Strategies, analysis, and news for futures and options traders.

Futures & Options TRADER

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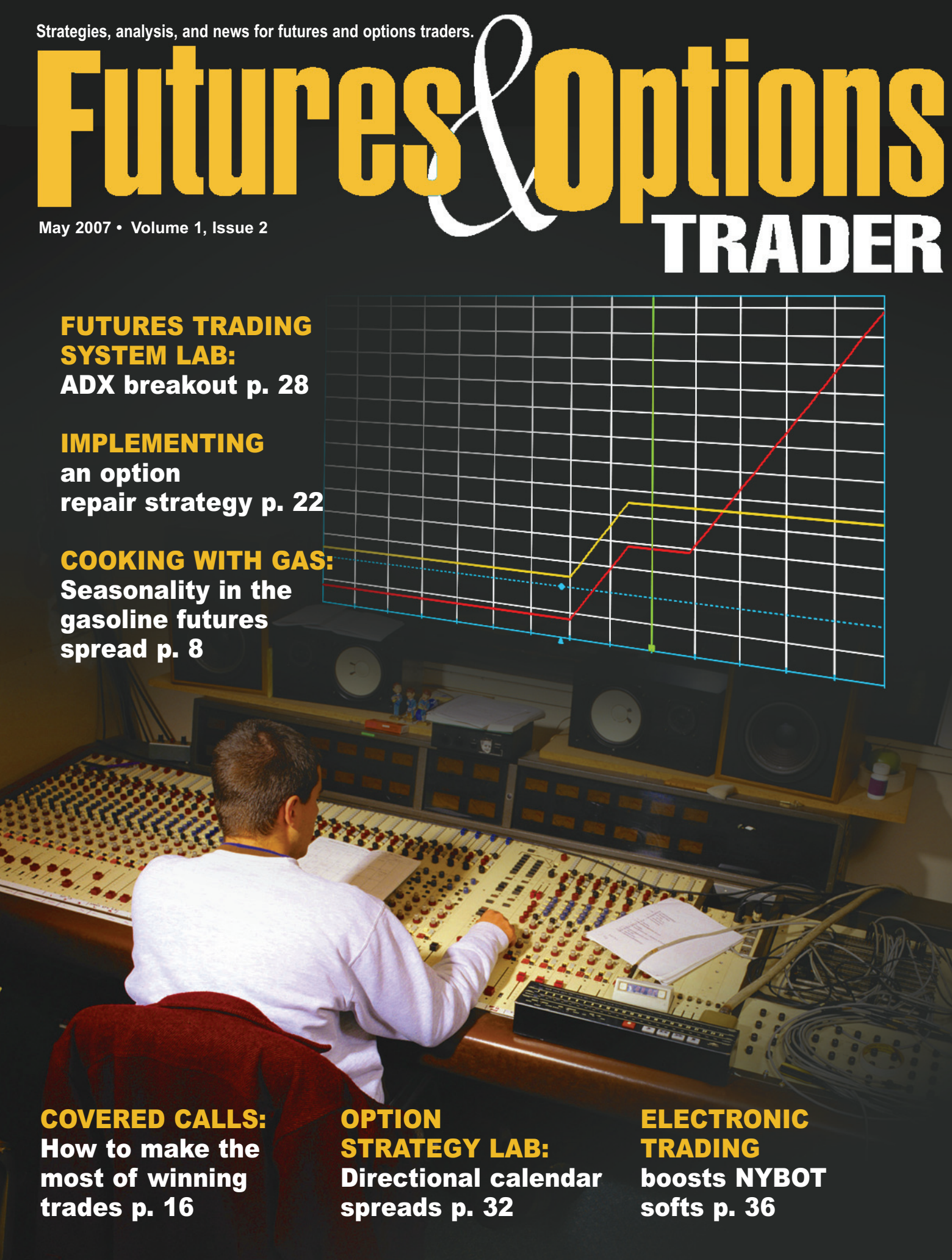

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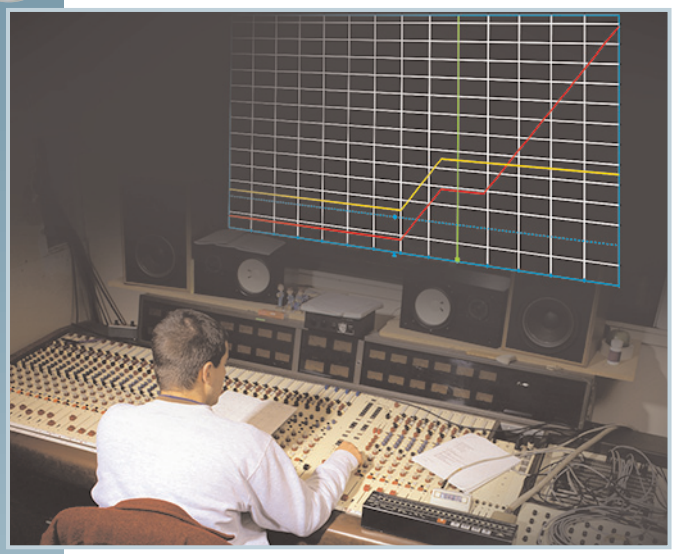

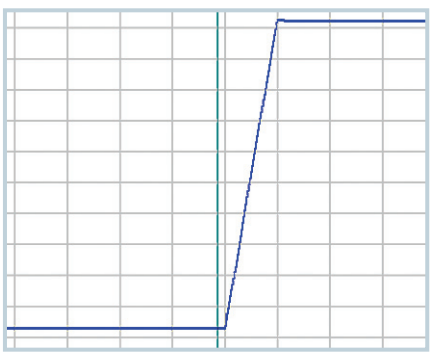

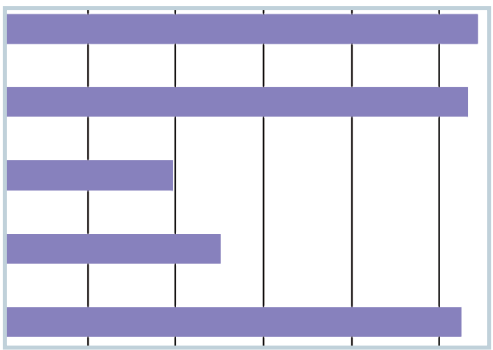

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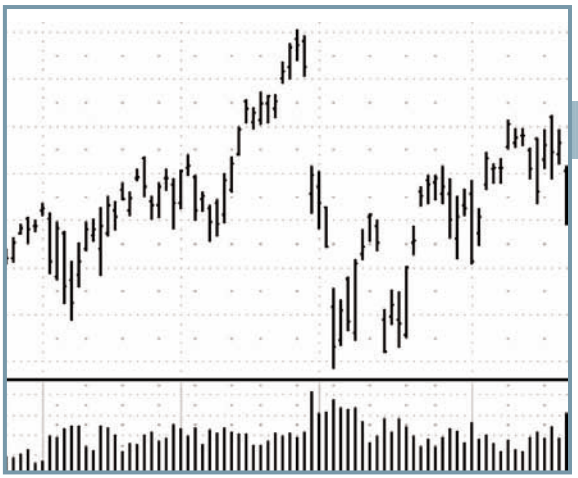

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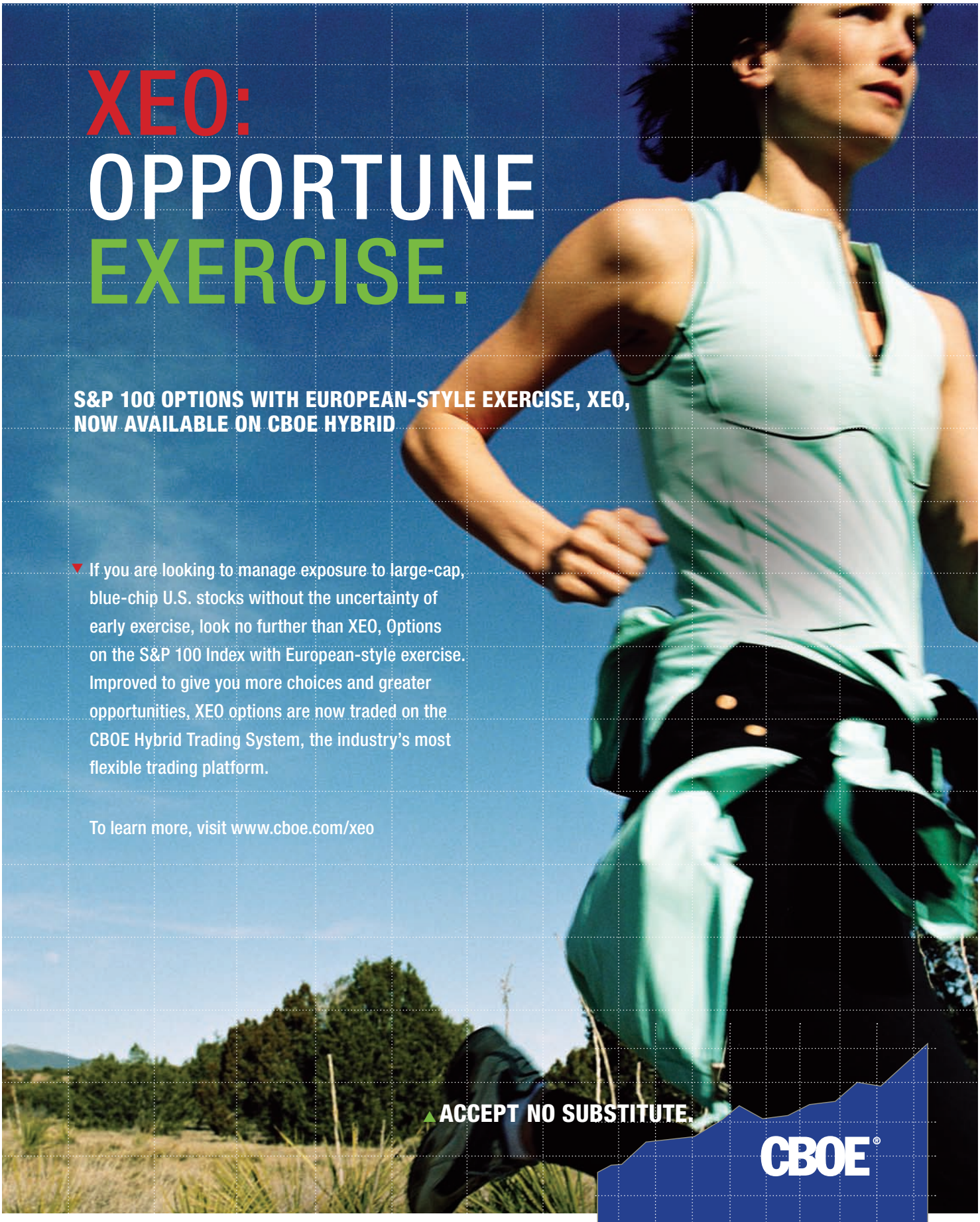

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Let's get rolling

I enjoyed Marc Allaire's article ("Rolling covered calls") in the April issue of *Futures and Options Trader*. I've been doing this and find it works well for me in a select number of stocks.

When my covered stock gets called away, I write a put for the next month or so at the same strike price. Since the written put is equal or nearly equal to a covered call position, is this another alternative to rolling the calls out? Managing a dividend in this case is also important. I'd be interested in your thoughts on the pros and cons of doing this.

— Jack Chow

Marc Allaire responds:

I like what you're doing. In fact, I have done this for clients, and I also do it in my personal account.

When a stock gets called away I take the opportunity to reassess it: If ABC just got called away, do I want to write puts on ABC or does XYZ represent a better opportunity? I have one stock right now against which I have sold an April call and I have to make the decision pretty soon: roll, sell puts on the same stock, or sell puts on a different stock.

Collar trades: Theory vs. practice

If the credit received from placing a collar trade (see "The collar trade," *Options Trader*, March 2007) does not beat a risk-free rate of return, you could receive from a T-Bill or similar instrument, then the trade is an economic loss (regardless of whether it has positive cash flow) and should not be taken. It is a bad trade and you should say so without qualification.

After reading the article, I researched the possibility of placing collars on a few of my selected holdings and discovered I could not achieve a credit for near- or mid-term expirations. I found that credit collars, when available at all, are associated with very low rates of return.

This leads me to conclude that selling the security and investing the proceeds in T-Bills would usually be the better alternative to a collar if you are worried there is a significant risk your stock will lose value.

If you can come up with collar examples that provide a credit, do not involve legging in, and have an expected upside of beating a risk-free rate of return, I would love to see a follow-up article.

— Ronald R. Hull

David Bukey responds:

I agree with your conclusions — the trade was only meant as an example and did not include carrying costs. However, the collar has one possible advantage — it can still generate more profit than a T-Bill if the stock rallies to the short call's strike.

The article has generated a great deal of interest, and one of our regular contributors may write a follow-up article for an upcoming issue.

Gasoline seasonal spread

Seasonality in gas futures might not be a mirage, but you need to do some work to benefit from this tendency.

BY KEITH SCHAP

According to the usual unreliable sources, unleaded gasoline (RB) is a seasonal market, but there are plenty of skeptics.

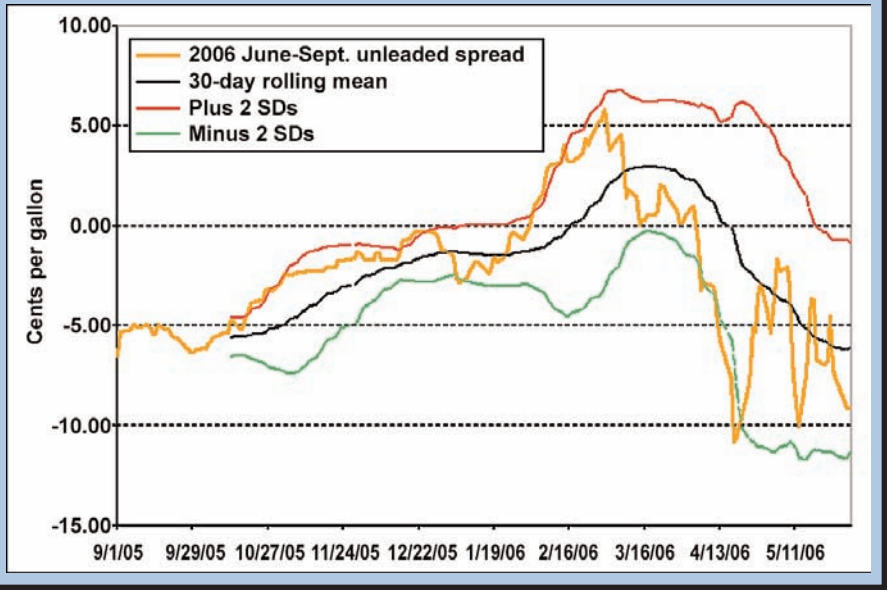
A logical way to check this out would be to analyze the June-September gasoline futures spread over the past 20 years. A simplistic study of this spread suggests the skeptics are right: Seasonality doesn't exist or, if it does, it exists to such a slight extent as to be useless in real trading.

However, a more detailed analysis produces a different conclusion: Gasoline seasonality is not only real, exceptions to it are infrequent.

Also, knowing when to look for this seasonality can lead to some genuinely interesting spread trade opportunities — not every year, to be sure, but often enough to make this a rewarding spread to monitor.

FIGURE 1 — THE 2006 JUNE-SEPT. UNLEADED GASOLINE SPREAD

The widening of the gasoline futures spread from -6.55 to 5.75 from September 2005 to March 2006 indicated the market was encouraging storage. The subsequent narrowing, from 5.75 to -10.90, implied the opposite.



The logic of gasoline seasonality

The conventional market wisdom is that gasoline demand peaks during the summer driving season, which extends from Memorial Day weekend to Labor Day weekend. This makes sense, given how many vacations fall within this time period. Also, people naturally get out and about more during late spring and summer than they do during winter. Repeated trips to home improvement stores and garden centers, recreational activities, and outdoor festivities all require extra driving.

But this explanation is an oversimplification. The complete gasoline storage picture begins to unfold during the fall and winter months.

A cold winter naturally increases demand for heating oil. Because refiners must produce both heating oil and gasoline, and because a barrel of crude oil produces about twice as much gasoline as heating oil, increased heating oil demand can result in an oversupply of gasoline. This extra gasoline must go into storage. Conversely, a warmer winter will result in a higher supply of heating oil, which reduces the storage space available for gasoline.

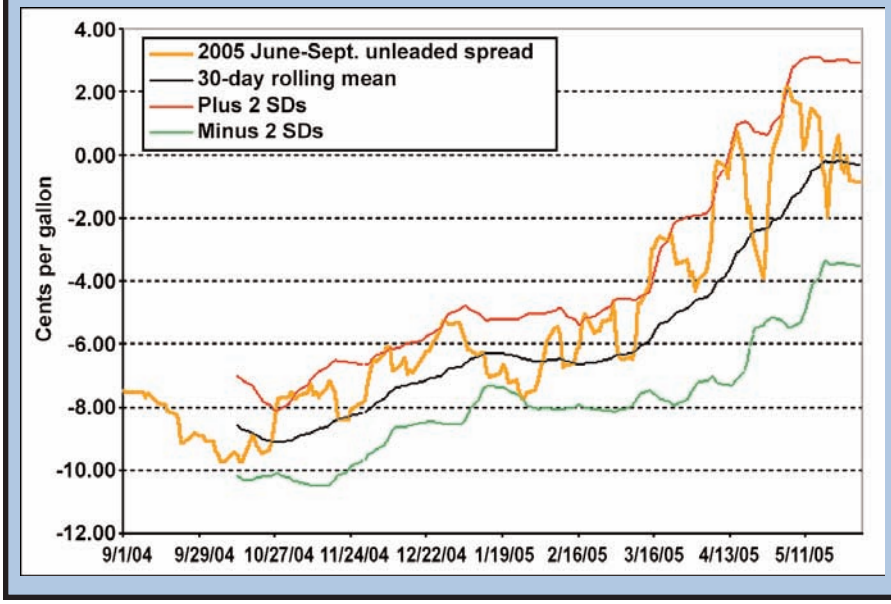
Economic conditions affect the demand side of the supply-demand equation. When the economy is strong, people are likely to drive more — both for business and personal reasons — than when the economy is weak.

Also, the energy infrastructure can affect what happens in the gasoline market. A pipeline break, for example, can interrupt the availability of gasoline and force users to scramble for what limited supplies exist.

The month-to-month gasoline futures spreads provide reliable gauges of the balance among all the factors affecting the supply-demand situation.

FIGURE 2 — THE 2005 JUNE-SEPT. UNLEADED GASOLINE SPREAD

During the winter and spring of 2005, the June-September gasoline spread widened steadily to a peak of 2.14 on May 4, signaling a lack of concern about gasoline supplies.



During a normal or colder winter the gasoline market will "build carry" (i.e., deferred-month futures prices will be higher than near-month futures prices), which will encourage storage. During the spring months, the market begins to shift the pricing of the June and September contracts (among others) with summer driving in mind.

Figure 1 displays the June-September spread for 2006. To calculate this spread, subtract the September contract's price (HUU6) from the June contract's price (HUM6). This spread widened (moved from negative to less negative and ultimately to positive) from -6.55 cents per gallon on Sept. 1, 2005, to 5.75 cents on March 1, 2006. This 12.30 cents-per-gallon widening represents a market encouraging the storage of gasoline. (The upper and lower bands on the chart are two standard deviations above and below the 30-day moving average of the spread.)

In contrast, from March 1 to April 18, the June-September spread narrowed 16.65 cents, from 5.75 to -10.90 cents per gallon. The June futures price rose 49.36 cents (from 171.04 to 220.40 cents per gallon) during this 48-day period, while the September futures rose only 32.71 cents (from 176.79 to 209.50). This March 1 to April 18 narrowing of the June-September gasoline spread gave a clear message: Deliver supplies in June, not later.

The "deliver earlier rather than later" message is understandable when you remember it occurred in the aftermath of hurricane Katrina and concerns about adequate supplies were high. So, perhaps this wasn't a good year to use for illustration.

The 2005 June-September gasoline spread reinforces this doubt because it tells a very different story. Figure 2 tracks the 2005 spread from Sept. 1, 2004 to the end of May 2005. During the winter and spring of 2005, the June-September spread widened steadily to a peak of 2.14 on May 4. This widening signals a lack of concern about gasoline supplies — not at all what the common wisdom would have you believe.

Two versions of spread history

These two examples cast doubt on seasonality claims, but a single exception doesn't make a case either way. One way to examine June-September gasoline spread history is to record spread levels on two dates, calculate the spread change, and see whether there is a consistent pattern over many years.

Table 1 lists the spread levels for the first trading day in March and the first trading day in May and the spread change between those two days. A negative spread change signals a narrowing spread (supposedly the normal expectation) while a positive spread change signals a widening spread. The March and May dates are arbitrary, but they represent reasonable moments at which to capture the basic impulse of the spread.

TABLE 1 — A SIMPLISTIC APPROACH TO JUNE-SEPT. SPREAD HISTORY

There were only 12 instances of narrowing spreads during the 20-year analysis period.

	First March day	First May day	Spread change
1987	-0.52	-0.35	0.17
1988	1.78	-0.26	-2.04
1989	-3.84	-12.37	-8.53
1990	-4.02	-3.18	0.84
1991	-5.92	-7.63	-1.71
1992	-3.85	-2.96	0.89
1993	-0.98	-2.09	-1.11
1994	-0.02	-0.44	-0.42
1995	-1.64	-5.35	-3.71
1996	-4.33	-9.31	-4.98
1997	-1.31	2.44	3.75
1998	0.15	0.23	0.08
1999	1.15	-2.02	-3.17
2000	-11.20	-7.87	3.33
2001	-6.54	-15.63	-9.09
2002	-3.79	-4.35	-0.56
2003	-15.05	-4.89	10.16
2004	-9.75	-12.24	-2.49
2005	-4.65	0.87	5.52
2006	5.75	-4.51	-10.26

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TABLE 2

This is a more detailed and practical look at the spread.

	June-Sept. spread	June futures price	Sept. futures price	+2 SDs	-2 SDs	Days to May 1
2/25/87	-0.40	48.70	48.30	0.08	-2.34	65
5/18/87	-2.01	55.30	53.29	0.35	-1.77	
Change	-1.61	6.60	4.99			
3/8/88	3.69	44.56	48.25	3.68	-7.15	54
5/10/88	-5.25	51.62	46.37	0.97	-4.91	
Change	-8.94	7.06	-1.88			
2/21/89	-3.29	51.24	47.95	-2.66	-5.48	69
4/27/89	-12.74	72.27	59.53	-3.79	-12.77	
Change	-9.45	21.03	11.58			
4/12/90	-2.10	58.10	56.00	-2.36	-5.23	19
5/9/90	-6.37	63.97	57.60	-1.76	-5.60	
Change	-4.27	5.87	1.60			
3/1/91	-5.92	61.67	55.75	-4.83	-6.86	61
5/3/91	-8.26	71.36	63.10	-5.31	-8.55	
Change	-2.97	7.42	5.50			
3/9/92	-2.93	60.03	57.10	-3.27	-4.94	53
5/4/92	-3.90	66.45	62.55	-1.69	-3.97	
Change	-0.97	6.42	5.45			
2/18/93	-0.80	58.65	57.85	-0.94	-2.47	72
5/6/93	-2.41	61.80	59.39	-0.94	-2.21	
Change	-1.61	3.15	1.54			
3/1/94	-0.02	46.83	46.81	0.34	-0.35	61
4/15/94	-1.51	50.78	49.27	0.27	-1.47	
Change	-1.49	3.95	2.46			
3/10/95	-0.84	53.39	52.55	-0.94	-3.00	52
5/17/95	-7.71	66.76	59.05	-2.20	-7.05	
Change	-6.87	13.37	6.50			
2/6/96	-1.98	53.89	51.91	-1.97	-2.66	85
4/30/96	-12.46	72.31	59.85	-4.89	-12.29	
Change	-10.48	18.42	7.94			

	June-Sept. spread	June futures price	Sept. futures price	+2 SDs	-2 SDs	Days to May 1
2/13/97	-1.30	63.83	62.53	0.32	-15.28	77
3/20/97	-11.46	66.19	54.73	2.11	-11.46	
Change	-10.16	2.36	-7.80			
3/10/98	1.50	48.69	50.19	1.27	-2.57	52
4/17/98	-0.44	53.49	53.05	1.77	-0.79	
Change	-1.94	4.80	2.86			
2/11/99	1.35	39.43	40.78	1.23	0.17	79
4/29/99	-2.30	55.30	53.00	-0.52	-2.59	
Change	-3.65	15.87	12.22			
3/1/00	-11.20	88.10	76.90	-5.30	10.20	61
4/5/00	-4.60	76.90	72.30	-5.15	-12.56	
5/4/00	-13.43	90.88	77.45	-3.45	-11.37	
Change	-8.83	13.98	5.15			
3/2/01	-6.60	85.70	79.10	-6.60	-9.32	60
5/22/01	-21.19	110.78	89.59	-10.79	-20.46	
Change	-14.59	25.08	10.49			
2/26/02	-3.00	66.95	63.95	-2.88	-3.88	64
5/9/02	-1.43	77.46	76.03	-1.87	-7.97	
Change	1.57	10.51	12.08			
3/7/03	-17.07	110.67	93.60	-10.77	-16.76	55
5/2/03	-4.06	76.78	72.72	-4.58	-12.56	
Change	13.01	-33.89	-20.88			
3/9/04	-7.56	104.58	96.93	-8.21	-10.42	53
5/20/04	-21.85	145.02	123.17	-5.59	-20.32	
Change	-14.29	40.44	26.24			
3/1/05	-4.65	146.00	141.35	4.60	-8.14	61
5/4/05	2.14	146.64	148.78	2.17	-5.47	
Change	6.79	0.64	7.43			
2/14/06	4.00	159.06	163.06	3.72	-4.50	76
4/18/06	-10.90	220.40	209.50	5.90	-7.27	
Change	-14.90	61.34	46.44			

The "Spread change" shows there were 12 narrowing spreads. Twelve years out of 20 hardly makes this seem a "normal" condition. Further, the location of the peaks and valleys of these spreads shift from year to year as weather and various economic factors affect the market.

With this in mind, a more realistic starting point for spread evaluation might be to look for the greatest width anywhere from Jan. 1 to about the mid-March and the narrowest point occurring between mid-April and mid-May.

Table 2 shows more details about these 20 spreads. The initial and ending dates fall within January to mid-March and mid-April to mid-May, respectively. In addition to the spread level on each date, the table includes the June and September futures prices, the plus and minus two standard deviation (SD) boundaries, and the number of days from the initial day to May 1.

TABLE 3 — INITIAL SPREAD LEVELS (NARROWEST TO WIDEST)

After filtering out the two initial spreads more inverted than -10.00, 16 of the remaining 18 years exhibited normal narrowing.

Year	Initial spread level	Year	Initial spread level
2003	-17.07	1996	-1.98
2000	-11.20	1997	-1.30
2004	-7.56	1995	-0.84
2001	-6.60	1993	-0.80
1991	-5.92	1987	-0.40
2005	-4.65	1994	-0.02
1989	-3.29	1999	1.35
2002	-3.00	1998	1.50
1992	-2.93	2006	4.00
1990	-2.10	1988	4.17

Table 3 shows the initial spreads from narrowest (-17.07 in 2003) to widest (4.17 in 1988). Spreads as deeply inverted as those of 2003 and 2000 indicate situations where the spread is unlikely to narrow more and will probably widen.

Filtering out the two initial spreads that were more deeply inverted than -10 cents per gallon leaves 18 years. Of this group there were only two years when the spread widened rather than narrowed. This means 16 of the 18, or 88 percent, exhibited "normal" narrowing. This version of spread history offers strong support to seasonality claims. Theoretically, a trader who sold the spread (i.e., bought June futures and sold September futures) on the initial date of Table 2 would have made at least a small amount of money 88 percent of the time. (Of course, the 2005 loss would have been a major speed bump.)

An approach to trading the June-September gasoline spread

Despite the strong tendency for the June-September spread to narrow, no one should trade any spread on autopilot. If you need proof of the danger of assuming a given spread "always" develops in a certain way, consider the case of Amaranth, the hedge fund that lost $6.5 billion in less than a month in August and September 2006. In any case, these trades require some knowledge of the underlying supply-demand situation and a method for knowing whether to sell the June-September gasoline spread.

A series of "filters" can help determine whether to sell the spread and, having sold it, when to unwind it. One possible set of trade entry filters:

Filter 1: Look for a spread selling opportunity anywhere from Jan. 1 to March 15.
Filter 2: Reject any spread of -10 cents per gallon or narrower.
Filter 3: Sell the June-September gasoline spread only if the spread is wider than the plus-two standard deviation (SD) level.

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The Amaranth meltdown: The danger of "always"

Speaking of unreliable sources, take a look at the news reports of the collapse of the hedge fund Amaranth.

Various articles in September 2006 (and later) attributed Amaranth's losses to having traded a March-April natural gas spread on the assumption the spread "would increase," as a *New York Times* article put it (Gretchen Morgenson and Jenny Anderson, "A Hedge Fund's Loss Rattles Nerves," Sept. 19, 2006). This article went on to say, "But instead the spread collapsed."

Another article, citing the same numbers as the earlier *Times* piece, said, "The immediate cause of Amaranth's spectacular losses was an unprecedented narrowing in spreads between the March and April 2007 gas futures. The spread between the two futures contracts fell from $2.50 at the end of July to around 75 cents at the end of September. Usually, there is a large gap between the March and April prices, because gas prices fall in April relative to March, with the onset of summer. This is the case every year, so most analysts said that this narrowing of spreads between the two months was much rarer than a 'sigma six' event (an event that has approximately less than 0.1 percent probability of happening)" (Raghuvir Mukherji in *The Hindu Business Line*, Jan. 14, 2007).

When analysts and the reporters who quote them say, "This is the case every year" and the narrowing was "much rarer than a 'sigma six event,'" red flags should begin to wave. A check of the March-April spread during the late-July to late-September period (cited in the *Times* article) from 1990 through 2005 suggests this supposedly rare spread behavior is actually fairly common. By "widen," these writers and their sources meant the spreads became more inverted. (The spreads narrow in the terminology used here.)

In fact, the March-April natural gas spread widened (that is, became less negative or even positive) in six of these 16 years. This hardly makes the 2006 spread behavior seem like a "sigma six" event.

Further, along with a more realistic sense of normal spread behavior, it is important to be aware of what is happening in the underlying market — something the Amaranth traders and their supervisors apparently were not.

Normally, the market creates incentive to build inventory through widening spreads. Once seasonal consumption begins, the market takes the carry out of the spreads and the spreads narrow or even invert, creating an incentive to use inventory to meet demand.

However, a large change in storage capacity can affect the behavior of the spread, and apparently this is what happened in 2006. An early September 2006 note on the Energy Information Administration Web site claimed U.S. natural gas storage capacity had reached 3,084 billion cubic feet, far more than had been available earlier. This should have been obvious to any trader.

FIGURE 3 — THE 1996 JUNE-SEPT. UNLEADED GASOLINE SPREAD

In 1996 the June-September spread narrowed past the minus-two SD level four times from March 20 to April 29. Only the April 29 date met the criteria of XFilter 1.

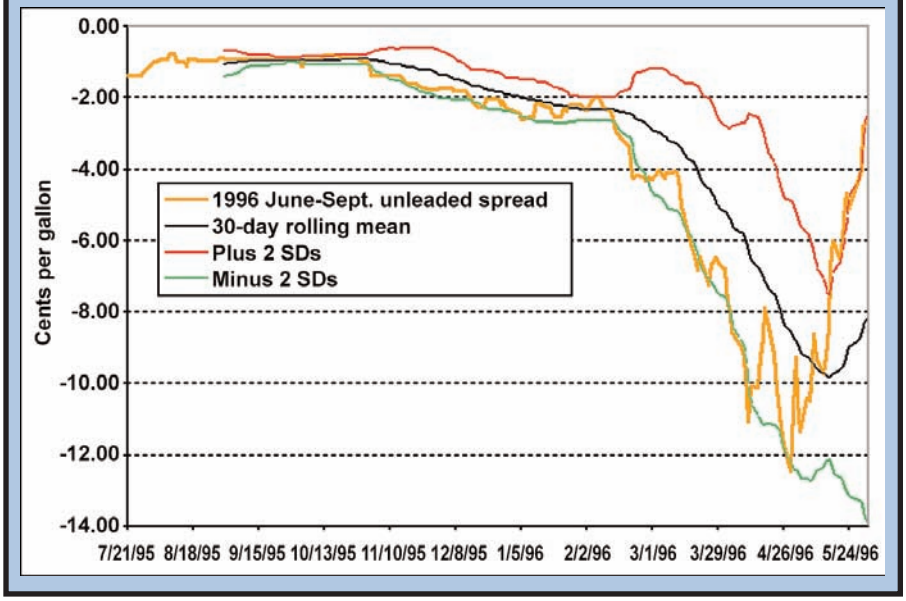
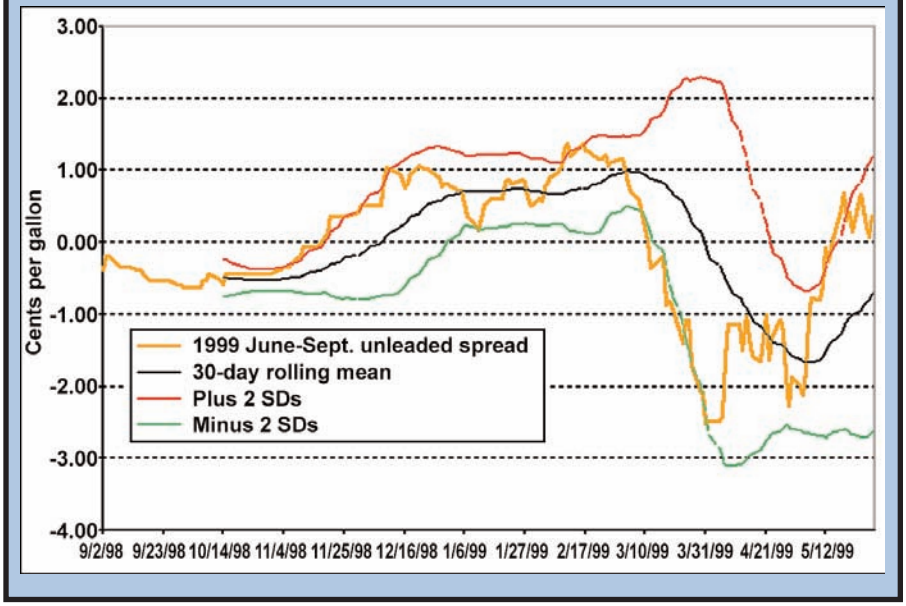


FIGURE 4 — THE 1999 JUNE-SEPT. UNLEADED GASOLINE SPREAD

The spread narrowed past minus two SDs on March 31 and never again reached that degree of narrowing. However, this spread did narrow to -2.30 on April 29.



The spreads on the initial dates listed in Table 2 all pass through Filter 1. Next, the 2000 and 2003 spreads do not pass through Filter 2, but all the others do. Finally, the spreads on the initial dates in 1987, 1989, 1991, 1994, 2002, and 2005 do not pass through Filter 3 because they are narrower than the plus-two SD level. Overall, this set of filters would have led to selling the June-September gasoline spread in 12 of the 20 years.

Another consideration involves Filters 1 and 2. The March 1, 2000 June-September spread was -11.20 cents per gallon, a level significantly narrower than the -10 threshold specified in Filter 2 and also narrower than the minus-two SD level. These are two strong reasons for not having sold the spread on March 1, 2000. However, by April 5, the spread had widened to -4.60 cents, which is wider than the -5.15 plus-two SD level on that day. Even though this is well past the March 15 boundary of Filter 1, this might have been a good trade to make — given fundamental data supporting such a move.

A possible exit strategy

Knowing when to exit these trades can also be a challenge. Again, a set of filters can help. Two possible exit filters are:

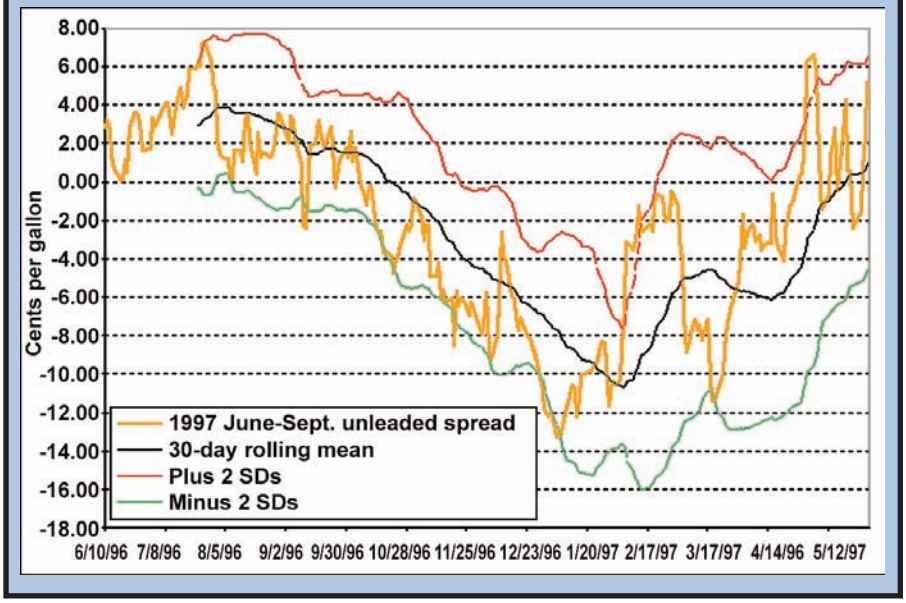
> XFilter 1: Look for an opportunity to unwind the spread trade after April 15 and no later than May 20.
> XFilter 2: Unwind the spread trade when the spread is narrower than minus two SDs.

Table 2 reveals 1997 and 1999 to be exceptions to XFilter 1, while 1992, 1998, and perhaps 1999 are exceptions to XFilter 2. Figure 3, a plot of the 1996 spread, illustrates another interesting exit challenge for spread traders. During 1996, the June-September gasoline spread narrowed past the minus-two SD level four times from March 20 to April 29. Only the April 29 date meets the criteria of XFilter 1. Despite this, it would have been tempting to unwind at any of the other three points, especially on April 11 when the spread narrowed to -11.11 cents per gallon. After all, this is almost April 15, and a one-lot spread unwound here would have earned $3,834.60 (-11.11 minus -1.98 = 9.13 * 420 = $3,834.60).

The 1999 spread poses a different kind of challenge. The spread narrowed past minus two SDs on March 31 and never again reached that degree of narrowing (Figure 4). A similar situation occurred in 1997 (Figure 5), during which the spread narrowed to -11.46 on March 20 and, as was the case in 1999, never reached anything near this degree of narrowing again. Note, however, the path of the minus-two SD boundary. It began trending upward from mid-February

FIGURE 5 — THE 1997 JUNE-SEPT. UNLEADED GASOLINE SPREAD

The uptrending minus-two SD boundary seems to indicate a momentum shift and the need to look for a chance to unwind the trade. The chance came on March 20 in 1997.



on. This seems to indicate a momentum shift and the need to look for a chance to unwind the trade. The chance came on March 20, 1997.

The 1999 spread lacked this apparent momentum shift. However, this spread did narrow to -2.30 on April 29. Unwinding on this day, having missed the earlier chance, would have still produced a good result. The point is, there is no sure way to know in many cases.

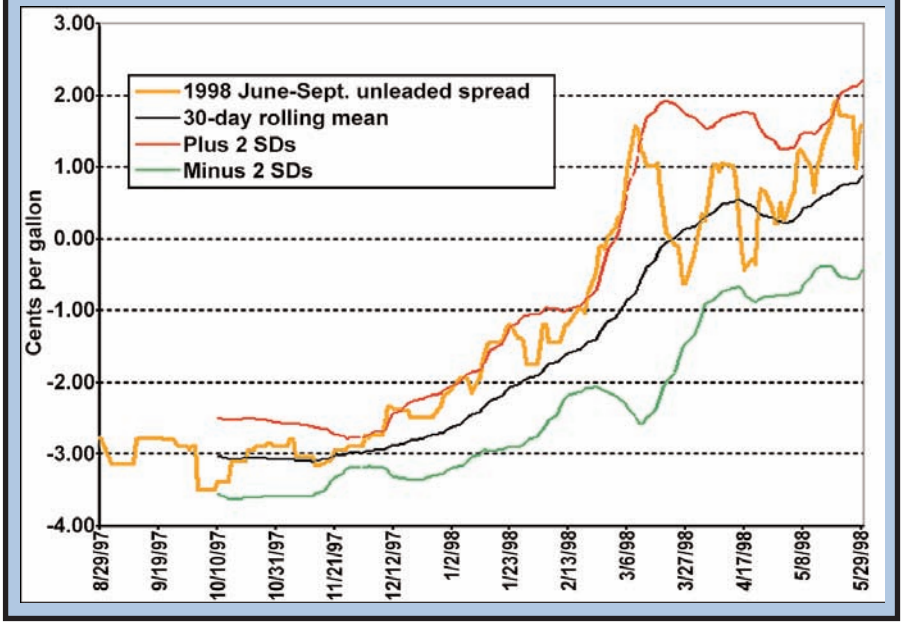
The 1998 exception to XFilter 2 seems like the 1997 case, in a way. As Figure 6 shows, the entry signal would have seemed inescapable. From there, the June-September spread narrowed to -0.63 cents on March 27, widened for a little more than two weeks, and then narrowed to -0.44 on April 17. The spread never came within shouting distance of the minus-two SD boundary. However, as in 1997, both the 30-day moving average and the minus-two SD boundary were trending upward. The April 17 level would have been the time to make the best of things.

The 1992 exception to XFilter 2 again involves upward trending SD boundaries. Because of this, the May 4 -3.90 spread level would have been a good time to unwind.

The XFilter 1 dates may seem arbitrary, but they are not. The June unleaded contract trades right up to the end of May, but much of the trade leaves the market well before the end of the month. Figure 7 plots a simple average of June contract open interest for the final 42 trading days of each of these 20 years. This covers all of April and May, and a day or two of March in a few cases.

FIGURE 6 — THE 1998 JUNE-SEPT. UNLEADED GASOLINE SPREAD

This spread never came close to the minus-two SD boundary, but both the 30-day moving average and the minus-two SD boundary were trending upward, targeting April 17 as a good entry point.



The dip at the 20-day mark falls on or about May 3, after which open interest builds slightly before falling off the table right at the end. This open interest data makes mid-April to mid-May seem like a good unwinding point. During this interval, enough people are still in the market to make trading relatively efficient. After May 20, the diminishing open interest adds significantly to the risk.

Granted, the market can make some exciting looking moves during the last 15 or 20 days a contract trades, but attempting to trade these moves is probably as risky as carrying exposure into a grain delivery month.

Evaluating the filters

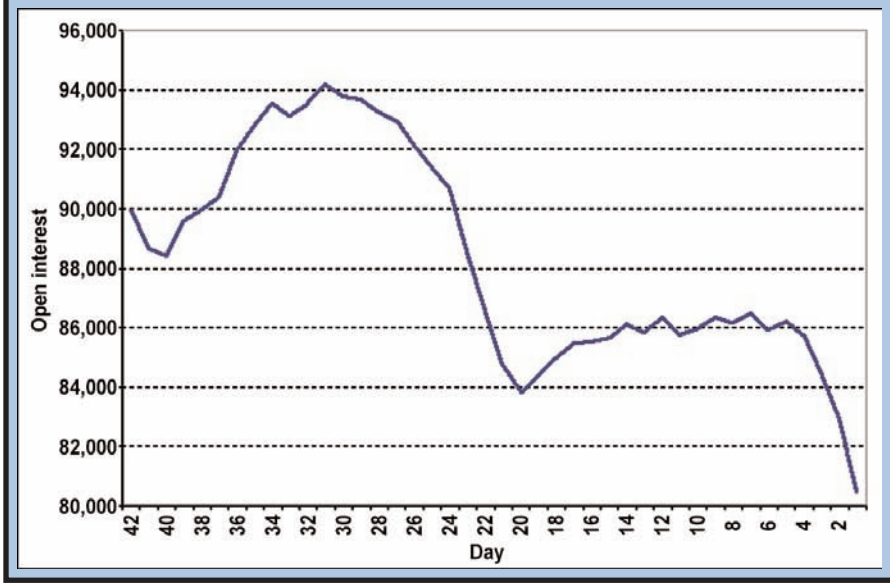
We must also consider whether these filters are blocking any potentially good trades. In fact, while these filters do block all the losers during the 20-year period, they also block a few winning trades. Perhaps one or more of the filters should be relaxed.

Table 4 summarizes the results given three scenarios. The "spread change" column repeats the spread changes from Table 2. These are the results of selling one-lot June-September gasoline spreads each year from 1987 through

continued on p. 14

FIGURE 7 — AVERAGE OPEN INTEREST LAST 42 TRADING DAYS (1986-2005)

The average of June gasoline futures open interest for the final 42 trading days suggests mid-April to mid-May is a logical window for unwinding the trade. The shrinking open interest after May 20 significantly increases risk.



2006 using the spread values for the initial date shown in Table 2 (except in 2000) and the final date shown for each year. (Narrowing spreads appear as negative numbers.) The "gain/loss" column translates these spread changes into dollar values by multiplying by 420 and changing the sign to reflect gains when the spread narrowed and losses when it widened. The bottom line shows this "no filter" approach netted $39,908.40.

The "filters" columns use the same assumptions about when the spreads were put on and unwound, but applies the entry filters. The "included" column shows the dollar gains for the 13 years the filters allowed trades. The sum of these gains is $42,630. The "filtered out" column shows the gains or losses from the years the filters would have blocked trades.

An ideal set of filters will block all the losing trades and allow all the positive trades. Clearly, these filters do not do this. "Filtered out" contains four trades with positive results. While the three under $1,000 dollars represent only small missed opportunities, the 1989 trade represents significant missed profit.

Perhaps entry Filter 3 should be relaxed to specify putting on a trade any time the spread is wider than plus one SD. Of course, this relaxation is likely to let a loser or two slip through the filters.

In fact, this plus-one SD filter allows the 1987, 1989, 2002, and 2005 trades to slip through. It still eliminates the 1991 and 1994 trades which generated small positive returns. Entry Filter 2 blocks the 2003 trade, which is the biggest loser. The four trades this relaxation allows through — two positive, two negative — contribute a net gain of $1,134.00 to the $43,764.00 bottom line of the "relaxed filters" columns.

Another way to evaluate the filters is to look at the probability of success and the maximum drawdown in a given sample. The more rigorous set of entry filters allows 13 trades, all of which would have generated gains. Based on this sample, the more rigorous filters seem to offer 100-percent success on a smaller number of trades. The relaxed set of filters would have resulted in

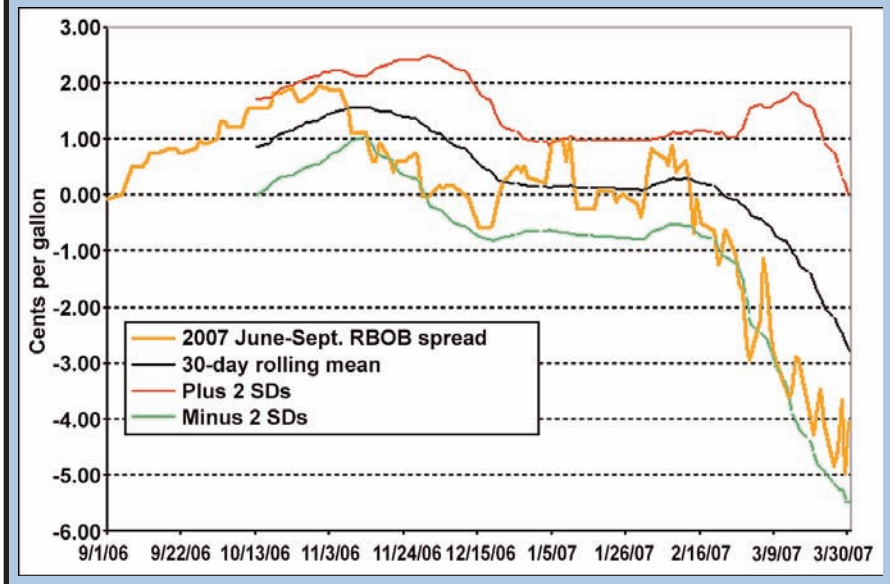
TABLE 4 — EVALUATING THE ENTRY FILTERS

The relaxed filters offered a small additional gain, but using the full filters resulted in a higher average trade, making this option the most efficient use of capital.

	No filters		Filters		Relaxed filters	
Year	Spread change	Gain/loss ($)	Included ($)	Filtered out ($)	Included ($)	Filtered out ($)
1987	-1.61	676.20		676.20	676.20	
1988	-8.98	3,754.80	3,754.80		3,754.80	
1989	-9.45	3,969.00		3,969.00	3,969.00	
1990	-4.27	1,793.40	1,793.40		1,793.40	
1991	-2.34	982.80		982.80		982.80
1992	-0.97	407.40	407.40		407.40	
1993	-1.61	676.20	676.20		676.20	
1994	-1.49	625.80		625.80		625.80
1995	-6.87	2,885.40	2,885.40		2,885.40	
1996	-10.48	4,401.60	4,401.60		4,401.60	
1997	-10.16	4,267.20	4,267.20		4,267.20	
1998	-1.94	814.80	814.80		814.80	
1999	-3.65	1,533.00	1,533.00		1,533.00	
2000	-8.83	3,708.60	3,708.60		3,708.60	
2001	-14.59	6,127.80	6,127.80		6,127.80	
2002	1.57	-659.40		-659.40	-659.40	
2003	13.01	-5,464.20		-5,464.20		-5,464.20
2004	-14.29	6,001.80	6,001.80		6,001.80	
2005	6.79	-2,851.80		-2,851.80	-2,851.80	
2006	-14.90	6,258.00	6,258.00		6,258.00	
Total		**$39,908.40**	**$42,630.00**	**-$2,721.60**	**$43,764.00**	**-$3,855.60**

FIGURE 8 — THE 2007 JUNE-SEPTEMBER RBOB SPREAD

So far this year the June-September spread has been profitable. The three entry filters indicated a June-September spread sell opportunity on Jan. 5.



17 trades, two of which would have been losers. Thus the relaxed filters would have resulted in an 88 percent success rate during these 20 years. The biggest drawdown using the relaxed filters would have come in 2005, but this $2,851.80 loss amounts to only six percent of the $47,275.20 earned on the 15 positive trades.

However, this small $1,134 incremental gain for the 17 relaxed filters trades might not be worth it. The average gain per trade in the no filters scenario is $1,995.42. The average in the filters scenario is $3,279.23. And the average in the relaxed filters scenario is $2,574.35. Using the more rigorous filters might lead to the most efficient use of trading capital.

This year's spread

This analysis amply demonstrates the existence of a seasonal event in the gasoline market. There may not be a trade every year, but this does not mean seasonality is a mirage. Rather, the challenge for spread traders is to figure out what the market is anticipating in the current year — hence the use of the filters.

Figure 8 tracks the 2007 spread from Sept. 1, 2006, to March 30, 2007. Traders will have noticed gasoline futures contract specifications have changed to keep up with developments in the underlying market. The Harbor Unleaded (HU) contract has morphed into Reformulated Gasoline Blendstock for Oxygen Blending (RB). As far as the spreads are concerned, this changes nothing. Figure 8 shows the three entry filters indicated a June-September spread selling opportunity on Jan. 5, 2007, and so far this has been a good year for the spread. Contract changes notwithstanding, seasonality is alive and well in the gasoline futures market.

For information on the author see p. 6.

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Repairing a losing covered call

Covered calls are rarely a lost cause, even if the stock falls.

Before taking a hit, consider these alternatives.

BY MARC ALLAIRE

The covered call has the reputation of being an extremely simple and safe strategy — just buy stock and sell call options against it. The goal is to collect premium if the stock trades sideways or rallies only to the option strike price by expiration. But what if the stock doesn't behave as expected?

Despite its conservative reputation, the covered call has a great deal of downside risk — similar to selling uncovered puts. If the stock sinks, you could lose almost as much as if you simply held an underlying long equity position. Admittedly, the option premium offers some protection, but a sharp drop could still be devastating.

Last month's article on covered calls (see "Related reading") focused on getting the most out of a winning covered call position using a technique called "rolling," which consists of buying back the short call and selling a same- or higher-strike call in a later-expiring month.

Here we'll examine how to fix flat or losing positions with similar tactics.

Going nowhere fast

Let's assume you entered a covered call trade a few months ago in Computer Sciences (CSC) when the stock was trading at $51.25 and the March 52.5 calls were trading at $1.00. On March 12, CSC was unchanged and the calls would expire in a few days. What should you do?

Although this is an options strategy, the underlying stock is your primary concern. You bought CSC because it had a bullish outlook, but you must now re-assess the situation. If that outlook has changed dramatically, you should let the calls expire and sell the stock. However, if your outlook is still bullish or just neutral, you could roll the position by letting the March 52.5 calls expire worthless and selling the April or May calls. Table 1 shows that at this point, April and May 52.5 calls could be sold for $1.00 and $1.40, respectively.

Some traders consider rolling the position an optimal situation: You keep the stock and sell a second series of calls. With any luck, the stock will remain unchanged for another month and the process can be repeated.

But if CSC truly flatlines, its option premiums will reflect this reduced volatility and may deflate enough that selling additional calls cannot be justi-

Strategy snapshot

Strategy:	Repairing a losing covered call.
Logic:	Sell calls to collect premium and lower the break-even point. If position faces unrealized losses of at least 5 percent, buy ATM calls and sell OTM calls on a one-for-two basis to offset some of this cost. Then, if stock regains momentum, try to exit repair spread cost-free and continue holding stock.
Criteria:	Covered call (long stock + short call) has unrealized losses. Outlook for underlying stock is at least neutral. If adding spread, the strike-price distance between the long and short call should be about half your per-share losses in the stock. For a stock down $5, for example, the spread between the strikes should be 2.5 points; for a stock down $10, look for five-point spreads.
Timing:	Establish repair position shortly after original short calls expire worthless.
Maximum profit (or min. loss):	Call strike - stock cost + total call premiums received.
Maximum loss:	Stock cost - total call premiums received.

fied. If this happens, you should sell CSC and move on.

Getting even: "Revenge" strategies

Next, let's assume you bought International Paper (IP) and sold the March 42.5 calls, which were out-of-the-money (OTM), for a combined debit of $38. By March 19, the stock had dropped to $35.50, and the covered call was underwater. The good news is the March 42.5 calls expired worthless, but the bad news is they expired far OTM, so you faced a per-share loss of $2.50.

Most importantly, you must decide if you are still comfortable holding IP. If the stock's outlook has changed, then sell it at a loss.

But what if the worst is over and IP drifts sideways for the next couple of months? If so, consider selling May 37.5 calls at $0.60 on March 19. At first glance, this appears dubious: Breaking even is the best-case scenario, because you agree to sell International Paper at $38.10 (37.5 call strike + $0.60 premium) when the position's cost was $38 (Table 2). But this trade went awry, so exiting and breaking even isn't a bad outcome. With any luck, you could roll the May 37.5 calls to the same-strike June or July calls and squeeze a small profit out of the position.

Advanced repairs

Now assume a couple of months ago you bought 500 shares of Dell Inc. (DELL) at $28.20 and sold five March 30 calls at $0.70 each for a net cost of $27.50 per share. On March 8, Dell traded at $22.50, and you faced an unrealized loss of $5. At this point, breaking even seems difficult. (This example assumes the 30 calls will

continued on p. 18

Covered write vs. buy write

Two roads lead to a covered call (long stock, short call): a "covered write" and a "buy-write." A covered write involves selling calls against a stock you already own. You may have bought the shares last week, last month, or last year, but you decide to sell calls against that stock now. Traders usually see the stock trading near their target price and think "If Caterpillar (CAT) climbs to $70 from $67.67 on Feb. 12, I want to sell it."

A buy-write is an alternate strategy that purchases the stock and sells calls simultaneously. Most brokers let you execute this as one trade. Traders who place buy writes are motivated by yield; they want to generate a certain return before the calls expire.

The examples shown here apply to either strategy. For simplicity, the term "covered call" is used.

TABLE 1 — SELLING CALLS FURTHER OUT ON COMPUTER SCIENCES

If CSC is unchanged after putting on the covered call, sell same-strike April or May calls and collect at least another $1 in premium. However, if your outlook is bearish or volatility has plummeted, sell the underlying shares and move on.

Position	Long/short	Credit/debit
Computer Sciences (CSC) at $51.25	Long	-$51.25
March 52.5 call	Short	$1.00
	Net debit:	**-$50.25**
Roll to repair: If the calls expire worthless on March 17, sell same-strike April or May calls:		
April 52.5 call	Short	$1
	or	
May 52.5 call	Short	$1.40
	Net debit:	**-$49.25 or -$48.85**

TABLE 2 — COLLECTING A SMALL GAIN ON INTERNATIONAL PAPER

If the underlying drops after you establish a covered call, try to sell slightly OTM calls (one or two months to expiration) to potentially break even.

Position	Combined debit
International Paper (IP) + short March 42.5 calls	-$38
IP traded at $35.50 on March 19	Unrealized loss -$2.50
Roll to repair:	**Credit**
Short May 37.5 call	$0.60
Best-case scenario:	Realized gain
IP trades above the short strike by May 19, stock is called away at $37.50, and you keep $0.60 premium.	$0.10

TABLE 3 — ADVANCED REPAIR — ADDING A SPREAD TO DELL

If this Dell covered call faces a $5 loss, buy August 22.5 calls and sell same-month 25 calls for a $0.20 per-share debit. This lowers the breakeven point to $25 from $27.50 without adding risk.

Covered call components	Long/short	Credit/debit
500 shares of Dell at $28.20	Long	-$28.20
5 March 30 calls at $0.70 each	Short	$0.70
Total cost and breakeven:		-$27.50
Dell traded at $22.50 on March 8.	Unrealized loss:	-$5.00
Repair strategy:		
5 August 22.5 calls	Long	-$9.50
10 25 August 25 calls	Short	$8.50
	Repair cost:	-$1 (-$0.20 per share)
	New break even point:	**$25**

expire worthless.) To lower Dell's average cost and reduce the breakeven point to $25, you could buy another 500 shares at $22.50.

There are a couple of problems with this approach, though. First, you would need an additional $11,250 in capital, which doubles your downside risk: If DELL continues to drop, every point costs $1,000.

In theory you could sell OTM calls, but the May 25 calls are bid at $0.20 and the May 27.5 calls are offered at $0.05 with no bid. It's going to be tough breaking even simply by writing calls.

How can you lower Dell's breakeven point but avoid adding more capital and increasing risk? First, buy five August 22.5 calls at $1.90. This adds leverage without any additional downside risk, because you will only exercise the calls to buy stock if it makes economic sense — i.e., if they are in-the-money (ITM).

Second, to partially offset the long call's cost, sell 10 August 25 calls at $0.85. No margin is required for writing these calls, because five are covered by the long stock position and the other five are covered by the long 22.5 calls.

Table 3 shows the details of the original covered call and this repair strategy. Entering the position costs just $1 ($8.50 short-call collected premium - $9.50 long-call paid premium). Ideally, you can enter the position for even money or for a small credit, but reality sometimes gets in the way; see "Repair strategies" for details about which expira-

TABLE 4 — POTENTIAL GAINS AND LOSSES

The repair strategy will do no harm if Dell trades flat or falls, while the break-even point drops to $25. However, if the stock rallies above $25, you will still break even.

DELL at August expiration	Value of DELL shares	Long August 22.5 calls	Short August 25 calls	Short August 25 calls	Total value
$20	$20.00	$0.00	$0.00	$0.00	$20.00
$22.50	$22.50	$0.00	$0.00	$0.00	$22.50
$25	$25.00	$2.50	$0.00	$0.00	$27.50
$27.50	$27.50	$5.00	-$2.50	-$2.50	$27.50
$30.00	$30.00	$7.50	-$5.00	-$5.00	$27.50

TABLE 5 — MINIMIZING A LOSS

Baker Hughes fell 11.6 percent below the covered call's breakeven point by March 19. Although you could have minimized this loss by selling May 65 calls for $2, you still would have lost at least $4. Selling the stock might be the best idea, depending on your outlook for BHI.

Position	Credit/debit
Baker Hughes (BHI) at $72	-$72.00
Short March 72.5 calls	$1.00
Net debit:	**-$71.00**
	Unrealized loss
BHI traded at $62.74 on March 16	-$8.26
Roll to repair:	
Short May 65 calls	$2.00
Best-case scenario:	**Smallest potential loss**
Baker Hughes hits or exceeds short 65 strike by May 18.	-$4.00

Repair strategies

If you own stock in need of repair, you might find the strategies outlined below appealing. It doesn't matter whether you acquired the shares as part of a covered call or simply bought them outright.

In most stocks, the option chain includes four expiration months — six if Long-Term AnticiPation Securities (LEAPS) are listed. These contracts offer a number of strike prices stretching from in-the-money (ITM) calls to deep out-of-the-money (OTM) calls, and they can be combined multiple ways — leaving you with little idea where to start. Here are a few pointers:

Start by choosing an expiration date. For stocks down 5 to 10 percent, look at three-month calls. For stocks that have fallen 15 to 20 percent, start with six-month calls.

Then pick a strike price to buy. Start with calls that are closest to the money. (You can fine tune this later.)

Finally, find a strike to sell. The strike-price distance between the long and short call should be about half your per-share losses in the stock. For example, for a stock down $5, the spread between the strikes should be 2.5 points; for a stock down $10, look for a five-point spread.

Buy one lower-strike call for each 100 shares held and sell two higher-strike calls. You should be able to establish the position cost-free or for a small credit or debit. Don't hesitate to pay $0.25 for this spread if it helps you break even on a $40 or $50 stock.

What if you can't establish the option trade for close to even money? If you are unwilling to pay a spread's debit, you will have to use longer-dated options. If the spread offers a large credit, you can either pocket this premium or use shorter-dated options. With a little practice, you should be able to find the right fit relatively quickly.

tion months and strike prices to use.

The best way to understand the complete position — long 500 shares, long five at-the-money (ATM) calls, short 10 OTM calls — is to analyze its value at expiration (Table 4). There are two columns for the short 25 calls, because you sold two of these calls for every 100 shares owned and for each 22.5 long call.

What does the strategy accomplish? First, if Dell falls or remains unchanged, the strategy does no harm — the long and short calls expire worthless and the position's risk is limited to the original 500 shares. (Of course, you lose an additional $1, but more about that later.) Also, if the stock rallies to $25, the position's value will rise to $25 and you break even — the same result as if you had bought another 500 shares at $22.50. However, this options strategy avoids the additional downside risk of buying more underlying stock.

Finally, if Dell rallies above $25, you still break even. This is the strategy's true cost: Its benefits — low entry cost and a lowered break-even point — are counterbalanced by its limited upside.

Practical considerations

Should you only establish this position if it's cost-free? Also, what if the stock rallies and you want to change your mind?

Let's first consider this repair strategy's cost. The position could be entered at a $0.20 per share debit. Is this paying too much? This increases the position's overall cost to $27.70, and Table 4 shows the position's maximum value is $27.50. Therefore, the best-case scenario is exiting at a $0.20 per-share loss — not a bad outcome for a stock that has been a major disappointment.

Let's assume you enter the repair strategy when Dell trades at $22.50 on March 8. If Dell rallies to hit $24, the strategy works in your favor. If it hits $25, you will feel like a genius, because the position is about to break even. At $26.25, you have second thoughts, and at $27.50 you wish you never repaired the stock. At this point, Dell finally starts to perform as originally expected — the outlook wasn't wrong, it was just early. Once the shares would have become profitable, they will get called away from you by the short call's holder.

How much would it cost to get out of this situation? Look at Table 4's option prices. If Dell trades at $27.50 at expiration on Aug. 18, each long August 22.5 call is worth $5.00 and two short 25 calls are worth $2.50 each. To unwind the trade, sell the long 22.5

continued on p. 20

Related reading

Marc Allaire articles:

"Rolling profitable covered calls"
Options Trader, April 2007.
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"Straddles vs. strangles, round two"
Options Trader, January 2007.
Neither strategy always outperforms the other. However, having a clear price forecast makes it easier to select the best position.

"Selecting calls based on ROI"
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Traders seem drawn to complex options strategies, but sometimes simply buying calls is the best way to catch an up move. Learn how to weigh the possibilities by comparing various calls' return on investment.

Other articles:

"Writing covered calls and puts"
Options Trader, June 2006.
Selling options against a position in the underlying instrument brings risk as well as opportunity. Learn how to build covered call and put positions and increase the odds of their success.

"Easing the pain: Options repair strategies"
Options Trader, May 2005.
It can be frustrating when the market doesn't go your way, but it doesn't have to be painful. Two option "repair" strategies — a bear put spread and a butterfly spread — can reduce an unprofitable long put's risk and preserve potential profitability.

"Covered writes: Where trading and investing meet"
Active Trader, June 2002.
Covered writes are a way to generate income on existing investments and boost overall returns.

"How to write a covered call"
Active Trader, August 2001.
The covered call is a good introduction to the simple uses of options. Here are the steps for selling options against stock you own.

"Taking cover with options"
Active Trader, May 2000.
Using covered calls can add flexibility to your trading plan.

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calls and buy back the short 25 calls for no cost ($25 long-call cost - $25 short-call cost). Changing your mind doesn't cost much, because you only have to pay the bid-ask spread (i.e., buy the ask and sell the bid) and commissions.

The point of no return

Finally, let's examine another losing covered call that is more difficult to repair. Let's assume you entered a covered call in Baker Hughes (BHI) when it traded at $72 on Feb. 14 and sold March 72.50 calls for $1 — a net debit of $71.

On March 16, expiration Friday, BHI is $62.74 and you now consider selling the May 65 calls for $2.00. The total investment is $71, so if you sell the 65 calls for $2.00, the potential effective selling price drops to $67 (65 short strike + $2 premium). If BHI hits or exceeds $65, you still face a $4 per-share loss. This doesn't make much sense. Why would anyone sell calls that effectively lock in losses?

The issue here is discipline, not when to sell covered calls. You now own shares of Baker Hughes outright without any calls written against the shares (i.e., no hedge). What should you do if it starts going down? Most disciplined investors place a stop order to sell shares and cut losses if a stock hits a predetermined level.

You are trying to cut your losses by selling the May 65 calls. If BHI rallies to $65, the stock will be called away, and you will be ready for the next investment opportunity. Of course, you should have at least a neutral outlook on the stock before selling calls against a losing position. If your forecast for BHI is now bearish, cut your losses in the most direct way — by selling the underlying shares.

For information on the author see p. 6.

Squeezing extra profits from long calls

These spreads can boost profit and lower risk if you build them from an already-profitable long call.

BY PHILIP BUDWICK

One of the benefits of trading options is that you can adjust a position to either lock in profits or limit risk. But just because you can tinker with an options trade doesn't always mean you should.

Adjustments are often discussed in terms of how to "repair" a losing trade by changing a trade's risk profile to fit a different market outlook. The following discussion instead focuses on adjusting a profitable long call position. A long call can act as a building block for various spreads — bull call spreads, call ratio spreads, or butterflies — that can be tailored to different market forecasts.

Also, the same techniques can be applied to a long put. The goal in either case is to extract as much profit as possible when the underlying market moves in your direction.

Strategy snapshot

Strategy:	Building on a profitable long call.
Positions:	*Bull call spread:* Winning long call + short same-month, higher-strike call. *Bull call spread + call*: Bull call spread components + long same-month call two strikes above the initial one. *Call ratio spread:* Bull call spread components + one extra short call. *Long call butterfly:* Call ratio spread components + one higher-strike long call.
Logic:	To capture profits from the long call without giving up the possibility of additional gains.
Criteria:	The long call has gained at least 50 percent; the underlying price forecast is neutral or better; the options expire in roughly six weeks. Leg into all spreads with a credit.
Best-case scenario (at expiration):	• *Bull call spread:* Stock closes at short strike. • *Bull call spread + call*: Stock climbs sharply. • *Call ratio spread:* Stock closes at short strike. • *Long call butterfly:* Stock closes at short strike.
Worst-case scenario (at expiration):	• *Bull call spread:* Stock drops below long strike. • *Bull call spread + call*: Stock drops below long strike. • *Call ratio spread:* Stock climbs sharply. • *Long call butterfly:* Stock drops or climbs sharply.

Bull call spread

Let's assume you were bullish on Apple Inc. (AAPL) on April 4 when it was trading at $94.50 and you bought one May 95 call at $4.60. The long call's premium represents its maximum risk, while its maximum reward is unlimited (Figure 1). Ideally, AAPL will trade higher by expiration on May 19 and the call will increase in value. If Apple climbs 7.9 percent to $102 within two weeks, the long 95 call will increase in value to approximately $8.50, which represents a $3.90 profit.

Say you expect AAPL to move higher but you also are concerned the stock is now trading near its 52-week high and could sell off. If the stock drops, the long call's profits will disappear. But if you sell it now, Apple might continue rallying and you would miss out on additional gains, especially since the call doesn't expire for 30 days.

One way to lock in some profit with-

out giving up future gains is to convert the position into a bull call spread by selling a higher-strike call with at least enough premium to cover the long call's initial cost. If Apple was trading at $102 on April 18, you could sell the May 100 call for $5.25 and create a bull call spread for a net credit of $0.65 ($5.25 short 100 call premium - $4.60 long 95 call premium).

A bull call spread typically requires a debit — that is, you pay out more in premium than you collect — because the long call is closer to the money and more expensive than the short, higher-strike call. However, you bought a call and waited for it to increase in value before selling another May call to create the spread — a technique called "legging." This approach guarantees a minimum profit of $0.65 — the spread's credit — regardless of whether AAPL rallies or plummets by expiration (Table 1).

If Apple is trading below $95 by May 19 the calls will expire worthless and you will keep the $0.65 credit. But if the stock is trading above the short 100 call's strike price at expiration, the spread will gain another $5 — the difference between the strikes, which represents the spread's maximum gain. Because you legged into the bull call spread for a net credit, you will keep that entire premium, too. Therefore, the adjusted position's maximum profit is $5.65 ($5.00 from spread + $0.65 credit).

Figure 2 shows the adjusted position's potential gain at expiration. The trade's maximum profit is capped at $5.65, which is the trade-off for removing the position's risk.

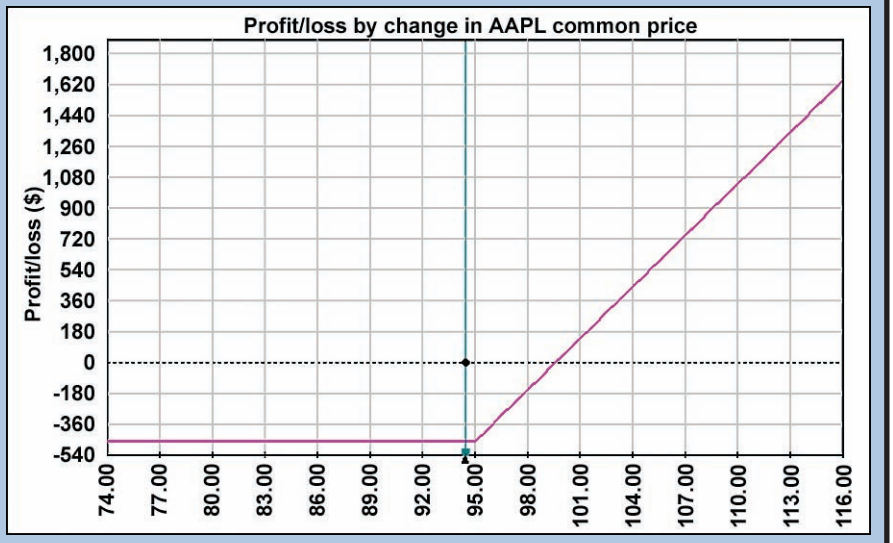
Bull call spread plus call

However, if a stock is still in a strong uptrend after you leg into a bull call spread, that trade-off — reduced risk for limited gains — might not be worthwhile. Let's assume you hold a May 95-100 bull call spread on AAPL for a $0.65 credit, but you believe Apple will rally more. At this point, you could buy a same-month

continued on p. 24

FIGURE 1 — LONG CALL RISK PROFILE

This long May 95 call risks $4.60 but has unlimited potential gains if Apple rallies strongly by expiration.



Source: OptionVue

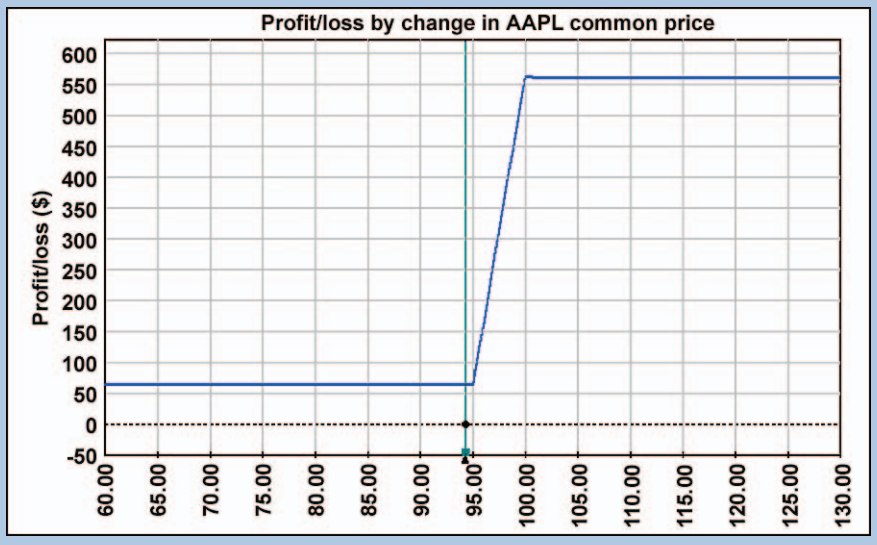
TABLE 1 — LEGGING INTO A BULL CALL SPREAD

After the long May 95 call increases in value, you can sell a same-month OTM call to lock in some gains without giving up all additional profits. However, gains are limited to $5.65, which is the tradeoff for taking the risk out of the position.

Position	Long/short	Credit/debit
1 May $95 call when AAPL traded at $94.50.	Long	-$4.60
If AAPL rallies to $102, sell OTM call to create bull call spread:		
1 May $100 call	Short	$5.25
	Net credit:	**$0.65**
Scenario:		
AAPL drops below $95 by May 19 expiration.	"Worst-case" gain:	$0.65
AAPL trades above $100 by same date.	Maximum gain:	$5.65

FIGURE 2 — BULL CALL SPREAD RISK PROFILE

Entering this bull call spread after the long May 95 call increases in value guarantees a profit even if Apple drops below $95.



Source: OptionVue

TABLE 2 — BULL CALL SPREAD + LONG CALL

Adding a long 105 call to the spread creates a small downside risk but restores the position's upside potential.

Bull call spread components	Long/short	Credit/debit
1 May $95 call	Long	-$4.60
1 May $100 call	Short	$5.25
	Net credit:	**$0.65**
Add long call:		
1 May 105 call	Long	-$2.65
	Total position debit:	**-$2.00**

call one strike above the spread to restore the original long call's unlimited upside potential. The bull call spread's credit helps purchase this additional long call at a reduced cost.

If Apple is trading at $102 on April 18, a May $105 call would cost $2.65. The entire position (long 95 call, short 100 call, long 105 call) costs only $2 ($2.65 option cost - $0.65 spread credit; see Table 2). The $2 debit also represents the trade's maximum risk, which is less than the original long 95 call's largest potential loss of $4.60. Also, the adjusted position has the same unlimited upside profit potential as the initial long 95 call.

Figure 3 compares the 95-100 bull call spread's potential profits to the adjusted position's risk profile at the May 19 expiration. Adding a long 105 call to the spread introduces a small downside risk but enhances upside potential.

If the market was trending strongly, you could repeat the process in the next expiration month — e.g., by purchasing an at-the-money (ATM) June call, waiting for it to gain ground before legging into a risk-free bull call spread, and then adding long calls at higher strikes to lock in various profitable positions at expiration. This technique keeps risk low while still exploiting Apple's continued climb. You will lose money only if the stock doesn't move as expected and falls below $96.75.

Remember this adjustment works best when you expect a stock to soar and you want to buy calls and then add bull call spreads as it trades higher. Of course, if you're not as bullish, selling the original long 95 call at a profit might be a better idea.

Call ratio spreads for flat markets

To review, on April 4 you bought a May 95 call for $4.60 when AAPL traded at $94.50 and the stock rallied to $102 by April 18. If you expect the stock to be range-bound over the next few weeks, you could convert the position into a call "ratio" spread by selling two higher-strike calls for each long call. This trade allows you to take partial profits from the long call and then benefit from a sideways market.

The adjustment is similar to entering a bull call spread, but instead of selling one higher-strike call you sell two, creating a 1:2 ratio of long to short call options. Unlike a bull call spread, a call ratio spread includes at least one naked, or unprotected, short call — which means risk and margin levels are higher. You should only consider this adjustment if you expect Apple to trade sideways and can manage the

risks of an additional naked call. If AAPL rallies sharply, you could face unlimited losses, because you must buy stock and sell it to the call holder at the strike price, which will be below the market.

To create a call ratio spread in Apple options, you could sell two May 100 calls for $10.50 ($5.25 each). The long 95 call becomes a 95-100 call ratio spread with a net credit of $5.90 ($10.50 short premium - $4.60 long 95 call premium). Table 3 shows the details of this adjustment and Figure 4 compares the potential gains and losses of the 95 long call (purple line) to the call ratio spread (green line).

If Apple declines to $95 or below by expiration on May 19, all of the calls will expire worthless and you will keep the adjusted position's $5.90 credit. Therefore, you have avoided all downside risk. If AAPL trades between $95 and $100, the short 100 calls will expire worthless, and you can sell the 95 call at its intrinsic value (up to $5). So if Apple trades at $100 at expiration, the call ratio spread's profit will be $10.90.

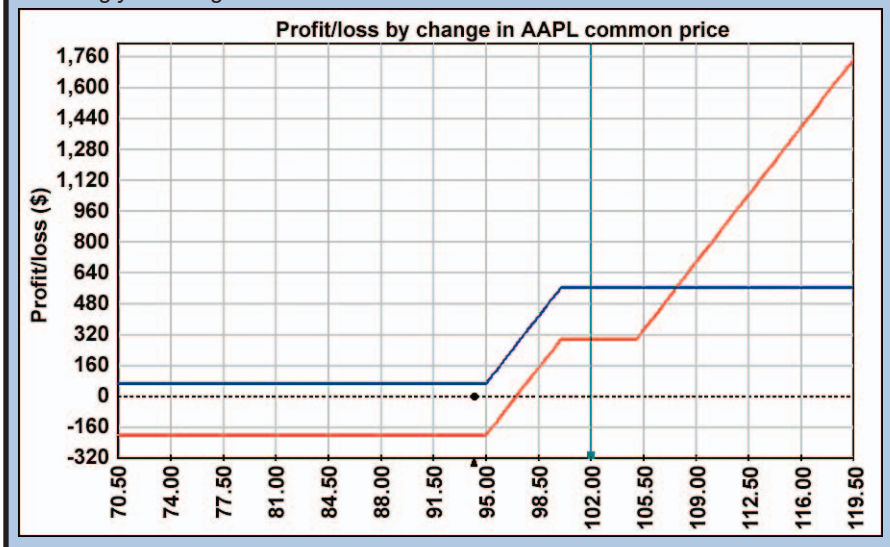
As AAPL moves above $100, the extra short call starts to cut into profits until the stock climbs to $110.90, which is the position's break-even point. In this case the long 95 call will be worth $15.90 and the two short $100 calls will be worth $21.80 total — a net loss of $5.90, which is offset by the spread's $5.90 credit.

Figure 4 shows the call ratio spread profits if the stock falls dramatically, and its largest profit occurs at the 100 short strike. However, if the stock trades sideways after hitting $102, the ratio spread has a wide profit zone and even makes money if the stock drops below the original long call's

continued on p. 26

FIGURE 3 — BUYING A HIGHER-STRIKE CALL

The 95-100 bull call spread's potential profits are compared to the adjusted position's risk profile at May 19 expiration (blue and red lines, respectively). Buying a 105 call reintroduces downside risk but lets you continue to profit from a strongly trending market.



Source: OptionVue

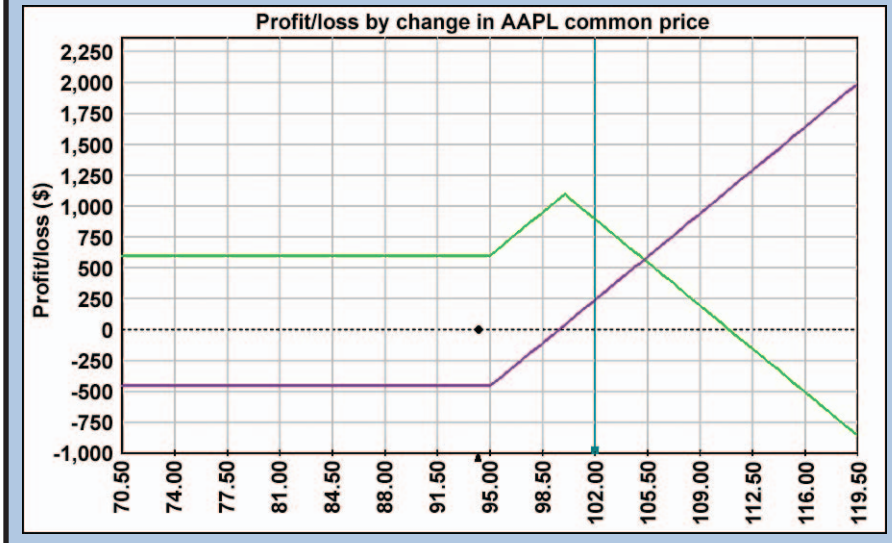
TABLE 3 — CALL RATIO SPREAD

Instead of entering a 95-100 bull call spread, consider selling two May 100 calls to capture more premium if you expect Apple to trade sideways. However, such "ratio spreads" have an uncovered short call that can generate big losses if the stock rallies strongly.

Position	Long/short	Credit/debit
1 May $95 call	Long	-$4.60
Convert to call ratio spread:		
2 May $100 calls	Short	$10.50
	Total credit:	**$5.90**

FIGURE 4 — LONG CALL VS. CALL RATIO SPREAD

Converting a profitable long call into a call ratio spread (green line) removes all downside risk. However, you should avoid this adjustment if you feel the stock could still rally before the May calls expire.



Source: OptionVue

TABLE 4 — LONG CALL BUTTERFLY

Building a long call butterfly from a profitable long May 95 call locks in a "worst-case" profit of $3.25, and the spread can gain more ground if the stocks trades sideways by expiration.

Position	Long/short	Credit/debit
1 May $95 call	Long	-$4.60
Convert to long call butterfly:		
2 May $100 calls	Short	$10.50
1 May 105 call	Long	-$2.65
	Total credit:	**$3.25**

strike price (95).

Avoid this adjustment if you feel the stock could still rally before the long call expires, because it will lose value. Nonetheless, the call ratio spread is flexible: It works best in flat markets, but it also offers a small cushion if the stock edges slightly higher. In the Apple example, the call ratio spread becomes a loser only if the stock rallies more than 8.7 percent within a month.

Long call butterfly

Let's assume you expect Apple to trade sideways until the May expiration, but you don't want the upside risk of selling naked calls. In this case, after the stock rallies from $95 to $102 you could convert the long May 95 call into a long call butterfly that locks in partial profits and offers additional gains if AAPL goes nowhere.

With Apple trading at $102, the May 100 and 105 calls would cost $5.25 and $2.65, respectively. To convert the long 95 call to a long butterfly, you could sell two 100 calls for a combined credit of $10.50 and buy one 105 call for $2.65 (a net credit of $7.85). The adjusted 95-100-105 call butterfly offers a credit of $3.25 ($7.85 - $4.60 long 95 call's cost).

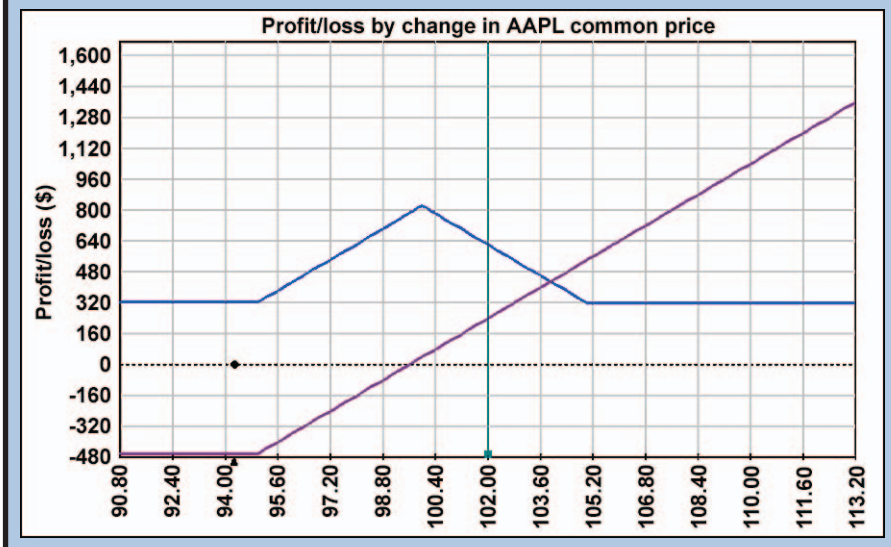
Table 4 shows the butterfly's components and Figure 5 compares the adjusted position's risk profile to that of the original long 95 call (blue and purple lines, respectively).

If AAPL is trading below $95 at expiration on May 19, all the calls will expire worthless and you would keep the $3.25 premium. On the other hand, if the stock moves sideways and trades between $95 and $105, the butterfly could gain up to $5, which is the distance between each of its strikes. Finally, if Apple rallies above the highest strike ($105) by expiration, the short calls' losses offset the long calls' gains. This outcome is identical to a sharp sell-off in the stock — you still keep the spread's $3.25 credit.

Figure 5 shows how converting a winning long call into a butterfly can be a clever adjustment, because you can take profits now and potentially earn more if the stock goes nowhere.

FIGURE 5 — LONG CALL VS. BUTTERFLY

If Apple drops below $95 or rallies above $105 by expiration on May 19, the long call butterfly (blue line) still collects $3.25 premium. But if the stock moves sideways as expected, the butterfly could gain an additional $5.



Source: OptionVue

The volatility factor

Overall, these adjustments won't be hurt by changes in implied volatility (IV) because IV will likely rise as the original long call becomes profitable. This means you could be able to collect more premium when selling calls to adjust the trade.

For example, if the stock moves higher and IV increases, selling a higher-strike call to create a bull call spread works in your favor. Changes in volatility will not affect the spread significantly, because while an IV

drop might hurt the long call, it should help the short call. Therefore, if IV drops you still have a cost-free call spread with a guaranteed profit.

Similarly, selling two calls to build a call ratio spread works best when IV is relatively high, because the position is short volatility overall. Again, if implied volatility is high, you will receive more premium to cover the long call's original cost.

Additional premium also provides a bigger net credit and raises the adjusted position's breakeven point. If IV collapses, the position can profit simply from a decrease in volatility.

IV changes affect long butterflies in a similar way. If IV increases, the butterfly offers a larger credit, which translates to more potential profit. Butterflies are sensitive to implied volatility, so it is preferable to enter one when IV is high. If IV declines and the stock stays flat, the butterfly will increase in value.

Finding the edge

The key to enhancing returns is matching the most appropriate adjustment to your forecast of the underlying. Ideally, these changes will increase potential profits and minimize risk.

For example, converting a profitable long call into a bull call spread plus call works well in strongly trending markets. However, you shouldn't convert a winning long call into a call ratio spread in the same type of market.

But if your long call has nearly doubled in value and you don't know how the underlying stock will behave in the next month, simply close the position at a profit and move on.

For information on the author see p. 6.

Related reading

Philip Budwick articles:

"Calendar spreads surrounding earnings news," *Options Trader*, March 2007.
Trading options on stocks just before a company reports earnings isn't always a great idea, but this strategy takes advantage of the market's uncertainty in these situations.

"Avoiding options trading mistakes," *Options Trader*, February 2007.
Some of the most popular option trades are based on faulty assumptions about how options behave. This discussion of common mistakes and misconceptions might surprise you.

"Directional butterfly spreads," *Options Trader*, December 2006.
Butterflies aren't just market-neutral strategies. They can be used to make directional bets with better risk-reward ratios than outright option purchases or simple vertical spreads.

"Combining call calendar spreads with stock," *Options Trader*, October 2006.
Adding a calendar spread to an underlying position instead of simply creating a covered call offers some surprising benefits. The combined strategy helps lock in profits without sacrificing further upside gains.

"Selling premium with a twist," *Options Trader*, August 2006.
Ratio put spreads offer more potential profit than other premium selling strategies such as naked puts or simple credit spreads. And these trades are more flexible than they initially seem.

"Ratio call spreads," *Options Trader*, June 2006.
Ratio call spreads can enhance an underlying position's potential gains at no extra cost, or in many cases, for a net credit.

Other articles:

"Managing profitable trades," *Options Trader*, August 2006.
Handling a profitable option trade might seem easy, but it can be difficult to decide whether to cash out or hold on for further gains.

"The art of adjustment," *Options Trader*, October 2005.
Adding an out-of-the-money short put to a bull call spread can boost potential profits as long as the market remains bullish, but it also increases downside risk. We'll explore two "repair" scenarios — how to minimize an unprofitable trade's loss and exit a winning trade while optimizing returns.

"Easing the pain: Option repair strategies," *Options Trader*, May 2005.
It can be frustrating when the market doesn't go your way, but it doesn't have to be painful. Two option "repair" strategies — a bear put spread and a butterfly spread — can reduce an unprofitable long put's risk and preserve potential profitability.

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ADX Consolidation Breakout 1

Market: Futures.

System concept: This system is designed to trade breakouts from consolidations defined by the Average Directional Movement Index (ADX), an indicator designed to measure whether a price is trending without regard to the direction of the trend.

When the ADX is below a specified threshold, directional movement will be defined as low, implying a flat or dull market. (The traditional interpretation of the ADX is that a value above 25 indicates a trending market.)

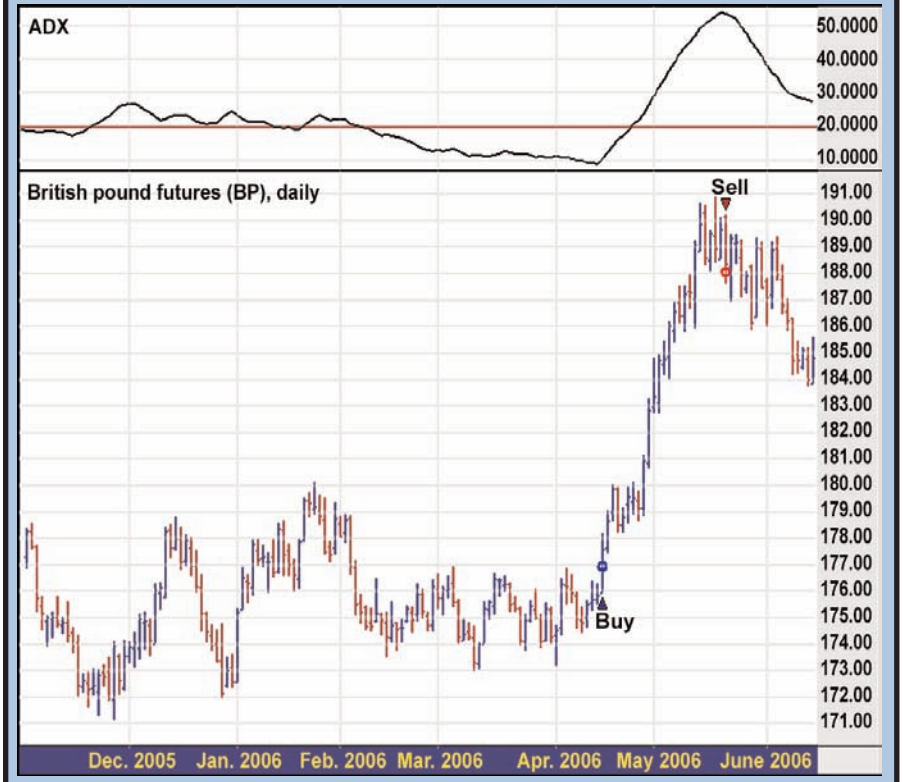
The longer the indicator remains at a low level, the more likely a strong trending move will emerge. The system defines a directionless, range-bound market as one that has had an ADX reading at or below 20 for 30 trading days. At this point, the system uses a simple channel breakout rule to enter the market.

Figure 1 shows a breakout trade from a lengthy consolidation in the British pound futures (BP). Notice the ADX remained below 20 for two months prior to the trade signal.

Figure 2 shows a short trade in sugar (SB). Although this trade was profitable, notice how the system failed to capitalize on the preceding uptrend from December 2005 to January 2006. Later, we will explain why.

FIGURE 1 — LONG TRADE EXAMPLE

A prolonged low ADX reading sets the stage for an upside breakout trade.



Source: Wealth-Lab

Strategy rules:

1. If the 14-day ADX has remained under 20 for the past 30 trading sessions, then either:
   a) **enter long** the next day with a stop at the highest high of the past 20 days, or
   b) **enter short** the next day with a stop at the lowest low of the past 20 days.
2. **Close long** position tomorrow with a trailing stop at the lowest low of the past five days.
3. **Cover short** position tomorrow with a trailing stop at the highest high of the past five days.

Risk control and money management: Risk 2 percent of account equity per position. No stops are used.

Starting equity: $1,000,000 (nominal). Deduct $8 commission and 0.1 percent slippage per trade.

Test data: The system was tested on the *Active Trader* Standard Futures Portfolio, which contains the following 20 futures contracts: British pound (BP), soybean oil (BO), corn (C), crude oil (CL), cotton (CT), E-Mini Nasdaq (NQ), E-Mini S&P 500 (ES), 5-year T-note (FV), euro (EC), gold (GC), Japanese yen (JY), coffee (KC), wheat (W), live cattle (LC), lean hogs (LH), natural gas (NG), sugar (SB), silver (SI), Swiss franc (SF), and 30-year T-Bond (US). Data source: ratio-adjusted price data from Pinnacle Data Corp (www.pinnacledata.com).

Test period: April 1997 to March 2007.

Test results: The results give reason for optimism. Over the 10 years of test data the system posted a net profit of 136 percent and an annualized gain of almost 9 percent after commissions and slippage. Notice the steady, low-volatility ascent of the equity curve in Figure 3. Also, the lines representing long and short trades are relatively balanced: When one takes a rest, the other tends to kick into gear.

Eight of the 11 years were profitable (Figure 4). The worst annual return was less than -3.9 percent. Also, profits were fairly evenly distributed across the portfolio; only four of the 20 markets produced net losses.

The maximum drawdown was a tolerable -15.3 percent (Figure 5), and the average drawdown was only -3.3 percent. Figure 6 shows it took the system 507 days to overcome its

continued on p. 30

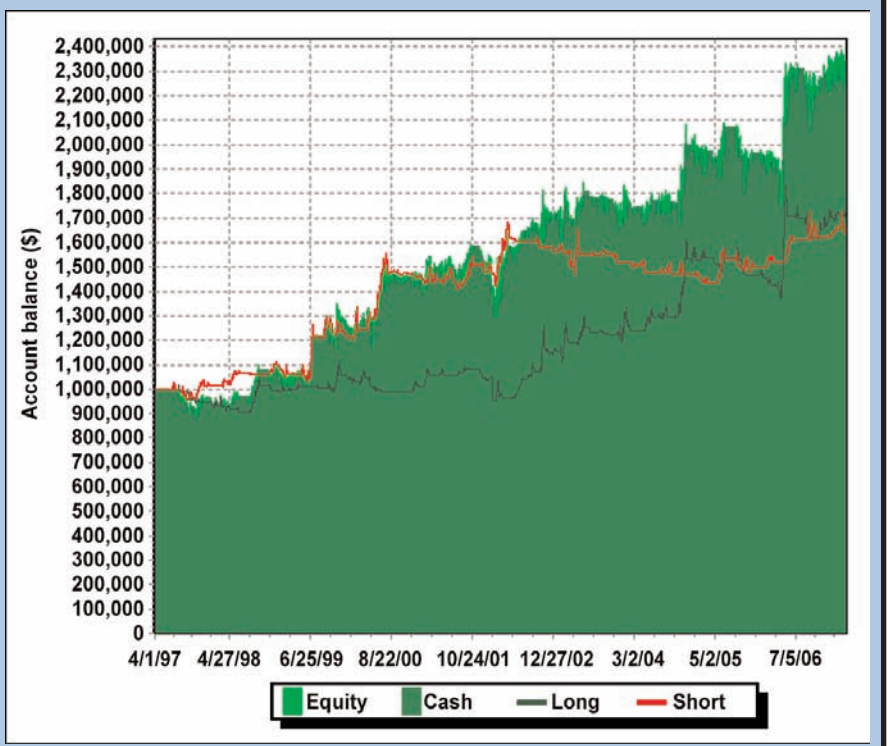
FIGURE 2 — SHORT TRADE EXAMPLE

The system takes trades only after periods of low directional movement, so it will miss some moves when the market is already trending.

Source: Wealth-Lab

FIGURE 3 — EQUITY CURVE

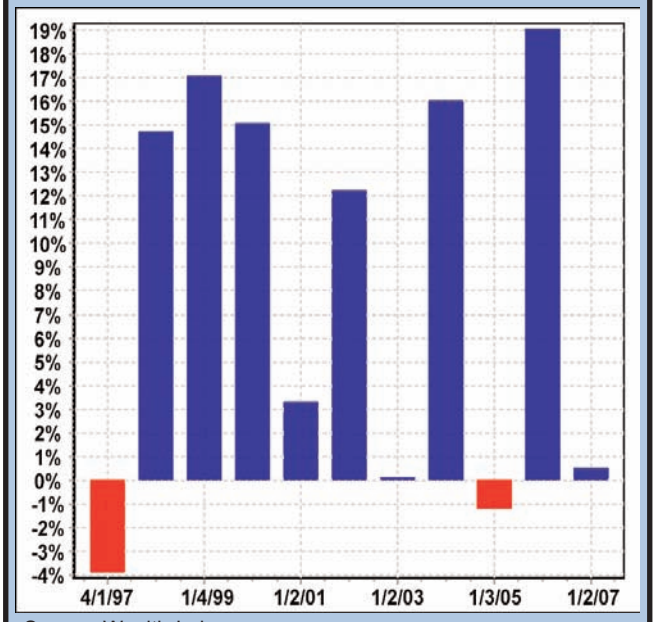
Equity growth was relatively smooth and steady.



Source: Wealth-Lab

FIGURE 4 — ANNUAL RETURNS

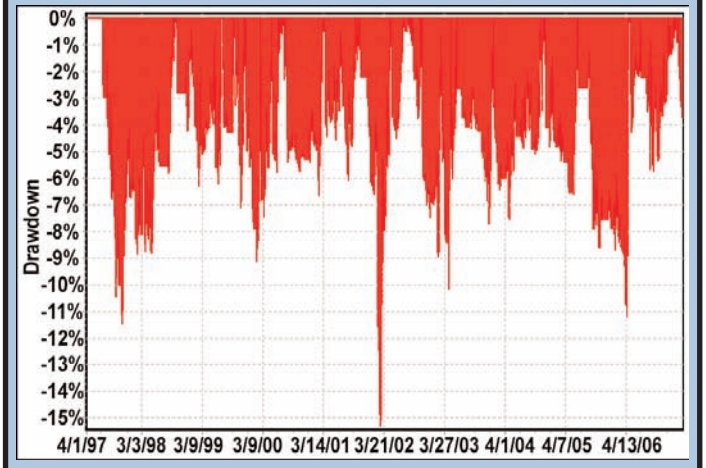
The system had only two losing years during the test period.



Source: Wealth-Lab

FIGURE 5 — DRAWDOWN

Both the maximum and average drawdown numbers were moderate.



Source: Wealth-Lab

longest drawdown, while recovery from other drawdowns was relatively quick (around 70 days on average).

The average trade size was a solid 0.60 percent, but because of its quick-exiting trailing stop, this is not a system to ride trends until they end. (It would be logical to test a combination of the system's entry rules and a good trend-following exit.) However, the system has low market exposure (2.4 percent) because positions are held less than 10 days on average. Winners lasted three times as long as losers (14.5 vs. 5.7 days) on average.

Another important characteristic is the system's rather low number of trades — only 318 trades over 10

STRATEGY SUMMARY

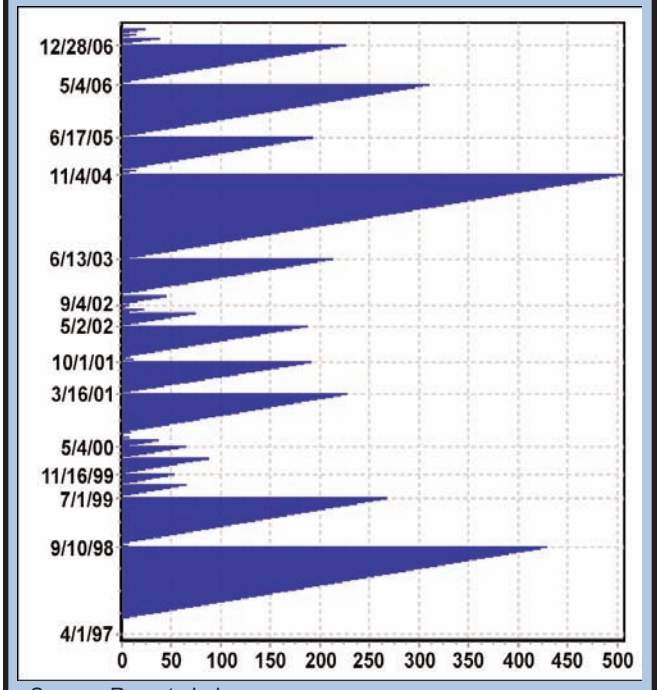
Profitability		**Trade statistics**	
Net profit ($):	1,362,080.10	No. trades:	318
Net profit (%):	136.21	Win/loss (%):	45.60
Profit factor:	1.61	Avg. profit/loss (%):	0.58
Payoff ratio:	1.85	Avg. holding time (days):	9.68
Recovery factor:	5.49	Avg. profit (winners):	3.58
Exposure (%):	2.36	Avg. hold time (winners):	14.50
Drawdown		Avg. loss (losers) %:	-1.94
Max. DD (%):	-15.29	Avg. hold time (losers) :	5.64
Longest flat period:	507 days	Max consec. win/loss:	7/7

PERIODIC RETURNS

	Avg. return	Sharpe ratio	Best return	Worst return	Percentage profitable periods	Max consec. profitable	Max consec. unprofitable
Monthly	0.78%	0.23	12.15%	-11.56%	51.67	6	7
Quarterly	2.31%	0.42	19.28%	-6.54%	62.50	9	3
Annually	8.44%	0.98	19.04%	-3.89%	81.82	7	1

FIGURE 6 — DRAWDOWN DURATION CHART

In addition to having fairly tame drawdowns, the system was also relatively quick to recover from them.



Source: Reports-Lab

years, which comes out to 1.6 trades per market per year. This might seem very picky but it is not a case of over-optimization — there are only five numerical arguments in the trade rules, so the system is not bogged down with parameters.

The answer can be seen in Figure 2. Because it ignores expressly trending markets, the system acts on opportunities only when price has settled into a directionless range. But it would be wise to conduct additional tests in different time frames, markets, or both, before drawing too-firm conclusions.

The default 30-day period for validating a low-directional condition is also subject to further optimization; certain markets might have tendencies to work better with longer or shorter periods.

Bottom line: This ADX-based breakout system produced solid returns with low volatility throughout the test period. In addition to serving as a complementary system to other types of systems, it could potentially function as a good entry filter.

— Volker Knapp of Wealth-Lab

LEGEND:

Avg. hold time — The average holding period for all trades.

Avg. hold time (losers) — The average holding time for losing trades.

Avg. hold time (winners) — The average holding time for winning trades.

Avg. loss (losers) — The average loss for losing trades.

Avg. profit — The average profit for all trades.

Avg. profit (winners) — The average profit for winning trades.

Avg. return — The average percentage for the period.

Best return — Best return for the period.

Exposure — The area of the equity curve exposed to long or short positions, as opposed to cash.

Longest flat period — Longest period (in days) between two equity highs.

Max consec. profitable — The largest number of consecutive profitable periods.

Max consec. unprofitable — The largest number of consecutive unprofitable periods.

Max consec. win/loss — The maximum number of consecutive winning and losing trades.

Max. DD (%) — Largest percentage decline in equity.

Net profit — Profit at end of test period, less commission.

No. trades — Number of trades generated by the system.

Payoff ratio — Average profit of winning trades divided by average loss of losing trades.

Percentage profitable periods — The percentage of periods that were profitable.

Profit factor — Gross profit divided by gross loss.

Recovery factor — Net profit divided by max. drawdown.

Sharpe ratio — Average return divided by standard deviation of returns (annualized).

Win/loss (%) — The percentage of trades that were profitable.

Worst return — Worst return for the period.

For information on the author see p. 6.

Futures Lab strategies are tested on a portfolio basis (unless otherwise noted) using Wealth-Lab Inc.'s testing platform. If you have a system you'd like to see tested, please send the trading and money-management rules to editorial@activetradermag.com.

Disclaimer: The Futures Lab is intended for educational purposes only to provide a perspective on different market concepts. It is not meant to recommend or promote any trading system or approach. Traders are advised to do their own research and testing to determine the validity of a trading idea. Past performance does not guarantee future results; historical testing may not reflect a system's behavior in real-time trading.

Directional calendars on the S&P 500

Market: Options on the S&P 500 index (SPX). The strategy could also be applied to other stock indices, ETFs, and stocks with liquid options contracts.

System concept: This lab compares two strategies with similar profiles: a horizontal calendar spread and a butterfly spread. Both positions try to collect premium from short options and protect them with long options, but they protect against large losses differently. Calendars have long options in later-expiring months, while butterflies have long options at different strikes above and below the market.

Despite these differences, both strategies have a common goal: to sell strikes at (or near) where the underlying may trade at expiration. Depending on your forecast, this technique could be market-neutral (selling at-the-money options) or directional (selling out-of-the-money options).

A previous options lab ("Directional butterflies on the S&P 500," *Options Trader*, November 2006) used technical analysis to place directional butterfly trades in S&P 500 index options, an approach that gained 213 percent (40.1 percent annualized) over a five-year test period.

This lab tests directional calendar spreads on the S&P 500 using some of the same rules. Calendar spreads involve selling options in the front month and buying the same number of contracts at the same strike price in a later-expiring month. Figure 1 shows the potential gains and losses of a bearish calendar spread placed on May 12, 2006 and held through May 17, 2006. With the S&P trading at 1,291.20, the spread contained five short June 1,270 puts and five long July 1,270 puts. (The same formula was used in both labs to identify short strikes — see Trade rules.)

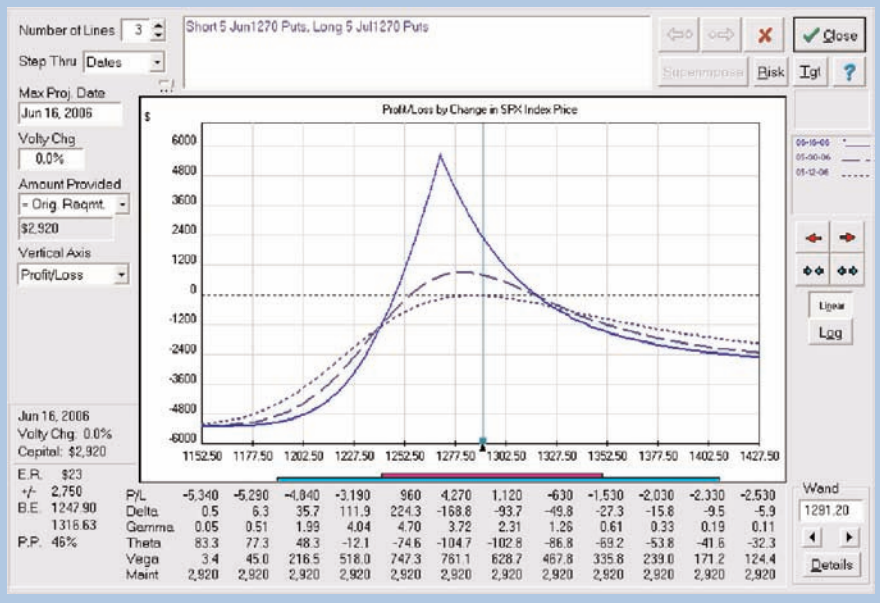
Figure 1's calendar spread would have earned its maximum profit if the S&P 500 closed at the 1,270 strike by June 17 expiration, so the S&P 500 needed to drop 21.20 points. If this occurred, the short June 1,270 puts would have expired worthless and the long July 1,270 puts would have had high intrinsic value.

This calendar spread had a wider profit zone than a butterfly spread entered with the same rules. The calendar's downside breakeven point was 0.92 points lower (1,247.90 vs. 1,248.82), and its upside breakeven point was 25.42 points higher (1,316.63 vs. 1,291.21). However, this flexibility ignores possible changes in implied volatility that affect calendar spreads more than butterflies. Figure 1's calendar spread had a vega of 3.18, which means it would lose $318 for every one-point drop in implied volatility.

The system uses a 50-day simple moving average (SMA) and the stochastic oscillator to identify bullish and bearish conditions. First, it enters bullish calendar spreads when the S&P 500 is above its 50-day SMA, while it places bearish spreads when the S&P is below its 50-day SMA. Second, the strategy uses a stochastic oscillator with 15-12-5 settings to determine whether or not the S&P 500's momentum is accelerating. The system enters a bullish spread when the S&P 500's relative price rises and enters a bearish spread when its relative price declines. (Both indicators must point in the same direction before trades are entered.)

FIGURE 1 — BEARISH CALENDAR SPREAD — MAY 2006

The system's directional rules entered this bearish calendar spread just before the S&P 500 fell another 1.64 percent in mid-May 2006.



Source: OptionVue

Bullish and bearish conditions: Place a bullish calendar spread when the following criteria are met:

Stochastic crossover: the %K line crosses above the %D line and the S&P 500 closes above its 50-day SMA. %K must be below 70, however, to avoid overbought situations.

Moving-average crossover: the S&P closes above its 50-day SMA while %K is above %D but still below 70.

A bearish calendar spread is entered if the opposite scenario occurs (i.e., %K must stay above %D but below 30).

Trade rules:

Bullish entry

1. Sell five calls in the first expiration month with 30 (or more) days available. The strike should be approxi mately one-half a standard deviation above the current price. This standard deviation is calculated

using the implied volatilities of the ATM call's bid andask prices.

2. Buy five same-strike calls in the next expiration month

Bearish entries use the same rules, except the calendar spread is constructed with puts.

Exit when any of the following conditions occur:

1. Both the stochastic and moving-average indicators signal an opposite trend.
2. The S&P 500 touches the short strike.
3. If the calendar is still open on the Friday one week before options expiration, exit at the close.

FIGURE 2 — CALENDAR SPREAD PERFORMANCE

Placing directional calendar spreads on the S&P 500 would have nearly doubled your money from January 2001 to August 2006. But this performance lagged the directional butterfly approach because of decreasing implied volatility.

Source: OptionVue

Test details:

- The test account began with $10,000.
- Commissions were $5 base fee plus $1 per option.
- Prices executed between the bid and ask, when available. Otherwise, theoretical prices were used.

Test data: The system was tested on cash-settled S&P 500 index (SPX) options at the CBOE.

Test period: Jan. 18, 2001 to Aug. 2006.

Test results: Figure 2 tracks the directional calendar spread's performance, which gained $9,780 (97.8 percent) from January 2001 to August 2006. A majority of the trades were profitable (62 percent), nearly matching the directional butterfly's success rate, although both positions didn't always gain or lose ground together in the same month.

The calendar spread gained 17.5 percent annualized, which demonstrates a clear trading edge, but this performance nonetheless lagged the butterfly's annualized return of 40.1 percent (see Strategy Summary). Overall, the calendar spread wasn't as profitable because of the drop in implied volatility in the past several years. The calendar spread will likely outperform the butterfly spread during periods of increasing volatility.

Although this test included minimal commissions, higher fees will likely affect the performance of both strategies. Always include accurate brokerage fees and consider the effect of bad fills before trading any position.

— Steve Lentz and Jim Graham of OptionVue

STRATEGY SUMMARY

	Calendars	Butterflies
Net gain ($):	9,780.00	21,350.00
Percentage return (%):	97.8	213.5
Annualized return (%):	17.5	40.1
No. of trades:	58	55
Winning/losing trades:	36/22	34/21
Win/loss (%):	62	62
Avg. trade ($):	168.62	388.18
Largest winning trade ($):	3,160.00	5,330.00
Largest losing trade ($):	-2,890.00	-2,595.00
Avg. profit (winners):	847.50	1,271.18
Avg. loss (losers):	-942.27	-1,041.43
Avg. hold time (winners):	14	16
Avg. hold time (losers):	19	15
Max consec. win/loss :	10/5	7/3

Option System Analysis strategies are tested using OptionVue's BackTrader module (unless otherwise noted).

If you have a trading idea or strategy that you'd like to see tested, please send the trading and money-management rules to Advisor@OptionVue.com.

LEGEND:

Net gain – Gain at end of test period, less commission

No. trades – Number of trades generated by the system

No. of winning trades – Number of winners generated by the system

No. of losing trades – Number of losers generated by the system

Win/loss (%) – The percentage of trades that were profitable

Avg. trade – The average profit for all trades

Largest winning trade – Biggest individual profit generated by the system

Largest losing trade – Biggest individual loss generated by the system

Avg. profit (winners) – The average profit for winning trades

Avg. loss (losers) – The average loss for losing trades

Ratio avg. win/ avg. loss – Average winner divided by average loser

Avg. hold time (winners) - The average holding time for winning trades

Avg. hold time (losers) – The average holding time for losing trades

Max consec. win/loss – The maximum number of consecutive winning and losing trades

Pump up the volume

Move to ICE heats up NYBOT softs

Electronic trading of the "soft" contracts — sugar, coffee, cocoa, cotton, and frozen concentrate orange juice — at the New York Board of Trade has so far been popular with traders.

The products, which trade on the IntercontinentalExchange platform, set electronic volume records twice in three days in early April, trading a record 149,389 contracts on April 11. In March, almost 60 percent of all softs volume was electronic.

The introduction of electronic trading has also led to an increase in overall volume. Measuring from Feb. 2, the day electronic trading began, until April 20, and then comparing daily average volume with the same time period in 2006, volume for every product in the group except for orange juice has risen.

Coffee volume is up more than 13 percent, cocoa volume more than 25 percent, cotton more than 35 percent, and sugar more than 41 percent. Orange juice volume declined 10 percent, but OJ is by far the least-traded of the softs and thus more susceptible to large or small volume days skewing the overall average, particularly in a small sample period.

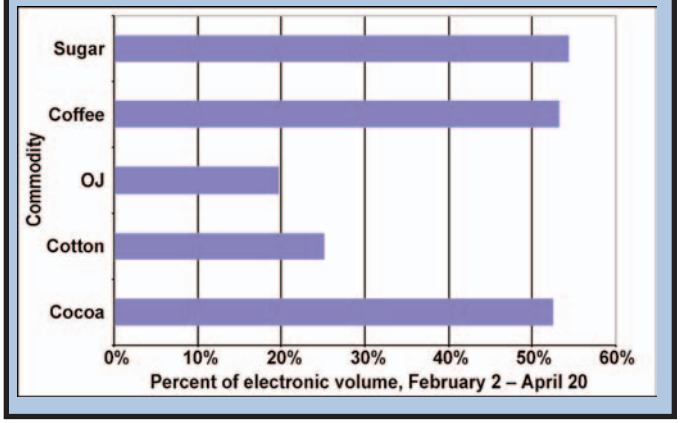
Electronic volume accounts for just more than half the total volume trading from Feb. 2 to April 20 in cocoa, coffee, and sugar. About a quarter of cotton volume is electronic and not quite one-fifth of orange juice volume (Figure 1).

Not surprisingly, it took a little while for traders to become accustomed to electronic trading. From Feb. 2 to Feb. 15, about 22 percent of cocoa volume was executed electronically. From April 2 to April 20, that grew to almost 71 percent.

Similar growth rates occurred in cotton (16.6 percent, 31.3 percent), orange juice (9.1 percent, 29.3 percent), coffee (38.9 percent, 58.7 percent), and sugar (27.1 percent, 67 percent).

FIGURE 1 — SPARKING AN INTEREST

Traders have shown a desire to trade the NYBOT soft products electronically, with three of the contracts doing more than half their business electronically.



A scramble to the starting line

ICE challenges NYMEX on Middle East crude contract

Very much under the radar just a few years ago, the IntercontinentalExchange (ICE) continues to flex its muscles in the changing exchange landscape.

After tipping over the apple cart with its unsolicited bid for the Chicago Board of Trade in March, the ICE is trying to top the New York Mercantile Exchange (NYMEX) by offering Middle East sour crude oil futures ahead of the NYMEX's launch.

The Dubai Mercantile Exchange (DME), which is co-owned by the NYMEX, had been planning "Oman" sour crude futures for years and had originally set a launch date of May 1. However, the DME delayed the launch until June 1, citing regulatory issues.

That gave the ICE the opportunity to swoop in and begin trading Dubai futures on May 21, pending regulatory approval. The ICE already trades Brent crude oil, which is the benchmark European contract, and West Texas Intermediate crude, the benchmark in the U.S.

The ICE and the DME will not have identical contracts — the Dubai contract will be cash-settled, while the Oman contract will be physically settled. Dubai and Oman are equally considered as the benchmark for Middle East crude oil.

While the ICE made a big splash with its announcement, skeptics question if the exchange can actually pull off what it promised. A month is a very short amount of time to set up and launch a major contract, and traders doubt the contract will begin as scheduled.

Still, the ICE is obviously not shy about getting its name in print, regardless of the circumstances.

The exchange denies the contract launch is an attempt to trump the NYMEX, saying customer demand prompted the creation of the contract, which has been in the works for more than a year.

While both the ICE and the NYMEX do a healthy business in West Texas crude and demand for Middle East crude is high, it remains to be seen if two exchanges are necessary.

Still, besides the delivery differences in the contract, there are other areas where the contracts vary. The ICE is a proven exchange with established technology, so liquidity shouldn't be a problem. On the other hand, the DME's contract is backed by a Middle East oil producer, a first for a crude oil contract.

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Anybody's game

CBOT battle cools down

As far as mega-deals go, the one that will eventually decide who buys the Chicago Board of Trade has been developing pretty slowly after an initial shock.

In March, the IntercontinentalExchange (ICE) stunned the futures world with an unsolicited bid for the Chicago Board of Trade (CBOT), which had agreed to a purchase by the Chicago Mercantile Exchange (CME) in October. The first several days after the announcement were predictably filled with much rhetoric on both sides and declarations of who had the better deal.

Since then, however, the three parties involved have been relatively quiet. The CME and CBOT have both delayed their initial votes on the merger, but no new conditions or terms have been added by either bidder.

In late April, the CBOT said in a letter to shareholders that it would "soon" complete its review of the ICE offer, although it didn't specify what its next move was after finishing its evaluation. *The Wall Street Journal* reported earlier in the month that CBOT executives said price would not be the only factor in choosing a suitor.

The day before, the ICE announced it was moving its technology operations to Chicago. A spokeswoman says the transfer will be completed by January 2008, although she denies the move was intended to sweeten the CBOT offer and says it had been planned before the merger bid was announced.

The ICE bid is worth about $1 billion more than the CME bid, although the CME has so far refused to up its offer, calling the ICE bid inferior despite its financial advantage. However, that didn't stop CME shareholders from urging the exchange at its annual meeting to increase the total value of the deal to ensure it doesn't fall through.

After the meeting, CME CEO Craig Donohue said any change in the offer would have to be approved by the board of directors and refused to speculate beyond that, while chairman Terry Duffy called the CME's relationship with the CBOT "as strong as ever."

The CME bid is backed by the floor traders at the New York Board of Trade, which was purchased by the ICE in January. The traders are upset about the ICE's decision to remove a fee connected with electronic trading of the NYBOT's major products, including coffee, sugar, and cocoa.

The traders say the fee elimination will increase the amount of electronic trading at the exchange, which could ultimately cost the traders their jobs. The traders claim the ICE lied when it said it was committed to preserving the trading floor, and they placed full-page ads in Chicago newspapers warning CBOT shareholders to "watch their backs" when dealing with the ICE.

Energy boost

NYMEX lists uranium futures

The New York Mercantile Exchange (NYMEX) is expanding its energy complex by adding uranium futures beginning May 6.

The price of uranium on the spot market has skyrocketed as supply has diminished even though the number of power plants being built has increased. The futures contract would give nuclear plants a hedging tool, and the futures will be cash-settled to avoid the need for delivery.

In 2002, uranium cost about $5 a pound. As of late April, the price had increased to $113 a pound, an increase of more than 2,160 percent.

However, the spot market is very illiquid, and a futures contract would provide uranium traders with liquidity and the ability to price the product in future months.

Some energy analysts believe a uranium contract is especially important now because pollution and global warming concerns will lead to the creation of even more nuclear reactors.

Uranium will be traded both on NYMEX's ClearPort electronic platform and on Globex, the Chicago Mercantile Exchange's electronic trading system the NYMEX is leasing space on.

The NYMEX says it will consider adding uranium options if liquidity and open interest support them.

Tick, tick, tick

CBOE teams up to create options database

Data provider Tick Data and the Chicago Board Options Exchange (CBOE) joined forces in April to create the first commercially available database of historical option prices.

Working with the Options Price Reporting Authority, the groups compiled a database of tick data that dates back to July 2, 2004. The data can be used to test the validity of algorithmic trading systems, or for pre- and post-trade analysis of any strategy.

The database can be searched to find corporate actions in the underlying stock, including stock splits, dividends, and symbol changes. The data can also be updated daily.

"Thanks to significant advances in data storage and processing power, we can now offer a research-ready database of historical intraday options data," says Neal Falkenberry, senior vice president of Tick Data.

Tick Data has been supplying data to the financial industry for more than 20 years, although this is their first foray into options.

"The ability for clients to access this data in an efficient and easy-to-use manner is a value that cannot be overstated," says Patrick Fay, a senior vice president at the CBOE.

Tick Data is a division of Nexa Technologies. For more information on the options database, visit www.nexatech.com/eng/products/tickdata/index.html.

MANAGED MONEY

Top 10 option strategy traders ranked by March 2007 return
(Managing at least $1 million as of March 31, 2007.)

Rank	Trading advisor	March return	2007 YTD return	$ under mgmt.
1.	Pirates of Profit	16.00	23.02	2.7M
2.	Ascendant Asset Adv. (Strategic2)	10.35	29.32	22.0M
3.	Daniel J. Bennett (S&P Options)	8.81	4.34	29.5M
4.	Goodnight Cap Mgmt (S&P Option)	7.49	-4.93	2.9M
5.	CKP Finance Associates (LOMAX)	5.48	-2.83	7.1M
6.	Ascendant Asset Adv. (Strategic1)	4.98	16.93	3.0M
7.	Steinitz Voss Cap'l Mgmt (Index Prem)	4.39	9.20	3.1M
8.	Aksel Capital Mgmt (Growth & Income)	4.01	6.89	6.7M
9.	Zenith Resources (Index Options)	3.42	1.06	38.1M
10.	BC Capital Management	3.06	3.64	33.8M

Source: Barclay Trading Group (www.barclaygrp.com)

Based on estimates of the composite of all accounts or the fully funded subset method.
Does not reflect the performance of any single account.
PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE PERFORMANCE.

FUTURES SNAPSHOT (*as of April 27*)

The following table summarizes the trading activity in the most actively traded futures contracts. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields. Volume figures are for the most active contract month in a particular market and may not reflect total volume for all contract months.

Note: Average volume and open-interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity for CME futures is based on pit-traded contracts, while price activity for CBOT futures is based on the highest-volume contract (pit or electronic).

Market	Pit Sym	E-Sym	Exch	Vol	OI	10-day move	% Rank	20-day move	% Rank	60-day move	% Rank	Volatility ratio/rank
S&P 500 E-Mini		ES	CME	1.05 M	1.86 M	2.79%	85%	4.94%	95%	3.37%	25%	.39 / 37%
10-yr. T-note	TY	ZN	CBOT	964.1	2.45 M	0.16%	33%	-0.71%	47%	0.99%	64%	.31 / 37%
5-yr. T-note	FV	ZF	CBOT	445.7	1.55 M	0.11%	20%	-0.09%	17%	0.97%	82%	.31 / 37%
Eurodollar*	ED	GE	CME	401.3	1.71 M	0.01%	50%	-0.07%	57%	0.04%	59%	.13 / 25%
30-yr. T-bond	US	ZB	CBOT	325.1	846.3	0.19%	29%	-0.71%	24%	0.25%	26%	.27 / 20%
Nasdaq 100 E-Mini		NQ	CME	255.1	370.4	4.09%	89%	6.48%	97%	5.51%	52%	.64 / 75%
Crude oil	CL		NYMEX	219.9	322.0	4.45%	30%	0.65%	4%	15.99%	65%	.27 / 13%
2-yr. T-note	TU	ZT	CBOT	167.4	968.7	0.05%	33%	-0.06%	38%	0.83%	92%	.27 / 28%
Russell 2000 E-Mini		ER	CME	159.6	424.1	1.26%	30%	3.80%	48%	2.90%	19%	.23 / 10%
Eurocurrency	EC	6E	CME	151.4	204.2	0.71%	37%	2.05%	87%	4.75%	95%	.14 / 5%
Mini Dow		YM	CBOT	114.9	79.5	3.96%	90%	5.91%	95%	3.65%	33%	.65 / 71%
Japanese yen	JY	6J	CME	93.5	193.7	-0.63%	27%	-1.91%	84%	0.88%	40%	.29 / 32%
Corn	C	ZC	CBOT	91.3	305.0	-1.30%	0%	-2.72%	15%	-8.49%	41%	.27 / 72%
British pound	BP	6B	CME	67.5	121.4	0.48%	21%	1.50%	44%	1.46%	32%	.29 / 50%
Gold 100 oz.	GC		NYMEX	64.4	191.6	-1.17%	100%	3.07%	10%	2.84%	14%	.24 / 23%
Soybeans	S	ZS	CBOT	57.2	161.2	-2.03%	33%	-5.02%	73%	0.22%	2%	.16 / 17%
Swiss franc	SF	6S	CME	48.5	59.8	0.45%	11%	0.46%	13%	3.03%	79%	.16 / 5%
Sugar	SB		NYBOT	45.8	215.9	-7.07%	100%	-6.60%	54%	-13.21%	79%	.22 / 23%
Natural gas	NG		NYMEX	42.2	91.1	0.38%	0%	2.92%	14%	4.00%	15%	.30 / 60%
RBOB gasoline	RB		NYMEX	38.5	50.0	3.67%	37%	8.96%	22%	48.15%	88%	.26 / 46%
Canadian dollar	CD	6C	CME	34.8	113.8	1.86%	47%	3.30%	86%	5.65%	96%	.32 / 53%
Wheat	W	ZW	CBOT	32.6	115.5	4.60%	9%	14.25%	100%	8.74%	25%	.65 / 68%
S&P 500 index	SP		CME	31.4	602.8	2.79%	85%	4.95%	95%	3.37%	25%	.39 / 37%
Australian dollar	AD	6A	CME	29.8	116.7	-0.28%	100%	2.73%	56%	7.28%	97%	.19 / 7%
Gold 100 oz.		ZG	CBOT	29.2	28.2	-1.10%	100%	1.93%	3%	2.83%	15%	.24 / 22%
Heating oil	HO		NYMEX	28.1	54.1	0.63%	0%	1.83%	7%	15.30%	63%	.37 / 43%
Soybean oil	BO	ZL	CBOT	25.2	120.3	-0.12%	0%	1.39%	19%	11.33%	48%	.37 / 65%
Soybean meal	SM	ZM	CBOT	21.0	56.4	-3.66%	30%	-9.35%	77%	-7.65%	100%	.19 / 22%
Silver 5,000 oz.	SI		NYMEX	20.1	52.6	-4.59%	100%	0.77%	0%	-2.05%	18%	.45 / 87%
S&P MidCap 400 E-Mini		ME	CME	16.8	85.9	1.98%	45%	4.14%	50%	5.43%	32%	.22 / 13%
Crude oil e-miNY		QM	NYMEX	15.9	7.2	4.45%	30%	0.65%	2%	15.99%	65%	.26 / 13%
Cotton	CT		NYBOT	15.0	89.8	-2.67%	39%	-7.73%	98%	-7.41%	71%	.40 / 80%
Mexican peso	MP	6M	CME	12.1	51.1	0.83%	78%	1.30%	73%	0.49%	24%	.25 / 32%
Fed Funds**	FF	ZQ	CBOT	11.7	85.0	0%	75%	0.01%	86%	0%	0%	.44 / 55%
Coffee	KC		NYBOT	10.8	56.3	-4.29%	73%	-3.25%	44%	-9.05%	44%	.31 / 82%
Nikkei 225 index	NK		CME	9.6	50.1	-0.77%	50%	0.81%	14%	-1.39%	78%	.35 / 50%
Copper	HG		NYMEX	9.6	26.8	-0.50%	100%	13.87%	58%	38.89%	76%	.15 / 8%
Cocoa	CC		NYBOT	8.4	51.9	-3.34%	100%	-6.13%	100%	12.68%	53%	.37 / 73%
Live cattle	LC	LE	CME	8.4	46.2	-3.89%	60%	-4.43%	100%	3.84%	21%	.42 / 72%
Silver 5,000 oz.		ZI	CBOT	4.9	8.1	-4.61%	100%	-0.10%	0%	-2.14%	9%	.44 / 86%
Mini-sized gold		YG	CBOT	4.5	5.7	-1.10%	100%	1.93%	3%	2.83%	15%	.24 / 22%
Nasdaq 100 index	ND		CME	4.1	48.9	4.09%	89%	6.48%	97%	5.51%	52%	.64 / 75%
Dow Jones Ind. Avg.	DJ	ZD	CBOT	4.1	40.2	3.96%	90%	5.91%	95%	3.65%	33%	.65 / 72%
Lean hogs	LH	HE	CME	3.8	14.5	-1.97%	100%	16.60%	75%	15.03%	84%	.16 / 7%
Natural gas e-miNY		QG	NYMEX	3.4	4.5	0.38%	0%	2.92%	18%	2.14%	7%	.27 / 20%
Orange juice	OJ		NYBOT	2.3	13.6	-3.13%	0%	-12.47%	73%	-12.63%	74%	.31 / 12%
New Zealand dollar	NE	6N	CME	2.2	26.4	0.75%	5%	4.04%	65%	8.67%	99%	.13 / 0%

*Average volume and open interest based on highest-volume contract (December 2007)
**Average volume and open interest based on highest-volume contract (July 2007)

Legend

Vol: 30-day average daily volume, in thousands (unless otherwise indicated).

OI: Open interest, in thousands (unless otherwise indicated).

10-day move: The percentage price move from the close 10 days ago to today's close.

20-day move: The percentage price move from the close 20 days ago to today's close.

60-day move: The percentage price move from the close 60 days ago to today's close.

The "% Rank" fields for each time window (10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the "% Rank" for 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the "% Rank" field shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, the "% Rank" field shows how the most recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100 percent means the current reading is larger than all the past readings, while a reading of 0 percent means the current reading is smaller than the previous readings. These figures provide perspective for determining how relatively large or small the most recent price move is compared to past price moves.

Volatility ratio/rank: The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The rank is the percentile rank of the volatility ratio over the past 60 days.

MOST-LIQUID INSTRUMENTS*

Indices	Symbol	Exchange	Options volume	Open interest	10-day move	% rank	20-day move	% rank	IV/SV ratio	IV/SV ratio — 20 days ago
Nasdaq 100 index	NDX	CBOE	2.44 M	214.3	1.84%	47%	5.38%	94%	15.3% / 12.1%	16.8% / 15%
S&P 500 index	SPX	CBOE	128.8	1.73 M	0.95%	25%	4.33%	78%	11.6% / 9.6%	13% / 13%
S&P 500 futures	SP	CME	31.8	217.2	0.88%	20%	3.84%	77%	11.2% / 9.2%	13% / 12.8%
E-Mini S&P 500	ES	CME	23.7	149.1	0.88%	20%	3.85%	77%	11.8% / 9.8%	12.7% / 14.4%
S&P 100 index	OEX	CBOE	19.7	117.3	1.29%	25%	4.73%	86%	11.3% / 9.3%	12.4% / 12.8%
Stocks										
James River Coal	JRCC		1.82 M	21.6	-4.83%	100%	21.29%	67%	70.4% / 61.6%	58.2% / 43.9%
Dendreon	DNDN		1.30 M	825.6	-4.39%	0%	16.24%	48%	241.5% / 141.1%	129.6% / 113.3%
Las Vegas Sands	LVS		1.21 M	80.7	-3.61%	89%	-1.64%	22%	37.4% / 27.7%	38.4% / 36.5%
Akamai Technologies	AKAM		611.3	102.0	-18.76%	100%	-11.70%	78%	41.4% / 44%	40.3% / 30.3%
Baidu.com	BIDU		609.6	84.1	23.16%	92%	25.92%	89%	34.6% / 38.5%	44.4% / 37.4%
Futures										
Eurodollar	ED-GE	CME	472.4	10.54 M	0.01%	100%	-0.06%	38%	11.9% / 3%	13.3% / 4.5%
10-yr. T-note	TY-ZN	CBOT	107.7	1.32 M	0.90%	100%	0.05%	0%	3.9% / 3.5%	4.2% / 4.2%
Corn	C-ZC	CBOT	55.0	1.06 M	-1.70%	21%	0.96%	12%	40.4% / 41.7%	40.6% / 30.1%
Crude oil	CL	NYMEX	54.9	733.6	3.30%	10%	-0.24%	0%	27.2% / 26.8%	33.4% / 33.2%
S&P 500 futures	SP	CME	31.8	217.2	0.88%	20%	3.84%	77%	11.2% / 9.2%	13% / 12.8%

VOLATILITY EXTREMES**

Indices — High IV/SV ratio										
Russell 2000 Index	RUT	CBOE	10.7	372.2	-2.03%	100%	1.73%	13%	17% / 11.2%	19.1% / 15.5%
Gold/silver index	XAU	PHLX	1.9	64.8	-7.46%	100%	0.04%	0%	27.7% / 21.4%	28.2% / 26.4%
Nasdaq 100 index	NDX	CBOE	2.44 M	214.3	1.84%	47%	5.38%	94%	15.3% / 12.1%	16.8% / 15%
S&P 500 futures	SP	CME	31.8	217.2	0.88%	20%	3.84%	77%	11.2% / 9.2%	13% / 12.8%
S&P 100 index	OEX	CBOE	19.7	117.3	1.29%	25%	4.73%	86%	11.3% / 9.3%	12.4% / 12.8%
Indices — Low IV/SV ratio										
S&P 500 volatility index	VIX	CBOE	14.6	555.1	18.70%	100%	-2.87%	12%	77.2% / 87.9%	103.6% / 146.3%
Stocks — High IV/SV ratio										
Dollar General	DG		1.1	6.7	10.82%	87%	11.79%	97%	16.5% / 6.8%	17.1% / 10.5%
MasterCard	MA		2.8	151.8	2.08%	64%	5.12%	63%	37.6% / 20%	34.9% / 25.7%
EchoStar Comms	DISH		1.1	79.7	-0.81%	100%	7.14%	78%	30.4% / 16.5%	27.6% / 24.9%
MSCI Emerging Market ETF (iShares)	EEM		2.6	244.7	-2.78%	100%	3.73%	18%	28.2% / 15.4%	NA
Palm	PALM		5.7	229.5	-1.23%	21%	-6.89%	89%	50.5% / 28%	42.9% / 42.4%
Stocks — Low IV/SV ratio										
Medimmune	MEDI		18.0	188.7	24.74%	50%	55.76%	84%	9.5% / 41.5%	43.2% / 36.5%
Avanir Pharmas	AVNR		5.8	21.6	187.90%	58%	192.62%	78%	110.3% / 185.4%	NA
SunPower	SPWR		2.3	65.8	10.97%	15%	33.36%	95%	38.7% / 54.9%	45.7% / 55.2%
Burlington Northern SF	BNI		1.3	64.8	-6.32%	100%	8.84%	52%	25.4% / 34.4%	25.6% / 25.7%
Honeywell Intl	HON		1.0	60.8	14.35%	83%	17.63%	98%	21.1% / 28.2%	20.2% / 20.3%
Futures — High IV/SV ratio										
Eurodollar	ED-GE	CME	472.4	10.54 M	0.01%	100%	-0.06%	38%	11.9% / 3%	13.3% / 4.5%
British pound	BP	CME	1.4	10.3	0.45%	21%	1.07%	28%	6.3% / 4.8%	6.2% / 5.2%
Live cattle	LC	CME	2.5	53.3	-3.26%	36%	-4.92%	100%	16.3% / 12.5%	15.7% / 15.6%
Coffee	KC	NYBOT	8.8	108.2	-2.12%	44%	-2.84%	33%	28.2% / 22.6%	24.4% / 23.2%
S&P 500 futures	SP	CME	31.8	217.2	0.88%	20%	3.84%	77%	11.2% / 9.2%	13% / 12.8%
Futures — Low IV/SV ratio										
Orange juice	OJ	NYBOT	1.8	37.3	-2.44%	0%	-12.29%	70%	31.6% / 42.3%	21.3% / 22.2%
Cocoa	CC	NYBOT	1.3	25.9	-5.52%	100%	-7.94%	100%	29.2% / 36.5%	30.5% / 27.7%
Wheat	W	CBOT	17.3	192.3	2.15%	8%	13.41%	97%	35.7% / 42.6%	27.7% / 23.3%
Cotton	CT	NYBOT	9.2	177.7	-2.22%	37%	-8.05%	100%	20.3% / 24.1%	16.7% / 14.5%
Heating oil	HO	NYMEX	3.0	12.1	1.91%	23%	0.95%	4%	28% / 32.6%	36.1% / 33%

* Ranked by volume ** Ranked based on high or low IV/SV values.

LEGEND:
Options vol: 20-day average daily options volume (in thousands unless otherwise indicated).
Open interest: 20-day average daily options open interest (in thousands unless otherwise indicated).
IV/SV ratio: Overall average implied volatility of all options divided by statistical volatility of asset.
10-day move: The underlying's percentage price move from the close 10 days ago to today's close.
20-day move: The underlying's percentage price move from the close 20 days ago to today's close. The "% Rank" fields for each time window (10-day moves, 20-day moves) show the percentile rank of the most recent move to a certain number of previous moves of the same size and in the same direction. For example, the "% Rank" for 10-day moves shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the "% Rank" field shows how the most recent 20-day move compares to the past sixty 20-day moves.

Global stock index futures guide

The U.S. is still the leader in equity index futures trading, but other contracts around the world have built solid volume, and some European index futures are now among the most actively traded.

BY FOT STAFF

If there were any remaining doubters, the late-February, early-March stock sell-off proved that national equity markets are inescapably parts of an international equity market whole.

The Feb. 27 "Shanghai surprise" downturn that began at a relatively low-profile Chinese stock exchange reverberated in markets at every corner of the globe. What in years past would have been a regional phenomenon, or at least an event that took some time to ripple through the international financial system, was a nearly instantaneous shock.

The increased access to international markets is nowhere more evident than in the world of stock index futures contracts. Futures traders now have access to electronically traded equity futures markets around the world, with some of the top-volume contracts being traded outside U.S. borders.

Table 1 lists a collection of some of the top-volume stock index futures contracts, along with several lower-volume representative contracts from different areas of the globe.

The next section briefly reviews these contracts, starting with Australia and Asia and working toward the Americas. In the contract descriptions "quarterly cycle" refers to the March-June-September-December contract month cycle; "serial months" refers to contracts listed in consecutive calendar months (January, February etc.)

Sydney Futures Exchange (www.sfe.com.au)

The Sydney Futures Exchange Limited's (SFE) key equity index contract is the SFE SPI 200 futures contract (Figure 1), which is based on the S&P ASX 200 Index — the benchmark equity index in Australia.

Contract: SFE SPI 200 futures.
Underlying index: S&P ASX 200 Index.
Pricing/contract size: A$25 per index point.
Minimum price fluctuation (tick size): A$25.
Contract months: Quarterly cycle, up to six quarter months ahead; serial months up to two non-financial quarter months ahead.

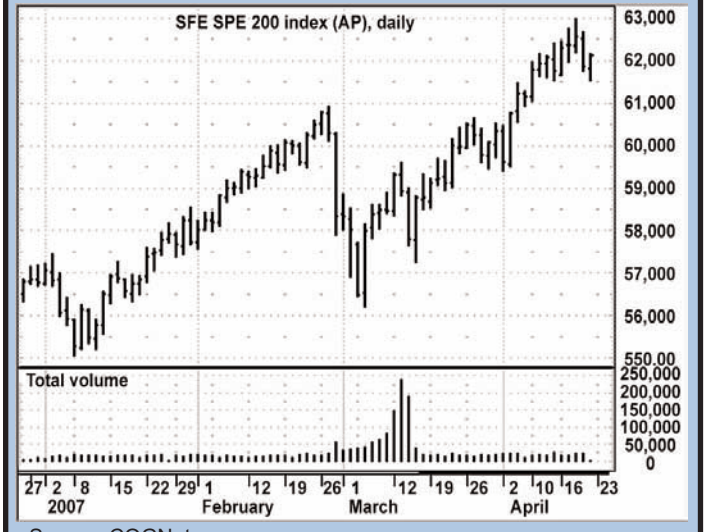
Singapore Exchange Limited (www.sgx.com)

The Singapore Exchange Limited (SGX) resulted from the Dec. 1, 1999 merger between the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange (SIMEX).

The exchange trades futures on three key Asian stock indices: the Japanese Nikkei 225 futures (Figure 2), the MSCI Taiwan Index futures (Figure 3), and the MSCI Singapore Index futures (Figure 4).

Contract: SGX Nikkei 225 futures.
Underlying index: Nikkei 225 Index.

FIGURE 1 — SPI 200 FUTURES



Source: CQGNet

FIGURE 2 — SGX NIKKEI 225 FUTURES

Source: CQGNet

Pricing/contract size: ¥500 times the Nikkei 225 Index price.
Minimum price fluctuation (tick size): 5 index points (¥2500).
Contract months: Three nearest serial months and five nearest quarterly cycle months.

Contract: SGX MSCI Taiwan futures.
Underlying index: MSCI Taiwan Index.
Pricing/contract size: US$100 times MSCI Taiwan Index price.
Minimum price fluctuation (tick size): 0.1 index points (US$10).
Contract months: Two nearest serial months and next four quarterly cycle months.

Contract: SGX MSCI Singapore futures.
Underlying index: MSCI Singapore Free (SiMSCI) Index.
Pricing/contract size: S$200 times MSCI Singapore Index.
Minimum price fluctuation (tick size): 1 index point (S$20).
Contract months: Two nearest serial months and next four quarterly cycle months.

Hong Kong Exchanges and Clearing Limited (www.hkex.com.hk/index.ht)
In 1999 the Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, and the Hong Kong Securities Clearing Company Limited merged under a single holding company, HKEx. The exchange's two leading futures contracts are the Hang Seng futures (Figure 5) and the H-shares futures (Figure 6).

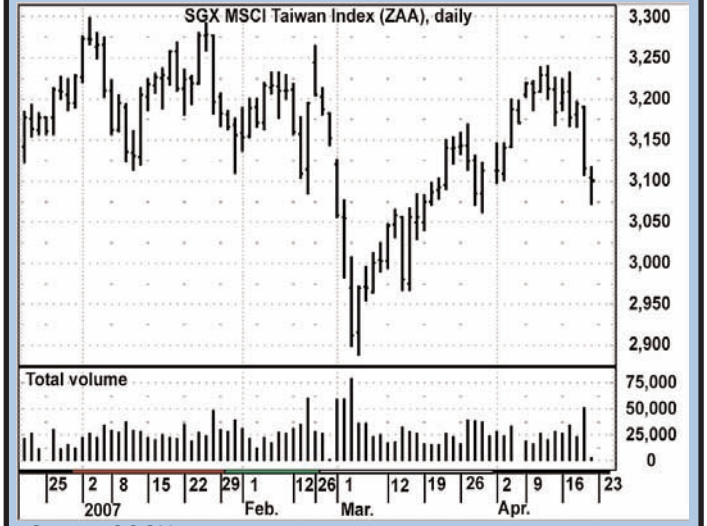
Contract: Hang Seng futures.
Underlying index: Hang Seng Index.
Pricing/contract size: HK$50 per index point.
Minimum price fluctuation (tick size): 1 index point.
Contract months: Two nearest serial months and the next two quarterly cycle months.

Contract: H-Shares futures.
Underlying index: Hang Seng China Enterprises Index
continued on p. 42

TABLE 1 — EQUITY INDEX FUTURES AROUND THE GLOBE

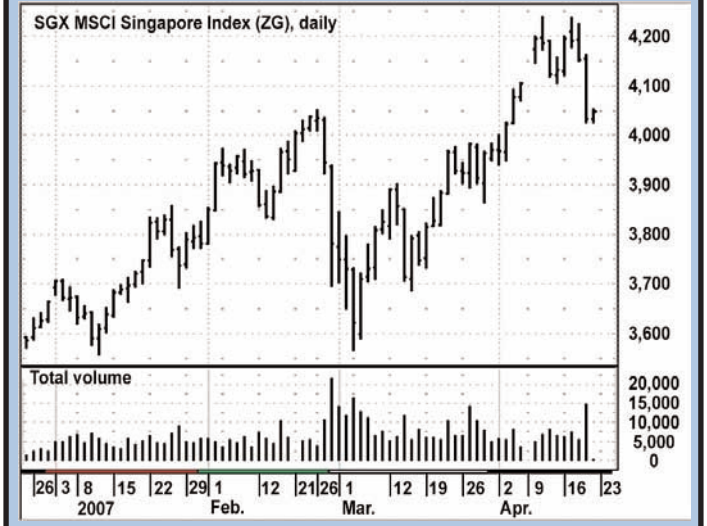
Contract	Exchange
Ibovespa Index	Brazilian Mercantile & Futures Exchange
Mini-sized Dow	Chicago Board of Trade
E-Mini S&P 500	Chicago Mercantile Exchange
E-Mini Nasdaq 100	Chicago Mercantile Exchange
E-Mini Russell 2000	Chicago Mercantile Exchange
E-Mini S&P 400 MidCap	Chicago Mercantile Exchange
Nikkei 225	Chicago Mercantile Exchange
Dow Jones EURO STOXX 50	Eurex
DAX Futures	Eurex
FTSE 100 Index	Euronext.liffe
Hang Seng Index	Hong Kong Exchanges and Clearing Limited
H-Shares Index	Hong Kong Exchanges and Clearing Limited
Mini Nikkei 225	Osaka Securities Exchange
Nikkei 225	Osaka Securities Exchange
SGX Nikkei 225 Index	Singapore Exchange Limited
SGX MSCI Taiwan Index	Singapore Exchange Limited
SGX MSCI Singapore Index	Singapore Exchange Limited
SFE SPI 200	Sydney Futures Exchange
TOPIX	Tokyo Stock Exchange

FIGURE 3 — MSCI TAIWAN FUTURES



Source: CQGNet

FIGURE 4 — MSCI SINGAPORE FUTURES



Source: CQGNet

FIGURE 5 — HANG SENG FUTURES

Source: CQGNet

FIGURE 6 — H-SHARES FUTURES

Source: CQGNet

(HSCEI).
Pricing/contract size: HK$50 per index point.
Minimum price fluctuation (tick size): 1 index point.
Contract months: Two nearest serial months and the next two quarterly cycle months.

Osaka Securities Exchange (www.ose.or.jp)
Founded in 1878, the Osaka Securities Exchange (OSE) is the second-largest securities exchange in Japan. The exchange launched its Nikkei 225 futures contract (Figure 7) in 1988, and in July 2006, the OSE launched the mini Nikkei (Figure 8), which is one-tenth the size of the full contract.

Contract: OSE Nikkei 225 futures.
Underlying index: Nikkei Stock Average (Nikkei 225).
Pricing/contract size: Nikkei 225 times ¥1,000.
Minimum price fluctuation (tick size): ¥10 (value per tick: ¥10,000 per contract).
Contract months: The next five months in the quarterly cycle.

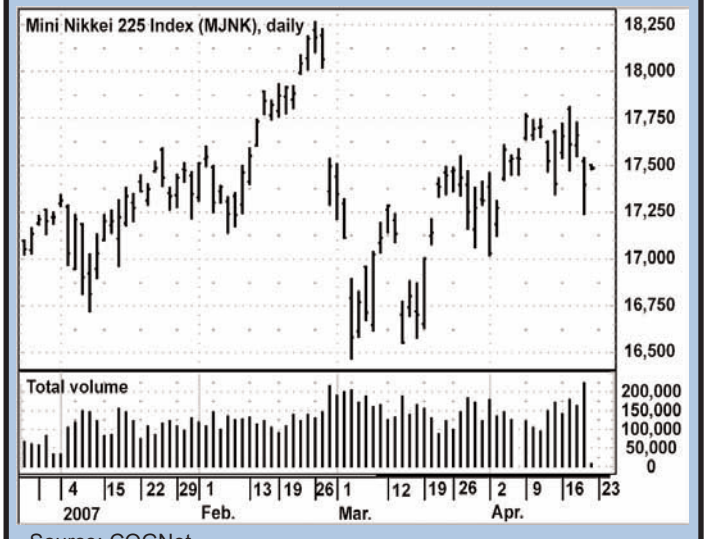
Contract: OSE Mini Nikkei 225 futures.
Underlying index: Nikkei Stock Average (Nikkei 225).
Pricing/contract size: Nikkei 225 times ¥100.
Minimum price fluctuation (tick size): ¥5 (value per tick: ¥500 per contract).
Contract months: Next two months in the quarterly cycle.

Tokyo Stock Exchange
(www.tse.or.jp/english/index.shtml)
The Tokyo Stock Exchange (TSE) is the second largest stock exchange in the world. Its two key equity indices are the Nikkei 225 Index (not shown) and the Tokyo Stock Price Index (TOPIX),

FIGURE 7 — OSE NIKKEI 225 FUTURES

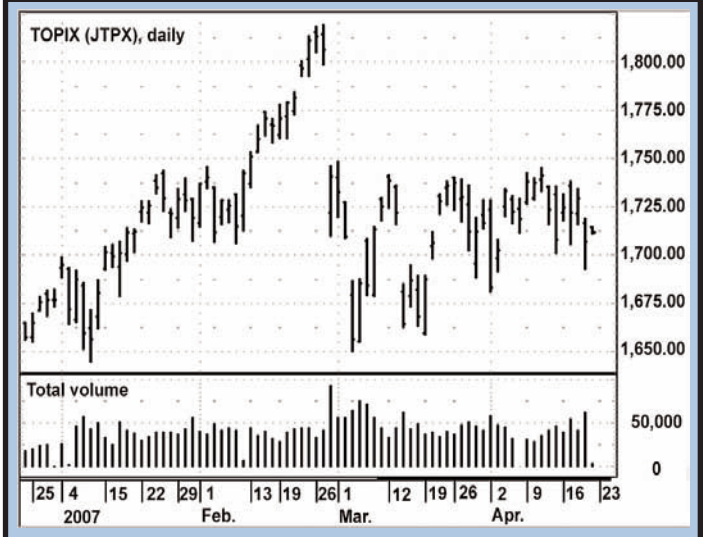
Source: CQGNet

FIGURE 8 — OSE MINI NIKKEI



Source: CQGNet

FIGURE 9 — TOKYO STOCK PRICE INDEX (TOPIX) FUTURES



Source: CQGNet

FIGURE 10 — DOW JONES EURO STOXX 50 FUTURES

Source: CQGNet

which is a composite index of all common stocks in the Tokyo Stock Exchange's first section. Figure 9 is a chart of the TOPIX futures.

Contract: TOPIX futures.
Underlying index: Tokyo Stock Price Index.
Pricing/contract size: ¥10,000 times the TOPIX.
Minimum price fluctuation (tick size): 0.5 points.
Contract months: Next five quarterly cycle months.

Eurex (www.eurexchange.com/index.html)
Eurex, based in Frankfurt, Germany, is the world's largest derivatives exchange and leading clearinghouse. The two most popular contracts traded are the Dow Jones EURO STOXX 50 futures (Figure 10) and DAX futures (Figure 11).

Contract: Dow Jones EURO STOXX 50 futures.
Underlying index: DJ EURO STOXX 50 Index.
Pricing/contract size: EUR10.
Minimum price fluctuation (tick size): 1 point.
Contract months: Up to nine months, including the three nearest quarterly cycle months.

Contract: DAX futures.
Underlying index: DAX, the blue-chip index of Deutsche Börse AG.
Pricing/contract size: EUR25.
Minimum price fluctuation (tick size): 0.5 points.
Contract months: Up to nine months, including the three nearest quarterly cycle months.

Euronext.liffe (www.euronext.com/index-2166-EN.html)
Euronext provides electronic trading for regulated derivative markets in Belgium, France, the UK, the Netherlands, and Portugal. Figure 12 shows the FTSE 100 futures contract.

Contract: FTSE 100 futures.
Underlying contract: FTSE 100 Index.
Pricing/contract size: Contract valued at £10 per index point.
Minimum price fluctuation (tick size): 0.5 (£5.00).

continued on p. 44

FIGURE 11 — DAX FUTURES

Source: CQGNet

FIGURE 12 — FTSE 100 FUTURES

Source: CQGNet

FIGURE 13 — MINI-SIZED DOW FUTURES

Source: CQGNet

FIGURE 14 — E-MINI S&P 500

Source: CQGNet

Contract months: Nearest four quarterly-cycle months.

The Chicago Board of Trade (www.cbot.com)
The CBOT is the world's oldest futures exchange, established in 1848. A dominant market in fixed-income and grain futures, the exchange offers three futures contracts that track the Dow Jones Industrial Average; the Mini-sized Dow futures contact (Figure 13) is the most popular.

Contract: Mini-sized Dow futures.
Underlying index: Dow Jones Industrial Average.
Pricing/contract size: $5 times Dow Jones Industrial Average.
Minimum price fluctuation (tick size): 1 index point ($5).
Contract months: Nearest four quarterly cycle months.

Chicago Mercantile Exchange (www.cme.com)
The Chicago Mercantile Exchange is the top-volume exchange in the U.S., and many of the most popular U.S. stock index contracts are traded through its Globex electronic trading system, which was launched in 1992.

In 1997, the CME offered E-Mini S&P 500 contracts (Figure 14) for Globex trading. The contract is one-fifth the size of the standard S&P 500 futures. Following up on the success of the E-Mini S&P 500 futures, the exchange launched E-Mini Nasdaq-100 futures contracts (Figure 15), E-Mini Russell 2000 futures (Figure 16), E-Mini S&P 400 MidCap futures (Figure 17), and Nikkei 225 futures (Figure 18), among other contracts.

Contract: E-Mini S&P 500.
Underlying index: S&P 500 Index.
Pricing/contract size: $50 times the Standard and Poor's 500 Stock Index.
Minimum price fluctuation (tick size): 0.25 points = $12.50.
Contract months: Nearest two months in the quarterly cycle.

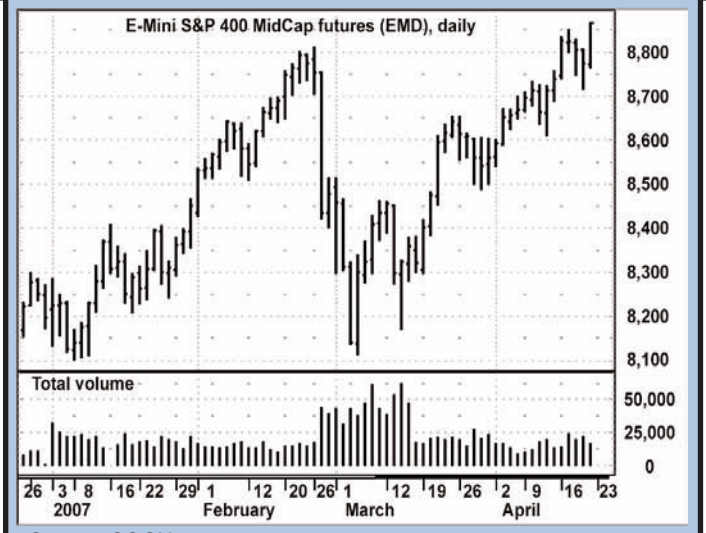
FIGURE 15 — E-MINI NASDAQ-100 FUTURES

Source: CQGNet

FIGURE 16 — E-MINI RUSSELL 2000 FUTURES

Source: CQGNet

FIGURE 17 — E-MINI S&P 400 MIDCAP FUTURES



Source: CQGNet

FIGURE 18 — CME NIKKEI 225 FUTURES

Source: CQGNet

Contract: E-Mini Nasdaq 100.
Underlying index: Nasdaq 100 Index.
Pricing/contract size: $20 times the Nasdaq 100 Index.
Minimum price fluctuation (tick size): 0.25 index points = $5.
Contract months: Nearest two months in the quarterly cycle.

Contract: E-Mini Russell 2000.
Underlying index: Russell 2000 Index.
Pricing/contract size: $100 times the Russell 2000 index price.
Minimum price fluctuation (tick size): 0.10 = $10.00.
Contract months: Nearest two months in the quarterly cycle.

Contract: E-Mini S&P 400 MidCap.
Pricing/contract size: $100 times the Standard & Poor's MidCap 400.
Minimum price fluctuation (tick size): 0.10 = $10.00.
Underlying index: Standard & Poor's MidCap 400.
Contract months: Nearest two months in the quarterly cycle.

Contract: Nikkei 225.
Underlying index: Nikkei 225 Stock Index.
Pricing/contract size: The CME offers Nikkei 225 contracts traded both in dollars and yen:

Dollar-denominated contract: $5 times the Nikkei stock average.
Point value: 1 index point = $5.00.
Yen-denominated contract: 500 Japanese yen times the Nikkei stock average.
Point descriptions: 1 point = 500 Japanese yen.

Contract months: Nearest four months in the quarterly cycle.

Brazilian Mercantile & Futures Exchange

(www.bmf.com.br)

The Mercantile & Futures Exchange (BM&F) was founded in July 1985. Through agreements and acquisitions of other exchanges over the next two decades, it expanded into one of the dominant financial exchanges and clearinghouses in Latin America, trading and clearing a wide range of financial futures, commodities, fixed income, and equity securities. The BM&F's flagship stock index futures contract is the Ibovespa futures contract (Figure 19).

Contract: Ibovespa futures.
Underlying index: The Ibovespa (Sao Paolo) index.
Pricing/contract size: Index points times the Brazilian Real (R$) value of each point.
Minimum price fluctuation (tick size): Five (5.00) points.
Contract months: April, June, August, October, December.

Trading international markets

Despite the increasing correlation of equity markets around the world, trading in stock index futures has continued to grow. The proliferation of equity derivatives contracts on popular global stock indices gives traders ample opportunity to move into markets offering the best opportunities and trading conditions.

However, trading non-domestic contracts typically requires opening a brokerage account in a host country, denominated in the local currency. As most major brokerages have international arms operating in most of the world's major financial centers, this is not the impediment it might have been several years ago. There is also a regulatory consideration: Trading futures in different countries means you are subject to different regulations and offered limited oversight; the U.S. Commodity Futures Trading Commission (CFTC), does not regulate foreign futures markets, for example.

FIGURE 19 — IBOVESPA FUTURES

Source: CQGNet

Legend

CPI: Consumer Price Index

ECI: Employment cost index

First delivery day (FDD): The first day on which delivery of a commodity in fulfillment of a futures contract can take place.

First notice day (FND): Also known as first intent day, this is the first day a clearinghouse can give notice to a buyer of a futures contract that it intends to deliver a commodity in fulfillment of a futures contract. The clearinghouse also informs the seller.

FOMC: Federal Open Market Committee

GDP: Gross domestic product

ISM: Institute for supply management

LTD: Last trading day; the first day a contract may trade or be closed out before the delivery of the underlying asset may occur.

PPI: Producer price index

Quadruple witching Friday: A day where equity options, equity futures, index options, and index futures all expire.

MAY 2007

29	30	1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31	1	2

JUNE 2007

27	28	29	30	31	1	2
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The information on this page is subject to change. Futures & Options Trader *is not responsible for the accuracy of calendar dates beyond press time.*

May

1 April ISM
FND: May sugar futures (NYBOT); May orange juice futures (NYBOT)
FDD: May coal, natural gas, and crude oil futures (NYMEX); May aluminum, palladium, copper, platinum, silver, and gold futures (NYMEX); May oats, rice, wheat, corn, soybean products, and soybean futures (CBOT); May cocoa, sugar, and coffee futures (NYBOT); May cotton futures (NYBOT)

2 **FND:** May propane, gasoline, and heating oil futures (NYMEX)

3 **LTD:** April milk options (CME)

4 April employment
LTD: May U.S. dollar index (NYBOT); June cocoa options (NYBOT); May pork belly options (CME)
FDD: May propane futures (NYMEX)

5

6

7 **FND:** May pork belly futures (CME)

8 **LTD:** May cotton futures (NYBOT)
FDD: May gasoline and heating oil futures (NYMEX); May pork belly futures (CME); May orange juice futures (NYBOT)

9 FOMC meeting

10 March trade balance
LTD: May currency options (CME); May orange juice futures (NYBOT)

11 April PPI
LTD: June sugar and coffee options (NYBOT)

12

13

14 **LTD:** May oats, rice, wheat, corn, soybean product, and soybean futures (CBOT); May lean hogs futures and options (CME)

15 April CPI
LTD: May cocoa futures (NYBOT); May lumber futures (CME); May Goldman Sachs Commodity Index options (CME)

16 **LTD:** June platinum options (NYMEX)
FND: May lumber futures (CME)
FDD: May lumber futures (CME)

17 **LTD:** June crude oil options (NYMEX)

18 **LTD:** All May equity options; May S&P options (CME); May Nasdaq options (CME); May Russell options (CME); May Dow Jones options (CBOT); May coffee futures (NYBOT); June orange juice options (NYBOT); June cotton options (NYBOT)

19

20

21

22 **LTD:** June crude oil futures (NYMEX)

23

24 **LTD:** June aluminum, copper, silver, and gold options (NYMEX); May feeder cattle futures and options (CME)
FND: June crude oil futures (NYMEX)

25 **LTD:** June T-bond options (CBOT); June natural gas, gasoline, and heating oil options (NYMEX); June coal futures (NYMEX); May pork belly futures (CME)

26 **LTD:** May platinum futures (NYMEX)

27

28 Markets closed – Memorial Day
FND: June coal futures (NYMEX)

29 **LTD:** June natural gas futures (NYMEX); May aluminum, palladium, copper, silver, and gold futures (NYMEX)
FND: June natural gas futures (NYMEX)

30

31 GDP (prelim) for Q1
LTD: June propane, gasoline, and heating oil futures (NYMEX); May milk options (CME)
FND: June T-bond futures (CBOT); June aluminum, palladium, copper, platinum, silver, and gold futures (NYMEX)

JUNE

1 May employment
April personal income
May ISM
LTD: July cocoa options (NYBOT); June live cattle options (CME)

2

3

4

5

6

7

8 April trade balance
LTD: June currency options (CME); July sugar and coffee options (NYBOT)

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▼ **Nirvana Systems, Inc.** has released OmniTrader Professional. The new version is faster than prior versions, supporting up to 500 symbols in real time. The release includes integrated brokerage support for MB Trading and Interactive Brokers, plus new OmniPilot scripts that enable individuals to fully automate trading strategies with these brokers. For additional information, visit www.omnitrader.com/pro/news.

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Account equity: Value of account, which includes cash and investments.

American style: An option that can be exercised at any time until expiration.

Assign(ment): When an option seller (or "writer") is obligated to assume a long position (if he or she sold a put) or short position (if he or she sold a call) in the underlying stock or futures contract because an option buyer exercised the same option.

At the money (ATM): An option whose strike price is identical (or very close) to the current underlying stock (or futures) price.

Average directional movement index (ADX): Measures trend strength, regardless of direction. The higher the ADX value, the stronger the trend, whether the market is going up or down. The indicator can be applied to any time frame, although it is typically used on daily charts.

Although the ADX concept is straightforward, its calculation is rather lengthy. The indicator was designed by Welles Wilder and is described in detail in his book *New Concepts in Technical Trading Systems* (Trend Research 1978).

Calculation:

1. Calculate the positive or negative directional movement (+DM and -DM) for each bar in the desired lookback period. Bars that make higher highs and higher lows than the previous bar have positive directional movement. Bars that make lower highs and lower lows than the previous bar have negative directional movement.

If a bar has both a higher high and a lower low than the previous bar, it has positive directional movement if its high is above the previous high more than its low is below the previous low. Reverse this criterion for negative directional movement. An inside bar (a bar that trades within the range of the previous bar) has no directional movement, and neither does a bar whose high is above the previous high by the same amount its low is below the previous low.

2. If a bar has positive (negative) directional movement, the absolute value of the distance between today's high (low) and yesterday's high (low) is added to the running totals of +DM (-DM) calculated over a given lookback period (i.e., 20 bars, 30 bars, etc.). The absolute value is used so both +DM and -DM are positive values.

3. Calculate the sum of the true ranges for all bars in the lookback period.

4. Calculate the Directional Indicator (+DI and -DI) by dividing the running totals of +DM and -DM by the sum of the true ranges.

5. Calculate the directional index (DX) by taking the absolute value of the difference between the +DI value and the -DI value, dividing that by the sum of the +DI and -DI values, and multiplying by 100.

6. To create the ADX, calculate a moving average of the DX over the same period as the lookback period used throughout the other calculations.

The option "Greeks"

Delta: The ratio of the movement in the option price for every point move in the underlying. An option with a delta of 0.5 would move a half-point for every 1-point move in the underlying stock; an option with a delta of 1.00 would move 1 point for every 1-point move in the underlying stock.

Gamma: The change in delta relative to a change in the underlying market. Unlike delta, which is highest for deep ITM options, gamma is highest for ATM options and lowest for deep ITM and OTM options.

Theta: The rate at which an option loses value each day (the rate of time decay). Theta is relatively larger for OTM than ITM options, and increases as the option gets closer to its expiration date.

Rho: The change in option price relative to the change in the interest rate.

Vega: How much an option's price changes per a one-percent change in volatility.

Bear call spread: A vertical credit spread that consists of a short call and a higher-strike, further OTM long call in the same expiration month. The spread's largest potential gain is the premium collected, and its maximum loss is limited to the point difference between the strikes minus that premium.

Bear put spread (call credit spread): A bear debit spread that contains puts with the same expiration date but different strike prices. You buy the higher-strike put, which costs more, and sell the cheaper, lower-strike put.

Beta: Measures the volatility of an investment compared to the overall market. Instruments with a beta of one move in line with the market. A beta value below one means the instrument is less affected by market moves and a beta value greater than one means it is more volatile than the overall market. A beta of zero implies no market risk.

Bull call spread: A bull debit spread that contains calls with the same expiration date but different strike prices. You buy the lower-strike call, which has more value, and sell the less-expensive, higher-strike call.

Bull put spread (put credit spread): A bull credit spread that contains puts with the same expiration date, but different strike prices. You sell an OTM put and buy a less-expensive, lower-strike put.

Butterfly: A non-directional trade consisting of options with three different strike prices at equidistant intervals: Long one each of the highest and lowest strike price options and short two of the middle strike price options.

Calendar spread: A position with one short-term short option and one long same-strike option with more time until expiration. If the spread uses ATM options, it is market-neutral and tries to profit from time decay. However, OTM options can be used to profit from both a directional move and time decay.

Call option: An option that gives the owner the right, but not the obligation, to buy a stock (or futures contract) at a fixed price.

Carrying costs: The costs associated with holding an investment that include interest, dividends, and the opportunity costs of entering the trade.

Covered call: Shorting an out-of-the-money call option against a long position in the underlying market. An example would be purchasing a stock for $50 and selling a call option with a strike price of $55. The goal is for the market to move sideways or slightly higher and for the call option to expire worthless, in which case you keep the premium.

Credit spread: A position that collects more premium from short options than you pay for long options. A credit spread using calls is bearish, while a credit spread using puts is bullish.

Deep (e.g., deep in-the-money option or deep out-of-the-money option): Call options with strike prices that are very far above the current price of the underlying asset and put options with strike prices that are very far below the current price of the underlying asset.

Delta-neutral: An options position that has an overall delta of zero, which means it's unaffected by underlying price movement. However, delta will change as the underlying moves up or down, so you must buy or sell shares/contracts to adjust delta back to zero.

Diagonal spread: A position consisting of options with different expiration dates and different strike prices — e.g., a December 50 call and a January 60 call.

European style: An option that can only be exercised at expiration, not before.

Exercise: To exchange an option for the underlying instrument.

Expiration: The last day on which an option can be exercised and exchanged for the underlying instrument (usually the last trading day or one day after).

In the money (ITM): A call option with a strike price below the price of the underlying instrument, or a put option with a strike price above the underlying instrument's price.

Intrinsic value: The difference between the strike price of an in-the-money option and the underlying asset price. A call option with a strike price of 22 has 2 points of intrinsic value if the underlying market is trading at 24.

Iron condor: A market-neutral position that enters a bear call spread (OTM call + higher-strike call) above the market and a bull put spread (OTM put + lower-strike put) below the market. Both spreads collect premium, and profit when the market trades between the short strikes by expiration. All options share the same expiration month.

Lock-limit: The maximum amount that a futures contract is allowed to move (up or down) in one trading session.

Long-Term Equity AnticiPation Securities (LEAPS): Options contracts with much more distant expiration dates — in some cases as far as two years and eight months away — than regular options.

Market makers: Provide liquidity by attempting to profit from trading their own accounts. They supply bids when there may be no other buyers and supply offers when there are no other sellers. In return, they have an edge in buying and selling at more favorable prices.

Naked (uncovered) puts: Selling put options to collect premium that contains risk. If the market drops below the short put's strike price, the holder may exercise it, requiring you to buy stock at the strike price (i.e., above the market).

Open interest: The number of options that have not been exercised in a specific contract that has not yet expired.

Out of the money (OTM): A call option with a strike price above the price of the underlying instrument, or a put option with a strike price below the underlying instrument's price.

Parity: An option trading at its intrinsic value.

Premium: The price of an option.

Put option: An option that gives the owner the right, but not the obligation, to sell a stock (or futures contract) at a fixed price.

continued on p. 50

Put spreads: Vertical spreads with puts sharing the same expiration date but different strike prices. A bull put spread contains long, higher-strike puts and short, lower-strike puts. A bear put spread is structured differently: Its long puts have higher strikes than the short puts.

Stochastic oscillator: A technical tool designed to highlight shorter-term momentum and "overbought" and "oversold" levels (points at which a price move has, theoretically at least, temporarily exhausted itself and is ripe for a correction or reversal).

Calculation: The stochastic oscillator consists of two lines: %K and a moving average of %K called %D. The basic stochastic calculation compares the most recent close to the price range (high of the range - low of the range) over a particular period.

For example, a 10-day stochastic calculation (%K) would be the difference between today's close and the lowest low of the last 10 days divided by the difference between the highest high and the lowest low of the last 10 days; the result is multiplied by 100. The formula is:

$$\%K = 100*\{(C_t-L_n)/(H_n-L_n)\}$$

C_t is today's closing price
H_n is the highest price of the most recent *n* days (the default value is five days)
L_n is the lowest price of the most recent *n* days
The second line, %D, is a three-period simple moving average of %K. The resulting indicator fluctuates between 0 and 100.

Fast vs. slow: The formula above is sometimes referred to as "fast" stochastics. Because it is very volatile, an additionally smoothed version of the indicator — where the original %D line becomes a new %K line and a three-period average of this line becomes the new %D line — is more commonly used (and referred to as "slow" stochastics, or simply "stochastics").

Any of the parameters — either the number of periods used in the basic calculation or the length of the moving averages used to smooth the %K and %D lines — can be adjusted to make the indicator more or less sensitive to price action.

Horizontal lines are used to mark overbought and oversold stochastic readings. These levels are discretionary; readings of 80 and 20 or 70 and 30 are common, but different market conditions and indicator lengths will dictate different levels.

Straddle: A non-directional option spread that typically consists of an at-the-money call and at-the-money put with the same expiration. For example, with the underlying instrument trading at 25, a standard long straddle would consist of buying a 25 call and a 25 put. Long straddles are designed to profit from an increase in volatility; short straddles are intended to capitalize on declining volatility. The strangle is a related strategy.

Strangle: A non-directional option spread that consists of an out-of-the-money call and out-of-the-money put with the same expiration. For example, with the underlying instrument trading at 25, a long strangle could consist of buying a 27.5 call and a 22.5 put. Long strangles are designed to profit from an increase in volatility; short strangles are intended to capitalize on declining volatility. The straddle is a related strategy.

Strike ("exercise") price: The price at which an underlying instrument is exchanged upon exercise of an option.

Time decay: The tendency of time value to decrease at an accelerated rate as an option approaches expiration.

Time spread: Any type of spread that contains short near-term options and long options that expire later. Both options can share a strike price (calendar spread) or have different strikes (diagonal spread).

Time value: The amount of an option's value that is a function of the time remaining until expiration. As expiration approaches, time value decreases at an accelerated rate, a phenomenon known as "time decay."

Vertical spread: A position consisting of options with the same expiration date but different strike prices (e.g., a September 40 call option and a September 50 call option).

Volatility: The level of price movement in a market. Historical ("statistical") volatility measures the price fluctuations (usually calculated as the standard deviation of closing prices) over a certain time period — e.g., the past 20 days. Implied volatility is the current market estimate of future volatility as reflected in the level of option premiums. The higher the implied volatility, the higher the option premium.

Volatility skew: The tendency of implied option volatility to vary by strike price. Although, it might seem logical that all options on the same underlying instrument with the same expiration would have identical (or nearly identical) implied volatilities. For example, deeper in-the-money and out-of-the-money options often have higher volatilities than at-the-money options. This type of skew is often referred to as the "volatility smile" because a chart of these implied volatilities would resemble a line curving upward at both ends. Volatility skews can take other forms than the volatility smile, though.

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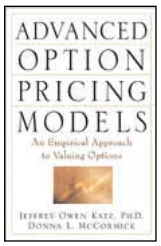

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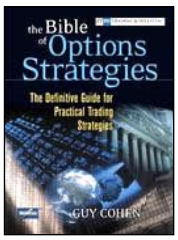

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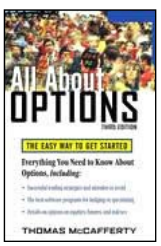

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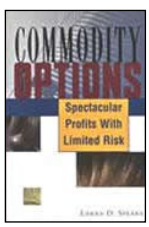

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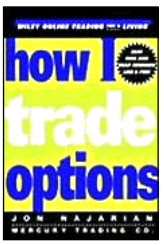

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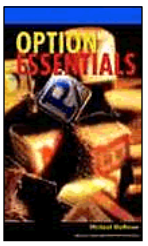

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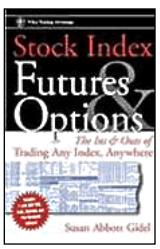

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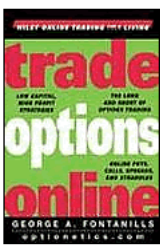

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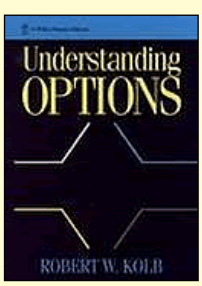

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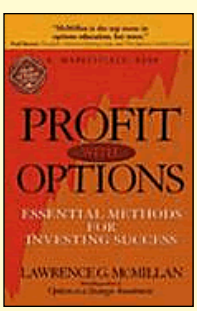

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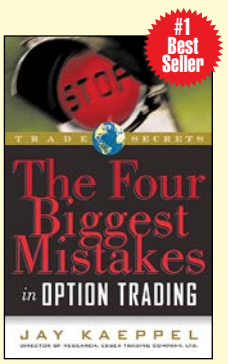

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Event: The Options Course for Advisors and Planners
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For more information: Visit www.cboe.com

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Event: The Traders Expo San Diego
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Location: Marriott Hotel & Marina, San Diego, Calif.
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Event: Forex Trading Expo
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Event: Wealth Expo
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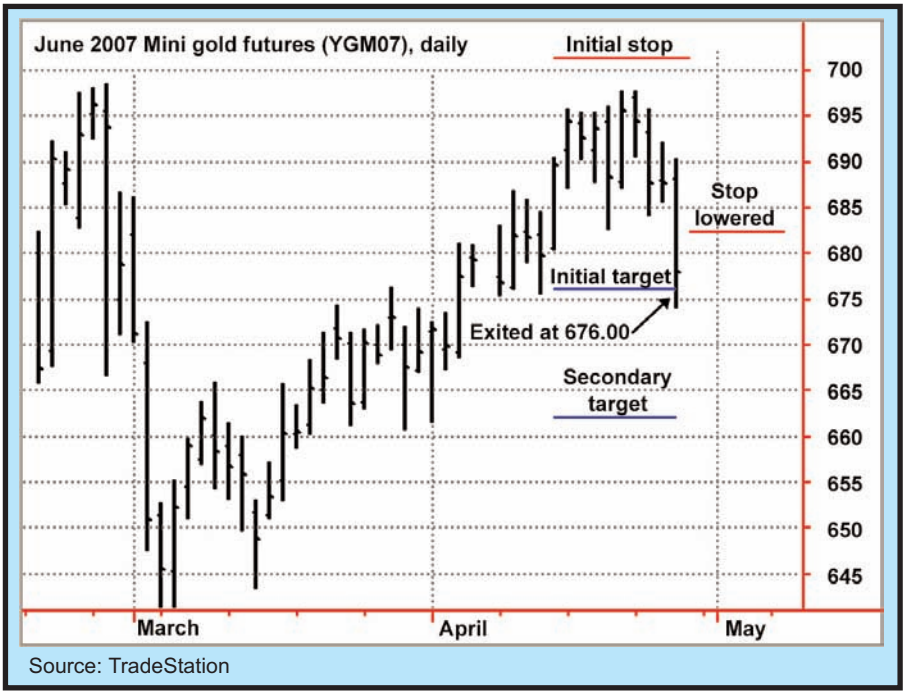
Nov. 30-Dec. 2, Schaumburg, Ill.

Price analysis shows potential for a downturn near resistance.



Source: TradeStation

TRADE

Date: Wednesday, April 25, 2007.

Entry: Short mini gold futures (YGM07) at 687.50.

Reasons for trade/setup: After selling off from just below $700 to around $641 in late February and early March, gold rallied back to 697.70 on April 20 before stalling again. The market's failure to surpass its previous high has no doubt made gold bugs nervous.

Toward the end of the trading session on April 25, it was apparent the market was going to form an inside day with a lower close. Testing showed a move below the inside days implied additional downside movement. We got short a tick below the closing price.

Initial stop: 701.40, which is 2.80 above the Feb. 27 high.

Initial target: 676.00, which is 0.30 above the April 12 low. Exit part of the position and lower the stop on the remainder of the trade. Secondary target: 662, which is just above the three lows from late March and early April.

RESULT

Exit: 676.00.

Profit/loss: +11.50.

Trade executed according to plan? No.

Outcome: The day after entry turned out to be a big down day: The market hit the initial profit target of 676.00 and dropped as low 674.30 intraday. We immediately lowered the stop to 682.40 to lock in a profit on the second half of the trade — just in case this turned out to be another fake-out to the downside. Gold has made plenty of sharp down moves like this one, only to rally and close in the upper half of its daily range (April 2, for example).

Gold bounced a little after making its first morning low at 675.40, rallying as high as 678.40. It subsequently turned back down, and we decided to exit the remainder of the position at the initial target price. The selling urgency seemed to have left the market, and we decided it would be easy enough to re-enter on the short side; an upside reaction of some kind is virtually inevitable after such a big down day (e.g., Feb. 27 and 28).

If the market plummets again tomorrow, we'll regret it, but an overnight 1.7-percent profit was too tempting to sit on.

TRADE SUMMARY

Date	Futures	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Trade length
4/25/07	YGM07	687.50	701.40	676.00	0.83	676.00	4/26/07	11.50 (1.7%)	13.20	1.90	1 day

Legend: IRR — initial reward/risk ratio (initial target amount/initial stop amount); LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade).

Stock sells off — counter to expectations — but a short put trade profits nonetheless.

TRADE

Date: Wednesday, April 4.

Market: Options on Research in Motion (RIMM).

Entry: Sell 10 April 120 puts at $0.35 each.

Reasons for trade/setup: In early April, options on Research in Motion (RIMM) appeared expensive because their implied volatility (IV) was 38 percent and the stock's historical volatility was just 27 percent. However, the company planned to release fourth-quarter earnings within a week, so inflated IV was not surprising.

Testing showed that since December 1999, RIMM has tended to trade sideways the week before quarterly earnings and encounters a bullish bias the following week. In the two weeks surrounding earnings, RIMM's average up

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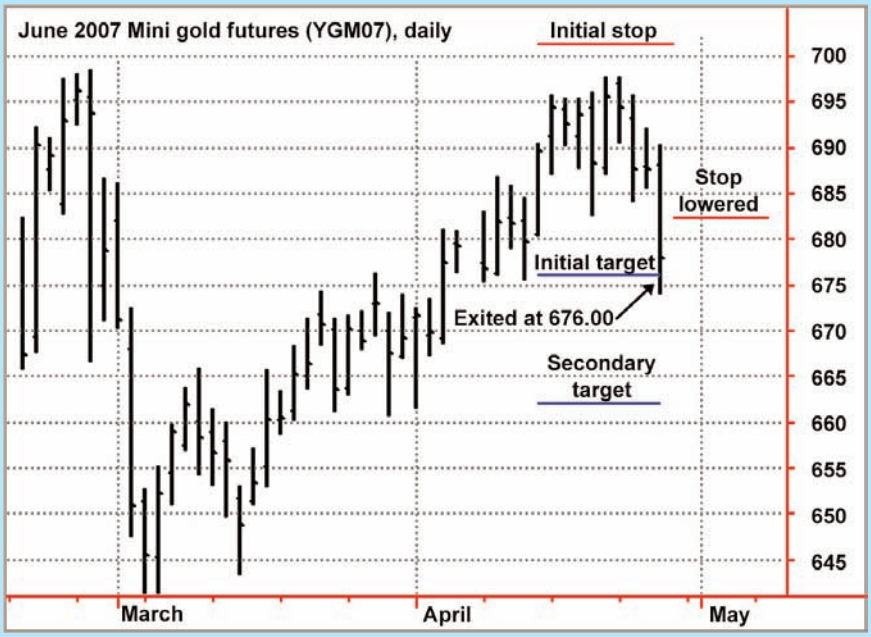
FIGURE 1 — SHORT PUT RISK PROFILE

Selling April 120 puts on Research in Motion should be profitable because the short strike is well below its historical trading range (shaded area) and the second standard deviation (blue bar, below).



Source: OptionVue

TRADE STATISTICS

Date	April 4	April 20
Delta	40.66	0.23
Gamma	-4.71	-0.10
Theta	47.81	0.57
Vega	-32.65	-0.13
Probability of profit	98 percent	100 percent
Breakeven points:	119.65	119.65

TRADE SUMMARY

Entry date	April 4
Underlying security:	Research in Motion (RIMM)
Position:	10 short April 120 puts
Initial capital required:	$14,585
Initial stop:	Exit trade if RIMM drops below breakeven point ($119.65)
Initial target:	RIMM trades above $120 by April expiration
Initial daily time decay:	$47.81
Trade length (in days):	15
P/L:	$350 (2.4 percent)
LOP:	$310
LOL:	$100

LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade).

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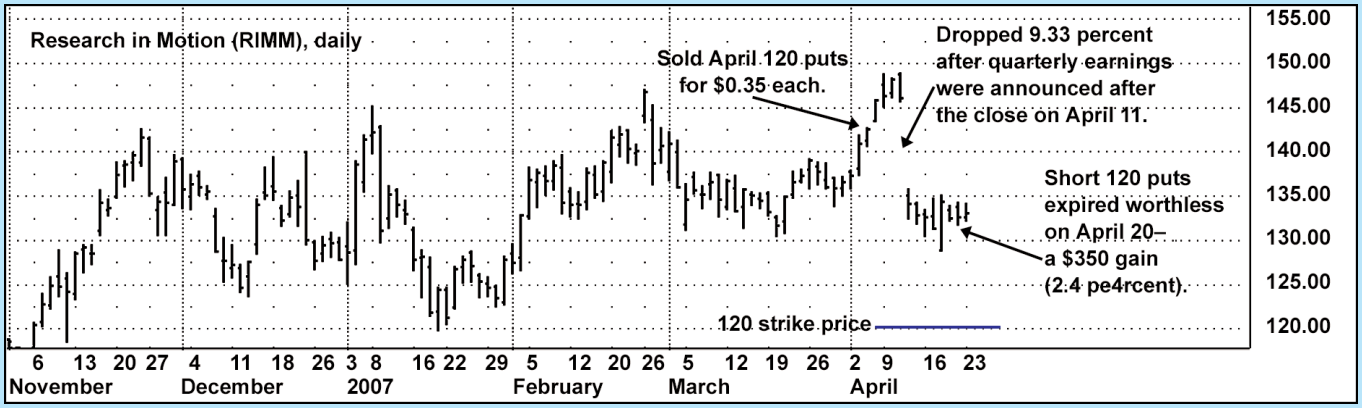
FIGURE 2 — POST-EARNINGS DECLINE NOT A THREAT

RIMM fell 9.33 percent on April 12 after quarterly earnings hit the Street — not enough to endanger the 120 short puts, which expired worthless on April 21.



Source: eSignal

move was 18.59 percent and its average down move was -11.09 percent — a fairly wide trading range. Selling options with strikes above or below these levels could be profitable.

On April 4, RIMM traded at $142.10 and April 120 puts cost $0.35. These puts were nearly 16 percent out-of-the-money (OTM), with an IV of 50 percent. By contrast, the average IV of all RIMM puts was just 40 percent. According to the market, the stock could drop more than 16 percent by April 21 expiration in response to earnings, but testing showed this was not likely, so we sold April 120 puts for $0.35 each.

Figure 1 shows the position's potential gains or losses on three dates: trade entry (April 4, dotted line), halfway until expiration (April 13, dashed line), and expiration (April 21, solid line). The shaded area represents RIMM's potential trading range until expiration, and the red and blue bars (below) show the first and second standard deviations, respectively.

The strategy has a 98-percent chance of success mainly because the 120 short strike is so far OTM — well below the second standard deviation and RIMM's historical trading range. Finally, the 120 strike also represents a three-month low, which could act as a possible support level (see Figure 2).

The position will be held until the short puts expire on April 21, unless RIMM drops to the breakeven point beforehand.

Initial stop: Buy back puts at the breakeven point of $119.65.

Initial target: RIMM trades above $120 until April 20 (last trading day).

RESULT

Outcome: Figure 2 shows RIMM climbed in the four days before earnings news, which benefited the trade. The stock jumped 4.4 percent to all-time highs within two days. Although Research in Motion fell 1.6 percent just before earnings were released after the April 11 close, RIMM needed to slide another 17.82 percent before the 120 short puts moved into-the-money.

The stock opened 7.57 percent lower the next day and declined 0.64 percent further by April 12's close. Despite this plunge, the April 120 puts were worth just $0.10 at that point. Research in Motion continued to drop and even traded within 7.1 percent of the breakeven point on April 18. However, the short 120 puts expired worthless two days later, and we kept the $350 premium — a 2.4-percent gain.

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