

thinkMoney®/38

Random musings for traders at TD Ameritrade—WINTER 2018

NOT ALL BIG MOVES ARE CREATED EQUAL

FIND THE ONES WITH
THE MOST LOVE.

PAGE 16



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16

Not All Big Moves Are Created Equal

The news often sensationalizes big moves, but talking heads may not mention what savvy traders know: It's not the size of the move that matters. It's more about the volatility behind the move. Look at vol, throw in some stats, and find out how big a move really is.

20

Think Like a Trader, Act Like an Investor

After two black swan events in the first part of this century, it became clear to traders that a traditional portfolio mix of stocks, bonds, and cash doesn't necessarily keep you from losing your pants. It's time to rethink the principles.

24

Dollar vs. the World: Turn Down the Noise. Hear the Market Whisper.

We hear a lot of global craziness in the news about how the dollar could lose its currency reserve status. Let's look beyond the news to uncover the warning signs.

29

The Non-System System for Smarter Trading

You can go long or short a security, but what if a stock is trading sideways? You never know which way price will move, but you could consider adding a little oomph with these options strategies.

32

What Drives the Dow?

Most traders track indices as part of their investing strategy. But how is an index created? What are they made up of? It may not be too glamorous, but get "index savvy" and be the brain trust at your next cocktail party.



Cover Photograph by
Dan Saelinger

MISCELLANEOUS

In the Money

Capiche? Know more about spread prices. Then decide whether to take a trade or move on.

Gear Head Options Time & Sales - how to filter data and focus on what's important.

Ask the Geek Where to go for more education and how to sync chart drawings.

Toys for Traders Fun tools to spice up your trading screen.

Vol Whisperer Mean reversion: What does it mean or what doesn't it mean?

REGULAR COLUMNS

6 A Quick Howdy**9 Love Notes****35 Associate Spotlight**

Catch up with Victor Jones, TD Ameritrade Network's on-screen talking head.

36 Trader Glossary**38 The Back Page**

When it's not safe to call yourself a trader, how do you make yourself elusive? Give yourself a new job title.

"Having relatively balanced beta-weighted deltas could help diversify your positions and potentially reduce unsystematic risk."

Think Like a Trader, Act Like an Investor, Page 20



SKILLS BAROMETER: See a dot. Read or pass. If you've ever been frustrated spending your precious few minutes reading articles that aren't for you, these little color dots at the beginning of each article will help you skip to the stuff that matters most to you.

EASY
SEASONED
PRO

The Trouble With "Bigness"

• THREE TRADERS, three lattes. One latte to satisfy the fat cravings, one to satisfy the sweet tooth, and one for that celebratory treat after making a great trade. All three lattes are the same size, but each has a different aroma, appearance, and sensory effect. It's sort of the same with price moves. We strive to find big moves to trade. They can make us euphoric, but in reality, not all big moves are created equal. Sure, a \$10 move in a \$100 stock isn't going to be the same as a \$10 move in a \$20 stock. That's nothing new. But there's more to price moves than what's on a trading platform.

So, what other ingredients go into a price move? Prepare to be surprised. Just as lattes are made up of different ingredients, so too are price moves. Each trader has different needs, different goals, different desires. A price move in one stock may not mean the same thing to a momentum trader as it does to a contrarian trader. Which is why it's a good idea to throw in a mix of volatility and some simple math calculations just to know how big a move really is. Curious to find out more? A good place to start is to read the feature article "Not All Big Moves Are Created Equal" on page 16.

The same can be said of indices; moves aren't created equal. That has more to do with how the indices are created—they're weighted differently. Most are either price weighted or market cap weighted. So, when you see a big move in an index, what does it mean for a trader? Turn to page 32, "What Drives the Dow?" and turn your index savviness up a notch.

No two traders are alike. Each has a unique set of goals to be met. So, when you see big moves in the market, there's no need to get turned on by them all. Only go after the ones that deserve your attention.

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

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EDITOR-IN-CHIEF

Kevin Lund
EDITORIAL DIRECTOR/
LEAD WRITER
Thomas Preston
EDITOR
Eileen Sutton
ART DIRECTOR
Mace Fleeger
DESIGNER
Jennifer Roberts

CONTRIBUTING WRITERS

John Hart
David Kier
Jayanthi Gopalakrishnan
CHIEF PHOTOGRAPHER
Dan Saelinger
ILLUSTRATORS
Joe Morse
Randall Watson

PUBLISHER
T3 Custom
www.t3custom.com
info@t3custom.com



TD Ameritrade Contact
Info You Could Use
Client Services Rep:
800-669-3900
New Accounts:
800-454-9272

thinkorswim Support
800-672-2098
thinkorswim@tdameritrade.com
Platform Feedback
thinkorswimfeedback@tdameritrade.com
Tech Support
thinkorswimtechsupport@tdameritrade.com
paperMoney Support
thinkswimpapermoney@tdameritrade.com
All Other Inquiries
tdameritrade.com/contact-us

General Mailing Address
200 S. 108th Ave
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1

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2

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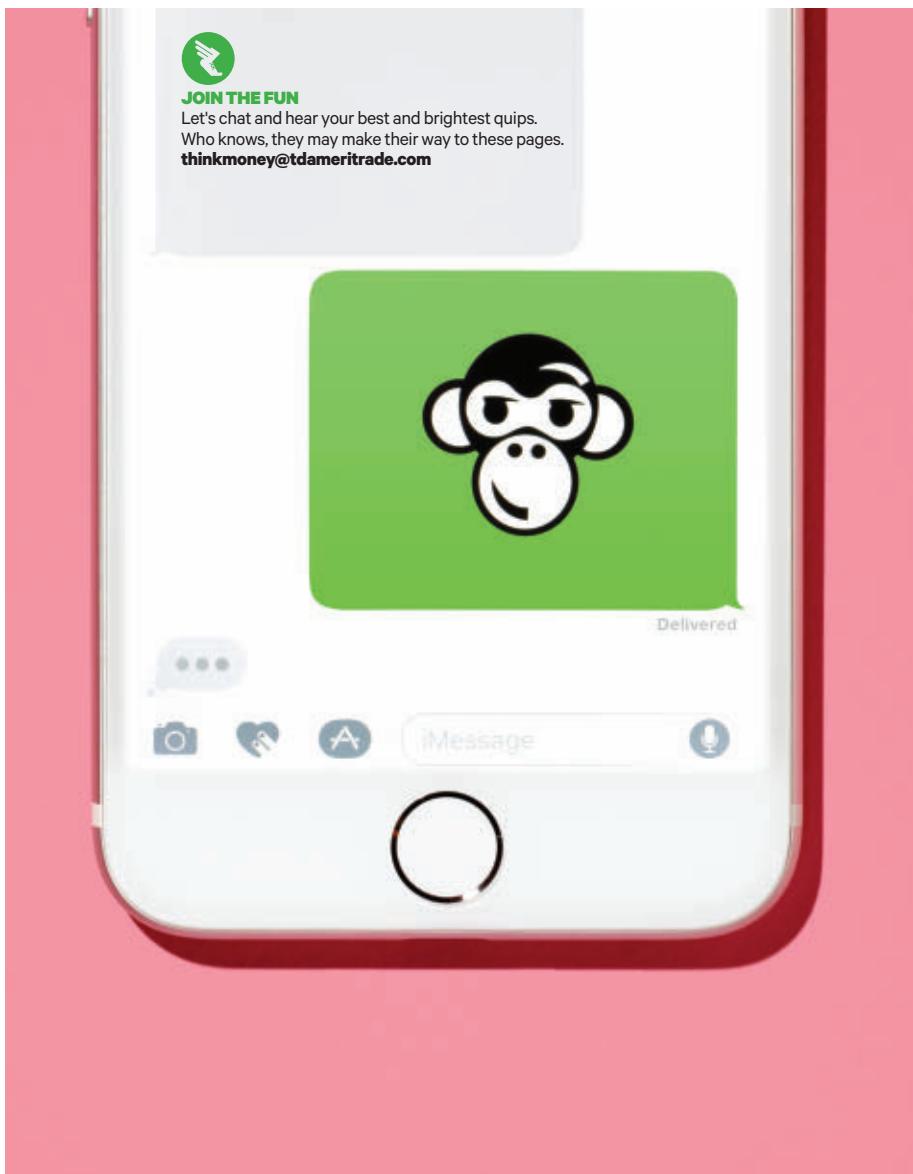
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Best in Show ... (To Our Inbox)

Hey, can I find swim lessons in the archives? Would love to stay but my boss doesn't agree. Imagine that! —**Jim**

Can I transfer money from my paperMoney account to my regular trading account? —**Vic**

Anybody here homeless? I'll give you a room to live in and a stipend. —**David**

The comments from Chat Room Pearls, right, are excerpts from chat rooms, emails, and tweets submitted by TD Ameritrade clients, and are their views and may not reflect those of TD Ameritrade. Testimonials may not be representative of the experience of other clients and are no guarantee of future performance or success. TD Ameritrade reserves the right to modify Love Notes for grammar, consistency, and similar purposes.

Chat Room Pearls...

I never thought I had ADD until I joined this chat room.
—TRISTAN

Einstein was rigged. I mean, the dude blew the "I before E" rule in his name.
—IAN

My favorite greek is baklava. Who's with me?
—JANICE

Why are they called smartphones when many people who use them are clearly participant awarders in an IQ contest?
—DINA

I went to the doc 'cuz I no longer get goosebumps about stocks. Thought it might be a stroke. Doc said, "It's just a post-earnings thing. It'll clear up soon."
—NICK

Do you know how many times I've gotten accidentally banned and purposely banned just 'cuz they didn't like "the outfit I was wearing"?
—THOMAS

Baby? Is this a trading chat room or a dating room?
—NATHAN

CHAT SWIMMER #1
The option chain looks like a war zone! You can sell the Dec 50s for \$1.80.

CHAT SWIMMER #2
I played it once for about 60% max profit. Spent all the proceeds on Xanax!

Good day to all. I'm resting today, recovering from the punch in the gut yesterday. Whoever said to keep size small in this market is a god.
—RACHEL

CHAT SWIMMER #1
There's no math magic to speed up a moving average. Like I said, there're different methods to calculate finite or infinite impulse in a time series (mathspeak for moving averages).

CHAT SWIMMER #2
I'm not looking to adjust the tension on the timing belt. I'm looking for the internal timing of the engine.

CHAT SWIMMER #1
LOL. I'm a coder and mathematician. :)

Cocktail party chatter has been known to do more damage than the cocktails!
—FRANK

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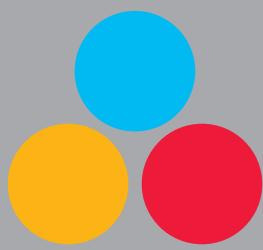
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IN THE MONEY



• WHEN OPTION PRICE penny increments were introduced in 2007, it was a great moment for online traders. The penny increment meant that bid/ask spreads could narrow to \$0.01. And narrower bid/ask spreads meant you could try to get an order filled with less slippage, as well as potentially get an execution on the order closer to fair value. Since then, the number of stock options with penny increments has expanded dramatically. But when you look at some options' bid/ask spreads, they're still wider than \$0.01—sometimes wider than \$0.05.

Profits Matter

You see, market makers on any given exchange still create those bid/ask spreads. For equity and index options, they must post bid/ask spreads at which they're willing to buy or sell options. That obligation is what they get in exchange for making two-sided (i.e., bid and ask) markets.

If a market maker has to buy an option on the bid price and sell it at the ask price whenever you want to do a trade, she makes the bid/ask spread wide enough to make a theoretical profit when she buys or sells. That's the market maker's "edge." The narrower the bid/ask, usually, the smaller the edge. Which is good for us as self-directed traders.

Spreads Vary

But a market maker will often hedge that option trade with shares of the underlying stock. If market makers can't execute their stock hedge because the stock is volatile or illiquid, they'll widen the option's bid/ask spread. In other words, if they can't easily hedge the option trade, they risk losing their edge. So, they build in more edge (i.e., widen out the bid/ask spreads) to give

CAPICHE • SEASONED

Hit the Bid, Lift the Offer, or Trade In Between

BIG IDEA: KNOWING HOW TO "HAGGLE" THE MARKET MAKERS ON SPREAD PRICES COULD HELP YOU DECIDE WHETHER TO TAKE A TRADE OR MOVE ON.



IN THE MONEY

themselves a better chance to make money.

You might see narrower bid/ask spreads for options on stocks that are actively traded and have narrow bid/ask spreads themselves. Those options may have open interest in the hundreds, or even thousands, so there are potentially lots of participants willing to buy and sell that option.

That said, when you trade, you want to get the best price—meaning a lower price when you’re trying to buy an option, and a higher price when you’re trying to sell. If you see a narrow bid/ask spread for an option, say, \$0.02 or \$0.01, you can buy or sell that option and give less edge to the market maker. Combined with high open interest, an option doesn’t get more liquid than that.

A wide bid/ask spread might signal caution is prudent. For example, if it’s \$0.10 or more and has low open interest, you may have a tough time getting filled in between the bid/ask spread, and may have to give the market maker more edge when you do a trade. That increases trading costs above commissions.

Find Your Edge

When open interest is low and bid/ask spreads are wide, you might consider moving on to the next trade. Chances are no one wants to play unless they get an edge for taking your trade. So, take your ball and go play somewhere else. —Words by THOMAS PRESTON

Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more on the risks of trading and trading options, see page 37, #1-2.

GEAR HEAD • SEASONED

Deciphering the Data

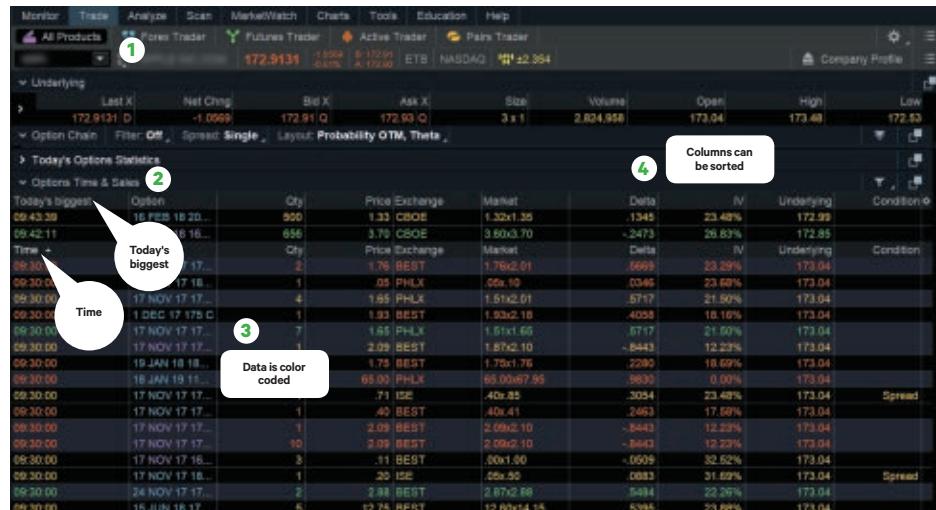
BIG IDEA: WERE THE TRADES CALLS OR PUTS? WAS A SALE AT THE BID OR BELOW, AT THE ASK OR ABOVE, OR BETWEEN THE BID AND ASK?



COOL TOOLS

For the latest release notes and thinkorswim how-to videos, go to tic.thinkorswim.com.

• What can you gain from knowing the details of every trade that took place in an underlying during a given trading day? At a high level, you may get a feel for volume (the size of trades) and momentum (the flow of trades). Wondering if sentiment is bearish or bullish? If you notice a lot of trades above the ask, then sentiment may be leaning toward the bullish side. If trades are taking place below the bid, sentiment may be more bearish. You may notice some unusual trading activity; maybe there were some large orders at a specific price. But it’s a lot of data that scrolls very quickly. The “Options Time & Sales” tool in the thinkorswim® platform from TD Ameritrade can help you organize this data and make sense of all the little bits.



Time	Today's biggest	Cty	Price	Exchange	Market	Delta	IV	Underlying	Condition
09:42:11	16 JAN 18 20...	500	1.33	CBOE	1.32x1.35	.1345	23.48%	172.99	
09:42:11	6 16...	656	3.70	CBOE	3.60x3.70	-.2473	26.83%	172.85	
09:36:00		2	1.76	BEST	1.76x2.01	.5669	23.29%	173.04	
09:30:00	17 JAN 18...	1	.05	PHLX	.05x.10	.0346	23.68%	173.04	
09:30:00	17 JAN 18...	4	.15	PHLX	1.51x2.01	.5717	21.50%	173.04	
09:30:00	1 DEC 17 175 C	1	1.93	BEST	1.93x2.18	.4058	18.16%	173.04	
09:30:00	17 NOV 17 17...	7	1.65	PHLX	1.51x1.65	.6717	21.60%	173.04	
09:30:00	17 NOV 17 17...	1	2.09	BEST	1.87x2.10	-.8443	12.23%	173.04	
09:30:00	19 JAN 18 18...	1	1.75	BEST	1.75x1.76	.2290	18.69%	173.04	
09:30:00	16 JAN 19 11...	65.00	65.00x67.95	65.00x67.95	9800	0.00%		173.04	
09:30:00	17 NOV 17 17...	.71	1.02	40x.85	.3054	23.48%	173.04	Spread	
09:30:00	17 NOV 17 17...	1	.40	BEST	.40x.41	.2463	17.58%	173.04	
09:30:00	17 NOV 17 17...	1	2.09	BEST	2.09x2.10	-.8443	12.23%	173.04	
09:30:00	17 NOV 17 17...	10	2.09	BEST	2.09x2.10	-.8443	12.23%	173.04	
09:30:00	17 NOV 17 16...	3	.11	BEST	.60x1.66	-.0509	32.52%	173.04	
09:30:00	17 NOV 17 16...	1	.20	ISE	.65x.50	.0883	31.69%	173.04	Spread
09:30:00	24 NOV 17 20...	2	2.93	BEST	2.87x2.88	.5494	22.26%	173.04	
09:30:00	16 JUN 18 17...	5	12.75	12.80x14.15	.5395	23.68%	173.04		

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

MAKE SENSE OF OPTIONS TIME & SALES DATA:

1 – From the Trade tab, select All Products and enter the symbol of the underlying.

2 – Expand the Options Time & Sales section. There are two categories here—“Today’s biggest” and “Time.” Today’s biggest finds the largest call and put trades for the current trading day.

Time lists all the trades chronologically.

3 – The data is color coded:

Blue = calls
Purple = puts
Red = trade took place at bid or below
Green = trade took place at ask or above
Yellow = trade took place between the bid

and ask
Some traded options have a shaded background. This shows if an option was in the money (ITM) or out of the money (OTM).

4 – Some columns can be sorted, such as quantity, price, delta, and implied volatility (IV).



TOYS FOR TRADERS

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The thinkorswim daily chart data for U.S. equities and indices has been expanded to span a full century—it now goes back as far as 1902. To see all the daily data for a given symbol, go to the “Daily” time aggregation menu and select the option to show “Max available.” Also, the time frame menu now has a “custom” option, which allows you to display and save specific date ranges or periods.

INTRADAY IMPLIED VOLATILITY

Implied volatility data for all optionable symbols can be displayed on intraday charts. To access this data, change your chart to an intraday aggregation. The “ImpVolatility” study will work by default on all intraday aggregations. Any thinkScript chart studies you have created using the “impVolatilityQ” function will use this data automatically when applied to an intraday chart.

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All fundamental data in the Fundamentals tab of thinkorswim is available as watchlist columns. To add them, navigate to the watchlist column customization menu and select the “Stock Fundamentals” category in the dropdown menu. Double-click on the desired metric to add columns to your watchlists. Many of the data points can be customized by time frame and display aggregation. Once you add a column, click to the right of the column name to select the period and aggregation of the data point.



Ask the Geek

BIG IDEA: A LITTLE Q&A WITH **JOHN HART**, MANAGING DIRECTOR, TRADER PRODUCT DEVELOPMENT AT TD AMERITRADE

• Help! I have so many questions. What's a good place to start?

You've come to the right place and thanks for reaching out; we're focused on making education accessible to all, and thinkorswim® could be a good launch pad to move forward with confidence. *thinkMoney* is also a treasure trove of trading discussion. And if you look to the thinkorswim platform, TD Ameritrade Network (found in the Trader TV gadget) beams market commentary, market education, and the exclusive Swim Lessons. If you scan the tabs in thinkorswim, you'll see a new Education tab where the TD Ameritrade Education team

“The education team is constantly building out courseware that could take you from zero to guru.”

—JOHN HART
@JOHNHART_TDA

is constantly building out courseware that could take you from zero to guru. Also, don't forget our tried-and-true chatrooms, where you can reach out and collaborate with other TD Ameritrade clients. It doesn't stop there; we are on social media (hit me up personally @johnhart_TDA) and of course, there's always email and phone support.

Hi John, I'm mobile all day, but do most of my technical analysis at night on my desktop. How do I get these technical analysis drawings while not at home?

You're not alone. Life is mobile today, and you need to have all of your data with you. It's for this reason we introduced a massive overhaul of the thinkorswim mobile charts. You can now quickly add drawings to the mobile charts and create and manage the sets of drawings right from your iOS or Android device. We went the extra step and made all your drawings sync with the desktop, so no matter where you are, you'll have the most up-to-date drawings with you, and there's no need for a refresh button. We synchronized everything for you. It's that easy.

I'm a volatility trader and spend a lot of time looking through lists of stocks. I'm trying to identify all the companies that have positive EPS that might have some likely near-term movement. Can you help?

Sure. Here's the short answer:

<http://tos.mx/giLwFu>

And here's the long answer: Yes! The thinkorswim scanner is the place to start with this. There's too much data out there for anyone to realistically stay on top of it all. Set the push notifications on thinkorswim Mobile and then from the desktop, import the link given earlier and add an alert when scan results change (instructions can be found here: <http://tlc.thinkorswim.com/center/release/rel-09-10-2016.html>). This scan will find every company with positive EPS, an elevated Market Maker Move, and a higher differential between historical and implied volatility. Feel free to tweak the scan to match what you're looking for. Note the beauty of this particular scan is that it'll usually not have many results. I like this because the criteria are so tight that if something matches, I know it's worth my time to look at it.

Mean Reversion: Fact vs. Fiction

BIG IDEA: YOU HEAR THE WORD “REVERSION” ALL THE TIME IN TRADING, BUT WHAT DOES IT MEAN...OR WHAT DOESN’T IT MEAN? LET’S FIND OUT.



• IMPLIED VOLATILITY, and the CBOE Volatility Index (VIX) in particular, have become popular topics among traders and investors. In volatility (“vol”) discussions, one specific term has been gaining currency: mean reversion.

Mean reversion, in relation to vol, refers to situations where, most of the time, vol sticks pretty close to some average (mean) level. And when vol deviates from that mean—higher or lower—it has a tendency to move back, or revert, toward the mean (reversion). For example, most of the time VIX moves around some average, say, 13.

Sometimes it might jump up to 17, but then settle back down around 13 again. Should the VIX drop down to 10, it might rise back up again to that 13 average. In other words, thanks to mean reversion, VIX tends to oscillate around an average price.

OPTIONS TRADING LENS

Mean reversion describes a kind of cyclical behavior, but it’s not as precisely defined as some other cycle analyses. In fact, mean reversion, as a concept, exists only in the trading world. You might see it referenced in social science, but you won’t find it in

a statistics book. Also, there’s no widely accepted metric to quantify mean reversion. Compare that to pricing options with Black-Scholes-based complex models.

In other words, vol’s mean reversion is really in the eye of the beholder.

In fact, implied vol doesn’t have a single constant average. It may move in a narrow range for days or weeks. But then an event shakes the market that could send it higher, where it might oscillate around a new mean for a time. Or vol might sink to a lower level because of market confidence or complacency, and it might oscillate around that lower average for some time.

When looking at longer time frames, in recent years, mean reversion to the downside has been observed. That’s when the VIX rises, say, for several days on unexpected world events like Brexit, and then sinks down to a lower level, where it may remain for weeks or even months.

One of the clearest examples of vol’s mean reversion is centered around earnings or news events. Implied vol has a tendency to rise ahead of uncertainty, which could mean an important earnings announcement for a stock or an upcoming FOMC meeting. Once earnings come out, the uncertainty is over, and vol may drop. This can happen whether the news is good or bad, or even if the stock in question rose or fell. But it doesn’t always happen that way.



COOL INFO

For more on mean reversion in relation to volatility, read “Reversion to the Mean: Taking Volatility to a New Level” on [tickertape](#). [tdameritrade.com](#)

CONCEPTUAL, BUT USEFUL

For the time being, until we figure out a way to effectively measure mean reversion, treat vol’s reversion as a potential confirmation of your existing strategy. You might consider using a long [vega](#) trade if you think vol is low and could revert higher, or a short [vega](#) trade if you think vol is high and could revert lower.

Thomas Preston is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.



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WORDS BY **MARK AMBROSE**

NOT ALL BIG MOVES ARE EQUAL

EASY / TAKE AWAY: Put volatility and probabilities in context to help determine your next trade and your preferred strategy.

BIG IDEA: THE NEWS OFTEN SENSATIONALIZES BIG MOVES, BUT TALKING HEADS MAY NOT MENTION WHAT SAVVY TRADERS KNOW: IT'S NOT THE SIZE OF THE MOVE THAT MATTERS, IT'S MORE ABOUT THE VOLATILITY BEHIND THE MOVE. SO, LOOK AT VOL, THROW IN SOME STATS, AND FIND OUT HOW BIG A MOVE REALLY IS.

PHOTOGRAPHS BY DANSIELINGER





Watch the financial news long enough, and you're bound to hear someone channeling Johnny Most at a Celtics game: "XYZ is up 5 points!" "ABCD is down 3%!" Surprise slam dunks—and stock price changes—often mean big stories. And market news could be pretty boring without the drama. But if you don't put volatility ("vol") in context, it's hard to tell whether all the excitement over a stock is caused by a game-winning three-pointer, or a mere first-quarter free throw.

CREATE A GAME PLAN

This is where you come in, the savvy trader, who can interpret and frame certain market events by relying on a mix of vol and statistics. Nothing too complex, but enough to answer the question, how big is big?

This is important because it can help you incorporate market news into a trading strategy. Are you a momentum trader looking to buy into strength or short into weakness? A contrarian looking to buy stocks with big selloffs, or short stocks after big rallies? Whatever your strategy, it's vital to have a metric that helps you determine whether a big price change warrants your attention. Let's get started.

First, a few statistics. In some financial models and theories (e.g., Black-Scholes), stock and index percentage price changes are assumed to be normally distributed. Think of a bell curve with a peak in the middle that theoretically represents 0% change. You'll find big down moves on the left-hand side, and big up moves on the right-hand side. In reality, price changes in all cases may or may not be normally distributed, but the normal distribution lets us determine a couple useful things about how big is "big."

One standard deviation up and down from the mean theoretically covers about 68% of price changes. Two standard deviations up and down cover about 95%. And three standard deviations up and down cover about 99%. Further, a stock or index's vol determines the size of a standard deviation in terms of price. The higher the vol, the bigger the dollar change in the stock price that stan-

dard deviation represents. Yes, one standard deviation covers 68% of a theoretical price change. But vol determines whether those price changes are \$1 or \$10. A \$1 change in a \$10 stock is a much bigger percentage (10%) than a \$1 change in a \$500 stock (0.2%). And whether the \$10 stock might change that 10%, or that \$500 stock might change that 0.2%, depends on each stock's volatility.

CONSIDER A LEVEL PLAYING FIELD

A \$10 stock with 15% volatility would have a theoretical range of \$8.50 to \$11.50 68% of the time in one year. To get that, multiply the stock price (\$10) by the volatility (15%), then add or subtract that from the prevailing stock price. Multiplying stock price by its vol gives you a theoretical standard deviation for a year.

Now, say you want to know the standard deviation for a day, week, or month. No problem. Just multiply that vol number (always a one-year number on the thinkorswim® platform from TD Ameritrade) by the square root

of the time period to adjust it to your desired time frame.

For example, for the standard deviation of one trading day, divide one by the number of trading days in a year (262 is used here), take the square root, multiply by the vol, then multiply that by the stock price.

For that \$10 stock with a 15% vol, the one-day standard deviation would be the square root of $1/262$ (or 0.0618) $\times 0.15 \times \$10 = \0.093 . Theoretically, that stock could land in a range between \$9.907 and \$10.093, 68% of the time. If the stock

moved down \$0.19 in one day from \$10 to \$9.81, it would have theoretically dropped just over two standard deviations based on that 15% volatility. Two standard deviations is a pretty large move according to the normal distribution, even though the price changes only \$0.19.



RUN YOUR PLAYS

Let's put it all into practice. Say a stock has rallied from \$80 on Monday to \$85 on Tuesday. On Monday, the stock had an overall vol of 30%. So, $0.0618 \times 0.30 \times \$80 = \$1.48$. And \$1.48 is one standard deviation based on Monday's price and volatility. Theoretically, 68% of the time, the stock might have closed in a range between \$78.52 (down \$1.48) and \$81.48 (up \$1.48) on Tuesday. But instead, it rose \$5 on Tuesday. Divide the \$5 change in the stock price by the \$1.48 theoretical standard deviation to see how many standard deviations it rallied ($\$5/\$1.48 = 3.38$ standard deviations). Theoretically, with 99% of the potential stock prices being up or down three standard deviations, a 3.38 standard deviation price change is pretty unusual.

If the vol of that \$80 stock was 60% on Monday, then $0.0618 \times 0.60 \times \$80 = \$2.97$. That's theoretically one standard deviation, and $\$5/\$2.97 = 1.68$. A 1.68 standard deviation price change is big, but not unusual, theoretically.

The \$5 price change in the \$80 stock is that same p/l for 100 shares. But in statistical terms, it means different things. The \$5 change when vol was 30% is worthy of some excitement. The \$5 change when vol was 60%, not so much. In other words, when vol was 60%, the market was perhaps expecting a big price change, and the \$5 move wasn't as big as it might have been.

To get the vol and stock price numbers to do this analysis, hit the **Charts** page of thinkorswim (Figure 1).

- 1—From “Studies,” add the “ImpVolatility” study to the Charts, which shows the overall implied vol of a stock’s options.
- 2—Set the cursor over a date that’s before the price change in question.
- 3—You’ll now see the closing price of the underlying stock or index on the upper left of the chart, and the overall implied vol of the stock or index in the upper left-hand corner of the ImpVolatility study window.

Then consider the stock or index’s price after a big change, and subtract the closing price of the previous date from that post-move price to get the price change.

Adjust the vol for time, do some multipli-

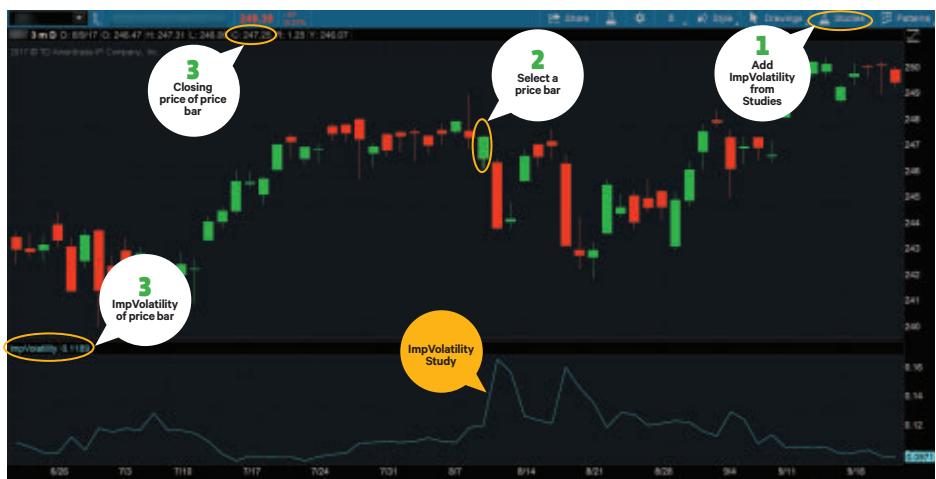


FIGURE 1: Sizing up standard deviation of price change. Hover your cursor over a price bar before and after the price change in question. Next, get the closing price and overall implied vol of the underlying stock or index. Then plug the numbers into the formula and figure out the standard deviation of the price change. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

cation and division, and determine the price change’s standard deviations.

FAIR GAME

Why do you have to adjust vol by the square root of the time frame? If a stock moves up +1% one day, and down -0.999% the next, the stock price has had almost zero net change. But was it volatile? Yes. To make sure positive price changes don’t offset negative price changes (which would give the impression that there’s no vol), all the price changes are squared to make them positive. By averaging squared changes, you get a variance that’s directly related to time. Because it’s a square of the stock returns, that variance is harder to interpret. So, we take its square root to get back to the vol of stock returns. If you take the square root of the variance, you must take the square root of time, too. That’s why vol is related to the square root of time.

Now, past performance does not guarantee future performance, and vol’s not a perfect predictor of future potential returns. Sometimes it can underestimate a stock’s potential price changes, while other times it can overestimate. In other words, vol might predict a stock’s 3% move in a month, when it

actually moved 5% (underestimating). Or vol might predict a stock’s 10% move in a month when it actually moved 8% (overestimating). Also keep in mind that the normal distribution at the base isn’t a perfect descriptor of returns. In practice, returns are rarely distributed along a “clean” normal distribution.

All in all, this analysis gives price movement a context. Going back to the \$80 stock, if the \$5 rise in price represented a statistically less likely 3.38 standard deviation change, a contrarian bearish trader might seize that potential opportunity to enter a trade, while a momentum bullish trader might wait for the stock to drop before entering. If the \$5 price rise represented a statistically more likely 1.68 standard deviation change, the contrarian bear might wait for the stock to rally before shorting it, while a momentum bull might get long at that point and see more upside potential.

NO FREE THROWS

Use vol and statistics as one more metric in your trading toolbox. It’s not a strategy in and of itself. But it may help you determine entry and exit points for certain trades by quantifying the “bigness” of price changes.

For more on the general risks of trading and trading options, see page 37, #1-2.

TAKE ACTION

For an overview on volatility, read “**Markets Move. Get Over It. An Options Volatility Primer.**” Go to the thinkMoney archives online at tickertape.tdameritrade.com/thinkmoney/12.

● SEASONED / **TAKE AWAY:** Three things traders can use to “balance” their portfolios.



**THINK
LIKE**



**ACT LIKE
AN INVESTOR**

BIG IDEA: AFTER TWO BLACK SWAN EVENTS IN THE FIRST PART OF THE CENTURY, IT BECAME CLEAR TO TRADERS THAT A TRADITIONAL PORTFOLIO MIX OF STOCKS, BONDS, AND CASH DOESN'T NECESSARILY KEEP YOU FROM LOSING YOUR PANTS. IF EVERYTHING COMES DOWN AT THE SAME TIME, PERHAPS IT'S TIME TO RETHINK THE PRINCIPLES OF HEDGING. JUST ASK A TRADER.

WORDS BY **THOMAS PRESTON**

PHOTOGRAPHS BY DAN SAELINGER







Stock, bonds, cash—that's an investor's standard menu. You put, say, 70% of your money in stocks, 20% in bonds, and 10% in cash. The assumption is that stocks and bonds are somewhat uncorrelated, meaning they don't move up and down at the same time. If stocks crash, bonds might go up, and vice versa. And cash will just stay cash. You make adjustments to the percentages depending on your market outlook. Maybe you do that every month, or every quarter, or less often. And you think you and your portfolio are set.

BUT THEN, CORRELATION HAPPENS.



Think back to 2008, when stock prices crashed. Bonds moved up initially as stocks dropped, but then bonds dropped, too. When bonds drop at the same time as stocks, they're not a great hedge. Sure, you could have sold bonds when they peaked and reallocated into cash, but who has that foresight? Being able to catch the right side of big moves can be as much a matter of luck as skill. And if you're adjusting your percentage allocations every few months or years, are you nimble enough to take advantage of potential shorter-term opportunities?

A trader might have an approach that adds agility to her portfolio. No, we're not saying you, the investor, should turn into a trader. Rather, analyze what a trader does so you become a more informed investor. The trader's three primary concepts to manage a portfolio—**delta**, capital requirements, and return on capital—are what you might like to consider. Let's see how.

GOTTA LOVE CHANGE

Delta is the amount an option's price changes when the underlying stock or index moves \$1. But that delta can be extended to your entire portfolio through **beta-weighting** on the thinkorswim® platform from TD Ameritrade (you'll

find a detailed explanation in *thinkMoney* 36). Beta-weighting converts deltas of individual positions into beta-weighted deltas in some common unit—like the S&P 500—so you can look at your portfolio's risk from an “apples-to-apples” point of view (even though it contains grapes, oranges, and pears).

Like an investor, a trader will look at the total beta-weighted delta of her portfolio to assess overall risk. But she'll also look at each position's delta to see if one is much bigger or smaller than the others. That could indicate excess risk in one security where she doesn't want it.

Say you have 300 shares each of various stocks. But the deltas have been beta-weighted to the SPX, which shows that in SPX terms, FAHN has more deltas than GVRC. A trader might decrease the deltas in FAHN by selling some shares, buying a **collar** (buy a protective put, sell a covered call), or selling covered calls. Or she might increase the deltas in GVRC by buying shares or shorting puts.

Having relatively balanced beta-weighted deltas could help diversify your positions and potentially reduce unsystematic risk. Traders never know which trade could be a loss, and they don't want an oversized position to take them down. Investors probably don't want that either.

IT'S GREAT TO HAVE FUNDS

To execute a trade, you need a certain amount of capital (i.e., money) in your account. How much capital you need depends on the trade(s) and type of account you have. Some trades in certain underlying stocks have bigger capital requirements. Some have less. Explore how much capital an individual position requires on the **Position Statement** section of the **Monitor** tab on the thinkorswim platform.

The BP effect, or buying power effect, is the impact a position has on an account's available trading capital, or buying power (Figure 1). With naked **short** option positions, the BP effect is negative, and it's easy to see how much capital one position is using. If you see that one position uses more capital than the others, you might consider reducing that stock's position, or hedge it so that its BP effect is more in line with the others.

Making sure the capital requirements of your positions are relatively equal means you'll have an idea of how much you'll need if you want to increase an allocation into equities or bonds, or how much capital you might free up by closing certain positions.

THETA RETURNS? HMM ...

Return on capital is a way to think about how much a trade could potentially make relative to its capital requirements. Now,



TAKE ACTION

What's the idea behind beta-weighting? Read **"Are You Missing the Forest for the Trades?"** in the *thinkMoney* archives online at [tickertape](#). [tdameritrade.com/thinkmoney/36](#).

what a trade could “potentially” make is anyone’s guess. For a realistic return on capital that doesn’t depend on a stock’s direction, consider something more quantifiable, like **theta**, which measures an option’s sensitivity to

time decay. In an options trade, theta is how much total credit you receive less transaction costs (positive theta) or the debit you paid (negative theta) over time, all things being equal. Because time is constant, looking at return on capital based on theta can help you balance positions as you might for delta and capital requirements.

For example, say a trade that makes an estimated \$10 of positive theta every day and requires \$1,000 in capital has a lower return on capital than a trade making \$10 of positive theta every day that requires only \$500 of capital. Is it a perfect metric? No. But it lets you compare apples to apples, like beta-weighted delta. But unlike deltas, which need to be beta-weighted before you can add them together for your portfolio, you can simply add the theta of individual positions together to get a total theta. (One day passing is the same for every position, and theta is expressed as the dollar change in value, per one day passing.)

Now, capital’s theta return doesn’t mean additional cash is generated in your account. Here’s how a trader thinks about capital’s theta return. She may prefer to earn a certain percentage of her capital—say 0.01%—from theta every day. That’s \$1 of theta for every \$10,000 of capital requirement. If a short **out-of-the-money** (OTM) put position, for example, has a lower capital return than she’d like, consider the components of her calculation: theta and capital requirement. She can’t change the short put’s theta. But she can possibly reduce her capital requirement by turning it into a short put vertical. To build a short-put vertical out of an existing short put, she needs to buy a further OTM put. But which one?

On the thinkorswim platform, you’ll find the theta of each option on the **Trade** page (Figure 2). Look at the theta of your short put. Then look for a further OTM put with a small theta that won’t reduce the positive theta of the short put too much, but with a strike that isn’t too far away from the short put’s strike.

For example, if you’re short a put that has \$1.50 of positive daily theta and a capital



FIGURE 1: What's your buying power? Analyze the buying power effect of your positions so you know which may use more capital than others. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.



FIGURE 2: Watch theta. Customize the settings on your option chain from the Layout dropdown to view the theta of calls and puts. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

requirement of \$20,000, its theta return on capital is 0.008%. If you buy a put that’s 30 strikes further OTM that has a theta of \$0.20, the resulting short put vertical will have a net theta of positive \$1.30 (\$1.50 – \$0.20) and a capital requirement of about \$3,000. By sacrificing some positive theta to reduce capital requirements, you’ve increased the position’s theta return on capital to 0.0433%. Yes, your potential profit is smaller. But capital’s theta return is higher.

If a trade is tying up your capital, you probably want it to contribute in a positive way. Having a target theta return on capital tells a trader that each position is contributing its fair share. Say the daily theta of your portfolio is \$559, and the total capital requirement (BP effect) is \$358,296. The portfolio’s theta return on capital is 0.156% per day. If that number is lower than your target, then you may need to reduce capital requirements. If it’s greater, you may need to reduce position size.

THE LOVE TRIANGLE

All these metrics—delta, capital requirements, and return on capital—can change daily. As a trader, you make daily adjustments to your overall portfolio by entering new trades and closing existing trades. As an

investor, you might want to think of these metrics in terms of a range—from an acceptable low to an acceptable high. That way, daily metrics changes can fluctuate but still remain within your range.

Remember, position adjustments increase commission costs, so keep an eye on how many you make.

All these metrics are available on the thinkorswim platform. Whatever your preferences and trading style, you can still use overall percentages of stocks, bonds, and cash. But within stocks and bonds, you can add new criteria and likewise evaluate positions in terms of delta, capital requirements, and theta return on capital. And although an investor may not make daily portfolio adjustments, it’s worthwhile to check the portfolio’s metrics daily. All you have to do is log in.

Thomas Preston is not a representative of TD Ameritrade. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more on the risks of trading and trading options, see page 37, #1-2.

BIG IDEA: WE HEAR A LOT OF GLOBAL CRAZINESS IN THE NEWS ABOUT HOW THE DOLLAR COULD LOSE ITS CURRENCY RESERVE STATUS, BUT TRADERS LOOK BEYOND THE NEWS AND UNDERSTAND THE RELATIONSHIPS BETWEEN DIFFERENT MARKETS. SO, WHAT'RE THE WARNING SIGNS THE DOLLAR COULD LOSE ITS GLOBAL STATUS? FOCUS ON WHAT MATTERS.

● SEASONED / **TAKE AWAY:** Consider relying on volatility, inter-market correlations, and overall bias to help construct your trading decisions.

DOLLAR VS. THE WORLD: TURN DOWN THE NOISE. HEAR THE MARKET WHISPER.

WORDS BY
**JAYANTHI
GOPALAKRISHNAN**

PHOTOGRAPHS BY DAN SAELINGER



THE TOP-RANKED

NBA player likely won't remain at the top of the basketball world forever. At some point, age will take over and his dominance on the court will become legend. But until then, he'll keep fighting to maintain his top-ranking status. There's a corollary here to the U.S. dollar, which has been the world's dominant reserve currency since 1921. After 96 years on top, some analysts think it's getting up there in age. And may need to be benched.

No currency has maintained its reserve status forever. The record is 110 years, which was held by Spain (1530–1640). On the other hand, what's to say the dollar can't break that? The future is naturally a rumor, and no one can offer predictions with any certainty. But the dollar's potential decline is a great story for the press. You'll routinely hear all kinds of speculation about the reason for the dollar's decline—from geopolitical tensions, to nations moving to settle trades in native currencies, to other currencies growing stronger. These ideas will keep non-traders wringing their hands for a while.

TRADER GLOSSARY
TURN TO PAGE 36

But your trader status means you don't just focus on the news. As a matter of course, you work to understand the relationship between the dollar and other markets. This helps you gauge when the dollar's in trouble, which markets might be affected, and how that impacts what you trade.

FIRST THINGS FIRST

You're likely not going to wake up one morning to find the dollar has been replaced. If that were to happen, it would be a gradual process. And its successor will become clear slowly—whether it's one currency, a basket of currencies, or a basket of commodities.

Hypothetically, what if the markets were to move away from a dollar-denominated world? How would this affect the price of international commodities like gold, oil, or the softs, where the dollar is the standard unit of currency? What if Russia were to make the ruble a dominant currency? How would that shape trades for natural gas?

Here's the thing: if countries start to "de-peg" from the dollar (not have their currency's exchange rate tied to the U.S. dollar), it could certainly impact the value of the dollar as a reserve currency. But nobody knows how much that value is. And the de-peg may or may not put pressure on the dollar's price relative to other currencies.

WHAT ABOUT VOL?

Volatility ("vol") comes and goes constantly. If you think the dollar is making subtle

moves that suggest it might lose its reserve status, consider adding commodity futures correlated to the dollar—gold, oil, or softs—as the price of these products will be impacted. But keep in mind that pricing in U.S. dollars is merely a receipt for a transaction. For example, oil has the same value all over the world, but in each nation, it's priced in its local currency. Even if changes in the dollar impact the margins of local producers or consumers, the "real" value of oil doesn't change. If the dollar becomes weaker, a particular commodity's price could move lower or higher in local markets.

But this can't be predicted, and it doesn't matter where oil is priced. What matters is there's liquidity and it can be traded. If the dollar gets "fired," vol for commodities will likely increase. And there are different ways to measure vol. For instance, you could add the ImpVolatility study to the /CL chart. Another vol measure for crude is the OVX—the CBOE Crude Oil ETF Volatility Index. Based on past news events, take a look at how these indicators moved up and down within a range. If vol spikes without a correspondingly large news event, and stays high, something else could be brewing. Vol telegraphs market uncertainty, and that's when traders pay attention to risk. But there's often more to it than a vol spike.

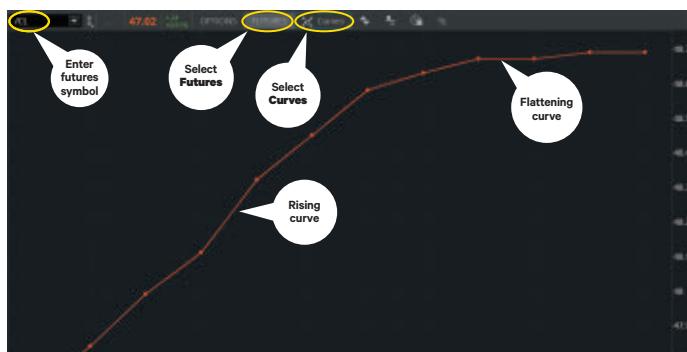


FIGURE 1: Check the curve. The spread between the spot and future price in crude oil is rising faster in the nearer months. Notice how the curve flattens as contracts move farther out in time. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

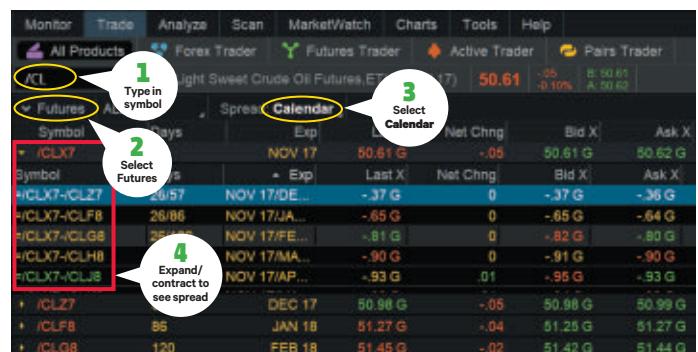


FIGURE 2: Analyzing calendar spreads. In just four steps you can go from stock symbol to trading a calendar spread. Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

SUPPLY, DEMAND, AND HANDY CURVES

Futures contracts trade on a curve. And the shape of that curve could help “shape” your trades. Because futures are contracts for a future delivery date—one month out, six months out, one year out—the shape of the curve can reflect the market’s overall bias. Futures contracts trade at different prices for different months. And that price is based



TAKE ACTION

Open a futures account.

For qualified accounts, you’ll need Tier 2 options approval to trade futures and Tier 3 to trade options on futures. Log in to your account at tdameritrade.com. Under the **Trade** tab, select **Futures Trader** to access charts, quotes, and more.

The futures curve is available on your thinkorswim® platform from TD Ameritrade. Click on the **Charts** tab, then **Product Depth**. Enter the futures symbol in the symbol box, click “Futures,” then “Curves.” To make things look less busy, you could filter out some of the futures series. Because the curves are based on speculation, the further out you look, the less certainty. And that means higher prices in the longer term, which is what is going on in the futures curve of /CL in Figure 1. It slopes upward. When the shorter-term outlook is more uncertain than the longer term, the futures curve begins to slope down.

The shape of the curve is not about the direction of price movement. It has more to do with the rate at which demand is growing faster than supply, or supply is growing faster than demand. When the spread between the spot and future’s price is rising, oil prices typically increase. And when the spot/future spread starts narrowing, prices typically decrease.

Keep in mind that a price curve’s shape can move dramatically based on the underlying’s price. And nearby months tend to be more responsive to the market’s supply and demand than futures prices further out.

ANALYZE SMARTER

Besides supply and demand, changes in inventory reports, geopolitics, and fundamentals can stir up vol in various futures markets. So, if vol goes higher and the futures curve gets steeper, it can mean a lot of market uncertainty. You can sometimes leverage this type of information in a trade.

Your goal is not to speculate on the direction of oil prices. Instead, by looking at vol and the futures curve, you can start to analyze futures by analyzing the relationships between contracts. You may want to consider trading **calendar spreads**, which is an alternative strategy to purchasing the long future. Futures calendar spreads are

different than options calendar spreads in that they speculate on the relationship between the near-term and longer-term futures contracts.

On the thinkorswim platform, you can chart the futures spreads (Figure 2).

- 1—From the **Trade** page, type in the futures symbol.
- 2—Select “Futures,” and choose to list all contracts.
- 3—Select “Calendar” from the spread choices.
- 4—Expand the contract you’re interested in, right-click on the spread you’re considering, select the “More Info” option, and then Charts (see Figure 3).

Spreads are charted by subtracting the farther-out month’s price from the closer month’s price. And if those spreads continue to widen with increased vol, it may be time to pay close attention. Would you sell the longer-term contract and buy the nearer-term one?

HEAR ALL, SEE ALL

Separate from the fate of the dollar, consider a similar analytic approach when factoring in potential changes and market turbulence. Don’t get hung up on headlines. Instead, look at those news ripples, refine that information, and figure out how to use it to create a trade. Determine which futures will be impacted, then review their vol, the futures curve, and spreads between contracts to make a more informed decision.

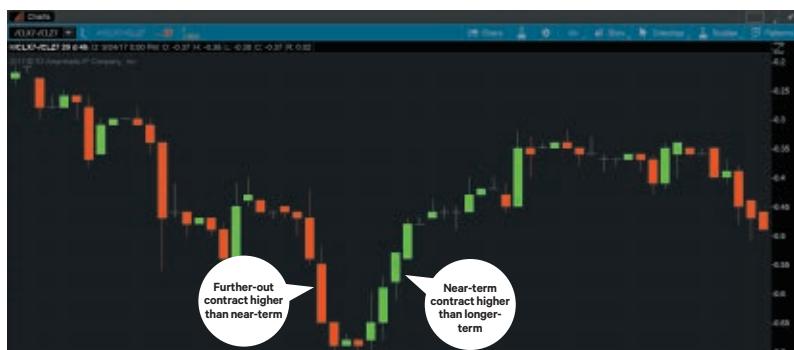


FIGURE 3: Trading calendar spreads in futures. Charting the spreads allows you to see if the spread between two contracts is increasing or decreasing. Would you buy the shorter-term contract and sell the longer-term one, or vice versa? Source: thinkorswim® from TD Ameritrade. For illustrative purposes only.

Jayanthi Gopalakrishnan is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

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For more information on the risks of trading and futures, please see page 37, #1 & 3.



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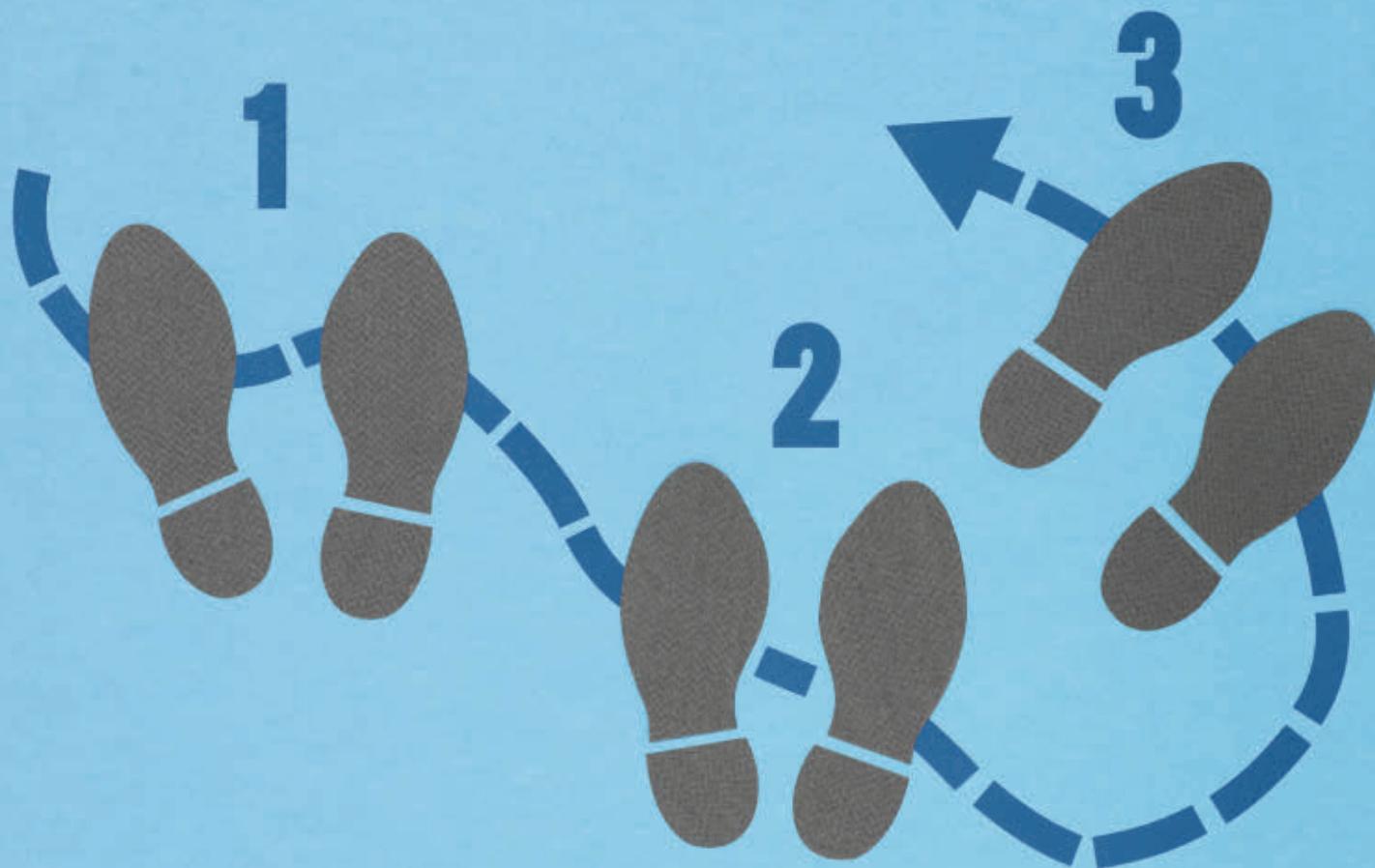


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THE NON-SYSTEM SYSTEM FOR SMARTER TRADING

PHOTOGRAPH BY DAN SAEILINGER



● EASY / TAKE AWAY: If you're not sure which way your stock might move, try using these bullish, bearish, and neutral options strategies.

BIG IDEA: SURE, YOU CAN GO LONG OR SHORT A SECURITY, BUT OFTEN A STOCK CAN TRADE SIDEWAYS. YOU NEVER KNOW WHICH WAY PRICE WILL MOVE, BUT YOU CAN CONSIDER ADDING A LITTLE OOMPH BY INCORPORATING SOME OPTIONS STRATEGIES. WORDS BY **THOMAS PRESTON**

SAY YOU HAVE A SYSTEM FOR FINDING AND executing stock trades. And maybe that system is working. But if you could make it better, would you?

Making it better might mean reducing trade risk, adding *theta* so the position could decay as time passes if the stock's price doesn't move, and maybe increasing the probability of making a profit. Sounds a little like the intro to the TV show *The Six Million Dollar Man*. But you don't need to crash and burn before you try these techniques.

HUMAN POWERS, ONLY

It's not that you have to change how you determine trading decisions. You can keep doing what you do. But you may consider an alternative strategy for those decisions. Every trading choice has trade-offs, whether decreased profit potential or increased commissions. That's why you should consider all aspects of a strategy. Let's see how options combine risk, positive *theta*, and potential increased profit in three scenarios.

1 BULLISH—Long Shares vs. Short Put

Yup, a traditional strategy. If you're bullish on a stock, you buy its shares. If the stock price goes up, you make money, and if it goes down, you lose. Now, you know that if you buy stock, the max you can lose is the price you pay for it. And while stock prices can go to zero, they don't usually. However, a stock's price doesn't have to go to zero to be considered a crash; even a 20% drop could do it. Consider a 20% drop in a \$20 stock. That's \$4 and, if you owned 100 shares, the loss is \$400. The long 100 shares can also make \$400 if the stock price rises

\$4. So the p/l for a certain percentage price change up or down in the stock's price is the same.

As an alternative to long stock, let's look at a **short put** (Figure 1). A naked short

put is a bullish trade. You sell an **out-of-the-money** (OTM) put and take in a credit. Sure, a naked short option sounds risky, and it is, but a short put's maximum risk isn't greater than owning the stock. In other words, the max risk on a naked short put is the strike price minus the credit received, and its breakeven point is the strike minus the credit, plus commissions.

For example, if you sell the 18 strike put on a \$20 stock and receive a \$0.40 credit, it would have a breakeven point of \$17.60 with a max possible loss of \$1,760 if the stock goes to zero, not including commissions. The long 100 shares you bought for \$20 would lose \$2,000, not including commissions.

If the stock price drops 20% and closes at \$16 at the option's expiration, then the short 18 put would have a \$160 loss. The 18 put would have an intrinsic value of \$2, but you took in a \$0.40 credit. The loss is $\$2.00 - \$0.40 = \$1.60$, or \$160 not including commissions. That's less than the \$400 loss on 100 shares.

If the stock stays above \$18 through expiration, the short put would still make its max profit of \$40, not including commissions. That means the stock can drop from \$20 to \$18, and the short 18 put can theoretically still profit. Even if the stock stays at \$20, all things being equal, the put's price will erode because of time decay, and you get to keep your proceeds. There's a wider range of stock prices for the short put to be profitable (\$18 and higher) than there is for the long stock (\$20 and higher). And that wider range increases the short put's chance of making money.

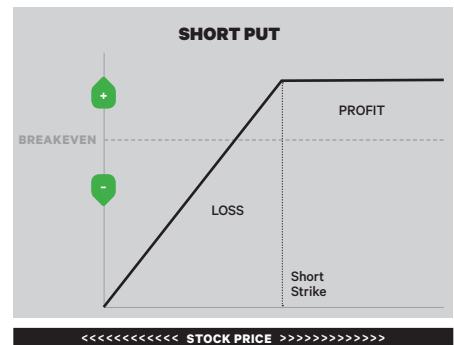


FIGURE 1: Shorting a put. It's a bullish strategy where a naked put is sold for a credit. The max risk is the strike price minus the credit. You might short a put when you believe the stock could move up or sideways prior to expiration. For illustrative purposes only.

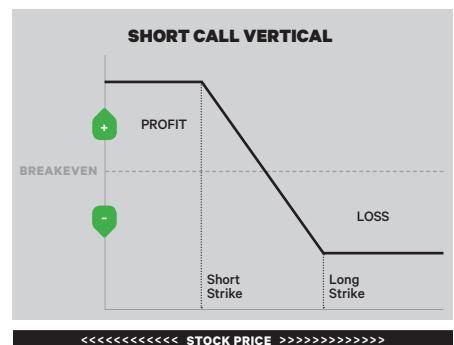


FIGURE 2: Short call vertical. It's a defined-risk strategy where potential losses are limited. Your trade will stop losing money when the stock's price rises above the long strike, but potential profits are also limited. For illustrative purposes only.

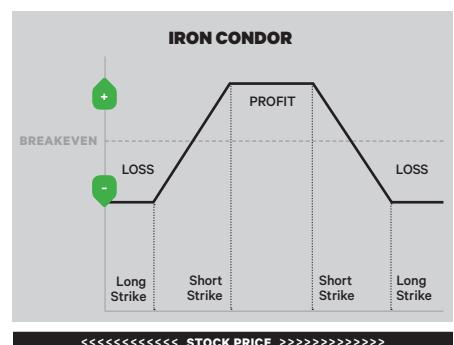


FIGURE 3: Iron Condor. If you think a stock or index may move within a narrow range, you could consider an iron condor. Its potential profit and losses are limited. For illustrative purposes only.

What's the downside to the short put? If the stock rallies past \$20.40, then the profit on the stock would be greater than the profit on the short put. The long shares theoretically have unlimited potential profit. The short put is also not eligible to receive any dividends, and can incur higher commissions. The naked put strategy also includes a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.

2 BEARISH—Short Shares vs. Short Call Vertical

If you think a stock's price will drop, the traditional strategy is to sell its shares **short**. If the stock's price drops, the trade is profitable. If the price rises, the trade loses money. The max profit is the stock price itself, which happens if the stock price goes to zero. If you shorted 100 shares of an \$80 stock, the max profit is \$8,000, not including commissions. However, the short stock position theoretically has unlimited risk: there's no limit to how high the stock's price might go.

The bearish alternative could be a short call vertical (Figure 2). Sell short an OTM call and buy long a further OTM call in the same expiration, and you receive a credit for selling the call vertical. For example, on a stock trading at \$80, a short call vertical might be to sell the 82 call and buy the 84 call for a \$0.65 credit. The max profit on the short 82/84 call vertical is your \$65 credit. Max profit occurs if the stock closes below \$82 at expiration. The breakeven point is the short call strike (\$82) plus the credit (\$0.65), which is \$82.65. If the stock is anywhere below \$82.65 at expiration, the short call vertical has some profit.

The max loss is the difference between the strikes (\$84 - \$82) minus the credit (\$0.65), which in this example is \$135. This occurs if the stock closes above \$84 at expiration.

Compare the \$65 max profit on the short call vertical to the potential profit of shorting the stock. If the stock price drops below \$79.35, the short 100 shares make a larger profit than the short call vertical. But what if the stock rallies, say, 5% and goes from \$80 to \$84? The short 100 shares would lose \$400, and the short call vertical would lose \$165, not including commissions. And what if the stock price rose to \$82? The short 100 shares would lose \$200, and the short call vertical could still make \$65.

In this example, the short call vertical can profit if the stock closes anywhere below \$82.65 at expiration, while the short 100 shares only make money if the stock is below \$80. The short call vertical has positive time decay, and can make money if the stock price stays at \$80 as time passes, all things being equal. So, in theory, the short call vertical has more opportunity for some profit than the short stock.

Just like the bullish short put, there are downsides. The short call vertical has smaller potential profit and potentially higher commissions than the short stock position.

3 NEUTRAL—No Trade vs. Iron Condor

When you don't think a stock's price will change, there's no traditional strategy. Maybe you buy the stock and collect a dividend, but that's still a bullish trade. For a trade that could profit if the stock price doesn't move, you might consider using options.

The classic neutral options trade is the **iron condor**—a short OTM **call vertical**, and a short OTM **put vertical**, in the same expiration (Figure 3). You take in a credit when you sell the iron condor. The speculation is that the stock price will stay above the short put strike and below the short call strike, and you hope to keep the credit as profit.

For example, if the stock price is \$100, an iron condor might be long the 96 put, short the 97 put, short the 103 call, and long the 104 call, for a credit of \$0.35. The max profit is the \$35 credit, less transaction costs, if the stock closes between \$97 and \$103 at the option's expiration. The iron condor has two breakeven points: the short put strike (\$97) minus the credit (\$0.35) and the short call

strike (\$103) plus the credit (\$0.35), or \$96.65 and \$103.35.

The max possible loss is the difference between either the call strikes (\$104 - \$103), or the put strikes (\$97 - \$96), minus the credit (\$0.35), which is \$65 in this example. The max loss happens if the stock closes either below the long put strike, or above the long call strike at the options' expiration.

Although the max potential profit on the iron condor is limited, so too is the max possible risk. Because the iron condor has positive time decay, the position can result in a profit as time passes, so long as the stock price stays within a narrow range, all things being equal. A downside of the iron condor is that it's a four-leg strategy that can entail substantial transaction costs, including commissions. Still, it's a strategy that has the potential to make money through speculation that the stock's price won't move up or down much.

THE ROAD LESS TRAVELED

These alternative strategies aren't your only choices, but you can engage them if you're not confident in your directional strategy. If you like the idea of lower risk, positive time decay, and higher chances of making money, then these other trading approaches might be worth the downside of lower potential profit and higher commissions.

Thomas Preston is not a representative of TD Ameritrade. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more on the general risks of trading and trading options, see page 37, #1-2.

● SEASONED / **TAKE AWAY:** *Know which stocks drive the markets.*

WHAT DRIVES THE DOW?

BIG IDEA:
MOST TRADERS TRACK INDICES AS PART OF THEIR INVESTING STRATEGY. BUT HOW IS AN INDEX CREATED? WHAT ARE THEY MADE UP OF? FACT: SOME INDICES ARE IMPACTED BY A HANDFUL OF STOCKS. IT MAY NOT BE TOO GLAMOROUS, BUT GET “INDEX SAVVY” AND BE THE BRAIN TRUST AT YOUR NEXT COCKTAIL PARTY.

WORDS BY
JAYANTHI
GOPALAKRISHNAN



TRADING THE DOGS

SHORT-TERM—Through the lens of a shorter-term strategy, sophisticated options traders might consider selling puts on some of the Dogs. Say ABCD stock made it to the Dogs list and is trading at \$53.38. You could sell a 50 put for, say, \$2.80, less transaction costs. If the stock price stays above \$53.38 through the expiration date of the options contract, your put would have expired* worthless, and you would have made \$280, less transaction costs. If the stock price goes below \$50 prior to expiry, you will likely be assigned the shares and end up purchasing them at \$50 per share at a time when the current price of the underlying stock is lower. But, if you happen to purchase the shares before the ex-dividend date, you could potentially pick up some dividend yield.

LONG-TERM—A longer-term strategy may involve buying vertical spreads on LEAPS (Long-Term Equity Anticipation Securities—these are options with nine months or longer to expiration) on the Dogs. Because this is a longer-term strategy, it could tie up your capital for the duration of the trade, which means you may have to sacrifice other opportunities. It can be difficult to close a position before expiration, absorb any profits or losses, and free up capital to take advantage of other opportunities.

percentage of the index, but have a disproportionate influence. For example, Gavorin Com (GVRC) may have greater sway than, say, Phystil Com (PHYL), only because GVRC's price is higher. At the closing bell, it doesn't matter that GVRC, by market cap, is a smaller company.

TRADER GLOSSARY
TURN TO PAGE 36

LOOK BEYOND THE CLOUDS

Should the market move and reporters react, knowing the flow of indices will help sensitize you to which stocks are actually making moves.

In general, if the S&P 500 moves big, expect its largest-cap stocks to have potentially created the bigger impact. If you hold stock positions or options on the index, this insight can help you strategize your possible position plays. It could work the other way, too. Based on earnings reports or other public data, if you expect a big price change in one of the Dow's top 10 stocks, you may want to trade in that particular stock.

You may have heard of "Dogs of the Dow." Users of this strategy buy the 10

highest-yielding Dow stocks at the start of the year and then rebalance at the start of the next year. So, each year they're investing in dividend stocks. Sure, it's a more conservative, long-term approach. But some sophisticated traders could also add some of those "Dogs" to their plate by trading their options.

LITTLE TOWNS, BIG TWISTERS

It seems counterintuitive, but often, only a handful of stocks drive some of the markets' most dramatic moves. Being aware of these stocks will take you one step higher on your market awareness ladder. So, when you see Auntie Em hollering for Dorothy, it may be because the markets, like the skies, are talking.

Jayanthi Gopalakrishnan is not a representative of TD Ameritrade. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

**Please note that the Dogs of the Dow stocks are dividend-paying stocks, and if there is an ex-dividend date between the sale date and the expiry date, there is a greater likelihood of early assignment on or shortly after the ex-dividend date. It is not possible to invest directly in an index.*

For more on the general risks of trading and trading options, see page 37, #1-2.

LIKE CLOCKWORK, THE LOCAL WEATHER guy says all kinds of stuff on the nightly news. You know the basics, but even though you're nodding your head, you have no idea what "plummeting central pressure at the rate of an additional 25 millibars" really means.

Whether you're braving gale-force trades all day long, or your quieter, trade-free IRA account feels like year-round sunshine, you've certainly heard of the Dow, NASDAQ, and S&P 500. After all, countless news outlets blast their closing values nightly. And most everyone pays attention, 'cuz—hip or not—these indices drive global markets. If you own a portfolio, it's quite likely that you have one or more stocks that are part of an index. So, when the news guy says an index closed at a certain level, is it just regular rain that could potentially flood your basement, or a scary millibars thing?

WEIGHT YOUR STORMS

Every index comprises a set number of weighted stocks. But not all indices are weighted the same, which is something traders often overlook.

Take these three leading indices as an example: the NASDAQ 100, the Dow Jones Industrial Average (herein referred to as the Dow), and the S&P 500. The NASDAQ 100—considered a tech index by many—consists of 100 non-financial companies. This index is "capitalization-weighted" (cap-weighted), meaning the component securities are weighted based on market cap (price times the number of shares outstanding). The S&P 500 is also cap-weighted. The influence of this weighting means a handful of larger companies make up most of an index's total market cap. Not surprisingly, larger-cap stocks can have a significant impact on the index's movement. Peruse both indices in terms of caps. See which stocks rank in the top 10. Should these stocks move big in a single day, you'll likely see a noticeable impact in the index's movement. And don't overlook that some stocks exist in more than one index.

The Dow represents 30 large-cap, dividend-paying stocks. The index is weighted by price, making it an average of all its stock prices. (In math-speak, that's the total of all stock prices, divided by the number of stocks.) Price weighting means that smaller companies can make up a larger



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Company Profile: Information/estimates provided by Insight Guru, a separate and unaffiliated firm. Stock prices are impacted by numerous factors and estimates of prices in the future are not guaranteed. Market volatility, volume and system availability may delay account access and trade executions. This is not an offer or solicitation in any jurisdiction where we are not authorized to do business.

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ASSOCIATE SPOTLIGHT

Tune In with Victor

DURING YOUR NEXT TRADING BREAK, TUNE IN TO WATCH VICTOR JONES AND HIS TEAM ON THE NEWLY LAUNCHED TD AMERITRADE NETWORK FOR A SMART, HIGH-ENERGY ONLINE DOSE OF PLATFORM TIPS AND MARKET INSIGHTS.

Illustration by Joe Morse

• A PASSIONATE, veteran trader, Victor Jones needs no excuse to talk about the markets. Recently returned from two years in the TD Ameritrade Singapore offices, Victor's primary focus is client education. He works hard to make that education as effortless as possible, and is excited to co-host the company's new online TD Ameritrade Network, which can be accessed from the Trader TV module on the thinkorswim® platform from TD Ameritrade or from tdameritradenetwork.com.

1

So TD Ameritrade is taking education to the airwaves?

Yes we are, and I'm thrilled to be involved with our new network. Best of all, I get to co-host the show with other smart, funny people. It's a lot of fun. There are plans to add more shows on a range of topics, and more hours of content. My dream job has always been to show up somewhere and talk for a living. Finally, I'm getting the chance.

2

What do you find exciting about trading?

I'm what you'd call a trading addict.

I couldn't work at a place unless they allowed me to trade. Whether it's in the morning, during work, or at home when I'm having dinner, I'm trading. (Yeah, even while my girlfriend is trying to get my attention.)

I come from the sports world. You play any game to win. There's a similar element in trading where, at the end of the day, it's clear whether you've won or lost. And I like that element of competition, either against myself, or against the market. Every day you try to come out on top. And if you didn't do well, you assess yourself. It could have been emotion, risk management, or something else. You



I can't get away from sports. When I was in Singapore, I played in a semi-pro basketball team and boxed.

learn from those mistakes. If you can manage risks, instinct, and the relationship between markets, you get sharper. Over time, progress becomes self fulfilling. You become like me. And you can't look away!

3

Give us a snapshot of a typical "TV" day.

We start early in the morning by doing a rundown

call where we go through the show's content. Collectively, we write and research for the show until 9:00 a.m. CT, and then broadcast the show live from 10:00 a.m. to 11:30 a.m. CT. After lunch, we start to map and prepare for the next day's show.

I think of it as "edu-tainment," or education made to be as fun as possible. I also work to tell as many corny jokes as I can fit into an hour. Full disclosure: we all do.

4

What's with your famous stare?

Those are my patented smoky eyes! That's 31 years in the making. It didn't just happen; it took a lot of practice. The truth is that I'm blind and refuse to wear my contacts. I like to guess what's happening in the world around me rather than know for sure.

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TRADER GLOSSARY



Beta weighting

- Standardizing a portfolio's positions into one unit.

Call vertical—The simultaneous purchase of one call option and sale of another call option at a different strike price, in the same underlying, in the same expiration month.

Calendar spread—A defined-risk spread strategy, constructed by selling a short-term option and buying a longer-term option of the same type (i.e., calls or puts). The goal: as time passes, the shorter-term option typically decays faster than the longer-term option, and profits when the spread can be sold for more than you paid for it. The risk is typically limited to the debit incurred.

Collar—A protective collar combines the writing, or selling, of a call option with the purchase of a put at the same expiration. Typically, this involves a call with a strike price above that of the underlying stock and a put with a strike below the stock. The strikes create “floor” and “ceiling” prices, “collaring” the underlying stock in between. In return for accepting a cap on the stock’s upside potential, the investor receives a minimum price at which the stock can be sold during the life of the collar.

Delta—A measure of an option’s sensitivity to a \$1 change in the underlying asset. All else being equal, an option with a 0.50 delta (for example) would gain 50 cents per \$1 move up in the underlying. Long calls and short puts

have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (-) deltas, meaning they gain as the underlying drops in value.

Iron condor—A defined-risk, short spread strategy, constructed of a short put vertical and a short call vertical. You assume the underlying will stay within a certain range (between the strikes of the short options). The goal: as time passes and/or volatility drops, the spreads can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the largest difference between the adjacent and long strikes minus the total credit received.

Out of the money (OTM)—An option whose premium is not only all “time” value, but the strike is away from the underlying equity. For calls, it’s any strike higher than the underlying. For puts, it’s any strike that’s lower.

Put vertical—The simultaneous purchase of one put option and sale of another put option at a different strike price, in the same underlying, in the same expiration month.

Short—To short is to sell an asset, such as an option or stock, that you don’t own in order to collect a premium. If you believe the price of the asset will decline, you can “borrow” the

stock from your broker at a certain price, and buy back (“cover”) to close the position at a lower price later. Your potential profit would be the difference between the higher price you shorted at and the lower price you covered.

Short call vertical—A defined-risk, directional spread strategy, composed of a short call option and a long, further out-of-the-money call option. Short call verticals are bearish and sold for a credit at the onset of the trade. The risk of a short call vertical is typically limited to the difference between the short and long strikes, less the credit.

Short put—A bullish, directional strategy in which a put option is sold for a credit, without another option (of a different strike or expiration) or instrument used as a hedge. The strategy assumes that the stock will stay above the strike sold; in which case, as time passes and/or volatility drops, the option can be bought back cheaper or expire worthless, resulting in a profit.

Vega—A measure of an option’s sensitivity to a one-percentage-point change in implied volatility. For example, if a long option has a vega of 0.04, a one-percentage-point increase in implied volatility will increase the option premium by \$4.

Theta—A measure of an option’s sensitivity to time passing one calendar day. For example, if a long put has a theta of -0.02, the option premium will decrease by \$2 per option contract.

Verticals/vertical spreads—An option position composed of either all calls or all puts, with long options and short options at two different strikes. The options are all on the same stock and of the same expiration, with the quantity of long options and the quantity of short options netting to zero.

CBOE Volatility Index (VIX)—The de facto market volatility index used to measure the implied volatility of S&P 500 index options. Otherwise known to the public as the “fear index,” it is most often used to gauge the level of fear or complacency in a market over a specified period of time. Typically, as the VIX rises, option buying activity increases, and option premiums on the S&P 500 index increase as well. As the VIX declines, option buying activity decreases. The assumption is that greater option activity means the market is buying up hedges, in anticipation of a correction. However, the market can move higher or lower, despite a rising VIX.

DISCLAIMERS

IMPORTANT INFORMATION YOU NEED TO KNOW

1

GENERAL DISCLAIMER

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Past performance of a security or strategy does not guarantee future results or success.

Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. Options are not suitable for all investors as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options (<http://www.optionsclearing.com/about/publications/character-risks.jsp>) before investing in options.

It is not possible to invest directly in an index.

2

OPTION STRATEGIES

Trading options involves unique risks and is not suitable for all investors.

Spreads, condors, butterflies, straddles, and other complex, multiple-leg option strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced option strategies and often involve greater risk, and more complex risk, than basic options trades. Be aware that assignment on short option strategies discussed in this article could lead to unwanted long or short positions on the underlying security.

Maximum potential reward for a long put is limited by the amount that the underlying stock can fall. Should the long put position expire worthless, the entire cost of the put position would be lost.

When trading short option strategies, there is a risk in getting assigned early on the options sold, even if they go in the money by \$0.01, obligating you to deliver

shares you don't own (in the case of a short call) or purchase shares (in the case of a short put).

The risk of loss on an uncovered short call option position is potentially unlimited since there is no limit to the price increase of the underlying security. Option writing as an investment strategy is absolutely inappropriate for anyone who does not fully understand the nature and extent of the risks involved.

Short naked put and cash-secured put strategies include a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.

Short naked option strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance.

A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)

3

FUTURES

Futures trading is not suitable for all investors as the risk of loss in trading futures is substantial. Futures accounts are not protected by the Securities Investor Protection Corporation (SIPC). Futures and futures options trading services provided by TD Ameritrade Futures & Forex LLC. Trading privileges subject to review and approval. Not all clients will qualify.

Futures and futures options trading is speculative, and is not suitable for all investors. Please read the Risk Disclosure for Futures and Options prior to trading futures products (https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA631.pdf).

Top Five Disguises for Much-Maligned Options Traders

• No rest for the weary. It seems like traders are everyone's favorite punching bag. We're Wall Street personified, whatever that means. Sometimes you get trapped in those conversations while you're just out getting tacos. And if you need to get back to your trading platform, you'll want to extricate yourself quickly. So, when a surly interlocutor asks, "What do you do, anyway?" consider these five "alternative" jobs to survive the moment.



1

FOOD TESTER

• Convenient if you're at a restaurant. Announce this with slow sidelong glances as your eyes peruse the many wonderful dishes laid out across the table. Throw around words like "divine" and "decadent" and "ambrosial." And while they're salivating, make your escape. **Clothing/gear:** pants, no belt, previously stained lobster bib.

2

ORNITHOLOGIST

• Who doesn't like birds? Birds also have names that are strange. Kind of like options strategies. If you stick a random word in between "lesser" and "tail," you'll sound like you know what you're talking about. When questioned, say you're hot on the trail of a "lesser lump tail." While everyone is looking up, you take flight. **Clothing/gear:** binocular, upturned head.

3

LIVING STATUE

• You know, those odd, interesting folks who entertain tourists everywhere on earth. A real statue artist would have painted their face and hands, but you won't have that luxury. Strike a pose for those staring at you and don't move a facial muscle for many long seconds. Then make a quick escape with un-statue-like speed. **Clothing/gear:** Superhero costume, chiseled stare into imaginary horizon.

4

TALENT SCOUT

• Everyone, secretly, is a star in their own mind. Depending on the situation, pretending to scout for movies, commercials, and off-off-off Broadway will distract adversaries long enough for you to move to a new location. **Clothing/gear:** ability to make a square out of the right and left thumbs and index fingers.

5

SOMEONE WHO ACTUALLY GIVES A DAMN

• Let's face it, you get pummeled by the market a few times, you can handle slings and arrows hurled by non-traders. Your natural response might be a weary, "Oh, please." But if you want to play, respond with a question like this: "How does a change in implied volatility impact a double diagonal?" If they don't get it, they'll slink away. If they do, you've found a new friend.

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This is the credit card for you.



Issued by TD Bank N.A.

You're invested in pursuing your financial goals. And we're invested in helping you get there. The TD Ameritrade Client Rewards Card is the only credit card that actually puts money into your eligible account with a **10% bonus**.* It's truly designed with your needs in mind.

1.5%

in rewards
on all purchases
no caps, no limits**

10%

bonus
when you redeem your rewards
for cash back into an eligible
TD Ameritrade account**

\$0

annual fee
credit card[†]
and additional card
member benefits

\$100

bonus
when you open your card
by 3/31/18 and spend
\$500 in the first
90 days*

Apply now. Call 855-489-5689 or visit tdameritrade.com/clientrewards to learn more about the card and rewards.

* If you open a new TD Ameritrade Client Rewards Credit Card between 1/1/2018 to 3/31/2018, you are eligible to earn a one-time bonus of 10,000 Client Rewards bonus points if you spend \$500 in total net purchases ("net purchases" defined as any purchase in any category subject to the limitations described in the terms and conditions) using your new TD Ameritrade Client Rewards Credit Card within 90 days of account opening date. This offer only applies to new TD Ameritrade Client Reward Credit Card accounts opened between 1/1/2018 and 3/31/2018. This bonus offer is non transferable.

** As long as your credit card account is open and in good standing.

† APRs for purchases will be a variable 16.99%, 18.99%, or 23.99 %, based on creditworthiness. APRs for balance transfers will be a variable 13.99%, 18.99% or 23.99%, based on your creditworthiness. APR cash advances is 26.24%. All APRs will vary with the market based on the Prime Rate. Balance Transfer fee: 3% of each balance transfer, minimum \$5. Foreign Transaction fee: 0%. Minimum Interest Charge—\$1.00.

This information was printed as of 12/11/2017 and it is accurate as of this date. This information may change. Please contact TD Bank at 1-855-489-5680 for information that may have changed after this date.

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