Futures & Options TRADER

August 2008 • Volume 2, No. 8

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For all subscriber services:
www.futuresandoptionstrader.com

Editor-in-chief: Mark Etzkorn
metzkorn@futuresandoptionstrader.com

Managing editor: Molly Flynn Goad
mgoad@futuresandoptionstrader.com

Senior editor: David Bukey
dbukey@futuresandoptionstrader.com

Contributing editor:
Keith Schap

Associate editor: Chris Peters
cpeters@futuresandoptionstrader.com

Editorial assistant and Webmaster: Kesha Green
kgreen@futuresandoptionstrader.com

Art director: Laura Coyle
lcoyle@futuresandoptionstrader.com

President: Phil Dorman
pdorman@futuresandoptionstrader.com

Publisher,
Ad sales East Coast and Midwest:
Bob Dorman
bdorman@futuresandoptionstrader.com

Ad sales
West Coast and Southwest only:
Allison Ellis
aellis@futuresandoptionstrader.com

Classified ad sales: Mark Seger
seger@futuresandoptionstrader.com

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▼ **George Hoekstra** is a research engineer in the petroleum refining business. He started trading options 30 years ago while studying under Myron Scholes who was his professor at the University of Chicago. Hoekstra holds a degree in chemical engineering from Purdue University and an MBA from the University of Chicago. He can be contacted via his Web site, http://hoekstratrading.com/default.aspx.

▼ **Lee Leibfarth** (lee@powerzonetrading.com) is an independent futures trader and trading system researcher. He is an affiliate of the Market Technicians Association and president of PowerZone Trading, a company that provides a range of services for traders. His articles on technical analysis and market technology have been featured in a variety of publications.

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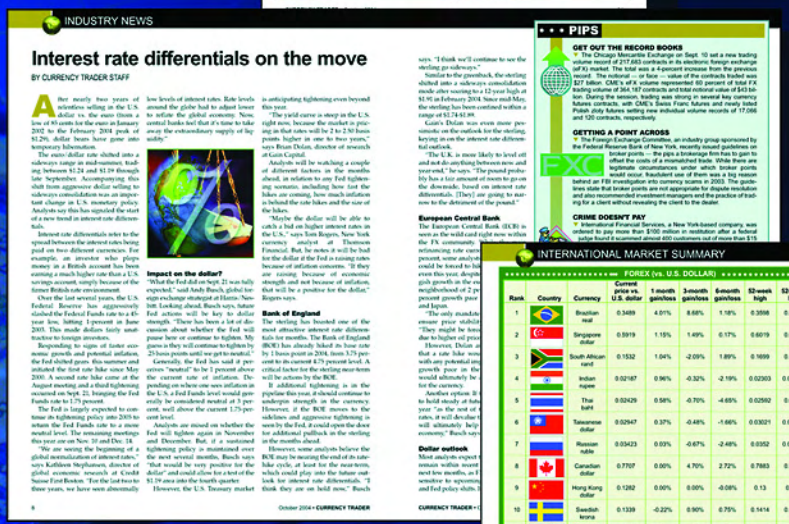

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Improving the three-bar pullback pattern

Getting in is only part of the story. This pullback strategy illustrates the crucial role exit rules play in profitability.

BY LEE LEIBFARTH

Trading pullbacks is based on the reality that even in a strong trend, price rarely moves straight up or down: It will repeatedly retrace its steps briefly before continuing to trend higher or lower. In Figure 1, for example, the E-Mini S&P 500 futures (ES) were in a strong uptrend in March and April 2007 but price still pulled back occasionally before trending higher.

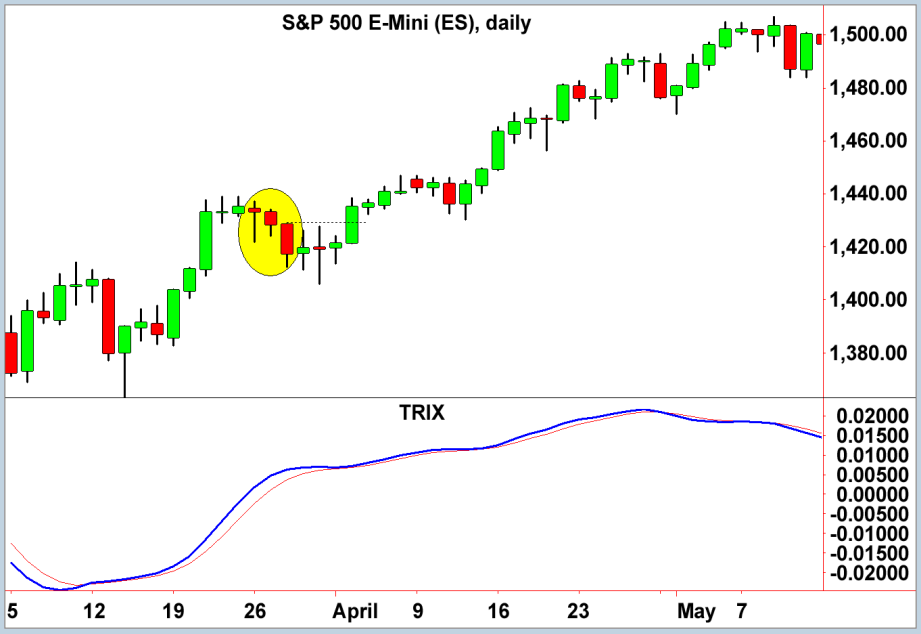
There are three basic components to a pullback strategy. First, define the trend. Next, objectively define the pullback by size (the point or percent distance from a prior high to a recent low) or length (i.e., the number of bars). Finally, determine when to enter and exit each trade in a way that maximizes profit and minimizes risk.

Most traders pay more attention to a system's entry rules than its exit rules. This trading strategy identifies three-bar pullback patterns in the E-Mini S&P 500 futures and explores each step in the development process in further detail, with a special focus on modifying exits to boost the probability of winning trades and protect against large losses.

Strategy snapshot	
Strategy:	Three-bar pullback.
Market:	E-Mini S&P 500 (ES).
Logic:	Identify a trend, wait for price to pull back slightly, and enter at a more attractive point.
Money management:	Modify exit rules to fit trade style: capturing short-term gains or following longer-term trends.

FIGURE 1 — TRADE EXAMPLE

The basic three-bar pattern (yellow) waits for the market to retrace slightly within a trend and then enters in the trend's original direction.



Source: TradeStation

Identifying the trend

Traders often use simple moving averages (SMA) to determine trends. For instance, if price is above a 20-day SMA, the trend may be considered up, and if price is below the 20-day SMA, the trend is considered down. Similarly, the market might be in an uptrend if a shorter-term 20-day SMA crosses above a longer-term 40-day SMA, and so on.

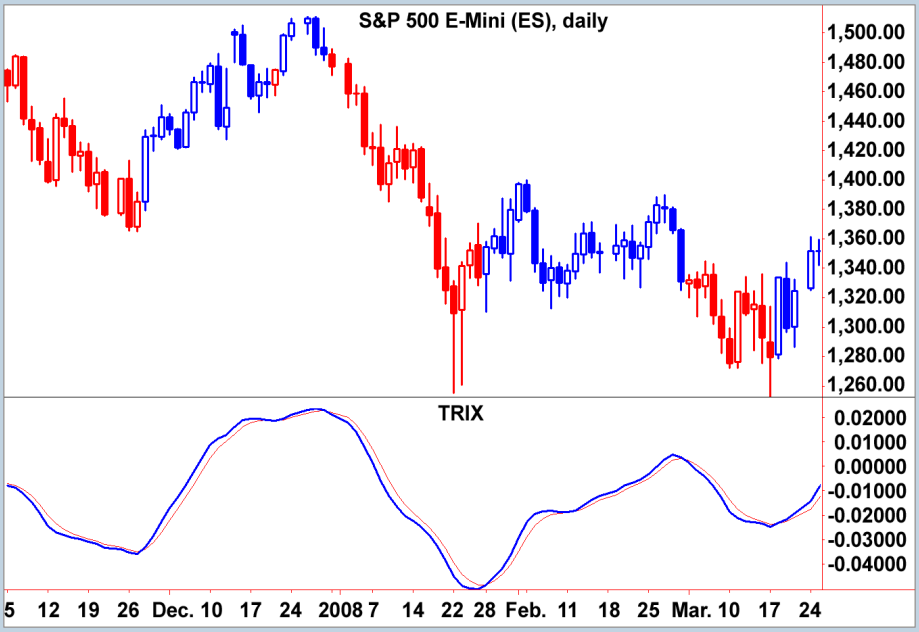
The problem with simple moving averages, especially longer-term ones, is they are slow to signal the formation of a new trend — that is, they lag the market. To combat this effect, this system uses the nine-bar TRIX indicator, which is a triple-smoothed exponential moving average (EMA) that reacts quickly to changing trends. The trend is up if the TRIX crosses above its signal line, represented by the 3-bar EMA of the TRIX. And the trend is down if

the TRIX crosses below that signal line.

Figure 2 shows uptrends and downtrends in the ES futures from Nov. 5, 2007 to March 24, 2008 (blue and red bars, respectively). Two trends stand out. First, the TRIX crossed above its signal line on Nov. 28, a bullish sign. The market climbed roughly 1.5 percent by Dec. 20, when a bearish signal appeared. After the TRIX crossed below its signal line on Dec. 31, the E-Mini S&P 500 fell about 9 percent before another uptrend appeared on Jan. 25.

FIGURE 2 — IDENTIFYING TRENDS WITH THE TRIX INDICATOR

The TRIX indicator identified the E-Mini S&P 500's short-term trends fairly well from November 2007 to March 2008. Uptrends are highlighted blue and downtrends are highlighted red.



Source: TradeStation

Three-bar pullback pattern

After a trend has been established, the next step is to find a three-bar pullback, defined as three consecutive closes above or below each day's open.

Pullback in uptrend:

1. Today's close is below its open.
2. Yesterday's close is below its open.
3. The close two days ago is below its open.

Pullback in downtrend:

1. Today's close is above its open.
2. Yesterday's close is above its open.
3. The close two days ago is above its open.

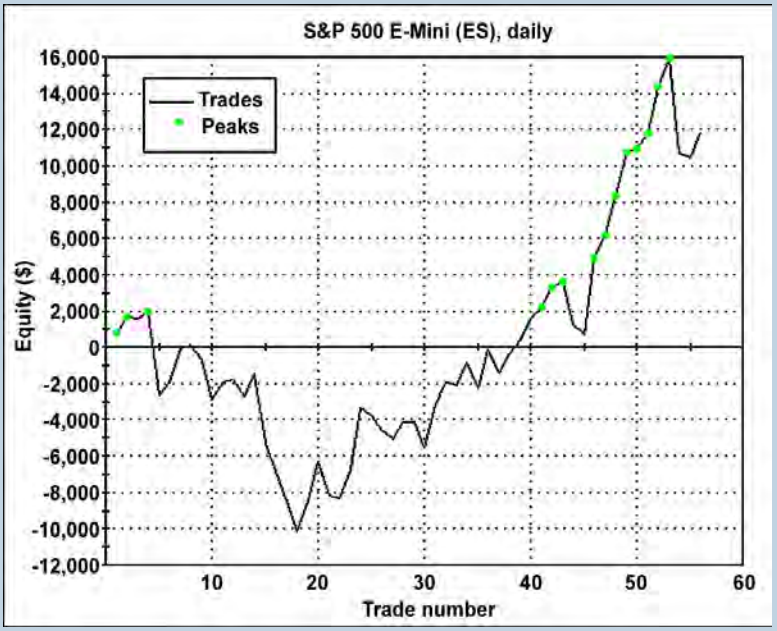
Notice the system has no exit rules yet. It is a stop-and-reverse (SAR) system that is always in the market. It enters the market at the next day's open after three-day pullbacks from uptrends and downtrends and holds the trade until the opposite signal is triggered.

We tested this basic pullback system on five years of daily E-Mini S&P 500 data (July 14, 2003 to July 11, 2008). Figure 3 shows the strategy's equity curve. The system earned $11,850 with a profit factor (net gain/net loss) of 1.35. However, the approach suffered a large drawdown in the first half of the test period.

continued on p. 10

FIGURE 3 — BASIC PULLBACK SYSTEM EQUITY CURVE

The basic stop-and-reverse pullback system earned $11,850 with a profit factor of 1.35 during the past five years. However, the approach suffered a large drawdown in the first half of the test period.



Source: TradeStation

Strategy code

The following TradeStation EasyLanguage code can be copied from http://www.activetradermag.com/index.php/c/Strategy_code.

Three-bar short-term strategy

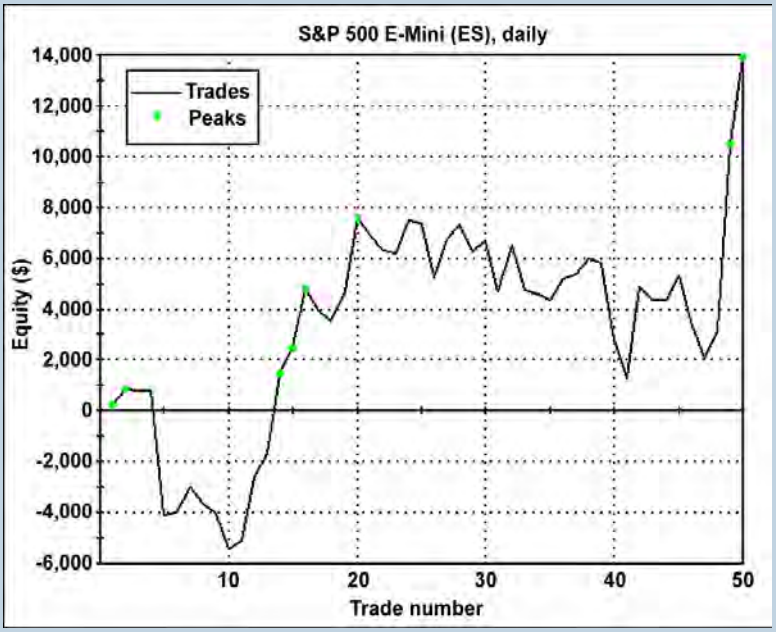
```
inputs:
        Price(c),
        TrixLength(9),
        SignalLineLength(3),
        History(60);
variables:
        LongCondition(false),
        ShortCondition(false),
        TrixLine(0),
        SignalLine(0),
        TrendState(0),
        BuyTrigger(false),
        SellTrigger(false),
        BuyPrice(0),
        SellPrice(0),
        UpTrend(blue),
        DownTrend(red);
TrixLine = trix( Price, TrixLength ) ;
SignalLine = xaverage(TrixLine, SignalLineLength);
LongCondition = c < o and c[1] < o[1] and c[2] < o[2];
ShortCondition = c > o and c[1] > o[1] and c[2] > o[2];
if TrixLine > SignalLine then TrendState = UpTrend else
TrendState = DownTrend;
if TrendState[3] = UpTrend and LongCondition then begin
        BuyTrigger = true;
        BuyPrice = h;
        SellTrigger = false;
end;
if TrendState[3] = DownTrend and ShortCondition then begin
        SellTrigger = true;
        SellPrice = l;
        BuyTrigger = false;
end;
if BuyTrigger then buy next bar at BuyPrice stop;
if SellTrigger then sellshort next bar at SellPrice stop;
if marketposition = 0 then begin
        BuyTrigger = false;
        SellTrigger = false;
end;
if marketposition = 1 then begin
        sell next bar at highest(h, History) limit;
        sell next bar at lowest(l, History) stop;
        BuyTrigger = false;
end;
if marketposition = -1 then begin
        buytocover next bar at lowest(l, History) limit;
        buytocover next bar at highest(h, History) stop;
        SellTrigger = false;
end;
```

Three-bar trend-following strategy

```
inputs:
        Price(c),
        TrixLength(9),
        SignalLineLength(3),
        TrailFloorAmount(2000),
        TrailPercent(5);
variables:
        LongCondition(false),
        ShortCondition(false),
        TrixLine(0),
        SignalLine(0),
        TrendState(0),
        BuyTrigger(false),
        SellTrigger(false),
        BuyPrice(0),
        SellPrice(0),
        UpTrend(blue),
        DownTrend(red);
TrixLine = trix( Price, TrixLength ) ;
SignalLine = xaverage(TrixLine, SignalLineLength);
LongCondition = c < o and c[1] < o[1] and c[2] < o[2];
ShortCondition = c > o and c[1] > o[1] and c[2] > o[2];
if TrixLine > SignalLine then TrendState = UpTrend else
TrendState = DownTrend;
if TrendState[3] = UpTrend and LongCondition then begin
        BuyTrigger = true;
        BuyPrice = h;
        SellTrigger = false;
end;
if TrendState[3] = DownTrend and ShortCondition then begin
        SellTrigger = true;
        SellPrice = l;
        BuyTrigger = false;
end;
if BuyTrigger then buy next bar at BuyPrice stop;
if SellTrigger then sellshort next bar at SellPrice stop;
if marketposition = 0 then begin
        BuyTrigger = false;
        SellTrigger = false;
end;
if marketposition = 1 then BuyTrigger = false;
if marketposition = -1 then SellTrigger = false;
setstopcontract;
setpercenttrailing(TrailFloorAmount, TrailPercent);
```

FIGURE 4 — TWEAKING THE ENTRY RULES

Adding more detailed entry rules improved the basic three-bar pullback system, raising the profit to $13,887 and the profit factor to 1.54. Also, the revised system had a smaller maximum drawdown than the original one (Figure 3).



Source: TradeStation

Better entry points

One way to improve the strategy is to look for a sign of strength (or weakness) to confirm the trend will continue. Instead of just entering the market immediately after a three-bar pullback, wait until the market moves in the direction of the trend again.

For long trades, perhaps wait until the market climbs to the high of the pullback's third day to buy the market (Figure 1, yellow circle). For short trades, wait until the market drops to the low of the pullback's third day to sell short.

Long entry: Buy the market on a stop at the high of the pullback's third day.

Short entry: Sell short on a stop at the low of the pullback's third day.

These rules improved the strategy's performance slightly. Figure 4 shows the revised system's equity curve, which earned $13,887 during the same five-year test period with a profit factor of 1.54. Also, the revised system had a smaller drawdown than the original one.

The importance of exit rules

Although exit rules are an afterthought for many traders, they shouldn't be ignored; they help define a strategy's goals and can make or break your system.

First, let's consider profit targets as well as protective stops. One idea is to place these exits at prior highs and lows that represent support and resistance — points at which a trade's momentum may fade. In this case, the system will take profits at 60-day highs and cut losses at 60-day lows:

Long trade exit:

1. Profit target: Place a limit order to sell at the highest high of the past 60 days.
2. Stop-loss: Place a stop order to sell at the lowest low of the past 60 days.

Short trade exit:

1. Profit target: Place a limit order to buy to cover at the lowest low of the past 60 days.
2. Stop-loss: Place a stop order to buy to cover at the highest high of the past 60 days.

For shorter-term traders, this exit strategy's biggest advantage is that it limits the amount of risk; the system isn't always in the market and a protective stop is clearly defined.

Table 1 shows the performance statistics for this version of the system. The strategy gained $16,900 and had a profit factor of 1.65. Also, its average winning

continued on p. 12

TABLE 1 — ADDING SHORT-TERM EXITS

System performance was improved by adding short-term exit rules that took profits at 60-day highs and cut losses at 60-day lows. The revised system gained $16,900 and had a profit factor of 1.65.

Total net profit	$16,900.00	Profit factor	1.65
Gross profit	$42,925.00	Gross loss	-$26,025.00
Total number of trades	56	Percent profitable	46.43%
Winning trades	26	Losing trades	30
Avg. profit	$301.79	Ratio avg. win / avg. loss	1.9
Avg. winner	$1,650.96	Avg. loser	-$867.50
Largest winning trade	$6,712.50	Largest losing trade	-$4,625.00
Largest winning trade as percentage of gross profit	15.64%	Largest losing trade as percentage of gross loss	17.77%
Max. consec. winning trades	6	Max. consecutive losing trades	6
Avg. bars in winning trades	9.69	Avg. bars in losing trades	6.83
Avg. bars in total trades	8.16	Account size required	$8,012.50
Total commission	$0.00	Percent of time in market	32.60%
Return on initial capital	16.90%	Annual rate of return	3.28%
Buy and hold return	11.89%	Return on account	210.92%
Avg. monthly return	$419.69	Standard deviation of monthly return	$2,005
Max intraday drawdown	-$9,650.00	Longest flat period	83 days

trade was nearly twice as large as its average losing trade ($1,650.96 vs. $867.50, respectively).

Trend-following exits

Another way to trade three-bar pullbacks is to follow the trend. In this scenario, the goal is to hold the trade as long as the trend continues. After the market pulls back and a trade is entered, the system uses a wide trailing stop designed to ride out the trend.

The trailing stop becomes active after a trade reaches an initial $2,000 profit. At that point, the trade will exit after 5 percent of its maximum profit is lost.

Table 2 shows this system's performance. The strategy gained $27,900 since July 2003, compared to only $16,900 when short-term exits were used. The system also had a larger profit factor (2.12 vs. 1.65) and a smaller maximum drawdown ($8,075 vs. $9,650) than the short-term exit versions.

However, the trend-following system was in the market

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70.7 percent of the time compared to just 32.6 percent of the time for the short-term system.

Getting the details right

These examples show the basic three-bar pullback pattern has merit, but its performance can be improved by adding the proper exit rules. Although these strategies can certainly be expanded and improved, they aren't optimized and are good starting points for further research.

For information on the author *see p. 6.*

TABLE 2 — ADDING TREND-FOLLOWING EXITS

Adding a trailing stop to the system generated a larger profit and a smaller maximum drawdown than the short-term exit version of the system (Table 1), but the system was in the market twice as often.

Total net profit	$27,900.00	Profit factor	2.12
Gross profit	$52,900.00	Gross loss	-$25,000.00
Total number of trades	55	Percent profitable	60.00%
Winning trades	33	Losing trades	21
Avg. profit	$507.27	Ratio avg. win / avg. loss	1.35
Avg. winner	$1,603.03	Avg. loser	-$1,190.48
Largest winning trade	$2,887.50	Largest losing trade	-$4,900.00
Largest winning trade as percentage of gross profit	5.46%	Largest losing trade as percentage of gross loss	19.60%
Max. consec. winning trades	9	Max. consecutive losing trades	3
Avg. bars in winning trades	14.12	Avg. bars in losing trades	20.52
Avg. bars in total trades	16.40	Account size required	$5,500.00
Total commission	$0.00	Percent of time in market	70.67%
Return on initial capital	27.90%	Annual rate of return	5.17%
Buy and hold return	11.89%	Return on account	507.27%
Avg. monthly return	$690.00	Standard deviation of monthly return	$2,223
Max intraday drawdown	-$8,075.00	Longest flat period	98 days

Outside days in crude oil

Outside bars are sometimes followed by interesting moves in the oil market.

BY FOT STAFF

Crude oil's July meltdown — approximately 18 percent in 10 days — may have scared many "crude bugs" out of the market, but it would take many such moves over many more years to change a simple fact: Crude oil has, in recent history, an upside bias.

Figure 1 shows this bias is not exclusive to the most recent bubble, either. Even before 2007-2008, this market had established its current paradigm. Crude oil futures (CL) have been on an overall upward trend since the late 1990s, although the chart certainly makes clear how sharp the setbacks in this market can be.

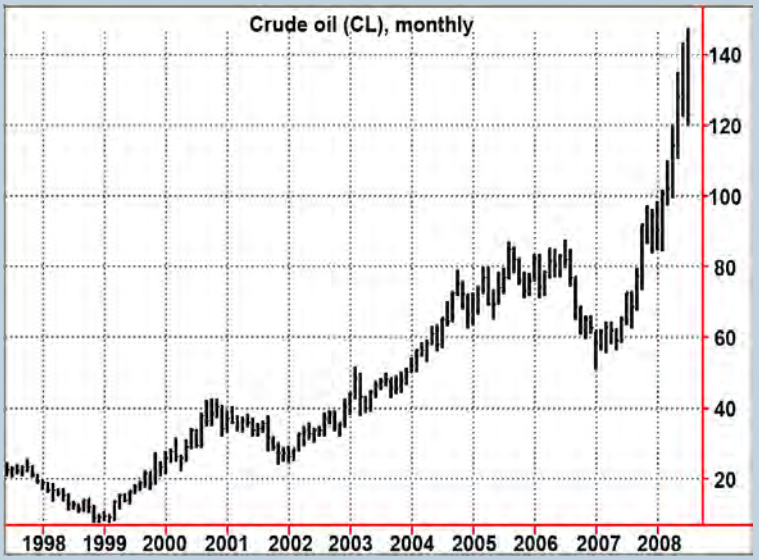
From June 23, 1996 through June 23, 2002, the median close-to-close change in crude oil futures was $0.01 and the median five-day close-to-close change was $0.06. Between June 24, 2002 and July 28, 2008 those numbers increased to $0.07 and $0.49, respectively.

In a market with such a pronounced bias, a logical trading approach would be to identify points at which the market has corrected and is due to reverse to the upside. Such strategies are common in the stock market, which has an even more evident upside bias. In general terms, sharp down moves would present discounted prices and buying opportunities.

Not all markets behave the same way, though, and the oil market is notoriously volatile and fickle — the epitome of false moves and head fakes. A common pattern offers some interesting — and sometimes counterintuitive — trading ideas for taking quick profits.

FIGURE 1 — LONG-TERM TREND

Crude took a big hit in July, but for a decade its story has been one of mostly rising prices.



Source: TradeStation

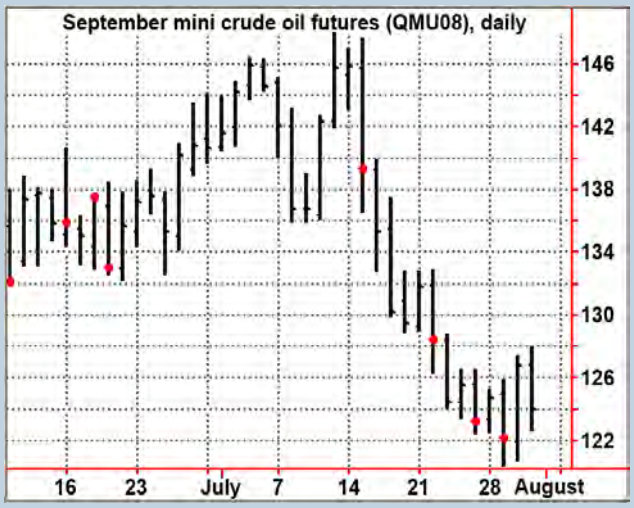
Outside days

Outside bars are often objects of analysis because they are short-term volatility surges (a higher high and lower low than the previous bar) that are sometimes associated with news shocks or surprises. Figure 2 highlights some recent outside bars in the September mini crude oil futures (QMU08).

For example, if a market first trades above the previous day's high and then reverses sharply intraday to fall below the previous low, it might be the result of a new piece of bearish market information. If the market also closes solidly lower (i.e., below the open, below the previous close, and even below the previous low), it could be seen as a sign of at least near-term future weakness; testing would indicate whether

FIGURE 2 — OUTSIDE DAYS

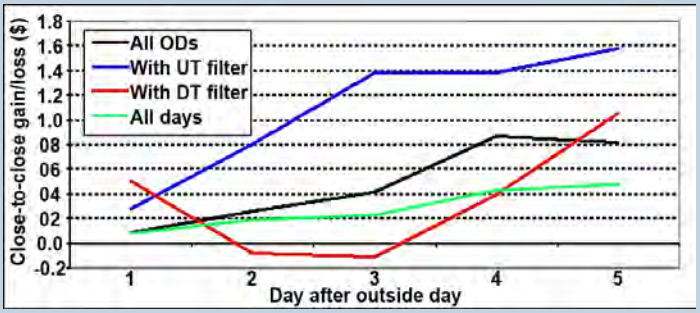
Outside days have been common lately in the oil market, and are often immediately followed by choppy price action.



Source: TradeStation

FIGURE 3 — OUTSIDE DAYS WITH UPTREND/DOWNTREND FILTERS (JULY 2004-JULY 2006)

Outside days that were accompanied by the uptrend filter posted the biggest gains.



this hypothesis had any merit.

In the stock market, however, this kind of "bearish" outside day is more often than not a buying opportunity, largely because of the equity market's overall bias. There are plenty of exceptions to this general rule, but the fact remains that over the long-term, stocks move higher and sharp down moves (which can accompany news shocks) are often reversed to the upside.

Do outside days have similar characteristics in the oil market? To find out, let's look at the performance after outside days in the mini crude oil futures over a four-year period. Two types of outside days will be tested:

1. Outside bars that close at or above the opening price and at or above the previous day's close ("OD up").
2. Outside bars that close at or below the opening price and at or below the previous day's close ("OD down").

Formulas for these two types of outside days are:

1. $H_0 > H_1$, $L_0 < L_1$, $C_0 >= O$, $C_0 >= C_1$
2. $H_0 > H_1$, $L_0 < L_1$, $C_0 <= O$, $C_0 <= C_1$

where,
H, L, O, and C = high, low, open, and close prices, respectively
0 = today
1 = one day ago (yesterday)

One important consideration is whether the outside bar is occurring when price is moving higher or lower. To incorporate this information, we'll also test what happens after the outside day patterns form using two simple filters:

1. Uptrend filter ("UT filter"): The outside day's low must be greater than or equal to the lows five and 10 days ago ($L_0 >= L_5$, $L_0 >= L_{10}$).
2. Downtrend filter ("DT filter"): The outside day's high must be less than or equal to the lows five and 10 days ago ($H_0 <= L_5$, $H_0 <= L_{10}$).

The patterns will be studied during two periods: July 30, 2004 through July 28, 2006 and July 31, 2006 through July 28, 2008.

Very interesting

Figure 3 shows the median performance over the first five days after outside days in the 2004-2006 period. The gains or losses are

continued on p. 29

The quest for cheap options

Comparing historical and implied volatilities can lead to attractive option-buying opportunities.

GEORGE HOEKSTRA

Option traders often attempt to gain an edge by purchasing options on a stock they expect to be more volatile than what is implied in the price of its options. Higher volatility translates into higher option prices, so if the assessment of future volatility is correct, it will increase the chances of a profitable trade.

Is it possible to make money this way? Many academic studies tried to answer this question by focusing on stock index options and have concluded the answer is no. However, one recent academic study of options on individual stocks has drawn different conclusions.

Despite the challenges of analyzing individual stock options — they are often thinly traded and have outdated prices and wide bid-ask spreads — professors Amit Goyal and Alessio Saretto recently reported some of their findings in a paper titled "Option returns and volatility mispricing." They concluded that historical volatility can provide a significant edge in trading individual stock options.

In short, you can find cheap options by searching for large differences between a stock's historical and implied volatilities. But how practical is this approach for retail traders?

Finding cheap options

To help understand the Goyal-Saretto study, consider the following strategy: Each month, sort all stocks in the options market into 10 percentile groups based on the difference between their historical and implied volatilities. Then, label the top 10 percent of those stocks "tier 1" for that month. This group has the biggest difference between historical and implied volatility values.

Options on these stocks should be underpriced in the sense that they are priced for an expected (implied) volatility lower than what the stock has actually experienced in the last year.

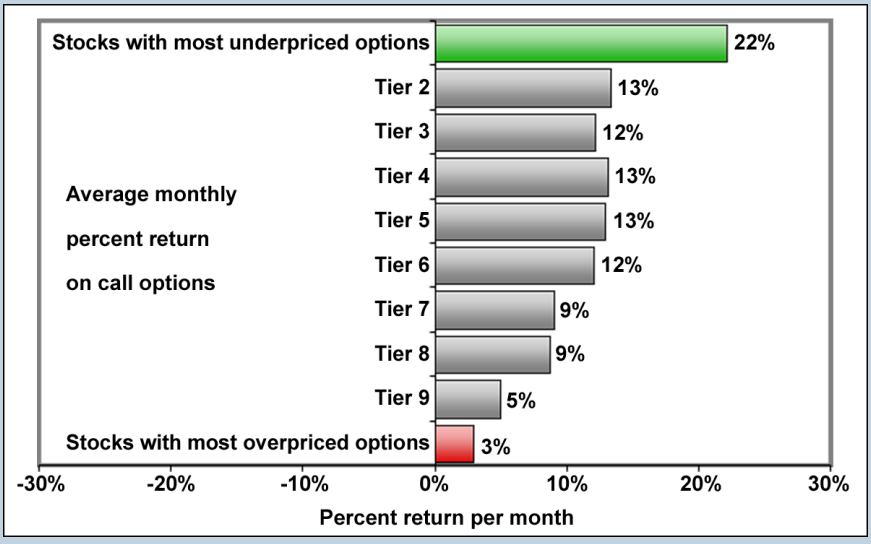
The strategy buys options on all tier-1 stocks. On the Tuesday after each month's expiration day, buy a one-month, at-the-money (ATM) call on each tier-1 stock. Sell this portfolio of calls at expiration. The next Tuesday, repeat the process with updated volatility data and buy another portfolio of underpriced calls.

The idea is that tier-1 stocks will, on average, be about as volatile as they have been in the past year. If so, the odds of success are improved because the stocks' actual, or historical, volatility will be higher than the expected (implied) volatility of their options.

This strategy of buying underpriced call options would have earned an average 22 percent per month from January 1996 to December 2005, according to the Goyal-Saretto study. The authors simulated this approach

FIGURE 1 — MONTHLY RETURNS FOR CALLS

A portfolio of the cheapest calls (tier 1) gained 22 percent per month, while performance lagged for more expensive calls (tiers 2 to 10).



Source: Goyal-Saretto study

using bid-ask option prices on 3,885 stocks covering the entire U.S. equity option market from 1996 to 2005. They also calculated option returns for the other nine stock tiers, from the cheapest options (tier 1) to the most expensive (tier 10).

Figure 1 shows the study's results. The green bar represents the tier-1 stock options' monthly profit (22 percent), the gray bars show the monthly performances of Tiers 2 to 9, and the red bar shows the performance of options on the tier-10 stocks, which you would avoid buying.

Profits deteriorate as you move down the tiers. This downward trend shows there was a large advantage in buying cheap calls, measured by the difference between one-year historical and implied volatilities.

What about puts?

What if you had chosen to buy tier-1 puts instead of calls? Figure 2 shows the monthly performance of puts in Tiers 1 to 10, from cheapest to most expensive. Performance suffered as the tier number climbed, proving that cheap puts had an advantage over expensive ones. Tier-1 puts earned only 0.4 percent per month (green bar), while the other nine tiers lost money. By contrast, the most expensive tier-10 puts (red bar) lost an average 28 percent per month for 10 years. (In reality, anyone buying tier-10 puts would have gone broke long before the study ended in December 2005.)

Why did calls perform so much better than puts? Figure 3's weekly S&P 500 chart shows the market doubled during the study's 10-year time period, despite the 2000-2003 bear market. However, Figure 2 shows you could have eked out a profit buying only cheap tier-1 puts during the 10-year study period.

If you had simply bought individual stocks from January 1996 to December 2005, you would have earned 1.3 percent per month. Figure 4 shows little deviation among the 10 tiers, which means the various option groups from Figures 1 and 2 didn't perform differently because of their stocks' directional movement; rather, these differences were driven by bias in options pricing, a bias that is, on average, predictable from the difference between historical and implied volatility.

(To download the Goyal-Saretto article, which also discusses straddles, buy-sell strategies, and other hedging strategies, click here.)

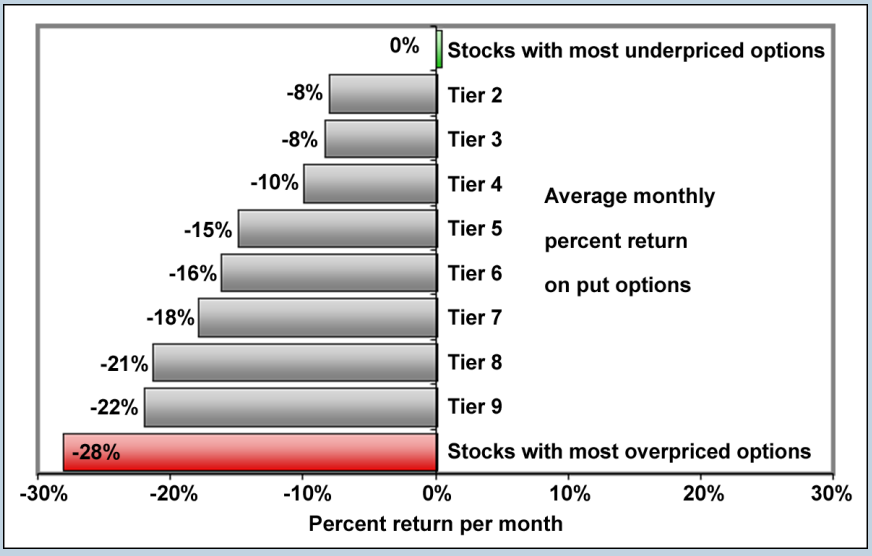
Real-world trading

Although the study shows volatility analysis can theoreti-

continued on p. 18

FIGURE 2 — MONTHLY RETURNS FOR PUTS

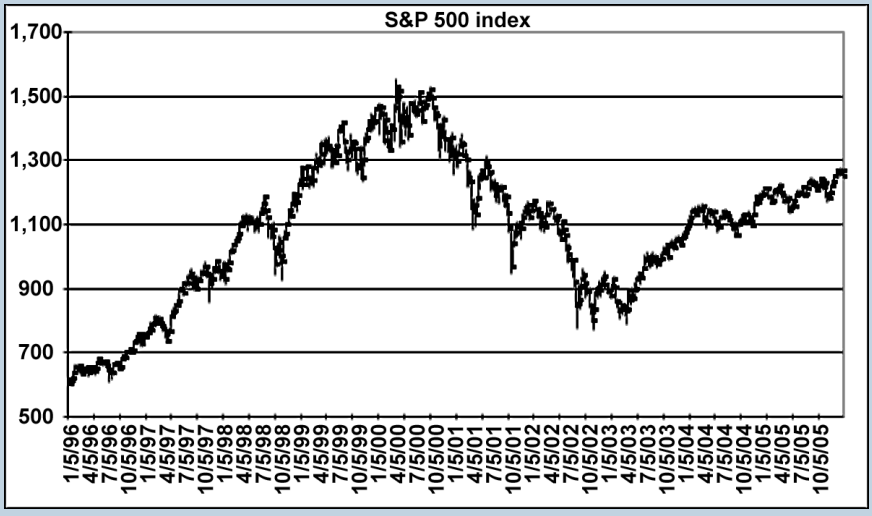
Most puts lost money during the study's 10-year time period because the S&P 500 doubled from 1996 to 2005. But you could have eked out a small profit if you had bought cheap tier-1 puts during this period.



Source: Goyal-Saretto study

FIGURE 3 — S&P 500, 1996 TO 2005

Despite getting cut in half from 2000 to 2002, the S&P 500 doubled from January 1996 to December 2005 — which is why most puts lost money during the 10-year study.



Volatility explained

Implied volatility

Volatility is one of the standard variables of an option's price. The others (for stock options) are the underlying price, the strike (exercise) price, the time (days) until expiration, the prevailing interest rate, and dividends.

Implied volatility can be thought of as a reflection of the volatility in the market at a given time (though it is sometimes referred to as the "market's current estimate of future volatility"), rather than the actual historical volatility calculated over a certain past period.

With all other factors static, higher volatility will result in higher option prices. As a result, many traders look for high relative volatility when selling options and low relative volatility when buying options. It is possible to determine the implied volatility by working backward from the option price, inserting all the other variables from the price of the option in an option pricing model and "solving" for implied volatility.

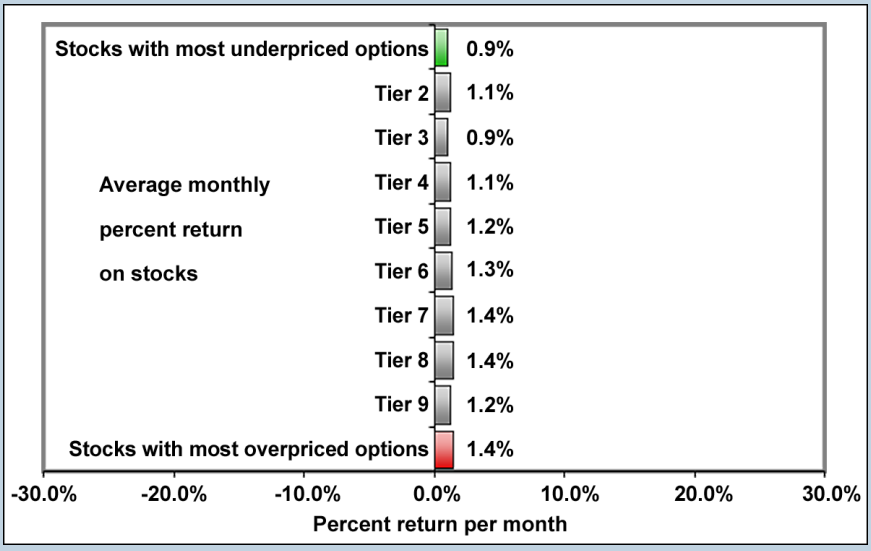
Historical volatility

Historical volatility is the measure of a stock's price movement based on historical prices. It measures how active a stock price typically is over a certain period of time. Usually, historical volatility is measured by taking the daily (close-to-close) percentage price changes in a stock and calculating the standard deviation over a given time period. This standard deviation is then expressed as an annualized percentage. Historical volatility is often referred to as actual volatility or realized volatility.

Short-term or more active traders tend to use shorter time periods for measuring historical volatility, the most common being five-day, 10-day, 20-day, and 30-day. Intermediate-term and long-term investors tend to use longer time periods, most commonly 60-day, 90-day, 180-day and 360-day.

FIGURE 4 — MONTHLY RETURNS FOR STOCKS

Stocks earned only 1.3 percent per month during the 10-year study, and there was little deviation among the different tiers. This implies the difference in option performances shown in Figures 1 and 2 was driven by volatility rather than the stocks' directional moves.



Source: Goyal-Saretto study

cally offer a huge edge in the equity options market, applying this strategy in the real world poses several problems, among them:

Risk. Buying portfolios of calls or puts is risky, because returns are extremely volatile. Even if you could make money within 10 years, there would be many drawdowns along the way.

Trade execution. Low-volume stock options have wide bid-ask spreads. A significant chunk of potential profits will disappear because you would end up buying illiquid options at above-bid prices.

Transaction costs. The academic study ignored commissions. In reality you would be buying and selling hundreds of stock options each month. Transaction costs would erode your profits.

Despite these drawbacks, any strategy that earned 22 percent each month (Figure 1) is worth exploring further, even if you can only capture a portion of that gain.

Developing a plan

The first step to accomplishing this is to reduce the study's scope from the cheapest 10 percent to perhaps only 10 of the best underpriced options each month. Also, you need to find out how to get good fills on orders in thinly traded options with wide bid-ask spreads. Finally, you need a plan to control risk.

One approach is to set up an account that will hold a mix of cash and call options. Then, study the volatility of tier-1 stocks to find a few candidates each month, buy in-the-money (ITM) calls that expire in four to seven months, and use a simple rule for selling those calls. A representative exit rule would be to sell after a call gains 50 percent.

When narrowing the list of tier-1 stocks, search for those that show consistently high historical volatility. You want to find stocks with consistently large weekly price ranges (high-low). Bypass stocks whose historical volatility is dominated by one or two anomalous spikes.

Buy options with at least four months of remaining life. You must allow at least this much time for the volatility advantage to unfold. Finally, buy ITM options. Out-of-the-money (OTM) options sometimes don't respond to normal price action, especially when they are thinly traded.

This type of strategy will have volatile returns and works best in bull markets. To manage risk, limit each purchase to less than 5 percent of your account value and always hold half the account's value in cash. The best way to ride out down markets is to spread your purchases out over time and diversify across market sectors.

Although this approach isn't as sophisticated as the academic study, it is based on the same underlying premise: analyzing volatility will give you an edge by leading you to cheap options that will outperform in the long run. The key is to find bargains among each month's tier-1 stocks.

When hunting for option-volatility bargains, it is helpful to first group stocks into price ranges. In January 2008, for example, there were 480 stocks trading around $30 per share in the listed options market.

These stocks were sorted to find 48 stocks (10 percent) with the largest differences between their 100-day historical volatilities and current implied volatilities. The average 100-day historical volatility of these stocks was 54

continued on p. 20

TABLE 1 — TIER 1 STOCK CANDIDATES: FEBRUARY 2008

These stocks were culled from a list of the cheapest 10 percent of stocks from different price ranges ($20, $30, $40, etc).

Tier 1 stocks for February 2008	100-day historical volatility	Implied volatility
Knightsbridge Tankers Limited (VLCCF)	41	28
Privatebancorp Inc. (PVTB)	45	35
Marshall & Ilsley Corporation (MI)	59	38
MF Global Ltd (MF)	43	40
Health Care REIT Inc. (HCN)	30	25
Frontline Ltd. (FRO)	47	31
Grant Prideco Inc. (GRP)	41	23

FIGURE 5 — PERFORMANCE OF CHEAP CALLS

Nine of the 12 options trades from February 2008 were profitable. Eight of the winners gained from 50 to 100 percent, while the other one earned 8 percent. The three losses were September calls on MF Global and Marshall & Ilsley, which were still open positions as of July 18.

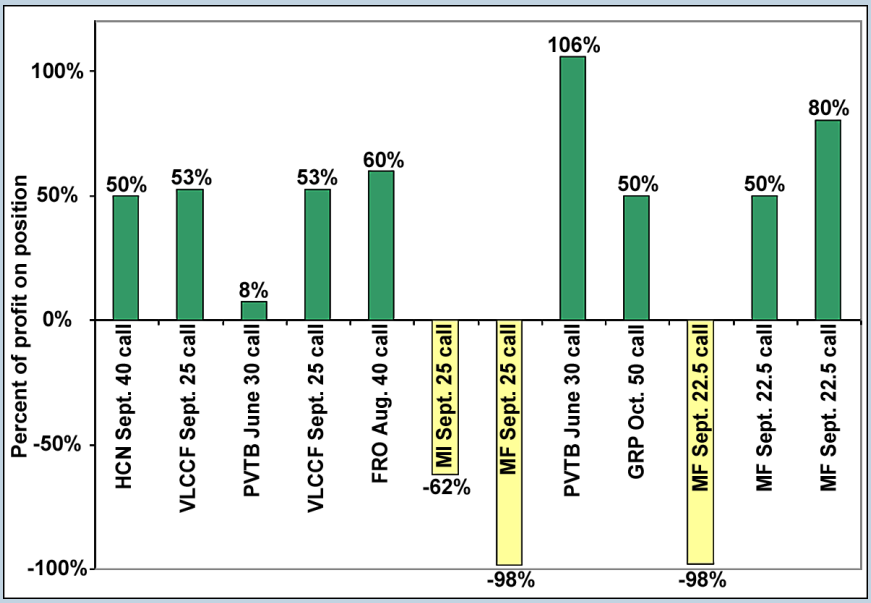


FIGURE 6 — KNIGHTSBRIDGE TANKERS LTD

When Knightsbridge climbed to $26.57 on Feb. 1, a 25-strike September call was bought for $2.95. The position was held for 11 weeks and then sold at $4.50 when VLCCF reached $28.89 on April 21.

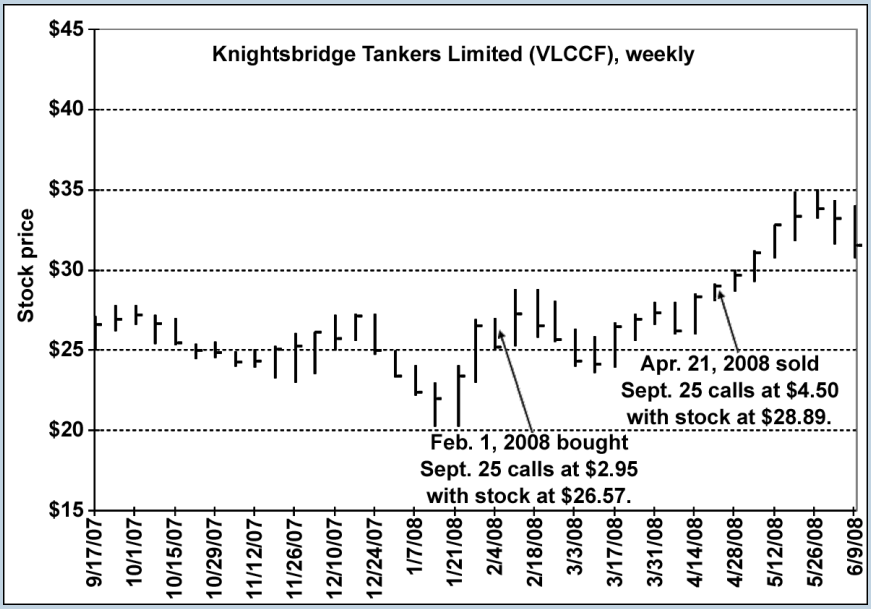
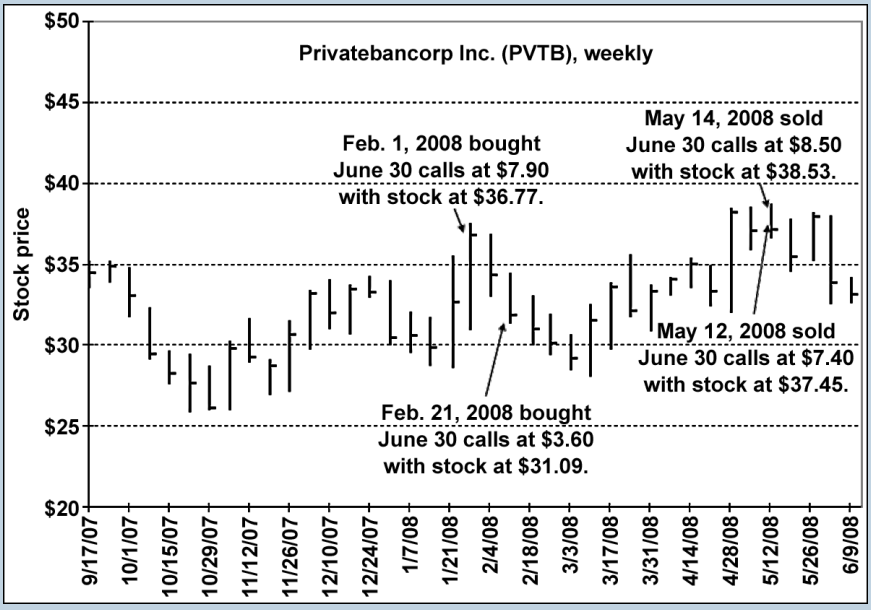


FIGURE 7 — PRIVATEBANCORP

When PVTB traded at $36.77 on Feb. 1, an ITM June 30 call was bought for $7.90. After Privatebancorp fell sharply, the 30 call was bought again at $3.60, and both trades made money.



percent, and their average implied volatility was 34 percent. This difference reflects the assumed source of profit in tier-1 stocks.

The volatility patterns of these stocks were then studied in detail, and the list was boiled down to three that were deemed most attractive for investments in February. The process was repeated for stocks in other price ranges, eventually resulting in the selection of seven stocks for option investments in February 2008 (Table 1).

Trade examples

Figure 5 shows the outcome of 12 calls that were bought in February 2008 and will expire between June and October. As of June 15, nine of the positions had been closed at a profit. Eight of those trades gained from 50 to 100 percent, while the other profitable trade — June 30-strike calls on Privatebancorp Inc. (PVTB) — earned 8 percent.

The three remaining open positions were September calls with large losses. The two calls on MF Global are likely to expire worthless in September, while the Marshall & Ilsley (MI) 25-strike call had lost 62 percent.

Overall, Figure 5's calls gained an average 21 percent. When buying calls on seven stocks in one month, expect a range of outcomes. Just because tier-1 stocks seem cheap doesn't mean their calls will be profitable. Figures 6, 7, and 8 illustrate this point for three of these stocks.

Figure 6 shows a weekly chart of Knightsbridge Tankers Limited (VLCCF). When Knightsbridge climbed to $26.57 on Feb. 1, a 25-strike September call was bought for $2.95. This call was ITM by $1.60 and expired in seven months. The position was held for 11 weeks and then sold at $4.50 when VLCCF reached $28.89 on April 21. It only took a move of $2.30 in this stock over 11 weeks to generate a profit of 53 percent. The call's attractive price showed there was no "fat" in its premium, so a relatively small move would do the trick.

Figure 7 shows a weekly chart of Privatebancorp (PVTB). When PVTB traded at $36.77 on Feb. 1, an ITM June 30 call was bought for $7.90. Again, there was no fat in the option

premium; its time value was only $1.10.

During the first two weeks, Privatebancorp fell by more than $5, and two more 30-strike calls were purchased at $3.60 when PVTB traded at $31.09 on Feb. 21. By the middle of May Privatebancorp had rallied above $38, generating a profit of 9 percent on the first trade and 106 percent on the second trade. Figures 6 and 7 show these profits came from normal fluctuations of both stocks, with no exceptional moves.

Figure 8 shows a string of losing trades on MF Global (MF). On Feb. 19 MF was trading at $28 and September 25 calls were bought at $5.40. Then, on Feb. 28 and 29 MF Global plunged from a high of $29.38 on Feb 28 to a low of $14.27, closing at $17.55 on Feb 29. This stock delivered plenty of volatility, but in the wrong direction for call buyers.

Three additional purchases were made as MF dropped on Feb. 29. We bought September 22.5-strike calls at $2.20, $1.20, and $1.00. Two of these trades were closed on the same day, both at $1.80 as MF Global bounced off its low during a panic sell-off. Overall, the four trades yielded two profits (50 and 80 percent), and two losses (98 percent each) on options that will probably expire worthless in September.

The simplest edge

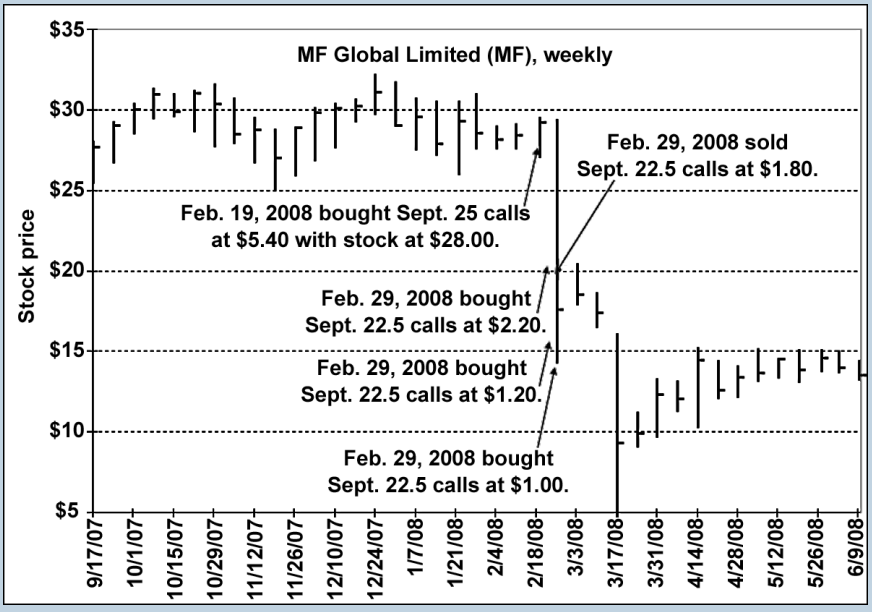
Not all options will be profitable in any given month. But if you buy cheap options, capturing 50-percent profits shouldn't be difficult from normal fluctuations in the stock.

The Goyal-Saretto study shows volatility is the key to long-term success in options trading. Regardless of your options strategy, it pays to focus on the difference between historical and implied volatilities.

For information on the author see p. 6.

FIGURE 8 — MF GLOBAL

After buying the September 25 calls for at $5.40, MF Global fell to $14.27 on Feb. 29. However, we bought 22.5-strike calls during the decline and two of the four trades were profitable.



Related reading

George Hoekstra articles

"Getting a handle on volatility," *Options Trader*, September 2006
Want to understand volatility? Before you dive into option-pricing models and complex math, do some basic price comparison. You'll be surprised how much you can learn.

"Focusing on volatility," *Options Trader*, August 2005.
To hone in on options with the most favorable odds, structure a search that focuses on a certain stock price, exercise price, and expiration date, and then use a simple analysis approach to identify options that are the most underpriced.

"The option pricing edge," *Options Trader*, October 2005.
Buying options at a 10- to 20-percent discount can be the difference between making and losing money over time.

"Bargain hunting options," *Active Trader*, January 2005.
If you get the willies every time read "standard deviation," take heart: This volatility analysis approach and option trading strategy takes the mathematical sting out of finding inexpensive options.

You can purchase and download past articles at *http://store.activetradermag.com.*

Trading seasonal patterns with spreads

Market: Options on the S&P 500 index (SPX). This strategy could also be applied to other broad-based indices and ETFs with liquid options contracts.

System concept: One of the most basic seasonal patterns is the tendency for stocks to rally from October to May and languish from May to October. This pattern has appeared in 36 of 37 global markets going back to 1694 in some cases, according to a study in the *American Economic Review*. Predicable market patterns often disappear as traders try to exploit them, but the May-October effect remains profitable.

A previous Options Lab compared credit and debit spreads that were designed to take advantage of this pattern; both strategies were profitable (see "The May-October effect," *Options Trader*, July 2006). This system updates the original test and breaks down its performance year-by-year to find out which type of vertical spread is preferable. Originally, buying debit spreads was the clear winner, but was that a fluke?

The first strategy sells out-of-the-money (OTM) credit spreads (short option, long OTM option), and the second strategy buys at-the-money (ATM) debit spreads (long option, short OTM option). The test enters bullish spreads in October and places bearish spreads in May.

Credit spreads contain a short OTM option and a long same-month option that is 50 points further from the money. The spread is entered at a net credit, which you keep if both options expire worthless. Vertical credit spreads sold one standard deviation OTM have approximately a 75 percent chance of expiring worthless

Debit spreads consist of a long ATM option and a short same-month option with a strike 50 points further from the money. This means we bought the strike with the highest time premium. Vertical debit spreads are directional trades that are entered at a net debit, and they become profitable only if the underlying's price moves far enough in the right direction.

Both strategies were always in the market, meaning they were either long or short the appropriate vertical spread, depending on the season.

TABLE 1 — ANNUAL PERFORMANCE BREAKDOWN

The majority of the debit spreads' gains were in the first two years, while the credit spreads' yearly profits were more consistent.

Time period	Credit spread	Debit spread
5/15/01 – 5/15/02	+ 1,107	+ 3.682
5/15/02 – 5/15/03	+ 1,157	+ 3,932
5/15/03 – 5/15/04	+ 507	- 28
5/15/04 – 5/15/05	+ 877	- 538
5/15/05 – 5/15/06	+ 732	+ 402
5/15/06 – 5/15/07	+ 832	+ 162
5/15/07 – 5/15/08	- 993	- 3,198

Trade rules:

Credit spreads

1. On the first trading day on (or after) May 15, enter a bear call spread in December SPX options and close the existing bull put spread. Sell the December call at the first strike price located just above one standard deviation, as determined by the implied volatility (IV) of the December ATM call. Simultaneously buy a December call at a strike 50 points higher (further OTM).
2. On the first trading day on (or after) Oct. 1, enter a bull put spread in June SPX options and close the existing bear call spread. Sell a June put at the first strike price located just below one standard deviation, as determined by the IV level of the June ATM put. Simultaneously buy a December put at a strike 50 points lower (further OTM).
3. Exit if the S&P 500 touches the short option's strike.

Debit spreads

1. On the first trading day on (or after) May 15, enter a bear put spread in December SPX options and close

FIGURE 1 — CREDIT SPREAD PERFORMANCE

The credit-spread approach earned $4,219 overall and gained ground in all but one year.

Source: OptionVue

the existing bull call spread. Purchase a December ATM put (i.e., the strike price with the most time premium available). Simultaneously sell a December put at a strike 50 points lower (further OTM).

2. On the first trading day on (or after) Oct. 1, enter a bull call spread in June SPX options and close the existing bear put spread. Purchase a June ATM call. Simultaneously sell a June call option at a strike 50 points higher (further OTM).

Starting capital: $5,000 for each type of spread.

Execution: When possible, option trades were executed at the average of the bid and ask prices at the daily close; otherwise, theoretical prices were used. Commissions were $5 base fee plus $1 per contract. Far OTM spreads were closed for $0.10 if a spread's fair value was zero.

Test data: The system was tested using the cash-settled S&P 500 index (SPX) options at the CBOE.

Test period: May 15, 2001 to June 30, 2008.

Test results: Unlike the original Options Lab in which debit spreads prevailed, here both strategies gained roughly the same amount since May 2001. Credit spreads gained $4,219 vs. $4,414 for debit spreads. In short, the May-October effect has fizzled over the past two years.

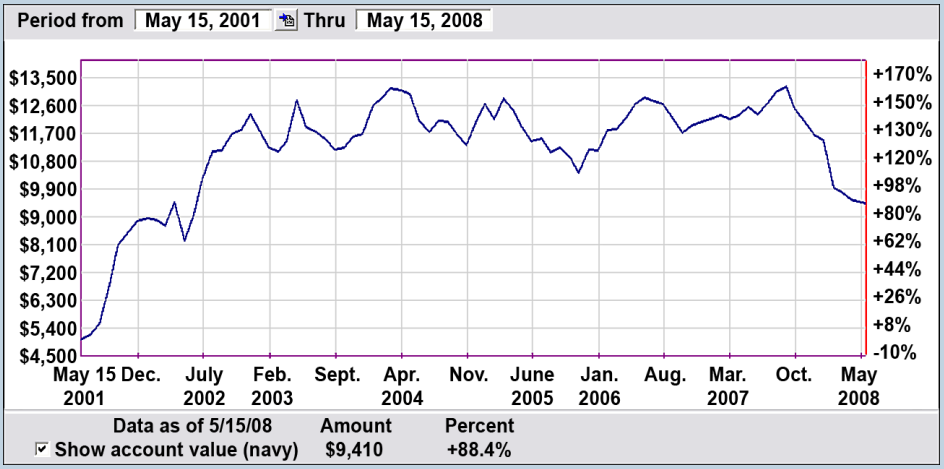
Table 1 breaks down the performance of both spreads by year. Figures 1 and 2 show the equity curves of both methods. Debit spreads gained the most ground from 2001 to 2003 and then lagged the credit-spread approach in each of the remaining five years.

Bottom line: The debit-spread approach depends on the underlying market's direction, which means the May-October effect worked well from 2001 to 2003 and then stopped working. By contrast, credit spreads performed more consistently because their strikes were further OTM and had a higher probability of success. That the credit spread approach had 8 percent winning trades shows there is still a trading edge for seasonal trends in the equity market.

— Steve Lentz and Jim Graham of OptionVue

FIGURE 2 — DEBIT SPREAD PERFORMANCE

The debit-spread method gained $4,414 overall, but most of these gains were in the first two years.



Source: OptionVue

STRATEGY SUMMARY

	Credit spreads	Debit spreads
Net gain:	$4,219.00	$4,414.00
Percentage return:	84.4%	88.3%
Annualized return:	12.1%	12.6%
No. of trades:	14	14
Winning/losing trades:	12/2	8/6
Win/loss:	87%	57%
Avg. trade:	$301.36	$315.29
Largest winning trade:	$791.00	$2,836.00
Largest losing trade:	-$1,194.00	-$2,874.00
Avg. profit (winners):	474.75	1,519.75
Avg. loss (losers):	-739.00	-1,290.67
Avg. hold time (winners):	181	201
Avg. hold time (losers):	130	158
Max consec. win/loss :	8/1	4/2

LEGEND:

Net gain – Gain at end of test period.
Percentage return – Gain or loss on a percentage basis.
Annualized return – Gain or loss on a annualized percentage basis.
No. of trades – Number of trades generated by the system.
Winning/losing trades – Number of winners and losers generated by the system.
Win/loss – The percentage of trades that were profitable.
Avg. trade – The average profit for all trades.
Largest winning trade – Biggest individual profit generated by the system.
Largest losing trade – Biggest individual loss generated by the system.
Avg. profit (winners) – The average profit for winning trades.
Avg. loss (losers) – The average loss for losing trades.
Avg. hold time (winners) – The average holding period for winning trades (in days).
Avg. hold time (losers) – The average holding period for losing trades (in days).
Max consec. win/loss – The maximum number of consecutive winning and losing trades.

Option System Analysis strategies are tested using OptionVue's BackTrader module (unless otherwise noted).

If you have a trading idea or strategy that you'd like to see tested, please send the trading and money-management rules to Advisor@OptionVue.com.

Jason Perl hits DeMark

Carving out a niche has paid off for this analyst.

BY FOT STAFF

Since 2004, analyst Jason Perl has headed the Technical Strategy for Fixed Income, Currencies and Commodities division at UBS bank. He has made a name for himself applying the market-timing tools of vaunted analyst Tom DeMark, and his new book on the subject, *DeMark Indicators* (Bloomberg Market Essentials/Bloomberg Press), is due out in October.

Describing himself as "fairly contrarian by nature," Perl was drawn to DeMark's work, which had just been introduced to the public through DeMark's first book, *The New Science of Technical Analysis* (John Wiley & Sons, 1994). He met DeMark at a conference and the two struck up a friendship; DeMark was instrumental in getting Perl's analysis career off the ground.

Perl's book came about after a Bloomberg representative saw a presentation Perl gave in New York in March 2007. Bloomberg was considering a series of books on market timing and technical analysis and, being one of the primary providers of DeMark's tools, was looking for an author to cover the topic. Although DeMark has authored several books himself, Perl points out the advantage of having someone else write *DeMark Indicators* (DeMark wrote the foreword).

"Tom has some incredible ideas, but they didn't come across that well in terms of explanation, initially," Perl says. "And I think part of the problem wasn't his fault; when he published his first book it was difficult for users to apply his ideas because the indicators weren't readily available."

Perl describes the book as "a user guide as opposed to a complete reinterpretation," focusing on the tools he uses the most in his own work.

"The [tools] are very objective," he says. "I'm not particularly objective and I found trading to be quite an emotional process. I often had the right idea but I got talked out of it or I had the right idea at the wrong time. And I wasn't clever enough to figure out how to make more conventional indicators less subjective. The discipline of Tom's indicators really appealed to me."

As do many other traders and analysts, Perl stresses the importance of using tools and techniques you're comfortable with.

"I think that's very important," he says. "Just because something works isn't necessarily justification to use it.

"Hypothetically, If I told you I had a system that consistently made 90 percent a year but occasionally would have an 80-percent intra-year drawdown, you would probably think, well, if it's made 90 percent every year for the past *x* years, it must be fantastic. And you put aside the fact that it could have an 80-percent drawdown. But I would suggest if it did have an 80-percent intra-year drawdown — even if it had been profitable 100 years before that — psychology would kick in and you would think, maybe this is the one time this isn't going to work anymore. That's inevitably the point at which you abandon it — and the point at which [things turn around] and you would have recouped everything you lost and got back on track.

> "My subjective interpretation of things is largely irrelevant. Let the market tell you what's happening in an objective manner and develop a set of rules to figure out how to trade the signals."

"Tom's indicators have ingrained in me that my subjective interpretation of things is largely irrelevant," Perl concludes. "Let the market tell you what's happening in an objective manner and develop a set of rules to figure out how to trade the signals."

A major focus of the book, according to Perl, is context: Putting all the pieces of the analysis puzzle together and identifying situations in which different signals are confirming a particular move.

"At the bank I basically cover everything except single stocks, so the book by implication covers everything and addresses a lot of the questions people regularly ask or want clarification about," he says. "It's very important for me to be able to objectively look at the picture globally. Sequential, TD Wave, REI, and some of the TD versions of moving averages put everything in context. Is this a correction or a major reversal within what's ultimately an exhausted long-term trend? That's where the real money is made."

Despite his big-picture, total-market perspective, Perl's analysis is not necessarily based on an exceptionally long-term time horizon.

"I think more in terms of percent moves than duration," he explains. "Because today a 50-percent move can occur in a couple of months, whereas in the past that would have taken a couple of years.

"I personally don't look at anything less than daily price data, so by definition the time frame is at least a couple of weeks," he adds. "But invariably it's less than three months simply because the margin of error increases on market timing the further out you go."

An extended Q&A with Perl that includes market analysis examples appears in the October issue of Active Trader *magazine, on newsstands in September.*

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FUTURES SNAPSHOT (*as of July 29*)

The following table summarizes the trading activity in the most actively traded futures contracts. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend for explanations of the different fields. Volume figures are for the most active contract month in a particular market and may not reflect total volume for all contract months.

Note: Average volume and open-interest data includes both pit and side-by-side electronic contracts (where applicable). Price activity for CME futures is based on pit-traded contracts, while price activity for CBOT futures is based on the highest-volume contract (pit or electronic).

Market	E-symbol	Pit symbol	Exchange	Volume	OI	10-day move/rank	20-day move/rank	60-day move/rank	Volatility ratio/rank
E-Mini S&P 500	ES		CME	2.34 M	2.19 M	4.15% / 100%	-1.90% / 16%	-11.19% / 82%	.24 / 12%
10-yr. T-note	ZN	TY	CBOT	984.8	1.83 M	-0.96% / 63%	0.65% / 19%	-0.86% / 17%	.23 / 10%
5-yr. T-note	ZF	FV	CBOT	631.9	1.57 M	-0.88% / 57%	0.08% / 20%	-0.83% / 10%	.26 / 20%
E-Mini Nasdaq 100	NQ		CME	453.9	296.0	2.39% / 100%	-1.44% / 17%	-7.85% / 42%	.13 / 0%
*Eurodollar**	GE	ED	CME	377.4	1.12 M	-0.05% / 60%	0.05% / 13%	-0.25% / 24%	.12 / 38%
30-yr. T-bond	ZB	US	CBOT	318.5	883.8	-1.72% / 56%	-0.79% / 22%	-1.51% / 35%	.27 / 0%
2-yr. T-note	ZT	TU	CBOT	289.8	918.7	-0.74% / 86%	0.06% / 26%	-0.72% / 25%	.22 / 33%
Crude oil		CL	NYMEX	278.8	246.3	-11.93% / 82%	-13.32% / 100%	0.29% / 0%	.30 / 63%
E-Mini Russell 2000	ER		CME	267.0	627.6	8.19% / 89%	3.41% / 78%	-2.25% / 18%	.45 / 56%
Mini Dow	YM		CBOT	212.3	100.7	4.17% / 100%	0.30% / 0%	-12.29% / 91%	.24 / 14%
Eurocurrency	6E	EC	CME	205.4	163.2	-1.74% / 100%	-1.16% / 53%	0.51% / 6%	.58 / 100%
Gold 100 oz.		GC	NYMEX	142.2	242.0	-6.36% / 100%	-2.96% / 50%	4.42% / 25%	.58 / 88%
Japanese yen	6J	JY	CME	133.5	152.9	-2.91% / 100%	-2.07% / 52%	-3.03% / 36%	.31 / 80%
Natural gas		NG	NYMEX	90.9	92.5	-20.45% / 69%	-32.40% / 100%	-18.32% / 100%	.57 / 90%
Corn	ZC	C	CBOT	83.2	310.9	-8.36% / 31%	-19.47% / 76%	-1.33% / 20%	.43 / 63%
British pound	6B	BP	CME	82.8	92.4	-1.04% / 100%	-0.56% / 42%	0.30% / 34%	.38 / 8%
Swiss franc	6S	SF	CME	76.8	52.8	-3.06% / 100%	-2.50% / 48%	0.72% / 5%	.50 / 98%
S&P 500 index		SP	CME	44.5	516.7	4.14% / 100%	-1.90% / 16%	-11.19% / 82%	.24 / 12%
Soybeans	ZS	S	CBOT	42.6	67.9	-10.23% / 40%	-13.38% / 100%	7.10% / 26%	.54 / 75%
Canadian dollar	6C	CD	CME	41.2	83.3	-2.18% / 100%	-0.13% / 18%	-1.13% / 43%	.73 / 90%
Sugar		SB	ICE	41.2	292.0	-7.97% / 13%	-2.14% / 6%	11.58% / 49%	.42 / 65%
Wheat	ZW	W	CBOT	39.8	132.8	-2.34% / 5%	-7.76% / 44%	-0.50% / 1%	.12 / 25%
Australian dollar	6A	AD	CME	39.6	94.6	-2.54% / 100%	0.23% / 3%	0.39% / 1%	.41 / 85%
E-Mini S&P MidCap 400	ME		CME	32.4	94.4	4.06% / 100%	-2.18% / 21%	-6.52% / 51%	.27 / 38%
Heating oil		HO	NYMEX	31.8	38.2	-11.40% / 70%	-11.95% / 100%	5.01% / 8%	.32 / 70%
Silver 5,000 oz.		SI	NYMEX	30.4	60.3	-8.62% / 75%	-5.00% / 70%	3.05% / 15%	.61 / 93%
RBOB gasoline		RB	NYMEX	29.3	45.8	-11.14% / 69%	-14.39% / 100%	-1.48% / 100%	.28 / 72%
Soybean oil	ZL	BO	CBOT	24.6	43.2	-8.25% / 75%	-12.80% / 100%	2.05% / 7%	.59 / 97%
Crude oil e-miNY	QM		NYMEX	24.1	7.7	-11.93% / 82%	-13.32% / 100%	1.85% / 4%	.30 / 63%
Soybean meal	ZM	SM	CBOT	23.1	45.4	-10.74% / 40%	-12.24% / 100%	13.47% / 39%	.48 / 43%
Mexican peso	6M	MP	CME	22.3	106.4	2.57% / 77%	3.62% / 100%	4.22% / 89%	.44 / 88%
Gold 100 oz.		ZG	CBOT	17.0	9.2	-6.29% / 100%	-1.23% / 13%	6.84% / 42%	.56 / 88%
Nikkei 225 index		NK	CME	15.2	70.4	2.31% / 50%	-1.96% / 32%	-6.71% / 28%	.40 / 90%
Live cattle	LE	LC	CME	15.1	78.1	-2.06% / 0%	-5.68% / 60%	5.89% / 57%	.11 / 0%
Fed Funds	ZQ	FF	CBOT	12.5	148.0	-0.02% / 0%	-0.01% / 25%	-0.03% / 100%	.04 / 92%
Copper		HG	NYMEX	12.1	50.0	-2.96% / 33%	-8.18% / 93%	-8.23% / 93%	.35 / 60%
Lean hogs	HE	LH	CME	10.8	23.2	3.93% / 23%	8.71% / 78%	6.30% / 22%	.13 / 25%
Coffee		KC	ICE	8.7	57.5	-3.06% / 13%	-9.61% / 95%	5.41% / 33%	.23 / 40%
Mini-sized gold	YG		CBOT	5.7	6.9	-6.29% / 100%	-1.23% / 13%	6.84% / 42%	.56 / 88%
Cocoa		CC	ICE	5.6	58.8	-4.35% / 18%	-10.88% / 71%	8.16% / 21%	.32 / 48%
Dow Jones Ind. Avg.	ZD	DJ	CBOT	5.5	26.9	4.17% / 100%	0.30% / 0%	-12.29% / 92%	.24 / 10%
Nasdaq 100		ND	CME	5.4	26.9	2.39% / 100%	-1.44% / 17%	-7.85% / 43%	.13 / 0%
U.S. dollar index		DX	ICE	4.5	32.3	1.91% / 100%	1.15% / 39%	0.18% / 3%	.61 / 100%
Natural gas e-miNY	QG		NYMEX	4.5	2.3	-20.45% / 69%	-32.40% / 100%	-18.12% / 100%	.57 / 88%
Russell 2000 index		RL	CME	1.9	32.9	8.19% / 89%	3.41% / 79%	-2.25% / 18%	.45 / 57%
Silver 5,000 oz.	ZI		CBOT	1.4	2.0	-8.66% / 80%	-0.37% / 4%	6.06% / 22%	.59 / 92%
Cotton	CT		ICE	1.2	6.6	1.10% / 57%	-5.06% / 63%	3.02% / 24%	.25 / 42%

*Average volume and open interest based on highest-volume contract (June 2009).

Legend

Volume: 30-day average daily volume, in thousands (unless otherwise indicated).

OI: Open interest, in thousands (unless otherwise indicated).

10-day move: The percentage price move from the close 10 days ago to today's close.

20-day move: The percentage price move from the close 20 days ago to today's close.

60-day move: The percentage price move from the close 60 days ago to today's close.

The "rank" fields for each time window (10-day moves, 20-day moves, etc.) show the percentile rank of the most recent move to a certain number of the previous moves of the same size and in the same direction. For example, the rank for 10-day move shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the rank field shows how the most recent 20-day move compares to the past sixty 20-day moves; for the 60-day move, the rank field shows how the most recent 60-day move compares to the past one-hundred-twenty 60-day moves. A reading of 100 percent means the current reading is larger than all the past readings, while a reading of 0 percent means the current reading is smaller than the previous readings. These figures provide perspective for determining how relatively large or small the most recent price move is compared to past price moves.

Volatility ratio/rank: The ratio is the short-term volatility (10-day standard deviation of prices) divided by the long-term volatility (100-day standard deviation of prices). The rank is the percentile rank of the volatility ratio over the past 60 days.

MOST-LIQUID OPTIONS*

Indices	Symbol	Exchange	Options volume	Open interest	10-day move / rank	20-day move / rank	IV / SV ratio	IV / SV ratio — 20 days ago
S&P 500 index	SPX	CBOE	116.3	1.62 M	3.97% / 100%	-1.31% / 7%	20.7% / 23.5%	22.5% / 19.2%
S&P 500 volatility index	VIX	CBOE	113.4	957.7	-22.81% / 100%	-8.02% / 30%	57.7% / 114.1%	65.5% / 117.7%
Russell 2000 index	RUT	CBOE	109.0	656.6	7.88% / 88%	3.61% / 76%	25.6% / 30.8%	27.2% / 21%
Nasdaq 100 index	NDX	CBOE	32.6	223.9	2.62% / 100%	0.46% / 0%	25.1% / 26.9%	28.8% / 26.5%
E-Mini S&P 500 futures	ES	CME	28.8	159.7	4.15% / 100%	-1.90% / 16%	21.2% / 25.3%	22.1% / 22.2%
Stocks								
Apple Inc.	AAPL		231.2	1.09 M	-7.40% / 79%	-6.19% / 65%	41.5% / 51.4%	45.3% / 42.3%
Wachovia	WB		202.2	1.38 M	72.91% / 100%	1.09% / 9%	104.2% / 228.2%	97.3% / 84.4%
Bank of America	BAC		179.0	2.21 M	73.97% / 100%	34.98% / 100%	75.4% / 133.2%	61.5% / 55.2%
Microsoft	MSFT		133.8	2.13 M	-0.15% / 7%	-5.09% / 47%	30.6% / 41.6%	30.4% / 29.7%
Citigroup	C		117.8	2.74 M	26.72% / 88%	10.08% / 86%	60.8% / 106.7%	64.5% / 58.3%
Futures								
Eurodollar	ED-GE	CME	113.6	7.30 M	-0.05% / 60%	0.05% / 9%	31.5% / 19%	31.7% / 24.5%
Corn	C-ZC	CBOT	40.5	469.1	-8.36% / 31%	-19.47% / 76%	33.7% / 45.5%	39.5% / 37.1%
10-year T-notes	TY-ZN	CBOT	31.1	926.1	-0.96% / 63%	0.65% / 19%	6.8% / 7.7%	7.5% / 7.5%
E-Mini S&P 500 futures	ES	CME	28.8	159.7	2.76% / 100%	-3.02% / 24%	21.2% / 25.3%	22.1% / 22.2%
Sugar	SB	ICE	25.2	491.4	-8.65% / 30%	-16.95% / 91%	37.1% / 50.6%	36.3% / 48.8%

VOLATILITY EXTREMES**

Indices - High IV/SV ratio								
Swiss franc index	XDS	PHLX	2.2	57.9	-3.46% / 100%	-2.33% / 48%	10.7% / 9.7%	12.6% / 11.4%
Indices - Low IV/SV ratio								
S&P 500 volatility index	VIX	CBOE	113.4	957.7	-22.81% / 100%	-8.02% / 30%	57.7% / 114.1%	65.5% / 117.7%
Banking index	BKX	PHLX	7.4	114.3	35.30% / 100%	12.82% / 100%	58.4% / 99.6%	51.5% / 52.5%
Housing index	HGX	PHLX	1.3	75.2	15.82% / 89%	5.19% / 100%	51.9% / 75.3%	46.8% / 44.8%
Oil service index	OSX	PHLX	1.0	19.4	-6.11% / 53%	-15.26% / 100%	41.2% / 53.6%	35.7% / 34%
Morgan Stanley retail index	MVR	CBOE	3.0	59.6	10.89% / 100%	0.71% / 14%	43.3% / 54.1%	39.1% / 38.3%
Stocks - High IV/SV ratio								
Savient Pharma	SVNT		6.5	138.1	-5.25% / 100%	4.86% / 18%	85.8% / 58.6%	74.5% / 57%
Anheuser Busch	BUD		17.9	908.7	1.88% / 39%	9.22% / 50%	15.6% / 11.3%	31.6% / 22.2%
First Solar	FSLR		3.4	73.5	0.21% / 0%	1.74% / 20%	79.6% / 59.2%	69.4% / 59%
Elan Corp ADS	ELN		27.0	382.5	-1.83% / 0%	-5.06% / 50%	78.5% / 58.4%	66.8% / 67.6%
Huntsman	HUN		17.6	433.5	14.52% / 33%	21.05% / 96%	102.7% / 76.8%	102.3% / 64.8%
Stocks - Low IV/SV ratio								
Fording Canadian Coal	FDG		2.4	71.4	10.89% / 80%	-6.91% / 44%	29.1% / 87.4%	51% / 54.3%
Barr Pharma	BRL		2.5	62.3	43.06% / 63%	46.21% / 78%	21.1% / 49.4%	32.4% / 30.2%
Colonial BancGroup	CNB		1.4	60.1	83.29% / 92%	53.85% / 100%	82.8% / 192.3%	98.5% / 127.5%
Foundry Networks	FDRY		2.7	96.1	46.42% / 50%	48.90% / 100%	25.8% / 58%	42.3% / 45.6%
National City	NCC		23.1	330.6	38.33% / 100%	4.40% / 40%	76.8% / 171.1%	79.6% / 96.8%
Futures - High IV/SV ratio								
Eurodollar	ED-GE	CME	113.6	7.30 M	0.04% / 0%	0.29% / 73%	31.5% / 19%	31.7% / 24.5%
Soybean oil	BO-ZL	CBOT	2.3	74.7	-8.25% / 75%	-12.80% / 100%	28% / 23.3%	34.2% / 24.4%
Soybeans	S-ZS	CBOT	9.0	71.9	-10.23% / 40%	-13.38% / 100%	39.1% / 33.6%	38.8% / 28.2%
Cocoa	CC	ICE	1.5	9.2	-4.35% / 18%	-10.88% / 71%	38.5% / 34.2%	37.6% / 25.5%
Orange juice	OJ	ICE	1.9	40.3	-12.00% / 89%	-7.69% / 45%	52.3% / 47.1%	44.6% / 30.7%
Futures - Low IV/SV ratio								
Sugar	SB	ICE	25.2	491.4	-7.97% / 13%	-2.14% / 6%	37.1% / 50.6%	36.3% / 48.8%
Corn	C-ZC	CBOT	40.5	469.1	-8.36% / 31%	-19.47% / 76%	33.7% / 45.5%	39.5% / 37.1%
Silver 5,000 oz.	SI	NYMEX	1.0	36.7	-8.62% / 75%	-5.00% / 70%	31.6% / 39.3%	34% / 39.3%
Natural gas	NG	NYMEX	3.0	81.3	-20.45% / 69%	-32.40% / 100%	52.4% / 64.1%	44.5% / 39.9%
S&P 500 futures	SP	CME	15.3	91.2	4.14% / 100%	-1.90% / 16%	19.5% / 23.4%	22.6% / 18%

* Ranked by volume ** Ranked based on high or low IV/SV values.

LEGEND:
Options volume: 20-day average daily options volume (in thousands unless otherwise indicated).
Open interest: 20-day average daily options open interest (in thousands unless otherwise indicated).
IV/SV ratio: Overall average implied volatility of all options divided by statistical volatility of underlying instrument.
10-day move: The underlying's percentage price move from the close 10 days ago to today's close.
20-day move: The underlying's percentage price move from the close 20 days ago to today's close. The "rank" fields for each time window (10-day moves, 20-day moves) show the percentile rank of the most recent move to a certain number of previous moves of the same size and in the same direction. For example, the "rank" for 10-day moves shows how the most recent 10-day move compares to the past twenty 10-day moves; for the 20-day move, the "rank" field shows how the most recent 20-day move compares to the past sixty 20-day moves.

COT extremes

The Commitment of Traders (COT) report is published weekly by the Commodity Futures Trading Commission (CFTC). The report divides the open positions in futures markets into three categories: commercials, non-commercials, and non-reportable.

Commercial traders, or hedgers, tend to operate in the cash market (e.g., grain merchants and oil companies that either produce or consume the underlying commodity).

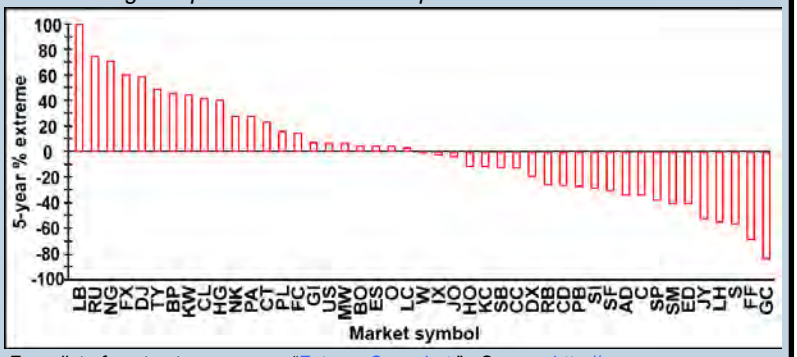
Non-commercial traders are large speculators ("large specs") such as commodity trading advisors and hedge funds — professional money managers who do not deal in the underlying cash markets but speculate in futures on a large-scale basis. Many of these traders are trend-followers. The non-reportable category represents small traders, or the general public.

Figure 1 shows the relationship between commercials and large speculators on July 22. Positive values mean net commercial positions (longs-shorts) are larger than net speculator holdings, based on their five-year historical relationship. Negative values mean large speculators have bigger positions than the commercials.

In gold futures (GC), for example, the difference between commercials and large speculators is near a five-year low, a bearish relationship. In lumber futures (LB), this relationship is near a five-year high, a bullish sign. These extremes don't act as stand-alone trade signals, but they sometimes precede major price reversals.

FIGURE 1 — COT REPORT EXTREMES

The largest positive readings represent markets in which net commercial positions (longs-shorts) exceed net fund holdings on July 22. By contrast, the largest negative values represent markets in which net fund holdings surpass net commercial positions.



For a list of contract names, see "Futures Snapshot." Source: http://www.upperman.com

Legend: Figure 1 shows the difference between net commercial and net large spec positions (longs - shorts) for all 45 futures markets, in descending order. It is calculated by subtracting the current net large spec position from the net commercial position and then comparing this value to its five-year range. The formula is:

a1 = (net commercial 5-year high - net commercial current)
b1 = (net commercial 5-year high - net commercial 5-year low)

c1 = ((b1 - a1)/ b1) * 100

a2 = (net large spec 5-year high - net large spec current)
b2 = (net large spec 5-year high - net large spec 5-year low)

c2 = ((b2 - a2)/ b2) * 100

x = (c1 - c2)

Options Watch: Industrial Sector ETF components

Compiled by Tristan Yates

The following table summarizes the expiration months available for the top components of the Industrial Sector exchange-traded fund (XLI). It also shows each index's average bid-ask spread for at-the-money (ATM) July options. The information does NOT constitute trade signals. It is intended only to provide a brief synopsis of potential slippage in each option market.

			Option contracts traded									Bid-ask spreads			
			2008					2009			2010				
Stock	Symbol	Exchange	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Jan.	Closing price	Call	Put	Bid-ask spread as % of underlying price
Caterpillar Inc.	CAT	NA	X	X		X		X	X		X	69.19	0.06	0.05	0.07%
General Electric Co.	GE	NA	X	X			X	X		X	X	27.69	0.02	0.02	0.08%
Lockheed Martin Corp.	LMT	NA	X	X			X	X		X	X	103.35	0.14	0.21	0.17%
FedEx Corp.	FDX	NA	X	X	X			X			X	78.04	0.11	0.18	0.18%
United Technologies Corp.	UTX	NA	X	X		X		X	X		X	64.07	0.10	0.14	0.19%
3M Co.	MMM	NA	X	X	X			X			X	69.63	0.15	0.11	0.19%
General Dynamics Corp.	GD	NA	X	X		X		X	X		X	87.91	0.18	0.18	0.20%
United Parcel Service Inc. Cl B	UPS	NA	X	X	X			X			X	61.59	0.11	0.14	0.20%
Norfolk Southern Corp.	NSC	NA	X	X			X	X		X	X	69.02	0.14	0.15	0.21%
Northrop Grumman Corp.	NOC	NA	X	X		X		X	X		X	68.87	0.14	0.16	0.22%
Deere & Co.	DE	NA	X	X			X	X		X	X	69.71	0.14	0.18	0.22%
Honeywell International Inc.	HON	NA	X	X			X	X		X	X	50.03	0.11	0.11	0.22%
Boeing Co.	BA	NA	X	X		X		X	X		X	62.34	0.15	0.14	0.23%
Raytheon Co.	RTN	NA	X	X		X		X	X		X	56.78	0.14	0.13	0.23%
Burlington Northern Santa Fe Corp.	BNI	NA	X	X	X			X			X	96.74	0.19	0.29	0.25%
CSX Corp.	CSX	NA	X	X		X		X	X		X	61.82	0.15	0.16	0.25%
Emerson Electric Co.	EMR	NA	X	X			X	X		X	X	48.96	0.11	0.15	0.27%
Union Pacific Corp.	UNP	NA	X	X		X		X	X		X	76.58	0.25	0.16	0.27%
Illinois Tool Works Inc.	ITW	NA	X	X			X	X		X	X	45.98	0.13	0.13	0.27%
Tyco International Ltd. (New)	TYC	NA	X	X	X			X			X	39.78	0.15	0.13	0.35%
Industrials Sector SPDR	XLI	NA	X	X			X	X		X	X	33.68	0.24	0.20	0.65%

As of July 28

Legend:
Call: Four-day average difference between bid and ask prices for the front-month ATM call.
Put: Four-day average difference between bid and ask prices for the front-month ATM put.
Bid-ask spread as % of underlying price: Average difference between bid and ask prices for front-month, ATM call, and put divided by the underlying's closing price.

measured on a close-to-close basis — i.e., the close of the outside bar to the closes one, two, three, four, and five days later.

The thick black line represents all outside days (there were 60). The blue line represents outside days with the uptrend filter (25 patterns), the red line is outside days with the downtrend filter (15 patterns), and the green line represents the performance of all one- to five-day close-to-close changes during the period.

First, all else being equal, crude oil tended to gain more than usual after outside days, regardless of whether they were up-closing or down-closing. Performance after ODs using the uptrend and downtrend filters was mostly what we might expect (or hope for) when using this kind of rule; they highlight the effect of the prevailing trend on the pattern. The market made larger gains when the uptrend filter was in place. The results using the downtrend filter were a little less pat: The median gain one day later was actually positive and larger than the one-day gain using the uptrend filter. The returns on days 2 and 3 were negative, but days four and five turned back to the upside — and the day-5 gain was actually larger than the day-5 gain for all ODs (without any filter).

Figure 4 shows the performance for up-closing and down-closing outside bars (29 and 30 patterns, respectively). These results are much more interesting, particularly in the first two days after the patterns. The median gains for days 1 and 2 were actually higher after down-closing outside days than after up-closing outside days. And although up-closing ODs outperformed on days 3 and 4, by day 5 the up- and down-closing results were comparable.

Figures 5 and 6 repeat Figures 3 and 4 for the 2006-2008 period, which contained 53 outside days. As was the case in 2004-2006, the post-outside bar gains in Figure 5 were larger than the market's overall median gains during this period. Also, the uptrend filter resulted in larger gains. Performance using the downtrend filter was jagged and was likely influenced by the market's high volatility. Perhaps surprisingly, the gain after five days was greatest when the downtrend filter was applied, which could reflect the power of the uptrend during most of this period; the conditions identified by the filter simply turned out to be buying opportunities in and of themselves.

Figure 6 repeats an interesting aspect of Figure 4: Down-closing outside days (24 patterns) posted the biggest gains on day 1, and despite the dip on day 2 and subsequent see-saw performance, by day 5 they had gains comparable to up-closing outside days (26 patterns). This tendency for crude to close higher the day after a down-closing outside day was one of the inputs used to take the long trade in crude oil described in the "Futures Trade Journal."

Stepping back

Despite some of the counterintuitive results surrounding some of the outside day variations, the performance is not that surprising. Down-closing outside days have tended to represent immediate short-term buying opportunities because of the strength of crude oil's uptrend during the analysis periods. Conversely, up-closing outside days have tended to represent short-term overextensions; the market is often quiet or negative immediately after these bars. However, after a few days have passed, the uptrend smoothed over the differences between the patterns.

The crude market's recent conditions are certainly historic and cannot last forever. However, it's important to adjust analysis for current conditions.

These simple tests provide basic information about the way crude oil trades. There are certainly other factors to consider (e.g., the size of the outside bar, the placement of the close, the price action that preceded the bar) when studying this kind of pattern or incorporating it in a strategy.

For more analysis of outside bars in the crude oil market, see the October issue of Active Trader *magazine (http://www.activetradermag.com), on newsstands in September.*

FIGURE 4 — UP-CLOSING AND DOWN-CLOSING OUTSIDE DAYS (JULY 2004-JULY 2006)

Up-closing outside days were typically unchanged at the close one day later, while the market was usually $.20 higher after down-closing outside bars.

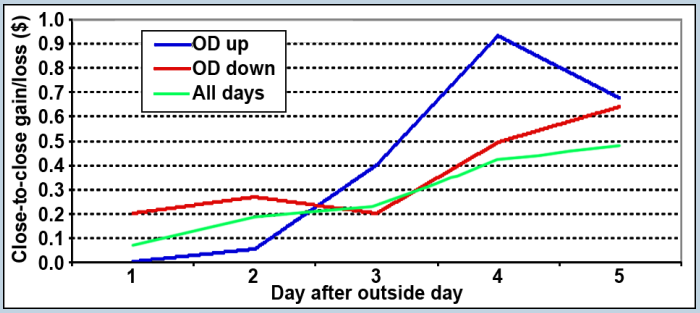


FIGURE 5 — OUTSIDE DAYS WITH UPTREND/DOWNTREND FILTERS (JULY 2006-JULY 2008)

Again, outside days were followed by more upside price action than the market tended to produce normally.

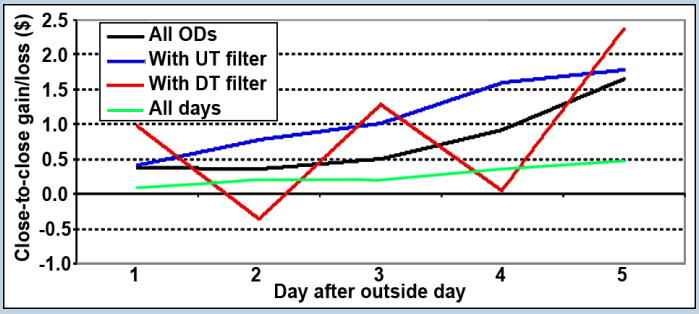
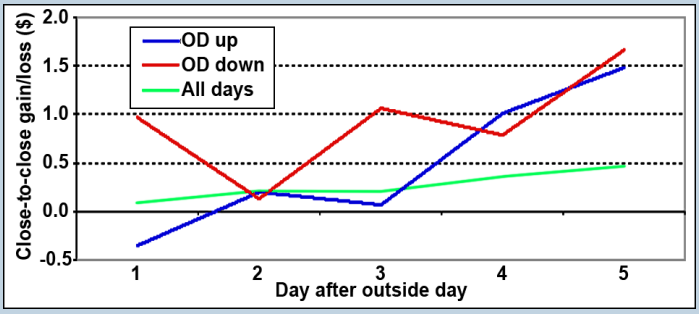


FIGURE 6 — UP-CLOSING AND DOWN-CLOSING OUTSIDE DAYS (JULY 2006-JULY 2008)

Down-closing outside days had the biggest close-to-close gain on day 1.



I'm just a bill

Oil speculation bill faces obstacles in Congress

BY LAUREN REES

Congressional Democrats continue to push for a bill to curb speculation in commodity markets, particularly oil, despite claims from industry regulators that speculators are not the cause of high energy prices.

From January 2007 through June 2008 crude oil (CL) gained five percent per month on average, and seven of those 18 months were double-digit percentage gains, including a 15.8-percent increase in October 2007. The Interagency Task Force on Commodity Markets (ITF) chaired by the Commodity Futures Trading Commission (CFTC), the Futures Industry Association (FIA), and Federal Reserve Chairman Ben Bernanke have all agreed rising energy prices are the result of "fundamental supply and demand factors" rather than speculation, according to the ITF's "Interim Report on Crude Oil."

"The Task Force has found that the activity of market participants often described as 'speculators' has not resulted in systematic changes in price over the last five-and-a-half years," the ITF stated in its report. "On the contrary, most speculative traders typically alter their positions following price changes, suggesting that they are responding to new information — just as one would expect in an efficiently operating market."

The release came just two days before the CFTC charged oil trading firm Optiver Holding with attempting to "bang the close" by amassing large positions just before markets closed to force prices up, then selling them quickly at the artificially inflated prices. The CFTC, however, said the manipulation was isolated, price changes were small, and the investigation was not related to recent Congressional energy price debates.

Meanwhile, Democratic Senate Majority Leader Harry Reid is leading legislation to increase the CFTC's resources and authority to improve the amount and quality of information available to the commission. His bill, called the Stop Excessive Energy Speculation Act, would close the supposed "London loophole" some believe allows oil traders to exceed CFTC position limits by trading in the London crude oil market. Another provision of this bill, and other bills circulating through the congress such as the House Agricultural Committee's Commodity Markets Transparency and Accountability Act, would require the CFTC to toughen position limits.

"While it mandates appropriate studies and it enhances energy market transparency, the bill has many provisions that would amount to liquidity-robbing, regulatory overkill," the FIA said of the "Stop Excessive Energy Speculation Act" in a statement released on July 17. "We fear that those provisions would undermine the bill's own transparency goals, make hedging more expensive, drive energy market activity overseas, and hopelessly complicate the regulatory mission of the [CFTC]."

Intending to move the bill before Congress leaves for its August break and prevent Republicans from amending it, Reid filed a version of the bill on July 22 that would allow a vote only on the speculation provisions. Senate Republicans blocked Reid's bill July 25 because they wanted to be able to debate their provisions on increasing domestic oil production by expanding offshore drilling.

Reid surprised Republicans July 28 by offering them a chance to vote on four amendments to the bill, one of which would expand offshore drilling. The amendments included the development of oil shale in western states, nuclear power plant construction, the allowance of new drilling on the outer continental shelf, and broader legislation encompassing the Republicans' recent slogan "find more, use less" by expanding offshore drilling, improving battery technology, and curbing oil futures speculation.

MANAGED MONEY

Top 10 option strategy traders ranked by June 2008 return.
(Managing at least $1 million as of June 30, 2008.)

Rank	Trading advisor	June return	YTD return	$ under mgmt.
1.	Ascendant Asset Adv. (Strategic2)	23.00	-29.53	27.8M
2.	Ascendant Asset Adv. (JLDeVore)	18.00	5.73	7.8M
3.	Kingdom Trading (Short Option)	9.60	17.66	1.1M
4.	Censura Futures Mgmt. (TEOW Aggr)	9.29	1.30	6.9M
5.	Ascendant Asset Adv. (Strategic1)	8.00	-66.10	2.7M
6.	Singleton Fund	7.85	26.16	40.9M
7.	ACE Investment Strategists (DPC)	7.16	26.66	6.3M
8.	CKP Finance Associates (LOMAX)	5.95	18.61	5.0M
9.	Aksel Capital Mgmt (Growth & Income)	5.56	91.71	10.4M
10.	LJM Partners (Aggr. Premium Writing)	4.85	25.12	222.3M

Source: Barclay Hedge (http://www.barclayhedge.com)

Based on estimates of the composite of all accounts or the fully funded subset method.

Does not reflect the performance of any single account.

PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE PERFORMANCE.

That's my final offer

CME Group makes last bid for NYMEX

BY LAUREN REES

The CME Group upped its bid to acquire the NYMEX in a "full and final offer" intended to sway NYMEX members while keeping its offer to shareholders the same.

The CME increased its offer by $113 million, with NYMEX members receiving $750,000 each for their seats, up from the original $612,000 offer. CME previously attempted to woo NYMEX members with a $1.1 billion share buyback plan plus a $5-per-share dividend.

The CME's new plan would also allow NYMEX members to retain their seats and pay lower trading fees, along with a reduced combined severance package. The New York exchange would also keep its trading floor until the end of 2012.

Some NYMEX members have criticized the CME's takeover bid, saying the Chicago exchange has offered too little. NYMEX shareholders and members will vote Aug. 18 on the merger. If approved by at least three-quarters of NYMEX membership, the agreement will put almost the vast majority of U.S. exchange-based futures volume in the control of the CME. (The NYBOT division of the IntercontinentalExchange dominates trading in the "soft" commodities — coffee, sugar, and cocoa — as well as orange juice, cotton, and the U.S. dollar index.)

The CME also announced $3.2 billion in financing commitments from Bank of America and UBS, with the two banks splitting the amount. CME and NYMEX management expect the transaction to close in the third quarter of this year pending both groups' membership and shareholder approvals.

A volatile substance

New index tracks oil volatility

BY CHRIS PETERS

On July 15 the Chicago Board Options Exchange (CBOE) introduced the Crude Oil Volatility Index (OVX), or "Oil VIX." Based on the United States Oil Fund (USO), the index uses the same calculation methodology as the CBOE's popular S&P 500 Volatility Index (VIX), and represents market expectations of near-term volatility in the crude oil market.

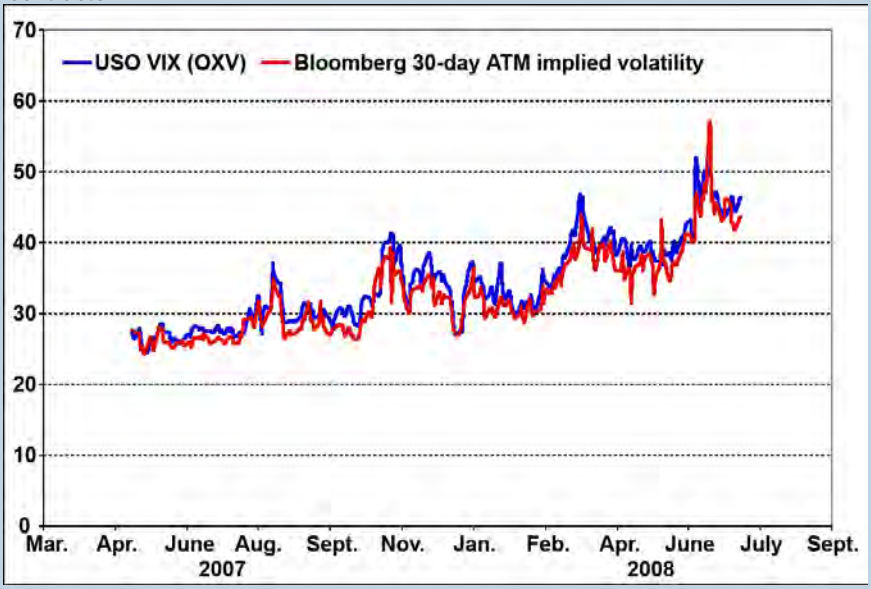
The USO fund tracks changes in crude oil prices by holding near-term futures contracts and cash, reflecting the spot price of West Texas Intermediate light, sweet crude oil. Options on USO began trading on May 9, 2007, and historical prices for the OVX benchmark can be tracked back to May 10, 2007.

The VIX formula, which is based on the implied volatility of at-the-money options, has been applied to many indices and licensed to exchanges across the world, but the OVX marks the first time it has been used on a commodity-based index. Initially, there won't be any options tied to the OVX.

The CBOE has plans to release further volatility indices based on other commodities and even currency pairs. Two volatility benchmarks released Aug. 1 track the SPDR Gold Trust (GLD) and the CurrencyShares Euro Trust (FXE). The Gold Volatility Index and the EuroCurrency Volatility Index can be tracked using the symbols GVZ and EVZ, respectively.

FIGURE 1 — OVX

The CBOE's "Oil VIX" (OVX) reflects the volatility of the U.S. Oil Fund (USO). This chart shows how the OVX compared to Bloomberg's hypothetical 30-day at-the-money implied volatility for options on front month NYMEX WTI futures contracts.



Source: Bloomberg, CBOE Research Department

American style: An option that can be exercised at any time until expiration.

Assign(ment): When an option seller (or "writer") is obligated to assume a long position (if he or she sold a put) or short position (if he or she sold a call) in the underlying stock or futures contract because an option buyer exercised the same option.

At the money (ATM): An option whose strike price is identical (or very close) to the current underlying stock (or futures) price.

Bear call spread: A vertical credit spread that consists of a short call and a higher-strike, further OTM long call in the same expiration month. The spread's largest potential gain is the premium collected, and its maximum loss is limited to the point difference between the strikes minus that premium.

Bear flag: Flags are short-term consolidation patterns. They are sometimes referred to as "continuation patterns" because they are often pauses in price trends and imply the continuation of those trends. Flags are essentially short-term trading ranges that last approximately three to 15 bars (roughly one to three weeks on a daily chart), although some people argue flags should consist of no more than 10 price bars.

A bear flag pattern represents a time when the market is taking a "breather" — pausing before resuming a down-trending move.

Bear put spread: A bear debit spread that contains puts with the same expiration date but different strike prices. You buy the higher-strike put, which costs more, and sell the cheaper, lower-strike put.

Beta: Measures the volatility of an investment compared to the overall market. Instruments with a beta of one move in line with the market. A beta value below one means the instrument is less affected by market moves and a beta value greater than one means it is more volatile than the overall market. A beta of zero implies no market risk.

Box spread: A hedged position in which the profit is determined in advance. A box contains one long call and one short put that share the same strike. Also, the spread contains one short call and one long put that share a higher strike price. All four options expire at the same time.

Bull call spread: A bull debit spread that contains calls with the same expiration date but different strike prices. You buy the lower-strike call, which has more value, and sell the less-expensive, higher-strike call.

The option "Greeks"

Delta: The ratio of the movement in the option price for every point move in the underlying. An option with a delta of 0.5 would move a half-point for every 1-point move in the underlying stock; an option with a delta of 1.00 would move 1 point for every 1-point move in the underlying stock.

Gamma: The change in delta relative to a change in the underlying market. Unlike delta, which is highest for deep ITM options, gamma is highest for ATM options and lowest for deep ITM and OTM options.

Rho: The change in option price relative to the change in the interest rate.

Theta: The rate at which an option loses value each day (the rate of time decay). Theta is relatively larger for OTM than ITM options, and increases as the option gets closer to its expiration date.

Vega: How much an option's price changes per a one-percent change in volatility.

Bull put spread (put credit spread): A bull credit spread that contains puts with the same expiration date, but different strike prices. You sell an OTM put and buy a less-expensive, lower-strike put.

Calendar spread: A position with one short-term short option and one long same-strike option with more time until expiration. If the spread uses ATM options, it is market-neutral and tries to profit from time decay. However, OTM options can be used to profit from both a directional move and time decay.

Call option: An option that gives the owner the right, but not the obligation, to buy a stock (or futures contract) at a fixed price.

Carrying costs: The costs associated with holding an investment that include interest, dividends, the opportunity costs of entering the trade, and, in the case of physical commodities, storage.

Collar: An options spread with three components — an underlying long position, a short call, and a long put that expires in the same month. It is a conservative, flexible strategy that profits if the underlying trades within a certain range by expiration. The strategy's goal is to improve a long position's odds of success by adding low-cost downside protection without limiting potential upside profits excessively.

The Commitments of Traders report: Published weekly by the Commodity Futures Trading Commission (CFTC), the Commitments of Traders (COT) report breaks down the open interest in major futures markets. Clearing

members, futures commission merchants, and foreign brokers are required to report daily the futures and options positions of their customers that are above specific reporting levels set by the CFTC.

For each futures contract, report data is divided into three "reporting" categories: commercial, non-commercial, and non-reportable positions. The first two groups are those who hold positions above specific reporting levels.

The "commercials" are often referred to as the large hedgers. Commercial hedgers are typically those who actually deal in the cash market (e.g., grain merchants and oil companies, who either produce or consume the underlying commodity) and can have access to supply and demand information other market players do not.

Non-commercial large traders include large speculators ("large specs") such as commodity trading advisors (CTAs) and hedge funds. This group consists mostly of institutional and quasi-institutional money managers who do not deal in the underlying cash markets, but speculate in futures on a large-scale basis for their clients.

The final COT category is called the non-reportable position category — otherwise known as small traders — i.e., the general public.

Covered call: Shorting an out-of-the-money call option against a long position in the underlying market. An example would be purchasing a stock for $50 and selling a call option with a strike price of $55. The goal is for the market to move sideways or slightly higher and for the call option to expire worthless, in which case you keep the premium.

Credit spread: A position that collects more premium from short options than you pay for long options. A credit spread using calls is bearish, while a credit spread using puts is bullish.

Debit: A cost you must pay to enter any position if the components you buy are more expensive than the ones you sell. For instance, you must pay a debit to buy any option, and a spread (long one option, short another) requires a debit if the premium you collect from the short option doesn't offset the long option's cost.

Debit spread: An options spread that costs money to enter, because the long side is more expensive that the short side. These spreads can be verticals, calendars, or diagonals.

Deep (e.g., deep in-the-money option or deep out-of-the-money option): Call options with strike prices that are very far above the current price of the underlying asset and put options with strike prices that are very far below the current price of the underlying asset.

Delivery period (delivery dates): The specific time period during which a delivery can occur for a futures contract. These dates vary from market to market and are determined by the exchange. They typically fall during the month designated by a specific contract - e.g. the delivery period for March T-notes will be a specific period in March.

Delta-neutral: An options position that has an overall delta of zero, which means it's unaffected by underlying price movement. However, delta will change as the underlying moves up or down, so you must buy or sell shares/contracts to adjust delta back to zero.

Diagonal spread: A position consisting of options with different expiration dates and different strike prices — e.g., a December 50 call and a January 60 call.

European style: An option that can only be exercised at expiration, not before.

Exercise: To exchange an option for the underlying instrument.

continued on p. 34

Expiration: The last day on which an option can be exercised and exchanged for the underlying instrument (usually the last trading day or one day after).

Fibonacci series: A number progression in which each successive number is the sum of the two immediately preceding it: 1, 2, 3, 5, 8, 13, 21, 34, 55, and so on.

As the series progresses, the ratio of a number in the series divided by the immediately preceding number approaches 1.618, a number that is attributed significance by many traders because of its appearance in natural phenomena (the progression of a shell's spiral, for example), as well as in art and architecture (including the dimensions of the Parthenon and the Great Pyramid). The inverse, 0.618 (0.62), has a similar significance.

Some traders use fairly complex variations of Fibonacci numbers to generate price forecasts, but a basic approach is to use ratios derived from the series to calculate likely price targets.

For example, if a stock broke out of a trading range and rallied from 25 to 55, potential retracement levels could be calculated by multiplying the distance of the move (30 points) by Fibonacci ratios — say, 0.382, 0.50, and 0.618 — and then subtracting the results from the high of the price move. In this case, retracement levels of 43.60 [55 - (30*.38)], 40 [55 - (30*.50)], and 36.40 [55 - (30*.62)] would result.

Similarly, after a trading range breakout and an up move of 10 points, a Fibonacci follower might project the size of the next leg up in terms of a Fibonacci ratio — e.g., 1.382 times the first move, or 13.82 points in this case.

The most commonly used ratios are 0.382, 0.50, 0.618, 0.786, 1.00, 1.382, and 1.618. Depending on circumstances, other ratios, such as 0.236 and 2.618, are used.

Float: The number of tradable shares in a public company.

Intermonth (futures) spread: A trade consisting of long and short positions in different contract months in the same market — e.g., July and November soybeans or September and December crude oil. Also referred to as a futures "calendar spread."

In the money (ITM): A call option with a strike price below the price of the underlying instrument, or a put option with a strike price above the underlying instrument's price.

Intrinsic value: The difference between the strike price of an in-the-money option and the underlying asset price. A call option with a strike price of 22 has 2 points of intrinsic value if the underlying market is trading at 24.

Leverage: An amount of "buying power" that increases exposure to underlying market moves. For example, if you buy 100 shares of stock, that investment will gain or lose $100 for each $1 (one-point) move in the stock.

But if you invest half as much and borrow the other half from your broker as margin, then you control those 100 shares with half as much capital (i.e., 2-to-1 buying power). At that point, if the stock moves $1, you will gain or lose $100 even though you only invested $50 — a double-edged sword.

Limit up (down): The maximum amount that a futures contract is allowed to move up (down) in one trading session.

Lock-limit: The maximum amount that a futures contract is allowed to move (up or down) in one trading session.

Long call condor: A market-neutral position structured with calls only. It combines a bear call spread (short call, long higher-strike further OTM call) above the market and a bull call spread (long call, short higher-strike call). Unlike an iron condor, which contains two credit spreads, a call condor includes two types of spreads: debit and credit.

Long-Term Equity AnticiPation Securities (LEAPS): Options contracts with much more distant expiration dates — in some cases as far as two years and eight months away — than regular options.

Moving average convergence-divergence (MACD): Although it is often grouped with oscillators, the MACD is more of an intermediate-term trend indicator (although it can reflect overbought and oversold conditions).

The default MACD line (which can also be plotted as a histogram) is created by subtracting a 26-period exponential moving average (EMA) of closing prices from a 12-period EMA of closing prices; a nine-period EMA is then applied to the MACD line to create a "signal line."

MACD = EMA(C,12)-EMA(C,26)
Signal line = EMA(MACD,9)

Market makers: Independent traders who attempt to profit by trading their own accounts. They supply bids when there may be no other buyers and supply offers when there are no other sellers. In return, they have an edge in buying and selling at more favorable prices.

Naked option: A position that involves selling an unprotected call or put that has a large or unlimited amount of risk. If you sell a call, for example, you are obligated to sell the underlying instrument at the call's strike price, which might be below the market's value, triggering a loss. If you sell a put, for example, you are obligated to buy the underlying instrument at the put's strike price, which may be well above the market, also causing a loss.

Given its risk, selling naked options is only for advanced options traders, and newer traders aren't usually allowed by their brokers to trade such strategies.

Naked (uncovered) puts: Selling put options to collect premium that contains risk. If the market drops below the short put's strike price, the holder may exercise it, requiring you to buy stock at the strike price (i.e., above the market).

Near the money: An option whose strike price is close to the underlying market's price.

Open interest: The number of options that have not been exercised in a specific contract that has not yet expired.

Opportunity cost: The value of any other investment you might have made if your capital wasn't already in the market.

Outlier: An anomalous data point or reading that is not representative of the majority of a data set.

Out of the money (OTM): A call option with a strike price above the price of the underlying instrument, or a put option with a strike price below the underlying instrument's price.

Parity: An option trading at its intrinsic value.

Physical delivery: The process of exchanging a physical commodity (and making and taking payment) as a result of the execution of a futures contract. Although 98 percent of all futures contracts are not delivered, there are market participants who do take delivery of physically settled contracts such as wheat, crude oil, and T-notes. Commodities generally are delivered to a designated warehouse; T-note delivery is taken by a book-entry transfer of ownership, although no certificates change hands.

Point and figure charts display price independently of time. Price advances and declines are represented by columns of Xs and Os, respectively. (Note: Charting programs often replace Os with squares because they are graphically similar.)

Each time price advances by a certain amount, called the "box size," an X is added to the ascending column of Xs. For example, when analyzing a stock, a box size of 1 point would mean an X would be added every time price gained 1 point. If the box size was .50, an X would be added every time price rallied 0.50 points, and so on.

To begin plotting a column of Os, price first has to decline a certain amount, called the reversal size. A reversal size of 2 would mean price would have to drop 2 points before you'd end a column of ascending Xs and begin plotting a column of descending Os.

Similarly, to begin a new column of Xs, price would have to turn back up 2 points or more. The larger the box and reversal sizes, the more price fluctuations a point and figure chart will filter out. For more detail on a chart, you simply decrease those values.

Premium: The price of an option.

Put option: An option that gives the owner the right, but not the obligation, to sell a stock (or futures contract) at a fixed price.

Put ratio backspread: A bearish ratio spread that contains more long puts than short ones. The short strikes are closer to the money and the long strikes are further from the money.

For example, if a stock trades at $50, you could sell one $45 put and buy two $40 puts in the same expiration month.

continued on p. 36

If the stock drops, the short $45 put might move into the money, but the long lower-strike puts will hedge some (or all) of those losses. If the stock drops well below $40, potential gains are unlimited until it reaches zero.

Put spreads: Vertical spreads with puts sharing the same expiration date but different strike prices. A bull put spread contains short, higher-strike puts and long, lower-strike puts. A bear put spread is structured differently: Its long puts have higher strikes than the short puts.

Ratio spread: A ratio spread can contain calls or puts and includes a long option and multiple short options of the same type that are further out-of-the-money, usually in a ratio of 1:2 or 1:3 (long to short options). For example, if a stock trades at $60, you could buy one $60 call and sell two same-month $65 calls. Basically, the trade is a bull call spread (long call, short higher-strike call) with the sale of additional calls at the short strike.

Overall, these positions are neutral, but they can have a directional bias, depending on the strike prices you select. Because you sell more options than you buy, the short options usually cover the cost of the long one or provide a net credit. However, the spread contains uncovered, or "naked" options, which add upside or downside risk.

Relative strength index (RSI): Developed by Welles Wilder, the relative strength index (RSI) is an indicator in the "oscillator" family designed to reflect shorter-term momentum. It ranges from zero to 100, with higher readings supposedly corresponding to overbought levels and low readings reflecting the opposite. The formula is:

RSI = 100 – (100/[1+RS])

where

RS = relative strength = the average of the up closes over the calculation period (e.g., 10 bars, 14 bars) divided by the average of the down closes over the calculation period.

For example, when calculating a 10-day RSI, if six of the days closed higher than the previous day's close, subtract the previous close from the current close for these days, add up the differences, and divide the result by 10 to get the up-close average. (Note that the sum is divided by the total number of days in the look-back period and not the number of up-closing days.)

For the four days that closed lower than the previous day's close, subtract the current close from the previous low, add these differences, and divide by 10 to get the down-close average. If the up-close average was 0.8 and the down close average was 0.4, the relative strength over this period would be 2. The resulting RSI would be 100 - (100/[1+2]) = 100 - 33.3 = 66.67.

Simple moving average: A simple moving average (SMA) is the average price of a stock, future, or other market over a certain time period. A five-day SMA is the sum of the five most recent closing prices divided by five, which means each day's price is equally weighted in the calculation.

Strike ("exercise") price: The price at which an underlying instrument is exchanged upon exercise of an option.

Support and resistance: Support is a price level that acts as a "floor," preventing prices from dropping below that level. Resistance is the opposite: a price level that acts as a "ceiling;" a barrier that prevents prices from rising higher.

Support and resistance levels are a natural outgrowth of the interaction of supply and demand in any market. For example, increased demand for a stock will cause its price

EVENTS

Event: The Options Intensive Two-day Seminars
Dates: Aug. 14, Oct. 23, Dec. 4
Location: CBOE Options Institute, Chicago
For more information: http://www.cboe.com

Event: Forex Trading Expo
Date: Sept. 12-13
Location: Mandalay Bay Resort & Casino, Las Vegas
For more information:
http://www.moneyshow.com/msc/lvfx/main.asp

Event: Real Trading with Dan Sheridan
Dates: Sept. 24
Location: CBOE Options Institute, Chicago
For more information: http://www.cboe.com

Event: Traders Expo Las Vegas
Date: Nov. 19-22
Location: Mandalay Bay Resort & Casino, Las Vegas
For more information: http://www.tradersexpo.com

Event: The Options Initiative Two-day Seminars
Dates: Nov. 20
Location: CBOE Options Institute, Chicago
For more information: http://www.cboe.com

to rise, creating an uptrend. But when price has risen to a certain level, traders and investors will take profits and short sellers will come into the market, creating "resistance" to further price increases. Price may retreat from and advance to this resistance level many times, sometimes eventually breaking through it and continuing the previous trend, other times reversing completely.

Support and resistance should be thought of more as general price levels rather than precise prices. For example, if a stock makes a low of 52.15, rallies slightly, then declines again to 52.15, then rallies again, a subsequent move down to 52 does not violate the "support level" of 52.15. In this case, the fact that the stock retraced once to the exact price level it had established before is more of a coincidence than anything else.

Time decay: The tendency of time value to decrease at an accelerated rate as an option approaches expiration.

Time spread: Any type of spread that contains short near-term options and long options that expire later. Both options can share a strike price (calendar spread) or have different strikes (diagonal spread).

Time value (premium): The amount of an option's value that is a function of the time remaining until expiration. As expiration approaches, time value decreases at an accelerated rate, a phenomenon known as "time decay."

TRIX indicator: A percent rate-of-change indicator of a triple smoothed exponential moving average (EMA). The TRIX is a momentum indicator that can identify trend changes. The calculation is as follows:

1. Take an n-period exponential moving average of price.
2. Take an n-period EMA of the value from #1.
3. Take an n-period EMA of the value from #2.

Positive values typically indicate an uptrend, while negative values indicate a downtrend. Traders also calculate a signal line of the TRIX by taking a shorter-term simple moving average of it. When its signal line crosses above the TRIX, market conditions are bullish, and when the signal line crosses below the TRIX, market conditions are bearish.

Vertical spread: A position consisting of options with the same expiration date but different strike prices (e.g., a September 40 call option and a September 50 call option).

Volatility: The level of price movement in a market. Historical ("statistical") volatility measures the price fluctuations (usually calculated as the standard deviation of closing prices) over a certain time period — e.g., the past 20 days. Implied volatility is the current market estimate of future volatility as reflected in the level of option premiums. The higher the implied volatility, the higher the option premium.

Volatility skew ("smile"): The tendency of implied option volatility to vary by strike price. Although, it might seem logical that all options on the same underlying instrument with the same expiration would have identical (or nearly identical) implied volatilities. For example, deeper in-the-money and out-of-the-money options often have higher volatilities than at-the-money options. This type of skew is often referred to as the "volatility smile" because a chart of these implied volatilities would resemble a line curving upward at both ends. Volatility skews can take other forms than the volatility smile, though.

▼ **TradingEducation.com** has launched a series of free Web seminars focused on educating traders of all levels. The 15 new "webinar" presentations will be updated regularly. The webinars now available focus on different market conditions and trading situations using VantagePoint Intermarket Analysis software. Another concentrates on technical analysis, money management, chart patterns, and more. To view the on-demand webinars, visit http://www.tradingeducation.com/webinar.

▼ Design, management, and security development firm **Market Studies, Inc.** has formed a new company with Passport Capital and S.A.C. Venture Investments, LLC. Market Studies, LLC, will offer quantitative models, market research, and market-timing tools through securities data vendors such as Bloomberg, CQG, and Thomson/Reuters, and will also develop more market-timing models.

▼ **Rosenthal Collins Group (RCG)** and **GAIN Capital Group** have partnered to offer clients their products and services. RCG introduced a white-label version of GAIN's online spot forex platform, RCG Forex Trader, and GAIN now provides access to RCG's futures and options trading through GAIN's Web site. The shared initiative expands upon the companies' European joint endeavor, RCG GAIN Limited, expected to go online during Q3 2008, offering online trading capabilities in forex and futures to self-directed UK investors. More information can be found at http://www.rcgdirect.com, http://www.gaincapital.com.

▼ Online broker dealer **TradeKing** has added two newcomers to its blog: Jonathan "Doc" Maher and Dan Sheridan, who join Larry McMillan, Brian Overby, and Nicole Wachs. To join the TradeKing community, visit http://community.tradeking.com.

▼ **E*TRADE** has introduced E*TRADE Mobile Pro, integrated mobile software that gives E*TRADE customers wireless access to their E*TRADE accounts. The software is available only on BlackBerry smartphones, and offers free real-time streaming stock and options quotes and live watchlists and portfolios. It also gives users the ability to trade equities and options, offers QuickTransfers from brokerage and bank accounts, and allows users to view all E*TRADE accounts on one screen. The new platform is available to E*TRADE securities customers at no extra cost. For more, visit http://www.etrade.com/mobile.

▼ Stock market investment forum **Silicon Investor** and sister site **InvestorsHub** have revamped their sites. The sites now have channels specific to forex and commodities, a comprehensive charting package, and advanced stock quote pages. In addition, the sites include International Super Quote, a source for global data. The sites also launched Toplists, which show the biggest gainers and losers in the current trading day. Silicon Investor launched SI Sentiment, a compilation of stock ratings by Silicon Investor users. For more information, visit http://www.siliconinvestor.com.

▼ **TD Ameritrade** has launched Pattern Matcher, a product designed to help investors monitor and research chart patterns. Users can browse a pattern library with explanations of each pattern, and then can click a pattern to search the markets for securities showing similar patterns. Users can also filter searches by time period, identify pricing characteristics, and utilize additional filters to narrow down search results. Pattern Matcher is free to TD Ameritrade clients. Visit http://www.tdameritrade.com and click on "Trading Tools."

▼ **FuturePath Trading** has released PhotonTrader Pro, new software that allows futures traders to enter trades directly from traditional and unique charts like Market Profile, volume at price, and candlesticks. The software also enables traders to place bracket orders and OCOs with one mouse click. PhotonTrader Pro uses drag-and-drop technology to modify orders and stops. The software includes redesigned primary trading applications, allowing various order modules to be linked, and gives numerous ways to display volume data. For more information on PhotonTrader Pro, visit http://www.fptrading.com.

▼ **TrimTabs Investment Research** now tracks the daily flows of S&P 500 futures contracts and E-Minis, which have an estimated value of $322 billion and provide leveraged exposure to the returns of the S&P 500. The daily flows of S&P 500 futures contracts and E-Minis are distributed to TrimTab clients who receive the Daily Liquidity Report. For more information, visit http://www.trimtabs.com.

▼ **Cunningham Trading Systems** released T4 Mobile, created for the iPhone. The software allows access to T4 WebTrader using a first- or second-generation iPhone. Users can monitor positions, watch market activity, and add or revise orders using their phones. For more information about T4 Mobile, visit http://www.ctsfutures.com.

Note: The New Products and Services section is a forum for industry businesses to announce new products and upgrades. Listings are adapted from press releases and are not endorsements or recommendations from the Active Trader Magazine Group. E-mail press releases to editorial@futuresandoptionstrader.com. Publication is not guaranteed.

Legend

CPI: Consumer price index

ECI: Employment cost index

FDD (first delivery day): The first day on which delivery of a commodity in fulfillment of a futures contract can take place.

FND (first notice day): Also known as first intent day, this is the first day a clearinghouse can give notice to a buyer of a futures contract that it intends to deliver a commodity in fulfillment of a futures contract. The clearinghouse also informs the seller.

FOMC: Federal Open Market Committee

GDP: Gross domestic product

ISM: Institute for supply management

LTD (last trading day): The first day a contract may trade or be closed out before the delivery of the underlying asset may occur.

PPI: Producer price index

Quadruple witching Friday: A day where equity options, equity futures, index options, and index futures all expire.

AUGUST 2008

27	28	29	30	31	1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31	1	2	3	4	5	6

SEPTEMBER 2008

31	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	1	2	3	4

The information on this page is subject to change. Futures & Options Trader *is not responsible for the accuracy of calendar dates beyond press time.*

August

1 **U.S.:** July unemployment, ISM
FDD: August natural gas, crude oil, platinum, copper, palladium, aluminum, gold, and silver futures (NYMEX); August 100 oz. gold, soybean, and soybean product futures (CME)
LTD: August live cattle options (CME); September cocoa options (ICE)

2

3

4 **FND:** August gasoline, heating oil, and propane futures (NYMEX); August live cattle and pork belly futures (CME)

5 **U.S.:** FOMC meeting
FDD: August pork belly futures (CME)

6 **FDD:** August propane futures (NYMEX)

7

8 **FDD:** August heating oil and gasoline futures (NYMEX)
LTD: September coffee and sugar options (ICE)

9

10

11

12 **FDD:** August live cattle futures (CME)

13

14 **U.S.:** July CPI
LTD: August soybean, soybean product, and lean hog futures (CME); August lean hog options (CME)

15 **LTD:** Equity options; September crude oil options (NYMEX); July cotton and orange juice options (ISE)

16

17

18 **FND:** September cocoa futures (ICE)

19 **U.S.:** July PPI

20 **LTD:** September crude oil futures (NYMEX); September platinum options (CME)

21 **FND:** September coffee futures (ICE)

22 **FND:** September crude oil futures (NYMEX)
LTD: September soybean, soybean product, corn, wheat, rice, and T-bond options (CME)

23

24

25

26 **LTD:** September gold, silver, copper, aluminum, heating oil, gasoline, and natural gas options (NYMEX); September 5,000 oz. silver options (CME); August pork belly futures (CME)

27 **LTD:** September natural gas, gold, silver, platinum, copper, palladium, and aluminum futures (NYMEX); August 100 oz. gold (CME)

28 **U.S.:** Prelim Q2 GDP
FND: September natural gas futures (NYMEX)
LTD: August feeder cattle futures (CME); August feeder cattle options (CME)

29 **FND:** September silver, platinum, copper, palladium, and aluminum futures (NYMEX); September 5,000 oz. silver, soybean, soybean product, corn, wheat, rice, oat, and T-bond futures (CME)
LTD: September gasoline, heating oil, and propane futures (NYMEX); August live cattle futures (CME); September lumber options (CME)

30

31

September

1 **FDD:** September crude oil and natural gas futures (NYMEX)

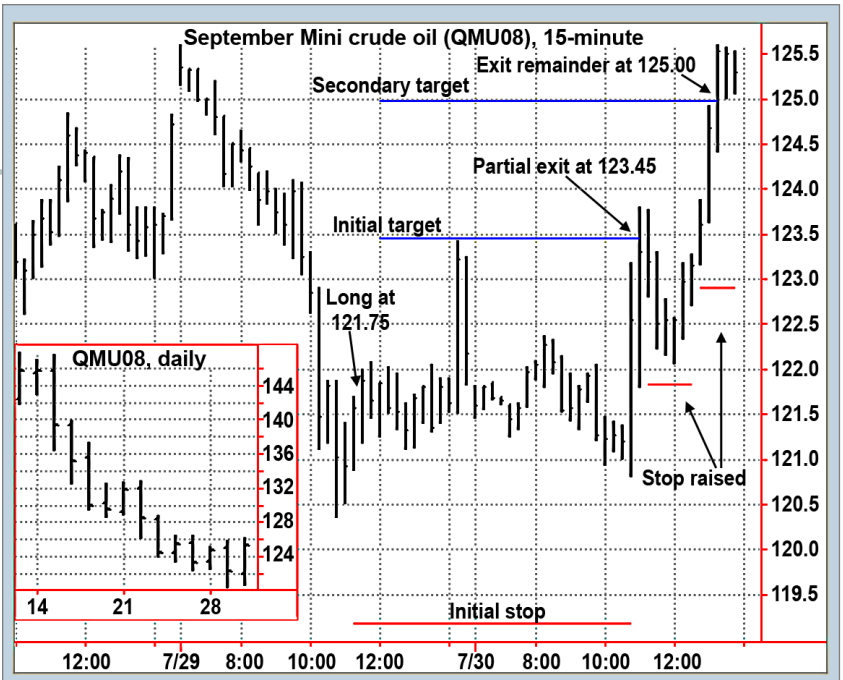
2 **U.S.:** August ISM
FDD: September gold, silver, platinum, copper, palladium, and aluminum futures (NYMEX); September soybean, soybean product, corn, wheat, rice, oat, 5,000 oz. silver, and T-bond futures (CME); September coffee, cocoa, and orange juice futures (ICE)

3 **FND:** September gasoline, heating oil, and propane futures (NYMEX)

4

5 **FDD:** September propane futures (NYMEX)
LTD: October cocoa options (ICE)
LTD: September currency options (CME)

An outside bar pattern triggers a buy in the falling oil market.



Source: TradeStation

TRADE

Date: Tuesday, July 29, 2008.

Entry: Long September mini crude oil futures (QMU08) at $121.75.

Reasons for trade/setup: Testing indicates favorable odds for an up move after an outside day (see "Futures Insight: Outside days in crude oil"). Oil has made two outside days recently (July 22 and July 25) as the market has sold off dramatically from its all-time high. The first trade was followed by more downside movement while the second was followed by a higher close.

As the current outside day has penetrated an obvious chart support level (the June low — see dashed line on chart), breakout systems and traders will likely be jumping on the short side; we expected this to be a feint and for the market to rebound (after potentially testing the round-number price of $120), at least temporarily.

We entered intraday, with the expectation the market would rally into the close after selling off early in the day.

Initial stop: $119.15, $1.225 below the outside day's low.

Initial target: $123.45, a little above the midpoint of the outside bar's range. Take partial profits and raise stop. Secondary target: $125.00.

RESULT

Exit: 123.45 (first half); 125 (second half).

Profit/loss: +1.7 (first half); +3.25 (second half).

Trade executed according to plan? Yes.

Outcome: Late in the regular session on the entry day the market came within a single tick (.025) of fulfilling the initial profit target before pulling back to close around $122.30. It traded down to $120.825 early the next day before exploding higher and hitting the first profit target, liquidating half the position. We then raised the stop on the remainder of the position to just above break even.

After a pullback, the market made an even larger surge, rocketing above $125 and filling the remaining exit order.

We are left with the sneaking suspicion oil is ready for a larger upswing, but given the extremely high volatility, we're glad we didn't tinker with the trade plan and got out quickly.

Note: Initial targets for trades are typically based on things such as the historical performance of a price pattern or trading system signal. However, individual trades are a function of immediate market behavior; initial price targets are flexible and are most often used as points at which a portion of the trade is liquidated to reduce the position's open risk. As a result, the initial (pre-trade) reward-risk ratios are conjectural by nature.

TRADE SUMMARY

Date	Contract	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Length
						123.45		+1.7 (1.4%)	1.70		
7/29/08	QMU08	121.75	119.15	123.45	.65	125.00	7/30/08	+3.25 (2.7%)	4.475	-.925	1 day

Legend: IRR — initial reward/risk ratio (initial target amount/initial stop amount); LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade).

After picking a market bottom, we exit too early and leave money on the table.

TRADE

Date: Tuesday, July 15.

Market: Options on the S&P 500 tracking stock (SPY).

Entry: Buy one July 120 call at $1.98.

Reasons for trade/setup: SPY opened at 121.80 on July 15, which represented a new multi-year low and a 0.5-percent drop from yesterday's low.

It isn't uncommon for the market to open below a previous low, but it rarely continues to trade below yesterday's low to form a down gap on a daily basis.

SPY has gapped down at the open 453 times since February 1993, but it has stayed below yesterday's open only 114 times during that period. The market will likely climb to yesterday's low of 122.40 at some point today.

Given the market is clearly in a downtrend, picking a bottom isn't a wise move. However, a short-term jump seems possible, especially because Intel Corp. (INTC) is expected to post positive earnings after the close.

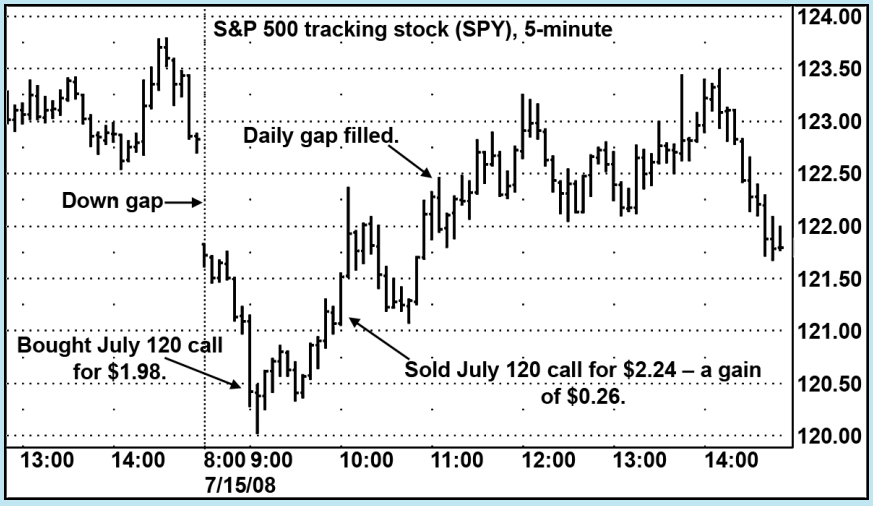
To profit from a brief up move, we bought July 120 calls after SPY fell to 120.45 at 10 a.m. ET. The bid-ask spread was only $0.01, so we placed a market order and bought the calls at $1.98, which was a terrible fill. We plan to exit after the market rebounds 1.6 percent to trade above yesterday's low of $122.40.

Initial stop: Exit if trade loses half its value.

Initial target: Exit if SPY climbs 1.6 percent to fill opening gap.

FIGURE 1 — CUTTING PROFITS SHORT

We bought calls at the right time, but exited the trade too early. If we had waited for SPY to climb above yesterday's low as planned, we would have earned an additional $0.80.



Source: eSignal

RESULT

Outcome: Despite the bad fill, Figure 1 shows we managed to buy near an intraday low. Although SPY immediately fell 0.4 percent to 120 shortly after we entered, the market quickly bounced back.

However, we didn't follow the exit rules. Instead of waiting until the opening gap was filled, we sold the 120 call for $2.24 after SPY rose to 121.10. The trade earned $0.26 per contract, but we could have earned another $0.80 if we had simply followed the original plan and exited after SPY closed the opening gap one hour later.

TRADE STATISTICS

	July 15 — 10:00 a.m.	July 15 — 11:00 p.m.
Delta:	52.47	69.12
Gamma:	10.52	9.35
Theta:	-21.12	-10.87
Vega:	5.00	4.43
Probability of profit:	26%	49%
Breakeven point:	120.96	120.96

TRADE SUMMARY

Entry date:	July 15, 2008
Underlying security:	S&P 500 tracking stock (SPY)
Position:	1 long July 120 call
Initial capital required:	$198
Initial stop:	Exit if trade loses half its value.
Initial target:	Exit if opening gap is filled.
Initial daily time decay:	$21.12
Trade length (in days):	1
P/L:	$26 (13%)
LOP:	$26
LOL:	-$32

LOP — largest open profit (maximum available profit during life of trade).
LOL — largest open loss (maximum potential loss during life of trade).

Buying puts on an exhausted market.

TRADE

Date: Thursday, July 17.

Market: Options on the S&P 500 tracking stock (SPY).

Entry: Buy one August 130 put call at $6.05.

Reasons for trade/setup: This second trade was inspired by the first one, but instead of buying calls after SPY gaps lower, we plan to buy puts after SPY gaps higher.

SPY jumped 3.8 percent within two days of hitting a 33-month low of 120 on July 15. On July 17, the market also opened 1 percent above yesterday's high.

After gapping higher at the open, SPY tends to drop and fill this opening gap. Of the 730 times SPY opened above the previous high since February 1993, it held above that high to form a daily up gap only 184 times. These numbers suggest SPY may drop to yesterday's high of 124.57 at some point today.

Figure 1 shows SPY reversed direction shortly after opening higher. To take advantage of a drop to an intraday low, we bought one August 130 put for $6.05 when SPY traded around 124.90 at 10 a.m. ET. The goal is to exit at a profit after the market falls to yesterday's high (or below).

Initial stop: Exit if trade loses half its value.

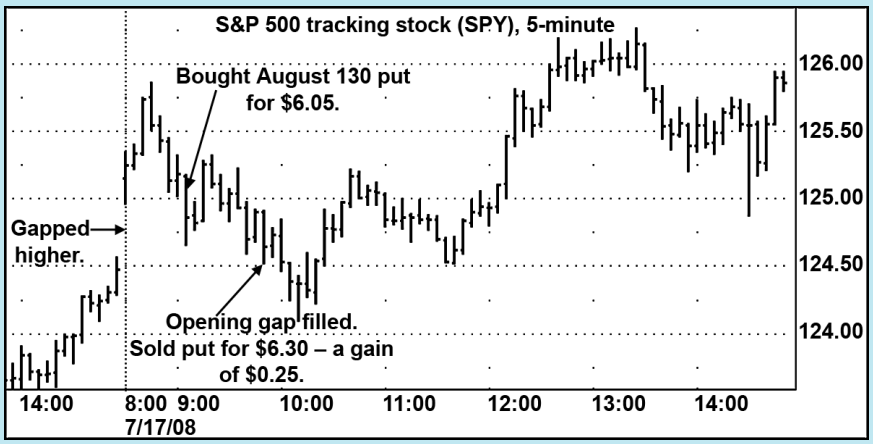
Initial target: Exit if market fills opening up gap.

RESULT

Outcome: Figure 1 shows the bearish trade went against us briefly as SPY rose above 125, but the market soon slipped to 124.50 around 11 a.m. ET. We sold the August 130 put for $6.30 — a gain of $0.25 per contract.

FIGURE 2 — CATCHING A DOWN MOVE

SPY opened higher and was poised to drop, so we bought an in-the-money (ITM) August 130 put and waited for the market to decline.



Source: eSignal

TRADE STATISTICS

	July 17 — 10:00 a.m.	July 17 — 11:00 p.m.
Delta:	-77.88	-76.56
Gamma:	4.52	4.53
Theta:	-3.49	-3.09
Vega:	11.84	11.10
Probability of profit:	44%	46%
Breakeven point:	124.73	124.58

TRADE SUMMARY

Entry date:	July 17, 2008
Underlying security:	S&P 500 tracking stock (SPY)
Position:	1 long August 130 put
Initial capital required:	$605
Initial stop:	Exit if trade loses half its value.
Initial target:	Exit if opening gap is filled.
Initial daily time decay:	$3.49
Trade length (in days):	1
P/L:	$25
LOP:	$25
LOL:	-$31

LOP — largest open profit (maximum available profit during life of trade).
LOL — largest open loss (maximum potential loss during life of trade).

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