

Option Strategies That Are Working Now

Presented by

Lawrence G. McMillan

“The Option Strategist”

3 Gurus Webinar

April 27, 2011

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Market Commentary
Market Commentary 4/8/2011
The market has spent nearly the entire week in a tight range, frustrating both bulls and bears.
Equity-only put-call ratios have continued to remain on buy signals, despite some occasional heavy put buying during the week.
Market breadth has been strong, for the most part. As a result, breadth remains on a buy signal, too.
Volatility indices (\$VIX and \$VXO) have drifted down to very low levels. In general, the decline in volatility is bullish for stocks.

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APR 12 CBOE Launches Gold Volatility Futures and Options
Trading has begun on the CBOE Futures Exchange (CFE) in Gold Volatility futures. If you'll recall, a VIX-like calculation can be made on any set of option prices on an individual stock, as long as there are continuous markets being made in...

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APR 8 Market Commentary 4/8/2011
The market has spent nearly the entire week in a tight range, frustrating both bulls and bears.
Equity-only put-call ratios have continued to remain on buy signals, despite some occasional heavy put buying during the week.
Market...

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APR 7 In focus: New highs in sight
Many of the major indexes have already made new post-2008 highs. This includes the Dow Jones Industrial Averag, the Russell 2000 Index, and the Value Line Index. The latter two are actually making all-time highs, having exceeded their 2007 highs...

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Implied Volatility (IV)

- **A “guess” at volatility during the life of the option**
- **When IV is low, options are cheap
... but when it’s high, they are expensive**
- **When IV rises, the option gets more expensive
(Causes: large price drops, takeover rumors,
FDA hearings, etc.).**

\$VIX

CBOE Invention – 1993:

...using 4 series of \$OEX options

...renamed \$VXO in 2003 conversion

Changed in 2003:

...uses “strips” of two nearest-term \$SPX options, to create an average 30-day volatility

**Created by Prof. Whaley, was Duke Univ.,
now Vanderbilt Univ.**

The VIX Formula

“VIX” is a formula that can be applied to any entity with continuous option markets over all strikes

So, as more and more VIX indices come along, they will be called “Gold VIX,” “Oil VIX,” etc.

So, current VIX is really “SPX VIX” or “S&P500 VIX”

New \$VIX Indices

Currently, CBOE publishes VIX on:

**Commodities: Gold (GLD), Silver (SLV), Oil (USO),
Euro FX (FXE)**

**Stocks: Apple (AAPL), Amazon (AMZN), Goldman
Sachs (GS), Google (GOOG), IBM (IBM)**

**Markets: S&P 500 (\$SPX), Emerging Mkts (EEM),
China (FXI), Brazil (EWZ), Gold Mining Stocks (GDX),
Energy Stocks (XLE)**

Each volatility index above has its own symbol (\$VIX for \$SPX; \$GDZ for GLD; etc.). *Just because an index is published, doesn't mean there are products to trade.*

Other VIX-like Indices

CME Group publishes:

A gold VIX based on CME Gold *futures options markets* (symbol: \$GVX)

And an oil VIX based on CME *Oil futures options markets* (symbol: \$OIV)

In order to actually *trade* Volatility:

1. The exchange must *create* and publish the volatility index, based on currently traded options: \$VIX for S&P 500, e.g.
2. The exchange must list *futures* on the vol index. CBOE Futures Exchange (CFE) lists VX futures expiring for the next 7 months.
3. The exchange then lists options on the index. Those options trade off the *futures prices*, even if they are eventually cash-settled.

\$SPX options

⇒\$VIX Index

⇒VX May futs

VX June futs

VX July futs

VX Aug futs

...

⇒\$VIX options

\$VIX Options

New Product: launched 2/24/06

Cash-Based options on \$VIX

Are *priced* like futures options, however

2/24/06: Current \$VIX Price: 11.46

Expiration:		Mar	Apr	May	
Strike:					
10	Calls	2.25	2.90	3.90	
	Puts	0.05	0.10	0.15	
12.5	Calls	0.65	1.30	2.05	
	Puts	0.70	0.65	0.60	
15	Calls	0.10	0.55	0.85	
	Puts	3.00	2.55	2.00	--- inverted put prices
Futures:		12.10	12.76	13.86	...because of using futures as “underlying”

Open interest is large: 2.75 million (8/03/2010)

Currently Tradable VIX Products

	<u>S&P 500 VIX</u>	<u>Gold VIX</u>
Underlying:	\$SPX	GLD
Vol. Index:	\$VIX	\$GVZ
Futures Sym:	VX (K,M,N,...)	GV (K,M,N,Q,U)
Futures OI:	190,068	16
Vol. Options:	\$VIX options	\$GVZ options
Vol. Opts OI:	4,024,600	104

CME Gold and Oil OI = 0 on futures! (no options)

ETN's Simulating \$VIX

VXX*: uses two front-month futures (most popular) 17+Mil

VXZ*: uses futs months 4 through 7 580.000

Newer products:

VIIX*/VIIZ: direct competitors with above ETN's 12,000/600

VIXY*/VIXM*: direct competitors with above 250,000/50,000

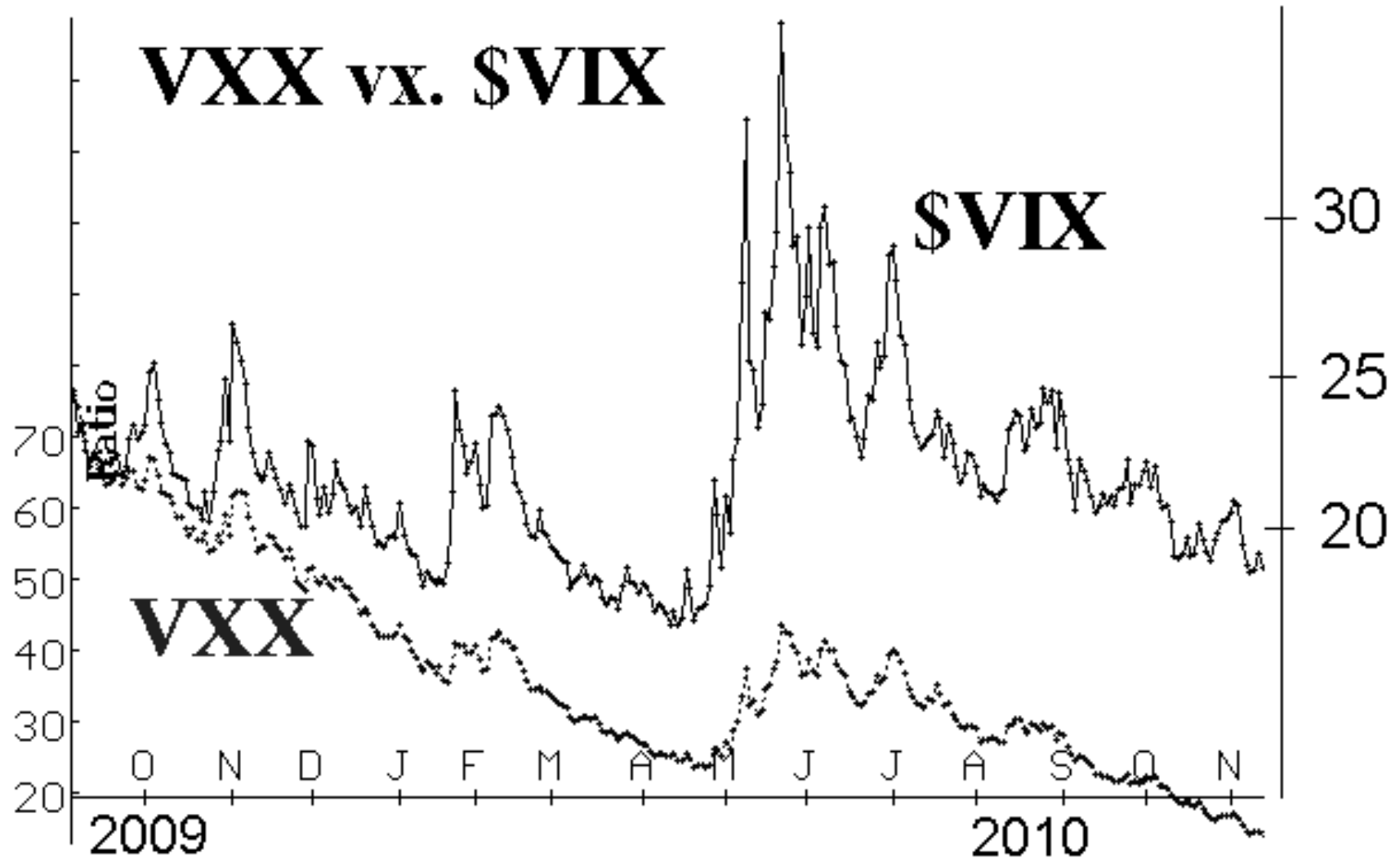
XIV/ZIV: *reverse* ETN's 400,000/4,000

TVIX/TVIZ: double the speed 2 Mil/3,500

XVIX: based on the term structure 30,000

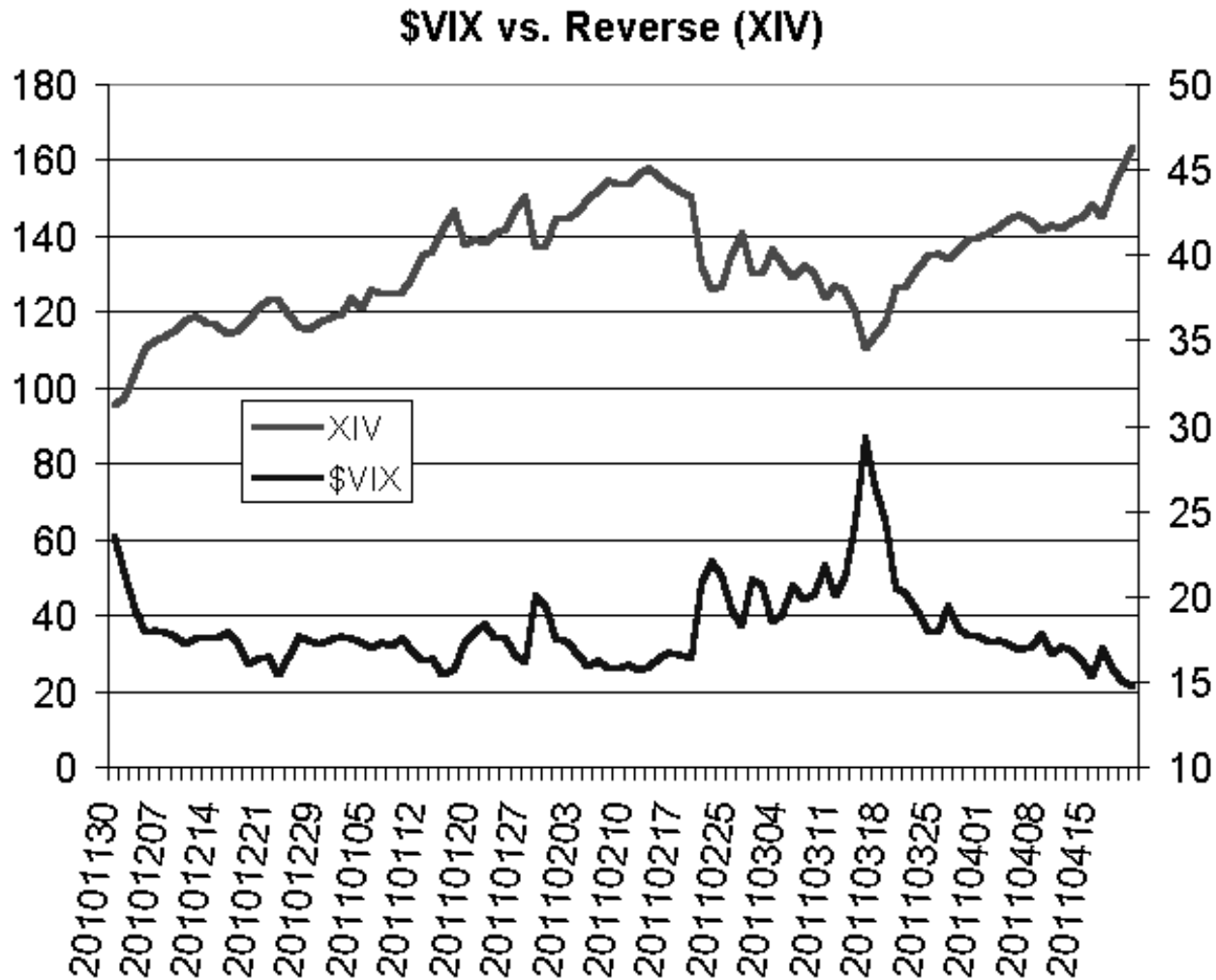
***:** has listed options

VXX underperforms \$VIX



Reverse \$VIX (symbol: XIV)

Get it? VIX spelled backwards



Using Option Data As A Forecasting Tool

	Direct	Contrary
Price	Event-Driven Skews High IV	\$VIX Extremes
Volume	Takeover Rumors	Put-Call Ratios

**Usually, implied volatility “tries” to
predict the stock’s volatility,**

But at the *extremes*,

**Implied volatility reflects the mood
of the public**

**And can thus be interpreted
as a contrary indicator**

	Direct	Contrary
Price	Event-Driven Skews High IV	\$VIX Extremes
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Implied Volatility Buy Signal

**Implied Volatility spikes during severe declines
(investors panic and buy puts)**

**A spike peak in IV in such a situation
Is a valid buy signal**

**Mostly useful in the broad market indices (\$SPX)
But also applies to stocks and futures**

IV Buy Signal:

IMPLEMENTATION:

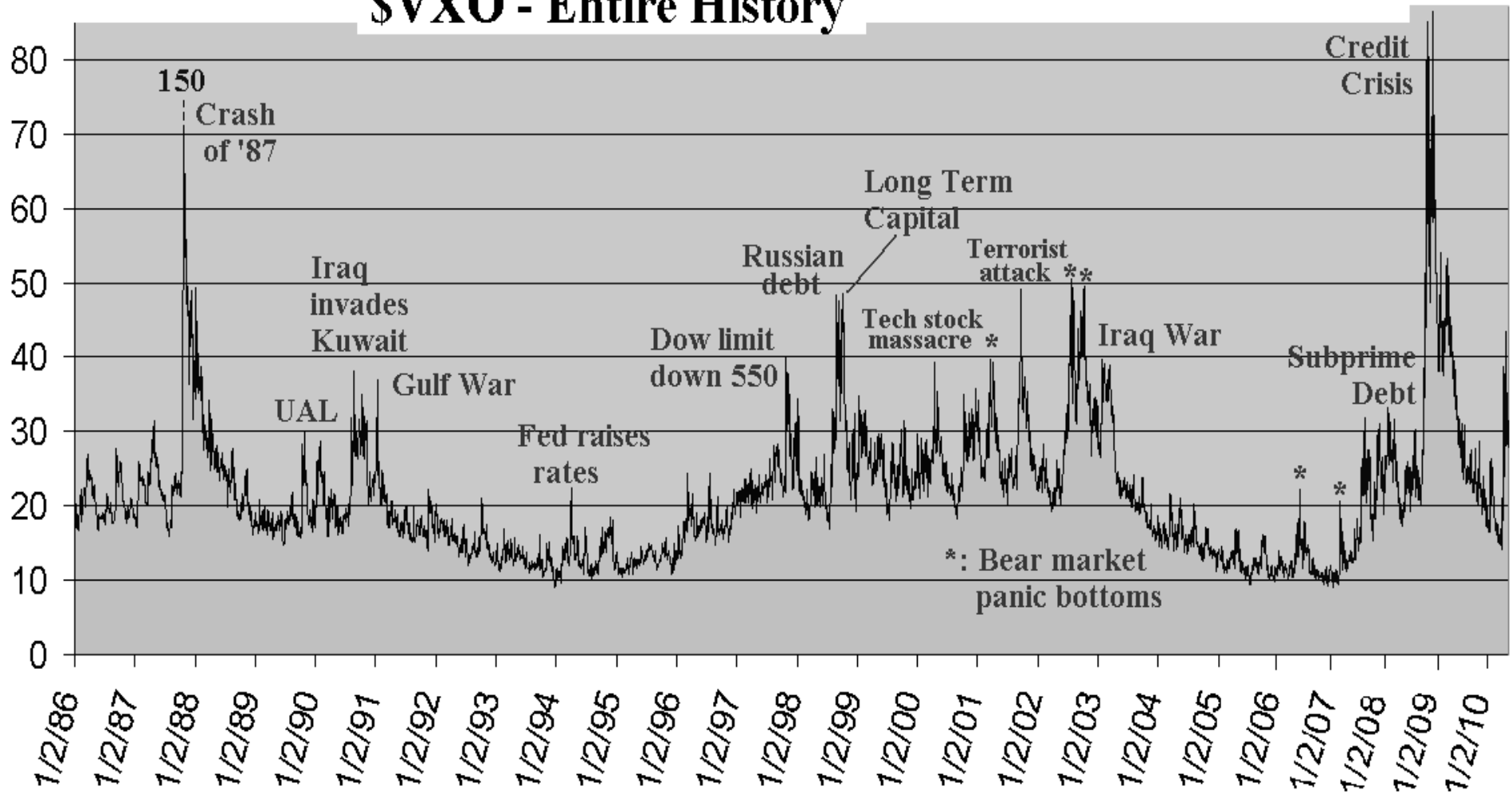
**WHEN IMPLIED VOLATILITY PEAKS
THE UNDERLYING IS READY TO RALLY**

**So either BUY THE UNDERLYING
or SELL NAKED PUTS**

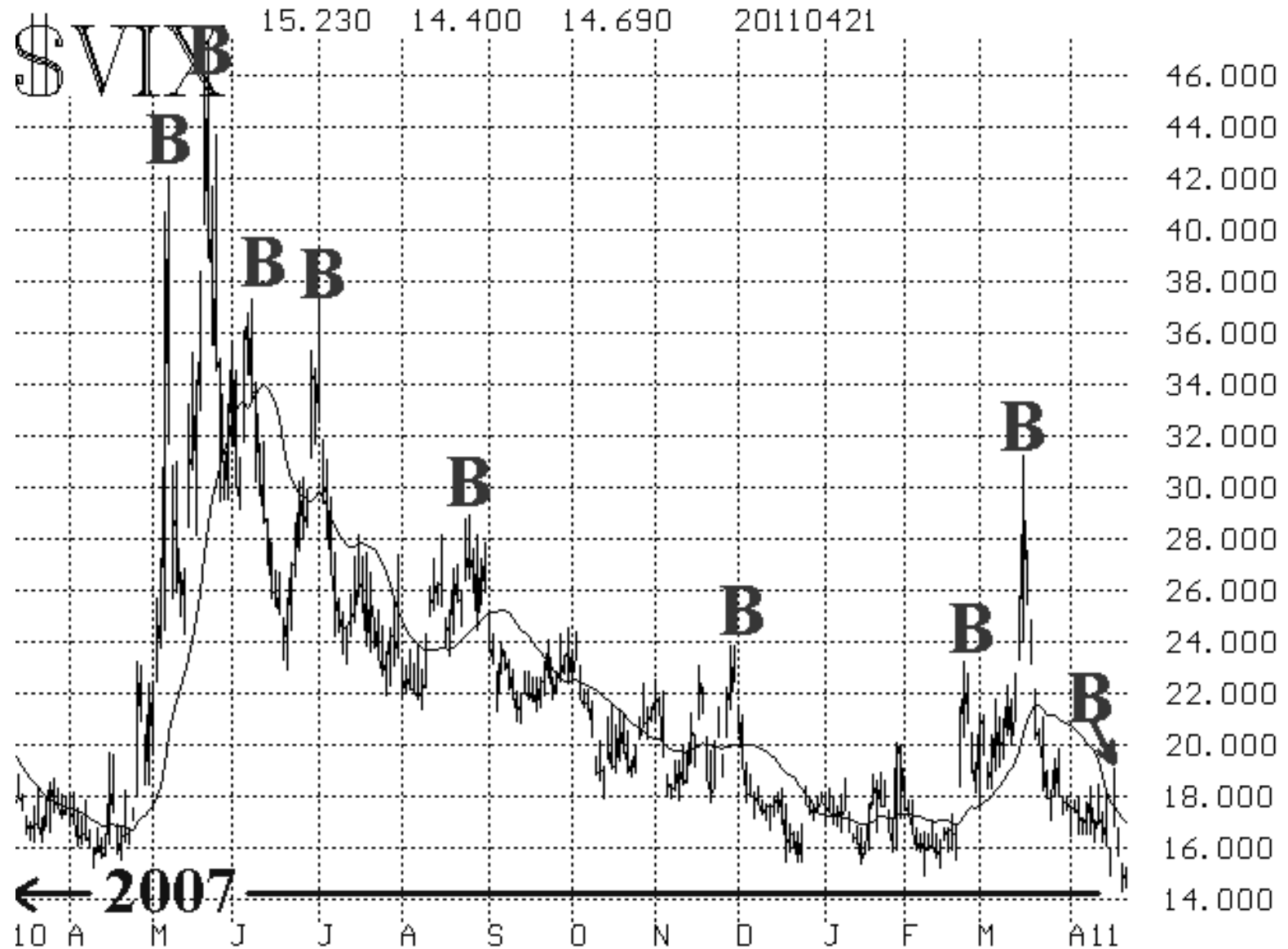
Stop: a new high in IV

History of \$VXO

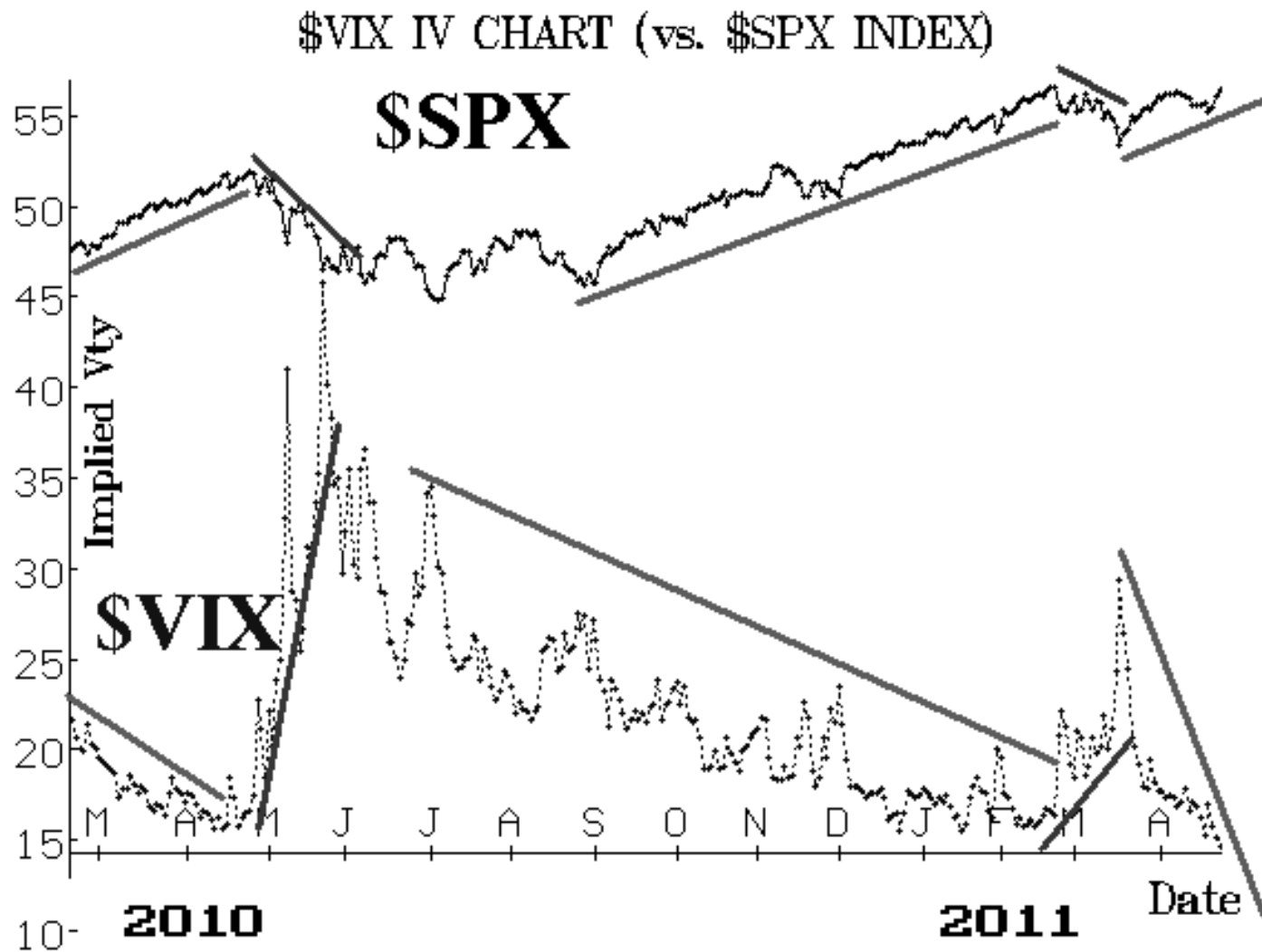
\$VXO - Entire History



Current \$VIX Chart



The *Trend* of \$VIX is Important



Warning of Price Explosion!!

Does the opposite apply?

**Is a low \$VIX reading
a precursor to a Sell Signal?**

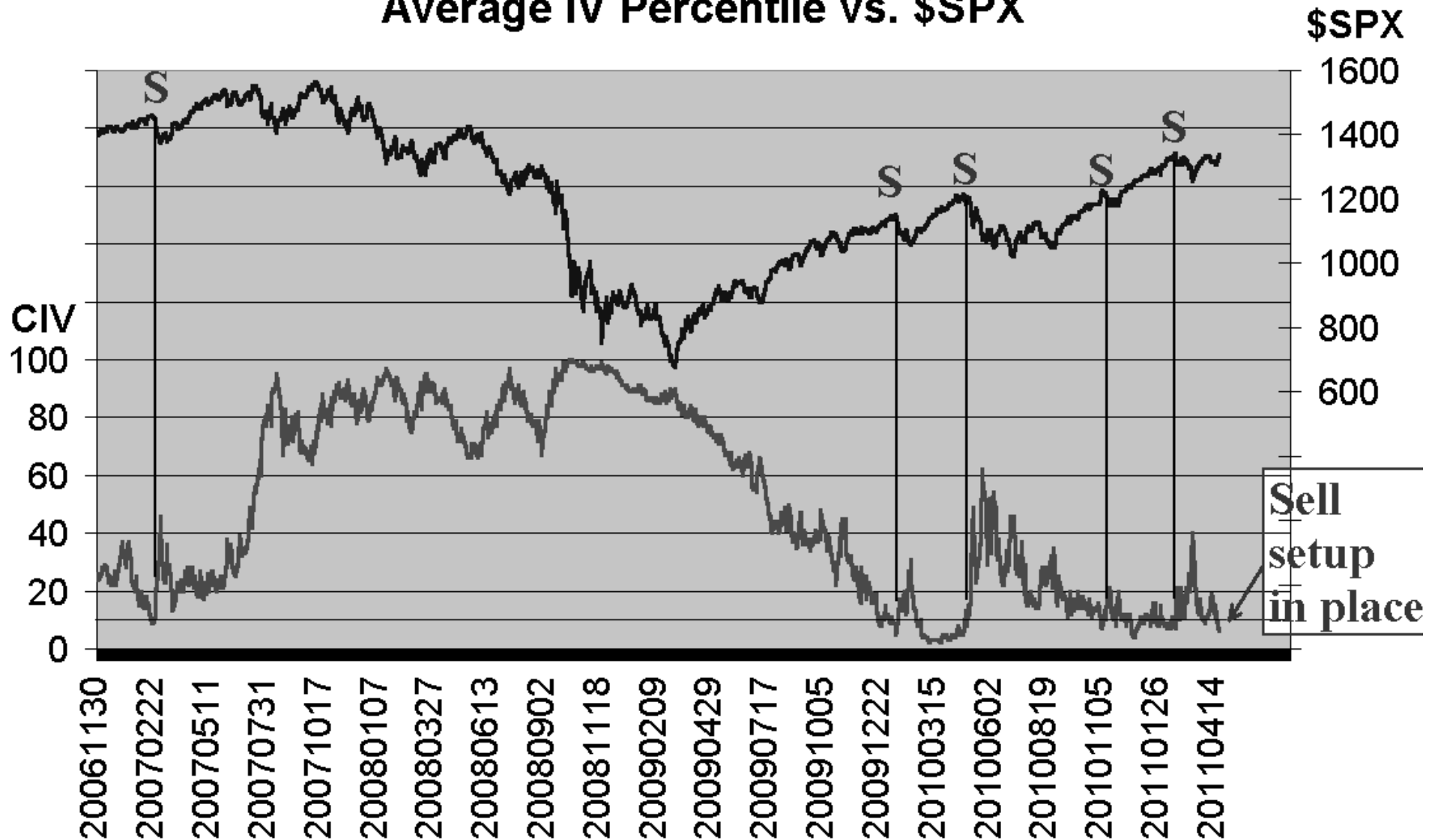
Not necessarily.

It's a precursor to an explosive move.

**Low '93-'95: Rally '95-'98
Low '06-'07: Bear Mkt '07-'09**

Composite Implied Volatility (CIV)

Average IV Percentile vs. \$SPX



PUT-CALL RATIOS

For any group of options,
you can calculate the ratio
of puts traded to calls traded

	Direct	Contrary
Price	Event-Driven Skews High IV	\$VIX Extremes
Volume	Takeover Rumors	Put-Call Ratios

“Standard”: volume only

“Dollar Weighted”: price times volume

Contrary Theory

**“TOO MUCH” PUT BUYING IS
BULLISH FOR THE UNDERLYING**

**“TOO MUCH” CALL BUYING IS
BEARISH FOR THE UNDERLYING**

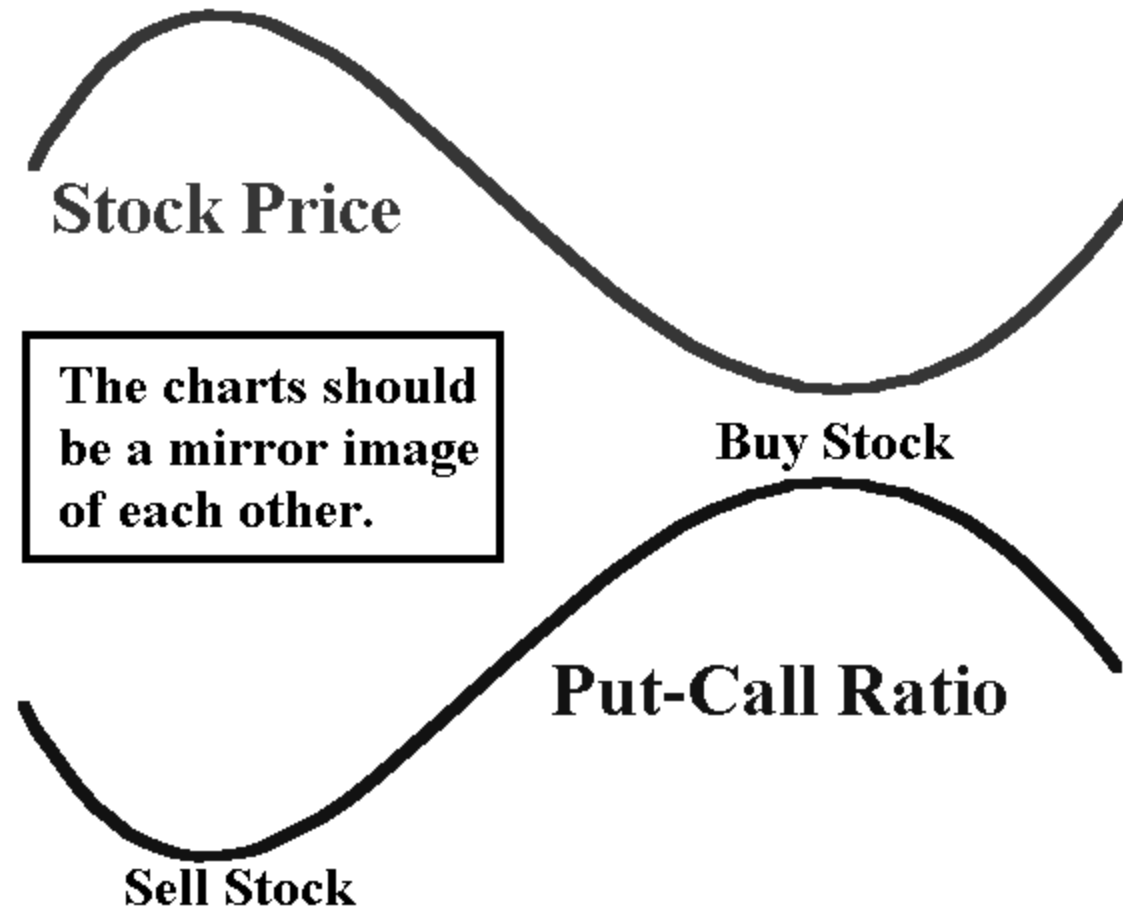
“Standard” Put-Call Ratio

$$\text{Ratio} = \frac{\text{Volume of Puts Traded}}{\text{Volume of Calls Traded}}$$

- Put buying generates high numbers**
- Call buying generates low numbers**

Keep a moving average (21 days?)

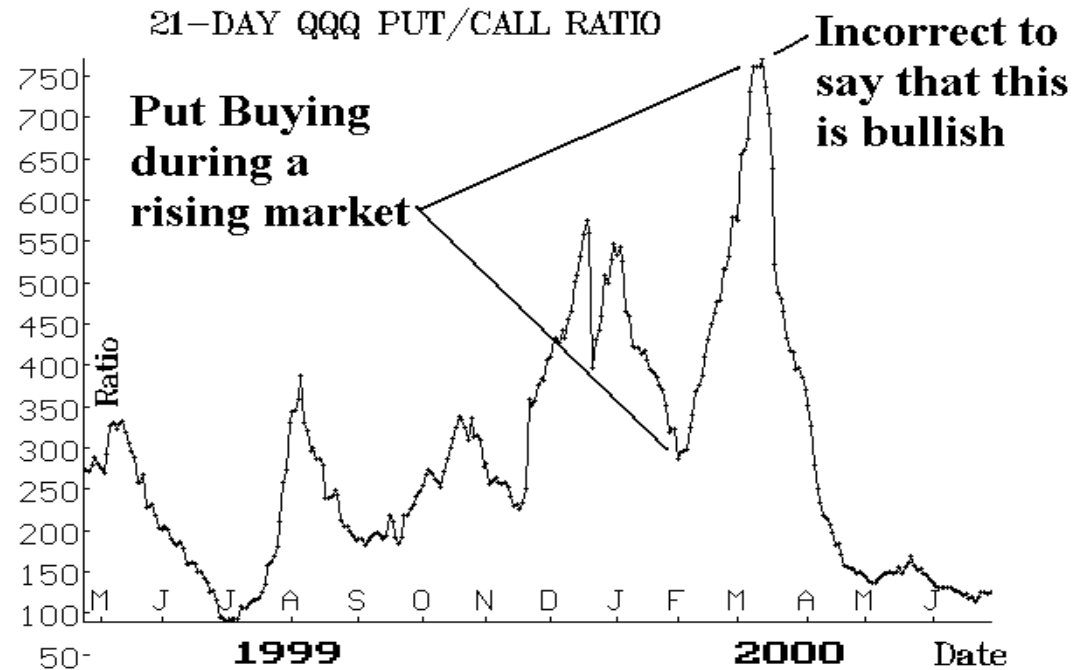
Stock Price and P-C Ratio



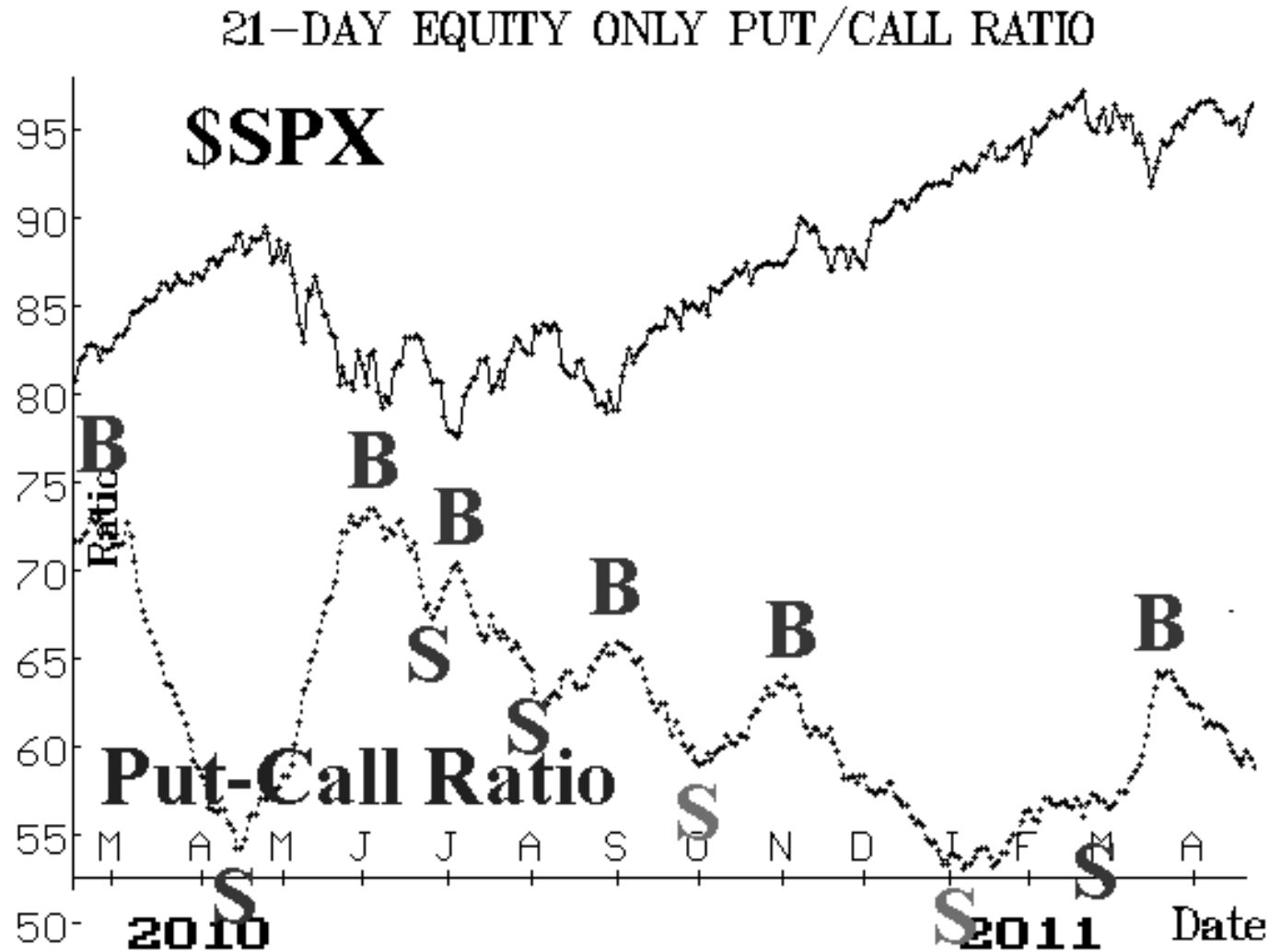
QQQ “NASDAQ” stock Put-call Ratio

Institutional Distortion

www.optionstrategist.com



Current Equity-only “standard”



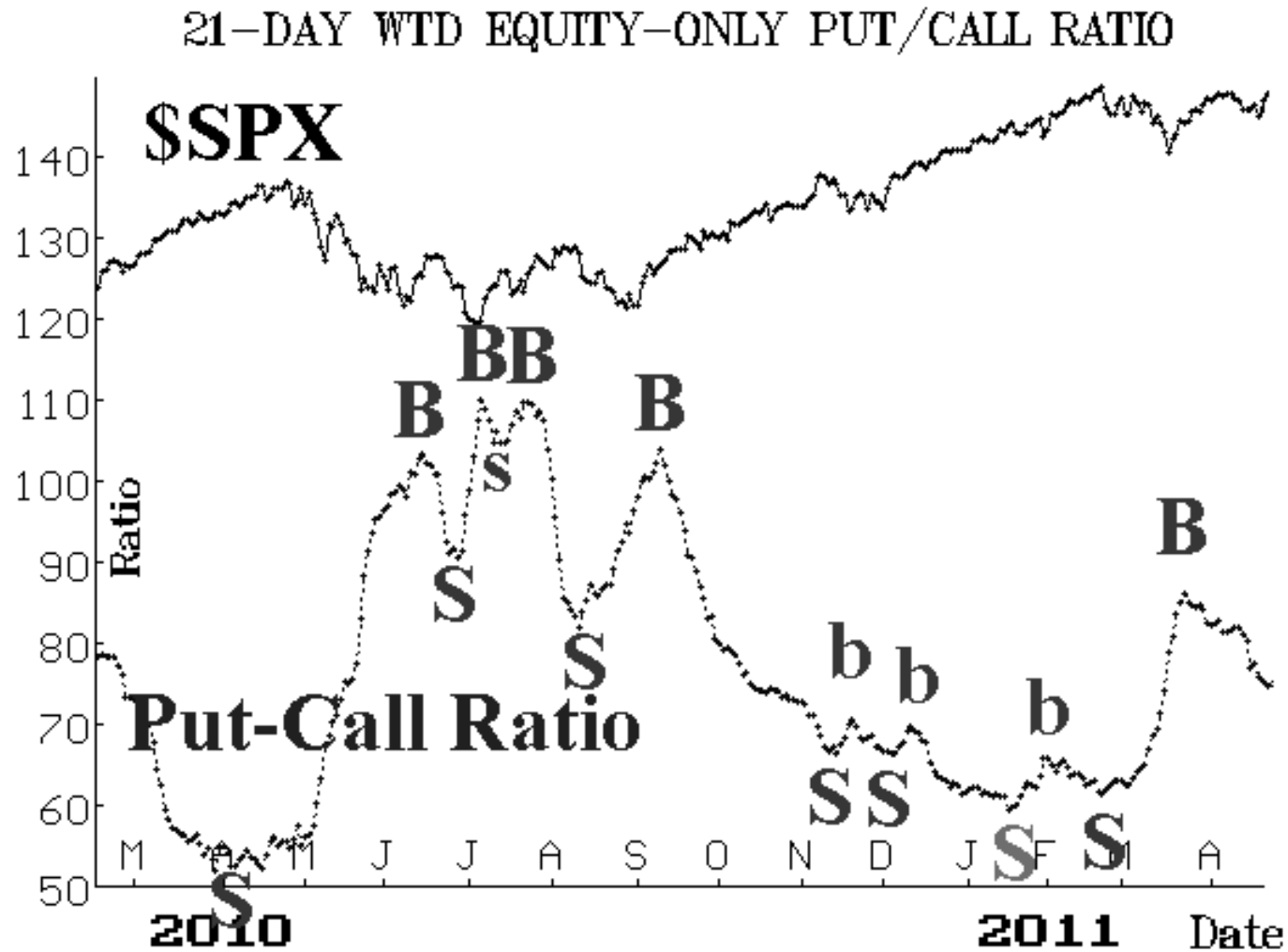
“Weighted” Put-Call Ratio

Dollar volume = option price x option volume

$$\text{Ratio} = \frac{\text{Sum of dollar volume of puts}}{\text{Sum of dollar volume of calls}}$$

**Measures dollars being spent on bearish opinion
vs. dollars being spent on bullish opinion**

Current Equity-only *weighted*



Stock Options Put-Call Ratio

When dealing with equities,

Concentrate on large-cap stocks

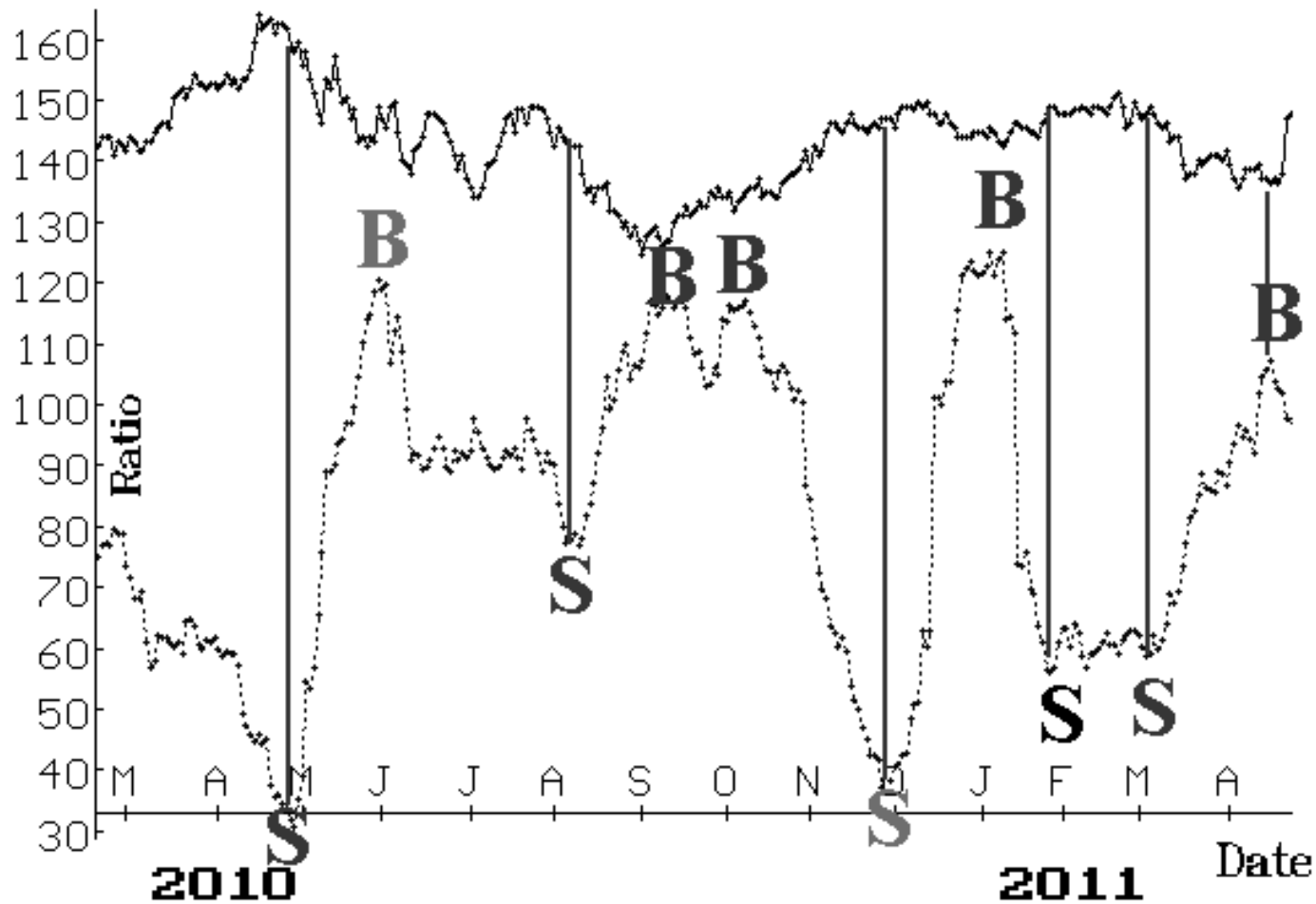
(Rumors and innuendo don't distort the ratios as much as with small-caps)

New signals: AAPL and INTC

Recent: AMZN

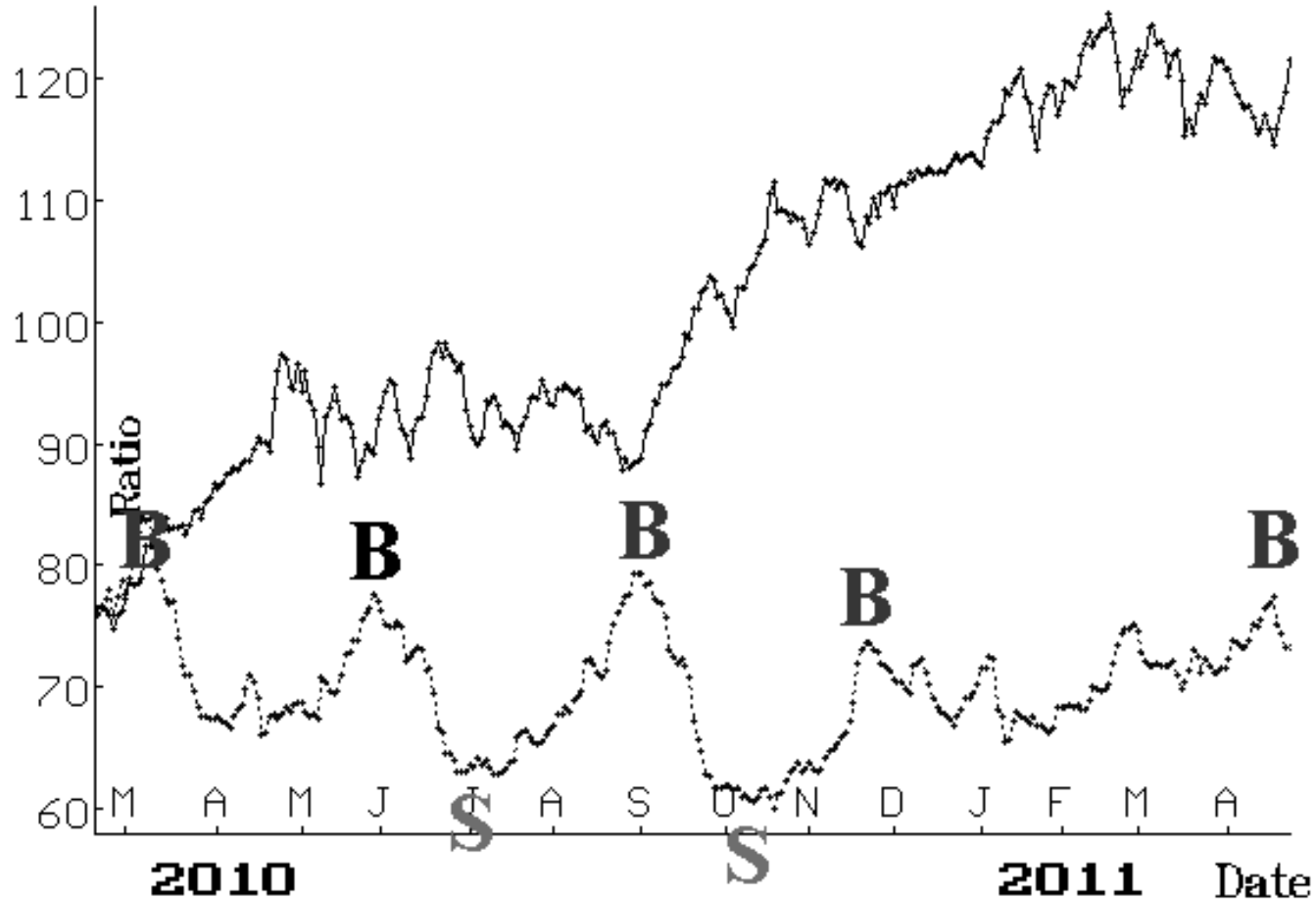
Intel *weighted*

21-DAY INTC Weighted PUT/CALL RATIO



Apple (AAPL)

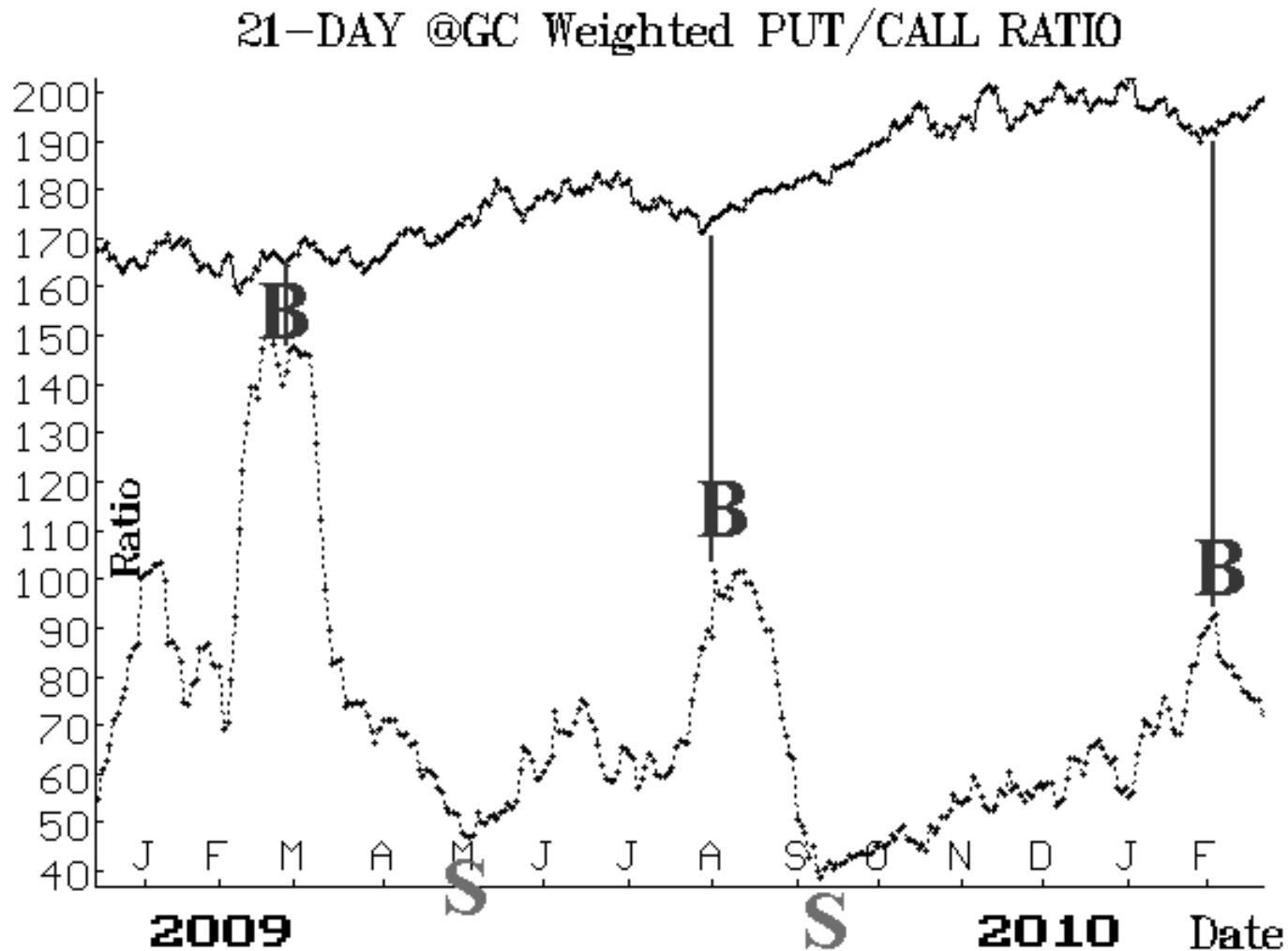
21-DAY AAPL PUT/CALL RATIO



Futures Option Put-Call Ratios

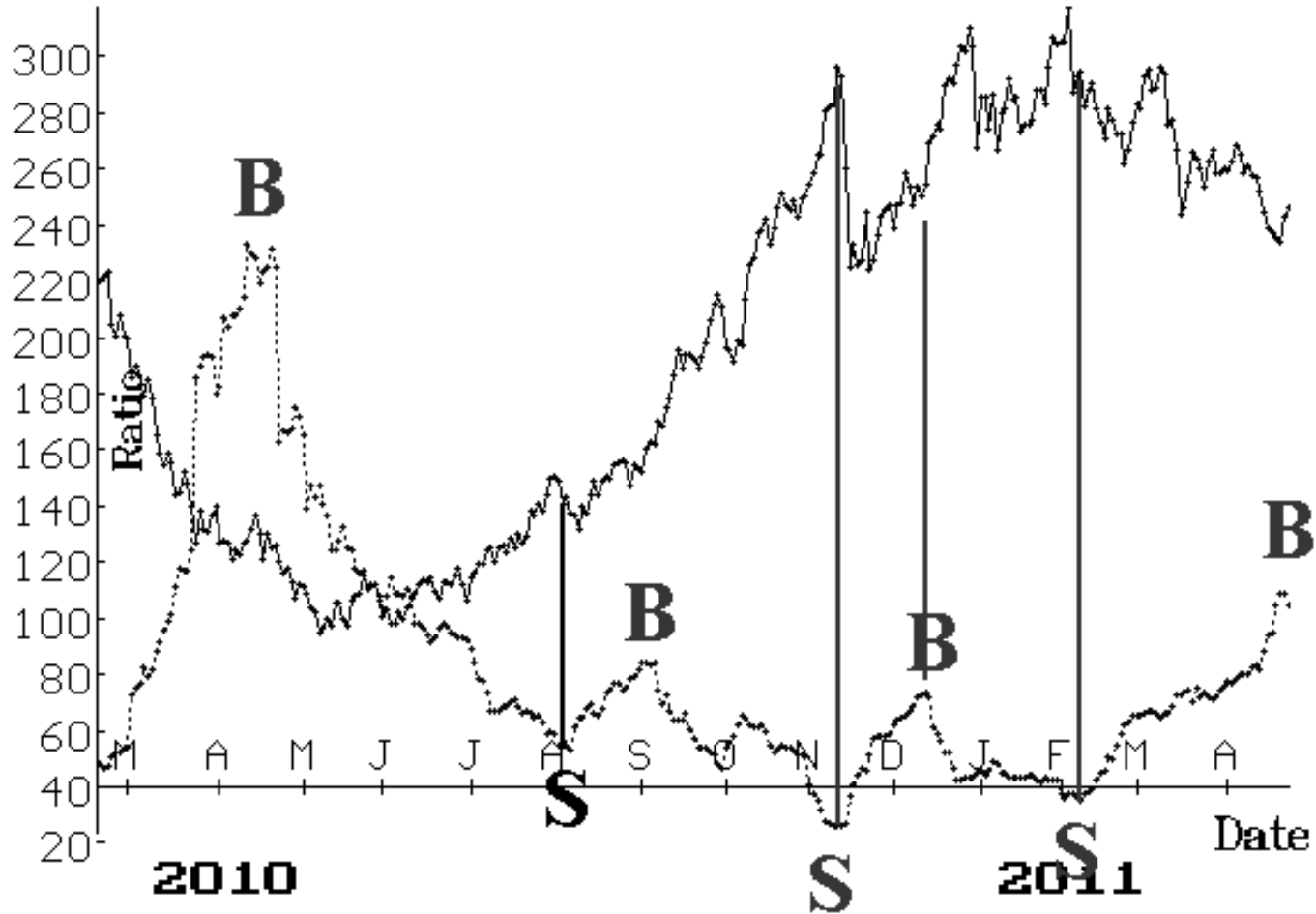
- Better than stocks or indices
- Sum volume over all contracts months
- Don't combine contracts (meats, grains, e.g.)
 - Doesn't work in *every* market

Gold Futures *weighted* (GLD)



Sugar (Weighted)

21-DAY @SB Weighted PUT/CALL RATIO



Futures With Good Put-Call History

Australian Dollar

British Pound

Cocoa

Coffee

Copper

Cotton

Crude Oil

Eurodollar

Feeder Cattle

Gold

Japanese Yen

Lean Hogs

Live Cattle

Lumber

Natural Gas

Orange Juice

S&P 500

Silver

Sugar

Swiss Franc

T-Bonds

10-Year Notes

(Grains are suspect)

What Option Do You Buy?

General Theory

- **Requite confirmation from chart**
- **3-month, at-the-money option**
 - **Planning to risk all unless signal reverses or profits build up (trailing stop)**

Trailing Stops

Type of Stops

20-day SMA

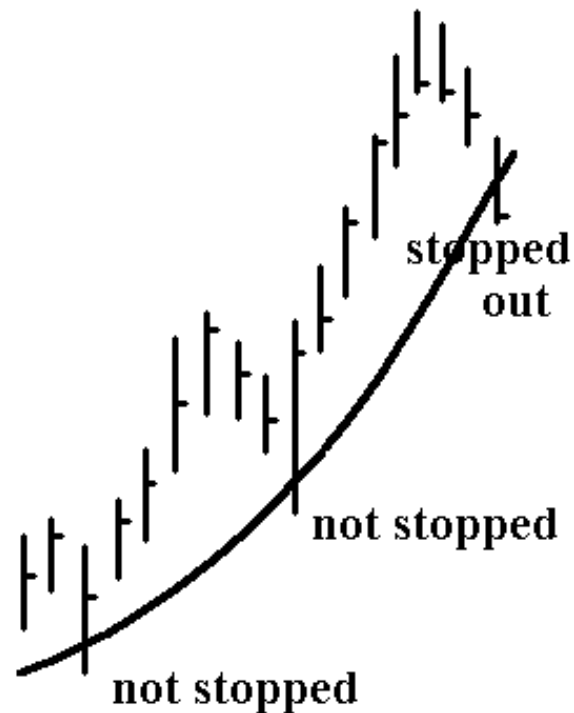
10% EMA

Chandelier

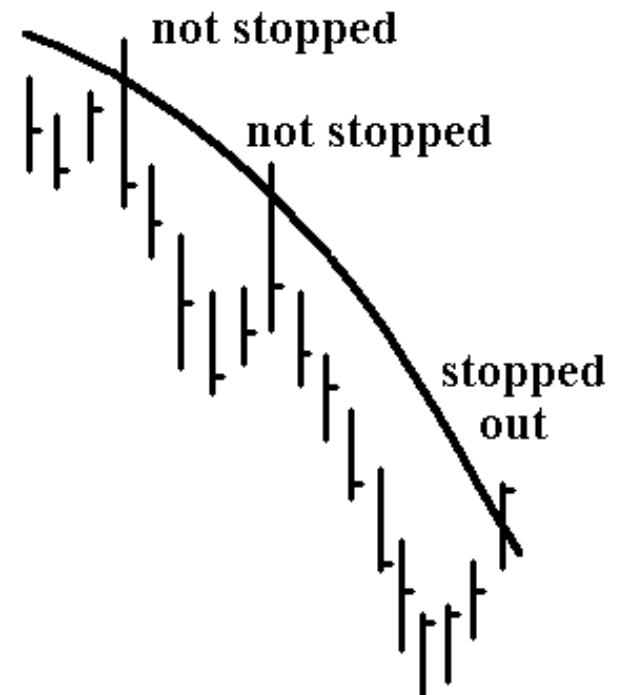
Parabolic

**Closing stops
recommended**

Trailing sell stop (you are long)



Trailing buy stop (you are short)



Options As A Direct Indicator

- **Option Volume**
- **Option Volatility (Skews)**

Option Volume As A Direct Indicator

In the past (1980's), those with inside information often traded options (illegally) because of the leverage. This practice has largely been thwarted, but rumors continue to persist. This is a high-risk form of trading

	Direct	Contrary
Price	Event-Driven Skews High IV	SVIX Extremes
Volume	Takeover Rumors	Put-Call Ratios

Rumors Are Rarely True

We monitor these carefully for our Daily Volume Alerts newsletter:

In the past year:

930 rumors

in 385 stocks

resulted in 35 takeovers

only 22 of which were in advance

You Can Do Better...

Strategic alternatives

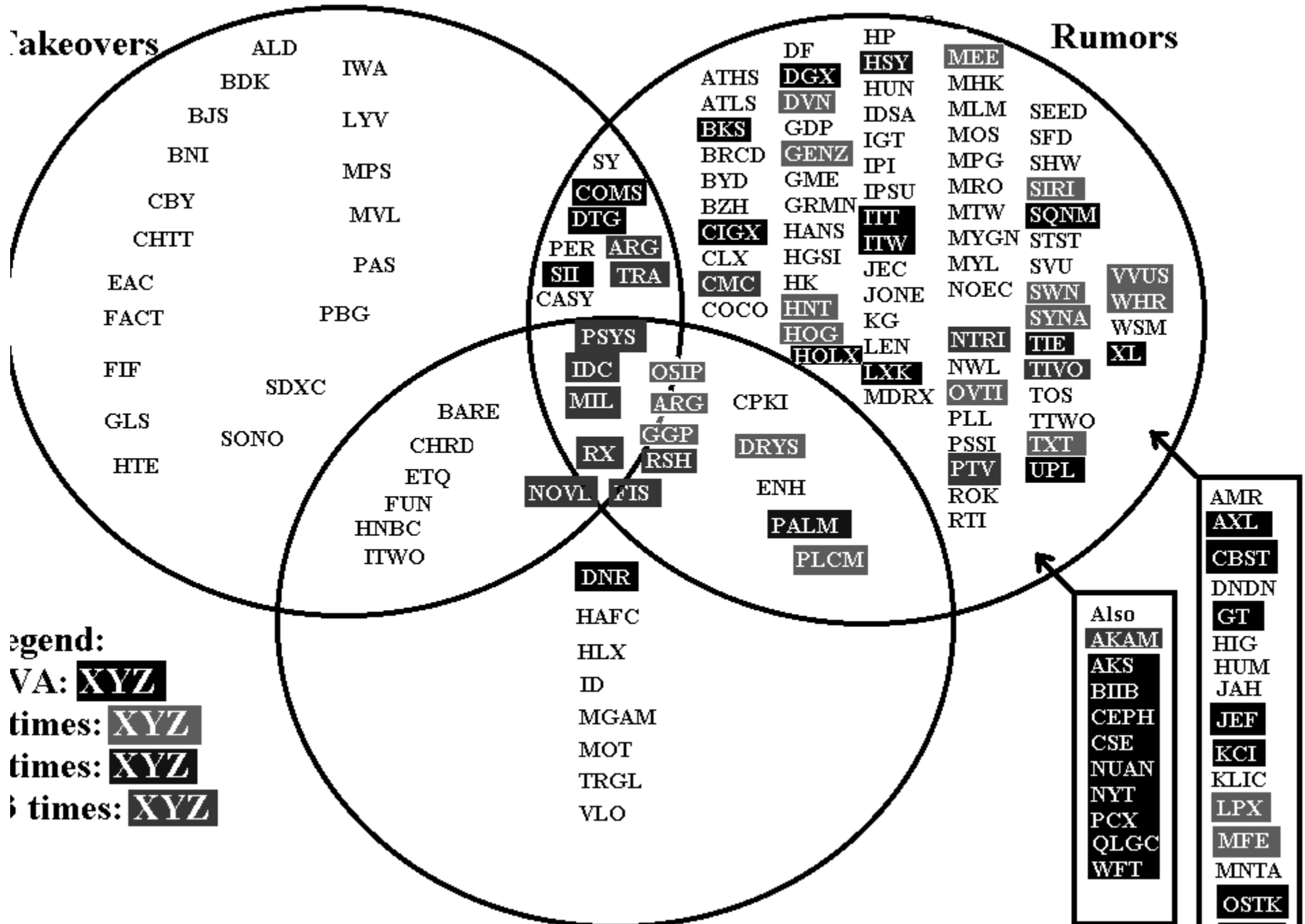
Actual bids

Outside research (WSJ)

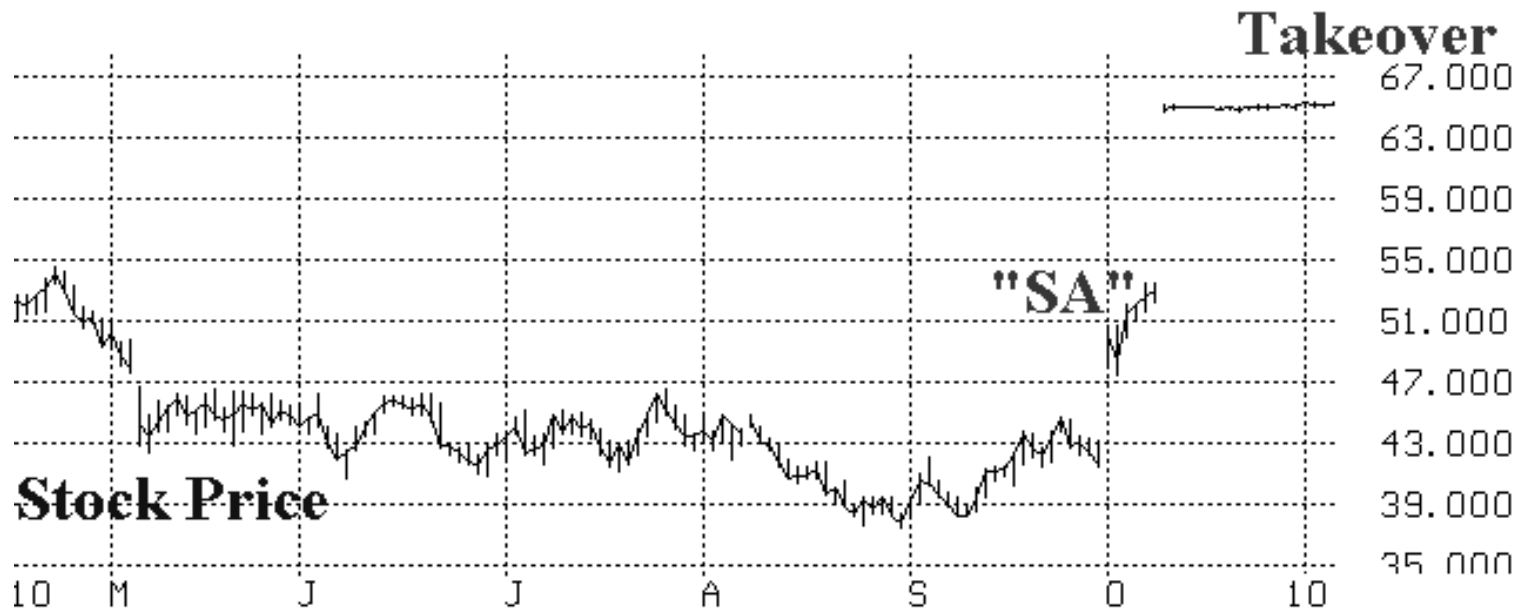
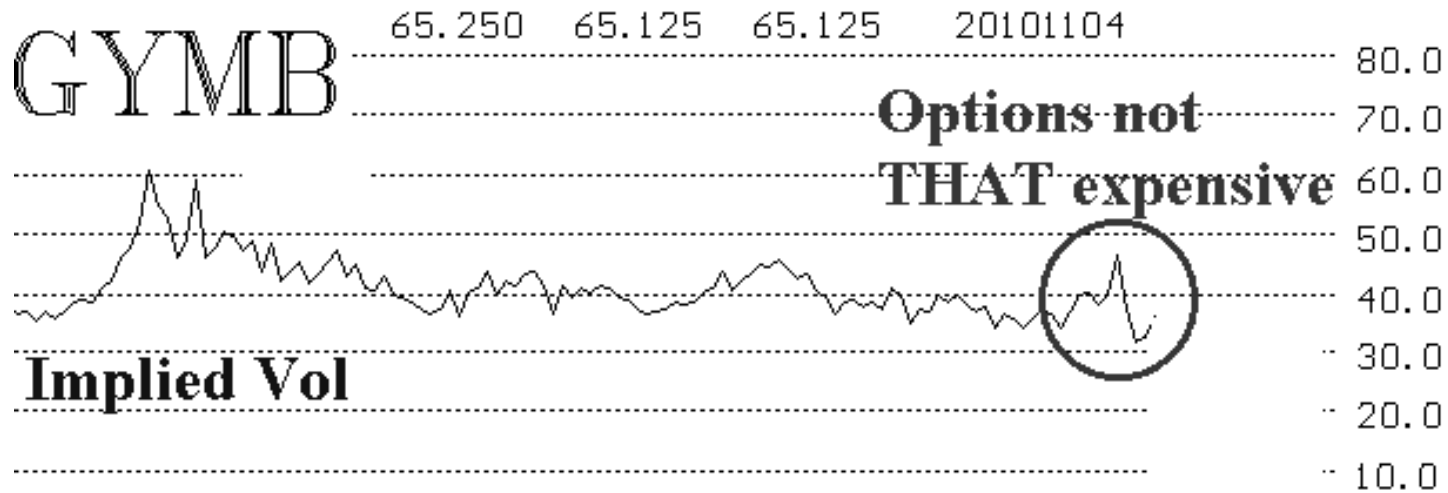
Expensive options a good clue

**Of 44 “S.A.” Situations in the last
year, 16 resulted in higher takeovers**

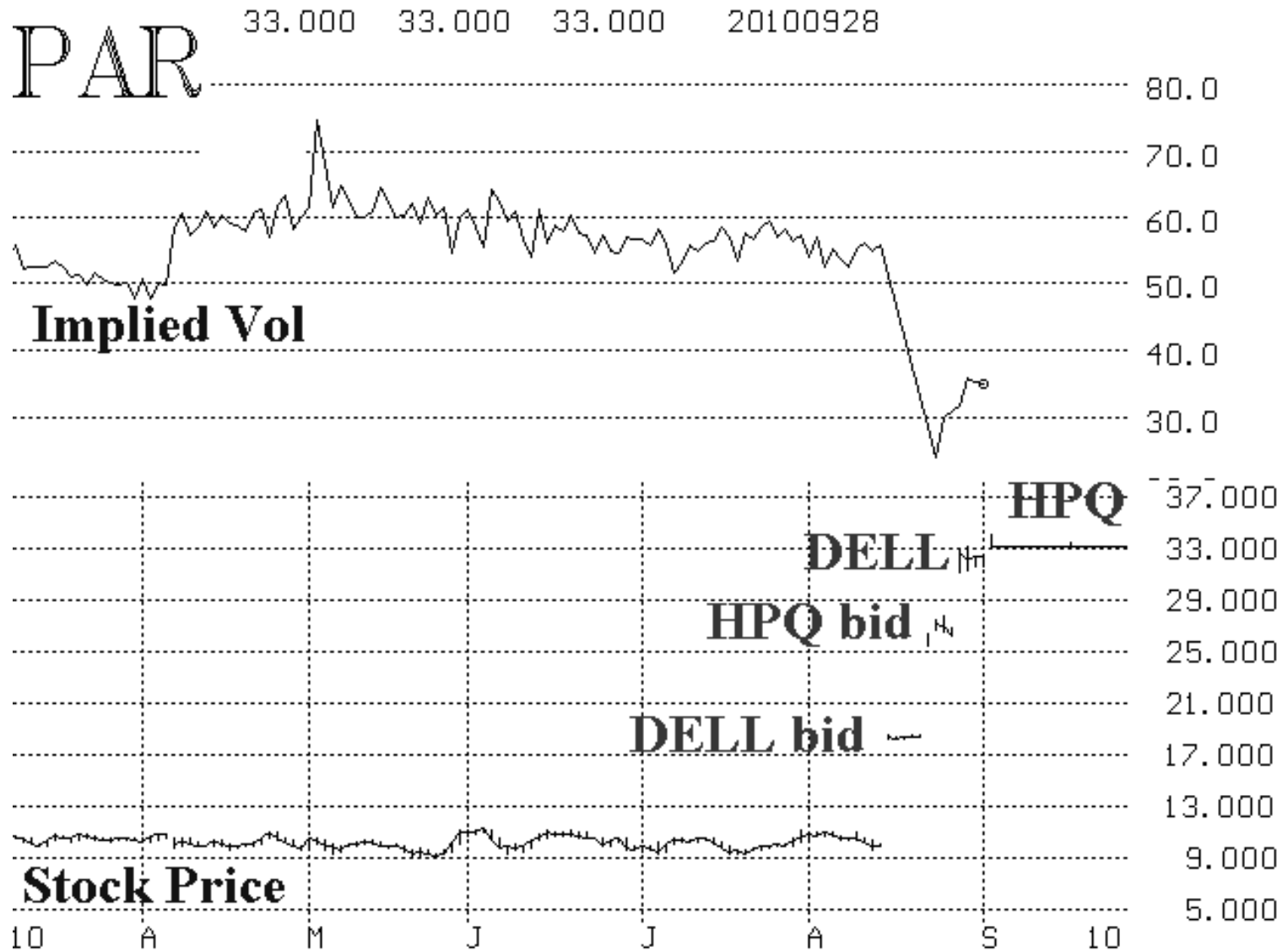
(Only includes stocks with listed options trading)



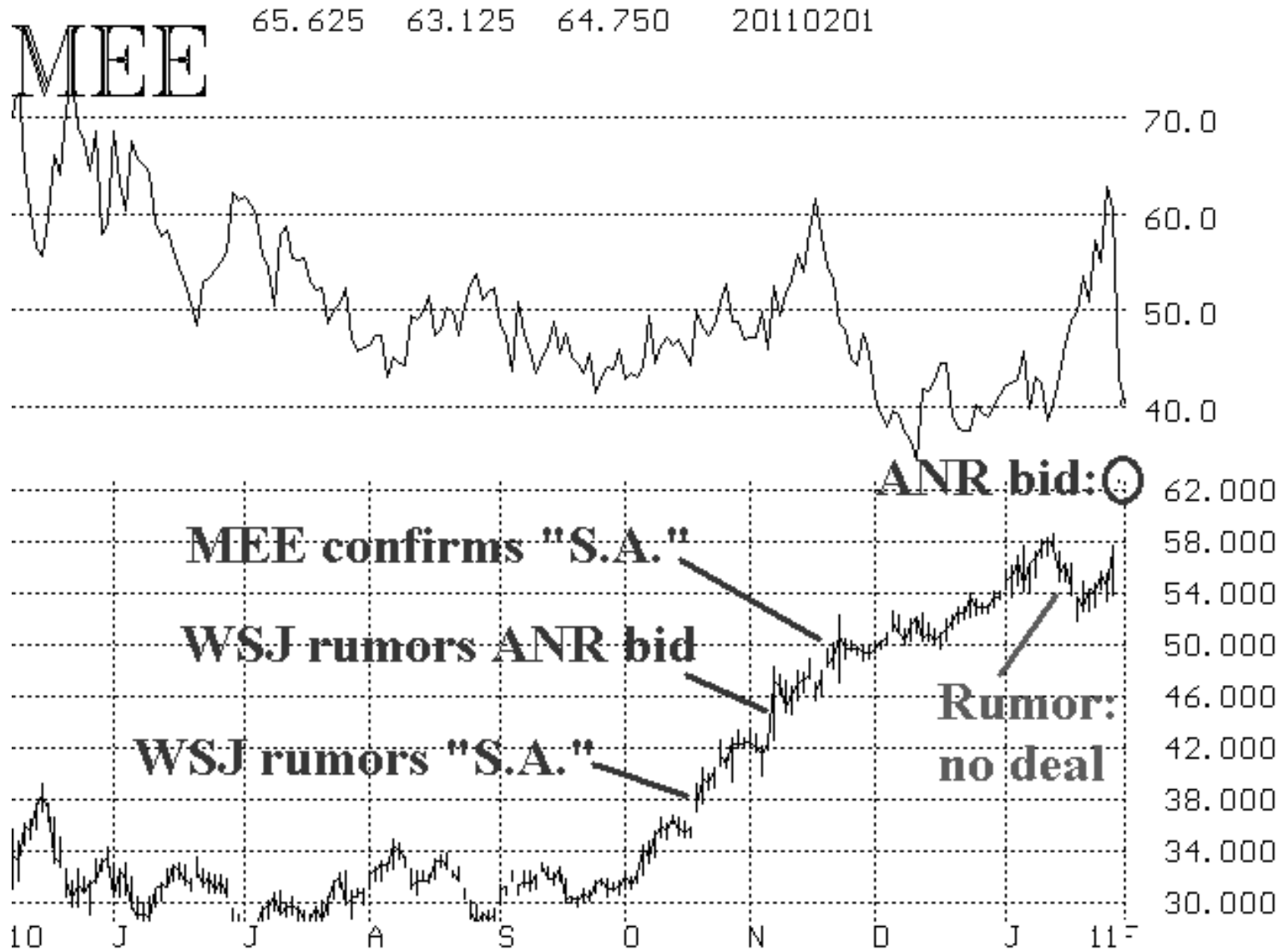
Gymboree (GYMB)



Bidding War for PAR



Massey Energy (MEE)



Not All "SA" Work Out



Current Possibilities

Blackboard (BBBB)

Big Lots (BIG)

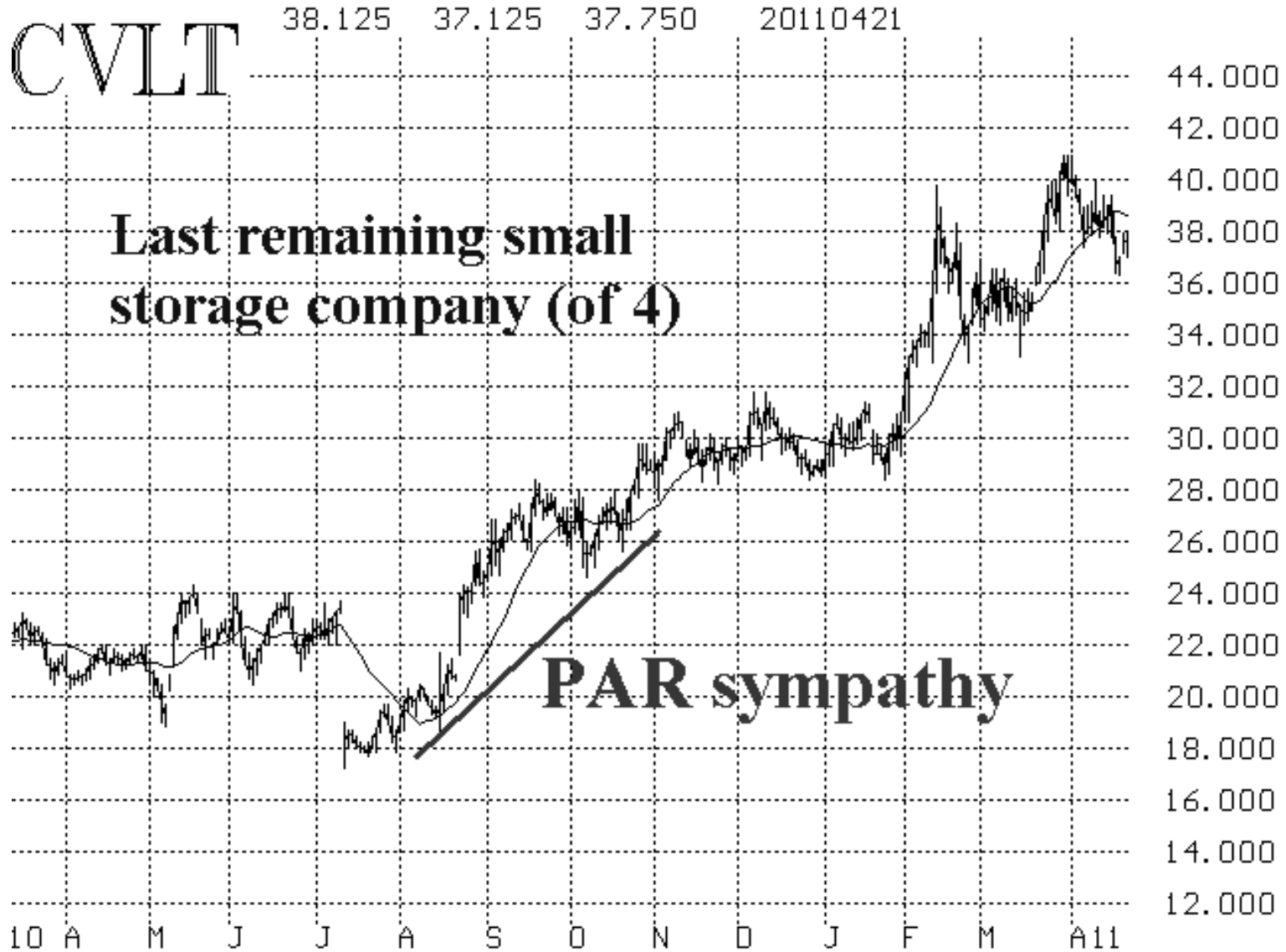
BJ's Stores (BJ)

Commvault Systems (CVLT)

Lawson Software (LWSN)

99 Cent Stores (NDN)

Commvault Systems (CVLT)



Blackboard (BBBB)



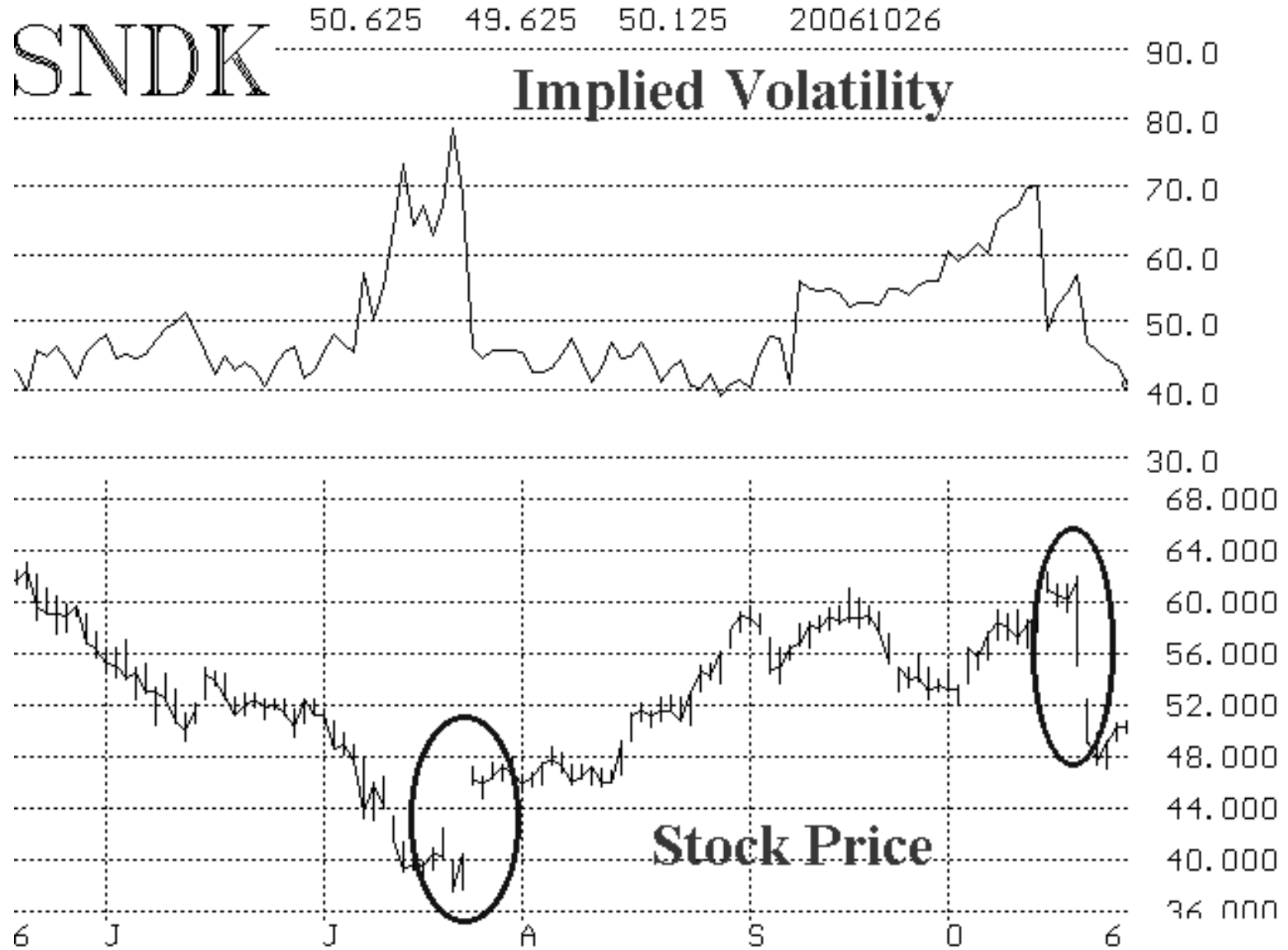
Implied Volatility Revisited

Implied Volatility will also increase when a volatile event of unknown outcome is about to occur:

- **Government rulings (FDA, FTC)**
- **Lawsuit Verdicts**

	Direct	Contrary
Price	Event-Driven Skews High IV	\$VIX Extremes
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SNDK Earnings Plays



Buying “Earnings-Driven” Straddles

- **Near-term straddle price**
- **Does the stock make and sustain moves of that size or more, on earnings?**
- **i.e., are earnings reports a catalyst to get the stock to move?**

- **Additional info: www.whispernumber.com**
 - **Only for statistics on past moves**

Baidu.com (BIDU)

Earnings tonight

Stock: 152

Apr 150 strad: 11.50

Buy Straddle?

Need 7.5% move

Have gotten that move in last 3 quarters.

Baidu.com (BIDU)

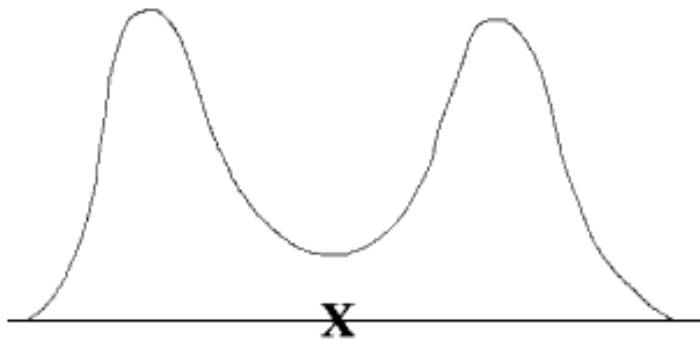


Dual Calendar

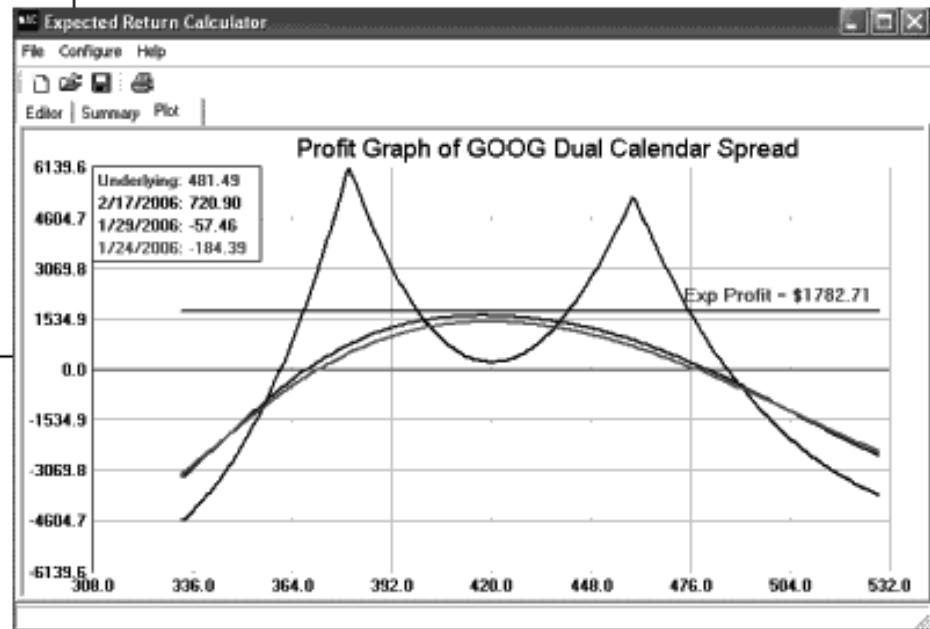
What Strategy Works Best?

Volatility Skew

An event will take place to move the stock and then it will move lognormally after that



One whose profit picture best fits the shape of the expected distribution.



Another Approach: Dual Calendar

Implied Vols:

April weekly opts: 75% implied

May “regular” opts: 48% implied

June “regular” opts: 43% implied

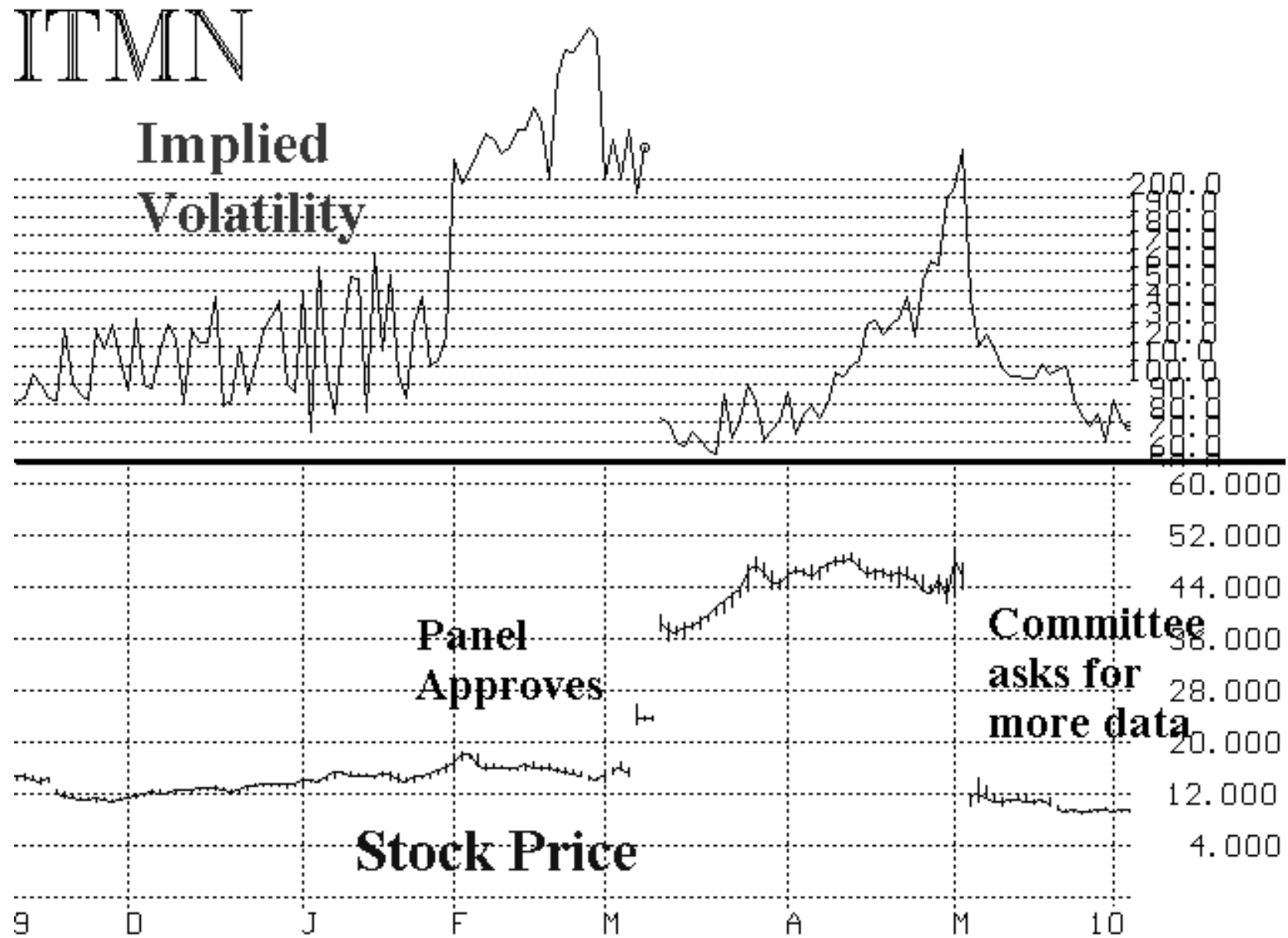
Buy 165 June-Apr call calendar

And Buy 140 June-Apr put calendar

Other Corporate “Events”

- **FDA hearings**
- **Biotech drug trial test results**
- **Lawsuit verdicts**

Intermune (ITMN) FDA Committee



Buying “Event-Driven” Straddles

- **Criteria similar to earnings buys**
- **Except no history to rely on**
- **Check straddle price as estimate**
- **Wait until date approaches, if date is known**
- **Otherwise buy the most expensive month since option market “knows” the date**
- **Regular feature in *The Option Strategist***

VVUS

7.250 7.000 7.125 20101104



Diet Pills – Not an FDA Favorite

ARNA

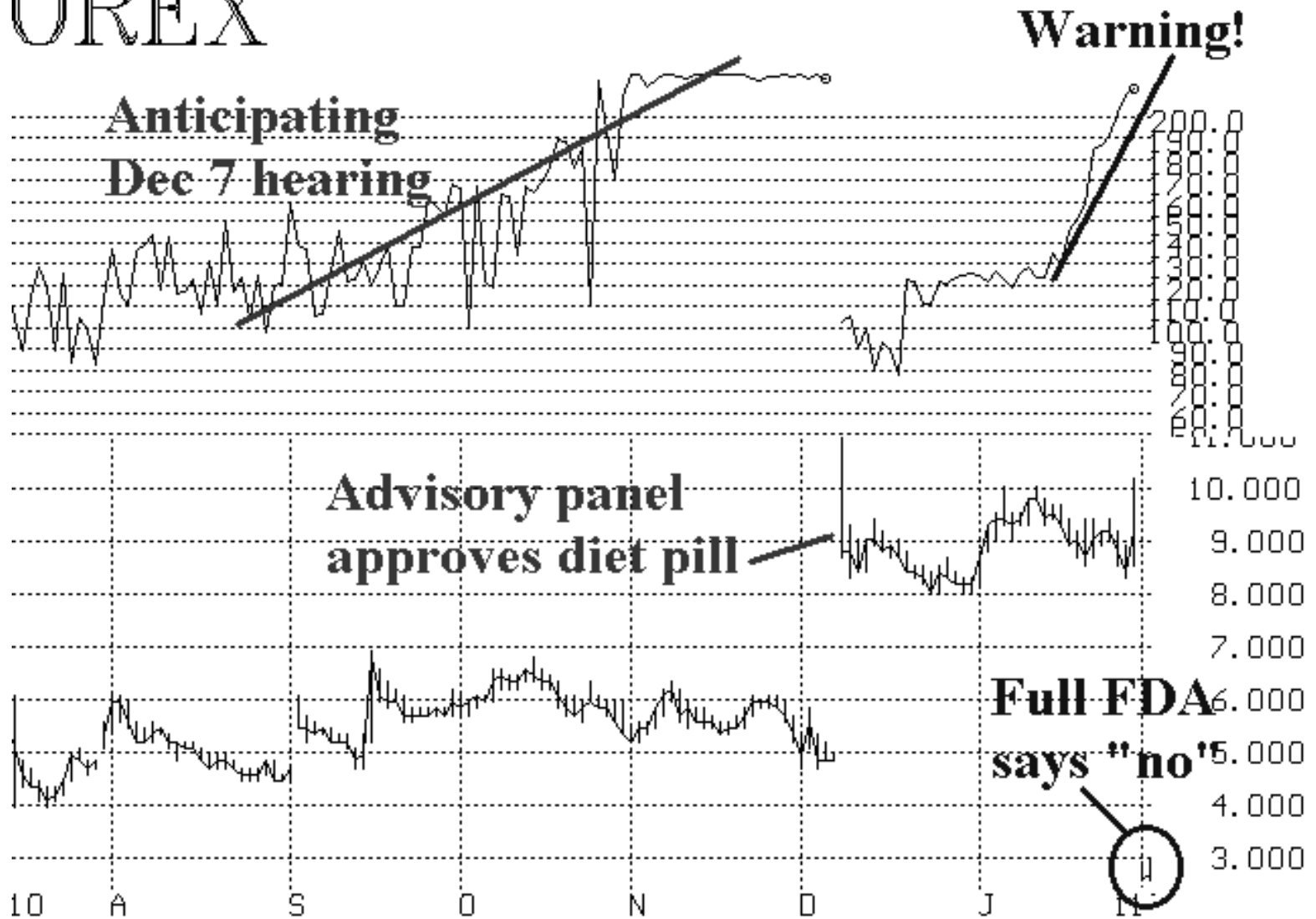
1.500 1.500 1.500 20101104



**VVUS bad
≠ ARNA good;
"street" is
wrong**

OREX

2.875 2.500 2.625 20110202



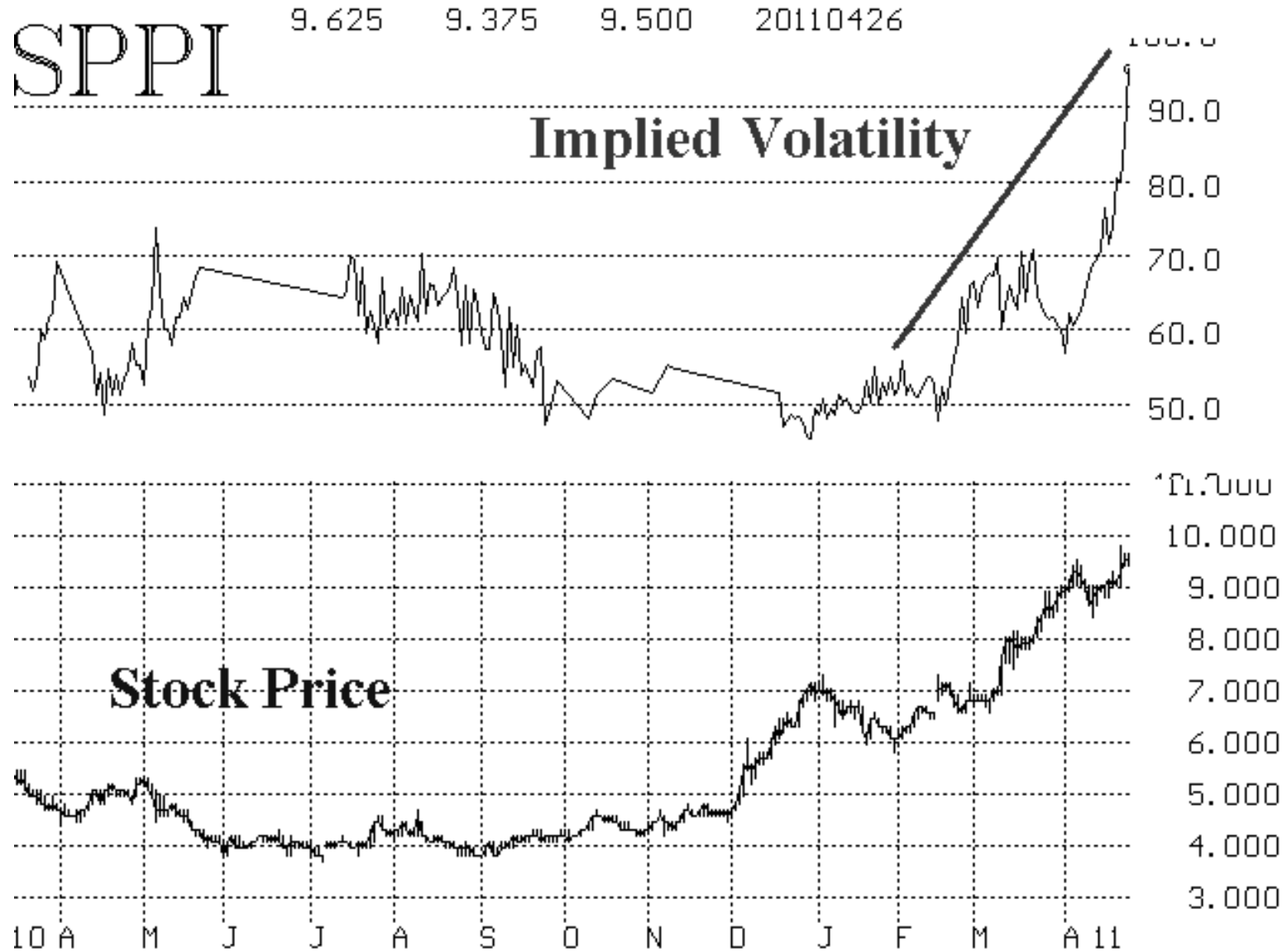
Next FDA Hearing

Spectrum Pharm (SPPI)

FDA Hearing: 4/29/2011

Colorectal Cancer Treatment

Spectrum Pharm (SPPI)



SPPI Strategy

SPPI: 9.45

	<u>Call</u>	<u>Put</u>
May 9:	1.30	0.90
May 10:	0.80	1.40

Implied Vols: **May: 106%**
 June: 84%
 August: 65%

**Analysts are looking for \$2 - \$3 move.
So, buying straddle/strangle is okay here.
Calendars not so attractive: Long vol too
high; May actual premium too small.**

Upcoming FDA Hearing

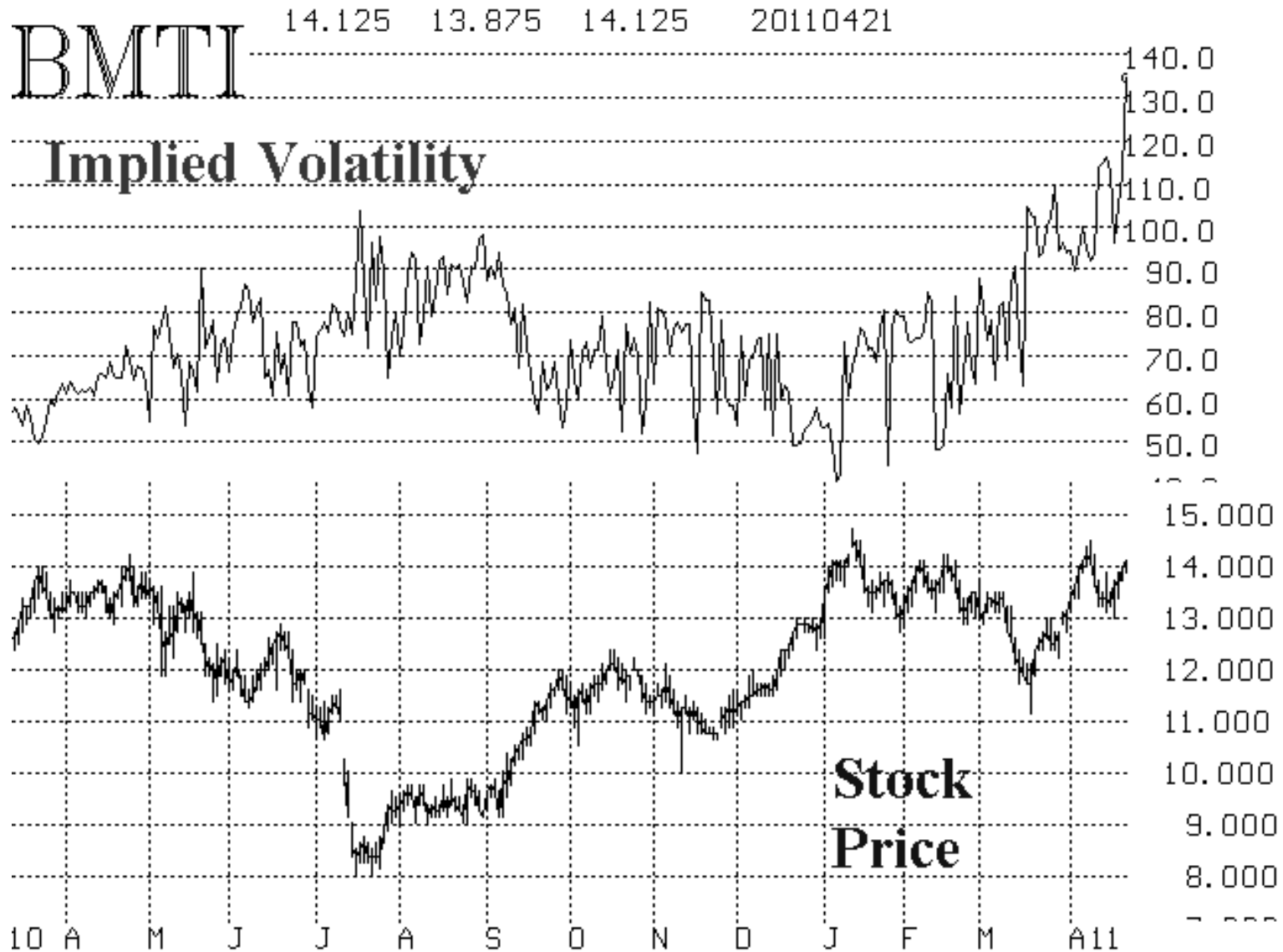
Biomimetic Therapeutics (BMTI)

Earnings: 5/10/2011

FDA Hearing: 5/12/2011

Bone Graft Treatment

Biomimetic Thera (BMTI)



BMTI Strategies

Stock: 14

Near-Term May 14 Straddle: 4.00

Straight Straddle Buy? Not thrilled.

May implied: 125%

June implied: 110%

Sept implied: 95%

All of these are too high to buy in a calendar.

BMTI Strategies – Part 2

There is a steep reverse skew:

May 14 put: 114% IV

May 13 put: 128%

May 12 put: 141%

May 11 put: 154%

May 10 put: 167%

So a call backspread might be best:

Buy 2 June 14 calls & Sell 1 May 10 call

BMTI Strategies – Part 2

There is a steep reverse skew:

So a call backspread might be best:

Buy 2 June 14 calls & Sell 1 May 10 call

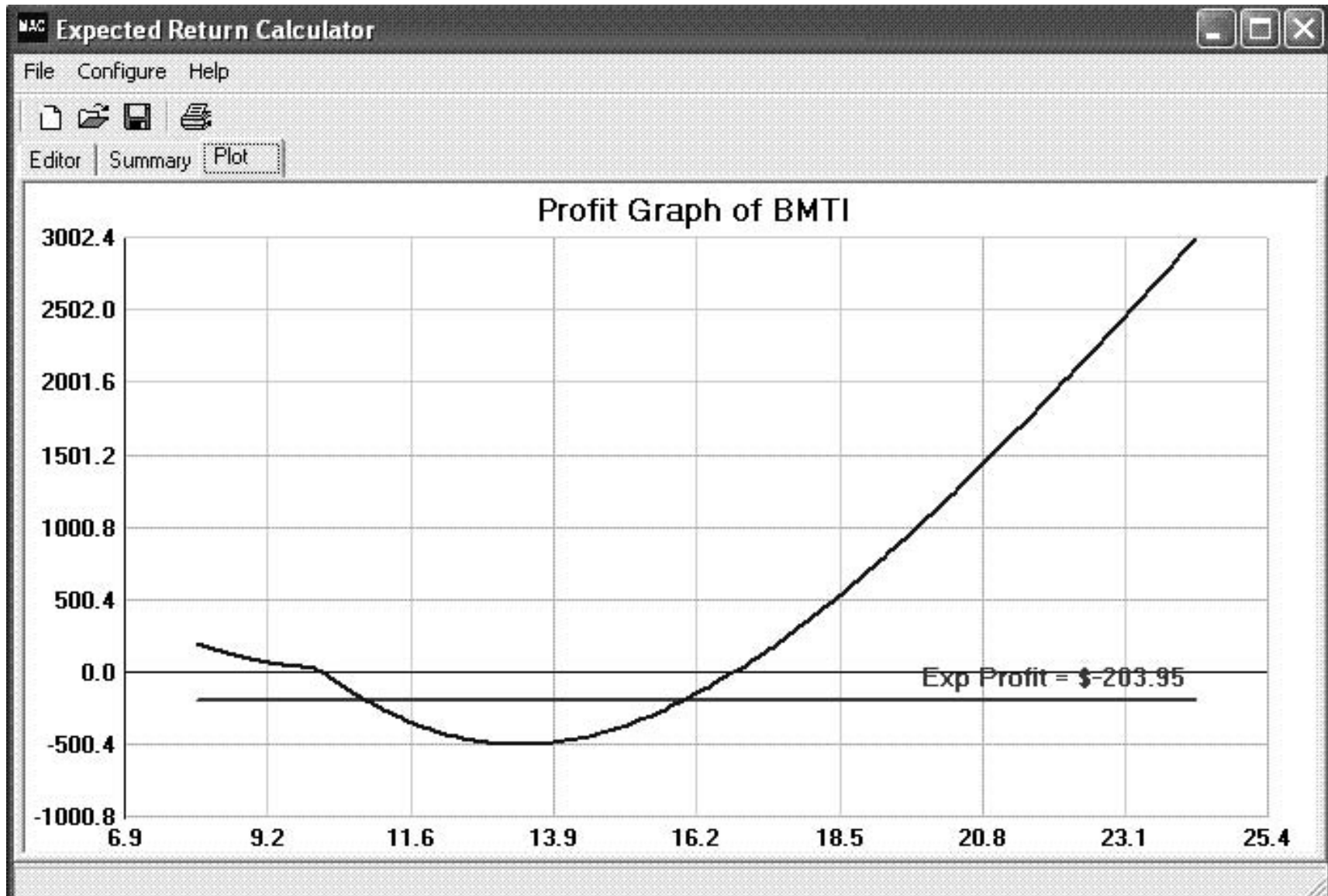
Or the equivalent:

Buy June 14 Straddle & Sell May 10 put

Actual: Buy 5 June 14 Straddles

And Sell 3 May 10 puts

BMTI Synthetic Backspread



Strategy Coverage

**The strategies covered in today's webinar
Are continuously followed in our newsletters:**

The Daily Strategist: takeovers, FDA, earnings, put-call ratios

Daily Volume Alerts: takeovers, earnings

The Daily Strategist: earnings, FDA, put-call ratios.

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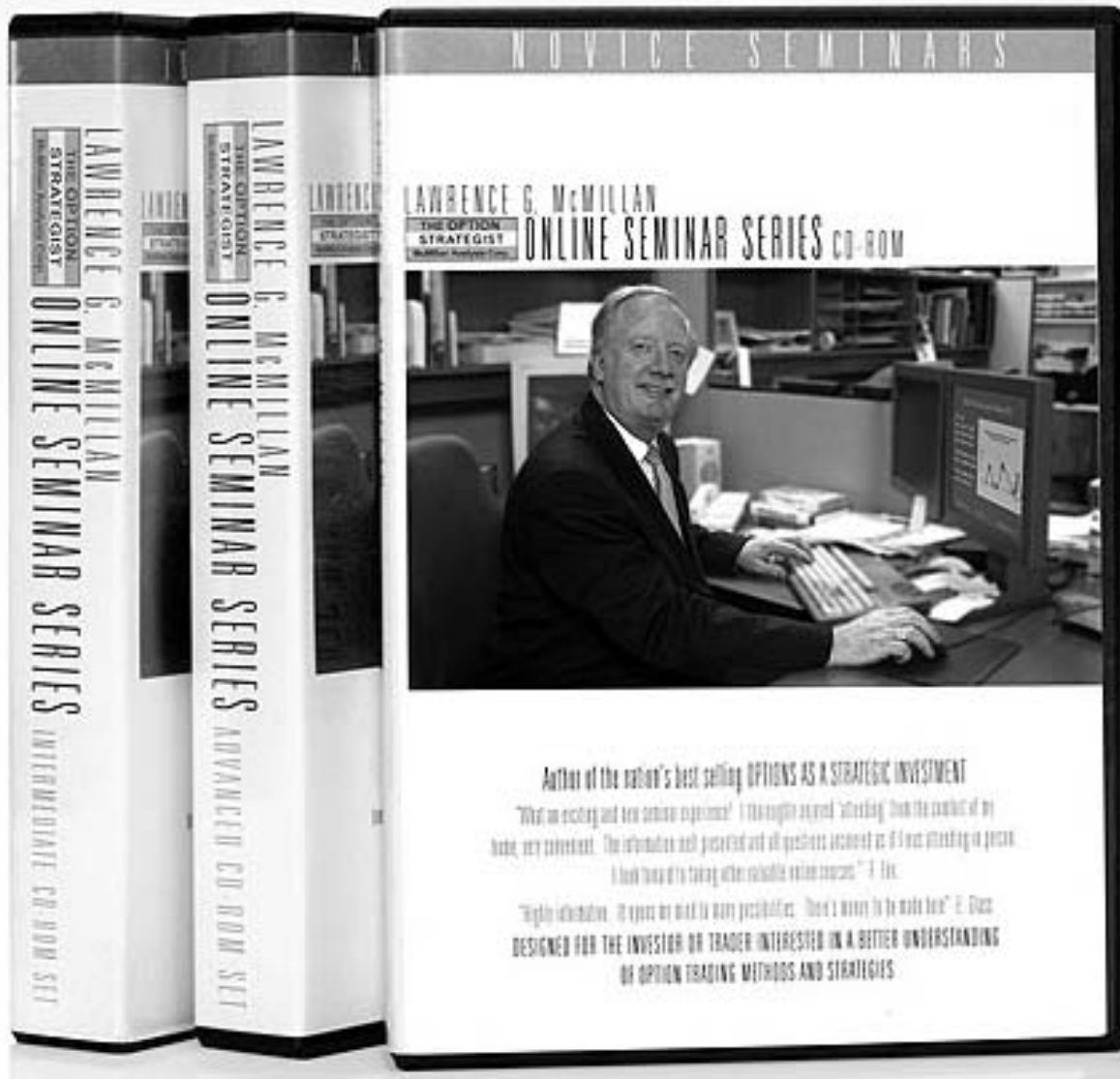
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