Sell a straddle prior to the announcement

By Dan Keegan

June 1, 2014 • Reprints

Question:

How can you profit from high time value prior to a news event while protecting yourself from a limit move?

Answer:

Sell a straddle prior to the announcement while buying tail protection with long out-of-the-money options.

The U.S. Department of Agriculture (USDA) grain report is released some time during the second week of each month. The most recent report came out May 9, 2014. The May grain report does not have a lot of hard data to work with. There are plenty of adjusted projections as opposed to real results that affect futures and options pricing. We will be taking a look at how the USDA grain report affects the corn (CBOT:CN14), wheat (CBOT:ZWN15) and soybean (CBOT:ZSN14) markets.

The premium level in options pricing generally will not drop until after the results of the grain report are released. Option premium comprises both expiration value and time value. Expiration value is the price that the premium will be trading at the conclusion of the expiration cycle. Let's use the example of the December 530 corn puts. December futures settled at $4.98¾ on May 9. The Dec 530 puts closed at 56.75. The Dec 530 puts would be priced at 31.25 at the end of the expiration cycle. That is the "in-the-money" portion of the current premium price. The remaining 31.25 is the time value. Time value is a wasting asset that vanishes completely at expiration. If there is a degree of uncertainty or fear in the marketplace then the rate of decay in the time value can be slowed down or even reversed.

The settlement price for July corn futures was $5.11-¼ on May 8. The Dec 510 calls closed at 40.5 and the Dec 510 puts closed at 40. The straddle was at 80.5 with 79.25 being time value. Theoretically time value should recede after a grain report because the degree of uncertainty in the marketplace will have diminished. Shorting the Dec 510 corn straddle at 80.5 is one way to take advantage of that.

If December corn makes too much of a move it won't matter how much time value recedes because the other part of the premium, expiration value, will have gained so much. The size of the straddle covers a lot of ground to the upside and the downside, but if there is a limit move to either the downside or upside the losses can be catastrophic. In order to define the risk in the position a trader can go long "tails." The tails are the insurance policies that stop the bleeding in the position. Going long both an out-of-the-money call and an out-of-the-money put accomplishes this purpose.

This trade of going long Dec 590 calls for 15.25 and going long the Dec 430 puts for 9.25 comprises a net debit of 24.5. The combined position now has a net credit of 56. This reduces the trades' maximum possible profit by 24.5 but the maximum possible loss at expiration is now 24 as opposed to being unlimited to the upside and $4.29 ½ to the downside. At noon EDT the crop report came out and December futures settled at $4.98¾. The Dec 510 straddle declined to 77.25 from 80.5 despite moving 12.5¢ further away from the strike price. The long tails, however, dropped from 24.5 to 22.375. The tails cut the profitability of the trade from 3.25¢ to 1.125¢. The trader also can place wider tails on such as going long the 610 calls and 510 puts. The premium that a trader has to pay for this insurance is not as large but the coverage is also not as good. The maximum possible loss would increase to 44 from 24.

Let's take a look at how this strategy worked for wheat. On May 8, July wheat settled at $7.29½. The Dec 730 straddle closed at 60.375. The tails, which were comprised of the Dec 670 puts and the Dec 790 calls, were priced at 15. The composite position logged in at a credit of 45.375. The maximum possible loss at expiration would be 14.625¢. On May 11, July wheat settled at $7.22½. The short straddle declined in price to 56.5 for a gain of 3.875¢. The tails actually increased in price to 16.125¢, thereby increasing the overall profitability to 5.125¢ (see "Playing the middle").

PLAYING THE MIDDLE

A quick profit in wheat.

Source: eSignal

A similar strategy in soybeans resulted in a net loss under a penny despite a move in the July futures of 28.5. The greater the movement in the underlying futures contract the less effective the strategy is. If there isn't a great deal of movement the results are instantly profitable.

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