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options

**ONLINE PUTS,
CALLS, SPREADS,
AND STRADDLES**

online

GEORGE A. FONTANILLS

trade options online

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My mission is to develop, teach, and trade high profit/low risk trading strategies for people who want to learn how to become successful options traders. I would like to take this opportunity to acknowledge the dedication of all our staff who continually contribute to my success and that of our companies. The staff of our education and research division, called “Optionetics” and Global Investment Research Corp., are totally committed to the welfare of our students by teaching them how to make high profits while managing the risks of trading. Additionally, our Boston-based money management business, Pinnacle Investments of America, Inc., has an equally dedicated staff who concentrate on helping me to maximize returns for our investors. I am grateful to them all and take this opportunity to mention some of the essential people in my life who inspire and support me. In particular, and in no order of importance, I would like to especially thank the following:

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Good luck and great trading!

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introduction

the online trading revolution

There is a revolution going on! Every day the Internet is changing the way human beings live, work, and play. Never before has information been so readily available. But we are infants in this new medium, constantly testing the limits of our postmodern playground. In the end, the far-reaching effects of living online will be a momentous testament to human evolution.

You may be wondering how this revolution began. In 1969 the U.S. Department of Defense developed a labyrinth of networked computers to enable the exchange of information to and from anywhere in the world. In its early stages, the Internet was little more than a basic text. But in 1989, an interconnected information network called the World Wide Web introduced a multimedia format with text, graphics, sound, and video. The Internet has since become a global communications system for commerce, research, entertainment, and investing. We are witnessing the birth of a new age.

Every 100 days, one million new users start surfing the Net the world over. This astonishing rate of growth has given birth to a new investing medium the like of which has never been seen before: online trading. The advent of online trading is changing the very nature of

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the investment game. Online brokers now handle 14% of all stock trades and this number is rising dramatically. As millions of independent traders gain access to information that used to be available only to investment professionals, computerized trading is quickly becoming the wave of the future—and the future is now. To compete in the markets of the third millennium, traders have to learn how to ride the crest of the cyberwave right into the heart of Wall Street.

Integrating online trading practices into your daily investment experience can be a painstakingly arduous process. Even if you have the time to keep abreast of the latest technological advances, the highest-tech gadgets and software programs of today are outdated as soon as you remove them from the packing box. The general public is adrift in a sea of soon-to-be-obsolete computers, out-of-date programs, and software that takes up way too much hard drive space. This tide will not turn anytime soon. Computer technologies are evolving at a seemingly exponential pace, advancing online trading to the vanguard of the economic front.

Keeping up with the increased demands of online trading maintenance is a double-edged sword. On the one hand, you have more independence than ever before; but on the other hand there's a huge commitment of time involved. Suddenly there's the constant barrage of e-mails to read, portfolio trackers to monitor, stocks that need to be researched, and daily news clips to be digested. After countless hours spent sitting in front of my computer, I realize I can't live without it. Computers increase my ability to analyze thousands of trades in a matter of seconds and make researching a company as simple as a few strokes on the keyboard. My computer also allows me to move faster than ever before. I can reach decisions that make or lose large sums of money without discussing my decisions with anyone. Therein lies the work. An online trader has to assume complete responsibility for understanding the intricacies of the marketplace and making good trading decisions. The computer can help in many ways; but comprehensive market knowledge and experience are vital to making money. Point-and-click investors cannot invest as though they are playing video games. There is real money at stake and the stakes are high if you enter the potentially lucrative world of the markets as an online trader.

As traders and investors, we are currently living in between two

portfolio trackers

a portfolio tracker is an online service provided by a financial web site or an online brokerage that enables an investor to keep track of the daily price movement, breaking news, and investor sentiment of a chosen list of stocks and indexes.

worlds. In the first world, telephones and newspapers remain the mainstay of an investor's necessary equipment. Every morning, millions of investors hungrily scan newspapers for clues to profitable trading opportunities while phones remain the primary means of placing a trade through a broker. I must admit that I personally revel in my ability to still talk to a real person. But these traditions are slowly giving way to the new world order of megabytes and modems, search engines and online brokerages. At the present time, online trading is an anomalous entity with a life all its own. Until the rules of this cyber-world solidify, investors will remain precariously balanced—one hand on the cellular phone and the other on the keyboard.

investing newspapers

Wall Street Journal With worldwide distribution and an extensive readership, the *Wall Street Journal* is packed with financial information and has the ability to significantly influence the markets. If a company gets in the *Wall Street Journal*, it is news! (interactive.wsj.com).

Investor's Business Daily (IBD) Founded by William J. O'Neil, the *IBD* was originally developed to add a new dimension of crucial information for the investment community. The *IBD* focuses on concise investment news information, sophisticated charts, tables, and analytical tools while adding valuable information that the *Wall Street Journal* may not provide (www.investors.com).

In two years (1997–1998), seven million new online trading accounts were opened. Online trading is currently responsible for 40% of the volume on Nasdaq. The phenomenal infiltration of millions of new online investors into the markets is unprecedented. Many online brokerages are stretched beyond their capacity, resulting in widespread growing pains. Massive bottlenecks on a number of high-volume Internet stocks as well as periodic access difficulties have triggered a variety of problems and losses for traders across the board. Buy and sell orders have been delayed or not processed at all. Online brokerage servers have experienced system failures and traders have been denied access to their accounts. The chat rooms are filled to the brim with complaints. Even the Securities and Exchange Commission (SEC) and other governmental regulators have been warning investors to exercise caution. But the record number of investors signing up with online brokerages speaks for itself.

There are some horror stories of entire systems shutting down totally for hours on end, and of online brokerages not being able to execute orders or handle the volume of calls. This has become the online

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trader's nightmare. Your money is locked up, you're stuck on hold for hours, and you can't access your account. Meanwhile the market is moving against you and you are unable to react. This time, it's not because of indecision but because of the inefficiency of your online broker's systems. The SEC is actively addressing this issue with aggressive requirements for all Internet brokers and random audits to ensure compliance. As online brokerage firms learn to forecast demand and set up the appropriate systems for support of a parabolic growth in the number of customers, these problems should become less apparent.

Nasdaq

the National Association of Securities Dealers automated quotations system is a computerized exchange that provides brokers and dealers with price quotations for securities traded over-the-counter as well as for many New York Stock Exchange-listed securities (www.nasdaq.com).

Securities and Exchange Commission (SEC)

commission created by Congress to regulate the securities markets and protect investors. It is composed of five commissioners appointed by the President of the United States and approved by the Senate (www.sec.gov).

Will online trading replace traditional investment methods altogether? It is conceivable that it will. There may always be a group of investors who never use online trading systems due to fear of the computer or fear of lost orders, but these individuals in the future will likely become the minority. In order to be prepared for this massive shift, investors need to become cyber-friendly. This is an uphill battle at best, as electronic investing parameters seem to be in a state of constant revision. The profusion of financial resource web sites and online brokerages can be overwhelming and confusing. Too much information can be crippling. What about the long-range services provided by a full-service brokerage? In order to reap the advantages and avoid growing pains currently afflicting the online trading industry, serious investors need to develop a systematic approach to cyber-investing.

People are attracted to online trading because it is an empowering situation. For the first time in history, anyone has access to the

kind of information that used to be the sole domain of powerful brokers and market analysts. Online trading has finally bridged the information gap by affording off-floor traders a new level of autonomy. This newly found independence can be satisfying as well as addictive.

For an options investor, the battle is even more complex. Although options augment the diversity of an investor's portfolio, they also increase the number of choices that have to be made. Just finding an online brokerage with the right combination of variables could take weeks of investigative research. There are a myriad of factors that require review (including commission costs, customer support, option services, timely executions and exits, and the ease of access to accounts especially during high-volume sessions). Many investors simply don't know where to start or whom to trust. Others simply don't have time for this kind of in-depth research.

But that's just the tip of the iceberg. Although there is an abundance of online brokerages that handle options, very few offer cross margining or handle complex options combinations and spread orders efficiently. In most cases, spreads must still be entered manually by phone to a live broker. That's because online systems tend to process a spread as two separate orders—a dangerous game, especially if one of the options is short. Unfortunately, nothing short of widespread restructuring will solve these problems. As this book goes to press, online brokerages are attempting to find solutions that will make online trading, especially options trading, safer and easier for off-floor investors. In addition, as more and more online brokers move from a correspondence clearing process to a self-clearing mechanism, we may see a giant step toward increasing the efficiency of online options trading.

options

a trading instrument that represents the right to buy or sell a specified amount of an underlying stock at a predetermined price within a specified time. The option purchaser has the right, but not the obligation, to exercise the specifics of the contract. The option seller assumes a legal obligation to fulfill the specifics of the contract if the option is assigned to an option buyer.

spread orders

the simultaneous purchase and sale of at least two different option contracts of the same underlying stock.

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To become adept at options cyber-trading, you have to have a working knowledge of options strategies, enough computer savvy to give you a competitive edge, and an online brokerage that can handle complex options strategies. This book is designed to provide you with the means to develop your skills as an online options trader. The journey into this new world awaits. Let's get started.

why trade options online

Options are a relatively new trading instrument. Options were traded over-the-counter (OTC) by a limited number of put/call dealers up until 1973 when the Chicago Board Options Exchange (CBOE) formally established a standardized list of recognized options. Currently the CBOE lists options on 680 stocks with more than 700,000 option contracts traded daily. The CBOE is an auction market system that employs floor brokers and market makers to execute customer orders and inspire additional competition in the markets. The three other domestic exchanges that trade options are the Pacific Stock Exchange (PCX) in San Francisco, the American Stock Exchange (AMEX), and the Philadelphia Stock Exchange (PHLX).

Chicago Board Options Exchange (CBOE)

the CBOE is the largest options exchange in the United States. Its web site offers new option listings, information on equities, options, and LEAPS, and tutorials. Specialization includes calls and puts on NYSE stocks, the S&P 500, U.S. Treasury bonds, and other indexes (www.cboe.com).

Pacific Stock Exchange (PCX)

the Pacific Stock Exchange is the third most active stock exchange in the country and the third largest stock options exchange in the world. More than 2,600 stocks, bonds, and other securities issued by publicly traded companies, as well as options on more than 550 stocks are traded on the PCX, along with a variety of indexes (www.pacificex.com).

Prior to the advent of online trading, investors had limited information resources and often needed a broker to perform company research or assess option volatility. But computer technology has

changed all that. Software has also changed the nature of the game by enabling traders to sort through thousands of possible option positions in mere seconds to find trading opportunities with the greatest chance of making money. However, finding and learning how to use the most suitable program for your needs can be very time-consuming. Luckily, most programs come with a 30-day trial period giving you the chance to play before you pay. (See Appendix C.)

American Stock Exchange (AMEX)

the American Stock Exchange is comprised of companies that were too small to be listed on the New York Stock Exchange. The AMEX web site united with Nasdaq's site to offer quotes, news, and exchange information as well as excellent educational materials (www.amex.com).

Philadelphia Stock Exchange (PHLX)

founded in 1790, the Philadelphia Stock Exchange was the first organized stock exchange in the United States. Trading more than 2,800 stocks, 700 equity options, 12 index options, and 100 currency options, the PHLX web site offers 15-minute-delayed quotes along with volatility charts, news, research, and daily market analysis (www.phlx.com).

As a professional, I could not trade options without the use of electronic investing technologies. Millions of investors and traders seem to agree. Prestigious full-service brokers are losing ground to on-line brokerages that offer 24-hour access and cheaper commissions. Although you still need a broker who is reliable and easily accessible, your scope of interest needs to go beyond the person at the other end of the phone line. You are forging a new relationship and your ability to prosper primarily relies on how well you can use the tools the Internet offers. This places new demands on you as a trader, increasing the scope of details you have to keep track of tenfold. You are no longer dependent on the whims of your broker. You are self-reliant, and this self-sufficiency requires you to balance independence with increased responsibilities (i.e., your ability to respond). Increased autonomy is one of the main reasons that trading options online is growing at such a phenomenal rate.

online pros and cons

Online trading offers options traders an assortment of advantages over traditional full-service and discount brokerages. The foremost advantage is that online brokerages have severely reduced their commission costs from the lofty levels set by traditional brokers. All brokers get paid a commission fee each time an order is placed or exited. The amount of this commission depends on what kind of service the broker provides. Each transaction is called a round turn and costs as little as \$5 at an online brokerage and over \$100 at a full-service brokerage.

Three main kinds of traditional brokers have dominated the playing field: full-service, discount, and deep-discount brokers. Full-service brokers require higher commissions because they research markets in order to advise clients. Discount brokers offer lower commissions because they limit their services to placing orders and facilitating exits. Deep-discount brokers offer even lower commission rates as they primarily trade large blocks for big investors. Online brokerages have broken the mold completely by offering the lowest commission costs ever via easy computer access. Although their services differ, timely executions and good fills are still the most important part of a brokerage's services. Since a one-tick difference in execution can cost you a bundle, look for an online brokerage that balances low cost with reliable service and good fills.

Another major improvement comes in the form of information. Online brokerages offer real-time quotes, charts, news, and analysis as well as the ability to customize this information to fit your portfolio. Now you have the means to research stock tips immediately, read up-to-the-minute news almost as it happens, monitor the mood of markets throughout the day, and access option premiums for price fluctuations and volatility. You no longer have to sit on hold waiting for your broker to say, "I'll get back to you on that." The marketplace is alive and you're right there with it.

In the old days, one of the best ways to find a good broker was through the recommendation of other traders. This hasn't changed much. For your convenience, reviews of more than 60 online brokerages have been included in Appendix E of this book. Since the Internet is in a constant state of evolution, this information will be updated at www.optionetics.com. You should also take a look at Gomez Advisors (www.gomez.com) or Online Investment Services (www.sonic.net/donaldj), two of the most comprehensive web sites that specifically rate and review online brokerages. If you want to know what your fellow investors have to say, there are a variety of online message boards and chat rooms that specifically post individual rants and raves; check out Yahoo!'s chats and forums directory (dir.yahoo.com/Business_and_Economy/Finance_and_Investment/Chats_and_Forums).

Gomez Advisors

founded by Juan Gomez, a senior analyst from Forrester Research, this well-researched site has become an Internet favorite and is widely referenced as the premiere online brokerage watchdog. Cyberfinance scorecards for bankers and brokerages are ranked by overall score, categories, and consumer profiles (www.gomez.com).

Online Investment Services

this free site is dedicated to researching and collecting comments on online brokerages. Compare high, middle, and deep discount brokerages by service, commission rates, and customer service. If you have an experience with a brokerage that you want to share with the public at large, this is the place to post it (www.sonic.net/donaldj).

Computerized trading also offers traders the chance to engage powerful software programs. Various analyses can be performed that directly access real-time and/or delayed quotes. One of the most popular functions is called screening. Screening enables a trader to choose a specific set of criteria—market outlook, strike spread, maximum risk, and volatility assumptions—in order to search for trades that meet those requirements. In the blink of an eye, you have a list of viable trades that can be further explored for signs of profitability.

real-time quotes

streaming quotes that are received as the prices change at the exchanges.

delayed quotes

quotes that are delayed up to 20 minutes from the actual price changes at the exchanges.

Finally, although commission fees are not tax deductible, online investors can deduct computer-related costs. Monthly Internet service provider fees, online subscriptions, and computer costs can be listed under “miscellaneous itemized deductions” (although you are

limited to writing off only any amount over 2% of your adjusted gross income). When it comes to taxes, it's best to seek professional help; but it doesn't hurt to save those receipts!

The disadvantages of online trading are primarily for new investors. Trading options requires a broker that can handle the intricate nature of complex spreads and delta neutral strategies. If you are just starting out in your trading career, you need a broker who is going to help you, not harm you. If your broker is little more than an order taker, then you are 100% responsible for every little detail—a precarious position for a new trader. If you are a novice trader, you need to find a broker that understands options trading and can give you the support you need to become a successful trader.

how to get the most from this book

The text of this book concentrates on two main areas of focus: option strategies and online disciplines. The first two chapters focus on introducing online trading practices into your everyday life as a trader. Since there is an overabundance of financial web sites, the sites, brokerages, and products selected for review are those that I believe to be most useful to options investors. Each chapter includes personal tips and insights designed to enhance your online experience and act as building blocks for your investment approach.

Chapter 3 takes you step-by-step through stock and options basics (experienced traders may wish to skip this chapter). Chapters 4 through 8 provide a detailed analysis of 15 managed risk option strategies that are designed to take advantage of everyday market opportunities using online resources. In order to enhance your ability to understand each strategy, I have included a hypothetical trade that details how to compute each strategy's maximum risk, maximum profit, breakevens, and exit alternatives. A great deal of effort has been expended to test these strategies and to develop off-floor techniques that enable traders to consistently build up their trading accounts.

By focusing on clear explanations of how to really make money in the markets using options, this book refrains from exposing readers to information that is overly theoretical or technically complicated. In fact, technical analysis has been intentionally avoided. I want to help you integrate these options-based trading techniques into a comprehensive strategic trading plan that fits your own personal profile.

Chapter 9 attempts to pull everything together by walking you step-by-step through a series of web sites in search of a profitable trade. Chapter 10 offers concrete information regarding online brokerages and their ability to cater to the unique needs of the option trader. After an in-depth review of every available online brokerage (as of July 1999), I have made my choice for the top 10 online brokerages for options