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THE VALUE LINE
Daily Options Survey
On Line at the Opening Bell, Every Trading Day

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The Weekly Option Strategist

March 15, 2004

Meet the Market Maker - Part III

In This Issue:

Early in 1999 and again last year, we had the pleasure of interviewing Jon ("Doctor J") Najarian, CBOE market maker.
We caught up with Jon again this past week. Here is what Doctor J had to say.

Our Interview

Value Line: When we spoke last year, we were looking at persistently high volatility and sky-high premiums. Now, we are looking at persistently low volatility (the longest stretch since the mid-1990s) and depressed premiums. In both instances, volatility stayed at extreme levels for unusually long time periods.

Which is worse, last year's high volatility or this year's low volatility?

Dr. J: I'll take the high volatility any day. Now, the day-to-day issues that made the markets so active and interesting in early 2003 (the Iraq war, the economy) are no longer there. The big question now is when will the Fed move on interest rates.

Which do you at Value Line prefer, high or low volatility?

Value Line: Here, we are forecasters. We prefer predictable volatility. Despite low volatility, option volumes are at record levels. What's going on?

Dr. J: Evidently, there are a lot of put-buying hedgers out there. Except for Rambus and a few others, what was two-dollar insurance a year ago, is one-dollar insurance now. It has been these purchasers of lower strike puts that has boosted volumes over the past twelve months.

Value Line: So, your advice is to be a hedger?

Dr. J: When premiums are this cheap, I would say yes. That said, there are plenty of interesting trades out there if you know where to look for them. One I like is gold. Soon there will be options on ETFs linked to the spot price of gold. These will have a lot more play than the traditional options on gold mining companies, which often underperform when gold itself rises. (This is because the mining companies hedge themselves with long-term collars, buying at-the-money puts and selling gold calls). In my opinion, gold has a lot of potential, considering the weak dollar and the strength of commodity and energy prices. With this new ETF, every share is going to be 1/10 of one ounce of gold – about $40.

Value Line: Where else might one look for interesting trades?

Dr. J: What I do is try to find where the smart money is going. Most individual investors don't pay for live feeds and don't want to spend the day looking at screens. Here is an example. On Applied Materials, prior to earnings (on February 18th), we saw 10 times as many calls as puts - and major volume. After the announcement (earnings $0.12 per share versus expectations of $0.08), the stock shot up from less than $22 to above $24. Often the option trades are telegraphing what the market thinks.

Value Line: Is there a particular time of day when it is important to look at option trading activity? And, can you tell me if this activity is being disguised?

Dr. J: Surprisingly, a lot of before-the-tape trading is not even disguised. Here is an example. On January 14th just before the close, we saw roughly 200,000 $47.5 January Bank One calls bought for a nickel with the stock at $45. (The calls were set to expire on Jan 16th.) When the announcement came out after the close of regular trading, this $10,000 investment had jumped to $300,000. This, of course, has been the most noticeable bit of questionable trading. But usually, I have to say that these types of bets are much better disguised. Trades are likely to take place in the middle of the day, when bid/ask spreads tend to be narrower.

Value Line: How do recommend that people react to this type of information? It can't all be looking in the rear view mirror?

Dr. J: Well, Bank One is an example of where investors do not have the time to react. But Applied Materials is an example of where they can. Other set-ups give you more time. The important thing is to listen to what the options market is telling you.

Value Line: Do you ever recommend selling premium via covered calls or spreads when you see a spike in volume and premiums?

Dr. J: With Rambus several weeks ago, we saw an example where implied volatility had jumped to the 130%-160% range. This was a very attractive bullish premium-selling situation. Granted, Rambus had just received an unfavorable patent ruling by the EU patent Office and was up in front of the U.S. FTC on an anti-trust complaint. But if you look at the total risk/reward scenario, it would have made sense to either buy an in-the-money call - or buy the stock – and sell an at-the-money slightly out-of-the-money covered call. Several days later, when the FTC Judge dismissed the case against Rambus, the stock jumped more than 30%, and implied volatility imploded to around 70%. Here, you could have been a winner on both sides; a favorable move in the stock and a drop in volatility.

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Value Line: So this market is not so boring after all. What do you think about the option market environment? Last year, you were raising the alarm about the prevalence of *internalization* and *payment for order flow* (PFOF) in the market. (See note at the end of this report.) Has the situation improved?

Dr. J: Well, it hasn't gotten any worse. There are a few offsetting forces at work here. Now we have a new Exchange, The Boston Options Exchange (or "BOX"), which in my opinion is set almost solely to accommodate internalization. True, the order is exposed for three seconds, but the company bringing in the order need only improve the bid or offer by one penny to internalize the trade. This is a long way from the transparent and continuous trading you get with open outcry. I sometimes wish that Eliot Spitzer (New York State Attorney General) would put on a superman cape and rescue the options market. But he would have to show that some law was being broken and that these practices have actually harmed citizens of the State of New York.

Value Line: What is going on at some of the other Exchanges?

Dr. J: Well, things have started to turn around in my hometown at the CBOE (Chicago Board Options Exchange). Seat prices have approximately doubled to $295,000 versus about $155,000 last year. Part of this turnabout is due to the CBOE's *Hybrid Trading System*. This system, allows for more screen-based trading, in addition to open outcry on the floor. Also, a number of major market making firms (Timber Hill, Goldman, Wolverine, and Susquehanna) are moving the bulk of their trading from the American Stock Exchange to the CBOE. So, even as we speak, the options landscape is going through some changes.

Value Line: Thanks Doc, we look forward to talking to you again. Let's see what the rest of 2004 brings us. Hopefully, a few slam dunks.

About Internalization and PFOF

Internalization is when the brokerage firm takes the other side of the options trade. Payment for order flow is when the market maker pays the broker for the order. Officially, these are allowed only when no better price has shown. However, it can be argued that these practices discourage market maker participation, dampen liquidity and narrow bid/ask spreads.

About Jon Najarian

Jon Najarian (Dr. J) has been a market maker at the Chicago Board Options Exchange (CBOE) for more than 20 years and has served a 3-year term on the CBOE's Board of Directors. Jon Najarian appears daily on Fox Television's "Fox News in the Morning" and hosts a daily radio show on CBS called "Stocks n Jocks, Taking Care of Business with Doctor J." This radio show is streamed and repeated on www.ptisecurities.com. Jon is a partner in PTI Securities & Futures and publishes his market observations on his subscription website www.insideoptions.com.

See "Meet the Market Maker," Op990215.Pdf & "Meet the Market Maker – Part II," Ot030113.Pdf in our Reports Archive.

Market Review - Week Ending 03/09/04

Market Indexes	Close	% Change	Volatility Indexes*	% Change
Dow Jones Industrial	10,456.96	-1.27%		
Nasdaq 100	1,437.47	-2.43%	26.05	16.19%
S&P 500	1,140.58	-0.74%	16.60	11.71%

Performance Tables

Common Ranks	% Change	Count	Percent
Rank 1	-0.76%	8156	7.87%
Rank 2	-0.96%	21173	20.44%
Rank 3	-0.60%	57226	55.23%
Rank 4	-0.33%	13090	12.63%
Rank 5	0.29%	3965	3.83%
Call Buyer's Ranks			
Rank 1	-5.08%	3879	7.49%
Rank 2	-4.48%	9776	18.88%
Rank 3	-1.63%	38122	73.63%
Call Writer's Ranks			
Rank 5	3.47%	2060	6.00%
Rank 4	2.84%	5349	15.58%
Rank 3	4.20%	26926	78.42%
Covered Call Ranks			
Rank 1	-0.27%	2463	7.17%
Rank 2	0.05%	5798	16.89%
Rank 3	-0.08%	16725	48.71%
Rank 4	-0.01%	6367	18.54%
Rank 5	0.23%	2982	8.69%
Put Buying Ranks			
Rank 1	0.65%	5126	9.83%
Rank 2	1.64%	9447	18.12%
Rank 3	1.43%	37563	72.05%
Put Writer's Ranks			
Rank 5	-2.21%	2443	6.73%
Rank 4	-2.21%	5632	15.52%
Rank 3	-2.48%	28216	77.75%
Married Put Ranks			
Rank 1	-0.11%	3998	7.67%
Rank 2	-0.12%	10060	19.30%
Rank 3	-0.13%	23985	46.00%
Rank 4	-0.19%	7857	15.07%
Rank 5	-0.20%	6236	11.96%

* - VIX for the S&P 100 and VXN for the Nasdaq 100