

THIRD EDITION

The Complete Guide to
**OPTION
SELLING**

How Selling Options Can Lead to Stellar
Returns in Bull and Bear Markets



JAMES CORDIER AND MICHAEL GROSS

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Returns in Bull and Bear Markets

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**JAMES CORDIER AND
MICHAEL GROSS**



New York Chicago San Francisco Lisbon
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Most of all, we thank our clients, past, present and future, without whom all of this would not be possible.

You are the sharpest, most elite investors in the world and we are honored to serve you.

INTRODUCTI

Congratulations. You have just purchased a book that will fundamentally change the way you view investing for the rest of your life. Many books promise this, but few

deliver. You will find that this one does.

Making money work for you has become increasingly complex and difficult in the past several years. The world as we knew it for many decades is evolving rapidly—in some cases, too rapidly for our liking. Traditional vehicles such as stocks, bonds, and real estate either go stagnant or dive and climb

with the rate and speed of a crashing fighter jet. Politicians and bureaucrats now meddle and attempt to influence what should be and once were free markets. The economy lurches and stalls under the same burdens. Much of what markets do seems artificial. For market news, we watch C-Span (for government debates) as much as CNBC.

You, the investor, the person who worked hard and now wants your money to work hard for you, is caught in the crossfire. Even in good times, investors are wary of what comes next. There is no consistency. Nothing to grab onto. Nothing to make you feel confident about tomorrow. The only constant is change.

Many investors I know

are happy to make any return, let alone double-digit returns. And 20%, 30%, 40%, even 50% returns on a consistent annual basis? That sounds like fantasy to most. Does it to you?

Are you exhausted from the “buy and hope” style of modern investing? Are you tired of your money being held hostage to the price direction of stocks or other

assets? Do you feel powerless to the forces of government, the media, the economy, or geopolitics?

Wouldn't it feel like freedom and self-sufficiency to have something that can work year in and year out regardless of what is going on in the world, the stock market, government, or the central bank? How would it feel to have the confidence of

knowing your investment can excel in nearly every kind of market scenario?

If you are serious about making your money work for you, about making *real* returns in a consistent manner, regardless of what direction markets are moving, you are about to get some good news.

There is a way to win. Casinos and insurance

companies know the secret and use it to make billions of dollars every single year. One hosts blackjack games and one trades policies for premiums. But both are playing the same game. They are playing and profiting from odds—odds that are tilted deeply in their favor.

You can use the very same strategy as that employed by these two

staggeringly profitable industries. You can do it with the little-known and widely unpublicized strategy of *selling options*.

Done correctly, the market condition, the political climate, or the time of year doesn't matter. It's completely independent of stocks, bonds, or real estate.

And the best part? Even for those familiar with buying

or selling options, very few individual investors know the concept described in the following pages—the concept you are about to learn.

Warning: This book might not be for you. If you are looking to get rich overnight by turning a small chunk of change into a fortune, move on to the next option book. If you are looking for 1001 ways to “trade options”

written in a textbook format, please move along. If you like to listen to flashy TV or Internet option gurus (who have never managed money in their lives), who will tell you all of the easy riches to be had if only you had their “option knowledge”—wrong place.

This book focuses on one simple strategy applied to an underutilized asset class. And

it can be strikingly effective, if you know the rules (*hint*: most do not).

Gurus, books, and courses that promise to teach you “everything there is to know” about options are frankly full of BS. I have been trading options for 30 years and I can assure you, I still have only scratched the surface of “everything there is to know.” Most option books make this

huge promise only to rehash the same basic common information—they show you what to do, they just don't show you how to do it.

That is because most of the guys writing these books, courses, and hosting TV shows are not professional money managers. Hard truth: if they were such outstanding option traders, they would be trading professionally. That is

where the money is and that is where the cream rises to. The best option traders in the world are likely guys whose names you have never heard.

I make no secret of the fact that I manage money for a living and that I am well paid for that task. I also make no secret that part of the motivation for writing this book is to attract new investors/clients to my

practice. That being said, most people reading this book will not become my client. First and foremost, most don't have enough capital and/or will otherwise not qualify to become a client of my firm. More so, however, there are those who have less capital, those who want to do things for themselves, or those who simply want a part-time semi-passive method of generating income or growing

wealth. If this is you, this book is very much for you, too. This knowledge should not be reserved simply for investors of means. It causes me no harm to share it with you. In fact, I consider it an obligation.

With the popularity of options soaring among mainstream investors since 2009, there seems to be a wealth of option information

flooding the market. Some of it is good. Most of it is utterly useless to the individual investor trying to increase his or her net worth.

You plunked your money down for this book, you deserve to get something you can really use to make money. If we never cross paths again, it is my sincere hope that you can say that this book made you money—

hopefully a lot of it.

It is also my hope that you keep it in a separate place, away from your other option books, so as not to contaminate it.

Unlike most of the gurus you see advertising their option knowledge, I have no course, seminar, or CD collection to sell you. You can rest assured that the knowledge you are obtaining

here comes from a real-life portfolio manager who has executed the strategies explained thousands of times. This is the real stuff—not always as neat and pretty as in the textbooks, but blunt, unpolished, and effective. You can take the knowledge you gain from this text alone and begin implementing it in a portfolio. No 1001 ways needed when you find one that works consistently.

Most investment or trading books aspire to teach you how to do something better (buy the right stocks, time trades better, see a different pattern, etc.). This book will introduce you to an altogether different way of generating capital that has existed only in a parallel shadow world of the mainstream investment landscape. As you will find, its participants skew to high-

net-worth investors, hedge fund managers, and private money.

We thought it time that someone brought it to your attention.

How do we know? Because we've worked alongside people implementing this strategy for the last 15 years. When McGraw-Hill asked us to do a third edition of this book, we

could not pass up the opportunity to share with the general investment community something they could be doing to really empower themselves.

Be warned: In this book, you are going to venture into an asset class that might initially make you feel uncomfortable. Bear with it. I promise you it is not as difficult or as intimidating as

you might think. It has simply never been explained to you properly before.

If you are a stock option guy who thinks you are interested only in selling options on shares, I urge you *not* to put this book down yet. You are going to learn something here that will open a whole new world to you. I promised to change the way you look at investing for the

rest of your life, and I mean it for the stock option guys, too.

You will find this book avoids the same, tired trading philosophies, complex number crunching, and painful Greek alphabet soup that plagues most books about options. Quite the contrary. Selling options doesn't have to be difficult. You will find this book simple and surprisingly easy

to follow. Common sense, not a fancy Greek calculator, is all that is required.

In addition, the lessons and concepts revealed here have not been “theorized” and calculated from the comfortable confines of a classroom or university library. This is hard-won knowledge, honed in the open warfare of market trenches. Combined, its authors have

more than 46 years of experience in the futures and options industry. We have read all the old option books, too. What we found is when you go to apply them in the real world, much of the information is impractical if not utterly useless. What you read here is what *really* works, what *really* matters—a library of book knowledge and a lifetime of real-world knowledge, relentlessly

culled and distilled into a concentrated potion. The result is a simple text that gives you only and exactly what you need to succeed. No wasted time or pages on what you don't need.

Who really makes money in the options business, who loses it, and why? Who doesn't want you to know about it? How do they do it, exactly? Most importantly,

this is a transfer of knowledge—how *you* can do it now—simply and effectively.

Though completely updated and adapted to meet modern market conditions, the core lessons of this third edition remain intact. The strategy that is about to be revealed to you works. That is not going to change. Therefore, whether you are reading this book in 2015 or

2030, the lessons are evergreen and will benefit you for decades to come.

It is not our intention in writing this book to put forth the proposition that selling options is the only way to invest. Nor do we propose that option selling is appropriate for every investor. It is also not our intention to mislead readers into believing that losses

cannot result from selling options. It is simply our belief that after all our years in the industry, all the option gurus, market prophets, backwards double-butterfly spreads, market crashes, wars, QEs, credit crunches, government shutdowns, and currency manipulations, this is the only way we've found to profit consistently in today's unstable, unpredictable, illogical markets. We believe

it is our duty to share it.

We originally wrote this book to help you to make money. This revised, fully updated, modern edition is published to help you make more of it. We will consider it a success if it achieves that end.

*James Cordier
Michael Gross
November 2014*

PART

I



SELLING OPTIONS: WHY AND HOW IT WORKS

The Option Seller's Secret

Excelling in the
World's Most
Underrated (and

Undiscovered) Investment Strategy

*For all of you
option buyers
out there that
are questioning
whether to take
the sell side of
the trade, let
me ask you
this: How many*

*times have you
bought an
option and had
it expire
worthless? If
you could turn
every option
you ever
bought into a
sell instead,
would you be
better off
financially
today than you
are now?"*

(Low rumble of

laughter and
nodding heads).

*Then what is
the question?*

JAMES CORDIER, LAS
VEGAS TRADERS EXPO,
2006

Have you ever heard it said
that the vast majority of
options expire worthless? It is
estimated that anywhere from
75% to 80% of all options

held through expiration will indeed expire worthless. Furthermore, experts estimate that only 10% or less of all options will *ever* be exercised. This being the case, why aren't more investors taking advantage of this phenomenal statistic?

Why are most investors stuck in traditional investments—held hostage to price movement based on

worldly factors far out of their control? Why are they settling for what they have been told are “normal” returns?

Why are the average sit-at-home investors not analyzing strike prices? Why are they not seeking the most glowing opportunities for deterioration instead of reviewing endless tables of mutual fund performance or

stock price-earnings (P/E) ratios? Why are they willing to be trapped by an asset they purchased, hoping and praying that it appreciates in value? Why are the majority of nonprofessional traders losing money year after year, trying to pick the perfect top or bottom by buying or selling a stock or futures contract?

Worst of all, why do

some “investors” buy out-of-the-money puts or calls that have only a remote chance of ever showing any kind of profit, let alone a windfall?

Why aren’t all of these people selling options? The answer is, either they don’t know about it, they don’t understand it, they are scared of it, or they just plain don’t care. It has been my experience that those who

consider themselves in the latter two categories are actually in one of the first two.

If this is you, it's not your fault. The concept of selling options goes against what most of us have always been taught about investing.

The Myth of the Mainstream

Investment Industry

We've all had investment "common knowledge" pounded into our heads since we picked up our first investment book: Buy low, sell high. Buy this percent of stocks, this percent of bonds. Buy and hold. The mainstream investment media reinforces these themes daily —primarily because they are

constantly being driven home by the multitrillion-dollar investment industry: mutual funds, stock brokerages, the financial planning industry, IRAs, 401Ks, advisors, authors, you name it.

These investments, of course, have their place. However, they share one basic drawback: They all rely on you to purchase an asset and then hope that asset

appreciates in value. This leaves you with only one way to make money: The price has to go up. And it has to go up after you bought it...from someone who thought the price was going down. So you have to be smarter or know something the seller didn't.

But what if the price doesn't move or, even worse, goes lower? You are out of

luck. There is no way for you to take advantage of that. You are held hostage to the whims of your asset price.

Oh, you may tell yourself that “over the long term” the thing is sure to appreciate. But if you are talking about a stock, there are a heck of a lot of factors that can move the price of it—and they may have nothing to do with the company itself. You buy and

hope the value goes up. What are the odds of that happening, and how long might that take? Well, nobody really knows.

Nonetheless, the industry has done an outstanding job of convincing the public that buying an asset for appreciation is the best or only way to invest. The problem? It's not true.

The Hapless Game of Option Buyers

Most traders and investors, especially in the commodities arena, have been taught from their first trading lesson that to turn a profit, a series of small losses must be accepted to make that one big gain. It is the potential for this one big gain that keeps traders and gamblers alike coming

back time after time and losing money time after time. Taking many losses to make one big gain is very difficult, even for the most experienced investor. Why? Because it goes against human nature. Humans are cursed with the feeling of hope when involved in an investment situation. We hope our losses will turn around for us and look for excuses to stay in our position for one more day.

Yet, when faced with a winning trade, the anxiety of remaining in the position is almost unbearable.

Many traders' first experience with futures is in buying options. This is because their brokers told them that this was the "safe" way to trade. "Limited risk" is what they are promised. Indeed, the purchase of options does limit your risk to

the amount of money that you invest in these options. Unfortunately, most of the time, the amount that you invest will be the amount that you lose if you use option buying. The odds are stacked tremendously against you. There is a very good chance that your options will expire worthless.

Maybe one of your positions made money. You

take what is left from that profit and reinvest in buying more options. Now there is a good chance that those options will expire worthless. Even if you manage to profit from a few, eventually the chances are that your luck will run out. When these options are all expired, you have lost your money. However, somebody else made money on those options (besides your broker).

Somebody took your premium and put it in his or her account.

Professionals Play the Odds

Did you ever watch the Professional Poker Players tour on ESPN? Hundreds or even thousands of people enter these tournaments. Yet

the same small bunch of guys tend to end up in the final games, on a consistent basis. Why?

Although many think that poker is a game of chance, this observation would suggest otherwise. These guys get there because they don't play poker like most people play poker. They are only playing odds, on each hand, on each draw of a card,

on each bet. They are approaching the game from a completely different perspective than most people do.

Unlike the investing public (buyers of assets or options on those assets), professionals and Wall Street insiders have often moved beyond the game of trying to guess which way the market is going to move.

Professionals are more interested in playing odds.

When I first bought my summer place in Chicago, I arranged for my boat to be transferred up from Florida for the warm weather months. On my second day at the boat dock, the man docking next to me asked me about the name of my boat—*The Option Sailor*. When I explained to him my

occupation, he invited me to lunch at his house. It turned out that my new friend “Stan” was a professional trader. He took me into his trading room. To say I was impressed was an understatement. The amount of equipment in this room was staggering, even to me—a portfolio manager. I could not imagine it was all necessary for an individual trader.

Stan traded in vehicles that I did not, so we had much to share with each other. When it was time to leave, I turned to ask him one more question: “Do you really feel all of these screens and programs give you an edge?”

“Only about 1%,” he quipped.

“You use all of this for a 1% advantage?” I asked

incredulously.

He smiled. “That’s all I need.”

The Option Seller’s Secret

Although Stan’s approach to gaining an edge may have been, in my opinion, a bit of overkill, the story illustrates an important concept. Real

professionals, the guys who make their livings from trading, are more interested in playing the odds. Without describing his trading program here, suffice it to say Stan's equipment was there more or less to calculate odds.

If you remember the 1980s movie *Wall Street*, the character Gordon Gecko bet only on “sure things.”

Though there may be no such thing in legitimate investing, professionals are looking to stack the highest odds in their favor before putting money at risk. Using strategies such as spreads, swaps, and arbitrage, pros can increase odds of success without betting on outright market direction.

Many of these institutional strategies require economy of scale (i.e.,

billions in equity), a physical presence on the trading floor, hundreds of thousands of dollars in “quant” software, or a team of highly skilled employees to execute effectively.

The Pro Strategy That Individual Investors Can Use

There is one strategy, however, favored by professionals, which can be learned relatively quickly by the individual investor. More importantly, it can be implemented fairly easily and efficiently by the personal investor.

The strategy is selling options.

The option seller's secret, the ace in the hole, is odds. If

you knew that the odds favor any option expiring worthless, would you not have an advantage before you ever do one lick of research on strikes, time, or underlying market? Further, do you think doing just a little bit of such research can improve those odds even more?

If you have ever lost money buying options, imagine that you had made a

premium for every option you held that expired worthless. Would you be ahead right now?

The option seller also enjoys the benefit of multiple profit scenarios. If you buy an asset, the price has to move up for you to make money. And if you buy an option, the price has to move in your direction quickly for you to make money. In either

situation, there is only one way to profit.

If you sell an option, the market can move in your favor, it can remain stationary, it can even move moderately against your position. In any of these scenarios, it still expires worthless. You still make money.

Of course you can also lose money selling options.

There is no free lunch. But in option selling, there are multiple ways you can make money but only one way you can lose it. I like those odds. And I like them a lot better than Stan's 1%.

What This Book Will Do for You

The purpose of this book is to

introduce the concept of option selling (or writing) to you, the nonprofessional individual investor. It is our belief that the individual investor has been deprived of not only a quality resource on the subject of pure option writing but also a concrete blueprint for *how* to sell options successfully. Selling options for premium has been a favorite strategy of professional and commercial

traders for years. After all, *somebody* has to be selling all those options to the general public, who seem to have an insatiable appetite for *buying* options all the time. More often than not, these are the people making the real money in this business.

You will learn how to do this for yourself. Simple concepts for selling options for premium and controlling

risk will be explained not in technical jargon but in simple terms. Our intention is to demystify option selling for the individual investor. The growing popularity of selling options is undeniable. Yet it remains one of the least understood concepts in the trading world. The misunderstood concept of unlimited risk—which seems to frighten some investors—will be broken down and

explained. After knowing the facts, unlimited risk may not be as intimidating as it sounds.

When you finish this book, you will not only know *about* selling options, you will both understand the process and, hopefully, be able to use it to generate stellar returns for years to come. This will hold true in bull or bear markets, good or

bad economies, quiet or volatile price moves, trends or no trends.

The concepts you will learn here can be applied to both stock and futures options. However, you will find that the focus of this book remains firmly on futures options. There are some very good reasons for this—especially if you are interested in making larger

sums of money. These will be explained later. In the meantime, if you think that you are interested in selling only stock options, I urge you not to put this book down yet; you may be pleasantly surprised at what you learn.

More importantly, you will join a very small group of elites who know the option seller's secret. This group is made up primarily of fund

managers, people who make their living trading and have high net worth, and/or sophisticated investors who spend a lot of time and money acquiring such knowledge. This group does not mind, in fact, may prefer, that option selling remain “off the radar screen” of the mainstream investment community.

But we’re happy to bring

it to yours.

Welcome to the club.

**Personal Revelation
from the Author**

**How I Discovered
Selling Options**

BY JAMES CORDIER

I never claim to have invented the concept of selling options. Rather, I acquired the knowledge more or less by stumbling upon it. I discovered commodities when I was 14 years old. I had a coin collection and kept it meticulously organized by date, type, etc.. One day I bought a set of silver coins and kept them together as a set. While my brother was

playing baseball, I was following the price of silver in *The Wall Street Journal*. A few months later, I noticed that silver prices had risen to over \$6.00 an ounce. It was about \$4.00 an ounce when I bought the coins. I took them down to my local metals dealer and asked what he would offer for my coin set. To my surprise, he offered me \$60 for the set,

a 120% profit from the \$25 I had paid for it. As much as I liked my coin set, I took the money. I could buy more coins. He bought them for the silver value alone.

When I got home I thought “That was pretty neat.” I was hooked. Ten years later, I became a commodities broker. One of my first duties was

helping my clients to buy options. It took me five years to figure out that buying options is a tough way to make money. I could study every tiny detail about soybeans, coffee, oil, or gold, get the market direction right, but we would still lose money because we bought an option.

And then I read a

statistic that said 80% of options expire worthless. So I started the study of option selling. I talked a few of my clients into giving the strategy a try. It worked—extremely well. There was only one problem. These guys were gamblers. They were futures traders. They were in it for the thrill. Making 20%, 30%, even 40% a year was not enough for

them. They wanted the action. Selling options was a little slow for their tastes. I discovered they would sell options for the premium and then use the premiums to make big bets on fast-moving futures contracts. Although some actually caught a few big moves and cleaned up, most of them didn't. Anything they could generate from selling

options was eventually lost trying to time moves in the futures market.

That's when I realized the difference between investors and gamblers. And so, in 1999, I started my own firm, specializing exclusively in selling options. My firm was for investors.

At that time, many investors were not ready to

accept this “new” investment strategy. They had never heard of it (despite the fact that funds had been quietly using it for years). We started slow, writing a few articles. And clients started coming. People started to get it. Then we started to get some buzz, and pretty soon thereafter McGraw-Hill came knocking. They thought we had a pretty

good concept and wanted us to write a book. We did. The first edition of *The Complete Guide to Option Selling* was published in 2004. Then CNBC, *The Wall Street Journal*, and Barron's started calling. Investors from around the world started calling. And we realized there were very few firms out there offering this. To say it snowballed from there

would be an understatement. But it's been a great ride. We very much enjoy being "the option seller guys."

Author Revelation

How I Discovered

Selling Options

BY MICHAEL GROSS

In 1996, I began my trading career as a retail commodities broker at a medium-sized investment firm. Eager and fresh out of training, my job at the time was to advise clients on the firm's research and recommendations. When new trades were recommended, I would call clients and inform them. Most of the time, at the preference of the

company's leadership, these trades involved buying options. Being new to the business, I embraced the strategy and dutifully called our clients with the trades. It did not take me long to notice that most of these options eventually expired worthless. When I asked my manager about this, he informed me that most futures traders want to "swing for the fence"

and that we were just helping them get what they wanted in the most cost-effective way possible. The fact that most of them lost money sooner or later (mostly sooner) seemed of little concern to him.

But it nagged at me.

One day, I was on the phone with a new client named Art. He was an older man in his mid-70s or

so. His account profile listed his profession as “investor” and he held a considerable net worth—higher than most any of the other clients with whom I had worked at the time. I was explaining to him the merits of our latest trade—buying soybean calls in expectation of drought.

“Son, I’ve been trading commodities futures for 40

years. How long have you been in this business?"

"About 6 months," I admitted sheepishly.

"And that is all you do is buy options?"

"Primarily ... yes sir."

"Well you better learn to sell them or you're not going to be around long."

It turned out that this guy made his living *selling* options. Why he had an

account with us, I do not know. Perhaps to take the other side of our trades.

What followed was a life-changing, albeit humbling, conversation. Here was a man who was worth more than half of my clients put together, and he was making a living—apparently a very nice one—doing exactly the opposite of what we were

recommending.

What was astonishing to me was that he did not consider himself a trader. He considered himself a businessman/investor who simply took advantage of opportunities when the odds were overwhelmingly in his favor. He did not sit around and watch a screen all day. In fact, he confided that he spent most of his

time playing golf, running his grandkids around, and shopping with his wife. He scanned his trading screen about 30 minutes each weekday morning, entered any order he wanted to place, if any, and that was it. Done for the day.

That day, a lightbulb not only clicked on in my head, it exploded. It made so much sense. Everybody

was buying options, swinging for the fence, hoping their lottery ticket would hit. But the only ones making any real money were those acting as the casino. They were the ones selling all of these options *we were buying*. They were willing to make a premium on each trade and that was it. But unlike the buyers, the odds were stacked overwhelmingly in

their favor.

In Art's case, he had no interest in gambling or swinging for fences. This was a pure business to him. He simply entered an investment arena full of gamblers and wishful thinkers and sold them their pixie dust, over and over and over again.

Traders came and went, year after year, washing

out, closing up shop. But Art just stuck around like a feature of the landscape.

For the 12 months following that conversation, I studied option selling with a passion I had never known. I pleaded with my supervisor and eventually went to the president of the company, asking if I could start selling options for my

clients. Repeatedly, I was denied.

“It’s too much risk.... That’s only for professionals.... They won’t understand it.... Nobody will want to do it.... It’s not exciting enough for them....” were the reasons I was given.

Apparently, making money for them was not on the mission sheet.

Eventually, I was granted permission to take a small group of clients who had expressed interest in the strategy and begin selling options. The early results were so encouraging that I began entertaining thoughts of starting my own firm.

When I met James Cordier shortly after that, I could not believe my luck

that he was actually working with some of his clients in selling options. We knew right then and there that we could work together. We knew we could take this to the public.

The “Who” of Selling Options

Insights From 30 Years in the Options Market

Are you the type of investor who has the right consistency and objectives to be an option seller? Or are you not? This chapter was meant to help you decide that based on who the typical option seller is (in our experience).

The Five Questions You Should Ask

This chapter is divided into the following five sections:

1. Why should you listen to us?
2. Who doesn't want you to sell options?
3. Who doesn't trade options at all?
4. Who is buying options?
5. Who is selling options?

The chapter's purpose is to

give you a feel for the type of investor who sells options and to help you better understand if the strategy is right for you. Does the typical option seller sound like you? Or are you more suited to be an option buyer? Or are you typically better off not investing in options at all? Of course, these are only generalizations and nobody fits neatly into a narrow category. The option selling

alternative is open to everyone, but only you can know if writing premium is the path you want to take!

Why Should You Listen to Us?

First of all, you don't have to listen to either of us. However, I have been dealing with option traders since

1984. Since 2000, I have worked almost exclusively with high-net-worth investors in the strategy of selling options. I have worked alongside investors of different nationalities, ages, professions, net worth, investment objectives, and risk tolerances. I estimate the total is over 1,500 individuals. In addition to this book and its two predecessors, I have

published more than 150 articles on selling options, many of which have appeared on *Yahoo! Finance*, *Businessweek.com*, or *Fortune.com*, to name a few. You may have seen me discussing our work during our many appearances on CNBC, Bloomberg News, Fox Business News, the Neil Cavuto show, or Larry King. My market insights are featured regularly in *The Wall*

Street Journal, *Barron's*, *Investors Business Daily*, and *Forbes*.

Although most observations here are not scientific and are based on our personal observations and experience in the industry, some of them are based on an actual study done on our client base in 2012. Nonetheless, this is not scientific data, so don't call

me up and ask me to defend it in a white paper.

With all of that said, this is what I have found to be the tendencies.

Who Doesn't Want You to Sell Options?

1. Your broker.

(Surprise!) It may seem counterintuitive to

think that your broker doesn't want you to sell options. Think again. Obviously, your stock broker does not want you to sell commodities options as that can mean money moved away from him or her. But it goes deeper than that, even if you already deal with a commodities broker. For most mainstream

brokerages, selling options is a hassle. I speak primarily of the commodities industry, but I know for a fact this carries over into the equities side of things as well.

Buying options is a lot easier for a broker to do. The broker doesn't have to watch the transaction as

closely (the risk is limited to the premium). The margin is much lower so he can buy a lot more options than he can sell. Buying options means trading in and out much more as the options lose value and he seeks “better opportunities.” Selling options is usually one sale and then a slow

wait to expiration.
Some brokers don't
like that.

Perhaps most
importantly, however,
is that it is likely the
broker doesn't
understand much about
selling options, and his
supervisor is
discouraging him from
doing it or promoting
it. Or if he does

understand it, he doesn't want to explain or "teach" it to you when it is much easier for him to buy them.

We are not putting down brokers here (we both started out as brokers)—just pointing out that some have their best interests at heart—not yours. Even online brokers make it harder to sell options

than to buy them, making you qualify for different “levels,” and charging higher than minimum exchange margins. If you want to sell options, you are best served finding a broker that specializes in this one strategy.

2. Your financial planner. I have a financial planner and I

love him. But if he didn't know me and I told him I wanted to sell options, he would try every which way but Sunday to talk me out of it. Why? Even though I truly believe he cares about my best interest, he doesn't know anything about selling options (especially, eek! commodities options).

Nor does he care to learn anything about them. More importantly, perhaps, he doesn't offer any "products" that pay him a commission for selling options. Thus, he deems it "too risky" and something better left unexplored. There is a place for financial planners, of course. But they are trained to sell a

selection of products that they or their firm offers. They do not offer, nor are they licensed to offer, commodities options (nor do I know of any that deal in stock options). If you want to sell options, you're going to have to learn it yourself or work with someone who knows what they are doing.

3. Your buddies at the club, the marina, the office, etc. (OK, the cool ones might, but the others, don't.)

Why? Because they don't understand selling options either.

Or, they might understand something about stock options, but they've heard commodities are "risky."

Everybody has

a story about Uncle Lester who lost his shirt trading pork bellies, right? Now you want to mess with options on these things? Everyone has the right to be uninformed: That doesn't mean you have to be.

Who Doesn't Trade

Options at All?

This question should be accompanied by a sister question, who *shouldn't* trade options at all? In general, if you count your pennies and only have two dimes to rub together, you shouldn't be investing one of them in an option account. If you are on a low or fixed income, have little or no liquid net worth

and your lifestyle would be affected by losing the money in your option account, you should not be trading options —buying or selling. Fortunately, most people who shouldn't trade options, *aren't* trading options.

As for the people who could be trading options but don't? Those would include people who are happy with their current investment

performance with no interest in potentially improving it. People with an extremely low tolerance for risk. Or, people who simply have no interest in learning new things or new ways of doing things.

Who Is Buying Options?

In my experience, and this is

a general statement, option buyers tend to be less capitalized and less experienced traders and/or investors. Although it is not a hard-and-fast rule, it is my opinion formed from nearly three decades in the business. The option buyers I have known and worked with (and there have been many) tend to skew toward those trying to turn a small amount of money into a large windfall. Just like

at the casino, this is most often a losers' game. We will explore this more in later chapters, but suffice to say, with the majority of options expiring worthless, buying them can be compared to buying a lottery ticket. At the end of the day, most of them are in the trash, worthless.

Buying options is often the preferred strategy of beginners—at least as it

applies to commodities. Its limited risk aspect allows them to “learn” about commodities with a defined downside. At least that’s how the pitch goes. In my opinion, the only thing they learn is how to lose money.

I must also preface that statement with the fact that I am referring to the individual investor only—one who is seeking to profit solely

through the buying or selling of an option. There are hedge funds, private equity funds, commercial hedgers, large traders, and others who buy options for a myriad of reasons. These could include risk protection, hedging positions, complex spreads, and more. Very few of these entities are likely to be buying options as a singular strategy in a pure speculative play. These investors are pros

and they know the odds. But their participation is where all of the liquidity comes from. Be grateful for them.

Who Is Selling Options?

First of all, hedge funds and private money managers sell a ton of options. Why and how they do it is a subject for

later chapters. This chapter focuses on the individual investor. Over the past five to seven years, we have begun to limit the number of new investors we accept as clients. One way of doing this is to gradually increase the minimum investment accepted. However, what we discovered was that the higher up the net-worth ladder we skewed, the more acute the tendencies listed

below became.

Thus, the characteristics listed below are derived primarily from our firm's client base from more than a decade. This means that these observations are based primarily on high-net-worth individuals. The information was obtained through both account information and new-client interviews, which we require for anyone applying

for membership. This is what we found. The commodity option sellers with whom we worked tended to be the following:

- Successful in their careers or businesses.
- Self-described as “somewhat” to “very experienced” investors, but few described themselves as “traders.”

- Worth between \$1 and \$5 million. (Others were above that level.)
- Seeking high returns—at least on some portions of their overall assets, and are open to alternative investments.
- Self-taught in how to trade or invest “the hard way” or “from the school of hard knocks.”
- Overwhelmingly male.

- Independent thinkers who are not easily swayed by others' opinions.
- Typically expert in at least one category or discipline, to appreciate the value of expertise, and to believe in hiring other experts to manage or help them manage their assets.
- Experienced (usually a

bad experience) in buying options (stock or futures).

- Self-described as neither risk averse nor as a “risk taker.”
- Willing to take calculated risks to obtain outsized objectives, both in investments and in life.
- Married with families (children or

grandchildren).

- Seeking diversity from equities, bonds, and other mainstream investments.

Surprisingly, most of our clients saw selling commodities options as a way to target high returns on their invested capital or to grow their net worth—as opposed to generate income. Other statistics we gathered include:

- Ages ranged from 35 to 75 years old with the concentration skewing toward the upper middle range.
- Nearly 40% were retired.
- Professions ranged from physicians, attorneys, pilots, accountants, real estate professional to self-employed,

entrepreneurs, investors,
or general
businesspersons.

- About 20% are classified as “other.”
- 31% never sold any kind of options before.
- 84% never traded commodities options before.

It is not my intention to judge or interpret these

observations but rather to allow you to do that for yourself. Does this sound like you? Does this sound like a club you would like to join? Does it sound like you are at least in the right place?

If so, read on and you will learn why people like this, perhaps people like you, choose to dump the “buy and hope” route to investing in favor of (or at least in

addition to) an enlightened approach—one few take the time to learn.

If you do, I can promise that you will never look at investing in the same way again.

Why Aren't You Selling Options?

The Key Advantages
of Option Selling

As enlightened as a seller of premium may be, our little corner of investing is still investing. Losses can still happen: It's the nature of the beast.

That being said, the name of this game is to make more money than you lose. That is your mission in *any* investment. Selling options is simply a different way to accomplish this mission. It

just so happens that it offers certain advantages that, in our opinion, make this feat much simpler, and maybe even easier, to accomplish. In the difficult game of making money in the markets, simpler and easier is best.

In our many years of professional investing, we've tried dozens of approaches and strategies in our search for the investment holy grail.

Although option selling may not be the holy grail, we've found nothing to match its consistency. The potential returns to be gained from such consistency are what have kept us with it for so long. The reason for this consistency is that option selling offers advantages simply not found anywhere else in the investment world.

Few in the general

investment community are aware of these advantages. Fewer still are employing the strategy of selling premium. Most are deterred by the terms *limited profit* and *unlimited risk*. This is good because as an option seller, you need plenty of traders *buying* options to help fund your retirement!

This chapter covers the advantages of selling options.

Before you learn the *how*, you must understand the *why*. For a complete comparison, however, you will also find the drawbacks to selling options in this chapter. And there are some—no strategy is perfect. We didn't write this book to put out one-sided propaganda but to give you the real story so that you can make your own decisions.

Advantage 1: The Odds Are Always in Your Favor

Let's start with the biggest and most obvious advantage. The fact is that most options do expire worthless. This is a fact: It has been confirmed by statistics. However, let's clarify this statistic. The actual figure is that most options (north or south of

80% based on whose figures you are watching) *held to expiration* expire worthless. Therefore, when we refer to percentages of options expiring worthless, we are referring to the options on the board at expiration. Some studies suggest that up to 60% of all options are closed out prior to expiration. However, these same studies indicate that only about 10% of all options ever get

exercised. What this means to you as a trader is that the longer you hold your short option, the better are your odds of success.

Options are a wasting asset. This means as time passes, the value of the option erodes. It therefore takes a progressively larger move to make the option profitable to the buyer. This is why such a large percentage of options

are closed out prior to expiration. Buyers know that the longer they hold their options, the better the chance that the value of those options will decay to zero. In addition, the closer an option is to expiration, the more difficult it becomes for that option to increase in price and produce or increase a profit for the buyer. Whether taking profits or cutting losses, many people will rush to the exits

before expiration day comes. As a seller, you have the luxury of just waiting it out, welcoming the inevitable. Some very inventive trading techniques have been created over the years, but nobody yet has come up with a way to stop the steady march of time.

The Option

Expiration Study

Futures magazine published a study in 2003 (Summa, 2003) regarding percentages of options expiring worthless. The study tracked options in five major futures contracts: the Standard & Poor's (S&P) 500, the Nasdaq 100, Eurodollars, Japanese yen, and live cattle. It was conducted over a three-year

period from 1997 to 1999. The research came to three major conclusions:

1. On average, three of every four options held to expiration expire worthless (the exact percentage was 76.5%).
2. The share of puts and calls that expired worthless is influenced by the primary trend of the underlying market.

3. Option sellers still come out ahead even when they go against the trend.

In terms of the first point, the results of this study confirm our experience in the market. However, putting some data behind our experience makes the point even more substantial. Consider that 76.5% of all options do expire worthless. (We

contacted the Chicago Mercantile Exchange in 2001 and asked exactly what amount of options it estimated expired worthless based on its years of recorded data. After several weeks of talking to several sources inside the exchange, we finally had somebody quote that the exchange's estimate was that about 74% of options expired worthless.) In our personal, not so scientific

experience, we fixed the figure closer to 82%. Therefore, there is no exact, nondebatable figure for the number of options that expire worthless. One must assume, however, that the actual number is somewhere in the neighborhood of these figures. This means that at least three of every four and possibly four of every five options held to expiration will expire worthless. And this is

shooting in the blind, throwing a dart at a board as your option picking procedure.

The second conclusion was that the amount of puts and calls expiring worthless is influenced by the primary trend of the underlying market. *In some of the studies, up to 96% of puts or calls expired worthless if they were written favoring the*

trend. This sounds like common sense, but you would be surprised at the number of traders who try to bet against a trend. When it comes to option writing, the old adage most definitely holds true: *The trend is your friend.* Write options that favor the trend and you could substantially boost your odds that the options will expire worthless.

The third conclusion may be even more significant. Option sellers still come out ahead even when they are going against the trend. The findings were that, even in bull markets, most calls expired worthless (although these figures were much lower than the 76.5% of all options that expired worthless), and most puts still expired worthless in a bear market. This means that you

could be dead wrong in your analysis of the underlying market and still have a better-than-even chance at making money on the trade. If this is correct, you could be right in your analysis of the market only half the time and still have a little better than 75% of your options eventually expire worthless. If you're any good at forecasting market direction at all, you may be able to bump your

averages a little to a lot higher.

David Caplan, in his excellent book *The New Options Advantage*, states that to profit consistently in futures and option trading, traders must give themselves some kind of “edge” in every trade they enter. By using a strategy that eventually wins about 80% of the time *before* you even do any market

research, you begin every single trade with a significant edge.

Advantage 2: You Don't Have to Pick Market Direction Anymore

One of the hardest parts of trading stocks or futures is trying to decide where the

market is going to go next. Option buyers have it even tougher. They not only have to get the direction right, they have to predict when the move will occur. *But isn't that the whole concept of investing?* You must decide where you think your stock or commodity price is headed and bet accordingly, right?

Not if you're an option seller.

At any given time the market reflects the exact value of a given commodity on that particular day for that particular delivery month. Traders speculating on price moves must forecast not only current and future fundamentals but also how the trading world will react to those fundamentals. One must be able not only to study past supply-and-demand figures and how they affected

price but also to know a little about crowd psychology. Predicting where prices will go is like trying to predict the direction of a hurricane. Even the experts can make only vague projections until the storm makes landfall.

Projecting where it *won't* go, however, can be another matter. If strong wind currents are blowing it northeast, and these wind

currents are expected to continue, one assumes that the hurricane will hit in some destination in a northeasterly direction. Therefore, the hurricane could veer off to the north or the east, maybe even way off from the direction of the wind, but it would be unlikely (although not impossible) for the storm to make a 180-degree about-face and head directly into the wind in a southwesterly

direction.

Knowledgeable option sellers bet that the storm will not make a 180-degree turnaround into the wind. That's all. They don't play the game of guessing where the storm will hit. That's a low-odds game. Guessing where it will not hit is much easier.

When you sell options in the way you will learn in this

book, this is how you will play the market. You no longer have to try to outguess the pros as to where the market will go. All you have to determine is a price level to which you believe the market will *not* go. When you become more skilled at selling options, you will be able to identify option selling at ridiculous strike prices, in which you will be able to take advantage of traders willing

to bet on the market going to these levels. A little fundamental knowledge can go a long way in this regard.

The following is an excerpt from an option seller article that we produced for publication several years back. With an ever-increasing flow of traders entering the futures and derivatives markets, the lesson is even more relevant today.

Option Selling 101: Think Like an Option Seller

BY JAMES CORDIER,
*PRESIDENT, LIBERTY
TRADING GROUP*

You may notice that many articles that

appear in our column have a longer-term outlook for price. Unlike many analysts and traders, we do not attempt to guess what market prices will do today, tomorrow, or next week. I recommend

approaching the market this way for several reasons.

1. Short-term trading is just too difficult.
I'm sure there are some consistently successful day traders out there.
That being said,
I've never met

any!

2. Markets can move very sporadically over short-term periods but over the long term will always have to adjust to reflect fundamentals.

3. As an intermediate-term option writer, short-term market

gyration does not concern you. You are concerned about longer-term market direction and, more important, where prices won't go.

It is for these reasons that our articles focus on long-term fundamentals and do not generally attempt to predict what prices will do

but rather what prices will not do. We believe that the most successful traders keep things very *simple*.

This is the approach that we suggest: I do not know what price is going to do. Based on the existing fundamentals, however, and what prices have done in past years when supply-and-demand factors were similar to

those of this year, I feel that *prices will have a very difficult time attaining a certain price level.* Therefore, I will sell calls (or puts) at that price level and not concern myself with short-term technical trading. Even if my market analysis or timing is off a bit, time value is still working for me, and I allow the market plenty of room to fluctuate in the

meantime.

Remember, if you are a seller of a *call*, the market can move lower, stay the same, or even move somewhat higher. As long as the futures price is *anywhere below* your call option's *strike price* at expiration, the option expires worthless. If the option expires worthless, you, as the seller, keep all

premiums collected as profit. As the seller of a *put*, you want the price to stay *above* a particular price level (strike price).

Although this type of thinking can be difficult at first for the futures trader used to daily action (it was for me), I've found that this approach has improved my overall trading results tremendously.

Remember this the next time you are tempted to bite on the latest market that is about to “skyrocket.” Time, value, and patience are your friends. Think like the option seller!

The point is that you can still have your hunches as to where the market might go; you just position yourself

differently. *In this way, if your price projection is right, you profit. If it is only partially right, you profit. If you are wrong, there is still a good chance that you will profit.* The market can move in the direction you projected, consolidate sideways with no clear direction, or even move in the opposite direction to what you projected. As long as you are not absolutely 100% wrong and the market

makes a rapid and/or sustained move in the exact opposite direction from what you predicted, you will profit on this position. You can use this strategy to excel in bull, bear, or stagnant markets.

This is why so many option sellers enjoy empowerment whereas so many mainstream investors feel helpless—held hostage to market whims, interest rate

fluctuations, economic distress or the direction of the S&P 500. Option sellers are secure in their knowledge that they have the ability to generate returns in most any market condition. They can position for higher prices, lower prices or stagnant prices and profit even if they are marginally wrong. They know an alternative definition of the term *financial security*.

Advantage 3: Accrued Profits Can Be Substantial

Let's face it. We're not in this game for paltry returns. Our financial planners can likely get us that—in a good year. If you are taking the time to learn an alternative strategy and then allocating risk capital toward it, you likely are after a bigger payoff.

Let me assure you that option selling has the horsepower to deliver in this area.

If your goal is to make *consistent* 25%, 40%, or even 50% annual returns in a responsible manner, option selling, especially futures option selling, may be for you.

Adrenaline Junkies Beware

That being said, if your goal is to make 200%, 300%, or 500% returns, like you see in all the hyped-up advertising for trading systems or “training seminars,” put this book down and go invest your money in some lottery tickets or head to Vegas. Over the long haul, your odds

will be about the same.

The uninitiated often sight low dollar amounts and high-margin requirements as deterrents to selling options. “It’s just a few dollars. Why bother?” is their argument. But these are typically the adrenaline junkies or the low-cap traders looking to hit a home run with a small equity base. The get-rich quick crowd.

Staying Outside of the “Boxing Ring”

Think of the investment world as a huge boxing ring with complete pandemonium going on inside. Bulls and bears (if you will) battling it out in the middle. Dollars and cents flying everywhere. Your goal is not to get in the ring and mix it up with them. They are either bigger or

stronger or smarter than you (or me, for that matter) or just plain crazy. This is the mistake Mr. Low Cap makes.

Instead, you sit outside the ring with a couple of buckets in front of you. As excess dollars and cents bounce, fly, and trickle out of the ring, you simply collect it all in your bucket. Maybe you don't have huge gains in any given week or month. But

you do this every month of the year. At the end of each month, you empty your bucket into a tub and start over.

At the end of the year, you check your tub. After 12 months, that tub can get mighty full—oftentimes, much fuller than it ever could have gotten by mixing it up in the ring.

Successful option sellers

think of their portfolio as a business. They are not gambling. They take only the high odds plays, over and over and over again. All the way to the bank.

When you learn to sell options on commodities, you'll learn how to supercharge this formula with the power of leverage.

Advantage 4: Time Is on Your Side

Sing it like Mick Jagger. As an option seller, you can. No matter what the market is doing, time is constantly, albeit slowly, eroding the value of the option. While the option can gain value from market movement, time will always be in your corner, working *for you*. It is also

working against the person who bought the option. We have an example that may help to illustrate the concept more clearly, especially for football fans.

As a seller of an option, you could be compared with a football team that plays defense for an entire game. How much time is on the clock when you start the game is up to you. You start

the game by giving yourself a predetermined point lead and giving your opponent so much time to beat you. For example, you can give yourself a 50-point lead and give your opponent two quarters to beat you (selling far-out-of-the-money options with more time value), or you can give your opponent a 7-point lead and two minutes to beat you (selling close-to-the-money options with little time

value). No matter what you choose, the clock always will be running against your opponent. As time goes on, your opponent's chances of winning the game begin to decrease (and yours increase). The opponent can't step out of bounds or call time out to stop the clock. The best part is, if you begin to feel uncomfortable at any point in the game, you can simply quit.

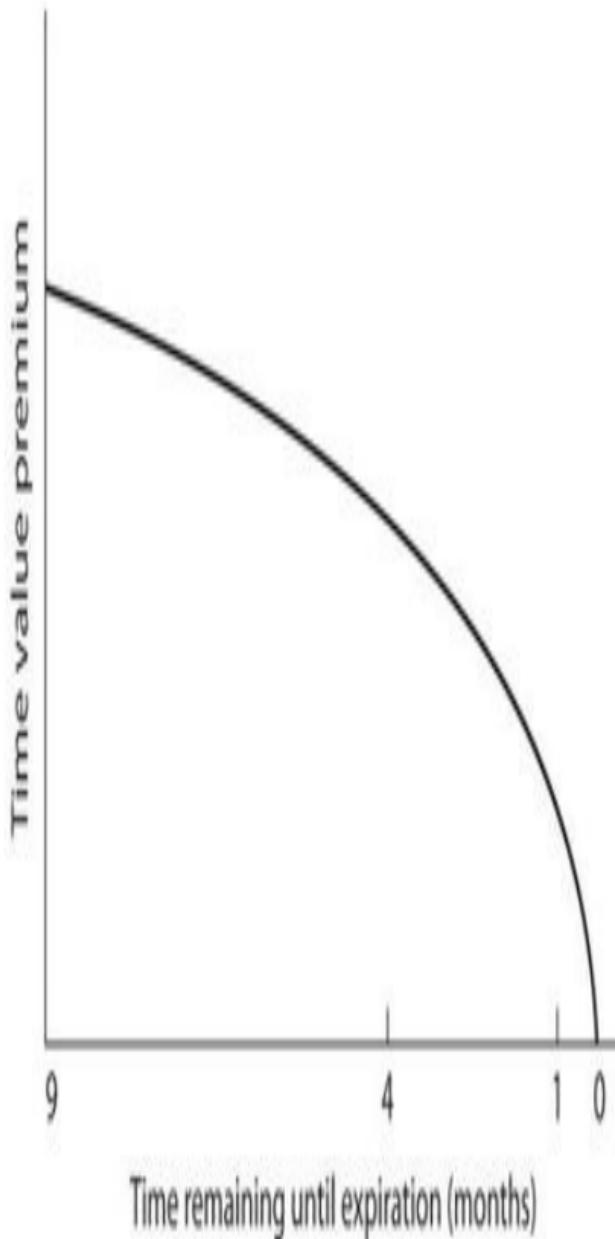
There are many fun comparisons to draw from this analogy. The point is that an option buyer is working against the market *and* time, just as a football offense trailing in a game has to work against the defense *and* the time left on the clock.

As an option seller, the passage of time is your greatest ally (see [Figure 3.1](#)).

FIGURE 3.1 Time Decay

Chart

The closer an option gets to expiration, the faster its rate of time decay.



Advantage 5: Taking Profits Becomes Simple

Almost every book or educational pamphlet on trading at one point or another refers to a central theme that has become the mantra for traders the world over: “Cut your losses short,

and let your profits run." This common knowledge is especially expounded among commodity traders. Traders have been drilled and instructed continuously that to make any money in the market, one must accept a large percentage of small losers while waiting for one or two large winning trades to not only recoup all the losses but also to provide an overall profit.

Although we have to agree with this concept in a general sense, applying it to a real-life trading account is extremely difficult, if not impossible, for most individual investors. Stops can be placed to limit losses on futures positions, but floor traders tend to have a feel for where large concentrations of stop orders may be sitting. We are not suggesting that these floor traders would run

these stops deliberately (of course not, floor traders and professionals care about you and would *never* do that), but it is very curious how a market will often crack a key point of support or resistance only to turn around and make a large move in the opposite direction.

When you are looking at a price chart, countless other traders are looking at the

same chart. They all see the same points of support and resistance at which to place their stops. This is why you will often see a market touch a critical point of support or resistance and then make a rapid move through the critical level during a single trading session. All those buy or sell orders are triggered at once, causing a rapid move in the market and stopping futures traders out of their

positions. There is nothing more frustrating to traders than having this happen and then to see the market make an immediate reversal and begin a large move in the opposite direction. Such traders were in the right market; they just couldn't stay in it long enough!

This is assuming, of course, that such traders had the discipline to place stops to

begin with. Cutting losses and letting profits run sounds good on paper, but the psychology of it goes against human nature. Emotions are a critical enemy of traders, and of all emotions, there is none so damaging to a portfolio as the feeling of *hope*. Hope is wonderful when applied to life outside the trading world. In the realm of trading, though, especially futures trading, it can rob you of your

money and wreck an account. Traders don't want to cut a loss because they have become emotionally attached to a position. They'll watch it going against them on a daily basis and *hope* that it turns around. Books on trading answer this by telling you not to be emotional about your trading. How can you not be emotional about your trading? This is your money that we're talking about! You're going

to be emotional about it no matter what you tell yourself.

What about deciding when to take profits? Letting a winner run can be even more psychologically difficult than cutting a loss short. A trader is so excited about seeing the market move in her direction that she becomes terrified that it will reverse and take back the profits it so willingly granted

her. We've seen more traders go bust by not knowing where to take profits than we've seen traders who get buried with one or two large losses. The result of this fear is that most traders take profits way too soon, even when they have a nice winner going. There are no hard-and-fast rules as to when to take profits. Nobody knows if the market is reversing on a given day or only experiencing a

short-term trend correction. This is one of the many reasons why futures trading is so difficult

Option Selling Is a Clear Antidote to This Dilemma

When one sells an option, as opposed to trading the outright futures contract, the

decision of when to take profits generally becomes one that you no longer have to make. The market makes it for you. As long as your option is not in the money, the value of your option will eventually deteriorate to zero at expiration. At this point, the position automatically closes out. You achieve full profit without ever having to decide if the market is correcting, going up or down

tomorrow on the open, or having to decide whether to “hang in there” to wring a few more dollars out of the trade. The most you can make is the premium that you collect. In most cases, this will be your objective on the trade. In other words, you have a very clear profit objective and a very clear method of taking that profit. What is your profit-taking strategy in a winning trade?

Do nothing. Simply let it expire.

This aspect of writing premium alone can be a boon to traders who have suffered losses because they are too quick to exit a winning trade or have a habit of holding the trade too long.

Advantage 6: Perfect Timing Is No Longer

Necessary

One aspect critical for success in futures trading is being able to time the market. Because of the leverage involved in trading futures, mistiming the market probably costs traders more losses than incorrectly picking the ultimate direction of prices. Although some traders can gain a fairly

decent insight into the long-term direction of price, it is what the price does in the *meantime* that causes them so much trouble.

A market moving in an overall trend upward owing to a long-term fundamental factor still will have moderate to severe corrections periodically. This can result for a number of reasons, including profit taking by

large funds or small speculators or a sudden news story that may cause some temporary sensation in the market but in reality has little effect on the long-term fundamentals of the market.

A trader may see the trend and decide to “get in on the action” and look for a place to buy. Whereas buying into an existing trend usually is not a bad way to go, timing

will determine the odds of success or failure on this trade. If all you had to do was play the trend, futures trading would be easy, and everybody would make money. This is even more difficult in volatile markets. Traders, especially small speculators, will buy the futures and then place a stop. More often than not they will place tight stops, giving the market little room to fluctuate

against them. This is what they have been taught, and this is why most of their trades will lose. They have to protect capital at all costs. Unfortunately, protecting capital does not allow much movement in a market that can and often does move sharply and rapidly in either direction for no apparent reason at all. Many, if not most, traders will be stopped out before the market begins

moving in the direction of the trend again (see [Figure 3.2](#)).

FIGURE 3.2 Price Chart Contrasting Buy and Sell Areas with Option Sale (June 2014 E Mini S&P)

Arrows show possible entry
and stop points for futures
traders.



Could have Sold Puts

Selling options avoids all this senselessness. In a bull trend, a seller simply can sell options far beneath the market, allowing wide price fluctuations within the trend that will not dramatically affect her position. In this way, she can sell options on an up or down day without the need for perfect timing. Even if she catches the market in a correction mode,

the fluctuation in her option price generally will be substantially less than if she were in a futures position. Thus, the trader has significant staying power in the market and is able to ride out short-term market fluctuations, unlike her futures-trading counterpart. (This generalizes futures traders as the average individual speculator. There are, of course, some well-

capitalized traders who are willing to commit large chunks of margin capital to ride out an adverse move. In addition to a large cushion of excess margin funds, this also requires a strong conviction in the market, as well as nerves of steel.)

Even the few traders good at timing the market can get bounced out of a good trend on random news events.

For instance, in 2013, coffee prices were in a steady downtrend. Expectations were for an ample 2013 Brazilian coffee harvest and the market was already pricing the new supply. In both May and July of 2013, weather reports out of Brazil indicated cold fronts moving through Brazilian growing regions (Northern Hemisphere summer is Southern Hemisphere winter).

News media covers it. Coffee traders short futures contracts cover their positions. They don't ask questions, they just cover. This may be smart for them, even though it is only precautionary.

For the option seller, however, short calls at \$1.85, there is no need to cover on a simple cold front. Cold fronts are one thing. A real crop-damaging freeze is another

(they are extremely rare), and it would likely be months before the effects of one would even be known. Precautionary short covering takes the futures trader out of his position. The call seller remains safely above the fray, able to continue in his position once the market resumes its downtrend (after the front passes). (See [Figure 3.3.](#))

FIGURE 3.3 Coffee Chart Showing Weather Rallies in 2013

Coffee prices experience short covering but does not affect call sellers position.

1100
1050
1000
950
900

Option Seller Short 185 calls

1150
1100
1050
1000
950
900
850
800
750
700
650
600
550
500
450
400
350
300
250
200
150
100
50
0



Short Covering on Weather



Short Covering on Weather

1100
1050
1000
950
900

Advantage 7: Multiple Methods of Risk Control

Regardless of the label of unlimited risk in selling short options, option selling risk can be just as definable and controlled as any other type of futures or stock trading risk. And there are multiple

ways to manage risk, depending on the investor's risk tolerance. This is mentioned here as an advantage only so you will know that you *can* control option selling risks and have several methods available to you. The subject of risk, however, is significant and therefore will be covered in its own full chapter ([Chapter 12](#)).

Drawbacks of Selling Options

Now that we have covered the many benefits of option selling, a potential option seller must also be familiar with the drawbacks of selling premium. They are presented here, warts and all, for your review. They are here so that you can draw a balanced, informed conclusion.

1. Unlimited risk. Here is the elephant in the room. I can compare teaching option selling to the uninitiated (not you) to giving fire to cavemen. In the right hands, it can provide light and warmth for a lifetime. In the wrong hands, it can burn fingers. Those with burnt fingers are typically the ones

shouting the “unlimited risk” mantra from the rooftops. However, the term in and of itself, while technically accurate, is misleading and horrendously misunderstood.

Novices who hear “unlimited risk” picture thugs in suits coming to confiscate their house and imprison their families. All because

they weren't watching
that corn put they sold
last week.

Let's be clear.
Anyone considering
selling option premium
in a portfolio,
especially a futures
portfolio, should be
aware that there always
exists the potential for
a move against one's
position that could

cause the investor to experience a loss. Just as if you buy a stock, you have unlimited upside. If the stock keeps going up forever, you'll make money forever. Unlimited risk is the same concept. If you let it go, it can keep going. If it keeps moving against you forever, you will keep losing money forever.

But there is a way to limit your risk, called *closing your position*, which you can do at any time.

There are many excellent ways to limit and manage your risk in option selling, including the use of stops or “covered” spreads, which we will cover later. Selling

options on futures, even naked, entails no more risk than trading the futures contract itself, nor does selling options on stocks contain any more exposure than does trading the underlying equity. Nonetheless, one must be aware that there is no free lunch. Risk of loss is always present and must be

managed. The unlimited aspect, if you will, means you don't have a built-in limit, as you do when you buy an option. *Unlimited* means you have to take the extra step of putting in risk controls yourself.

2. **Limited profit potential on individual trades.** In

selling option premium, your profit potential is limited to the premium you collect when you sell the option. No matter how far the market moves in your favor (away from your strike price), your potential profit remains the same. It is for this reason that traders chasing the “big score” and trading the market

for the adrenaline rush (a considerable percentage of small speculators) generally are not attracted to the concept of option writing. To use a baseball analogy, an option writer is an investor who is willing to give up his chance of hitting a home run in favor of consistently hitting singles over and

over again.

3. Potential scorn or ignorance of brokers or investment advisors. As stated previously, many brokers, advisors, and entire firms are either hesitant to write option premium for fear of risk, a general lack of understanding of how to employ an option

selling strategy effectively, or both. This sometimes can mean higher margin or account requirements for investors wanting to sell options in their accounts. You may have to do a little work before finding a good broker or money manager who is qualified to assist you in selling options

properly. We believe this is so important that there is an entire chapter dedicated to the subject (see [Chapter 15](#)). In the meantime, just remember that poor advice is often worse than no advice at all.

Selling Options and Catching Catfish:

The Logic of Selling Options

Let's assume that roughly 80% of options expire worthless for example purposes. What does this mean to a trader? Suppose that you and I went down to a fishing hole filled with catfish and bass. We toss a fishing line in the water. The hole is primarily a catfish haven,

with 80% catfish and 20% bass. I offer to pay you \$1 for every bass you pull up, whereas you must pay me \$1 for every catfish you pull up. There are even a few trophy bass in the hole that, based on their weight, I will pay you \$2, \$3, or even \$4 for hauling in. However, these are very few and far between, and I am more than willing to take \$1 for each catfish while you try and catch a trophy.

Chances are that you will pull up eight catfish and two bass. You'll pay me \$8, and I'll give you \$2 back for your bass. I will end up netting a hefty \$6 profit. You soon realize the error of your ways, and we decide to go into business with our little fishing hole.

Soon many novice anglers hear about the trophy bass in the fishing hole, paying high

prizes for anglers lucky enough to catch one. They are especially interested in the highly touted “monster” bass, one of which lurks in the dark water below and pays a prize of \$10 to the angler who hooks it.

The anglers line up at our hole to pay us \$1 for every catfish they catch. We generally have to pay them \$2 out of every \$8 they pay us.

Sometimes we only have to pay back \$1. Sometimes, if somebody has a “hot streak,” we may have to pay back \$3 or \$4. However, we almost always come out ahead at the end of the day.

Further, we don’t require them to cast 10 times. Some may come with only a few dollars and take a few casts. Some will fish all day. Most fish until they run out of

money.

Occasionally, someone will catch a trophy bass. In this case, we have to pay back \$3 or \$4 against our \$1 bet. The trophy bass causes much excitement. The newspaper comes and snaps pictures. More novice anglers and some people who have never fished before see the picture in the paper, get very excited, and stuff their pockets with

dollars and come running down to our hole to pursue the elusive trophy fish. This brings us even more business and makes us happy, for alas, most of them catch catfish and put dollars in our pocket.

Pretty soon a few savvy anglers catch on to our game and decide to stop handing us dollars. They set up their own little stand on the fishing hole and begin collecting dollars

for catfish. Fortunately, there are many new anglers coming to the hole now, trying to “hit it big” with a trophy bass. Many get frustrated with catching catfish and losing their money and come to the conclusion that “fishing is bad.” They quit altogether. However, many new, young hopefuls appear to take their place.

Soon another group of

entrepreneurs springs up. Their purpose is to take the anglers' money and give it to us and take any money we owe the anglers and give it to them. Some will even help you bait your hook and tell you where to throw your line. For this, they charge a fee. This now means that the anglers and you and I have to pay a fee on each fish that is caught, catfish or bass. Most of these middlemen like to

talk about the big bass and get anglers excited about the “monster” bass that lurks below. “Of course, you could lose your dollars,” they warn, “but think of the payoff if you catch the monster!” This gets anglers even more excited. Some take a middleman’s advice and cast to the spot to which he points. This, of course, costs the angler a slightly higher fee, for the middleman must spend more

time with him. The angler, of course, still catches mostly catfish.

Others anglers study the fishing hole for hours and look at depth charts at home to see where the giant fish may make its lair. Then they come to the hole with sophisticated computers and top-of-the-line fishing gear. Most fare little better than their unsophisticated

counterparts. The reason is that they are fighting a losing battle. Even though the large bass are swimming in the hole, the hole is still 80% catfish, and the \$1 the anglers must pay for each catfish eventually is going to exhaust their money supply, even if they catch a few bass along the way.

Although most of the middlemen do sincerely hope

that the anglers catch a big bass and try their hardest to help them to do so, they, along with their angler clients, fail to realize that the person making all the money is the one betting on catfish. Certainly, it lacks the glamour and excitement of pursuing a “monster” bass and the big prize it brings with it. However, for making money at the end of the day, it is devastatingly effective.

A few of these middlemen become wise to the catfish betting strategy and encourage their clients to begin betting on the catfish because there are many anglers willing to take a chance on catching a big bass. However, most shudder at the thought. “Bet on the catfish?” they ask incredulously. “Why would you want to do that? It’s too risky. What if somebody pulls

up that monster bass? What will you do then? You bet \$1 and you lost \$10. That could wipe you out! You may even have to run home and get more money so that you can pay that angler the \$10 you owe him. Is that what you want?"

"No, no" the ambitious angler fearfully replies. And so they go back to trying to catch the "monster" bass, and

eventually the angler runs out of money.

In case you haven't guessed, this is an analogy of the strategy of option selling and how most brokers and traders (especially novice traders) view it. The anglers chasing the "monster" bass are option buyers. Lured by big gains, they throw their line in the water (enter a long option trade) with only a 20%

chance of catching a bass (having a winning trade). Their chances of catching a bass that pays anything significant is even less. This is before they study the weather, select bait, and choose the area of the hole to which they will cast (analyze market conditions and strike prices). The fishing hole is the exchange. The middleman is, of course, the broker.

Chances are very good that the person getting paid \$1 for each catfish caught (the option seller) will have most of the money before long. But most anglers will not bet on the catfish. Most don't want to bet on catfish. Most want the chance to catch the big or "monster" fish and bet \$1 to make \$3, \$4, or even \$5.

There are two caveats to

betting on catfish (or selling options). One is that you have to come to the fishing hole with enough dollars in your pocket to pay up if an angler catches a big bass on her first one or two casts. The second is that from time to time you have to expect that somebody is going to catch a bass. In many cases you will already have more than enough profits in your pocket to comfortably pay the lucky

winner. However, when you make your first trip to the fishing hole, bet on a catfish, and somebody pulls out a big bass on the first cast, you have to have the gumption to pay the prize and go back to your catfish bet. Although the odds of this happening are low, it certainly can happen. You can see how it might be unwise for a catfish better to assume after this incident that “catfish betting is bad.”

Unfortunately, many option sellers make exactly this mistake and then tell all who will listen of their misfortune, especially if they had \$5 in their pocket and the angler, against all odds, pulled out a \$5 fish. This further perpetuates the misconception that option writing is a reckless approach to investing.

Now that you understand

the basic concept, there is much you can do to increase the odds that anglers will catch fewer bass and especially keep them from catching the “monster” bass and keep reeling in those catfish.

Conclusion

You have now learned the seven advantages that option

selling has over most any other kind of investing. You have also learned the disadvantages of option selling. We'll let you weigh them both for yourself.

Revisit the title of this chapter: “Why Aren’t You Selling Options?” Are you asking yourself that question yet?

The next chapter is written especially for the

option buyers (or former buyers) reading this book. It is also for the option intellectuals who will argue that the 80% figure is “misleading.” You are probably not in this group. But you will likely find it interesting nonetheless—especially if you ever find yourself in a discussion with one of these people.

Buying Options Versus Selling Options

Who Wins?

Have you heard any of these common bits of “knowledge” about options?

- Buying options allows you to take part in big moves with limited risk.
- Eighty percent of options expire

worthless.

- Volatility is the single most important factor for any option trader.
- If you sell an option and it moves against you, you are stuck until it expires.

In the debate between buyers and sellers of options, opinions can be represented as fact and fact can be

distorted into misconception. This chapter is to give you some insights into some of the most common facts, myths, and misconceptions about buying and selling options. It will help to clarify, confirm, or completely discredit some of this “common knowledge.”

It should also settle the argument once and for all about what side of the option

buy/sell equation you should be on. (Can you guess?)

Basic Training

Although this book is not meant to be a “how to” guide to market price forecasting or “101 option strategies you can use at home,” we believe that a basic review of options and the differences between buying and selling may be

helpful to novice readers exploring the subject for the first time.

We have presented the information in the format of metaphors and stories as often as possible so readers can readily comprehend what can be a complex subject. Nonetheless, certain aspects of options and option selling demand some technical explanations and definitions.

If you are already familiar with the basics of options and how they work, you may want to skip this chapter. However, if you are a beginner or are only moderately experienced and want to brush up on the fundamentals of options, this chapter could be a helpful primer.

To that end, let's start from the beginning—some

“basic training” if you will.

What Is an Option?

The standard definition of an *option* is the right, but not the obligation, to buy or sell a particular stock or commodity at a specified price. A *call option* is the right to buy a stock or commodity; a *put option* is the right to sell it. When buying or selling a put

or a call option in stocks, one call or put is the right to buy or sell 100 shares of that particular stock. In the case of futures, one option is the right to buy or sell one contract for that particular commodity (see [Table 4.1](#)).

TABLE 4.1 Underlying Asset of One Option

1 stock option

1 futures option

100 shares of underlying stock

1 contract of underlying commodity

Buying Options

Before we can begin exploring the concept of *selling* or *writing* an option, it will be useful to discuss the subject of buying options

because this is the strategy with which most option traders are familiar. The subject of *buying an option*, as well as some key definitions regarding option trading, are illustrated in the following example.

We are using the Standard & Poor's (S&P) futures contract in both examples in this chapter because it is a market to which both stock

and futures traders can relate. However, this is the general concept of how any buying or selling of options can be performed in either individual stocks or any commodities markets.

Example: Buying a Call Option on S&P 500 Futures

What is buying an option? What does it entail? What are the potential rewards and risks? To illustrate, let's consider a quick example.

If, in December, you buy a call option on the S&P 500 at a 1900 *strike price* for the month of March, you have the right (or *option*) to buy one contract of the March S&P 500 at the price of 1900 at any time during the life of

the option. You may exercise this right at any time you choose, before expiration in March. As this is a March option, this means that your right to buy the S&P 500 contract at this price will cease, or *expire*, in March. If this were a July option, your right to purchase a futures contract on the S&P 500 would end in July. The exact date this option expires will vary depending on the stock

or commodity you are trading. Therefore, if you want to exercise this right to buy the S&P 500 at 1900, you will have to do it before your time runs out (see [Figure 4.1](#)).

FIGURE 4.1 S&P 500 Price Chart Showing Strike Price Buying a March S&P 1900 Call Option

1900 Call



The right or option to purchase an S&P 500 contract at 1900 has a value to it. In other words, the call option you are purchasing has a value in and of itself, regardless of the price of the S&P 500. If March S&P 500 futures are trading at 1950, your right (or option) to purchase a March S&P 500 contract at 1900 would be worth more than it would be

if the June S&P 500 were trading only at 1850.

But who would want to buy a March S&P 500 futures contract at 1950 if the market price were only 1900? Nobody.

However, a person who thought the S&P 500 were going to move to 1950 by March might very well want to purchase the right to buy it at 1900, especially when he

can purchase this right for a fraction of the cost it would run him to buy the futures contract itself. In addition, he can avoid the risk of the S&P 500 decreasing in price and losing a large amount on his futures trade. The only funds he would have at risk would be the price, or *premium*, he paid for his option. If the price of the S&P 500 does not reach 1900 (the option's *strike price*) by the time the

option expires in March, it will expire worthless, and the trade is over.

Real-Life Example: Trader Mary's Experience

Let's review this concept in another example. Trader Mary just read an article about the U.S. economy that

was very bullish on the U.S. stock market. The fundamental outlook for equities looks very promising. There is, however, one point of concern: At the time that Mary is considering the trade, the Federal Reserve (Fed) could be getting ready to raise interest rates. This may or may not take place. However, if it does, there is a chance that the S&P 500 could fall substantially.

Mary is eager to position herself to take advantage of the situation if the S&P 500 soars, as she is expecting. However, the risk of an adverse move to the downside has her concerned enough that she does not want to purchase the futures contract outright. She instead sees that she can purchase a March 1900 call option for the price (premium) of \$2,000. Since the March S&P

500 contract currently is trading at about 1840 and it is only December, Mary sees this as a good bet, considering that she feels the price could go as high as 1950. If it does, Mary can exercise her option, buy a contract for the March S&P 500 at 1900, and then immediately sell it at 1950, making herself a gross profit of \$12,500 on the futures contract. This is calculated in

Table 4.2.

TABLE 4.2 Calculating Target Value on Mary's Long S&P Option

Target price of March S&P 500 futures contract	1950
Strike price of Mary's option	-1900
Intrinsic value of Mary's option at expiration	50 pts.
Cash conversion(every 1-point move in S&P 500 contract is worth \$250)	× \$250
Value of Mary's option at expiration	\$12,500

Of course, Mary will have to subtract the premium she paid for her option plus transaction costs to give her

the net profit, calculated in Table 4.3.

TABLE 4.3 Calculating Net Profit on Mary's Long Option

Value of option	\$12,500
Premium paid to purchase option	-2,000
Transaction fees	-79
Net profit to Mary	\$10,421

If the March S&P 500 contract does not reach 1900 (her option's strike price) or even falls substantially, the most Mary can lose is the \$2,000 she invested to purchase the call option.

Are these the only two outcomes that Mary can experience? No. They are not.

Mary Learns the

Hard Lesson of Option Buying: Time Decay

Let's say that two months go by. It is now February. Mary is sitting in her office one day watching the snow fall outside and decides to check her option price. She sees the March S&P 500 has traded as high as 1847 and as low as 1734 but is back to hovering

close to 1840 at the present time. Mary checks her option price and sees that it is now worth only \$1,000. In other words, if she bought the exact same option today, it would cost her only *half* of what it did two months ago. The market is in the same place it was when she bought her option. Yet Mary's option is now at a \$1,000 loss (see Figure 4.2).

FIGURE 4.2 S&P 500 Price Chart Showing Price Movement

The Value of Time Decay: 60 days after the option purchase, the underlying is at the same price. But the option is worth \$1,000 less



But how can this be? The futures contract is trading at the exact same price that it was two months ago! However, the right to buy March S&P 500 futures will now expire in one month instead of three months. Therefore, the option has less time remaining and is worth less. This is known as *time decay*. All other things being the same, time decay will

always slightly erode the value of the option with each day that passes. Hence, even if Mary is correct in her market analysis, time will always be her enemy as long as she is buying options.

How is this relevant? Isn't all that Mary cares about, as an option buyer, is if the June S&P 500 goes above 1250? No. It is not. This is the mistake many novice option

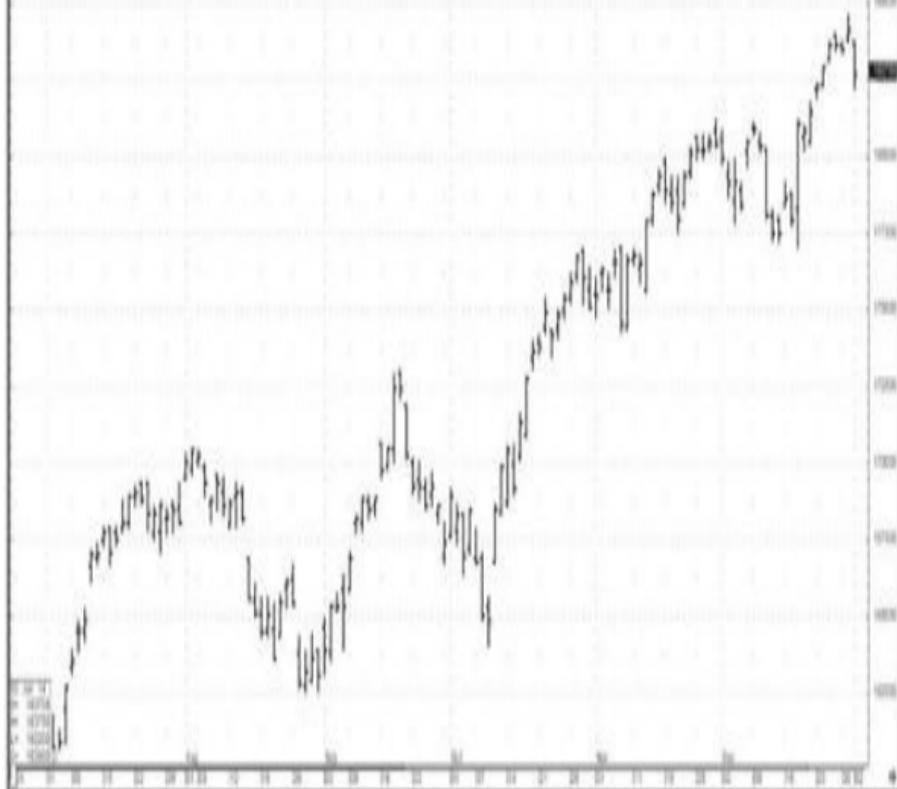
traders make. Most options never get exercised. Much of the time, the option positions, even profitable ones, are offset simply by selling them back to the market. Why?

It is at this point that we must delve into a few more definitions. If Mary bought a call option on the March S&P 500 with a strike price of 1900 and the price of March S&P 500 futures is currently

under 1900, then the option is said to be *out of the money*. If the price of the contract is *at* 1900, the option is said to be *at the money*. If the price of March S&P 500 is *over* 1900, the option is said to be *in the money* (see Figure 4.3).

FIGURE 4.3 S&P 500 Price Chart Showing Options In and Out of the Money

In the \$
At the \$
Out of \$



Intrinsic Value

The value of an option is made up of time value, intrinsic value, and volatility.

Time value has been discussed already. Volatility will be discussed later. However, option buyers tend to focus on potential *intrinsic value*.

An option is said to have

intrinsic value if it is *in the money*.

- **If it is not in the money, it cannot, by definition, have any intrinsic value.**

For example, if the strike price of the call is 1900, and the price of March S&P 500 is 1950, then the option is said to have 50 points of intrinsic value. If the option

were exercised at this point and the futures position closed out immediately, it would yield a profit of \$12,500. However, the option itself, in addition to its intrinsic value, also would have some *time value* remaining. The option itself would be worth more than \$12,500. Therefore, selling the option back to the market would be worth more to the owner of the call than

exercising it.

The exception to this would be if the option is expiring and the owner of the call wishes to own the stock or commodity at the specified strike price.

For this reason, when somebody refers to trading options, they are generally referring to the buying and selling of the options themselves. They are actually

speculating on the option prices and not on the underlying stock or commodity, although the price of the underlying stock or commodity will have a large bearing on the value of the option.

Profiting on the Long Option with No Intrinsic Value

In the preceding example, because the March S&P 500 was trading at 1840 when Mary bought her 1900 call, Mary bought an out-of-the-money option with no intrinsic value. This is why Mary was able to purchase the option fairly inexpensively. Can Mary make money even if the option never goes in the money? Yes. If the price of the March S&P 500 begins to

move toward 1900, the value of the option may start to increase. This is especially true if the price of the S&P moves rapidly, with a great degree of volatility. Although the option still has no intrinsic value, the chances of the option gaining intrinsic value begin to increase, thereby increasing the value of the option. If this value is increasing faster than the time value is eroding the premium,

the option may temporarily show a gain, even if it is out of the money.

In other words, if Mary bought her option for \$2,000, and the March S&P 500 price moved higher immediately, but not in the money, the price of Mary's option still may increase to, say, \$2,500. In this case, Mary could close the position out for a \$500 profit without ever exercising

her option.

Of course, to collect this gain, Mary will have to sell her option back to the market before the value drops again. If the price of the March S&P 500 has not moved above 1900 by the time the option expires, time value will have eroded all the option's value and it will expire worthless. Mary will lose the premium she paid but nothing more.

The main drawback to Mary's position is this:
Although she has absolute limited risk in that only the premium she paid can be lost, there is a high probability that she will indeed lose on the trade. The only way Mary can make money is if the futures contract makes a sharp and immediate move higher. Anything less, and time value eventually will decay the value of the option

away to nothing.

Buying Options: Summation

In summation, the three factors that make up the value of an option are intrinsic value, time value, and volatility. If you are buying an option that is out of the money, it will have no

intrinsic value. Only time and volatility will make up the price of that option.

The key advantages and disadvantages of *buying* an option are listed in [Table 4.4](#).

TABLE 4.4 Advantages and Disadvantages of Buying an Option

Advantages

Absolute limited risk

Potential for large gain

Disadvantages

Time delay always works against buyer

Only one way to profit: Market must make a substantial move in a short period of time
in favor of buyer

The Selling (or Writing) of Options

Now that we are familiar with some general definitions regarding options and the strategy of buying options, we can make our first probe into the core subject of this book, which is *selling* options.

In keeping with our example, let's say that trader Mary is still somewhat bullish on the March S&P 500. If she buys her 1900

call, the March S&P 500 will have to make a large move to the upside for Mary to have any hope of a profit. However, instead of buying a call, as in the preceding example, Mary decides instead to use the strategy of selling a put. But how can Mary sell this option when she doesn't own it?

The terms *buying* and *selling*, when used in relation

to options, are really just terms used to describe which side of an option trade a trader is positioned. When a trader buys an option, he is buying the *right* to buy or sell a stock or commodity at a specified price. When a trader sells an option, he is selling the buyer that right and therefore assuming the obligation to take the other side of the market should the buyer of the option exercise

the option. In other words, he “grants” the option buyer the right to buy or sell the underlying market at the specified price (strike price). This is why option selling is also known as option *granting* or option *writing*.

In options, there must be a buyer for every seller and a seller for every buyer. However, this does not mean that if you are holding an

open option position, you must buy or sell your option back to the same individual who bought it from or sold it to you. You will never know who is on the other side of your trade. You simply will buy or sell the option back in the open market to close your position.

Many new investors also make the mistake of believing that buying options is a

bullish strategy and selling options is bearish. This is a mistake. Buying a call is for bulls. Buying a put is for bears. When selling options, the opposite is true. Selling a put is a bullish strategy. Selling a call is a bearish strategy. **Table 4.5** illustrates this concept.

TABLE 4.5 Bullish and Bearish Option Strategies

Bullish Strategy

Buying a call

Selling a put

Bearish Strategy

Buying a put

Selling a call

Let's go back to our example. Mary decides that she will use a put selling strategy to take advantage of the bullish fundamentals she sees for the S&P 500. At the

time of her trade, March S&P 500 futures are trading at 1840. Rather than buy the futures contract outright, or buy the call, Mary decides that she will sell a put option. She looks at the option quotes and sees that a March 1650 put option on the S&P 500 is currently at a premium of \$700. She calls her broker and places an order to sell one. This is called selling the put *naked*, and it means that

she is not selling it in conjunction with other options or the futures contract itself but rather is simply selling it by itself. *Covered* and *spread* strategies will be discussed later. However, we believe that it is important to understand the naked option write before exploring more complex strategies.

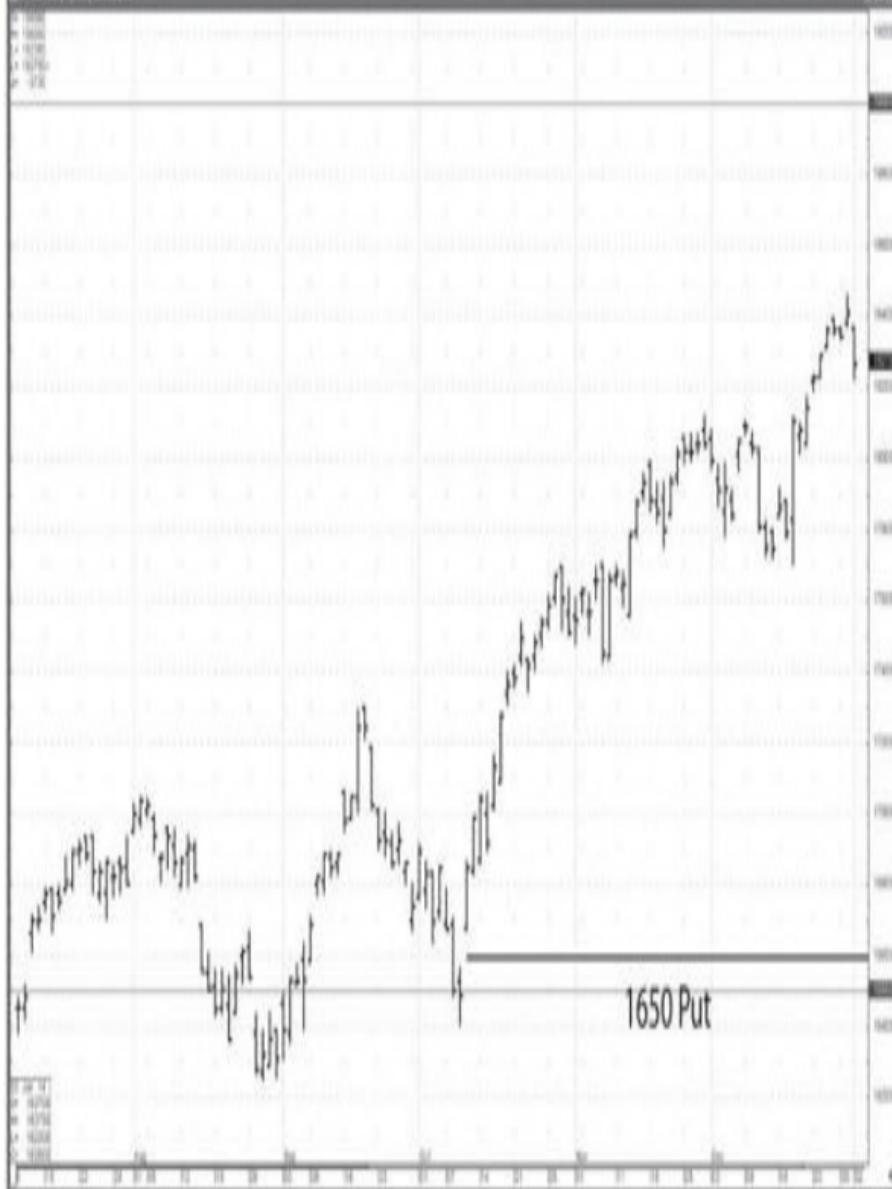
What happens to Mary's account when she sells the

option? Her account is credited immediately with the \$700 premium because somebody on the other side of the market just bought the March 1650 put option and paid Mary \$700 for the right to sell the March S&P 500 futures at 1650. This means that Mary has committed herself to buy one contract of March S&P 500 futures at 1650 should the buyer of this option decide to exercise it.

Most likely the only way the buyer of the option will want to exercise this option *would be* if the price of the March S&P 500 fell below 1650 (see Figure 4.4).

FIGURE 4.4 S&P 500 Price Chart Showing 1650 Put Option

Mary Sells a March S&P 1650 Put Option



To hold this position, Mary will have to put up a margin deposit. This is the same concept used to trade futures contracts, except margin requirements to hold short options generally are much less than they are to hold the outright contract. Margin is discussed in detail in **Chapter 6**.

If the price of the March S&P 500 is anywhere above

1650 at option expiration, the option will expire worthless, and Mary will keep the \$700 premium as her profit. Thus, \$700 is the most Mary can make. She gives up her chance to make a large gain on a big move upward in the futures market. However, she increases her chances dramatically to make a profit on the trade. At a current price of 1840, the price of the March S&P 500 can move

up, remain the same, or even fall almost 300 points, and Mary will still make the same profit on the trade. She gives herself a huge profit zone and can make money in a variety of market scenarios.

Mary's Risk in Selling an Option

But what is Mary's exposure?

Mary's risk is that the March S&P 500 falls below 1650 and remains there through option expiration. At that point, Mary would be assigned one contract of the March S&P 500, long from 1650. She could choose to liquidate the position immediately and accept whatever loss it would entail (if any), or if she wanted to be long the S&P 500 from 1650, she could simply hold

the position. Therefore, Mary's risk is that she will have to buy the March S&P 500 futures at 1650. In the remote possibility that this took place and Mary elected to remain in her position, she would need some additional capital to purchase the S&P 500 contract. Regardless, the \$700 premium remains Mary's to keep.

FIGURE 4.5 S&P 500 Chart

Showing Profit Zone of
Selling 1650 Put Option
Profit Zone: As Long as the
March S&P Futures is
Anywhere above 1650 at
expiration, the 1650 put
expires worthless. Mary then
keeps all premium as profit



Although having the option exercised is not the desired outcome for this trade, you can see that selling a put option carries no more risk, and in this example, less risk, than buying the futures outright.

By selling the option, however, Mary's other risk is that the value of her option could increase during the life of the option, thereby

increasing her margin requirement to remain in the trade. Mary could elect to exit the trade (buy the option back) for the going market price and take a loss, or she could put up the additional margin and hold the position. This is why Mary wants to select an option with a *low delta*. Delta is the only Greek symbol we will discuss in this book. It is simple and useful and will be explained more

fully in a later chapter. To simplify here, *Mary wants to sell an option that is far enough out of the money and with low enough volatility that the market can move a long way without greatly affecting the price or margin requirement of her option.* Therefore, a market move that is large enough to stop out a futures trader may mean only a minor price adjustment to Mary's put option.

Nonetheless, it is this potential for increased margin requirements that often scares traders away from selling options. Yet losses in a futures position, and thus margin requirements, can both accumulate much more quickly than in a short option. Remember, you're selling options because you want to stay away from the market's up and down whipsaw moves. Done correctly, selling

options should be a very slow-moving investment.

Volatility: How Important Is It?

One of the three main factors affecting the value of an option, as we mentioned previously, is

volatility. Volatility measures how fast and how much the option value is moving in relation to the underlying stock or commodity. Generally, underlying markets that are making large moves to the upside or downside or are experiencing large or rapid daily price fluctuations will produce options with higher volatility and thus higher-priced options.

Slowly moving or quiet markets generally will produce lower-valued options. Volatility is measured by a figure known as the option's *delta*.

Many books, seminars, and computer programs have been designed around calculating, analyzing, and capitalizing on the differences between an

option's delta and volatility. Much time, effort, and money have been dedicated to designing complex mathematical formulas for trading volatility, deltas, and other Greek symbols such as gammas and vegas that take other measurements of option volatility. Whereas it is not our intention to downplay the importance of option

volatility, we believe that these studies are responsible for much of the confusion and intimidation of option trading. The study of volatility has become so complex that it is all but impractical for use by the average individual investor.

Contrary to what the industry will have you believe, you do not need a

complex computer program to trade options effectively. Just remember this general rule of thumb pertaining to volatility and you should be fine: If volatility is *high*, conditions may favor option *sellers* because they can get more premium for the options they want to sell. If volatility is *low*, it may favor option *buyers* because they have to pay

less to purchase their options.

This does not mean that we recommend selling options with high deltas. We generally recommend selling options with low deltas in slightly volatile markets. This allows one to sell very far out-of-the-money strikes with little chance of going in the money. Therefore, the delta

is not low because the market is not moving: The delta is low because the option is so far out of the money.

How does one know if volatility is high or low? The number crunchers out there may cringe, but how about simply looking at a price chart of the underlying market? If the market has been making

rapid, sporadic moves, chances are that the volatility is high in the options. If the market is moving slowly or in a fairly defined price range, chances are that volatility is low.

For those who prefer a more scientific approach, there are many websites and software that measure the volatility of options.

Your broker should be able to give you the volatility of an option as well.

In our opinion, if you can use a little knowledge and a lot of common sense simply to pick a price level of where the market will not go, volatility becomes less important. We are not, however, suggesting that you disregard option volatility completely.

Options with historically low volatility often can be an indicator that prices in the underlying futures contract are very calm or trading in a narrow range. However, it also can be an indicator that a market is ready to break out of its trading range and make a sizable move in one direction. It therefore may not be a good idea to sell options with very low

historical volatilities.

Many technicians spend an inordinate amount of time studying the most minute details and comparisons between volatilities of options. But we are going to go against the grain and tell you right here and now that it is probably not necessary for you to do this to sell options effectively.

Many pundits will argue that volatility is the key to picking winning option trades and will trade based solely on volatility measurements. We cannot and do not agree with this philosophy. Just because an option has high volatility does not mean that it is a good option to sell. And just because an option has low volatility, it does not mean that it is a

poor option to sell.

We do give volatility its due in [Chapter 17](#). However, traders do not need to get all wrapped up in volatility to be successful option sellers.

Mary's Trump Card: The Buy Back

Of course, Mary does not

have to hold this option through expiration if she does not want to. As in the option buying example already presented, the value of the option can move up or down during its life depending on time value, intrinsic value, and volatility. *Mary may elect to liquidate her position at any time prior to expiration simply by buying back her option at the going market price.* This could result in a

loss or a profit. However, Mary controls it. She can close her position at any time for any reason. If she is getting uncomfortable, if she heard a news report she didn't like, if the market fundamentals changed, she can pull the plug on her trade and move on. That is how you handle risk in option selling.

There are several very

effective techniques for managing risk in short options, and these will be discussed in [Chapter 9](#). For now, the point is that most option selling trades done with the methods proposed in this book will, hopefully, rarely require you to employ one. The most important part of your risk management is selling the right options in the first place.

Although there are many more intricacies to selling options that will be discussed in the following chapters, the preceding example illustrates the basic concept of the approach.

Making \$700 on a trade may not sound very exciting at this point. But read on. What if you could sell groups of options, over and over, consistently having them

expire in your favor while having a reliable risk management plan in place to limit your downside on the few that move against you? What if you could sell these options at very low margin requirements—sometimes as low as the premiums collected?

John Summa's study (cited in [Chapter 3](#)) estimates that three out of four options

held through expiration expire worthless. Again, consider those percentages. Option sellers make money when options expire worthless, and option buyers lose money when options expire worthless. Now, setting aside all other pros and cons of option selling for now, if your goal in a particular trade is simply to make a profit, not to hit a “home run” but to make a

profit, wouldn't this be a good way to go into a trade, any trade, in any market, with this statistic behind you? Before you do a lick of research or pick any entry or exit points, you know that if you stick with your trade, you'll have odds and time both working in your favor?

In addition to odds and time, a seller of out-of-the-money options generally

doesn't have to pick market direction and generally doesn't have to decide where to take profits. He avoids two of the hardest decisions in investing.

This gets even more exciting when you consider the extra wrinkle of leverage that applies to selling options on futures contracts. The advantages and disadvantages of selling options is

illustrated in Table 4.6.

TABLE 4.6 Advantages and Disadvantages of Selling an Option

Disadvantages

Unlimited risk if position is not closed

Profit is limited to premium collected

Advantages

Time delay always works in seller's favor

Many ways to profit: Market can move in favor of seller, remain neutral, or even move moderately against the seller (large profit zone)

Profits take themselves (at expiration)

Seller does not have to guess outright at market direction

Odds overwhelmingly favor the seller

Is the Eighty Percent Figure a Myth?

The second edition of this book and subsequent articles and television appearances that it spawned provoked outrage among the option buying

community—especially those who make their livings convincing others to buy options (i.e., brokers and sellers of “educational” materials that promote buying options to “get rich”). “It’s a myth!” they shouted in their online forums and still do today.

I manage portfolios for a living and therefore have little time or interest in

beginning some kind of online debate with these “chat room” people. These people may be investors who write option-buying blogs and are looking to get some traffic. However, some of our readers actually look at this stuff, and so we believe it is important to address it in the current edition.

Their main point of

contention is that a large percentage of options get closed out prior to expiration and thus 80% of ALL options do *not* expire worthless.

This is true.

However, our contention is that *approximately* 80% of options *held through expiration* will expire worthless. Some even

challenge this figure. Others expound that option expirations are simply too numerous and complex and simply “cannot be calculated.” Others, looking to capitalize on our concept, took our figures and presented them out of context for personal gain—further enflaming the “buy guys.”

You should first

remember that there are a heck of a lot more (individual, nonprofessional traders) option buyers than option sellers. The reasons for this are explained in prior chapters. And they do not like people who tell them their strategy is a losing game. For the sake of amusement and curiosity, I read some of their online rants. I am interested to

know how many of these folks manage portfolios for a living.

The fact is there is not one single study that states the figure to be exactly 80%. We use that number as an estimated number based on different studies. *We stand by it, firmly.* Summa's study (featured in [Chapter 3](#)) is often cited in the futures industry and is

one I would match up against any buyer lobbyist argument. My experience in this industry has confirmed to me that his figures are quite accurate. Other studies have stated that up to 85% of call options will expire worthless (at expiration).

The irony is that the percentage of ALL options that expire worthless really

has no relevance to you,
the individual
investor/option seller. We
use this figure (whatever
the exact figure may be) to
illustrate a concept—to
make a point. A study that
would matter more to you
and me would calculate the
number of *deep out-of-the-*
money options that expire
worthless. My guess is that
this figure would be
astronomically higher.

When one refers to *all* options, as ours does, the figure includes options that are close to, at, and even *in the money*. These options would have much higher chances of expiring with some value left on them. Furthermore, the options with the most volume and open interest tend to be the ones that are closest to the money.

You cannot take a dart and throw it at a board of any and all options available, sell the one you hit, and think that's the way to consistent, high returns. However, if I did have to do that as my strategy, I would *much* rather be the seller than the buyer. I contend that over the long haul, the option seller would *still* make money this way.

But that is not how astute investors generate high odds returns. If you sell with the trend, if you sell deep out of the money, if you sell with little or no time, all of those factors affect the chances of the option going in the money.

The concept of this book teaches to sell *deep out-of-the-money options*. A simple look at the delta

(explained later) can tell you each individual option's chance of expiring worthless. A delta of .10 means the thing has a 10% chance of going in the money. Sell that option and it has a 90% chance of expiring worthless. That is mathematical fact that cannot be disputed.

The 80% figure is oft cited, and we use it to

make a point. However, at the end of the day, it is irrelevant to you. You *can* sell options that have a 90%, 95%, or even 98% chance of expiring worthless. The 80% figure doesn't really matter then, does it? Let all of the “chat room professors” argue that one for a while.

Should you wish to silence them, I suggest

simply requesting to see their account statements. I've yet to meet a rich option buyer.

Conclusion

The contest between buyers and sellers is, in our opinion, no contest at all. The option seller wins. The option buyer has a good pitch on the

surface. But if you dig just a scrape below the surface, the facts tend to speak for themselves.

Although there are no doubt countless option buyers jumping up and down, screaming about misleading statistics at this point (see box above, we intend to show them the error of their ways. The concept of selling time premium has been used by

professional and commercial traders since the inception of derivatives. It has been only recently that the individual investment community has started catching on. Unless you love to gamble, buying options is a losing proposition.

I have a daughter (Michael speaking) who is now 26. She loves to buy lottery tickets—lotto, scratch

off, you name it. Despite my numerous lectures on the futility of such a hobby, she continues to purchase her tickets on a regular basis. It's not about the money, it's for the rush. She loves to tell me about it every time she "wins." Yet not once has she shared with me all of the money she "invested" to get that win. Sound like anybody you know, maybe, from earlier in this chapter?

The allure of a big payoff for a small investment is innate to human nature. That is why there will always be plenty of buyers out there to purchase the options you wish to sell. And it is also why there are plenty of brokers and seminar salespeople willing to oblige them. Be grateful for them.

Selling options goes against a genetically

programmed human trait. It is counterintuitive. The majority will resist when you try to explain it to them. This is typically a good tip-off that you are on the right track.

Option sellers aren't in it for the rush. They are usually serious investors seeking a steady source of profits. They have no interest in trying to be home run hitters. They play Moneyball.

Unfortunately, the only way most investors eventually find their way to option selling is by having failed at every other approach first. I once asked a potential client why he decided on selling option premium as a means of investing. “Because I’m not a very good trader,” he said, “and option selling is the only way I can make any money in the market.”

Indeed.

Option Selling on Steroids

An Introduction to Futures Options

After decades of being the neglected stepchild of the investment world, commodities have finally begun to catch on with mainstream investors. Perhaps it is the expanding need to diversify that is driving this trend. Or it could be that after the varying degrees of financial trauma throughout the first decade and a half of the 21st century, futures may not look quite as

risky or as intimidating as they used to, at least in relation to everything else. Investors, especially high-net-worth investors, are now willing—and almost have to be willing—to explore alternatives.

Unlike stock in companies such as Enron, AIG, or Bear Stearns, commodities are physical products that people use

every day. Regardless of what is happening in credit markets or corporate boardrooms, people will still drink coffee, eat wheat, and fill their cars with gas. These assets will always have a value. In this day and age where anything goes in the investment world, that fact is beginning to carry a lot of weight with investors.

- Sugar cannot be considered “too big to

fail.” Silver cannot go bankrupt. The CEO of Soybeans cannot embezzle money from shareholders.

We use the terms *futures* and *commodities* interchangeably in this book. However, there are many kinds of futures contracts. In addition to the actual commodities futures such as corn, sugar, oil, or cattle,

there are financial futures. Financial futures contracts include T-bonds, Treasury notes, index futures (such as the S&P 500), and currency futures. It is ironic to note that most stock traders' introduction to futures is through the S&P 500 contract —the biggest, baddest contract on the board. These same traders often shudder at trading a soybean or coffee contract. To us, old-school

commodity traders, soybeans and coffee are not only smaller contracts with lower risk, they are (in our opinion) more predictable markets.

Stock option traders who overlook commodities options are missing the boat. Here's why every option trader should consider them.

A Thriving Industry

New volume records have been set in the last two years on many contracts at the Chicago Mercantile Exchange and the Chicago Board of Trade. New products and the continued expansion of electronic exchanges continue to point to a thriving, growing asset class that is now available to most all types of investors.

Yet, despite the

popularity of futures trading, the odds remain stacked against individual investors in the futures arena.

Studies confirm that about 76% of all futures traders end up losing money (there is no doubt that most of these are small speculators). It is no mystery why. It is amateurs against the pros in futures. No matter how hard small investors try, the pros are

usually one step ahead. If you read something on your screen, they probably knew about it yesterday. If you read something in the newspaper, they probably knew about it last week. By the time you go to trade it, it has already been priced into the market.

It is not the fact that small speculators don't have the time, nerves, resources, capital, or knowledge to

compete. It is the fact that they are amateurs competing against professionals, and this is the real reason most futures traders lose money. Lucky for you, you don't have to be part of this group. You don't have to go toe to toe with these heavyweights on their turf anymore. You can simply sell options.

Commodities Options for the Stock Option Seller

If you currently write, or are considering writing options on equities,

you are doing yourself a great disservice if you do not at least consider writing options on futures as well. The portfolios we recommend to clients are focused exclusively on

futures options. Here is why.

Key Advantages of Futures Options Over Stock Options

- 1. Substantially Lower Margins (Potential for Higher Returns).**
This is one of the

top reasons so many stock option sellers convert to futures. Margins posted to hold short stock options can be 10 to 20 times the premium collected. With the SPAN margin system used in the futures industry, options can be sold for margin

requirements as little as 1 to 1½ times premium collected. For instance, you might sell a corn option for \$600 and post an out-of-pocket margin requirement of only \$700.

2. High Premiums for Deep Out of

the Money Strikes. Unlike equities, where to collect any worthwhile premium, options must be sold 1 to 3 strike prices out of the money, futures options can often be sold at strikes deep out of the money. This allows you to

target price levels where short-term market fluctuations will not adversely affect the position. In addition, time value erosion may be allowed to work less impeded by short-term volatility.

3. **Liquidity.** Many equity option

traders complain of poor liquidity hampering their efforts to enter or liquidate positions.

Although some futures contracts have higher open interest than others, most of the major contracts such as Financials, Sugar, Grains, Gold, Natural Gas,

Crude Oil, and more have substantial volume and open interest offering several thousand open contracts per strike price.

4. Diversification. In the current state of financial markets, many high-net-worth investors are

seeking precious diversification away from equities. In equities, bear markets can wreck a portfolio and bull markets always seem ripe for correction. By expanding into commodities options, you not only gain an

investment that is *100% uncorrelated to equities*, your option positions can also be *uncorrelated to each other*. In stocks, most of the time, your individual stock (option) will be largely at the mercy of the index as a whole. If

Microsoft is falling, chances are, your Exxon and Coca-Cola are falling, too. In commodities, the price of natural gas has little to do with the price of wheat or silver. This can be a major benefit in managing risk.

5. Fundamental

Bias. When selling a stock option, the price of that stock is dependent on many, many factors—not the least of which is corporate earnings, comments by the CEO/Board, legal actions, Fed decisions, or direction of the overall index.

Soybeans, however, can't "cook their books." Silver can't get sued.

6. Supply and Demand. In commodities, it is most often old-fashioned supply and demand that ultimately dictates price. Knowing

these fundamentals can give you an advantage in deciding what options to sell.

Futures Contracts: What Are They?

Before one can understand how to sell options on futures, one must understand

what futures are. Farmers originated the buying and selling of futures contracts as a way to offer a hedge against price changes in their crops.

It works like this: A farmer has a crop of cotton growing in his field. He likes the current price that cotton is fetching at the market and would be very happy if he could sell his crop at this price. However, his crop will

not be ready to sell for three months. By selling a cotton futures contract (or number of contracts) equal to the amount of cotton he has growing in his field, he can effectively “lock in” the current price of cotton.

How does this work? As an example, let’s say the farmer estimates that his crop will produce 50,000 pounds of cotton this year. The

futures contract for cotton is for 50,000 pounds. Therefore, the farmer can sell one futures contract of cotton at today's price for the month he expects his cotton to be ready for delivery. Now if the price of cotton falls between now and the time his cotton is ready to sell, he will make up the difference in profits on his futures contract. If the price of cotton rises, he will lose on his futures contract, but he

will make up the difference on the sale of his physical cotton. It is a way for the farmer to avoid the risk of prices moving below a point at which he would be satisfied. This is called *hedging*, and it is still the primary purpose of the futures markets today.

Large institutional farms and agricultural producers hedge their products in

everything from cocoa to cattle to soybeans. Banks and government institutions hedge their exposure to currency fluctuations and interest rates. Worldwide brokerage houses hedge their exposure to the stock market with index futures contracts.

Hedgers also can be users of the actual products they want to protect against prices moving higher. A company

such as Pillsbury, which uses thousands of tons of flour in a year, may want to protect against higher wheat prices and hedge by buying wheat futures. Financial institutions use futures to hedge in this manner as well.

Pure hedgers make no actual net profit from trading futures. It is only a tool to cut risk and manage price swings in a product that their

business either produces or uses in some regard. Not only are these traders very well versed in their industry, but generally they also work for large organizations and have thousands or even millions of dollars in technical and human resources available to them to determine price directions and risk arrays of the commodities or financial instruments with which they are dealing. These traders are

known as *commercial traders*, or *commercials* for short.

The Role of the Speculator

To hedge their risk, hedgers have to have somebody assume their risk. *Speculators* fill this role. Speculators do not trade futures to manage

risk or lock in prices. Usually, they are not even in the physical commodities business. They are trading the contracts purely for profit. They are willing to assume the risk of the hedgers in the hope that a price move will produce profits for them. They do not deliver the goods, nor do they take delivery. They simply buy and sell the contracts and exit before delivery comes due.

The Commodity Futures Trading Commission (CFTC) divides speculators into two groups: *large* and *small speculators*. If a trader has a certain number of contracts in one commodity, usually 50 or 100, she is considered to be a large speculator in that particular commodity. Although many individual investors can easily hold this many contracts at a time, large speculators generally

are thought of as professional money managers or *funds*. Large investment houses or independent operators can trade commodity funds, made up of capital from many investors (similar to a mutual fund in equities). Ironically, some of these are known as *hedge funds*, supposedly because these funds can be somewhat of a hedge against adverse moves in the stock market. However, the purpose

of these funds is to produce a profit.

Fund managers trade billions of dollars and trade many thousands of contracts in a day. They have the ability to move the market to a certain degree when they decide to enter or exit positions. Like commercial traders, most have huge amounts of resources available to them, industry

contacts, and a wealth of personal or company experience on which to draw.

There is one category left. This is the *small speculator*. Small speculators are individual investors. They are the tiny capitalists trying to enter the race between the two titans. As we discussed, this group faces a decided disadvantage when trading actual futures contracts.

Selling options on those contracts, however, can be a way to level the playing field with the pros.

Contracts and Contract Months

A *futures contract* is an agreement to buy or sell a specified commodity in a specified amount at a

specified date. Every contract is for a specified amount of that particular commodity, currency, or financial product. Most commodities have different contract sizes depending on the unit that is used to measure it. For instance, a contract for corn is for 5,000 bushels of corn. A contract for crude oil is for 1,000 barrels of crude.

Unlike stocks,

commodities trade in different contract months. Corn for delivery in July is a different contract at a different price from a contract for corn for delivery in September. As a speculator, you will want to close out your positions before these contracts come due for delivery.

Some investors new to futures express the fear that

they will make a mistake and that a contract for a commodity will be delivered to their door. This is simply unrealistic. There are several layers of people whose responsibility it is to make sure this does not happen. You would be contacted by several of them (first and foremost, your broker) to inform you that it is time to exit your position, and if necessary, they probably

would do so on your behalf. Even if you did intend to take delivery, there is much paperwork and arrangements to be made before this could take place.

Option traders generally do not have to worry about this at all. Even when an entity wants to take delivery, they must possess a futures contract, not an option.

Contract Sizes and Point Values

Another difference between futures and stocks is how price moves are calculated. In a stock, you can buy 100 shares of stock, and if the price moves up \$1 a share, you make \$100. Because commodity contracts vary in size and units of measurement (i.e., barrels,

bushels, or pounds), each commodity has a different *point* value.

For example, the size of a crude oil contract is 1,000 barrels. The price in the crude oil contract is quoted at a price per barrel. Price changes in crude oil move in 1-cent increments. Therefore, a 1-cent move in the price of crude oil equates to a gain or loss of \$10 for every contract

a trader holds $(0.01 \times 1,000 = \$10)$. If a trader bought one contract for May crude oil at \$98.00 per barrel, and the price increased to \$98.50 per barrel, the trader would have made a \$500 profit ($50 \times \$10 = \500).

Contract sizes and point values for different commodities and futures contracts are listed in [Figure 5.1](#).

FIGURE 5.1 Futures Contract Specifications

Symbol	Future	Exchange	Hours	Months	Contract Size	Point Value
<i>Financial</i>						
ED	Eurodollar (3 month)	CME	7:20-2:00	H,M,U,Z	1mil.E	1pt. = \$25.00
ED	Euroyen (3 month)	CME	7:20-2:00	H,M,U,Z	100mil.Y	1pt. = \$250.00 Y
FT/RFF	Federal Funds (30 day)	CBOT	7:20-2:00	All months	\$5mil.	1pt. = \$41.67
EM/REM	Liber (1 month)	CME	7:20-2:00	All months	\$3mil.	1pt. = \$25.00
TB/TB	T-Bills (90 day)	CME	7:20-2:00	H,M,U,Z	1mil. bills	1pt. = \$25.00
TU/TU	T-Notes (2 years)	CBOT	7:20-2:00	H,M,U,Z	\$200,000 note	1/128 = \$15.625
FV/RPV	T-Notes (5 years)	CBOT	7:20-2:00	H,M,U,Z	\$100,000 note	1/64 = \$15.625
TY/TYD	T-Notes (10 years)	CBOT	7:20-2:00	H,M,U,Z	\$100,000 note	1/64 = \$15.625
US/USD	US T-Bonds	CBOT	7:20-2:00	H,M,U,Z	\$100,000 note	1/32 = \$31.25
<i>Currencies</i>						
ADRAD	Australian Dollar	IMM	7:20-2:00	H,M,U,Z	100,000 AD	1pt. = \$10.00
BR	Brazilian Real	IMM	7:20-2:00	H,M,U,Z	100,000 BrR	1pt. = \$10.00
BP/RBP	British Pound	IMM	7:20-2:00	H,M,U,Z	\$2,500 BP	1pt. = \$6.25
CD/CD	Canadian Dollar	IMM	7:20-2:00	H,M,U,Z	100,000 CD	1pt. = \$10.00
CZ/CZK	Czech Koruna	IMM	7:20-2:00	H,M,U,Z	4mil.CK	1pt. = \$4.00
EC/REC	Eurodollar	IMM	7:20-2:00	H,M,U,Z	\$125,000	1pt. = \$12.50
E7	Eurodollar (E-Mini)	IMM	5:00 PM-4:00 PM	H,M,U,Z	562,500	1pt. = \$6.25
FR/HUF	Hungarian Forint	IMM	7:20-2:00	H,M,U,Z	30mil.HF	1pt. = \$3.00
JY/RJY	Japanese Yen	IMM	7:20-2:00	H,M,U,Z	12.5mil. Yen	1pt. = \$12.50
JY	Japanese Yen (E-Mini)	IMM	5:00 PM-4:00 PM	H,M,U,Z	6.25mil. Yen	1pt. = \$6.25
Mp/RME	Mexican Peso	IMM	7:20-2:00	H,M,U,Z	500,000 MP	1pt. = \$5.00
NE	New Zealand Dollar	IMM	7:20-2:00	H,M,U,Z	100,000 NZD	1pt. = (\$10.00)
UN/NOK	Norwegian Krone	IMM	5:00 PM-4:00 PM	H,M,U,Z	2mil.NKr	1pt. = \$20.00
PZ/PLN	Polish Zloty	IMM	7:20-2:00	H,M,U,Z	500,000 PZ	1pt. = \$5.00
RU	Russian Ruble	IMM	7:20-2:00	H,M,U,Z	2.5mil.RR	1pt. = \$25.00
RA	South African Rand	IMM	7:20-2:00	H,M,U,Z	500,000 SAR	1pt. = \$5.00
SE/SEK	Swedish Krona	IMM	5:00 PM-4:00 PM	H,M,U,Z	2mil.SKr	1pt. = \$20.00
E1/SF	Swiss Franc	IMM	7:20-2:00	H,M,U,Z	125,000SF	1pt. = \$12.50
<i>Indices</i>						
CR	CRB Index	NYBT	9:00-1:30	H,M,U,X	\$200 3 Index Value	1pt. = \$10.00
NDJ/DJ	Dow Jones Ind.	CBOT	7:20-3:15	H,M,U,Z	\$10.3 Index Value	1pt. = \$10.00
MB	Muni Bond Index	CBOT	7:20-2:00	H,M,U,Z	\$1,000 3 Index Value	1/32 = \$31.25
ND/RNO	NASDAQ 100	CME	8:30-3:15	H,M,U,Z	\$100 3 Index Value	1pt. = \$5.00
NQ	NASDAQ 100 (E-Mini)	CMEE	5:00 PM-3:15 PM	H,M,U,Z	\$20 3 Index Value	1pt. = \$2.00
NK	Nikkei 225	CME	8:00-3:15	H,M,U,Z	\$5 3 Ave	1pt. = \$5.00
YU	NYSE Stock Index	NYBT	8:30-3:15	H,M,U,Z	\$50 3 Index	1pt. = \$5.00
ERI	Russell 2000 (E-Mini)	IOM	8:30-3:15	H,M,U,Z	\$100 3 Index Value	1pt. = \$1.00
SP/RSP	S&P 500	CME	8:30-3:15	H,M,U,Z	\$250 3 Index	1pt. = \$2.50
ES	S&P 500 (E-Mini)	CME	5:00-3:15 PM	H,M,U,Z	\$50 3 Index	1pt. = \$5.00
DX	US Dollar Index	NYBT	6:00 PM-9:00 PM	H,M,U,Z	\$1,000 3 Index	1pt. = \$10.00
<i>Dairy</i>						
DB	Butter	CME	9:30-1:10	H,K,N,U,V,Z	40,000lbs	1pt. = \$4.00
DA	Milk (Class III)	CME	9:30-1:10	All	300,000lbs	1pt. = \$4.00
DK	Milk (Class IV)	CME	9:20-1:10	18 consecutive months	200,000lbs	1pt. = \$20.00
NF	Non-fat Dry Milk	CME	9:40-1:20	All months	44,000lbs	1pt. = \$4.40
<i>Grains</i>						
NCC	Corn	CBOT	9:30-1:15	H,K,N,U,Z	5,000bu	1ct = \$50.00
XC	Corn (E-Mini)	CBOT	9:30-1:45	H,K,N,U,Z	1,000bu	1ct = \$10.00
MW	Wheat	CBOT	9:30-1:15	H,K,N,U,Z	5,000bu	1/4pt. = \$50.00
MW	Wheat (E-Mini)	CBOT	9:30-1:45	H,K,N,U,Z	1,000bu	1ct = \$10.00
HW	Wheat (Hard)	MGE	9:30-1:15	H,K,N,U,Z	5,000bu	1pt. = \$12.50
MW	Wheat (Hard Red Spring)	MGE	9:30-1:15	All months	5,000bu	1pt. = \$50.00
NOLO	Oats	CBOT	9:30-1:15	H,K,N,U,Z	5,000bu	1ct = \$50.00
NNR/NRN	Rough Rice	CBOT	9:30-1:15	F,H,K,N,U	2,000kibs	1ct = \$20.00
NS	Soybean	CBOT	9:30-1:15	F,H,K,N,Q,U,X	5,000bu	1ct = \$50.00

XS	Soybean (E-Mini)	CBOT	9:30-1:45	F,H,K,N,	1,000bu Q,U,Z	1ct = \$10.00
NS,SM	Soybean Meal	CBOT	9:30-1:15	F,H,K,N,	100tons Q,U,V,Z	1pt. = \$1.00
NBO,BO	Soybean Oil	CBOT	9:30-1:15	F,H,K,N,Q,	60,000lbs U,V,Z	1pt. = \$6.00
Livestock						
FC	Feeder Cattle	CME	9:05-1:00	F,H,I,J,K,Q,	50,000lbs U,V,X	1pt. = \$5.00
FM	Feeder Cattle (E-Mini)	CME	9:05-1:00	F,H,I,Q,U,V,X	10,000lbs	1pt. = \$10.00
LC	Live Cattle	CME	9:05-1:00	G,J,M,Q,V,Z	40,000lbs	1pt. = \$4.00
LH	Lean Hogs	CME	9:10-1:00	G,J,M,N,K,	40,000lbs Q,V,Z	1pt. = \$4.00
HM	Lean Hogs (E-Mini)	CME	9:10-1:00	G,J,M,N,Q,V,Z	10,000lbs	1pt. = \$10.00
PB	Pork Bellies	CME	9:10-1:00	G,H,K,N,Q	40,000lbs	1pt. = \$4.00
Lumber						
LB	Random Length Lumber	CME	9:00-1:05	F,H,K,N,U,X	110,000bdft.	1pt. = \$11.00
Metals						
HG,RHG	Copper (High Grade)	COMEX	7:10-12:00	F,H,K,N,U,Z	25,000lbs	1ct = \$12.50
GC,RGC	Gold	COMEX	7:20-12:30	G,J,M,Q,V,Z	100oz	\$1 = \$100
PA	Palladium	COMEX	7:30-12:00	H,M,U,Z	100oz	1pt. = \$5.50
PL	Platinum	COMEX	7:20-12:05	F,J,N,L	50oz	0pt. = \$5.50
SURSI	Silver	COMEX	7:25-12:25	F,H,K,N,U,Z	5,000oz	1pt. = \$5.50
Softs						
CC	Cocoa	ICE	7:00-11:50	H,K,N,U,Z	10 metric tons	1pt. = \$10.00
KC	Coffee	ICE	8:15-12:30	H,K,N,U,Z	37,500lbs	1pt. = \$18.75
CT	Cotton	ICE	9:30-1:15	H,K,N,V,Z	50,000lbs	1pt. = \$5.00
LB	Lumber	CME	9:00-1:05	F,H,K,N,U,X	110,000bdft	1pt. = \$10
OJ	Orange Juice	ICE	9:00-1:30	F,H,K,N,U,X	15,000lbs	1pt. = \$17.50
SB	Sugar #11	ICE	8:00-12:00	H,K,N,V	112,000lbs	1pt. = \$11.20
Energies						
CL,RCL	Crude Oil	NYMX	9:00-1:30	All Months	1,000bbl	1pt. = \$10.00
SC,RSC	Crude Oil (Brent)	NYMX	9:00-1:30	All Months	1,000bbl	1pt. = \$10.00
LBC,LBCA	Crude Oil (Brent)	IPE	9:00-1:30	All Months	1,000bbl	1pt. = \$10.00
LBC,LBCA	Gas Oil	IPE	9:00-1:30	All Months	100 metric tons	1pt. = \$25.00
HOR,HO	Heating Oil	NYMX	9:00-1:30	All Months	42,000gal	1pt. = \$4.20
NG,RNG	Natural Gas	NYMX	9:00-1:30	All Months	10,000mm/btu	1pt. = \$10.00
RB,RHU	Reform. Blend Gasoline	NYMX	9:00-1:30	All Months	42,000gal	1pt. = \$4.20

Times listed are Central Standard Time (CST) in the U.S.

Exchanges:

CBOT: Chicago Board of Trade

CME: Chicago Mercantile Exchange

COMEX: Commodity Exchange, Inc.

CSCE: New York Coffee, Sugar and Cocoa Exchange

ION: Index and Options Market (Div. of CME)

MACE: MidAmerica Commodity Exchange

MGE: Minneapolis Grain Exchange

NYFE: New York Futures Exchange

NYCE: New York Cotton Exchange

NYME: New York Mercantile Exchange

WPG: Winnipeg Commodity Exchange

Months:

F = Jan

G = Feb

H = Mar

J = Apr

K = May

M = Jun

N = Jul

Q = Aug

U = Sep

V = Oct

X = Nov

Z = Dec

Margins on Futures

The term *margin* has a completely different meaning in the futures world than it does in the world of equities. In stocks, one often can “borrow” money from the brokerage house to purchase stocks, at least a certain percentage of stock. This is known as *buying on margin*.

The investor then has to pay interest on the money she borrowed and hope that the gain from her stock purchase is enough to pay her interest charge and commission and still show a profit. This is a way of increasing leverage.

In futures, buying or selling on margin is a built-in feature. To use the preceding example, a crude oil contract trading at \$98 per barrel at a

contract size of 1,000 barrels would mean that the total value of the contract is \$98,000. Yet a trader can purchase (or sell) that contract for a small *margin deposit*, usually about 5% to 10% of the value of the contract. In the traditional way of buying stocks, to purchase \$98,000 worth of stocks would require \$98,000 worth of cash. However, to purchase \$98,000 worth of

crude oil, one only needs to put down the margin requirement, maybe \$6,000. The exchange will front you the rest.

This is where the leverage comes from in futures contracts. A small move in the value of the unleveraged stock produces a small gain or loss. A small move in the value of the commodity can result in a large gain or loss.

For instance, if you purchase 1,000 shares of stock at \$98 a share, you plunk down \$98,000. If the stock moves up to \$102 per share, you make \$4,000, or approximately 4% return on your investment ($4,000/98,000 = 0.0408$).

If you purchase a contract for crude oil at \$98, you put down your \$6,000 margin requirement, and when it

moves up to \$102, you make the same \$4,000, yet your return on investment is 66.7% ($4,000/6,000 = 0.667$). This aspect of leverage is why futures generally are considered an aggressive investment by the mainstream investment media. The misunderstanding of this leverage by new futures traders is where many make their mistake in futures. Properly understanding and

using this leverage can give you a decided advantage over many of your futures trading peers.

Figure 5.2 presents an example of what a margin sheet looks like. This is only a sample. Margins change all the time, and you should ask your broker for an updated margin sheet if you want to see a current margins for futures contracts.

FIGURE 5.2 Sample Margin Sheet: Listing of Margin Requirements for Futures Contracts

Margins

Market	Initial	Maintenance
10 Year agency	945	700
13 Week t-bill	405	300
Australian dollar	6,345	2,700
Bobl eurex	0.850 E	0.850 E
Brazilian real	4,480	3,200
British pound	3,510	2,600
Bund eurex	1,750,000 E	1,750,000 E
Butter	1,620	1,200
Canadian dollar	3,510	2,000
Cattle, feeder	2,025	1,500
Cattle, live	1,620	1,200
Cocoa	2,940	2,100
Coffee	4,200	3,000
Copper hi-grade	7,763	5,750
Corn	2,025	1,500
Cotton	2,520	1,800
CRB index	9,000	9,000
Crude oil	12,488	9,250
Dax	14,700,000 E	14,700,000 E
DJ euro stoxx 50	2,750,000 E	2,750,000 E
DJ stoxx 50	1,900 E	1,900 E
Dollar index	2,261	1,700
Dow industrial index	11,250	9,000
Euro Fx	6,075	4,500
Euro dollar	1,485	1,100
Euroyen (in yen)	405,000	400,000
FED funds (30 day)	878	650
Frozen OJ	1,820	1,300
Gold comex	7,425	5,500
100oz. gold (CBOT)	7,428	5,502
Goldman index	19,500	13,000
Heating oil	14,175	10,550
Japanese yen	4,860	3,600
KC value line	1,000	800
Lean hogs	1,350	1,000
Libor (1mo) CME	1,350	1,350
Lumber 110K	1,650	1,100
Mexican peso	3,000	2,400
Milk CME	1,350	1,000
Nasdaq 100 index	20,000	16,000
Natural gas tier 1	11,138	8,250
New FTSE 100	3,000	3,000
Nikkei index	6,250	5,000
NYSE index (YU)	15,500	15,500
NYSE small index (MU)	1,550	1,550
Oats	1,350	1,000
Palladium	3,713	2,750
Platinum	8,100	6,000
Pork bellies, frozen	1,620	1,200

Propane	4,388	3,250
RBOB gasoline	13,500	11,000
Rough rice	3,105	2,300
Russell 1000 index	20,000	20,000
Russell 2000 index	26,000	26,000
Russian ruble	4,950	3,302
S&P 500	30,938	24,750
S&P mid 400	33,750	27,000
Schatz	600 E	600 E
Silver comex	8,100	6,000
5,000oz. silver (CBOT)	8,640	6,400
Soybean meal	2,700	2,000
Soybean oil	2,025	1,500
Soybeans	4,725	3,500
Sugar #11	1,260	900
Swiss franc	3,915	2,800
US 2 Yr t-note	2,295	1,700
US 5 Yr t-note	2,295	1,700
US 10 Yr t-note	2,970	2,200
US t-bonds	3,645	2,700
Wheat	4,050	3,000
Wheat KC	3,125	2,500
Wheat MN	3,510	2,700
Mini corn	405	300
E-mini crude oil	6,244	4,625
E-mini dow industrial index \$5	5,625	4,500
E-mini euro FX	3,038	2,250
Mini gold	2,476	1,834
E-mini japanese yen	3,038	2,250
Mini wheat	810	600
Mini soybeans	945	700
Mini silver	1,728	1,280
E-mini S&P 500	6,750	5,400
E-mini S&P midcap	4,750	3,800
E-mini Russel 1000	4,000	4,000
E-mini Russel 2000	5,200	5,200
E-mini Nasdaq 100	4,000	3,200
NYMEX miNY gasoline (tier 1)	6,750	5,500
NYMEX miNY heating oil (tier 1)	7,088	5,250
NYMEX miNY natural gas (tier 1)	2,784	2,269

*Futures Margin Requirements can and do change as set by the Exchanges.

Check with your broker for a current margin chart.

Margin requirements for individual contracts are set by the exchanges and can be changed based on the volatility of the contract. These are called *minimum exchange margins*.

Individual clearing firms can add their own additional margin on top of the exchange margins and reserve the right to increase these margins without notice.

Serious traders usually look for a brokerage that offers minimum exchange margins.

You must distinguish between margin requirement for the futures contracts, and margin requirement for an option on that futures contract. These are two different things. As an option seller, you will rarely, if ever, need to know futures margins. They are presented

here for educational purposes only. As a future option seller, your main concern will be the margin on your option. In the futures business, a system call SPAN is used to determine futures option margin requirements. SPAN margin is a key to generating high returns. It is important enough to warrant its own chapter ([Chapter 6](#)).

How to Buy a Stock, Commodity, or Boat at a Synthetic Price

Have you ever noticed how easy it is to enter a trade? Whether it's a highly recommended company or the next hot commodity,

the day you buy it can be the easiest (and happiest) day of the trade.

A wise man once told me that the happiest days of a boat owner's life are the day he buys it and the day he sells it. You don't want the day you buy your new investment to turn out like the day you bought your new boat.

After many years of

trading experience, the one thing I've discovered is that it is of utmost importance to give your new investment time to work as planned. At the very least, allow it the opportunity to work as planned.

All too often, price volatility and noise from the business world will cause many investors to

rethink their position, close out what could have been a good investment, and call it a boat.

What do I mean by this? Let's consider an example.

The Terifly Trade

One day while sitting at your desk, a promising new company comes across

your radar screen. As with all investments, you do your homework. Everything you know about valuations, trend following, and economics have you convinced this company is a good buy. So you jump in.

Shortly thereafter, the stock you bought at 50 is suddenly trading at 45 and you ask, “what’s the

matter?" Initially your plan was to hold for 12 months, but you are already questioning your buy and hold strategy.

For the next few weeks the price is more stable. Your confidence returns. This stock, we'll call Terifly, now becomes part of your portfolio. While it was smack dab in the middle of your radar screen

at first, it now has taken its place with several other ideas. Some have gains; others don't.

After several more weeks, Terifly continues to trade in the mid-40s and its quarterly earnings are due out on Thursday, just a few days from now. With some anticipation you're thinking, "if my research was correct, I will soon

have vindication.”

Thursday afternoon arrives, and how about that? Terifly beats the street, and the stock is up a whopping 10% in after-hours trading! Yes! On Friday some analysts place upgrades on your new favorite company, and you go into the weekend with a winner: \$52 per share.

Terifly is now back on

the radar screen. “Let’s see if it has any follow-through,” you think with giddy anticipation.

Over the next several days the stock continues to trend higher, enjoying leftover buying from its great quarterly results. Before you know it, Terifly is trading at just over \$55 and all is well.

As the proud owner of

a company with a 10% profit, you find yourself faced with a decision. “Is this trade the winner I’m supposed to let run, or do I take the money and run? After all, if my investments during the year all paid 10%, I could beat the street, big time.”

You consider the initial game plan and make the decision to hold the stock.

“I’ve owned the company just a few months, and the plan was to stay in for at least one year,” you reason.

During the next few weeks trading in Terifly slows somewhat, and the upward momentum begins to fade. After hitting a high of \$57 the stock is now trading in the low \$50s. While its price is nothing to panic about, a thought

crosses your mind. “Maybe I should have cashed out.”

Terifly is no longer on the radar screen but is tucked back into the portfolio. It has now been nearly four months, and sure enough your stock closes at \$49.50 to end the week. Ouch. We’ve officially turned a winner into a loser. Terifly is now back on the radar screen,

but not for the reason it once was. Now it's suddenly on your "watch" list. You think back to other holdings that behaved like this. Often, they did not end well.

A few weeks pass, and it seems Terifly can't get a higher weekly close to save its life. 48, 47, 46. Suddenly the idea of holding tight for 12 months

has gone out the window. Which means buy and hold has now been replaced with “money management.”

Overanalyzing has now taken over this investment. Its days are numbered.

Flash forward. It has now been almost six months of watching Terify, and it has transformed from an

investment into a JOB. Its previous low for the year had been \$43, a level it approached shortly after your initial purchase.

You make the decision to place a sell stop if Terifly trades below the \$43 price level. It seems almost magical how your sell stop has now become a magnet, as the price continues to ease. Just one

week later the stop is hit. Terifly is no longer in the portfolio. And Terifly is no longer your problem.... Just like the day you sold your boat.

Naturally, after one year, you look up its price to see where it's trading. What do you know? Terifly is trading at \$60 per share. Turns out it wasn't a "dog with fleas" after all. If

only it was given an opportunity.

Investing the old-fashioned way isn't easy. Even individuals who have reached the pinnacles of their respective field or industry can find it difficult knowing when to hold 'em when it comes to investing.

Trying to trade the traditional way can turn you into a sheep, and, as

Gordon Gekko so eloquently stated, “Sheep get slaughtered.”

In order to stop being the sheep, you will need to stop buying stocks or commodities at the same price everyone else does.

Buying the Asset at a “Synthetic” Price

From now on, the next

time you choose to take a position, long or short, Exxon or Copper, try entering the market using a “synthetic” price. By selling far out of the money puts, you prevent, or at least drastically reduce, your chances of becoming one of the many sheep.

How about, instead of buying Terifly at 50, you sold the 12-month 40 puts

at \$5? Your synthetic price becomes \$35 per share. Your analysis is the same. Your investment plan is the same. Only this time you don't get slaughtered.

If Terifly stays above \$35 per share, you simply make \$5 per share on Terifly. If the price falls to or below \$35, you buy Terifly at \$35—substantially below where

you would have (\$50), and you still keep the \$5 per share.

Some will argue that this strategy caps your gain at only \$5.00. Or that it's difficult to calculate the required margin. And don't forget the margin to hold these puts could increase!

None of these are your problem. They are issues for the small,

undercapitalized trader (the option buyer).

Buying at a synthetic price is one way that selling options can be employed whether you are trading stocks or commodities (although in commodities, we would be interested purely in taking the premium). However, this story was presented to make a point.

When building a home, the materials can often be bought at vastly different prices. How is it that the well-capitalized developer pays much less for the same materials as an individual interested in building just one home? Easy answer. Because he can.

And how is it that the well-capitalized investor

pays much less for the same stock as an individual who wants to buy just one share? Easy answer again. Because he can. He knows how to buy at the synthetic price.

Then he can buy the boat he wants to keep!

A Crucial Word on Diversification

One reason that commodities are becoming more popular is that they offer a great amount of diversity to a portfolio. Most investors have much of their capital tied up in the stock market. If the stock market goes down, they lose money. Investors who trade individual stocks experience much frustration when they spend their time trying to pick the best-quality stocks only to lose because the market as a

whole falls. They can pick the highest-quality companies on the board and still lose because of macroeconomic factors that take the whole stock market down.

Commodities, currencies, and other financial contracts are not necessarily affected by the stock market or the factors that affect its movement. In most cases they move completely

independently of equities—sometimes perhaps even in opposite directions. For instance, talk of inflation may hurt stock prices but actually may benefit commodity prices. In addition, even if the prices of commodities are moving down, it is just as easy to go short in commodities as to go long.

Another reason that commodities are excellent

diversifiers is that although, as a whole, prices can move in a long-term general direction, they are not as affected by the complex, as a whole, as much as stocks. In other words, Pfizer and Walmart may move lower together because the whole stock market in general is down. However, the price of soybeans is fairly independent of the price of orange juice or natural gas.

There are many more opportunities to diversify within the diversifier.

Managed Futures

Nonetheless, trading commodity futures remains a losing game for most investors. For the reasons already mentioned, for most people it is simply too difficult to learn to manage

the leverage and analytic skills, and to acquire the resources necessary to be consistently successful.

So how does the average individual investor gain exposure to these potentially lucrative markets without losing his shirt? Many investors today are adopting the slogan, “If you can’t beat ‘em, join ‘em.” Growth of managed funds in futures has

exploded in the last five years.

Instead of trying to compete *against* the professionals, these investors are simply hiring a professional to trade *for* them. Although this does not guarantee a profit, most investors will fare much better over the long run having their funds managed professionally. Much of this

will depend, of course, on the trader who is managing your money. There is more on this in the chapter on hiring brokers and money managers (see [Chapter 15](#)). The other choice, of course, is to learn to sell options.

Some investors even may want to combine these two approaches and hire a professional money manager who *sells options* to trade

their account. This, of course, is a choice you may want to consider down the road as well.

Conclusion

If you have, up until now, only traded stocks or stock options, you may want to seriously consider incorporating commodities option selling into your

portfolio. Taking premium in commodities involves higher leverage, which can mean higher risks. However, selling commodities options can offer many advantages to an investor—not the least of which are much higher potential returns, high premiums, and availability of deep out-of-the-money strikes.

Selling commodities

options for the first time can be like *option selling on steroids* to the stock option seller.

Although not appropriate for every investor, the commodity futures markets are a thriving and growing asset class that has come into its own within the last 15 years—especially among the high-net-worth set. They can offer both valuable

diversification and potential for outsize profits. Because of the leverage involved, many investors, even sophisticated investors, enlist the help of a market professional when it comes to commodities.

Regardless, selling options, whether done by yourself or by your money manager, automatically relieves you of many of the burdens and pitfalls that

befall not only futures traders but also traders who buy options. Selling options can put you above the crowd at a point where you don't have to compete with the professionals in the futures pits—at least not directly. Achieving substantial returns in the futures market, *consistently*, can become a reality without taking outrageous risks. Only you, however, can decide if

commodity options are right for your portfolio. If you have a question about this, I would refer you back to [Chapter 2](#), “The ‘Who’ of Selling Options.”

The next chapter will explain to you a crucial component of selling futures options. It is the key to why futures options offer such high potential returns. It is called the SPAN margin.

SPAN Margin

Your Key to High Returns

I still remember the first time

I sold a stock option. I was collecting a \$150 put premium on a \$60 stock. The thing looked like a lock. I couldn't believe more people weren't selling these things. What was I missing? Then I found out. The margin requirement was over \$5,000 to hold the thing. Let's see, put up \$5,000 to make \$150 in 60 days: 3% in 2 months. Maybe that's not bad to most people. But to a person used

to selling futures options, it's "not what we're looking for," to say the least. I'm used to putting up \$5,000 to make \$3,500 in 60 days. That's what a futures option seller calls return. And it's what you can target, too, if you are using SPAN margin.

Selling options, especially futures options, entails a certain tolerance for risk. The strangeness of it, or even the

potential returns, can seem scary when you see it for the first time. The SPAN margin system gives you the ability to calculate futures option margin and is one of your biggest advantages in option selling. Use it.

What Is Margin?

If you have traded commodities in the past, you

are already familiar with the concept of margin. However, traders who have thus far limited themselves to equities may not be familiar with it.

Vastly different margin requirements are one of the key differences between stock and futures options. If you buy an option, you simply pay the premium and own the option. That's it. That's the deal. No margin.

When you sell an option, you collect that premium, but you now hold an open position with potential for loss. For this reason, the seller of a put or call is required to put up some collateral to hold the position. This collateral is not a cost. It is simply a “deposit” made with funds from your trading account. This deposit is known as your *margin requirement*. In this book, we

use the terms *margin* and *margin requirement* interchangeably.

Futures Margin vs. Buying on Margin

It is important not to confuse this type of margin with the concept of *buying*

on margin in stocks. In the latter, an investor borrows money from the brokerage to purchase more shares of stock. Futures margin is a completely different application of the word *margin* and has nothing to do with borrowing money from your broker.

Margin on Stock

Options

Whether you sell a stock option or a commodities option, you will have a margin requirement. The biggest difference is what that margin requirement will be versus the premium you collect. Let's first explore how stock option margins are calculated.

In the first edition of this

book, we gave a simple formula for calculating stock option margin. But stock option margin calculations have grown a bit more complex since then.

It is fair to say that many brokerage houses now charge what is known as “full cash margin.” This simply means that you pay the full value of the underlying shares of stock for your margin requirement.

Therefore, if you sell a \$150 put option on a stock and your strike price is \$50, your margin requirement is the value of 100 shares of that stock (\$5,000) minus the premium collected. That is for a naked, uncovered option (i.e., you don't already own the shares.)

Some, more option-friendly houses offer certain levels of "clearance." This

denotes you as a more sophisticated investor, therefore deserving of lower margin requirements. In light of new financial regulations, however, clearance for selling naked stock options is becoming more difficult to obtain.

Stock option margin for these investors is calculated by a formula that can vary from brokerage to brokerage.

However, the formula featured below seems to be a common one for stock options. Thus, it should illustrate the concept for our purposes.

Suppose you elect to sell a naked put or call on a stock. Assuming you had proper clearance to do this from your broker, you would likely be using a formula similar to the one below:

- 25% of the underlying stock's market value (100 shares) + the option ask price – any out-of-the-money amount

Let's illustrate this concept in an example.

Example: Don Sells a Call on XYZ Stock

Trader Don is bearish on XYZ stock. However, since Don does not want to tie up the capital necessary to short the stock, nor does he think that the stock will fall drastically, he believes that his best alternative is to sell a call. Don has obtained a certain-level “clearance” with his stock broker to obtain favorable margin requirements. With XYZ stock currently trading at \$70

a share, Don decides to sell a March \$72 call for \$150. His margin requirement is calculated in Table 6.1.

TABLE 6.1 Margin Requirement for Mary's Stock Option

\$1,750	(25% of the value of 100 shares of XYZ stock at \$70)
+150	(the ask price of the option)
-200	(amount out of the money)
\$1,700	(total margin requirement for selling the option)

Assuming the option expired with XYZ stock below \$72 per share, Don would have kept the full premium of \$150. Assuming

he sold the call 60 days prior to expiry, Don's rate of return would be as follows:

$$\begin{aligned}\$150/1,700 &= 8.8\% \text{ return in} \\ &60 \text{ days}\end{aligned}$$

Not bad. But this assumes that Don was able to find an option-friendly broker who allowed him the proper clearance and operated under this liberal margin formula. In addition, it does not include

transaction costs.

Let's recalculate Don's return using the full cash margin formula that many stock brokerages are now charging:

$$\frac{\$150}{(7000 - 150)} = 2\%$$

return in 60 days

Not as good, but still nothing to sneeze at.

Nonetheless, let's see what Don could do with that

same capital selling a futures option using the SPAN system.

Example: Don Sells a Soybean Put Option

This is a hypothetical example, but the margin requirement is based on that of a recent similar trade I made. As all of our trades use

SPAN margin, I believe it represents a typical premium/margin ratio in a futures option sale. In this example, trader Don, our option trader from the previous example, is bullish on soybeans. He sells a soybean put option and collects a premium of \$700. He is now short the soybean put.

To hold this position, Don

must put up some margin money. In this case, the SPAN margin requirement for this particular option is \$1,720. This simply means that Don must provide a \$1,720 margin deposit to hold this position.

But where does this money go? Who holds the deposit? Don does! The money never comes out of his account. Instead, it is set

aside in escrow, meaning that he cannot use it to participate in other trades. However, it remains in his account. Therefore, \$1,720 is set aside in escrow in Don's account to hold this position. However, didn't Don just collect \$700 from selling the option?

Yes, he did.

Using SPAN margin, Don can apply the \$700 he collected from selling the put

to cover part of his margin requirement. This leaves him with only \$1,020 that he must cover from his own funds. This is illustrated in **Table 6.2**.

TABLE 6.2 Example: Don Sells Soybean Put Using SPAN Margin

Total margin requirement	\$1,720
Minus premium collected	-700
Total out-of-pocket margin	\$1,020

Assuming that Don started with a \$100,000 account, Table 6.3 shows what Don's account would look like after he sold the option.

TABLE 6.3 Don's Account Snapshot After Selling Soybean Put Option

Opening balance	\$100,000
Premium collected	+700
Total account equity	\$100,700
Margin requirement (funds in escrow)	-1,720
Available equity for more trades	\$98,980*

*For example purposes. Does not include transaction costs

This example does not include transaction costs, which, of course, would be subtracted from the bottom line. However, it illustrates the general idea.

The *available balance* is the amount Don has available to invest in other positions. In futures trading, this is also known as *margin excess*, because buying and selling futures contracts also operates

on the margin principle.

The amount in escrow is the margin requirement that Don posted to hold his soybean put option trade.

The *total equity* is the value of Don's account if his option expires worthless and Don keeps the premium collected as profit. At that time, he would have his \$1,020 margin deposit back along with the \$700 premium

(profit) as part of his available balance.

This example of margin requirement is not unrealistic for futures options. In doing the math, one can see that selling the option can provide a very attractive return on funds invested.

If the option expires worthless, Don's return on capital invested would be as shown in **Table 6.4**.

TABLE 6.4 Don's Return on Capital Invested

Profit from selling option	\$700
Divided by	
Out-of-pocket funds "invested" for margin	\$1,020
$700/1,020 = 0.686$	
Return on invested capital	68.6%

Annualizing Don's Rate of Return

One also must consider that the life of the average option trade that we would recommend is about three to four months. Assuming that Don were to do this successfully two more times during the year, it would give him a 205.8% annual return on his original \$1,020

investment. As long as soybeans did not crash during this time, this would be realistic.

However, this example makes some assumptions and does not take into account other factors, such as risk parameters, increased volatility, early profit taking, and other considerations that will be discussed in forthcoming chapters. It also

does not take into account the possibility that the margin requirement could fluctuate, which it can and does do. This will be discussed later in this chapter. The point is that although some undereducated investors see option selling as “slow and boring,” the preceding numbers illustrate why many enlightened investors are now flocking to option writing as their strategy of choice.

What Is SPAN Margin?

The exchanges set margin requirements for each underlying futures contract. But for futures options, margin is determined by a preset formula. This formula in the Futures

industry is known as the SPAN system.

SPAN stands for Standard Portfolio ANalysis of risk. The SPAN margin system is calculated by a software program at the Chicago Mercantile Exchange (CME). I have never met anyone who could explain exactly how it is calculated! SPAN is based

on factors such as the time value left on the option, the amount by which the option is in or out of the money, and the volatility of the underlying contract. Most clearing firms have the software that calculates SPAN margin for every option.

However, attempting to explain the exact calculations for how it is determined, we feel, would be fruitless.

Suffice it to say that to find out the margin requirement for a futures option before entering the position, we would recommend calling your broker. Most brokers and brokerages that are option-selling friendly will be able to provide you with this at your request. After a few months of selling options, you should be able to estimate the approximate

margin of selling options in the futures contracts with which you are familiar. Of course, you will be able to see the exact figure on your statement once your position is established.

However, for those do-it-yourselfers out there, the Chicago Mercantile Exchange (CME) does provide a version of the SPAN software for

individuals to use. The cost at this time is about \$500, and the reviews we've heard are mixed. However, if you would like to obtain a copy of the software you can contact the CME or visit its website at www.cme.com.

Like many stock brokerages these days, there are now many futures brokerages who do not use

SPAN margin (or at least exchange minimum SPAN margin) unless accounts are owned or being managed by professional traders. Instead, many charge the full margin requirement for a futures contract to sell an option on that contract. With this system, the leverage is still better than that of stock options.

SPAN

margin, however, allows individual investors to obtain a higher rate of return on invested capital than if they had to provide a full futures contract margin to sell an option. If you are going to sell futures options, find a broker or portfolio manager who offers it. The exchange offers it to everyone to use. Yet many brokerages will not offer it

to you and, in fact, don't offer it. This is a big benefit of the pros and one that many individual traders don't know about (nor are most in the know eager to share with you). You learned it here. Don't sell option premium in futures without SPAN!

The Ever-Fluctuating

Margin

One of the biggest fears I have found in new futures option traders is fear of a margin call. They picture themselves getting one. “My God, a Margin Call! I’m ruined!”

You are not ruined. You do not have to fear margin calls. If you’re doing it right, you should never get a

margin call. And if you do get a margin call, there is a very simple way to get rid of it that requires no additional money from you.

All of that, however, in time.

Understanding how the margin requirement can change on your option goes a long way toward making positioning decisions that will keep you far away from any

talk of margin calls. That is what this section is about.

The margin requirement for any option you sell is changing and being readjusted constantly, literally on a daily basis. Often these changes are slight or even unnoticeable. But change they do.

As a general rule, if the value of your option is eroding, so is the margin

requirement. If the value of the option is increasing, the margin requirement will typically increase as well, in step with the option value. Let's view an example to see how this might work.

Example: Trader Mary Sells a Crude Oil Put

Trader Mary is bullish on crude oil. She knows the market can make sharp swings downward, however, and therefore decides that instead of buying the futures contract, she can sell a put several dollars below the market. Mary calls her broker and asks the SPAN margin requirement for selling a September \$74 crude oil put option. Her broker calls her back a few minutes later and

tells her that the total margin requirement is \$1,900. With September crude oil trading at \$94 a barrel, Mary sells a \$74 September put for \$700. Her out-of-pocket margin requirement is calculated in Table 6.5.

TABLE 6.5 Crude Oil Margin Calculation

\$1,900	(total initial margin requirement)
-700	(premium collected)
\$1,200	(Mary's out-of-pocket margin requirement to sell the put)

Mary put up an initial margin requirement to enter the trade. Now that she has an open position, that margin requirement can adjust. The same factors that affect the value of the option can affect

its margin requirement.

Let's assume that after Mary sells her option, September crude oil futures drop to \$84. If this happens, chances are that Mary's margin requirement will increase. How much cannot be calculated precisely because other factors, such as time remaining until expiration, volatility, and the options value, will come into

the SPAN calculation. Suffice it to say that the margin requirement will correlate loosely with the value of the option. If the value of the option increases by \$200, chances are that the margin requirement will increase by an amount close to \$200 or more. This is an approximation and can vary depending on circumstance.

It is also possible for a

margin requirement on an option to change if the exchange decides to raise minimum margin requirements for the underlying contract itself. In this case, the margin to hold the option would increase by a corresponding percentage. In other words, if the exchange raised margin requirements for crude oil futures by 10%, the margin requirement for Mary's

option also would increase by 10%. This is rare and typically happens only if the underlying futures price is becoming volatile.

Back Up Cash: Your Solution to Margin Fluctuation

The point is that margin requirements can fluctuate

throughout the life of the trade. It is for this reason that traders selling option premium should keep a certain amount of backup capital in their accounts to be prepared for these margin fluctuations. We generally recommend that new or conservative traders keep up to 50 percent of their account available as backup capital. This will be covered more specifically in later chapters.

The Upside of Margin Fluctuation

The upside of all this comes when the option deteriorates in value. This can happen as a result of either a favorable market move or time decay. When the option value begins to decrease, the margin requirement for that option decreases as well. This is, in fact, the “natural” direction

for a margin requirement to move as time erodes the option's value. Despite an option buyer's claims, this will happen the majority of the time if you are selling options correctly.

When this happens, these margin funds are released from escrow and into your available funds for use in other trades. Your escrow and available funds balance are

updated on a daily basis to reflect the daily changes in margin requirements. In other words, *if the value of the option is deteriorating, you do not necessarily have to wait until expiration to use the premium you collected from your option sale.* What this means is that you can often use your profits from a short option sale to finance other trades, even if you have not closed your original

position yet.

Your margin funds gradually become available to you as the option deteriorates. This is one feature that futures option traders in particular find very attractive in increasing their leverage in accumulating positions.

Conclusion

SPAN margin is the system

used to calculate margin on futures options. The leverage SPAN provides means that options sold on futures can provide a substantially higher ROI over equity options.

With the many advantages that option selling offers to a trader, selling premium can be a profitable experience in stocks or commodities—for a certain portion of your overall

portfolio. If you have traded only stock options in the past, the benefits of employing the same strategy in futures could greatly expand your investment horizons, if not your bottom line. We are not bashing equity options. Quite the contrary. Many investors have achieved substantial returns with a properly managed option-selling approach in equities. Our point is to make equity

traders aware that there is another vehicle with similar (in some cases, more desirable) properties that is available for diversification and potentially higher rewards.

PART

II



OPTION SELLING STRATEGY AND RISK CONTROL

How to Pick the Right Option to Sell

Lessons Learned from Three Decades in the

Field

In Part I, you learned what options are, why you might want to sell them, and who else is already selling them.

In this section, beginning with this chapter, you are going to learn how to sell options. Obviously, I cannot hope to convey all 30 years of

knowledge and experiences with options into a few pages of a book. What I can do is give you a framework, or *formula* if you will, to work from. And I will bring all of the knowledge, insights, and experiences of those 30 years to bear in conveying the most important points to make you successful. By ingesting this hard-earned knowledge and learning from my mistakes, you will save yourself

countless hours, months, or even years (not to mention capital) lost in learning them for yourself.

My apologies if this book does not contain the spreadsheets, greeks, and graphs favored by so many option “authors.” But I promised you this would contain real-life tips and experiences and that is what you are getting.

Think of me as that guy sitting beside you at the hotel bar, having a beer with you and—after looking around to be sure no one else is listening—giving you the “real story” in a low voice. That is the spirit of this chapter.

Formula for Selecting the Right

Option to Sell

Right Market + Right
Strike + Right Month

There are three main things to learn about selecting the right option to sell. You want to learn how to pick the right market, the right strike,

and the right month. The following several chapters will show you how to do all three.

Goals of the Option Seller

The first step is outlining what the goal of a proper option selling program should be. Below, I have listed the

three main goals of most of the option sellers with whom I have worked. The strategies and points described to you in this book are designed and tested to meet the following three main goals:

- Highest possible return
- Low stress
- Low maintenance

Goal 1: Highest Possible Return

Your first goal as an option seller is to have as many of your options expire worthless as possible, thereby achieving the highest potential return. But there are many ways to get there. You can go cross-country four wheeling, speeding over potentially frame-crushing canyons,

hitting your head on the ceiling all the way—and arriving sooner, perhaps, but bumped, bruised, bloody, and dirty. Or, you could simply take your air-conditioned Mercedes down the interstate. At this point in my life, I don't have a need for excitement and adventure—at least in my investments. I choose the latter. This brings us to Goal 2.

Goal 2: Low Stress

By employing the strategies discussed in this chapter, you not only can potentially increase the percentages of your options expiring worthless, you can also better your odds that your winners do not move sharply against you in the meantime. This causes stress. And one of the things we are trying to avoid

by selling options in the first place is stress. We want to be *outside* of the boxing ring, remember? Proper option selection can help you feel more confident that your losses on nonwinning trades will be smaller and easier to control.

The goal of selecting the right market, the right strike price, and the right month should be to pick options that

will provide a smooth, steady ride to zero at option expiration without the dramatics in the meantime. A properly managed option-writing portfolio should allow its owner to sleep well at night, should be low maintenance, and should be predominantly absent of heart-pounding, gut-wrenching decisions.

Many new traders

erroneously believe that this can be accomplished only through writing covered spreads. As you will see, this is not true. Although I find covered positions are preferable in many instances, writing naked positions can be a great strategy for boosting returns in some situations. While this may sound aggressive to some, it does not have to be; if done correctly, you should be able

to sleep well at night.

Goal 3: Low Maintenance

Many novice traders believe that selling options successfully means sitting in front of a screen all day, analyzing charts and quotes. Nothing could be further from the truth. Although you

certainly can do this if you want to, a big reason for selling options the way we do is the low-maintenance aspect. A key benefit you gain as an option seller is freedom. Freedom from stock prices, freedom from politics, and freedom from dependence on asset appreciation. Should not this also include freedom from a computer screen?

An option seller has no need to sit in front of a screen all day. In fact, many successful sellers of premium with whom we have worked may only check option prices once a day, once a week, or even once or twice a month. If you are trading options completely on your own, checking your positions daily is probably something you want to do. If you are working with somebody you

trust to monitor your positions, you may not need to check as often.

The Insurance Company Model of Selling Options

It has often been said that

selling options is similar to operating an insurance company. Buyers of car insurance pay insurance premiums to an insurance company to insure their vehicles. They pay these premiums month after month. In most cases, the driver never has an accident, and the insurance company keeps the premiums as profit. If a driver does happen to have

an accident, the insurance company must pay up.

An insurance company tries to weed out drivers that it deems to be prone to accidents. Some of these may get insured at higher premiums (to account for the higher risk the insurance company is taking on them), and some may not get insured at all.

Your job as an option

seller is to go through this very same process. Just as most drivers do not have accidents, most of your options will never go in the money. However, as in insurance, a few bad accidents can be bad for the bottom line. An insurance company, therefore, tries to reduce the chances that one of its drivers will have an accident by checking a

number of factors such as driving record, age of the driver, type of car, and other factors. As an option seller, you will go through this same process except, instead of drivers, you will be studying a market's "driving record," historical tendencies, current and future fundamentals, and other factors. An insurance company can in no way guarantee that the drivers it

selects will not have accidents, but it certainly can help its business by selecting only drivers who have what it considers a low chance of being in an accident. Thus, it can lower its risk and increase its profitability. You can too.

As an option seller or insurance company, you will have to “pay a claim” from time to time. The

secret is not only in keeping these “claims” small, but in generating new premiums coming in each month, enough to cover any such claim, many times over. You seek to do this month after month after month.

The Naked Option Sale—A Suggested

Approach to Getting Started

You are about to learn a strategy to follow in selling options in the futures market. By suggesting this, we are by no means suggesting that this is the only way to sell options successfully. There are as many option strategies around as there are traders. We are merely suggesting this

approach because it is the one that has performed most consistently for us and our clients over the years, based on our years of futures and option trading experience. In that time, we have managed, either in personal or client accounts, to employ just about every kind of option strategy you can imagine. Through it all, there was a single strategy that emerged that, although not without

risk, showed over and over again that it can profit consistently in a variety of markets. Therefore, we are not going to discuss the many ways a trader can sell options. We are going to skip all the fancy delta-neutral, standard deviation, backward triple butterfly spread discussions and concentrate on a single strategy that we believe the average individual investor can understand and begin to

implement almost immediately. Even though we are going to review recommended option spread strategies in a later chapter, this strategy will be all you need to get started in selling options effectively.

Based on experience, a desire for simplicity, and steady and *consistent* profits, we are going to recommend a method of *naked option*

selling as an initial strategy to learn. Before you jump in alarm at the thought of being “exposed” to the market by holding naked short options, relax. Just because you sell it naked does not mean that you have to *hold* it naked. Although this can be a productive approach, we also will discuss how more conservative traders can turn their naked option sale into a covered position in Chapter 9.

But we will treat a covered position as a risk-control method and discuss it at length under that heading. This chapter is about the selection and selling of the right options, regardless of whether they are naked or covered.

Just to be clear, this is not to be taken as the Holy Grail of option trading. It is simply an approach that has worked

well for both of us over the years and, if employed correctly, hopefully will work well for you. The strategy has a very high probability of success and carries no more risk than trading futures contracts. If managed correctly, many of the risks can be effectively minimized.

Your Core Strategy

for Selling Naked Options

In a nutshell, an outline for this simple strategy is as follows:

1. Select markets with very clear long-term bearish or bullish fundamentals (and/or seasonal tendencies).
2. Sell options with deep

out-of-the-money strike prices in favor of those fundamentals (or seasonal tendencies).

3. Choose expiration months in the “sweet spot” of time decay.
4. Set a risk parameter on each option that you sell and sit back and wait.

It sounds simple, and it is.

This is one of the primary benefits. However, simple does not mean easy. There are a number of factors to study and consider to give yourself the greatest odds of success. These will be the basis for this chapter. Let's review each in detail.

Step 1: Fundamentals—The

Key to Choosing the Right Market

In beginning your search for the best options to write for your portfolio, you must begin to familiarize yourself with the key fundamentals that affect each market or at least the markets in which you wish to trade. Technical traders may argue this point, but consider the logic. As

we've already discussed, technical factors can and do move the market on a short-term basis. However, long-term and sustained price movements are caused by the underlying base fundamentals of a particular commodity. And whereas technical indicators may reflect these fundamentals, they do not determine the ultimate direction of the market.

We pride ourselves on being excellent technicians. But we learned early that in commodities, fundamentals are king. This is particularly true for option sellers who are more concerned with longer-term overall direction than short-term swings. Fundamental knowledge can make (or save) you a lot of money as a commodity option seller and we cannot overstress its importance.

Nonetheless, short-term technical moves will often occur in outright contradiction to the long-term fundamentals. This is why (non-option selling) individual traders sometimes have a hard time trying to trade purely on fundamentals, at least on a short-term basis. Why? Because the pros know the fundamentals, too. And they are willing to be *very* patient.

How many individual traders are ultimately right about long-term market direction and still lose money? Many. It's part of the reputation of futures trading.

The fictitious interview that follows reflects the frustration of many futures traders. Although this brief interview reflects no specific conversation, we've heard it hundreds of times with

potential clients, and it always has the same basic theme.

John Tries to Beat the Pros: A Brief Excerpt

Trader John: I knew the

market was heading higher. We all knew it was going higher. There was [crop damage, a supply shortage, an impending war, etc.], and I felt pretty confident that the price was going up.

Broker: So what did you do, John?

Trader John: I bought. I

bought [add number]
contracts of
[soybeans, orange
juice, crude oil, etc.].

Broker: What happened?

Trader John: The market
went up, way up!

Broker: And?

Trader John: I lost. I lost a
little money. [In
reality, John
probably lost a lot of
money. But we'll let

him off the hook here.]

Broker: Why?

Trader John: Because the market went down and stopped me out first. Then it went up.

So they got John's money and his soybeans (or whatever commodity he was trading). Who got John's

money? Most likely either professional or commercial traders. They probably were watching the same fundamentals and technicals as was John and were either better at timing it or had the resources to ride out the short-term move against their position. They ultimately have more resources available to them than John does. They do this for a living, all day long, every day. John may be

very good at what he does and may be very intelligent and very dedicated to his trading. It doesn't matter. When push comes to shove, John stands little chance trading from his computer in his spare bedroom with the few spare hours he has each week. Even if John is retired and has all the time and money in the world, unless he is willing to dedicate his entire life to trading, spend

years and countless dollars and resources on becoming a professional trader, his chances of success against these heavyweights over the long term are very slim.

Leveling the Playing Field

But what if John could level the playing field? What if,

instead of beating them, John joined them? John could give up trying to duke it out with the pros in the futures pit and take a big step out of the chaos and into a favorite strategy of the very traders with whom he was competing. Although we are not saying that professional traders never buy options and always sell options, it is our contention that it is the small speculator who will tend to

hold simple long call or long put options to try to profit from some future move. Pros and commercials often do hold long option positions, but this is often part of a larger combination of option and/or futures positions or some sort of hedging situation. Very few pros or commercials will try to capitalize on a move simply by buying calls or puts. The odds are too low.

We believe that markets can and do move somewhat randomly *on a short-term basis*. However, as an option seller, longer-term fundamental trading is almost custom fit for your approach. This is why you will sell two to six months out. Selling with this much time value on your options will allow you to sell at strike prices far enough out of the money that your position may not be greatly

affected by short-term aberrations in a market.

If John had used this approach, he probably wouldn't have made as much money as he would have if he had captured the whole move in a futures position. (Who does?) But he would have made money, probably good money, based on his initial insight. The short-term move down would not have stopped

him out, nor would it have scared him out of his position if proper risk-management rules were followed.

Example: John Learns to Sell Naked Puts Instead of Going Long the Market

Let's look at Figures 7.1 and 7.2. Figure 7.1 shows a right

market analysis and a wrong trading method. **Figure 7.2** shows that John sells a put(s) and profits from being right.

FIGURE 7.1 March 2007 Soybean Chart Showing Buy and Stop Out Points

John gets soybean fundamentals right but gets stopped out prior to rally.

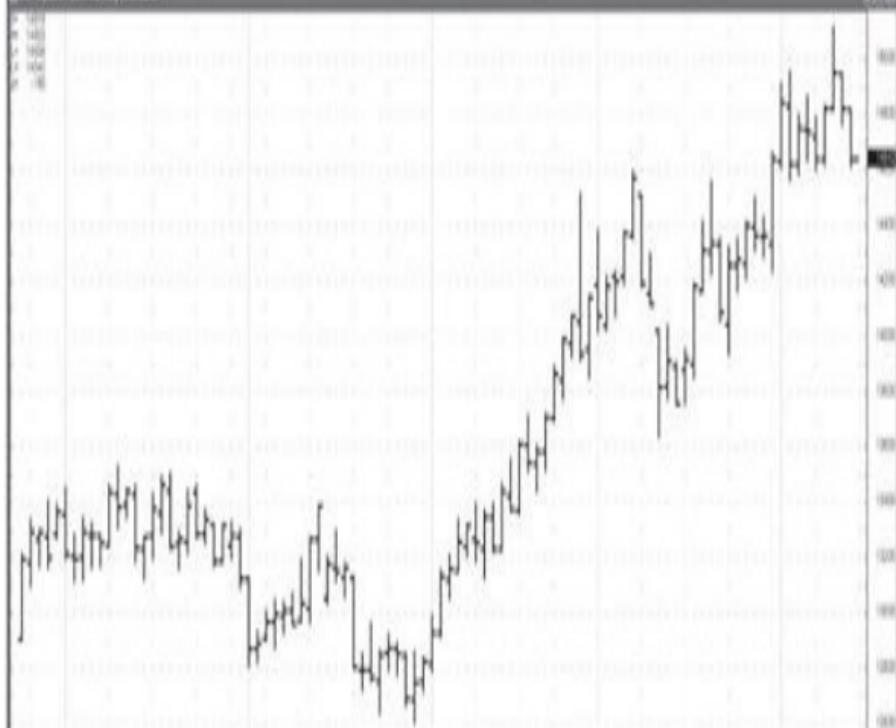


FIGURE 7.2 March 2007 Chart Showing Sale of \$5.80 Puts

In November, John sells \$5.80 soybean puts for \$600 each for less margin than he would have deposited for a futures contract. The market may move lower short term and then proceed higher. John remains in the market, and the options eventually expire, providing John with a good

profit.

14. Indexes, Commodity, Indicators



John Sells Puts Here

14	14
13	13
12	12
11	11
10	10
9	9
8	8
7	7
6	6
5	5
4	4
3	3
2	2
1	1
0	0

John learned to stop trying to outguess what the market is going to do over the short term. Nobody can do this consistently, not even the pros. It is just too difficult. As stated earlier, markets can move at random over the short term. There are too many variables that can sway daily prices, such as breaking geopolitical or financial news stories, fund accumulation or

liquidation, or simply the general mood of traders on a given day or week.

The option seller is freed from these short-term concerns and can focus wholly on the bigger picture of supply, demand, and long-term price trends. In other words, such an investor can focus on the fundamentals.

What Are the Fundamentals?

But what are fundamentals, and how does one track them? *Fundamentals* are the overall factors of supply and demand that affect the price of a given commodity. If you want to learn what moves the price of soybeans will make, learn where they are grown. Learn when their growing

seasons are. Learn who the largest producers are so that you can pay attention to their crops and supply situations and not be distracted by media reports from smaller producers. Learn what countries import these commodities and how much they use. Focus on key importers and overall world numbers.

The important part is

selecting the right market in which to trade in the first place. This is accomplished by knowing the fundamentals.

I have found this to be particularly true in the real commodities contracts such as wheat, coffee, and natural gas as opposed to financial markets such as Bonds or Currency futures. In fact, I believe it to be a considerable

advantage that traders of physical commodities have over stock index or financial futures traders, or even more so, stock traders. Everyone knows how to look up a P/E ratio or last quarters' earnings. But how many people can look at a USDA monthly Cattle on Feed Report and tell you how many cattle are likely coming to market in 90 days? Answer, very few—even

among the supposed “investors” who trade cattle futures. As a seller of commodities options, learning to use this advantage can be very beneficial to your bank account.

How do You get this Fundamental Information?

For those wishing to study the fundamentals, the first step is to know where to look for the right information. How do you acquire the facts and figures that combine to form the big picture of fundamental knowledge? A good place to start is the United States Department of Agriculture (USDA) website, which is the largest source of information for agricultural commodities. Take some time

to explore www.usda.gov. The Department of Energy (DOE) is another good place to mine data for energy traders, and its website is www.doe.gov. The exchanges also offer a wealth of fundamental information. Their websites can be found in the References and Resources section at the end of this book. News services such as Reuters, Bloomberg, and Oster Dow Jones offer

subscription-based financial news that includes daily updated fundamental information.

Good brokers can be a tremendous benefit to investors in the area of providing timely and relevant market fundamentals. Of course, it is always a good idea to have some basic understanding of the market in which you are trading, but

good brokers spend their time researching these data and mining this information *for* you. Knowledgeable brokers should be able to guide you in determining which fundamental data are relevant to the market and how they could affect price and condense all the information for you in a short summary and/or a few basic charts for your review. Especially good brokers will not only save

you a great deal of time but may be able to make a recommendation based on these data that actually will make you some money.

If your goal is to be a successful self-directed seller of option premium, we would recommend finding a broker with extensive knowledge in the fundamentals of the markets in which you wish to trade. This will save you

countless hours of research and years of study and can make your option selling decisions much easier.

However, good brokers are not necessarily good traders, and vice versa. You will learn more about this in **Chapter 20**.

Professional portfolio managers who trade your account can do this as well, but provide different levels of

service. A good portfolio manager will not only trade your account on your behalf but will also provide you regular commentary on the markets in which he or she is trading, keeping you updated on the fundamentals affecting those markets.

But you *can* learn them yourself.

We have devoted
Chapters 13 and 14

exclusively to the basic fundamentals of commodities and how you can use them to your advantage.

In the meantime, the lesson is as follows: In picking options to sell, select the market in which you are going to trade first and make sure you are somewhat familiar with the long-term (bullish or bearish) fundamentals of that market.

If a friend or relative asks why you are in that market, you should be able to give a two- to three-sentence summary that explains your rationale for being in the trade (not that it is any of their business).

While selling options in any market gives you favorable odds, selecting the right markets in which to sell premium can boost your odds

and substantially. If you can select favorable markets in which to write your premiums, you're already halfway there.

Seasonal Tendencies: The Option Seller's Secret Weapon

If you take only one piece of knowledge from this book and discard the rest from your mind forever, I recommend you take the concept of combining seasonal tendencies and option selling. Few mainstream investors have ever even heard of seasonal tendencies. And of the commodities traders who have, few know how to use them correctly. Learning

this concept alone is worth the time and money you have invested in this book. For I am convinced that a trader who learned to properly apply seasonal analysis to option selling could fund a retirement for as long as he could punch a “sell” button. Notice here that I used the words “properly apply.” Note also that I used the term “option selling” and not futures

trading.

Seasonal analysis is one of the most maligned, misunderstood practices in the trading industry. As an option seller, it is also your secret weapon—one of the most powerful arrows in your quill. We talk much about giving yourself an edge. Properly using seasonals can give you a tremendous edge. There is

a very good source of seasonal data available to everyone. The problem is that there are very few resources that show anyone how to use them properly in a trading program. Very few traders know how to use seasonals correctly. You are going to learn how to do this here. And the strategy you will learn (combining seasonals and option selling) is featured

nowhere else in the world.

Seasonal tendencies, or *seasonals* for short, use historical records to graph the tendency for certain markets to move in certain directions at certain times of the year. Whereas these tendencies are often very reliable, their exact timing and magnitude of movement are an inexact science at best. Seasonal

tendencies are mostly the result of certain fundamentals that take place in a particular market during a given period during a year (e.g., harvest and planting cycles, inventory accumulation periods, etc.). We consider seasonal tendencies a fundamental. But they are actually simply a reflection in price of regularly occurring fundamentals.

Seasonals and how to use them effectively are so important that we devote a full chapter to the subject ([Chapter 15](#)) and a second full chapter on some of the best seasonal tendencies you can use right now ([Chapter 16](#)).

For now, make a note to be aware of the seasonal tendencies of a market in which you are considering

selling options. Know the fundamentals behind the seasonal tendency, and analyze how they could affect prices of that commodity *this* year. Knowing the seasonal tendency can be an excellent place to start in selecting the right market to sell options.

Step 2: Write Out of the Money—Deep Deep Out of the Money

Once you have formed your basic fundamental conviction in a particular market, it's time to start looking at strike prices. As we mentioned earlier, one of the main knocks on option selling is

the unlimited risk factor. If you are selling at-the-money or close-to-the-money options, this risk is much closer and is much more immediate than it is if your strikes are considerably farther away from where the market is trading.

Selling the “Ridiculous” Option

In the summer of 2008, the press was playing up the “severe shortages” of natural gas in the marketplace. The financial media was in a frenzy over energy prices in general during this time period. But natural gas enjoyed a fundamental that played well in the press—a supply shortfall that looked good on paper and gave the public a *reason* why prices were rising. Small specs

rushed into the market and bought call options (their favorite gambling method of choice) to try to strike it rich.

Unfortunately, by the time the media had caught on to the story, the market had long since priced in the lower supplies. Whereas long-term fundamentals were shifting, the media sensation of shortages whipped fortune-seekers into a frenzy. By the

time peak usage season arrived in mid-summer, the market had already topped as higher prices began to substantially crimp consumption and distributors began to anticipate the slack autumn demand season. As commercial traders began to “lock in” the higher prices through hedging, commodity funds began to dump long positions aggressively. The market had to answer to its

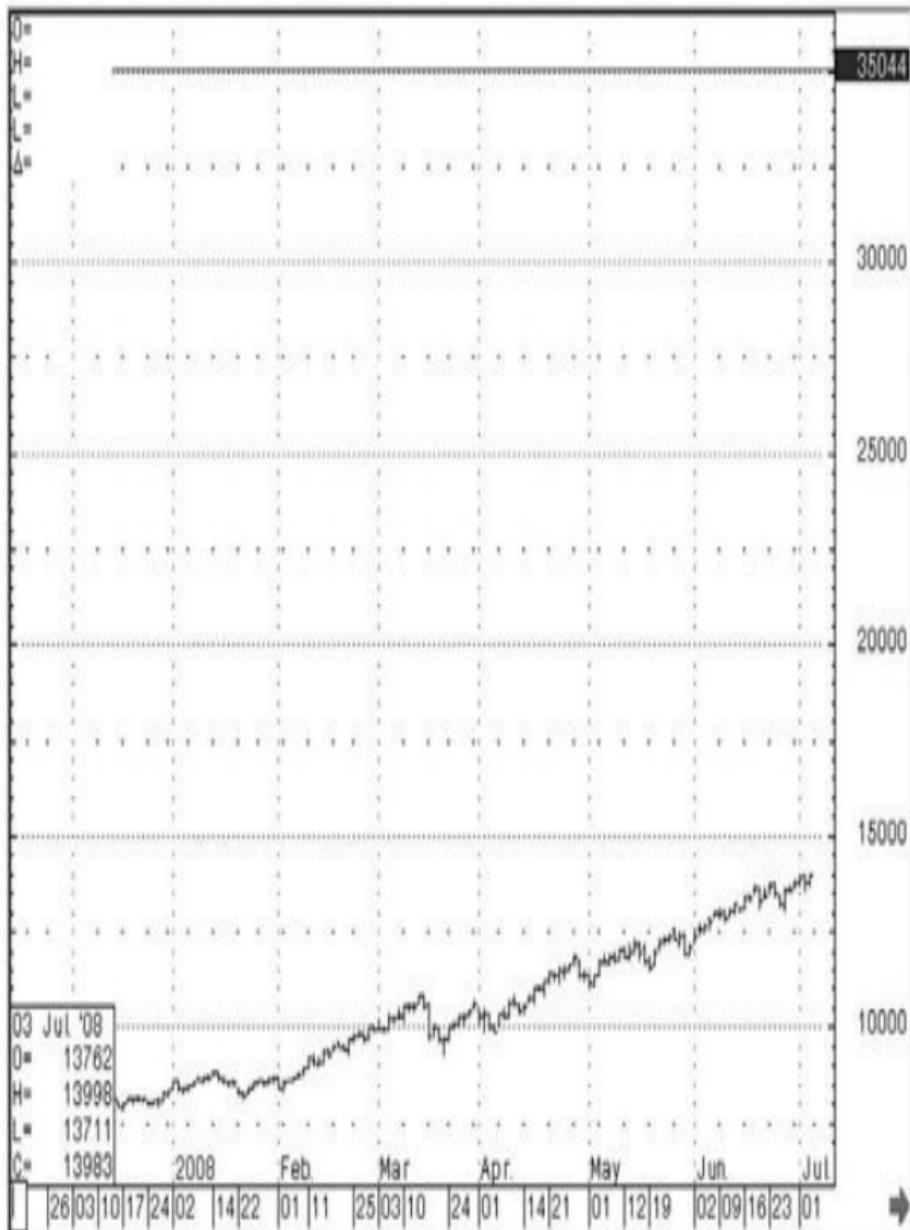
true fundamentals. Figures 7.3 and 7.4 illustrate how a trader could have taken advantage of the speculator-buying frenzy by selling outrageously priced call options.

FIGURE 7.3 November 2008 Natural Gas Chart
Natural gas rallies on media coverage.



FIGURE 7.4 November 2008 Natural Gas Chart Showing \$35 Strike Price At the height of the natural gas spec buying frenzy in July 2008, call options with strikes as high as $2\frac{1}{2}$ times the current value of natural gas were selling for premiums of \$400 or more. Traders willing to sell options to this bull-happy crowd could have sold November

35.00 call options for premiums of \$400. This is what we mean by “ridiculous” price levels.



In short, know your fundamentals. A good rule of thumb to follow is to fade the media and, more important, fade public opinion. In other words, do the opposite. If you're watching a report on the evening news about shortages in coffee, don't be one of the treasure chasers who calls their broker the next day to buy coffee. Chances are that it's already

priced in. If your fundamental analysis brings you to the conclusion that the market could continue to move higher, sell the puts and allow for sharp corrections (when the specs get stopped out). The more conservative investor can wait for the corrections and then sell puts. If the market looks like it may be overdone and there are “ridiculous” call strikes available, sell those calls.

Selling premium in volatile markets is an aggressive strategy, and you may be in for a little more “fluctuation” in your option values in the short term, especially if you’re a few days early in your position entry. However, it will be a whole lot less fluctuation than if you shorted the futures and were wrong in the short term.

Remember the preceding

example. If you thought that natural gas was overdone and faded the public by shorting the futures at 12.00 and you were early and the market went to 14.00, you would be smarting pretty badly and maybe even stopped out. If, however, you're short from 35.00, it doesn't hurt nearly as bad.

Step 3: Select

Expiration Months in the “Sweet Spot” of Time Decay

Thirty-Day Options: The Big Lie

Many option traders are tempted to sell only options with fewer than 30 days left until expiration. They do this because, all other things

being equal, an option will show its maximum time deterioration within the last 30 days of its working life. This is true.

However, many option sellers take it for granted that this means: *“To get the biggest bang for your buck, sell options with 30 days or less time value remaining.”* They know this to be true, because it has been drilled

into their heads by countless option books and Internet gurus who consider it “common knowledge” for any option seller.

Although this may read great in the \$600 option course, real-life experience taught me long ago this was fool’s gold—at least as it applies to commodities. (If you are *trying* to get exercised to get in or out of a

stock, then it can be a good strategy. But that is not where we are.)

What they don't tell you is that to collect any worthwhile premium, the trader must sell at strike prices perilously close to or even *at* the money. What does this mean? It means that even a small market hiccup can put the option in the money and either force the

trader out of his position or, worse yet, subject him to ever-increasing losses.

As long-term fundamental traders who want to make money *and* sleep at night, this is *exactly* what we are trying to avoid. Would you not rather sell options far out of the money and collect the same premium? I would. And so can you.

Selling in the “Sweet Spot”

In commodities, you can sell deep out-of-the-money options and collect large premiums. The catch is, you must sell options with more time value than your quick-trade counterpart. In my experience, this means selling options with two to six months in time value, with

my preference skewing to the middle of that range.

Why? Because I have found that this range offers a “sweet spot” in the time decay versus distance from the money ratio. On the one hand, you can sell far enough away from the market to avoid most short-term market swings. On the other, you collect the premium right before time decay really starts

to kick in around the 90-day mark.

This allows the market plenty of room to move and allows you plenty of room to be wrong—and still make money. In essence, you can often ride out the short-term plays and technical moves against your long-term view of the market.

You force the market to make a long-term, sustained

move against its core fundamentals in order to make you a loser.

Risk Benefits Baked In

In addition to employing this “distanced” view of the market, this approach has built-in benefits from a risk standpoint. Let’s assume that

your long-term fundamental analysis of the market is wrong. You still stand a good chance of making money. Remember, the market does not *have* to move in the direction that most favors you. It can move sideways or even against you for a while. The option will still expire worthless if the market does not reach your strike.

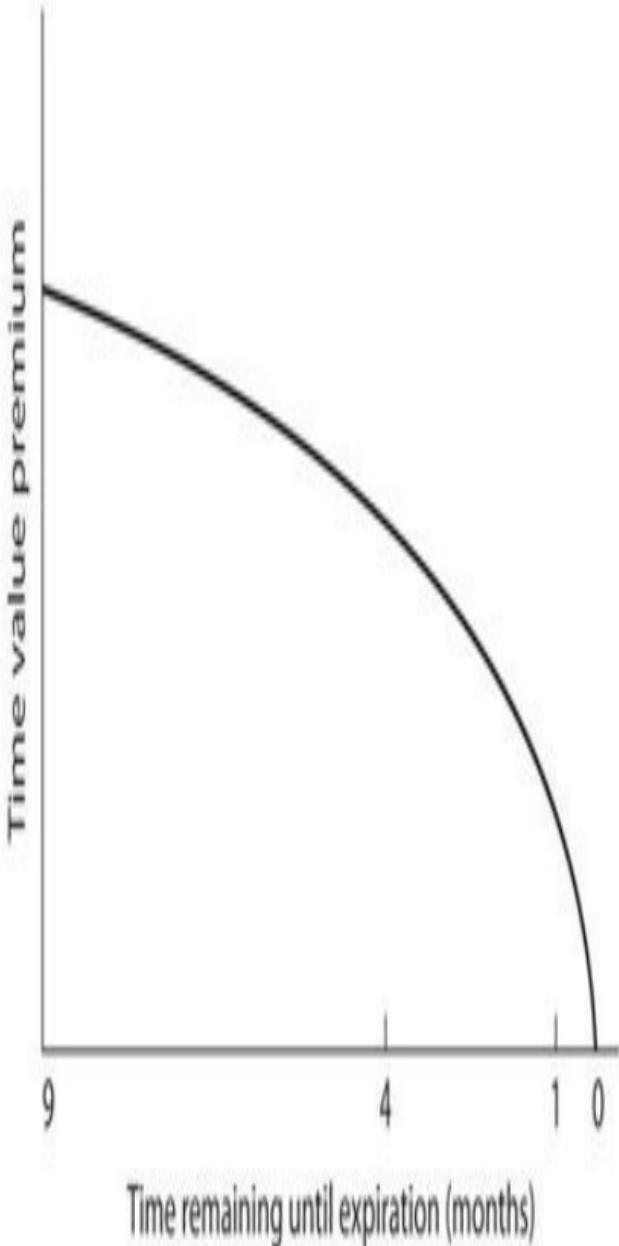
By selling deep out-of-

the-money strikes, you only have to pick where the market *won't* go, not where it's going. In my opinion, that is a heck of a lot easier than trying to guess exactly where it *is* going to go—tomorrow or next week.

On Selling Ahead of the “Sweet Spot” Curve

Almost anyone even remotely familiar with options has seen the curve in [Figure 7.5](#) illustrating the speed at which options deteriorate.

FIGURE 7.5 Time Decay Graph



Many option traders look at the chart in this figure and deduce that the fastest deterioration is in the final 30 days and therefore that it is best to sell options with only 30 days remaining until expiration. Although this is one theory that works well for some traders, you'd better be pretty good at picking short-term market direction if you hope to make money

consistently with this approach.

The alternative is to sell options with more than 90 days remaining. Sell ahead of the curve. Why? One reason, as we suggested earlier, is that the additional time value allows you the luxury of selling at strikes very far out of the money. The second reason is that if the market can avoid a sharp move

against you in the first few weeks of your trade, you enter the last 90 days of the option's life at a much more distant strike than the seller who has waited until now to sell his option. In other words, he has to sell closer-to-the-money strikes to receive the same premiums that you received 30 to 60 days earlier. As the premiums begin to drop, your risk begins to drop as well.

The “Down and Dirty” Way to Gauge Time Decay

A quick “down and dirty” way to gauge where your options could be in 30, 60, or 90 days is to look at option prices for several months, side by side. This is a limited tool because it does not account for market movement. But given a relatively stable market where the option seller is familiar

with the fundamentals, it can be very effective in selecting proper strikes (see [Figure 7.6](#)).

FIGURE 7.6 Crude Oil Option Table Showing Differences Between Prices

CL	MAR '09 CALLS	MAR '09 PUTS	APR '09 CALLS	APR '09 PUTS	MAY '09 CALLS	MAY '09 PUTS
UndPr	6361	6361	6429/-	6429/-	6524/-	6524/-
DTE	103	103	131	131	161	161
EXP	02/17/09	02/17/09	03/17/09	03/17/09	04/16/09	04/16/09
VOL	70.49	70.82	66.05	66.21	63.18	63.79
IVS	0.00	0.00	0.00	0.00	0.00	0.00
IR	1.94	1.94	1.97	1.97	1.97	1.97
11300	164	-61
11350	121	-56	4672	+447
11400	119	-54	4719	+448
11450	116	-53	4766	+449	205
11500	114	-52	4814	+451	152	-57
11550	111	-51	4861	+451	149	-56
11600	109	-50	4908	+452	146	-55
11650	106	-50	4956	+453	191
11700	104	-48	5004	+455	-63
11750	102	-47	5051	+455	138	-52
11800	100	-46	5099	+456	4845
11850	98	-45	5147	+457	+424
11900	95	-45	5194	+458	4938
11950	93	-44	5242	+459	+426
12000	91	-43	5290	+460	125	-47
12050	89	-43	5338	+460	5171
12100	88	-41	5386	+461	120	-46
12150	86	-40	5434	+462	+431
12200	84	-40
12250	113	-44
12300	80	-39	5579	+465
12350	79	-37	5627	+466	109	-42
12400	5675	+466	107	-41
12450	75	-36	5723	+467	5606	+454
12500	74	-35	5772	+468	103	-40
12550	72	-35	5820	+468	5701	+455
					141	-47
					5641	+440

If you are considering a certain strike and want to get a rough idea of what your option will be worth in 30 days (barring more than a moderate price move), simply look at the same strike price that is set to expire one month sooner. For instance, in [Figure 7.6](#), if you are considering selling the May crude oil 120 call, look at the April crude oil 120 call and

see what the difference in premium is. In this example, the difference is \$430 ($168 - 125 \times \10 per point). Your option is likely to lose that much in *time value* over the next 30 days (although it could gain or lose more value through market movement or volatility fluctuation). If you are comfortable with that level of deterioration, you could have the right month and strike.

We do say *rough* or *approximate* because although different contract months tend to hover around the same general price levels, they will trade most often at different prices to reflect the market's expectations for the future. These differences in price can be more apparent in some agricultural commodities that are subject to planting and harvest cycles than futures contracts such as

financials or currencies. If the differences in months are too great, simply adjust your comparison to a strike that is approximately the same distance out of the money.

Step 4: Set a Risk Parameter, Then Sit Back and Wait

This step is likely self-evident

if you have ever traded anything before. While selling options is different in many ways from most any other investment, this aspect of it remains constant. By knowing your exit point, you give yourself peace of mind.

There are two ways to lose on a naked option. The first is that it expires in the money and you get exercised at a loss. Since this is highly

unlikely and in fact entirely avoidable, we should most concern ourselves with the second way. The second way is that the market moves against your position to a level that increases both your margin and your options value. At some point in that equation, you want to close the position.

Risk management is an important aspect of an option-

selling portfolio. It will be covered thoroughly in [Chapter 11](#).

For now, simply note that step 4 in the formula is setting a risk parameter.

Useful Tips for Picking the Right Option to Sell

Tip 1: Use Option Open Interest as a Clue to Market Direction

Using open interest to gauge public sentiment can be an extremely valuable tool to option sellers looking to fade the public. The excerpt on the following page was a weekly article written by James

Cordier on this very subject. In reading it again, we felt it would cover this subject exceptionally well in its unaltered form.

Checking open interest in a particular stock or commodity is another tool to use in your overall analysis of potential options to sell. The approach is just as effective now, if not more so, as it was when the article was first

published.

Open Interest Can Be a Tip-Off to the Opinions of the General Public

JAMES CORDIER,
OPTIONSELLERS.COM
FROM OPTIONSELLERS.COM
BLOG

More often than not, the general public will be on the wrong side of the market, as is evidenced by the oft-sighted figure that 80 to 90% of futures traders lose money. Since the general public often favors buying options, one key indicator of where the public is positioned often can be determined by studying option open interest.

Begin by looking at open interest in both puts and calls of each particular market. If there is a discernible discrepancy between the number of open contracts in puts versus calls or vice versa, there is a good chance that the public is favoring one side of the market. A good rule of thumb—if given the choice—is to fade the public. For instance, if the

open interest in puts in a particular commodity is 50% greater than the open interest in calls, and most of the traders holding long options are small speculators (the general public), then that is a good indication that the public favors the short side of the market. Funds and commercials would have sold the puts to the small traders. All other factors

being equal, you may want to consider selling puts in this situation. The reverse would be true if open interest in calls was decidedly greater than puts.

A perfect example of this phenomenon is taking place in the silver market at this time. Look at the open interest in silver options, puts versus calls. Open interest in silver puts as of

yesterday stood at 8,546. Open interest in calls totaled 52,677. Call open interest is over six times put open interest. One can deduce from this figure that the public likes the long side of silver. The reasons for this are open to interpretation, but I'd be willing to guess that there are more than a handful of hopeful futures traders out there willing to put up

some hard-earned capital to bet on a sweeping silver rally this summer. And who might be selling these options to them? Probably professional traders and commercial silver players (and maybe a handful of sophisticated individual investors).

The caveat: These are my own personal rules, opinions, and general

observations. This is not to insinuate that the public always will be on the wrong side of the market, nor is it to suggest that this can be used as a trading system in and of itself. Nothing replaces solid fundamental and technical analysis. This is one of many factors one can consider when selecting options to write. Option buyers, who often are the

small speculators in the market, are trading the futures market hoping for big moves and big gains. This is why most small specs that trade are attracted to commodities—for the spectacular. The problem is that these large-scale moves that can produce profits for option buyers generally are few and far between.

It is my contention that the smart money in this business profits from the mundane. If we're lucky, 80 to 90% of futures traders will continue to disagree.

Tip 2: Strike a Balance Between Premium and Risk

A frequently asked question by many novice option writers is what type of premiums they should seek when writing puts or calls. This is often a matter of individual preference, but we may be able to offer some suggestions.

Premium Versus Margin

The first factor to consider is premium collected versus

margin requirement. An option selling at a \$400 premium with a \$600 margin requirement is a better sale than an option selling at \$500 with an \$800 margin requirement (as a return on capital invested). It has been our experience with SPAN margin that although margin requirements decrease as premiums decrease, return on capital invested tends to decrease as well as premium

decreases. Thus, an option sold for a premium of \$500 may have a better return as a percentage of capital invested than an option sold for \$200. Again, this is not a rule set in stone; it is more of an observation from years of option selling. However, when considering different strike prices, it may be helpful to compare premiums of different options with their respective margin

requirements.

Selling Too Far Out of the Money

Some traders seek options that are so far out of the money that they may only be commanding premiums of \$100 to \$200 each. Although these options often are far enough out of the money that they probably will not be greatly affected by short-term

market fluctuations, one has to weigh the premium collected versus projected risk. For starters, the commission paid to your broker will come out of this relatively small premium. Second, instead of selling five options for \$600 each, some traders may elect to sell 15 of the \$200 options, thereby collecting the same premium with a perceived lower risk. But is it lower risk? If your

risk parameter is risking to double premium collected, the \$200 option easily could double in value just as fast as the \$600 option. Count in slippage on your exit order, and your loss on the cheaper options could exceed your loss on the more expensive \$600 options (slippage on 15 options may be greater than slippage on five).

Third, look at what you

risk in a worse-case scenario, this being that both options go deep in the money and you, for whatever reason, did not get out beforehand. Even though the \$200 options were originally a few strike prices further away, you sold three times more options to collect the same amount of premium. Chances are that with a deep in-the-money move, the 15 positions at a few strikes further out are going to be a

greater liability than the five positions a few strikes closer.

Selling Too Close to the Money

The other end of the spectrum is a trader who sells options for high premiums at closer strikes. This trader runs the risk of selling too close and being stopped on a small move or, worse yet, have her option go in the money on a

small move. A balance must be struck. There is no general rule here except that you want to try to make sure that the premium collected justifies the risk you are assuming. This holds true whether you are selling one option or 500.

Tip 3: Sell Low Deltas

Although we promised not to get too involved with Greek figures and equations, this is a good time to bring up the concept of *delta*. Delta is the amount by which the price of an option changes for every dollar move in the underlying contract. Although we aren't going to focus on delta to a great degree in this book, the delta of the option you are considering can be a great help in deciding the right

strike price for you. The delta will give you a good idea of how far the option price will move in relation to the underlying market.

For instance, if you look at the delta of an option and it reads 17, this means that for every one point the futures market moves, the option price will move 0.17 of a point. This sounds simple, but remember that the delta is

constantly changing and readjusting with every tick in the market. Thus, the closer the underlying comes to your strike price, the higher will be the delta.

It is our recommendation that you seek options with low to very low deltas when you are selling. They will have the lowest chance of ever going in the money. While this sounds like

common sense, some will argue that by selling options with low deltas one will have to assume the greater risk of larger position sizes than if one were to sell fewer options with higher deltas. Maybe so, but we recommend it anyway.

If you know your fundamentals and you can pick strikes that will not be reached, you'll have a higher percentage of your options expiring worthless, lower

stress, and more consistency. With this type of winning percentage, you should be able to withstand the occasional oddball who exceeds your strike.

Option margin, delta, and size of position all come second to selecting the right market in which to sell. If you pick the right market, none of these things should matter in the end. However, all your

picks will not be right, and these factors *can* matter in an adverse move.

Much of this is based on the preferences of the individual investor. We've always preferred to sell options with deltas lower than 20, with premiums in the \$400 to \$700 range, with net margin requirements of no more than $2\frac{1}{2}$ times the premium collected.

Tip 4: Learn to Stagger Your Options

The option-selling selection formula you have been reading about in this chapter is the formula we followed for our first several years in business as a brokerage. In the years since converting to portfolio managers, the trading plan has evolved

somewhat. We have added a number of bells and whistles to make it more efficient and risk adverse (i.e., incorporating credit spreads, etc.). Nonetheless, the original format for option selection remains intact for the most part.

Staggering, while not technically part of the topic of “Picking the Right Option to Sell,” could have some

influence over what options you select. Staggering options is one of those bells and whistles we added to the trading plan later. However, it is a very important bell, and thus, we felt it warranted inclusion in this section.

What Is Staggering?

One of the complaints we initially heard from our aggressive traders was that by

selling premium two to six months out, the strategy was “slow and boring.”

Apparently, the fact that it worked was beside the point. Many investors who allocate a portion of their portfolio to options on futures do so not only for the opportunity for more sizable returns but also so that they can have a fun, exciting, and active portion of their portfolio that they can

get in and get their hands dirty, buying and selling and calling plays. Sorry, but if you like action, the trading plan you learn here may not be for you, except the part about the potential for sizable returns.

Many traders have compared the mental stimulation of this trading plan with that of “watching paint dry” or “watching a

chicken sit on eggs.” They do this for about the first 90 days. Then they start to get it.

You see, the final part of option selection under this plan is a concept that we call *staggering*. Staggering is a term we coined over a decade ago in the first edition of this book. I have recently seen a few greenhorn option bloggers try to claim it as their own. It is not.

Regardless, staggering works like this:

Staggering Options

Month 1: Sell one to two sets of options with expirations of two to six months away.

Month 2: Sell one to two sets of options with expirations of two to six months away.

Month 3: Sell one to two

sets of options with expirations of two to six months away.

During the first two months, there is a good chance that many, if not all, of the options sold will have shown little movement. Although the trader still believes in the program, her attention starts to wander, thinking about possible day trades in the market she saw

on the news yesterday or thinking about taking a flyer on that hot stock she saw on television yesterday.

But then a funny thing happens. At the end of the third month, the first set of options that the trader sold 90 days ago expires. Thirty days later, another set expires, and then another. The wait paid off. The eggs hatched!

As applied to your

trading, each month you continue to sell one or two sets of options—on average—depending on when opportunities are present in the market. The first 60 to 90 days may very well seem slow and boring—until you start having options expire once or twice per month. Then it's not so boring anymore. This is what we mean by *staggering*. It is positioning your portfolio to

have approximately one or more sets of options expiring every month.

This is not to imply that every set of options that you sell are going to expire worthless. But this is an ideal to which you may want to aspire with regard to structuring your option-selling portfolio. It seems to have immense popularity among many of the traders

whom we have advised. Perhaps it is because of the regularity for which it strives. Regardless, from a psychological standpoint, it can be desirable to be able to look at your statement and see that you have options *scheduled* to expire at regular intervals in the future. This is true whether you are an income- or growth-oriented investor.

Targeting High Premium Option Sales After Big Moves

Many traders will find a market with clear fundamentals and become excited about the trade

until they look at a chart. They see that the market has already had a sharp run or drop in price and therefore think that the move is over or that prices are now too high or too low. This can be a mistake, and you could be overlooking some of the best opportunities on the board.

First of all, if the

market has made a large move up or down, there is probably a solid fundamental reason behind it. Find out what it is. Is it something that is permanent and cannot be changed in the near future (e.g., crop damage), or is it something that had an effect on the market but is either in the process of changing or could change quickly without notice

(e.g., a temporary “halt” to imports or exports due to a trade spat)?

Second, did the market make this move in a rapid, violent explosion or collapse, or did it achieve its current price level as a result of a steady, continuing trend? If it’s a trend, your odds grow better already because, as we discussed earlier,

options expire worthless at an even higher percentage rate when sold in favor of the trend. These can be fertile grounds for sellers of options.

If the market just made a sharp move in either direction, conditions in the market are probably quite volatile. The upside to this is that the market volatility can drive option premiums

outrageously high and often make them extremely overpriced. This can be a lucrative time for option sellers. The downside is that the market will remain vulnerable to additional volatile moves in either direction, meaning that even your far out-of-the-money option could be affected to a large degree by short-term price moves. Decisions on whether to

trade these markets will depend on your temperament. If you are a conservative trader, it's probably best to stay out and leave it to the crowd with a slightly larger appetite for risk.

This is only an observation, but it has been our experience that markets that make large moves to the upside tend to correct

or move back lower more decisively and over a shorter period of time than markets that crash lower trying to recover. It may have something to do with the fact that small specs prefer to be long. However, it also brings to mind an observation made by Dr. Alexander Elder in his classic work, *Trading for a Living*. Dr. Elder compares slow and rapid market

declines to a man falling down and his ability to get back up. If he simply falls down a flight of stairs, he usually can pick himself up and brush himself off and continue on with minimal effort. However, if a man falls out of a third-story window, it can take him considerably more time to recover. Dr. Elder contends that the markets behave in a similar manner. Thus,

bargain hunters who rush in to buy a commodity or stock after a rapid decline may be in for a disappointment, unless they are truly long-term investors. Markets fall that rapidly for a reason. Unless that reason has changed immediately, don't expect markets that have just collapsed to rebound just as rapidly.

Selling Calls into Spike Rallies

Markets making new highs may not be the most desirable time to sell call options. Then again, in the right circumstance, they can be the *optimum* markets for selling calls.

Markets in decline often can be better and/or safer opportunities in

which to sell calls. Again, we stress the advantage of knowing the fundamentals in addition to the technical indicators that you may be seeing on a chart. A bearish technical trader who experiences a sudden rally in the market may see danger and be frightened out of his position. A bearish trader who knows the fundamentals and experiences a sudden rally

in prices sees opportunity.

However, if you are somewhat familiar with your fundamentals and have done some basic historical price studies (or your broker has), you probably can tell the strikes that are more at risk and the strikes that are downright ridiculous. These “ridiculous” strike prices are the target of the

astute seller of premium.

In this, we are talking about selling options against the existing fundamentals. Why? Because you may deduce that the fundamentals are bullish (or bearish) to the market but not *that* bullish (or bearish). In other words, the fundamentals are bullish or bearish, but now those factors may be

already priced into the market. When the media or the public picks up a story and runs with it, prices often get overblown. And option prices can get *way* overblown. In this sole exception to trading with the fundamentals, options should be sold sparingly and only when the trader believes that the market has gotten entirely carried away.

The Ridiculous Strike Price

Small specs, whipped into a frenzy by either the market's move and/or media reports, will rush to buy all the calls (or puts) they can afford, regardless of strike price or premium. If you can keep your head in this chaos, you often can sit back and "pick off"

these absurdly out-of-the-money premiums and profit handsomely when conditions calm down, usually in a few days to a few weeks, with little risk to your position. By “absurd,” we are talking about selling crude calls with a \$200 strike price with crude oil at \$110. We are talking about selling coffee calls with a \$500 strike price with coffee

prices at \$300 per pound. These are both trades that were available within the last few years.

It is often the case that volatility is already at maximum levels in these conditions and thus, the options can even have lower risk of appreciation than in “normal” market conditions. However, it nonetheless pays to

exercise two main risk control measures that can help you to avoid a big drawdown:

1. Allocate only a small portion of your portfolio to trades such as these. While these are often the highest probability trades on the board, the consequences of being wrong can be

more severe. If your regular position size is 10 option contracts, maybe take only three to five of these types of trades.

2. This is the one instance where you may use technical indicators to look for signs of tops or bottoms. In a rapid move higher or

lower, look for signs that the market momentum is slowing. For instance, in a market that has been racing higher rapidly for days and then opens higher and closes substantially off the highs or even lower on the day, this can be a key signal that the market is

reaching a peak or at least slowing to a more manageable pace, often a good time to sell inflated calls (or puts) far beyond the point of exhaustion.

Conclusion

You have now learned how to

go about selecting markets and strikes for selling options effectively. For the purposes of this chapter, we have focused on selling options naked. Selling naked can be an excellent strategy, and portfolios can be built successfully on this strategy alone.

However, for many reasons, some investors and managers (including myself)

prefer to incorporate option spreads into their portfolios. Spreads can limit risk, increase leverage, and even result in higher profits if used correctly. Yet they can also be tricky and even detrimental to your success if you do not know what you are doing. The next two chapters explain selling options as part of spreads. As you will learn, not all spreads are created equal. In fact, in

my experience, only a handful of the hundreds of types of spreads preached by the pundits are actually practical for the individual investor. The ones that are, however, can add an extra dimension of both safety and profitability to your option selling portfolio.

The Use and Abuse of Spreads

How to Keep Them from Taking Your

Money

Thus far we have only discussed selling options naked; however, a trader wishing to sell options like a professional may want to consider spreading as an alternative strategy. *But beware:* Of all the hundreds of different option-spreading

strategies available, there are only a handful that we've found to be practical for individual investors.

Some brokers and authors in the industry are not going to like what they read in this chapter. However, our mission is to write this book in a “no bull” manner. We are not going to say outright that something doesn’t work or that a particular strategy does

not have its merits. Given the right market situation, almost any strategy will work some of the time. Our intention is to share with you the observations we have made in working with hundreds of futures option traders over many years, and the observations in this chapter mean no disrespect to the knowledgeable authors in the field of option spreads.

The problem with trying to learn 101 different option spread strategies, however, is that one first must learn each detailed strategy and its benefits, drawbacks, profit potential, and risk. As if this is not difficult enough, the investor then must learn in what situations he is supposed to use each strategy. It's not enough for the market to move up or down.

Hypothetical Example

The reverse triple screaming phoenix spread works best in a market that begins to move higher, then moves slightly lower, drifts sideways for two to three weeks, makes a left at the Wendy's on the corner, and then soars into expiration, making new life of contract

highs the day the option closes out. In this situation, the user of the reverse triple screaming phoenix spread would net \$2,500 per spread. As you can see, it is the perfect type of spread for a market in this situation. But only if the Vega turns net positive before the Theta becomes neutral.

This is a fictitious

example, of course, but it serves to demonstrate our frustration with the public's seemingly insatiable appetite to "learn" complex spread strategies that they could rarely hope to use effectively. Market intellectuals love to teach these strategies and how they work. I will stop there as some of these people are my colleagues and I do not wish to downplay their work. However, my

experience has been that a market intellectual does not necessarily make a good trader.

Many traders new to options believe that it is necessary to learn all these spread combinations before they can trade effectively. This is not the case. Again, our point is not that these complex option spread strategies do not have merit.

However, if you are looking at inverted butterfly spreads and trying to determine the proper delta balance for your triple-ratio backspread, you'd better be a professional trader who wakes up to a quote screen every morning that looks like a Greek alphabet. At the very least, you should be a serious trader who has a lot of time to dedicate to trading and a lot of money to lose in the “educational”

phase of trading.

Traders who use these approaches effectively generally are people who have made trading their life, who know exactly what they are doing, and have paid their dues through many years of losses in learning the proper situations in which to use these approaches successfully. Our experience has been that the transaction

costs alone make many of these approaches impractical for the average individual investor.

The good news is that knowing 101 different option spreads does not make you a good trader. In fact, it may be detrimental to your bottom line. Making money in the real world means knowing a few good strategies and executing them extremely

well, over and over. Leave the 101 strategies to the intellectual option “theorists.”

We wrote this book for the people who just want to make money. You don’t have to be on the Pro Bass tour to go out and have a good day of fishing. You don’t have to be a professional to make money selling options either. Nevertheless, there are a few things you should know about

spreading before you toss your line in the water.

Spread Definitions

Vertical spreads. This refers to trading a combination of options in the same month, but

at different strikes. The bull call spread is an example of this. The strikes are higher or lower than each other, thus vertical.

Horizontal spreads.

Horizontal spreads refer to spreads that are the same strike but different

months. Thus, selling a December call and buying a February call at the same strike could be considered a horizontal spread. This is also sometimes called a calendar spread.

Diagonal spreads.

Diagonal spreads

combine both a horizontal and a vertical spread. For instance, a diagonal spread might sell a call in December, and then buy a call in February at a different strike.

Option Spreads:

Your Broker's Favorite Strategy

You'll find that option spreading is approved of, if not outright encouraged, by many futures brokers, brokerages, and advisory services (who are sometimes affiliated with a certain brokerage or group of brokerages). Many brokerages love option

spreading and often will recommend the strategy to their clients—especially in the case where the options are net long, or at the very least, short but covered. Why?

For two reasons. First, unlike futures trading or even options selling, the advantages of buying options or incorporating option selling into a “covered” spread position is that the

trade has absolute limited risk. Thus, a brokerage can calculate the client's total loss in a worst-case scenario and will make sure that this figure does not exceed the total funds in the client's account. This reduces liability to the client but more importantly to the firm itself. More importantly to the broker, it means he can kick back and not have to worry about managing the risk or

“keeping an eye on it.”

This is not necessarily a bad thing for you. It can work against you, however. With each position having an absolute maximum loss, traders (sometimes encouraged by their brokers) may position all their funds into limited risk spreads, leaving little or none as backup. Misled by the limited risk aspect of spreads, this

type of positioning shows terrible money-management technique that has the potential to damage an account.

Net long option spreads can be especially popular among younger, untested brokers who do not have the know-how or the experience to sell options effectively. Employers of these inexperienced brokers will

either encourage or require these brokers to recommend either buying straight options or buying covered-spread positions. Of course, if a client gives an order otherwise, they must fill it. But clients of these brokers who rely on trade recommendations often will be “steered” into covered short spreads, or preferably, outright long-option positions. This is one reason

it is important to know the broker or trader with whom you are working and his experience in futures and option trading.

This assessment certainly does not represent every firm in the industry, and these brokers are not bad people. However, new brokers have to start somewhere, and many firms willing to hire and train brand-new brokers want them

to start out with limited liability. In this way, when clients lose money (which they almost invariably do if they use this type of approach over time), they can lose money “safely” (with no risk of debit liability to the firm).

The second but equally important reason that brokerages love to use covered spreads is this: *They can generate a boatload of*

commissions for the firm. Situations that often can be played effectively with a futures contract or a single call or put also can be played with an option spread. They are pitched to the client as a way to limit risk and increase leverage, which very well may be true. The fact that the spread may have little chance of profiting (especially after hefty commissions are deducted), however, is often

downplayed.

In other words, instead of buying a single option (a strategy with which it is hard enough to turn a profit), a broker may suggest a multiple-option spread in which one or more options are sold in order to pay for one or more options that are purchased. Each spread can contain three to six options or more. Thus, instead of paying

one or two commissions, the client pays three to six commissions *per spread*. For a full-service brokerage charging \$100 per round turn per option, this can run into some substantial fees. It can be expensive even with a discount broker charging only \$30 per round turn. The fact that the “net” out-of-pocket cost, or margin, per spread may be less than simply positioning in an outright

futures or long option is irrelevant. This “net” figure often will not include fees, and even if it does, commission costs versus potential profit can make the spread impractical and generally a poor choice of investment for the trader.

To counter this hefty commission charge, some brokers may tout a large potential profit on the trade.

A \$500 commission for a single spread may not sound so bad if the potential profit is \$5,000. But look closely. In many cases it will take an enormous move in the futures price or require prices to end up in an extremely narrow range to obtain that *potential* profit. It's a low-odds bet and the only one that usually wins is the broker.

This is not to suggest that

every broker in the business is a money-hungry con artist. Quite the contrary, most brokers are good people who do not take advantage of their clients. As in every business, though, the brokerage industry has its bad apples.

This is also not to suggest that because a broker recommends a spread to you that he is trying to con you. In many cases an option spread

can be a viable alternative and a legitimate strategy to employ in a particular situation.

Even though we believe that some of these spreads often are impractical and not the best strategy for the investor in many cases, the right option spread can bless its user with many benefits. In fact, option spreads can often be a *preferred* strategy

in many situations. But if you use a multiple option spread, you want to make sure that if every option in that spread expires worthless, you are still making money.

As you will see, we have devoted an entire chapter to option spreads that we *do* recommend to investors ([Chapter 9](#)). We are simply suggesting that you carefully consider the risk/reward of a

spread. One question we always ask before putting on a spread is “What are the odds this thing shows me a profit?” How many things can go wrong and we’re still making money? We are looking for the highest odds, not necessarily the highest “potential” profit.

Tips for Analyzing

Spread Trades

Tip 1: Know the Difference Between *Potential Profit* and *Potential for Profit*

Potential *for* profit is hugely different from *potential profit*. A big selling point of some spreads is their *potential profit*. Consider the

following example.

Broker: John, if the price of heating oil increases by 30% in the next 30 days, this spread will make \$3,500!

Trader John: What does it cost to get in?

Broker: A mere \$300, John! That's over a 1,100% return if you're right—

excluding transaction costs, of course.

Trader John: What is my risk?

Broker: John, that's the best part! Your risk is *limited* to the \$300 you put in—excluding transaction costs, of course.

Trader John: That

sounds pretty good.
I sure can't afford
to lose much more.
But it sounds pretty
safe.

Broker: So how many do
you want?

Has the broker lied or
broken any compliance rules?
No, he hasn't. He properly
disclosed risk. He simply
focused the client's attention
on *potential profit*. If the

underlying commodity increases by 30% in the next 30 days, John's potential profit will be 1,100%, excluding transaction costs. But what is the potential *for* profit? What is the likelihood of this type of move in the market? Probably pretty slim, just like John's chances of showing any kind of profit on his trade.

Although the broker's

approach in this example may be legal, it certainly feels a bit unethical. But the broker sold John what he wanted—limited risk. Most brokers won't come on this strong, but some will.

Nonetheless, many brokers will try to please their clients by offering limited-risk types of trade recommendations in an attempt to appease the

client's fear of losing.

Tip 2: Don't Be Afraid of Losing on Occasion

This brings us to an important point. It is said that fear and greed drive the market. While this may be true, if you feel either of these emotions too strongly in your trading—

whether selling options or otherwise, you shouldn't be trading. Your emotions will undermine you, and you will lose.

Although nobody wants to lose money, there is a difference between not wanting to lose and being afraid to lose. If you are trading scared or afraid to lose, you have already lost. Fear is common in new

traders and/or undercapitalized traders. This is why many of these traders are drawn to option buying or covered spreads. “I know my risk,” they tell you. “My risk is limited.”

This is why investors are willing to put their money into a strategy such as buying an option that will expire close to 80% of the time. “Sure I lost all my money, but

I limited my risk!"

If you take nothing else from this book, please take this point.

**The term “unlimited risk” simply means this:
You have to manage
your own risk on this
trade.**

If it moves against you, you have to get out. The market is not going to do it

for you. It is simply an extra step you have to take. The term itself implies unwarranted fear. Respect it. But do not fear it.

If you walk into a pit of combat, do you want to walk in looking like Woody Allen, shivering and jumping at every twitch of the market? Or do you want to walk in like Clint Eastwood in *A Fistful of Dollars*? Both have

no desire to get slaughtered. Both may take measures to protect themselves. But one is not afraid to lose; the other is terrified. This very concept of fear, or lack of it, is what makes one more likely to achieve victory while almost ensuring the other of an early slaughter.

The markets work the same way. This is why we are going to strongly recommend,

right now, that you highlight the words in the heading that follows.

Tip 3: Focus on *Managing Risk, Not Limiting Risk*

If you use an investment vehicle that has built-in limited risk, you give up a huge likelihood of chances

for profit. For success in trading, protecting your investment capital is of utmost importance. If you are afraid of what will happen if you lose it, though, you shouldn't be trading. The market smells fear like a rabid pit bull.

The investment classic *Market Wizards*, by Jack Schwager, seems to put forth a recurring theme in trading

or investing. Many consistently successful traders and investors don't think of trading in terms of how much money they are making or losing. Successful traders think of trading as playing a game. The money is simply a by-product of playing the game successfully. They do not think of every trade in terms of making or losing money. This enables them to remain

unemotional, objective, and patient in their trading approach. The primary goal is still to make money. It is the way they approach it in their minds that gives them an edge.

If safety is what you seek, put your money in a certificate of deposit (CD). If you are afraid to lose, you shouldn't be trading futures or options. However, if you

can give up that fear and the need for absolute limited risk and instead focus on managing your risk, you will have already placed yourself above most small-spec traders in the market.

The industry caters to the greed and fear of small speculators, which is why buying options and long option spreads is so popular with this group.

Fear Versus Respect

We want to clarify this concept of securing absolute limited risk versus managing risk. We don't mean to suggest that a trader should approach the market like a Wild West cowboy with guns ablaze in the air. A healthy respect for the market is essential. A great firefighter may not fear the fire he is

fighting, but he certainly respects it. Our point is that if you fear the market so much that you must have absolute limited risk, the high price you pay for that luxury most likely will sabotage you in the long run.

Securing absolute limited risk primarily refers to buying options. Many traders (especially new traders) become enamored of the

concept of limiting risk. They are somewhat familiar with the concept of risk in the futures market, but it is a somewhat vague and disturbing notion to them. Being able to participate in these alluring markets while absolutely limiting risk is very appealing. Buying calls or puts sounds awfully good to them.

But it is most often their

downfall. To get the most out of these markets, you have to be willing to forgo automatic limited risk in favor of responsibly managed unlimited risk—if that makes sense.

The following box illustrates this point perfectly.

Betting on Elvis: A

Study in Limiting Versus Managing Risk

I once read in the newspaper that a London gambling house took a bet that Elvis Presley would be sighted riding down London's main thoroughfare on top of a

famous racehorse that disappeared in 1973 on his way to Wimbledon. On his arrival, he would proceed to qualify for the men's singles tournament and face a famous English mobster who had disappeared in the mid-1980s (who also apparently, would have to qualify for the men's singles at Wimbledon) in the first round. The bookie

took the bet for 10¢. If these events did indeed occur within a certain time frame (DNA would have to confirm that it was really Elvis), the bet would pay the gambler US \$2 million. The gambling house, in essence, had unlimited risk on the bet. Do you think the gambling house's dime was safe? What if the gambling house could cut its losses as soon as

somebody saw Elvis riding in on the long-lost racehorse?

The gambling house had, for all practical purposes, unlimited risk on the bet. But it managed its risk exceptionally well.

The first way the gambling house managed its risk was by picking a bet that had overwhelming odds in the house's favor.

It also managed its risk by giving itself leeway to “bail out” of the bet if it appeared as though the house might sustain a substantial loss.

The better, however, was able to limit his risk on the bet. His risk was limited to 10¢.

Which one do you want to be?

We are not suggesting

that the odds of selling options will be *this* much weighted in your favor. We are only illustrating the differences between limiting and managing risk.

There are option buyers and spreaders out there who are willing to bet on Elvis for the chance at big gains and limited risk. This concept can be magnified with the strategy of some

option spreads. We suggest that before you position in any spread, try not to get caught up in the low investment requirement and potential profit in the trade. Look at the big picture and what your odds are of profiting from the trade at all. Don't fall into the greed and fear trap. Don't bet on Elvis.

In keeping with this

theme, we tend to advise against positioning in spreads that leave the trader net long options (although these spreads can be more exciting for the action-seeking trader).

The next several pages highlight some of the most popular net long option spread strategies along with some observations.

I do not have the time or space here to call out every single spread strategy that investors should bypass. The ones featured here are some of the most popular I have seen pitched by brokers or ivory tower option books. I have lost too much money on these to ever use them again—regardless of their proposed merits. They are listed here so that you can avoid making these mistakes

by learning from my real-life experience.

Spreads Not Generally Recommended for Individual Investors

The Bull Call Spread (Bear Put Spread)

The bull call spread (or bear put spread) is a broker favorite because it limits risk and increases leverage for the investor, as well as provides a double commission for what otherwise often could have been achieved (possibly more effectively) simply by buying a call. Moreover, it is a net long option spread, which means it is for option buyers and therefore, we would not recommend it on those

grounds alone. We do cover it here, however, because of its popularity among novice traders and brokers alike. They are pitched as a way to reduce the cost of buying an option, therefore enabling a trader to take more positions (imagine that!).

How they Get Your Money

Bull call spreads sound good on paper, but we have rarely

seen them work in practical application. In my experience, if you absolutely must *buy* an option, your odds are better for profiting on a straight-up long put or call. Unless the market moves to a certain point above the highest strike on the spread and remains there through expiration, both options generally will expire worthless, resulting in a loss for the spread holder.

A bull call spread is illustrated in the following example.

Example: Judy Buys a Bull Call Spread

Trader Judy is bullish on crude oil at \$100 per barrel. She decides to employ a bull call spread strategy to take advantage of what she believes will be higher prices. In July, she buys a \$130

December crude oil call for \$800. She simultaneously sells a December \$135 call for \$300. The sale of the \$135 call partially offsets the purchase of the \$130 call, lowering Judy's out-of-pocket investment for the trade. Thus, her investment in the position is cut from \$800 (which it would be if she simply purchased the \$130 call) to \$500 (\$800 - \$300) (see [Figure 8.1](#)).

FIGURE 8.1 Crude Oil Chart
Showing \$130 and \$135
Strike Prices

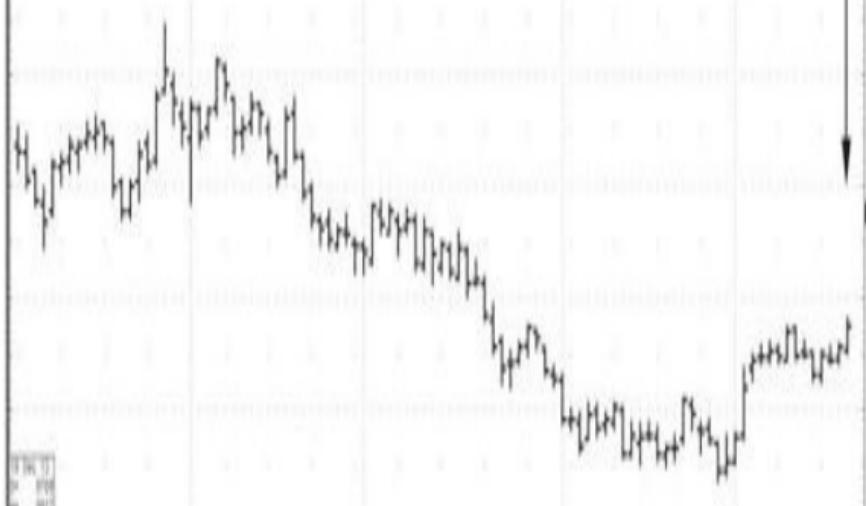
Profit/loss zones of 130/135
bull call spread.

Full Profit ↑

Sells 135 Call

Buys 130 Call

Loss ↓



Also, since any losses accrued by the short \$135 call are “covered” by the purchase of the \$130 call; the position has *limited risk*. The risk is limited to the \$500 Judy puts up for the trade.

The *potential profit* on the trade is the difference between the two strikes. For a crude oil contract, the potential profit on Judy’s trade is listed below.

Potential Profit on Judy's Bull Call Spread in Crude Oil

Long Call Strike – Short Call Strike × Size of One Contract \$135 – \$130 × (1,000 barrels) = \$5,000 Potential Profit

For Judy to reap this full profit potential, crude oil must be above \$135 at expiration, in which case both

options expire in the money. The \$130 call is profitable up to \$135, at which point its gains are offset by losses on the \$135 call.

A bear put spread works the same way except on the other side of the market (with puts) when the trader is bearish on the market.

As stated earlier, on paper, the bull call spread looks great: low initial

investment, large potential profit, and *limited risk*. It sounds too good to be true!

It does, and it makes a great sales pitch to novice traders. Of course, there are situations in which this strategy could work well. However, we've seen our share of bull call spreads and have only seen them work well in the trader's favor in a very few situations. Let's

examine why.

First of all, whenever you hear the terms “large potential profit” and “limited risk,” your “I will probably lose my money” antennae should go up.

The Flip Side of the Bull Call Spread

Although the potential profit on this bull call spread appears attractive, what is the

potential for profit? For the maximum return to be achieved on this position, crude oil prices would have to rally 35% prior to option expiration for Judy to reap full profit.

Granted the market's moves in the previous eight weeks made this type of move seem feasible to hyped-up traders. But to increase by 35% in the face of rising

supply? It is certainly possible for the market to make this kind of move. But is it likely? This is where knowledge of the fundamentals becomes so important.

The Trouble with Predicting Big Moves

The problem in predicting big moves is that the market is trading at its true value every

single day of the week. You have to see something coming in the future that the rest of the market does not. You have to predict almost exactly where the market will go. Then it has to make a substantial move in your favor in a very short period of time. What is the potential for profit? Probably very low.

In this case, the odds of success are even lower than

the strategy of buying the \$200 call outright. At least in this case, if the market moved up marginally but did not quite reach \$200, you might be able to profit from short-term appreciation of the call option itself. In a bull call spread, the options often will have very similar deltas. This means that both options' values will tend to move at nearly the same rate. What you are gaining on your long

\$200 call, you are often losing almost as much on your short \$205 call. Therefore, even if you were right and the market moved up \$10, \$20, or even \$30 per barrel, chances are that you would not have been able to cash out of your trade early with much of a profit, especially after commissions are taken into account. The market would have to at least eclipse the \$200 strike and

remain there through expiration for the trader to make any considerable profit at all. In other words, the long option has to go in the money and remain there through expiration for the buyer of the bull call spread to reasonably profit. And we already know the percentages and therefore can predict the chances of that happening.

How I Learned the Hard Way

This proved especially frustrating to me as a young broker when, as a team, we put countless hours of research into a market, came up with a reasonable synopsis of the market that, surprisingly,

often was correct, and then tried to position using an option spread of this nature. At the time, we felt that we were protecting clients and giving them what they wanted—low investments and limited risk. In hindsight, we were giving them little chance to profit from what was, at the time, decent research.

What would happen is

we would release a bullish (bearish) outlook for a market and then recommend a bull call (bear put) spread. The investor would place the trade, and the market indeed would move higher. The investor would call in.

“You guys were right. That market did just what you said! How much did we make?” the investor

would ask.

“Well John,” I would reply, “we haven’t made anything yet.”

A long explanation of option strategy would ensue. The market had moved higher, but neither strike had been attained. Thus, while the closer-to-the-money long option had appreciated in value, the losses from the more

distant short option had almost offset all the gains. Thus, with transaction fees figured in, the position was still at a loss.

Most of the time, in the following weeks, broker and client alike would watch disappointedly as the market then topped out or went into a sideways trading range as the bull call spread slowly

deteriorated, and died on the vine.

Bull call or bear put spreads can work if the market goes exactly where you think it is going to go and stays there. But it has to be there at or near expiration to really make it worth your while. In other words, you not only have to pick where the market is going, you also

have to decide when it is going to be there. And that can be very difficult to do.

Table 8.1 illustrates the benefit to drawback comparison of bull call/bear put spreads.

TABLE 8.1 Benefits and Drawbacks of Buying a Bull Call or Bear Put Spread

Benefits	Drawbacks
Limited risk	Must typically predict big moves
Lower cash requirement	Both options must typically expire in the money to achieve maximum profit (low odds of success)
High ROI if max profit achieved	Timing must be excellent Market must move quickly Profit potential is capped

Why Not Just Buy the Call?

As we now know, crude oil prices declined sharply into the third quarter of 2008. While the options in this example would have expired worthless, let's assume for a moment that crude prices continued to rally up to \$210 per barrel by October 2008. After transaction costs, slippage, and the price of his expired options, he would

have netted just over \$4,000 per spread. Had he simply purchased the \$200 call outright, his profit would have been over \$8,000. Yet another reason to stay out of the bull call: It limits your profit. If you are willing to pay the heavy price to obtain limited risk, you should at least retain your right to an unlimited profit and buy the straight calls.

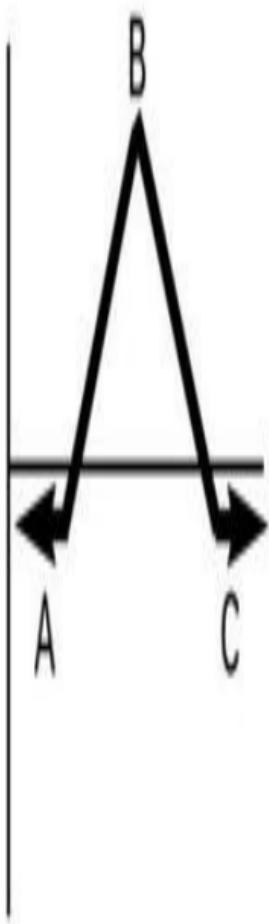
As we will see in the upcoming chapter, doing the exact opposite of this strategy can be a solid way to build equity in an option *selling* account.

The Butterfly Spread

A favorite of many option books (and many brokers, no doubt) is the butterfly spread. The butterfly seems to

promise all things to all people. Investors who spend the time to learn how to use it must think they have discovered the Holy Grail of option trading—until they try to use it (see [Figure 8.2](#)).

FIGURE 8.2 Butterfly Diagram



The butterfly takes its name from the shape of its

payoff diagram. The payoff from the butterfly is supposed to be highest at point *B*.

How They Get Your Money

Again, we'll go back to the theme of professional traders versus individual investors. Although certain strategies can be used effectively by professional and/or floor traders, they can be highly impractical for individual

investors. This is one of them. You have certain advantages as an individual investor that you can use in your favor. Trying to coordinate the positioning of multiple options at different strike prices at desired premiums while taking commissions and slippage into account is not one of them.

Nonetheless, the butterfly looks great on paper. The

following is an example of a typical butterfly spread and how it is supposed to work.

Example: Trader Mary Sells a Butterfly Spread on Crude Oil

Trader Mary is

neutral on April crude oil. In other words, she thinks that \$100 is a fair price for crude and believes that the price will be near this level on expiration day for April options. With

the market trading at \$100 a barrel, the trader enters the following position:

Buys 1 April crude oil \$95 call at 250 points (\$2,500)

Sells 2 April crude oil \$100 calls at 150 points

$(\$1,500)$ each
for a $\$3,000$
total credit

Buys 1 April crude
oil $\$105$ call at
75 points
 $(\$750)$ (see
Figure 8.3)

FIGURE 8.3 Crude Oil Chart Illustrating a Butterfly Spread The butterfly spread

CLJ04-Crude Light-Pit, Apr.'04, Daily



This is not the type of book that is going to explain all of the mathematical formulas and scenarios of how the butterfly spread can profit. However, the maximum profit in a butterfly spread occurs if the market expires right at \$100. In this case, both short \$100 calls expire worthless for a \$3,000

gain. The long \$95 call expires 500 points in the money for a \$1,500 loss. The long \$36 call expires worthless for a \$750 loss.

Therefore, the maximum profit on this particular example is \$750. Maximum risk on the trade is \$250, which would result from all options expiring worthless or all options expiring above the top strike price. In other

words, the net debit on the trade is your maximum risk.

The butterfly spread and its many variations can be made to sound very good—limited risk with profit potential three times the risk.

However, though the limited risk and sophisticated nature of the butterfly spread may look appealing, it has two inherent drawbacks:

1. The trader has to pick

almost exactly where the market is going and where it will be at a certain time in the future. Again, this is very difficult and exactly what we are stressing to avoid.

2. Even if the trader does happen to do this successfully, she has to cover four commissions plus fees

plus cover any slippage on the fills out of her profits, which are limited by the butterfly. These hefty fees for employing the butterfly can cut any profit received substantially and make a loss on the butterfly all the more painful.

Other variations of the butterfly spread include

spreads with names such as the *inverted butterfly*, the *condor*, and the *cartwheel*. Although these can qualify as credit spreads, for an individual investor, we would recommend staying away from all of them. In fact, try to avoid any spread that has the name of an insect, bird, or anything you might find in nature.

The Diagonal Spread (The Free Trade)

This spread was not covered in the first two editions of this book. However, as I have noticed it appearing more often in option newsletters and online advice websites, I felt it needed to be addressed here.

Diagonal spreads are often billed as “free trades.”

Have you ever heard it said that nothing in life is free? Well, it is a wise and true statement.

But before we dissect this common strategy, let's address some terminology.

There are almost as many categories for option spreads as there are option spreads. However, three of the main ones are vertical, horizontal, or diagonal. An explanation

for each follows.

Free Trade or Folly?

Option spreads are like fashion trends. If you missed it the first time, don't worry. Just wait 10 or 20 years and it will come around again.

Option spreads never go away. But they do fall in and out of fashion, at least among the pundits who make their living selling newsletters,

books, and courses. This is especially true in the way they are packaged and sold to the public.

Which brings us to the free trade. Free trades were popular among this group 10 to 15 years ago. I didn't hear much about them for a while until the last couple of years, when an astute newsletter guy resurrected their popularity.

Like any option spread,

for the right trader in the right situation, the free trade has its merits. I simply feel it to be impractical and a low-odds trade for any serious investor. It's great for people who like to "play" or "dabble" in the market—as I have seen it used primarily as a cheap way to buy options. And that's great. However, this book isn't for people who want to play or dabble.

What is a “free trade”? A free trade is a variety of the diagonal spread, which I typically do not recommend in the first place. However, as the free trade is what so many are familiar with, we will focus on it here.

*Example: John Employs a
“Free” Trade*

A free trade is best described by example. Let’s suppose

trader John is bullish on gold. In February, John sells an April Gold 1400 call for \$1,000. He then takes that \$1,000 and buys a June Gold 1480 call for the same price, \$1,000.

This is illustrated in [Table 8.2](#).

TABLE 8.2 John's Diagonal Call Spread (Free Trade)

Action	Price
Sells 1 April Gold 1400 Call	\$1,000
Buys 1 June Gold 1480 Call	\$1,000

On a price chart, John's trade would look like **Figures 8.4** and **8.5**.

FIGURE 8.4 April Gold Chart Showing John Selling

April Gold 1400 Call at
\$1,000

John sells an April Gold 1400
call for \$1,000.

144 Gold - Contract Apr 14 July

> 1310
> 1320
> 1340
> 1360
> 1380

1310
1320
1330
1340
1350
1360
1370
1380
1390
1400
1410
1420
1430
1440
1450
1460
1470
1480
1490
1500

Sells April Gold 1400 Call for \$1,000



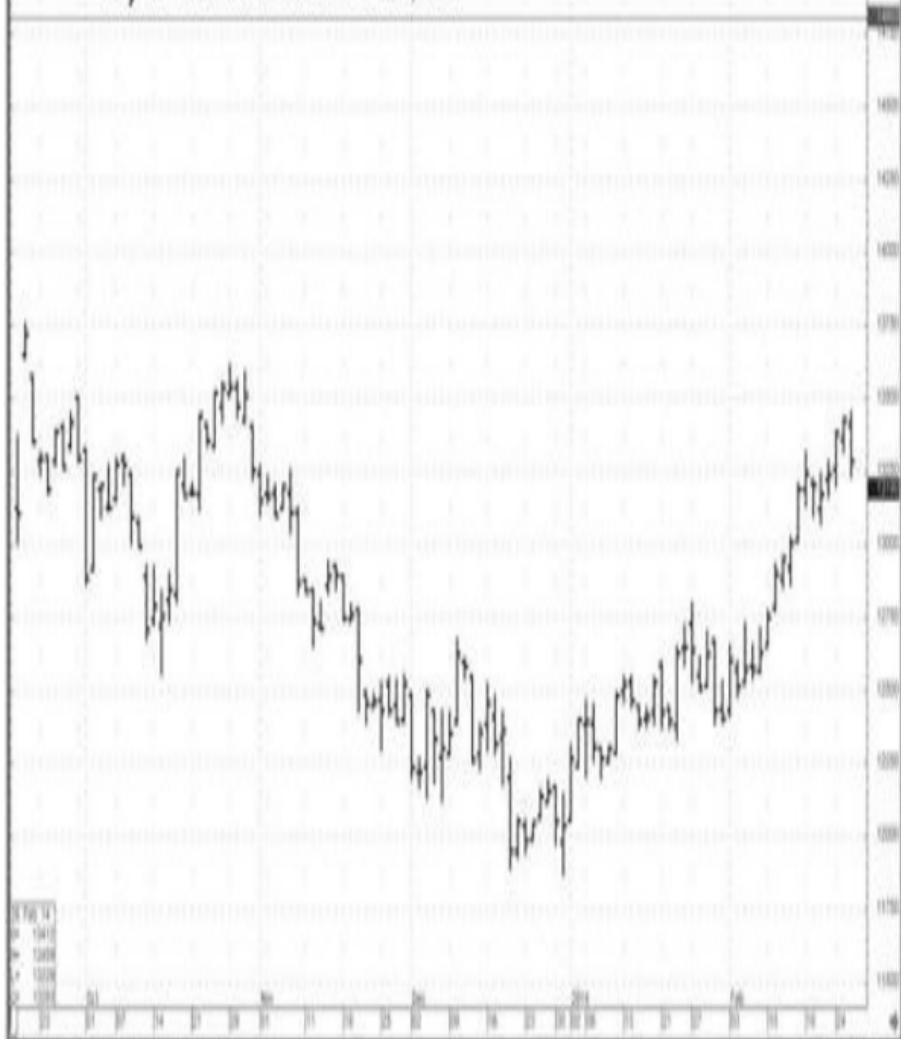
> 1400
> 1410
> 1420
> 1430
> 1440
> 1450

FIGURE 8.5 June Gold Chart Showing John Buying a 1480 Call for \$1,000

John buys a June Gold 1480 call for \$1,000.

Learn the English Language

Buys June Gold 1480 Call for \$1,000



Objective of the Free Trade

John's objective in this trade is to have the April call expire worthless, effectively “paying for” his June call. He would then hope for a rally in June Gold and look to profit from his long 1480 call. If it expires worthless, he still breaks even.

It sounds great when you first hear it. But then again,

so did putting a gas tank in the rear of a Ford Pinto.

How They Get Your Money

There are several ways they can get your money on this trade, as shown in the following list:

1. Low odds of success.

First and foremost, the free trade is a long option trade. It is designed to profit from

a large move by buying an option. We have already covered the numerous drawbacks to buying options. In this example, let's suppose John's April call does indeed expire worthless. That will mean gold will be somewhere below 1400 in April. That will give John about 60 days to get a major rally in

gold prices. His long call will already have eroded in value since the time he purchased it. Now, he needs it to start appreciating rapidly, right at the time it enters the most rapid time of decay. As we know, buying options is rarely a strategy that you can profit from consistently.

2. John has to have several things happen perfectly for him to profit. He has to have gold prices remain steady for 45 days or so, then rally sharply. He not only has to predict a big move, but his timing has to be perfect.

3. Free does not mean risk free. John may

initially “pay for” his long call with the sale of a short one. But he has much greater risk than simply buying a naked call. If he is right in the market but his timing is off, gold could rally prior to his April short call’s expiration. This could mean his April call is going deep in the money, while his long

call fails to keep up in value. John's maximum risk on this trade is \$8,000 (April Gold at 1480 on expiration day. June Gold expiring worthless). Although John's chances of taking a maximum loss is small, there nevertheless remains substantial risk here. That doesn't sound free to me. If you are a big

gold bull and you want to buy an option, why not just buy the option outright and have limited risk? There are a lot of ways for novice traders to get into trouble using this strategy—especially since “free” often connotes low risk. That it is not.

4. You lose even when

you break even. If you sell at even prices and everything expires worthless, you are still paying transaction costs. If you do many of these (which you will if you ever hope to hit on a winner), those costs can add up quickly. Remember my rule: I get paid if everything expires worthless—and that

means covering all costs, too. A free trade doesn't do that.

Suffice to say, any time you hear the word “free” in investing or trading, run for the hills. My (Michael) youngest daughter came to me last year with the great news that she had won a “free cruise” and had just filled out the paperwork to claim her prize. You know the story.

She got the call on the phone, So she claimed her “free” cruise, which eventually ended up costing me about \$4,000. No such thing as a free lunch.

The free trade strategy appeals to the crowd with little capital to invest and is looking to buy a lottery ticket on the cheap. But they give up an awful lot to get their “free” option. Don’t make

their mistake.

The Abuse of Spreads

Although this list certainly does not cover all of the option spreads to avoid (which is most of them), it gives you an idea of how easy it is to be misled into believing a certain option

spread is working to your advantage when, in fact, it is putting you at a disadvantage. As we've stated repeatedly, any spread can work in the right situation. But how likely is that situation?

Because of the complexity of option spreading, it is easy for option "educators" and self-appointed Internet gurus to lead you into woods you can

get lost in. Many, especially those fascinated with the math and science of options, mean well but miss the forest for the trees.

We have read commodity newsletters and brokerage advisory services that take option spreading to a ridiculous, almost shameless, bid for multiple commissions.

For example, a recent recommendation from a

newsletter we won't name was in coffee. It was selling 11 coffee calls, buying a futures contract, and then buying an at-the-money put for protection. They explain it and, of course, it looks great on paper. However, the market would have to move somewhat higher, but not too high, for the investor to make money—after paying 13 commissions plus covering the cost of buying an at-the-

money put. It seemed to us that the same thing could have been achieved simply by buying the futures contract outright. But the writers pulled out the “limited risk” card that has such mass appeal to the common trader. (Actually, if the coffee market had soared, risk would have been unlimited.) In the end, the trade violated just about every one of our “red flags” indicating option

spreads to avoid.

In the following box, there are a few rules of thumb our experience has taught us that may indicate a spread you are considering is one to avoid.

Checklist for Option Spreads to Avoid

If the spread you are considering exhibits any of these characteristics, it is best to move on.

1. *You can't explain the spread to your kid (wife, nephew, etc.).* If the trade is too complicated for you to explain

to somebody unfamiliar with commodities, you probably shouldn't be in it. My 12-year-old daughter asked me at the dinner table one night a few months ago about what I did at my job. After a brief explanation, she asked how people

make money investing in things like orange juice or pigs. I went to my briefcase and pulled out a recent chart of coffee. I took out a pen and drew a line across the top of the paper from the strike price at which we had recently sold naked calls. “This

chart tracks the price of coffee” I explained. “If the price stays below this line,” I said, pointing to the horizontal line I had drawn, “we make money.”

She sat in quiet contemplation for a few seconds and then exclaimed

triumphantly,
“That’s easy!”

Exactly.

2. *If everything in
the spread expires
worthless, you lose
money (after fees).*

There are some good reasons to use multi-option spreads, as we will see in the next chapter. However,

if you are going to the additional trouble and expense to implement a spread, it should be to tilt the odds greatly in your favor and give you many ways to profit. This especially means that if everything expires worthless,

you still win. If this scenario means you lose something, it's simply a gambler's bet.

3. *The spread requires the market to move to a certain place at a certain time.* As we've discussed, picking where the

market is going to go is extremely difficult. Picking when it is going to go there is nearly impossible. We advise option strategies that require you only to pick where the market is *not going to go*. Seek out simple strategies that give you a

very wide profit zone. The market should be in this profit zone already when you enter the trade. In this way, you force the market to move out of the profit zone for you to lose. Avoid all trades with very narrow profit zones or zones that

appear far away
from the current
market price.

Conclusion

Hopefully, this chapter has given you some real-life insight into option spreading and what to avoid. These examples by no means encompass all of the ways

they get your money. Nor does it encompass the impractical, low-probability spreads that are available for new traders to study, analyze, and attempt to implement. This chapter also does not cover all of the classic option-spread strategies that have been designed by professional traders, but alas, are impractical to all but the most highly skilled professional or floor trader. The guidelines

presented herein, however, should hopefully give you some valuable insights to help you avoid the quicksand.

Now that you've learned what not to do, it is time for some good news. There are a handful of option spreads that are practical for the individual investor to implement, and that can put the odds sharply in your favor and allow you to build a consistently

performing portfolio. It's time to learn how to get *their* money!

As we've stated, in our experience, there are only a handful of option spreads that we believe *actually* do offer you, the individual trader, an advantage in the market. To make money consistently, which is what we're after, you need strategies that are simple, and yet put you on

equal footing with the pros.

The next two chapters will give you the tools to operate on their level—and put you head and shoulders over most of your option-trading peers.

Recommended Spreads: The Few and the Proud

Spread Strategies That Really Work for the Individual Investor

As you have seen in previous chapters, there are dozens, if not hundreds, of ways to combine options of long/short, put/call, strikes/months, and more—all

in an effort to gain an edge on the market. Yet few actually offer a nonprofessional, individual trader advantages that are applicable in most real-life situations.

This chapter is about the few option spreads that do offer you an advantage. We have spent the better part of our careers separating the wheat from the chaff when it comes to option spreads. And

one thing I can tell you is that there is a lot of chaff.

However, the spreads you will read about here have proven their mettle time and time again. They can work in a variety of situations, are durable, easily entered, managed, and exited. Most importantly, they can offer you an edge if you use them correctly.

Just as we learned in the

last chapter, any spread has the potential to work in the right situation. The other side to that coin is that no spread is perfect for every situation. Thus, the first question we must answer is when to use an option spread.

When Should You Use an Option Spread?

My answer to this question is a simple one. You use an option spread when doing so would give you a distinct advantage over selling an option naked. Writing a spread may not always be the right strategy to use. Differences in premium may not be wide enough to make the spread worthwhile. There may not be enough liquidity in the strikes you want. You may have to take strikes too

close to the money. There are some situations where writing naked makes more sense.

When I am looking to enter a market, I'll look at both naked writes and credit spreads to see what the market is offering. I'll typically look for one of the spreads you'll see on the following pages. If none are available at the right premiums but I still love the

market, I'll write naked.

But my preference would be to spread every trade.

The reason for this, as you will see, is that using the right spread can add additional advantages to simply selling naked. The spreads you will be learning here will have some key characteristics in common. In the last chapter, we learned the characteristics of spreads

to avoid. The box “Characteristics of a Favorable Spread” is almost a reversal of that list.

Characteristics of a Favorable Spread

- 1. If everything
expires worthless,**

you still profit (after fees). By definition, this means you will only write what are known as *credit spreads*. A credit spread means you take in more premium than you pay out on the spread. Therefore, you get a *credit* by writing it. This

book is about selling options, not buying them. In every one of the spreads you will learn here, you will be looking to profit almost exclusively from the options that you sell. The options you buy will be used primarily as protection or to

increase your odds of profit in one way or another.

- 2. It is easy to understand and implement.** You should be able to explain it to your golf buddy in 30 seconds or less.
- 3. The market should be able to behave a great**

many different ways and you still profit. Some spread strategies require a very specific thing to happen in order for it to profit. The strategy you use should only lose if a very specific, unlikely market movement occurs. Everything else

should result in a profit for you.

4. You should not have to predict where the market will go. This is similar to the third point. You should, of course, have a bullish, bearish, or neutral bias to any market before selecting your

strategy. However, you want to leave yourself plenty of room to be wrong and still make money.

5. Slow moving. We want time decay here. That's all. And we want the easiest, smoothest ride to expiration. (Remember the

Mercedes?) We don't like, or need excitement. You can go to Vegas for excitement. Here you want boring, slow, steady money filling up your coffers every month. That means strategies that tend to balance out the role of volatility on

your option's values. You want slow-moving trades that get to zero with the least amount of up and down swings as possible.

Everything should be slow and boring —except your annual statement.

The credit spreads you are about to learn are the few that have stood out as exceptionally consistent over time.

They are relatively simple, yet relatively effective. They offer wide profit zones and in many cases high probability for solid profits, even *after* fees are factored in. They do not offer *limited* risk, yet they are

relatively easy trades in which to employ standard *risk-management* techniques.

Entering and Exiting Your Spread

Before discussing these strategies, it is important to discuss the entry and exit of spread positions. Selling naked options by themselves

is a relatively simple procedure. You decide on the premium you desire, enter the sell order at that premium, and find out if you have any takers. If it gets filled, great. If not, you can adjust your price or try again tomorrow.

Spread trading with options throws a different wrinkle into the equation. The absolute value of the options themselves is not as

important as the spread (price difference) between the two. That is what you are playing. That is where your money is.

A spread order can be placed all at once—as a spread. Thus, you could place your order as “Sell One September Corn 5.00 call and buy one September corn 5.50 call at a 10¢ to the sell side.” This means that you don’t care what the absolute prices

of the options are, you just want to make sure you sell the 5.00 call for at least 10¢ more than you buy the 5.50 call. (In corn, this would mean a \$500 difference.)

This is the standard way to enter a spread trade. It is also the way you should probably stick to most of the time. However, there is a second, more adventurous way to enter that you may

choose to use on occasion.

“Legging In” to an Option Spread

A more aggressive approach to spreading options is what is known as *legging in*. The trader who *legs* on the spread tries to establish one side of the spread at a favorable price and then waits for the market

to move in the other direction, giving him a more favorable price on the other end. In other words, he is *willing* to leave himself exposed on half the spread while he waits to establish the other half at a desirable price. Although we've seen some trades legged in very effectively, we've probably seen just as many result in the trader not getting the market move he had hoped for and

thus having to accept a much worse fill on the second half of the spread. Worse yet, he may not get a fill at all or may have to adjust his strikes, giving him a less desirable overall position. In other words, if you are trying to position in two different options to complete a spread, have limit orders on both: if one gets filled and the other doesn't, you could be left exposed to risk that you did

not anticipate.

Even though there may be some situations where legging in may be worth a shot, we cannot bring ourselves to outright recommend it. Much of this will depend on your personality. If you are slightly more aggressive, you may want to attempt to leg into a spread occasionally. If you decide to go this route, you

should have real-time option quotes and the ability to watch them every minute. The other alternative, of course, is to have a quality broker experienced in option spreads who has the ability to watch your spread closely and position for you.

Now that we've dispensed with the preliminaries, let's get on with it. The following are our recommended spreads

for individual traders.

Recommended Spread 1: The Short Option Strangle

The short option strangle is simply a variation of selling naked puts and calls. As a matter of fact, it *is* selling naked puts and calls. It is simply doing both at the *same*

time.

A short option strangle, or simply *strangle*, as we will refer to it, is the strategy of selling a naked out-of-the-money call and a naked out-of-the-money put on the same market. The strangle is most effective when the price of the underlying market remains in a defined range. An example of a strangle is given below.

Example: Trader John Sells a Strangle

Trader John is not sure which way Gasoline (RB) prices are headed. In January 2014, he identified price levels on both sides of the market that he believed would be highly unlikely to be attained before the expiration of May options (April 25).

In brief, John believes

that \$3.20 would be too high a price for gasoline futures to attain in this period. He also believes that the \$2.60 level would substantially underprice gasoline. John places the following trade: He sells one May Reformulated Blend Gasoline (RBK) call for 240 points (\$1,008) and one May Reformulated Blend Gasoline (RBK) put for the same premium, 250 points (\$1,050). As long as May

Reformulated Blend Gasoline is below \$3.20 and above \$2.60 at option expiration, both options will expire worthless, and John will keep both premiums for a total \$2,058 in profit, minus transaction costs.

John's out-of-pocket margin to hold the trade, using the SPAN system, is 3,460. John's trade is illustrated in Figure 9.1.

FIGURE 9.1 May 2014
RBOB Gasoline Chart
Illustrating the Strangle
Strategy
John sells a strangle (a put
and a call) on May RBOB
gasoline.



Date of Trade:

January 25

Strategy:

Short Option Strangle

Market:

May Reformulated Blend Gasoline (RBK)

Trade:

Sell 1 May 3.20 call for \$1,008

Sell 1 May 2.60 put for \$1,050

Total Premium Collected:

$(\$1,008 + \$1,050) = \$2,058$

Margin Requirement:

\$3,460

Expiration:

April 25

Synopsis:
If RBK Prices are ANYWHERE between 3.20 and 2.60 at expiration (profit zone), both options expire worthless.

John keeps the \$2,058 premium as profit

ROI if Successful:

$2,058/\$3,460 = 59.4\%$

Maximum Time of Open Trade:

90 days

The Profit Zone

The area between \$3.20 and \$2.60 is what we like to call the *profit zone*. The profit zone is the price range on the chart that the underlying market can be within at option expiration for the trader to keep all premiums collected on the trade. This particular strangle has a fairly

wide profit zone of about 60¢ (\$3.20 – \$2.60 = \$0.60) (see Figure 9.1).

Advantages of Selling the Strangle

In addition to meeting all of the conditions listed on the checklist at the beginning of this chapter, John enjoys several key advantages of

employing the option strangle. These are listed below:

- **Offsetting price movements.** As the market fluctuates up and down, the value of either the put or the call will increase. However, the value of the other option will decrease, at least partially offsetting the increase in the first. For

instance, if the market moves higher, the value of the 3.20 call may increase, but the value of the 2.60 put will decrease, thus offsetting, at least partially, the movement in the call.

Eventually, if the spread works correctly, this balancing act will continue while time decay continues to erode both options. This is in

contrast to selling naked on one side of the market, where the trader has no counterbalance on his position.

Although the decrease in one option may not offset the increase in the other exactly, owing to differing deltas, the balance is often enough to give the trader a much smoother, less-volatile ride to expiration.

- *Lower margin, higher dollar-for-dollar return.*

Because of this balancing effect, the exchanges often view strangling as a more conservative position than selling outright naked short options on one side of the market. For this reason, the margin requirement for a strangle often will be less than the sum of the

margin that would be required for selling either option by itself. For instance, the net margin requirement to sell the 3.20 call might be \$2,000. The net margin requirement for selling the 2.60 put might be \$1,900. The sum totals \$3,900. Yet, if both are sold together as a strangle, the margin for both totals \$3,460. A

strangle, then, often can offer a higher return on capital than selling one side of the market.

- *The market does not have to make a large move for you to profit.*
Unlike several of the spreads in Chapter 8, the market does not have to make a large move for you to profit. It simply has to stay in the profit

zone. In fact, it does not have to move at all; it is already in the profit zone! You do not have to pick where the market is going or when it is going to go there. In this case, the profit zone is fairly wide, offering what appears to be a high potential *for* profit.

Strangle Drawbacks

Although the strangle is an excellent option-writing strategy to use in many situations, like any other approach, it has its drawbacks.

- **It is vulnerable to large moves in the market.**
While the option sold on the other side of a strangle will offset losses of an adverse move against the other,

this offsetting effect is limited. If a trader is simply selling naked puts, a large move to the upside will greatly benefit the position. This is not the case in a strangle. A breakout move in one direction can cause a loss on one of the options that eclipses the profit on the other. A strangle still has unlimited risk on the

upside or the downside and therefore must be managed like a naked option position. Thus, you can and should close the position (or at least the affected side) if the market begins to run close to one strike or the other.

- **It has a limited profit zone.** The profit zone for selling naked options

on one side of the market is unlimited. The profit zone for a strangle, no matter how wide it is, is still finite. The price must remain within a certain range. Strangling, then, is not recommended for sharply trending markets but rather for markets that the trader feels will remain in a general trading range.

Strangling Volatile Markets

Trending markets are not always ideal choices for this approach, but this does not mean that *volatile* markets should be overlooked for strangling opportunities.

Volatile markets often can still trade in wide trading ranges, and the volatility can boost option premiums,

meaning that a strangle often can be sold with a very wide profit zone.

For instance, in the early part of 2014, investors worried that the stock market was due for a correction after the impressive performance of 2013. Yet, the following example from one of our weekly columns illustrates how a strangle could have been employed in the S&P

500 futures contract with a very wide profit zone. This piece ran on a variety of financial websites nearly 10 years ago. We updated it here to apply to more current market conditions. However, it is every bit as relevant today as it was in its original publication. The article illustrates some important points about strangling.

Strangling the S&P

remains a “bread and butter” trade for many professional and individual traders.

A New Bear Market for the S&P 500 or Just a Healthy Correction? Option Sellers Need Not

Decide

JAMES CORDIER,
OPTIONSELLERS.COM

Although day trading the S&P 500 is still a popular pastime among many “run and gun” traders today, it may not be the best approach to long-term financial health. While I’ve

run into a few traders who claim to be good at it, I haven't met one yet who has retired with all the profits he's banked.

I have worked with several short-term traders in the past and even used the approach myself on a small scale. The results were fair, and I must admit that it is an exhilarating game. However, with all

the sophisticated technical tools and up-to-the-minute reporting on government financial data and news releases, it simply seems that there is still too much left to chance when short-term trading. This is especially true when trading a market such as S&P 500 futures, a market more driven by emotion than any other I can think of. Emotions are an

irrational animal and may not respond the way a 50-day moving average or the latest government unemployment report says it should. We never know when a head fake by the Fed, or a riot in a Middle Eastern country will drive the market erratically in one direction for a day, a week, or even a month.

Unlike trading a

physical commodity, where crop forecasts, demand trends, and current supply can be measured to a certain degree, the S&P 500 can be affected by so many different variables that trading on fundamentals can be much more difficult, in my opinion, than trading a commodity such as soybeans, coffee, or crude oil. This is especially true

when trading futures contracts for short-term gain, where the slightest daily whim of the market can result in being stopped out or, at the very least, a disappointing loss that may cause you to question the rationale of your position. In other words, you can guess the market right, whether using fundamental judgment or good technical savvy, and be knocked out

of the market by a random event. Of course, this can happen in trading commodities as well, but, in my opinion, it is much more likely to happen when trading the king of the futures contracts.

The volatility of the S&P 500, coupled with the wide public interest in trading the contract, does create some outstanding

opportunities in the options, however. Whereas short-term traders are trying to decide whether to go long or short the market on today's action, sellers (or writers) of options can choose not to decide and simply take a high-probability position outside all of the market "noise."

To illustrate this strategy, look at the

horizontal lines in [Figure 9.2](#). Do you believe that the S&P 500 will remain between these two lines for the next 90 days? If you believe that the probability is high that it will, then an option strangle position may be for you.

FIGURE 9.2 June 2014 S&P Price Chart Illustrating a Strangle and Profit Zone

Short option strangles can offer a wide profit zone.



An option-selling strangle is the strategy of selling a call above the market and a put below the market—in this case far

above and far below. In this example, the trader is selling a May S&P 500 2050 call for 240 points (\$600) and a May 1300 put for 320 points (\$800). If the May S&P 500 is anywhere between 2050 and 1300 at option expiration on May 16, 2014, both options expire worthless, and the trader nets the sum of both premiums, or \$1,400 per

spread, minus transaction costs.

The drawbacks to this type of approach are that if the market moves beyond these ranges, the trader is subject to the same market risk that he would be if he were outright long or short an S&P 500 futures contract. Drawback 2 is that either option could increase in value during the

life of the trade, which also could potentially increase margin requirements.

The benefits of the position, however, are substantial. By selling on both sides of the market, the losses created by an adverse move in one direction are at least partially offset by gains on the opposing option. Of course, as long as the

market price remains between the two strike prices, time decay eventually will erode the value of both options. This “offsetting” effect of a strangle can create a more stable, less-volatile position for the investor.

The obvious benefit of the trade is that the trader leaves the market a wide range of potential

movement from which he can profit. Daily news reports, breakouts, or corrections are all things he no longer needs to worry about, at least on a short-term basis.

The objective generally would be to hold the position through option expiration, thus keeping all premiums collected as profit. Remember, for the

position to be profitable, the market must only remain in the described range for about the next 90 days. However, either or both options can be bought back at any time to close the position. This can be a key aspect of risk control.

An option strangle like this one is the type of opportunity that we prefer to recommend because it

provides a wide profit zone for the investor. It is one that I'll advise any day over trying to guess what tomorrow's newspaper will bring.

Risk Management and the Strangle

Managing risk on a strangle sometimes can be easier than

managing risk on a naked position on one side of the market. A common risk-management technique for option sellers is the 200% rule. The 200% rule states that you buy an option back if it doubles in value. It's a great rule, especially for beginners, because of its simplicity. We will discuss this technique in the section on Risk Management later in the book.

If you use the 200% rule on a strangle, then if the put and the call were sold at approximately the same premium, you could exit either the put or the call when it doubled in value. The odds of the market making a complete reversal and moving far enough to cause the other option to double would be unlikely, although not impossible. Therefore, if the 200% rule is used in a

strangle position, there is a good chance that one could come close to breaking even, even when losing on one side of the trade.

In other words, one option would be covered at 200%, whereas the other would expire, leaving the trader net even for the trade. Assuming each option was sold for \$500, the equation would work like this:

Call option exited at double premium	(\$500) (loss)
Put option expires worthless	+ \$500 (profit)
Net profit/loss	0

Of course, slippage and transaction costs must be figured into the equation, so a trader would not truly break even. In addition, for demonstration purposes, this illustration assumes that each option was sold for exactly the same price when, in

reality, this is rarely the case. Regardless, losses would still be minimal in this example, which makes the strangle a bit more attractive to risk-adverse investors.

More aggressive investors can choose to give the losing side of the equation a larger cushion for movement, risking it to triple original value or more. They are willing to withstand

temporary increases in the values of the options (to a certain extent) as long as the underlying market price remains within the *profit zone*. The strangle gives them this luxury because they know that the other side of the strangle at least partially offsets their loss.

In conclusion, traders generally should use the same risk-management techniques

for a strangle that are used for selling naked options on one side of the market. The offsetting effect of the strangle simply gives the trader more flexibility in deploying these techniques.

Recommended Spread 2: The Vertical Credit

Spread

In the previous chapter, we learned about the bull call and bear put spread. These were long option (vertical debit) spreads we do not recommend.

The opposite of the vertical credit spread comes in two varieties: the bull call spread and the bear put spread. The opposite of those

spreads are the bear call and bull put spreads, also called *vertical credit spreads*.

These are wonderful spreads as they offer a myriad of benefits with very few drawbacks, and for that reason deserve attention from any serious option seller. Vertical credit spreads are one of the most popular spread strategies used by serious option sellers. This is

especially true with the more conservative income players. The vertical credit spread is a versatile strategy that holds up very well in adverse market conditions. They are quite simple to deploy.

There are two types of vertical credit spreads. Bull put spreads are for bulls. Bear call spreads are for bears.

A bear call spread is illustrated in the following

example.

Example: Trader John Deploys the Bear Call Spread

Scenario: Trader John feels wheat prices are near a top in early Spring 2014 but is not sure where the top will be. Rather than risk selling futures and getting stopped

out or selling a naked call, he elects a more conservative strategy that will still allow him to profit if and when the rally stalls.

Trader John sells a July Wheat 840 call and collects a premium of \$800. He then takes part of the collected premium and buys a July Wheat 9.00 call for \$300. The net credit of \$500 (\$800 – \$300) would be his profit if

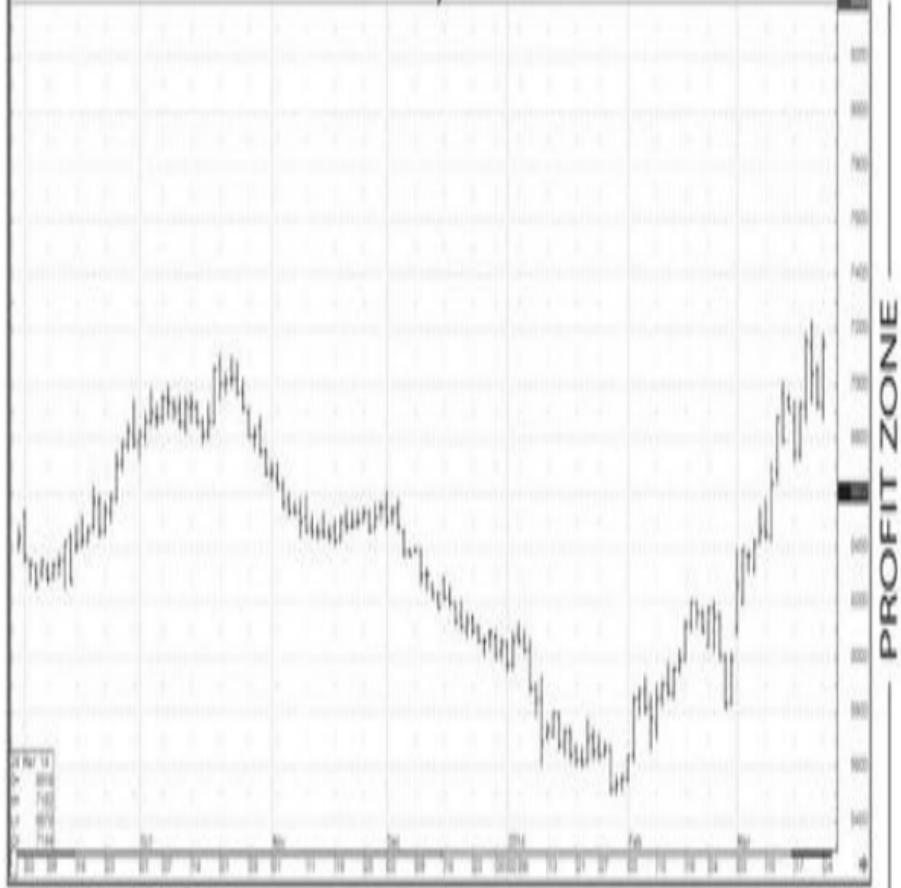
the options expire with July Wheat futures anywhere below \$8.40 per bushel. (See Figure 9.3.)

FIGURE 9.3 Wheat Chart
Showing 8.40 and 9.00 Strike
Prices Along with Profit Zone
A bear call option spread in
wheat.

Buy 1 July 9.00 Call

Buys 1 July 9.00 Call

Sells 1 July 8.40 Call



Source: IQ Option. © 2014 All rights reserved worldwide. <http://www.iqoption.com>

54 of 1234 (0.0%)

Bear Call Spread

Date of Trade:	March 19
Strategy:	Bear Call Credit Spread
Market:	July Wheat (WN)
Trade:	Sell 1 July 8.40 call for \$800 Buy 1 July 9.00 call for \$300
Total Premium Collected:	$(\$800 - \$300) = \$500$
Margin Requirement:	\$700
Expiration:	June 20
Synopsis:	If RBK prices are ANYWHERE BELOW 8.40 per bushel at expiration (profit zone), both options expire worthless. John keeps the \$500 net credit (difference in premium) as profit
ROI if Successful:	$\$500 \text{ premium} / \$700 \text{ Margin} = 71.4\%$
Maximum Time of Open Trade:	90 days

Calculating Risk on a Vertical Credit Spread

To understand the advantages of the vertical credit spread you must first understand the risks. Why? Because some of the best features of the vertical spread have to do with risk control and

limitation.

A vertical credit spread has limited risk. Although this sounds great, it is really irrelevant most of the time. Rarely, if ever, would you want to hold the spread to its maximum risk level. However, limited risk has a strong appeal to the conservative crowd and makes a lot of new option sellers feel better. Thus, it is

important that we cover it here.

The maximum possible loss on this trade would be \$3,000. That is, the dollar difference between the two strikes \times size of contract, minus premium collected. Thus, max loss calculation in this example could be calculated as follows:

$$(\$9.00 - \$8.40) = 60\text{¢} \times 5,000 \text{ bushels} = \$3,000 - \$500 =$$

\$2,500

This maximum loss would only be realized if July Wheat futures were above \$9.00 per bushel at expiration. The profits from the purchase of the \$9.00 call would *cover* any losses above that level.

Although it does provide limited risk, as we've discussed, you would almost certainly not hold this spread

to its maximum loss capacity (nor would any reasonable trader want to). Options can be exited at any time and there are plenty of good ways to keep your risk far below this maximum level. We will recommend a few of these in a moment.

Advantages of the Vertical Credit

Spread

The primary advantages of using the bear call or bull put spread are threefold.

- 1. Peace of mind.** First, it allows a trader the peace of mind of knowing his worst-case loss scenario. In other words, he can sleep very well at

night.

2. Durable in many market conditions.

Second, the spread allows a trader tremendous staying power in the market. Bull put and bear call spreads are rugged, durable, dependable spreads. Think about the commercial for Chevy pickup trucks.

If you want to drive into a salt mine and drive out with a truckload of premium and haul it up a rocky mountain to your bank, this is your spread. Let's explain that.

In the previous example, if July Wheat began rapidly increasing in price

and began to approach the \$8.40 price level, chances are the 8.40 call would begin increasing rapidly in value. If you held a naked call at this strike price, odds are good that one of the risk parameters for exiting naked options would be triggered.

However, with the covered position, the 9.00 call would be increasing in value *almost* as rapidly as the 8.40 call.

Therefore, profits from the long 9.00 call are making up much of the loss on the short 8.40 call. For this reason, in most cases, you can hold the spread in

adverse market conditions, up until the time the underlying contract approaches or even slightly exceeds the short strike and still exit the position at that time with a controlled and often minimal loss. In short, it holds up well in adverse market conditions.

3. Attractive margin requirement (high ROI). The third and possibly most enticing benefit of writing bull put (or bear call) spreads is the *attractive margin requirement* it gets from the exchanges. To demonstrate this, suppose in the previous example, the trader sold the 8.40

call naked and collected an \$800 premium. The margin requirement to hold that option at the time was about \$1,400. Therefore, the return on capital invested would be roughly 57%.

By writing the spread, some traders may believe they are

“sacrificing” premium or somehow accepting less to buy protection. Yet, by buying the protective put, the trader converts his position from one of unlimited risk to absolutely finite risk. Therefore, the exchange *lowers the margin substantially* for these types of positions.

If you would have entered the July 2014 bear call spread in March and filled at the premiums previously listed, the net (out-of-pocket) margin on the spread was approximately \$700. That's a 71% return on capital.

That doesn't sound like a sacrifice

to me.

Drawbacks of the Vertical Credit Spread

Of course, there are drawbacks to any strategy and the vertical spread has some as well.

- Remaining in the trade

through expiration. The primary drawback of using this approach is that to collect and keep the full premium credit, one must generally remain in the trade through expiration. This doesn't sit well with more “active” traders who prefer to trade in and out of the market.

Naked option

selling holds an edge here because if a trader is immediately right in the market and gets a large move in his favor, the naked option position can often be closed out immediately for a profit. However, for the position trader seeking an annual return on his capital, we prefer the covered positions in many

situations.

- **Cannot be used in all situations.** The second drawback to using the bull put (bear call) spread is that it cannot be used in all markets and/or all situations. Some markets may not have the open interest in the desired strikes for establishing such a position but may be

more favorable to naked selling. In addition, there are occasions where a desirable spread between strikes is simply not available. In other words, the credit between strikes is not worth the risk or is simply too small.

We will generally take the net credit after transaction costs and

compare this to the maximum risk on the trade (even though we have no intention of holding the position to its maximum loss). If the net credit is greater than 10% of the maximum risk, it may be a viable candidate for this spread. If not, it should probably be discarded in favor of a different strategy.

Another factor you may want to consider is that a bear call or bull put spread must often be sold slightly closer to the money than a naked option to collect a similar premium. However, one must weigh this against the limited-risk aspect the spread offers as opposed to selling naked.

Risk Management on the Vertical Credit Spread

More aggressive traders can risk a bull put or bear call spread until the first strike goes in the money. The more conservative strategy is to exit the position when the dollar spread between the two strikes doubles (or triples—depending on your risk

tolerance) from the point at which it was entered.

Recommended Spread 3: Selling Covered Calls On Stocks

Okay, I know I told you this book was focused primarily on commodities options. However, for the stock people

reading this, this strategy really cannot be left out.

Selling covered calls is a popular strategy among equity option traders for good reason. Selling covered calls in equities can be done with virtually no additional risk to the investor if she is already assuming the risk of holding the underlying stock. Selling covered positions takes on a slightly different twist in

trading futures. This is so because the leverage involved in selling calls on futures positions can make it a less practical strategy when employed in this arena.

Selling a Covered Call on a Stock

Selling covered calls in equities is illustrated in the

following example.

Mary is long 100 shares of Caterpillar (CAT) stock from \$95 a share. Mary intends to hold her stock for some time. If the stock gets to \$100, however, she would like to sell it and take a profit. Rather than put a limit order on her stock, Mary can sell a \$100 call and collect a premium.

Let's say that it is March

and Mary decides to sell a June \$100 call for \$200 ($\$2.00 \times 100 \text{ shares} = \200). If CAT stock is anywhere below \$100 per share on expiration day, Mary will keep the \$200 as profit, and she will still have her 100 shares. *Therefore, Mary has generated \$200 in income without assuming any additional risk.* The only risk that Mary has is the risk that Caterpillar stock will

decrease, which she already had before she sold the option. Therefore, the risk of selling the option is nil. The option is *covered* because Mary owns the underlying stock.

In addition, Mary pays no additional margin for selling this call.

But what if Caterpillar stock is at \$101 at expiration? Mary's option would expire

in the money and be assigned or exercised at \$100 per share. This means that 100 shares of CAT would be sold for Mary's account at \$100 per share, effectively closing Mary's CAT position at the price she wanted. Mary still keeps the premium as hers. Therefore, Mary profited on the appreciation of the CAT stock and from the premium of the call option.

To some, selling covered calls on equities is a “can’t-lose” proposition. To a certain extent, this is actually true. You can’t lose on the call itself. However, to sell a covered call, you also have to own the underlying security. Therefore, you must be ready to accept the risk that the stock will decrease in value. But many equity traders already hold shares of the stock, and therefore, selling

calls on those stocks presents no additional risk at all and is used as a good way to generate income if the investor plans to hold the stock over the long term.

Drawback to Selling Covered Calls on Equities

The only drawback to selling

covered calls in equities is that it limits the upside potential on the stock itself. If you own the stock from \$95 and you sell a call at \$100, you are capping your potential capital gain on the stock at \$5 per share. However, to some investors this is perfectly acceptable. The question you must ask yourself in employing this technique is, "Is the premium I am collecting worth capping

my upside gain in the stock?" If so, then selling covered calls can be an excellent way to generate income on your current stock portfolio.

Selling Covered Calls in Futures

Selling covered calls in futures is a different animal than selling covered calls in

stocks. In fact, it is as different as buying 100 shares of a stock or buying a contract for a commodity. The difference is in leverage.

The Leverage Difference

If you buy 100 shares of stock at \$20 a share, you pay \$2,000 and own the stock. If you buy a contract on a commodity, you may put a \$2,000 margin deposit down

to control a contract for \$30,000 worth of that commodity. In the stock, small changes in price usually mean small gains or losses. In commodities, this is a different story.

If you bought the stock at \$60 and it fell to \$59, you would have a loss of \$100. If you bought a contract for crude oil at \$60 and it fell to \$59, you would be out

\$1,000. Of course, this works the other way, too, and profits from a correct futures guess in the market can be substantial.

If you want to sell covered calls in futures, it can work exactly the way it works in stocks. If you are already holding the underlying contract, there is no additional risk to selling the short call.

The problem is, with the way futures contracts work with leverage, most futures traders are not looking to hold the contract for the long term. If the futures price starts moving lower, chances are the trader will want to get out, or she will have a stop in place and get stopped out before the market takes too much of her capital. In other words, where the stock trader may be able simply to ride it

out and stay in for the long haul, the futures trader often cannot afford (or simply does not want) to do this.

This is, however, irrelevant for our purposes here. One of the reasons we sell options on futures is to avoid the pitfalls of trading futures contracts—which is a whole different ball game.

Needless to say, selling covered calls is recommended

for the equity traders reading this chapter. However, we don't consider it to provide as many benefits in the futures arena.

Key Points to Remember About Recommended Spreads

Short Option Strangle

Benefits

- Double premiums
- Reduced margin
(increased return on equity)
- Short call and short put partially offset adverse moves against either

Drawback

- Vulnerable to breakouts in either direction

Bull Put or Bear Call Spread

Benefits

- Peace of mind (limited risk)
- Staying power—durable

in adverse market conditions

- Lower margin requirement—higher ROI

Drawbacks

- Must stay in trade longer to realize profits
- Requires selling closer to the money strikes
- May not be viable in low liquidity markets

Covered Call Writing on Stocks

Benefit

- No additional risk to holder of underlying shares
- No additional margin requirement

Drawback

- Limits upside potential

in underlying shares

This chapter taught you three high-odds option spreads that can be both practical and effective if you use them correctly. However, we have purposely left one out. We have done this because we feel it deserves a chapter all its own. It is a spread with incredible versatility. Because of this, we have deemed it Our

Favorite Option Selling
Strategy of All Time. After
learning its merits in [Chapter](#)
[10](#), perhaps you will, too.

10



The Best Option-Selling Strategy Ever

The Ratio Credit
Spread

Some spreads are used

because they maximize dollar return. Others because they provide strong risk protection. Others still are used because they can perform in the most varied kinds of market conditions. Few do all of these things exceptionally well.

One does, however. It's called the ratio credit spread.

The ratio credit spread or simply the "ratio spread" has

become my bread-and-butter spread for all of the reasons mentioned above. In this chapter, you will learn why. You will also learn how you can use this strategy to build an option-selling portfolio that can generate small or large amounts of cash for you in most any market condition.

The ratio spread (or ratio credit spread) is a strategy we recommended to investors in

the first edition of this book. However, I was cool to it for some years, preferring to use other strategies that seemed more straightforward. Of course, I was not entirely pleased with the first Maserati I ever bought either. Until I learned how to drive it.

This is a relevant comparison because the ratio spread is the Maserati of

option credit spreads. It takes a little time to learn how to handle it. But once you do, you can blow your competition off the road. Please, have a seat behind the wheel.

What Is a Ratio Credit Spread?

A ratio credit spread typically

works this way.

1. **Select an option strike you wish to sell.** Use the same analysis you would use when selling naked.
2. **Sell a group of those options and collect the premium.** Typically this means two to five options.
3. **Take part of the**

premium you collect from the sale of the options and buy one closer to the money strike in the same contract month.

Therefore, if you were bearish gold, you could sell 3 April Gold 1500 calls and collect \$1,000 each for a \$3,000 total premium. You could then take \$1,500 of that premium and buy one April

Gold 1450 call. Thus, your net credit collected would be \$1,500 (\$3,000 – \$1,500). Your trade would look like this:

Ratio Credit Spread

**Sell 3 April Gold 1500
Call Options for
\$1,000 each (total
of \$3,000 premium
collected)**

Buy 1 April Gold 1450

call for \$1,500

Net Credit to you:

**$(\$3,000 - \$1,500) =$
\$1500**

Your ratio of options sold versus options bought is three to one. And you collected a credit. Therefore it is called the ratio credit spread.

As you read, you can sell two to five options for every one purchased. However I have found the three to one

ratio offers the best balance between potential for profit and risk protection.

Why would you want to sell options this way? For that answer, let's explore how this spread works.

How Does a Ratio Credit Spread Work?

A ratio credit spread can offer you the best of both worlds as far as profit maximization and risk protection. For the purpose of this example, we will use calls. However, ratio spreads can just as easily be deployed for bullish traders wishing to sell puts.

In short, you sell three calls for the premium, buy one for protection. In the case of selling calls, if the market

moves higher (against the position), the long, closer-to-the-money call is increasing in value almost as fast as the three short calls. Thus, you can stay in the trade and ride out a sustained move against your position. Yet, even if everything expires worthless, you still keep your premium credit. Oftentimes in ratio spreads, you might not have to get out of the position until your short calls are actually

going in the money. That is one big reason you do ratio spreads.

Think about that for a moment. Unlike in naked calls, where if the option doubles, you are considering bailing, the profit on the long call allows you to remain in the ratio spread for much, much longer. This gives the short options more time to move back in your favor or

simply stabilize, allowing them to expire worthless anyway. While it can still happen, you've got to be *really* wrong about the market to lose on a ratio.

However, the ratio spread also has one hidden benefit that can end up paying you much more. To learn about all of these advantages, it will be best to demonstrate with an example.

Example: John Sells a Ratio Credit Spread

In February 2014, Trader John is bearish on the soybean market. He wants to fade the recent price rally. With May soybeans currently trading at \$14.00 per bushel with option volatility high, John sees that out-of-the-money calls are offering great

premiums. John is bearish on soybeans. He feels confident they cannot reach the \$15.70 price level within the next 2½ months, especially with the Brazilian harvest coming in. However, because he feels that the market could still move partially higher in the short term, he decides to employ a ratio credit call spread.

John executes the

following trades:

- John sells three May \$15.70 Soybean calls for 17¢ (\$850) each for a total of \$2,550 total premium collected.
- He then takes part of that premium collected and buys one May Soybean \$15.00 call for 25¢ (\$1,250).

This trade is illustrated in

Figure 10.1.

FIGURE 10.1 Soybean Chart
Showing Strikes of Ratio
Spread

Diagram of John's ratio
spread in soybeans.



Ratio Credit Call Spread May Soybeans

Date of Trade:

February 10

Strategy:

Ratio Credit Spread (Calls)

Market:

May Soybeans (SK)

Trade:

Sell 3 May 15.70 calls for \$850 each Buy 1 May 15.00 put for \$1,250

Total Net Premium Collected:

$(\$2,550 \times 3) - \$1,250 = \$1,300$

Margin Requirement:

\$1,200

Expiration:

April 25

Synopsis:

If Soybean prices are ANYWHERE below 1500 at expiration, both options expire worthless. John keeps the \$1,300 net premium as profit. If soybean prices are above 15.00 but below 15.70 at expiration, John's profit could be substantially higher.

ROI if Successful:

$\$1,300 / \$1,200 = 108.3\%$

Maximum Time of Open Trade:

75 days

John collects a total of \$2,550 ($\850×3) in premiums and pays back \$1,250 of it to buy a closer-to-the-money call. Therefore, John nets a \$1,300 *credit*. The *ratio* of the spread is three to one; that is, he sold three options and bought one option.

What Does This Accomplish? Three Main

Things

1. Keeping true to our first rule of option spreads, *if everything expires worthless, John makes money* (the net credit collected). Thus, John is profitable as long as May soybeans are below 15.00 at expiration.
2. If John is wrong on his timing and soybeans

move higher but remain below 15.70 (strike price of his short calls), *John could actually end up making MORE money than if everything expired.* In this scenario, John's short calls would expire worthless, allowing him to keep the premiums, while his long call would expire in the money, meaning

he could sell it or exercise it for a profit.

3. The protective long call means *soybeans can move substantially against John's short calls and still allow him to remain in the position*. His short calls are, for the most part, “covered” up until a certain point.

The Four Possible Scenarios

If John enters this position, there are four things that can happen. Let's explore what happens to John's ratio spread in all four.

Scenario 1: Soybeans stay below \$1,500 for the life of the trade. In this most-likely scenario, all of the options, long and short, expire

worthless. As in any good credit spread, John would make money. In this case, the \$1,300 net credit he collected.

Scenario 2: Soybeans move higher, above \$15.00, pressuring the short calls, but eventually settle back below \$15.00

at expiration. In this scenario, John still keeps the \$1,300 net credit. The difference is, the spread moved against him in the short term. But it didn't matter to John. Why?

As the market moved higher, the three short 15.70

calls are increasing in value, thus working against John. Yet the 15.00 call is increasing as well, at least partially offsetting any temporary losses on the 15.70 calls. If the 15.00 call goes in the money, this rate of appreciation will increase. Thus, the

losses on John's short calls are being, to a large degree, offset by his single, closer-to-the-money, higher delta long call. John's trade has staying power to ride out mild to somewhat substantial adverse moves.

Scenario 3: Soybeans

move higher and stay. Options expire with Soybean prices above \$15.00 but below \$15.70. This is the least likely but most profitable situation. Did you ever watch *The Price Is Right* and, at the end, the guy ends up winning both showcases

because he was so close to the right price? That's what this scenario is. In this case, John gets to keep all of the premium he got from selling his \$15.70 calls plus whatever the \$15.00 long option is worth at expiration.

Highest possible profit in this

scenario? \$6,050.

The highest possible profit would be obtained with the options expiring with soybeans right at \$15.70. At that point, the \$15.00 call is 70¢ in the money and the short calls are expiring worthless. It looks

like this.

\$3,500 (value of 15.00 call at 70¢ in the money ($0.70 \times 5,000$ bushels of soybeans in 1 contract = \$3,500) + **\$2,550** (premium collected from sale of 3 15.70 calls) = **\$6,050**.

Obviously, if beans are below

\$15.70, the profit will be less.

Regardless, you will only “hit” on a ratio spread like this about 1 out of 10 times. However, when you do, it’s a nice little bonus to your option-selling portfolio.

One important note to make: You

**do NOT position in
a ratio spread with
the goal of making
money on your
long call.**

Remember, we
are option sellers.
Trying to make
money on a long
call is a losers'
game. You use a
ratio spread to be
able to stay in the

spread until your short calls expire worthless.

Collecting your net premium is what is most important.

Making money on the long call is simply a welcome bonus when it happens.

Scenario 4: Soybean prices rally and

continue rallying beyond the \$15.70 price level. In this scenario, assuming he does not exit the trade, John likely takes a loss on his ratio spread. While I promised to go easy on the math, calculating the loss on a ratio takes a little explanation. To understand

potential losses, you must first calculate your breakeven point.

Breakeven and Risk on the Ratio Spread

In our soybean example, profit on the 15.00 call increases gradually until it reaches the peak profit level

of 13.70. At this point, the short calls go in the money and begin to erode the profits on the long call. While the long call will continue to offset one of the short calls one for one, the other two short calls will begin to eat away at the \$3,500 profit accrued between 15.00 and 15.70. Therefore, profits begin to decline above 15.70 and keep declining until the futures price reaches what is

known as the breakeven point.

The breakeven point is where the losses on the short calls becomes equal to the profit on the long call (at expiration). After this point, John begins accruing losses.

In this example, the breakeven point is at \$16.05. Breakeven is calculated as the point at which the sum of the losses on the three short calls

equals the profit on the long call. This calculation is illustrated for John's trade below:

Calculating Breakeven on John's Soybean Ratio Spread

**Breakeven Point: \$16.05
per bushel**

Profit on the \$15.00 when
soybeans are at
6.05:

$(16.05 - 15.00) = \$1.05 \times$
5,000 bushel per
contract = **\\$5,250**

Loss on three \$15.70 calls
when soybeans are
at 6.05:

$(16.05 - 15.70) = \$0.35 \times$
5,000 bushel per
contract = $\$1,750 \times$
3 = **\\$5,250.**

Thus, at the \$16.05 price level, John's long call is covering one of the short

calls penny for penny. The other two are more or less naked, in the money short calls at that point. Therefore, in the rare and totally deliberate circumstance that you find yourself still fully positioned in the trade when the options reach your breakeven point, you should probably get out. (See Figure 10.2.)

FIGURE 10.2 Soybean Chart

Showing Breakeven Levels and Profit Zones of Ratio Spread

John's ratio spread has a
breakeven point of 16.05.

Breakeven 16.05

Loss ↑

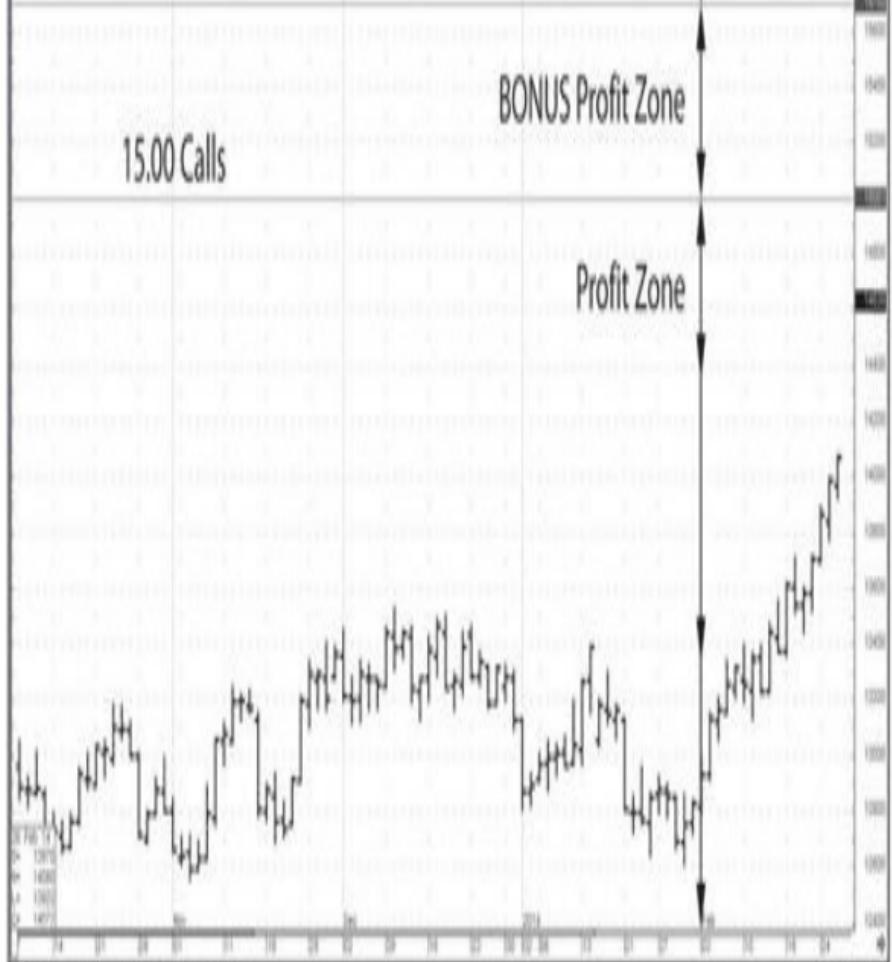
15.70 Calls

Profit Zone ↑

15.00 Calls

BONUS Profit Zone ↑

Profit Zone ↑



Although these examples and illustrations are accurate, they make one major assumption that can be at least marginally unlikely in a ratio spread. That assumption is that you remain in all of your positions through expiration. You might. But to assume you will do this on every trade would leave out one of the most important advantages of the ratio

spread. This is the advantage that over time and many trials, convinced me that ratio spreads were option seller gold.

Hidden Advantage to Ratio Spreading: The Ability to Adjust the Trade to Cut Risk or Increase Profits

To quote an unnamed wise man, *The best-laid plans go out the window once the battle begins.*

If you've done any amount of trading at all in any market, you know this to be true. Thus, it helps to have a strategy that can be adjusted on the fly.

In any other option-selling strategy we've described here, adjusting

typically means closing out a position and establishing a new one.

With the ratio spread, you can adjust it simply by shaving off part of the position. You can adjust to cut your risk or to increase profit.

Adjusting to Reduce Risk

For example, if we go back to our soybean example, suppose the market was rallying. John is becoming a bit concerned about his spread, but he is not ready to exit it completely. He could simply shed one of his short calls (buy it back), effectively turning his ratio spread into a 1×2 . We're not going to recalculate all of the math here. However, adjusting the trade in this manner cuts his

risk on the short calls and allows him to profit more on his long call if the market remains strong. Regardless, he keeps his core position.

Adjusting to Increase Profit

Or, suppose John's market analysis is correct and soybean prices begin to

plummet. John could at that point elect to sell his protective call, getting back some of the premium he paid for it. He would then simply hold his remaining short calls naked. This would mean a higher profit on the trade as he would keep all of his short call premium at expiration while getting some of his long premium returned (rather than losing it all at expiration).

This can be a great approach as once options reach a certain “point of no return,” getting them to gain in value is extremely difficult. When you notice two- or three-day rallies in markets and the calls are not increasing at all, or are in fact, declining in value on the rally, you know that time decay has taken over. That can be a great time to sell your protection.

As we will see later, it is likely you will be able to exit many of your short option trades prior to expiration at much or most of your potential profit. The ratio is no exception to this.

There are about a dozen different ways to use this advantage in the ratio spread. Using it can give you an edge —even over other option sellers.

Now that we've covered a full example, let's summarize the advantages and drawbacks of ratio spreads.

Summary of the Advantages of Selling the Ratio Credit Spread

The ratio credit spread meets every one of our criteria for a

good option-selling spread—
with several bonus
advantages. All are listed
below.

1. Pays the trader if all options expire worthless.
2. The profit zone is wide. There are many ways to make money; one way to lose.
3. It does not require the trader to pick where

or when the market is going to move to be profitable.

4. It can offer a significant *potential profit above and beyond the premium collected.*
5. It can withstand a fair amount of punishment from adverse market movement, giving it

substantial staying power in the market.

6. It can be adjusted and optimized as the market moves, allowing the trader to keep his core position yet adapt it to unexpected situations.

Drawbacks to Ratio Spreading

No strategy is without drawbacks. The ratio credit spread is no exception. Below are the drawbacks of employing a ratio.

- 1. It can be difficult to calculate mid-trade profit zones and breakeven points.**

Calculating values at expiration is easy.

Calculating what the values of the options

might do during the trade is more difficult. Thus, it is possible for the trade to show a paper loss at some points during the life of it, even though the breakeven has not been reached. This can be especially true if the market becomes volatile. As volatility increases, the value of the short

calls can begin to outpace the rate of gain of the single long call. Thus, in some circumstances, it may be necessary to close out, or at least adjust the trade, well before breakeven has been tested.

2. It can be cumbersome to position at the

desired premiums on both sides. Ratio spreads work best in high-volume markets with a fair amount of volatility. Quiet or lightly traded option markets—not so much.

3. **Ratio spreads share the same basic drawbacks of selling naked,** theoretically

unlimited risk (past a certain point) and potential for margin increases in adverse market conditions.

4. It **employs at least three, and as many as five or six, options in each spread**, potentially increasing the transaction cost of entering the trade.

However, this must be balanced against potential benefit.

Conclusion

Although any option spread will have its drawbacks, the ratio spread has proven, at least to me, that its advantages far outweigh its shortfalls. I've worked with and for high-net-worth

investors from six different continents. I can tell you that with a little coaching, the vast majority of them have come to prefer this strategy as the road to smooth, low-stress time decay. No, it's not perfect. Yes, you can still lose money with it.

However, a properly executed ratio spread cannot only increase your potential *for profit*, it can also increase

your outright potential profit. More importantly, it provides a valuable level of risk protection that can keep you in the market long after your naked option-selling competition has exited.

If you lose on a ratio spread, your market analysis must have been pretty far off. But when you do lose, it is often at a slower rate and more under your control.

These advantages are what earn the ratio credit spread its deserved title: The Maserati of Option Credit Spreads.

11



Option-Selling Mechanics

Quick Tips on
Liquidity, Timing,
Order Placement,
Assignment, Limit
Moves, and More

Liquidity

The subject of option liquidity is one that produces varying opinions on what is right and what is wrong; what is safe and what is risky. Given the choice, any investor would prefer high liquidity. But one of your advantages as an individual investor is that there will be option premium for you to

sell that may not be practical for a large institutional investor to trade. Whereas the large fund manager may need to trade several hundred or even thousands of options at a single strike price and therefore need very high liquidity, you may only need a few hundred contracts of open interest to sell enough options to satisfy your desired position. This may give you access to options that may

have better odds of expiring worthless (i.e., further out of the money strikes) than would be available to the institutional trader.

We've seen many investors trade for years in options with as few as 500 to 700 contracts and have rarely seen a trader run into problems with exiting a position due to liquidity. It may take a bit longer to get a

fill, and one may need to be a bit more flexible on pricing (on entering or exiting the position), but we cannot remember a time when the floor broker said, “We have no buyers at any price.”

Obviously, we would suggest looking for options with higher liquidity. But do not pass up what you believe is an excellent option trade simply because the option has

only a few hundred contracts outstanding. We would draw the line and say that most investors probably should not trade options at strikes with less than 500 contracts outstanding. The optimal open interest to look for is option contracts with 1,000 or more contracts open interest. Obviously, the more contracts you intend to sell, the higher open interest you should seek. You also will want to

consider the open interest in the surrounding strikes. If all the options tend to be in the same range of open interest, then your strike is probably okay. If your strike has 500 contracts open interest and the next higher strike has 5,000 contracts open interest, there could be a reason. It is probably best to go with the higher volume strike in this case (see Figure 11.1).

FIGURE 11.1 Gold Option Prices Showing Open Interest
It can pay to check open interest in the options you wish to sell.

GC	JAN.9 CALLS	JAN.9 PUTS	FEB.9 CALLS	FEB.9 PUTS	APR.9 CALLS	APR.9 PUTS
UndPr	7353*	7353*	7353*	7353*	7350	7350
DTE	38	38	70	70	128	128
EXP	12/26/08	12/26/08	01/27/09	01/27/09	03/26/09	03/26/09
VOL	39.91	41.72	40.90	42.24	38.72	38.78
IVS	0.00	0.00	0.00	0.00	0.00	0.00
IR	2.08	2.08	2.02	2.02	1.99	1.99
700	5670/-	12	2320/-	90	6980/-	2
710	5080/-	0	2730/-	0	6450/-	62
720	4530/-	4	3170/-	202	5940/-	78
725	4270/-	24	3410/-	4	5700/-	4
730	4020/-	7	3660/-	2	5470/-	144
735	3780/-	1	3920/-	101	5240/-	83
740	3570/-	447	4210/-	401	5030/-	405
745					5670/-	10113
750	3170/-	973	4810/-	32	4640/-	1954
760	2810/-	310	5440/-	200	4270/-	589
765					6900/-	520
770	2480/-	10	6120/-	0	3930/-	935
775	2330/-	7	6470/-	0	3770/-	561
780	2190/-	79	6820/-	75	3610/-	73
790	1930/-	0	7560/-	0	3320/-	402
795					8940/-	2310
800	1700/-	107	8330/-	0	3050/-	2533
805					9670/-	3027
810	1490/-	160	9120/-	0	2800/-	45
815					10420/-	415
820	1310/-	20	9940/-	0	2690/-	20
825					10800/-	0
830					4010/-	10
840					3890/-	236
845					11190/-	454
					3650/-	530
					3370/-	0
					3420/-	145
					3320/-	34
					13190/-	34
					14250/-	23
						11

Timing

In trading futures, stocks, or any number of other types of vehicles, timing of the entry is an essential element of a successful trade. In selling options, it becomes somewhat less important. One of the reasons that you sell options in the first place is to avoid the “where do I get in?”

dilemma. Therefore, the timing of your trade is not as important as your conviction about the long-term fundamentals. The flexibility of selling distant options can make up for a lot of oversights or outright mistakes in timing. Timing becomes even less important when it comes to spread trading because the spread or total credit received often can remain the same, even though

the value of individual options may be fluctuating.

Nonetheless, although not as important as in futures trading, the right timing can be the difference between collecting a large premium or a small premium on your option sale and therefore must be something to consider when placing a trade. Because this is not a book on technical trading, we

are not going to delve into all the technical indicators and chart patterns that may or may not help you to predict a market rally, correction, or reversal. Suffice to say that technical indicators can be used in the timing of your trades to optimize premiums on entry and possibly exits.

There are two schools of thought regarding momentum and the entry into a short

option trade. For purposes of this example, we will use selling calls to illustrate these two approaches. However, the methods can be reversed just as easily and used for selling puts.

Even though these methods may seem obvious, deciding which method to subscribe to will help you save time and make decision making easier for you.

Method 1 (more aggressive). Sell the call when the market is moving higher. Traders in this school of thought sell their calls when the market is moving against the calls, thus driving their values higher and producing more premium for the

sellers.

Method 2 (more conservative). Sell the calls when the market is moving lower. When the price of the underlying contract is moving away from your strike, the premium for the option should be falling. However,

the market's momentum is already carrying it in the direction that you, the call seller, want it to move. This can mean a lower premium for you but also can give your option a "head start" on deterioration.

In the end, whichever

method is used generally comes down to personal style.

Option Orders Placement

Once you have determined that your option has enough open interest for your intended purposes and have decided that the timing is

right to sell the premium, it is time to place your order. Several types of orders can be entered when selling options, but for our purposes here, we will review the two most common:

Market order. A market order is an order to sell your option(s) at whatever price the market is currently willing to

pay for them.

Limit order. With a limit order, you specify the price at which you are willing to sell your option(s). It is then up to the market to determine whether it wants to pay your price or not.

We strongly advise against placing market

orders when selling option premium. You will want to place *limit orders* when selling your options. This ensures that if filled, you will get your desired premium for the option that you are selling. Do not be too eager to enter the trade. Pick the price you want to get for the option, place the order, and let the market come to you. The order always can be adjusted. A market order in

an option is simply inviting huge slippage and a poor fill for yourself.

How to Price Your Option

There are two prices you'll want to look at before placing your order: the bid and the ask. At the risk of becoming too elementary, the bid and

the ask are defined below.

Bid. What the highest-priced buyer is currently willing to pay to buy the option.

Ask. What the lowest-priced seller is currently willing to pay to sell the option.

When these two come

together, an option trade takes place.

In slowly trading options, the bid and ask will have to be considered before placing your order. If there is a bid that has been sitting all day at 6¢ and an ask that has been sitting all day at 8¢ cents, you may start with an ask such as $7\frac{1}{2}$ ¢ cents and work down if you are willing to accept these prices.

In an actively traded option, generally the last price traded is as good a place as any to price your limit order if your objective is simply to get a fill. You can always adjust it slightly lower if your order is not getting filled. However, if you want to enter an order at a higher asking price, you always can do so and wait to see if the market moves enough to push the option value higher and

bring a buyer at your price. Some traders favor the approach of placing “wish” orders at the beginning of the trading day at premiums well above the current listed price. Occasionally (as a result of market movement or a desperate buyer), these get filled.

Working a limit order can be time-consuming if you are determined to get a fill. A

good option broker can be very helpful in this regard. If you have a good relationship with your broker, you can give her “limited discretion” to fill your order in your best interest. This can give the broker the leeway to work your order and make necessary changes in the order without contacting you every five minutes. Of course, you should only give this type of freedom to a

broker in whom you have established a great degree of trust.

The other alternative, of course, is to set your price and wait for the market to come to you. This can be an excellent strategy. The only risk is that the market moves away without filling you first, resulting in you not selling the strike price that you wanted.

No Lock Limit in Options

One fear that many futures traders have is getting caught in an adverse limit move. In other words, the trader is long in the futures, and the market “locks” limit down. This means that there are far more sellers than buyers—so many, in fact, that the market has moved its exchange set limit

for the day and is locked at that price for the day. If there are no willing buyers at that price level, the market will remain at that price until the following morning. In very volatile market conditions, the market can *lock limit down* or *lock limit up* for several days in a row because all the orders are on one side of the market.

As a futures trader, if you

are on the right side of a lock-limit move, it can be a windfall of profits. If you are caught on the wrong side, quite the opposite could be true.

To put it bluntly, if you're caught on the wrong side of the market, and the market is locked limit, this means that prices are moving rapidly against you and you cannot get out. Your losses are

multiplying daily, and there is nothing you can do about it.

To the fear mongers of “unlimited risk” in option selling, the following fact may be of interest: Options do not lock limit. Options do not have a daily limit move. Therefore, you can almost always get out. Granted, it may not be at a price that you like, but you can get out. This fact alone can provide peace

of mind for traders who fear getting “stuck” in a position.

Futures traders often look at option values when the futures contracts are locked limit up or down. It is thought that the option values will reflect the “true” value of the market.

It generally will take a major fundamental development to cause the market to lock limit up or

down, especially for several days in a row. A good example is the cattle market in December 2003 when the first-ever case of mad cow disease (BSE) was discovered in the United States.

The Worst-Case Scenario

New investors often ask us,

“What is the worst-case scenario we could face?” Our answer is that an asteroid could hit the earth and we are all vaporized in a millisecond. Really. What is the worst-case scenario when you fly on an airplane? The stock market? The economy? I cannot predict what a worst-case scenario would be. Another 9/11? The financial crisis of 2008? Who knows. I do know that you build

safeguard after safeguard into your portfolio so that if the worst case ever happens (which hopefully it never will) you have options (so to speak).

The story I am about to share with you is so old it has mold on it. But it happened to me. At the time, it was a worst-case scenario. And many of the risk-management safeguards you read about in

this book were forged in fire on the day this story took place. It was my worst-case scenario.

Our Worst Case

On December 22, 2003, the U.S. Department of Agriculture (USDA) announced that a cow in the state of Washington had tested positive for BSE. This

was as shocking as it was unprecedented.

This was especially true for me as we had naked short put positions in the cattle market. The memory of hearing the news will be etched in my brain forever. It was about 7 p.m. I was wrapping Christmas presents, sipping on a glass of Merlot, and had CNN turned on low in the background. I saw a

news anchor talking with a photo of a cow in the background. Then a video of a cow, stumbling and falling into a muddy pasture. Fortunately, the Merlot was not in my hand or it would have spilled all over the carpet.

The next morning, almost anybody long in the cattle market probably had the same basic thought: “Get out, get

out, GET OUT!"

Unfortunately, if you were long futures contracts, this would not be possible. The market was locked limit down the morning of December 23 and remained so through the Christmas holiday and into the following week. With everybody selling and nobody buying, the long futures traders were stuck in their

positions with nothing to do but watch the market open limit down for several days straight and wait until it started trading again at a much lower price (see [Figure 11.2](#)).

FIGURE 11.2 February 2004
Live Cattle Price Chart
Cattle prices react to the BSE (“mad cow”) announcement
in late 2003.

LCG04 - Live Cattle-Day Pit, Feb 04, Daily

9214

9250

9000

8750

8500

8250

8150

8000

7750

7500

7250

2004 01 15 22 01 06 13 20 27 Nov 03 10 17 24 01 08 15 22 29 02 12 20 26 Feb 02 09 17 23



We were short some puts and I knew we could get out if we really wanted to. But we had some room to maneuver. And instinct told me it might not be best to jump out on the first day down. Why?

Often in the case of jolting market news, the market not only will price in a worst-case scenario but also will likely overreact. Although the limit move in

cattle futures prices was 150 points (1.5¢) at the time, the options were already pricing in a move of 18¢ lower. The options had already priced a worst-case scenario. Thus, we figured the situation could only improve! Put option values reached their peak the first two days after the move as traders clamored to either cover short put positions or tried to hedge long futures positions by buying puts.

Exiting long positions was the only objective of many speculators. Although this may not have been the best course of action at the time, it was indeed possible for option traders. The same cannot be said for futures traders.

By the beginning of the following week, cooler heads began to prevail. Market limits on futures were

expanded to allow the market to start trading again. And while the futures market price was still moving lower, a very peculiar thing began to happen to the put option values. They began to decrease! Nobody really knew how much a single case of BSE would affect beef demand or prices in the long term. However, in the first few days after the announcement, all that

anybody wanted to do was exit longs, whatever way they could. The option values priced in the overreaction.

This is another testament to selling far-out-of-the money options. Although volatility had driven the option values and margins to a much higher level, losses for a cattle trader would have been much less if he was short puts rather than long

futures. The size of his losses would have depended on how far out of the money he had sold puts. The further out of the money he had sold premium, the less his losses were likely to be. Only about one-quarter of our puts ever went in the money. This bought us precious time.

By Monday, when the trade began to look at things in perspective, the option

values began pricing the futures market somewhat higher. Option traders who waited out the market's initial reaction would have been wise to wait until this point to exit. They still would have taken losses, but they would have been less severe than they were the previous week, and positions could have been closed out in an orderly, rational fashion rather than in panic.

We eventually did close all of our short puts. However, it ended up being simply a losing trade rather than the fiasco it could have been.

We use this example because it taught me some extremely valuable lessons about structuring and protecting an option-selling portfolio. The points illustrated below are ones you

can internalize now—without having to experience a “mad cow” experience of your own.

1. Options do not *lock limit* up or down, and you almost always can get out if you want out, as long as you are willing to accept the price the market is offering. Yet, in moves made based on big, breaking news where

panic buying or selling is evident solely from the news story, it is often better to wait until the dust settles after the market's initial surge to exit short option positions. The futures market may lock limit up or down, but **the option market often will price in a worst-case scenario in the first day or two**

after such a news event, only to back off once rational thought returns to the market. This means that out-of-the-money option volatility and therefore premiums can be at their highest in the first few days after such an event. If your short options already have priced a worst-case scenario, the situation

therefore can only get better, right? Losses often can be pared by waiting a few days after such a news event to exit. (Consequently, the days immediately following such an event can also be a great time to enter new short option positions.)

2. It illustrates the differences between

futures trading risk and option selling risk. Put sellers as a whole would have fared substantially better than futures traders in this type of move. This would have been especially true for traders following our recommended approach of selling deep out-of-the-money strikes. Futures traders would

have suffered the full brunt of the move, and they would have been locked in their positions until the market decided to let them out, probably at losses as high as 18 to 20¢ per contract.

Option traders, even ones who sold naked puts, could have exited at almost any time, most likely at a fraction

of the losses incurred by their futures-trading counterparts.

3. It illustrates the importance of **diversification**. If cattle puts were only a small part of your portfolio, this incident, although unpleasant, probably would only be a minor setback in your account.

4. It illustrates the importance of selling out-of-the-money options. This is fairly self-evident. The further out of the money, the lower the likely loss is in such a move.
5. It's a great argument for using limited-risk credit spreads such as those covered in the

previous chapters.

Close the Door on the Boogeyman

This is the type of example that option-selling naysayers point to when they try to convince you that option selling is no good, dangerous, or other. That is the boogeyman they tell you

about.

However, as you have read, if you were positioned far enough out of the money, had properly diversified, deployed a proper risk-management technique, and kept your head, you could have exited your position calmly, absorbed the loss, and moved on. The impact may have been even less if you were in a partially covered or

spread position.

However, the most notable feature about this example is its rarity. A fundamental change in a market with this speed and magnitude could be a once-in-a-decade occurrence. We are not talking about something like the soybean market going through a weather rally. In that case, you know that you're in the

growing season, and you've probably seen the weekly weather reports growing increasingly hot and dry (or wet, cold, etc.). This example is a completely unexpected turn of events that could not have been predicted through any type of analysis (think 9/11). You may sell options for many years and never run into a case such as this. However, it is important to know because, again, this is

the type of example the unenlightened “experts” love to use to scare you away from selling options. You can replace that fear with knowledge.

You can never completely eliminate the risk of something like this taking place. But you can plan for it, be prepared for it, and if you’ve managed your portfolio properly, learn from

it and move on.

Option Assignment: When Your Option Expires in the Money

Another fear that many new option sellers may experience is the fear of getting assigned. We've heard the fear in many a new trader's voice at the mere utterance of the

ominous word *assignment*. To these potential option sellers, we have one word of advice: *relax*.

In almost every case, if you are selling options as we are suggesting in this book, you will not be assigned unless you want to be assigned. In fact, being assigned does not necessarily mean that you are even taking a loss. Although the idea of

assignment or having your option *executed* may sound frightening, it is really only the process of having your investment shifted from one vehicle to another.

Theoretically, options sold on American exchanges can be executed or assigned at any time during the life of the option. This process is initiated by the option buyer. However, in almost every

case, this is not beneficial to the option buyer unless the option is actually in the money and is at or near expiration. As we stated earlier, in most cases, if the buyer of the option wants to exit the position, it is more profitable simply to sell it back to the market.

In other words, *for all practical purposes, you do not need to worry about being*

assigned unless your option is expiring in the money. Therefore, if you don't want to be assigned, it is best to buy your option back before this situation occurs. If you are using any of the risk-management techniques described in this book, chances are that you will be out of your options long before you were even in a situation where your options might be exercised.

If you do happen to get assigned, it is no big deal. There is nothing that you have to do. It is all handled by your broker. Instead of holding a short option, you are now long or short a futures contract from your strike price. If you do not want to be in this position, you can simply close it out immediately. It will cost you an extra commission, but it is just as easy as buying or

selling an option. This is another area where a good broker can be extremely helpful.

Example: John Gets Assigned on Silver Calls

Trader John was short a March silver 22.00 call when the option expired on

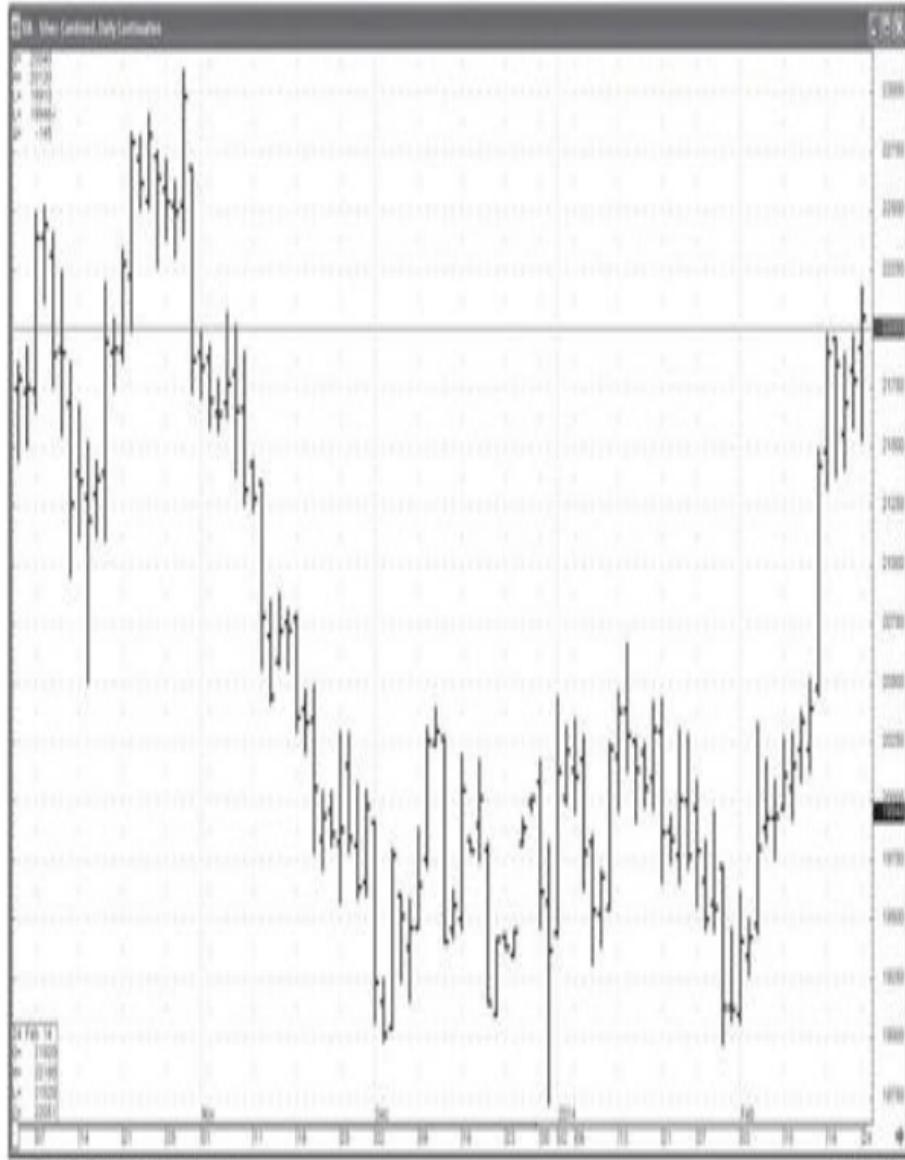
February 24 (see Figure 11.3). When the option expired, futures closed at 22.15, meaning John's option was 15¢ in the money. John's option was assigned the next day, meaning that John was now short one contract of March silver from 22.00. He could choose simply to hold the contract and play the futures market, or he could immediately close the position for a 15¢ loss.

However, the loss would be no greater than it would have been had he simply bought his option back with the March contract at the same price. (See [Figure 11.3](#).)

FIGURE 11.3 John Takes Assignment

John accepts assignment as March 22 silver call expires in the money. He can choose to hold the futures contract or simply close it out upon

assignment.



John gets assigned MAR Silver Call

Even if the option is assigned, John still gets to keep the original premium he collected from the sale of the option.

Most importantly, however, is to note that *John only took assignment because he wanted to take assignment*. If he did not, he could have closed his option out anytime prior to it going in the money.

Conclusion

The topics covered in this chapter are the areas where much of the misunderstanding and fear relating to option selling is contained. However, knowledge replaces fear. You now have an argument for outsiders and “half-knowers” who tell you that option selling is too risky. You know

something about the right orders to place when entering a position and what type of liquidity with which you may be comfortable. And although nobody wants a limit move against their position, you know the reasons why it is better to be short options on such a rare occasion than it is to be caught in the futures contract.

With this knowledge in

hand, it is now time to explore the most important subject in option selling—the subject of risk management.

12



Managing Your Option- Selling Risk

Defense Wins
Championships

In February 2014, the Denver

Broncos entered the Super Bowl with the most prolific offense in the NFL. Quarterback Peyton Manning was coming off of his best season ever, having set many NFL offensive records in passing and scoring. Fans and sportscasters alike waited to see what kind of offensive show the Broncos would put on in the Super Bowl. But it was not to be. Why?

Because Denver ran into arguably the NFL's best defense in the Seattle Seahawks. The Broncos were bogged down, stopped, and destroyed. The Seattle Seahawks became Super Bowl champs.

The fact that Seattle won came as little surprise to many old-school sports enthusiasts. There is an axiom in sports that has rung true

through the ages. Its truth runs the gamut from ice hockey to football: *Defense Wins Championships.*

More often than not, a team with a great defense is what gets it its Super Bowl trophy or Stanley Cup. And that axiom applies perfectly to investing. In regard to managing your option-selling portfolio, having a good “offense” is, of course,

important. However, it is the quality of your “defense” that will likely have the biggest impact on your overall performance. If you manage your downside risk properly, the profits take care of themselves. It’s that simple.

This chapter will share with you how to manage your risk in option selling—not how the “option enthusiasts” tell you to, but how it works

in the real world of serious investing.

If you just want to sell an option here and there, and have all the time in the world to watch and tinker with it, you can afford to get cute and “experiment” with different things. Then you can tell your friends all about it on Facebook. However, if you are investing hundreds of thousands, or several million

dollars into an option-selling campaign, a serious risk-management plan must be in place.

There are no fancy tricks here. Just a few simple, proven, and effective rules.

The Knock on Selling Options: The “Other” Twenty

Percent

The fact that 75% to 80% of all options held through expiration expire worthless always produces an initial question in the new option trader's mind: "What about the other 20%?"

The knock on option selling by outsiders or marginally experienced sellers, is that the "one big

loss” can come along and wipe out months of profits. This is true: It can happen. But the complaint typically comes from people who do not understand, or have never learned, how to manage their risk properly. You do not have to be in this group.

Having most of the options that you sell expire worthless is the easy part. What to do with the other

20% then becomes the whole ball game. Risk management in option selling is probably the most important aspect of your entire portfolio strategy.

Even though we have pointed out several times that the risks of option selling often are much fewer than most of the trading world makes them out to be, one cannot ignore the fact that option selling nonetheless

carries some inherent risks. Sizable chunks of accrued profits can be wiped out if a few losing trades are left to go astray.

The focus of this chapter, then, is not on picking winners but on how to manage the losers. “How do I manage my risk?” is almost always one of the primary questions a new or even experienced option seller

asks. Our hope is that after reading this chapter, you will be able to enter into an option-writing approach to your portfolio confident that you can handle or at least be familiar with appropriate strategies of risk management.

Risk Management Begins Before You

Enter a Position

We will begin with the old words of wisdom: “An ounce of prevention is worth a pound of cure.” Risk management of your portfolio begins not after you enter your position but *before* you enter any position. Risk management will be one of the primary factors you use to decide on an appropriate

strike price(s) at which to sell premium.

Risk-Management Prerequisite 1: Sell Far-Out-of-the- Money Options with Low Deltas

As you learned in [Chapter 7](#),
“How to Pick the Right

Option to Sell," many option sellers point out that options experience their greatest time decay in the last 30 days of their trading life. The logic goes that these would be the ideal options to sell because they will show the fastest deterioration and thus show a profit sooner. Even though this is true, generally it also means that in order to collect any worthwhile premium, the trader will have to sell very

close-to-the-money strike prices. Although this can potentially generate quick profits for the option seller, the problem is that even a brief market hiccup can put the option in the money, possibly producing quick and sizable losses.

Trying to sell short-term options puts you back in the game of picking short-term market direction, the *exact*

situation we are trying to avoid by selling options in the first place.

Trader Ted Learns the Hard Way

We had a new client recently who was very excited about starting his

option-selling portfolio. For the purpose of the story, we will call him Ted.

Based on long-term fundamental data and historical volatility, we recommended to Ted that he sell far-out-of-the-money coffee calls for his account. Ted liked the idea of the trade, but the fact that the options did not expire for almost four

months troubled him. It was not the fact that he didn't think the options would be profitable—he did. But four months seemed like an awful long time to wait, even though the trade would have approximately doubled his capital invested had the options expired worthless. Ted wanted *action*.

“If ya'll think the price

is going down, why don't we sell the 76 calls that expire next month?" he reasoned.

The calls we were recommending to Ted were more than 70¢ out of the money, and coffee was trading at about 70¢ per pound at the time. Coffee prices would have had to more than *double* for the options to go in the money.

Ted wanted to sell options that were only 6¢ out of the money that expired in less than 30 days. Whereas the options may have had close to the same deltas at the time, Ted's options stood a much higher chance of going in the money.

We tried to explain to Ted that although the fundamentals painted a relatively bearish picture

for at least the next six months, it did not mean that prices could not stage a temporary rally in the meantime and put his options in the money. The 140 calls we were recommending would remain well out of the money, even if the coffee market rallied 10 or 20¢.

Ted was unswayed. He made the mistake of

thinking that because the fundamentals were bearish, it meant that the market would go down, period. Unfortunately for Ted, that is not always how it works. Ted went ahead and sold the near-month 76 calls. Of course, the following week the market experienced a fund-led rally that saw it gain over 10¢ in just two weeks. Ted eventually bought back his positions

at more than three times the price at which he had sold them, losing about \$1,200 per option.

Sellers of the 140 calls barely felt a pinch. The market rally was short-lived, and the coffee market again settled back down into its previous trading range. The 140 calls expired worthless a few months later, doubling

the invested capital of the traders who had sold them at the time Ted sold his.

The moral of the story is not that selling close to the money is bad. Mathematicians who argue that options with matching deltas carry the same risk are wrong. Once an option goes in the money, its delta increases very quickly. Selling options close to the

money can work, but it is a much more aggressive strategy than selling further away with more time.

Deep Out of the Money: Lower Risk, Period

The first building block in your risk-control strategy should be to select far-out-of-the-money options with low deltas. In limiting yourself to

these types of options, you give yourself a wide margin of error for the market to make short-term fluctuations without affecting your position drastically. Even though these options can still lose money, you force the market to make a large-scale, sustained move (against your position) before your options will reach your risk parameters. In addition, because the deltas are much

lower, if the market is moving against you, the option values generally are moving against you much slower than they would be if they were in the money or close to being in the money. This gives you plenty of time to make decisions and, should it be necessary, to exit your position in an orderly fashion *on your terms* rather than being forced out or panicking and making a rushed,

emotional decision.

Risk-Management Prerequisite 2: Diversify Your Option-Selling Portfolio

Even though diversification often is heralded as a necessity in almost any type

of investment, nowhere is it more crucial than in option selling. By diversifying your option sales across different markets, you reduce your exposure in any given contract to a limited portion of your portfolio. Therefore, if a worst-case scenario does unfold, it should not have a large-scale impact on your account.

By diversifying, however,

we do not mean that you should diversify your futures option-selling portfolio over 25 different markets. Remember that option selection may start with identifying markets that offer very favorable fundamentals for selling puts or calls. Most markets will have mixed or cloudy fundamentals much of the time. Do not diversify for the sake of diversifying, but strive to find other markets

with clear fundamentals in which to expand your portfolio. Most of our option portfolios are diversified over four to six different futures sectors at any given time. Strive for that mix in yours.

Diversifying across many markets not only will increase your chances of having most of your options expire worthless, but it also will *decrease* your chances of

having losers take sizable chunks out of your account. By diversifying only into markets with fundamentals that you believe are favorable to your position, you can increase these odds further in your favor.

Risk-Management Prerequisite 3: Set Your Risk

Parameters When You Enter the Trade

This is a standard rule of futures trading regardless of whether you are selling options, trading spreads, or trading outright futures positions.

When I (Michael) was learning to scuba dive several years ago in the Florida Keys, one of the key safety points

constantly drilled into our heads was this: *Plan the dive; dive the plan.* In other words, before the diver ever jumps in the water, he has worked out a detailed plan as to what he wants to accomplish, how much time it will take, how much air he will need, and when he will be back to the boat.

The same type of plan should be implemented in

your option-selling portfolio. *Plan the trade; trade the plan.* When you sell an option, you should know *before* entering the position what your risk-management plan will be. What technique will you be using? When will it be enacted? What is your breakeven? What would be your loss on the trade if the technique were implemented properly? Improperly? Who will be putting your risk plan

into action—you, your broker, or somebody else?

Knowing this and having a plan in case the market throws you a curveball is the number 1 key to avoiding *emotional decision making*, which, as we know, is a primary enemy of a successful trader. Countless numbers of traders experience hefty losses that could have been cut to insignificant

amounts if a proper risk-management plan were followed.

“Let’s watch it for a day and see what it does” is not a risk-management plan.

What are these risk-management techniques? We will now explore them along with the benefits and drawbacks of each.

Risk-Management Techniques for Option Sellers

Many traders will call and ask us about a complex technique they read about that virtually ensures they “can’t lose” if they work it properly. This was no doubt learned in some option book or seminar given by somebody who makes his living by giving seminars, not

by trading.

“I sell a call, and if it goes in the money, I buy a futures contract, and if the futures moves against me, I buy a put and ...,” and they continue on and on discussing offsetting and then offsetting the offset.

Rather than delving into all these techniques and picking apart piece by piece what can happen to your account, let’s sum it up in two

short sentences: *Don't do this. It probably won't work.*

Not only will it probably not work, but you also probably will end up losing more money than you would have by just getting out. You will pay more fees, adding to your losses. You will spend more time trying to untangle and watch and counter and offset your growing position, all in an effort to get back

your growing loss. This is time spent that could be used to find new and profitable trades.

Trying to offset a losing short option position with futures contracts is like trying to get rid of the rats in your garage by releasing rattlesnakes. You may get rid of the rats, but then what?

If you start using futures as a risk-management tool for

your option selling, you're back in the game of trying to time the market and decide what it is going to do on a short-term basis. As we've indicated, if you are trying to trade short term, you could be leaving the fate of your funds in the hands of Lady Luck more than anything else.

Therefore, we strongly recommend the KISS (keep it simple, stupid) approach to

risk management in your option selling. Over the years, we have found that the simplest approaches are almost always the best approaches. The following are the three techniques that we have found to be most effective in our years of option selling. The following are the ones we've found to be the best.

Risk-Management

Technique 1: Spread the Market

Option spreads are not only a trading strategy but a risk-management technique. Selling naked options offers many advantages, but for the more risk-averse investor, a credit spread may provide a more comfortable fit. The spreads described in the

previous chapters are examples of how spreads can slow the market and reduce exposure.

For example, if you were bearish wheat and decided to sell calls above the market, you might choose to sell a 7.00 call and collect a premium of \$600. A naked seller would hold his position there. However, if you were a more conservative trader, you

may choose to turn this into a credit spread. You would take \$200 of the premium you collected from the sale of the 7.00 call and buy a 7.40 call. This effectively turns the trade into a bear call credit spread instead.

In other words, by buying the 7.40 call, you are purchasing built-in protection. Your net collected premium (or “credit”), is now

only \$400 (\$600 – \$200) and you have paid an extra commission. However, you now have limited risk on the trade.

If both calls expire worthless, you keep the premium you collected minus what you paid for the protection. If you are wrong, and the market and prices move higher, the long-call gains value almost as fast as

your short call, at least partially offsetting losses on your short call. In addition, this can keep you in a trade much longer without being squeezed out.

Protecting your short options in this way also has the added benefit of carrying lower margin requirements.

Credit spreads are not the perfect strategy for every occasion and will tend to

produce profits at a slower pace than selling naked premium. However, we consider it an excellent, albeit slightly sophisticated, risk-management strategy. A good option broker or portfolio manager can help you to make the right choice in selecting your “coverage” so that profits can be maximized (see **Table 12.1**).

TABLE 12.1 Buying Options to “Cover” Short Options

Benefits	Drawbacks
Limits risk	Give up a portion of collected premium
Moves slower in adverse conditions	Profits slower in favorable conditions
Lower margins	Slightly more complex to position

Risk-Management

Technique 2: Set an Exit Point Based on the Value of the Option Itself

This is the simplest and often best way to manage risk on a naked option or even a spread trade. To limit your risk, simply place an exit point on the value of the option (or spread) itself. It involves little

calculation, is easy to implement, and has the least number of variables as far as knowing what your anticipated loss would be. If you sell an option for 50 points, you exit the position if the option reaches 100 points (or 90 or 120—whatever your risk—tolerance is).

In our experience, we've found a good place to set this "stop loss" in many

circumstances is at double the premium received. Note: THIS IS NOT A HARD-AND-FAST RULE. It is a guideline for you. If you sold an option for \$400, exit the position if the option value reaches \$800. This amount seems to give the market plenty of room to move while at the same time holding losses to a manageable level if things do not go as planned.

We will refer to this as

the *200% rule*, but only because it sounds better than the *200% guideline*. It goes like this. If the option increases in value to 200% of the value for which you sold it, you exit the position. However, this level is not set in stone and can be adjusted depending on the individual market as long as this is done before the trade is entered. We do recommend the 200% rule to beginners not only for

its simplicity but also for its overall effectiveness.

Just Say NO to Stop-Loss Orders

Many traders assume this means placing a stop-loss order like they would if they had a futures or even a stock position. *We do not recommend actually placing a stop-loss order for your option.*

The reason is this: Let's say that you place a stop-loss order to buy your option back at 100 points. This means that if your option is bought or sold for 100 points at any time, your ticket is to be filled at the next available price. A single fill for that option at that price is enough to trigger your stop. If somebody places a market order, it could easily fill at your stop price, triggering your stop, even

though it may be a bit “out of line” with the rest of the market. (Surely, a floor trader would never do this deliberately!) Your stop order then becomes a *market order*, and in options, market orders can suffer tremendous slippage.

This can be especially true if you are not trading in the most liquid option markets. You end up with a

terrible fill, and somebody ends up selling your options back to you and getting a heck of a deal (surely not the floor trader who would never trigger your stop).

If a trader sold an option for 50 points and enters a stop-loss order at 100 points, there is nothing more frustrating than seeing the option trade at 75 to 80 points all day and then jump

suddenly up to 100 points, see the options fill at 105, only to settle back to 75 to 80 points for the day. For this reason, some traders like to add the variation that the option value actually must *settle* above the stop point at day's end before they will enter their exit order (for the following day's open). While we think that this can be a good technique, it does expose the trader to

potentially larger losses if the underlying is moving rapidly against the trader's position.

The Alternative to Stop-Loss Orders in Option Selling

Although it can open the door to second-guessing yourself, we advise using only *self-ordered stops* in implementing this technique for the reasons stated above. While, in using self-regulated

stops, it can be tempting to “hold” your order even as the option value exceeds your risk parameter, doing so is not advised. Plan the trade. Trade the plan. In the long term, it will save you much financial pain.

By *self-ordered stops*, we mean actually writing it down or entering an alarm on your computer. Attaching an outside stimuli to it makes it

more real, and thus, more likely to be obeyed.

Our systems have “self-stops” programmed right into our software systems. There are self-stops set on both the option values and on the underlying futures contracts. But no order goes to the exchange until we manually place them.

There is, of course, no guarantee that you will be

filled at your desired exit point, even when using a stop order. However, if you are trading far-out-of-the-money options, you should be able to close out the position within a few points of your desired exit level in most market conditions. A good broker can be very effective in helping you to exit at the right time.

The Mental Pain of Stopping

Youself Out

The drawback to this technique, of course, is that some or even many of the options that you exit eventually will expire worthless. This can cause a degree of “mental pain” to some traders and create a lot of “should haves” and “could haves.” But that’s a sucker’s game. Don’t second-guess your decision to take

manageable losses.

Granted, we have seen many well-capitalized investors choose to “ride it out,” especially if the option is still far out of the money when the premium hits their risk parameter. However, we also have seen account performance hurt by riding it out for too long.

Look at it this way: Our offices are on the western

coast of Florida. In Florida, we have our share of tropical storms and hurricanes. Every summer and early fall we have to keep one eye on the weather forecasts to see if there are any “areas of activity” in the Gulf of Mexico, Caribbean Sea, and Atlantic Ocean. Almost every summer there will be at least a few storms that threaten to come our way. The newscasts will issue warnings of the

storm. Having Tampa Bay in our backyards, we tend to listen to these newscasts. Often if a storm is approaching, the county will issue a *voluntary* or *mandatory* evacuation order. Many people do not like to evacuate (because of the time, trouble, and money involved) and commit themselves to “riding it out.” Most of these people have been very fortunate over the years

because our area has not experienced a major storm in a long time. However, what will happen to these people if and when the big storm finally does come? They and their families could experience severe trauma, injury, or worse.

If you are troubled by the fact that you exited an option and it eventually expired worthless, you should

consider the preceding example. You evacuated, and the storm missed your house. It cost you a small expense. This may happen many times to you. When the big storm comes someday, however, you will be long gone before it arrives (see **Table 12.2**).

TABLE 12.2 Premium-Based Exit Strategy

Benefits

Simple and easy to implement and understand

Effective in limiting losses

Probable loss can be estimated before entry

Drawbacks

Psychological temptation to override stop

Many of the exited options eventually will expire worthless

Fast-moving markets can cause option values to exceed stop level

(vulnerable to large adverse moves)

Risk-Management

Technique 3: Rolling Options

The concept of *rolling* options is not necessarily a risk-control technique in and of itself. It is more of an expansion on Technique 2. Rolling options can be done if the trader has stopped out of a short option sale using Technique 2 yet still feels that the fundamentals favor the

position and wants to be in the trade. In this circumstance, the trader closes out the short options at double premium (or whatever her risk parameter was) and “rolls up” to a higher strike price (or down to a lower strike price if she sold puts). In other words, the trader closes the original position (short calls) and sells more calls at a higher strike price.

This accomplishes three things. First, it removes the trader from options that have either increased in delta and/or have become closer to the money and puts her back in options that are far out of the money with lower deltas and have a much lower chance of going in the money. Second, it allows the trader to stay in a market that she feels eventually will be profitable. Third, from a

psychological standpoint, it allows the trader to avoid or at least reduce a loss in that particular market, even though in reality it is actually an entirely separate trade.

The concept of rolling options can be illustrated in the following example.

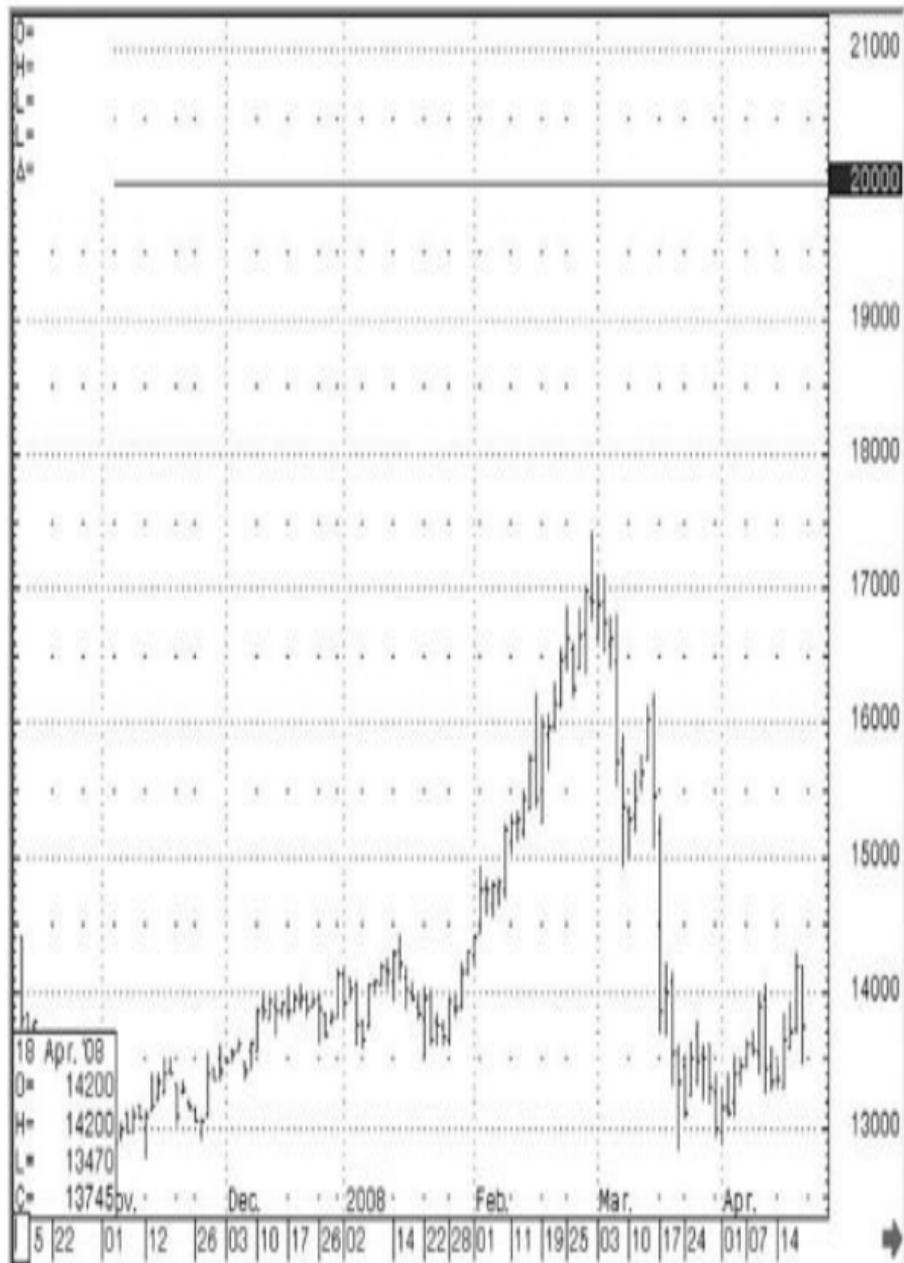
Example: Trader John Rolls His Option

In January, Trader John is

long-term bearish on the coffee market. Although John is not quite sure prices will go down right away, he feels relatively confident that coffee will not be trading at substantially higher prices later in the year. John decides to sell five July coffee 2.00 calls for 200 points (\$750) each (see [Figure 12.1](#)).

FIGURE 12.1 July Coffee Chart Showing \$2.00 Calls

John sells July coffee 2.00 calls.

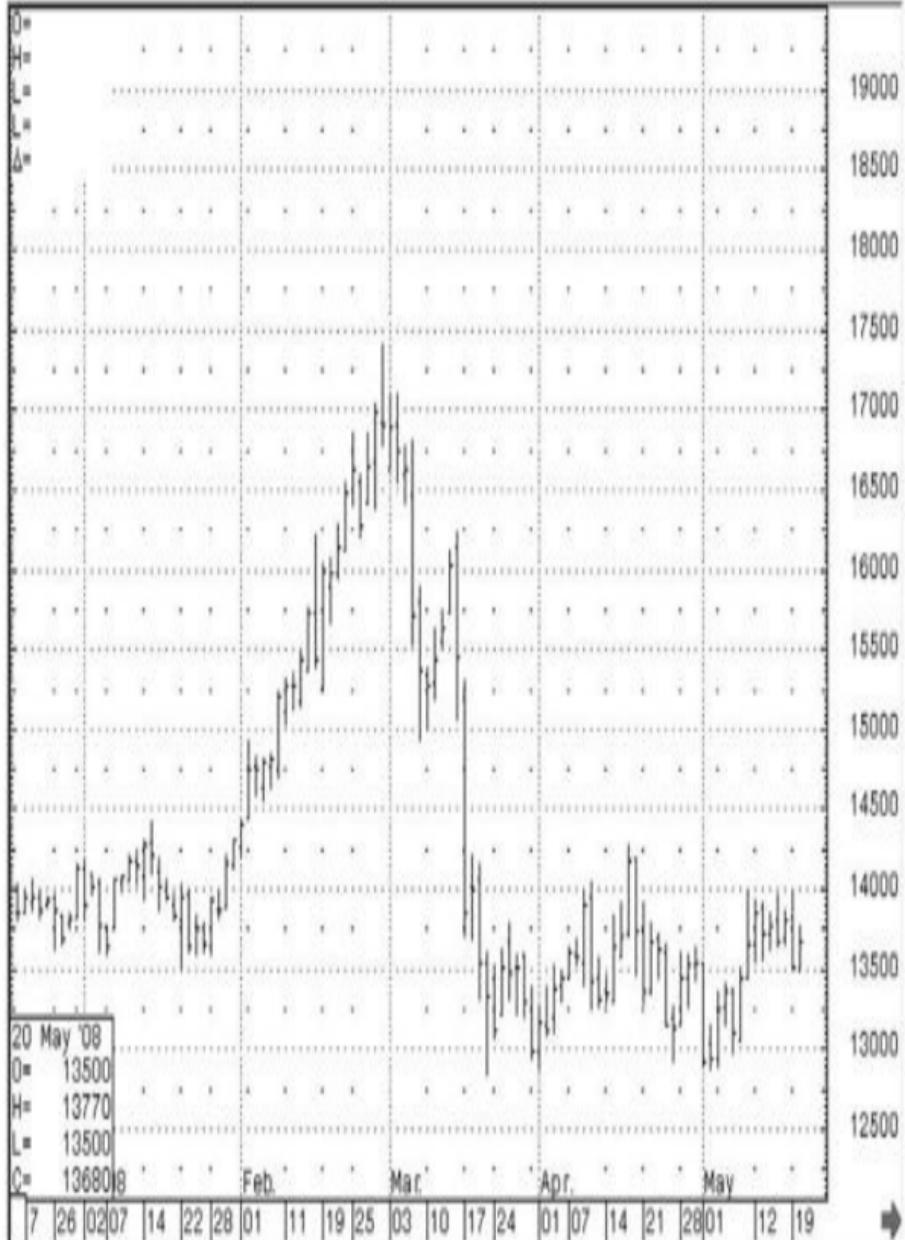


Over the course of the next 30 days, July coffee rallies more than 35¢ per pound because of supply problems out of Vietnam (perhaps John should have been paying closer attention to the fundamentals at work in the coffee market). Although this is a fairly large move for futures traders, it is of somewhat less significance to John because at its highs,

July coffee was trading at just over 1.70 per pound, a full 30¢ below his strike (see Figure 12.2).

FIGURE 12.2 July 2008 Coffee Chart Showing Thirty- Five Cent Rally

Thirty-five cents is a fairly large move for futures traders but not as significant to John.



Nonetheless, John's options increase in value from 200 points to 400 points during the course of the move. John had decided on risking the trade to double premium and therefore exits his position at 400 points—a \$3,750 loss ($5 \text{ calls} \times \750 loss on each call) plus transaction costs.

John, however, is convinced that the

fundamentals do not support coffee prices over \$2.00. He sees that the July coffee 2.60 calls are now trading for 200 points each, with much lower deltas than the 2.00 calls. John sells 11 of the 260 calls for 200 points each.

Why does John sell 11 calls? He sells five to collect the original premium he intended to keep as profit. He sells five more to recover the

loss he accrued in his 2.00 calls. And he sells one additional option to cover the transaction costs for rolling the position.

Therefore, if July coffee stays below 2.60 without the calls reaching John's risk parameter, John will erase his loss and make his originally intended profit on the \$2.00 calls. In John's mind, the loss "never happened" (see [Figure](#)

12.3).

FIGURE 12.3 July 2008
Coffee Chart Showing John
“Roll” His Options
John “rolls out” of 2.00 calls
and into 2.60 calls.

"Rolls in" to 260 calls

26015

24000

"Rolls out" off 220 calls

22027

20000

18000

16000

14000

10 Apr. '08

O= 13950

H= 14045

L= 13250

C= 13425

Nov.

Dec.

2008

Feb.

Mar.

Apr.

08 15 22 01 12 26 03 10 17 26 02 14 22 28 01 11 19 25 03 10 17 24 01 07



When Rolling Options Is Not the Best Choice

In this example, John indeed would have been successful. However, rolling options is not necessarily best for every trade in which you stop yourself out. If a market has moved against your position to the point at which you are forced out, there must be a reason for it. It is best to

know what it is before deciding to reposition in the same market. In addition, this is a time where you should be reexamining the original fundamentals that caused you to enter the trade initially. Does the long-term (two- to five-month) picture remain unchanged? If it remains the same and you still like the market and the position, this may be a candidate for rolling.

A good question to ask yourself is this: If I had never been in the position and now were looking at this market anew, is this a trade I would enter, or do I see better opportunities elsewhere? Do not make the mistake of simply rolling in order to “not take a loss” or for “revenge” on the market that took your money. John might make his money back in soybeans, silver, or crude oil. He

reentered the coffee trade because he thought it was the best opportunity for making a profit. This is the only reason you should do so as well.

Risks of Rolling

The major risk of rolling, of course, is that the market can continue to move against your new positions, potentially magnifying your losses to a painful degree. For

this reason, rolling options can be considered a more aggressive strategy for some traders.

There is no rule, however, that states that the position must be doubled up. If you are simply considering selling the higher-priced strikes as a completely new trade, any number of options can be sold.

Rolling as illustrated in

John's case generally is for the highly capitalized trader who is not intimidated by losses. These traders, of course, tend to perform better over time than less-capitalized ones. However, they are willing to assume larger short-term drawdowns as well.

In theory, if a trader has enough money, and if the market continues to move

against him, he simply can continue to roll his positions into higher strikes, doubling down each time. It is an option play on the futures trading technique of *scale trading*.

Eventually, the market is going to reach a point where it stops moving against the trader, and the last set of options that he sold will expire worthless, giving him

all his money back. However, this strategy can require hoards of capital and can result in substantial losses if you run out of money before the options expire. You win through a war of attrition. For this reason, it is not recommended for most individual investors.

For most investors, one roll will be enough. If you roll your positions and stop

out again, you probably have misread the market somewhere and are best moving onto a different trade (Table 12.3).

TABLE 12.3 Rolling Options

Benefits

Allows a trader to remain in a market in which she feels that her position is fundamentally sound

Allows a trader to recoup losses from her original position in which she was stopped out Psychological confidence gained from "being right"

Drawbacks

Can result in magnified losses if the trader has fundamentally "misdiagnosed" the market

Risk-Management

Technique 4: Basing Risk on Value of Underlying

The alternative approach to setting exit points based on the value of the option is to set exit points on the actual price of the underlying futures contract. This is considered to be a more aggressive approach to risk management by some. It can

mean notwithstanding large increases in the value of your option and/or margin requirements over the short term. It also can be slightly more difficult to gauge what your probable losses would be.

Exiting the position with little time left on the options may only result in nominal losses or none at all. Exiting the position with much time

left on the option could mean a larger loss. However, this technique can also increase the chances that your position ultimately will be profitable.

Let's first examine why an investor would want to consider such a strategy. The figure of 75% to 80% of all options expiring worthless would not take into account options that you sold and then had them double in value, at

which point you exited them. As discussed earlier, many of these would still expire worthless and therefore would have to be considered part of the large percentage just listed, yet for you they would have been losing trades.

Traders who can't stand the thought of exiting an option that they still feel eventually will expire may

want to consider this method. However, if this method is used regularly, chances are that eventually one could experience a more sizable loss. Nonetheless, it can be a very effective method of risk control, especially if it is used only in certain market situations, such as options with little time value remaining.

Two Ways to Use the

Underlying Market Method

There are two ways one can employ such a strategy. One is to hold the position unless a certain technical condition is violated (e.g., support, resistance broken, trend-line violated, etc.).

A second way to implement this method is to risk the option until it goes in the money. In other words, if you sell a call or a put at a

particular strike, risk the trade until the futures reach that price. This works better with options sold closer to the money. It can be used with options sold at distant strike prices and eventually should produce profits most of the time. However, in the event that the strike would be attained, losses could be substantial. Yet, with strikes sold relatively close to the money, it can be an excellent

method of risk control. Technical traders often prefer this method because options can be sold just beyond points of key support or resistance.

The following example illustrates this concept.

Example: Trader John Sells T-Bond Put Option

In July, Trader John is long-term fundamentally bullish on T-bonds. When he senses that

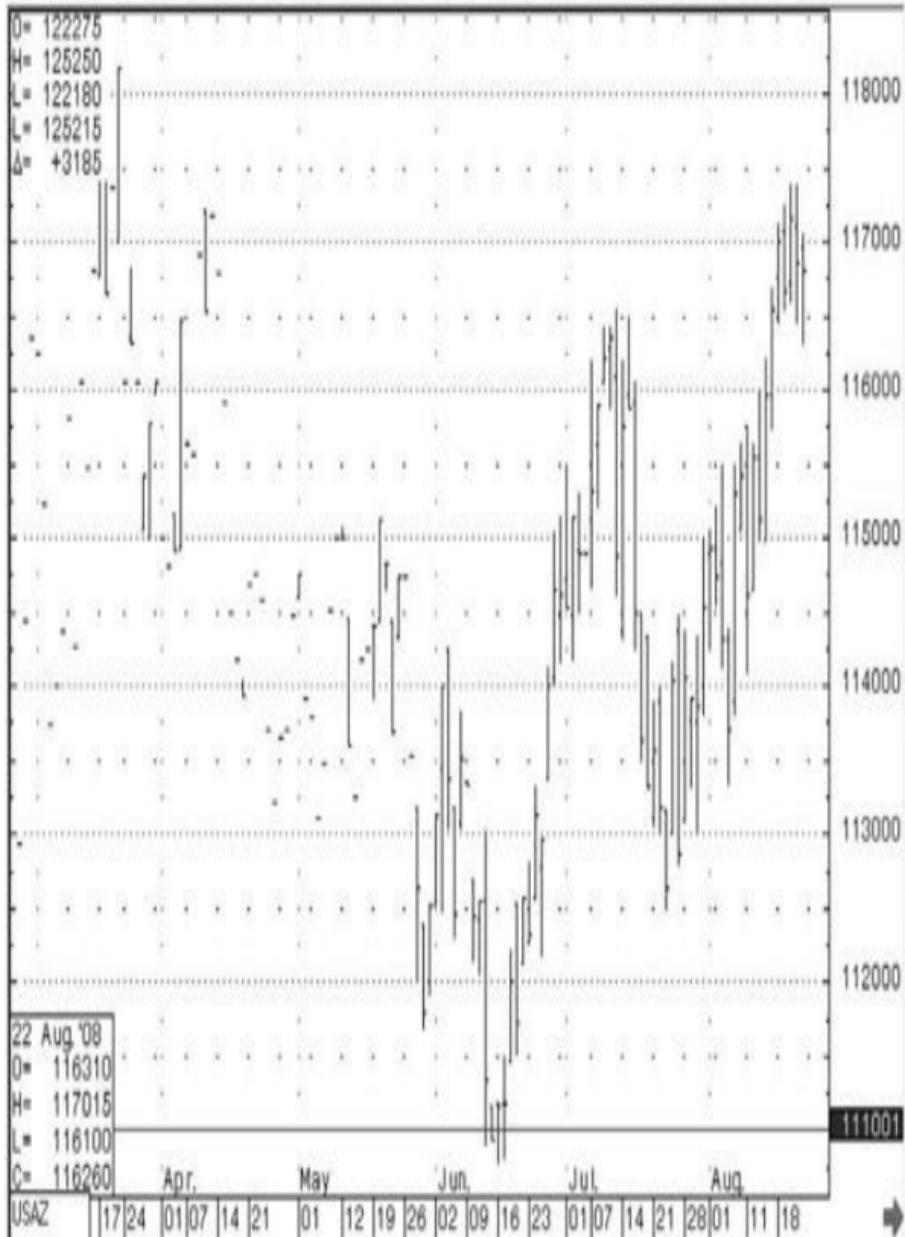
there may be an uptrend developing, he takes it as his cue to position in the trade. However, John is afraid of trading the T-bond futures because short-term moves easily could stop him out of his position. Instead, he elects to sell the December 111 put because he believes that prices will at least remain above that level through expiration in November.

John knows that a quick correction in the market could occur at any time that easily could cause his option to double or more in value without actually reaching the 111 price level. Therefore, John decides that he will stay in his options unless the 111 price level is violated. He accepts the fact that his options could increase substantially in value during the course of the trade. He

has backup capital available should this occur (see Figure 12.4).

FIGURE 12.4 December 2008 T-Bond Price Chart
Showing Risk to 111

John sells December 110 T-bond puts and risks a price move to 111.



John enters the trade with December T-bonds trading at near 115. T-bonds experience several small dips lower and back higher over the next few weeks, any of which may have stopped him out of a futures position. In late July, T-bonds experience a severe downturn, causing John's options to gain significantly in value. However, the price of T-bonds has not yet

reached his strike price. Instead of closing or rolling, John sticks it out, as per his original risk plan. He has confidence in his fundamental conviction and is not going to be swayed by short-term market swings.

Eventually, prices begin to ascend again and go on to prove John right. The option values come back to where they were, then begin to

decay, and ultimately expire worthless.

Traders with closing positions at 200% of premium were losers. John was a winner.

The Flip Side

What if, however, John had been wrong? What if prices had continued to fall all the way down to 111? John would then have bought his

options back at whatever price the market demanded at that time. While it is difficult to determine what the value of John's options may be in this situation without including several pages of hypothetical forecasting models, John most likely would have experienced a loss greater than the trader who exited at the 200% premium level—more if the market moved quickly and

reached his strike with much time left until expiration and less if it moved slowly and reached the strike with only a little time remaining.

Downside of Using Underlying as Your Risk Trigger

This strategy, although very effective in many situations, carries a higher degree of risk. Experience with

fundamental analysis of a particular market is really what determines if this is an appropriate approach for you. It is not recommended for the beginner (**Table 12.4**).

TABLE 12.4 Basing Risk on Value of Underlying Contract

Benefits	Drawback
Allows trader to profit from more trades than would a premium-based risk approach	Losses on the few trades that are losers could be substantial
Allows very wide range of market movement while permitting the trader to remain in the trade	

Risk-Management

Technique 5: The Buyback—Take Profits Early

Although this technique may not make you a lot of money, it certainly might save you plenty. In this book, we talk often about options expiring worthless at expiration. In truth, in a successful trade, you will not need to hold it that long. At least, you may

not want to. Options can be bought back at any time for the going market price. In most cases, if the option has decayed substantially in value, we recommend doing exactly that. As you know from past chapters, as an option moves ever closer to expiration, as long as it remains out of the money, time decay will continue to erode the value of the option. Often, especially if a market

has moved favorably, what will happen is the option value will decay down to a nominal value even with 30 to 60 or 90 days remaining until expiration. In this case, it can benefit the option seller to buy back the option, thereby closing the trade and taking the profit off the table.

Example: Jerry Takes Profit on Gas Call

For instance, let's assume that in June, an investor Jerry sold the November natural gas \$30.00 call for \$400 each. This strike was more than 100% out of the money as November natural gas was only trading near \$14.00 at the time. The strike had very little chance of going in the money even if the uptrend continued. But notice how quickly the value of the option decreased as the

market began to fall. (See Figure 12.5.)

FIGURE 12.5 November 2008 Natural Gas Futures*



By mid-July, the listed price of the option had declined all the way down to \$10 cash value—nearly worthless. Yet there remained nearly 90 days left until expiration on this option. Would this be a good buyback candidate?

Absolutely it would.

If this were your trade, you could buy the option back for a \$390 profit (\$400 –

$\$10 = \390). By doing this, you accomplish three things by harnessing the benefits of the early buyback:

- 1. You take over 97% of your potential profit from the trade and eliminate your exposure in the position.** At this point there is little to gain from this position ($\$10$) and everything to lose.

Chances are overwhelming that this option will expire worthless, but why take the risk for 90 more days if there is nothing to gain?

2. **You free up valuable margin.** Chances are this position does not have much of a margin requirement at this point, but it is probably

still pulling a few hundred dollars. By freeing this margin and eliminating the risk exposure, you can redeploy funds in other markets, or sell more natural gas calls as you now have no additional exposure there.

3. **You book a winning trade.** By taking profits early, you take the

trade off the books. It is one less trade you have to monitor, one less line you have to look at each week. You free your mind and capital to pursue other opportunities.

For the most part, we do recommend early buybacks when they are viable. Options decay at different speeds depending on the movement

in the underlying and time until expiration. Some may be bought back three months early, some may be bought back two weeks early, some you may have to hold through expiration.

In investor portfolios that we manage, buybacks are typically considered when the option premium has decayed down to 10% or below of its original sale price. If you

have made 90% or more of the potential profit on the trade, you may want to consider booking it. We call this the “10% rule.”

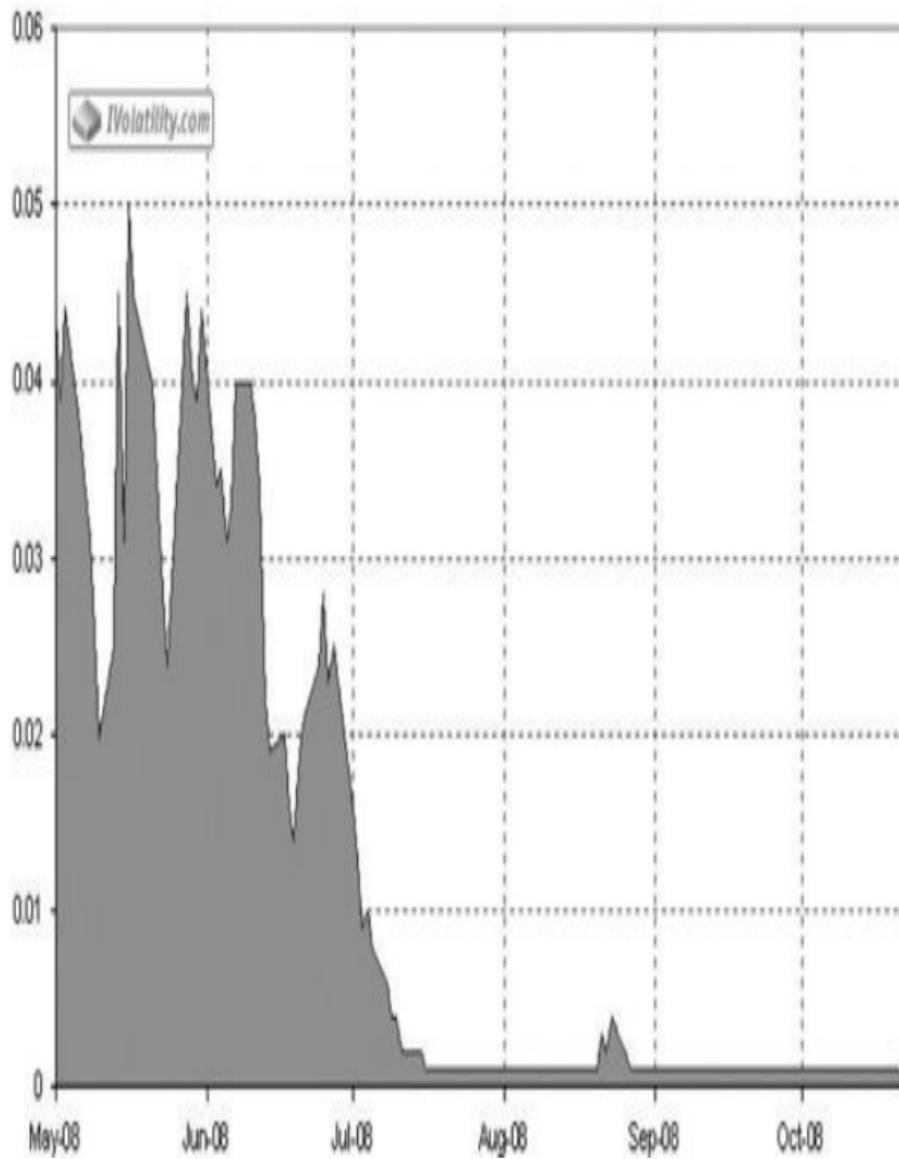
FIGURE 12.6 Daily Option Value of November Natural Gas 30.00 Call

This option price chart shows the daily value of the November natural gas 30.00 call. Notice that as natural gas prices were peaking (see

Figure 12.5), the option value was already beginning to decline, indicating a change in trend. As the futures price began to fall, the option price declined rapidly and, by mid-July, was nearly worthless.

(Option Value Chart courtesy of *Ivolatility.com*)

Natural Gas November '08 30 call settle



Additional Points on Risk Control

Time Your Entry to Help Manage Your Risk

If you are comfortable with the market and the strike price, using some traditional

technical indicators to help you time your entry (such as stochastics or simple moving averages) can be beneficial. If your research is good, chances are that you'll do just fine. Remember, this is option selling. You have a great deal of room to be wrong! However, a good risk-management plan will be in place to take care of those times when you are too wrong.

Although the technical ups and downs of a daily chart should not greatly concern a longer-term option trader, continue to watch longer-term weekly and monthly charts for possible trend changes and/or breakouts. If these correspond with your fundamental analysis, you could have a great opportunity to sell calls or puts for many months. If it is in contrast to your

fundamental analysis, you may want to reconsider your position or adjust your risk parameter.

Continue to Monitor Fundamentals During Your Trade

Not wanting to beat a dead horse, but once again, this all comes back to fundamental

knowledge of the markets in which you trade. Know the factors or scenarios that could occur to produce a price move to your strike (regardless of what risk method you are using). Analyze the chances of any of these things taking place. You can never account for everything, but you can account for what is currently known.

You should continue to track long-term fundamental developments over the course of your trade. Fundamentals are slow moving and do not have to be monitored every day, or even every week. However, just because these fundamentals tend to change slowly does not mean that they do not change. Most news items are not fundamental changes; they are simply what they are,

news items. However, keep an eye out for new themes starting to develop in your market.

Talk of a new type of beetle eating the leaves of the crop in which you are invested may be just a news item. Continued talk of it over the course of several weeks, along with talk of “crop damage” or potential “yield adjustments,” could be

another matter. Major macro-economic changes can also appear at different times and create either warning flags or opportunities for astute option sellers. If there is a fundamental change in the market in which you are positioned, and it seems to be affecting price, it can be a good idea to get out first and ask questions later. Just remember that generally it takes a major development to

change the long-term fundamentals of a commodity, and most news stories that you hear or read about the market are, at least as far as you are concerned, “noise.”

Experience is probably the only way to learn the difference.

Conclusion

In this chapter, you have learned both beginner and advanced techniques for managing your short option risk. However, I would recommend that unless you are a highly experienced seller of premium, you stick with simple buybacks based on premium as your primary means of managing risk (i.e., 200% rule for risk and 10% rule for profit taking). You can't go too far off the tracks

if you stick with these two.

If we could stress one point about risk control in option selling, however, it would be this: Your risk-control strategy begins when you are *looking for options to sell*. Your objective is not to pick winners. Your objective is to stay out of losers. Do this, and your winners and your profits will take care of themselves.

Remember, Defense wins Championships. Your Super Bowl ring should be your 1099 in January.

PART

III



MARKET ANALYSIS AND OPTION SELLING

13



Fundamentals

The Dirty Little Secret
About how Money
Really Gets Made in
Commodities

In this age of computer software, “high-frequency

trading,” smartphones, and smart tablets, you have a plethora of choices when it comes to computer geniuses who can “teach you how to trade.”

This software does 10,000 volatility calculations and tells you the exact best option to trade. This one analyzes 20,000 different chart patterns and tells you which market to buy. This course or

seminar will give you 150 different chart patterns to watch for. All you have to do is whip out your credit card and instant riches are yours for the taking.

We didn't know it was that easy.

We're going to share with you a "dirty little secret" about commodities. All those little patterns and indicators and volatility studies may be

interesting to watch and even have some merit in some instances. However, if you really want to know how a market will behave (or not behave), you have to be willing to do what these guys are not willing to do. You have to get in there and get your hands dirty. You have to learn the *fundamentals* of what is really moving your market.

In commodities, it's all about supply and demand. Ditch the book on Fibinacci numbers and pick up a book on Economics 101.

If there is an uptrend in the corn market, it's not the little imaginary trend line that is making it go up. It's because China is low on corn this quarter and needs more of it to feed all the new hogs and chickens they are raising.

It's that simple. Not easy, mind you, for there is plenty of "noise" in getting a proper read on a market. But at its core, simple. If you learn the things that really matter, you'll be better able to stay above the noise and see the big picture.

Knowing the big picture gives you a much clearer perspective on what prices are likely to do, or not do,

over the longer term. For option sellers, this is a crucial determination.

Learning a few things about supply and demand in a handful of core commodities can give you a tremendous advantage in these markets. Using these in conjunction with the strategy of option selling is a powerful combination of which most traders, let alone individual

investors, are unaware.

This is because, in commodities, markets can gyrate back and forth for a number of reasons over the short term. But over the intermediate to longer term, they will always obey their master, supply and demand. And this is the time frame that you are most concerned about as an option seller.

Recommended Reading

Jim Rogers, author of *Hot Commodities* and one of the most well-known commodities traders of our generation, made a name for himself by correctly calling the commodities bull market of the last

decade. He appears on CNBC regularly, although I have never been in the studio the same time as he has. I finally had the pleasure of meeting Jim at a South Florida conference a few years back.

His book is a “must have” for anyone who has never invested in commodities and I highly recommend it. Although

some of the examples are a bit dated (it was published in 2004), it is an easy-to-read primer for new commodities investors. Jim is all about the fundamentals, and if you read his book, you will see why.

Knowing how to apply fundamental knowledge to option selling can give you a

tremendous advantage over most people who are trading commodities, let alone selling options.

The Great Debate

The debate between fundamental and technical analysts has raged for decades. For novice readers, it may be important to clarify the difference before

proceeding any further.

Fundamentals, by definition, consist of the economic factors behind a commodity or financial instrument, such as supply and demand and the factors that affect, or could affect, supply and demand.

For example, the fundamentals of cotton would include the size of last year's crop, the amount of cotton left from that harvest that is still available for export or

domestic use, the pace of exports this year, the progress of the upcoming crop, and projected weather that could affect its growth. These are all fundamentals.

Technical analysis, on the other hand, is the study of charts, chart formations, and an array of technical indicators that affect volume, price momentum, strength of buying or selling, and so on.

Because technical trading is both quantifiable and easier to teach (e.g., buy when prices hit this line), it attracts both the mathematical and the statistical crowds along with novice traders.

Pure technicians believe that all the current fundamentals are always priced into a futures contract at any given time and therefore there is no use in

studying the fundamentals—
it's all in the price patterns.

This may be true to a certain extent. All the current fundamentals probably are already figured into price. What the pure technicians overlook is that studying fundamentals is not done to determine how they are affecting price *today*, but rather it is done to project how these factors will affect

price in the *future*.

Why Favor Fundamentals?

Our opinion is that both should play a role in trading decisions. However, for selling options in commodities, fundamentals should be given the lion's share of your attention.

Why, after 46 combined (between the two of us) years of trading commodities, of analyzing trend lines, of measuring stochastics against the MACD line, of looking at head and shoulder tops and bottoms—why in the world would we say this?

For two reasons.

- 1. Most small traders in commodities are trading technically—**

at least primarily technically. They have likely never learned how to track or properly use the fundamentals of the commodity they are trading. This is because they think they are too difficult, unimportant, or both.

“Everybody knows” how to trade

technically. The 23-year-old kid who's straight out of college and is going to make his fortune trading commodities (okay, that was me at one time, but that's beside the point) knows how to trade technically. How? Because every trading book in the world taught him the same lessons. He

knows how to draw the trend line. He knows what a head and shoulders top looks like. He knows what a breakout on strong volume supposedly means. The problem is, so does everybody else. With the advent of modern trading software, even the people who don't know about technical

indicators are using them. Maybe that is why technical trading is not nearly as effective as it used to be.

Everybody is watching the same indicators, the same patterns, the same squiggly lines. How many people are getting burned time after time on false

breakouts, fake reversals, and so on? How many times has it happened to you? Small-time traders can play these games all they want. In commodities, supply and demand are king.

2. **Unlike stocks, commodities have an actual end user.** Thus, commercial players

make up a big part of the volume in commodities contracts. Producers and end users are constantly using the futures markets to hedge against price swings up or down. This is, in fact, why the commodities futures markets were created. Believe me, the guy growing the wheat has

a pretty good idea of what his crop is going to look like this year. And the guy at Pillsbury has a pretty good idea of how much wheat he is going to need this year to make his oven pop biscuits.

These guys trade on supply-and-demand fundamentals. If you know what these

fundamentals are, you give yourself a big advantage over all of the “techies” out there.

Techie Joe and the Corn Market

For example, let's suppose you are “Techie Joe” futures trader. One day, your little software program tells you to

sell short corn because doohickey line one crossed doohickey line 2 for three days. So, being the disciplined technician that you are, you sell it.

The problem is, back in Indiana, the Kellogg Company doesn't like the dry conditions in the cornfield this year and decides it's time to hedge against a price spike later in the year. They've got

a lot of cornflakes to make and don't want to be paying too high a price for their corn supplies. So they buy 100 tons of corn in the futures market. And they buy it every day for 10 days. And price goes up for 10 days. And you get routed out of your corn position and lose a bunch of money. And the best part? Kellogg doesn't give a rat's @** about your little doohickey lines.

But if you knew about the dry conditions in the cornfield, you probably wouldn't have either. That's how the market *really* works.

The Best Way to Use Fundamentals

Fundamentals should be your guide in deciding which markets to trade.

Fundamentals will help you to determine the markets where conditions are appropriate for selling out-of-the-money strikes on one side (or both) of the market. Remember that your goal is not to determine what price is going to do. That is what everybody else is doing and it is very difficult—even for professionals. Let them make that mistake—and pay for it.

Your job is only to determine what is *least likely* to happen. This is how you turn fundamental knowledge into cash.

Technicals: A Time and Place for Everything

If you are a technician and are offended by what I just

said, you can pull in your guns. I did not say technical indicators were useless. I simply said in commodities, fundamentals should determine *which* markets to trade. Technical indicators can help you with the *when*.

The Problem with Technical Indicators

The problem with technical indicators is that they rarely look clear when you are using them in a real trade. Technical analysis books always make it look very simple and easy because they use examples in which the indicator worked very well.

The truth is, in many cases, the technical buy-and-sell signals will not be very clear, at least not until well

after the move has already taken place. This is yet another reason why incorporating fundamentals into your thinking is so important.

I still give technicals some weight in our trading decisions. However, as an old technician turned fundamentalist once told me, “Technicals work ... until they don’t.”

I have learned, through experience, to use technicals as more of a timing or optimization tool. They are employed after fundamentals have dictated in which markets we should be trading and what is least likely to happen there. As timing is less important in selling options, technical tools simply aren't as crucial as getting the overall market view right. Remember that in

option selling, even if you miss-time your entry or are even outright wrong on market direction, in many cases you can still end up making money on the trade.

One of our basic convictions in this book is that an option writer should select the market in which she would prefer to sell puts or calls based on a fundamental scenario that she feels will

make the market biased toward moving higher or moving lower over the intermediate to long term. The trader can then look for favorable technical setups as opportunities in which to enter positions in these markets.

Fundamentals Versus Technicals:

How I Was Converted

BY JAMES CORDIER

My “rookie year” as a commodities broker was 1984. That was over three decades ago. But some stories from my first few years in the business stick in my memory as though

they happened yesterday.
This is one of them.

As the new guy on the block, one of the most commonly asked questions that I received from potential clients was “Are you a technical or a fundamental trader?”

My answer was always the same, “Technical, of course.”

At any given moment, I

could pick up the phone and be asked my opinion of cocoa prices, pork bellies, or even Treasury bonds and have the answer shortly after punching up the chart.

“Well, Mr. Duke, I can tell you right now that I would cover any short positions you might be holding in cocoa. I show a Relative Strength Index

reading of only 12, and it looks like the slow stochastic could cross at any time.”

“Interesting,” says Mr. Duke, “What about pork bellies? How do you see bacon prices faring?”

“As for bellies, stick a fork in um, they’re done! That’s a head and shoulders top for sure.”

“And Mr. Cordier,

what about interest rates and the Federal Reserve? What do you see there?"

"Well, Mr. Duke, that one is a little tougher." I would coolly reply, "But looking at the June bonds, I can't remember ever seeing a market this oversold. I think I'll give bonds a strong buy. Besides, Mr. Volker would not put us in a recession. Would he?"

It was at the first commodity seminar I had ever attended that the technical seed was sown. The home office in Chicago had decided that it would send the brass to help give our branch office 90 miles to the north a jump-start. The office had just opened and consisted of the owner, two managers, and four hungry kids who had just passed

their Series 3 (commodity broker license) exams. This would be my first formal training in a business I had been dreaming about for many years.

One nice suit after another would approach the podium and, using the latest technology in overhead projecting, would point out the highs and lows of various price charts

where a savvy investor could have made a small killing.

After listening to one analyst explain how easy it was to go long on the *buy* signals and take profits on the *sell* signals, it was time to hear about *formations*—bull flags and bear flags, double tops and double bottoms. Everyone there, including me, thought,

“Okay, these could be the secrets to our future success!”

Turning to a fresh page, I drew the chart that was illustrated on the fuzzy screen above.

“Here is an example showing a sharp rise in price that is followed by a period of consolidation, otherwise known as a *bull flag*,” the speaker

continued. “The sharp rise in price is the *pole*, and the consolidation is the *flag*. Later, a break above the consolidation will project an equal increase in price as the pole itself.”

“Wow, that seems easy enough,” I thought.

The next morning I went into the office armed with what could be the tools I needed to become a

successful broker. The first thing was to back test what I had learned the previous night. Sure enough, after looking at just two or three charts, I found that there *were* pennants and flags and heads and shoulders everywhere!

Shortly thereafter, out came the straight-edge ruler, and lines were drawn above and below support and resistance levels. Sprinkle

in a few key indicators, and *voilà!*

“I will be technical trader, thank you.”

A few weeks later I was spending all of my time studying the current issues of *Commodity Perspective* morning, noon, and night. For several hours each day I carefully paged through one commodity at a time,

looking at each chart like a surgeon examining a patient until I finally found it. There it was right in front of me—December wheat, *bull flag!*

This chart had a flag formation so clear, so discernible, so absolutely perfect, that the only thing it was missing were the stars and stripes themselves. That weekend

I started saying to myself,
“Blue Horseshoe loves
December wheat.”

Monday morning was here, and it was time to start on my road to riches. The grain markets were called to open steady, so I expected that I should be able to enter the trade I had studied all weekend long at the price I had hoped for. The flag formation

consisted of a “pole” that measured 11¢, followed by four days of consolidation. Buy here, and wait for the breakout to the upside, which should net us about a dime (\$500 per contract). It was just like it said in my lessons. Now it was go time!

The opening bell rang at 9:30, and wheat started trading at \$2.44, up $\frac{1}{2}$ ¢

from Friday's close. I placed the order using a large red telephone that had no buttons, only a receiver. About ten minutes later, the floor was calling back with the fill, \$2.44½, up 1¢ on the day. After a couple of hours had passed, trading slowed considerably, this after what seemed like quite an active open. Corn and soybeans were both

sporting modest gains,
whereas wheat prices
generally were steady to a
shade higher. As the end of
the trading day was fast
approaching, grain prices
started moving higher.
With each new high, the
sound of the clacker board
seemed to get louder. At
the close, December wheat
settled at \$2.46½, up 3¢ on
the day and 2¢ above my
entry price. What a great

business!

After the dust had settled, I pulled out my charts and a pen to add a 3¢ bar to the December wheat. The breakout to the upside had started, and we should look forward to a payday in the next couple of sessions. “This technical trading really does work!” I thought.

As I was getting ready

to leave for the day, I noticed my manager and another broker huddled in front of a screen.

“What do you see there, Jerry?” I couldn’t help but inquire.

“Well it looks like wheat will be heading higher. It crossed the wire that Egypt is rumored to be in the market for over 200,000 metric tons of

wheat, and the sale could come as early as tomorrow.”

Cha Ching! What a great business!

Driving home that night I kept telling myself, “Don’t be greedy. If the market is up 7 more cents in the morning, take the money and run. Stick to the program. Do your homework, and find the

next trade.”

I decided after a long celebratory dinner that I would do just that.

Pulling out my charts, I started paging through the different commodities for hours that night. I was at it again. However, nothing looked as good as wheat did from a couple days earlier, and it was getting late, so I wrapped it up for

the night. Besides, I had a big day ahead of me. My trading career was about to take off, courtesy of my new best friend, the chart book.

At 8:00 a.m. Tuesday, walking through the large double doors at the office, I could not wait to get the opening call. My manager was staring at his screen, so I poked my head into

the often-opened door and asked, “Did the Egypt tender go through? Did they buy all 200?”

Jerry looked up at me with an unfamiliar smile and said, “Yeah, they bought their wheat.”

“Yes!” I thought. “But what is with him? Oh well, maybe he should study his charts a little closer.” I proceeded to my desk and

pulled out my books and the phone numbers of my clients long the wheat. Soon, I would have good news to report.

It was almost 9:30. I was about to reap the fruits of my labor. Would the wheat market move up the additional 7¢ today, or might I have to wait a while longer?

Finally, the clacker

board started clicking, first corn, and then soybeans. For some reason, wheat was taking longer. Then wheat opened. What? Down 4! Down 5! What was going on? What about the bull flag? It was perfect! What about Egypt?

The broker in the cubicle next to me stood up and asked in his usual calm voice, “Cordier, what is

going on?"

"Wheat—the wheat is down almost 6¢!" I said.

Steve replied, "Well, you know that Egypt bought wheat last night and ..."

"I know they did, so why is it falling?" I demanded.

"It was French. Egypt bought 210,000 metric tons of wheat from France."

“French! Schmench!
What difference does that
make!” I blurted,
incredulous.

Steve, who got his start
in commodities at a grain
elevator, then said to me in
what was almost a whisper,
“You ... have a lot to
learn.”

As it turned out,
December wheat had
rallied days before, when

rumors surfaced that Egypt could be in the market with a large purchase. Consolidation then followed as traders waited for the announcement.

In this case, the market move of December wheat was predicated totally by the origin of the wheat that Egypt was about to purchase. An Egyptian purchase of U.S. wheat

may have been positive for Chicago Board of Trade (CBOT) wheat prices. A purchase from France was benign. It was a disappointment for U.S. wheat traders, and therefore, prices fell. It was my first lesson in the world of fundamental trading, and things have never been the same since.

It was a huge eye-

opener to me to discover that there was a whole other world of trading information beyond my charts, measurements, and indicators. The technical charts reflected what was going on with prices and how they were moving. The fundamentals were the reasons *why* they were moving.

As I discovered,

relying on my charts alone to try to predict market movement was like trying to hit a baseball with one eye closed: Your perspective is always going to be off.

Fundamentals and Technicals: Happily Marrying the Two?

The story in the boxed text illustrates how important it is to know the fundamentals of a particular market before positioning in that market. However, we also have pointed out that this knowledge should not be used at the complete expense of technical analysis.

Rather, it can be used in conjunction with technical indicators to optimize one's

overall positioning process. Remember our goal? A smooth, steady ride to expiration, right? Fundamentals can get you the right market. Getting the timing right can make it a smoother ride. Even for unconverted technicians, knowing the fundamentals can help to boost returns by giving you a better feel for which breakouts, reversals, and buy-and-sell signals are

more likely to be the real deal and which are false signals. A successful “marrying” of the two can be a revelation to any kind of trader.

The Power Couple

For instance, let's assume that two markets, orange juice and live cattle, are trading in a narrow trading range. The U.S. Department of

Agriculture (USDA) has just released a report showing that the most recent Florida orange harvest yielded the largest crop in five years. Frozen orange juice supplies in storage are at a 12-year high. The market is awash in juice.

Cattle, on the other hand, will soon be experiencing a drawdown in supply based on this year's 50-year low in the

calf crop.

Both markets break out to the upside. Both markets indicate buy signals on key technical indicators. Which market is more likely to start a sustained uptrend, and which is likely to fall back into the range or lower?

The simple answer is that the cattle market is more likely to experience a sustained move higher,

whereas the orange juice market is more likely to fall back down. Both have experienced a price breakout on the chart. However, cattle has bullish fundamentals; O.J. has bearish ones. If I'm a betting man, I take the cattle.

The pure technical trader would buy both on the breakout and give little regard to the fundamentals. However, given the same

situation over different markets 10 times in a row, the technician who takes only the buy signals in markets with favorable fundamentals almost surely will outperform the pure technician. It's a very potent combination.

How You Can Use Fundamentals and Technicals Together

We suggest selecting

potential markets in which to sell premium by studying the fundamentals first. Once a select group of markets has been placed on a “watch list” consisting of markets with very bullish or very bearish long-term fundamentals, these markets then can be monitored for technical buy-and-sell signals.

Why New

Commodities Traders Often Fail (and Never Come Back)

Novice traders often will favor technicals because they are much quicker and more tangible to learn. There are formulas and measurements and rules. Although the realm of technical trading is

immense, a trader can learn one simple indicator, and bingo, he has an instant trading system. He's ready to go at it.

Studying the fundamentals and how they are likely to affect price is more abstract. It requires independent thinking. It takes time, education, judgment, and experience. The argument that fundamentals

are already “priced in” may be something that pure technicians tell themselves to free their minds from the burden of having to study the economics of a particular market.

Fund managers are mostly technicians and can move markets for short periods on technical buy-or-sell signals. These moves sometimes can fly in the face of the existing

fundamentals. Therefore, even as an option seller, you may not want to ignore technical factors completely.

Nonetheless, over the long term (of which option sellers are primarily concerned) a market's price will ultimately be determined by its fundamentals. For this reason, it is crucial that you gain at least a basic understanding of what the

key fundamentals are for the markets you are trading. *It is one of the key advantages that you have over mechanized fund traders and beginners alike.* They are slaves to their systems. You can use technical indicators and yet still retain the ability to think for yourself.

Doing so can save you time, preserve peace of mind, and help you make a lot more

money.

Using Your Fundamental Data: The Less the Better

What you are about to read may sound counterintuitive. But once you begin following fundamental information, it will make perfect sense to you.

You will find that the fewer factors involved in the price makeup of a particular commodity, the greater the advantage of fundamental analysis.

You will also find that most physical commodities, such as soybeans, unleaded gasoline, and coffee, will have three to five key fundamental factors that affect most of their price

moves.

Financial contracts, on the other hand, can have many factors that can or could affect price, many that cannot be forecast with any degree of accuracy (e.g., government decisions or votes). It may be true then that fundamental analysis is more of a benefit to traders of physical commodities. When trading financial contracts such as

bonds, currencies, or even gold (considered a financial), you may have to rely more on technical savvy because fundamentals often appear very cloudy or mixed at any given time. This is why I prefer, and recommend, trading real, physical commodities.

They grow soybeans once a year in the United States. I know where they grow it. I

know how much they need. And the U.S. government measures it every month and tells me how well the crop is progressing and how close they are to hitting their goal. I'll take that seven days of the week and twice on Sunday over trying to guess what some central banker or government bureaucrat is going to do tomorrow.

The Special Significance of Fundamentals to Option Sellers

There is one final, albeit key, reason why we believe that incorporating fundamentals is so important in selling options. Technical trading is all about forecasting and measuring where and when

prices *might* move. It promises nothing in forecasting where prices will *not* go. And as you already know, picking a least-likely scenario is your *primary* and, frankly, *only* concern as an option seller.

But what does that mean? And why is that the case? Let's consider an example.

Why Don't You Care Where Price Goes?

It would be nice if after selling every option, prices moved immediately away from your strike, providing fast deterioration and quick profits for you. It happens sometimes. Other times it does not. Yet, in the end, it doesn't really matter if your strike is \$3 out of the money

or 3¢ cents— your option will still expire worthless, yielding the same profit.

This is why you are mainly concerned with selecting a price level that the current market will *not* reach. This is where fundamentals can have special significance to the option seller—they can be priceless in identifying least likely scenarios.

The debate between

fundamentalist and technical traders is always about which is a more effective price *forecasting* model. Which one is more effective in determining where prices will go? There is, of course, no correct answer to this. Either way, it is very difficult to determine where *prices will go*.

The point is, as an option seller, *it doesn't matter!*

Option sellers care only where it's *not* going. And it is in determining where prices *won't* go that fundamentals will butter your bread. The following example illustrates this point.

Example: Two Fundamentalists— But Only One Makes

Money

Two fundamental traders are following the development of this year's U.S. soybean crop. One is a futures trader. The other, an option seller.

At midsummer, the market has already priced a certain-sized crop into the market (as most technicians argue it should). During the course of a week, rumors

begin to surface of a strange disease eating away at leaves in certain growing regions. Traders are unsure to what magnitude it has spread or what effect it will have on yields. The following week, the talk continues to swirl. More outbreaks are reported, and some people start to suggest that the fungus on the plant is stunting the growth of the new soybeans.

At this point, the market has already started to move higher on the uncertainty. Nobody knows how this could affect yield or, ultimately, price. However, it is probably safe to assume that yield will be at least slightly affected. Does it not follow logically that prices would have to remain somewhere higher than they were a few weeks ago to account for this shortfall?

There is either a little damage or a lot. Either way, there will likely be fewer soybeans than we thought there would be a few weeks ago.

The futures trader is asking how high the market can go and/or if it can still move higher from today's price. But she is asking the wrong questions. She doesn't know the answers. Whatever her trade, she is gambling to

some degree.

The option seller doesn't know if prices have topped out or are only getting started in a breathtaking move higher. But it doesn't matter. It only matters that it seems like a pretty good bet that prices are not going to fall below where they were a few weeks ago before the disease was announced.

Why? Because it appears

that supply is smaller now than it was then. By how much, we don't know. Again, it doesn't matter. It's smaller. All the option seller has to do is sell puts below where the price was a few weeks ago and wait.

This example is simplified of course, but it demonstrates how a key fundamental development can be exploited by an option

seller where it may be more difficult for a futures trader or (worse yet) an option buyer to profit. It illustrates why knowing the fundamentals is so important for option sellers.

Putting It All Together: Executing Your Fundamental

Option Sale

Now that you have learned how and why to use fundamentals and technical factors in selling options, let's put everything together into one trade example.

Example: Trader John Sells Live Cattle Puts

In researching the fundamentals for live cattle in late 2013, Trader John has determined that the fundamentals will favor the upside in cattle prices in the coming months. As the economy recovers, U.S. beef demand is near all-time highs. Demand from developing economies has resulted in soaring exports. More importantly, however, ongoing drought in the U.S.

Midwest has reduced the U.S. cattle herd to the lowest levels in over 60 years.

John feels that the market may be significantly underpriced as the market has not yet fully accounted for the cattle shortages projected for 2014 (by the USDA). John considers this a very friendly fundamental setup. *At the very least (IMPORTANT), he feels it unlikely that cattle*

prices will fall substantially in light of the projected supply shortages. He begins to watch the charts for possible favorable points of entry.

In this case, one of John's favorite technical indicators is a Bollinger band (shown in [Figure 13.1](#)). The wavy lines in the middle of the chart are what this popular technical indicator looks like. When

price breaks above the top line, technicians take it as a buy signal. When price breaks below the bottom line, technicians take it as a sell signal. (See [Figure 13.1](#).)

FIGURE 13.1 April 2014 Live Cattle Chart with Bollinger Bands Illustrating “Buy” Signals

John sells puts below the market on technical buy signals in a fundamentally

bullish market.



John Sells Live Cattle Put On Breakout

Since John's fundamental bias is bullish (he believes that the existing fundamentals will pull prices higher), he will look for technical buy signals as opportunities to sell puts far beneath the market. He will not sell calls on the sell signals because his fundamental bias is to the upside. Therefore, he takes only the buy signals in this market and ignores the sell

signals.

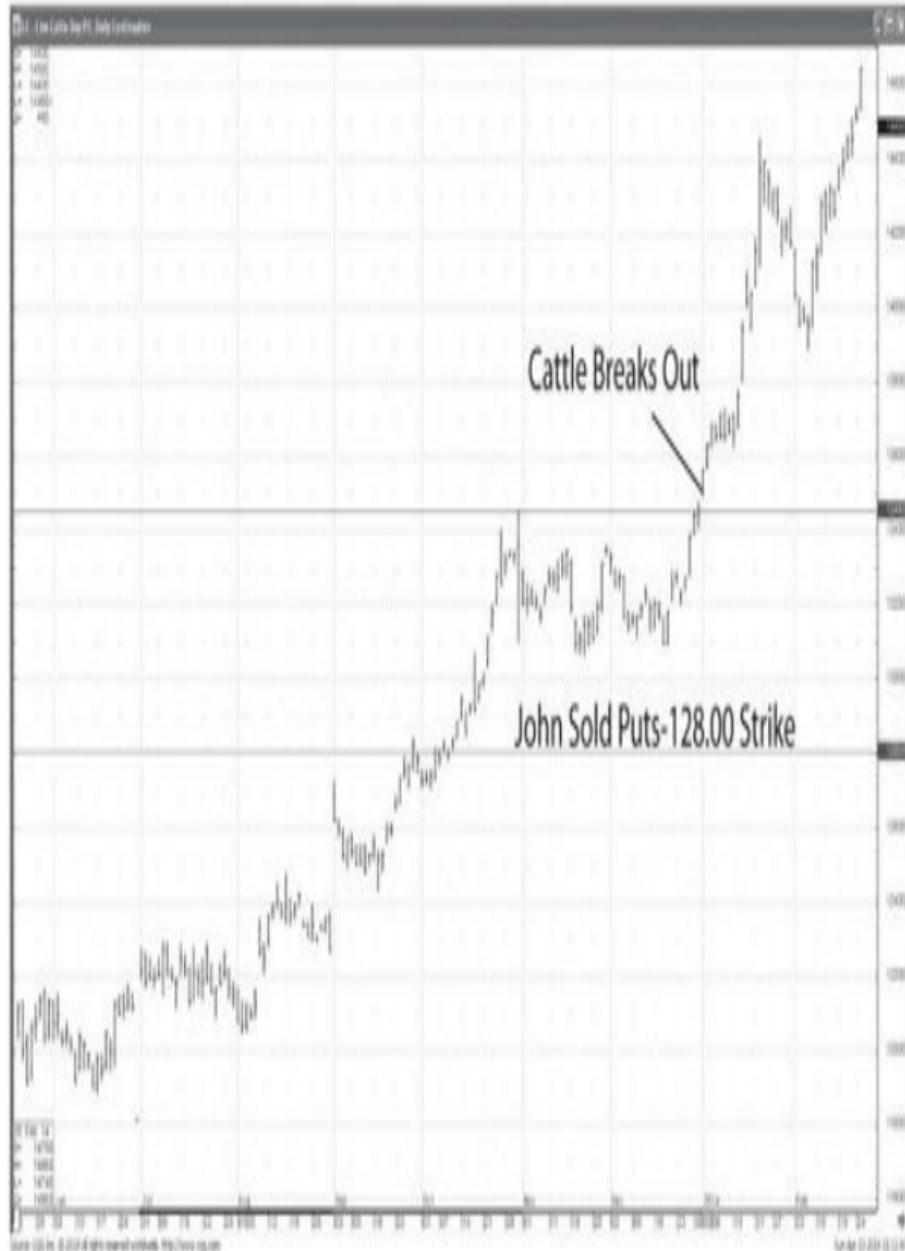
On December 31, he gets a buy signal as the price breaks above the top line of his Bollinger band. In addition, price also breaks through long-term resistance at 1.3453 per pound. For a technical trader, this is a strong buy signal. For the fundamentalist, it comes in a very strong market. John pulls the trigger and sells 10

April Cattle 1280 puts for \$500 each. He collects \$5,000 in premium.

History proves John correct as cattle prices rally through early 2014 and John keeps all premium as profit. (See [Figure 13.2](#).)

FIGURE 13.2 April 2014 Live Cattle Chart Showing Rally in Cattle Prices Technical breakout in Cattle prices supported by

fundamentals.



John has taken the lessons from this chapter and successfully applied them to generate profits. Of course, prices could have reversed and moved lower and John would have lost money. But John takes the necessary steps to put every advantage in his corner before placing his trade. That's the sign of a pro. And it's how you can trade, too, by putting in just a bit

more effort than the other guy.

Granted, technical setups are not always as clean as the one in the example. This is another reason why the fundamentals are so important. You don't need a perfect technical setup to sell options. But avoiding unfavorable setups can help you with the timing of trades.

Conclusion

With the popularity of so many technical tools and the equipment now available to users, the majority of traders now rely on technical indicators to dictate their trading decisions. But this book is not about trading the next hot-tech IPO or “momentum” stocks. This is about commodities. Old

school. Things that have a value determined by real buyers and sellers. In this world, supply-and-demand fundamentals are king.

Ignore them at your peril. Embrace them and you give yourself a big advantage in the market. They are available to all. But only a few know how to use them. You can join this elite group and learn how the old guys

still take home the money.

Using technical indicators and/or chart patterns can help you in the timing of your option sales. But fundamental research should always dictate in which market(s) you trade.

Fundamentals are not some mysterious, invisible hand guiding the market. In fact, they are commonsense supply–demand figures that

can be analyzed and conclusions can be drawn from. In our business, we continually research the fundamentals of the futures markets and pick out the ones that we believe offer the best option-selling opportunities for our clients. In fact, this is where we spend most of our time. Because many investors do not have the time to perform this research on their own, they get our research

reports with both fundamental and technical information for the markets they are in. I recommend you create these for yourself if you are trading on your own. They can help you clarify and organize your reasoning for taking premium in a particular market.

Even if you are working with a broker who is well-versed in fundamental analysis, it may help you to

know some of the basic economics and key figures of individual markets that can help to determine price direction (or nondirection).

For those who wish to learn the key fundamentals of some of these markets for self-study, **Chapter 14** is for you.

14



Key Fundamentals of Select Markets

What to Watch, Where
to Find Them

Now that you have learned the importance of fundamentals when selling commodities options, it's time to learn some of the key fundamentals that affect certain markets and where you can find them.

Every stock, every commodity, and every futures market has fundamental factors that determine its value. Fundamentals for a

stock may include factors such as the financial position of the company, profitability, price-earnings (P/E) ratio, and so on. Fundamentals for a commodity may include current supply on hand, projected new crop growth, and consumer trends in preferences. Fundamentals in a financial contract may include government policies, interest-rate adjustments, and economic growth rates. For

our purposes, we will define a *fundamental* as the current or future supply and demand or any factor that can have an effect on either the supply or the demand for that particular commodity or financial product.

Not to review Economics 101, but the balance between supply and demand ultimately will be what determines the price of a commodity or

financial product. If supply is high and demand is low, prices probably will be low or move lower. If supply is low and demand is high, prices probably will be high or move higher. If interest rates rise, fewer people want to buy bonds, and bond prices fall. If part of the soybean crop is damaged by a lack of rain in the summer, there are fewer supplies to go around in the fall, and prices rise.

We have already discussed how trading fundamentally can be a much more feasible approach in option selling than in futures trading. If a market is fundamentally bullish, chances are that it has already priced in those fundamentals to a certain extent. Thus, if you buy a futures contract, you may be buying right before the market goes into a corrective mode. However, if

the fundamentals remain bullish, chances are that the correction will be mild and/or short-lived (by long-term standards) before prices either stabilize or continue to press higher. As a futures trader, these inevitable corrections can force you out of your position and cause losses that sometimes can be severe, even if your fundamental analysis is correct.

By selling options, you can increase your chances of profiting from a correct fundamental diagnosis. If you are bullish and sell puts, you can sell at strike prices far below the market. Your position can withstand a certain degree of movement against it. However, if your fundamental analysis is correct, the market will not go into an all-out sell mode as long as these fundamentals

continue to hold up. Thus, even if the market has already priced the existing fundamentals, it probably won't fall substantially, meaning that if you sold options far enough away, they should be safe and ultimately profitable—this is the ideal scenario.

The Key

Fundamentals: What You Should Be Watching

To form a fundamental bias toward the markets, however, you first must know the key fundamentals that you should be following. This is the purpose of this chapter. There are some markets that lend themselves more favorably to fundamental analysis than

others. These are generally markets with three to five key long-term fundamentals to watch. Markets with many fundamentals (such as the stock market or currencies) are more difficult to trade fundamentally and must be given more technical consideration. Having some fundamental knowledge, however, can help you to trade any market.

The following are some key fundamentals to watch in a group of select markets that we have chosen to review in this book. This is certainly not a complete list of markets or fundamentals. However, these are some of the primary commodities that are suited for option selling.

Energy

Most people, even nontraders, are somewhat familiar with energy fundamentals. Oil is produced in the Middle East (OPEC), Russia, Venezuela, Nigeria, Norway, and the United States. Of these regions, the Middle East remains the largest exporter of crude oil, for now.

Yet, with the discoveries of both the Marcellus and Bakken shales and the advent

of fracking, the United States has become a major player on the world oil stage. Already a major producer of natural gas, the United States could become energy independent within the next decade and quite possibly a become considerable exporter of both oil and natural gas.

The United States is by far the largest consumer of crude oil, followed by China

and Japan. China's emergence as an economic force since its entry into the World Trade Organization (WTO) in 2001 has produced a massive increase in crude oil demand that has added tremendously to the global daily crude oil draw.

Energy markets are swayed heavily by seasonal factors as well, though we are not going to cover them

heavily in this chapter. The seasonal tendencies of crude, heating oil, unleaded gas, and natural gas will be covered extensively in [Chapter 16](#) on seasonal analysis.

In 2008, crude oil futures soared to an all-time high in prices approaching \$150 per barrel. During the highs in price, there was much talk of a global production peak. That, of course, ended with

the new discoveries in North America.

New supply channels from North America have made crude oil prices less susceptible to supply shocks from the Middle East or elsewhere. Although energy prices can still be affected by geopolitical events, the advent of higher U.S. domestic production has made them less so. Energy

prices can also be very *seasonal* in nature. These two factors together can make the energy markets a great place to collect premium for option sellers.

For supply/demand figures, I recommend you monitor the weekly American Petroleum Institute (API) report, which measures energy storage levels and draws, and periodic reports

from the U.S. Department of Energy (DOE). Individual reports here are not as important as supply/demand trends in the reports.

Grains and Oilseeds

Soybeans

While China and a handful of other nations grow significant

amounts of soybeans to feed their own populations, the United States and Brazil are the world's primary exporters. For this reason, it is a good idea to focus on the U.S. and Brazilian crops when analyzing soybean supply.

The U.S. soybean crop is usually planted in April and May and harvested primarily in September and October.

The Brazilian crop is usually planted in October and November and harvested in March, April, and May. Weather disruptions during the growing seasons often can cause price moves.

Key figures to watch are the U.S. and world *ending stocks*, current and projected. Ending stocks are a comprehensive figure and consist of the amount of the

commodity left over at the end of the crop year. In the United States, the new crop year begins on September 1.

Ending stocks are the total amount of supply left over after total annual usage has been subtracted from annual supply. Therefore, *ending stocks are a way of measuring total supply and demand*. A rudimentary form of fundamental analysis is

looking at past years' ending stocks and then looking at the average price level of the commodity during that year or the following year. There often will be a correlation between prices and ending stock levels. You then can compare this year's projected ending stocks with those of previous years where figures were similar to get a rough idea of a price range toward which the market should

gravitate this year. Although this may not tell you where prices are going, it can be a big help in projecting where prices won't go. I keep our clients updated on ending stocks through our newsletter. However, you can get them through the USDA website at www.USDA.gov.

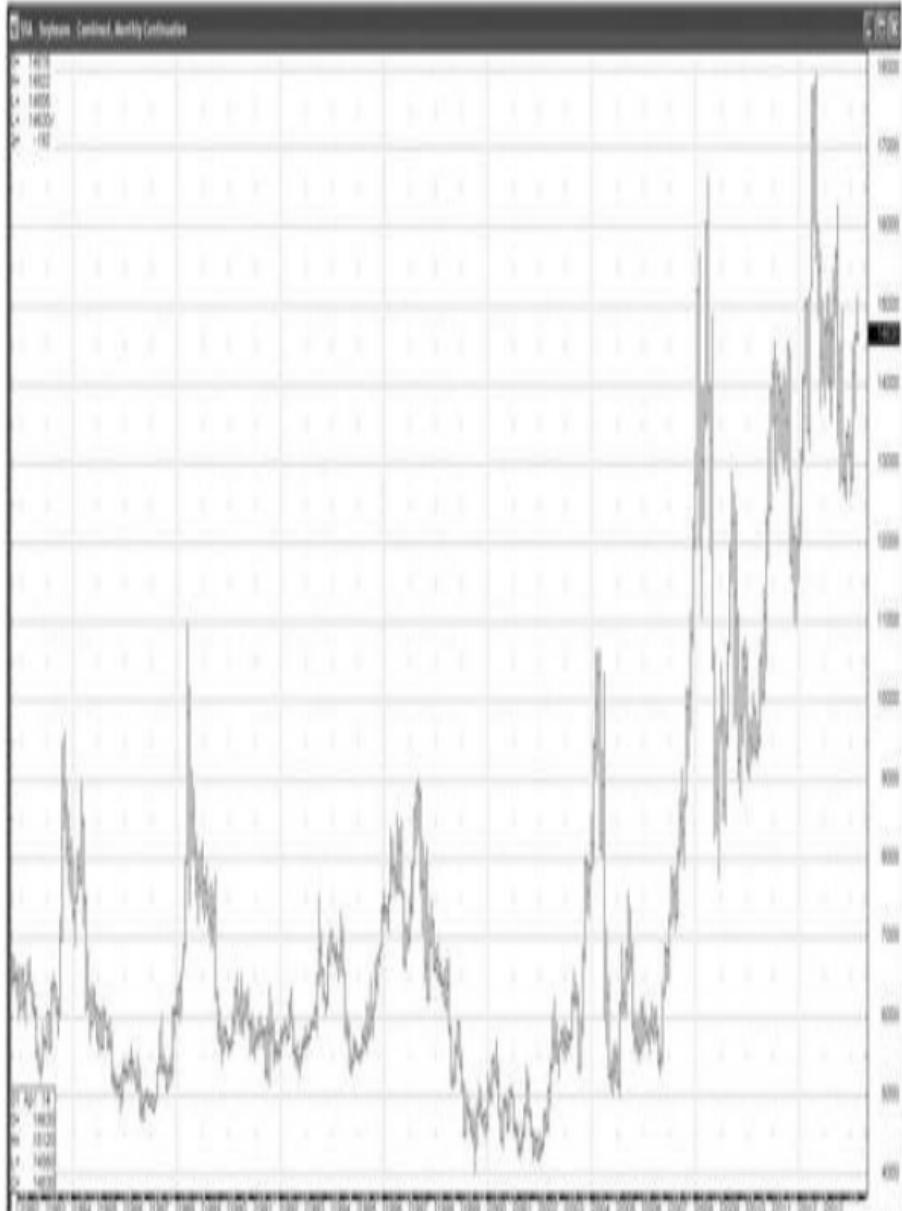
It goes without saying, then, that any factor that may change the projected supply

or projected demand could change ending stocks, which, in turn, could move prices. Weather, pests, shipping disruptions, and political unrest are just a few of the factors that can affect supply. Increased or decreased consumption, trade spats, and competition from substitute products are a few of the factors that can affect demand.

A key fundamental shift in the soybean and grain markets in the first two decades of the 2000s has been the emergence of the Chinese as a major importer of corn and soybeans. The corn and soybean bull market of the past 15 years (see [Figure 14.1](#)) has been driven primarily by unprecedented demand from China. Expect this to be a recurring theme in many commodities

throughout the coming decade as growing global populations and increased standards of living compete with biofuels for their share of the grain supply.

FIGURE 14.1 Soybean Monthly Chart



Most of the information you will need to get a basic fundamental picture of the grain or any agricultural market can be obtained for free from the U.S. Department of Agriculture (USDA) at www.usda.gov. The key report to watch is the *monthly supply/demand report* (which measures U.S. and world supply and demand and updates projected ending

stocks). Other key reports to watch are the *quarterly grain stocks report* and *planting intentions* (released in the spring).

Corn

In the United States, corn and soybeans are grown in similar locations during similar growing seasons and often can be interchanged for one

another when farmers are deciding on how many acres of each to plant. Frequently, this is decided based on which crop they think may be more profitable in a given year.

The United States is the world's largest exporter of corn. However, the U.S. share of the export market has shrunk considerably in just the last decade. In 2005, the

United States supplied nearly two thirds of the world's corn exports. By 2015, that number had fallen to one third. With the advent of new exporters such as Argentina entering the trade arena, global production figures and ending stocks play a more important role in price forecasting for corn than they once did.

Nonetheless, the U.S.

supply and export demand remain the key figures on which to focus when researching corn. Most corn information is released in the same reports listed for soybeans and can be found at the same place, the USDA. The news services listed in the resources section of this book also can do a good job of keeping a trader updated on factors that could affect supply and demand.

However, we strongly recommend focusing on the monthly figures released by the USDA and not getting caught up in daily news releases. The exception to this would be when you notice a supply or demand trend developing.

Growing Chinese and developing country consumption plus the advent of ethanol use in fuels will

mean strong demand continuing to underpin the corn market well into the 2020s.

Wheat

Unlike corn or soybeans, wheat is grown almost globally. Whereas Europe, China, and India are large producers, the United States remains the world's largest

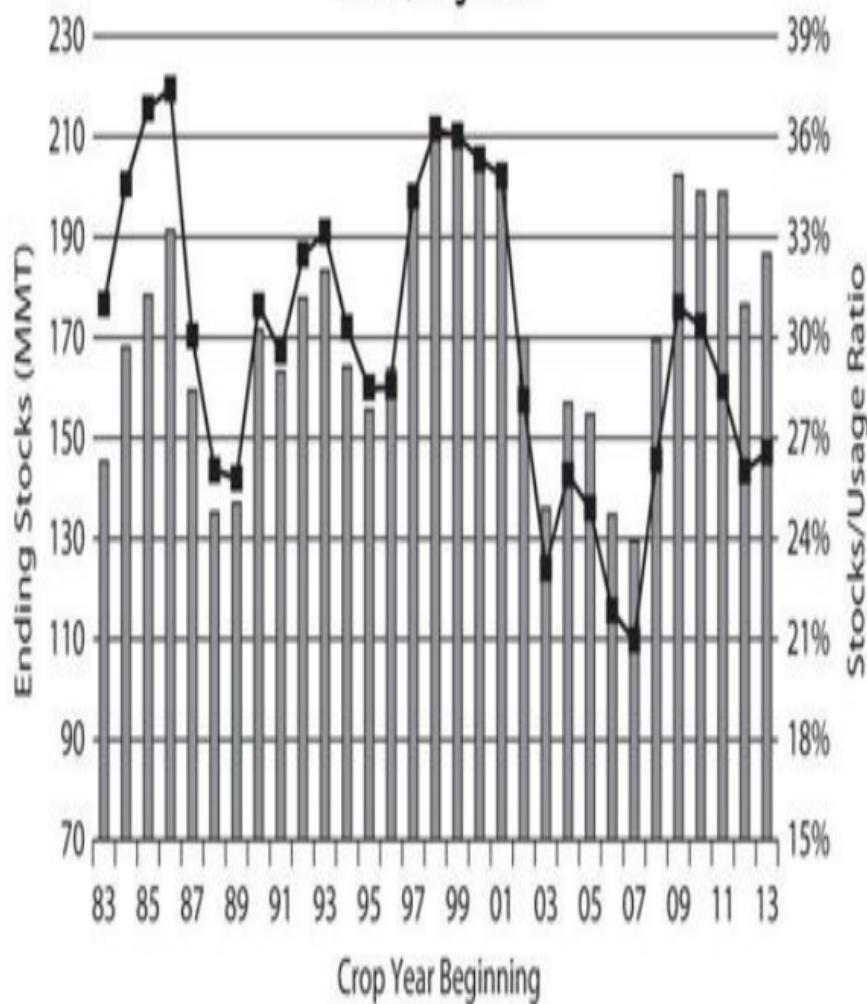
exporter; however, the United States supplies only about 20% of the world export market. Major competitors of the United States for the export business are Australia, Canada, Argentina, and the European Union.

Supply, demand, and ending stock figures for wheat can be found in the same reports as those for corn and soybeans. However,

when analyzing wheat, one should pay more attention to world figures as opposed to only U.S. figures. Because wheat is a global commodity, events in other major producing nations can have a strong effect on wheat prices (see [Figure 14.2](#)).

FIGURE 14.2 USDA Report Showing Wheat Ending Stocks

World Wheat - Ending Stocks vs. Stocks/Usage Ratio



The Interchangeable Grains

Grain and oilseed markets are unique in that there can be crossover uses between them. Thus, a shortage in soymeal might cause a cattle feedlot to switch over to corn. A rally in corn prices might cause a food manufacturer to switch

over to wheat. A rally or price decline in one can often be a precursor to a similar price move in another. Often these price swings can happen in tandem, even if the fundamentals of one do not affect the other. Thus, a trader of corn should also be monitoring fundamentals in both soybeans and wheat, and vice versa. This is true from both a risk-management perspective as well as a

profit-seeking perspective.

Example: Corn Versus Wheat

In the summer of 2012, the U.S. Midwest experienced a ravaging drought. Corn and soybean crops were affected. By July, it became apparent that autumn production estimates would have to be substantially reduced.

Wheat fields were less

affected. More importantly, global wheat production was projected to be more than ample in the fall. So why did wheat prices rally, too?

It's called a "sympathy rally." Wheat, in some circumstances, can be used as a "substitute" grain for corn or even soymeal. Wheat rallied because the market concluded that as corn prices rose, feed producers that were

able would increase wheat usage and curtail corn and/or soybean usage. There was no shortage of wheat. Yet there became an expected demand increase in wheat. Thus, wheat prices rose in tandem with corn and soybeans. This is illustrated in Figures 14.3 and 14.4.

FIGURE 14.3 July 2012

Wheat Chart

Corn prices rise on drought

concerns.

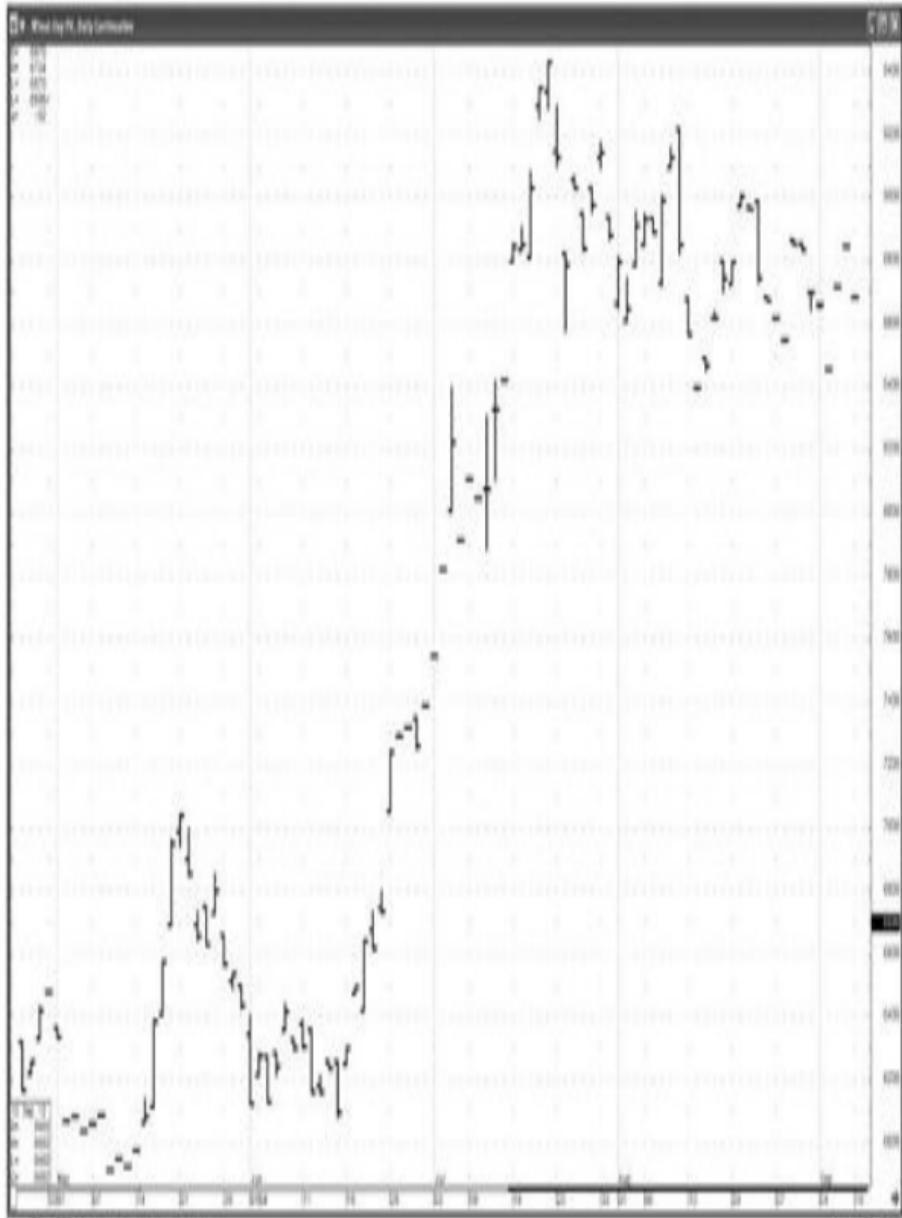


FIGURE 14.4 July 2012

Corn Chart

Wheat prices rally in
“sympathy” with corn.



This substitution effect does have its limits. Thus, grains and oilseed prices do not move in tandem. Often there is, however, a loose correlation. Exploiting that correlation can be another profit avenue for more advanced option sellers. If you study the fundamentals of the grain markets, it will not take you long to begin to notice both correlations and

discrepancies that you can use to your advantage as an option seller.

(The “Texas Strangle” is one example of this that we sometimes feature in our newsletter.)

The grain and oilseed markets, as a whole, are excellent markets in which to take option premium. Fundamental information is both widely available and

often easy to interpret—at least for the limited needs of option sellers. These are also very liquid markets in both the futures contracts and options.

Many new futures traders start in the grain markets.

Regional Commodities and the Plight of Orange

Juice

Whereas some commodities have an equal global value, such as gold, crude oil, and wheat, others may involve regional dynamics that can require a different level of study.

Global commodities are produced in several different countries, but there are other commodities that may be

produced in only one or two specific countries or regions. Because there are fewer supply figures to follow with such commodities, they sometimes can lend themselves better to fundamental analysis than globally produced commodities. These are known as *regional commodities*. Regional commodities include products such as orange juice, live

cattle, and lumber.

For instance, Brazil is the major supplier of orange juice to the United States. The United States used to produce the balance of its orange juice needs domestically. However, whereas oranges are grown in both California and Florida, it is mostly the Florida oranges that are used to make juice. In the second decade of the 2000s, a disease known as

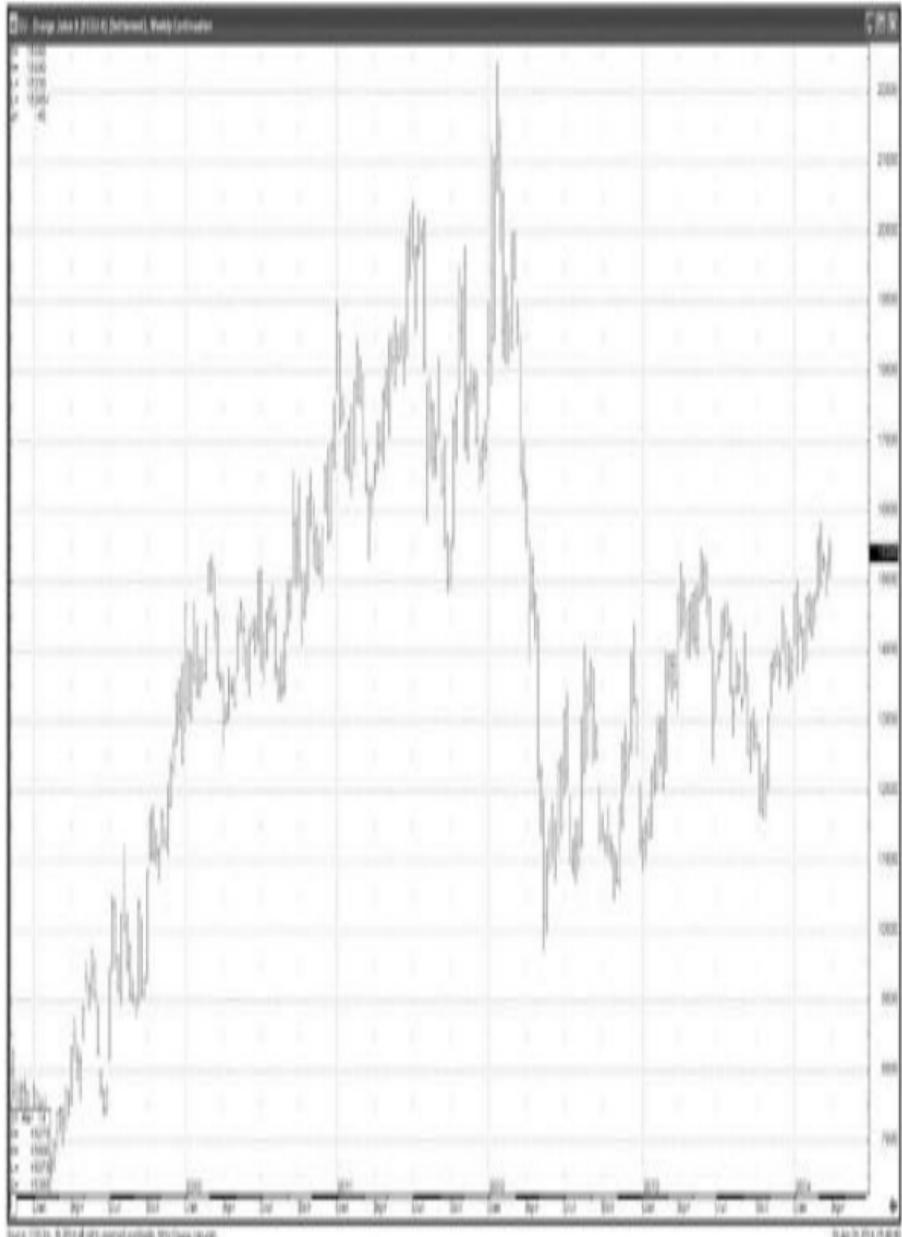
citrus “greening” has plagued Florida orange groves to the point where production has dropped up to 50% over where it had been in the early 2000s. Eradicating greening has proved to be costly and difficult. Unlike crop diseases in field crops where new plants emerge each year, an orange tree has a peak production life of more than 20 years. Therefore, the disease can carry over from

year to year.

Florida greening helped drive juice prices to all-time highs in early 2012 before Brazil was able to pick up the slack enough to ease the shortfalls (see [Figure 14.5](#)). Florida growers winning or losing this fight will be a big fundamental to watch into the 2020s—as will Brazil’s increasing (or failing to increase) exports.

FIGURE 14.5 Orange Juice Chart Showing 2012 Rally

Orange juice prices hit all-time highs in early 2012 as Florida supply fears grip the market. As a result of higher prices, a fundamental shift takes place in juice. The United States begins importing more Brazilian oranges.



Therefore, following Brazilian and Florida orange production can be a good place to start when studying orange juice fundamentals. The Frozen Concentrate Orange Juice (FCOJ) contract on the Intercontinental Commodity Exchange (ICE) is strongly affected by rises or drops in Florida or Brazilian orange production. Again, the USDA is your source of

information. The monthly supply/demand reports will list projected production figures along with U.S. and Brazilian ending stocks during the growing seasons.

Frozen orange juice is an excellent example to illustrate how core fundamentals can occasionally shift dramatically. If a trader can recognize the change, he can sell options and profit from

the same fundamental for months or even years.

This is a key example of why knowing fundamentals can be important for a trader in analyzing potential option sales.

Know How They Make the Stuff

Another key point is to note how some crops are produced. Commodities such as corn or soybeans are replanted each year and thus can often enjoy the old adage, “*High prices cure high prices.*” A shortage one year typically results in higher prices. Farmers respond to these higher prices by growing more of that crop the following year to make more profit. It

is capitalism at its finest.

Other commodities, however, such as cocoa, coffee, and orange juice, grow on trees, which means much longer crop cycles where underproduction cannot be increased overnight by simply planting more next year. This often means that trends in these commodities can be longer

term in nature than more supply-flexible markets like corn or cotton where production can be increased or decreased on an annual cycle.

Cattle

Live cattle for delivery against the Chicago Mercantile Exchange contract

are produced almost exclusively in the United States. Therefore, monitoring U.S. beef supply and U.S. beef demand is a key approach to making long-term price projections.

The USDA cattle on feed report is released once a month and breaks down how many young animals are on feed and how many animals have been marketed during

the preceding month. Thus, it is a gauge of both supply and demand and is the key report to watch in the industry.

Traders in cattle futures often watch what is known as the *cash market*. These are the actual auctions of cattle ranchers selling their cattle to packing houses. The prices paid for these cattle often constitute a good measure of demand for beef and also can

have a broad effect on futures prices, although the reverse also can be true. Cash cattle usually trades during the last two or three days of the business week. Often packers and producers will hold at their bid or asking prices until later in the week when one relents, resulting in the cattle being sold.

Cattle traders also watch daily *box beef prices*, which

are a measure of what supermarkets and other retail outlets are willing to pay for certain cuts of beef. These can be obtained through a good news service.

The cattle market is one where an informed trader can often “see” the future supply working its way through the supply chain. While this can be advantageous, demand trends (and seasonal demand

tendencies) become more crucial.

Precious Metals

We have all heard of gold prices quoted in such terms as the “Hong Kong a.m. gold fix” or the “London p.m. gold fix.” Gold prices are sometimes hot, sometimes not, but gold is gold no matter where it is being traded.

Often thought of as a safe haven, gold always has been a staple benchmark of financial security.

Understanding the many nuances that cause the yellow metal to fluctuate in price, however, is quite thorny. On one occasion, a report showed a recovering economy will be quite bullish for precious metals because gold is considered a hedge against inflation. Then another report

suggested a robust economy, and gold prices sank with thoughts of higher interest rates. It's tough to call.

News of potential military confrontations used to whip gold traders into a buying frenzy. These days, that is not always the case.

Gold is often seen as an inflation hedge and can often be linked to fluctuations in the U.S. dollar. Higher dollar

values typically pressure gold while a falling dollar tends to be supportive of its price. In the current age, gold tends to take its cues from the Federal Reserve.

The Golden Age for gold was the “QE Years” when the Fed lowered interest rates to nearly zero. Gold had a wild bull market from 2009 through 2011. Then it started worrying when the Fed was

going to take away the candy. It is likely that the Fed will play a larger role in gold prices than will any other factor for the next several years.

This illustrates a key point about gold. The gold market trades like a financial market more than a commodities market. Investor and fund demand drive this market even though

newsletters will kid you that demand for jewelry plays a role. Gold takes its primary price cues from the financial news pages and investor sentiment.

Now let's compare that to how some of its cousins behave.

Gold Versus Industrial Metals

Industrial metals such as copper, silver, and platinum share some of gold's financial properties. However, these metals also carry an extra dimension that can influence their longer term directions—information that can be beneficial to option sellers.

Even though silver and even copper can double as an inflation hedge, they also derive a large part of their

price direction from
industrial demand.

A Metals Case Study

As a glaring example, we need look no further back than the financial crisis, subsequent recession, and beginning of quantitative easing in the United States. In early 2009, the metals markets had all fallen on hard

times as recession had substantially crimped demand expectations. When the Federal Reserve began its extended quantitative easing, it began an unprecedented and extended price rally in all metals. At the peak of this bull market, copper was changing hands at over \$4.50 a pound. Gold traded over \$1,900 for the first time ever (Figure 14.6). Also enjoying a high percentage gain was

silver, trading just shy of \$50.00 an ounce (levels not seen since Bunker Hunt ruled the silver pit).

FIGURE 14.6 Gold Chart: 2009–2011



It was a rally sponsored by huge fund and speculative buying on the expectation of a falling dollar and inflation. But there was another element at work. From early 2009 to the highs in 2011, gold prices increased by 123%. Impressive to say the least.

Copper prices, however, rallied by 208% ([Figure 14.7](#)). And silver prices

soared by a whopping 371%
(Figure 14.8).

FIGURE 14.7 Copper Chart:
2009–2011
Copper rallies by 208%.

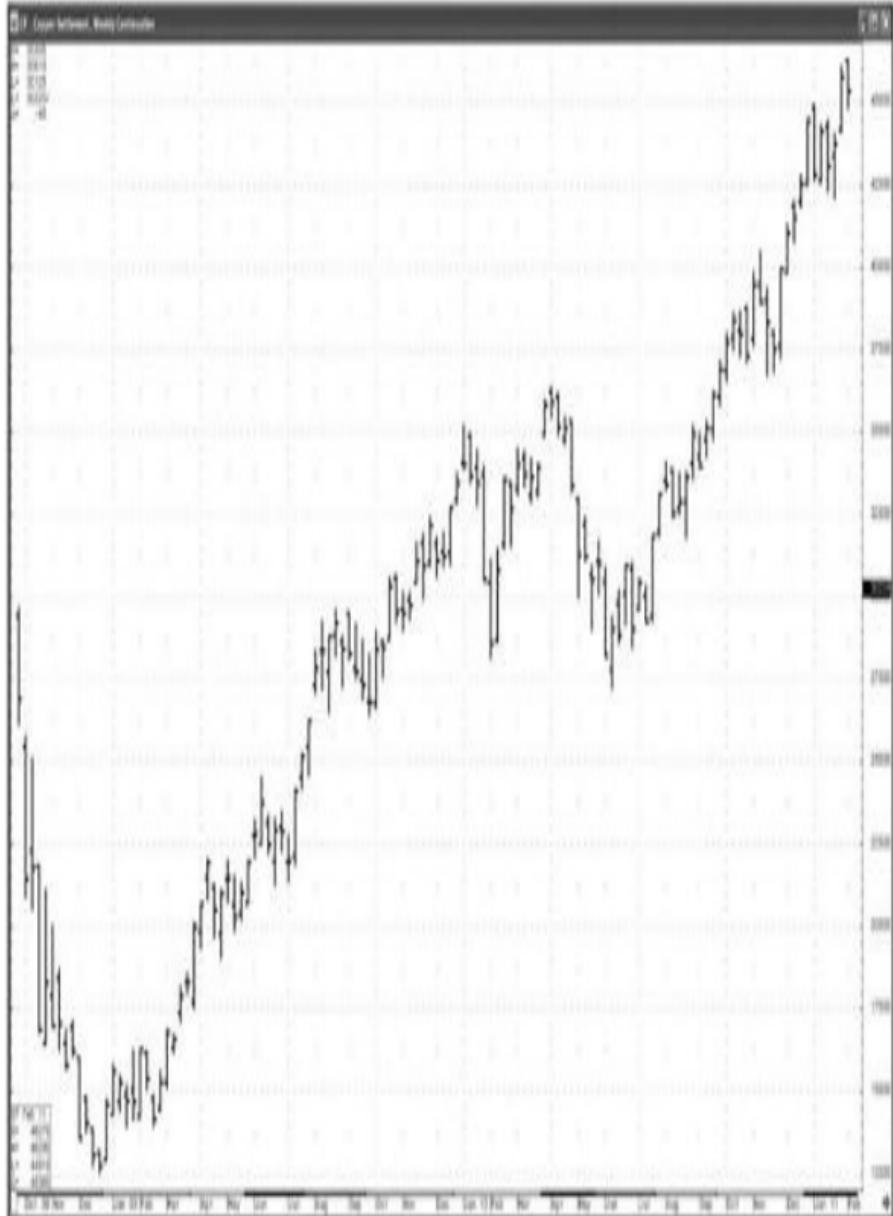
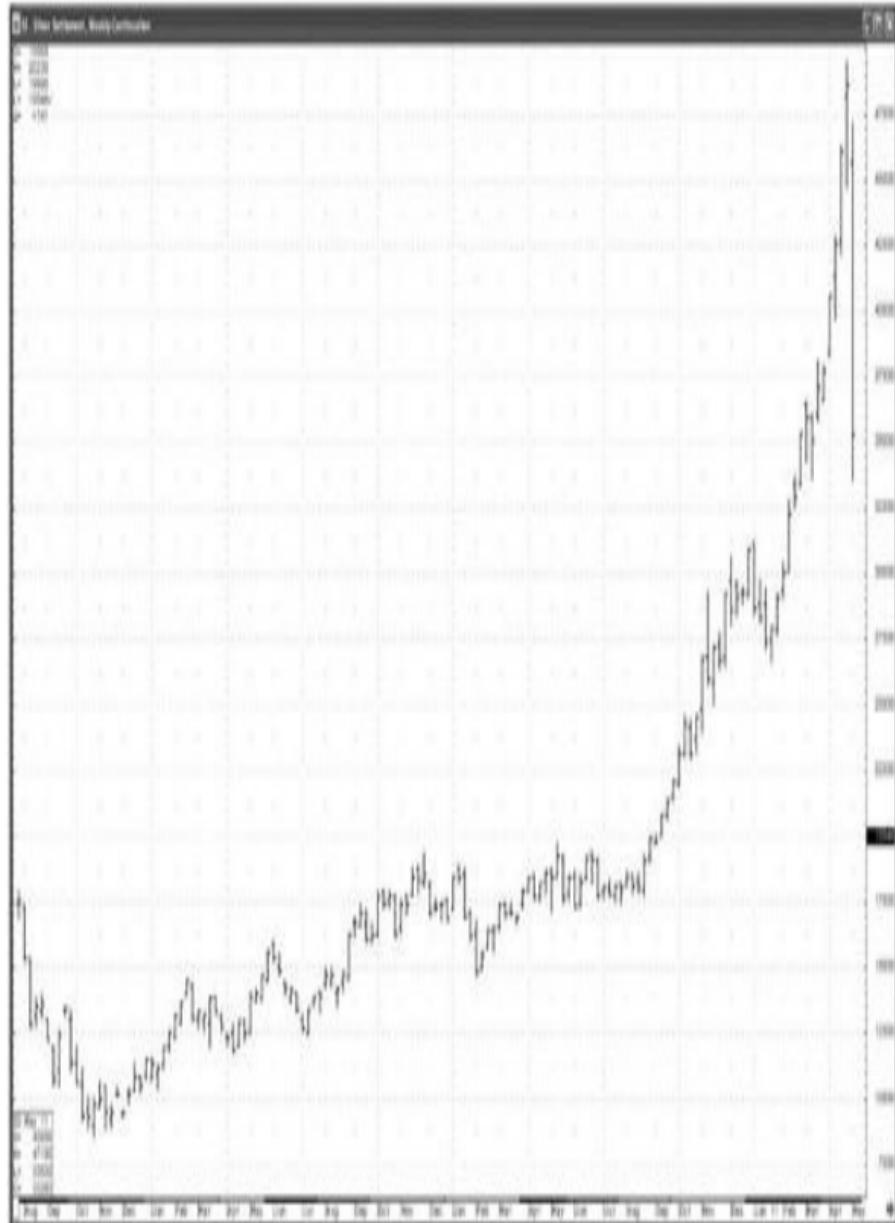


FIGURE 14.8 Silver Chart: 2009–2011

Silver grabs a 371% price gain.



Why the discrepancy?

All three markets were enjoying voracious investor demand. Any investor product featuring metals from bullion to Exchange Trade Funds (ETFs) was hot.

Copper, while generating some interest from investor demand, was benefiting more from the expectation of more industrial demand. Despite a recession in the United States

and Europe, China and some of the smaller emerging economies continued to build. Thus, demand remained brisk from these countries. As industrial users feared higher prices from investor demand, they began aggressively forward buying to meet future needs. Copper was cheap as well, having fallen further than gold during 2008.

Therefore, while investor

demand was fueling all of the metals markets, the industrial metals had extra rocket boosters derived from global commercial players.

But why did silver outperform both?

Because silver, in this situation, enjoyed the best of both worlds. Silver, like gold, is also considered a strong hedge against inflation. Yet it continues to have many

industrial uses around the globe. Thus, it enjoyed more investor demand than copper, yet more industrial demand than gold.

If you remember nothing else about trading metals, remember this. Gold is mainly a financial instrument with its primary demand coming from investors. Copper is primarily an industrial raw material with

its demand coming primarily from the commercial sector. Silver shares both worlds and derives demand from both industrial and investment sectors. The fundamental premise on which you are basing your trade, then, should determine which metal you would choose to collect your premium.

Coffee and the Softs

Markets

I love trading coffee! And I really love selling options in the coffee market. Coffee is what is referred to as one of the “Softs” markets. Softs include coffee, sugar, orange juice, cocoa, and sometimes cotton. Ironic since I believe cotton is where the name “softs” comes from. Softs are also sometimes referred to as

“exotics.”

I like taking premium in softs (particularly coffee), because so few people understand the real fundamentals that drive price. Unlike most of the grains or meats, which are impacted to a large degree by U.S. production, many softs are grown outside of the United States. Thus, clean, concise USDA data is not always

available. You have to dig a little deeper to get the goods in softs. But doing so can pay handsomely.

The USDA does have “Ag Attaches” in many of these countries, and they do estimates. However, I have found it best, especially in the coffee market, to look at a number of different estimates. The USDA will do a production estimate for

Brazilian coffee. But so will the Brazilian government. There are also several private forecasting companies that release their own estimates. These can often be the most reliable. To get all, I suggest getting a subscription to Dow Jones or Bloomberg Commodity newswires. These are often available through the same companies that offer market quotes and charting.

Let's talk about coffee.

Coffee Fundamentals

Fifty-seven different countries grow coffee, making it truly a global commodity. There are two basic types of coffee, arabica and robusta. Arabica coffee tends to have a milder flavor and usually is grown at higher attitudes. Robusta coffee has

a heavier flavor and tends to be produced on low lands. Arabica is the preferred coffee in the Western Hemisphere and trades at a premium price. Like many fine foods, these two coffees often are blended to create yet another distinctive taste.

Arabica coffee is the contract traded on the International Commodity Exchange (ICE). Robusta

coffee is traded on the London International Financial Futures and Options Exchange (LIFFE). Arabica coffee is the primary product of many Central American countries and Colombia. Robusta is grown in many countries, including India and Vietnam. Brazil is by far the world's largest producer and exporter of both arabica and robusta coffees. Therefore, Brazilian production can have

a large impact on coffee prices especially those at the ICE.

Brazil grows more than three times as much coffee as the world's second largest exporter, Vietnam. Brazilian production takes on even more weight for U.S. market traders when one considers that Vietnam primarily produces the robusta variety of coffee (traded in London),

whereas the majority of Brazil's production is that of the arabica variety traded on the ICE.

Brazil experiences an every-other-year “on/off” cycle in coffee production where higher production years are usually followed by lower production years. This is a natural cycle of coffee trees. The first thing traders of coffee should be aware of

is if Brazil is in an “on” or “off” production year. Remember that futures markets tend to “forward price” commodities about six months ahead. This means that the markets will begin pricing in a harvest up to six months before the actual harvest comes in.

Okay. You already know more than 90% of the people currently trading coffee. But

let's dig a little deeper.

Beginning in the late 1990s, coffee production started to migrate north to the more temperate states, concentrating in Espírito Santo, São Paulo, and Minas Gerais. This moved the bulk of production out of frost-prone areas and has largely insulated Brazilian production from headline grabbing freezes that plagued

the market back in the 1980s and 1990s. As Brazil's coffee industry was enjoying huge profits from high coffee prices, co-ops started pouring money into new production. Billions of young seedlings were planted. This new investment would change the landscape in coffee for years to come.

News of big profits soon traveled to the Far East, and a

new player began to emerge in the coffee arena. Vietnam was ripe to enter, with its cheap labor and near-perfect climate. The world would make room for yet another coffee supplier but, more importantly, a supplier with little domestic consumption. During the year 2000, Vietnamese robusta production topped 11 million bags, just 1 million bags shy of an average yield from the

former powerhouse Colombia. Of the 11 million bags produced that year, over 10 million were available for export. By 2007, Vietnamese annual production had surged to more than 16 million bags.

Flash forward to present day. Vietnam is now the world's second largest producer of coffee—primarily the robusta variety—making it a country to

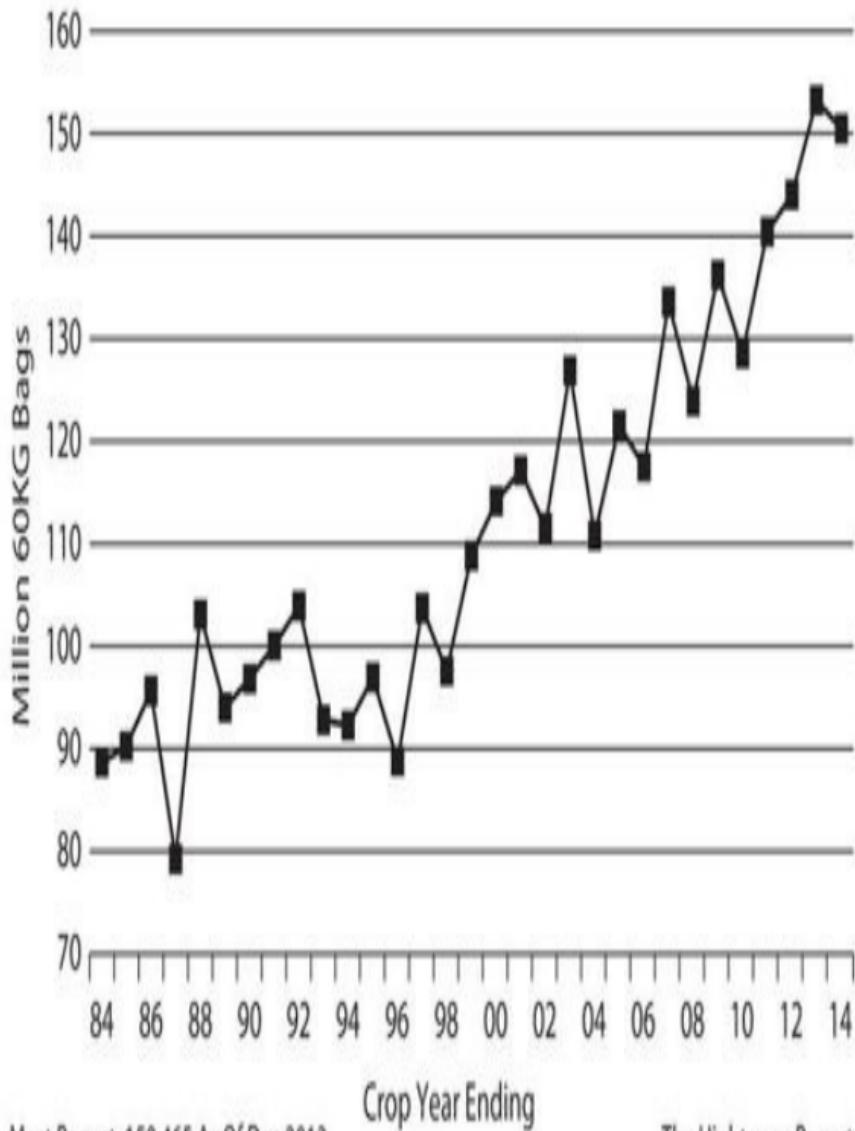
watch for fundamental coffee traders. Brazil, however, benefiting from expanded and more densely planted hectares, continues to lead the world in production of all coffee, high-quality arabica in particular. World production has risen steadily since the mid-1990s, setting an all-time record in 2013. (See [Figure 14.9](#))

FIGURE 14.9 Coffee Global

Production Chart

Global coffee production has risen steadily since the mid-1990s.

World Coffee Production



Most Recent: 150.465 As Of Dec 2013

The Hightower Report

Yet coffee demand has all but kept pace. “New” demand has emerged in the last decade from growing middle classes from China and India in particular.

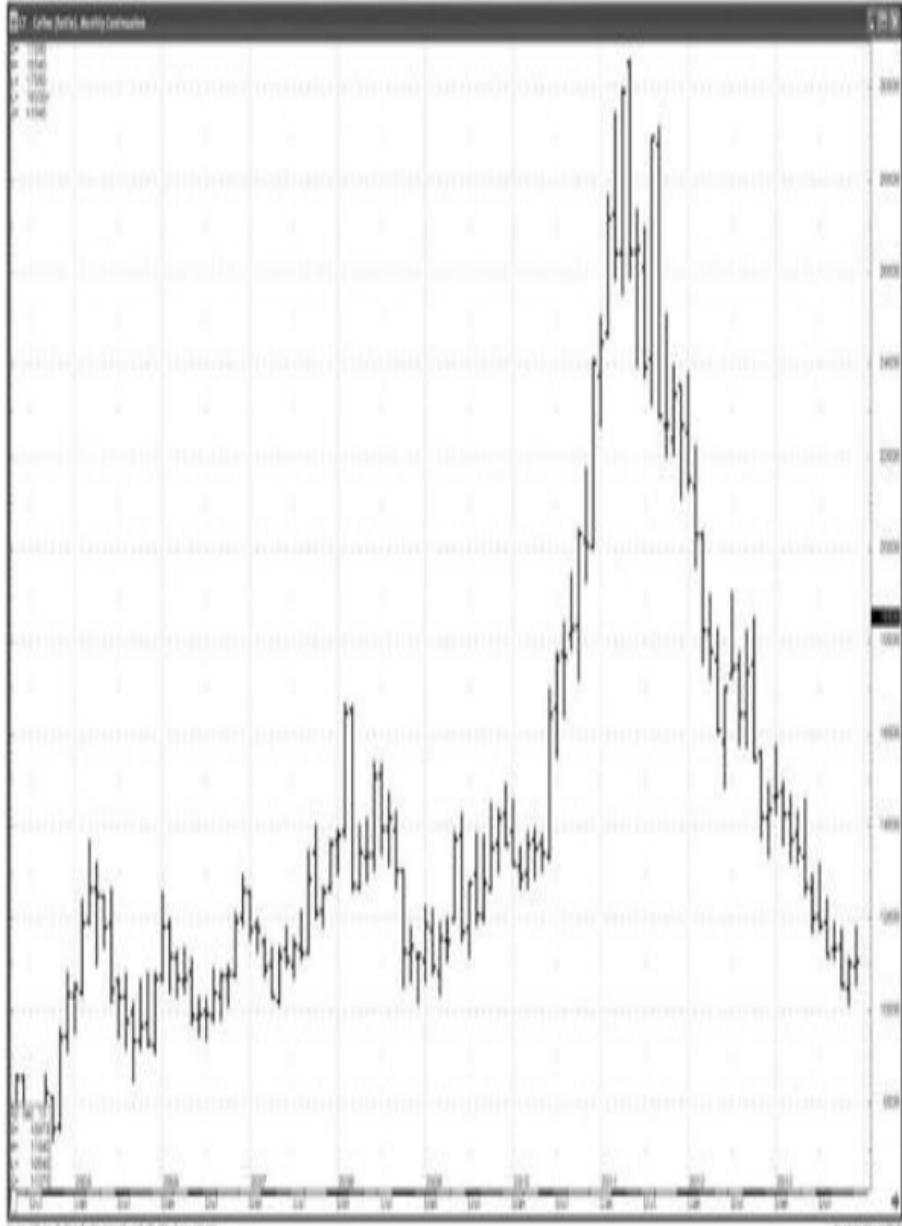
This means that coffee can still be sensitive to supply disruptions. 2011 saw coffee prices rally to over \$3.00 per pound on dwindling supplies of high-quality Arabica blends. (see Figure 14.10)

This was primarily a result of poor harvests in Central America. It is interesting to note that during this time, supplies of lower quality coffee were ample. However, many brands of premium coffees, such as those used by Starbucks, come from smaller arabica growers in Central America. Brazil provides a large chunk of this. But Central American growers make up a substantial

remainder of the pie.

FIGURE 14.10 Coffee Monthly Price Chart: 2010– 2011 Rally

Coffee prices spiked in 2010 into 2011. Volatility can remain in option prices for years after such a rally—regardless of current fundamentals.



What I love about coffee is that volatility from past moves seems to remain in option prices for years afterward—regardless of current fundamentals! Is anyone actually studying this stuff or just watching a 20-year chart? All the public remembers are the headlines from several years ago. This can be a big advantage to you as a fundamentally informed

option seller—in all of the softs markets.

Harvest Cycles in Coffee Can Mean Option-Selling Opportunities

Coffee prices have historically been most volatile in the Brazilian winter (despite the reduced frost

risk) which is June to September and during the coffee “flowering” season in October, in which the coffee beans sprout. However, the March to April time period has also become a time to watch in recent years as Vietnam has become a bigger player on the world stage. This is normally the time of year when Vietnamese beans come onto the world market. The futures market has begun

to show a growing impatience with weather or transportation delays during this time. Any and/or all of these factors can be potential opportunities for option sellers.

A Word on “Macro” Fundamentals

It should also be noted in this chapter that there will be

times where macroeconomic factors, such as the global boom and then bust of commodities as a whole in 2008, will overshadow the individual fundamentals of certain markets at times. However, these macroeconomic issues are merely larger scale supply/demand issues in which (in the case of 2008) demand for many independent commodities

rises and falls at the same time due to outside economic forces. Even though these types of markets can provide their own set of opportunities and challenges for the option seller, they are more the exception than the norm. Individual commodities markets tend to march to the beat of their own drummers.

In a normal market, the price of coffee and the price

of natural gas have little in common. Therefore, prices will always return to reflecting these differences. This is why investing in a basket of commodities can truly be a diversified portfolio.

Financial Futures Fundamentals

You will notice that fundamentals of financial markets such as bonds, currencies, and stock index futures are not covered in this chapter. This is *not* because we believe that knowing the fundamentals of these markets is not important. We simply believe, after years of trading them, that knowing the fundamentals here do not offer a definitive edge.

Fundamentals of these markets are so extensive and so subject to individual opinion and interpretation that it would have taken a whole chapter to cover each one. However, individual research into these markets certainly can help to give perspective to a purely technical approach.

Do You Trade for Fun or Money?

About 10 years ago, I noticed that my trading performance was so much better in the physical commodities compared to financial futures. It was crystal clear to me that

knowing the fundamentals of the real commodities gave us an edge there while there were simply too many moving parts in the financial products. So I stopped trading financial options almost altogether. It was the best decision I ever made.

It always amazes me when I talk to a client or potential client who wants

to trade a market because she “likes” it. These are not beginners. These are high-net-worth investors who I assume have at least a basic knowledge of investing. Yet, she wants to trade the S&P because she “likes” it. I typically have two questions for her.

1. How much money has trading this market (actively)

made you in the last 10 years? Not the story of the time you hit it just right—just how much, *net*, in the last 10 years?

2. Do you want to trade for fun or to make money?

Trading the S&P or bonds or currencies may sound sexy. Heck, it may be fun. After all,

everybody has an opinion on the S&P. What is more fun than being right? Makes great conversation at the club. Everybody knows what you're talking about. But tell them you just took premium out of the cocoa market. See what kind of look you get then. Then *they'll* have two questions for you.

1. What is premium?

2. What is the cocoa market?

This, of course doesn't bother me. I have no clue what moves the S&P. I have my opinions, just like everybody else. But at the end of the day, a word from the Fed can make me wrong. Same goes for currencies, bonds, and the rest of them.

What moves coffee

prices? That I can tell you. I cannot tell you exactly where the price is going to go. But I understand what is moving it. Most can't. Even most that are trading it can't. That's a market where an informed trader can make money. That's what I care about.

If you care about making money more than having good banter for the

golf course, be willing to go where the others won't look. And learn the fundamentals of those markets—like the others don't.

Conclusion

The fundamentals in this chapter should give you a starting point for researching

commodities and the type of information that you will want to seek. The commodities explored in this chapter certainly are not a complete list, and you will want to research and compare findings of your own on these and other commodities and futures markets.

Our client newsletter, *The Option Seller*, provides condensed and summarized

commodity fundamentals for our investors and clients. If you would like to receive a free sample of the newsletter, visit

www.OptionSellers.com.

The next two chapters are devoted to a branch of fundamental analysis known as *seasonals*. Seasonal analysis can be a powerful tool in formulating an outlook for a market under any

economic condition. These chapters will show you how.

15



Seasonal Tendencies in Option Selling

A Most Potent Profit
Formula

You are about to learn what

could be the most powerful weapon in your option-selling arsenal. Hidden from view, shrouded in mystery, scorned by the uninformed, *seasonals*, as they are known to the initiated, can give you real insights into that “hidden hand” that seems to move market prices of commodities.

But be forewarned: Introducing seasonals to the

uninformed can be like giving a cave man fire. If he uses it right, he can light the way for the rest of his life. Use it wrong and he burns his fingers off.

Most investors have never heard the word *seasonals*. Of the commodity investors who have, few have ever used them. Of the ones that have, very few know how to use them properly (i.e., to

generate consistent profits).

Like I said, to get to the real gold in this business can take some digging. We're going to save you the trouble here.

What Are Seasonals?

A seasonal tendency, or seasonal, is just that. For our purposes, we will define seasonal tendency as the

tendency for prices of an individual commodity to move a certain direction at a certain time of year. A 15-year seasonal chart (which you will see in this chapter) is simply taking 15 years of price movement during a certain time period each year and averaging them together. What this can reveal, of course, is simply a tendency. It doesn't mean it will happen every year. If it does, it might

not happen at the same time or the same degree this year, or next.

Those little disclaimers are what make it so hard for futures traders to profit consistently with seasonals. There is no buzzer that goes off to tell you when to buy it and sell it (although many have tried that) or to avoid it altogether this year.

Traders and gurus have

tried different methods to “catch the move” of a seasonal tendency. Some have achieved success for brief periods, only to flame out in time. But just as the traders in previous chapters, they are seeking the wrong answers to the wrong questions. They are asking seasonals to tell them where the market is going (and worse yet, *when* it is going there). You are only going to

consult them to determine where prices are *not* going. In that, you will find the true value of the seasonal.

The Wrong Way to Use Seasonals

Seasonal tendencies of commodities markets, or *seasonals* as they are known to traders, are like option

selling in a way. They are one of the most interesting yet misunderstood areas of trading. This makes them vulnerable to misuse and, of course, bad word-of-mouth from the misusers.

As in option selling, traders who see seasonal charts for the first time may think that they have just discovered the Holy Grail of trading, the inside secret, the

real force driving the market.

The seasonal chart looks so simple. Buy on this day; sell on this day. It has worked for 14 of the last 15 years. There were a few authors several years ago who made a lot of money selling books on seasonal trades. There were entire books that just gave lists of dates to buy and dates to sell. All you had to do was follow it. It's magic! Then

they all found out the hard way that it wasn't.

Unfortunately, seasonal analysis is much more complex than buying on one day and selling on another, as many traders have discovered painfully. These statistics are interesting to look at, but they are only reflecting a cyclic occurrence in the market. To be truly able to understand seasonals and trade them

effectively, you have to understand what these occurrences or *fundamentals* are. You must then be able to track and measure them to determine if they are indeed occurring this year, to what degree, and on what time schedule. You must know the key reason that typically causes this seasonal tendency to take place. Then you must be able to determine if those same fundamentals are in

place *this* year. Sounds complex, but it isn't that hard with a little study.

Trying to trade on a certain date and get out on a certain date because a book says so is putting your faith solely in statistics and averages. What many traders unfortunately have found out is that the market doesn't care about statistics and averages. Therefore, many traders who

have tried this timing method and lost money concluded that seasonals in general are no good. This is a shame for them but good for you! You'll have less competition and more people to take the other side of your trades. You are going to learn how you can combine real seasonal tendencies with option selling into a very potent profit strategy.

Why Traders Lose with Seasonals

Before we begin exploring how to make money with seasonals, we first must examine why traders lose trading seasonals. There are three main reasons this happens. Let's explore these mistakes so you won't make them.

1. **They try to time the market.** The first mistake traders make with seasonals is that they assume that because the market increased (or decreased) in value between a given two dates x of the last 15 years, they will make money if they buy (and sell) on those same dates *this* year. In short,

they forget they are looking at *averages*, which can vary widely in individual years.

These dates often show corresponding profits that could have been made had the trader done the trades in years past. If a trader looks closely, these often show that a few years had big gains,

whereas many years had minimal or almost negligent gains. Then you also can see the losing years.

Look at how big the losses were in losing years as opposed to the gains. Often you will see a few years with big profits but equally big losses in others and several years in

between with small or very small profits.

Therefore, a trader could be taking a large risk for minimal gains.

This is why the term *average profit* can be very misleading.

2. **They fail to realize that winning years often can have large moves against the seasonal average that a**

trader would have had to “ride out” to capture the profit, whether it was large or small. If the profit from the trade was \$300 in year x but it had a \$2,500 drawdown in the meantime, do you still think you would be in the trade? Even if you were, is that the type of trade you want to be in — riding out a \$2,500

loser for a \$300 gain? Probably not. At least not if you want your trading account to last for long.

To put it bluntly, trying to trade seasonals by picking an absolute day to get in and out every year is not only pointless, but it also could be hazardous to your

wallet.

3. They try to trade seasonals using futures contracts. The initial mistake traders make is trying to time the market in the first place. However, the biggest mistake they make is trying to do it with futures contracts.

Trading futures contracts requires

almost perfect timing to begin with. If you try to time your seasonal trade by calendar dates, even if the seasonal move occurs, what if it is a week or two off this year? What if you go long, and the market decides to take a big dip before making a run higher, assuming that a move takes place at all? You could be

stopped out long before the market even goes into a seasonal rally.

There is a strategy, however, that can keep you in the market, even if prices do correct while you are in your position. In fact, you can profit from this strategy even if the seasonal move doesn't take place at all. The

strategy, of course, is called *option selling*.

The Right Way to Approach Seasonals

Selling options instead of trading futures on seasonals can be stunningly effective. However, knowing how and why the seasonal works and the likelihood of it repeating

this year are key in a successful seasonal option sale. Do your market analysis right, and the proper option-selling months and strikes will become obvious.

Looking at a book of seasonal tendencies is a great place to start in your search for good option sales. Browse through the charts and look for markets that have a strong tendency to make a clear,

sustained move up or down at a certain time or times of the year. Look particularly for markets that often go from extreme highs directly to extreme lows (or vice versa) without a lot of “riffraff” in between. Markets that have a tendency to go from yearly highs to yearly lows without a lot of ups and downs in the middle can be excellent candidates for option sales.

Try not to pay too much attention to the smaller ups and downs, or blips, on the seasonal average charts. Focus on the major moves and the long-term tendencies.

Now let's go through the steps to performing a successful seasonal option sale.

Steps to Identifying a

Profitable Seasonal Option Sale

Step 1: Learn to Read the Seasonal Chart—Properly

Figure 15.1 is an example of a seasonal chart. The solid line represents a 15-year average of price performance for that particular contract

month. The dotted line represents a 5-year average of price performance. The numbers on the side of the chart are not prices: 0 represents the lowest average price of the year, whereas 100 represents the highest average price of the year.

FIGURE 15.1 November Natural Gas Five- and Fifteen-Year Seasonal Overlaid*

Nov Natural Gas(NYM)
15 Year Seasonal(99-13)

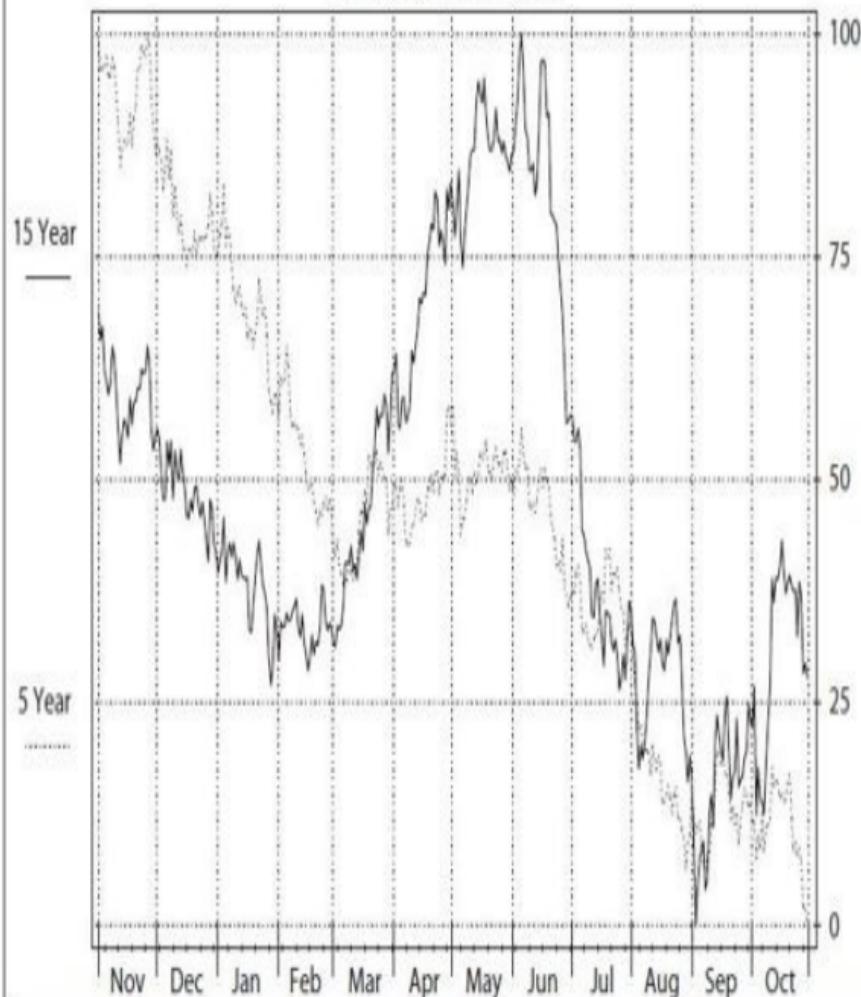


Chart Date: Apr 8, 2014

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*Chart courtesy of Moore Research Center, copyright 2014.

The key word here is *average*. This chart tells us that, on average, natural gas prices tend to increase beginning sometime in early February and continue right up through mid-June, when they tend to decrease sharply into summer. Does this mean that you buy natural gas every February 1 and sell it every June 15? Absolutely not. This is only the beginning.

Seasonal averages are simply raw material for your trade. This provides you with candidates that you will weed through to find a few finalists that have the highest probabilities of success.

The fact that these are averaged from 15 years of price data can be very confusing to the novice trader. A large, random move that happened to occur over

the course of a few years often can skew the average and make it look like a small move occurs every year, especially if you are looking at a five-year average.

This is why you want to look for the markets that tend to move from one extreme to another and not try to catch the short-term swings that show up on a seasonal chart. Look at the big picture.

The second note about averages is the time frame in which the move takes place. Again, the seasonal chart reflects the *average* time frame. This means that a price move in a general direction could have begun several weeks before or several weeks after what is being reflected on the seasonal charts. This is another reason why trading futures contracts on seasonals

is so tough. If you trade off the 5- or 15-year average, you may get in too early for a move that occurs this year and end up stopped out, or you may enter the position too late and miss a move that already occurred.

Tip: Look for markets where actual price performance tracks closest to the averages.

We recommend looking

at the actual price charts from the last 15 years in addition to the seasonal charts before deciding to trade a seasonal average. The closer the actual price charts follow the seasonal, the better trading opportunity you may have. Several years of wide variance above and below the seasonal average with a strong variation in time frames may combine to form an impressive-looking

average, but it can be treacherous to trade.

In contrast, markets that demonstrate close historical adherence to the seasonal average can be good trading opportunities. For instance, Figure 15.2 shows a 15-year seasonal average for June crude oil.

FIGURE 15.2 June Crude Oil Fifteen-Year Seasonal*

Jun Crude Oil(NYM)
15 Year Seasonal(99-13)

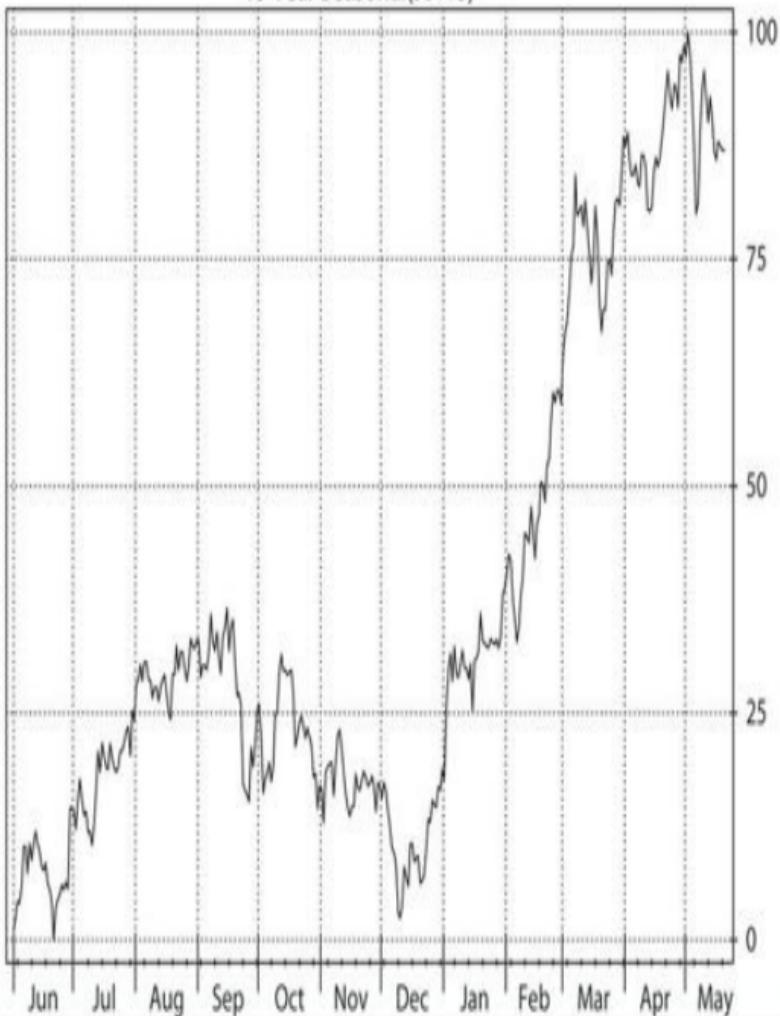


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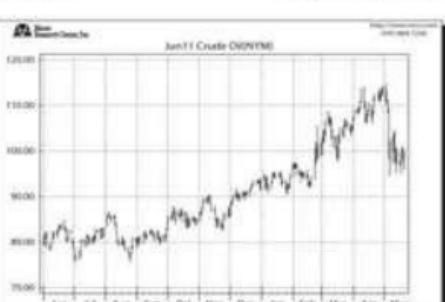
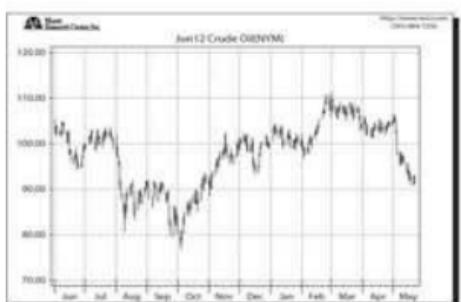
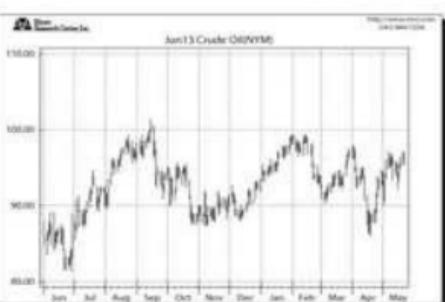
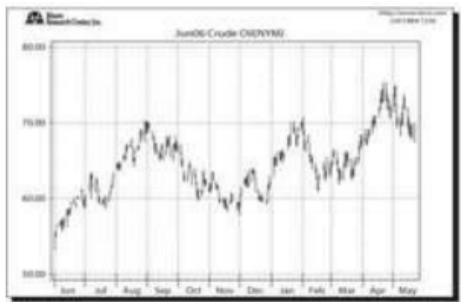
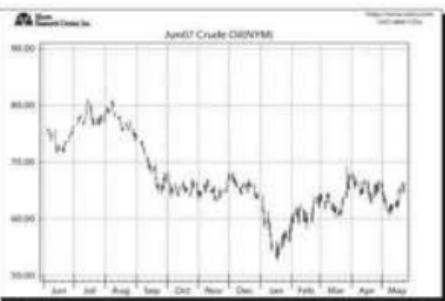
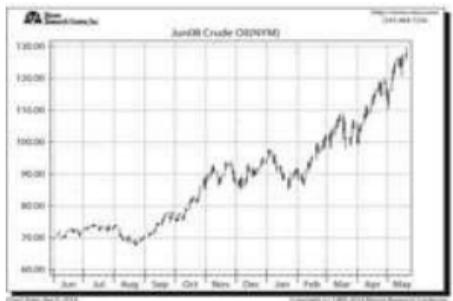
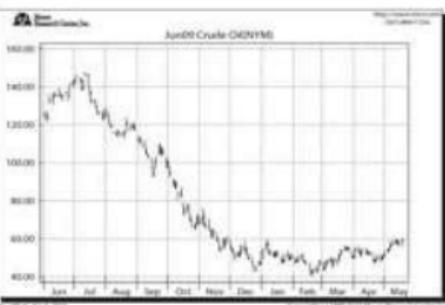
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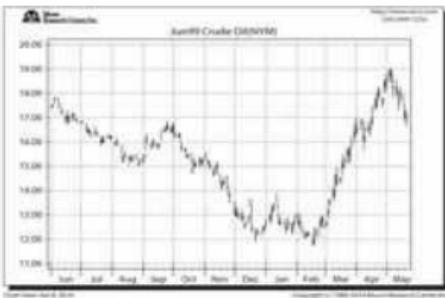
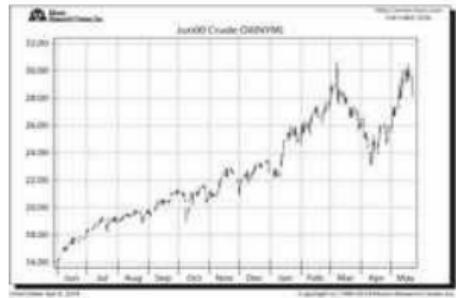
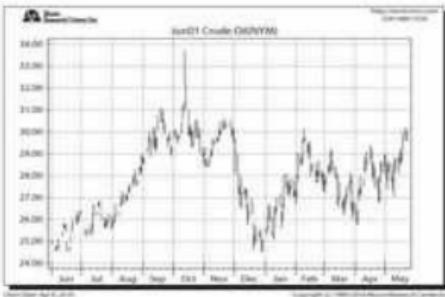
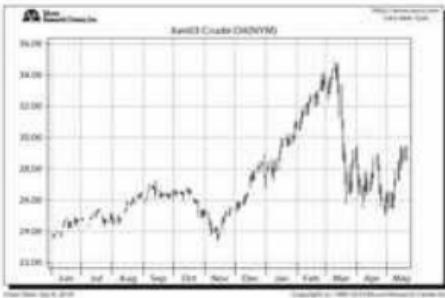
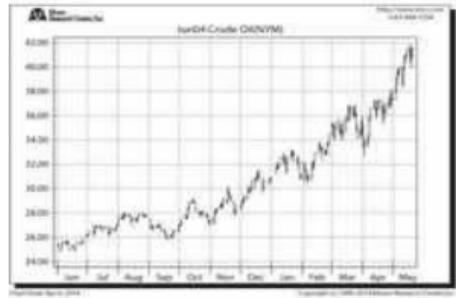
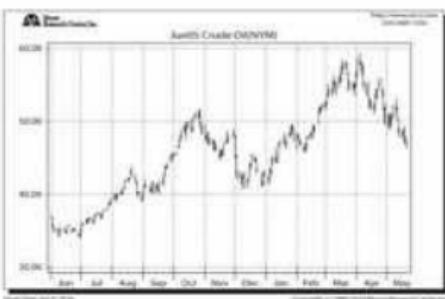
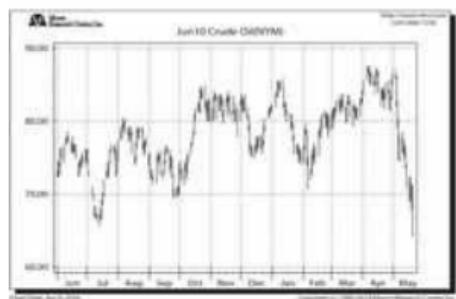
The energy complex can offer some excellent seasonal opportunities for option selling. The cyclic nature of energy markets is one reason that the historical price charts that follow match up relatively closely to the seasonal average. [Figure 15.3](#) demonstrates that June crude oil has exhibited a fairly close adherence to seasonal averages in many of the

previous 15 years.

FIGURE 15.3 June Crude Oil Fifteen-Year Price History*

Over the last 15 years, how many years would you have made money selling puts far beneath the crude market in December?





The seasonal average versus actual performance for the December euro, however, tells a different story (see Figure 15.4).

FIGURE 15.4 December Euro Fifteen-Year Seasonal*

Dec EuroFX(CME)
15 Year Seasonal(99-13)

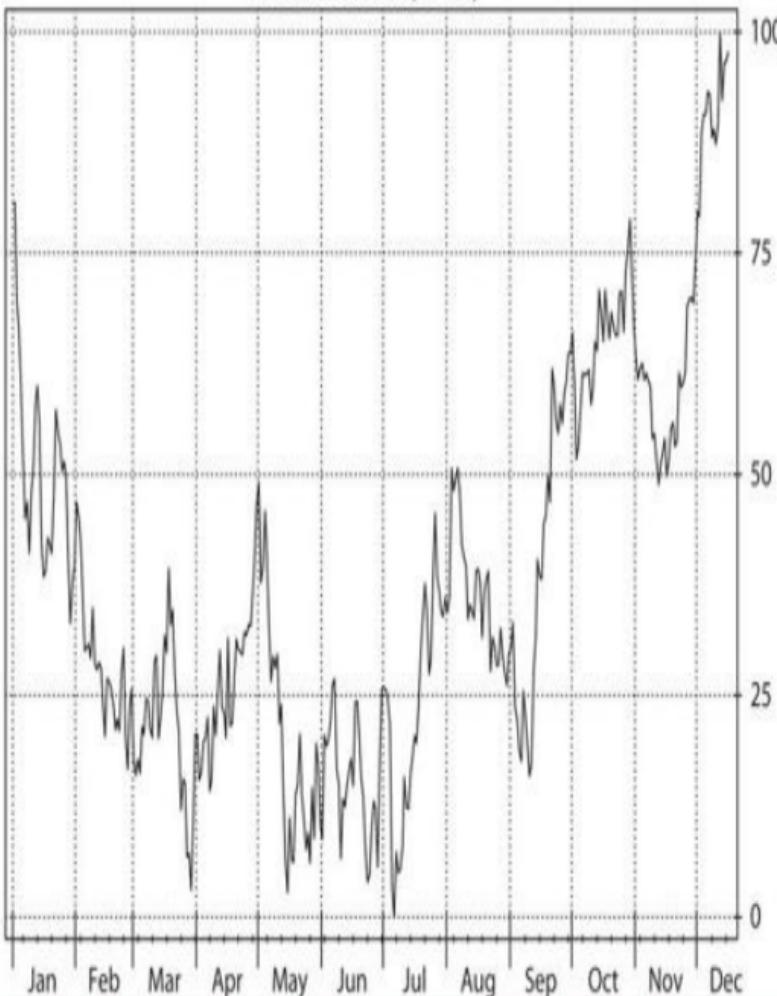


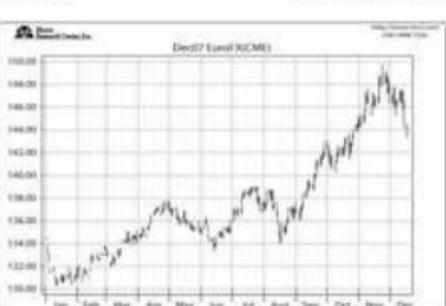
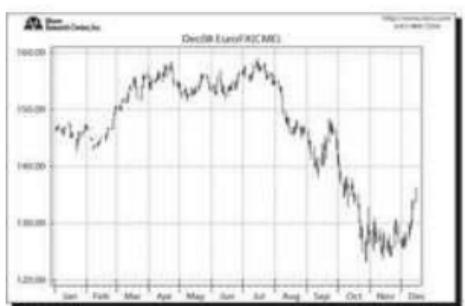
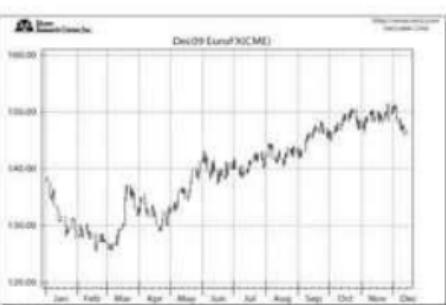
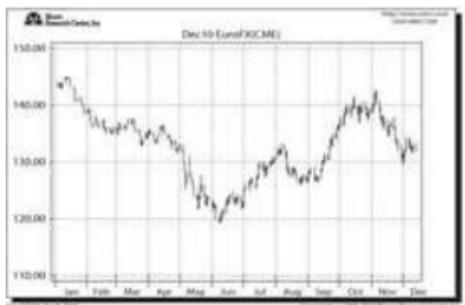
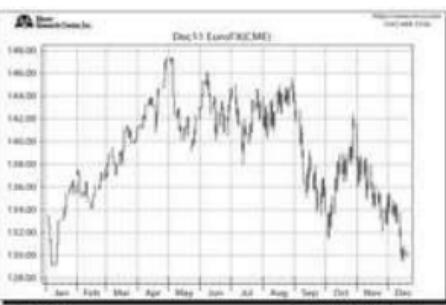
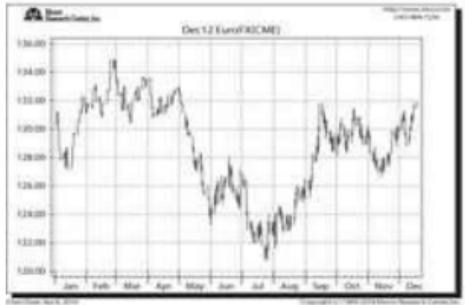
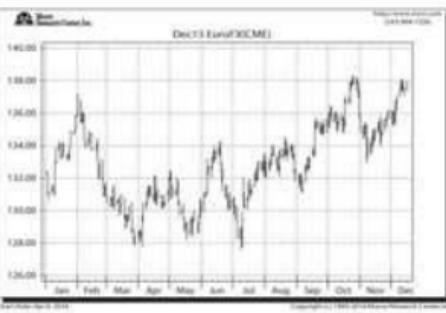
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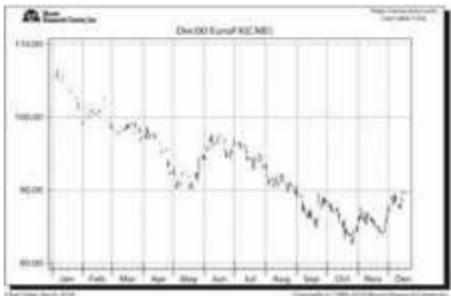
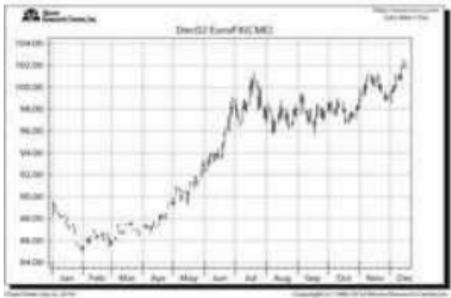
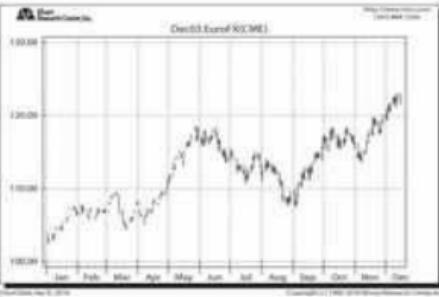
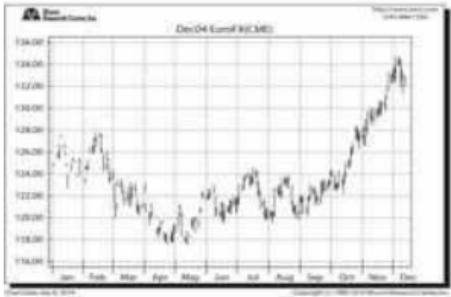
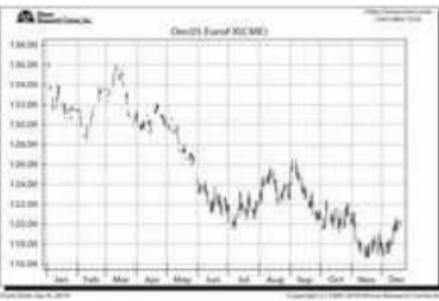
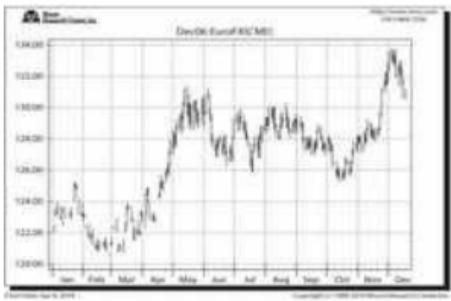
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The seasonal chart for the December Euro appears to show a fairly steady ascent from lowest to highest price from June through October and then trailing off into December. Yet when one looks at historical performance in [Figure 15.5](#), there is a wide range of price performance that varies considerably from the average. This is an example

of prices combining to produce a somewhat misleading seasonal chart.

FIGURE 15.5 December Euro Fifteen-Year Price History*





*Chart courtesy of Moore Research Center, copyright 2014.

Often a quick way to determine if you have a consistent seasonal pattern is to compare the 5-year seasonal average with a 15-year seasonal average. If they are fairly uniform, it could be an indication that the seasonal move is consistent. September coffee is a good example of this (see Figure 15.6).

FIGURE 15.6 September Coffee Five-Year Over Fifteen-Year Seasonal Average*

September coffee 5-year seasonal averages match up well with a 15-year seasonal average. This could indicate a more consistent seasonal price pattern.

Sep Coffee "C"(ICE)

15 Year Seasonal(99-13)

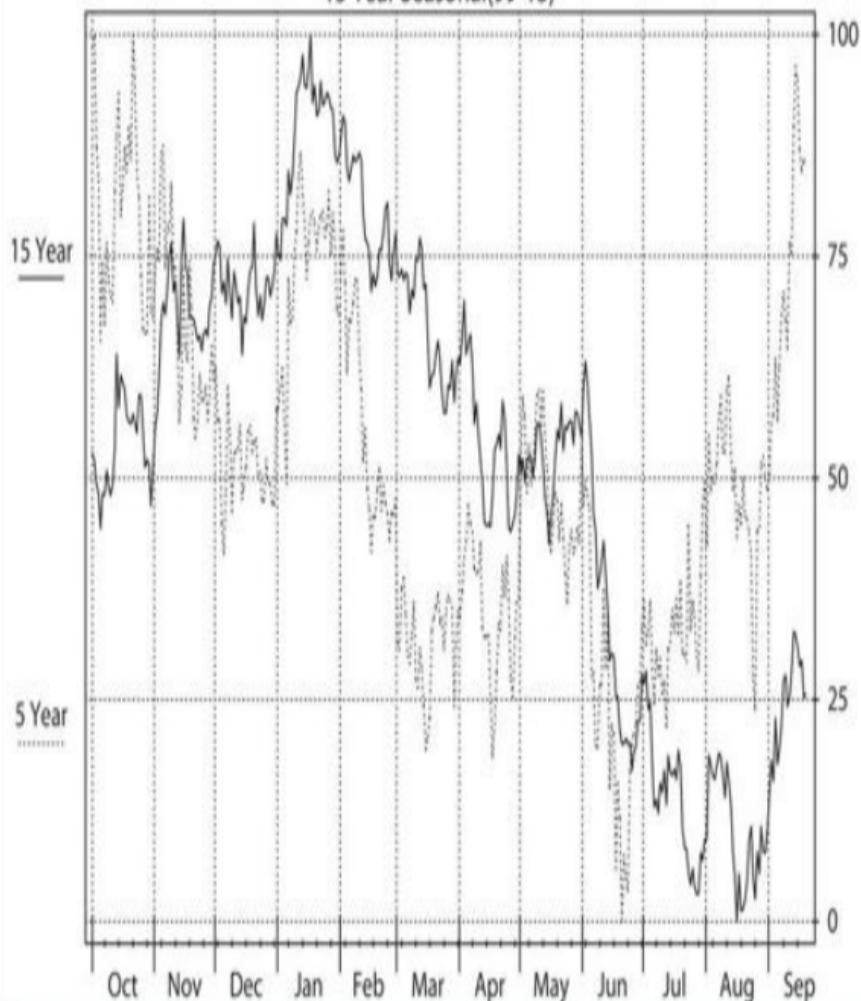


Chart Date: Apr 8, 2014

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If there is a wide variation between the 5- and 15-year seasonal average charts, it could mean that the moves that occurred in the past may have been random occurrences that combined to make a good-looking seasonal average but were not really seasonal moves at all. It also could mean that a new fundamental has been developing in more recent

years that is forging a new seasonal tendency.

Step 2: Learn the Reasons Behind a Seasonal Tendency

Once you have identified a seasonal move that seems to occur fairly consistently at certain times of the year, it is time to find out why.

Seasonal moves do not occur magically. There is something that causes them to happen year after year.

If you remember the old “Scooby Doo” cartoons, at the end, Scooby or Shaggy would pull off the mask of the ghost and find it was just Old Man Johnson. When studying seasonals, you have to play the role of Scooby Doo. You have to pull back

the mask and look behind the scenes to see what is really causing this “magical” move to occur. Almost always, there is a key fundamental behind the mask. It’s not a supernatural force. It’s more likely Old Man Harvest, Old Man Summer, or Old Man Inventory Building.

***Key Fundamentals Occur
Regularly in Commodities***

The occurrence of a key fundamental at specific times of the year tends to be especially true in physical commodities. These would include grains, softs, meats, and energy.

These are consumable commodities that often have production and/or distribution cycles that occur at the same time of the year every year. There are some years in

which outside factors will mute a corresponding price move in the commodity, but in “normal” years, price may tend to favor movement in one direction during these time periods.

Finding out these key fundamentals and learning how, when, and where they occur will give you a key edge in trading seasonal tendencies. Instead of simply

looking at a seasonal chart and betting that prices will move higher because the averages say they will, you can follow the fundamentals that historically have driven the seasonal tendency.

For example, if it is a move in relation to a harvest, you can track the progress of the harvest. Is it on schedule this year? What size of harvest is expected? What is

the condition of the crop thus far? If everything points to the expectation that this will be a normal harvest year, it may be logical to expect that prices may react as they have in years past to the upcoming harvest. If there appears to be a special situation this year that could disrupt, enhance, or affect harvest in another way, however, you may want to dig deeper before deciding on positioning. Experience

can play a key role because it is difficult for a novice to determine what may disrupt a key fundamental and what might not.

Step 3: Look at This Year's Price Chart

After you have identified a consistent seasonal pattern and have confirmed that the

key fundamental(s) that cause it appear to be taking place on *schedule* this year, it is time to look at the actual price chart.

The first thing to consider is if this year's price action has coincided with the general seasonal pattern thus far. For instance, suppose coffee prices are seasonally projected to fall to an annual low in September before

rallying. Yet, you look at the price chart in September and the market has been on a two-month extended rally. The seasonal says to buy in September. Yet, the price dip that is “supposed” to occur prior to the rally has not happened, at least not yet. Do you still want to buy just because the seasonal tendency says so? What is the problem here?

In a situation like this, it is possible that other fundamentals may have combined to drive prices away from seasonal averages, making conditions unfavorable to a seasonal move.

Another thing to consider is that the seasonal move came early this year and that you may have missed it already. Or perhaps it is well

within seasonal norms, but the seasonal average chart has the move taking place 30 days later. This is why it is important to look at daily price charts and compare their pattern with the seasonal pattern. If it appears that the basic patterns of the chart are the same but that this year's chart is matching up early or later, it may be a good bet that the move you want to catch could take place earlier

or later as well. The important thing is the overall long-term direction. The following example illustrates this concept.

Seasonal Example: Soybeans

July soybean seasonal averages point to a seasonal move higher beginning in February (see [Figure 15.7](#)). In 2014, this move did begin

when the seasonal average said it should (see [Figure 15.8](#)), then corrected briefly but sharply in March before resuming the uptrend. Many futures traders would have stopped out or exited the trade on this temporary price break. The good news: Distant put sellers that positioned in February most likely would still have had their options expire worthless.

FIGURE 15.7 July Soybean Fifteen-Year Seasonal Average*

Jul Soybeans(CBOT)
15 Year Seasonal(99-13)

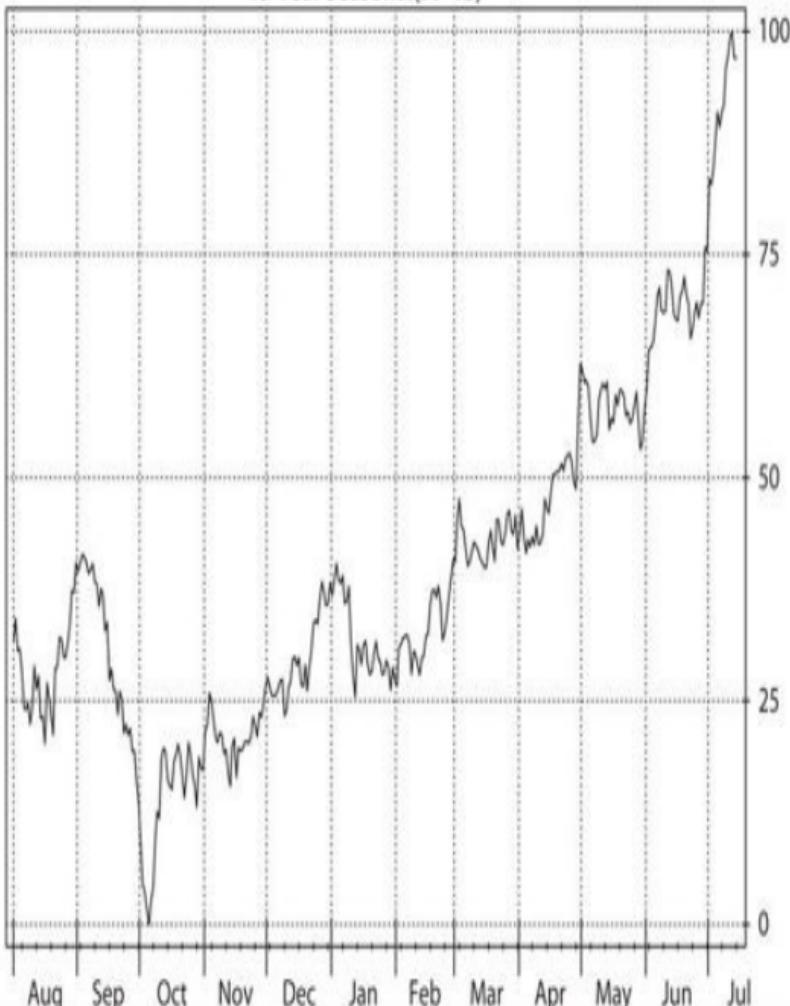
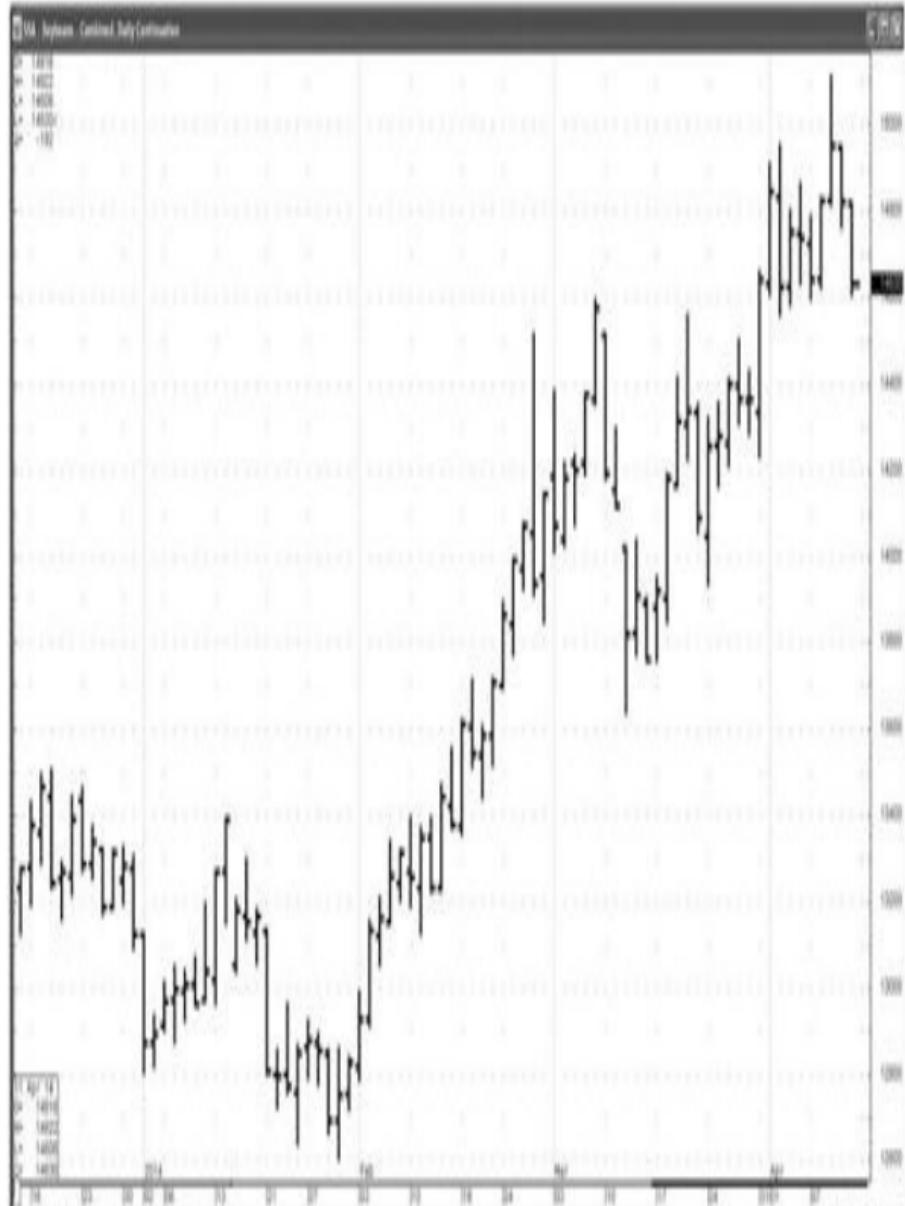


Chart Date: Apr 8, 2014

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FIGURE 15.8 2014 Soybean Price Chart



Step 4: Review Relative Price Levels

You also will want to be aware of the absolute price of the commodity when considering the likelihood of a seasonal move. If prices generally have traded in a range between \$4 and \$8 for the last eight years and this

year price is at \$12, will that affect your seasonal tendency? It very well could.

This is why it is so important to know the fundamentals behind the move. If your seasonal average indicates that you should buy, and the price is this high, it could mean that prices are too high to move much higher even though seasonal tendencies favor it.

If your seasonal average indicates that you should sell, this could mean that a more precipitous decline will occur this year.

Help often comes from examining price charts from previous years to determine how prices reacted to the seasonal tendency in years where price levels were comparable with today's prices.

Selling the Option on the Seasonal

You've gone through the four preceding steps and have identified a market where you feel a seasonal move up or down is likely to occur. Now what? How do you know exactly when to position?

The truth is that you don't. Technical traders can use their favorite indicator for

clues when to go long or short during the seasonal time frame. But miss by a few days in futures trading, and you're out of the trade. Even if all of your research points to a seasonal move, there is still no guarantee that a move will take place. And there is always the possibility, of course, that a *countertseasonal move* could occur. In other words, prices could move in the exact

opposite direction from which the seasonal averages indicate they have in the past.

Nonetheless, if you've done your homework and feel that you've got a good seasonal tendency from which to trade, you've already taken a great stride in tipping the odds in your favor. Now it's time to really overweigh the scales.

If your seasonal tendency

indicates that a strong and sustained price increase is likely to occur over the next three months, instead of trying to time it perfectly with futures, simply sell put options far below the market. If your seasonal chart indicates that a long, gradual price decline is likely over the next eight weeks, instead of shorting the futures, sell the calls high above the market.

In other words, take the high road. Don't try to make a killing. Settle for a solid profit. Sell the options instead, and if the move takes place, great. You make your money. However, if it does not take place, fine, you still make your money. Even if the market moves moderately against you, you make money. If your timing is off and the move comes early or late, you still make money.

Remember our Golden Rule: Don't try to guess where the market is going. You only have to decide where it is *least likely to go*. Seasonals can be a tremendous force for your portfolio in this regard.

By selling the option on the opposite side of the seasonal tendency, you force the market to make a sustained counterseasonal

move for you to lose. Not just a short-term correction or delay, it has to make a *major move against* the fundamentals that traditionally have caused the market to move in the opposite direction.

You force soybeans to make a sustained move higher when supplies are most plentiful, right at harvest. You make heating oil

launch a sustained trend lower right when distributors begin accumulating inventory for winter needs, when demand is highest.

Going back to the very first chapter of this book, pros are playing odds—amateurs are swinging for the fence. In selling options with the seasonal tendency, you're not betting a seasonal move will take place *this* year. You're

only betting that a severe counterseasonal move *won't* take place. That's high odds investing.

Conclusion

Combining seasonal tendencies with selling distant options can be a high-powered technique for accumulating consistent trading profits. It can, in fact,

be a most potent formula for option-selling success.

This does not, of course, mean seasonal option selling is without risk. As they say, past performance is not indicative of future results. You can still lose when selling options on a seasonal, even if you do everything right. This is only a piece (although a valuable piece) of your overall option-selling

machine. Other pieces (such as risk management) must also be functioning properly for overall success.

We've discussed seasonal tendencies and the importance of knowing the fundamentals behind them. In general, physical commodities such as agricultural and energy markets tend to exhibit more discernable seasonal

tendencies than do financial contracts.

An excellent resource for a wide variety of seasonal data are our good friends at Moore Research Center, Inc. You can find contact information for them in the resources section at the end of this book.

In [Chapter 16](#), we will review some of our favorite seasonal patterns, what

causes them, and how you may be able to take advantage of them in an option portfolio.

16



The Best Markets for Seasonal Option Sales

A Primer for Seasonal
Neophytes

In Chapter 15 you discovered how to use seasonal tendencies and to get the most out of seasonal charts. Now you are about to learn some of the more attractive and consistent seasonal patterns that you can use to select high probability option sales.

This is by no means a complete list of tradable seasonal patterns, but it should give you a good basis

from which to begin your own analysis of seasonal price movements. These are based on our experiences in selling options on these specific commodities.

You will notice that the focus of this discussion is on the fundamentals that cause the seasonal moves rather than exact dates to buy and sell. It is on these factors that you should place your

emphasis as a seasonal option seller.

Energy

With the weather patterns in North America, seasonal ebb and flow of supply and demand for energy used for heating, cooling, and transportation can be pronounced. The energy market can offer some

excellent opportunities for seasonal option sellers, although the market cycles may not be what you would think.

For instance, a winter rise in heating oil prices is often touted in radio ads that sound like advertisements for car dealership “blowout” specials: “Demand is highest as people need heating oil and natural gas to heat their

homes during winter," they reason.

Although it may be true that actual use may be highest in winter on the retail level, distributors begin accumulating inventory for winter needs long before the first green leaf has turned orange in Vermont. Thus, demand tends to increase as this takes place, often producing rising prices.

Traders who purchase heating oil contracts in the fall may have already missed a seasonal move.

Whereas the entire energy complex shows some impressive and relatively consistent seasonal patterns, option sellers may want to favor crude oil and natural gas contracts. This is so because volume and open interest in heating oil and

unleaded gasoline options can be thin, especially if you are selling options in back-month contracts. Crude oil and natural gas offer substantially more liquidity. Therefore, for the purposes of this chapter, we will focus on crude oil and natural gas contracts. However, if a trader can find enough liquidity in heating oil or unleaded gasoline options, there are some very enticing seasonal tendencies

for these contracts as well.

Selling Puts in Crude Oil or Unleaded Gasoline in December

Crude oil and all the petroleum contracts follow distinct seasonal cycles of accumulation and distribution. These patterns of

supply and demand tend to hold true regardless of the actual price of crude oil. This is what can make them such an effective tool in selling options.

Crude oil is used by refineries to make gasoline and heating oil. Refineries can gear up their facilities to produce more gasoline or more heating oil depending on what the market is

demanding at any given time.

Refineries ramp up heating oil production in late summer and gradually taper it off into fall. By December, supplies on hand have likely reached adequate levels, yet gasoline production for summer has not yet ramped up. Thus, refinery operating rates often hit a low by late fall, early winter.

Not by coincidence, crude

oil prices tend to fall to their lowest levels of the year in the November to January time frame. Thus, selling puts in crude oil during this time period often can be an excellent trading approach if the fundamentals appear to be following normal seasonal patterns (see Figure 16.1).

FIGURE 16.1 May Crude Oil Fifteen-Year Seasonal Average*

May Crude Oil(NYM)
15 Year Seasonal(99-13)

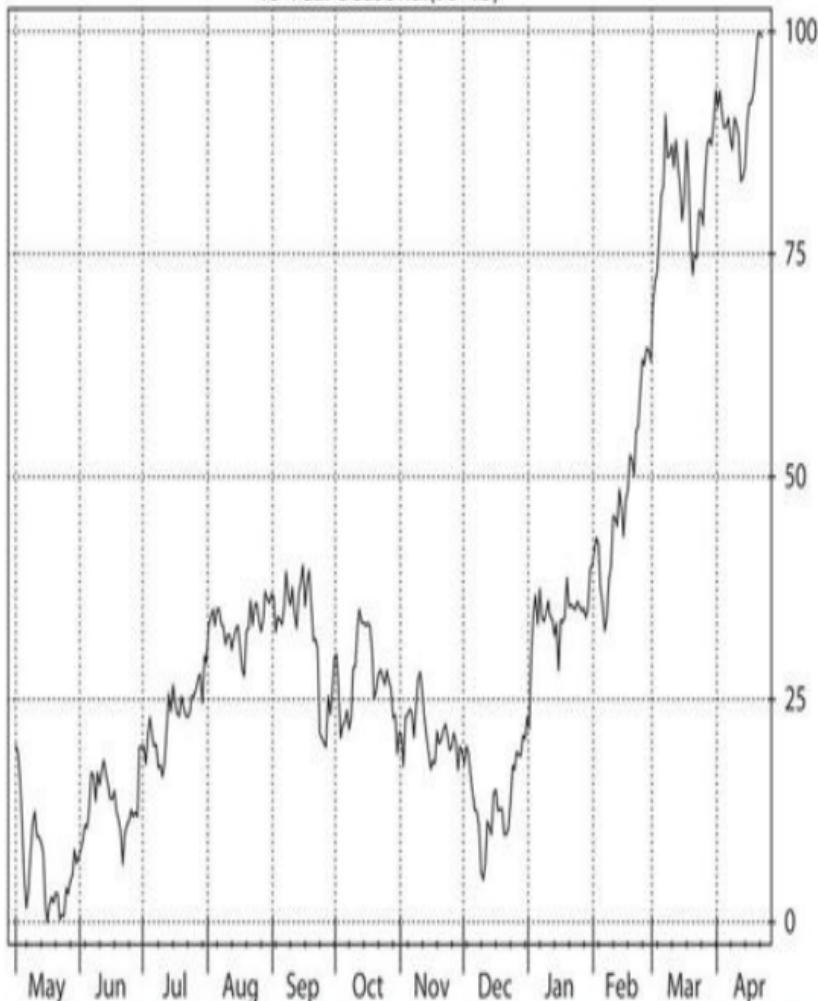


Chart Date: Apr 8, 2014

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Prices Are Low but Why Sell Puts?

While demand for gasoline remains relatively stable for nine months of the year, the North American and European summer generally produces a spike in demand for retail gasoline. Not only are roads easier to navigate

without snow and ice, making driving easier, but school is out.

Summer is the time of the traditional American and European vacation, which almost always entails a road trip. In other words, summer is travel time in the Northern Hemisphere, which means more driving and requires more gasoline. There is no debate that gasoline demand

in North America and Europe is highest during the summer months. Do you think that it is a coincidence that you are usually paying the highest prices of the year at the pump during the summer?

Yet trying to profit from this trend can be tricky. Why? If you learn nothing else from the seasonal chapters in this book, remember this: Price precedes consumption. What

do we mean by that? Let's take a look.

Price Precedes Consumption

To meet expected summer demand, distributors begin stockpiling gasoline supplies as early as January. This means that refineries will have to retool facilities to

focus on gasoline production to meet this demand. This “restructuring” phase generally takes place in early to mid-winter (in the Northern Hemisphere), once heating oil supplies are deemed adequate to meet winter needs. This means refineries shut down for a few days to a few weeks to gear their facilities for maximum gasoline production.

These temporary shutdowns can often jump-start a rally in oil product prices because stocks often show a draw during this period. However, as gasoline production kicks into full gear, demand for crude begins to rise rapidly again, and thus prices often tend to follow. Again, gasoline prices generally are rising as well during this time as distributors are accumulating

inventory, driving up demand.

Sometime in the April to June time period, when distributors begin to determine that supply will be adequate to meet summer needs, gasoline inventory building will begin to slow, and production of unleaded gasoline will be curtailed, resulting in reduced demand for crude oil. *Thus, crude oil*

prices often peak during the height of the accumulation phase, in late spring, and then recede slowly to reflect the reduced demand of distributors.

The energy market often suffers another low during midsummer as demand for crude oil wanes. However, it is during this time that refineries once again switch over to heating oil

production, beginning the cycle all over again.

This is the normal seasonal cycle of the energy market. There is no magic here. Just solid supply/demand fundamentals. Of course, other factors also affect the daily price of crude oil, such as weekly builds or draws in stocks or violence in the Middle East. But seasonal cycles are the “big picture”

fundamentals. It will help tremendously to focus on these in your trading. As an option seller, you have the luxury of being able to focus on the big picture and not on the day-to-day news and technical timing to which most futures traders are limited.

Counterseasonal

Moves

Just because crude oil prices have a good track record of following seasonal demand cycles, it does not mean that prices cannot move in the opposite direction. This is called a *counterseasonal move*, and although it is not the norm, it will happen occasionally. There are still factors that could counteract

seasonal demand cycles in all commodities. Seasonal demand cycles are a major fundamental. But they are not the *only* fundamental.

For instance, crude oil prices in particular can be sensitive to worldwide geopolitical events. Although this is certainly not the only thing that can cause a counterseasonal move, it would be key factor to

consider.

This is what is meant by monitoring fundamentals to determine if normal seasonal supply-and-demand patterns are occurring on schedule. You must be aware of outside fundamental developments that could disrupt normal supply/demand cycles. You won't always be able to determine if something may or may not affect the cycle

dramatically, but an impending war is probably a good reason for pause. Supply/demand cycles can be very strong and can override a lot of other fundamentals, even the ones currently grabbing headlines. Common sense and experience will be your guides.

How to Position

Should you just start selling crude puts in November? Again, let common sense be your guide. For example, if it is December and crude oil is at the highest price levels of the year, the seasonal approach may not be the best play this year. Yet, if the market appears to be at least nominally tracking seasonal averages, positioning in favor of those averages continuing makes good sense.

Remember, although your analysis may forecast increasing prices soon, you don't need a rally to profit. Your only stipulation is that prices don't fall dramatically.

Consequently, crude oil call sales at the end of the cycle in late May to early June can also be a solid way to generate premium using seasonal analysis.

Selling Natural Gas Calls in May

The peak use season for natural gas is during the winter months as it is quickly becoming the primary fuel used for heating in North America. Yet natural gas demand surges in the summer months as well because natural gas is used by many power plants to generate

electricity to power air-conditioning units during hotter temperatures. Retail demand during the winter months overlap with commercial demand as distributors are accumulating inventories to meet summer supply needs. This will often result in prices trending higher during the winter and early spring. This can also make for a good seasonal play (discussed below).

This inventory

accumulation cycle tends to climax in May and June. By this time, distributors have typically accumulated enough inventories to meet expected summer demand. Once inventories are deemed adequate, wholesale demand drops off substantially (see [Figure 16.2](#)). This can often be reflected in the price of natural gas. Thus, the month of June can be an excellent

time period to sell calls in natural gas.

FIGURE 16.2 August Natural Gas Fifteen-Year Seasonal Average*

Aug Natural Gas(NYM)
15 Year Seasonal(99-13)

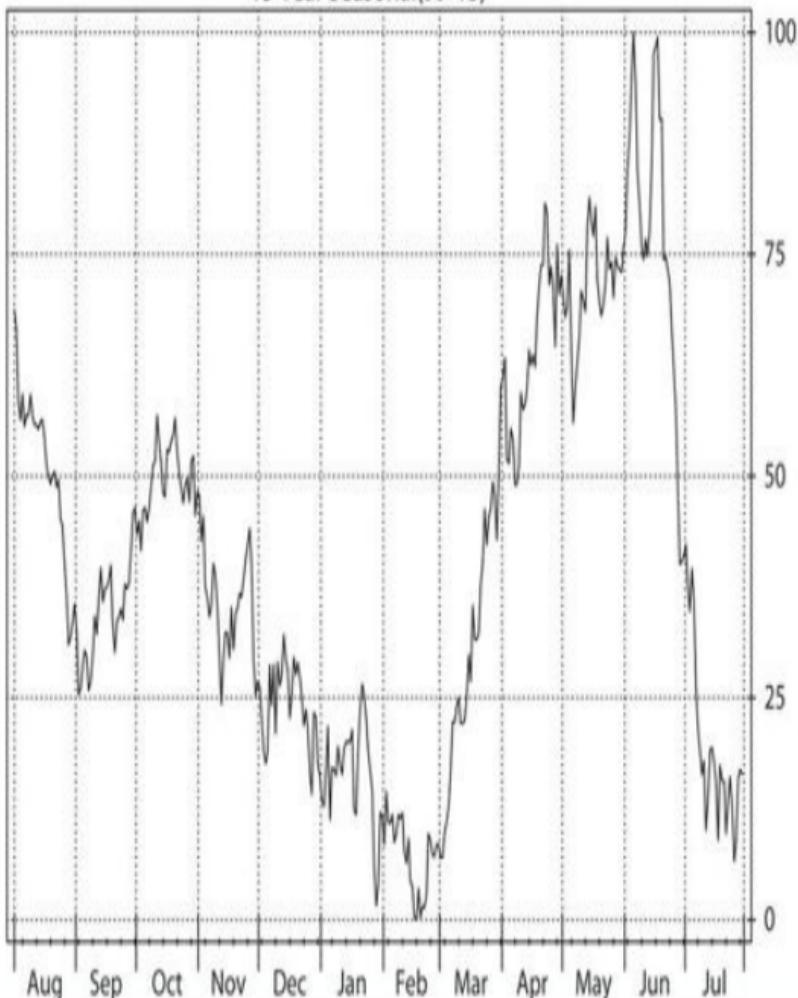


Chart Date: Apr 8, 2014

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It is ironic that this cycle occurs precisely at the time that demand at the retail level is just ramping up again. This is a pure illustration of price preceding consumption.

Is Hurricane Season still a Seasonal Factor in Natural Gas?

Aside from this key fundamental, however, there is another reason why this time period makes selling natural gas calls so enticing. The Atlantic hurricane season officially begins on June 1. The media has turned the month of June into an annual “hurricane” warning event as they are always on the lookout for something with which to frighten the public (“better stay glued to this

channel or you could be in danger”).

This brings speculators out in droves. However, these speculators (read “general public”) will prefer to buy calls over the futures. Thus, demand for the calls can often surge without any big moves in the underlying price. In other words, implied volatility often surges.

The hurricane play,

however, is largely a farce. Yet, there is often good money to be made here. The buying frenzy in the calls often begins weeks ahead of the “official” start to the Atlantic storm season. What many of these call buyers fail to realize is that the official start is typically not the real start.

Speculators buy natural gas calls in fear of a hurricane

moving through the Gulf of Mexico and knocking out natural gas rigs, thereby knocking supply off line. Can it happen? Hey, we all remember Hurricane Katrina.

However, Katrina was a once-in-a-lifetime storm that hit a direct bull's-eye on natural gas rigs. Most rigs in the Gulf can handle storms up to a Category 3 and not lose much production. Even the

strongest of storms typically require a direct hit to knock production off line. Several storms have raged through the heart of natural gas production zones in the Gulf since Katrina. Few, if any, produced any considerable price moves.

A final consideration is the time frame. Whereas hurricane season officially begins in June, anyone who

lives near the Gulf of Mexico knows that Gulf temperatures are rarely warm enough in June or even July to support a major hurricane. It isn't until August or September that most Gulf Coast residents begin watching their tropical weather reports in earnest. That is about a three-month window to sell options to the hurricane speculators and reap some substantial time premium.

What the hurricane players really miss, however, is the advent of all of the new supply channels that have come online since the time of Katrina. We are talking specifically about the advent of hydraulic fracking and the production of natural gas from wells on both the Marcellus and Bakken shales.

I (Michael) grew up in Western Pennsylvania, where

I still have family and own a little property. The county I grew up in now looks more like Saudi Arabia than Northeast United States. There are wells everywhere with new ones going up every day.

But the wells in my area are not oil wells. These wells are pumping natural gas. So much they have not yet figured out how to capture it

all yet. They burn the excess off, producing huge fireballs in the sky at night that can be seen from a dozen miles away. This is real “new supply” and it has rendered the once all-important Gulf of Mexico rigs less important. This means threats to Gulf natural gas rigs may not have the impact on gas prices that they once had.

All of this being said, a

bona fide Category 3 or higher hurricane entering the Gulf of Mexico is usually a good reason to close out your short natural gas calls, if only for precautionary reasons.

Selling Natural Gas Puts in January and February

As we saw above, natural gas

tends to follow similar seasonal tendencies as found in petroleum, albeit for somewhat different reasons.

As with heating oil, retail demand for natural gas is highest in the winter months for heating needs. As discussed earlier, natural gas is used as the primary heating fuel for newer homes, especially in northern and western regions of the United

States. Distributors in these regions, then, must anticipate this demand surge and begin accumulating inventory in the months leading up to the heating season. These are the months that wholesale demand accelerates, and price tends to follow.

Almost exactly like heating and crude oil, accumulation begins to slow sometime in late autumn,

when distributors determine that supply should be adequate to meet winter needs. This often will be accompanied by a drop in prices (see [Figure 16.3](#)).

FIGURE 16.3 November Natural Gas Fifteen-Year Seasonal Average*

Nov Natural Gas(NYM)

15 Year Seasonal(99-13)

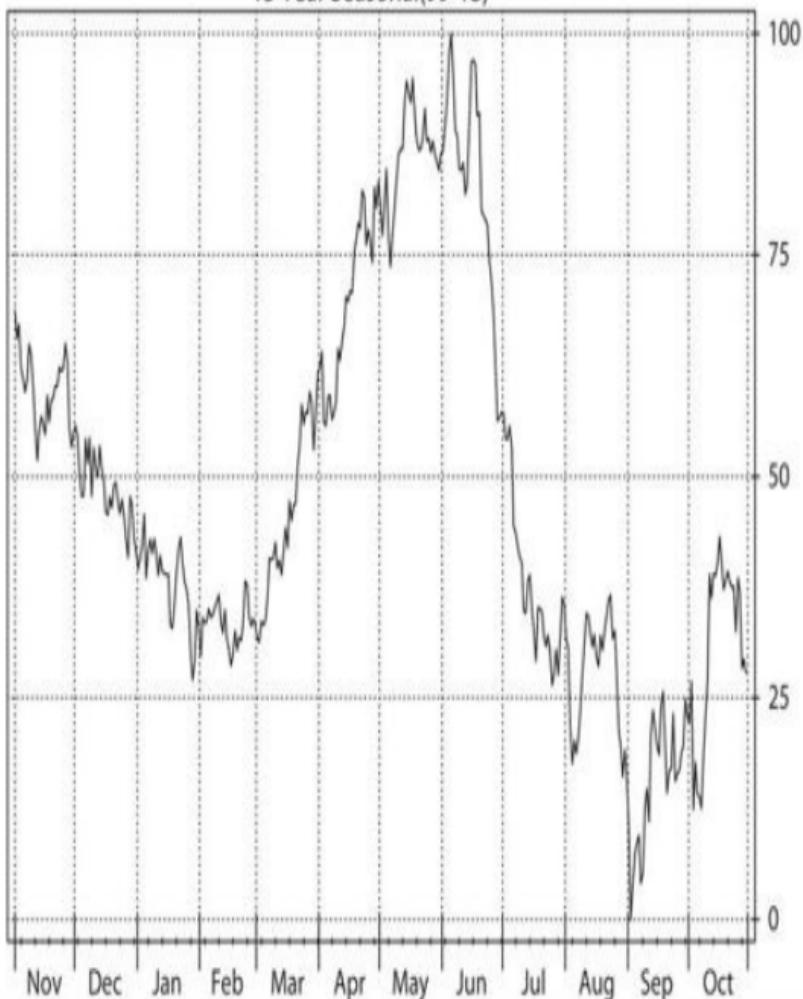


Chart Date: Apr 8, 2014

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The second and possibly more powerful seasonal tendency for natural gas tends to begin in the heart of winter. It is ironic that when retail natural gas demand is peaking in the December to February time frame, futures prices often are near yearly lows. This can change very quickly, however.

Retail demand for natural gas peaks again during the

summer months because it is used as a primary fuel to generate electricity to power air conditioners in southern and western regions of the United States. With this retail demand spike expected to begin in June, southern natural gas distributors begin taking advantage of the lower prices and generally begin accumulating inventory sometime in the January to February time frame.

This accumulation phase can become very pronounced in February and March. Thus, a price increase corresponding with the rising demand is often the result. Put sales far beneath winter and summer lows, then, often can be a great trade in natural gas.

A key figure natural gas traders watch during these times of the year is the

weekly injections into storage, which is released by the Department of Energy. This shows what kind of supply is being built to meet summer or winter needs.

An added benefit of trading natural gas is that unlike crude oil, which the United States still relies heavily on and imports to fill its demand needs, most natural gas used in the United

States is produced in North America. This makes the commodity less vulnerable to geopolitical events overseas than crude oil and its products.

You can use technicals, common sense, and a good broker in timing your seasonal option sales in natural gas.

Soybeans

Agricultural commodities tend to have distinctive seasonal tendencies that often can be used very effectively in conjunction with an option-selling campaign. Whereas seasonals in energy are based more on demand cycles, seasonals in agricultural commodities often are more the result of

supply cycles.

Crops that are grown in the soil obviously will be dependent on the seasons for their growth cycles. Therefore, it follows that supplies would be highest at harvest time and lowest in the months just preceding harvests.

Soybeans have a very dynamic harvest cycle now that South America has

eclipsed the United States in total production of soybeans. Until the early 1990s, the world's supply of exportable soybeans was produced primarily in the United States. Thus, following one harvest cycle was all that was needed.

However, with the advent of increasing South American production to today's levels, major soybean harvests now take place twice a year, or

every six months. Soybeans are harvested in the United States in the September to November time frame, whereas autumn harvests take place in Brazil and Argentina in the March to June time period.

Selling Soybean Calls During the U.S. Summer

Soybean prices will often put in harvest lows sometime in September or October. At no time during the year will supplies be higher than right after harvest. Thus, logic and Economics 101 dictates that when supplies are highest, prices will be lowest. This seems to be confirmed by a seasonal chart of November soybeans. Prices tend to break sharply into the peak of harvest season.

The old pattern for November soybeans generally saw soybean prices reaching an apex in May as U.S. supplies of old crop generally were dwindling and new crop planting jitters often were peaking.

Yet, growing worldwide demand for food, grains in particular, have made prices ultra-sensitive to weather. Severe weather causing real

or perceived crop damage can send soybean prices jumping during summer months. For this reason, it appears that the seasonal has shifted later into the summer, closer to when the U.S. soybean crop actually goes to pod in August, before the market is satisfied that the harvest is safe. The seasonal price break occurs in earnest.

Prices can still peak

during planting anxiety in May and then gradually price in the “new crop” or new supply into the fall harvest. Selling calls on May price strength can still be a solid seasonal play. However, selling calls on weather rallies during the U.S. summer months can also be a sound seasonal strategy (see Figure 16.4).

FIGURE 16.4 November

Soybeans Fifteen-Year Seasonal Average*

Nov Soybeans(CBOT)

15 Year Seasonal(99-13)

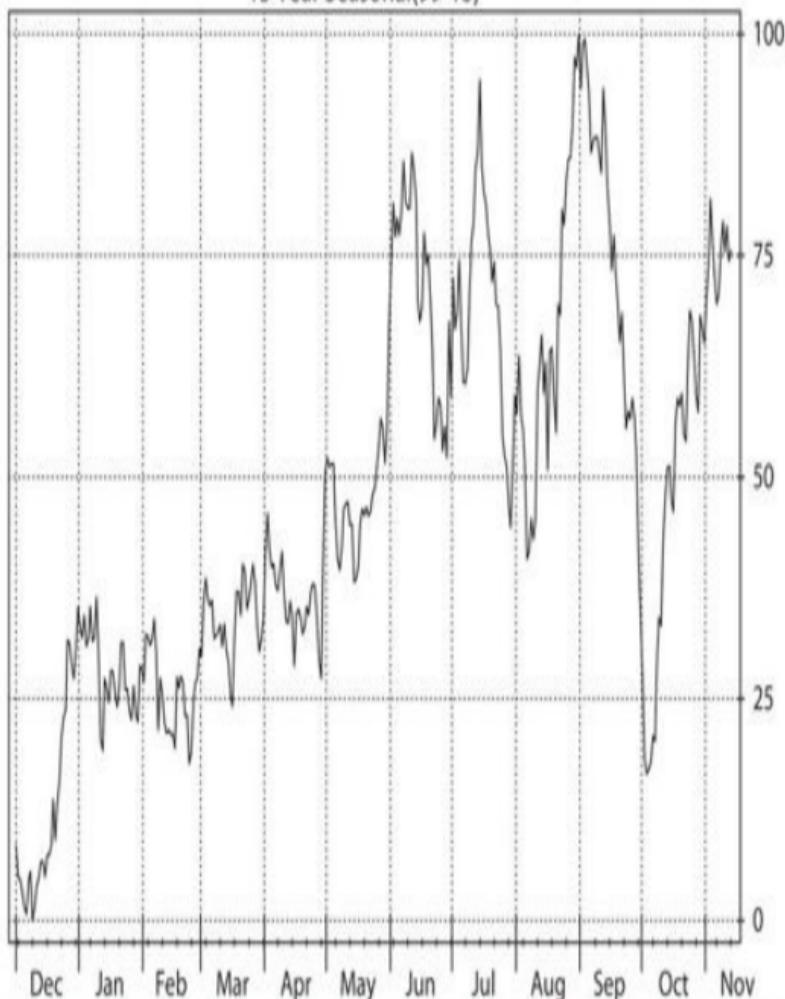


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A bona fide crop-damaging weather event in the United States can make you wrong here. But the real deal doesn't happen very often. Eventually, they still harvest the beans. Weather can make the "ridiculous strike prices" mentioned in earlier chapters available in this market.

You can take a lot of premium out of the soybean

market as there are a lot of beginners playing here. And they *love* to buy call options in the summer. So do their brokers, as it's an easy sell.

Selling Puts on Soybean Harvest Cycles

Unlike equities, however, there is some common sense

present in the commodities market. Soybean prices tend to hit their seasonal price lows in October, right at the end of harvest (the term *harvest lows* is a common one when discussing agricultural prices). Not coincidentally, this is the time when supplies will be at their highest and thus, prices often at their lowest (see [Figure 16.5](#)). This can often be a good time to sell puts in soybeans.

FIGURE 16.5 May Soybeans Five- and Fifteen-Year Seasonal Averages Overlaid*

Agricultural markets tend to make price bottoms when supplies are highest—right after harvest.

May Soybeans(CBOT)
15 Year Seasonal(99-13)

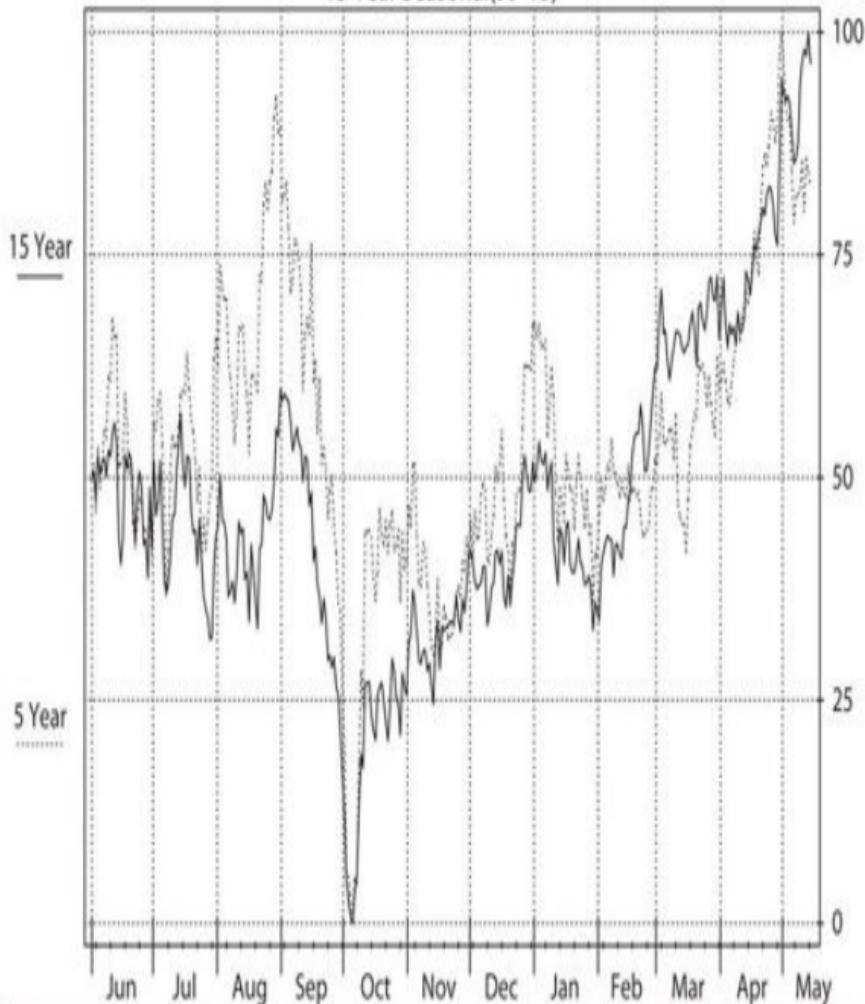


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Secondary Put Sales in February

South American soybeans generally are being planted when U.S. soybeans are being harvested in October and November. Farmer sales of soybeans often are heaviest during the winter months as U.S. farmers cash in soybeans

from the autumn harvest and use the proceeds to restock supplies and equipment for the upcoming crop year. This selling often reaches a peak during the heart of the U.S. winter and can result in price weakness.

This phenomenon is known in trading lore as the *February break* and has gained a lot of notoriety, especially over the last few

crop years. However, once this selling climax is finished, the U.S. soybean supply has dwindled and the world looks toward the Brazilian crop to meet import needs.

Brazil, however, does not begin harvesting beans until March and the bulk of the harvest is typically not available until May. This low period of supply can often result in a spring price rally

that can last for several months, especially if there are any delays in planting the new U.S. crop in April and May.

As with other seasonal tendencies, trying to time the low of a February break with futures contracts can be like trying to time your jump out of a falling elevator. Selling options, however, does not require the picking of a low.

If other fundamentals and outside news events have been taken into account, selling puts far beneath the soybean market in February can be as good a seasonal play as any. A broker or news service with access to U.S. export and Brazilian crop estimates can be extremely helpful in this regard.

Again, remember that these are seasonal *averages*

and that the February break could occur as early as January or as late as March, if it occurs at all.

Grain

Corn harvest cycles are roughly the same as soybeans in the United States. Corn farmers, however, do not have to contend with a large worldwide competitor as far

as exports go. China used to export corn, but by the mid-2000s, the country focused on trying to grow enough corn to avoid having to import large quantities. Today, with an expanding middle class with a growing appetite for meat, China has grown into a huge producer of livestock, and thus, has a voracious appetite for foreign corn.

Brazil is not a large corn

producer, but Argentina has become a considerable producer of corn. The United States, however, remains by far the largest exporter of corn on the world market.

Corn seasonal price tendencies, then, are much more reflective of U.S. harvest cycles. There are several price tendencies to study in corn. However, one of the more consistent is the

one we will mention here (see Figure 16.6).

FIGURE 16.6 September Corn Fifteen-Year Seasonal* Selling Corn Calls in May can be an excellent strategy.

Sep Corn(CBOT)
15 Year Seasonal(99-13)

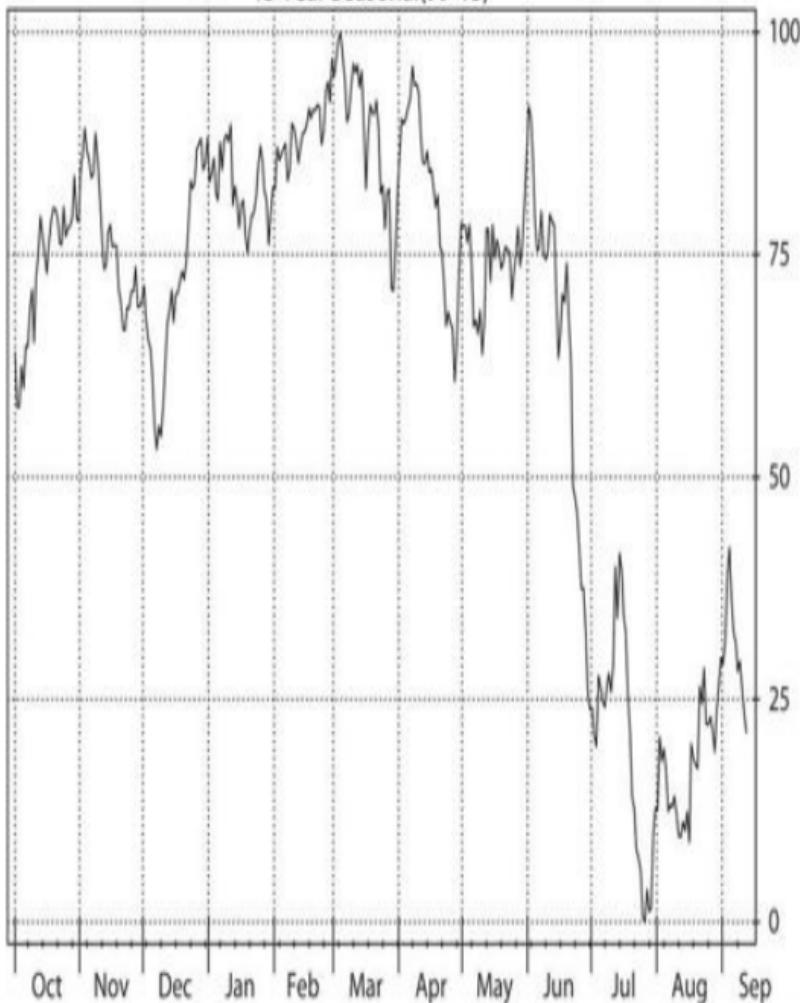


Chart Date: Apr 8, 2014

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Corn is planted in April and May (spring in the United States) and harvested in September and October (fall in the United States). Corn takes slightly longer to develop than soybeans, and therefore, the planting of corn usually is started ahead of soybean planting. Although rumors often will swirl ahead of planting about dry soil or too much rain, once planting

is completed and the crop is “in the ground,” anxiety tends to dissipate, and prices tend to decline in anticipation of a new crop on the way. Therefore, *selling corn calls in May can be a good way to generate revenue through premium collection.* You don’t bet on a price decline, you only bet against a substantial rally.

Call sellers seeking higher

premiums can begin selling calls as early as March if no abnormal fundamental developments are readily apparent. Again, the further out of the money the better. Options sold in March will have to be held longer, meaning that there is more time for price to move against your position before time decay can begin balancing out adverse moves. However, you also may be able to sell

strikes further out of the money than you will be able to in May.

Weather anxieties can still cause corn prices to rally in the spring. You want to be positioned to ride out rallies to take advantage of the bigger picture.

Real weather damage to crops, however, is not as common as one may think. Furthermore, weather

problems don't happen overnight. They happen over a period of weeks or months. Set your risk controls and stick by them, and you should not have to fear large losses caused by adverse weather.

Frozen Orange Juice

Oranges for juice production generally are produced in the United States and Brazil. U.S.

oranges are grown in Florida and California, though oranges for juicing come primarily from Florida.

Because oranges grow on trees, there is no planting season for oranges. However, there is a growing season and harvest for oranges. While much of the orange juice in the frozen concentrate orange juice (FCOJ) contract now comes from Brazilian oranges

(see Chapter 14), seasonal tendencies for this contract are still heavily influenced by the development of the Florida orange crop.

Orange juice for the March contract comes from oranges harvested in December and January. Harvest season for Florida oranges begins in December. Yet frost season in Florida begins in December as well.

Thus, prices have a tendency to run up in anticipation of “frost season” and then fall once the main Florida orange harvest begins in December. This is the result of both hedgers and small speculators buying orange juice ahead of “frost season.” The seasonal tendency says this is a great opportunity for astute option sellers to take their money. We agree.

We wrote an article on this phenomenon several years ago that we think is still relevant in explaining this seasonal tendency for this book. The article appears in the box.

In summation of the article, prices tend to rise in October and November as a freeze premium builds into the market. Once harvest begins in December, prices

have a tendency to plummet. Even though the possibility of a freeze occurring prior to harvest still exists, freezes are less likely now than they were a decade or two ago because the bulk of orange production in Florida has moved further into the southern regions of the state. These areas have higher average annual temperatures and therefore are less likely to freeze.

Orange Juice Futures

Approaching Harvest Is Often a Trading Opportunity in FCOJ

JAMES CORDIER AND
MICHAEL GROSS,

The coming freeze season for Florida oranges often encourages the market to build in a risk premium. By December, however, the market has often

done so. But the production season coincides with the freeze season. What does this mean? This means that speculators bid up prices of frozen orange juice futures in November in

anticipation of
“freeze season” in
Florida. Harvest
usually begins in
December.

Therefore, barring a
killer frost, the
market goes from a
frost premium in
price to a situation

where orange supply is the highest it will be at any time during the year. Thus, orange juice prices often go from their highest points of the year to their lowest in a matter of a month. This

phenomenon is unique to the orange juice market but often can present a very lucrative opportunity for call option sellers.

**Is Freeze Season
Still Freeze Season**

for Florida Oranges?

Being in Florida, I am probably quoted more on the orange juice market than on any other commodity. Orange juice also happens to be one of the least written about commodities on the board. This is why I believe that orange juice happens to be

a great market to trade fundamentally. There simply is not a great amount of information available to the general trading public about orange juice—at least not as much as there is for a market like soybeans, where we get daily updates on crop conditions, soil moisture, and export news.

There has been a basic

fundamental change in orange production in Florida over the last 15 years. Much like the coffee market (which also prices in a “freeze premium” in the month of May), producing areas gradually have moved out of the high-risk freeze areas in recent years. In the 1990s, Florida’s orange crop was ravaged by a series of freezes. Instead of

replanting trees in those same freeze-prone areas, producers began planting trees much further south in the state. Those trees began producing a substantial part of the Florida orange crop by the middle of the last decade (2005–2006).

Today, Florida orange-producing areas are significantly further south than 15 years ago and thus

are far less susceptible to the damaging freezes that grabbed headlines in years past. The seasonal price rally in orange juice has continued to persist mainly due, in our estimation, to the small speculator.

These days, it is blight and disease, not freezes, that pose the greatest threat to Florida oranges. Nonetheless, we believe

that conditions are right for the market to follow the historical preharvest price pattern.

We are fortunate as option sellers because spec-led freeze rallies drive up call option premiums to overinflated levels and can make for an excellent option sale. We are not suggesting that a crop-damaging freeze is not

possible, only that it is much more unlikely than it was 10 to 15 years ago. Even in the unlikely event that a cold snap occurs, we feel that if option sales are executed at higher strike prices, traders should be able to ride out all but the most severe freeze. At the time of this writing, it is 80°F outside my window.

Look to be a seller of

orange juice calls over the next two to four weeks on rallies. We feel that the orange juice market is basing for a seasonal swing higher, and aggressive traders can position on a 3¢ to 4¢ rally. However, we will exercise caution and wait until the traditional seasonal top in middle to late November before recommending positioning. We will be working closely

with clients in the timing of this trade.

Selling calls on a November to December rally in frozen orange juice can be a high-probability and sometimes fast-profit opportunity. March calls at high strikes often offer the best bargains (see Figure 16.7).

FIGURE 16.7 March Orange Juice Fifteen-Year Seasonal*

Mar Orange Juice(ICE)

15 Year Seasonal(0-14)

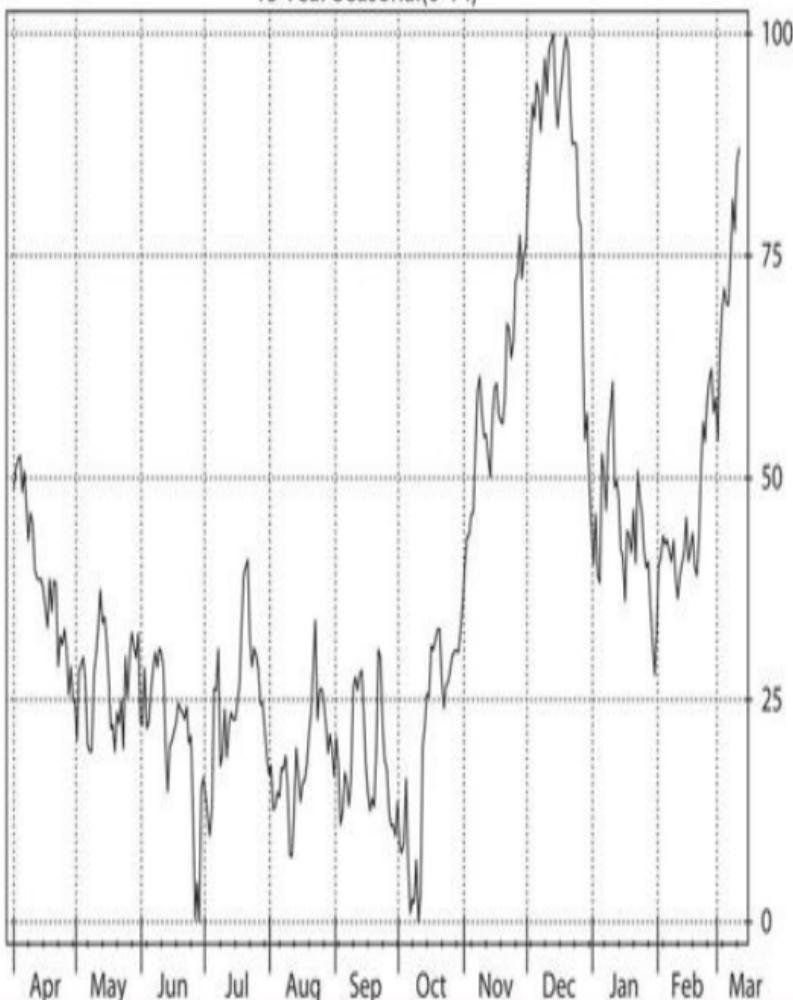


Chart Date: Apr 8, 2014

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Again, these are averages, and there is no rule that says that orange juice prices can't move higher in December. A broad look at the overall market and solid risk management obviously remain vital components. But this seasonal tendency remains as intact in 2014 as it was in 1999 and should continue to be for as long as oranges are grown in Florida.

Selling Coffee Calls Ahead of Harvest

Coffee is produced in many nations across the globe with tropical climates. Brazil, however, is by far the world's largest coffee producer and coffee exporter, which makes the market very sensitive to the status of the Brazilian coffee crop each year. Yet Vietnam has become a major

player on the world's coffee market and is now the world's number-two producer.

As with oranges, coffee is not replanted each year like corn or soybeans but rather grows on trees (that actually look more like bushes). Therefore, there is no planting season for coffee, but harvest cycles can make coffee a good market for

seasonal trading.

Brazil begins to harvest coffee in May of each year. But the market often begins to forward-price the new crop of beans after the sensitive flowering season late in the year. Anxiety is often high during flowering season in Brazil, and this is when the next year's crop is most susceptible to damage (this is similar to pollination time in

corn or podding season in soybeans).

During this time, the coffee tree develops flowers. The flowers then drop off and in the place of each flower is a coffee bean. Thus, the more flowers, the more beans. And the better the weather, the more flowers.

Prices tend to gain strength through the flowering season as anxiety

builds. Yet by January, the flowers are gone and the beans are emerging. Anxiety fades. Prices will often weaken (see [Figure 16.8](#)).

FIGURE 16.8 September Coffee Fifteen-Year Seasonal*

Sep Coffee "C"(ICE)
15 Year Seasonal(99-13)

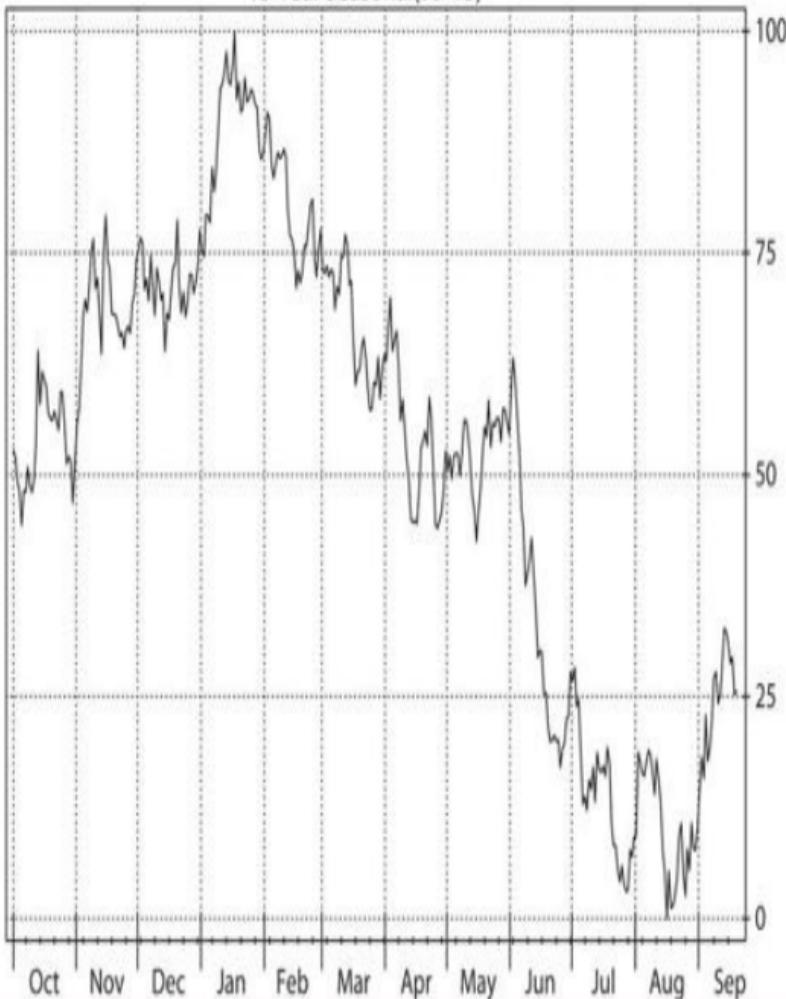


Chart Date: Apr 8, 2014

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At the same time, Vietnam is harvesting coffee beans and is already dumping new supply on the market. Thus, the combination of fading anxiety over the Brazilian crop plus fresh supply from Vietnam, can often see prices weaken through the early months of the calendar year. Selling coffee calls early in the year can be an excellent seasonal

play. Secondary opportunities can come in May or June, just prior to the Brazilian harvest.

Cattle

Weather and the changing of the seasons also have a direct effect not only on beef production but also on demand for beef. Since about 90% of all beef produced in the United States is consumed

in the United States, cattle prices at the Chicago Mercantile Exchange are affected by factors affecting the U.S. herd and by factors affecting the North American appetite for beef.

Media “pop analysis” dictates that beef demand is highest in summer because of barbeque season, thus prices will be higher during the summer months. This is only

slightly true. Although there is a slight increase in beef demand in late spring and early summer, demand for beef tends to wane during the hot summer months because families favor quick meals and are eating on the run, with summer activities (e.g., swimming, soccer, softball) taking precedence. In addition, lighter and/or cooler foods often are preferred in summer as opposed to sitting

down to a pot roast. Yet seasonal charts confirm that prices, at least of Feeder Cattle (young animals placed on feedlots), do indeed often peak during the U.S. summer (see [Figure 16.9](#)).

FIGURE 16.9 September Feeder Cattle Fifteen-Year Seasonal*

Selling feeder cattle puts during the April to May time period often can be a good

summer play.

Sep Feeder Cattle(CME)

15 Year Seasonal(99-13)

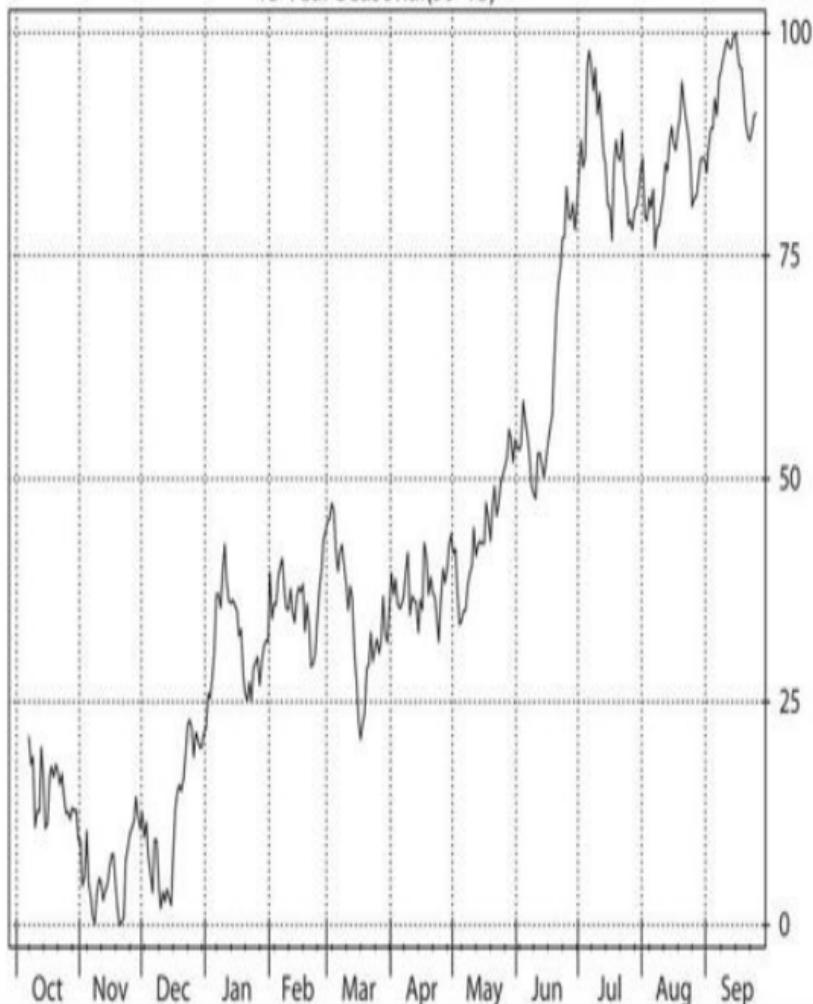


Chart Date: Apr 8, 2014

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But why is this the case?

It generally takes four to six months after a young feeder calf is placed on feed before it reaches its optimal meat production weight. During the summer months, it is easier to raise cattle. Not only is there less stress on the animal, but often, feeders can put cattle out to graze in pastures instead of keeping them “in the pen.” As cattle

can be raised less expensively this way, it is not uncommon to see more cattle on feed during the warmer summer months. These cattle will then reach maturity during the late fall when they will be bid on by meat producers. Thus, supply of slaughter-ready cattle can often be highest in the late fall, early winter.

During the winter to spring period, the opposite

takes place. Cattle are harder to raise. Cold temperatures can make it harder to put weight on the animals. They must also be fed a diet heavy in corn and soymeal, thus making them more expensive to raise. The result is often fewer live cattle being delivered to meat packers in the late spring and summer months.

Selling cattle puts during

winter months can be a solid premium generator. However, individual-year fundamentals must be given their due. The monthly USDA cattle on feed report is the key report to watch in this market.

Seasonals and Financials

We do not put as much stock

in financial seasonals as we do in physical commodity seasonals. For one thing, the fundamentals supporting such moves do not appear as solid. Second, in our opinion, many seasonal tendencies in financials do not seem to be as consistent as those in the hard commodities. There are, however, a few tendencies you may wish to explore.

Many investors have

heard that the stock market makes a low in October. While some may dismiss this as myth, the seasonal averages of the March Standard & Poor's (S&P) contract seem to support this viewpoint (see [Figure 16.10](#)).

FIGURE 16.10 March S&P 500 Fifteen-Year Seasonal*

Mar S & P 500(CME)
15 Year Seasonal(0-14)

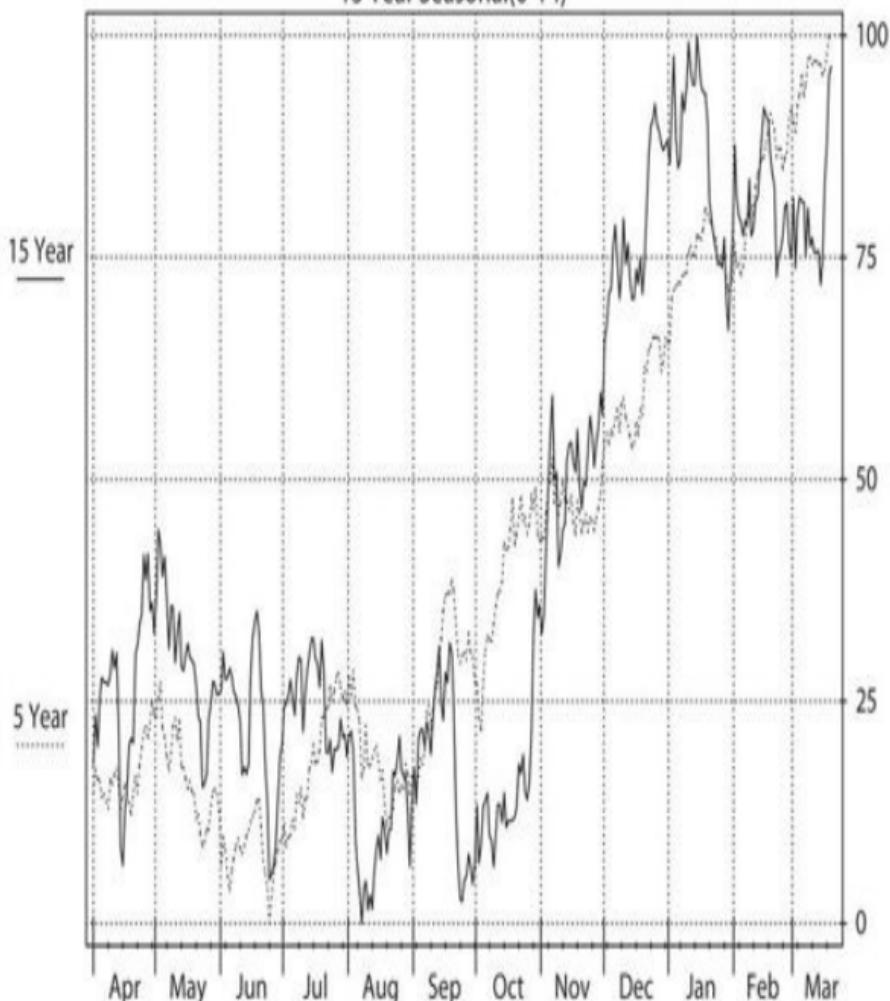


Chart Date: Apr 8, 2014

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Currencies also exhibit a curious tendency to have a seasonal preference. The yen, for instance, often may exhibit a bias of weakness against the U.S. dollar in late autumn because that is when Japanese multinationals repatriate yen for the half-fiscal-year accounting (see Figure 16.11).

FIGURE 16.11 March

Japanese Yen Fifteen-Year Seasonal*

Mar Japanese Yen(CME)
15 Year Seasonal(0-14)

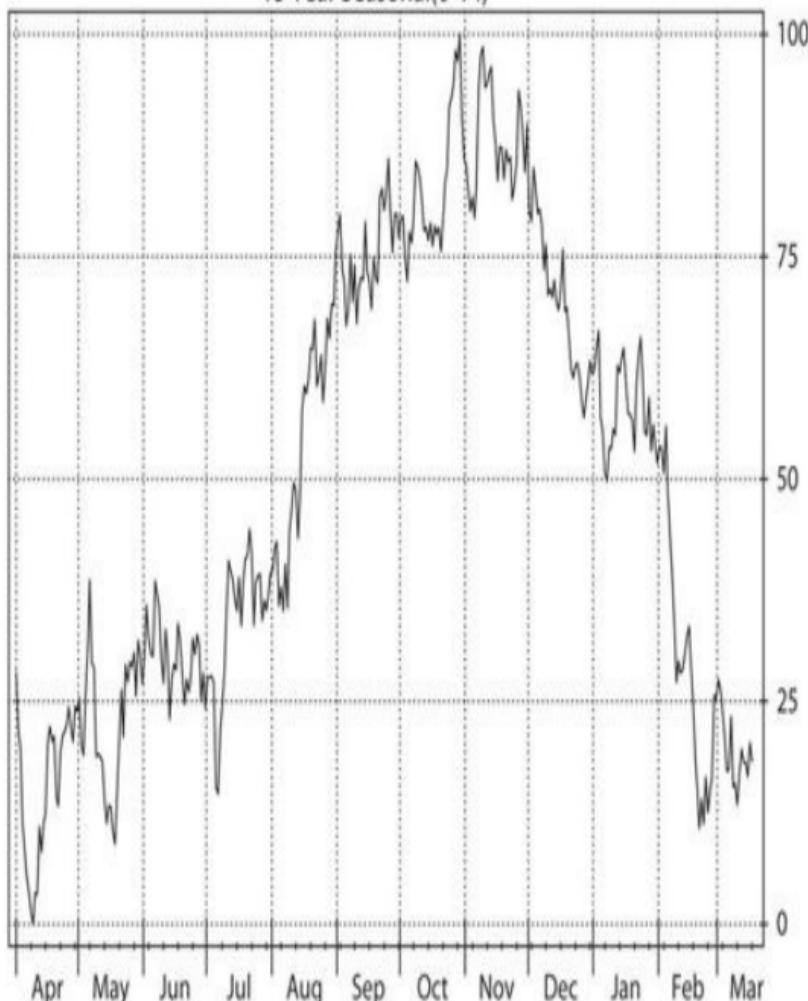


Chart Date: Apr 8, 2014

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Although there are many financial seasonals for traders to consider, it is very difficult to get a handle on all the fundamentals that go into the price makeup of a financial contract and gauge if they are coming together on time to make a seasonal move. Financial contracts are also highly sensitive to geopolitical or economic news. Sometimes even minor

events can move the market in large intervals.

Despite the impressiveness of the charts on the next page, we have found that financial seasonals as a whole are not quite as consistent as some of the commodities, having many wide aberrations from the averages.

Nonetheless, they do present occasional

opportunities for the right traders. You may want to further research financial seasonals on your own to find potential option-selling opportunities.

Conclusion

Several seasonal tendencies were covered in this chapter, but these are certainly not all that are available. The ones

discussed here constitute a limited list of those that have proved the most consistent in our option-selling program over the years. You may want to explore seasonals further to discover other tendencies of certain markets that may prove useful to you.

While seasonals certainly are not guaranteed and are only an average of a broad compilation of data, they can

be very effective tools to an option seller.

Seasonal tendencies are a focus of our client newsletter *The Option Seller*. For a free sample issue, visit www.OptionSellers.com.

OptionSellers.com
Interview with
Jerry Toepke,

**Editor, MRCI
Publications,
Moore Research
Center, Inc.
(Seasonal Research
on Futures
Markets)**

Moore Research

Center, Inc. (MRCI) is the premier resource on seasonal tendencies in the United States. We have relied on MRCI for years for all of our seasonal data. They have generously provided

all of the seasonal charts you have viewed in the last two chapters. As a special treat for our readers,

Jerry Toepke, editor of MRCI publications, has agreed to do an interview

exclusively for *The Complete Guide to Option Selling*. We hope you find his insights helpful.

OptionSellers.com: Thank you for being here Jerry and sharing your insights with our readers. Let's get right to it.

OS: How long have you been studying seasonal tendencies?

JT: I was first introduced to *quantitative* seasonal analysis when in 1988 I came to Moore Research Center (MRCI), at the time not only a branch of a major commodities brokerage firm but also that firm's computer

research facility. Growing up on a Midwest farm gave me a general familiarity with seasonal pressures and tendencies for both grains and livestock. Upon later becoming a futures broker and trader, seasonality had an even greater professional impact. But when I arrived at MRCI, Steve Moore

taught me the concepts of seasonal research and Nick Colley the intricacies of quantifying the market's own historical price movements to find those that recurred in the same direction in a more or less timely manner with a great degree of historical reliability.

OS: What got you interested in this avenue of commodities analysis?

JT: Having already been in the business for 10 years, I was initially skeptical. But I quickly became fascinated by how timely the optimized entry and exit dates could be. What's more, I then

began to see and understand even better how seasonal trends and strategies fit with seasonal conditions and events. Market movement began to make more sense.

Because futures markets anticipate, seasonal analysis could help me anticipate. So, rather than be frustrated, for example,

by a price decline going into soybean harvest when supplies were still incredibly tight and then a rally out of harvest when supplies were finally abundant, I could understand the phenomenon of “anticipation and realization.” Further, it helped me better “read” a market because

seasonal analysis could tell me what normal market behavior was at any given time of year. So comparing current market action to seasonal market behavior gave me an idea of whether current conditions were relatively normal—or whether the market was consciously or unconsciously

anticipating some powerful, unusual condition or event.

OS: What does your company do for investors and/or portfolio managers?

JT: MRCI does not presume to tell anyone how or what to trade. Instead, all efforts are directed to help others *research* their *trades*.

Thus, MRCI provides its seasonal research via several services and publications. *MRCI Online*, the primary service, draws from about 40 major futures markets to present every month 15 seasonal strategies and 15 seasonal spread strategies with entries that month. Each strategy has an

optimized entry and exit date between which that market or spread has moved in the same direction in at least 80% of the last 15 years (if available), a table of historical detail, and daily/weekly/monthly charts in support. Trade and Spread Reviews track the daily performance of each

strategy as published, and Portfolio Reviews show the results of each. In addition, traders can find historical daily (many no longer found elsewhere), weekly, and monthly charts; correlation studies; seasonal volatility studies; seasonal patterns for each delivery month of all

major U.S. and some international futures; etc. Each Friday, the *Weekly Spread Commentary* draws two spreads from *MRCI Online* and discusses seasonal fundamentals that may have helped generate their seasonal patterns; presents the supporting charts and history; and then tries to highlight any

relevant chart levels, recent or upcoming government of industry reports, and any news that could affect the spread this year. For commercial firms and those with special interests, MRCI offers a series of *special historical reports*, each of which analyzes a specific market complex (soy, metals,

forex) and presents seasonal trading ideas for year-round.

OS: What do you feel are some of the more consistent seasonal patterns—especially in the physical commodities?

JT: Most markets have seasonal patterns, even those not so much influenced by weather.

For example, one might not expect currencies to have seasonal patterns, but each country does have its own fiscal year which can affect the timing and amount of monetary flows.

However, seasonal patterns for several physical commodities are perhaps more consistent. First and foremost, one might

think of heating oil, gasoline, and natural gas—all with demand driven by patterns of consumption directly related to weather and the change of seasons. Second, seasonal patterns in nearly all crops—corn, wheat, soybeans, cotton, orange juice, coffee, sugar, cocoa—have evolved in large part by

the timing of harvest and patterns of supply. Finally, because they are essentially markets for live animals rather than storable commodities, seasonal disparities in supply and demand are already partially built into the price structures of cattle and hog futures. Nonetheless, the timing of corn harvest has

helped generate seasonal patterns in both cattle and hog slaughter and, thus, supply.

OS: What market or markets do you think have seen the most significant changes in the last five years? Why have the patterns changed?

JT: Until just a few years

ago, U.S. interest rate futures had well-defined and some of the more consistent seasonal patterns. Rates themselves exhibited a strong tendency to peak seasonally in April/May—perhaps due to temporarily tightened monetary liquidity as payment of income taxes due mid-April transferred

massive financial assets from out of the private and into the public sector. But then those rates, all else being equal, consistently eased through the remainder of the U.S. fiscal year ending September. However, the FOMC's interest rate suppression of the last few years may have disrupted or

distorted the seasonal ebb and flow of rates such that seasonal reliability has suffered somewhat.

OS: What advice would you give to somebody who is new to seasonal analysis? What kind of things should they be looking for in a market?

JT: Most traders new to seasonal analysis tend to follow the entry and exit dates literally. That has tended to work out well over time—as long as they take all of the strategies diversified by market rather than expecting each and every one to work exactly as published every time. However, as they

become more familiar with seasonality, how it works, and what it can and can't do, traders tend slowly to become more selective, applying their own knowledge and trading know-how, being willing to enter a day or two earlier or a day or two later when conditions warrant, using trading and

money-management techniques that suit their own style and market perspective. Eventually they may find that they can tell at a glance whether or how closely a market may be following its seasonal pattern and thus how they may best take advantage of the seasonal research for themselves. MRCI

entry and exit dates are optimized, after all.

They are not “etched in stone” but rather meant to guide traders as they “research their trade.”

OS: Thank you Jerry. We appreciate your insights.

JT: Thank you.

17



Volatility Simplified

All You Need to
Know About the Most
Misunderstood Option
Component

We promised we weren't going to do it. We promised you would learn to sell options effectively and not have to relearn calculus. So relax. You will not. Not even in this chapter. However, it is difficult to write *The Complete Guide to Option Selling* without at least having some discussion about volatility.

While we sidestep the

issue of volatility in other chapters of this book, we do not mean to imply that volatility is unimportant to option sellers. Quite the contrary, volatility can play a significant role in the price of an option and the price movement of an option. It simply happens to be our contention that the base fundamentals of the underlying market are much more important.

To use our football analogy again, knowing your market fundamentals is your *offensive* game plan. Your risk-management strategy is your *defensive* game plan. Volatility is the weather. It is the *conditions* you are playing in. In other words, the quality of your offense and defense will ultimately determine your success at the end of the year. But volatility can help or hurt you along the

way, and it is something to be considered in your game plan when planning a trade.

During our occasional speaking engagements, I often sense a collective groan when we introduce the concept of volatility. But in congruence with our philosophy of simplicity, we are going to attempt to simplify the concept in this chapter, and tell you

everything you need to know to be successful.

To begin, we should first discuss what volatility is not.

The Trading Plan You Don't Need

Chances are, if you are reading this book, you are not a professional portfolio manager. You are not a risk

analysis manager at a hedge fund. You are not a “quant.”

Chances are you are (or were) a doctor, an accountant, an attorney, a business owner, or a success in some field that you have devoted yourself to. But option trading is not your listed profession. Therefore, many of the books, reports, and “white papers” written on the mathematics of volatility analysis are not for you. Oh,

they may be promoted as though they were for you, and the authors may think they wrote them for you. But they are not for you.

You have a practice to run, a business to oversee, a case to try in the morning—or better yet, a golf game or grandchild's baseball game to get to. Option trading is an extracurricular activity in which you have an interest.

But you didn't count on the quantum physics. Don't feel guilty. And don't let them make you feel guilty for not studying it all and learning how this skew outpaces that skew but only in strikes of three standard deviations from the mean. You don't need it to make money.

Yes, I am quite sure that a small edge may be gained through a tedious formula of

number crunching that will identify the absolute optimum strike with the theoretical best probabilities of expiring. And guess what? One fundamentally driven move can make the whole point moot.

So while we attempt to keep volatility in perspective, here is our first point for nonprofessional traders. Do not base your trading system

on volatility unless you have some professional-grade software, an expert knowledge of it, and a whole lot of time to implement it. There are many books, courses, and other help now on the market that preach volatility trading. These systems were very popular in trading the S&P for several years in the early 2000s. Traders would sell the volatility in the S&P. By

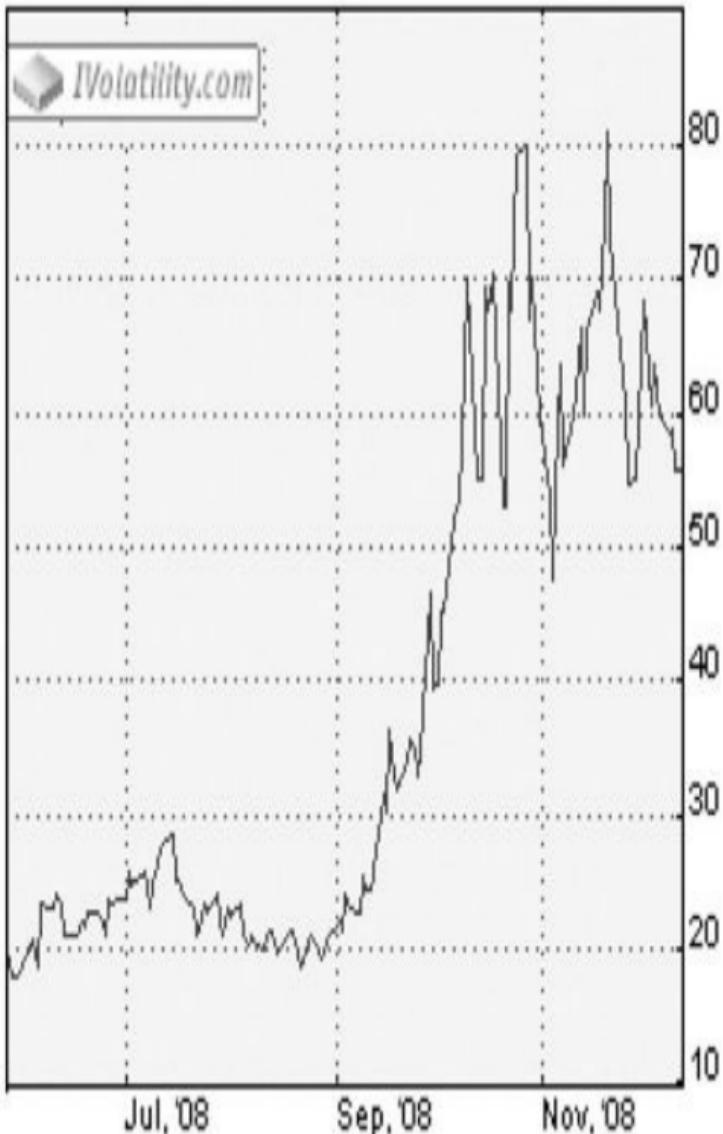
selling the volatility, we mean they would follow a volatility index (such as the popular VIX, [Figure 17.1](#)) and when the measurement got to a certain level, they would sell options on both sides of the market (a strangle). It worked very well for a couple of years. As one of my clients once told me “A lot of smart people were doing it.”

FIGURE 17.1 VIX Price

Chart*

Volatility cannot and should not be traded in a vacuum.

VIX PRICE CHART



But when we focus on volatility alone, we tend to ignore the realities going on in the underlying. How many S&P strangle players who took premiums every month for several years were in the market in mid-2008? Volatility was surging in September of 2008. Volatility alone dictated this as a good time to sell strangles. Knowing what happened in

October, do you wish you would have sold calls *and* puts? That is where the fundamentals come in.

What Is Volatility?

Before moving forward, we should again define volatility as a quick

refresher on the subject. Strip all the fancy formulas away and volatility is simply a measurement of how wide of price movements a market will make before an option expires worthless. When markets are very active, in other words, making large daily, weekly, or monthly swings, they are said to be “volatile.” Volatility is a relative measurement, as

we will see. However, to put it simply, more volatile markets tend to increase the value of the options in that market. The wider movements mean there is a higher perceived risk to the options and thus, higher premiums are justified. Option buyers are more eager to buy options in these markets and option sellers charge more for them.

Sometimes, these higher premiums are justified. Other times, it turns into a sucker's game. Volatility can get "out of hand" at times and make the ridiculous opportunity available to sellers. Volatility is why one could sell refined blend gasoline \$4.20 calls in late 2008 when the futures price was at \$1.20 per gallon. Volatility is why one could

sell \$4,500 gold calls in 2011 with gold trading at \$1,800 per ounce. Your fundamentals should still determine the markets you trade, but volatility can hand you some handsome gifts.

The simple rule of thumb is that higher volatility favors option sellers and lower volatility does not. Again, this does

not mean that you should not sell options in a lower volatility market if you have identified a fundamental advantage. Volatility is but one factor to consider when identifying opportunities.

How Do I Know if Volatility Is High or

Low?

Just because a market moves around a lot does not necessarily mean that the options in that market are offering an out-of-ordinary advantage to sellers. There are two types of volatility: *historical* and *implied* volatility. But these are actually just two different methods of trying to measure

the same thing. Both historical and implied volatility are trying to estimate how far a market will move in the future—regardless of the direction.

Historical Volatility

Historical volatility is a measurement of how far prices move over a given period of time from an

average or mean value. We're not going to go into how historic volatility is calculated, but rather, how you can use it.

Historic volatility is stated as an annual percentage. If the historic volatility for a given market for a 90-day period is stated as 32%, it means that if this same volatility holds true for the next year, the price of this

market (stock or commodity) could be expected to vary 32% either way from today's price.

In other words, historic volatility uses the underlying market's past price movements to estimate how far this market will move in the future.

Implied Volatility

If there is one subject that is probably most confusing to option traders, it is the concept of implied volatility. Implied volatility is still trying to predict how far the market will move in the future. However, instead of using the historical movements of the underlying to project this, implied volatility uses the price values of the options themselves. The problem

seems to come in that individual investors seem to think that they need to know how to calculate implied volatility on their calculators and to learn all of the formulas necessary for doing so. You don't. The simplest of software programs, quote systems, or more (free or otherwise) will typically calculate it for you.

Using Implied Volatility

Implied volatility works like this. Let's say Trader John wants to sell silver puts. The day he decides to sell his put, silver makes a massive move to the downside, falling \$1.00 per ounce in one day. Seeing this move in the market, traders (at least the public) rush to buy silver puts to take

advantage of an additional move lower. The demand for the puts themselves rises. As the market has just moved lower, however, the sellers of the put options have become more fearful that their strike price may be reached (or they simply know that put sellers are less willing to sell). Therefore, they ask for a higher premium to sell their options. Put option values therefore rise. Implied

volatility measures the movement of the price of these options and uses it to calculate the “expected” range of movement in the underlying, based on how the option traders are maneuvering.

Implied volatility (IV) is also expressed as a percentage. Each individual option will have its own implied volatility. The IV of

all of these options is combined to create the IV of the underlying. Implied volatility will often rise when considerable moves in the market take place over a short period of time.

It is not uncommon for implied volatility to rise more on downside moves than on upside moves in the market. This is because fear is often greater on downside than on

upside moves. And while these types of downside move will generally inflate the values of the puts, we have seen rare circumstances where a sharp move downward can create enough fear and unpredictability in the market that it increases the IV in all options in that market to the point where call options can actually *increase* on value on the price collapse!

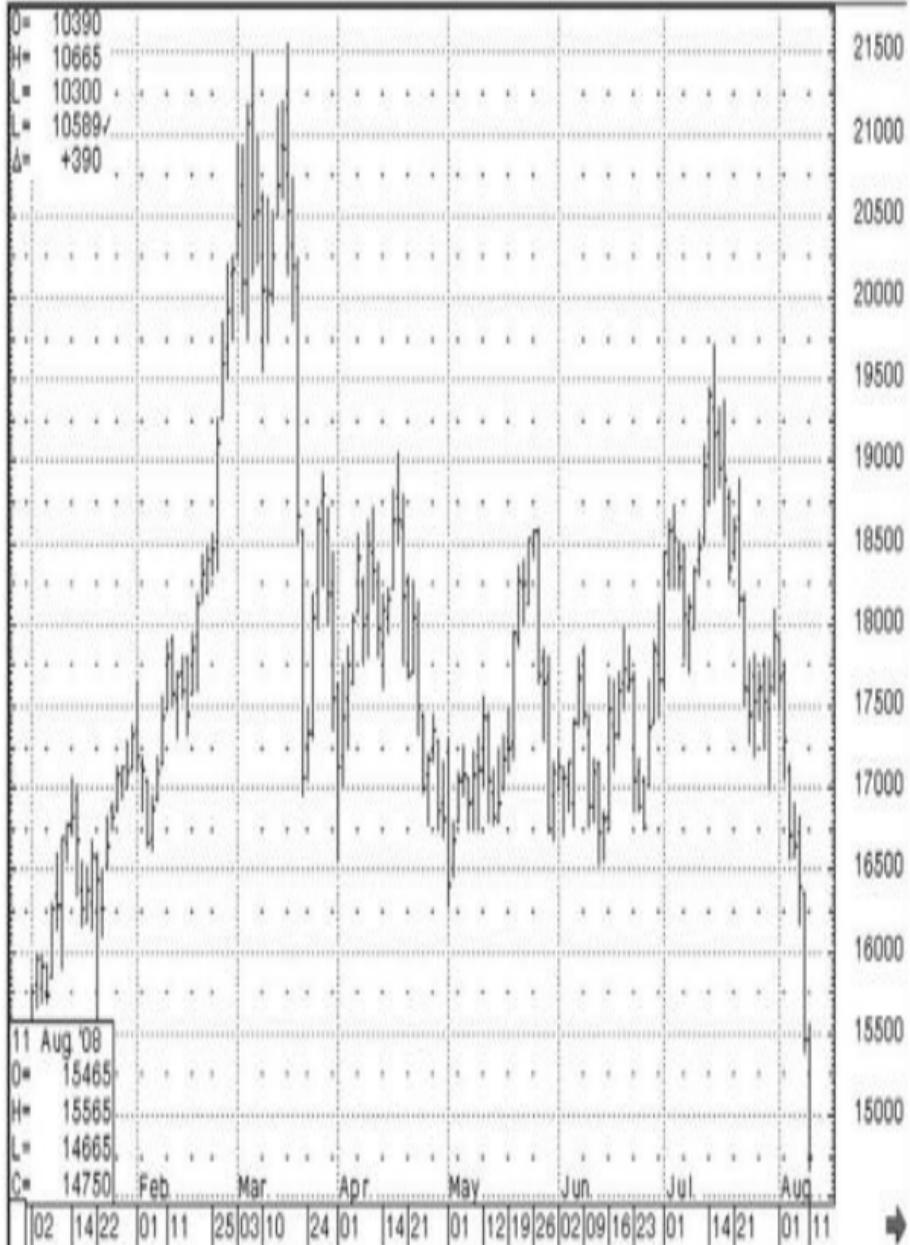
These types of surges in implied volatility, however, can be outstanding option-selling opportunities, provided they are taking place in a market you have already identified as fundamentally favorable.

Selling “Overvalued” Options

Like market players in general, option values tend to overreact to sharp moves in the market. It has been our experience that a one- or two-day extreme move in an underlying's price can cause option values to surge. These can be outstanding times for selling premium as these options tend to experience a knee-jerk-like increase in implied volatility ([Figure 17.2](#)). Oftentimes, these

volatile daily price ranges are not sustainable and the market will calm down within a short period of time, even if it continues on the same path.

FIGURE 17.2 Sharp Moves in the Market Will Usually Increase Implied Volatility



For instance, suppose in John's silver trade, John sells a December silver \$7.00 put on the day the market dropped by \$1.00 per ounce. The fear in the market allowed John to sell his put at an inflated premium.

Let's assume that the day before John sold his put, the put's value was \$400. Let's further assume that on the day of the put sale, John received

\$900 for this put. John sold the put because (a) his fundamental analysis dictated that silver would not reach \$7.00 per ounce; and (b) because he chose to take advantage of the investor fear in the market on that day.

If the price movement of silver trades moves in narrower ranges over the course of the next several trading days, investors may

“come to their senses” and begin to realize that silver is probably not going to make \$7.00. It may still be heading lower, but the rate of its descent has slowed. Investors begin to grow calmer. Implied volatility falls. So does the value of John’s put.

Within a few short weeks, silver prices are at the same level they were when John sold the option. But John’s

option is back to \$400, simply because implied volatility levels have declined. John has already made a \$500 profit from volatility alone ($\$900 - \$400 = \$500$).

At this point, John could close out his option (buy it back) and take the profit, or, if he still believes silver prices are not going to \$7.00 an ounce, he may choose to

hold it and keep the additional \$400 in profit at expiration.

The moral is, sweeping moves in the market, particularly if they break major support or resistance on a chart, can often create considerable jumps in implied volatility. As these types of price swings can often not be sustained over longer periods, these short-term spikes in

volatility are often short-lived. And they are often opportune times to sell inflated premium and take advantage of these “overvalued” options.

Historical Versus Implied Volatility to Identify “Expensive” Options

Knowing when an option has become overvalued, however, is difficult to know simply by looking at it. But there are some indicators that could lead you in the right direction.

Remember that when dealing with volatility, everything is relative. In the early 2000s, when oil traded at \$30 per barrel, a \$2.00 daily move was considered a

major move and would certainly warrant headlines. In 2008, oil prices regularly traded in a \$4.00 to \$7.00 range per day. A \$2.00 move could happen in a minute and would hardly register a blip on the volatility scale. Relativity, then, is what matters in the volatility world.

There are literally thousands of methods,

studies, and formulas for working with volatility and calculating one's odds of success. However, in keeping with the theme of this book, we are going to discuss only methods that we are (a) familiar with; (b) have worked well in our portfolios; and (c) are simple and applicable to the mainstream, individual investor.

I must preface this section

by giving credit to our friends at ivolatility.com, who have assisted us much in volatility studies. Over the years, we have found the method below an effective tool in suggesting options that may be exhibiting overvalued tendencies. But we must stress again that volatility is relative, and you should only use these methods as an additional tool in evaluating a potential option trade. This is

not a trading system.

If historical volatility can be expressed as a percentage, and implied volatility can be expressed in the same context, then an overlay of these two charts, based on their daily changes, can tell us something.

As historical volatility measures the actual price movements of the underlying and implied volatility

measures investor predictions of price movement based on option values, then an overlay of the two can show the difference between option trader expectations and the actual historical price swings in the market. Implied volatility will often follow a similar path to historical volatility. It is when there is a discrepancy between the two that things begin to get interesting.

If we take a three-month historical volatility chart and then compare how far above or below implied volatility has moved beyond historical, we establish a range ([Figure 17.3](#)). Let's suppose that at one point within the past three months, implied volatility was 30% above historical volatility. Let's also suppose that that point was not achieved before or since that time. A move tomorrow

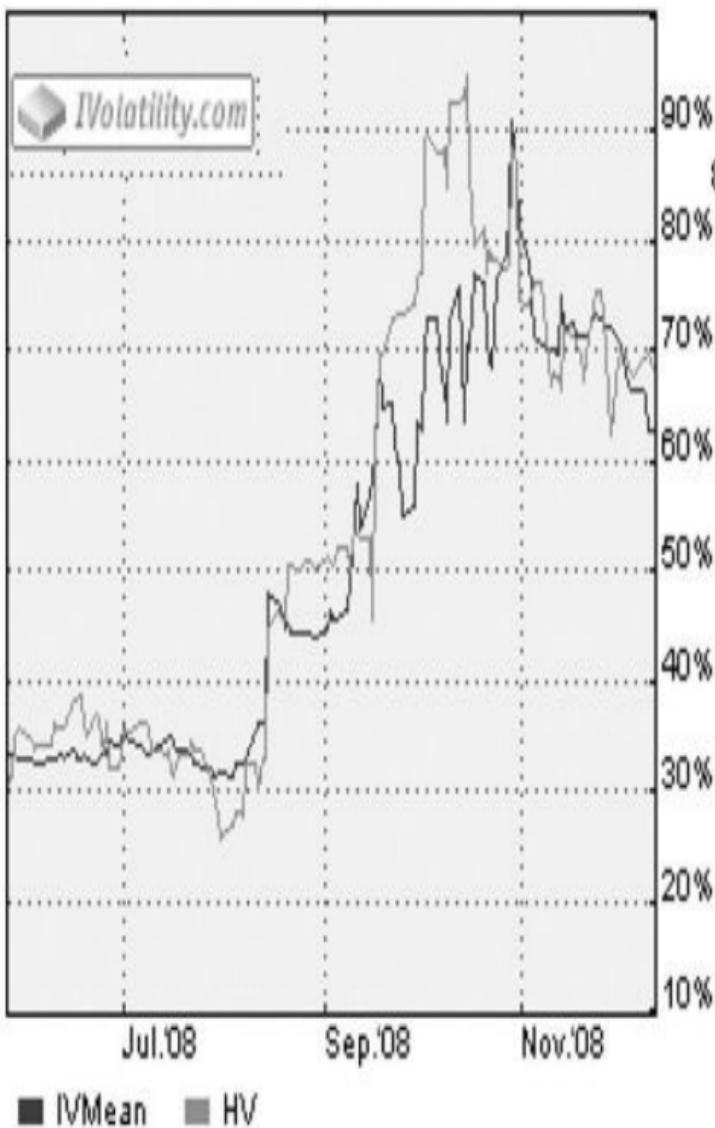
that saw implied volatility move 31% beyond historical volatility would then indicate that investor expectations were far exceeding the six-month historical volatility—at least more than they ever have within the last six months. When this happens, it could indicate that investor expectations are exceeding historical norms. Sometimes this is warranted. But oftentimes, it is not. If it is

investor or media hype pushing up this implied volatility, one could be looking at overvalued options. It indicates that investor expectations could be “out of line” with what historical price movement suggests, and therefore one might expect to see a drop in volatility as investor expectations come back “into line.” This would be similar to what happened with John’s

silver option in the earlier example.

FIGURE 17.3 Using Our Suggested Model, a Three-Month Volatility Chart of Comex Silver Indicates That Volatility May Have Favored Sellers in Late August but Favored Buyers in October*

COMEX SILVER IVIndex30d vs HV30d



In other words, to identify what we might consider an overvalued option, we would look for markets that show implied volatility near or exceeding three-month highs (percentage wise) over historical volatility. Again, however, this is relative. If wide swings between implied and historical volatility are the norm, then this method may not be that useful. It is

the variation from the norm where option sellers can look for opportunity.

Why do we suggest three months? Because this is generally within the life spans of the options we choose to sell. Again, this is relative to the user. Short-term traders might only use two to three days of historical volatility, whereas longer-term players may use a year or more of

historical volatility charts.

The key point is that you are looking at how far implied volatility currently is above or below historical volatility and how that compares to where it has been over the last three months. If it is higher than it has been at any point within the last three months, it could be overvalued and be a good candidate for an option sale.

If implied volatility is substantially lower than historical volatility, and this is clearly not the norm, then one may say it is a situation that could favor an option buyer (although we clearly do not recommend buying options).

Of course, this would only be true if the underlying was one in which you had a strong fundamental bias.

Conclusion

The purpose of this chapter was to take the sometimes complex subject of volatility and simplify it into a distilled version suitable for the individual to use at home. We do not present this chapter as the “be all and end all” of volatility studies, as it certainly is not. However, if your main concern is to know

enough about volatility to make money selling options, it should serve the purpose well.

Do not take this chapter to mean that an option must be “overvalued” in order to make a good option sale. As we stress throughout this book, fundamentals of the underlying market should dictate your option sales. Volatility is, at best, a tool

you can use in your decision making or timing process. At the very least, it is a factor you can consider when analyzing your sale.

For instance, if you are bearish natural gas at \$10.00 and you can sell a call at a \$20.00 strike, is it going to matter to you in the long run what the volatility was? Probably not. If you sell it when the option has become

historically “expensive,” you’ll probably get more money for it. The problem is, the volatility isn’t always going to be perfectly timed with when the fundamental opportunity is present.

In general, markets with higher historical volatilities offer further out-of-the-money options which you can sell. It is simply that when implied volatility surges, you

can often sell them for more.

Consequently, if you do sell an option and implied volatility surges afterward, the value of that option will probably increase on you. However, if your fundamental analysis is sound, and your trade has been structured properly, you may find it best to simply ride it out. The strategy of “rolling,” described in

Chapter 12, was specifically designed to counter implied volatility surges in fundamentally sound markets in which you are already positioned.

When identifying trades for our managed portfolios, we utilize volatility as one of many factors to be considered before positioning in a particular market. However, if you prefer a do-it-yourself

approach to working with volatility, our friends at *ivolatility.com* and *Optionetics.com* offer some excellent resources for learning and measuring.

I have known fundamental traders who have sold options successfully for years without giving volatility much thought. However, knowing what it is and how it works can give you an extra

edge in your option-selling portfolio.

18



How to Structure Your Option- Selling Portfolio

Tips on Building Your
Premium Ladder

I had a friend in college named Chip. Ever since I knew Chip, he was perpetually disorganized. Shortly after we graduated, he called me one day and informed me he was coming to visit me in Florida (he lived in Pennsylvania). I assumed he would call me back to set a date or get directions or make some kind of *plan* for his visit.

Five days later, Chip showed up at my front door.

“How did you get here?”

I asked half-bemused, half-perplexed.

“I drove.”

“Did you have a map?” I probed.

“No,” he responded.

“Then how did you find my house?”

“I kept stopping and asking directions,” he replied quite matter-of-factly.

“To Florida?” I asked incredulously.

“Yes.”

As it turned out, Chip had driven more than 1,000 miles, eventually locating my house, using only a vague sense of direction and a shamelessly outgoing personality. It had

taken him five days and several wrong turns, but he eventually made it.

Chip knew how to drive and how to read road signs, but he did not have a plan as to where he was going or how he was going to get there. Believe it or not, some investors trade this way. Unfortunately, most are not as lucky as Chip. It is very difficult to get where you are

going if you do not have a plan for getting there.

This is why constructing a plan for your option-selling portfolio is so important. In this book, you've learned why, how, when, and where to sell options. You have the eggs, flour, sugar, and mixer. But you still have to combine the ingredients correctly and cook at the right temperature to get a cake.

Steps for Structuring a Successful Option- Selling Portfolio

Steps 1 to 3 involve establishing a trading plan for your portfolio—a theme we allude to several times in this book. The remaining steps involve how to structure your portfolio and position for maximum gains and minimal risk. These steps pull together

many of the trading concepts we have covered.

While we certainly do not recommend trading like Chip, we also think it important to not “overplan” your option-selling portfolio. Option selling, especially on fundamentals, requires a certain degree of flexibility that you cannot write into a computerized trading plan. I know the number crunchers

out there are already wrinkling their noses because we are not going to give them a formula to plug into their spreadsheets and “run the numbers” for the next three weeks. However, “paralysis by analysis” is just as big a threat as underplanning, in our opinion. It is important to have a general trading plan. But give yourself some leeway to make informed trading decisions and

adjustments along the way.

Step 1: Set Your Objectives

Constructing an effective option-selling portfolio starts out like any self-help book you have ever read. You must have a goal. You must have an objective. “I want to make money” is not specific

enough.

“I want to make 40% annualized returns after fees” is specific.

“I want to generate X amount of quarterly income” is specific.

“I want to diversify my overall investment holdings into a new asset class” is specific.

Your first step in constructing your portfolio is to decide why you are starting the portfolio and what you hope to accomplish. It sounds simple enough and yet many investors fail to define this from the beginning, which can result in an unfocused trading plan and inconsistent results. Knowing your objectives from the beginning will help

you to better define, build, and if necessary, adjust your trading plan.

This is the very first step we take with any client of our firm and it is the first step you should take as well. Even if you are hiring a professional trader to manage your account on your behalf, you must first set your objectives before any trading plan is constructed.

Step 2: Determine What You Will Do When Your Objectives Are Attained

Again, it sounds simple. But most investors take the Chip approach and decide as they go. Knowing where you are going means making more focused decisions. It is your

money. You can't afford to be unfocused! What will you do if, and when, you meet your objective?

- Take money out of your account?
- Add money to your account?
- Stop trading?
- Continue with your program with an objective of building on

gains? (Better set a new objective.)

Hitting an objective is gratifying and often a good time to reevaluate your game plan. However, it helps to have a general idea of what you will do when you reach your portfolio goal.

Step 3: Decide What

You Are Willing to Risk to Achieve Your Objective

It is true that there is no such thing as a free lunch. If you want to attain 30%, 40%, 50% returns or more, you are going to have to be willing to put some funds at risk. You can't expect to make 40% on your money taking T-bill risk. I cannot count the number of

investors who have called me over the years and asked “what would my maximum drawdown be?”

We’re all adults here. If you want the short, blunt answer, your maximum drawdown is 100% of your equity and then some. If you ask for a worse-case scenario, then that is it. Just as if you buy a stock and the company goes belly up, you lose your

investment. That's a worse-case scenario. That is what is technically possible.

However, if you want a more realistic answer, one would have to do something terribly, terribly wrong to ever end up in this predicament. Like watching your grossly undiversified, over-positioned portfolio move sharply against you day after day without doing

anything about it. *Unlimited risk* simply means that you have to manage your risk yourself. The market is not going to do it for you. If you buy an option, the structure of the market allows you to rest assured that you have a finite risk. The trade-off is that the odds are high your option will expire worthless and, as a buyer, you will lose.

In selling options, you get

high odds of success in your favor. The trade-off is you have to take steps to manage your own risk.

And as we learned in [Chapter 9](#), there are plenty of effective ways for doing this. Step 3 of structuring your portfolio is to know which of these methods you intend to use in your trading plan and how much of your capital you are willing to risk to achieve

your objectives.

As we tell investors when helping them build their trading plan, your success as an option seller will have not so much to do with the 80% or so of options that expire worthless. It will have more to do with how you handle the 10% to 20% that do not.

Chapter 9 discusses strategies for managing risk on individual trades. But one

must also consider the risk approach to the portfolio as a whole. Below are the questions you may want to answer for yourself about how you want the risk managed in your own account.

- 1. Do I want to spread or write naked?**

Naked selling can offer faster profits and early exits. Spreads can offer

limited exposure but longer time frames for profit realization. *We typically recommend a combination of both.*

However, you must select strategies that not only match the market's temperament, but your own.

2. **How much of my portfolio funds do I want to keep as**

“reserves?” No matter how many markets or trades you have on at any given time, you want to keep a certain portion of your trading account in liquid reserves. As you learned earlier, margin requirements for short options can fluctuate on a daily basis, depending on market movement and

volatility. Keeping a healthy portion of the account in cash reserve makes for a more stable portfolio. You can devise your own comfort level for the amount of cash you choose to keep in reserve. This subject is discussed in greater detail later in this chapter.

3. Think through how you will handle losses and if you have a “drop dead” point at which you will cease trading and modify your trading plan.

Moderate, periodic losses are to be expected and are part of any normal trading program. If kept manageable in an option-selling program,

they can generally be made up with your other trades as long as you are diversified properly. However, if you experience a substantial loss over a given time period, you should have a predetermined figure in mind as to at what point you cease trading and reevaluate.

Trading, even selling

options, when you are rattled or frustrated is not a good idea. Set a drop-dead point of what you would be uncomfortable losing. If your account hits that point, close your positions and take a week or two off. Coming back and making adjustments is much easier with a clear head.

**There is no answer as to
“what type of drawdowns
can I expect?”**

I have seen traders have a 10% to 20% drawdown and freak out. I have seen traders start out on top and never have a drawdown (against invested capital). In general, if you are selling futures options, you are targeting 20% to 50% returns. Therefore, to stay in the

game, you should realize that drawdowns of 10% to 20% or more are not out of the question and that you should be comfortable with this type of movement on the funds you have invested. Realize that this is the normal ebb and flow of futures options and that drawdowns of this nature, while unpleasant, can also be recovered somewhat quickly with this type of strategy.

That being said, this is no guaranteed annuity. You can lose more than 20%. You can lose as much as you want to lose or as much as the market can take from you. Selling commodities options is an aggressive investment by traditional standards. Although it is our opinion that a properly managed portfolio will well outstrip the risks, you have to make your own call. If you have never

invested in anything more aggressive than 10-year muni's, selling options can be a big step for you. If you already sell stock options or trade the S&P, then you already have the right mindset. It's simply a matter of learning a new set of rules.

Step 4: Diversify Your Option-Selling

Portfolio

Once you have established your initial trading strategy and risk parameters, it is time to begin establishing positions. It's time to start selling options!

One concept we have repeatedly discussed is to only sell options with the most clear-cut fundamental advantages. However, a

cornerstone to a successful portfolio is diversification.

Will you be able to fully diversify your portfolio when you first begin selling options? Well, you could, but we would advise against it. You will look to sell options only in markets offering a distinct fundamental advantage. This will obviously not be all markets at all times.

At the same time, you will want to build toward diversifying your option sales across several different sectors. A portfolio built on selling S&P options is not diversified. I have talked to many traders who based whole portfolios on selling S&P strangles. These portfolios can do well for a while, until a big move comes along. It is during these moves that S&P-only traders

tend to discover the value of diversifying.

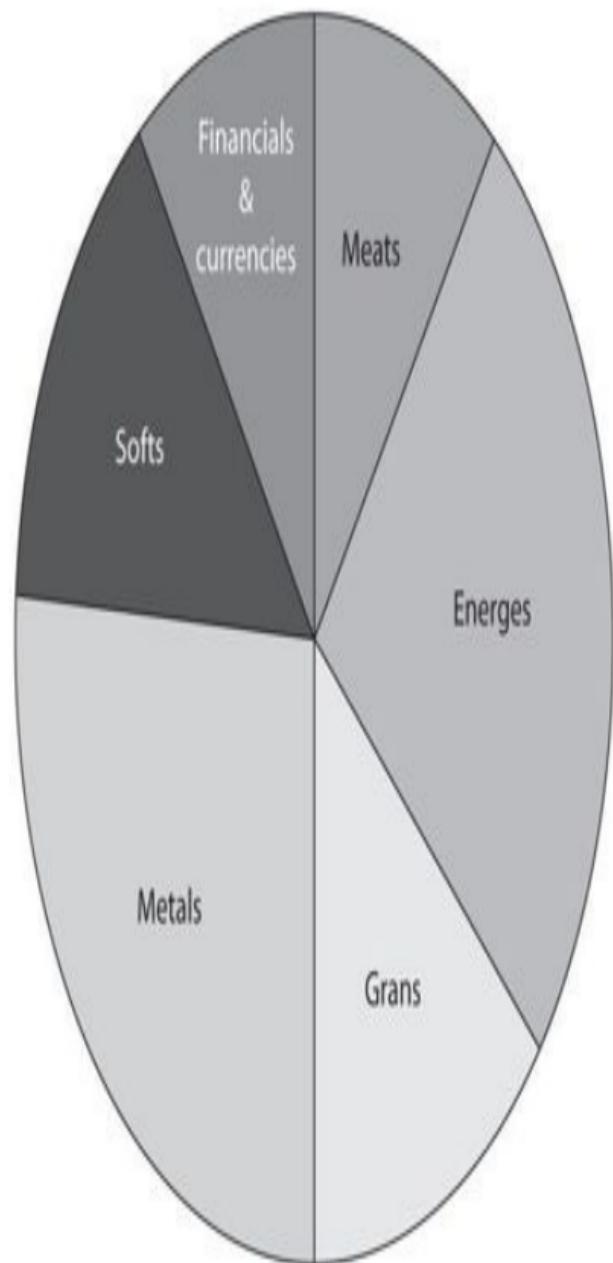
One of the benefits of trading commodities options is that one can sell options across a widely diversified spectrum of physical products. As we illustrated earlier, one can sell a variety of stock options across several equity sectors, yet if the stock market as a whole moves up or down, all stocks

tend to follow suit. In commodities, except in special circumstances, this is generally not the case. Therefore, one may be short sugar calls and short heating oil puts and be right on both.

Figure 18.1 illustrates how a sample portfolio might look for a typical well-diversified account.

FIGURE 18.1 Pie Graph Showing Sample Portfolio

Diversification



Note that this is only an example and the face of this pie chart constantly changes in a real-life portfolio. Notice that some markets are short-only calls, some only puts, and some are short both calls and puts (strangled). This reflects the trader's fundamental views of the underlying markets—bearish, bullish, or decidedly neutral. Strangles are typically written

in markets where the trader is not overly bullish or bearish, but volatility has surged to levels where simply selling distant options on both sides of the market looks like a high probability play. Note also that when a category denotes short puts or calls in a certain market, these could be naked or covered positions.

Keeping your portfolio

diversified carries obvious benefits. The typical knock on option selling is that one losing trade can wipe out months of gains. (It would not be surprising to learn that this “drawback” probably derived from nondiversified S&P traders.) Let’s face it, trades can go bad; markets can make erratic, illogical moves. You can lose money selling options. If a trade goes bad, and it is your only trade,

and you have 50% of your portfolio in this trade, chances are that you are going to take it on the chin, even if you used proper risk-management techniques.

If you are diversified over five or six different markets and one goes bad, chances are that it's only a small percentage of your overall portfolio. You take the loss, you move on. You make it up

somewhere else.

Probably the most difficult challenge we face as portfolio managers is not the trading. It is getting option traders or even neophyte option sellers to think about this as an *investment*, and not as *trading*. You manage the portfolio as a *portfolio* and not as a *trading account*.

You plant your garden and then let it grow.

Occasionally, you pick the fruit and/or pull up dead plants and replace them. You do not throw seeds every which way and see what pops up. Nor do you plant all one crop and risk a blight destroying your entire garden. You don't "load up" on something just because it looks good. You have to think of each trade as to how it fits in and balances the entire portfolio. For instance,

if you are already short crude oil and heating oil puts and you see an opportunity to sell unleaded gasoline puts, you could be risking overloading your portfolio in a single sector. This is true even if selling unleaded gas puts looks like an excellent trade.

This does not mean that you have to equally balance your portfolio across all sectors. You or your portfolio

manager may like some markets better than others or feel there is less risk in some trades than others. There is no crime in overweighting certain markets at certain times. Which brings us to our next step.

Step 5: Manage Your Cash Margin

Effective margin management is crucial to your success as an option seller. Again, as we have stated several times in this book, over positioning, not miscalling the markets, is probably the number-one reason traders lose money selling options. In a futures options account, your “available margin” is simply your cash balance. This is the amount of cash you have

available in your account that is not being used to hold open option positions.

However, what some new option sellers overlook is the fact that margin requirements for positions can, and most do, change—in fact, they do on a daily basis. SPAN margins for each position are recalculated and marked to the market at the end of each day. Most of the time, these

changes will be nominal. If the option is decaying, the margin requirement to hold the position will change and your available margin (also known as excess equity) will rise. Consequently, if a position is moving against you (or even if volatility is simply increasing), the margin requirement to hold that position can increase. This means that you will want to have excess cash in reserve

to account for such changes in margin. Every position is not going to immediately race to zero and expire worthless. In fact, many of your short option positions may initially increase in value. This is normal.

Remember, one reason we sell options is so we don't have to time the market (although we can always try). We sell options to give the

market plenty of room to move around. We don't try to pick market tops and bottoms. Long-term fundamentals can be accurate in assessing longer-term price projections. But if you sell your option in this market, the chances are 50–50 that the underlying is going to move against you the following day. This doesn't necessarily mean the option value will move against you. But it can.

For instance, you may sell a call on day one and day two the underlying price of the market goes up. Chances are your option value, and thus your margin requirement for that position, may increase. Most of the time, if you are selling far out-of-the-money options, these increases will be nominal and benign—especially if time value is running out on the option. But you nonetheless want to

have excess margin available in your account to cover these margin fluctuations.

For a moderate to conservative account, this typically means holding at least 30% to 40% of your total portfolio in cash. If you sell all naked options, you may want to hold slightly more. However, this type of cash cushion should be more than adequate to handle most

market fluctuations if you are properly diversified.

The Margin Call Fear

New option traders tend to live in fear of the margin call. As we discussed earlier, margin calls are nothing to fear. It simply means you either have to close a position or increase your equity stake if you wish to hold your position. If you are getting a

margin call, chances are you should probably be closing something.

However, if you are following these cash management rules, the chances of you ever receiving a margin call in an option-selling account are remote.

Table 18.1 illustrates a suggested portfolio structure for new option-selling accounts. These are presented

for example purposes only and no representation is made that this structure will be successful for all accounts at all times. However, we tend to base our managed portfolios on these models and have found them to be effective over the years. Perhaps you will as well.

TABLE 18.1 Chart Showing Different Strategy

and Portfolio Objectives

Portfolio Strategy A: The Conservative

Strategies used	70% covered positions, 15% strangles, 15% naked
Margin used	Recommended level of no more than 40–50% of account margined (invested in trades) at any given time
Risk strategies	Conservative
Diversity	Accounts under \$500,000—Objective of being diversified over 4–7 different markets and/or sectors at any given time Accounts over \$500,000—Objective of being diversified over 6–10 different markets or more at any given time
Markets traded	Grains, meats, energies, and softs
Annual target return	
Objective	25–30%

Portfolio Strategy B: The Moderate

Strategies used	60% covered positions, 20% strangles, 20% naked
Margin used	Recommended level of no more than 50–60% of account margined at any given time
Risk strategies	Conservative and some aggressive
Diversity	Accounts under \$500,000—Objective of being diversified over 4–7 different markets and/or sectors at any given time Accounts over \$500,000—Objective of being diversified over 6–10 different markets or more at any given time
Markets traded	Grains, meats, energies, and softs (Accounts over \$500,000 may also trade stock index options)
Annual target return	
Objective	30–40%

Portfolio Strategy C: The Aggressive

Strategies used	50% covered positions, 25% strangles, 25% naked
Margin used	Recommended level of no more than 60–70% of account margined at any given time
Risk strategies	Aggressive
Diversity	Accounts under \$500,000—Objective of being diversified over 4–7 different markets and/or sectors at any given time Accounts over \$500,000—Objective of being diversified over 6–10 different markets or more at any given time
Markets traded	Grains, meats, energies, and softs (Accounts over \$500,000 may also trade stock index options)
Annual target return	
Objective	Over 40%*

Step 6: Do Not Overtrade

Overpositioning usually results from overtrading. Overtrading usually results from overzealous traders ready to pull the trigger on whatever the flavor of the day may be. Remember, this is an investment, not an “activity.”

This is meant to be slow and steady. Many of our managed portfolios may only trade two to four times per month. You execute a trade only when everything appears to be in your favor. Your fundamentals, your strike, your premium, your market. Work toward diversifying your portfolio, but do not feel that you must immediately distribute your capital into seven different sectors. Wait

for your opportunities; pick your points.

Conclusion

Like any other type of investing, a successful option-selling portfolio starts with a good trading plan. An investor should view her option-selling portfolio as an investment, not an “activity.” Choose your main objective

for the portfolio and what you are willing to risk to attain it. Your portfolio should be diversified. Fortunately in commodities, true diversification is possible. Keep a healthy portion of your capital as backup equity (in cash). Do not overtrade.

There are many Chips out there in the investment world. Any one of them would probably be glad to tell you

the sob story of his trading gone awry. If you want to make money in the options market, don't be like Chip. Have a plan.

PART

IV



GETTING STARTED

19



How to Avoid the Mistakes New Option Sellers Make

Learn Them Here and
Save Yourself Time,
Money, and
Headaches

Like most other investments, or any other endeavor, there is a learning curve that new option sellers must experience on their way to becoming successful. No matter how many books you read or how many back-tested models you study, there is no replacement for tried-and-true experience. And with experience comes mistakes.

The purpose of this

chapter is to review the most common mistakes made by traders new to option selling. Although we generally try to preempt these mistakes by new clients, there are those who insist on doing it their way, right or wrong. While experience ultimately will remain your best teacher, the observations on the following pages may make the educational phase of your new investment approach a

much more pleasant and hopefully profitable experience.

Mistake 1: Trading on Your Own with a Discount Broker

While this statement may sound self-serving, it is based not only on personal observations but also on what

has been written in many other books, courses, and trade journals alike. A discount broker is an order clerk whose job it is to answer the phone and take your order. That is it. Discount brokers provide a service to highly experienced traders who do their own research, their own analysis, their own portfolio planning, and their own trade placement.

These days, in many cases, you may not even be talking to a human order taker anymore. You can enter orders directly through your computer.

If you have a lot of time to invest in learning how to be a semiprofessional trader and are committed to regular and sustained study of commodities fundamentals, this can be the eventual path

you wish to take.

However, if you are new to trading commodities or options, especially selling options, it may serve you better to work with an advisor who is highly experienced in the field. If you are an investor with little time or patience to do the legwork yourself, professional guidance is crucial.

In addition to helping you

with everything from bid/ask spreads to calling you when something breaks in the market that could affect your position, a good full-service broker can advise you on market news, order placement, stops, and risk control, and provide a calm voice of reason in adverse market conditions. If the broker is really good, she can even advise you on new positions that will *make you*

money.

As a new option seller, think of yourself as a flight student at the controls of a 747. From your training, you may be able to fly the plane fairly smoothly, maybe even land it by yourself. What happens, however, when you're trying to land in a thunderstorm and all of the sudden the plane starts to shake and a strange alarm

goes off that you have never heard before? Would you prefer to have an experienced pilot, specializing in the plane you are flying, to talk you through the landing or even take the controls? Or would you prefer to have a passenger sitting beside you saying, "What are you going to do now?"

Of course, a good full-service broker is going to cost

you a little more than a discount order clerk. Costs can be analyzed on an annual or per-quarter basis to determine if your broker is worth the fees. However, a good broker can save you thousands in the long term. While nobody knows what the market will do tomorrow, an experienced broker will help you to “land the plane.” A better broker will keep you out of the thunderstorm

altogether.

The natural extension of a broker is a portfolio manager who simply flies the plane for you. Instead of sitting in the cockpit, making all of those decisions, watching indicators, trying to figure out what that alarm means, and worrying about landing the darn plane, you simply sit in first class (or in the cockpit “jump seat”) while an

experienced captain takes you to your destination. If you are a trader, you likely are best served by a broker. If you are more of an investor, you are likely best served by a portfolio manager.

Much of this, of course, comes down to personality and time availability. Are you more motivated by the enjoyment and challenge of flying—or are you more

about getting to your destination comfortably and safely?

Suffice it to say that if you are investing six or seven figures into an option-selling portfolio, investing in professional guidance should be the first trade you make.

Mistake 2: Overpositioning

The second most common mistake we see new option sellers making is overpositioning. Because of the high odds of success on any individual trade, many new option sellers experience euphoria at having their first few options expire and think that they have discovered the Holy Grail of investing. This often can lead to a “can’t lose” mentality. Combined with the low margins of

selling futures options, the potential to sell more options than an account should safely be holding becomes a realistic temptation.

Don't do it. Almost invariably the position you choose to "load up" on will be the one that sinks.

Even if you experience early success at option selling, which we can honestly say many of you

probably will, you cannot lose respect for the market. Unlike futures traders or option buyers, whose path to success lies in taking a series of small losses while waiting for one big winner, your approach will be the opposite. Your approach will be to take a series of many moderate winners and to avoid one big loser.

Given the current rate of

success of most futures traders and option buyers, your chances are pretty good. However, overpositioning your account increases the chances that one loss could affect your overall portfolio substantially. We generally recommend that clients not margin more than 50% of their total funds at any given time, and we recommend having that portion diversified over at least three

to five commodities at any given time for accounts under \$500,000. Any more of the former or less of the latter could mean that you are overpositioned.

Mistake 3: Trading an Undercapitalized Account

A pilot friend once said that

in training new flight students, planes were taken to higher altitudes, giving students more room for recovery if they made a mistake. The same is true for your option-selling account. The more capital you have, the more room you have for recovery in the event of a bad trade and the more flexibility you have in your diversification and risk-management techniques.

Trading an undercapitalized account often means trading scared. It can lead to everything that one should avoid in option selling, including overpositioning, over- or under-risking, and emotional trading.

We generally recommend starting a futures option-writing portfolio with at least \$250,000. For our clients, we

typically recommend a \$1 million starting portfolio. Sure you can start with less and “play” with it. But in my experience, the guys who play are the guys who lose. If you are going to sell options, I suggest making a serious commitment to it. You are doing something few understand how to do. Do it right and you have the potential to do very well. But you have to commit.

The problem with many traders is that they remain in a *gambler* mind-set instead of an *investment* mind-set. Many traders are attracted to futures because they believe that they can take a small amount of money and turn it into a large amount of money in a very short period of time. We already know the track record of most of these traders.

Option selling is not

going to do this for you. However, option selling, if done correctly, can take a set amount of money and get a *very* good return on it—consistently. This is what is meant by an *investor's* mindset. What do we mean by *very good return*? If you intend to trade your account in a conservative to moderate manner, according to the techniques used in this book, you realistically could target

a 20% to 50% annual return on your capital. Do we guarantee that you can do this? Of course not. You might never hit it. You might *lose* money. But many prospective investors ask for a ballpark target ROI. Based on our experience, we believe that this is a realistic objective.

You must, however, be sufficiently capitalized.

Mistake 4: Not Having a Trading Plan and/or Exit Strategy Established Before Trade Entry

Although many traders dismiss the role that psychology plays in the trading process, it has been noted by most top traders and authors that failure to control

emotions is probably the number-one reason traders lose money. Markets look entirely different to you when you are analyzing trades from a distance than when you are following them with your money on the line. No matter how controlled you think you are, your emotions probably are affecting your thought process without you even knowing it.

Think of it as a Dr. Jekyll–Mr. Hyde type of situation. Before you enter the trade, you are Dr. Jekyll, the calm, rational thinker who forms and implements a controlled plan. Once you enter the trade, you become Mr. Hyde, instinctive, irrational, reacting and overreacting to every piece of stimuli passing in front of your eyes. There is a little of this in all of us, even the most

polished professional trader.

This is why most traders develop a plan or a system. Systems do not have to be complicated. They are simply a set of rules you develop before you enter the trade so that you have a road map to follow once you make the “change” from objective analyzer to emotional reactor. Remember plan the trade, and trade the plan? This is another

way of saying it.

Systems can range from a couple of simple entry and exit guidelines written on a piece of paper to a multidimensional computer program. Frankly, you probably could do just as well with either in your option-selling account.

The most important part of a system is the exit strategy. You must know

when, where, and how you will exit the trade and what circumstance will cause you to do so. Never change your plan once you are in a trade.

One of the primary ways that traders lose more than they should is by violating this rule. On the day they enter the trade, they are Dr. Jekyll on the phone, confident, cool, in control. Then, several days or weeks

later, after the market has shifted, the same person is on the phone, but it sounds nothing like the rational fellow that spoke earlier. Mr. Hyde is now in charge. His voice is high, maybe a little faster, and he is excited and afraid. He asks his broker nervous questions, such as, “What do you think?” “What are they saying?” and “What should I do?”

Nietzsche once said, “A man without a plan is not a man.” While we are not going to question the wisdom of Nietzsche’s philosophy, a more fitting quote for the modern-day investors might be, “A person without a plan is not a successful trader.”

Know your exit strategy *before* you enter. Let Dr. Jekyll do the thinking part. All Mr. Hyde has to do is

carry it out.

We work closely with our investors in designing and setting a trading plan not only for their portfolios but for each individual trade. However, if you are doing this on your own, you'll want to make setting an exit strategy your top priority.

Selling options already puts you into an elite group of futures traders who actually

stand a chance to make some good money in the market. Setting a pretrade exit strategy will put you above most of even this specialized group.

Mistake 5: Trying to Pick Tops and Bottoms

Although you will have an

added margin for error in selling options, trying to pick tops or bottoms remains one of the highest-risk approaches to trading. Not only is it higher risk, but it also is probably unwise.

If you are trying to pick a top or a bottom, you are betting on a reversal in trend. This means that you are trading against the current trend and most likely against

the current fundamentals. Markets can make fast and sometimes significant short-term moves in contrast to existing fundamentals. However, a market rarely will establish a long-term trend without some form of base fundamental driving it. Picking a top or a bottom is trading against the trend, which automatically reduces the odds of your option expiring worthless.

Remember the statistics in the earlier chapters? A market doesn't have to have a trend for you to sell options in it. However, if there is a trend, it is best to be selling your options in favor of it.

We had a client for several years who we'll call Sam. Sam would buy and sell futures contracts because he thought the market was "too high" or "too low."

Consequently, his strategy often was to buy or sell against the trend. Sam employed a custom version of scale trading in which he would continue to add to his position as the market moved against it. His thought process was that as long as he had enough capital, he simply could continue to average down until, eventually, the market would reverse from its extreme levels. Although

Sam had substantial capital in his account, this strategy often required him to meet margin calls to continue to hold his positions. He was a stubborn man, though, and he did well for a while. Although he had some big wins and big losses, he was running at about even after a couple of years.

About halfway through his third year, Sam was

betting big that crude oil prices were “too high” above \$26 (this was of course, many years ago). He continued to short futures, and prices continued to go up. As you can guess, Sam’s story ends badly. Crude oil continued to increase in price and soon exceeded \$40 a barrel. Eventually, Sam got a margin call that he could not (or did not want to) meet. In other words, he ran out of money

and was forced to liquidate all his positions at substantial losses. His account was nearly depleted.

Although we tried on several occasions to convert Sam to an option-selling approach, he was not interested. However, although an option-selling approach may have extended his trading career, we believe that his strategy of positioning

suffered from a substantial flaw that eventually would have done him in regardless of the vehicle he was using.

Selling a market because it is “too high” or buying because it is “too low” generally does not make good trading sense. Who determines what is too high or too low? The market does. If it is trading at a certain price level, that is what the

commodity is worth that day. It's not too high or too low. It's just right. This is why fundamental trading with futures contracts is so difficult. You may think that a market has bullish fundamentals, so you have to buy it at the price at which it is currently trading. On the day you buy the contract, the price is not too low. It is fairly priced.

With option selling, you can pick a price far below (or above) the current fair price and say, “That price *would* be too low. I do not think the market will go there.” Since the market is not there on the day you sell your option, your strike price *is* too low, and therefore, your trade is at least logical.

The entire point of selling options is to avoid trying to

outguess the market. No need to do that anymore. There are much easier ways to make money than trying to pick tops and bottoms.

Mistake 6: Forming an Emotional Attachment or Aversion to a Particular Market

Although this may fall under the category of trading on emotion, it is common enough that it deserves a mention of its own. It is not uncommon for traders, especially new traders, to become emotionally attached or averse to a market. These are two extremes of what is basically the same mistake: forming an emotional association with a particular market—positive or negative.

We've seen it cause losses as often as we've seen it produce missed opportunities. Both are equally damaging to your portfolio, and you should guard against this all-too-common mistake.

This phenomenon usually develops after a trader experiences a very positive or very negative experience or string of experiences in a particular market. The trader

then comes to the conclusion that a particular market is “good” or “bad.” The trader who wholeheartedly jumps into a trade because she made money in it before is making the same mistake as the trader who refuses to enter a trade based on a bad experience in that particular market in the past.

As rational people, we know that there is no such

thing as “good” or “bad” markets. If you bought a contract for cotton and cotton went down, you lost money and therefore might be hesitant to trade cotton in the future. However, the trader who sold cotton and made a profit may think that cotton is a great market to trade. The cotton market, however, is like the ocean. It could care less about your well-being, but it has no desire to cause

you harm either. You could bask comfortably in its warm tropical waters or drown in its cold icy depths. It is up to you what you do with it. However, it is not going to change to accommodate you. The market is the same way.

Let's look at a common example. Trader Mary sells puts in the Euro, and they expire worthless, netting her a profit. Mary feels good about

the trade and therefore feels good about the Euro in general and may start to take a particular interest in trading it again. If the fundamentals remain favorable to Mary's positions, she may be able to continue to sell options profitably in the Euro for a long period of time.

The danger comes when fundamentals or the trend for the Euro begin to change.

Mary may have formed such a strong emotional attachment to trading the Euro that she overlooks the subtle signs that a basic fundamental shift is starting to take place. Mary continues to sell puts because it has always been a good trade in the past. She feels very comfortable selling Euro puts. The Euro is a “good” market. Mary’s emotional attachment has turned to complacency, and she allows

it to override her objectivity when analyzing the market. She may even allow herself to overweigh her portfolio in Euros. When prices finally turn, Mary could pay the price for her emotional attachment.

If the attachment is strong enough, Mary may continue to position in the same trade, refusing to accept that the market conditions have

changed. We have seen traders take considerable losses this way.

You don't have to make that mistake. Don't form emotional attachments to markets – good or bad.

The “Revenge” Trade

A variation of this mistake is

a trader's urge to take "revenge" on a market in which he lost money. In this case, if a trader lost money trading soybeans, he has the opinion that "Soybeans took my money, and I am going to get it back from them."

Of course, this is irrational thinking as well. But it is another example of Mr. Hyde rearing his ugly head to trash the organized

laboratory of your portfolio. The trader feels that he has to “get his money back” because it is being held hostage by the market in which he lost it. Therefore, he may want to try to reposition in the same trade or take the opposite position to capitalize on the very move that took his money in the first place. The trader refuses to accept that he had to take a loss and feels that if he can get it back in the same

market, it will somehow erase the loss altogether because it was all part of the same trade. Never mind that much better opportunities may be available in other markets and that the trader may be passing up countless opportunities to make his losses back many times over.

If you find yourself feeling this way, it is best to take a few days, or even a

few weeks, off from trading and let yourself come down from this experience. You will be in a much better state of mind to begin approaching the market rationally when you come back.

The Entrenched Bias

Even if your actions are not this extreme, traders often form long-term biases in

particular markets based on past experiences. Try not to let past experience cloud your judgment when analyzing new trades.

An example of this can be taken from the BSE (Mad Cow) example we discussed in an earlier chapter. A client and good friend of ours, we'll call "Tom," was short put options when the news of Mad Cow broke. Even though

Tom had been able to exit his position at reasonable losses, it nonetheless left a bad taste in his mouth for trading cattle. He had developed an emotional aversion, even though it had no basis in reality.

About 60 days after the Mad Cow news had been digested by the market, it appeared that an exceptional opportunity was available in

the live and feeder cattle markets. The main reason that cattle prices fell (other than immediate investor knee-jerk reaction) was not because the market believed that people would stop eating beef. It fell because importers of U.S. beef closed their borders to the product. Since exports made up about 10% of total U.S. beef production, we predicted that supplies would rise and, therefore, prices

would be lower.

Cattle fundamentals before the BSE scare, however, were extremely bullish. Demand was at a record high, and supply was not keeping pace. The calf crop was near a 50-year low. The U.S. border had been closed to Canadian beef, which met up to 10% of U.S. demand, due to an earlier BSE outbreak in that country.

These fundamentals were still in place, even after the export pace was slowed. Within a period of about nine weeks, cattle prices had come back to pre-BSE levels. Demand for beef had not waned after the BSE scare, but the borders were still closed.

The public, however, had seen the reaction of the market after one incident.

This brought out the small-spec fortune-seekers who dreamed of retirement by buying cattle puts and hoping for another BSE outbreak.

Put option prices skyrocketed as more of this money poured into the market. Whereas before the scare, option prices could be sold maybe \$7 to \$8 out of the money for decent premium, the same premium

now could be had at strikes more than \$20 out of the money. What is more interesting is that these options were up to \$10 below the lows achieved during the BSE outbreak.

The key fundamental here is that price had to adjust lower from BSE because the borders of the main U.S. imports had been closed. Now they were already

closed. They couldn't be closed again! Even in the unlikely situation that another BSE discovery would occur, if the borders were already closed, why would the market fall to the levels of late December, let alone \$10 beneath them? Buying options on a market because something might happen is outright gambling. Betting on a price level that is highly unlikely to be achieved *even*

in the event that the certain something takes place is downright foolish.

It looked like a slam dunk to sell these puts so far beneath the market. Yet Tom was downright opposed to doing any type of trading in cattle. His emotions had produced an aversion to trading cattle. In his mind, he had taken a loss in cattle, and therefore, trading cattle was

bad.

Tom had let his emotions keep him out of what would have been a very profitable opportunity. If he would have sold the cattle puts at these levels, he would have been rewarded with options that eroded fairly quickly and smoothly, in addition to being positioned in a seemingly low-risk trade. This not to mention, he would have made

back all of the money he had lost in cattle 60 days earlier. And although it was a fundamentally sound trade, it also had something else going for it. It faded the public, which is almost always a good idea.

Don't let your emotions get in the way of such opportunities for you. Accept that no market is good or bad. Only your position is good or

bad. The market is like the ocean. It cares not about your well-being, nor does it wish you any inherent harm. It is neutral.

Keep an open mind, and approach each trade as a brand-new opportunity, independent of past profits or losses.

Conclusion

Through our careers, we've seen many investors, especially investors new to option selling, make many of the same mistakes when first starting out. Although these mistakes can be tremendous learning experiences, it might be easier to learn from the mistakes of others first, without having to sacrifice hard, cold cash.

If you can avoid these

mistakes, you'll be able to skip over some of the pitfalls that new option sellers make and give yourself a much higher chance of profiting consistently.

Chapter 20 will explain how to tell if you have a good broker or portfolio manager and give advice on finding one.

20



Finding a Good Broker or Money Manager

The Best Trading
Decision You'll Ever
Make is Choosing the
Right Professional

Robert Kiyosaki, in his classic book *Rich Dad, Poor Dad*, suggests that there are several strategies and philosophies that separate the rich in our society from the poor and middle class. Kiyosaki points out that one of these key differences is that the rich tend to seek out experts to advise and manage much of their financial affairs, whereas the poor and middle class seem to

subscribe more to a “do it yourself” mentality. He argues that in an attempt to save money up front by handling legal, accounting, and investing matters on their own, the poor and middle class end up losing money in the long run.

If you were being sued, would you read a book on law and attempt to defend yourself? Would you go

through all the ads in the Yellow Pages to find the cheapest lawyer you could find? Or would you seek out the best litigation attorney you could find and launch a rigorous defense to dismiss the case and countersue for court costs?

If you needed heart surgery, would you seek out a “discount” doctor—perhaps a first- or second-year intern

who agreed to cut you a “really good” deal? Or would you research and interview to find the most experienced, skilled surgeon you could find?

Most people would want to hire the best in either of these situations. Yet, when it comes to money matters, many look to hire the broker with the “cheapest” commission. They do this

because they do not see the need or use for a qualified broker, or they have had a bad experience with a broker in the past. Nowhere is this more true than in futures trading. Everybody has a story about the broker who “didn’t get me out” or “told me to buy on the high.” Others tell of outlandish commission charges leveled by an incompetent broker.

It is true that these brokers exist. Yet it is unfortunate that many of the people who have been turned off to brokers because of a bad experience will never experience the pleasure of working with a true professional. The actions of a few can tarnish the image of the hard-working professionals whose complete focus is on improving their clients' performance.

Some traders don't see the need for a qualified broker until they run into trouble. We cannot count the times that we have had distraught traders call and explain the precarious trading situation that they had gotten themselves into and ask how to get out of it.

“I sold these options,” he'll explain, “and then I bought one of these to offset

it, but then XYZ happened. What should I do?”

“Why don’t you ask your broker?”

“He doesn’t give advice,” he’ll respond. “It says on your website that that is what you do.”

“Yes, I do. To my clients.”

We have spoken to brokers and other account managers who dedicate their

lives to studying the markets and improving their clients' bottom line. They are amazed at the public's expectation that their services simply can be obtained for free. Several times a month our firm receives e-mails from readers of our articles that state simply, "Please send me your best trades with strikes and risk zones. Thank you." There are several variations to this request, but this is the

main theme. Yet, if they read an article by an accountant about saving on their taxes, would they write a letter to the accountant and ask for free tax advice?

The Most Expensive Advice: Free

This expectation, however, may not be all the public's

fault. Some brokers who telemarket their services will hand out recommendations left and right to anybody who will listen. Many online brokers now offer “free trading ideas” to their eager followers.

“Ideas?” Really? This online trader is so desperate for action that he is taking “ideas” from the tech geek at 10dollartrades.com. Beware

of the broker or website passing out free trading “ideas” like popcorn. To paraphrase a quote from Mr. Kiyosaki’s book, “Free advice is often the most expensive advice.”

“You get what you pay for” is another piece of timeless wisdom. This does not suggest that the higher the fee, the better the broker or trader. It does suggest that, on

the whole, if you want competent advice and guidance, you probably are not going to get it on the cheap. This holds true in almost any profession.

It is true that there always will be a certain portion of traders who possess enough knowledge and skill themselves that they only need an order taker or an online trading platform to

place their trades. But I can assure you, these guys are not taking trading “ideas.”

We also forget that to many, regardless of what they say, making money is not their primary reason for trading. They trade as a hobby or pastime and seek the challenge, excitement, or fun of trading. Going it alone is part of the challenge. There is nothing wrong with this, if

this is your thing.

However, if your sole purpose is to increase the size of your investment, and you want to do it using the sophisticated strategy of option selling, a broker or trader who knows what he is doing can be the difference between success and failure. A good broker or manager should pay for himself many times over through the course

of a year or years.

Throughout this book we have told you about the various benefits and advantages of working with a good trading advisor. We promised earlier to define what a good broker or advisor actually is and what one actually does to help your bottom line. This chapter will describe this along with how you can find a good account

professional to help you sell options profitably.

Types of Market Professionals

Before we delve into the subject of what makes a good professional, let's first examine the types of brokers and advisors that are available.

Discount broker. A discount broker is generally a firm that employs a group of “brokers” whose job is primarily to be an operator or order taker. This also includes online “self-placed” orders. Their only function is to take orders. Many firms provide online research,

quotes, and yes, even “trading ideas” for their clients.

They are very popular with the day-trading set, as well as with professional traders who watch the markets as a full-time pursuit. They are also popular with trading “enthusiasts.”

Discount brokers serve a function and are very useful to these types of individuals.

However, if your career or business is not full-time trading, you may be better served elsewhere.

Full-service broker. Full-service brokers can

play several roles. They can act as a professional “caddy” to your trading, providing you with up-to-the-minute research reports and custom charts, calling you with market updates or developments in your account, watching your account for you,

assisting you with placing the right orders, personally working your order for a specified price, and generally being there to support you in any way they can. An inexperienced broker can still serve you well in this regard, as long as she is focused on personal attention to

your account. Some full-service brokers can give “trading recommendations.”

It might seem like common sense that a professional who is close to the market every day would have to pick up a few “tricks of the trade” along the way. However, just

because a person is a broker does not mean that he is a good trader, nor does it mean that he is competent enough to give trading advice. It is in this regard that gaps in competence levels are widest. A broker in the business for two months can give advice just as

easily as a broker in the business for 20 years. And there is no guarantee that either one of them will provide you with good trading advice. This is why doing your homework is important when you are selecting a broker.

Commodity Trading Advisor. A commodity trading advisor (CTA) is a specialized designation and is quite different from a commodities broker. A broker gets paid to execute your trade for you. A CTA gets paid to manage your account. A CTA is

not a broker. He is a professional trader. In other words, you hire a CTA to trade your account for you. CTAs (also known as portfolio managers) often charge an annual management fee (usually a small percentage of total equity in your account), in addition

to an “incentive fee.” The incentive fee is a percentage of profits generated in your account. This can be in addition to any commissions charged to the account. There are also some that waive all of these separate charges and simply charge a flat

trading fee on
individual positions.

If you hire a CTA, you are turning over the trading in your account to a professional trader. CTAs are required to provide their clients with what is known as a *disclosure document* that describes in detail their fees, account sizes, the trading plan that will be used to invest your funds,

performance, and many pages describing risks.

Like brokers, CTAs come with a wide range of experience and competence. Although a CTA does have to be licensed, being a good trader is not part of the requirement. A CTA does not have to pass any test determining his trading savvy. Therefore, like most any other profession, their

skill level can range from outstanding to very poor.

While some CTAs have little more knowledge or trading experience than the average individual investor, there are some skilled professionals in this field who manage millions of dollars. Unlike hedge funds, however, CTAs typically manage your account individually for you—not mixing your funds with

other investors. Good ones will work with you in planning your trading approach, keeping you informed as to what is going on in your portfolio and the strategies being employed in it.

What You Should Know About Brokers

As I mentioned at the outset of this book, my firm is very selective in who we accept as a client. We don't work cheap. We have a set way of doing things. And to limit our admissions, we set a moderately high opening account balance (at least by the standards of the garden-variety investor). Although this exclusive approach may be a turn-off to some, it limits our client base to the type of

investor who has the mind-set and disposition we prefer to work with—as well as that most conducive to success.

I tell you this not to be smug or noninclusive. Quite the contrary: I tell you this so you know I have no conflicts of interest in recommending what could be construed as the competition—or speaking honestly about other professionals in this industry.

Ninety percent of the people reading this book will never contact my firm. That's okay.

The goal of this book is to help you sell options and make money doing it. This is regardless of who you choose to help you manage your funds, what your trading preferences, net worth, or ultimate investment objectives.

Broker or “Salesperson”

While the trend has clearly been toward online trading among the mainstream investment crowd, there are some signs the tide is beginning to turn back toward working with a full-service broker—especially among the higher-net-worth set. However, many books that

we have read on trading in general are antibroker. In other words, they encourage you to do everything on your own because brokers are basically commission-hungry salespeople, eager to take as much of your money as they can before they help you lose the rest in the market.

Having worked as brokers in this business for a combined 26 years before

becoming portfolio managers, we feel that we may be able to shine a little light on to this perception.

Sadly, in some cases, this perception of brokers is correct. In some cases brokers are salespeople converted from another field who got a license and now, instead of selling advertising or cookware, are selling brokerage services. Although

this does not mean that they are bad people, it does mean that their ability to help you make money is limited. If you are looking for a discount broker, this may not make much of a difference. It takes little talent to pick up a phone and place an order. If you are looking for a market professional to guide you through the golden minefield of the futures markets, it could be critical.

There are, however, many skilled professionals in the field. You'll just have to look a little harder to find them.

The word *broker* can encompass so many different job responsibilities that the range of individuals and how they view their jobs is endless. A choice that is recommended to many brokers starting out in the field is to decide whether they

want to be traders or “equity raisers.” Since most brokers (or “account executives”) are not good traders, they focus on raising equity. The test to become a futures broker is mainly on rules and terms and how the market works. There is nothing about trading or how to be a good trader. Therefore, if a broker wants to be a good trader, in most cases he has to learn on his own. There are some larger

firms that offer some training to help brokers trade better. In most cases, however, a broker is doing his best with limited company or outside research or his own very limited knowledge to help you invest your money.

Why should a broker have to be a good trader? He doesn't. There are great brokers who are not good traders. But if he is going to

give you recommendations, shouldn't he be at least a marginally better trader than you?

Three Types of Brokers to Watch Out For

The Salesperson

Any professional from a

dentist to an attorney has to market his or her services. However, the manner in which these services are marketed often tells as much about the person or company that is being represented.

There is no way to know for sure if you are talking to a good or a bad broker by the way her services are marketed. However, there are some general guidelines that

can tip you off to the fact that you may want to keep looking. The broker who calls you out of the blue, with no prior contact, and begins a pitch on a “great trading opportunity” that you have to get in on “right now” is probably *not* the market professional that is going to be a long-term partner in your investment program. How does she know if it’s a great investment for you? Does she

know your financial situation? Does she know your risk tolerance?

Salesperson brokers have one goal—to get you as their “customer.” They are often people who have little interest in futures or commodities except that it is the latest thing they are selling. They can be smooth talkers, but they seldom last long in the business. To be a true

commodities broker is a demanding job, and one has to love his work to excel in it. People with little interest in the market who become brokers to “make a lot of money fast” are often disappointed.

As we’ve stated, a good broker does not necessarily have to be a great trader. But he should have some interest in the market and be able to

talk about it intelligently. If you have somebody who continues to pitch you on a single trade or commission rate but stumbles repeatedly when you ask anything about the market or trading, you probably have a salesperson.

The Rookie

Futures brokers have one of the highest turnover rates of

any profession, especially within the first two years of their careers. Therefore, a large number of new brokers enter the field every year. Being new does not necessarily make them good or bad. But they are going to have to learn the business by making mistakes. Do you want them to learn on *your* account?

Of course, some rookies

eventually will turn into good brokers someday. However, you need somebody who can help you now, and this is probably not the person, especially if you are going to rely on her for trading advice and guidance.

The Grifter

Almost all brokers, as well as the firms that employ them,

are paid on a commission basis. This automatically creates a conflict of interest. With this arrangement, the broker can become susceptible to allowing his primary interest be the number of trades that can be generated from your account rather than the performance of your account. There are brokers and even unscrupulous brokerage firms who intentionally recommend

that their clients get in and out of trades early and often for the sole purpose of generating commissions rapidly. This is known as *churning*, and it is not only a strict violation of Commodity Futures Trading Commission regulations, it is also illegal.

In the movie *Boiler Room*, Ben Affleck played the “pit boss” in a brokerage such as this. More recently,

Leonardo DiCaprio played the sleaziest of brokers in *The Wolf of Wall Street*. If you saw the movie and thought that it was an exaggeration, it was not.

The “brokers” in these types of firms cold-call hundreds of people in a day and use high-pressure tactics to get unsuspecting investors to send them funds. If you feel that you are being

pressured into investing in futures or have a telesalesperson who sounds extremely excited on the phone and is insisting that you have to send money right now, you may be talking to one of these people. They are often not very knowledgeable about the market in general and sometimes are hesitant to answer questions about the background of their firm or themselves. But they usually

are very forceful and aggressive in telling you about the “golden opportunity” that they have uncovered in the market, which, coincidentally, probably will be gone in a few short days (just enough time for you to send them a check).

If you have doubts about the person, ask for his and/or the firm’s National Futures

Association (NFA) identification number. The NFA does a good job of weeding most of these types of people out of our industry, but there are always a few who slip through the cracks. The NFA is like the Better Business Bureau for brokers. The NFA website www.nfa.futures.org gives the background and complaint history of all its brokers and member firms.

All practicing brokers and firms are required to be members. If the individual in question is not a member, or if the report on the broker or the firm pulls up a long laundry list of complaints, it's best to steer clear.

If you can avoid these types of brokers, it will allow you to focus on merit and skill when choosing from the remaining group of brokers.

What you are looking for is a true market professional—a pro.

However, if you want a quality, professional broker, chances are that you are going to have to find him because he's probably not going to find you. This is not to say that there are not good brokers who telemarket their services. For years, this was the primary way for brokers

to find clients. If you have ever purchased or ordered anything even remotely associated with trading, chances are that your name and phone number are on a list somewhere. Many brokerage houses purchase these lists for calling, e-mailing, or mailing purposes.

These days, most established, experienced brokers do not have to cold-

call phone lists to get new clients. An account manager or successful CTA most certainly does not. If you get an unsolicited cold call from a broker you have never contacted, it does not mean that he is a bad broker or is doing something unethical, but it could mean he or his firm is new or inexperienced, and this is how they have to acquire new clients.

Because there are no clear-cut rules on how to determine if a broker has the right stuff, you will rely much on gut feel and common sense. However, the list below may be helpful in knowing what to avoid when searching for the right broker. Red flags that the broker on the other end of the phone may be inexperienced or may not have your best interest at heart follow:

1. The broker is vague or elusive when you ask him for background information about himself or his firm.
2. The broker stumbles or changes the subject repeatedly when asked about markets or trading knowledge.
3. The broker is *overly* enthusiastic about what she is talking to you

about.

4. The broker is pitching you on a “rare opportunity” or tells you that you have to get into the market right now or you will “miss out.”
5. The broker’s company advertising is high-profile radio or TV ads touting huge profits with little risk or

“proprietary” trading strategies that have produced huge profits in years past.

6. You feel you are being pressured or get the feeling that you are talking to a used car salesperson. If you've never heard of this broker or his company before and he is pitching you on a trade

within five minutes of introducing himself, this is not a good sign. A broker's first conversation with you should give you the feeling that you are getting to know each other and are beginning a new professional relationship.

7. The broker is asking for excessive

commissions. Full-service brokerage firm commissions and services vary in cost, and it is difficult to say how much is too much. Most full-service futures brokerages these days charge somewhere between \$49 and \$100 per round-turn commissions. However, if you are

paying more than \$100 per round turn, you are probably paying too much. If the broker is asking for *a lot* more than this, treat her like a robber breaking into your house because that is exactly what she is trying to do. Tell her not to call back, and then hang up the phone. We've heard horror stories of firms

charging \$200 to \$300 per round turn. There is nobody who can justify that kind of commission. The top stars in the industry will charge you less than that. How can a smooth-talking salesperson justify that kind of commission? She cannot, and chances are that she or her firm cares about

little else.

What to Look for in a Good Option- Selling Broker, Money Manager, or Commodity Trading Advisor

Experience

Futures brokers have one of the highest turnover rates of any profession. Many brokers who start in the business wash out within the first two years. The ones who make it beyond this point must at least have learned how to do something right. To succeed over the long term, a broker has to love what he or she does and be at least competent in it. This is even more true for a CTA.

Look for a broker who has been around the block. There will always be some young up-and-comers who may be honest and helpful on the phone, but you don't want them to learn at your expense with your account. If you are serious about your trading, especially in the advanced technique of option selling, and are hiring a CTA to manage your money, look for somebody with at least 5 to

10 years of experience.

Credentials

Just because somebody has been in the business for a while does not guarantee that she is a good broker. Find out her background and accomplishments in the industry. Where has she worked before? Does she have any other certifications?

Does she have a large amount of complaints on file with the NFA? You want to find out if this is her career or just her latest job.

If you are interviewing a CTA, check if his firm is registered as a Commodity Trading Advisor. Has he published anything? Good money managers often research markets and publish their findings (at least the

findings they want to share with the public). Has he published any articles in publications you may have heard of? Does he publish a newsletter? Does he give any market opinions or insights to the media? Look for things that show that the money manager may have a respected name in the industry. The more involved he is in his industry, the more likely it is that he respects his

business and his clients.

Honesty

It should go without saying that the broker is honest, and gauging her level of honesty is up to your judgment. However, as a guideline, beware of brokers or managers who talk about big gains and little risk. Disregard a broker who tells you that

you have to get in right now or you'll "miss out." It is likely that this broker has a sales quota to meet or a contest to win, and if you don't send your money today, *she's* going to miss out. There are always new opportunities tomorrow. If you feel a lot of pressure to open an account, chances are that you are dealing with a salesperson broker.

Knowledge of Option Selling

As we've said before, some brokers are inexperienced or undereducated in selling options and may be little more versed in it than you are. This is fine if you are dealing with a discount broker simply to place orders for you. However, if you are hiring a full-service broker

and paying for it, you are more or less hiring an advisor. This is even more true if you are hiring an account manager/CTA.

For this reason, you want to hire the best advice you can find. You may have to interview a few before you find one who is friendly to and experienced in option writing. Be thorough. Some brokers will say anything to

get you to open an account.
“Option selling? Ah, yeah,
sure, I do that all the time!”

Have some good
questions for her, and listen
to how she answers them. If
she stutters and backtracks or
puts you on hold a few times
to get answers to your
questions.... well, you know
what to do.

Focused on You, Not on Himself

Regardless of whether he realizes it or not, a broker's or account manager's purpose is to help *you* to succeed. In talking to him, you should sense that you've found an ally to help you through the course of your option-selling investment. If you instead get the feeling that the person on

the other end of the phone is standing on top of his desk hawking snake oil, his focus probably isn't on you. Good brokers or account managers know that they're good. In talking to them, you should feel like you're talking to a cool, relaxed professional.

Like any business, the futures industry has good and bad people in it. The good news is that the dishonest or

disinterested ones usually don't last long as brokers. Brokers who open investors' accounts to "turn and burn" them to make a quick buck usually will get burned themselves before long. The true professionals in the industry have learned that the only path to long-term success is to put you, the client, first and to build long-term, lasting relationships built on trust.

By hiring a broker or advisor, you are more or less hiring somebody to go to battle for you in the tough, winner-take-all world of futures options. Especially with the sophisticated vehicle of option selling, you'll need one with competence, honesty, and skill. You'll probably have to wade through a pool of salespeople and rookies before you find a broker who has the right

combination of all three. But there are some talented people out there who really can make a difference in your trading.

Your job now is to go find one.

21



Option Selling as an Investment

Frequently Asked
Questions

At this point in the book, if

you are beginning to consider an option-writing portfolio or are getting some ideas for ways to enhance or improve your current portfolio, you may have some questions on some of the key points of option selling or how some of the aspects of the approach may affect your particular situation.

Many of our prospective clients tend to have the same

questions, and we have listed them in this chapter along with our answers. The question-and-answer format has proved most helpful to many prospective option sellers, especially in the finer details of the strategy that may not have been discussed thoroughly enough in other chapters.

Hopefully, you will find this chapter useful in tying up

some of the loose ends in answering some of the more obvious questions you may have in beginning an option-writing portfolio. Most of these questions are taken from actual conversations between us and traders who are considering an option-selling approach. Some of the answers may reflect our personal bias in trading techniques. However, our biases are carved out of many

years of ups and downs in the futures markets.

Q: What is your overall view of futures trading in general?

A: Interest in investing in commodity futures trading has grown rapidly among individual investors in the

past decade. New records are being set at the Chicago Mercantile Exchange in volume in several contracts. Yet this growth has not been equal in all parts of the industry. It seems to be expanding rapidly at both ends and shrinking in the middle. Thus, electronic trading has really taken off and has seen modern exchanges like the Intercontinental Commodity

Exchange (ICE) thrive. The same is true for managed futures, which are growing at a torrid pace as investors look for seasoned professionals to trade futures and/or options for them. The shrinkage seems to be coming with the traditional full-service broker who “helps” the client trade but doesn’t do it for him. It seems these days, people either want to be all on their own or have somebody

managing the whole thing for them.

The majority of new clients I get now are first-time commodity investors. In the unstable world in which we live, people seem to be realizing that commodities are the staples of life and that investing in them can be much more than just a diversification tool in a portfolio. The problem is that

most people don't understand leverage and that futures contracts are a highly leveraged investment. Trading the conventional way is a high-risk, high-return proposition. Many traders approach the market as a gamble. It has been our experience that if you approach this highly leveraged form of investing in a conservative manner, you often can achieve a very

attractive return on your money. This is where selling options on these contracts comes into play.

Q: How do you recommend a new account go about positioning in the market?

A: We would first recommend limiting your amount of trades. Our most successful accounts don't trade very often. When we feel there is an opportunity, we generally recommend taking the most conservative position possible and then enter it in numbers. In other words, instead of trading every day or every week in 10 different markets, only trade when you believe there

is a stellar opportunity to sell premium, and then don't be afraid to build a position there. Our most successful accounts over the years have only traded an average of three to five times per month. It is not like long-term stock investing, where you buy and hold forever. These things expire every month so you have to go get more premium each time they do. But it should not be like day trading

either.

Q: I've read several books and other literature on options, option spreads, and straddles, and so on. It seems that there are some

strategies out there that offer some big profit potentials with little risk. I've looked at delta-neutral strategies, free trades, and so on. Do you recommend any

of these strategies?

A: Yes, if an opportunity presents itself. If you read Chapters 9 and 10 on spreads and recommended spread strategies, you know that some spreads can be impractical for individual investors. However, there are some that can be advantageous to you.

Strangling the market can be a profitable approach in certain situations. We also recommend vertical credit spreads and ratio credit spreads.

Q: Why do you suggest naked option selling in some situations?

A: One of the strengths of naked option selling is its sheer simplicity. If you're bullish on a market, you sell puts. If you're bearish, you sell calls. We've seen traders have great success through the years by simply picking general market direction in a few select markets. If they're wrong, they can still make money. If they're really wrong, they get out if and when the option premium hits

their predetermined risk parameter. We see no need to make it more complicated than that.

The downside, of course, is that the market potentially can exceed your risk parameter. For this reason, some investors are more comfortable in covered or spread positions, even though it may mean slower profits on the options sold. It is really a

matter of personal preference and risk tolerance. We suggest a mix of spread and naked strategies across several markets until you can determine which approaches are more congruent with your personality.

**Q: What criteria do
you use when
selecting markets**

to trade and strike prices to sell?

A: We use a combination of fundamental and seasonal analysis, and we are looking at general price direction over a two- to six-month period. We are selecting far-out-of-the-money options with two to five months' time value remaining. We try to select price levels that could only be

achieved through a radical change in fundamentals. The object is to select the options with the highest probability of expiring worthless, even if we have to wait a few months for them to do so.

Q: Fundamentals.
Isn't that long-
term trading?
What about

technicals?

A: Technicals can move the market temporarily, but eventually, prices will have to reflect the fundamentals. Of course, we use technical indicators in timing our option sales, but they will not dictate what markets we trade. Many traders and even brokers use technical analysis as their sole means of trading

simply because they don't know the fundamentals or don't want to take the time to learn them. Learning the fundamentals of a market and how they can affect price can be time-consuming and difficult. However, in our opinion, trading solely on a technical basis is like trying to hit a baseball with one eye closed: Your perspective is going to be off. If you're investing capital into a

commodity trading idea, you should at least try to become familiar with the base fundamentals of the market you're trading or be working with somebody who understands these factors. An approach using a combination of fundamentals and technicals should help to give you the full picture of what is going on in a market.

Q: How about volatility? I've read that volatility is the most important factor to pay attention to when trading options.

A: Most option books tout volatility as the most

important factor when deciding which options to trade. We are certainly aware of the volatility and would prefer to sell options at the higher end of their volatility ranges. However, isn't a study of the factors likely to affect the price of the underlying more important than the volatility of the option? Would you want to sell a put option in a market with extremely bearish long-

term fundamentals simply because the put options were exhibiting high historical volatility? (Think S&P puts in September of 2008.)

We've had more success by incorporating some projections for longer-term market direction (or at least projecting where the market won't go) rather than focusing solely on volatility.

Q: What about the risk? Doesn't selling options entail unlimited risk?

A: Yes, theoretically it does. But the term is a bit misleading. Unlimited risk simply means that you have to manage the risk on your position yourself—the market

is not going to do it for you—like when you buy an option. Selling options can carry the same risk as trading the underlying contract, but usually less, and never more. Some traders will dismiss option writing as “too risky.” (We find it amusing to note that many of these traders, however, will trade futures contracts without hesitation.) Without knowledge, anything is risky. Experienced option

writers (who, incidentally, generally are commercial or professional traders who are gladly selling options to small speculators) know that although selling an option bears the same theoretical risk as a futures contract, the value of the option will almost always move more slowly than the futures contract. Same risk but slower speed. Nonetheless, having an excellent risk-

management plan is the key to consistent profits.

Q: I know that if the option expires out of the money, I will keep all premiums collected as profit if I am the option

seller. But what can happen in the meantime if the market is moving against my position? Will my option value increase? Will my margin?

A: Yes. Both can increase.

This is one reason that you'll want to use only a certain percentage of your account funds and keep the rest as backup capital. Remember that while you will have a fixed risk parameter in place, you can still buy the option back to close the position at any time. Your risk-management plan should revolve around keeping losses small. Certain spreads can limit or reduce margin

increases and/or losses on an option position.

Q: How much would the value increase? How much would the margin increase?

A: It all depends on the option, the volatility, and how

much time is left on it. Keep in mind that if you are selling far-out-of-the-money options with low deltas, the values generally will increase very slowly, even if the market is moving against you. Remember also, when selling options, that the market can move for or against you, but time value is always working for you. The value of your short option almost always will move for or against you

at a slower pace than the futures contract.

**Q: What percentage
of my account
funds should I
keep as backup
capital?**

A: As a general rule of thumb, we would recommend

margining no more than 60% to 70% of your account at any given time unless you are willing to meet a margin call should you get one. Ultraconservative accounts may want to margin less than that; aggressive accounts can margin more than that. We've watched investors margin up to 80% to 90% of an option-selling portfolio and rarely have a margin issue. However, we've also seen

them get margin calls and subject themselves to overpositioning. If they're good positions, you can still make money by holding them. You just have to add more deposit money in the meantime. The trouble comes when the investors overposition and then can't or don't want to meet a margin call when it comes, even if their positions are good. Then they have to take potentially

profitable positions off at a loss, after paying commissions on those losing positions. This can happen even if the options only exhibit minimal fluctuations. The good news is that managing your margin is pretty easy if you don't get too greedy.

Q: What is the risk-

management technique that you suggest?

A: As with any trading method, you must learn to take some losses. The difference with option selling is that, statistically, most of your trades should be winners. Thus, it becomes even more important not to let one big loser eat away

your profits or, worse yet, cause a drawdown in your portfolio. We suggest beginners start out by using the “covered” technique that we described in the chapter on recommended spreads. In other words, they should use a portion of the premiums collected to buy some further out-of-the-money options, providing at least partial coverage. We also suggest exploring strangling

strategies to novice and experienced investors, as the strangle can offer a risk-balancing feature and can protect traders from moves against either side, to a certain point.

For naked option sellers, we have found over the years that the *200% rule* is a good way to limit losses while at the same time giving option values room to fluctuate. By

the 200% rule we mean that if the option doubles in value from the point at which you sold it, you exit the position. It is true that many of these options also will expire worthless eventually. However, you cannot take the chance that the option you are holding will be the one that makes an extended move against you. When you begin to learn the personality of a particular market, you may be

able to adjust the 200% rule to allow more or less leeway in certain markets. Until then, it is a good stop-out point for beginners to help keep you on track and away from big losers.

Any of the techniques described in Chapter 12 can be effective in managing risk. Again, much depends on the individual investor.

Q: With regard to the 200% rule, how often does this happen—an option doubling in value after I've sold it?

A: How often have you bought a far-out-of-the-money futures option and had

it double in value *for* you? Much will depend on your option-selling savvy and technique. However, with time value working in your favor, the majority of your options sold should be expiring worthless.

Q: How many options should I try to sell in a

month?

A: We would not focus on the number of trades you feel you have to accomplish. Rather, focus on trading only when an opportunity presents itself. Our experience with successful accounts is that they usually establish about 8 to 10 major positions a year. However, they may continue to sell options in these

positions as long as they continue to produce profits. Therefore, the number of trades may vary. These generally are “investors” not looking for “action” but rather for high percentages and returns. If you are looking for excitement, you’ll be best served going to a discount firm and opening a day-trading account.

Q: What would you consider a position?

A: We define a *position* as a series of strike prices and/or contract months all in one market. For instance, if you were bullish on crude oil in the winter of 2013–2014, you may have sold April \$75 puts, May \$130 calls, along with June \$70 puts. All of these

options together could be considered your position. You may take weeks or months to establish this position, staggering or layering options at what you feel are opportune times. This concept of layering is central to the approach we recommend to investors.

Q: Could you please

explain staggering?

A: “Staggering” or layering is a concept we recommend to “smooth out” the equity curve for investors. It was designed for investors seeking a steady, income-producing trading plan. Layering is the practice of selling different options in different markets with expiration dates about four to

six weeks apart. If this is done correctly, the trader should have a set of options expiring approximately once a month. As some options expire and others deteriorate, the trader then uses the premiums collected to sell more options three to five months out, set up the same way, increasing position sizes if he desires. Of course, not every option sold will be profitable, but this is the

structure for which you may want to strive in an effort to produce more evenly distributed returns. One note about staggering: Your first 60 to 90 days of trading may seem slow because you are more or less “filling a pipeline.” After your first set of options expires, however, things should begin to get a little more interesting.

Q: What type of premiums do you recommend an option seller target to collect on individual options?

A: Much of that depends on the investor and her risk tolerance and return

objectives. Most of the options that our clients prefer will collect between \$400 and \$700 in premium. We generally won't recommend selling an option if it has less than a \$400 premium. You want to strike a balance between time remaining on the option and distance the strike is out of the money. There is no hard-and-fast rule for this. This part comprises experience and personal

preference.

Q: I've had brokers tell me that I can offset or hedge the risk of my short option if I buy or sell a futures contract at the point the option

goes in the money. Is this a viable strategy?

A: This strategy looks good on paper but often opens up the proverbial can of worms for the investor using it. What if the market moves your option into the money, then back out, and then back in again? Are you going to keep buying it and selling the

futures contract(s) again? Or are you going to risk an adverse futures move that will cause losses far outstripping any gain you may receive by having your option expiring worthless? And this doesn't even include the additional transaction costs you are going to incur by buying and selling the futures contract(s). If you enter a futures contract, where are you going to set

your stop for that? How will you time your entry? Now you have two trades to worry about instead of one. You're watching the market tick by precious tick, trying to time entry and exits, worried about placing stops, and trying to guess where the market will go tomorrow. Aren't those all the things we're trying to avoid by selling options in the first place? Offsetting with futures may work in some

situations, but our experience has been that it's best to set a firm exit point when you enter a trade and abide by it. Again, simplicity is your best avenue to success.

Q: I've found a broker who sells options, but he tells me to sell

options with only 30 days until expiration or less because that is when they lose their value the quickest. Is this true, and do you recommend this approach?

A: Yes it is true. Yet for the most part, we do not recommend this approach unless you are into active, fast-moving trading. It may work better in stocks, with traders willing to take possession of the stock if the option goes in the money. However, if you are selling options purely to collect premium, especially in futures, the options you sell could carry a higher risk of

going in the money.

It is true that the closer options get to expiration, the faster they begin to lose value. This time decay accelerates in the last 30 days in the life of an option. However, when an option reaches its last 30 days of life, chances are that it has already lost most of its time value. Therefore, the only options available to sell generally will

be options very close to the money. Selling options this close to where the market is trading can mean that even the slightest market “hiccup” can put your option in the money and you take the same losses you would in a futures contract. Once again, you’re back to day trading and—trying to pick short-term market direction—exactly what we’re trying to avoid.

Another reason that brokers may like to recommend selling short-term options is that they can trade in and out quickly, often producing many more commissions than a long-term approach could net them. Of course, all brokers are not like this, but you should be on the lookout for ulterior motives. Some brokers will “outbid” others on commission rate, only to

make up the difference in increased transactions.

Sell as far out of the money as you can at strikes that appear highly unlikely to ever be attained.

Q: How can I expect to collect any premium if I am selling far out of

**the money?
Aren't these
options cheap
because they are
so far away?**

A: Only if you are looking at options that expire in the short term. The further out in time you go, the further out-of-the-money options you can sell. We are not aware of any

official studies on this; however, our experience has been that you should look to trade time value for distance out of the money. While they both help make up the value of the option, there is a 100% chance that time decay will happen, yet it is always an uncertainty what the market will do. Therefore, sell the time value and force the market to make a large move against you for you to lose.

Good research can help to sway the odds of positioning away from where the market will go in the longer term. It can do little to predict what prices will do tomorrow.

The only caveat to selling time value is that if you sell too far out, you leave too much time for fundamentals to change in the market. Again, it is about striking a balance. You don't want to

wait 12 months to make a few hundred dollars either.

Q: If option selling is such an effective strategy, why doesn't everybody just sell options?

A: Most people are attracted to futures trading initially for

the potential for huge gains. They want to take some “play” money and, well, “play.” Since futures trading often looks scary because the potential exists to lose more than one has in the account, buying options starts to look pretty good. Limited risk and unlimited profit potential sound about right for what they are looking for. Brokers clamoring for their business know this and often will drive

this point home, especially to traders trying futures for the first time. Most of these traders buy options, lose their money, close their account, and conclude that futures trading is “bad” and then tell everyone who will listen what a terrible investment futures are and how anybody who invests will lose.

A few, however, will stick around, curious as to

who made all the money that they lost and how they did it. These few, along with sophisticated investors who have already discovered the approach on their own, will combine with the professionals to make up the option-selling crowd.

Misunderstood risk, misunderstood margin, and the general hesitance of the industry to promote the

strategy are some top reasons why most traders aren't selling options. Compared with striking it rich in crude oil or buying at the low of what "research" shows will be the move of the year, selling options looks pretty slow and boring. What do you think is easier for a salesperson to pitch to a new trader, ready to hit it big in commodities?

You'll find very few investors whose first foray into futures trading will be in option selling. The investors selling options are usually intermediate to highly experienced investors who have been down that road years ago. They don't look at their option-selling portfolio as "play" money. They view it as a serious investment. Gambling is for Vegas.

We've heard many traders refer to their first experience in futures as "paying for their education." If you are new to futures, perhaps now you can skip or at least minimize this often costly first step.

Q: I see Standard & Poor's (S&P) puts that I can sell for close to \$500 that

are available at strike prices that I don't ever think the market will reach again. What would be my margin on an option such as that?

A: There is no way to really

tell until you can give an exact option and strike price and have a SPAN margin run for it. Most decent clearing firms have SPAN software available and can provide brokers with the margins within minutes. Most of the time, if you have SPAN for one option in a particular month, you can estimate the margins for other nearby strikes in that same month. You also can purchase the

SPAN software from the CME. But that really shouldn't be necessary unless you are a professional trader. Most of the options that our clients sold last year had out-of-pocket margin requirements of 100% to 200% of the value of the premium collected. However, larger and more volatile contracts such as the S&P index can sometimes have larger margin requirements as

a percentage of premium collected, meaning less return on capital invested.

Q: I just sold an option for a premium of \$500. I had to put up a margin requirement of \$600 to hold the

position.
Therefore, I have
\$1,100 total tied
up in escrow. Do I
have to wait until
this option expires
to use this capital?

A: No. If and when the value of the option begins to deteriorate, not only does the

premium gained become available in your account, but the margin requirement generally will drop as well. For example, if this option fell to a value of \$300, that would mean that \$200 ($\$500 - \$300 = \200) of the value of that option would move into your general funds available for you to use in another trade. However, the margin requirement may have dropped to, say, \$250 as well.

This would be an additional \$250 back into your general funds for you to use to leverage new positions. This gradual deterioration effect continues until the option expires, and the option's value is zero (assuming that it expires worthless), at which time the full \$1,100 will be out of escrow and back into your available balance. Of course, by this time you already may have moved

these funds into other trades. This means that you don't have to wait for old options to expire to add new positions. Just remember that it can work both ways.

Q: What would you say is the number-one reason that traders *lose*

money selling options?

A: Overpositioning. Hands down. Traders start out selling options, have a little success, and get so excited that they're making money trading commodities that they go way overboard with it. Bulging with overconfidence, they load up their accounts and way overmargin

themselves. This can either set them up for a big loss or put them in a position in which they can get forced out of a trade on a very small move against them. Of course, this assumes that traders have some idea of the fundamentals and technicals of the markets with which they are dealing. If a trader has no idea or is not working with somebody who has an idea of the base factors

affecting price, he may lose before he has the chance to overposition. Even so, if he's selling options, he probably could go on trading successfully for a while before the market eventually calls him out.

Q: I don't have the time to watch all this and study

**charts,
fundamentals,
and strike prices
all night long. Can
I still do this and
be effective?**

A: Of course. This is why investors choose to go with managed accounts or hire an account advisor to do the legwork for them. There are

investors who are just concerned about a good return and don't have time to watch the market, and there are traders who like to be a little more hands-on. What type you are will determine what type of industry professional can serve you best. There are many competent portfolio managers available. If you would like to learn about professionally managed option-selling

portfolios, feel free to visit
www.OptionSellers.com.

Hopefully, this chapter has answered some of the questions that may have lingered in your mind. [**Chapter 22**](#) will offer a review and conclusion to the material covered in all the preceding chapters.

22



Pulling It All Together

A Quick Review of
What You Have
Learned

We hope that by reading this
book you have gained some

helpful insights into option trading and the futures industry in general. Although there are certainly other books and publications that you can read that will give you layers upon layers of theories, data, and statistics, it is our opinion that everything you need to know to begin selling options effectively is contained within the covers of this book.

As you've noticed, a few central themes have been repeated throughout these chapters. They are listed here.

1. Selling options, if done correctly, can offer some wide and distinct advantages over traditional investments, buying options, or trading futures.
2. “Know your market” is every bit as important,

if not more so, as
“Know your option.”
Technical trading
sometimes can help
traders with short-term
direction and timing,
but selling options for
annual returns means
projecting where prices
won’t go in the long
term. This is why
knowing the
fundamentals of the
commodity you are

trading is important.

3. Even though option selling can be a very consistent approach, one losing position that is allowed to run can cancel out weeks or months of option profits. For this reason, a solid risk-management strategy is essential and should be decided at the time of

entry into a position.

While these are the core concepts you have read about, there are key points from this book that will be reviewed in the following pages. Hopefully, this chapter can serve as a summary if and when you decide to review the key concepts of the book at a later time.

Chapter Reviews

Chapter 1 disclosed to you the option sellers' secret: That the odds favor option sellers—especially deep out-of-the-money option sellers. It is a secret that has been closely guarded by professional traders and money managers in the know. Now you are “in the know.”

Chapter 2 discussed *who*

was selling options. We disclosed some of the characteristics of the clients with whom we had worked and tried to draw lines of similarities between them. Option sellers are a distinct subset of the overall investment community and, as such, seem to share certain characteristics.

Chapter 3 discussed the advantages of option selling.

We reviewed a study of options at the CME and saw how the majority of options held through expiration do, in fact, expire worthless. Profit taking becomes much simpler and easier when selling options. Time always benefits the option seller, giving him an advantage over the option buyer, who always has time working against him. Option sellers also benefit from the fact that they do not have to

determine where prices are going to go. They only have to determine where prices *won't* go, and they have a large margin of error if they are wrong. The timing of entry into short option trades is also very forgiving. The seller of options does not have to have near-perfect timing like the futures trader does.

Chapter 4 compared

buying options with selling options to illustrate the differences. We learned that option buyers face a distinct disadvantage in the market—one that becomes an advantage to option sellers.

We learned that an option is the right to buy or sell a stock or commodity at a specified price. This right can be bought or, in our case, sold. We learned why

investors buy options and the drawbacks to this approach, specifically that the market generally must make a large move in a short period of time for an option buyer to profit. The value of an option is made up of *time value*, *intrinsic value*, and *volatility*.

If the value of the underlying contract moves beyond the strike price of an option (above a call or below

a put), the option is said to be *in the money*. If the value of the underlying contract is at the strike price of the option, the option is said to be *at the money*. If the value of the underlying contract has not yet reached the strike price of the option, the option is said to be *out of the money*.

Volatility should be considered when selling options, but some traders

become too caught up in measuring volatility without thoroughly examining the fundamentals of the underlying market, which ultimately can be more important. The delta of an option is a measure of its volatility. We learned that a seller of options can have the same risk as a futures trader but that the position moves much more slowly than a futures position, giving a

trader more time to exit.

Sellers of options can exit their positions by buying them back at the current market price at any time during the life of the option (provided they entered the market with sufficient liquidity). While an option will expire worthless as long as it does not go in the money, the value of the option, as well as its margin

requirement, can increase in the meantime if the market is moving closer to the strike.

Chapter 5 compared selling futures options to stock options. We explained why we recommend futures options to stock option traders. We discussed the growing popularity of futures as an investment vehicle and the fact that most small speculators who enter the

market end up losing money. Commercial traders are defined as people in the industry of a particular commodity, such as a large sugar producer. Commercials use futures to hedge their product against future price moves. Large speculators generally are fund managers who can manage millions or even billions of dollars in equity and often can move markets with their entry and

exists of positions. Both of these types of traders have advantages over the small speculator. We learned how selling options puts you above all of this fray and on equal footing with the professionals.

Chapter 6 taught us how margins work on short options. In particular, we learned about SPAN margin on futures options. *Buying on*

margin in equities trading has a completely different meaning from *margin requirements* in futures trading or option selling. Margin is the deposit that you, the trader, provide out of your trading account in order to hold an option position. In futures option selling, this margin is determined by a system called SPAN, which takes volatility, distance from the money, and other factors

into consideration before placing an appropriate “risk deposit” on short option sales. There is not a set formula for SPAN, but you should be able to get a SPAN margin for just about any option from your broker. Serious self-directed traders also can order SPAN software from the Chicago Mercantile Exchange and calculate SPAN margins for themselves. The benefits of

futures options over stock options include lower margin requirements, higher premiums for distant strikes, and better liquidity in most instances.

Chapter 7 covered the wide subject of selecting the right option to sell for premium. We introduced the basic strategy of selling naked options on futures. We suggested limiting your

search for sellable options to markets with very clear long-term fundamentals, bullish or bearish, and then selling far-out-of-the-money options with low deltas in the opposite direction of the fundamentals.

We

recommended selling options with two to six months of time value in order to allow you to sell strikes further out of the money and still collect good premium. Do not rule

out a market simply because it has already made a significant move. These markets are often moving in the direction they are for a good reason and can provide good opportunities for option sales (in favor of the trend). Open interest often can be a tipoff to what side of the market the small speculator is betting. Heavy open interest in calls and substantially less open interest in the puts of

the same market often indicate that the public is bullish on the market. This can be a good opportunity to sell call options because the public is often wrong. The “sweet spot” of deterioration of an option is generally the last 90 days of its life. Selling ahead of this time period will enable you to collect the maximum premiums before the fastest period of deterioration occurs.

Staggering or layering options throughout different contract months not only provides diversification but also allows an investor to experience option expirations nearly every month (conceding, of course, that she will have to cover a few of them).

Chapter 8 explored how spread trading is often misused by risk-adverse

traders who focus too much on limiting risk as opposed to managing risk. We learned how spreads often can run up commission costs and benefit the broker more than the trader. Many spreads are impractical for use by individual investors and can have costs that often outweigh the benefits or safety they may provide. It is important to focus more on potential *for* profit than on

potential profit. Potential profit sometimes can look very great, but the chances of achieving it are often slim. Focusing on potential profit is like trying to win the giant stuffed bear at the carnival by throwing a ball into the can. The potential prize is large, but the chance of winning it is small. We learned that the first prerequisite of a good option spread is that if all of the options expire worthless,

you still make money. Many spreads are so cumbersome and difficult to implement that they are not recommended for individual investors. These include multiple-option spreads such as the *butterfly*. Beware of the “free trade,” which can be anything but.

Chapter 9 covered the few spread strategies we recommend as both

advantageous and practical for the individual investor. Spreads can be entered all at one time, or the trader can try to time his entry by entering one side at a time. The latter is known as *legging in* and is considered a more aggressive approach. Spread strategies that we recommend are the short-option strangle, the bear call/bull put spread, and writing the covered call, which we feel is more

practical in stocks than in commodities. We recommend that any spread be established at a credit or net short options. This means that if all options in the spread expire worthless, the trader will still net a profit after commissions.

Chapter 10 described my favorite spread strategy of all time, the ratio credit spread. The ratio credit spread

combines a built-in risk-control feature with the ability to experience profits beyond just premium collected. It is possibly the most durable option spread there is and can generate income in many different market conditions. It has an “adjustability” feature that means you can adapt it to unexpected market circumstances. However, the spread is not practical in all

markets or at all times.

Chapter 11 advised that you should seek out options with open interest of at least 500 contracts to ensure sufficient liquidity before positioning. A *bid* is what the closest-priced buyer is willing to pay for an option. An *ask* is the price at which the closest-priced seller is willing to sell an option. Option prices cannot lock limit up or

down like futures contracts. Therefore, you usually can get out of option positions whenever you want, although it may not be at a price you want to pay. Being assigned on an option, otherwise known as having an option exercised, is a fear of many new option sellers, but in reality it rarely happens and shouldn't happen unless that is your intention. It generally will only benefit an option

buyer to exercise her option if it is deep in the money at or near expiration. This can be avoided easily by buying your option back before it goes in the money. Even if an option is exercised, it is generally not the worst thing. In this event, you would be assigned a futures position that could be closed out immediately, most likely resulting in a loss similar to what you would have

experienced in buying back your option.

Chapter 12 explains the key topic of risk control when selling options. Defense wins championships. Risk management begins before you enter a position by selecting far-out-of-the-money options with low deltas for your selling. Diversifying your portfolio and deciding on your risk

parameters before you enter the trade are also key factors in managing risk. There are many different ways to manage or offset risks in option selling. We do not believe in offsetting losing positions with new positions because they can create two problems out of one. Instead, we recommend two simple risk-management techniques. These are basing your exit point on the value of the

option or basing your exit point on a specific price level of the underlying commodity. Placing stops on options can be an inefficient risk-control method in your portfolio. Rolling options can be an effective strategy in a market that you believe is still favorable to your views, but your short option values have reached risk parameters.

Chapter 13 taught us the

difference between fundamental and technical analysis and why commodities option sellers may wish to overweight their analysis toward fundamentals. Technicals may be helpful in timing trades and projecting short-term direction, but fundamentals ultimately will determine the direction of prices. Furthermore, fundamentals also can be

very helpful in selecting price levels the market will not attain. After using fundamentals to determine which markets she will enter, a trader can then use technical analysis to assist in the timing of her entry. Most individual traders do not understand how to use fundamentals in commodities. Knowing them can give you a big advantage.

Chapter 14 reviewed

some of the key fundamentals of a select group of commodities and futures markets. Whereas some commodities are produced and consumed globally, others may be produced and/or consumed regionally, giving them fewer fundamentals to follow and therefore making them easier markets in which to form a fundamental opinion. It is important to focus on long-

term fundamentals that may affect prices up to three to six months down the road. Key sources of fundamental information include the U.S. Department of Agriculture (USDA), the American Petroleum Institute (API), the Department of Energy (DOE), major news services, and of course, your broker.

Chapter 15 examined how seasonal analysis can

assist a trader in making successful option-selling trades. Seasonals often are misunderstood and misused by novice traders. A seasonal average is just that, an average. Markets can make wide variations from the average. A trader should focus on the overall move during a certain time of year and realize that although the market may have a bias to move higher or lower at

certain times of the year, trying to match your trade to exact days based on a seasonal chart is unwise. Traders should realize that behind every seasonal tendency there is usually a set of fundamentals that causes the seasonal move to occur. Traders should know these fundamentals and follow them closely. Traders also should take the relative price of the commodity into

account when considering seasonal tendencies. It is wise to look not only at the averages but also at the actual price performance of the last 15 years to determine how close they have been to the average.

Chapter 16 contains some of our recommended seasonal patterns to consider for option selling. These include selling energy puts in

December, selling soybean puts in February, selling corn calls in May, selling orange juice calls in December, and selling coffee calls in January.

Chapter 17 covered the broad topic of volatility. Outlined were definitions of volatility, how it is used, and how it is misunderstood. The key concept was that fundamentals almost always

trump volatility, yet volatility remains a helpful tool in selecting option trades. We outline a simple system for determining if an option is overvalued or undervalued.

Chapter 18 covered how to structure your options-selling portfolio. We learned that setting an objective and risk parameters are the important first steps in any portfolio. Discussed were

strategies for diversifying, managing margin, and how to take profits and losses. We covered the concept of staggering. A key concept was that what determines your returns at year's end is how you manage losing trades.

Chapter 19 listed some of the most common mistakes that new futures option traders make. These were

ordered as follows:

1. Starting off without professional assistance.
2. Overpositioning.
3. Trading an undercapitalized account.
4. Not establishing a trading plan or exit strategy before entering your trade.
5. Trying to pick market

tops and bottoms.

6. Forming an emotional attachment or aversion to a particular market.

Avoiding these mistakes will not guarantee that you will be profitable. However, it will help you to avoid some of the most common pitfalls and may increase your likelihood of success.

Chapter 20 discussed

how and why to find a good broker or money manager. Believe it or not, who you work with could be your biggest determinant of success or failure in selling option premium. Many of the most successful people in history have attained their success by surrounding themselves with the most talented, competent advisors they could find. The hard part is finding them. A discount

broker is basically an order clerk and offers cheap commissions. A full-service broker can offer you a wide range of services and help. CTAs are professional traders who can manage your account for you. All brokers and CTAs are legally required to be registered with the National Futures Association (NFA). Background information on all registered brokers and

firms is available to the public on the NFA's website at www.nfa.futures.org. To find a good option professional, look for career experience, credentials, publishing history, honesty, experience with and knowledge of option selling, and a focus on you, not on him- or herself or a particular trade.

Chapter 21 answered

some of the most popular questions that investors new to option selling have been known to ask. Among subjects addressed were recommended position sizes, diversifying, and criteria used for selecting trades. Conservative traders should margin no more than 50% of their portfolio at any given time. Traders may want to consider the 200% rule when first starting out—if an option

doubles in value, get out. We recommend targeting premiums of between \$300 and \$700. Selling options close to the money with less than 30 days left produces quick expirations, but trades can move almost as fast as trading actual futures contracts.

A Final Word

The information that you have read in the preceding pages is the product of our years of trading futures and options. Through these years, we have come to the conclusion that selling options is the best way for the small speculator to compete successfully and consistently with the pros. Like all futures trading or investment strategies, it has its risks. It has drawbacks. It has

detractors. Regardless, it has been our experience that investors choosing to sell options as their primary (or only) futures trading strategy have fared *substantially* better than the average futures trader. It is not a strategy for the action seeker. It is a strategy for the serious *investor*.

Hopefully, the knowledge in these pages will help you

to become a successful option seller. At the very least, it may help you to decide if option writing is a strategy that fits right with your personality and individual investment style.

Despite the gimmicks, hyped-up “courses,” and salespeople disguised as industry professionals, there are many good people in the futures industry who can help

you to be successful. We've listed some suggested websites and resources in the back of this book that may help you get started.

You'll want to interview several brokers and/or money managers before deciding on one that is right for you before you embark on an option-selling portfolio. If you already have a broker, you may want to reinterview

him or her to determine his or her experience and views toward option selling. You may want to consider our firm, OptionSellers.com, for these purposes as well. You can find our contact information in the back of this book. There are many competent brokers and money managers around, however, and we encourage you to talk to other members of our professional community.

before making your final decision.

We wish you the best of luck as you begin what should be an exciting new avenue in your lifetime investment process.

If you have questions or comments along the way, feel free to write us an e-mail or visit our website or blog at www.OptionSellers.com. A free sample edition of our

fundamentally based client newsletter is available to you there.

You've now completed *The Complete Guide to Option Selling*. You've learned the what, where, when, who, and how of option selling. Now it is time to ask yourself the question that will decide *your* investment future: Is option selling for you?

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