN LUND**

Here's what we know. Options aren't stocks. And you can't just track profit and loss (P&L) in a vacuum based on what the underlying stock is doing—making it tough to figure out your exit strategy. For that, you've got to consider stock price, time, and volatility (vol), which are measured individually by the options "greeks"—delta, theta, and vega. Knowing how each greek works alone is one thing. You should also know how they play off one another during the life of your trade. Master this, and you're well on your way to mastering the art of the exit.

COMPARING TWO TRADES

Let's examine the greeks with a holistic approach. We'll consider two different trades—a long call and a long call spread—from the time each trade is placed, to three days later, and then at the end of one week. We'll also look at what can theoretically happen to those trades if the stock moves up or down $5, or if the price is unchanged.

On the day of the trade, suppose the underlying stock is at $125, and both trades expire in 30 days. Out of the gate, the trades have the following greeks:



PHOTOGRAPHS BY
DAN SAELINGER

LONG 125 CALL	LONG 120-129 CALL SPREAD
Price = $4.50	Price = $4.50
Delta = +50	Delta = +30
Gamma = +3	Gamma = 0
Theta = -8	Theta = -1
Vega = +14	Vega = +1

Remember, these are theoretical numbers. Transaction fees and commissions may apply.

WHAT HAPPENS TO THE LONG 125 CALL?

Three Days Later

• **If the stock's up $5:** The long delta works in this trade's favor, and it benefits from gamma. The long gamma measures how much the delta increases as the stock moves higher. With an incrementally higher delta, a larger profit can potentially be gained.

Delta and gamma drive profits as the stock moves higher, but theta is working against this trade. We haven't assumed any change to the implied volatility (IV), so vega isn't going to factor into the P&L. What if IV dropped five points? For starters, profits wouldn't be as high—something to consider at the start of the trade.

• **If the stock's down $5:** Based on delta, the downward move means the trade will lose. But the long call starts with a +50 delta, and by the time the stock is down to $120, the delta has dropped to +32. Even though the trade is losing, it's losing at a slower rate (because the delta is declining, as measured by gamma). Long gamma can help the trade profit faster if the stock is going in the right direction, and it can slow down the rate of loss if it isn't.

TRADER GLOSSARY
TURN TO PAGE 33

Theta, which measures the effect of time decay, remains a drag and is responsible for more losses. If there's one silver lining, it's that theta is dropping because the option is now out of the money—nothing to brag about. Vega is still positive, which might help cushion the losses if IV increases (as it sometimes does when stocks drop).

• **If the stock price is unchanged:** When there's no stock movement, the delta and gamma don't play a role in generating the P&L. It's only theta and vega. And because we're not looking at IV changes, the only culprit here is theta.

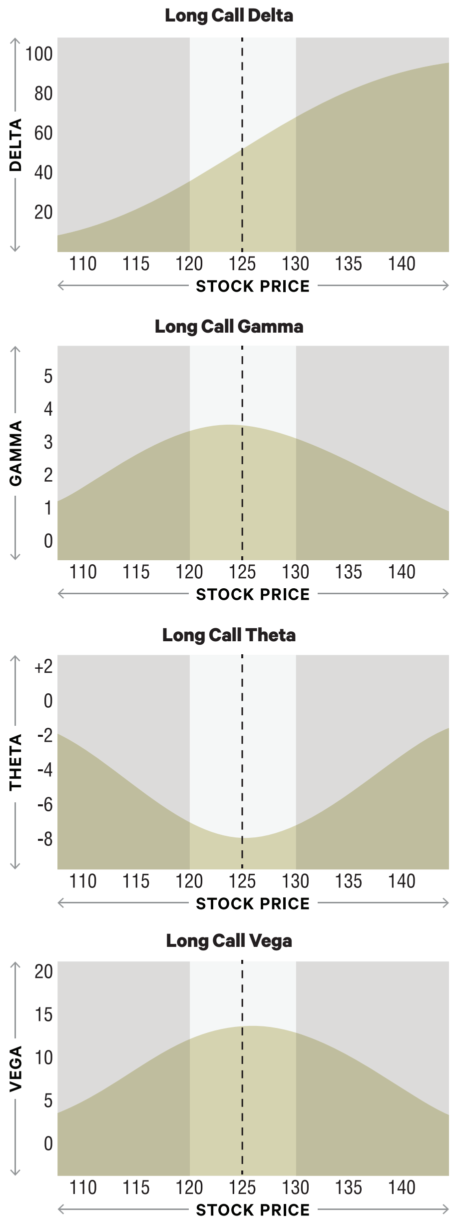
Seven Days Later

• **If the stock's up $5:** Delta and gamma will contribute to the trade's profitability based on the same dollar move in the underlying. What's different now is that a full week has passed. And that means theta's going to have a bigger say in the matter.

• **If the stock's down $5:** At this point, there's not much working in this trade's favor. Delta is a loser, and gamma does what it can to help slow the rate of loss. But a full week of theta sets in and drags the whole trade lower. Any increase in IV would help offset losses because vega gets smaller.

• **If the stock price is unchanged:** Delta and gamma don't play a role with the stock price unchanged, so it's only theta in this example (and vega if there are any changes to IV).

LONG CALL



For illustrative purposes only.

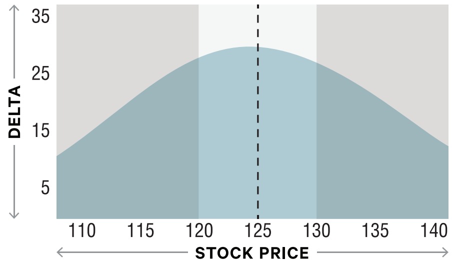
GREEKS CHEAT SHEET / LONG CALL

	$120 (STOCK DOWN $5)	$125 (UNCHANGED)	$130 (STOCK UP $5)
TRADE DATE +3	Delta and theta contribute to losses; gamma helps slow the losses from the delta. Net result is a loss of $234.	No movement over three days, so theta results in a loss of $27.	The trade profits from delta and gamma, while theta plays the role of spoiler. The net result is +$268.
TRADE DATE +7	Delta and theta contribute to losses as the trade loses $265, another $31 since trade date +3.	After seven days and no stock movement, the loss is $63, which is an additional loss of $36 since trade date +3.	Delta and gamma drive profits but are tempered by the additional losses from theta. The net result is a profit of $237, $31 less since trade date +3.

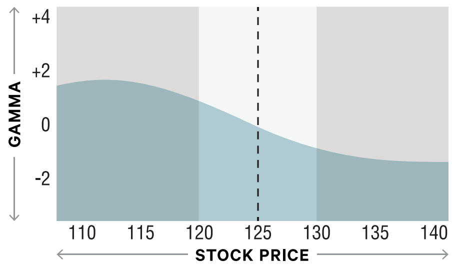
For illustrative purposes only.

LONG CALL SPREAD

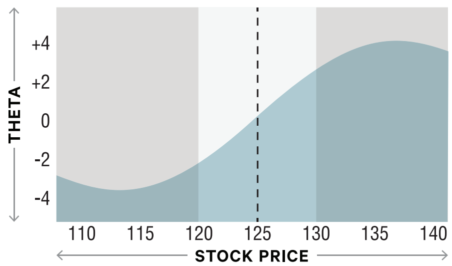
Long Call Spread Delta



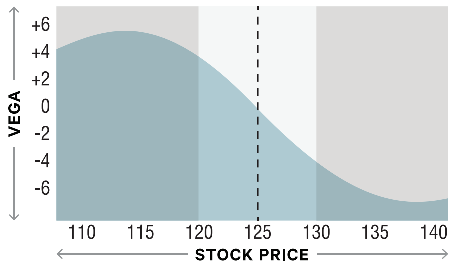
Long Call Spread Gamma



Long Call Spread Theta



Long Call Spread Vega



For illustrative purposes only.

WHAT HAPPENS TO THE LONG 120-129 CALL SPREAD?

Three Days Later

• **If the stock's up $5:** Again, the delta generates a profit with the stock moving higher, but it's a smaller delta to start with because the spread nets the delta from the long and short calls. In fact, this is why all the greeks for the call spread are smaller. With a smaller delta, and virtually nonexistent gamma, the profits from the stock moving won't be as high as the individual call trade.

Theta isn't going to be a drag on the long call spread profits because the trade has a slightly positive theta. Why? In a vertical spread, the option that's closest to the at-the-money (ATM) strike will be most sensitive to theta, gamma, and vega. Here, the short 129 strike influences the trade more than the long 120 strike. Therefore, time helps.

Again, assume no changes to IV. But it's worth noting the vertical spread has a negative vega, which gets increasingly negative with the stock up $5. This provides protection against a vol drop that the long call doesn't have.

• **If the stock's down $5:** Again, delta is the main reason this trade loses with the stock down. Although it starts with a lower net delta, there's little to no gamma to help lower the delta much further. Theta has flipped from slightly positive to slightly negative because the long 120 strike is now closer to the money than the 129 short strike. Overall, this is a slower-moving trade, so the losses will be less compared to the individual long call.

• **If the stock price is unchanged:** As with the long call, delta and gamma play no part, so it's only theta at this point.

Seven Days Later

• **If the stock's up $5:** The spread has the smaller delta and little to no gamma. But notice what happens to the theta as the stock moves closer to the short strike and more time passes. Theta gets more positive, which means time is helping this trade. You won't get this from the long call.

• **If the stock's down $5:** The smaller delta means lower losses, and gamma is negligible. Theta is still negative, because the stock is closer to the long strike.

• **If the stock price is unchanged:** Delta and gamma don't affect the trade. But because the short strike is closer to being ATM, the trade maintains a slightly positive theta.

BEAR IN MIND, THERE CAN BE MULTIPLE forces to consider when calculating or predicting the P&L of an option. Visualizing the greeks working together helps.

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.

VISUALIZE YOUR TRADE.

To view your trade profile and the impact of greeks, go to the **Analyze** tab on thinkorswim® from TD Ameritrade, add a symbol, and select **Risk Profile** to get started.

GREEKS CHEAT SHEET / LONG CALL SPREAD

	$120 (STOCK DOWN $5)	$125 (UNCHANGED)	$130 (STOCK UP $5)
TRADE DATE +3	A smaller delta leads to smaller losses; gamma is still not involved, and theta hurts trades minimally. There's a net loss of $150.	With a positive theta of around $1 per day, the trade profits $3.	Profits from delta; gamma has no real impact; and theta can claim it helped out some. The net result is +$153.
TRADE DATE +7	Smaller delta and negative theta lead to a loss of $161, $11 more since trade date +3.	With a positive theta of around $1 per day, the trade profits $6, compared to $3 at trade date +3.	Delta and theta drive profits; short gamma is negligible. Net profit of $168, which is $15 more since trade date +3.

For illustrative purposes only.

SKILL LEVEL
SAVVY

TAKE AWAY:
Use the right tools to understand how futures contracts are priced.

TRADING FUTURES & HEDGING YOUR APPETITE

BIG IDEA: FUTURES TO MATCH YOUR LIFESTYLE? SURE. WHETHER YOU'RE BUYING GROCERIES, FILLING YOUR TANK WITH GAS, OR SHOPPING FOR YOUR NEXT HOME, UNDERSTAND HOW DIFFERENT TYPES OF FUTURES CONTRACTS COULD HAVE INFLUENCED THEIR PRICES.

WORDS BY
JAYANTHI GOPALAKRISHNAN

PHOTOGRAPHS BY
DAN SAELINGER

Warren Buffett said it best: "Invest in what you know." What could be more familiar than what you eat, what's in your home, or the gas in your car? You can invest in what you know with stocks and options, but there's another asset class you may be overlooking—futures.

If you've been avoiding futures because they seem complicated or risky, maybe it's time to give them another look. You could speculate on the S&P 500, hedge against the risk of your portfolio falling, or see how futures relate to products you use. The things you can do with futures might surprise you (assuming, of course, that your account qualifies).

Whether you're buying a house, gas, or stocks, there's always a chance prices will rise or fall. Businesses and individuals can hedge prices by trading futures contracts—agreements to buy or sell something at a specific price at some point in the future. For example, the price you paid for a box of Twinkies could depend on corn (/ZC) or wheat futures (/ZW). Gasoline prices may be tied to crude oil futures (/CL). The price of a stock you like to trade could also be related to price swings in the S&P 500 Index futures.

Futures trading involves substantial risk and is not appropriate for everyone. But every trader should get to know futures, because what happens in the futures markets can spill over into the equity markets. Before the stock market opens each day, futures are already trading. Equity index futures activity can indicate which way the markets might open. You can also trade futures to hedge your lifestyle by using the same strategies as the pros but on a smaller, less-leveraged scale.

HOW TO SPECULATE

To understand how futures can impact the stock market, let's see how, as an example, a trader can speculate using either the S&P 500 E-mini (/ES), which is a smaller version of the big S&P 500 futures contract, or the Micro E-mini (/MES) contract, which is even smaller. /ES delivers the cash equivalent of $50 times the value of the contract, while /MES delivers the cash equivalent of $5 times the value of the contract. So, if /MES is valued at 3386, the notional value of a contract would be $16,930. Which futures contract you use depends on the size of your trading account. Because /MES is the newest kid on the block, let's use it in our examples.

Before buying an /MES contract, a trader may have to put up some cash to cover the initial margin requirement. To find out how much, fire up the thinkorswim® platform from TD Ameritrade, select the **Trade** tab, and enter a symbol. You'll see the initial margin requirements for each contract. So, if the initial margin is $1,320, that's how much is required to initiate a position that could be worth $16,930. That's called leverage. And it can be good and bad.

If the S&P 500 Index (SPX) moves up by 50 points, that could be a $250 gain. A 50-point drop could mean a $250 loss. Note: An account may need more cash to maintain the position. This is known as maintenance margin, and the amount can be found on the CME Group website. Typically, for /MES, it's $1,200. If the account value falls below the maintenance margin, it'll trigger a margin call, and you'll have to come up with the cash pretty fast. That's one downside of leverage.

That said, what's the benefit of buying /MES or /ES futures over, say, an exchange-traded fund (ETF) or mutual fund that mimics S&P 500 stocks? When trading /MES or /ES, you're not actually buying securities. You can use leverage to speculate on the stock market, and if things go your way, you could potentially make better returns while putting up a lot less cash. Of course, if things don't go your way, there's potential for significant losses.

LEARN ABOUT LEVERAGE
and futures margin calls by reading http://bit.ly/TT-MargCall

EVERYDAY REALITIES

Beyond equity indices, there are futures on physical commodities and financials. Just about everything you buy is associated with price-changing factors—weather, politics, supply, demand, and transportation. With futures, you can take all these factors into account ahead of time.

For example, you're probably not going to find day-to-day price movements in your weekly grocery bill. Food price fluctuations are mostly dependent on agricultural futures. Farmers often use futures to protect their commodities from price changes. Gas prices, as you know, fluctuate more often. That's because it's a harder product to produce. Oil has to be discovered, extracted, refined, and distributed before it goes to the pump. On the other hand, financial futures are more abstract than physical commodities. We're talking foreign currency markets, interest rate futures, and equity indices, which aren't tangible in the "new car" kind of way.

As already mentioned, what happens in equity futures often spills into the stock market. Before markets open, one thing traders could do is observe equity futures. This can kick-start the speculative thinking. Anything can happen overnight, and often index futures like the Dow or S&P futures react first. These reactions can also give you some idea of how traders could be interpreting a news event. The movement in the futures markets can help you understand how interest rates are likely to move, or maybe what you can expect to pay next time you fill up your tank.

HEDGING YOUR LIFESTYLE

Can futures be used to reduce the risk of big price moves for things like falling stock prices, interest rates, or gas prices? Let's find out.

Protecting equities. Suppose a trader has a portfolio that comes pretty close to tracking the SPX. The trader has no intention of liquidating any positions. One alternative: Consider using the /ES or /MES to hedge an entire portfolio. Of course, it's important to make sure the hedge is in proportion to the portfolio value. Hedging a $100,000 portfolio with /ES would be a stretch.

Let's say a trader has a $100,000 portfolio. If the thinking is that the market's going to drop 5%, then the trader may consider shorting /MES. Let's do a little math. If the market drops 5%, the portfolio's value could drop by $5,000. If /MES is trading at $3,386, a 5% drop would mean a decline of around 169 points. Because each point is worth $5, that's roughly $846.50. So, theoretically, a 5% market drop would reduce the portfolio's value by $4,153.50. It'd still be a loss, but that loss would be less than if the trader hadn't shorted the futures contract. If the market rose, the portfolio would be exposed to additional losses. Again, the downside of leverage.

Hedging an adjustable-rate mortgage. Say someone took out a $500,000 mortgage with an adjustable rate tied to 10-year bonds. If interest rates rose by two percentage points (200 basis points), they might have to pay an additional $10,000 in interest over the life of the loan. That's no small change. To reduce the risk of such a move, consider shorting 10-year Treasury bond futures (/ZN). Remember, bond prices and interest rates have an inverse relationship. A one-point move in /ZN is $1,000, so if interest rates rise, /ZN could offset the additional interest. It may not be the perfect hedge, but it could help.

TRADER GLOSSARY
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Follow the (gas) money. Oil prices can be influenced by several factors, from global demand to geopolitical tension. If there's a significant rise in gas prices, chances are crude oil futures (/CL) are moving higher as well. How do you make up for that? Buy futures, perhaps. And never forget the risks involved in futures trading and, more important, the effects of leverage.

START OUT BY WATCHING FUTURES for equity indices, crude oil, and bonds. Once you learn about futures and understand how they work, consider opening a futures account.

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 futures, see page 35, #1 & 3.

HOW TO TRADE FUTURES ON THINKORSWIM®

Ready to see how futures prices move? On the thinkorswim platform from TD Ameritrade, select the **Trade** tab, then **Futures Trader**. You'll see a bunch of dashboards and charts. In the symbol box, enter **/MES** for Micro E-mini S&P Futures. The quote box displays the sell (bid) and ask (buy) price, as well as the number of contracts at those prices (see Figure 1).

If you have a futures account, you can place your trades directly from the dashboard.

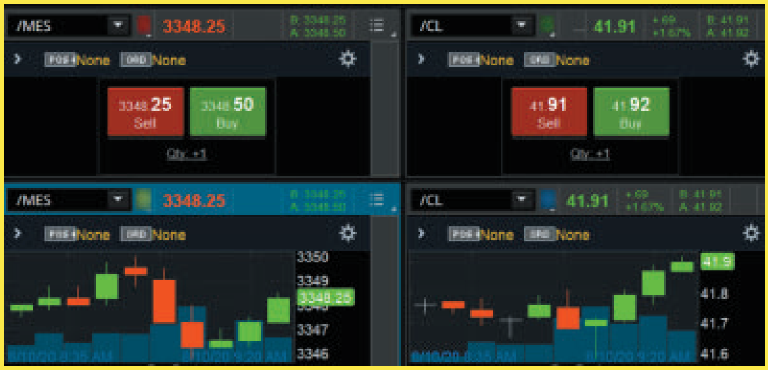

FIGURE 1: FUTURES TRADER. You can set up your thinkorswim Futures Trader page to display quotes and a chart for a futures contract.

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

If you've opened a futures account and have started trading, you may want to check out the **Active Trader** tool on the **Trade** tab (see Figure 2). Here you'll see charts, buttons, and lots of changing numbers. It can be a little intimidating, but it also provides active futures traders with a lot of vital information.

FIGURE 2: ACTIVE TRADER LAYOUT. You can set up Active Trader on the thinkorswim Trade tab to display multiple futures. Here you see a chart on the left and the Active Trader screen on the right.

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

1 – Charting. On the left is something familiar: a price chart. Enter a symbol such as /MES to bring up the chart. The platform will default to the most active contract. You can customize the chart as desired.

2 – Analyzing. Add studies such as moving averages, Fibonacci retracement levels, or the Commodity Channel Index (CCI).

3 – Placing orders. From the Control bar on the right, you can view the order-book depth, time and sales, trade price, and trade size. Prices are displayed vertically, with the prevailing price at the center. You can also see the number of contracts on the bid/ask and volume. Customize the trading buttons at the top to enter buy or sell market orders, or limit orders to buy on the bid price or sell on the ask price.

TRADING FUTURES

Futures contracts have different contract specs. Know what they are for the contracts you may want to trade. http://bit.ly/TT-Tick

SKILL
LEVEL
SAVVY

TAKE AWAY: *Explore how taxes can work in your favor.*

Form: **Special Focus**

WORDS BY **DOUG ASHBURN**
PHOTOGRAPHS BY **DAN SAELINGER**

TAXES

Section

THE BUSINESS OF RUNNING YOUR TRADING BUSINESS

1

BIG IDEA: FILING TAXES CAN BE A DRAG. WITH A LITTLE ORGANIZATION, IT CAN BE LESS PAINFUL. AS YOU PREPARE TO FILE, BE AWARE OF IMPORTANT ITEMS TO HELP MAKE THE PROCESS SIMPLER AND QUICKER.

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HEY TRADER:

We've always known you were special, a unique breed. Did you know that in some cases, the IRS thinks you're special too?

You know that no matter how you made your cash, Uncle Sam wants his slice. But sometimes it's good to stand out. So, let's consider a few special circumstances for traders your accountant might not be aware of.

FOR STARTERS ...

Chances are you know about income, capital gains, capital losses, and so-called "wash sales." This will all be important later.

There are basically two major categories of income as far as the IRS is concerned: earned income, which includes salary and wages, and investment income, which includes the profit from trades in equities, options, and other asset classes.

Suppose your earned income for the year was $100,000 and your trading income was $30,000. You'd be taxed at the prevailing marginal tax rate on your earned income and at the capital gains rate—either short term or long term, depending on how long you held your positions—on your trading income.

Now let's say that instead of earning $30,000 from your trades, you lost $30,000. You can only deduct $3,000 of the losses against your earned income, leaving you with a taxable income of $97,000.

And then there's the wash-sale rule. At its most basic, this rule prevents investors from taking an artificial loss as a means to lower their tax bill. But the fine print gets more complicated.

Ready to dive deeper? Let's talk taxes.

1 / THE TRADER'S ELECTION AND MARK-TO-MARKET

Want to balance out capital gains and losses? You can, but only if you satisfy exact IRS criteria. Here's what the guidelines say:

Special rules apply if you're a trader in securities in the business of buying and selling securities for your own account. To be engaged in business as a trader in securities, you must meet all the following conditions:

- *You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.*
- *Your activity must be substantial.*
- *You must carry on the activity with continuity and regularity.*

How do you know if you qualify as a "trading business"? Again, the IRS spells out the criteria:

- *Typical holding periods for securities bought and sold.*
- *The frequency and dollar amount of your trades during the year.*
- *The extent to which you pursue the activity to produce income for a livelihood.*
- *The amount of time you devote to the activity.*

If your trading activities don't meet the definition of a business, you're considered an investor, not a trader. It doesn't matter whether you call yourself a trader (or a day trader).

But if you've determined you're indeed "special," taking the trader election allows you to mark-to-market (an accounting method that uses prevailing market price to determine value). So, using the earlier example, if you have $100,000 in earnings and $30,000 in losses, you can net them together. But take note: The $70,000 would be treated as ordinary income.

In a word, plan ahead for the trader election. For the coming tax year, set your status when you file the previous year's taxes. If you want to apply, this is the time (for you and/or a tax-planning professional) to start the application process.

2 / THAT 60/40 SPLIT

Have you traded futures, foreign exchange, index options, or other products that are marked to market? If so, you'll need to file Form 6781, Gains and Losses from Section 1256 Contracts and Straddles.

Here's a shocker for this time of year: This requirement can be considered good news.

Section 1256 contracts get special tax treatment of 60/40. So, positions held for any amount of time will receive 60% long-term capital gains treatment and 40% short-term capital gains treatment.

As an example, if you held a futures contract for three days and had a net gain of $1,000, $600 would be taxed at the long-term capital gains rate, and $400 would be taxed as ordinary income, which is often a higher rate.

This "preferential" tax treatment doesn't stop there.

Section 1256 contracts are not subject to the same wash-sale rules as equities. Likewise, net gains and losses are carried over to Schedule D. If there's a loss on 1256 contracts, they can be carried back, that is, they can offset the current or previous year's gains.

3 / THOSE PESKY WASH SALES

A wash sale is when you sell a security at a loss and repurchase the same, or nearly identical, investment soon afterward. If you sell a stock or option for a loss, then buy the same stock or options on the same underlying stock within a 61-day window (30 days before or after the closing transaction), you can't use the loss on your original sale against your taxes. The loss is added to the cost basis of the replacement shares, deferring the loss until those shares are later sold. The holding period for the replacement shares will also be adjusted to include the holding period of the shares sold for a disallowed loss.

Remember: The IRS considers all your accounts as one entity. So, if you have accounts at two different brokerages, you can't sell for a loss in one account and buy the shares back in another. (Well, you can, but you won't be able to deduct the loss.)

DO YOU TRADE OPTIONS?

HERE ARE FOUR TAX STRATEGIES YOU COULD APPLY TO HELP PROTECT SOME GAINS FROM OPTIONS TRADING.

LEAPS®

Trading Long-term Equity AnticiPation Securities (LEAPS)—options contracts that expire up to two years and eight months in the future—can offer a tax advantage compared to buying and selling short-term options contracts. Of course, the position's holding period dictates the tax treatment. If you use LEAPS to diversify a longer-term portfolio and hold the position for more than 365 days, any profits will be treated as a long-term gain and taxed accordingly.

INDEX OPTIONS AS A HEDGE

As mentioned earlier, using Section 1256 contracts—including options on the S&P 500 Index (SPX), Nasdaq-100 (NDX), and other broad-based indices—can give you preferential tax treatment. This can come in handy if, for example, you're looking to hedge portfolio exposure without triggering a tax event. The same goes for futures contracts.

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KNOW ABOUT THE 60/40 TAX TREATMENT.

It could come in handy: http://bit.ly/TT-TrdTax

A B C D

BUYING PUT OPTIONS TO OFFSET GAINS

If your large stock position shows a substantial gain but you don't want to pocket the profit because of short-term tax consequences, you might buy stock puts to hedge the gains in the underlying. But there are risks. If the stock continues to march higher, your puts will likely lose. An option that's out of the money (OTM) at expiration will result in a loss of the entire premium (plus transaction costs). And long options tend to decay, so that "theta" meter is working against you for as long as you hold the option.

To help with theta risk, consider buying in-the-money options, because they'll have some intrinsic value and not all "time" value, initially. Of course, they can still expire worthless if they're OTM at expiration.

TRADE IN AN IRA

That's right. Trading in a self-directed retirement account, like an Individual Retirement Account (IRA), can come with benefits at tax time. Investors are only taxed when a distribution is made, so the wash sale in the traditional sense doesn't apply. However, transactions in an IRA can cause a wash sale in a taxable account. Say what? That's right, the IRS will look at the holdings in both accounts to determine if the wash-sale rule was violated in the taxable account. Brokerages vary on rules for trading within retirement accounts, so do your homework. And some don't allow options in IRAs, while others limit options trading to specific strategies.

FILING TAXES DOESN'T HAVE TO BE like trying to find your way in the dark. Now that you're aware of what to focus on before filing your taxes, the entire process may become more organized and streamlined.

THINKORSWIM® TAX TOOLS

TD Ameritrade clients have access to GainsKeeper on tdameritrade.com (after logging in to your account, go to **My Account > Tax Center**).

GainsKeeper can help you figure out the tax consequences for any trade. On the thinkorswim platform, you can export transactions in a .TXF (tax exchange format) file, which you can use with compatible tax preparation software. Use the path **Monitor > Account Statement**. Select the actions menu on the right, then **Export to file...** and upload the data.

Here's how you could use the transactions info:

1 - Find positions that were carried over from the previous tax year and not marked-to-market. Enter the date acquired and the cost basis for long positions, or enter the date sold and sales proceeds for short positions. If any fields need editing, there'll be a prompt.
2 - Remove positions held over until the next tax year.
3 - Find positions that should be marked-to-market and move them into a separate file to add to your 1040 Form 6781.
4 - Find missing data and edit as needed.
5 - Enter matched records into your Schedule D. Enter the appropriate mark-to-market index trades in Form 6781.

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

TD Ameritrade does not provide tax advice. We suggest you consult with a tax-planning professional with regard to your personal circumstances.

FIGURE 1: VISUALIZING MARKET BREADTH. **Comparing different market breadth indicators from the Charts tab on thinkorswim® can help confirm market internals.** *Source: thinkorswim from TD Ameritrade. For illustrative purposes only.*

What's the Market's Breadth?

Try this trifecta—McClellan oscillator, NYSE advance/decline line, and NYSE Tick Index.

• The term "market breadth" may sound unusual, but it can tell you plenty about how broad-based a trend is likely to be. Most financial media publish the number of NYSE stocks that closed higher and lower in a trading day. The difference between the two is commonly called market breadth.

Sometimes an index moves to new highs, yet the number of stocks in the index making new highs may not be proportional. This could raise the cautious yellow flag. And this is where market breadth indicators can provide insight.

MEASURING BREADTH

There are a bunch of breadth indicators. We'll focus on three: the McClellan oscillator, NYSE advance/decline (A/D) line, and NYSE Tick Index. These can give you a heads-up on which way the market might move or if sentiment might change, especially if indicators are at extreme levels.

Note that the breadth indicators discussed here are based on the NYSE Composite Index. So, it's best to use the indicators with a correlated index such as the S&P 500 Index (SPX). If you want to compare against another index, such as the Nasdaq Composite Index, you may want to use breadth indicators based on the Nasdaq.

McClellan oscillator. This oscillator can be plotted as a subchart, making it simpler to compare against price moves. When the oscillator is positive, it means money is coming into the market. When it's negative, money is leaving the market. At extreme levels, the oscillator indicates oversold/overbought levels. A divergence between the indicator and index could indicate a strong reversal.

WANT TO LEARN more about the A/D line? Check out http://bit.ly/TT-AdvDecLine

CHARTING MARKET BREADTH.

1 – From the **Charts** tab, add **SPX** to the symbol box for one chart.
2 – Select **Studies** and add the **McClellan Oscillator** (McClellanOscillator) and **NYSE A/D** line (AdvanceDecline).
3 – On the second chart, insert **$TICK** in the symbol box and place chart below the SPX chart.

NYSE advance/decline (A/D) line. This is a daily running total of the number of NYSE advancing stocks minus declining stocks. If the SPX and NYSE A/D line correlate, it could indicate the trend is likely to continue. But if the indicator is at an extreme level, and the index's moves aren't correlated, this could merit caution.

NYSE Tick Index ($TICK). This tracks the number of stocks trading on an uptick minus the number trading on a downtick. The tick index is typically used by day traders, but many traders use it to help make entry and exit decisions. An extreme $TICK reading can indicate selling or buying exhaustion. When the $TICK moves, say, between +400 and -400, it may suggest choppiness. If $TICK is at an extreme level and price is at a relative high, you may be seeing the day's high.

IF ALL THREE INDICATORS "CONFIRM," that's a pretty good indication of potential market moves. For more confirmation, take your charting expertise one step further: Consider adding other technical indicators such as moving averages and Fibonacci retracements.—Words by JAYANTHI GOPALAKRISHNAN

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

While this article discusses technical analysis, other approaches, including fundamental analysis, may assert very different views.


SKILL
LEVEL
PRO
TAKE AWAY:
Understand how options greeks move together through the life of a trade.

Don't Follow the Money

Follow the Greeks

BIG IDEA:
WHEN TRADING STOCKS, WINNERS AND LOSERS ARE BASED ON HOW MUCH YOUR STOCK MOVES AFTER YOU GET IN THE TRADE. WITH OPTIONS, YOU NEED TO CONSIDER PRICE, TIME, AND VOLATILITY—ALL AT THE SAME TIME. TO DO THAT, YOU'LL NEED TO UNDERSTAND THE INTERPLAY OF A FEW OPTIONS GREEKS AND HOW, WHEN COMBINED, THEY PLAY OFF ONE ANOTHER.
WORDS BY **KEVIN LUND**

Here's what we know. Options aren't stocks. And you can't just track profit and loss (P&L) in a vacuum based on what the underlying stock is doing—making it tough to figure out your exit strategy. For that, you've got to consider stock price, time, and volatility (vol), which are measured individually by the options "greeks"—delta, theta, and vega. Knowing how each greek works alone is one thing. You should also know how they play off one another during the life of your trade. Master this, and you're well on your way to mastering the art of the exit.

COMPARING TWO TRADES
Let's examine the greeks with a holistic approach. We'll consider two different trades—a long call and a long call spread—from the time each trade is placed, to three days later, and then at the end of one week. We'll also look at what can theoretically happen to those trades if the stock moves up or down $5, or if the price is unchanged.

On the day of the trade, suppose the underlying stock is at $125, and both trades expire in 30 days. Out of the gate, the trades have the following greeks:

PHOTOGRAPHS BY DAN SAELINGER

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.

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 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 options contract's delta is expected to change per $1 move in the underlying.

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.

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.

Out of the money (OTM)—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.

Straddles (long)—A market-neutral, defined-risk position composed of an equal number of long calls and puts of the same strike price. The strategy assumes the market will break out one way or another, in which case, a profit occurs when one side of the trade gains more than the other side loses. Break-even points are calculated by adding and subtracting the total debit to and from the strike price of the options.

Strangles (short straddle)—A market-neutral strategy with unlimited risk composed of an equal number of short calls and puts of the same strike price (straddle) or two different strike prices (strangle), resulting in a credit taken in at the onset of the trade. The strategy assumes the underlying will stay within a certain range, in which case, as time passes and/or volatility drops, the options can be bought back cheaper than the credit taken in or expire worthless, resulting in a profit. Break-even points of either strategy at expiration are calculated by adding the total credit received to the call strike and subtracting the total credit received from the put strike.

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—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.

Volume and Open Interest: What's the Difference?

Not much, but used together, volume and open interest can help you gauge the liquidity of options contracts.

• If there's no liquidity, there won't be a whole lot of trading. Liquidity moves the markets, but it's a piece of the trading puzzle that option traders tend to overlook. Most option traders look at strike prices, put/call prices, expiration, volatility, and options greeks. That's all fine. But once you decide to place a trade, wouldn't you like to get filled at a fair price? This is why knowing the liquidity of a particular contract is important.

Identifying liquidity in options contracts involves looking at the volume and open interest (OI) of different expiration/strike combos. This can help you figure out which contracts are the most active. In general, traders often assume volume and OI tell you the same thing, and they sort of do—but there are subtle differences. And they often work together, which is why you need to look at both when trying to find the contracts with the most activity.

TRADER JARGON
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LET'S START WITH VOLUME

More volume—the total number of contracts traded in any given day—means more liquidity. During the trading day, any traded contract—whether a buy or sell—gets added to volume. Volume goes up during the trading day and resets to zero at the start of the next trading day. When you compare different contracts in an option chain, you can start to glean which ones might have more trading activity.

SO, WHAT'S OPEN INTEREST?

OI calculates the total number of open options contracts—trades that have been transacted but haven't been exercised, assigned, or closed. Unlike volume, OI can go up or down, and it doesn't reset every day. Let's look at an example to illustrate. Assume all these trades occurred on the same day:

- Adam purchases five calls from Betty. Volume = 5; OI = 5.
- Betty buys one call back from Adam. Volume = 6, OI=4.
- Charles sells two calls to Danielle. Volume =8, OI=6.
- Charles buys a call from Adam. Volume = 9; OI = 6.

Because Charles is opening one contract and Adam is closing one, OI doesn't change; it's even or net zero.

Basically, OI tells you how much trading activity is going on between now and expiration.

WHAT'S THIS GOT TO DO WITH TRADING?

When looking at volume and OI, you want to locate the action. Generally, you'll see more liquidity in the at-the-money strikes, but there may be times when there's more activity in the out-of-the-money or in-the-money strikes.

When liquidity is higher, you'll usually see tighter bid/ask spreads. When it's lower, the spread between the two will likely be wider. A tighter bid/ask spread could give you a quicker fill at a fairer price.

BESIDES HELPING YOU decide which strikes to trade, keeping an eye on liquidity gives you an idea of what traders are thinking. This can be helpful ahead of earnings and other news events. Sometimes volume may be much higher than OI. At other times, the opposite. The trick is to find a good blend between volume and OI. And that requires a bit of art, science, and practice.

HOW TO LOOK UP VOLUME AND OPEN INTEREST.

On the thinkorswim® platform from TD Ameritrade, from the **Analyze** tab, bring up the **Option Chain**. Then select **Volume**, **Open Interest** from the **Layout** menu.

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

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

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 are provided by TD Ameritrade Futures & Forex LLC. Trading privileges are subject to review and approval. Not all clients will qualify.

Futures and futures options trading are speculative and are 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).*

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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