

ThinkorSwim Options Training

Notes from 2/2/07, San Diego - Doubletree Hotel, South Hotel Circle.
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ABOUT Think or Swim (“TOS”)

- Founded in 1997. Platforms first ready in 1999.
- Desktop, Web-based and mobile platforms available.
- Focus is on options and order routing.
Merrill, and Citigroup use the institutional version for the platform.
- 11 Technology upgrades planned for 2007
- Churn rate [percentage of clients to move from one brokerage to another] in the retail markets averages about 35% for most brokerage firms. TOS claims to have a churn rate of 12%.
- Investools ← → TOS merger. Arranged between Lee Barber, CEO of Investools and Tom Sosnoff and Scott Sheridan, principals of TOS.
- Since merger, there are 70 people working on technology.
- Investools previously bought Prophet.net (Java-based charting tools), and that technology was previously incorporated into TOS platforms. Future versions of TOS will likely include latest version of Prophet Charts [which is currently in latest version of Investools Toolbox]
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TRADING STRATEGIES:

Don recommends trading in products like the SPDRS (Symbol: SPY) which is a derivative (1/10 of the S&P 500 Index).

- Choose a product like the SPY and always try to get fills at the mid-point.
- VOLATILITY = RISK, but volatility is NOT measured on the stock price, but rather it is measured based on the number of PUTS on the underlying.
- Always consider the WORST CASE scenario.
- Look at the probabilities of a trade. (NOTE: Delta and Probability of Expiring are almost the same, so you can approximate risk by looking at Delta)
- Be a SELLER or premium. You will want a positive THETA, which is the rate of decay. As a seller, option premium declines with time, so you are really waiting to see you money [stay with you.]
- Sell out of the money “junk” and manage risk. (see other rules)
- Don’t place trades [on spreads or stocks] when the Market is closed, as you will get bad fills, and probably not get your prices.

Rules to consider:

1. **Be a SELLER of Premium**
Bearish Strategy: **SELLCALL** spreads
Bullish Strategy: **SELL PUT** Spreads
2. **Trade liquid products** which he defines as:
Massive Liquidity
High Open Interest
Tight Markets
3. **Sell Spreads 4-10 WEEKS prior** to expiration date.
Don't sell Front month options. Exit 4-10 Calendar DAYS before expiration.
4. **Look for trades with 50 – 70% probability of success.**
(As traders gain more experience, they can move up to 85%)

CASH Management Rules:

1. **Never risk more than 3-5%** of your available trading capital on any one trade.
2. **Exit all trades 4-10 Calendar Days** prior to option expiration date.
Absolute last day should be Tuesday of option expiration week.
Close out trades when you can buy back leg for .05 - .10
[TOS charges no commissions on repurchases priced at .05]

OTHER OBSERVATIONS:

- Margin requirements are changing April 2. Margins will be almost unlimited [partially to compete with European market rules]
- In addition to SPDRS (SPY), other possible products which meet the liquidity criteria include, MNX, IWM. (OEX ??)
- Use the TOS (website: www.thinkorswim.com) to look at archives of chat rooms as a source of training materials.
- Don't do 1 TRADE for 10 contracts, but consider doing 3 trades for 3, 3, 4 contracts across different strike prices or dates on same underlying.
- Dan recommended Iron Condor's on index products (like SPY).
- Don't use the QQQQ, use MNX instead. It offers better tax consequences, although Don could not elaborate.)
- Look at the Futures (/ES7HG, /NQ7HG), as movements in the futures determine which way the equivalent indexes will move.
- Don Kaufman included this addendum in an email to Brian Cox: *Your group should explore the following index products which exhibit massive liquidity, tight bid/ask, spreads and high open interest; SPY, IWM, DIA, DJX, MNX, XLE, SMH, QQQQ. For extremely experienced traders you could look into the XEO, SPX, NDX, and the RUT.*

OPTION GREEKS:

Delta	Equals the amount of change in your position return/(loss) for \$1 move in underlying
Gamma	Amount of return (loss) in position for NEXT \$1 move .
Theta	Time decay. Amount you make (or lose) per day. Be a seller of premium so that Theta decay is positive.

EXAMPLE:

SPY trading at 144.79 on 2/2/07 (during training class)

Here is an example of a BEARISH (Bear Call Credit Spread)

BUY 148 CALL for MAR '07 and

SELL 147 CALL MAR'07 for a NET CREDIT of +0.35

(NOTE: Screen shot was taken several days later and pricing has changed slightly to 144.81, so that using mid-point numbers on option prices below now may vary by a cent or so. However, the mid-point returned by the TOS system still shows .35 CREDIT at current pricing)

RISK: is -0.65 (= \$1.00 spread width – CREDIT of .35)

BREAK EVEN: SHORT CALL Price + CREDIT = **\$147.35**

(Below 147 on MAR expiration date = Max Profit. Above 148 = Maximum loss)

PROBABILITY: TOS platform includes a Probability of Expiration (In The Money) for each option based on implied volatility. In the example chosen, the Probability that the 147 strike price will be reached (by at least .01) is shown at 34.2%, which also means there is a 65.8% probability that the 147 Strike for MAR will expire worthless [which is what we want.]

Therefore this trade has a 65.8% probability of success

PROBABILITY = RISK divided by SPREAD WIDTH.

But we can also simply estimate the probability of success on the trade by looking at our risk (\$0.65) divided by the SPREAD width (\$1.00) which comes out to 65%.

Traders should be able to estimate probability without using the TOS tool.

SPY		SPDRS		Easy to Borrow		Theo Price		Pr		
UNDERLYING										
LAST X	NET CHNG	BID X	ASK X	SIZE	VOLUME	OPEN				
144.81	+ .20	144.79	144.80	50 x 2	49,607,700	144.73				
TRADE GRID										
OPTIONS										
CALLS		Date	2/4/07		Stock Price Adj	+ .00		Vol Adj	+0.00%	(RESET)
THEO ...	PROB...	OPRA	LAST X	BID X	ASK X	EXP	STRIKE	BID X	ASK X	THEO P...
FEB 07 (12) 100										
MAR 07 (40) 100										
6.05	77.78%	SFBCJ	5.90	6.00	6.10	MAR 07	140	.55	.65	19.19%
5.20	74.07%	SFBCK	5.00	5.10	5.30	MAR 07	141	.70	.75	23.05%
4.30	70.45%	SFBCL	4.30	4.20	4.40	MAR 07	142	.85	.90	27.58%
3.55	64.84%	SFBCM	3.80	3.50	3.60	MAR 07	143	1.10	1.15	33.71%
2.80	58.68%	SFBCN	2.80	2.75	2.85	MAR 07	144	1.40	1.45	40.65%
2.10	51.48%	SFBCO	2.10	2.05	2.15	MAR 07	145	1.75	1.80	48.41%
1.53	43.18%	SFBCP	1.55	1.50	1.55	MAR 07	146	2.20	2.25	57.00%
1.03	34.20%	SFBCQ	1.05	1.00	1.05	MAR 07	147	2.75	2.85	65.82%
.65	25.37%	SFBCR	.65	.60	.70	MAR 07	148	3.40	3.50	74.91%
.38	17.18%	SFBCS	.38	.35	.40	MAR 07	149	4.20	4.30	82.98%
MAR 07 (54) 100										
POSITION AND ORDER ENTRY TOOLS										
		DELTA	GAMMA	THETA	VEGA	P/L %				
SPY		.00	.00	.00	.00	0.00%				
ORDER ENTRY AND ORDER QUEUE										
ORDER ENTRY		ORDER QUEUE								
SPREAD	SIDE	QTY	SYMBOL	SPC	EXP	STRIKE	TYPE	PRICE	ORDER	
VERTICAL	SELL	-1	SPY	100	MAR 07	147	CALL	.35 LMT	LIMIT	
	BUY	+1	SPY	100	MAR 07	148	CALL	CREDIT		

EXAMPLE 2: IRON CONDOR (see screen shots that follow)

As Don describes it... We will sell some OTM junk above the current price and sell some more OTM junk equidistant from the current price.

In this example, the SPY is still selling at 144.81 on 2/2/07 and we will look at doing an Iron Condor for MAR '07, and we go for a \$2 wide spread.

Buy 150 CALL -0.20 (midpoint = .20, Ask = .25, Bid = .15)

Sell 148 CALL +0.65 (midpoint = .65, Ask = .70, Bid = .60)

AND:

Sell 141 PUT +0.73 (midpoint = .73, Ask = .75, Bid = .70)

Buy 139 PUT -0.48 (midpoint = .48, Ask = .50, Bid = .45)

The net credit on this trade based on the MARK (midpoint) is

$$-.20 + .65 + .73 - .48 = .70$$

$$\text{RISK} = \$2.00 - 0.70 = \$1.30$$

$$\text{Probability} = \$1.30 / \$2.00 (= \text{Real Risk} / \text{Spread Width})$$

$$\text{Break Even: } 141 - .70 = \$140.30 \text{ on low OR } 148 + .70 = \$148.70 \text{ (on high)}$$

(note: Total risk is NOT \$4, because the worst case at expiration, only one of the spreads can be a losing spread. We lose on price less than 140.30 or more than 148.70)

symbol	description		information layouts		strike	qty					
SPY	SPDRS		Easy to Borrow		Theo Price	Prob of Expiring					
UNDERLYLING LAST X: 144.81 NET CHNG: +.20 BID X: 144.79 ASK X: 144.80 SIZE: 50 x 2 VOLUME: 49,607,700 OPEN: 144.73 HIGH: 144.95 LOW: 144.38											
OPTIONS Date: 2/4/07 Stock Price Adj: +.00 Vol Adj: +0.00% (RESET)											
POSITION AND ORDER ENTRY TOOLS DELTA: .00 GAMMA: .00 THETA: .00 VEGA: .00 P/L %: 0.00% P/L YTD: \$0.00 BP EFF: \$											
ORDER ENTRY AND ORDER QUEUE ORDER ENTRY ORDER QUEUE											
SPREAD	SIDE	QTY	SYMBOL	SPC	EXP	STRIKE	TYPE	PRICE	ORDER	RULES	EXCHAN
IRON CO...	SELL	-1	SPY	100	MAR 07	148	CALL	.70	LMT	LIMIT	DAY
	BUY	+1	SPY	100	MAR 07	150	CALL	CREDIT			BEST
	SELL	-1	SPY	100	MAR 07	141	PUT				
	BUY	+1	SPY	100	MAR 07	139	PUT				
Advanced Order Single Order Nat: .55 Mid: .70											

[NOTE: You cannot price individual options at penny increments [for now], but a spread contract CAN be submitted at a .01 increments. On the TOS platform, you can adjust the slide bar on the order entry screen anywhere between the NATURAL and Midpoint.]

In this example, the Natural Price would be the BID price for each SELL, and the ASK price for each BUY, or

SELL 148 CALL +0.60 (Bid)
 BUY 150 CALL -0.25 (Ask)
 SELL 141 PUT +0.70 (Bid)
 BUY 139 PUT -0.50 (Ask)

So the NATURAL is 0.55 and can be seen in the slide bar.

(NOTES taken by Marc Covitt: Edited 2/4/07)