

Futures & Options

September 2009 • Volume 3, No. 9

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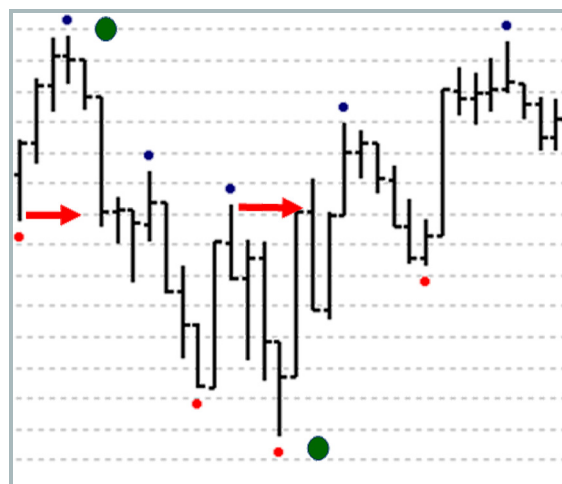
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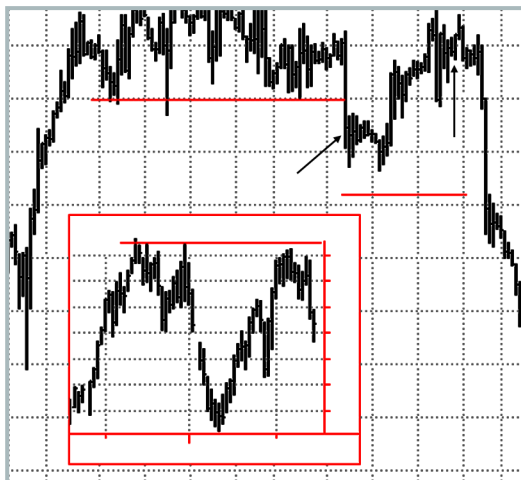
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Futures & Options TRADER

A publication of Active Trader®

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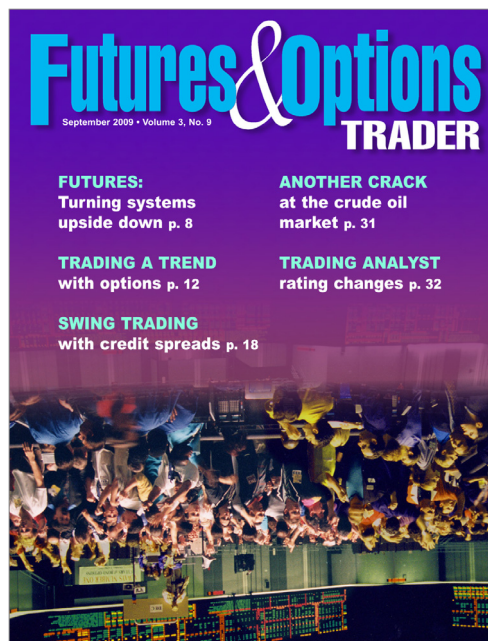
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Turning systems upside down

Inverting the rules of two popular trading techniques produces much better results than their standard applications.

ART COLLINS

Note: A version of this article originally appeared in the February 2007 issue of Active Trader magazine.

“Reversal bars” have several definitions, but the basic concept is a bar that makes a new high or low but then reverses to close in the opposite direction, implying a shift in momentum and a potential directional change.

Figure 1 shows an example of a reversal high bar (sell signal) in the 30-year T-bond futures (US). At the highlighted top, the market traded above the previous day's high but closed lower. A reversal low bar (buy signal) is the opposite — a lower low and a higher close.

What significance does the pattern really have? This is the question a serious market scientist would ask, while the more casual trader might prefer not to dig that deep. It's comforting to trust in daily reversals because they are both visually and theoretically appealing: A market breaks out to new territory, but it can't hold the move through the end of

the day. The change in direction seems like an obvious signal; something big is sure to follow.

A mechanical trader's job, however is to never take such general observations for granted, but to put the signal through its paces.

Testing

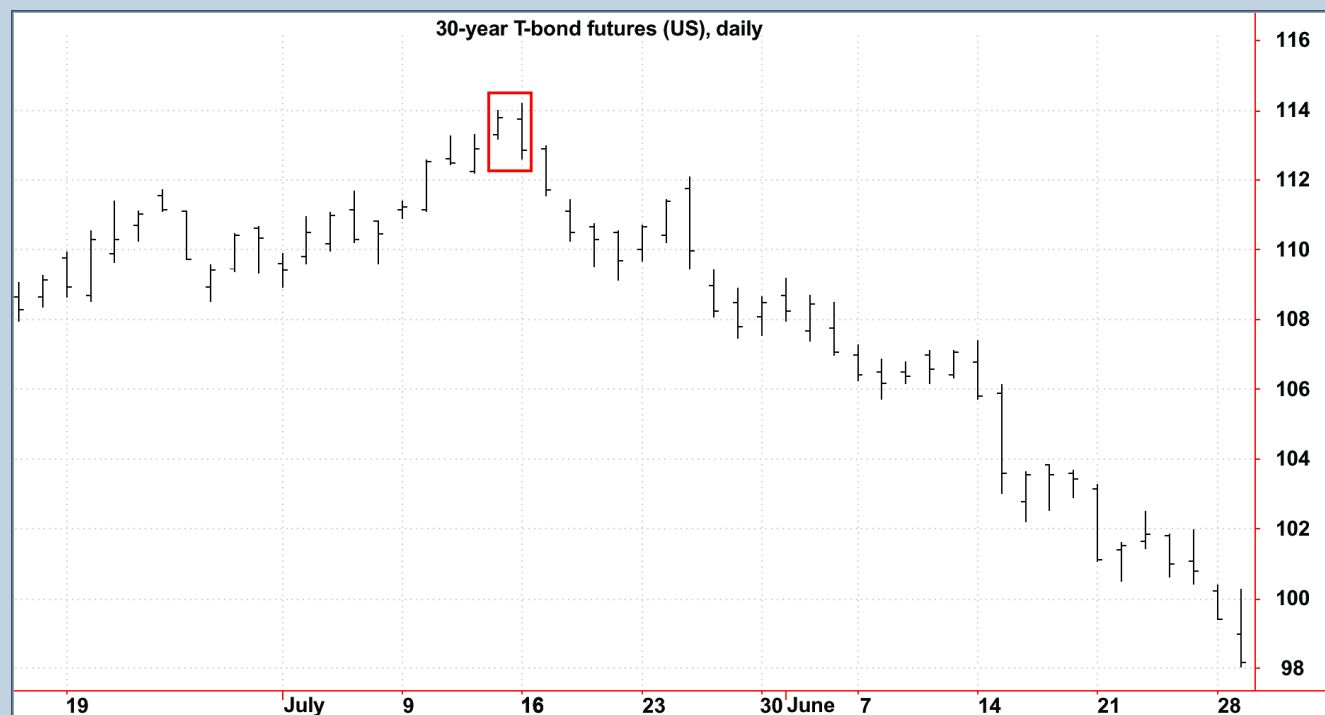
Let's start with a basic test of the first-day follow-through: What happens after entering on the close of a reversal day and exiting on the following close?

To increase the chances that a reversal bar will occur at a price extreme, for this test a reversal high day was defined as a day that exceeds the high of a day that is higher than the previous nine highs. The opposite would be true for reversal low days. Figure 2 shows these signals in the S&P futures.

Table 1 shows results of entering on the close of these reversal bars and exiting on the next day's close in nine

FIGURE 1 — NINE-DAY REVERSAL, FIRST-DAY FOLLOW-THROUGH

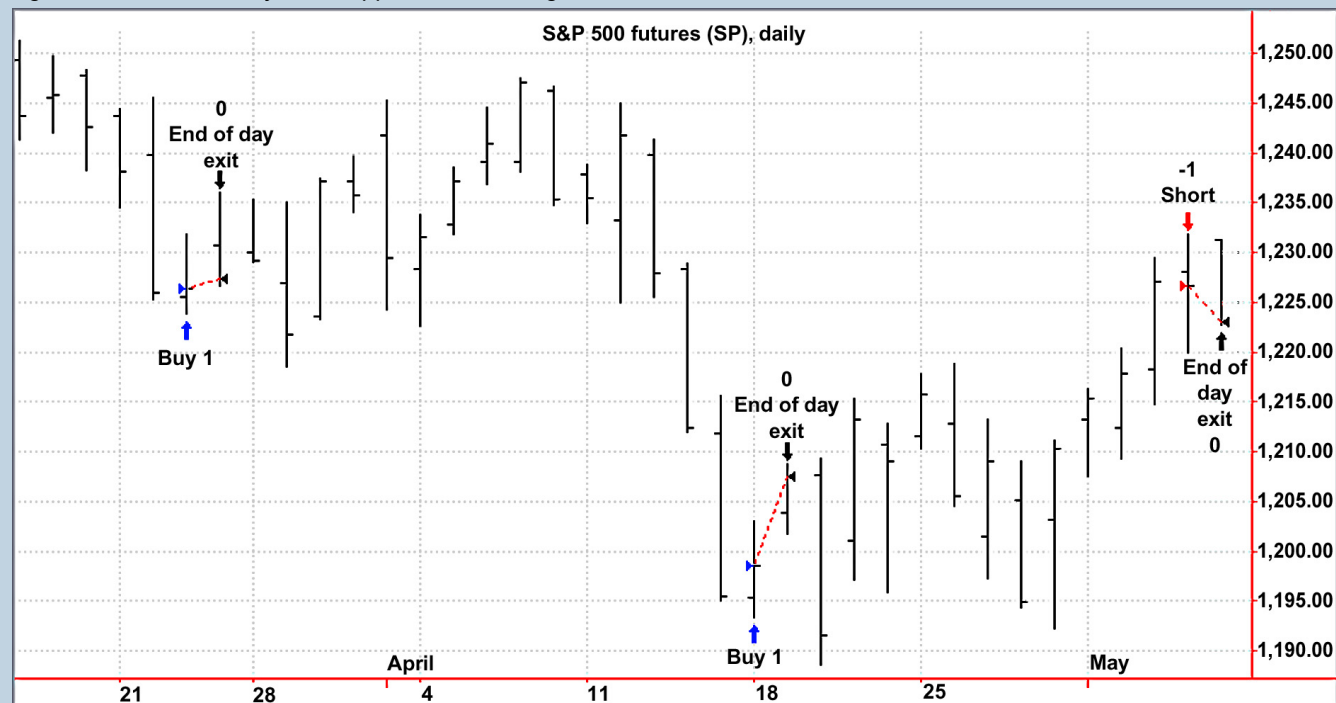
At the highlighted top, the market traded above the previous day's high then reversed intraday to close below the previous low.



Source: TradeStation

FIGURE 2 — NINE-DAY REVERSAL SIGNALS

For the test, a reversal high day was defined as a day that exceeds the high of a day that is higher than the previous nine highs; a reversal low day is the opposite. These signals are shown here for the S&P 500 futures.



Source: TradeStation

financial futures markets (regular pit session-hours only) from Jan. 2, 2000 through Nov. 28, 2006. (No slippage or commissions were included in these tests.)

The signal is obviously no great shakes. Even the Russell's \$40,825 profit is diminished by its sizeable \$26,175 drawdown. The resulting return-on-account (ROA), which is derived by dividing the former figure by the latter and then multiplying by 100, produces a mere 156-percent increase over the five-and-a-half-year test period.

Adjusting the nine-day high/low qualifier didn't nudge the signal into mechanical-system territory; running optimization tests for ROA from two days to 50 days produced good results in different markets at different times. For example, the best ROA results for the five-year T-note and the Japanese yen occurred using two days, while the T-bonds' best ROA occurred using 50 days.

Tables 2 and 3, which include the results of using two days and 50 days, respectively, show how the best performance in a given market spans the entire optimization field — not something you want to see in a robust, one-size-fits-all system idea.

Another modification — altering the exit day — did not produce the robustness and consistency necessary to have faith in a system based on this signal. Table

4 shows the results (in the full-sized S&P 500 futures) of exiting on the closes of each the first 10 days after the reversal bar. Again, there was no evidence a certain "neighborhood" of values was better than any other.

Table 5 shows the original nine-day system without the exit rule, which simply reverses direction when a signal in the opposite direction occurs. The results are all over the board.

Reversal days may provide occasional picture-perfect examples for a "Trading 101" lecture, but the tests indicate that in reality, they generate many false signals. However, our eyes simply aren't as easily drawn to the misfires as they are to the signals that pan out.

continued on p. 10

TABLE 1 — NINE-DAY REVERSAL, FIRST DAY FOLLOW-THROUGH

Entering on the close of the nine-day reversal bars and exiting on the next day's close produced mixed results in nine financial futures markets.

| Market | Symbol | Net profit | # Trades | % Profit | Profit/trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|--------------|----------|--------|
| S&P 500 (full) | SP | -\$7,000 | 105 | 45.71% | -\$66.67 | \$33,325 | -21.01 |
| Nasdaq 100 (full) | ND | \$2,025 | 115 | 45.22% | \$17.61 | \$46,500 | 4.355 |
| Russell 2000 (full) | RL | \$40,825 | 119 | 47.90% | \$343.07 | \$26,175 | 156 |
| T-bonds | US | -\$1,156 | 85 | 41.18% | -\$13.60 | \$3,781 | -30.57 |
| 10-yr. T-notes | TY | \$703 | 73 | 45.21% | \$9.63 | \$3,156 | 22.28 |
| 5-yr. T-notes | FV | -\$2,000 | 58 | 41.38% | -\$34.48 | \$2,656 | -75.3 |
| Japanese yen | JY | -\$4,350 | 42 | 45.24% | -\$103.57 | \$8,375 | -51.94 |
| Eurocurrency | EC | -\$14,638 | 60 | 45.00% | -\$243.96 | \$16,963 | -86.29 |
| Swiss franc | SF | -\$1,875 | 51 | 50.98% | -\$36.76 | \$5,013 | -37.4 |

Source: TradeStation


TABLE 2 — TWO-DAY REVERSAL

The five-year T-notes (FV) and the Japanese yen (JY) produced the best ROAs using a two-day reversal.

| Market | Symbol | Net profit | # Trades | % Profit | Profit/ trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|---------------|-----------|--------|
| S&P 500 (full) | SP | \$20,075 | 195 | 48.21% | \$102.95 | \$45,600 | 44.02 |
| Nasdaq 100 (full) | ND | -\$71,850 | 213 | 46.01% | -\$337.32 | \$113,375 | -63.37 |
| Russell 2000 (full) | RL | \$900 | 219 | 47.03% | \$4.11 | \$61,150 | 1.472 |
| T-bonds | US | \$10,906 | 165 | 47.27% | \$66.10 | \$7,781 | 140.2 |
| 10-yr. T-notes | TY | \$12,765 | 162 | 50.62% | \$78.80 | \$3,625 | 352.1 |
| 5-yr. T-notes | FV | \$4,313 | 129 | 51.94% | \$33.43 | \$3,172 | 136 |
| Japanese yen | JY | -\$2,500 | 87 | 43.68% | -\$28.74 | \$8,713 | -28.69 |
| Eurocurrency | EC | -\$15,213 | 103 | 44.66% | -\$147.69 | \$17,650 | -86.19 |
| Swiss franc | SF | \$1,550 | 103 | 49.51% | \$15.05 | \$7,800 | 19.87 |

Source: TradeStation

TABLE 3 — 50-DAY REVERSAL

The 30-year T-bonds produced the highest best ROA performance using 50 days. Tables 2 and 3 together illustrate that altering the number of days used to qualify the reversal in the S&P 500 futures did not improve results.

| Market | Symbol | Net profit | # Trades | % Profit | Profit/ trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|---------------|----------|--------|
| S&P 500 (full) | SP | \$36,275 | 48 | 56.25% | \$755.73 | \$19,200 | 188.9 |
| Nasdaq 100 (full) | ND | -\$6,300 | 50 | 42.00% | -\$126.00 | \$30,625 | -20.57 |
| Russell 2000 (full) | RL | \$44,775 | 54 | 57.41% | \$829.17 | \$20,250 | 221.1 |
| T-bonds | US | \$6,281 | 37 | 51.35% | \$169.76 | \$3,219 | 195.1 |
| 10-yr. T-notes | TY | \$2,078 | 36 | 52.78% | \$1,594.00 | \$3,625 | 57.32 |
| 5-yr. T-notes | FV | -\$563 | 35 | 48.57% | \$16.07 | \$2,047 | -27.5 |
| Japanese yen | JY | -\$4,713 | 17 | 23.53% | -\$277.21 | \$5,850 | -80.56 |
| Eurocurrency | EC | -\$4,250 | 26 | 50.00% | -\$163.46 | \$6,713 | -63.31 |
| Swiss franc | SF | -\$250 | 21 | 52.38% | -\$11.90 | \$2,263 | -11.05 |

Source: TradeStation

TABLE 4 — CHANGING THE EXIT DAY

Altering the exit day also failed to improve the signal's overall consistency. There was no evidence a certain "neighborhood" of values was better than any other in the S&P 500 futures.

| Exit day | Net profit | # Trades | % Profit | Max DD | ROA % |
|----------|------------|----------|----------|----------|---------|
| 1 | -\$7,000 | 105 | 45.71% | \$33,325 | -21.005 |
| 2 | \$24,875 | 102 | 52.94% | \$30,575 | 81.3573 |
| 3 | -\$625 | 98 | 47.96% | \$46,650 | -1.3398 |
| 4 | -\$11,875 | 96 | 44.79% | \$64,525 | -18.404 |
| 5 | -\$750 | 88 | 43.18% | \$65,675 | -1.142 |
| 6 | -\$33,375 | 84 | 45.24% | \$88,325 | -37.787 |
| 7 | \$10,425 | 84 | 45.24% | \$81,525 | 12.7875 |
| 8 | -\$34,075 | 82 | 41.46% | \$93,600 | -36.405 |
| 9 | \$3,975 | 77 | 45.24% | \$53,125 | 7.48235 |
| 10 | \$1,925 | 77 | 48.05% | \$67,175 | 2.86565 |

Source: TradeStation

Inverting the signal

Experimenting with other aspects of reversal days led to potentially more viable signals:

1. If yesterday's high was above the previous high and its close was below the previous close (a normal reversal high), then buy the next bar at market.
2. The entry day's ultimate high is the profit target.
3. The stop loss is the entry day's low, minus one tick.
4. In the event of an inside day, keep the orders intact for the following day(s) until a trade is triggered.

Reverse the rule for reversal low days and short trades.

You're reading this correctly — the rules are designed to buy after reversal high days and sell after reversal low days. Table 6 shows the interesting results.

Granted, this isn't a perfect system, but it is more consistently profitable than traditional rules.

Turning the RSI inside-out

For comparison, let's look at an approach based on the [relative strength index \(RSI\)](#), which is most commonly used as an overbought/oversold oscillator. A reading at or above 70 suggests price is overbought (implying a down move) while a reading at or below 30 suggests an oversold condition (implying an up move).

Even strict traditionalists, however, know that both overbought and oversold readings can persist for extended periods when price is in a strong trend.

The strategy uses a nine-bar RSI applied to five-minute price bars:

1. If the daily trade session is 45

minutes or older and the RSI is 85 or higher, then buy on the next bar's opening; continue attempting to enter the trade up until a half hour before the close.

- Exit all trades 5 minutes before the close.

Reverse the rules for short trades (using an RSI reading of 15 or lower).

Table 7 shows the results of a test from Jan. 2, 2001 to Nov. 29, 2006 for the stock index contracts and May 15, 2001 to Nov. 20, 2006 for the others. This test used E-Mini index futures instead of the full-sized, but the system uses only the regular day-session hours (8:30 a.m. to 3:15 p.m. CT for the indices, and 7:20 a.m. to 2 p.m. CT for the other markets).

Again, although the system is not outstanding, it is obviously better than the traditional use of the RSI (buying when the indicator is oversold and selling when it is overbought), which would have produced the opposite profit and loss statistics of those in Table 7.

Do these tests suggest traditional tools are useless, or could they somehow be validated in combination with other robust methodologies?

Considering the possible permutations, you can't debunk anything out of hand — but this is the wrong question to ask, anyway. Does it really matter whether an idea dovetails or contradicts a popular concept? All that matters is what can be demonstrated through research. If you trust analysis you constructed from the ground up, axioms don't matter too much. 🐼

For information on the author see p. 6.

TradeStation code for the signals in this article can be found at www.activetrader.com/code.htm.

TABLE 5 — ALWAYS IN (NO EXIT DAY)

The basic nine-day reversal system (without the exit rule) was very inconsistent.

| Market | Symbol | Net Profit | # Trades | % Profit | Profit/Trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|--------------|-----------|--------|
| S&P 500 (full) | SP | -\$2,450 | 41 | 63.41% | -\$59.76 | \$66,050 | -3.709 |
| Nasdaq 100 (full) | ND | -\$73,025 | 49 | 71.43% | -\$1,490.31 | \$259,975 | -28.09 |
| Russell 2000 (full) | RL | -\$76,825 | 44 | 52.27% | -\$1,746.02 | \$216,625 | -35.46 |
| T-bonds | US | \$13,375 | 36 | 58.33% | \$371.53 | \$7,063 | 189.4 |
| 10-yr. T-notes | TY | -\$1,734 | 31 | 61.29% | -\$55.95 | \$13,281 | -13.06 |
| 5-yr. T-notes | FV | -\$3,641 | 21 | 52.38% | -\$173.36 | \$8,828 | -41.24 |
| Japanese yen | JY | \$41,850 | 24 | 83.33% | \$1,744.00 | \$11,313 | 369.9 |
| Eurocurrency | EC | -\$6,388 | 28 | 57.14% | -\$224.55 | \$31,350 | -20.38 |
| Swiss franc | SF | -\$14,988 | 20 | 50.00% | -\$749.38 | \$32,813 | -45.68 |

Source: TradeStation

TABLE 6 — INVERTING REVERSAL DAY SIGNALS

Buying after reversal high days and selling after reversal low days was more consistently profitable than trading any of the traditional rules.

| Market | Symbol | Net profit | # Trades | % Profit | Profit/trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|--------------|-----------|--------|
| S&P 500 (full) | SP | \$5,300 | 424 | 57.08% | \$12.50 | \$77,025 | 6.881 |
| Nasdaq 100 (full) | ND | \$194,025 | 431 | 61.95% | \$450.17 | \$106,800 | 181.7 |
| Russell 2000 (full) | RL | \$56,800 | 424 | 61.32% | \$133.96 | \$107,500 | 52.84 |
| T-bonds | US | \$7,469 | 384 | 63.80% | \$19.45 | \$19,843 | 37.64 |
| 10-yr. T-notes | TY | \$2,141 | 384 | 62.50% | \$5.57 | \$12,641 | 16.94 |
| 5-yr. T-notes | FV | \$12,078 | 342 | 62.28% | \$35.32 | \$4,859 | 248.6 |
| Japanese yen | JY | -\$12,739 | 236 | 65.68% | -\$53.97 | \$17,850 | -71.37 |
| Eurocurrency | EC | \$4,475 | 300 | 62.00% | \$14.92 | \$15,463 | 28.94 |
| Swiss franc | SF | \$1,500 | 281 | 63.35% | \$5.34 | \$13,838 | 10.84 |

Source: TradeStation

TABLE 7 — RSI INVERSION

Reversing the RSI's traditional overbought and oversold signals improved the indicator's performance.

| Market | Symbol | Net profit | # Trades | % Profit | Profit/trade | Max DD | ROA % |
|---------------------|--------|------------|----------|----------|--------------|----------|--------|
| E-Mini S&P 500 | ES | \$5,388 | 331 | 53.47% | \$16.28 | \$9,388 | 57.39 |
| E-Mini Nasdaq 100 | NQ | \$18,900 | 377 | 55.70% | \$50.13 | \$10,380 | 182.1 |
| E-Mini Russell 2000 | ER2 | \$7,990 | 402 | 56.22% | \$19.88 | \$5,580 | 143.2 |
| 30-yr. bonds | US | \$4,125 | 359 | 49.58% | \$11.49 | \$6,688 | 61.68 |
| 10-yr. notes | TY | \$10,203 | 345 | 55.36% | \$29.57 | \$3,265 | 312.5 |
| 5-yr. notes | FV | \$5,578 | 373 | 50.67% | \$14.95 | \$2,406 | 231.8 |
| Japanese yen | JY | -\$7,938 | 256 | 45.70% | -\$31.01 | \$11,038 | -71.92 |
| Eurocurrency | EC | \$26,800 | 347 | 53.60% | \$77.23 | \$3,300 | 812.1 |
| Swiss franc | SF | \$1,613 | 340 | 52.06% | \$4.74 | \$4,738 | 34.04 |

Source: TradeStation



Trading a trend: Adding options to futures

Options can make it easier to take advantage of a longer-term trend,
but you have to get the details right.

BY KEITH SCHAP

Note: A version of this article originally appeared in the March 2007 issue of Active Trader magazine.

Consider how you might feel if you went long the 5-year T-note futures (FV) at 102-28 and the price soared to 105-28 — and then fell back to 104-19.5. If this was a 10-contract trade, the move from 102-28 to 105-28 would have been worth \$30,000, but the retreat to 104-19.5 would have cost you \$12,656.25, leaving you with a \$17,343.75 profit. Not bad, but you would probably chafe at giving back so much of a big gain. Fair enough.

In fact, these prices represent a long-term trade from the latter part of 2006: 102-28 was the December 2006 5-year T-note futures (FVZ06) closing price on June 28, 2006, 105-28

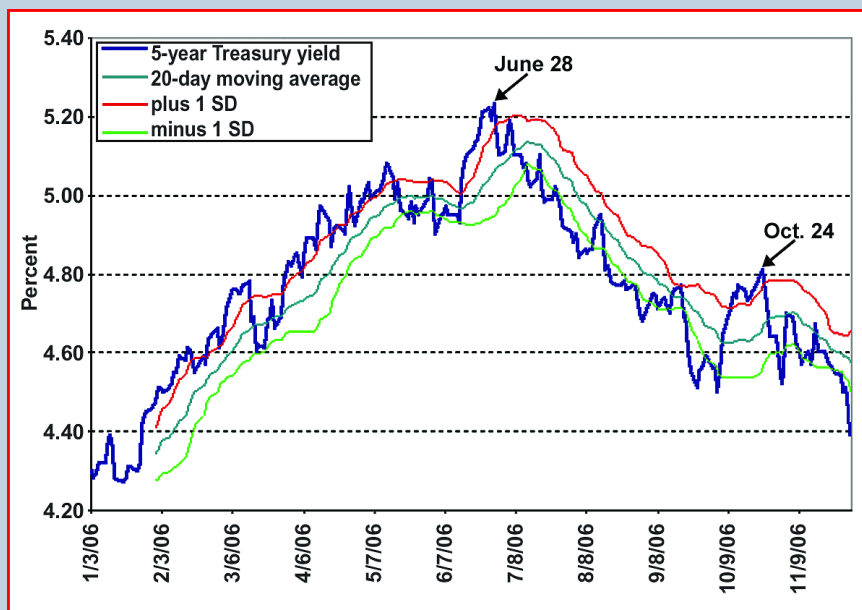
was the price more than three months later on Oct. 4, and the retreat to 104-19.5 was the Oct. 24 price.

Trades spanning such long periods might seem rare outside institutional circles and, indeed, there are probably as many reasons for not making such trades as there are traders who don't want to make them. For starters, margin on 10 FVZ06 contracts would have tied up \$6,000 of your capital for a long time. This might have kept you from taking other trade opportunities. Also, this kind of trade can be hard on your nerves because there is always the possibility the market will make a sudden move and take back some, if not all, of your gain.

Nonetheless, from time to time situations arise in which long-term trades, coupled with strategic option positions, make good sense. It pays to understand what can happen during such trades and to develop strategies for dealing with potentially damaging events.

FIGURE 1 — FIVE-YEAR T-NOTE YIELD

After the late-June high, the yield on the 5-year T-note trended steadily lower until late September and early October, at which point it bounced sharply, reaching 4.81 percent on Oct. 24.



Strategy snapshot

Strategy: Protective option for long-term trend trade.

Market: Any market with tradable options.

Logic: Using put options to protect against a down move while in a profitable, longer-term trend trade.

Components: Long OTM put option(s) with the appropriate position size determined by dividing the number of futures contracts by the option's delta.

Market background

On June 28, the day before the final Fed rate hike in 2006, the 5-year T-note yield (see “Treasury basics”) was 5.20 percent — its highest level to that point in 2006. Figure 1 shows the yield picture from Jan. 3 to Nov. 30. The yield trended steadily lower until late September and early October, hitting 4.51 percent on Sept. 25, then bouncing up slightly and touching 4.49 percent on Oct. 4. From there it moved sharply higher, climbing all the way to 4.81 percent on Oct. 24.

The December 5-year T-note futures prices in Figure 2 are a mirror image of the yield series in Figure 1 from May to December. The price trends steadily upward from the June 28 low of 102-28 to the Sept. 25 high of 105-27. After the Sept. 25 peak, the price dipped, then climbed back to 105-28 on Oct. 4. The next 20 days would have been ugly for long position holders, but the market then climbed back to reach 106-10 on Dec. 1.

Figure 2 also includes a 20-day moving average with one-standard-deviation (SD) boundaries above and below it (i.e., modified Bollinger Bands; for more information on Bollinger Bands, see “Key Concepts”). Note the sharp move above the upper SD level that led to the Sept. 25 high. Nearly the entire Sept. 25 to Oct. 4 price move remained above the upper SD level. These developments could be interpreted as a sign the market was potentially getting overextended and traders should be ready to unwind a long position or go short.

Modeling the price action around the September high produced more tangible data.

Between August 2002 to Sept. 6, 2006, the market was lower three of five times 10 days after the following pattern: three consecutive days with lows above the upper SD boundary, with the final day's close being lower than the previous two closes. (This pattern also occurred at the Dec. 5-6 top.)

Treasury basics

Treasury bonds and notes (T-bonds and T-notes) are securities issued by the U.S. Treasury. By purchasing these securities you are, in effect, loaning money to the government, which then pays you interest (determined by a “coupon rate”) on a semiannual basis and returns the principle when the bond or note reaches its maturity date.

The minimum face value is \$1,000. For example, if you purchased a \$1,000 five-year T-note with a 4-percent coupon rate, you would receive \$20 every six months (\$40 per year) and the \$1,000 principle would be paid back to you on the maturity date five years from now.

Yield represents the total return (interest plus principal) of the bond or note held to maturity and assuming all interest payments are reinvested at a constant rate.

Five-year T-note futures (FV) trade in 1/64th increments (actually, halves of 32nds); each tick is worth \$15.625. Prices are displayed several ways — 105 21/32, 105²¹/32, 105-21, and so on. The prices in this article separate the 32nds in a price quote with a dash — e.g., 106-10 represents 106-10/32; 64ths are separated from 32nds by a decimal point — e.g., 106-10.5 represents 106-10.5/32 (ten and a half 32nds, or 21/64ths).

FIGURE 2 — FIVE-YEAR T-NOTE FUTURES PRICES

T-note prices move inversely to yield. This segment of 5-year T-note futures prices from May through December 2006 are a mirror image of the same period in Figure 1. After the Sept. 25 peak, prices dipped, then climbed back to 105-28 on Oct. 4. The market dropped sharply over the next several days.



Another bit of price modeling also indicated the market was susceptible to selling in the coming days. After the market made three consecutive closes above the upper SD boundary, followed by a day with a lower high, lower low, and lower close, the 5-year T-note futures were lower 10 days later 52 percent of the time (based on 54 sample pat-

continued on p. 14

**TABLE 1 — DECEMBER 5-YEAR T-NOTE PUT OPTIONS WITH GREEKS**

If you were long FVZ06 futures in early October with the market trading around 105-28, you could have chosen from among the December 105.5, 105.0, and 104.5 puts to protect against losses.

| | Price (64ths) | Price (\$) | Delta | Gamma | Theta | Vega |
|---------------|---------------|------------|---------|--------|---------|--------|
| Dec 105.5 put | 17 | 265.625 | -0.3576 | 0.5487 | -0.2798 | 8.8513 |
| Dec 105.0 put | 8 | 125.000 | -0.2009 | 0.4131 | -0.2106 | 6.6735 |
| Dec 104.5 put | 3 | 46.875 | -0.0944 | 0.2476 | -0.1257 | 4.0081 |

TABLE 2 — FINDING THE RIGHT NUMBER OF PUT OPTIONS

Option delta can be used to help you find the appropriate number of options to match an underlying futures position: divide the number of futures contracts by the deltas of the different options.

| | No. of futures | Put delta | No. of puts |
|---------------|----------------|-----------|--------------|
| Dec 105.5 put | 10 | 0.3576 | 27.96 (28) |
| Dec 105.0 put | 10 | 0.2009 | 49.78 (50) |
| Dec 104.5 put | 10 | 0.0944 | 105.93 (106) |

terns between 2002 and 2006).

Given such conditions, the real question is what to do about it. The obvious move for many traders would be to exit the position. However, an often overlooked alternative would be to hold the position and buy an out-of-the-money (OTM) December 5-year T-note put option. The obvious reason for buying such an option is to protect against a downturn, but it also buys time.

Finding the best option

The put position requires careful

thought — you cannot simply buy 10 puts to protect 10 futures contracts and expect satisfactory results.

If you were still long in early October with FVZ6 trading around 105-28, the choices for December puts on FVZ6 would have included the 105.5, 105.0, and 104.5 strike prices. Table 1 shows the prices and “Greeks” for these options, with 45 days remaining until the expiration, 2.85 percent implied volatility, and a 5.20-percent interest rate. (The dollar prices result from dividing 17, 8, or 3 by 64 and multiplying by 1,000.)

Among other things, option delta can help you find the correct number of options to match the price sensitivity of your futures position. In Table 2, dividing the number of futures contracts (10) by the deltas of the different options shows you would need to buy 28 of the December 105.5 puts, 50 of the December 105.0 puts, or 106 of the December 104.5 puts.

You might be wondering why you should even think about buying 106 December 104.5 puts when you can get by with only 28 December 105.5 puts. There are two issues here: cost vs. the greater overall effectiveness of farther OTM options. As we shall see, the December 104.5 put is the least expensive option, and also the most productive — both in terms of dollars earned and percentage return on investment (ROI), which is the final trade value divided by the initial position value, multiplied by 100.

By Oct. 24, not only had the FVZ6 price dropped to 104-19.5, but implied volatility had fallen to 2.62 percent. Declining implied volatility is not good news for option holders. In this case, however, the futures price change more than overcame the negative effects of falling volatility and time decay. At this point, with 25 days to expiration (and the same 5.20-percent interest rate) the December 105.5 put price was 58/64, the December

TABLE 3 — THE OTM OPTION

With a put option in place, you can afford to wait and see what develops, confident knowing the option is protecting you against a loss. In this case, the farthest out-of-the-money option generated the best return on investment.

| Puts on FVZ6 | Initial cost of 1 put | Initial position value | Ending cost of 1 put | Final position value | Result | ROI |
|------------------------|-----------------------|------------------------|----------------------|----------------------|-------------|------|
| Buy 28 Dec 105.5 puts | -\$265.625 | -\$7,437.50 | \$906.250 | \$25,375.00 | \$17,937.50 | 241% |
| Buy 50 Dec 105.0 puts | -\$125.000 | -\$6,250.00 | \$515.625 | \$25,781.25 | \$19,531.25 | 313% |
| Buy 106 Dec 104.5 puts | -\$46.875 | -\$4,968.75 | \$234.375 | \$24,843.75 | \$19,875.00 | 400% |

105.0 put price was 33/64, and the December 104.5 put price was 15/64. Compared to the 105.5 put's price of 58/64, the 104.5 put's 15/64 price seems weak, but in reality, it isn't.

Table 3 shows the initial and ending prices for single options, the initial and ending position values (the option price multiplied by the number of options), the position results, and the ROIs. (The negative numbers in the "Initial cost of 1 put" and "Initial position value" columns indicate long options.) Based on the ROIs, being long 106 December 104.5 puts might be the optimal way to buy time in this situation. After all, given these assumptions, this put costs less and earns more.

Option traders are accustomed to one reason for buying time. When you buy options, the more time to expiration, the higher the cost because more time equals more opportunity for something good to happen. In this situation, however, there is another reason to buy time. Obviously, once you become certain a downturn is the beginning of a longer-term trend, you will want to unwind your long futures position. With the put position in place, you can afford to wait and see what develops, confident in the knowledge the option is protecting you against a loss.

Also, using the OTM strike price means your option position may even generate a small gain in addition to providing loss protection. If you decide this down move is only a temporary hiccup in the upward trend, the put will generate an incremental gain, and you will still have your long futures position in place.

The dream vs. the reality

In a Lake Wobegon world — you know, where we're all above average

TABLE 4 — THE DREAM VS. THE REALITY

A trader with the ability to pick tops and bottoms perfectly could have racked up the hefty profit shown here, but such performance is not realistic.

| Date | Action | Price | Position \$ value | Result |
|----------|-------------------------|---------|-------------------|------------------|
| 6/28/06 | Buy 10 FVZ6 | 102-28 | 1,028,750.00 | |
| 10/4/06 | Sell 10 FVZ6 | 105-28 | 1,058,750.00 | 30,000.00 |
| 10/4/06 | Buy 106 Dec 104.5 puts | 0-03 | 4,968.75 | |
| 10/24/06 | Sell 106 Dec 104.5 puts | | 24,843.75 | 19,875.00 |
| 10/24/06 | Buy 10 FVZ6 | 104-19+ | 1,046,093.75 | |
| 12/1/06 | Sell 10 FVZ6 | 106-10 | 1,063,125.00 | 17,031.25 |
| | | | Total: | 66,906.25 |

TABLE 5 — LESS ACTION, SOLID RESULTS

The position is still capable of turning a profit without perfect timing. The results here show what would have happened if you bought the 106 December 104.5 puts on Oct. 4 and exited Oct. 24.

| Date | Action | Price | Position \$ value | Result |
|----------|-------------------------|---------|-------------------|------------------|
| 6/28/06 | Buy 10 FVZ6 | 102-28 | 1,028,750.00 | |
| 10/4/06 | | 105-28 | 1,058,750.00 | |
| | Buy 106 Dec 104.5 puts | 0-03 | 4,968.75 | |
| 10/24/06 | | 104-19+ | 1,046,093.75 | |
| | Sell 106 Dec 104.5 puts | | 24,843.75 | 19,875.00 |
| 12/1/06 | Sell 10 FVZ6 | 106-10 | 1,063,125.00 | 34,375.00 |
| | | | Total: | 54,250.00 |

when it comes to picking tops and bottoms in the markets — the shrewd move would be to sell the 10 FVZ6s on Oct. 4 and lock in the \$30,000 gain and to buy the 106 December 104.5 puts on that day. Then, on Oct. 24, you could sell the puts to lock in another \$19,875 and buy the 10 FVZ6s again. By Dec. 1, FVZ6 was trading at 106-10, so you could sell the futures to book another \$17,031.25. Having done all this, your total June 28 to Dec. 1 gain would be \$66,906.25 (\$30,000 + \$19,875 + \$17,031.25). Table 4 provides the details of this trade sequence.

Sadly, such a world doesn't exist. For example, you might not have sold your 10 futures contracts until Oct. 5 at 105-20.5, in which case your June 28 to Oct. 5 gain would be \$27,656.25 — still pretty good. Also, you might not have been so sure about the Oct. 24 bottom. As a result, you might not have bought FVZ6 again until Oct. 27, when the price was 105-09. If you bought at that

continued on p. 16

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price and sold at 106-10 on Dec. 1, your gain would have been \$10,312.50 rather than \$17,031.25. This makes the total futures gain \$37,966.75 rather than the “Lake Wobegon” profit of \$47,031.25.

Further, if you had waited until Oct. 5 to buy the puts and unwound the position on Oct. 27, your option trade would

have suffered a loss. On Oct. 5, the December 104.5 put cost 4/64 (\$62.50) and had a -0.1229 delta. This delta leads to a put trade size of 81 (10/0.1229). The Oct. 27 price was 3/64, or (\$46.875), so the 81 puts would have lost \$1,265.625. This brings the total futures and options trading result to only \$36,703.13.

A better approach might be to keep the futures position until you decide the trend has played out or you want to be out of this trade for some other reason. If you hold the futures trade until, say, Dec. 1, when FVZ6 was trading at 106-10, the June 28 to Dec. 1 futures trade would have earned \$34,375.

Suppose you bought the 106 December 104.5 puts on Oct. 4 for \$4,968.75, as shown in Table 3. Then, after FVZ6 plunged sharply, let's say you saw either Oct. 13 or Oct. 24 as good exit points for the option trade. If you had chosen the earlier date, when the December 104.5 put was trading at 12/64 (\$187.50), the put trade would have earned \$14,906.25. Had you waited until Oct. 24, when the December 104.5 put was trading at 15/64 (\$234.375), the trade would have earned \$19,875, as Table 3 shows.


Either of these amounts added to the \$34,375 futures result significantly improves overall performance, the total coming to either \$49,281 or \$54,250. Table 5 lays out the details of this trade sequence using the Oct. 24 exit date.

Underscoring trading reality

Trades extending over many weeks obviously require careful monitoring and involve a variety of tradeoffs. On balance, it probably pays to do as little as possible in terms of moving in and out of the market. Granted, if you pick the optimal moments, you can earn more by trading in and out. But this is no small task.

Timing also matters in the options component of complex trades such as these. Miss the optimal point by a few days, and the results can change dramatically.

Careful market watching can reduce the risk of a mishap in either part of the trade. Also, you may want to have price targets in mind, especially for the options. You can locate these targets using whatever trading tools you are comfortable with.

Despite the potential risks of these trades, long-term futures or stock trades protected at key points with judicious option positions can be rewarding. In any case, it is wise to think through the market's possible behavior and plan your strategic moves well ahead of time. 

For information on the author see p. 6.

Related reading

“The TUT spread: An active spread for active traders”

by Keith Schap

Active Trader, October 2005.

The U.S. Treasury yield curve adjusts constantly to the ebb and flow of economic news and inflation fears; even relatively small yield-curve shifts can generate gratifying results for yield-curve spread traders. The spread between 10-year and two-year T-note contracts offers a vehicle for taking advantage of interest rate shifts. Note: This article is also part of the “Keith Schap: Futures Strategy Collection, Vol. 1” — a discounted set of articles.

“Using options instead of stops”

Options Trader, January 2007

This article discusses why buying protective options limits risk and can offer more flexibility than simply placing a stop order.

“Treasury bonds and notes” by Thom Hartle

Active Trader, June 2005.

T-bonds and T-notes are used as a source of income for investors and as a trading vehicle by speculators. Here's an overview of the Treasury market, from the cash market to bond ETFs and futures.

“Short-term T-bond trading” by Thom Hartle

Active Trader, October 2002.

This strategy takes quick intraday profits using rules determined by the daily trend. The technique described in this article uses a multiple time-frame approach: Two indicators applied to daily bars work together to determine the trend; two others, Bollinger Bands and the moving average convergence-divergence (MACD) indicator, identify entry and exit signals on an intraday basis.

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Trading market swings with credit spreads

Market: Options on the S&P 500 index (SPX). This strategy could also be applied to other instruments with liquid options contracts.

System concept: Previous Options Lab articles have tested the profitability of trading **credit spreads** with tech-

nical indicators — relative strength index (RSI), commodity channel index (CCI), moving average convergence-divergence (MACD), and stochastics — to determine entry and exit points. This system also trades credit spreads, but it uses only price action to trigger directional trades.

Price action is best studied in the context of major swing points, price levels where buyers take control from sellers, and sellers take control from buyers. Major swing points are defined by five price bars. For a swing high, one bar is preceded by two lower highs and followed by two lower highs (Figure 1, blue dots). For a swing low, one bar is preceded by two higher lows and followed by two higher lows (red dots).

Figure 1 shows two major swing points in the S&P 500 index along with the positions they triggered. The trend is bearish when price drops below a swing low. At this point, the system opens a **bear call spread** (short call, long same-month call at higher strike) and closes any existing bullish positions. The trend is bullish when price surpasses a swing high. When this occurs, the system enters a **bull put spread** (short put, long same-month put at lower strike) and closes any open bearish positions.

Bear call and bull put spreads are vertical credit spreads. Credit spreads are one of the most versatile option strategies to trade. A credit spread involves two options of the same type (call or put) with different strikes in the same expiration month. The short option is typically positioned **at** or **out of the money** (ATM, OTM), with the long option positioned farther OTM than the short one.

The spread makes money as time passes. If the underlying's price stays the same or moves away from the short strike, the spread's cost will decline toward zero as the likelihood of the short strike finishing **in the money** (ITM) decreases.

Figure 2 shows the potential gains and losses of a June 815/825 bull put spread entered on April 29, 2009 when the S&P 500 index closed at 873.60. The trade will be profitable if the S&P 500 closes above 821.96 at the June 19 expiration.

Trade rules:

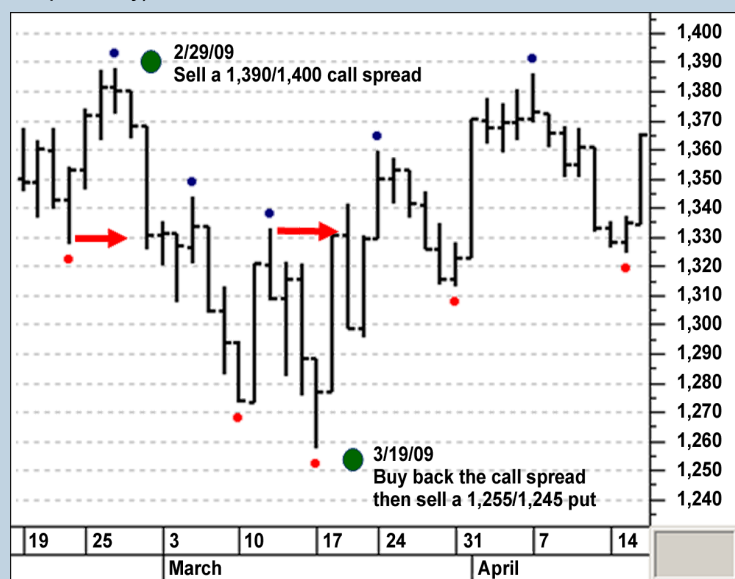
Bullish signal

Price surpasses a swing low by one tick:

1. Close any open bear call credit spreads.
2. Enter a bull put credit spread as follows:
 - A. Sell five puts at a strike just below the most recent swing low.

FIGURE 1 — SWING HIGHS AND LOWS

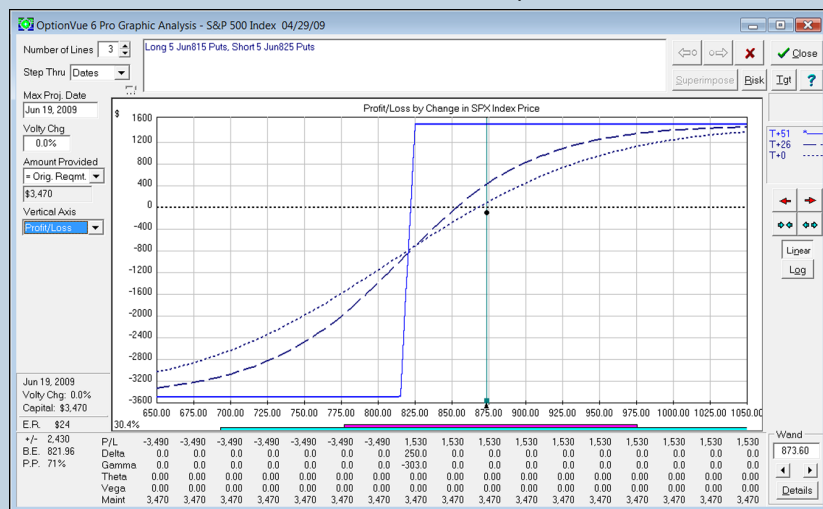
Swing-high patterns are surrounded by two lower highs; swing-low patterns are surrounded by two higher lows (blue and red dots respectively).



Source: MetaStock

FIGURE 2 — BULL PUT SPREAD

This June SPX 815/825 bull put spread was entered on April 29, 2009 when the market closed at 873.60. It had a 71-percent chance of success.



Source: OptionVue

- B. Use the first expiration month with 21 or more days remaining.
- C. Buy five puts at a strike price 10 points farther OTM.

Exit: Let the spread expire worthless unless a bearish trade is triggered.

Bearish signal

Price drops below a swing high by one tick:

1. Close any bull put credit spreads.
2. Enter a bear call credit spread as follows:
 - A. Sell five calls at a strike just above the most recent swing high.
 - B. Use the first expiration month with 21 or more days remaining.
 - C. Buy five puts at a strike price 10 points further OTM.

Exit: Let the spread expire worthless unless a bullish trade is triggered.

Starting capital: \$10,000.

Execution: Option trades were executed at the average of the bid and ask prices at the daily close, if available; otherwise, theoretical prices were used. Each spread held five contracts per leg. Commissions were \$5 per trade plus \$1 per option. No commissions were charged when a spread expired worthless.

Test data: The system was tested using options on the S&P 500 index (SPX).

Test period: Jan. 12, 2007 to June 15, 2009.

Test results: This system had some very large winning

FIGURE 3 — SYSTEM PERFORMANCE

This trend-following system gained 44.5 percent since January 2007.



trades without suffering many large losing trades. One reason for its success is that new swing points act as trailing stops. After a position is entered, the market often moved in the right direction before forming another swing point. This tended to trigger a profitable exit and a new position that was more favorable than the initial one.

Figure 3 shows the system's performance, which gained \$4,445 (44.5 percent) in slightly more than two years, an 18.3-percent annual return. The system had 22 winners vs. 20 losers, a win-loss ratio of 52 percent. Overall, the system was profitable because its average winning trade was larger than its average losing trade (\$781.59 vs. -\$637.50, respectively).

— Steve Lentz and Jim Graham of OptionVue

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

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

STRATEGY SUMMARY

| | |
|---------------------------|-------------|
| Initial capital: | \$10,000 |
| Net gain: | \$4,445.00 |
| Percentage return: | 44.5% |
| Annualized return: | 18.3% |
| No. of trades: | 42 |
| Winning/losing trades: | 22/20 |
| Win/loss: | 52% |
| Avg. trade: | \$105.83 |
| Largest winning trade: | \$1,630.00 |
| Largest losing trade: | -\$1,090.00 |
| Avg. profit (winners): | \$781.59 |
| Avg. profit (losers): | -\$637.50 |
| Avg. hold time (winners): | 28 |
| Avg. hold time (losers): | 11 |
| Max. consec. win/loss: | 5/5 |

LEGEND:

| |
|--|
| Initial capital — Starting account value. |
| Net gain — Gain at end of test period. |
| Percentage return — Gain or loss on a percentage basis. |
| Annualized return — Gain or loss on an annualized percentage basis. |
| No. of trades — Number of trades generated by the system. |
| Winning/losing trades — Number of winners and losers generated by the system. |
| Win/loss — The percentage of trades that were profitable. |
| Avg. trade — The average profit for all trades. |
| Largest winning trade — Biggest individual profit generated by the system. |
| Largest losing trade — Biggest individual loss generated by the system. |
| Avg. profit (winners) — The average profit for winning trades. |
| Avg. loss (losers) — The average loss for losing trades. |
| Avg. hold time (winners) — The average holding period for winning trades (in days). |
| Avg. hold time (losers) — The average holding period for losing trades (in days). |
| Max consec. win/loss — The maximum number of consecutive winning and losing trades. |



FUTURES SNAPSHOT (as of Aug. 27)

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

Note: Average volume and open-interest data includes both pit and side-by-side electronic contracts (where applicable).

| Market | Symbol | Exchange | Volume | OI | 10-day move/ rank | 20-day move/ rank | 60-day move/ rank | Volatility ratio/rank |
|-----------------------|--------|----------|--------|--------|----------------------|----------------------|----------------------|--------------------------|
| E-Mini S&P 500 | ES | CME | 1.86 M | 2.52 M | 1.55% / 6% | 4.78% / 42% | 9.44% / 40% | .33 / 88% |
| 10-yr. T-note | TY | CME | 781.9 | 1.06 M | 0.23% / 17% | 1.05% / 39% | 1.97% / 100% | .11 / 0% |
| 5-yr. T-note | FV | CME | 415.6 | 760.1 | 0.79% / 33% | 1.57% / 50% | 1.66% / 100% | .15 / 0% |
| Crude oil | CL | NYMEX | 293.6 | 249.5 | 2.79% / 18% | 8.29% / 30% | 5.35% / 5% | .32 / 80% |
| Eurodollar* | ED | CME | 288.4 | 601.4 | 0.13% / 25% | 0.33% / 52% | 0.21% / 54% | .23 / 2% |
| E-Mini Nasdaq 100 | NQ | CME | 285.3 | 312.8 | 0.44% / 0% | 2.01% / 12% | 9.78% / 16% | .24 / 76% |
| 30-yr. T-bond | US | CME | 254.2 | 659.4 | 1.72% / 40% | 2.63% / 56% | 5.22% / 100% | .18 / 12% |
| Eurocurrency | EC | CME | 205.0 | 131.7 | 0.76% / 9% | 2.10% / 69% | 1.37% / 10% | .21 / 48% |
| 2-yr. T-note | TU | CME | 183.5 | 672.8 | 0.08% / 18% | 0.17% / 48% | 0.09% / 91% | .18 / 0% |
| Mini Dow | YM | CME | 129.9 | 65.7 | 1.91% / 28% | 5.25% / 49% | 9.59% / 45% | .31 / 83% |
| Mini Russell 2000 | TF | ICE | 125.4 | 368.4 | 1.20% / 0% | 4.86% / 30% | 9.76% / 31% | .34 / 83% |
| Natural gas | NG | NYMEX | 103.2 | 110.5 | -3.90% / 23% | -14.35% / 73% | -15.85% / 50% | .42 / 10% |
| British pound | BP | CME | 100.8 | 94.7 | -1.62% / 60% | -1.24% / 84% | 0.57% / 1% | .15 / 50% |
| Japanese yen | JY | CME | 91.1 | 83.7 | 1.75% / 56% | 2.27% / 73% | 3.64% / 59% | .21 / 12% |
| Australian dollar | AD | CME | 75.6 | 102.5 | 2.19% / 46% | 1.50% / 27% | 6.31% / 18% | .18 / 47% |
| Gold 100 oz. | GC | NYMEX | 74.7 | 230.0 | -0.96% / 50% | 1.07% / 18% | -1.90% / 44% | .19 / 0% |
| Corn | C | CME | 66.3 | 189.1 | -0.43% / 11% | -2.77% / 19% | -25.30% / 94% | .09 / 0% |
| Canadian dollar | CD | CME | 61.8 | 92.7 | 0.48% / 27% | -0.14% / 5% | 1.16% / 8% | .22 / 47% |
| Sugar | SB | ICE | 47.0 | 311.0 | 1.26% / 6% | 19.95% / 79% | 51.04% / 100% | .11 / 2% |
| Swiss franc | SF | CME | 36.1 | 37.5 | 1.26% / 67% | 2.88% / 87% | 1.17% / 7% | .26 / 55% |
| Wheat | W | CME | 35.9 | 101.7 | -1.33% / 0% | -7.98% / 48% | -23.06% / 89% | .12 / 0% |
| RBOB gasoline | RB | NYMEX | 33.6 | 55.1 | 0.60% / 0% | 2.02% / 11% | 3.53% / 0% | .16 / 18% |
| Heating oil | HO | NYMEX | 31.5 | 42.9 | -2.29% / 63% | 5.12% / 15% | 4.22% / 5% | .17 / 12% |
| E-Mini S&P MidCap 400 | ME | CME | 29.9 | 102.7 | 0.72% / 0% | 5.85% / 38% | 10.71% / 38% | .28 / 73% |
| Silver 5,000 oz. | SI | NYMEX | 24.4 | 46.5 | -5.12% / 75% | 5.45% / 37% | -7.12% / 77% | .26 / 18% |
| Copper | HG | NYMEX | 22.5 | 56.8 | -2.25% / 100% | 11.10% / 53% | 23.79% / 26% | .21 / 28% |
| S&P 500 index | SP | CME | 18.9 | 376.2 | 1.56% / 6% | 4.80% / 42% | 9.44% / 39% | .33 / 88% |
| Soybean oil | BO | CME | 16.9 | 40.7 | -3.80% / 29% | 3.07% / 10% | -7.75% / 77% | .24 / 23% |
| Mexican peso | MP | CME | 14.9 | 68.1 | -2.39% / 100% | 0.43% / 17% | -0.13% / 3% | .43 / 98% |
| Soybeans | S | CME | 13.9 | 29.8 | 4.60% / 42% | 8.28% / 67% | -5.74% / 58% | .60 / 100% |
| Soybean meal | SM | CME | 12.7 | 31.0 | 12.83% / 100% | 16.51% / 79% | -0.13% / 0% | .72 / 100% |
| Crude oil e-miNY | QM | NYMEX | 11.5 | 4.4 | 2.79% / 18% | 8.29% / 30% | 5.35% / 3% | .34 / 87% |
| Nikkei 225 index | NK | CME | 10.2 | 33.7 | 0.85% / 7% | 4.47% / 40% | 10.55% / 35% | .29 / 78% |
| Coffee | KC | ICE | 9.1 | 48.0 | -8.59% / 50% | -2.88% / 15% | -12.29% / 94% | .29 / 32% |
| Lean hogs | LH | CME | 8.5 | 32.6 | 5.51% / 0% | -12.31% / 54% | -16.40% / 77% | .19 / 3% |
| Live cattle | LC | CME | 7.5 | 31.6 | 4.04% / 100% | 3.55% / 34% | 10.16% / 98% | .46 / 77% |
| Cocoa | CC | ICE | 7.1 | 40.4 | -2.69% / 67% | -2.66% / 20% | 3.18% / 21% | .45 / 60% |
| U.S. dollar index | DX | ICE | 6.6 | 24.9 | -0.67% / 9% | -1.70% / 60% | -1.86% / 16% | .17 / 50% |
| Fed Funds** | FF | CME | 5.9 | 40.8 | 0.06% / 23% | 0.17% / 70% | 0.22% / 72% | .18 / 7% |
| New Zealand dollar | NE | CME | 5.0 | 23.9 | 1.54% / 30% | 5.61% / 75% | 8.45% / 20% | .16 / 52% |
| Mini-sized gold | YG | CME | 4.2 | 3.4 | -0.79% / 64% | 1.74% / 36% | -1.50% / 31% | .20 / 7% |
| Natural gas e-miNY | QG | NYMEX | 3.7 | 6.1 | -3.90% / 21% | -14.35% / 74% | -15.85% / 52% | .47 / 35% |
| Nasdaq 100 | ND | CME | 2.2 | 19.9 | 0.44% / 0% | 2.01% / 12% | 9.78% / 16% | .24 / 75% |
| E-Mini eurocurrency | ZE | CME | 2.0 | 2.2 | 0.76% / 9% | 2.10% / 69% | 1.37% / 10% | .21 / 52% |
| Mini-sized silver | YI | CME | 1.9 | 1.8 | -4.95% / 88% | 5.93% / 40% | -6.89% / 80% | .27 / 23% |
| Dow Jones Ind. Avg. | DJ | CME | 0.9 | 11.1 | 1.91% / 28% | 5.25% / 49% | 9.59% / 44% | .31 / 82% |

*Average volume and open interest based on highest-volume contract (September 2010). **Average volume and open interest based on highest-volume contract (February 2010).

Legend

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

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

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

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

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

The "rank" fields for each time window (10-

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

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

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

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MOST-LIQUID OPTIONS*

| Indices | Symbol | Exchange | Options volume | Open interest | 10-day move / rank | 20-day move / rank | IV / SV ratio | IV / SV ratio — 20 days ago |
|--------------------------|--------|----------|----------------|---------------|--------------------|--------------------|---------------|-----------------------------|
| S&P 500 index | SPX | CBOE | 186.3 | 1.25 M | 1.83% / 24% | 4.42% / 45% | 22.3% / 17.8% | 22.3% / 20.9% |
| S&P 500 volatility index | VIX | CBOE | 125.7 | 1.83 M | 0.60% / 0% | 3.54% / 15% | 129% / 67.4% | 133.8% / 76.8% |
| Russell 2000 index | RUT | CBOE | 58.4 | 654.8 | 1.46% / 6% | 5.33% / 40% | 28.3% / 23.3% | 28.2% / 28.2% |
| E-Mini S&P 500 futures | ES | CME | 32.8 | 147.7 | 3.32% / 59% | 5.12% / 51% | 22.4% / 21.7% | 22.1% / 24.1% |
| Nasdaq 100 index | NDX | CBOE | 17.1 | 168.7 | 1.51% / 47% | 2.22% / 14% | 23.4% / 20.6% | 23.8% / 23% |

Stocks

| | | | | | | | | |
|------------------|------|--|-------|---------|--------------|---------------|----------------|---------------|
| Citigroup | C | | 723.0 | 14.86 M | 22.34% / 42% | 79.18% / 100% | 76.7% / 109.1% | 73.4% / 72.2% |
| Bank of America | BAC | | 306.7 | 3.97 M | 4.02% / 25% | 32.54% / 81% | 53.2% / 55.8% | 51.4% / 58% |
| General Electric | GE | | 113.1 | 3.29 M | -2.54% / 20% | 15.26% / 56% | 42.9% / 42% | 40.3% / 45.9% |
| Yahoo | YHOO | | 76.2 | 1.06 M | 2.46% / 56% | -11.82% / 80% | 36.9% / 29.5% | 46.6% / 44.8% |
| Apple Inc. | AAPL | | 71.4 | 794.0 | 2.63% / 24% | 5.60% / 22% | 33.1% / 22.1% | 29.9% / 28.3% |

Futures

| | | | | | | | | |
|------------------------|----|-----|-------|--------|---------------|--------------|---------------|---------------|
| Eurodollar | ED | CME | 103.6 | 5.67 M | 0.10% / 100% | 0.13% / 51% | 97% / 44.4% | 83.4% / 38% |
| 10-year T-notes | TY | CME | 41.6 | 563.9 | 1.71% / 70% | 1.00% / 42% | 8.5% / 7.5% | 9.8% / 8.8% |
| Corn | C | CME | 39.6 | 579.8 | 1.60% / 10% | 2.23% / 28% | 37.1% / 47.3% | 35.4% / 46.2% |
| Sugar | SB | ICE | 34.8 | 310.0 | -0.95% / 100% | 18.10% / 75% | 46.6% / 51% | 39.5% / 29.3% |
| E-Mini S&P 500 futures | ES | CME | 32.8 | 147.7 | 3.32% / 59% | 5.12% / 51% | 22.4% / 21.7% | 22.1% / 24.1% |

VOLATILITY EXTREMES**

Indices - High IV/SV ratio

| | | | | | | | | |
|--------------------------|-----|------|-------|--------|-------------|-------------|---------------|----------------|
| S&P 500 volatility index | VIX | CBOE | 125.7 | 1.83 M | 0.60% / 0% | 3.54% / 15% | 129% / 67.4% | 133.8% / 76.8% |
| S&P 100 index | OEX | CBOE | 13.1 | 91.4 | 2.02% / 35% | 4.22% / 49% | 21.4% / 16.6% | 21.4% / 19.7% |
| S&P 500 index | SPX | CBOE | 186.3 | 1.25 M | 1.83% / 24% | 4.42% / 45% | 22.3% / 17.8% | 22.3% / 20.9% |
| S&P 500 futures | SP | CME | 12.8 | 74.0 | 3.34% / 59% | 5.14% / 51% | 22% / 18% | 22.2% / 21.3% |
| Russell 2000 index | RUT | CBOE | 58.4 | 654.8 | 1.46% / 6% | 5.33% / 40% | 28.3% / 23.3% | 28.2% / 28.2% |

Indices - Low IV/SV ratio

| | | | | | | | | |
|-----------------------|-----|------|-----|-------|-------------|--------------|---------------|---------------|
| Mini Nasdaq 100 index | MNX | CBOE | 6.6 | 235.4 | 1.52% / 47% | 2.22% / 14% | 23.1% / 29.8% | 23.4% / 31.9% |
| Gold/Silver index | XAU | PHLX | 1.2 | 14.7 | 0.17% / 0% | -1.84% / 19% | 40.2% / 40.7% | 40.1% / 42.5% |

Stocks - High IV/SV ratio

| | | | | | | | | |
|---------------------|------|--|-----|-------|---------------|---------------|----------------|----------------|
| Medarex | MEDX | | 8.8 | 208.0 | 0.32% / 13% | 0.19% / 2% | 10.4% / 1.8% | 16.1% / 43.5% |
| Osiris Therapeutics | OSIR | | 2.2 | 61.3 | 19.57% / 100% | 9.04% / 54% | 205% / 58.5% | 119.8% / 58% |
| Arena Pharma | ARNA | | 1.7 | 95.1 | -3.41% / 9% | -9.94% / 44% | 150.2% / 56.2% | 116.9% / 66.2% |
| Spectrum Pharma | SPPI | | 1.5 | 71.4 | -1.00% / 0% | 4.53% / 7% | 130% / 57.9% | 115% / 105.5% |
| Evergreen Solar | ESLR | | 1.3 | 88.1 | -12.44% / 93% | -22.46% / 89% | 100.1% / 47.7% | 101.4% / 73% |

Stocks - Low IV/SV ratio

| | | | | | | | | |
|----------------------|------|--|------|-------|---------------|---------------|-----------------|-----------------|
| American Axle & Mfg. | AXL | | 17.4 | 138.4 | 75.29% / 35% | 365.63% / 92% | 159.9% / 293.3% | 239.7% / 187% |
| Huron Consulting | HURN | | 5.0 | 21.1 | 41.06% / 100% | -56.43% / 68% | 76.9% / 129% | 43.2% / 32.9% |
| Radian Group | RDN | | 1.8 | 20.7 | 23.47% / 5% | 205.50% / 71% | 98.9% / 150.4% | 114.9% / 130.9% |
| Assured Guaranty | AGO | | 1.9 | 43.2 | 15.70% / 45% | 34.06% / 68% | 61.7% / 91.6% | 65.3% / 67.3% |
| Brunswick | BC | | 1.3 | 58.7 | -1.06% / 100% | 92.20% / 57% | 83.9% / 122.2% | 88.7% / 86.8% |

Futures - High IV/SV ratio

| | | | | | | | | |
|-----------------|----|-----|-------|--------|--------------|-------------|---------------|---------------|
| Eurodollar | ED | CME | 103.6 | 5.67 M | 0.10% / 100% | 0.13% / 51% | 97% / 44.4% | 83.4% / 38% |
| 2-year T-notes | TU | CME | 5.1 | 99.5 | 0.16% / 75% | 0.07% / 39% | 1.9% / 1.5% | 2% / 1.2% |
| S&P 500 futures | SP | CME | 12.8 | 74.0 | 3.34% / 59% | 5.14% / 51% | 22% / 18% | 22.2% / 21.3% |
| 5-year T-notes | FV | CME | 11.8 | 140.5 | 0.95% / 67% | 0.82% / 32% | 5.7% / 4.8% | 6.5% / 4.5% |
| Live cattle | LE | CME | 1.5 | 116.5 | 2.58% / 100% | 0.62% / 15% | 15.3% / 13.2% | 16.2% / 15.3% |

Futures - Low IV/SV ratio**

| | | | | | | | | |
|--------------|----|-----|------|-------|--------------|---------------|---------------|---------------|
| Corn | C | CME | 39.6 | 579.8 | 1.60% / 10% | 2.23% / 28% | 37.1% / 47.3% | 35.4% / 46.2% |
| Soybean meal | SM | CME | 2.8 | 53.1 | 3.59% / 27% | 7.22% / 48% | 31.3% / 38.9% | 37.6% / 44.3% |
| Lean hogs | HE | CME | 1.2 | 38.3 | -3.05% / 5% | -20.87% / 74% | 44.6% / 54.2% | 32.2% / 36.1% |
| Eurocurrency | EC | CME | 2.0 | 26.2 | 1.13% / 30% | 0.92% / 38% | 10.6% / 12.1% | 11% / 10.9% |
| Wheat | W | CME | 9.8 | 111.4 | -4.57% / 35% | -9.38% / 54% | 33.5% / 37.9% | 33.1% / 38% |

* Ranked by volume

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

LEGEND:

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

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

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

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

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




Natural gas and platinum near COT extremes

The **Commitments of Traders (COT)** report is published weekly by the Commodity Futures Trading Commission (CFTC). The report divides the open positions in futures markets into three categories: commercials, non-commercials, and non-reportable.

Commercial traders, or hedgers, tend to operate in the cash market (e.g., grain merchants and oil companies that either produce or consume the underlying commodity).

Non-commercial traders are large speculators ("large specs") such as commodity trading advisors and hedge funds — professional money managers who do not deal in the underlying cash markets but speculate in futures on a large-scale basis. Many of these traders are trend-followers. The non-reportable category represents small traders, or the general public.

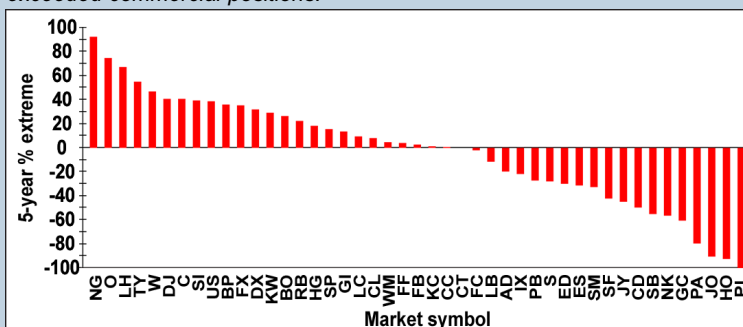
Figure 1 shows the relationship between commercials and large speculators on Aug. 18. Positive values mean net commercial positions (longs-shorts) are larger than net speculator holdings, based on their five-year historical relationship. Negative values mean that large speculators have bigger positions than the commercials.

In August, commercial positions exceeded speculator positions in natural gas futures (NG), a bullish dynamic that has existed for more than a month. However, speculators held more positions than commercials in platinum (PL) and heating oil futures (HO), a bearish sign. 

— Compiled by Floyd Upperman

FIGURE 1 — COT REPORT EXTREMES

The largest positive readings represent markets in which commercial positions (longs-shorts) exceeded speculator holdings in August. The largest negative values represent the opposite relationship — speculator positions exceeded commercial positions.



For a list of contract names, see "Futures Snapshot." Source: <http://www.upperman.com>

Legend: Figure 1 shows the difference between net commercial and net large spec positions (longs - shorts) for all 45 futures markets, in descending order. It is calculated by subtracting the current net large spec position from the net commercial position and then comparing this value to its five-year range. The formula is:

$$\begin{aligned} a1 &= (\text{net commercial 5-year high} - \text{net commercial current}) \\ b1 &= (\text{net commercial 5-year high} - \text{net commercial 5-year low}) \\ c1 &= ((b1 - a1) / b1) * 100 \\ a2 &= (\text{net large spec 5-year high} - \text{net large spec current}) \\ b2 &= (\text{net large spec 5-year high} - \text{net large spec 5-year low}) \\ c2 &= ((b2 - a2) / b2) * 100 \\ x &= (c1 - c2) \end{aligned}$$

Options Watch: Russell 2000 index top components (as of Aug. 27)

Compiled by Tristan Yates

The following table summarizes the expiration months available for the top 20 small-cap stocks in the Russell 2000 index (RUT). It also shows each stock's average bid-ask spread for at-the-money (ATM) September options. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of potential slippage in each option market.

| Stock | Ticker | Option contracts traded | | | | | | | | | | | | Call | Put | Bid-ask spread as % of underlying price |
|-----------------------------|--------|-------------------------|------|------|------|------|------|-------|-------|------|---------------|------|------|-------|-----|---|
| | | 2009 | | | | | | 2010 | | 2011 | Closing price | | | | | |
| | | Sept. | Oct. | Nov. | Dec. | Jan. | Feb. | March | April | Jan. | | | | | | |
| Medarex Inc. | MEDX | X | X | X | | X | X | | | X | 15.98 | 0.05 | 0.08 | 0.39% | | |
| Bally Technologies Inc. | BYI | X | X | | | X | | | X | X | 40.99 | 0.18 | 0.20 | 0.46% | | |
| Human Genome Sciences Inc. | HGSI | X | X | | | X | | | X | X | 18.96 | 0.09 | 0.09 | 0.46% | | |
| Tetra Tech Inc. | TTEK | X | X | | X | | | X | | | 30.66 | 0.16 | 0.16 | 0.53% | | |
| Proassurance Corp. | PRA | X | X | X | | | X | | | | 53.19 | 0.29 | 0.29 | 0.54% | | |
| Watson Wyatt Worldwide | WW | X | X | | | X | | | X | | 44.96 | 0.19 | 0.30 | 0.54% | | |
| Rock-Tenn Co. | RKT | X | X | | | X | | | X | | 51.58 | 0.30 | 0.26 | 0.55% | | |
| Knight Capital Group Inc. | NITE | X | | | | | | | | | 19.96 | 0.11 | 0.11 | 0.56% | | |
| Polycorn Inc. | PLCM | X | X | | | X | | | X | X | 22.88 | 0.15 | 0.13 | 0.60% | | |
| Vistaprint | VPRT | X | X | | | X | | | | | 41.56 | 0.26 | 0.24 | 0.60% | | |
| Platinum Underwriters Hldgs | PTP | X | X | | | X | | | X | | 36.18 | 0.21 | 0.23 | 0.60% | | |
| Tupperware Brands Corp. | TUP | X | X | | | X | | | X | | 37.40 | 0.31 | 0.31 | 0.84% | | |
| Piedmont Natural Gas | PNY | X | X | | X | | | X | | | 25.08 | 0.19 | 0.29 | 0.95% | | |
| The Warnaco Group Inc. | WRC | X | X | | | X | | | X | | 39.27 | 0.36 | 0.40 | 0.97% | | |
| Owens & Minor Inc. | OMI | X | X | | X | | | X | | | 45.22 | 0.44 | 0.45 | 0.98% | | |
| Palm Inc. | PALM | X | X | X | | X | X | | | X | 13.25 | 0.10 | 0.16 | 0.99% | | |
| Skyworks Solutions Inc. | SWKS | X | X | X | | X | X | | | X | 11.82 | 0.10 | 0.15 | 1.06% | | |
| Jack Henry & Assoc. | JKHY | X | X | | X | | | X | | | 23.43 | 0.31 | 0.25 | 1.20% | | |
| Highwoods Properties Inc. | HIW | X | X | X | | | X | | | | 28.90 | 0.43 | 0.43 | 1.47% | | |
| IPC Holdings | IPCR | X | | | X | | | | | | 32.07 | NA | NA | NA | | |

Legend:

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

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

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

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

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

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

Backspreads and ratio spreads are leveraged positions that involve buying and selling options in different proportions, usually in 1:2 or 2:3 ratios. Backspreads contain more long options than short ones, so the potential profits are unlimited and losses are capped. By contrast, ratio spreads have more short options than long ones and have the opposite risk profile.

Note: These labels are not set in stone. Some traders describe either position as option trades with long and short legs in different proportions.

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

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

Bollinger Bands: Bollinger Bands are a type of trading “envelope” consisting of lines plotted above and below a moving average, which are designed to capture a market’s typical price fluctuations.

The indicator is similar in concept to the moving average envelope, with an important difference: While moving average envelopes plot lines a fixed percentage above and below the average (typically three percent above and below a 21-day simple moving average), Bollinger Bands use standard deviation to determine how far above and below the moving average the lines are placed. As a result, while the upper and lower lines of a moving average envelope move in tandem, Bollinger Bands expand during periods of rising market volatility and contract during periods of decreasing market volatility.

Bollinger Bands were created by John Bollinger, CFA, CMT, the president and founder of Bollinger Capital Management (see *Active Trader*, April 2003, p. 60). By default, the upper and lower Bollinger Bands are placed two standard deviations above and below a 20-period simple moving average.

Upper band = 20-period simple moving average + 2 standard deviations

Middle line = 20-period simple moving average of closing prices

Lower band = 20-period simple moving average - 2 standard deviations

The option “Greeks”

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

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

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

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

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

Bollinger Bands highlight when price has become high or low on a relative basis, which is signaled through the touch (or minor penetration) of the upper or lower line.

However, Bollinger stresses that price touching the lower or upper band does not constitute an automatic buy or sell signal. For example, a close (or multiple closes) above the upper band or below the lower band reflects stronger upside or downside momentum that is more likely to be a breakout (or trend) signal, rather than a reversal signal. Accordingly, Bollinger suggests using the bands in conjunction with other trading tools that can supply context and signal confirmation.

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

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

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

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

The Commitments of Traders report: Published weekly by the Commodity Futures Trading Commission (CFTC), the Commitments of Traders (COT) report breaks down the open interest in major futures markets. Clearing

members, futures commission merchants, and foreign brokers are required to report daily the futures and options positions of their customers that are above specific reporting levels set by the CFTC.

For each futures contract, report data is divided into three “reporting” categories: commercial, non-commercial, and non-reportable positions. The first two groups are those who hold positions above specific reporting levels.

The “commercials” are often referred to as the large hedgers. Commercial hedgers are typically those who actually deal in the cash market (e.g., grain merchants and oil companies, who either produce or consume the underlying commodity) and can have access to supply and demand information other market players do not.

Non-commercial large traders include large speculators (“large specs”) such as commodity trading advisors (CTAs) and hedge funds. This group consists mostly of institutional and quasi-institutional money managers who do not deal in the underlying cash markets, but speculate in futures on a large-scale basis for their clients.

The final COT category is called the non-reportable position category — otherwise known as small traders — i.e., the general public.

Correlation coefficient, sometimes referred to simply as correlation, refers to the degree of similarity between two variables. In the markets, correlation is typically used to measure how close the relationship is between two price series (e.g., two distinct stocks or markets), between an individual stock (or trading fund) and an index, and so on.

Correlation coefficients range between -1.00 and +1.00, with +1.00 representing perfect positive correlation (i.e., two variables moving precisely in tandem); -1.00 represents perfect negative correlation (i.e., two variables moving exactly opposite to one another). A correlation coefficient of zero means the two variables have no discernible relation.

The site <http://davidmlane.com/hyperstat/index.html> offers relatively easy-to-digest definitions of this and other statistical terms.

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

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

Debit spread: An options spread that costs money to enter, because the long side is more expensive than the short side. These spreads can be verticals, calendars, or diagonals.

Delivery period (delivery dates): The specific time period during which a delivery can occur for a futures contract. These dates vary from market to market and are determined by the exchange. They typically fall during the month designated by a specific contract — e.g. the delivery period for March T-notes will be a specific period in March.

Diagonal spread: A position consisting of options with different expiration dates and different strike prices — e.g.,

a December 50 call and a January 60 call.

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

Exercise: To exchange an option for the underlying instrument.

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

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

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

Naked option: A position that involves selling an unprotected call or put that has a large or unlimited amount of risk. If you sell a call, for example, you are obligated to sell the underlying instrument at the call’s strike price, which might be below the market’s value, triggering a loss. If you sell a put, for example, you are obligated to buy the underlying instrument at the put’s strike price, which may be well above the market, also causing a loss.

Given its risk, selling naked options is only for advanced options traders, and newer traders aren’t usually allowed by their brokers to trade such strategies.

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

Near the money: An option whose strike price is close to the underlying market’s price.

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

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

Parity: An option trading at its intrinsic value.

Physical delivery: The process of exchanging a physical commodity (and making and taking payment) as a result of the execution of a futures contract. Although 98 percent of all futures contracts are not delivered, there are market participants who do take delivery of physically settled contracts such as wheat, crude oil, and T-notes. Commodities generally are delivered to a designated warehouse; T-note delivery is taken by a book-entry transfer of ownership, although no certificates change hands.

Premium: The price of an option.

continued on p. 26



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

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

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

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

Relative strength index (RSI): Developed by Welles Wilder, the relative strength index is an indicator in the “oscillator” family designed to reflect shorter-term momentum. It ranges from zero to 100, with higher readings supposedly corresponding to overbought levels and low readings reflecting the opposite. The formula is:

$$RSI = 100 - (100/[1+RS])$$

where

RS = relative strength = the average of the up closes over the calculation period (e.g., 10 bars, 14 bars) divided by the average of the down closes over the calculation period.

For example, when calculating a 10-day RSI, if six of the days closed higher than the previous day's close, subtract the previous close from the current close for these days, add up the differences, and divide the result by 10 to get the up-close average. (Note that the sum is divided by the total number of days in the look-back period and not the number of up-closing days.)

For the four days that closed lower than the previous day's close, subtract the current close from the previous low, add these differences, and divide by 10 to get the down-close average. If the up-close average is 0.8 and the down close average is 0.4, the relative strength over this period would be 2. The resulting RSI would be $100 - (100/[1+2]) = 100 - 33.3 = 66.67$.

Simple moving average: A simple moving average (SMA) is the average price of a stock, future, or other market over a certain time period. A five-day SMA is the sum of the five most recent closing prices divided by five, which means each day's price is equally weighted in the calculation.

Straddle: A non-directional option spread that typically consists of an at-the-money call and at-the-money put with the same expiration. For example, with the underlying instrument trading at 25, a standard long straddle would consist of buying a 25 call and a 25 put. Long straddles are designed to profit from an increase in volatility; short straddles are intended to capitalize on declining volatility. The

strangle is a related strategy.

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

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

Time decay: The tendency of time value to decrease at an accelerated rate as an option approaches expiration.

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

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

Variance and standard deviation: Variance measures how spread out a group of values are — in other words, how much they vary. Mathematically, variance is the average squared “deviation” (or difference) of each number in the group from the group's mean value, divided by the number of elements in the group. For example, for the numbers 8, 9, and 10, the mean is 9 and the variance is:

$$\{(8-9)^2 + (9-9)^2 + (10-9)^2\} / 3 = (1 + 0 + 1) / 3 = 0.667$$

Now look at the variance of a more widely distributed set of numbers: 2, 9, and 16:

$$\{(2-9)^2 + (9-9)^2 + (16-9)^2\} / 3 = (49 + 0 + 49) / 3 = 32.67$$

The more varied the prices, the higher their variance — the more widely distributed they will be. The more varied a market's price changes from day to day (or week to week, etc.), the more volatile that market is.

A common application of variance in trading is standard deviation, which is the square root of variance. The standard deviation of 8, 9, and 10 is: $\sqrt{0.667} = .82$; the standard deviation of 2, 9, and 16 is: $\sqrt{32.67} = 5.72$.

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

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

**Legend****CPI:** Consumer price index**ECI:** Employment cost index**FDD (first delivery day):**

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

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

FOMC: Federal Open Market Committee**GDP:** Gross domestic product**ISM:** Institute for supply management

LTD (last trading day): The first day a contract may trade or be closed out before the delivery of the underlying asset may occur.

PPI: Producer price index**Quadruple witching Friday:**

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

SEPTEMBER 2009

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

OCTOBER 2009

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

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

September**1 FND:** September orange juice futures (ICE)

FDD: September crude oil, natural gas, gold, silver, copper, aluminum, platinum, and palladium futures (NYMEX); September T-bonds, corn, wheat, soybeans, soybean products, oats, and rough rice futures (CME); September coffee and cocoa futures (ICE)

2 FND: September RBOB gasoline and propane futures (NYMEX)
Petroleum status report**3** Natural gas storage report**4 LTD:** September currency options (CME); October cocoa options (ICE)**5****6****7** Labor Day holiday (U.S.)**8 LTD:** October cotton futures (ICE)
Weekly crop progress report**9 FDD:** September heating oil and RBOB gasoline futures (NYMEX); September orange juice futures (ICE)**10 FND:** August pork bellies futures (CME)
LTD: September orange juice futures (ICE)
Petroleum status report
Natural gas storage report**11 LTD:** October coffee and cotton options (ICE)
Crop production
World agricultural production**12****13****14 LTD:** September corn, wheat, soybeans, soybean products, oats, and rough rice futures (CME)
Weekly crop progress report**15 LTD:** September cocoa futures (ICE); September lumber and currency futures (CME); October sugar options (ICE)**16 FND:** September lumber futures (CME)
FDD: September lumber and currency futures (CME)
LTD: October platinum options (NYMEX)
Petroleum status report**17 LTD:** October crude oil options (NYMEX)
Natural gas storage report**18 LTD:** September coffee futures (ICE); September single stock futures (OC); September index futures; October orange juice options (ICE); September index and equity options
Cattle on feed**19****20****21** Weekly crop progress report**22 FND:** October crude oil futures (NYMEX); September T-bonds futures (CME)
LTD: October crude oil (NYMEX)**23** Petroleum status report**24 FND:** October cotton futures (ICE)
LTD: October gold, silver, and aluminum options (NYMEX)
Natural gas storage report**25 LTD:** October natural gas, heating oil, RBOB gasoline, and copper options (NYMEX); October soybean products options (CME)**26****27****28 LTD:** October natural gas, gold, silver, copper, aluminum, platinum, and palladium futures (NYMEX)
Weekly crop progress report**29 FND:** October natural gas futures (NYMEX)
Agricultural prices**30 FND:** October gold, silver, copper, aluminum, platinum, and palladium futures (NYMEX); October soybean products futures (CME)
LTD: October heating oil, RBOB gasoline, and propane futures (NYMEX); October sugar futures (ICE)
Petroleum status report**October****1 FDD:** October crude oil, natural gas, gold, silver, copper, aluminum, platinum, and palladium futures (NYMEX); October soybeans products futures (CME); October sugar and cotton futures (ICE)
Natural gas storage report**2 FND:** October heating oil, RBOB gasoline, and propane futures (NYMEX); October sugar futures (ICE)
LTD: October live cattle options (CME); November cocoa options (ICE)



▼ **eSignal** has released the latest update to its eSignal 10.5 software, which includes extended intraday historical data. The update allows users to access 12 years of minute-based bar data for North American equities and indices, and two years of North American, European, and Asian futures, forex, and treasuries. eSignal 10.5 includes “hot lists,” a market scanner highlighting traditional gainers, losers, and volume lists. Hot lists can perform unique scans, such as unusual volume, most volatile, and trade rate, the last of which displays the fastest trading stocks in the previous minute. The new sector lists give users the ability to list which symbols are in specific sectors, create watch lists, and insert symbols into a quote window for sorting and analysis. Additional features include an optimized global portfolio window, shared symbol lists (enables users to move synchronized lists of stocks, futures, and other data from one page to another or from one PC to another), forward-curve and yield-curve charts, new data fields, and more. eSignal 10.5 is available now. For more information, visit www.eSignal.com or call (510) 723-1765.

▼ **CME Group** will launch 10 over-the-counter (OTC) cash-settled options products for clearing: European- and Asian-style options on corn, wheat, soybeans, soybean meal, and soybean oil. These contracts are listed by the CBOT for clearing only through CME ClearPort, and are subject to CBOT rules and regulations. The exchange-cleared OTC agricultural commodity option market participants must have a net worth of at least \$10 million and meet other Commodity Futures Trading Commission (CFTC) requirements. Date of launch is yet to be determined. For more information, visit www.cmegroup.com/otcags. In addition, the CME Group launched clearing services for nine new petroleum swap futures contracts. These contracts are listed for trading by NYMEX through CME ClearPort, and are subject to NYMEX rules and regulations. The new swap futures contracts and their commodity codes are: dated Brent (Platts) daily (7G); premium unleaded gasoline 10 PPM (Platts) Rotterdam FOB barges (7L); premium unleaded gasoline 10 PPM (Platts) Rotterdam FOB barges BALMO (7N); EuroBob gasoline 10 PPM (Platts) Rotterdam FOB barges (7P); EuroBob gasoline 10 PPM Rotterdam FOB barges BALMO (7S); gasoline EuroBob Oxy (Argus) Northwest Europe (7H); gasoline EuroBob Oxy (Argus) NWE barges BALMO (7R); gasoline EuroBob Oxy (Argus) NEW barges crack spread (7K); and gasoline EuroBob Oxy (Argus) NWE barges crack spread BALMO (7I). For more information, please visit www.cmegroup.com/clearport.

▼ **The Nasdaq OMX Group** introduced Top of PHLX Options (TOPO), a low latency options data feed that provides direct access to data from Nasdaq OMX PHLX. TOPO offers recipients the same information PHLX provides to the Options Price Reporting Authority (OPRA) for inclusion in the consolidated market feed, without extra transmission and processing latencies. TOPO was created in conjunction with the launch of PHLX's enhanced trading platform, which is based on the INET architecture. TOPO is available to trading firms, market data vendors, and individual investors and can be accessed directly from NASDAQ OMX or through authorized Nasdaq

OMX extranets and market data distributors. For more information, visit www.NASDAQOMXTrader.com/TOPO.

▼ **Fidelity Investments** and **Deutsche Bank Securities** announced an agreement that provides Fidelity's retail and institutional brokerage clients the opportunity to participate in the initial public offerings (IPOs) and follow-on equity offerings underwritten by Deutsche Bank. The exclusive relationship expands Deutsche Bank's potential investor base to include Fidelity's extensive list of retail brokerage customers as well as customer accounts managed by Fidelity's registered investment advisor (RIA), correspondent broker/dealer, and other institutional clients. Fidelity's distribution platform adds to Deutsche Bank's current distribution capabilities to high-net-worth clients via its Private Bank and Private Client Services divisions. Visit Fidelity.com for more information.

▼ **John Bollinger's Group Power** (www.grouppower.com), which provides industry group analytics for investors, has relaunched with expanded technical analysis tools, improved charts for the U.S. equity market, and a wide array of technical indicators to assist traders with industry group and sector analysis, market timing, and investment decisions. Group Power tells investors which industry groups are on the move so they can take advantage of specific group and sector trends. The service tracks more than 5,000 U.S. equities that have been broken down in 235 different industry groups. Group Power's structure groups companies based on both their specific business characteristics and their stocks' trading pattern. As a result, Group Power's industry-group breakdown is especially sensitive to market action. Sector and industry-group rankings are provided so investors can see which are gaining or losing in strength. Performance comparisons between the S&P 500 and Nasdaq Composite are provided for assessing relative strength. Group Power's charts include indicators to assist with market timing: TRIN 10-day open, groups over 10-day, 50-day, and 200-day moving averages, new highs and lows, and more. The sector and group charts include historical rank, momentum, money flow, advance/decline, and much more.

▼ **Tradesignal GmbH** has added the Morningstar data feed to its charting software Tradesignal enterprise edition. Morningstar offers global market data for traders and financial institutions. Tradesignal enterprise edition is a technical chart analysis and systematic trading platform used in the trading rooms of stock, currency, futures, and energy traders as well as by banks, fund managers, and insurance companies. The platform combines industry-standard data feeds from international providers such as Morningstar with customized charting and analysis functions. For further information, visit www.tradesignal.com.

Note: The New Products and Services section is a forum for industry businesses to announce new products and upgrades. Listings are adapted from press releases and are not endorsements or recommendations from the Active Trader Magazine Group. E-mail press releases to editorial@futuresandoptionstrader.com. Publication is not guaranteed.

Event: FXpress User Group Conference
Date: Sept. 14-15

Location: Calyon International Bank, New York City

For more information: Visit <https://portal.fxpress.com> and click on "Events"

Event: 4th Annual Paris Trading Show
Date: Sept. 18-19

Location: Paris, France

For more information: www.salonat.com
Event: 4th Annual FIA and OIC New York Equity Options Conference
Date: Sept. 22-23

Location: New York Marriott Marquis

For more information: www.futuresindustry.org
Event: Melbourne Trading & Investing Expo
Date: Oct. 2-3

Location: Melbourne Convention & Exhibition Centre

Event: Sydney Trading & Investing Expo
Date: Oct. 30-31

Location: Sydney Convention & Exhibition Centre

For more information on both expos: Go to <http://tradingandinvestingexpo.com.au>
Event: Financial Markets World's Risk Management for Non-Quants
Date: Oct. 7-8

Location: Bayards, New York City

For more information: Visit www.fmwonline.com
Event: FXstreet's International Traders Conference
Date: Oct. 14-16

Location: Barcelona, Spain

For more information: www.traders-conference.com
Event: TradeStation Futures Symposium
Date: Oct. 15-17

Location: Costa Mesa, Calif.

Date: Dec. 10-12

Location: Naples, Fla.

For more information: Visit www.tradestation.com/strategy
Event: Lawrence G. McMillan's Intensive Options Seminar
Date: Nov. 7

Location: New York City, Marriott Marquis

For more information: Go to www.optionstrategist.com and click on "Seminars"

MANAGED MONEY

Top 10 option strategy traders ranked by July 2009 return.
(Managing at least \$1 million as of July 31, 2009.)

| Rank Trading advisor | July return | 2009 YTD return | \$ under mgmt. |
|--|-------------|-----------------|----------------|
| 1. CKP Finance Associates (Masters) | 11.87% | 136.80% | 1.2 |
| 2. Oak Investment Group (Ag Options) | 8.05% | 41.43% | 4.2 |
| 3. Kingdom Trading (Short Option) | 7.20% | 22.85% | 1.4 |
| 4. ACE Investment Strategists (DPC) | 5.81% | 57.81% | 14.5 |
| 5. Kawaller Fund | 4.37% | 12.65% | 1.2 |
| 6. Financial Comm Inv (Option Selling) | 2.94% | 21.43% | 12.8 |
| 7. GrowthPoint Invest. (Index Condor) | 1.68% | 8.93% | 2.9 |
| 8. HB Capital Mgmt (Diversified) | 1.26% | 11.37% | 19.8 |
| 9. Washington (Singleton Fund) | 0.84% | 26.38% | 48.5 |
| 10. K4 Capital Management (MVS) | 0.83% | 6.62% | 14.9 |

Source: Barclay Hedge (<http://www.barclyhedge.com>) Based on estimates of the composite of all accounts or the fully funded subset method. Does not reflect the performance of any single account. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE PERFORMANCE.

Event: The Fifth Middle East Forex Trading Expo and Conference 2009
Date: Nov. 17-18

Location: Jumeirah Emirates Towers Hotel, Dubai

For more information: www.meforexexpo.com
Event: International Traders Expo
Date: Nov. 18-21

Location: Mandalay Bay Resort & Casino, Las Vegas

For more information: www.tradersexpo.com
Event: International Traders Expo
Date: Feb. 13-16

Location: Marriott Marquis Hotel, New York, N.Y.

For more information: www.tradersexpo.com
Event: 26th Annual Risk Management Conference
Date: March 7-9

Location: The Ritz-Carlton Golf Resort, Naples, Fla.

For more information: Visit www.cboe.com/rmc



Good entry, discretionary exit pay dividends despite adverse move.

TRADE

Date: Tuesday, Aug. 11, 2009.

Entry: Long October crude oil (CLV09) at \$71.38.

Reason for trade/setup: This trade was based on the expectation of an up move out of the consolidation that had formed between Aug. 3 and Aug. 10, and a push above the implied resistance of a previous high.

After selling off sharply to around \$60 in mid-July after rallying above \$70 in late-June, crude oil surprised many traders by reascending "Mt. \$70" relatively quickly. Although the October contract consolidated around \$74 in early August — right at the level of the June high—the failure of the bears to quash the bullish momentum portended a continued up move.

However, we anticipated a "false move" before the market moved higher — a downside breakout that would flush out longs and suck in short sellers before trapping them with an upside reversal. As a result, with the market trading in a very narrow range (mostly between \$72 and \$73) on Aug. 10, we planned to wait for a sharp break below the consolidation's approximate support level (around \$72, and preferably below the Aug. 5 low of \$71.72) before going long.

The market made a sharp downward break on Aug. 11 and we entered at \$71.38.

Initial stop: \$70.18, .42 below the July 27 high.

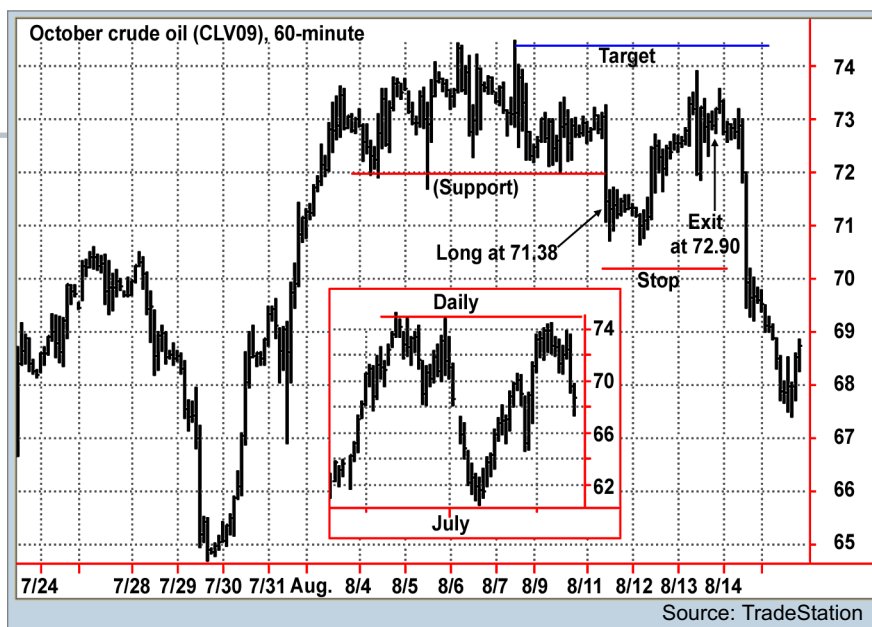
Initial target: \$74.40, just below the Aug. 7 consolidation high.

RESULT

Exit: 72.90.

Profit/loss: 1.52 (2.13 percent).

Outcome: The market traded as low as \$70.74 on the entry



day before stabilizing, and it slipped to a slightly lower low of \$70.68 the next day before turning higher.

As crude jumped back above \$73 early on Aug. 13, the trade plan seemed to be working nearly perfectly. But as the market climbed just shy of \$74 — within shouting distance of the initial profit target — the wheels came off, and price slammed more than \$2 lower in the next two hours. The market subsequently rebounded to \$73.38, but volatile trading over the next several hours prompted an early exit, at \$72.90. The market simply didn't seem confident at this point about pushing to a new high, and we didn't want to lose any additional open profit.

Although the market had one last hurrah left, rallying again to \$73.57, the next day it took a real nose dive, falling \$2.50 in the space of a couple of hours and tumbling below \$68 within the next two days.

In this case, the resistance held, but the decision to buy on an initial downside breakout of the consolidation resulted in any entry that put the trade in any immediately favorable position, buffering it from the adverse move that was soon to come. 📍

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

TRADE SUMMARY

| Date | Contract | Entry | Initial stop | Initial target | IRR | Exit | Date | P/L | | LOP | LOL | Length |
|---------|----------|-------|--------------|----------------|------|-------|-----------|-------|-------|------|------|--------|
| | | | | | | | | Point | % | | | |
| 8/11/09 | CLV09 | 71.38 | 70.18 | 74.40 | 2.52 | 72.90 | 8/13/2009 | 1.52 | 2.13% | 2.54 | -.70 | 2 days |

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



Even Ben Bernanke couldn't bail out this trade.

TRADE

Date: Friday, Aug. 7.

Market: Options on Kraft Foods (KFT).

Entry: Buy three August 28 calls for \$1 each.

Reasons for trade/setup: In early August, the broad U.S. market indices had climbed at least 15 percent off their July lows. And although the market stalled briefly, most stocks were still in rally mode.

Before the Aug. 7 opening bell, investment bank Credit Suisse upgraded Dow component Kraft Foods (KFT) from "neutral" to "outperform." In response, KFT opened 1.6 percent higher that morning. Research shows that Dow stocks tend to trade higher after analysts upgrade them, even following large overnight jumps. Upgraded Dow stocks have climbed an average 0.49 percent throughout the day, posting gains 55 percent of the time since June 2007.

The goal is to profit from a short jump in Kraft, so to keep things simple, we plan to buy August **in-the-money** (ITM) calls. Buying options that expire in two weeks may seem foolish given that **time decay** is greatest during this period. But front-month ITM options tend to have higher deltas than their later-expiring counterparts. We intend to exit the trade at the close, so time decay isn't really an issue.

We bought three August 28-strike calls for \$1 each when KFT traded at \$28.75 at the Aug. 7 open. Figure 1 shows the position's gains and losses at entry. The long trade has a total delta of 234, so it should behave like 234 shares of Kraft stock. But unlike stock ownership, if the market tanks, we will only lose a maximum of \$300 (as opposed to more than \$6,000).

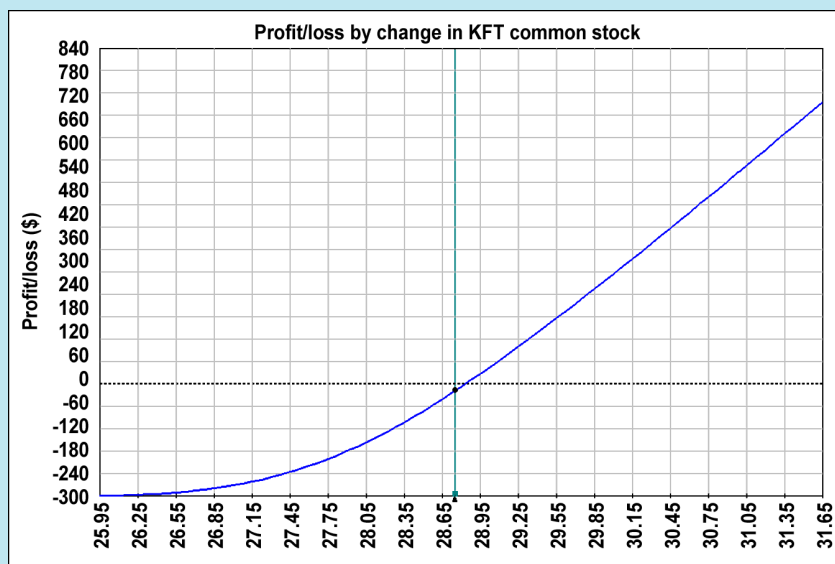
Initial stop: Exit if KFT drops below yesterday's close of \$28.36.

TRADE STATISTICS

| Date: | Aug. 7 | Aug. 12 |
|------------------------|---------|---------|
| Delta: | 233.99 | 214.9 |
| Gamma: | 63.39 | 98.07 |
| Theta: | -4.75 | -5.41 |
| Vega: | 5.90 | 5.09 |
| Probability of profit: | 43% | 32% |
| Breakeven point: | \$29.00 | \$29.00 |

FIGURE 1 — LONG CALLS ON KRAFT FOODS

By purchasing August calls, we can profit from a rally in Kraft Foods while limiting risk to the cost of the trade (\$300).



Source: OptionVue

Initial target: Hold until today's close.

RESULT

Outcome: Figure 2 shows Kraft failed to push much higher after the open. At times, the position was in positive territory, but the expected rally never appeared. Kraft basically traded sideways on Aug. 7, and we should have exited the position with a small loss as planned.

Instead, we held the position over the weekend hoping the broader market's uptrend would allow us to exit without taking a loss. Moreover, the Federal Reserve was planning to meet on Aug. 12, and stocks tend to rally as investors wait for the Fed's decision on interest rates.

Abandoning the plan and relying on hope was a bad idea.

TRADE SUMMARY

| | |
|----------------------------------|--|
| Entry date: | Aug. 7, 2009 |
| Underlying security: | Kraft Foods Inc. (KFT) |
| Position: | 3 long August 28-strike calls |
| Initial capital required: | \$300 |
| Initial stop: | Exit if KFT drops below yesterday's close. |
| Initial target: | Hold until close. |
| Initial daily time decay: | -\$4.75 |
| Trade length: | 5 days |
| P/L: | -\$105 (-35%) |
| LOP: | \$0 |
| LOL: | -\$105 |

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

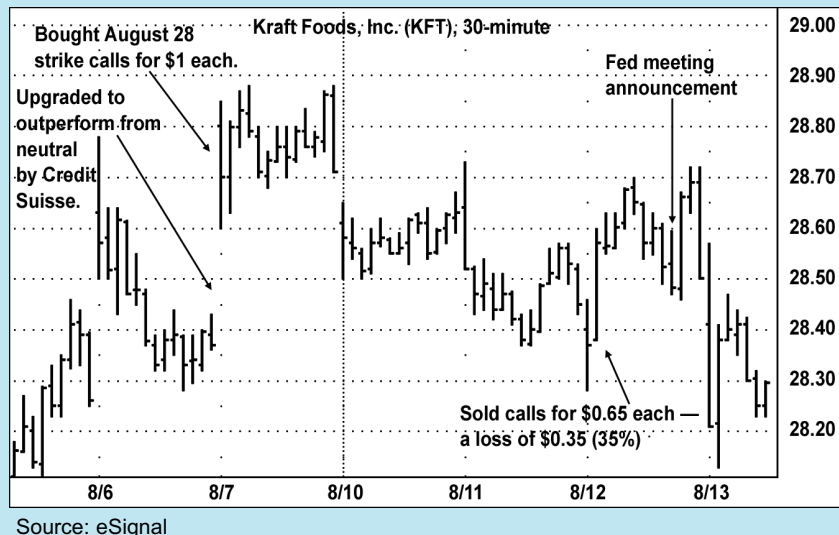
LOL — largest open loss (maximum potential loss during life of trade).

KFT opened down 0.7 percent the next day and traded lower over the next two days. Meanwhile, the calls lost one-third of their value as KFT sank and August expiration loomed. The broad market opened higher on the Fed's announcement day (Aug. 12), but Kraft failed to respond; it now traded 1.5 percent below our entry price, and we finally sold the calls for \$0.65 each — a loss of \$0.35 per contract (35 percent).

Such a large loss highlights the importance of sticking to the plan. Kraft clearly didn't react to the upgrade as expected, so we should have cut our losses early. Also, we jumped into the trade without considering the larger picture. Kraft Foods belongs to the consumer staples sector, the second-worst-performing group so far in 2009. ☹

FIGURE 2 — BUYING HIGH, SELLING LOW

Instead of rallying as expected, Kraft Foods traded sideways. We could have avoided large losses by exiting at the close, but we stubbornly held on as KFT tumbled.



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