REVISED EDITION

The *New* Options Advantage

Gaining a Trading Edge Over the Markets

David L. Caplan

REVISED EDITION

The *New* Options Advantage

Gaining a Trading Edge Over the Markets

David L. Caplan

McGraw-Hill
New York San Francisco Washington, D.C. Auckland Bogotá
Caracas Lisbon London Madrid Mexico City Milan
Montreal New Delhi San Juan Singapore
Sydney Tokyo Toronto

Library of Congress Cataloging in Publication Data Available.

ISBN 1-55738-863-6

Printed in the United States of America

8 9 0 BRB/BRB 9 0 2 1 0 9

Credits
The author wishes to acknowledge the following corporations for granting permission to use the materials listed on the following pages.

FutureSource 955 Parkview Blvd., Lombard, IL 60148 (800-621-2628):
pages 4, 5, 22, 45, 46, 47, 54, 64, 65, 76, 77, 96, 97, 100, 103, 107, 111, 112, 113, 117, 124, 126, 127, 132, 135, 137, 138, 158, 159, 173, 174, 191, 192, 194, 195, 223, 224.
CQG P.O. Box 758, Glenwood Springs, CO 81602 (800-525-7082):
pages 16, 36, 37, 42, 95, 123, 124.
Com-Tech Software: 141 W. Jackson, Suite 1531-A, Chicago, IL: pages 105, 106, 186.
Chronometrics: page 56.
Los Angeles Times: page 6.
Dow Jones and Company: pages 19, 57, 197.
Optionomics: pages 222, 223.
OptionVue 175 East Hawthorne Parkway, Vernon Hills, IL 60061 (708-816-6610): 45, 46, 47, 48, 49, 50, 51, 61, 62, 63, 90, 91, 92, 93, 214–221, 226–233.

Preface

Since finishing my first option trading book, *The Professional Options Trader's Manual* in 1987, I have been continually asked when a new and "updated" version would be available. As I explain in the Introduction, even though the original *Manual is* only eight years old, and all of the concepts and theories are current and accurate, the changes in the options market and results of continuous research and trading require important additions.

This book presents the most up-to-date information that can be used as a "fine tuning" mechanism to my original work to improve our chances for success. It is a culmination of the last eight years' research and actual "hands-on" trading.

If I had to summarize the two most important things that I have learned these past several years, they would be flexibility and patience. I use flexibility in two ways: (1) Flexibility in not being married to a particular view of the market, but being able to flow with the trend of the market. Listen to what the market is telling you by its actual price action. (Others' interpretations may be right or wrong, and your own views of last month may now be incorrect.) and (2) Flexibility in your choice of options strategies by not just using one or two strategies that you like just because they were successful in the past. These strategies may be inappropriate for today's market.

For example, in 1984 and 1985, ratio option spreads were my favorite. Options were just being introduced, and quite often there were pricing inefficiencies in out-of-the-money options. This, coupled with a previous bull market in gold, silver, and sugar, provided for very high option premiums in out-of-the-money calls, perfect for ratio spreads. At that time, I wanted to do nothing else but these positions. However, in 1986 they began to disappear as the bull markets subsided and more traders began recognizing the inefficiencies.

In the quieter, trading range markets of 1986 and 1987 neutral option positions became my favorite. These ended in late 1988 when volatility continued to drop steadily. In 1989, option volatility was substantially trailing the futures market volatility, making it inappropriate to sell options. In 1994, with low option volatility and large moves in underlying markets, "free trades" were favored.

What we are doing, therefore, is using *flexibility* in working with what the markets give us, not "forcing" a trade that we may like, but does not fit the current technical pattern in the futures or option pricing levels.

Patience can be summarized by not overtrading, and waiting for the best opportunities. Overtrading tends to put too much pressure on us both emotionally and financially, forcing us into difficult situations if a market temporarily moves against us. Waiting for the best opportunities means that we will not buy a call option just because the market is moving up. As I will show, purchasing an option can lose money even if the market continues to move as expected. I require that the market not only be in a trending mode, but also that option volatility be at favorable levels. This allows us the benefits of options (limited risk, lower cash outlay, etc.,) while not being severely hampered by their negative factors (overvaluation, time decay, etc.).

Again readers will note these articles and reports continue to be the product of my actual, hands-on option trading, which has been my primary profession since futures' options were reintroduced in 1982. There is a lot of "mileage" in this book. Take advantage of it. I have experienced the victories and the defeats, and hopefully will save you the dollars that I had to spend in learning what "not to do."

(If you would like a current copy of the *Opportunities In Options* newsletter containing our most up-to-date research, contact our office C/O O.I.O., P.O. Box 2126, Malibu, CA 90265 or call (800) or (310) 456-9699.)

David L. Caplan
Malibu, California

Introduction

This is not just another options book! Since I immersed myself in options thirteen years ago, I have purchased and read every book on the subject I could find. In the beginning, there were few others available than the free booklets provided by the various futures exchanges. These books uniformly provided a definition of what an option was, a glossary of option terminology, and a description of basic option strategies. In fact, my "Bible" at the time was *Options As a Strategic Investment* by McMillan, a book that was about ten years old. When I wrote my first book on options several years later, *The Professional Option Trader's Manual*, I could still count the number of books on options on both hands. Even more distressing, these books were still very similar to each other. They were technically correct, clinical discussions of options, providing the necessary definitions, Greek letters, mathematics, and probability distribution graphs. The problem was that after reading and studying these books, and feeling I understood them, I still had no idea how options would help me in my trading. Being no different from most other traders, I was searching for the system, method, or black box that would provide me with some type of lead over others, and the markets. Knowing that most traders lost, made me determined to work harder to succeed. Options appealed to me because there seemed to be very few people that understood them. The typical comment from traders was: "Sure I know options. You buy a call if you want the market to go up, and you buy a put if it's going to go down." However, my investigation of options showed that by combining options of different expiration periods or strike prices, and having the ability to buy or sell options, that there were literally billions of combinations of potential strategies. Because of the few individuals or books that had any information on options, I felt that this was an overlooked and underutilized trading strategy and, more importantly I felt that with hard work and research I could find the "trading edge" I was searching for. Also, having an aptitude in mathematics and probability, I decided that this was the best way to put my talents to use. After all of my work, study, and research into options, simply buying calls or puts did not appeal to me as having a trading edge. (In fact, as I will discuss in detail, I have found that the odds of buying options are heavily against you, except in three specific instances.) Discussions with other traders still provided me with no hint of how to use options. In fact, it was not until a discussion I had with my former broker, who I had chosen because he was more knowledgeable than any other on option trading, that I began to formulate my strategies. He recommended a ratio spread involving gold options. At first, this trade seemed unappealing, since it involved several positions which would cost me three times as much commission, slippage, etc. Further, it seemed that the main benefit of the trade was that there would be little loss if gold went lower. There was something about the strategy that interested me though. Fortunately, this position was recommended to me on a Friday, and I was able to spend the weekend studying this trade and the gold market in detail. I found that by using the ratio spread that he suggested, but changing the parameters (strike prices and expiration periods) I could formulate a position that would be profitable if gold dropped over $400, if it didn't move at all, or even if it rose over $100 per ounce! Gold was trading at about $425 an ounce at that time, and I determined that my range of profitability was from zero to $530. However, even more importantly, if gold did not rise over $75 in the next month (which it had only done once in history), I would not lose, if I took the precaution of closing out the spread if gold rose above $500 after that first month.

Although quite concerned that I had made a mistake in my calculations, I decided to jump in the water and initiated the position. After all, I was bullish on the gold market and these positions had profit potential of up to $10,000 per position with margins of about 10% of that figure, and best of all, a large range of profitability. Well, there was good news and bad news. First, the bad news, the gold market collapsed. I was wrong on the market's direction. But, the good news was even better. The option strategy had totally protected me from loss. In fact, as I expected from my calculations, I was profiting from these positions even though my prediction of market direction was wrong! I then knew that options was what I was looking for. Although they cannot help you to predict market direction, I found that options still could provide an unbelievable advantage of:

1. Magnifying your gains when you are correct on the market;
2. Providing strategies that can be profitable over a wide range of prices; and
3. Strategies that can sometimes make money when your prediction of market direction is wrong.

In 1987 I presented my findings in *The Professional Option Traders Manual.* On the cover it was described as "The first hands-on trading manual detailing the most effective option strategies that can be used to any trader's advantage." I also avoided mathematics, Greek letters, and theoretical discussions of probability, and instead discussed how to use options in trading to get a "trading edge," what type of markets to look for, my favorite strategies, etc.

Although the manual was well received by both the public and the industry, there were two factors that I had failed to consider in my original work. The first was the changing nature of the options markets. As option volatility ranged from extremely low levels to extremely high (sometimes without regard to the volatility in the underlying markets), the use of different strategies was required.

The second factor I failed to take into consideration was insights from the daily use of options over the years—that can only be gained by savoring the victories and stomaching the defeats. Although I was able to relate many of these in my *Opportunities in Options* newsletter, I felt frustrated because I knew that no one read everything, and many times because of lack of time or space limitations, I was not able to relate some important new concepts or ideas. This is the reason for the revised *Options Advantage* book.

There are two final notes I would like to mention to my readers. First, even though my book uses mostly examples from options on futures, these strategies can also be applied to equity options. The main differences between future options and equity or stock options is use of margin and exercise as discussed at the end of Chapter 1.

Second, I am including a chapter on basic option trading, because my publisher thought that it could benefit new traders that happen to pick up the book as one of their first. If you're an experienced option trader, skim it quickly as a refresher, or skip it entirely. However, I did not include mathematical formulas, or complicated hypothetical discussions. Computers can do all the math you'll ever need, and there are many good texts that cover these subjects already. However, there are few, if any, books that show how to use all this great theory. Just understanding the mathematics of options without knowing how to use them is like knowing how to build a car, but not being able to drive—you just can't get anywhere!

My past subscribers and readers will recognize some of the material in this book from my previous manual, newsletters, and articles. This is necessary both for maintaining continuity, and due to the fact that there is just so much that is worthwhile that can be said about options. Use this material as a refresher to review these important principles, which are the cornerstones of our option trading techniques.

Table of Contents

CHAPTER 1

The "Trading Edge" Philosophy

BEYOND "LIMITED RISK," "CHEAP," AND "LEVERAGE"

In numerous seminars I've given on options trading, I have often asked participants the main reason that they have used options in the past. Invariably, more than 90% cite limited risk, cheap, and/or leverage as their primary reasons. While options provide these advantages, the use of options for only these reasons can almost guarantee that you will eventually lose your money.

Limited Risk

There is no question that when purchasing options your risk is absolutely limited to the amount of premium that you paid for the option. You know in advance how much you can lose. However, just knowing how much money you're probably going to lose is not very comforting when your chances of making money are very slim. Buying far out-of-the-money options, purchasing overvalued options, and purchasing options in trading range markets are usually "dead ducks." You have almost no chance of making money.

Cheap

Cheap options are always available. For example, you can purchase an option for $25 on an S&P contract that has a value of close to $200,000. However, when was the last time you bought something just because it was cheap? How many of us have bought a "cheap" old car, piece of equipment, clothes, etc., only to find it costing a lot more money later on when it needed repair. This is exactly the same with options. Buying an option just because it is "cheap" is never a good reason.

Leverage

In the example of the S&P option above, you are obtaining leverage of over 99%. However, if leverage is the only factor that impresses you, lotteries provide an abundance of this. For a $1 investment in a lottery you can win tens of millions of dollars, and your chances are probably just as good at making money as with that $25 option in the S&P contract.

Yes, options are cheap and do provide limited risk, and leverage. However, you should not consider only these reasons for buying them: options should only be bought when premiums are reasonable, and your trading plan indicates the market is likely to make a large move with the potential for big profits.

POPULAR MISCONCEPTIONS ABOUT OPTIONS

Learning how to obtain a "trading edge" over the market with options is similar to improving your golf game. You can't go very far unless you unlearn your old bad habits. With options, popular misconceptions that have been advanced by many books and brokers are responsible for significant losses by many traders. Let's examine five of these misunderstood ideas.

1. *"If you buy an option and the market goes in your favor you will always profit."*

Wrong. When you purchase an option you pay not only for its intrinsic (actual) value, but for its time value. Each day you hold an option, the time value must drop somewhat. The market must move in your favor enough to offset this decay of time value premium. Even if the market has made a large enough move to make your option profitable, unless you cash the option out at an opportune time it must continue to a move in your favor. Buying options is like swimming upstream against a heavy current; unless you move very fast you'll be swept away.

As shown in Exhibit 1.1, the S&P 500 had moved over 3,000 points higher in four months (a gain of $15,000 per futures contract). However, some call options would have provided no profit to the trader during this period. Even more distressing, a not so well-priced call option, that could have been purchased by many investors because of its reasonable price, actually lost value, even while the market made new all-time highs. There are many examples of this in recent trading as shown in Exhibits 1.2, 1.3, and 1.4.

2. *"There is big money to be made in selling overvalued options."*

This is another good news-bad news situation. The good news is that over 80% of the time this statement is correct. You will make money selling overvalued options. The bad news is that the other 20% of the time can cost you far in excess of all the profits you've made. This is because when selling options your profits are strictly limited to the premium you receive. However, your risk is not. And over time, all markets make giant, unexpected moves. Over the last several years I've seen moves in silver equal to $20,000 in a futures contract in one hour; 5,000 ($25,000) point moves in the S&P in one day; moves in bonds of 10 ($10,000) points overnight, etc. Getting caught in one of these moves without a trading plan can wipe out years of profits.

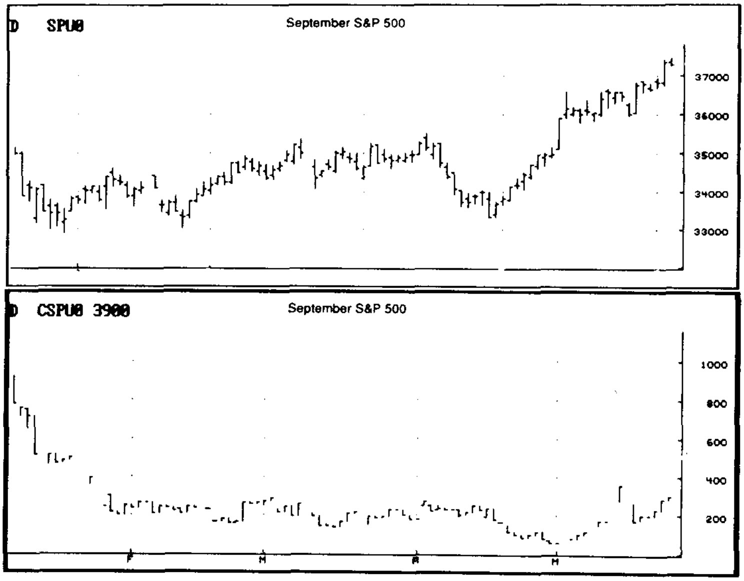
3. *"It is easy to find arbitrage spreads to guarantee profits."*

The truism here is that discrepancy in prices sometimes allows trades to be done with little or no risk, and when done in large quantities, substantial profits can be locked in by these traders. However, for those interested in arbitrage, you will be competing with firms with capital bases of $100,000,000 or more, employing many full-time analysts, computer technicians, mathematicians, etc., who use both round-the-clock and full-time computer analysis of markets in the United States and around the world at costs of tens to hundreds of thousands of dollars per month. Additionally, because of the volumes in which they deal, their trading costs are much lower than the average traders. They are able to obtain the fills without the slippage (loss occurring in executing an order) that others would experience. You have the same chance of competing against these firms and profiting at arbitrage as you would in beating Jack Nicklaus in golf or John McEnroe in tennis.

Finally, if you're still not convinced, ask the "derivative" trader of 1994, if arbitrage spreads are an easy way to profits!

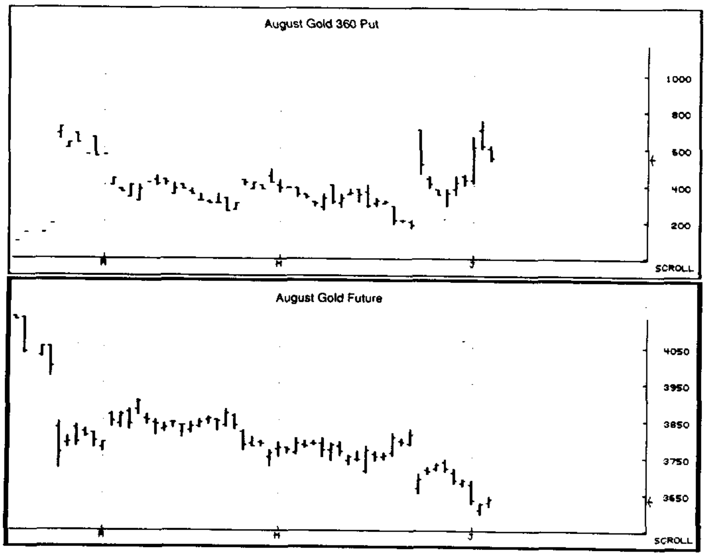
4. *"Computer programs can tell you how to trade options, which ones to buy and sell, and which strategy to use."*

Exhibit 1.1



Note: Although the S&P 500 moved to new highs, many calls lost value.

Exhibit 1.2
August Gold 360 Put



Note: The August gold 360 put lost premium value, even though gold dropped almost $50 ($5,000) per contract.