

San Diego Investools User Group

Selling Time without Greek Intervention

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Simple Disclaimers

- Putting money into the capital markets (any of them) may cost you an arm and a leg. It may also provide significant cash flow and capital growth. (It will likely be somewhere in between.)
- You, and no one else, are responsible for the decisions you make about your money that you put into the capital markets. This includes delegating money decisions to someone else. (You will also be held accountable for your decisions.)

Disclaimer

- Information presented here is for informational purposes only.
- Transaction costs include commissions based on multiple commission schedules. As such, any examples presented do not include transaction costs specific to your situation.
- No financial recommendations of any kind are being made in this presentation.

Other Disclaimers

- The San Diego Investools User Group and the presenter are NOT financial advisors, financial planners, and make no recommendations regarding your money and its use in the capital markets.
- Trading in the capital markets can result in the loss of some or all of your initial investment.
- Trading derivatives and other leveraged devices (options, futures, forex, etc.) can result the loss of more than your initial investment.

Disclaimer Summary

- It is your money, you are responsible for it.
- If you abdicate decision making about your money to any one else, you are still responsible for your money.

Content Note

- If you are trading to a satisfactory level of profit and I make a comment during this presentation that contradicts your trading plan, trading strategies, or experience ...

–I AM WRONG !

– Forget what I say

Option Greek Warning #1

- Option greeks were developed to support the option market maker doing their job
- Option market maker job description
 - Provide market liquidity – buy from sellers; sell to buyers
 - Manage/mitigate risk (potential loss to self & employer)
 - Make money for self & employer
- Market maker job does NOT include helping you make money

Option Greek Warning #2

- The intrinsic value of an option cannot be manipulated by an option market maker
 - It can be shaved with the bid-ask spread
- The extrinsic (time) value of an option can and is managed (manipulated) by an option market maker while doing their job
 - This will occur all the way through option expiration if necessary

Selling Time without Greeks

- Calendar strategy
 - Not supported by any textbook
 - Some may decry this strategy
 - Uses long option to allow selling premium
 - Does not require long option to appreciate
 - Long option can be close to/or worthless and still make profit target
 - Uses call options ONLY
 - Backtested to 2005 using thinkback

Selling Time Without Greeks

- Calendar Strategy (continued)
 - Live trading for 20+ months
 - Correctly configured backtest trades and all live trades have current result of no net losing trades (some ended at break even)
 - Same danger as all time selling strategies
 - Cannot be used as cash flow strategy by itself
 - There are months when no acceptable trade develops

Selling Time Without Greeks

- Underlying Selection
 - Vanilla, unlevered, index based ETF
 - High volume, >2,000,000 shares daily average
 - Option strikes at \$1 increments
 - Large open interest (>1,500 contracts) for front and second month strikes near the money
 - My personal choices: SPY, IWM, GDX
 - I have also used XLE and EEM in the past

Selling Time Without Greeks

- Position entry gateways – BOTH MUST be present for position to be opened
 - Estimated monthly premium (less than short option price) times the number of months available to be sold must be 150% or more (148% is NOT close enough) of the cost of the long option
 - Initial position must be capable of producing a 60% ROI in the first month based on TOS analyze tab

Selling Time Without Greeks

- Exit is set at 20% of initial cost to enter trade, including in and out transaction costs, which becomes fixed profit target
- Fixed profit target does not change when rolls are performed
- Rolls may (will) add cost to the trade which reduces the final ROI.
 - Experience indicates to expect not more than 9-11% ROI on completed trades

Selling Time Without Greeks

- Management
 - Roll short strike up and down directionally (vertical roll) in \$2 increments to maintain ATM status
 - If underlying goes up \$2, roll short strike up two strikes to return it to ATM
 - If underlying goes down \$2, roll short strike down two strikes to return it to ATM
 - Maximum short strike movement is +/- \$8 from long option
 - If long option is at \$130, short option moves between \$122 and \$138

Selling Time Without Greeks

- Management
 - Roll short strike into next month 7-9 days prior to expiration when coordinated with vertical roll
 - Roll short strike into next month 4 days prior to expiration if no vertical roll was required in current or previous three market days
 - Complete roll after mid-day eastern

Estimating Available Monthly Premium

- Use current income from selling the roll (buy front month, sell second month) as estimate
- Use theoretical pricing model on TOS trade page to estimate option price at time of roll and use difference with current price
 - Michael Follett explains this during online Advanced Options workshop
- Other estimating method of your choice

Example

- Front month option priced at \$2.10
- Selling calendar roll occurs for \$1.25
- Estimated monthly premium is \$1.25
- Assume 6 month maximum trade duration
 - $\$1.25 \times 6 = \7.50 estimated premium to be collected during trade
 - 6 month long option priced at \$6.50
 - $\$7.50 / \$6.50 = 115\%$ - NO TRADE
 - 6 month long option priced at \$4.90
 - $\$7.50 / \$4.90 = 153\%$ - Trade allowed for this gateway

Example

- Initial position
 - Buy ATM call 5 (tight) to 7 months out
 - Sell ATM call (same strike) 25-40 days from expiration
 - Trade entered ONLY if both position gateways (total collected premium > 150% of long option and >60% ROI on perfect first month) are met

Probabilities and Odds

- Remember that there are no data supporting “option probabilities” as being the actual “odds” that an event occur
 - A sold option listing a 40% probability of expiring in the money by \$0.01 or more is NOT the same as 3:2 odds of the option expiring worthless
- The “probabilities” are calculated based on current pricing, making the probabilities dependent on what is “priced into” the market

Probabilities and Odds

- Consider 20 Jan 2008
 - Market pundits, talking heads, experts, traders and investors all expected the FOMC to lower the Fed Funds and Discount rate by 50 basis points
 - The market had “priced in” the 50 basis point drop

Probabilities and Odds

- What happened?
 - The FOMC did what the market had “priced in” and dropped both rates by 50 basis points
 - On the news, the S&P 500 jumped up almost 2%, on news that was already “priced in”
 - Next, the S&P 500 gave back the 2% and dropped an additional 0.5%, again on news that was already “priced in”
 - All on the day of the announcement

Recent Example

- AA up \$0.67 (17.89) during market trading on 3 May 2011
- May 11 \$18 strike call up \$0.45 on same market move and calculated delta of 0.49 shown AFTER the move
 - Option price moved 67% of the underlying move
- Option price move is NOT consistent with the calculated option greeks.