# Dynamic Trading with Weekly Options

TIM HADDOCK

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## with

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## by

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**Disclaimer**

Trading and especially day trading offers great profit potential but can involve a high degree of risk. If you engage in trade stocks, options or other financial instruments you have to be aware of the inherent risks. Do not trade with capital you cannot afford to lose. The strategies outlined in this book are for educational purposes only and do not constitute a recommendation to buy or sell any financial instrument. Past performances are no indication to future results.

**Acknowledgement**

We have created all charts using the Think or Swim platform as provided by TD Ameritrade - 2013© TD Ameritrade IP Company, Inc.

Other screenshots of the trading platform are of the same source.

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**Introduction**

You may have been wondering whether it could make sense for you to get involved in options trading, either as an add-on to the management of your whole portfolio or as an independent activity trading just the options. The former would involve strategies for generating extra income from your portfolio by writing covered calls or for hedging by buying the appropriate call or put options. In this book we will not cover this conservative approach.

We will rather focus on option strategies that do not involve actual stock positions. Some of these strategies can generate substantial income with controlled risk; others try to take advantage of a movement of the underlying stock, either up or down. In any case, we will keep the risk involved under tight control. We sincerely believe that controlling risk is the key to monetary success; as long as you follow a sound trading methodology profits will take care of themselves.

You may have read that about 80% or maybe even 90% of options expire worthless and may have wondered who could be so stupid to buy such a risky investment. This number really should not come as a surprise, because options are designed to be a wasting asset. Only if a certain condition is met, stock price exceeding the strike price, the option retains some value and will be exercised. Many buyers of options don't even mind if the options expire worthless, provided they have been part of a certain strategy, like in spreads; or if they consider the option as an insurance premium. Once you realize these facts, the number 80% becomes much less frightening.

On the other hand, you might have come to the conclusion that selling options instead of buying them must be the way to riches. A number of books out there are advising strategies to this end, from selling naked puts to selling straddles and iron condors. Especially iron condors have been widely promoted as a strategy that can make money even for the uninitiated. Nothing is farther from the truth.

Most of these books give you the right tools but lack in the teaching of the proper way to initiate and manage a position, especially when things do not go as expected. Option strategies have one common characteristic with a

chain saw. They can be very useful and produce superior returns when properly used, but can lead to disastrous results in the hands of an inexperienced novice.

If some of this sounds Greek to you, don’t worry, we will explain the terminology and the strategies in much more detail in the following chapters. And even though there is a little more Greek to come, we will keep it easily digestible. You will get to understand the concepts without pain.

In this book we will attempt to give you some easy to follow guidance so that you can avoid the pitfalls and help your equity curve move on the desired upward slope.

## What is an option?

We are talking here about listed stock options only. Employee stock options or options you might come across in the real estate or other businesses are not the subject of this book.

Listed stock options come in two versions, calls and puts.

A **call option** simply is a contract giving the buyer of that option the right, but not the obligation to buy a specified number of stocks (usually 100) at a predetermined price (strike price) until some date in the future (expiration date). The buyer of a call option is hoping for the underlying stock to move up and will make money if the stock price climbs above the strike price plus the option premium paid. This has to happen before the expiration of the option, of course.

The seller of the call option has no choice, just the obligation to sell the stocks whenever the option buyer wishes to exercise his right. Obviously, the seller hopes that the stock price will stay below the strike price until expiration date. This way he can keep the stocks (or avoid to go short) and keep the premiums he had received upfront.

A **put option** simply is a contract giving the buyer of that option the right, but not the obligation to sell a specified number of stocks (usually 100) at a predetermined price (strike price) until some date in the future (expiration date). The buyer of a put option is hoping for the underlying stock to move down and will make money if the stock price drops below the strike price minus the option premium paid. This has to happen before the expiration of the option, of course.

The seller of the put option has no choice, just the obligation to buy the stocks whenever the option buyer wishes to exercise his right. Obviously, the seller hopes that the stock price will stay above the strike price until expiration date. This way he does not have to buy the stocks but he can keeps the premium he had received upfront.

Obviously, there is value in an option. For the buyer it is similar to a lottery ticket, giving the chance for a profit, risk being limited to the price paid. On the other hand, the seller of either call or put option requires some compensation for assuming this obligation and the obvious risks involved.

How much should that option premium be? Just like a stock price it is determined by supply and demand, buyers and sellers agreeing on some price they find acceptable. But there must be some rationale behind to give us some idea how much that fair value actually could be. Someone with an understanding what the fair value for an option should be certainly has some advantage. Can such a fair value be determined and how?

## Factors determining the price of an option

Options have been around for a couple thousand years, the notorious Greeks had them already and much later, the Dutch for their tulip trades and the Japanese for their rice trades. But it took until 1973 when the CBOE created the first regulated market, starting with a small number of call options. In the same year Fisher Black and Myron Scholes developed an option pricing model. Later, both have been awarded the Nobel Prize in economics. The original model covered European options which can be exercised only at expiration. It is named after its creators Black-Scholes model.

Later the model has been refined and several other models have also been developed, like the Cox-Ross-Rubenstein and the Bjerksund-Stensland models, which were developed in 1979 and 1993. This was an important development since these models can be used to price American options which are mostly used for stock options traded on US markets. They have the added complication that exercise is possible anytime before expiration. Since this means a higher risk for the option seller, they tend to be priced higher than European options.

The option pricing models take the following parameters into account:

Stock Price

Strike Price

Time to expiration

Stock volatility

Risk free interest rate

Dividend

In this book we will disregard the last two items. Since we are focusing on short term trading of options only we can easily avoid the times when a

dividend payment is due. And most of the stocks we like to focus on are not paying dividends anyway. The effect of the risk free interest rate is also negligible because of the currently low level of rates and of course also because of our very short time horizon.

# Basic concepts

## Price, in the money, out of the money

Two prices are having an effect on the option premium, the actual stock price and the strike price, or rather the difference between the two which can be negative or positive. A list of option prices for different strike prices, also called an option chain, will show you what's going on.


Fig. 1 AAPL option chain, calls

The chain in Fig. 1 shows you the available call options for the 4th week in October. The number 3 in brackets indicates the remaining days in their life (1). For simplicity and clarity we have limited the display to 10 options around the current share price. If you need to see more you can click on the little triangle in the box 'Strike' (2).

Case 1: If you buy an option with a strike below the current price like 515 you would have to pay 10.70. The stock has to move to 525.70 only to break

even. An option with the strike price less than the actual share price we call to be in the money or ITM.

Case 2: The strike price closest to the current share price is 520 and the last traded price was 7.72. Buying this option gives you the right to buy AAPL during the next three days at 520. Since you paid 7.72 for the option the stock has to move to above 527.72 just to break even. Strike and stock price are reasonably close together, so we call the option to be near the money. If strike and share price are equal we call the option to be at the money or ATM.

Case 3: Buying the 530 call would be less costly at 3.60, but the stock now would have to move to 533.60 just to break even. An option with the strike price greater than the actual share price we call to be out of the money or OTM.

If the stock price moves up, so will the option price move up but in different degrees dependent on the distance from the strike price. How much is indicated by the Delta. A Delta of 0.43 means that the price of the option will move by $0.43 when the stock moves by $1.00. And a Delta of 0.94 tells us that the option moves almost like the stock itself.

Delta is one of the two most important “Greeks” you should remember since it helps in making the proper choice to trade. You can customize the display to show the desired Greeks by clicking on the little triangle in any of the column headers (Fig. 2).

Fig. 2 AAPL option chain with Theta and Delta

### Intrinsic and time value

If we analyze these examples further we will see that in case 1 you could buy the stock at 515 and sell it immediately at the current price of 521.36 letting you pocket 6.36.The 6.36 part of the option price is called the intrinsic value, while the remaining 4.34 is commonly called time value.

In case 2 where we are near the money the intrinsic value is 1.36 while the time value is 6.36.

In case 3 the OTM option has no intrinsic value at all and the option price is pure time value.

The length of time remaining in the life of the option plays an important role to determine how much premium a buyer is willing to pay for the option. The longer until expiration the more a buyer would have to pay for the option. To see the effect of time have a look at the chain one week further out:

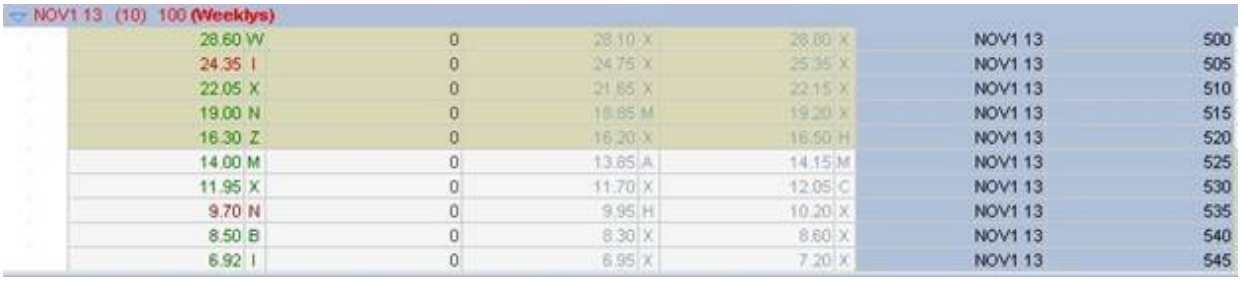



Fig. 3 option chain, 10 days out

The options we have been looking at are priced as follows:

**Actual share price 521.36 of AAPL**

| Strike | Premium (3days) | Premium (10 days) | Time value (3 days) | Time value (10 days) |
|---|---|---|---|---|
| **515** | 10.70 | 19.00 | 4.34 | 12.64 |
| **520** | 7.72 | 16.30 | 6.36 | 14.94 |

| | | | | |
|---|---|---|---|---|
| **530** | 3.60 | 11.95 | 3.60 | 11.95 |

The effect of the seven extra days on the option price is quite impressive.

This tells us of course that premiums will come down as time progresses. In other words, time value is eroding coming closer to expiration and when finally time is running out on expiration day time value is going to disappear completely. This is why we can call an option to be a wasting asset. The value of the option at expiration is therefore reduced to its intrinsic value, which for OTM option is of course zero. This erosion is also called time or theta decay. Fig. 2 shows also the Theta which tells us how much the option price will change per day (if the stock price remained unchanged). This is the other one of the two most important option “Greeks”. Time decay accelerates as we approach expiration and this effect can be exploited in option selling strategies which we will investigate later.

### Volatility and expectations

If we compare the option prices of different stocks with the same expiration dates we will notice that time value can be much higher for some than for others. Apparently, there is another factor besides time influencing the price of an option. This is generally attributed to volatility.

How do we know what the volatility of a stock is? Usually, it is determined by a statistical approach. One of the well known yardsticks is the good old standard deviation, which has some serious flaws, though. It is the assumption of a normal distribution (bell curve) that works with many phenomena occurring in nature, but not really that well with the stock market, which is characterized by interchanging periods of high and low volatility. And special events like earnings announcements, mergers or a currency crisis in Europe or China can create quite some turbulence in our markets as well and upset the bell curve mechanics. There are simply more black swans out there, big and small, than the bell curve would predict. This is the reason for occasional serious distortions in the pricing of options.

Since past data are used we call the volatility number derived this way historical volatility. To assume that historical volatility will remain on the same level for the next few days is rather questionable, we feel. There can always be a shift in sentiment, the launching of new products, earnings surprises, takeover talks or any other black swan might surface any time with significant impact on volatility and therefore on option prices. This could happen even overnight when the markets are closed. Historical numbers are therefore not necessarily a good guide for the future, not even for the immediate future.

To summarize, if a stock exhibits large price movements we say that its volatility is high and a trader would be willing to pay up for the option since he sees a chance of catching a movement large enough to cover the cost of the option and make some profit on top. And the more time is left, the higher he will evaluate the chances for success, justifying a higher option price.

### Historic vs. implied volatility

The inputs for the option pricing formulas are all known with the exception of volatility, which would have to be estimated based on historical data. We can put in the number that has been derived through statistical analysis, knowing that this is not without problems. The result would be an approximation for a fair option price. The actual price of the option, however, very often differs quite a bit from this fair or theoretical price telling us that more is going on. Apparently, buyers with the expectation (or even knowledge) of a strong move and thus increasing volatility in the stock are willing to pay up for the option.

To measure how much of a movement they expect we can use the option pricing formula, put in the actual option price and solve the equation for volatility. The result is called implied volatility and is a great measure for the expectations in the market. Fortunately, we don't have to do the math ourselves. Any serious trading platform should be able to do that for you along with the other Greeks you may or may not care for.

Getting closer to expiration we will see a breakdown of volatility which should finally go to zero.

A stock can exhibit low actual volatility before earnings announcements with Bollinger Bands contracting to within the Keltner Channel, a phenomenon called the Squeeze by John F. Carter in his book *Mastering the Trade*. At the same time the option price can be very rich due to increased implied volatility, i.e. high expectations for a big move. Just before earnings announcements implied volatility in popular stocks can jump to 150% or even more.

Later we will show how to take advantage of that.

# Weekly options

### What are they?

Technically speaking they are identical to any regular option in the final eight days before expiration. In the old days when there were only quarterly expirations available you had four times a year with options 8 days before expiration, which is the equivalent of a weekly option. With the advent of the monthly option this number increased to 12 per year and since the introduction of options with weekly expiration in 2005 we now have 52 weekly options for an increasing number of stocks per year.

Weekly options are created every Thursday morning and expire on Saturday of the following week. Trading of the option stops at 16:00 on Friday, however.  In weeks with the expiration of a monthly option there is no need for a separate creation since the monthly with 8 days to expiration exhibits the same characteristics. If it walks like a duck, quacks like a duck, it is a duck.

It took a while until weekly options gained in popularity and only since 2009 their trading volume began to surge significantly. They are now available for many stocks, ETFs and index products. You can find a list of available weeklies on the CBOE website:

http://www.cboe.com/micro/weeklys/availableweeklys.aspx

As new additions are made regularly, it is worthwhile to check that list from time to time.

### Characteristics

The behavior of a weekly option is just the same as for any other option in the final days before expiration. The main feature is the accelerating time or theta decay which is compressed into a time span of just 8 days.

## Some technicalities

### Order entry

When you see an options quote on your screen you will notice that there is a bid and an ask price just like with stocks or any other traded financial instrument. The difference between the bid and ask prices is called bid/ask spread or just spread. This should not be confused with option spreads which are a trading strategy we will be talking about later.

The market maker wants you to buy at the ask price and sell at the bid price so that the market maker can stay above the poverty line. Since the introduction of decimal quotes in 2001 spreads have tightened significantly, especially for actively traded stocks. In options markets, however, the volume is not comparable to stocks and therefore we are sometimes greeted by spreads that look just obscene or rather **are** obscene.

Don't get too impressed by that. If you have made up your mind about a particular option you want to buy or sell, just enter your order near the mid price and you still have a fair chance to get filled. To increase your chances for a fill you might go a bit closer to the market maker's price. And if you don't get a fill – what the heck, there are many other opportunities around.

Just do the math, based on a $50 stock a difference of 10 cents in a fill does not do much harm, but in the case of a $2.00 option the difference of just 10 cents in the fill means a difference of 5%.

### Conditional orders, Stop loss orders

Things are not always developing as we have planned or hoped for, in real life as well as in the markets. Our analysis might have been flawed or market forces have shifted for whatever reason in an unforeseeable way. If we have a spread trade in place there is a built-in stop loss and we know our maximum risk exactly. But sometimes we don't want to endure the maximum loss or we want to protect a profit or just be happy to break even. One way would be to set up a stop-loss on the option price. This might be

acceptable with heavily traded options and narrow bid/ask spreads but we would generally advise against that. It's almost like handing a blank check to the market maker. We would prefer to use some profanity here, but let's just say that you risk being taken to the cleaners.

A better strategy is to use a conditional order, where the trigger for the stop is not the price of the option, but of the stock itself. Using this method you will save a bundle over time. In thinkorswim the screen for conditional orders is accessible by clicking on the little gear on the far right.

Fig. 4 order entry screen

This will open the following screen which offers you many ways to structure your conditional order:

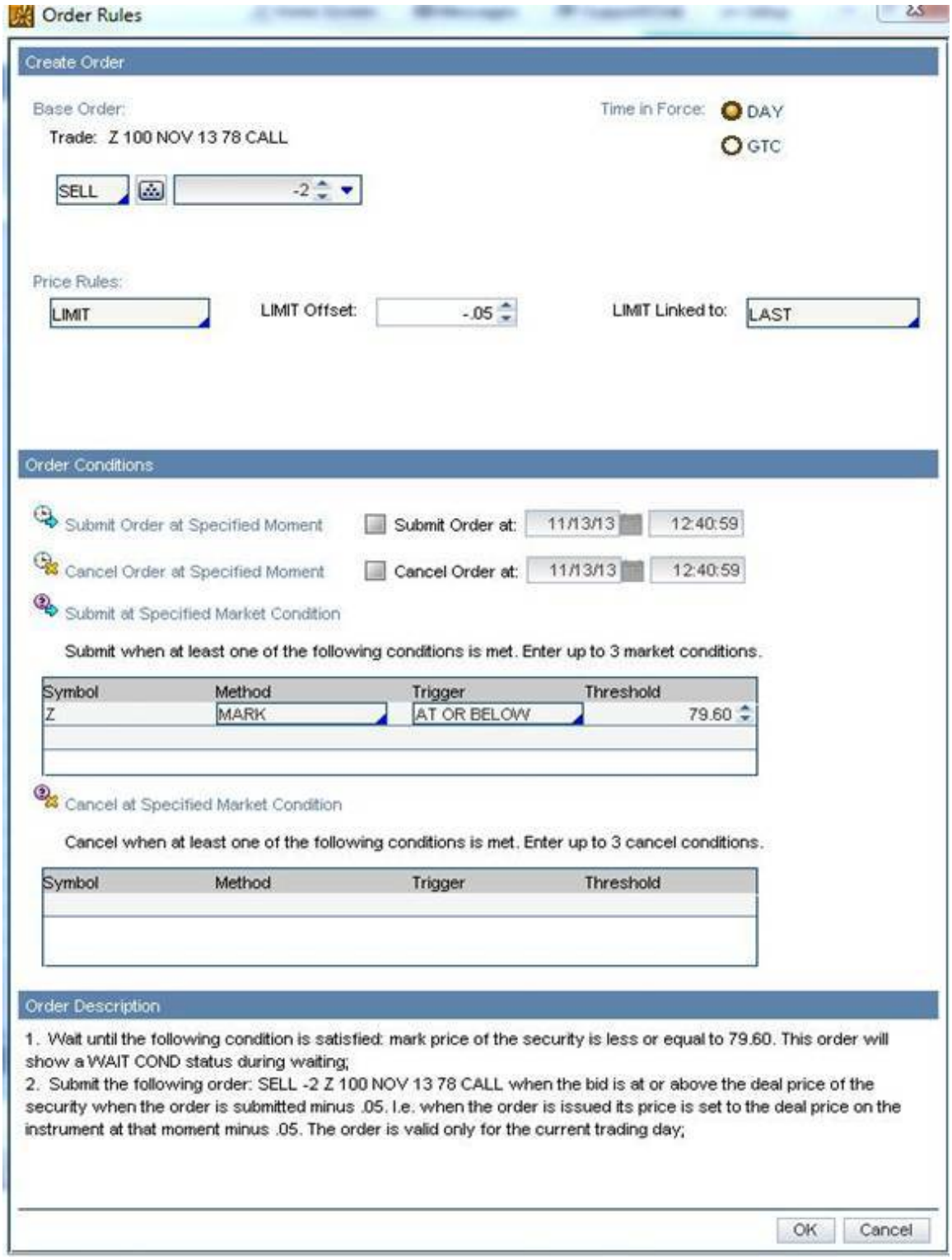



Fig. 5 Conditional order screen

If you don’t see the little gear you should talk to your account representative and have your platform upgraded to the orange version. This version is intended for futures and forex traders but it certainly does come handy for any active trader and does not involve extra costs. In addition to the conditional order entry there are also some additional reporting features. One of them is a counter for day trades remaining if your account is below the $25,000 threshold.

### Commissions

Commissions will have a major impact on the profitability of your trading, especially when you are trading some complex strategies involving several legs.

Not all brokers are created equal and the fees and fee structure may differ substantially from one to another. Basically, there are two pricing structures in the market. One is that you have a fee per option contract, typically around $2.00. The other consists of a ticket charge of about $10 plus a fee per contract of about $0.75. Depending on the number of contracts you typically trade you may want to talk to your broker and choose the pricing structure which better suits your trading habits.

Since commission levels can be quite different from account to account we will not include commissions in all of our examples.

### Assignments

If your option moves into the money you could be assigned the stock anytime until expiration. It does not happen very often, but you should be aware of that possibility.

There is nothing to worry about, though. You can always get rid of that position the next day by selling or buying back the stock. By doing that the next day you can avoid a margin call and your day trading count won’t be affected as well.

## Setting up your charts

We will create two charts for each stock side by side, a Heikin Ashi Chart on the left and a regular candle stick chart on the right. Since we like to keep our charts as clutter free as possible we will plot just the exponential moving averages with 13, 21 and 55 period lengths.

On the lower frame we will plot the TTM_squeeze which includes a momentum indicator as well.

No other indicators are needed. If you have a favorite indicator you can't trade without, by all means use it.

### Heikin Ashi Charts

This type of chart is a variation of the candle stick charts which originated in Japan more than 200 years ago.  Heikin Ashi charts have been invented in Japan as well and show some unique properties. While regular candle sticks display data as they are, Heikin Ashi bars are the result of a calculation as follows:

Open = (open of previous bar + close of previous bar) / 2

Close = (open + high + low + close) / 4

High = maximum of high, open or close (whichever is highest)

Low = minimum of low, open or close (whichever is lowest)

Heikin Ashi charts show much smoother trends cutting out a lot of noise. But at the same time you have to be aware that due to the particular calculation the last prices of the bars are not identical to the actual data. That's why you should never use them just by themselves. Always having a regular chart of your choice side by side is a good idea. It could be a regular candle stick chart or a bar chart, which does not have to be in the same time frame. You just want to know where the stock is really trading at any given moment.

A strong uptrend is characterized by white candles and no tails at the bottom, while in a strong downtrend the candles have no wicks and are solid red.

Inside bars and bars with long wicks and tails indicate indecision, similar to regular candle charts. Other than that we would advise not to apply the known interpretations of regular candlesticks.

## About Strategies

Many strategies have been developed around the basic call and put options, from the simple buying or selling a call or put to more complex strategies with colorful names like vertical, diagonal or calendar spreads, butterflies, iron condors and more.

Strategies targeted to benefit from an up or down move are commonly referred to as directional. Strategies to benefit from time decay focus on capturing the option premium for income and are often referred to as non-directional.

We do not like the classic distinction between directional and non-directional for psychological reasons. This distinction encourages wishful thinking which could paralyze your actions and reactions. If you enter a trade with the intention to be non-directional, your mind is set into that frame and you might still stick to that bias even though the stock has changed its direction to up or down and going beyond the zone that you wanted the stock to stay in. Especially in the short time frame we are focusing on a stock can change its direction anytime on a dime. Also, these so called non-directional strategies tend to be based on a statistical approach, calculating or rather guesstimating probabilities of a stock to make a certain move or stay within certain limits.

We do not deny that these strategies have some value but we are convinced that they will give you only mediocre returns at best.

Most of the modern trading platforms offer an order entry menu for a number of these strategies. This is certainly convenient but at the same time it lures you into that static or statistical mind frame in which you can achieve only mediocre returns.

Out of the many available strategies we will focus on just a few. Operating in the short time frame of a week, any variation of **calendar strategies** does not make too much sense and we will disregard those. Additionally, we will

disregard strategies requiring a lot of capital. Therefore, **naked or covered writing** strategies as well as all **ratio based strategies** are out.

Selling weekly calls and puts are strategies we are not using because of the capital requirements. They would not be suitable for smaller accounts as well. We include a short description anyway since they are widely known and used.

Selling calls against stocks held in the portfolio is called selling **covered calls**. If the stocks move above the strike price the seller of the call has to sell the stocks at the strike price. This is a rather popular strategy to generate additional income from a portfolio.

Selling calls without having the stock in the portfolio is called selling **naked calls**. The call seller has still the same obligation and in order to fulfill his obligation he has to buy the stock in the market at whatever price they are traded in order to avoid a short position in the stock. The risk of such a strategy should be rather obvious. Theoretically, it's unlimited. A stop loss can limit the damage, but an extreme overnight move after an earnings surprise or a takeover bid could devastate a portfolio.

**Selling puts** is a viable strategy to lower your entry price when you are determined to buy a certain stock. It can be used as a protection of a short position in the stock as well.

In the 1980s and 1990s after the Black-Scholes model gained wider recognition one popular strategy was to sell options if their price was higher than the theoretical value and buy them if the price was lower. Many have burned their fingers with that strategy, mainly because of the bell curve's underestimating the probability of extreme events. We will therefore disregard this strategy as well.

**Butterflies** can be very profitable despite the high commissions – one butterfly consists of not less than four contracts! - if you are good at predicting where exactly the stock will be at expiration. Once in a while we also succeed at that but just not consistently enough. This strategy works best with stocks having a tendency of pinning, which happens more often with monthly options of stocks with a large institutional following. It is a strategy with high profit/low probability characteristics. We will therefore not cover this strategy in this book.

In the following we will give you a short description of the strategies we are using and then, most importantly, we will show you how to implement them in a dynamic approach with actual trading examples.

### Buying weekly calls or puts

The simplest strategy with options is just to buy calls or puts.

The only way you can win with this strategy is if you have a quick move up in case you bought a call or down if you bought a put.

On the other hand if the move goes in the wrong direction or just sideways your maximum loss is what you paid for the option. But you have two more enemies, shrinking implied volatility and the passing of time, of course.

### Spreads

Spreads come in different flavors like vertical, calendar, diagonal or ratio spreads. In this book we will focus only on vertical spreads.

You can either buy a spread, then it is called a debit spread or you can sell it and then it is called a credit spread. And you can do it either with calls or puts. In our trading we usually do not use debit spreads since we do not like their specific mechanics.

A call credit spread would look like this:

Actual stock price of XYZ 98

Sell XYZ 100 call at $2.50

Buy XYZ 105 call at $1.00

Net credit is $1.50 which will be credited to your account. In case the stock stays below 100 until expiration, both options will expire worthless and you can keep the premium received. If the stock moves beyond 100 at expiration you will either have to deliver the stock at 100 or buy back the option before expiration. In case the stock moves beyond 105 you would have the same obligation to sell the stock at 100, but you could buy the stock at 105 to cover that obligation. Your loss is $350 per contract ($ 500 minus the proceeds of $150), which the maximum loss you can incur. The maximum profit is the $150 premium received. On the surface the profit/loss ratio looks rather meager with 0.43 but this has to be evaluated

in the context of the probability of the stock making the move from 98 to beyond 105 in the limited time remaining until expiration.

Depending on your broker your margin requirement for this position can be anywhere between the max loss of $350 and the difference in strike prices which is $500. To stay on the conservative side we will use the higher amount further on in this book.

A put credit spread would look like this:

Actual stock price of XYZ 98

Sell XYZ 95 put at $1.75

Buy XYZ 90 put at $0.75

Net credit is $1.00 which will be credited to your account. In case the stock stays above 95 until expiration, both options will expire worthless and you can keep the premium received. In case the stock moves beyond 95 you would have to buy the stock at 95 or buy back the option and you could sell the stock at 90 to cover that obligation. In case the stock moves beyond 90 you would have the same obligation to buy the stock at 90, but you could sell the stock at 90 to cover that obligation. Your loss is $400 per contract ($ 500 minus the proceeds of $100), which the maximum loss you can incur. The maximum profit is the $100 premium received. On the surface the profit/loss ratio again looks rather meager with 0.25 but this has to be evaluated in the context of the probability of the stock making the move from 98 to beyond 90 in the limited time remaining until expiration.

The advantage of spreads is the built-in stop loss. A spread allows you also to trade a stock regardless of its price. In a small or medium sized account you would probably not consider trading a $500 stock like AAPL. By using a spread the capital requirements are reduced to the difference of the strikes at most.

**A word of caution:**

The risk and chance for a spread based on a $500 stock are much higher than for a $50 stock. For a $500 stock a move of $5 is just 1%, for a $50 stock the same move would mean 10% which certainly is less likely to occur over the span of a few days.

### Iron condors

An iron condor simply is the combination of a call credit spread and a put credit spread. One iron condor therefore consists of four single options. Depending on your commission structure this could be rather costly to establish. On the other hand you will collect a credit on both the call and put spread, while your capital requirement is only based one spread. In percentage terms your return on capital is much bigger that way. This holds true for most brokerage firms, but make sure with your broker what his requirements are.

Iron condors have been and are still been promoted by many books and costly webinars as the sure way to generate steady income with controlled risk. Sure, you know from the outset what your maximum loss is and it may look reasonably small. But the problem with iron condors is that in most cases your short options have to be uncomfortably close to the actual share price in order to collect a reasonable premium. This means of course, there is considerable risk that the maximum loss actually will occur or you will be forced to struggle rescuing your position in order to avoid maximum loss. In the case of less volatile stock you might be relatively safe, but then the premiums you could collect are mostly not worth the trouble and commissions. A series of small wins can easily be wiped out with one trade ending in a maximum loss.

For these reasons we will usually not start out with an iron condor, but we might end up with one after a few days. But it will have much wider wings and considerably less risk.

## Dynamic trading approach

Our dynamic approach focuses on the price action of a stock and we will initiate option positions suited to a particular situation. It might be followed up with another position depending on the course the stock is sailing. We might end up with an iron condor, but we normally would not start with it.

In order to achieve superior returns you need an edge in the market that statistics cannot offer you.

Of course, we know that the price of the stock (the underlying) is the main driving force for option prices. So we have to start here for implementing a workable and profitable strategy. Once we have a good grip on the stock and its behavior we can play the options with much more confidence and less risk. This is the main edge we have to work on.

The crucial thing to remember at all times is a variation of one of Bill Clinton's famous words:

**It's the underlying, stupid.**

To gain this edge we first have to have a list of suitable candidates that we are going to follow and that have the potential for substantial moves. Next we look for possible set-ups of stocks ready to move in one of the three directions. It may sound like pure semantics but we would prefer to distinguish between three general directions, up, down and sideways.

## Selection of candidates

Since you cannot reasonably follow the whole market, you have to create a short list of stocks to follow. Most modern trading platforms let you screen the great universe of stocks according to your criteria and help you to find the candidates offering the best chances. Here is a scan we did on November 11, 2013 before the market:

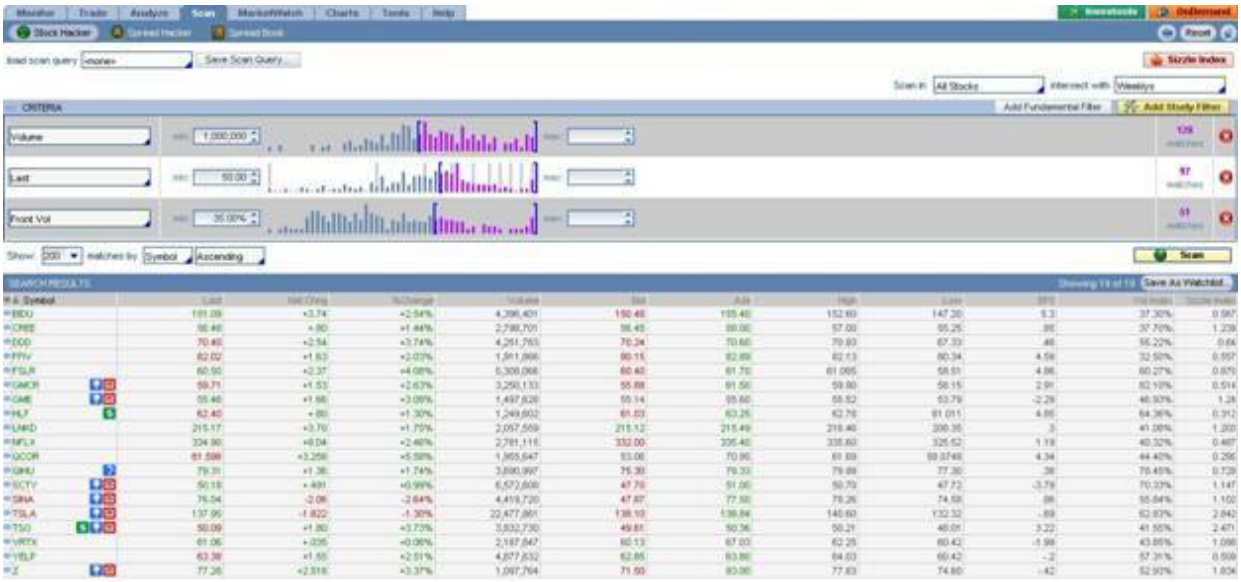


Fig. 6 Scan result

We are searching for stocks with a minimum trading volume of 1 million shares a day and a share price of at least $50. This ensures a minimum level of liquidity at least in the underlying stock. The minimum share price of $50 makes sure that we can deal with option premiums of more than 50 or 60 cents. The lower the premiums, the greater will be the relative impact of commissions eating into our profitability. The next selection criterion is volatility, which we set at 35%. Higher volatility means bigger premiums and a greater probability for significant moves.

In thinkorswim you can intersect this result with ‘Weeklys’ since we just want to look at stocks with weekly options. We name and save the resulting

list as a watch list which we will detach from the gadget list for better viewing and additional editing. In our example the scan gave us 19 stocks to watch.

## Squeezes

For the identification of possible set-ups we like to use the squeeze indicator which has been created by John F. Carter. In thinkorswim you can find this indicator under ->Studies ->Add Studies ->John Carter's Studies ->TTM_Squeeze. If you are not using thinkorswim you can buy this indicator at John's website tradethemarkets.com for several other platforms. This is just for your information, not a promotion, since we have no relation to his group whatsoever.

If you don't have access to this indicator, you can substitute it by plotting both Bollinger Bands and Keltner Channels on your charts as we have described already in our book *Day Trading with Heikin Ashi Charts*. In that book we show you also how to set up a scan for squeezes in multiple timeframes simultaneously.

Essentially, the squeeze happens when the Bollinger Bands move to within the Keltner Channel, which is equivalent to a serious contraction of volatility. The assumption is that such a contraction of volatility cannot last for too long and when volatility expands again it does so with a rather strong price move, up or down.

Note that the reduced volatility as documented by the squeeze does not necessarily mean that the implied volatility and therefore option premiums are low as well. We will come back to this in the chapter 'Trading before earnings'.

## Situational setups

When and how are we going to apply these strategies?

## Trading on a Squeeze breakout

This is probably the situation we are trying to take advantage of most. It is a fairly reliable set-up and we usually start by establishing either a call or put credit spread. If the signal looks strong and convincing we might also add a single call or put position.

We have described this squeeze breakout strategy already in our book *Day Trading with Heikin Ashi Charts* and we will use it with options as well, however with some minor modifications. These are mostly affecting the setting of stops. Due to the wider bid/ask spreads and possibly higher commissions in options trading we try to keep the number of transactions at a minimum. Being stopped out and reentering an option position can impact the cost of trading significantly. Also, when we are a seller of spreads time is our friend and gives us some extra cushion simply by running out.

We will consider long calls or puts only until Wednesday before expiration as the acceleration of time decay is inevitably approaching. Because of this time decay long calls or puts will be very often just day trades. We might allow us exceptions to carry a position overnight only when we feel particularly strong about a setup.

Another exception is a lottery ticket trade we might consider on the day of expiration.

We have a clear preference to enter credit spreads anytime from Monday of expiration week onwards. During the last two days before expiration premiums will have come down already so much that a credit spread might not be possible at a reasonable level. But depending on implied volatility it might still work occasionally.

Normally, we don't like to enter option positions in the first two days of their life which are preceding a weekend. You might be tempted to take advantage of the time decay of two full days while the market is closed. But everybody else in the market and the market makers know about the looming weekend and tend to price in the weekend decay already on Friday into their option quotes. And you never know what kind of black swan is floating by over the weekend, which is the favorite timing for central banks to come up with big and often nasty decisions.

The time frame we are trading this strategy is based on 15-minute charts. For confirmation of the longer trend we will check the situation on the hourly chart on a regular basis.

Here are the entry rules:

### The long entry rules

Make sure the moving averages are stacked in the right order. The medium term moving average is above the long one and the short one is on top.  It's ok if the shortest average is just heading up and about to cross to the upside.  Moving averages might look like an old hat to you but they still are doing a good job in filtering out the better setups. By simply following this rule you will be able to stay on the right side of a trend and eliminate quite a number of losing trades.

Make sure your stock is in a squeeze in the time frame you are trading in, which is the 15-minute chart in our case. If you see a squeeze in a higher time frame as well, consider this a reinforcement of any signal.

The long entry signal: A white Heikin Ashi bar following another white bar is the signal bar, provided it's not an inside bar. Both should have very small or no tails. These two bars will typically show a size of about double or more of the average true range of the last 14 periods. You enter a long position, either a put credit spread or a long call, when the price of the stock retraces to the midpoint of the signal bar. Important: You have to watch this retracement on the regular chart since the HA chart is not reflecting the actual price. You can do that manually or place a conditional order as explained above.

If the signal bar and the preceding bar are just of average size but are nicely shaped without tails the signal is still ok but a bit less aggressive. You would

then consider just a put credit spread.

The Heikin Ashi signal usually precedes the volatility break out by one or two bars. Momentum will expand as well which is a good confirmation that we are on the right track.

### The short entry rules

Make sure the moving averages are stacked in the right order. The medium term moving average is below the long one and the short one is on the bottom.  It's ok if the shortest average is just heading down and about to cross to the downside.  Moving averages might look like an old hat to you but they still are doing a good job in filtering out the better setups. By simply following this rule you will be able to eliminate quite a number of losing trades.

Make sure your stock is in a squeeze in the time frame you are trading in, which is the 15-minute chart in our case. If you see a squeeze in a higher time frame as well, consider this a reinforcement of any signal.

The short entry signal: A red Heikin Ashi bar following another red bar is the signal bar, provided it's not an inside bar. Both should have very small or no wicks. These two bars will typically show a size of about double or more of the average true range of the last 14 periods. You enter a short position, either a call credit spread or a long put, when the price of the stock retraces the midpoint of the signal bar. Important: You have to watch this retracement on the regular chart since the HA chart is not reflecting the actual price. You can do that manually or place a conditional order as explained above.

If the signal bar and the preceding bar are just of average size but are nicely shaped without wicks the signal is still ok but a bit less aggressive. You would then consider just a call credit spread.

The Heikin Ashi signal usually precedes the volatility break out by one or two bars. Momentum will expand as well which is a good confirmation that we are on the right track.

## Stops and exit

Place an initial stop with a conditional order based on the stock price just below (above for shorts) the signal bar. Trail the stop two or three bars behind the current bar for now. If one bar is followed by one or more inside bars, leave the stop at its last position and continue trailing it up once the inside situation is cleared. If a strong trend emerges as anticipated we want to give the stock some room and will trail just outside the medium term moving average.  As soon as you see one or more dojis with long tails and wicks treat this as a warning sign and tighten your stops.

## Note

The squeeze is a very reliable setup since no stock will stay in a low volatility situation forever. And exiting a squeeze happens very often with a powerful move. A scan for squeezes quickly identifies potential candidates. But there are many situations in fast moving markets that a squeeze has no time to develop or when the Bollinger Bands come close but don’t penetrate the Keltner Channel.

The Heikin Ashi entry rules are the most important ones and may be taken just by themselves or with the support of your favorite rationale to enter the market.

## Example for a squeeze break out

Fig. 7 Z chart, November 12, 2013

A scan for squeezes has drawn our attention to Z. A look at the 15-min HA-chart reveals that we had been in a squeeze from late Friday to late Monday (November 11, 2013). Before Monday's close there was a feeble first attempt for a breakout which you can see on the 5-min chart as well. Tuesday morning things seem to get underway with a bit more conviction and we see a first well formed 15-min HA bar. The moving averages are still almost flat but with a hint of an upturn. On the 5-min chart we see an impressive spike and a 50% retracement. Moving averages are stacked in the right order. We feel that the downside risk is limited and decide contrary to our rules not to wait for a second well formed HA bar and to establish a put credit spread by selling the 77 put and buying the 75 put for protection for a net credit of just $0.65. In cash terms it is not a whole lot but we might

add a call credit spread after a run to improve the profitability. But the maximum profit is almost half of the maximum loss which is acceptable.

Before we enter into more aggressive positions we want to see the second well formed HA bar, in line with our rules.

| Order Description | SELL -2 VERTICAL Z 100 NOV 13 77/75 PUT @.65 LMT [TO OPEN/TO ... |
|---|---|
| Break Even Stock Prices | 76.35 |
| Max Profit | $130.00 |
| Max Loss | $270.00 (not including possible dividend risk) |
| Cost of Trade including commissions | credit $130.00 - $12.99 = credit $117.01 |
| Buying Power Effect | ($282.99) |
| Resulting Buying Power for Stock | ($254.81) |
| Resulting Buying Power for Options | ($254.81) |

Note: Share it on MyTrade

QUEUE EDIT DELETE SEND

Fig. 8 Z put credit spread order

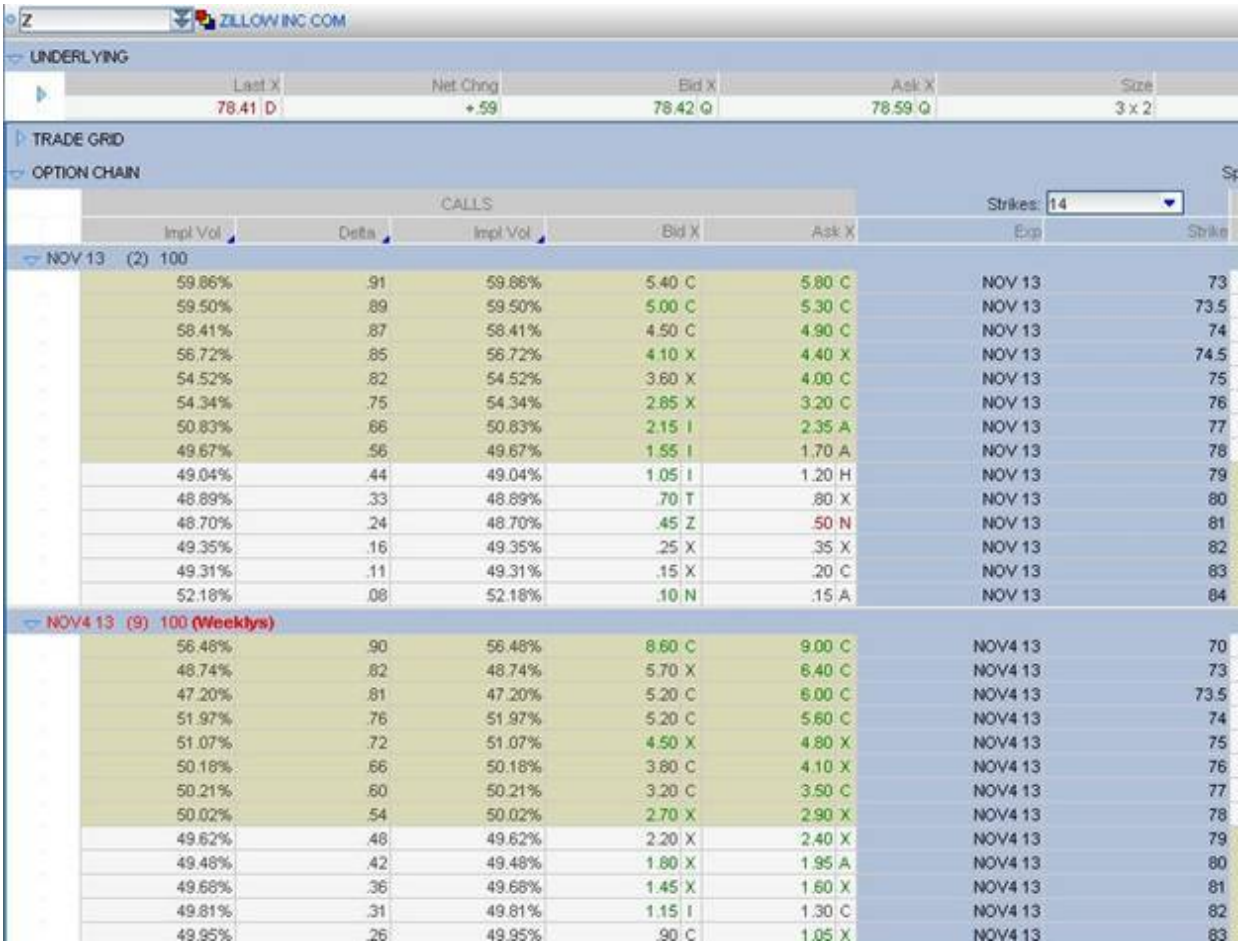
Z spent all Tuesday chopping around with inside bars and no conviction whatsoever, moving even back into a 15-min squeeze. The moving averages showed a modest but clear upward trend and were stacked in the proper order. This is an indication that the breakout of the squeeze most likely will be to the upside.

Our put credit spread still looks fine with premiums slowly eroding.

The next chart shows the developments during the rest of the week.


Fig. 9 Z HA chart November 15, 2013

We have to wait until Wednesday, November 13, 2013 (Fig 9) for some action to start. Around 10:40 we have two reasonably well formed HA bars and the first indication of a squeeze breakout. This looks like a good spot to go long a call for a quick move, probably just a day trade. A look at the option chain shows that implied volatility is around a healthy 50%. The bid/ask spreads are not really tight but still reasonable. We will go for the 78 and 80 calls and place the orders near the midpoint, at $1.65 and $0.75 resp. and get filled within a few minutes.



Z ZILLOW INC COM

UNDERLYING

| Last X | Net Chng | Bid X | Ask X | Size |
|---|---|---|---|---|
| 78.41 D | +.59 | 78.42 Q | 78.59 Q | 3 x 2 |

TRADE GRID

OPTION CHAIN

Strikes: 14

| CALLS | | | | | | |
|---|---|---|---|---|---|---|
| Impl Vol | Delta | Impl Vol | Bid X | Ask X | Exp | Strike |
| NOV 13 (2) 100 | | | | | | |
| 59.86% | .91 | 59.86% | 5.40 C | 5.80 C | NOV 13 | 73 |
| 59.50% | .89 | 59.50% | 5.00 C | 5.30 C | NOV 13 | 73.5 |
| 58.41% | .87 | 58.41% | 4.50 C | 4.90 C | NOV 13 | 74 |
| 56.72% | .85 | 56.72% | 4.10 X | 4.40 X | NOV 13 | 74.5 |
| 54.52% | .82 | 54.52% | 3.60 X | 4.00 C | NOV 13 | 75 |
| 54.34% | .75 | 54.34% | 2.85 X | 3.20 C | NOV 13 | 76 |
| 50.83% | .66 | 50.83% | 2.15 I | 2.35 A | NOV 13 | 77 |
| 49.67% | .56 | 49.67% | 1.55 I | 1.70 A | NOV 13 | 78 |
| 49.04% | .44 | 49.04% | 1.05 I | 1.20 H | NOV 13 | 79 |
| 48.89% | .33 | 48.89% | .70 T | .80 X | NOV 13 | 80 |
| 48.70% | .24 | 48.70% | .45 Z | .50 N | NOV 13 | 81 |
| 49.35% | .16 | 49.35% | .25 X | .35 X | NOV 13 | 82 |
| 49.31% | .11 | 49.31% | .15 X | .20 C | NOV 13 | 83 |
| 52.18% | .08 | 52.18% | .10 N | .15 A | NOV 13 | 84 |
| NOV4 13 (9) 100 (Weeklys) | | | | | | |
| 56.48% | .90 | 56.48% | 8.60 C | 9.00 C | NOV4 13 | 70 |
| 48.74% | .82 | 48.74% | 5.70 X | 6.40 C | NOV4 13 | 73 |
| 47.20% | .81 | 47.20% | 5.20 C | 6.00 C | NOV4 13 | 73.5 |
| 51.97% | .76 | 51.97% | 5.20 C | 5.60 C | NOV4 13 | 74 |
| 51.07% | .72 | 51.07% | 4.50 X | 4.80 X | NOV4 13 | 75 |
| 50.18% | .66 | 50.18% | 3.80 C | 4.10 X | NOV4 13 | 76 |
| 50.21% | .60 | 50.21% | 3.20 C | 3.50 C | NOV4 13 | 77 |
| 50.02% | .54 | 50.02% | 2.70 X | 2.90 X | NOV4 13 | 78 |
| 49.62% | .48 | 49.62% | 2.20 X | 2.40 X | NOV4 13 | 79 |
| 49.48% | .42 | 49.48% | 1.80 X | 1.95 A | NOV4 13 | 80 |
| 49.68% | .36 | 49.68% | 1.45 X | 1.60 X | NOV4 13 | 81 |
| 49.81% | .31 | 49.81% | 1.15 I | 1.30 C | NOV4 13 | 82 |
| 49.95% | .26 | 49.95% | .90 C | 1.05 X | NOV4 13 | 83 |

Fig. 10 Z option chain, November 13, 2013

Momentum continues to accelerate and we are on the right track. Now it's time to protect our profits with a stop order. Since the spreads in options can widen at anytime there is a considerable risk of getting a bad fill with stop orders as mentioned before. We therefore place a conditional order, based on the stock price rather than the option. Go back to Fig. 5 to see how our conditional order looks like.

We are going to trail the stops giving the stock some room since the trend looks very much intact with the moving averages neatly stacked and clearly heading up. Naturally, we have to expect retracements as nothing is going straight up or down and for now we will trail just below the 21-period moving average.

Wednesday afternoon's orderly correction is contained above the short moving average and does not look like a topping action at all. We decide to continue holding our calls, even though we had originally planned only for a day trade. As of now there is also no reason to sell a call credit spread yet. We would want to see a clearer topping action before doing that.

The next correction on Thursday morning looks pretty tame as well with lots of inside bars. Again, the retracement stops at the short moving average. In the afternoon the uptrend resumes again until we get the second retracement of the day, again very tame. This time the retracement goes as far as the medium term moving average. Interesting to note is that the implied volatility did not shrink at all despite the fact that we have only one more day to go until expiration. This encourages us to hold on to our position overnight again, looking to get out in Friday's morning session. At latest in the afternoon we expect the time value to evaporate swiftly and the options ending the day at their intrinsic value.

Friday morning greets us with yet another firework. Once the stock reached 85 we just head for the exit and sell the 78 call for $7.10 and the 80 call for $5.10. As you can see from the chain (Fig. 11), both options have a delta of 1 and the implied volatility is no longer correctly calculated. The at the money options, however, are experiencing the volatility crush setting in, but volatility remains surprisingly high. We are happy to leave the party at this point since insanity seems to creep in.

Fig. 11 Z option chain, November 15. 2013

The result of our trading is as follows

| Action | open | close | profit |
|---|---|---|---|
| **Sell 77/75 PCS** | 0.65 | Exp. Worthless | 0.65 |
| **Buy 78 call** | -1.65 | 7.10 | 5.45 |
| **Buy 80 call** | -0.75 | 5.10 | 4.35 |

Things don't turn out that nicely all the time, we are first to admit that this was an exceptionally lucky week.

But we wanted to show you that trading weekly options should not be static. Following a static approach you might have considered to sell an iron condor right from the outset. This would have been based on some statistical considerations and guessing some maximum moves of the stock. We also were considering an iron condor as one of the strategic options, the difference being that we wanted to leg into an iron condor only once we had some idea where the upper limit could be. This risk aversion prevented us from being trapped into an iron condor which very likely would have handed us a maximum loss.

## Another squeeze breakout example

Monday morning. November 18, 2013 we scan for squeezes and find FSLR as a candidate for a move. FSLR has spent most of Friday in a 15-min squeeze and went into an hourly squeeze Friday afternoon as well. We also notice that FSLR started the morning session coming out of a 15-min squeeze. But the second HA bar of the day was an inside bar with a long wick and tail showing not a lot of conviction and on the third bar we were back into a squeeze.

After a lot of chopping around with moderately positive momentum we see at noon some possible positive action developing but FSLR went right back into a squeeze again. A series of red bars without wicks develop which is a clear sign that the developing  uptrend was about  to fail.


Fig. 12 FSLR HA chart, November 18, 2013

At 13:25 we look at the option chain and decide to enter a call credit spread, selling the 65 call for $1.05 and buying the 67.50 for protection at $0.34 for a net credit of $0.65 per contract. Our maximum loss at this point is $185 per contract ($250 less the $65 we received). We set our initial stop with a conditional order based on a stock price of $64.75. We will trail the stops three bars behind for now to give the stock some room. If the downtrend develops as expected we will continue to trail just outside of the medium term moving average until we see signs for the termination of the trend. Trading a spread gives us some cushion overhead in addition to having time erosion working for us. If we were trading the stock itself we would run the stops somewhat tighter.

The bar at 14:15 shows utter indecision and the next bar is an inside bar confirming just that. Apparently, we are seeing here just a small retracement within a downside move. The momentum is slightly negative and we will give it a try and go for a long put in addition to our call credit spread. We choose a 64 strike which is rather close to the money and get filled at $1.20.

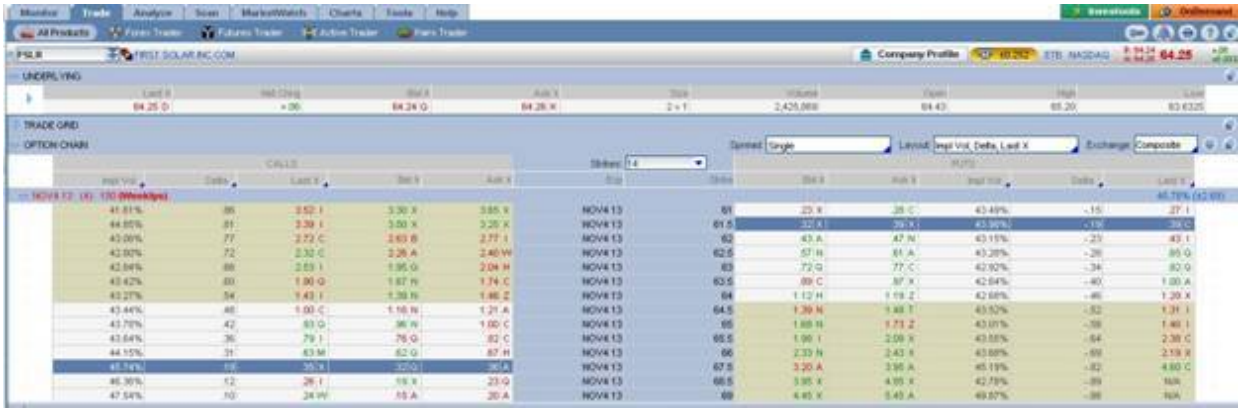


Fig. 13 FSLR option chain at 14:35, November 18, 2013

The break out of the squeeze happens on the 14:45 bar along with perfectly shaped HA bars. Following the extremely long 15:00 bar we just see a few inside bars giving no indication of a trend change and we decide to carry our positions into the following day.

We spend most of Tuesday (Fig. 14) watching the carnage. After 14:00 momentum is recovering and the stocks seems to stabilize. To stay on the side of caution we decide to get out of our long put position and we sell the 64 put at $3.80. We could buy back the 65 call at $0.15, but we rather leave it in place as most likely it will expire worthless anyway.

Instead, we establish the second leg of an iron condor by selling the 60/57.50 put credit spread for $0.74 for which no additional margin is required. The maximum loss for the iron condor is $111 ($250 less $139 total premium received). By placing a conditional stop loss order (stock price of $59) our risk is reduced even further.

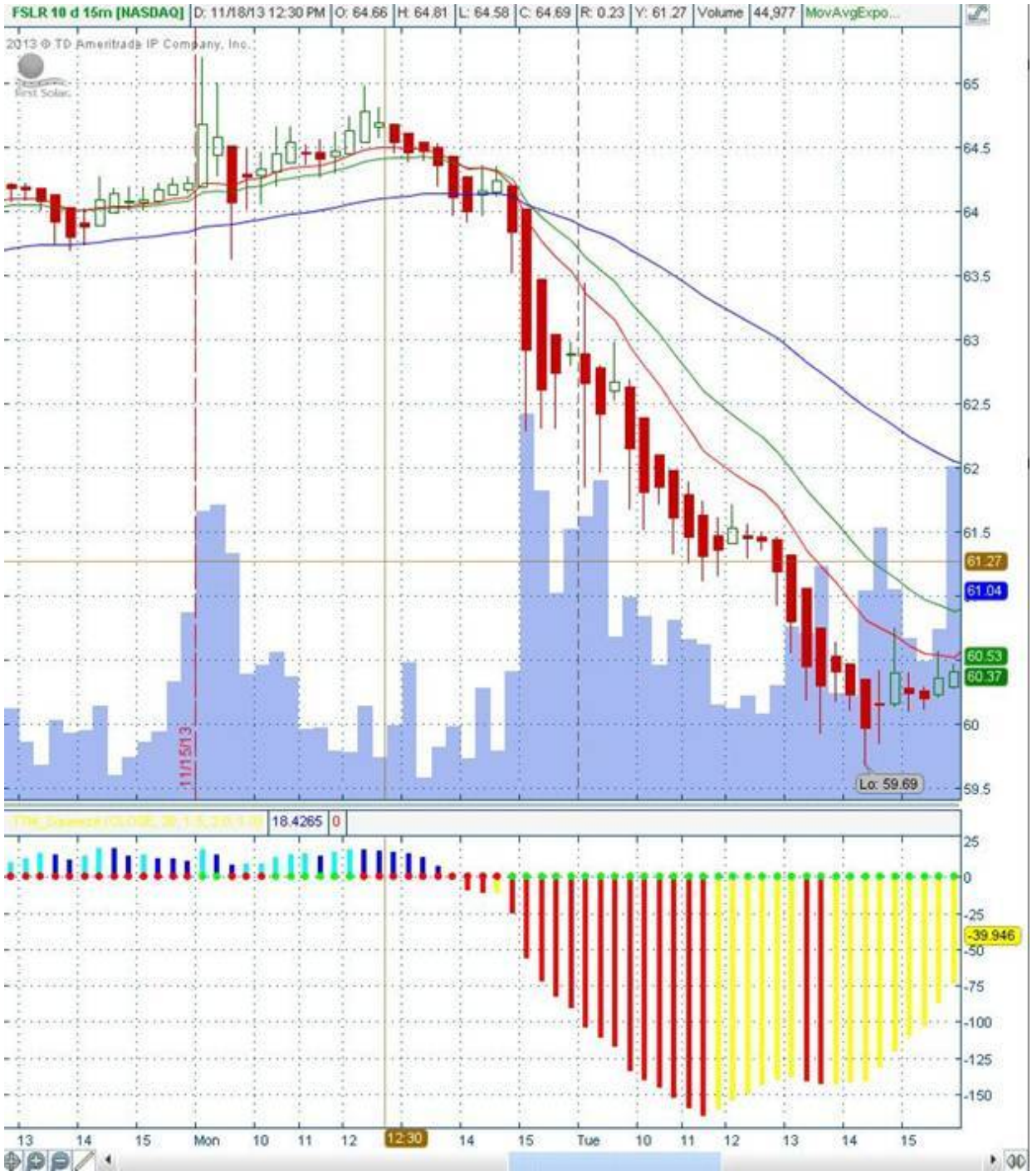



Fig. 14 FSLR, HA chart, November 19, 2013

On Wednesday, November 20, 2013 we were taking no action, just enjoying time eating away at our iron condor. Around 12:30 the HA bars looked

tempting, but the short and medium moving averages were sloping slightly upwards.

The 14:00 HA bar was a good move down, but it was followed by 3 inside bars. At 15:00 the downtrend resumed, but we were not willing to take another position into the close.

Thursday morning (Fig. 15) started with a strong 3 bar move to the upside. While the moving averages were not stacked in the right order, the short and medium ones were pointing clearly up. It looked more like a bounce than a trend change and we might have taken a trade in the stock with a buy limit of 61.50 for a quick day trade to take advantage of it. For an option trade so close to expiration we would need a clearer setup, though.

The results were now as follows:

| Action | open | close | profit |
|---|---|---|---|
| **Sell 65/67.50 CCS** | 0.65 | Exp. Worthless | 0.65 |
| **Buy 64 put** | -1.20 | 3.80 | 2.60 |
| **Sell 60/57.50 PCS** | -0.74 | Exp. Worthless | 0.74 |

This concludes the regular trading for this week. From now until the end of the week we would just look at lottery trades.

## Lottery trades

We call trades on the last day before expiration lottery trades since option premiums generally will have come down substantially due to time and implied volatility erosion. In the final hours you can pick up options for pennies and if you can catch a move carrying a stock above a strike you can make quite a bundle and risking just the small amount of premium.

Needless to say, that we would just buy either call or put options. Selling spreads would mean too much risk for too little return.

You will notice that even with lottery trades we watch the squeeze and the HA charts very closely in the 15 minutes time frame.


Fig. 15 FSLR HA 15-min chart, November 21 and 22, 2013

Late on Thursday, November 21 a look at the hourly HA chart (Fig. 16) shows that the initial bar is just followed by inside bars becoming smaller

and smaller. The last hourly bar of the day is pure indecision. And the 15-min HA bars show the beginning of a down trend that we had passed on as we were approaching the close. But it certainly deserved a closer look on Friday morning.

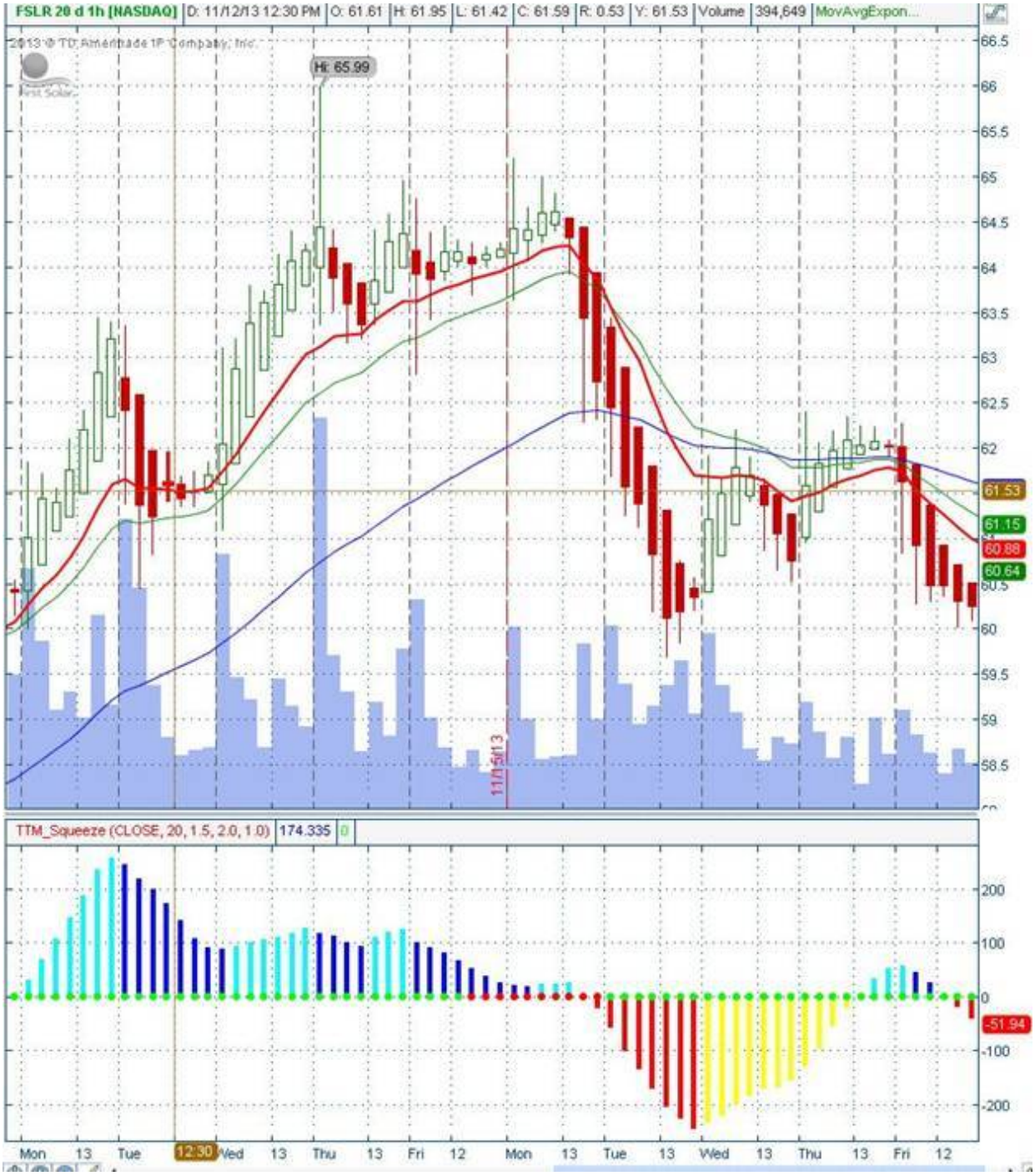


Fig. 16 FSLR HA hourly chart, November 18 through 22, 2013

The first two 15-min HA bars on Friday morning (Fig. 15) are decidedly lower but show long wicks, usually a sign for caution. Also, the second bar is an inside bar. On the other hand, moving averages and momentum point lower so that we expect the squeeze to be broken to the downside.

A look at the option chain shows that implied volatility has come down to about 34%, which doesn't come as a surprise given the short remaining life. This makes the puts more affordable and we buy some 61 puts for 30 cents. We can sell these for 80 cents half an hour before the close, not a lot of profit in cash terms but as a percentage it looks nice with 30%.

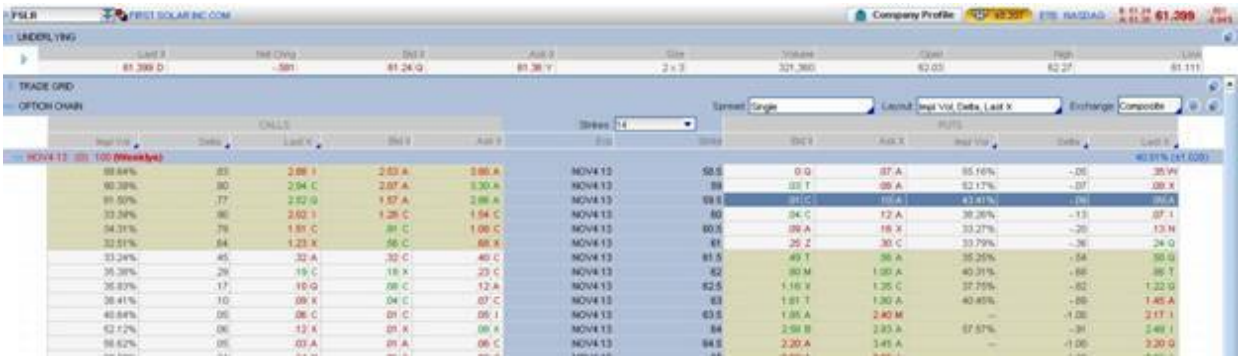


Fig. 17 FSLR option chain at 1000

## Trading before earnings

Caution – this is a strategy not for the faint of heart. The risk is limited and clearly defined, but you might have to live through a wild ride.

Pending earnings announcements are one great opportunity for capturing rich option premiums. Of course, the prime candidates for this strategy are the widely followed high flying stocks like Apple, LinkedIn, amazon, Mastercard, Netflix, Goldman Sachs and the like. Basically any stock which will show big movements in case of a positive or negative surprise because of a wide following by institutions as well as retail investors.

In the days before the announcement these stocks might just meander sideways in expectation but with expanding option premiums. Implied volatility might reach lofty levels of well over 100% during the week the announcement is due. If you look a bit further out to the next week's or month's expiration the implied volatility decreases substantially. This is our chance to take advantage of the exuberance and the rich premiums.

In trading before earnings we usually give preference to hourly charts as we are not looking for day trades. Nevertheless, we will certainly look at 15-minute charts as well when timing entry or exit points.

In the following example we will establish an iron condor by legging in over a short period of time before the earnings announcement.

Take a look at Fig. 18 showing the quote page for LNKD with the option chain for vertical spreads.

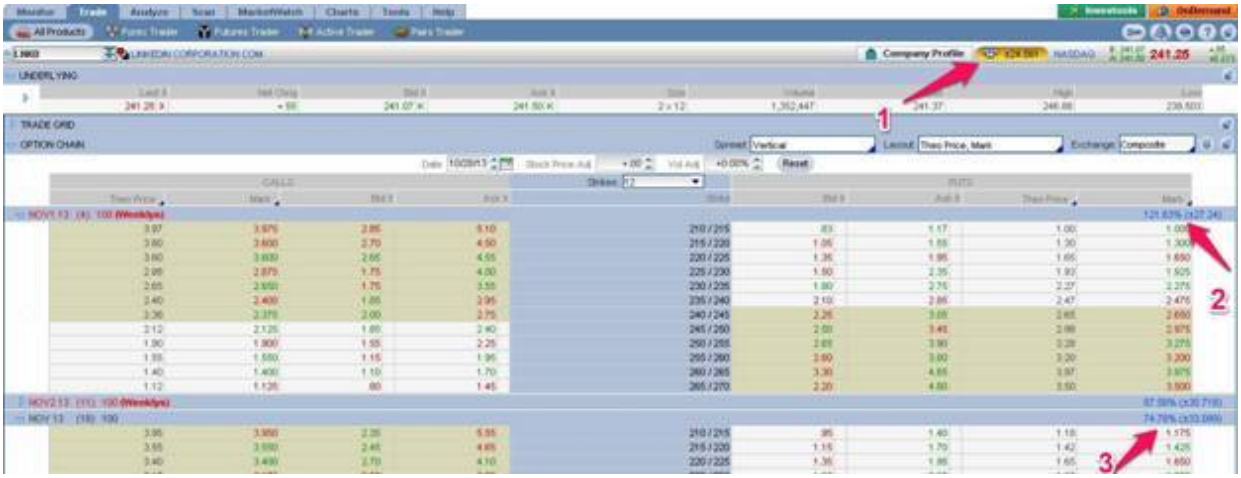



Fig. 18 LNKD option chain, October 28, 2013

Close to the top (1) you can see the expected market maker's move, indicated by MMM and highlighted in yellow. This item is not always available. You will see it mostly during earnings season for the more active stocks. Currently the expectation calls for a monster move of $24.56 up or down which is about 10%.

The top lines of the option quotes show the implied volatility for this week (2) at 121.6% and the following week (3) at 87.6% for 11 days to go. Below

that you can see that the implied volatility drops further to 74.8% in the November expiration which is 18 days out.

Today is Monday, October 28 and earnings are expected on the 29th after the close. We have no idea whether the news will be good or bad. All that counts is the reaction of the market and the degree of that reaction. We want to be positioned so that the impending move will stay within the range determined by our option position. Our expectation is that the implied volatility will collapse after the dust has settled after the announcement, thus driving down the price of the option. Time is also on our side since so close to expiration time decay will kick in in earnest very soon. Price action over the last few days has been relatively quiet because of the looming earnings announcements and also the upcoming FOMC meeting.

Fig. 19 shows the hourly HA chart. It also shows on the lower graph that we are in a squeeze since last Wednesday. The squeeze underlines that we are in a period of low volatility which usually means low options premiums. But this is not the case today as we have seen in Fig. 18 with implied volatility being sky high.

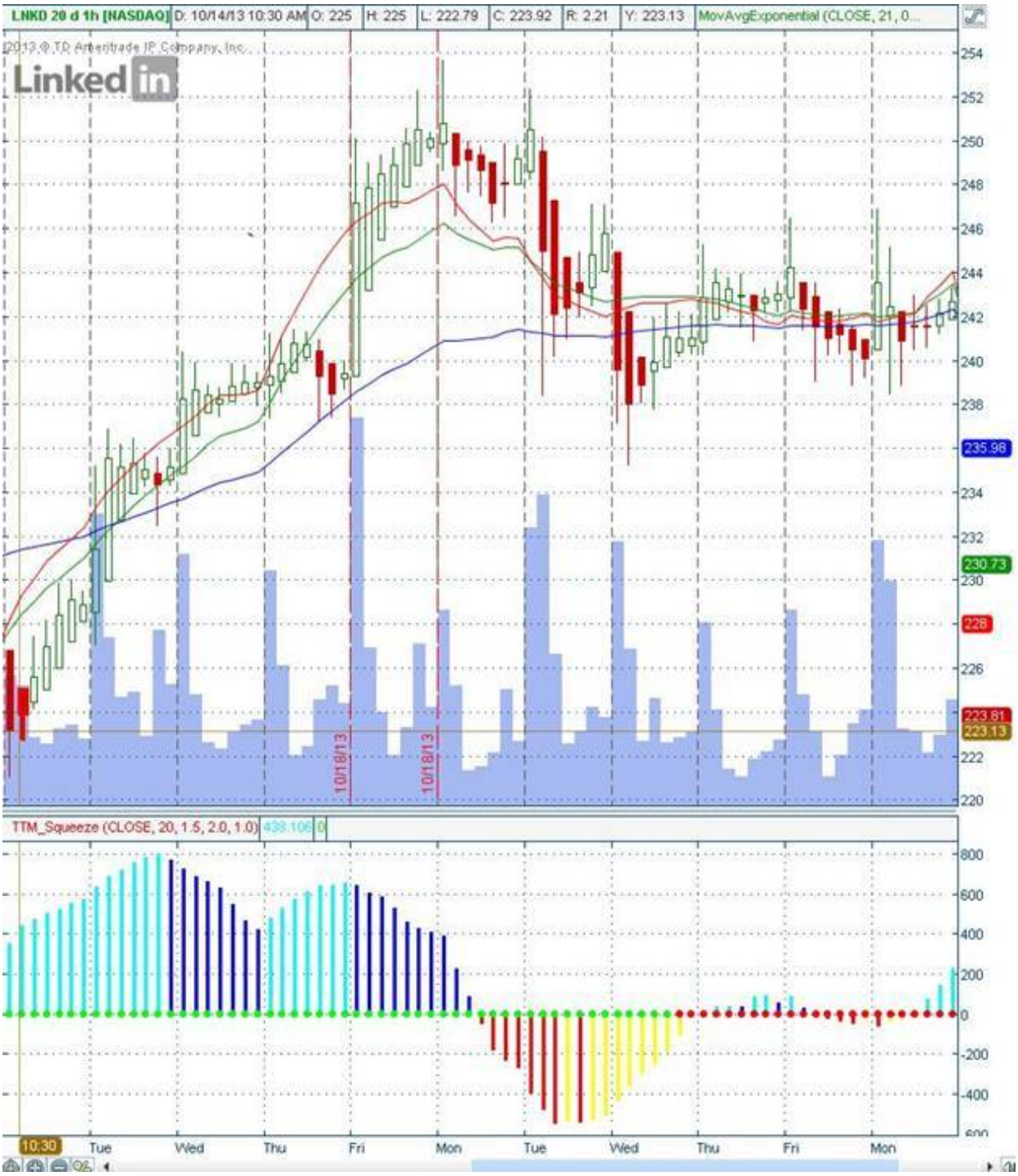



Fig. 19 LNKD hourly HA-chart, October 28, 2013

We therefore decide to establish an iron condor. To increase our chances for a decent fill we will go for it by legging in by two separate orders for a call credit spread and a put credit spread.

If the expected market maker move of 24.50 in either direction is holding water the stock could move to 265.75 on the upside and 216.75 on the downside. The conservative approach would be to establish the iron condor with the short sides of the spreads outside of these limits.

The 265/270 call credit spread would bring in about $1.12 and the 215/210 put credit spread about $1.00 for a total of $2.12 per contract. The maximum risk of that position would be the difference of the strikes minus the credit received, $500 - $212 = $288 per contract.

However, we are willing to be a little bit more aggressive and would go for a 260/265 call credit spread and a 225/220 put credit spread giving us $1.40 + $1.60 = $3.00 per contract. The maximum risk is now only $200 per contract, but the chance of going there is somewhat higher.

Before entering this order we quickly check the risk profile:

Fig. 20 LNKD risk profile of iron condor

We feel very comfortable with the wide range the stock could go to and still not endangering our premium income. We go ahead and place these orders that both got filled within the next hour:


Fig. 21 LNKD call credit spread order

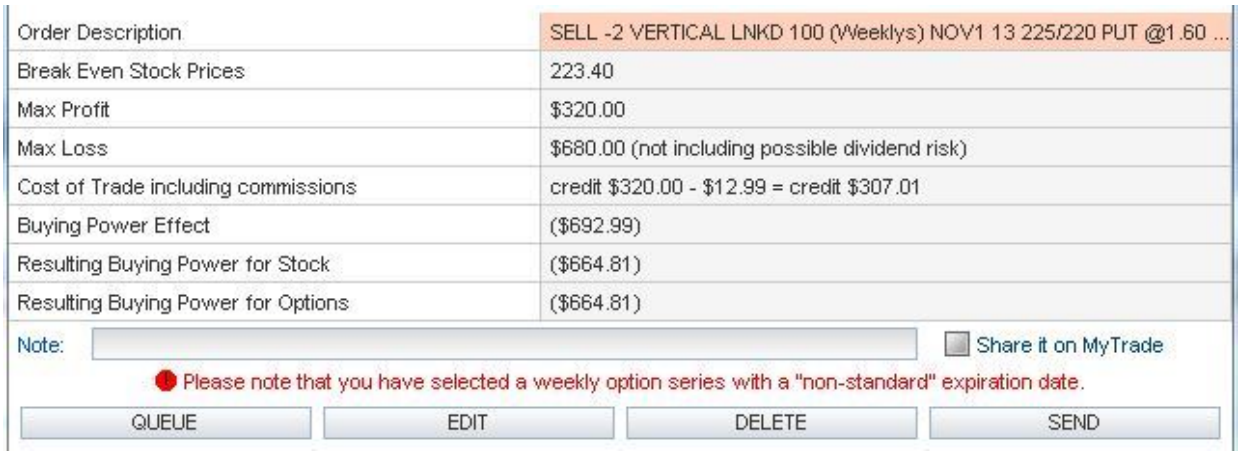



Fig. 22 LNKD put credit spread order

The hourly Heikin Ashi chart on Tuesday had given us rather divergent signals with moving average clearly heading down, the squeeze exiting to the downside and momentum negative as well, thus a clear sell signal. Only the stock price rose for most of the day and the HA bars alone could have given us some reason to enter the market long. But before earnings announcement extra caution is required since anything can happen and we would ignore these signals. Our short call at $260 was never challenged, though.

Now, we just have to wait for the announcement which is scheduled for October 29 after the market close. The next chart shows what happens in

after hours trading. Theoretically we could react to the news by establishing some hedging position in stocks only, since the option market is closed. Since after hours trading can be very erratic and emotional, we decide against it. And our position has a clearly defined risk that we are willing to sit out. And of course, we do not want to deploy more capital to that position.


Fig. 23 LNKD 15-min HA-chart, after hours post announcement

The next day opens with a sharp slide (Fig. 24) that we saw in the making during after hours trading the previous day just following the announcement. Given the strong negative reaction we were looking to exit

the put side on any small bounce, even though our put was not in immediate danger yet.


Fig. 24 LNKD hourly HA-chart, October 30, 2013

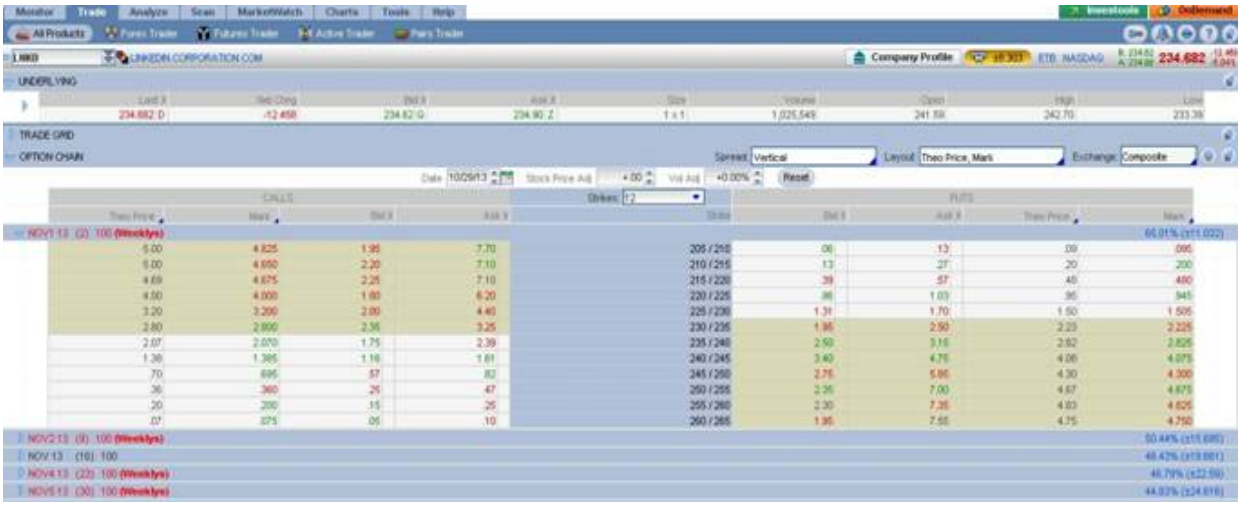


Fig. 25 LNKD option chain, October 30, 2013

A quick look at the option chain shows that the implied volatility has almost halved to 65% so we can easily close the put spread at $1.00. This gives us a profit of only $0.60 per contract, but we expect the call side to expire worthless and leave us the entire premium of $1.40 for a total profit of $2.00 per contract.

We will continue to watch LNKD further and look for a chance to reestablish a put credit spread at a lower level. As long as we have the near worthless call credit spread in place, no additional margin would be required. A bounce could happen now anytime, but so far the Heikin Ashi chart does not give us any reason for an entry yet.

The third hourly bar on Thursday looks promising but it is followed just by some inside bars. This certainly does not yet look like a trend change but at least like a pause in the downtrend. There are only one and a half days until expiration and given the sideways action we think that the $220 level could hold.

A look at the 15-minute chart (Fig. 26) confirms that we have some bottoming action and a squeeze with some upward bias going on:


Fig. 26 LNKD 15-min HA-chart, October 31, 2013

We decide to go ahead and sell the following 220/215 put credit spread which gets filled quickly:

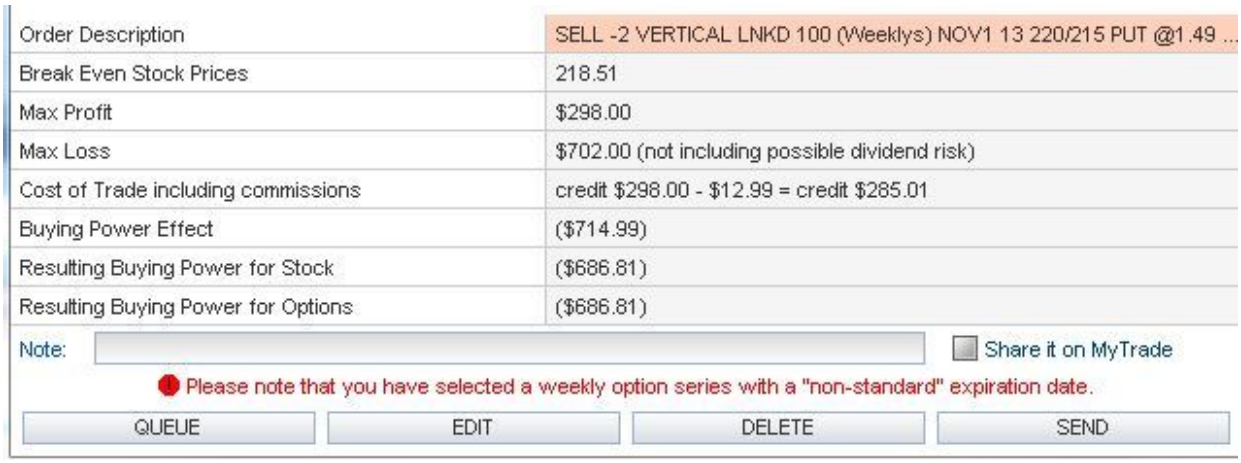



Fig. 27 LNKD put credit spread order

So far our proceeds have been as follows:

| | |
|---|---|
| Sale of 265/270 call credit spread | $1.40 |
| Sale of 225/220 put credit spread | $1.60 |
| Cover 225/220 put credit spread | -$1.00 |
| Sale of 220/215 put credit spread | $1.49 |
| Net cash flow | $3.49 |

Again, we have a position of an iron condor with slightly expanded wings and the maximum risk reduced to $1.51.

One word of caution for traders not qualified as pattern day traders. If you did close and reopened the put credit spread during the same day, this would be counted as a day trade because the 220 put appears in both transactions. The sale of a 215/210 put credit spread would have caused no problem.

The last hourly bar on Thursday afternoon looks suspicious but we decide to hold the put spread over night since we are still $3.50 above the short put and we are expecting premium decay to accelerate going into the last day before expiration.

The second hourly bar on Friday (Fig. 28) is a clear sell signal and we exit the put spread at $0.46 on the next bar not willing to risk too much in the last hours.

One possibility was just to close out the short 220 put. The remaining long 215 put would then be a lottery ticket position. But given the series of inside bars some of which looked like dojis, we were convinced that LNKD would not go much beyond 220 before the close.


Fig. 28 LNKD hourly HA-chart, November 1, 2013

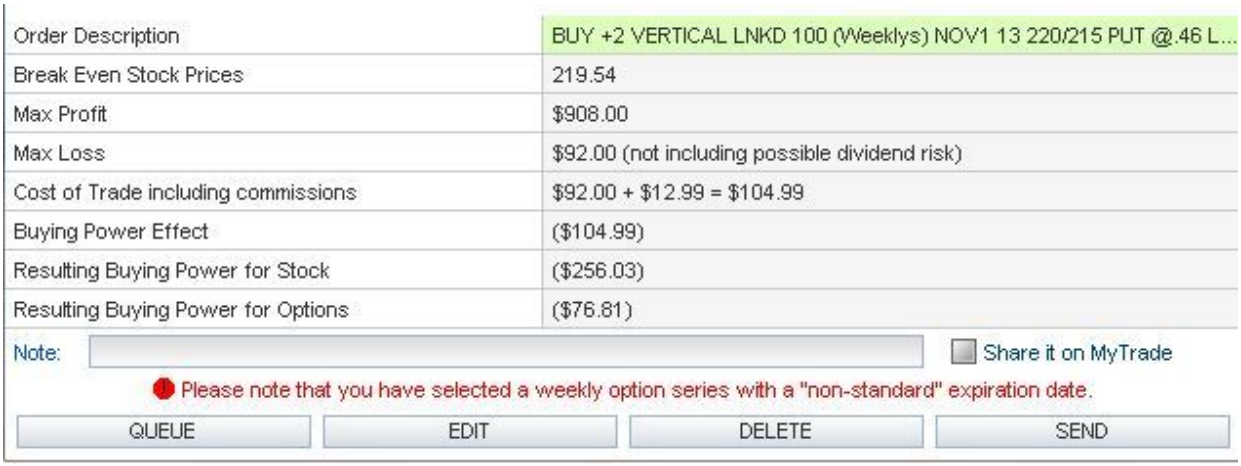



Fig. 29 LNKD put credit spread cover order

The results for LNKD were now as follows:

| Action | open | close | profit |
|---|---|---|---|
| **Sell 265/270 CCS** | 1.40 | Exp. Worthless | 1.40 |
| **Sell PCS 225/220** | 1.60 | 1.00 | 0.60 |
| **Sell 220/215 PCS** | 1.49 | 0.46 | 1.03 |

The total profit per contract was $303 which based on the (conservative) risk amount of $500 gives us a return of about 60% for the week.

## Conclusion

As you could see you don't need a whole arsenal of complicated trading strategies to trade weekly options. Many of the fancy ones may look sophisticated and might give you some intellectual satisfaction, but they will rack up your commission bill. After all, we trade to make money not to boost our ego.

Keep it simple and never forget that the driving force for option prices is always the underlying. And that you can make time and implied volatility your ally.

--$$$$$--

We sincerely hope you were able to make some profitable trades already using our Dynamic Trading Strategy. We would like to hear it. For your success stories and suggestions we welcome your email at traderhaddock@gmail.com.

In case you could not see the charts provided properly on your device, don't hesitate to shoot us an email and we will make sure you can get access to them.

And of course, if you enjoyed the book we would be grateful if you could leave a short review on amazon.com.

Other books by Tim Haddock and Ravi Kapoor:

Day Trading with Heikin Ashi Charts