

Safety First

Sunday May 14<sup>th</sup>, 2006

## Adjustment to your Positions Part 2 – Risk Management

You've got to admit, this business is a blast (especially if you are on the right side of it.) We mentioned last week that the SPX was about 1326 and I outlined an adjustment strategy if your spread got into trouble. (See below for notes on it again.) Well as you likely know, Uncle Ben rose interest rates as expected and didn't drop many clues as to future direction of interest rates and on top of that commodity prices soared (gold, silver etc..) This 1-2 punch was able to take 260 points off of the Dow in the 2 days following. Again, if you are on the right side of these things, this business rocks!

Ok, let me take a minute to get your mind around the already profitable trades we entered into for June. Soon after the Bernake comments ended up essentially a non-event. I began to fish for June calls. This is right on target with the 5-6 weeks that I ideally like to initiate these positions. We were at multi-year highs, overbought, and a Fed meeting with no bullish implications and heading into a more neutral time of the year, combine that with the 'Sell in May and Go Away' commentary that you read here a couple weeks ago and you can see a nice setup for bear calls for June's expiration. Positions already initiated for June include the 1370/1380 for \$1.00 credit, 1350/1360 for \$2.20 credit (initiated last week) and 1350/1360 for \$1.45 credit. Initiated the day after the Fed announcement. If you are seeing the market overbought and beginning to show major signs of weakness, obviously this is an opportune time to initiate your Bear Call Spreads, judging my the emails, many of you are already good at this.

Technical Analysis prior to position entry will yield the Iron Condor / Spread Trader more choices on any potential adjustment. My initial thought last year, is to wait until the market bottoms out and then go fishing for some Bull Puts, however this is where I want to begin, as you'll be the beneficiary of my mistakes last year... Friends, to echo my sentiments last week, an options trader's main job is risk management. Sure the rates of return and the money is great, the debt freedom and being able to make money anywhere in the world, but those are all expected benefits from the disciplined approach you are taking here. If you want to solidify this – write down **"I am a great Risk Manager!"** and paste it to your computer monitor. I regress. So think about this and internalize it. Why would you place a Bull Put on a downtrending stock / index? Over the last few days, judging by the VIX jumping up to 14, there has been new found respect for the market / put buying. (Remember this index in the late ninties would range from about 18-30) People usually don't panic and buy, but they do panic and sell. Let me also submit to you that we could be at a MAJOR top in the market – it that possible? We've been uptrending since 2003 and most recently from October lows of near 1170 to a high of 1325. That sounds like about 13% in 6 months, in the face of \$75 oil, rising interest

rates, and consistent global uncertainty. Is it possible that we'll retrace to 1240 – of course! Just be open to it.

Why the long winded explanation, with a spread trader, you have many choices on how to exit, however those choices become more limited with a poor entry. I think the entries for June explained above are good to go, in fact in the bit more aggressive account, I may re-enter at a lower level as these positions are already profitable. As the RSI is way oversold, we are to expect a bounce in the near term and how that bounce resolves itself will be very tell-tale as to the nearer term direction.

From last week:

Let me take this time to give you a some benchmarks for your credit spread adjustments, now these are without the technical analysis that we use.

- >15 days from expiration, 10-15 (20) points from your short strike OR when delta of short strike hits 25-30, whichever comes first
- <15 days from expiration, 5-10 points from short strike or when the delta of short strike hits 25 whichever comes first.
- Close position (both legs) and move up your sold 'wings.' Increase position size by 50%

Risk Management. Consider your profits from trading from a yearly perspective with this strategy. You'll find it a bit easier on your emotions. Lastly, in a trending environment, I would have a tendency to only put on one leg of a Condor and then look to potentially play the move with bias options (long calls or puts.) This is the time of year to calm down a bit with this strategy, remember it is largely neutral.

Wait for the impending bounce to resolve itself and see how it behaves. Let the trade come to you.

Stay Disciplined,  
Michael Drew