options central

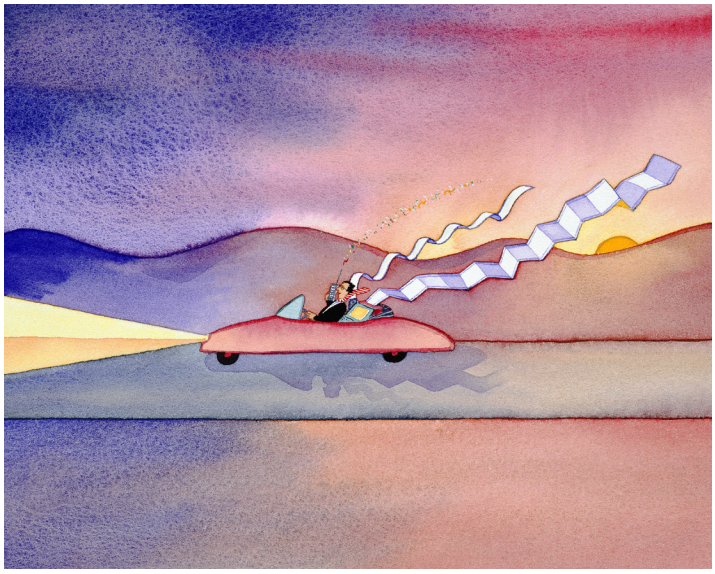
SUMMER 10

In this summer 2010 issue:

How to Change Your Strategy for a Changing Market

By: Barry Nobel

Back in the 1980's and 90's when I was a member of the Philadelphia Stock Exchange, there were two types of traders on the floor. There were the guys who would think about how much money they could make on a trade, and those who would think about how much money they could lose. I was in the latter group. I would hold a position for seconds, minutes or days, but I never planned to hold it until expiration. My strategy was to take advantage of small price discrepancies between the underlying stock and the option. I looked at the world at a single moment — what the theoretical edge was, what I was going to do and how I could lock up the position or get out with a profit.



The very nature of options, specifically the fact that they expire, makes most options investors active. These instruments are used most effectively when changes in the price are continuously monitored and reviewed as the options approaches expiration. Passive investors, on the other hand, may look at profit and loss over years without adjusting their investment portfolio. When their options go in-the-money, passive investors may hold them instead of selling, but in doing so, they may miss opportunities to profit from changes in volatility.

continued inside

Barry S. Nobel is Vice President NASDAQ OMX PHLX. Previous to this he was the Vice President of Marketing for the Philadelphia Stock Exchange. He has held this position since May 1999.

Currently, Mr. Nobel is part of the senior management team of the NASDAQ OMX Option Markets. NASDAQ Options Markets offer equity options, Sector Index Options, and World Currency Options products.

From 1984 to 1999, Mr. Nobel was general partner of Nobel Securities, a proprietary trading firm on the PHLX that traded equities, equity options, fixed-income securities and currencies. Prior to that, Mr. Nobel was associated with Newcomb Securities (Newcomb), a New York-based arbitrage trading firm. At Newcomb, he spearheaded a partnership between Newcomb and Reuters International for a screen-based trading system for U.S. Treasury fixed-income securities that included extensive promotion throughout Europe and North America.

Mr. Nobel has been an active volunteer participant in the National Adoption Center - Global Interdependence Center, and Rutgers University.

He holds a bachelor's degree in economics from Rutgers University in New Brunswick, NJ.

NASDAQ OMX PHLX

continued from front

Let's go back to the basics for a moment. Options prices reflect intrinsic value (the difference between the strike price and the current market value of the underlying stock) and time value. While in-the-money options prices are affected by both intrinsic value and time value, out-of-the money options prices reflect only time value. Whether options are in-the-money or out-of-the money, volatility impacts their price.

Volatility can be historical or implied. Historical volatility is calculated by determining the average deviation from the average price of a financial instrument in the given time period. In other words, it's the measure of stock price fluctuation. Mathematically, volatility is the annualized standard deviation of a stock's daily price changes. Implied volatility is an indication of whether options prices are over- or undervalued. Options pricing models calculate a theoretical value for the option. Increasing volatility increases the price of the option.

The Chicago Board Options Exchange Volatility Index (VIX®) is a popular measure of implied volatility. People sometimes call it the "The Fear Index" because it is an indication of uncertainty in the market. The normal range for the VIX is 17-25. In the period between 2004 and 2006, the VIX dropped to around 10-12. It went up to around 80 at the height of the 2008 Bear Stearns and Lehman Brothers failures. In the first half of 2010, the range on the VIX was 15-48.

The VIX can swing wildly, but generally speaking, low levels of realized market volatility accompany periods of low VIX readings. Long and gradually up-trending markets, like the 2004-2006 period, tend not to be volatile. When there are significant downdrafts, the VIX can easily move to the high 20s and above.

"During the latter part of 2007 and all of 2008, over-leveraging and financial services industry-specific risk spilled over into the mainstream economy, thus creating widespread uncertainty."

FROM THE Editor

Welcome to the Summer 2010 issue of Options Central – The Options Industry Council's educational newsletter!

In this issue, Barry Nobel, Vice President of NASDAQ OMX PHLX, discusses how to be versatile with strategies in today's changing market. Then in the Bid and Ask section, OIC's Help Desk provides frequently asked questions relating to the new Weekly Options. Don't forget to review our Readers' Quotes section where fellow investors share their thoughts.

We hope you enjoy reading this issue of Options Central and as always, we welcome your feedback

Volatility Trends

Volatility is affected by several factors. Macroeconomic trends revealed through statistical data releases and major crises affect the market as a whole. Events such as mergers and acquisitions, government regulations and environmental disasters can increase volatility in specific companies or sectors.

During the latter part of 2007 and all of 2008, over-leveraging and financial services industry-specific risk spilled over into the mainstream economy, thus creating widespread uncertainty. These conditions caused the markets to go into wild convulsions.

Risk and uncertainty drive volatility, which affects particular companies and industries as well as the general economy. During the financial crisis, some sectors were more volatile than others. If one drew a continuum, financial services would be at the high end of the volatility spectrum and low-cost consumer staple goods would be at the low end. Between late spring and fall 2008, for example, the volatility of Bank of America and Citigroup shares increased by a factor 10, whereas the share volatility of giant retailers Wal-Mart and Costco merely doubled.

Normally, one or two asset classes might experience high volatility simultaneously. During the crisis, however, there were wild price swings in just about all asset classes. The dollar rose by around 10 percent against the euro, oil declined by approximately 72 percent, and the Dow Jones Industrial Average fell by about 24 percent. The upheaval in asset prices translated into business uncertainty. Companies rely on those asset classes to buy raw materials, sell products and raise capital. The uncertainty, in turn, led to a freeze in economic activity.

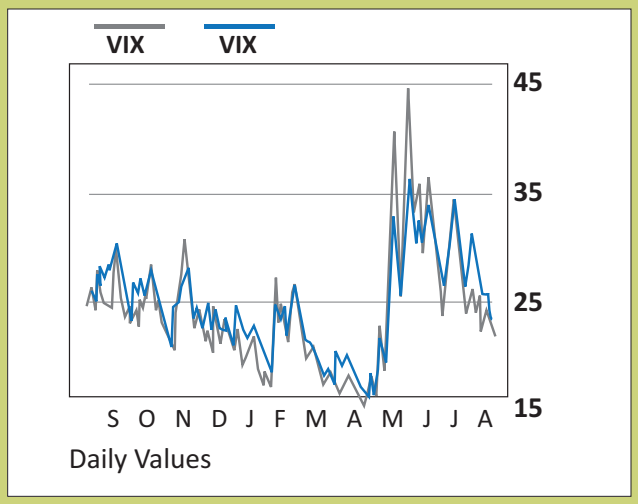
Investment decision-making was based on emotion – fear to be exact. Traditional buy and hold investors liquidated riskier positions and fled to cash. Speculators both bought and sold aggressively depending on the latest news or rumors from around the world. These massive crosscurrents resulted in much higher trading volumes and contributed to heavy intra-day volatility.

Volatility affects trading volumes and liquidity. High volatility means market uncertainty, which in turn could mean more opportunity resulting in higher options trading volume. But over a long period of time, high volatility can potentially suppress volume. Some investors may become risk averse and choose to remain on the sidelines until the market stabilizes. When volatility goes up, so do options prices. When options become too expensive, investors avoid buying them because they perceive the price of the risk to be too high. Investors may sell options when implied volatility is high and expect it to decline. However, options writers have to put up collateral against their positions. When volatility is high, so are margins, and this can potentially deter investors from opening new positions. Conversely, when volatility is very low, investors may lose interest.

Some volatility is good for investors. Don't forget, with uncertainty comes potential reward. An investor who owns an underlying stock, has a long-term investment strategy and is willing to endure the risk of being in the market, can take advantage of the uncertainty and be rewarded for it. But investors should educate themselves about how volatility can work for and against them.

I remember being an inexperienced floor trader making options markets in a savings and loan that was declining in price. The volatility went from the low 30s, to the mid 60s, to the high 80s, and to the mid 90s. I didn't understand volatility, so

Figure 1: CBOE Volatility Index



Source: CBOE®

"Uncertainty drives investors to incorporate options into their portfolios because they can help protect and enhance profits."

I started to sell it when it got to about 96 or 98. My younger brother, who was my partner, came over and asked me if I was missing part of my position. I explained to him that, no, I was just short all those calls and puts. He asked me why I was doing that. My answer was that the volatility was 98 and it could only go to 100. He said, "Barry, you have to understand what you're doing before you do it."

Volatility went to 120 almost before we could breathe. I thought volatility could only go to 100%. I learned a hard lesson that day.

Options Plays On Volatility

Most long-term investors start trading options using a simple buy-write strategy. They sell single stock calls against the underlying equities in their portfolio to generate additional income. This strategy allows the stocks to grow over time, combining income and capital appreciation. It also reduces the risk in the overall position because the options premium offsets some of the loss if the stock goes down in price.

Another alternative is to sell index or ETF options instead of single stock options against your portfolio. For instance, you could buy an ETF and write monthly at-the-money ETF calls on all assets in the portfolio. Essentially you get the return of the market with far less volatility and risk.

You can also write at-the-money ETF calls against the underlying ETF that you own. This will allow you to capture the dividend of the portfolio you own. Some investors lean toward accumulating dividends in calmer markets. In times of higher volatility, they de-emphasize dividends and write more index calls. In a rising market, they might want to have more of the stocks invested in dividend paying names that can appreciate with the market, and have fewer index calls written against them.

Yet another buy-write strategy is to sell ETF calls on a portion of the portfolio and buy out-of-the-money ETF puts against the full notional value of the portfolio, providing protection against a falling market.

Keep in mind, you should always choose an options strategy that is most suitable in the current market environment. I was leading an OIC seminar in Philadelphia in 2010 at a time when volatility was declining. It had just broken through 16, and it looked like it was headed toward 15. We were discussing the benefits of selling calls against a long position and a member of the audience asked why anyone would want to sell the premium when volatility was low. That was a perceptive question because in that particular environment it may have been better to deploy a stock replacement strategy; sell your stocks and buy long-term call options, thereby reducing your overall risk and exposure. The objective is to gain the same type of exposure to the underlying asset for a lower cost than buying it outright. Investors often buy in-the-money options because the delta (the change in the price of the option which corresponds to the change in the price of the underlying stock) will be close to 100 and will typically change $1 for every $1 gain in the underlying stock.

If you think a stock in your portfolio might go down, you could sell it and buy an at-the-money call. It's like buying insurance. If the market goes up, you can exercise your call and restore your long position. If the market goes down, all you've lost is the premium you paid for the call.

Some investors like to take advantage of combination strategies. Straddles are used when there's going to be a big move in the market, but the direction is uncertain. It's established by taking a position in both a call and a put with the same strike price and expiration date. Straddles can be either bought or sold, and typically the strike price is at-the-money or close to it. Strangles are similar to straddles except that the put and call have different strike prices, both out-of-the money with the same expiration month.

Spreads also can be used to take advantage of vola-

tility, especially when you are moderately bullish or bearish. A bull call spread is the purchase of a call option on an underlying stock and the sale of a call option on the same underlying stock with the same expiration month, at a higher strike price. A bear put spread is the purchase of a put option on an underlying stock and the sale of a put option on the same underlying stock with the same expiration month, but with a lower strike price. In a calendar spread, you sell short-term options (one month) with high implied volatility and buy longer-term options with low implied volatility.

Getting In and Out

Charts and graphs showing the breakeven point and profit and loss at expiration are useful for understanding the dynamics of an options strategy. If you're just starting out though, try not to get blinded by charts and graphs. Think in terms of the opportunity that options can provide, not in terms of how much money can be made or lost on the trade by holding them to expiration.

Taking the plunge into options is daunting for some investors, so start by selling one call option, even if you have 10,000 shares of a given stock in your investment portfolio. That first step turns a passive investor into an active investor. Then, watch the options price and see what happens when uncertainty comes into the market.

Online broker-dealers have tools that allow investors to do sophisticated pre-trade analysis and narrow their search for the right trade. An investor might start by looking for steady stocks that have gone up 10 percent in the last year, but not more than 5 percent in one day, one week or 30 days. The choice can be narrowed further by selecting stocks whose volatility has not increased or decreased more than 10 percent within a certain time frame, or stocks that are highly correlated with the volatility of the market as a whole. The next step might be to look at the trade history of these stocks over the last several months to see if your strategy would have worked. Eventually the tool comes up with a suggested trade, the projected income to expiration and a success factor expressed as a percentage. Some programs allow the investor to move seamlessly from the analytics program to the trade ticket allowing the investor to send the order for execution.

While getting into the trade is straightforward, getting out can be more problematic. In fact, retail investors tend to not get out; they just stay in. ("Get out" means to close a position, sell out of a long option or buy back a short position.) Some investors marry their positions, forgetting what it's like to date. This is what differentiates active and passive investors. Active investors liquidate a position when the target profit has been attained, or when it has not worked as expected. If they are uncertain, they sell part of their holdings.

Options are like an insurance policy on a portfolio. Think of it this way: people purchase insurance because the future is unpredictable. They hope they won't have to use it, but they're happy it's there when they need it. Similarly, uncertainty drives investors to incorporate options into their portfolios because they can help protect and enhance profits. Understanding how options work gives investors the confidence to incorporate them into their portfolio, albeit on a small scale. With experience, people begin to see their investment as something not predictable or stagnant but something that needs care and attention. They begin to become active investors.

Online brokers and OIC allow investors to "mock trade" and test their strategy before executing it. Those who have questions about options can call the free OIC help desk at 1-888-OPTIONS and speak to options professionals.

In addition, those investors who are not self-directed and would like to take advantage of increased yield can reap the benefits of options through the many managed buy-write funds that are available through your investment advisor. Volatility swings are par for the course; understanding how to navigate them, actively or passively, will greatly impact your investing.

To simplify the computations, the examples in this article do not include commissions or transaction costs. Commissions and transaction costs will affect the outcome of all stock and options transactions and must be considered prior to entering into any transaction. Investors considering options should consult their tax advisors as to how taxes may affect the outcome of contemplated options transactions.

Common Options Terms

At-The-Money
A term that describes an option with a strike price that is equal to the current market price of the underlying stock.

Buy-Write
A covered call position in which stock is purchased and an equivalent number of calls written at the same time. This position may be transacted as a combined order, with both sides (buying stock and writing calls) being executed simultaneously. Example: buying 500 shares XYZ stock, and writing 5 XYZ May 60 calls.

Historic Volatility
A measure of actual stock price changes over a specific period of time. See also Standard deviation

Implied Volatility
The volatility percentage that produces the 'best fit' for all underlying option prices on that underlying stock.

In-The-Money
An adjective used to describe an option with intrinsic value. A call option is in the money if the stock price is above the strike price. A put option is in the money if the stock price is below the strike price.

Liquidity
A trading environment characterized by high trading volume, a narrow spread between the bid and ask prices, and the ability to trade larger sized orders without significant price changes.

Straddle
A trading position involving puts and calls on a one-to-one basis in which the puts and calls have the same strike price, expiration, and underlying stock. A long straddle is when both options are owned and a short straddle is when both options are written. Example: a long straddle might be buying 1 XYZ May 60 call, and buying 1 XYZ May 60 put.

Volatility
A measure of stock price fluctuation. Mathematically, volatility is the annualized standard deviation of a stock's daily price changes.

Q: Is it true that some exchanges are trading options series that expire weekly?

A: Yes, and they call them "Weekly Options Series" or "Weeklys". In addition to previously listed index Weekly options series, the exchanges are now participating in an approved pilot program which allows trading in some equity and ETF Weeklys. These Weeklys have a very short time until expiration – approximately one week. Weekly option series will be listed on a Thursday or Friday and, in most cases, expire the following Friday. Each exchange can list weekly options series on a limited number of classes during the pilot program. You will want to become fully familiar with the contract specifications of any option product you trade by visiting the exchange website where that contract trades.

Q: Will Weekly options be listed every week?

A: Weekly Option Series will be listed each Thursday or Friday (depending on the listing exchange's rules) and expire the following Friday except for those instances when the following Friday is a standard Expiration Friday (the 3rd Friday of the month). If the following Friday is an OCC holiday, the weekly option series will expire on the Thursday preceding the holiday. No new Weeklys are listed that would expire during the expiration week for standard options (the third Friday of each month). In other words, the exchanges do not list new Weeklys on the 2nd Thursday of a month and do not trade Weeklys during the following, standard expiration week until new series are listed on Thursday of that week.

Q: How can one distinguish the Weekly from the Standard options?

A: You will see the explicit numerical calendar day of expiration in any contract you trade since the option symbols now include the expiration date. Data vendors may display this data in different formats. Ultimately, entering correct order information for the specific call or put you want to trade is your responsibility. If you have any doubt at all about the product you are trading, the expiration date, the symbology key (if needed) or any other data you're entering then check with your brokerage firm before placing your order.

To learn more about Weekly Options, click here.

If you don't find the information you're looking for, email one of our options professionals at options@theocc.com.

Readers' Quotes

"Thanks for the insight – now I see how shorting the naked put was indeed a bullish strategy. Since I'd already bought a single put when the stock price dropped from $20 to $17, I sold another put to hedge against the price increase (from $17 to $19). Selling covered calls sounds like a good idea, too, since I am somewhat ambivalent about owning this stock.

I'm learning so much about options value, strategy, and volatility through these paper trades and through my OIC study guides and handouts. Thanks again"

Brenda Chau - OIC's Call Center

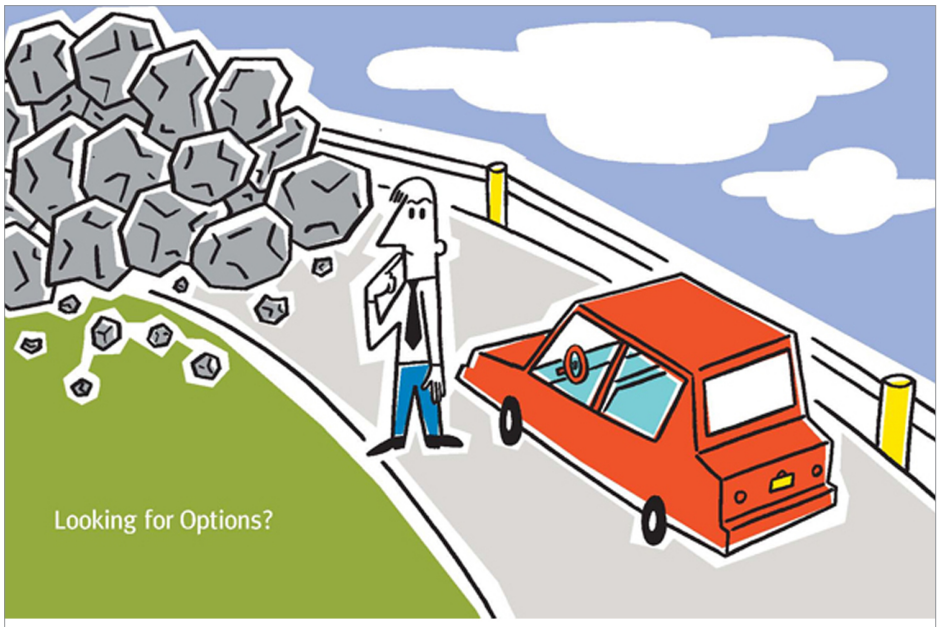
Want to let others know about a strategy that worked great for your portfolio? Have an experience to share about an educational tool that gave you some insight into options trading?

The Options Industry Council invites you to submit your options experiences to be featured in *Options Central*. Send us your testimonials to be featured in our Readers' Quotes section for our next issue!

***Options Central* welcomes letters and questions that address articles or other options items. Submit letters to optionscentral@theocc.com.**

Letter submissions may be edited for space. By submitting any letter, you consent to its publication along with your name. *Options Central* is under no obligation to print all pieces submitted.

Editor's Note - An options investor may not have typical results as stated above as there are multiple, different outcomes from strategies in options trading.



SAVE THE DATE FOR AN UPCOMING IED THIS YEAR!

OIC's Investor Education Day (IED) will help you develop your ability to trade Options – an ideal investment for stuck markets, and stuck investors.

New York - October 5
New York Marriott Marquis

Chicago - October 23
Hyatt Regency Woodfield
Schaumburg

ied INVESTOR EDUCATION DAY

Space is limited so register today at **OptionsEducation.org** or call **1-888-OPTIONS**.

Upcoming Seminars

Check out www.OptionsEducation.org for a complete description and schedule of OIC seminars. Below is the schedule for live seminars running throughout the fall.

September

15 Detroit, MI - Basic
16 Detroit, MI - Intermediate
21 San Jose, CA - Basic
21 Parsippany, NJ - Volatility
22 San Jose, CA - Intermediate
23 Philadelphia, PA - Volatility
28 St. Louis, MO - Intermediate
28 Los Angeles, CA - Basic
29 St. Louis, MO - Volatility
29 Los Angeles, CA - Intermediate
30 Atlanta, GA - Volatility

October

5 Schaumburg, IL - Intermediate
6 Schaumburg, IL - Volatility
6 Minneapolis, MN - Basic
7 Minneapolis, MN - Intermediate
21 Boston/Cambridge, MA - Volatility
26 Baltimore, MD - Intermediate
27 Baltimore, MD - Volatility
27 New York (Downtown) - Basic
28 New York (Downtown) - Intermediate

November

3 Pasasdena, CA - Intermediate
4 Pasasdena, CA - Volatility

Registration is required. The seminars listed here are FREE and held from 6 p.m. - 9 p.m. To register for a seminar or order educational materials, call 1-888-OPTIONS or visit www.OptionsEducation.org.

OIC The Options Industry Council

One N. Wacker Drive, Suite 500
Chicago, Illinois 60606

1-888-OPTIONS (1-888-678-4667)
www.OptionsEducation.org

FOR MORE INFORMATION

If you have additional questions about options, contact your financial advisor or one of the exchanges listed here.

BATS Options Exchange
1-913-815-7000; www.batsoptions.com

Boston Options Exchange
1-617-235-2000; www.bostonoptions.com

Chicago Board Options Exchange
1-877-THE-CBOE; www.cboe.com

International Securities Exchange
1-212-943-2400; www.ise.com

The NASDAQ Options Market℠
1-800-846-0477; www.nasdaqomxtrader.com/options

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