

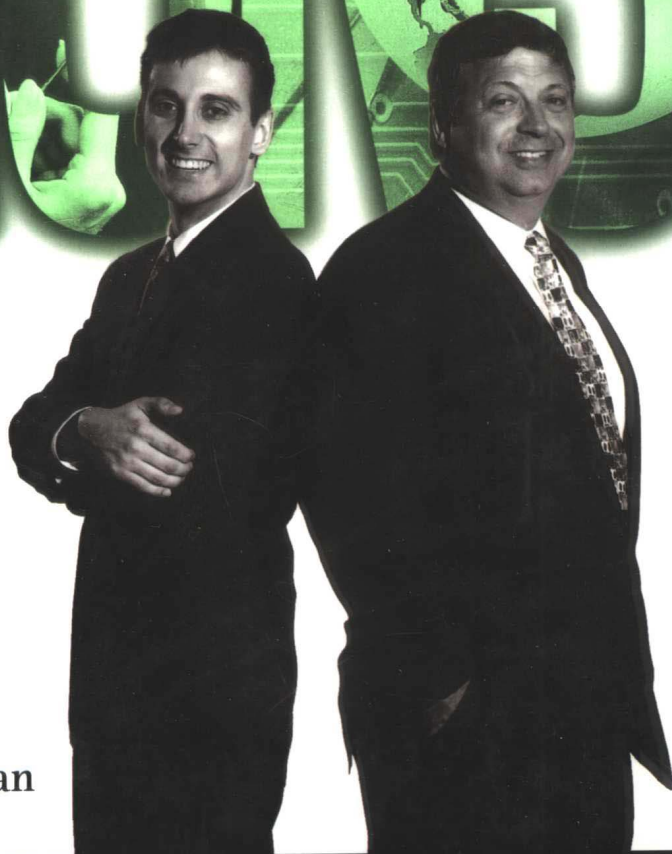
DEMARK ON DAY TRADING

OPTIONS



**USING OPTIONS
TO CASH IN ON
THE DAY TRADING
PHENOMENON**

Foreword by Lawrence G. McMillan



Thomas DeMark & Thomas DeMark, Jr.

DEMARK ON DAY TRADING OPTIONS

Using Options to Cash In
on the Day Trading Phenomenon

Thomas R. DeMark

Thomas R. DeMark, Jr.

McGraw-Hill

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

Library of Congress Cataloging-in-Publication Data

DeMark, Thomas R., date.

DeMark on day trading options : using options to cash in on the day trading phenomenon / by Thomas R. DeMark and Thomas R. DeMark Jr.

p. cm.

Includes index.

ISBN 0-07-135059-4

I. Options (Finance)—United States. I. DeMark, Thomas R., Jr. II. Title.

HG6024.U6D46 1999

332.63'228—dc21

99-21299

CIP

McGraw-Hill



A Division of The McGraw-Hill Companies

Copyright © 1999 by Thomas R. DeMark and Thomas R. DeMark, Jr. All rights reserved. Printed in the United States of America. Except as permitted under the United States Copyright Act of 1976, no part of this publication may be reproduced or distributed in any form or by any means, or stored in a data base or retrieval system, without the prior written permission of the publisher.

2 3 4 5 6 7 8 9 0 DOC/DOC 9 0 4 3 2 1 0 9

ISBN 0-07-135059-4

The sponsoring editor for this book was Stephen Isaacs and the production supervisor was Tina Cameron. It was set in Times New Roman by North Market Street Graphics of Lancaster, Pennsylvania.

Printed and bound by R. R. Donnelley & Sons Company.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

*—From a Declaration of Principles jointly adopted by a Committee of
the American Bar Association and a Committee of Publishers.*

Although both the authors and the publisher believe the information, data, and contents presented are accurate, they neither guarantee their accuracy and completeness nor assume any liability. It should not be assumed that the methods, techniques, or indicators presented in this book will be profitable or that they will not result in losses. Trading involves the risk of loss, as well as the potential for profit. Past performance is not a guarantee of future results.

Options involve risk and are not suitable for all investors.

McGraw-Hill books are available at special quantity discounts to use as premiums and sales promotions, or for use in corporate training programs. For more information, please write to the Director of Special Sales, McGraw-Hill, 11 West 19th Street, New York, NY 10011. Or contact your local bookstore.



This book is printed on recycled, acid-free paper containing a minimum of 50% recycled de-inked fiber.

To my namesake and partner (T.J.) for his exceptional writing talents and organizational skills, as well as thorough knowledge of options and trading.

To my wife Nancy and our other children, Carrie, Meghan, Rocke, Evan, and Dominic for enriching my life.

To Steve Cohen, a market magician and professional trader who excels at every aspect of the business, for his support and commitment to market timing, as well as his friendship.

To Bruce Hauptman for his interest in the indicators and his friendship.

To Rick Knox, Matt Storz, Duane Davis, Larry McMillan, Chris Evans, John Hill, John Snyder, Rick Bensignor, and Mark Ellingson for their friendship and support.

To the management and software developers at Aspen Graphics, Bloomberg, Bridge, CQG, Data Transmission (DTN), Dow Jones Markets, FutureSource, Omega Research, Option Vue, Quote.Com, and Window on Wall Street.

Thomas Sr.

To my father Thomas whose name, birthday, and passion for trading I share.

To my mother Nancy who has taught me what is important in life. For the morals she has instilled in me and my siblings, as well as her incredible kindness, understanding, love, and friendship.

To my brothers and sisters for their encouragement and love.

To John DiFrancesca, my floor trading partner, for his attitude, humor, and friendship.

To Rich Rovetto and Tim Slater for taking a chance on me and introducing me into the trading and seminar communities.

To my roommate and friend Matt Stauffer for his inspiration and for teaching me to live life to its fullest, each and every day.

To Dan Davis, the Maddens (Rob and Scott), Doug Jansen, Joe Gits, Sr., Jason Perl, Thomas Stridsman, Leslie Richman, Brian Walls, Pat Raffalovich, Kathy Simpson, Drew Bryant, Marshall Persky, Martha Arriaga, Bruce McDonald, Bob Hendrickson, Trippe Lonian, Landon Stone, Mayeti Gametchu, Greg Forbes, Kris Kahn, Brad Murray, Mark Torres, Jeff Walsh, Sean Ladley, Dave Jones, Terry Kaufman, Mike Dillard, and Mindy Rozak for their friendship and support throughout the years.

Thomas Jr. (T.J.)

Foreword

DERIVATIVES HAVE TAKEN ON an ever increasing importance in the markets. The broad definition of *derivatives* includes options, futures, and many more exotic instruments that are conjured up by the leading investment banks. For most traders, though, *derivatives* means options—stock options, futures options, or index options. The virtual explosion in trading volume of options of all types attests to their importance. Moreover, there has been an increased interest in short-term trading—even day trading. This work by the DeMarks addresses both issues with a degree of professionalism reflective of their experience as traders and system designers.

This is not a get-rich-quick book. The setups, signals, and concepts described herein will require some study by even the most astute trader in order to use them successfully. But that is good news. So many books on day trading are published that seem to tout the concept as an easy road to riches. Any serious day trader—and I consider myself among them—knows that day trading is hard work, which is difficult on the psyche, and the concomitant rewards are available only to those who are willing to “pay the toll,” so to speak. This book should appeal to both the aspiring trader and the experienced trader as well, for it lays out nontrivial concepts that can lead to excellent profits.

Most of the systems in this book are a continuation of the ones described in DeMark’s earlier works—they deal with the timing of the purchase or sale of the underlying security. Options can, of course, be used in place of the underlying in any trading system—buying calls instead of taking a bullish signal on the underlying stock, index or futures, or buying puts instead of shorting the same. However, there is one very interesting new twist present here: the TD % F system. In this instance, DeMark lays out an option trading system that depends only on the price of the option itself! There is no consideration of what the underlying is doing—although the movements of the underlying, of course, influence the price of the option. I have often been a proponent of using options as a technical indicator to

predict the movement of the underlying security—option volume spikes, sudden increases in the expensiveness of options, and put-call ratios are all accepted ways of doing this. Now, perhaps, another indicator has been introduced that may help in determining price reversals by the underlying security.

Options are very useful as sentiment indicators. Unfortunately, most of our fellow option traders are wrong in their market opinions most of the time. That's why the put-call ratios—which measure option volume—are important contrary sentiment market indicators. This book describes a new sentiment indicator. It uses the dollar-weighted values of puts and calls *during* a trading day or at the close of trading. This indicator is similar to the put-call ratio that is commonly used for measuring sentiment, but because it uses price as well as volume *and* open interest, it may truly represent a new way of looking at sentiment. As always, though, the astute contrarian will want to be in a position opposite to that of the majority of traders.

TD % F is only one of many indicators presented in this book. It is important to understand that these are indicators—not *systems*. A *system* has specific entry and exit points and an exact track record can be constructed using them. However, most systems are hard to use for individual traders because somewhere along the line they conflict with the trader's own penchant for trading. The DeMarks, on the other hand, have given us *indicators*—rules for determining when a market is ready to be bought or sold, but which stop short of the dictatorial rules of a system. The good news is that this method gives the trader some room to use reason and logic in the way he or she employs the indicator; the bad news is that inexperienced traders might not be able to “reason” very well.

There is little mention in this book of terms you would find in a conventional option book—such as *implied volatility*, *delta*, *gamma*, *theta*, or *vega*. But that's okay. This isn't an option theory book—rather it is designed primarily as a trading book and it recommends that you use options to do that trading. When I am trading options for a short-term trade, I prefer to use near-term, in-the-money options, for they have little time value premium and most closely reflect the movements in the underlying security. The DeMarks espouse the same philosophy. You want to be able to capture quick price movements without having to worry a lot about time decay or possibly a change in the volatility pricing structure of the options—that is, how expensive the options are. Day traders of options don't have to worry much about either one—there is little time decay in the course of a single day, and options don't normally have a significant change in their pricing level in one day's time. Moreover, options limit your risk if something especially untoward should happen, but they allow for almost unlimited rewards.

In addition, the beauty of the DeMarks' approach is that these systems are geared toward option buyers. Forget spreads, covered writes, strangles, and so forth. If you can identify the likelihood of a swift movement by the underlying

security—and that’s what this book is all about—then you can concentrate on buying options as your trading vehicle. There is no need for the hedged strategies. In fact, it’s a myth that option writers make all of the money in option trading. Anyone who has written covered or uncovered calls on the major stocks—especially the technology stocks—during the ongoing bull market has suffered the consequences. Even those who have employed bull spreads have found their profits reduced because they limited their profit potential. So the DeMarks’ approach—and it is a valid one—is to forsake the exotic and stick with the basic: buy calls if the underlying is going to rise, and buy puts if it’s going to fall. Of course, determining what the underlying is going to do is a difficult endeavor, but the indicators presented herein are very useful for that purpose.

While many setups and indicators are presented in this book, my favorite is the TD Camouflage. It is simple, seems to have excellent results, and can be quickly understood by even the most novice trader. If you come away with nothing else, learn this one concept. It should improve your short-term trading results.

Another very interesting concept that is stressed in this book is that of using the current day’s opening price as the point from which to measure net change for the day. Not a single pricing service approaches the markets in this way—from newspapers to the most sophisticated and expensive real-time data services. Yet, as the DeMarks stress throughout, the most important thing for a trader to know about a stock, future, or index is how it is doing *relative to today’s opening price*. I won’t get into examples—the DeMarks do that—but suffice it to say that I agree with this concept and perhaps this book’s greatest contribution to investment theory will be the realization of that ideology.

Readers who are familiar with Tom DeMark’s previous works will find these systems to be similar to ones you have previously discovered. New traders will be intrigued by them as well, and should learn a lot. Again, I stress that this is not a trivial, “make-a-million” (while you lie on the beach) book. It is a serious endeavor and requires study and concentration. But from the myriad of examples and charts that point out how these indicators work, you should be able to see that any serious time spent studying these techniques should prove profitable to you in your trading.

If you want to keep track of these indicators yourself, you will need software to do it. There are just too many calculations and too many markets to expect that you can do it by hand. The DeMarks address this problem, though, by providing a list of potential software solution providers in the appendix. This, of course, necessitates having a computer and a pricing service so that you can monitor these setups at all times. However, for the trader who is interested in only a market or two—and these indicators appear to work well on the biggest market: S&P futures (and OEX traders can be included as well)—it *would* be possible to keep the information updated by hand, at least on a daily basis.

The summary chapter is extremely well done, for it ties together the concepts laid out in the more detailed portions of the body of the work. In fact, it is *so* good in describing what the book is about, that you might want to glance at the summary chapter first and *then* delve into the detail of the book.

Overall, I think you will find this book interesting and will also find that it contributes to your profitability, whether you are a day trader using five-minute, ten-minute, or hourly charts, or if you are a short-term trader using daily charts and planning to hold for several days at a time.

Lawrence G. McMillan

Preface

WELL, I STAND CORRECTED. After the completion of each of my first two books, I vowed never again to submit to such an ordeal. Articles, yes; seminars, maybe; but books, no, never. So, now that this work has been completed, I shall make the same statement once more: “never again.” I promise—I think. I suppose I knew all along that I would write just one more book. I always felt as if I had so much to say and too little space and time in which to say it, which is probably not a surprise to many of you who know me. But what is different about this book? Why options and why now? You might say my son’s involvement in floor trading and then in managing funds, as well as his keen interest in this area of the market were certainly catalysts.

To some of you already familiar with our work, a few of the indicators in this book may seem to be simply a rehash of our previous books and articles, only this time applied to option trading. Believe us, this is not the case. We’ve developed several option rules and indicators which we are sharing with you for the very first time and have added several additional settings, qualifiers, and applications to our existing library of indicators, all of which have enhanced their efficacy. The indicators discussed in Chaps. 6, 7, 8, and 9 apply to the underlying asset as opposed to the option itself. From these indicators, a trader can apply the results to option trading to identify low risk call buying and put buying opportunities. To other readers unfamiliar with our work or to beginning traders, this is a great place to start. One of the biggest complaints regarding our previous written works has been the perceived complexity of the techniques presented and discussed. We understand this concern; after all, accepting new and unorthodox approaches to market analysis is just plain difficult. Fortunately, this book is a departure from the highly detailed technical writings of the past. Although the ideas discussed in this book have been an ongoing collaborative effort between father and son, the organization and writing skills that T.J. has provided have simplified the descriptions and the

explanations of the material. Although unexpected, should you experience difficulty with any aspect of this book, don't be discouraged—just like learning to ride a bicycle, once the skill is acquired, it becomes second nature.

We refer to the information in this book as market timing indicators, not turnkey systems intentionally. The reason for this distinction is that our techniques lack precise entry and exit levels and instead concentrate upon trading opportunity zones. Our goal is simply to provide the components from which traders can select, design, and build their own trading models with which there exists a level of comfort. Our contribution is the various trading concepts and the assortment of trading methodologies from which to choose. We encourage your research and experimentation with the various indicator settings, as well as indicator combinations. It is only through experience and testing that you will acquire an aptitude with these methods.

Now to answer the question many have posed throughout the years. Why does *TD* preface each of our indicators? Believe us when we say it is neither our intentions to promote our initials, nor is there some underhanded mercenary motivation at work here. Our legal counsel advised us to trademark our indicators to ensure proper control of their distribution and to limit our liability should others offer facsimiles for sale and distribution and misrepresent their effectiveness or intended application.

We do not profess to be experts in the intricacies of various option-writing programs and mathematical models. Since being introduced to option trading almost three decades ago, we have been fascinated by these markets. The purchase of options has served as a poor traders' alternative to trading stocks and futures. Most of the techniques we developed specifically for option trading were tested by closely following both the intraday and the daily price activity reported by quote services, as well as option charts we created ourselves. Not until we decided to write this book did we realize that there existed a serious data deficiency within this industry. There was a lack of uniform option data and some of the data which was provided proved to be inconsistent and riddled with errors. Data reliability and availability are two serious industrywide problems. Unfortunately, the data providers with whom we had success specialized in only equity or only futures information, but not both. Fortunately, the occasional errors in data reporting even by these services while conducting tests proved to be tolerable. Consequently, we recommend you observe and monitor closely, the integration of the various data and the techniques before you commence trading.

While we have personally traded and used these indicators successfully over the last 30 years, we feel it is important that you not assume they are infallible. Extraneous factors, such as money management and discipline, also contribute to one's trading success. Each trader has his or her own trading pain threshold and as a result, the location of one's stop losses and profit levels may be different from

other traders who may be more or less emotional. Therefore, we stress the importance of not only paper trading each indicator, but also the proper integration of those you especially like into your trading regimen.

Since the majority of our indicators are designed to anticipate trend exhaustion or trend reversals, they may appear unorthodox to some readers of conventional technical analysis. I stress that we are not trend followers; to be one and, at the same time, day trade options is incongruous. We prefer to buck the prevailing market sentiment, intending to anticipate the inflection point where the trend reverses. We believe that this is the only way to day trade options properly. We feel that, at the very least, the market-timing techniques presented in this book will improve a trader's ability to identify ideal low-risk entry levels.

Individually, these indicators may appear *intimidating* and seem unsuitable for your style of trading. However, given the variability and the diversity of this suite of market-timing tools, inevitably at least a few should comfortably complement various aspects of your trading style. We encourage you to apply them and to experiment with variations of these tools and settings. We've never meant to imply that we are blessed with the Holy Grail of trading indicators; however, we do believe we are on the right track. Assuming your appetite for market-timing research is as voracious as ours, our experience and ideas should enable you to trade more profitably.

Introduction

BEFORE A BABY CAN WALK, it must first learn to crawl. Before the walls of any building can be erected, architectural plans must be prepared and carefully followed to insure a sound foundation is in place. Likewise, before any discussion of techniques to day trade options can be presented, it must be preceded by an explanation of what options are; where and how they are traded; what filters or screens can be used to select option trading candidates and then, once purchased, what techniques can be applied to predict and monitor their price activity; what types of market orders can be placed to execute option trades; what methods can be used to lock in profits and exit trading positions; and what contingencies exist to protect against the inevitable—trading losses. These factors, together with an acute awareness and appreciation for the risks and the rewards associated with trading options, should prepare a prospective trader for this exciting and financially rewarding form of trading.

Within the investment industry, there is a commonly held belief that more than 90 percent of option buyers lose money. The majority of books and courses devoted to the subject of option trading have been written by authors who are convinced that the only way to trade profitably is not to buy options, but rather to write or to sell them based upon a series of complex, mathematical pricing models and strategies. Unfortunately, most of these writers are theoreticians and not active option traders. They fail not only to address the reasons why most option buyers consistently lose money but also to provide methods which can improve a buyer's chances of trading success. Were these authors traders themselves, they would be more inclined to develop option-trading methods that concentrate upon the timely purchase of options with the potential of open-ended profits, rather than merely to rely upon complicated formulas that are designed to control option-trading risk but, at the same time, limit reward. Our experience indicates that these complex approaches serve to intimidate and confuse most traders, discouraging their participation and therefore preventing their chances for trading profits.

Although some option-writing techniques may be profitable, the degree of success traders enjoy is limited to the value of the option at the time the trade is initiated which is a function of market volatility, the underlying security price, and the time remaining before an option's expiration, among other considerations as well. In actuality, trading defensively and adhering to option models and complicated option-writing strategies contradicts the goal of most option traders, which is to leverage their investments and make a significant amount of money within a short period of time. They perceive, we believe incorrectly, that this selling methodology is a safer and a more profitable means of trading than the outright purchase of options. Similarly, we could present theoretical price valuation models that describe option price behavior given various levels of price activity of the underlying security along a specified time spectrum. After all, models are helpful since they are designed to provide a trader with an option-pricing road map. On the other hand, how often has real-time trading conformed to a market model? Not often and especially not in those instances in which traders have relied heavily upon a specific game plan to trade their own accounts aggressively.

We're certain there are a number of excellent books that discuss how to write or sell options and lock in respectable returns. Unfortunately, the option-investing public is often precluded from participating in these trading strategies because the implementation of these techniques requires either a large capital commitment or the possession of the underlying security. As a result, an undercapitalized trading novice is forced to either buy options outright or forego participation in this potentially rewarding trading opportunity. Fortunately, we believe that what may be perceived by some as an inferior and riskier approach to option trading is in reality a preferable form of trading, provided proper guidelines are followed. In other words, we feel that buying options outright without the requirement of, or concern for, complex formula-ridden and capital-intensive methods of writing or selling options can be more rewarding, both financially and emotionally. If you are like we are, you prefer limited risk and unlimited gains and that is precisely the focus of our book.

Despite the multitude of formidable barriers to successful trading, there exist numerous strategies which enable traders to buy and to sell options, even intraday, profitably. These methods are a reasonable and a practical alternative to the sophisticated, hypothetical trading techniques which require large account balances and complex computer-driven market models. We believe all that is required is a basic understanding of the operation of the options markets and a measure of trading discipline and money management skills. This book concentrates upon the presentation of simple, easily understood methods to identify option-trading opportunity zones. Our methodology deemphasizes the commonly accepted practice of selling an option in anticipation of the premium value's decline to zero as time lapses into option expiration. Rather we attempt to provide a disciplined option trader with an

open-ended profit potential, since our basic approach merely requires buying and then liquidating an option position at the appropriate time.

Although this book may occasionally describe or refer to various option-writing strategies or trading models, they are incidental to the thrust of our discussion which is to present a number of approaches to successfully buy and day trade options. Certainly, there is nothing to prevent a trader from employing the day-trading techniques presented in this book and then electing to extend the holding period longer than the conclusion of the entry day's trading. The important consideration is to adhere to the application of a mechanical and disciplined approach to both the selection of option-trading candidates and the timing of their purchase.

You've heard the expressions "you're only as good as your last trade," "trading opportunities are like city buses—if you miss one, another will appear shortly," and the ever quoted market nemesis "coulda, woulda, shoulda." (As in, "I *coulda* bought it; if I had, I *woulda* made a lot of money; now that I know this, I *shoulda* bought it.") Each phrase emphasizes the importance of two critical factors often neglected by most traders; namely, discipline and money management. Without proper respect for these elements of successful trading, one is doomed to failure. Obviously, not all trades will be profitable and unless contingencies exist to preserve one's capital against such unforeseen events, trading becomes gambling. Having a systematic approach or a mechanized set of indicators to time entry clearly provides a trader with a distinct advantage over discretionary and emotional trading. This is the basis of our focus. Discipline is an extension of one's psyche and personality, and, although it can be acquired, we view it as more innate. Money management, on the other hand, is a skill which can be taught, but its mastery usually comes with market maturity and experience. This book is not intended to concentrate upon the mechanics of money management or the psychology of a trader but rather to impart a defined set of option-trading rules which should provide the framework required to trade options successfully.

It appears to happen all the time to the uninitiated, inexperienced option trader. Some lucky trader purchases an option anticipating a forthcoming news announcement or development. The expected event occurs and while the underlying security may double in price, the option's value may increase many multiples of that amount. Examples such as these, however, are the exceptions rather than the rule. History confirms that it is much more likely that the value of an option will expire worthless than produce lofty gains such as those described. Just as playing slot machines is usually a losing proposition and the casino's odds of winning are greater than those of the gambler, so too the frequency of failure is much greater than success for option buyers as opposed to option sellers or writers. Unless an option buyer's timing is precise and option-trading methodology is disciplined, trading losses are a foregone conclusion. That is exactly why our emphasis is upon introducing effective methods that will tip the scales in favor of the option buyer.

It's amazing how people will foolishly spend their hard-earned, after-tax dollars on a whim or market rumor. Many traders part with their money without a thorough understanding of how options behave. We believe most option buyers' selection processes are random and driven primarily by emotion. To trade options profitably, it's important that a buyer have an edge over the writers or sellers of options, as well as other option buyers. With the proper trading tools and mindset, a trader should be equipped to establish just such a trading advantage. The techniques we present are certainly not a panacea for all the ailments afflicting option traders. Nevertheless, they should help eliminate the commonly held perception that buying options is a nonreturnable or a nonrefundable form of securities trading. The indicators and option-trading techniques we describe will provide a new, fresh perspective in which to view option trading, all of which should contribute to your trading success. Best wishes for trading profits.

Acknowledgments

THE RESEARCH AND composition of this book have been a joint endeavor, father and son. However, the project would never have been completed were it not for the efforts of Mssrs. Stephen Isaacs and Jeffrey Krames, McGraw-Hill's "good cop, bad cop" team. Their encouragement and direction were a positive influence. The book's copy editor, Christina Palaia from North Market Street Graphics, was instrumental in providing the necessary continuity and editing.

Window on Wall Street (800-998-8439) and CQG (800-525-7082) generously supplied the charts and data presented throughout this book. Deltasoft (Option Oracle)—800-250-7866—was a reliable resource for option data and for the implementation of option trading strategies, as were CSI (800-274-4727) and More Research (514-484-7256).

Once again Duane Davis and his team of programmers and support staff at Financial Software Systems (FSI) (714-731-3384) were invaluable in their support and direction.

Trademarks

ALL OF THE FOLLOWING indicators are registered trademarks and are protected by U.S. Trademark Law. Any unauthorized use without the express written permission of Market Studies, Inc. or Tom DeMark is a violation of the law. They are as follows: TD Absolute Retracement, TD Breakout Qualifiers, TD Camouflage, TD CLOP, TD CLOPWIN, TD Combo, TD Countdown, TD Critical Price, TD Critical Qualifier, TD Demand Line, TD Differential, TD Dollar-Weighted Options, TD Double Retracement, TD Exit One, TD Fibonacci Range, TD Line, TD Magnet Price, TD Open, TD Percentage Factor (TD % F), TD Point, TD Price Oscillator Qualifier (TD POQ), TD Range Expansion Index (TD REI), TD REBO, TD Reverse REBO, TD Relative Retracements, TD Sequential, TD Setup Trend (TDST), TD Supply Line, TD Termination Count, and TD Trap.