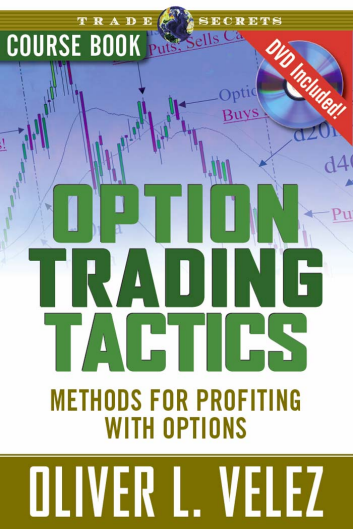

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WITH OPTIONS
OLIVER L. VELEZ

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OLIVER L. VELEZ



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From the Publisher

The editors at Marketplace Books have always kept a steady goal in mind, and that is to present actionable information on stock trading in the most straight-forward, practical medium available. Sometimes this involves a book, sometimes a newsletter, a DVD, or an online course program. What we've learned from the many products we've developed over the years is that a cross-medium approach is the most effective way to offer the greatest possible value to our readers.

So an idea was born. This innovative book and DVD set is one of the first in a series that combines a full course book derived from the actual presentation itself. Our idea grew out of a simple question. Students of stock trading spend a great deal of their own money attending lectures and trade shows. After all the travel, effort, and expense, that student will still have to assimilate a host of often complex theories and strategies. Sometimes he or she may want to ask a question or dig deeper into an issue, but they hold back; maybe because they still don't know enough about the bigger picture or maybe they don't even know some of the basic terminology. They may buy the DVD, but still . . . a lecture in itself is not a comprehensive learning tool and a person may still need yet another lecture or host of trial and error book purchases to master the subject.

So the question was: Does the average student of trading get enough out of an individual session to effectively carry their studies home and master a subject? The answer was a resounding no! Most attendees get bits and pieces of the message out of a long and expensive lineage of lectures, with

critical details hopefully captured in page after page of scribbled notes. For those who are gifted with a photographic memory and vast organizational skills, the visual lecture is just fine, but for the rest of us, the combination of the written word and a visual demonstration is the golden ticket to the mastery of any subject.

A comprehensive approach to learning is the course you are about to embark upon. We've taken Oliver Velez's original lecture and extracted his core content into an easy to read and understand course book. You'll be able to pour over every word of Velez's groundbreaking presentation, taking in each important point in a step by step, layer by layer process. All of this is possible because our editors have developed this title in classic textbook form. We've organized and highlighted the key points, added case studies, glossaries, and key terms.

Let's face it, stock trading in any medium takes years to master. It takes time to be able to follow charts and pick out the indicators that mark the wins you'll need to succeed. And beyond the mathematical details and back-tested chart patterns, every presenter has three very basic premises for every student trader; they are to control your emotions, stay close to your trading plan, and do your homework. It's so important to know the full picture of the profession because it could either make you rich or put you in line for that second night job.

This DVD course book package is meant to give you all the visual and written reinforcement you need to study, memorize, document, and master your subject once and for all. We think this is a truly unique approach to realizing the full potential of our Traders' Library DVDs.

As always, we wish you the greatest success.

Accessing the Video

To access the streaming video that comes with this book, please register at www.wiley.com/go/wileytradingvideo.

Meet Oliver Velez

Oliver L. Velez, best selling author, trader, advisor, and entrepreneur, is one of the most sought after speakers and teachers on the subject of trading financial markets for a living. His seminars and speaking events have been attended by more than 60,000 traders all over the world, and his runaway best selling books, Strategies for Profiting on Every Trade and Tools and Tactics of the Master Day Trader, are considered must-read classics for anyone interested in trading markets for a living. Dow Jones dubbed him "the messiah of day trading" and financial programs on CNBC, Bloomberg and Fox News frequently seek out his expertise. Mr. Velez and his life-long dedication to bringing more awareness to trading as a way of life, have been favorably mentioned in the New York Times, the Wall Street Journal, Barron's, Forbes, Stocks & Commodities and a whole host of other financial publications. He has also been the subject of numerous articles and books written about Wall Street's most successful traders, including the popular book, Bulls, Bears and Brains.

Oliver L. Velez is internationally known for founding and growing Pristine Capital Holdings, Inc. (a firm he started out of his New York City basement apartment) into one of the country's premier educational institutions for investors and self-directed, retail traders. After serving as Pristine's Chairman and CEO for 12 years, Mr. Velez decided to turn his full attention to the professional trading arena. His new training program called Trade for Life™, which includes a 2-day seminar and 5-day Live Trading Session with Mr. Velez himself, is designed to train traders to go beyond retail to trade the markets professionally.

Today, Mr. Velez runs Velez Capital Management, LLC ("VCM"), one of the country's fastest growing private equity trading firms. VCM currently employs 260 professional traders who have been meticulously trained to trade his own personal account. Mr. Velez financially backs each one of his traders, absorbing all their losses, while sharing in the gains with the trader. Mr. Velez' vision is to grow his professional team of traders to more than 1,000 globally over the next 3 years. For the past 19 years, he has espoused the revolutionary idea that "micro trading," like "micro banking" has the potential to serve as a solution to many of the world's social ills. Through VCM and the Velez Family Foundation, Mr. Velez will be opening up trading divisions and training centers in Beijing, Vietnam, Moscow and Mexico City. More major cities throughout the world will be added in the future.

Introduction

Welcome to Options Trading the Pristine Way

Welcome to Options Trading the Pristine way. Let me take a few minutes to explain exactly what that means. I'm sure that most of you reading this book have had some form of experience trading either stocks or options. Most of you have had experience doing both. Most of you, I am willing to bet, have had negative experiences more often than positive experiences, and that is certainly nothing to be ashamed of. It is a fact of life, simply because 85% of all those who participate in the markets from a short term perspective lose money.

I am Oliver Velez, and you may know me as the CEO of Velez Capital Management or as the co-founder of Pristine Capital Holdings. For those of you that are not aware of Pristine.com, it is the number one rated website for active, self-directed traders, and Pristine.com has been rated America's number one leading educational firm for active, self-directed traders.

This is a game for those who have not only more knowledge than the majority of the market participants, but more discipline to carry out that knowledge. You need to be very aware, if you are not, of the fact that knowledge alone means absolutely nothing in the markets. As a matter of fact, having too much knowledge, even too much of the right knowledge, without the discipline can be a very dangerous combination. Knowing what to do is no guarantee that we will do it. The unique combination of knowledge and the discipline to carry

out that knowledge is certainly what creates the necessary ingredients for success in the market.

I want to make it abundantly clear that in the course of one book it is virtually impossible to learn how to trade options. In the course of one book, it is impossible to learn how to trade stocks. But, what I can do in this book is give you a very firm foundation and an understanding of how I deploy various option tactics to maximize returns, minimize risk, hedge, and speculate.

First of all, let's get rid of some of the misconceptions out there. If you stay up late enough, and watch the right cable channels, you have probably learned many different ways to make millions in the market, especially if you use options. Some of these advertisements are really quite tricky because they imply that you do not need to know anything about the stock market. It is as if there were simply option strategies that existed independent of underlying price patterns. Nothing could be further from the truth.

Options do not exist in a vacuum; their primary mover is the price of the underlying stock.

Options have many important strategies and uses. They are not a source of risk-free trading, however. Any option strategy requires or benefits from the knowledge of where the underlying price pattern is going. When you hear of strategies that are thought to be "risk-free," it is referring to the fact that once established, the position has a limited risk. You may "leg into" a position and establish it at no cost, but in that case you have already earned the money that you are leaving

invested in the trade, which allows you to call it a risk-free trade.

There is also a concept called arbitrage. This, however, is really taking advantage of the imperfections in the marketplace. It is a specialty and fairly hard to find. It involves the simultaneous buying and selling of the same or similar security to capture the difference.

Options have a variety of uses. They may be used to set up highly leveraged positions. They may be used as a hedge to current portfolios. They can be used to add income to a current portfolio. They can be used to enter stock positions at a specified price, and actually, it's possible to be paid to enter the position you would have entered anyway. You may be the seller of options and earn premium for taking the other side of option transactions.

Options have many uses including limiting risk, but they are never risk-free.

The uses and various strategies of options are almost countless. There is an option tool to do almost anything you want to do in the marketplace. No matter how sophisticated you are in your options' applications, no matter how knowledgeable you are about options, you will be a failure as an options trader if you do not know how to predict price movement with some degree of accuracy.

I'm appalled at the number of people who actually come into the market having no knowledge of stocks, but feel that because options, from a numerical point of view, are cheaper to purchase, this is the ticket to wealth in the markets. This is

absolutely wrong. Options, as you know, are derivative of the item. If you do not know how to trade the item, you have no business trading the derivative. If you do not know how to successfully predict, with a high degree of accuracy, what a stock may do in the upcoming days or weeks, you have no business trading options.

The key is to understand the movement of the underlying security and enter the proper option transaction at the proper time. Understanding the movement of the underlying security is what the Pristine Method™ is all about. When you couple the technical ability of the Pristine Method™ with some basic option strategies, the result can be very good.

Please continue reading this introductory chapter. I want you to understand several things about the market in general and about trading options specifically. We need to talk about psychology and discipline. We need to discuss the fact that no option trade in the world can survive without understanding the movement of the underlying stock. We will be discussing the need for an approach to the market that is not the same old buy and hold philosophy. We also need to discuss briefly the difference between fundamental and technical trading.

As a prerequisite to trading options, we must know how to trade stocks; as a prerequisite to both of these, we need to understand psychology and how the market works.

As I mentioned above it is likely that your initial experiences with the stock market or with options was not all that favorable. How do I know that? I know that because the stock market is one of those arenas where 90 percent of the people

lose to 10 percent. It is a zero sum game where knowledge is king and experience is queen.

This situation exists because of the tremendous lack of knowledge, experience, and discipline by the average nonprofessional in the marketplace. To overcome this handicap you must be different. You must do something beyond what 90 percent of market participants do. Specifically you must get educated, resolve to follow a plan of how you're going to play the market, and that plan must allow you to get experience without burning through cash.

Are You an Investor?

One of the things that must be understood if you're going to participate in the marketplace is that this is truly a different game than what existed years ago. The term "investing" is no longer a valid term to use in the stock market. Not if investing means to buy and hold a security until death do you part. Because of rapid changes in the marketplace, constant management of positions is required. This is the concept of "trading." There is nothing wrong with longer-term holdings, just so they are managed properly. We will discuss this when we discuss core trading in the first chapter. The average holding time for a stock has gone from four years to four months in a very short period of time. That trend is continuing, and it is not here because of day traders. The fact is that day traders are here because of the market's incredible propensity to change, which has occurred with the technological advances of the last two decades.

The average holding time for a stock has gone from four years to four months in a very short period of time.

If you go back to the '50s and '60s, the main capitalization of the market was in manufacturing, machinery, and automobiles. If someone wanted to start up a new car company and drive General Motors out of business, it would have been an incredible undertaking. It would have required vast amounts of money and, more importantly, large amounts of time. Today things are different—very different. The main capitalization of the stock market today is in technology and services. The difference today is that "two kids in a garage" can bring any big company to its knees overnight.

While longer-term positions can be perfectly fine if managed properly, the term "investing" as is commonly used is a dead term, in my opinion.

There are countless examples of this, which can be found all over the recent history of the market. The story of the Iomega Company is a great example of how a one product company can be brought to its knees almost instantly because "two kids in a garage" can create incredible technological advancements without any real capital.

Perhaps you have also heard of a company called TIVO Inc. They are the makers of one of the first products to record your television as you watch it. That sounds like a great idea, doesn't it? Without a doubt it is. The question is, "is it a good investment?" The stock quickly ran up to over 78 dollars, as the prospects for the stock looked incredible. It was not long before the stock was trading under three dollars. It was a great product, not necessarily a good investment. It was a great

trade if you managed it properly, but it was not a good investment.

Did TIVO Inc. sell off because of a lack of interest in recording television programs? Not at all. It was simply the fact that Microsoft and every cable service provider came out with a competing product. A lifetime of technological improvements occurred over several months. This is the way of technology today. Make your money and preserve most of what you have. It may be gone tomorrow.

Consider if you held stocks long during the 2000-2002 crash—I'm sure I don't have to explain much further. The world moves quickly and does not wait for investors who get married to their stocks.

Fundamental versus Technical

Let's also have a discussion about the value of trading on fundamentals. In an upcoming chapter we will be discussing the Pristine Method™. The Pristine Method™ is a technical form of trading, which is basically the opposite of fundamental trading. There is plenty of discussion about using options to play various fundamental events. The answer here is no different than the answer to using fundamentals as a way of trading the underlying security. Remember the majority and most basic moves of the option will be reflecting the moves of the underlying security. To say we are technical

traders means that we do not believe in fundamental analysis as a way to predict price patterns.

It is not to say that the good companies don't eventually make more money and have higher stock prices. It is simply to say that all of the fundamentals are already built into the stock price to varying degrees. Since you are about to read a book that teaches a method of using stock and option trading based solely on technical analysis, I want to make sure you understand the difference between fundamental and technical analysis, and why, in all my years of trading, I never have and never will rely on fundamental analysis over technical analysis.

The most simple and basic reason comes down to this. Charts do not lie. CEOs, analysts, brokers, and a whole series of self-promoting talking heads on television do lie on occasion. When we talk about technical analysis, we are talking about predicting price movement from prior chart patterns. We're looking for cycles or repetitive patterns that have consistently proven to have good odds of producing a movement once a set of criteria is met. Opponents of technical analysis say this can't be done, but we do this every day.

When we talk about fundamental analysis, we're talking about evaluating the company and trying to fix a dollar amount to the actual worth of the company. Fundamental analysts look at things like price earnings ratios, PEG ratios, balance sheets, sales increases, management of the company, their competition, recent acquisitions, projected sales, and a whole ongoing list of accounting-related numbers. Fundamental analysts will look to all these various items and calculate the worth of the company and then translate that to

the price per share of the stock. If their calculations show that the stock should be valued at $22.00 but it is currently trading at $18.00, then the stock is a "buy" because it is "undervalued" by $4.00 and will certainly rise to the "correct" price soon.

Fundamental analysis uses the numbers generated by accountants to determine the fair value of one share of stock.

When we talk about technical analysis, we are talking about price patterns. These price patterns form on a chart, which is the one and only place where the stock market does not lie.

Once we have charts, technical analysts use some other concepts to help find consistent price patterns to trade. We use things such as support and resistance levels, trends, moving averages, and other forms of technical indicators. The value of any particular stock is not based on what fundamental analysis says the price should be, but rather on what the price actually is after being allowed to trade in an open market.

Technical analysis uses charts and past price patterns and assumes that the current price a stock is trading at is always its fair value.

There is a natural tendency, especially among new traders or investors, to want to use fundamental analysis. It seems to be common sense. There is a great desire by new traders to want to do their homework, research the numbers, and determine what the exact price the stock should be. Since you are about to learn a method based on technical analysis, let's look at some examples that will help convince you that there is no

battle in the debate between technical analysis and fundamental analysis.

Were any of you trading or investing in the late 1990's? Were you at least aware of what the market was doing if you were not trading? The stock market was moving higher in a frenzy and being led by tech stocks, especially Internet stocks. Many of these Internet stocks were startup companies that were not even making money yet. It would not be unusual for a new Internet company to come out at the time of their quarterly earnings report and say something to this effect:

"Ladies and gentlemen: we told you earlier that we would not likely have earnings at the time of this quarterly report. Well, we did not disappoint you; we do not have earnings yet. We told you that by next quarter we should be breaking even, but it appears we are going to have to revise that as we will still be losing money as of next quarter. We also mentioned that we may turn a profit by the end of the year, but unfortunately, that's not going happen either. By the way, we are actually burning through money so quickly that we will have to hold a secondary offering to sell more stock to raise more money so we can make it until the end of the year. Thanks for joining us today."

After the CEO gave a ringing endorsement such as the one above, what do you think the stock did? It usually tripled in the next three months. There was a period of time that lasted for several years in which stocks that never had earnings went up astronomically in price. So my first question to you is: why did these stocks rally? What was it that made them go up in price so dramatically? Were there fundamental reasons for their rally? Could a fundamental trader even have traded any

of these? Fundamental traders could not touch the stocks because there were no fundamentals to speak of. The stocks did not have earnings. They only had projected earnings, which often proved to be nothing more than guesses in many cases.

The 1990s were just one example of beautiful technical patterns that a fundamental trader would not be allowed to trade.

What about technical traders, could they have traded these? Absolutely. These stocks yielded some of the nicest price patterns ever seen. Does that mean that a technical trader is willing to buy a stock that does not even have earnings? Absolutely. Isn't that simply playing the greater fool theory? Yes it is, but that is what trading and investing comes down to whether you like to admit it or not. When you want to buy, there is a need to find someone who is willing to sell it to you at a price that you have determined to be very cheap. When we want to sell, we have to find someone who is willing to buy at a price you consider to be very expensive. Both of these people are the greater fools provided we turn out to be correct. If we are not correct, then we may be the greater fool in that instance.

Less than 20 percent of fund managers manage to beat the market, and their upgrades and downgrades can often be self-serving rather than accurate.

Do you want to rely on analysts' recommendations? Did you know that during the stock market crash from 2001 through 2002 only about 7 percent of all stocks were rated a sell? There are two possible reasons why this happened and both

were true to some extent. First, as many of you may have found out firsthand, some of the so-called professionals on Wall Street do not really have any real concept of when to buy and sell stocks. In most years less than 20 percent of fund managers beat the performance of the stock market itself.

Second, there are some very strong reasons why many analysts cannot and will not downgrade the stock. They have relationships with many of these companies, and those relationships bring in big dollars to their company. They are simply not allowed to downgrade some of the stocks. This may seem wrong to you, and it is, but it is allowed and happens on a regular basis nonetheless.

Have you ever seen a stock upgraded only to see it sell-off the entire day and for several weeks to come? Some upgrades and downgrades are not based on a stock's performance, but rather the need of the firm that issued the upgrade or downgrade to buy or sell more of the stock. In other words when a firm has a large client who wants to sell stock, they will often try to sell that stock to their smaller clients through their customer side brokers; and, if that doesn't work, they may upgrade the stock to get the public more actively involved in buying the stock to offset the sales they're going to have from their institutional client. Does this sound like a major conflict of interest? Of course it is, and it is one of the biggest secrets on Wall Street.

Analysts' upgrades and downgrades, earnings announcements, and news in general are all fundamental ways of looking at stocks and they usually don't produce consistent results.

Here is another item to think about if you are still enticed by fundamental analysis. Have you ever witnessed a company release an outstanding earnings report, only to see the stock sell off after hitting a multi-month high the day of the announcement? If you are a fundamental trader, when do you buy a stock? It must be on good news or good earnings or when some positive event occurs with the fundamentals, correct? So how frustrating must it be to have the company finally announce their first good earnings report and upon purchasing the stock, you sit with it as it falls for weeks and months. This is a common event, and it is due to the fact that the market is a great anticipator of events. Many events, some foreseen, and some not foreseen, are already built into each stock's price.

When news is announced, the big piece of missing data for fundamental players is, how much of this news has already been built into the stock price? When you understand price patterns, you will be able to better tell when good news ignites a new move and when good news will end an old move.

Whether you realize it or not, current stock prices already have many future events built into them.

If you still want to rely on fundamental analysis, think about this. How did the fundamentals look on Enron when it was trading over 100 dollars? They looked good. They looked very good. CNBC told me almost every day how good they looked. So what was the problem there? The numbers used to derive the fundamental analysis were all made-up numbers. They lied and cheated and created numbers that were nowhere near the truth. Then fundamental analysts started using the

numbers and looking at them to the nearest penny to determine what the price of the stock should be. But the numbers were off by dollars not by pennies. Was this a unique situation? Not by any means. Many other companies with big names like MCI were caught doing this, and many others are under investigation. Many have simply not been caught. If you are using fundamental analysis to determine what the exact price of the stock should be, the numbers you are looking at are often derived in fiction; so, your battle is futile.

The examples go on and on. The bottom line is that if you think you are going to hop on the Internet one evening and research a company to the extent that you can determine what the correct price of the stock is, then make a buy or sell decision to correct the error that the market currently has the stock priced at, you will be sadly disappointed time and time again.

The Upcoming Chapters

Let's take a look at what we will be covering in this book. In Chapter One we are going to review a few basics. We need to talk about the four styles of trading, and they fall into two major categories. This is an important backdrop to any form of trading and perhaps most important in trading options. Because time value changes quickly, you cannot afford to be in the wrong timeframe.

In Chapter Two we are going to talk about the tools of the options trader. These are the specific technical things you need to trade options.

In Chapter Three we are going to actually touch upon some of the basic concepts of the Pristine Method™ of trading. This is how we will determine the action of the underlying security, that is, the stock. If you are new to Pristine, you may not understand what the Pristine Method™ is. The Pristine Method™ is an approach that gives the individual market participant the ability to predict, with a relatively high degree of accuracy, short term price movement in the next two, five, or ten periods of time.

So by the time you have finished that chapter, you will have at least some of the basics of the Pristine Method™ to help you determine who is winning the battle in any stock at any moment in time. Who is the Goliath controlling the action? If you do not know how to determine who is controlling the action, you will not be a successful stock or options trader.

We're going to learn when to be a bull, when to be a bear. We're going to learn a counting method that, in a very simple but powerful way, will give you the ability to count your way to relatively consistent profits. And, of course, we're going to go over Pristine trading combinations.

Anyone who has followed my work for even a short period of time, recognizes the fact that I am a true believer in combinations. I believe in finding that one thing in the market that statistically happens seven times out of every ten times it occurs. Next, finding something else that happens seven to eight times out of every ten times you see it, and then

requiring them to happen together before I act. That is what we'll be covering during Pristine trading combinations.

In Chapter Four we will move into Pristine options, or the Pristine options approach. We'll talk about some of the advantages and disadvantages of trading options. We will look at the buying and selling calls, buying and selling of puts, and various combination strategies with options.

We will wrap up all that we've learned in the last chapter called "Putting it all Together."

In the Appendix we will discuss some of the technical items regarding option pricing, talking about items such as the fact that there are three determinants of price. These are time, premium, and decay. We will also discuss the "Greeks."

I want to close out this introductory chapter with one more mention regarding the topic of discipline. I have a very unique way that I ease individuals into our methods, our approaches, and the market as a whole. I tell them that you must have four consecutive winning trades on paper, using this specific technique, before moving on. Give me four in a row, and you will have earned the right to move to the next step.

The next step is to take the next trade with a very small amount of money at risk. Very small. This will start the psychological juices flowing. Why? Because irrespective of the money you put on the line, when you see your P&L start jumping up and down, especially in real time, the demons start to reveal themselves. Give me 4 wins in a row with 20 shares, or 1 options contract, and you will have earned the

right to go to 50 shares, or 2 options contracts. Then 100 shares, 300 shares, 500 shares, until you get to the maximum risk amount you want to be at for each of your trades. What do you think happens if you experience four losers in a row? You go backwards. You have earned the right to step down. You have the obligation to step down. If you go about things in this manner, it becomes very difficult to lose any significant amount of money while learning. And you will be learning. You'll discover that you don't really know some of the strategies as well as you thought you did. You'll discover that executing some of the strategies was not as simple as it appeared.

And through this learning process, we ease you into trading. And there will be a point, let me tell you, in virtually every successful trader's life in the market where the zeroes at the end mean nothing. Whether it's 1,000 shares or 10,000 shares means absolutely nothing. It's the same trade, barring, of course, liquidity issues and things of that nature.

If you are one of those readers who goes to the last page of the Introduction, go back and read. There is too much information here. You need to understand all the mechanics of stock trading at a fair level before using option strategies. There is a lot that must be digested just learning the stock part of the trade, and much of that understanding is in this chapter.

Chapter #1

The Four Styles of Trading

First, we need to have a discussion regarding the way options interact with the four styles of trading. This chapter is going to be devoted to the explanations regarding the various timeframes and charts that are used by well-rounded traders. You may first start thinking that this is not relevant to you because you want to trade options. Again, I must remind you that you are not really trading options. You are trading stocks (or whatever underlying security you prefer), and the option is simply the vehicle through which you choose to play out your bias on the particular stock strategy.

Let me explain further. Let's say you find a stock that you consider to be in a bullish position on the daily chart. For the moment I don't care if the stock is following the Pristine Method™ or any other method you currently use. The point is that your bias is to be long the stock. One of your options, of course, is simply to buy the stock and be long the stock. However, you also can accomplish the objective of making money when the stock increases in price by several other means. You may buy long calls on the stock that are "out of the money" looking for a home run. You may go long calls that are "deep in the money" looking to reduce your margin requirements while capturing the same net profit. You may sell puts to capture some premium and have very good odds of keeping that premium, or run the risk of a large loss if you

are wrong. You may do one of a wide variety of bullish spreads, which will all have different time limits, risks, and rewards.

The point is that all this starts with a timeframe and a strategy to play. There are of variety of option strategies and some of them are designed to rely less on knowing the price movement on the underlying stock; however, they all require knowledge of the underlying stock to make or to maximize gains.

The only timeframe that comes into question when using options is the intraday timeframe when holding less than the majority of the day. Because options typically have wider spreads and less liquidity, it is not as common to use them for shorter day trades or scalping. However, if you find a Pristine Buy Setup on the daily chart, you may choose to play that long position using a combination of options. The same might be true for a core trade you find on a weekly chart. Options can be especially beneficial when using them on guerrilla trades. Because guerilla trades often involve highly volatile moments in time, strategies can use that to benefit from the selling of high volatility and the repurchase when volatility subsides. So it is just as important to understand your timeframes and underlying strategies when trading options as it is for trading. So let's get an understanding of the Pristine timeframes and styles of trading.

There are four trading styles. They are core trading, swing trading, guerrilla trading, and micro trading. Notice that there is no mention of the term "investing." I believe in being diversified over different timeframes in the market. This should include longer-term positions, but these positions

would come under the category of core trades. They are entered based on the technicals and are managed accordingly. They are not based on fundamentals, and we do not get married to core trades. When they stop performing, the positions are exited. To the extent that the term investing implies a buy and hold approach, investing is dead.

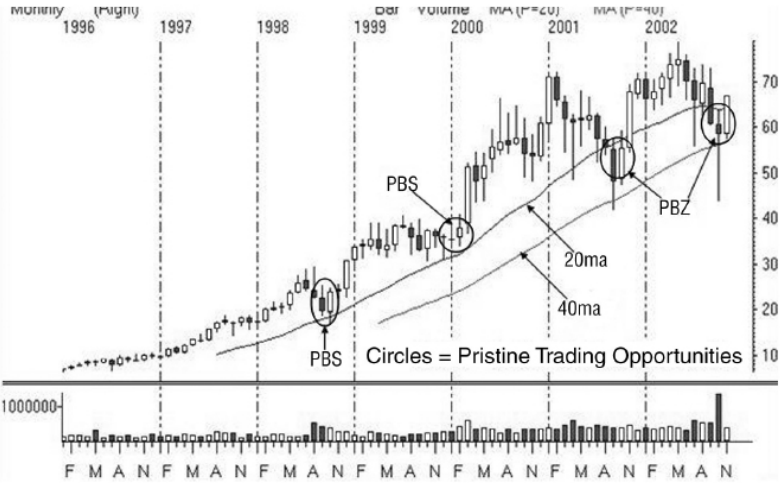
A Look at Available Timeframes

It is important that you understand the timeframes available and where option trading fits in so that you can properly play the timeframe you select. The Pristine Method® of trading makes six major timeframes available to its practitioners. These can be grouped into three broad categories. They are long term, intermediate term, and short term.

The long term timeframe consists of yearly and monthly charts. A yearly chart is a chart where every bar represents one year of trading. The yearly chart is used primarily for cyclical analysis and sometimes for long term trading. On the monthly chart every bar represents one month of trading, or approximately 20 trading days. Swing and core traders will review the monthly charts of all stocks in their universe at least once a month. The monthly chart is an excellent chart for longer-term core trading, and the swing trader may use monthly charts to help find longer-term trends. Figure 1.1 is an example of a monthly chart.

Figure 1.1 - Example of a Monthly Chart

For color charts go to www.traderslibrary.com/TLEcorner



The vertical dotted lines represent the years, and the scale along the bottom lets you know that every bar represents one month.

A trader's universe of stocks is a subset of all tradable stocks, which includes the biggest total list of stocks that a trader would ever use for trading.

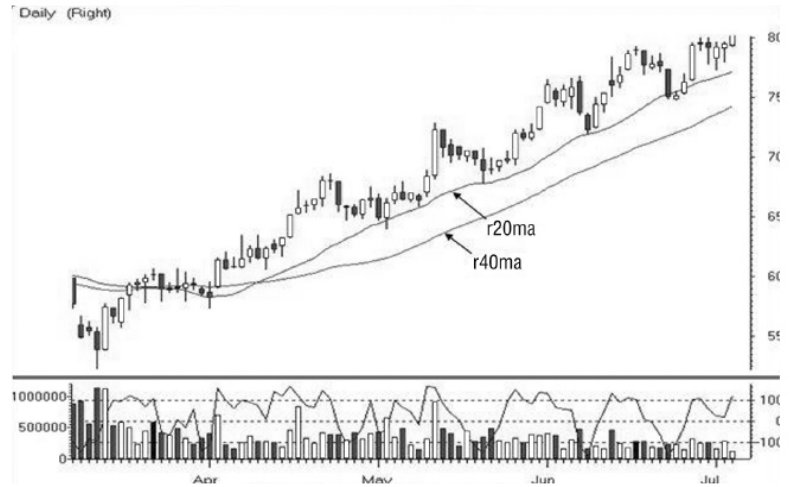
The next timeframe is the intermediate term timeframe, which consists of weekly and daily charts. The weekly chart is the key chart used by longer-term traders and will be the source of 85% of their plays. On the weekly chart every bar represents one week or five days' worth of trading.

The daily chart is the home for the swing trader. Eighty-five percent of the swing trader's trades will originate from the

daily chart. Every night the swing trader will review their universe of stocks through the eyes of the daily chart. Let's take a look at the daily chart in Figure 1.2.

Figure 1.2 - Example of a Daily Chart

For color charts go to www.traderslibrary.com/TLEcorner



The daily chart is the most common chart you will see if you are not an active trader. Every bar represents one day's worth of trading. Notice that the bars and the overall flow of the chart are the same as a weekly chart or a monthly chart. This is true of all charts, even intraday charts. The Pristine Method® works equally as well on any timeframe because we're trading people, not stocks. These charts all use Japanese candlesticks as the charting technique. I do not consider a chart a chart unless it is displayed in Japanese

candlesticks. We'll be discussing the use of these candlesticks shortly.

Notice also the two moving averages on this chart. They are the simple 20-period moving average and the simple 40-period moving average. These two moving averages are staples that should be on all of your longer-term charts. They are used as trend-setting tools that help us determine the nature and quality of the trend of any particular stock. The Japanese candlesticks and these two moving averages will give us virtually all of the tools we need for trading the "stock," and thereby the option, effectively.

The 20- and 40-period simple moving averages should be staples on all your longer-term charts

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Next we have the short term timeframe. This timeframe consists of hourly charts and other intraday charts such as the 15-minute and 5-minute charts. Take a look at the hourly chart in Figure 1.3.

Figure 1.3 - Example of an Hourly Chart



Here every bar represents one hour's worth of trading. The vertical lines here represent the breaks from one day to the next. Note that different trading platforms show slight differences because of the fact that there are six and a half hours in every trading day. You may opt to start your hourly charts at 9:00 Eastern Standard Time or 9:30 Eastern Standard Time, and depending upon your choice, there will be a slight difference in the final result. There is no uniform agreement on which is appropriate.

The hourly chart is an incredible chart. It is versatile in that it can be used for short term hits by swing traders, and it serves as an excellent alternative in choppy environments for one to two day holds. It is also used widely by the intraday trader to help determine the trend of the current day.

The hourly chart is a very versatile chart that can be used by swing and intraday traders.

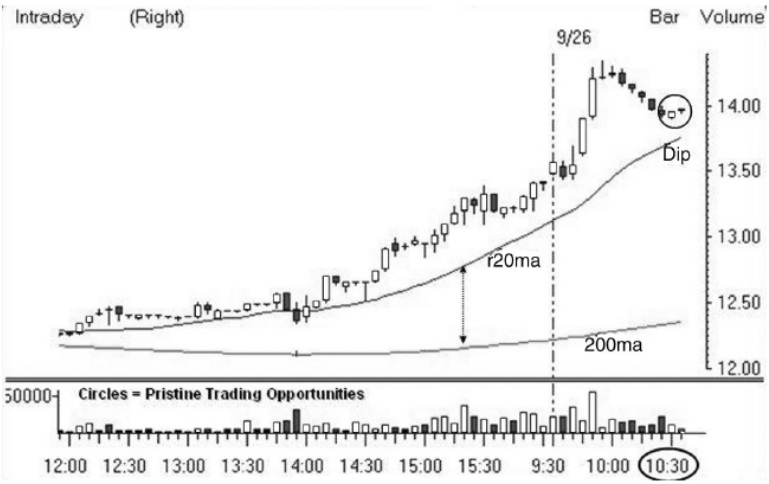
Here are examples of intraday charts, namely the 15-minute and 5-minute chart as shown in figures 1.4 and 1.5, respectively. Again the vertical lines represent the day breaks. These charts are used primarily by day traders and occasionally to refine management in longer-term trades.

Figure 1.4 - Example of a 15-min. Chart

For color charts go to www.traderslibrary.com/TLEcorner



Figure 1.5 - Example of a 5-min. Chart



The Four Styles

The use of these charts makes available four major styles of trading. These four major styles of trading can be grouped into two broad categories. They are known as the wealth building style and income producing style.

The wealth building style includes core trading and swing trading. Core traders primarily use the weekly charts for holding periods ranging from a few weeks to many months. This is the long term style of trading and differs from investing because all trades will be managed and never left to the "buy and hold" mentality. Swing traders will primarily use the daily chart and look for holding times from two to five days, and occasionally out to ten days.

The income producing style of trading includes guerrilla trades and intraday, or micro trades. Guerilla trades refer to a specific set of hit-and-run type tactics that range from swing trading off of the hourly chart to a list of very specific trading tactics that Pristine traders use. Intraday or micro trading uses intraday charts, and traders will be exiting all positions by the end of the day.

If you're going to be trading the markets full time, it is important to understand that you need to be involved in both the wealth building and income producing styles of trading. The reason for this is because when markets are trending up or down and experiencing very strong moves, the vast majority of money is made from longer-term positions and longer-term holds. When markets tend to go sideways for long periods of time, it can become difficult to produce wealth from longer-term trading. Traders who are able to produce income on shorter time periods to supplement the longer-term moves of the market will have an advantage over those who are restricted to one type of trading.

Diversify

Diversifying in stocks is just a way to water down results. You should be diversified only over time, not over a variety of stocks.

I do not subscribe to the notion that you are supposed to be a one-dimensional market player. I believe that you do not step into the circle of professionalism until you become a multi-dimensional market player where you are playing multiple time frames, not necessarily multiple stocks.

I am not a big supporter of diversification of stocks. Diversification was one of those concepts created by academics and utilized by individuals that primarily lacked talent in the market. Diversification is that theory that you throw enough against the wall and hope something is going to stick and make you look good. If you have a high accuracy on a favorite strategy, do you really want to diversify? No, you want to maximize that accuracy by concentrating. What you want to do is diversify over time. I am not a strong believer of diversification of stocks, but I am a very strong believer in diversification over time.

So there are times when your wealth building styles will be performing well and your income producing styles will not. There will be times when your income producing styles, where you take bite-sized consistent gains, will actually be performing extremely well, and your wealth building approach to the market may not be doing as well. Diversifying over time and maximizing your best strategies will maximize your earning potential.

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Self-test Questions

1. Which of the following is not one of the four styles of trading?

a. Core

b. Swing

c. Buy and Hold

d. Micro

2. Which moving averages should be “staples on your longer-term charts”?

a. 5- and 10-period

b. 20- and 40-period

c. 50- and 200-period
d. 100- and 350-period
3. Swing traders spend most of their time looking at which type of chart?
a. Daily
b. Monthly
c. Weekly
d. Intraday
4. When it comes to trading, diversification is:
a. A great way to get to know different stocks.
b. A technique to screen out the worst stocks.
c. The highest risk form of investing.
d. A way of watering down results.
5. Which of the four forms of trading are most helpful for "wealth-building"?
a. Guerilla and Swing
b. Micro and Guerilla
c. Core and Swing.
d. Core and Micro
For answers, go to www.traderslibrary.com/TLEcorner
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2

The Tools for Options Trading

In order to trade options there are a few basic necessities that we will need. Since we need to focus on the underlying security, or stock, we need all the tools that the stock trader needs. Those basic tools will include charts in various time frames, displayed in Japanese candlestick form. They will need to have color-coded volume and the 20- and 40-period simple moving averages. We want to have a couple of technical analysis tools known as Bollinger Bands and the Commodity Channel Index, otherwise known as the CCI. That will cover the analysis of the underlying stock. We will also need to have an execution system that handles option trading on a direct access platform, and you may also want to have access to an option analytics program. Let's talk about each one of these in more detail.

Charting Tools

First of all, notice on all of the charts I have shown you, Japanese candlesticks are used. A price chart is not a price chart to me unless it is displayed in Japanese candlestick form. Technically, a Japanese candlestick does not display any more information than a regular bar chart. They both

display the opening, closing, high, and low of that particular period. The difference is that the Japanese candlesticks display the information in a way that is much easier to see visually. The area between the high low is colored either red (black) or green (white) depending upon whether the stock closed above or below its opening price. This places the emphasis on who won the battle each and every time period.

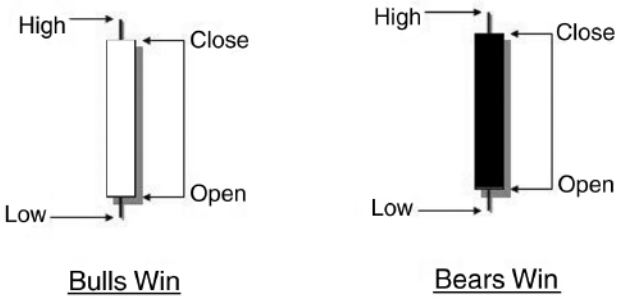
Charts can be displayed in a line form, a bar form, or several other forms. The Japanese candlestick shows the information better visually than other methods.

A good example of this difference in focus was seen on the day Microsoft gapped up five dollars. From the moment the stock opened, it began selling off and continued to drop steadily throughout the day until it had lost three and a half dollars of the morning gap. Late in the afternoon the star of one of our favorite cable shows was giving her afternoon run-down and reported in an elated voice that, “traders were buying up Microsoft all day long as the stock was trading one and a half dollars higher.” While it is true that the stock was still up one and a half dollars, the true sentiment of the stock was very bearish as it had lost almost all of its opening gain.

This also allows for much more efficient scanning when looking for many of these patterns. Take a look at the examples of these two Japanese candlesticks in Figure 2.1.

Figure 2.1 - Candlestick Examples

For color charts go to www.traderslibrary.com/TLEcorner

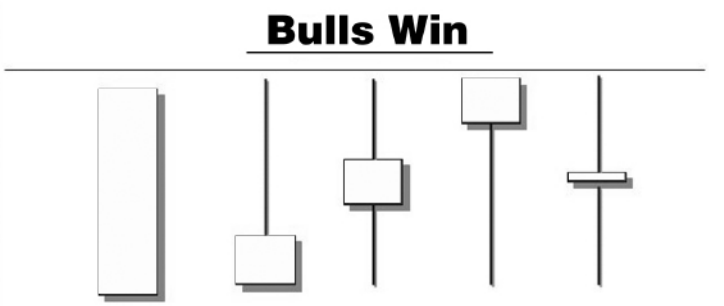


Their black and white boxes represent the open and closing prices for that time. When the stock closes above its opening price, the bulls have won that session, and the box is colored white. This is known as the body of the candlestick. The lines extending from the top and bottom of the body represent the high and low for that time period. These are called wicks, tails, or shadows. The second candle is black because the bears won the battle for this particular period of time. They were able to close the stock at the price at which it opened.

Figure 2.2 shows examples of five different bullish candles. They are all considered bullish because the body is white as the bulls closed the price above the opening price.

Figure 2.2 - Bullish Candles

For color charts go to www.traderslibrary.com/TLEcorner



It is important to understand that while all of these candles are white, there is a great degree of difference in the bullishness of the candles. When the opening and closing price are very close together, the significance of black or white becomes less important. In these cases, the size and position of the tail becomes as important as the color of the candle. In the examples above, the first and fourth candles are very bullish not simply because of their white bars but because they closed at the high of the days range. While the second candle is white, it can actually be considered somewhat of a bearish candle. This is because the white body is very small, and there is a huge topping tail sitting on top of the body. This means that at one time, the bulls had run the stock all the way to the high of the day, as shown by the top of that topping tail. However, by the end of the day the bears had run the stock down to near the low of the day. There is some truth in the old adage that novices open the market and professionals close the market.

Topping tails and bottoming tails are the graffiti marks of big sellers and buyers and should be respected.

The next tool that should be on all of your charts is color-coded volume bars. The understanding of volume in conjunction with price is critical to your success as a trader. Traders who understand these two can make a living in the markets without the need of anything else. Now despite what I just said, the concept of volume is often misunderstood and overused. There are literally entire books written on volume, but when it comes down to it, volume really serves two main purposes. Increases in volume can help identify the beginning of new moves and can help identify the ending of old moves.

Technical Tools

Other tools we will need are the 20- and 40-period moving averages. These are used to help determine the quality of the trend that the stock is in. These moving averages are simple moving averages because we use them mainly to determine the quality of a trend, and nothing has proven to be superior. The 20-period moving average should be a staple on all your charts. I do not consider a chart to be a chart unless it has a 20-period simple moving average on it. The 40-period simple moving average used in conjunction with the 20 can help give us a better view of the trend especially when these two moving averages become parallel to each other like a pair of railroad tracks.

Next let's look at a technical indicator known as the CCI, which is an abbreviation for the Commodity Channel Index. I am not a big believer in the use, or overuse, of technical indicators. There are charting packages available today that literally contain hundreds of technical indicators. Just the

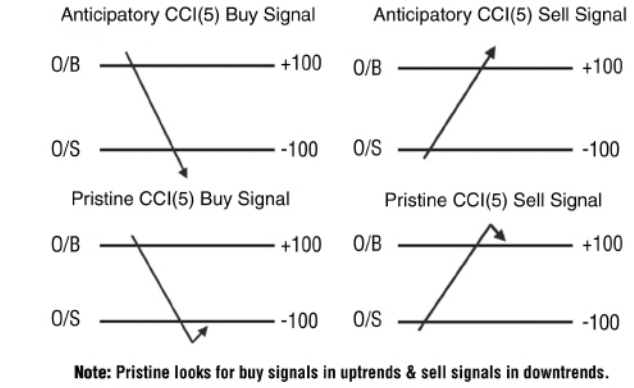
simple fact that there are hundreds available should tell you the value of any one of them. They are often very popular with novice traders because they tend to represent something newcomers to the market like to see. Many new traders are often searching for the Holy Grail of trading. They're looking for that one market guru or that one indicator that will deliver consistent profits time and time again. Something you need to understand about technical indicators is that they all have one thing in common. They are all taking the past price and volume data on your charts and creating a new line from old data. They have a value in many instances but should never be used to make buy and sell decisions. Traders often find one particular indicator that works on a certain stock for a certain period of time and feel they have found the Holy Grail to trading. However, they soon discover that the indicator needs to be tweaked and adjusted and eventually discarded. For making buy and sell decisions there is nothing superior to the price pattern itself.

The danger is in feeling that any single indicator will give you consistent profits. I have seen traders use so many indicators on their charts that it is difficult to even see the price bars through the mess of spaghetti. Some traders find that one or two particular indicators help them in the process of making a decision and that is perfectly fine. Moving averages are actually technical indicators. While they are the simplest of the indicators, they do present us with valuable information. But I do not use a moving average to determine my entry. I use them as a guide to help determine the quality of the trend. The proper use of technical indicators is to use them as a filter. By that I mean once your decision is made to enter a position, you may choose not to because the indicator has not "approved" the trade.

Technical indicators should not be the basis for buy and sell decisions.

The indicator I like to use on daily charts is the 5-period CCI. In practice I typically overlay the CCI over my volume on the bottom panel of the chart. Figure 2.3 shows what the CCI looks like all by itself and how we use it.

Figure 2.3 - CCI-5



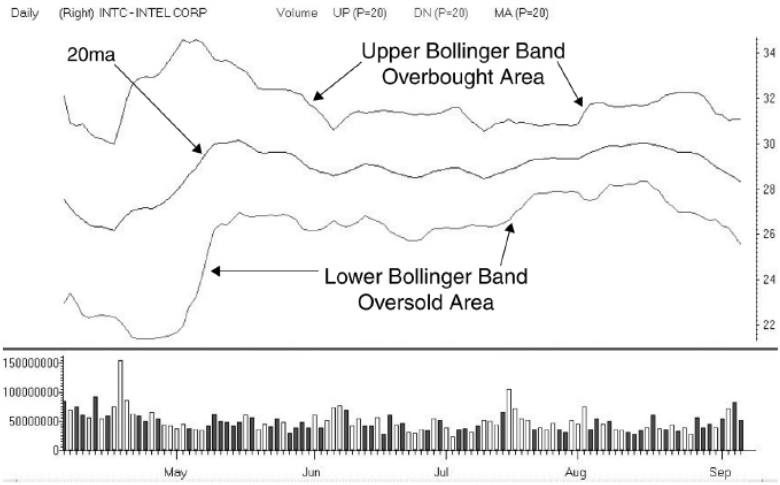
If we are waiting to buy a stock, we want the CCI to drop below -100. Once it does that, its job is done as it has now "approved" the trade. It does not need to be below -100 at the time you take the trade nor does it need to go above -100 to enter the trade. Notice that while we call this an anticipatory buy setup, it should never be considered a buy on its own. It is only a filter to discard the trade if the CCI does not do what you need it to do.

Let's review Bollinger Bands. Credit John Bollinger for creating such a phenomenal tool, especially as it relates to

options trading. I want standard Bollinger Bands with the parameters set to 2 standard deviations away and 20 periods (Figure 2.4).

Figure 2.4 - Bollinger Bands

For color charts go to www.traderslibrary.com/TLEcorner



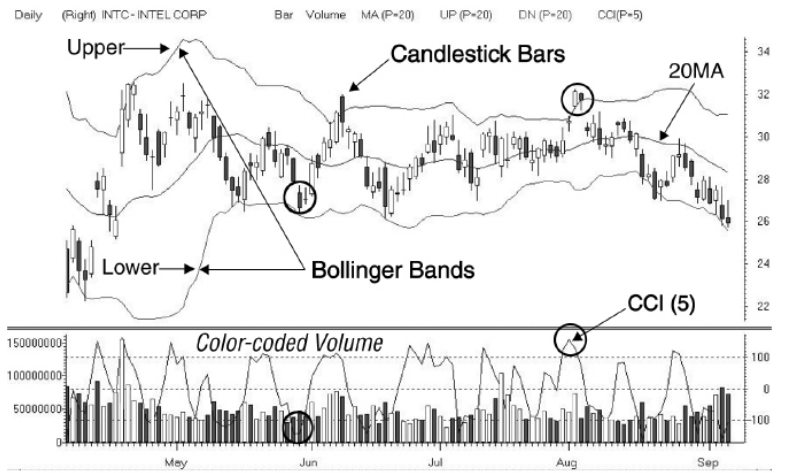
I want to make sure that my charts and technical tools are kept as clean and simple as possible. Remember the price pattern itself is always the most important tool you have to work with. You'll see in the upcoming strategies that Bollinger Bands have a specific use in options trading.

Figure 2.5 is an example of our charting tools. We have a candlestick chart on a daily chart, and we have volume color-coded as well. You can clearly see the effect of the Bollinger Bands. The middle line is the 20-period moving

average. You have the upper Bollinger Band, 2 standard deviations away from the 20-period moving average, and the lower Bollinger Band 2 standard deviations away from the 20-period moving average. This is all very easy to do. Virtually every single charting package on the planet offers Bollinger Bands. What Bollinger Bands help us do is attempt to measure, in an objective way, how overbought or oversold a stock is. It tries to visually point out when a stock has experienced a great degree of volatility and should run out of steam in that direction.

Figure 2.5 - Options Technical Tools

For color charts go to www.traderslibrary.com/TLEcorner



Bollinger Bands help to objectively show overbought and oversold conditions through the use of standard deviations.

Next on this chart we see the example of the Commodity Channel Index I described earlier. This is a very unique indicator. I will not look at a daily or a weekly chart without the 5-period CCI on the chart. There is something you must keep in mind about using a CCI, or any technical indicator for that matter. You will never make a decision because of a squiggly line doing something on your chart. You only make the decision based on price. The squiggly line confirms what you have already decided to do. It "allows" the trade or filters it out. Remember that. You never make a decision because "this line" crosses "that line." You buy based on price. This confirms what you have already decided to do. It's a confirming indicator. Remember that the CCI is a 5-period CCI, and I like to overlay the CCI on top of my volume so that it doesn't take a lot of room away from my analysis with the stock. I also like it because I can see various volume climaxes with overbought or oversold CCI readings, which become very clear.

Take a look at the chart of this stock (Figure 2.5). I want to see some of the moments of opportunity. We will be talking more about some of these but notice a couple now. Note where the price bars puncture the upper Bollinger Band combined with a CCI overbought reading. Notice how this creates an opportunity every time. Often a drop all the way back to the lower Bollinger Band. Then, notice what happens when we break the lower Bollinger Band combined with a CCI below -100. Especially if that happens near a prior low. It creates an opportunity to buy the stock or to actually step up the leverage through an option strategy.

Remember that price always comes first. Technical indicators serve the purpose of filtering out or negating trades and should never be used as an actual buy or sell signal.

Always look for multiple things to align in the same direction. When the CCI and Bollinger Band are both showing overbought or oversold conditions, there is usually an opportunity there.

Notice the rally outside of the upper Bollinger Band. It has come up to revisit a prior area of stark terror. Do you realize how many people bought the top tick on this particular day? And while the stock is going down, on the first day, they have a headache. On the second day, they have a migraine. On the third day, they're crying. On the fourth day, they cannot tell their spouse. On the following day, some people may be selling, but some actually play ostrich long enough to get their money back. And when it comes back to the origin of prior trouble, they want to sell. So we puncture outside the Bollinger Band, plus we revisit a prior troublesome area, plus we have an overbought CCI signal. A stock player is thinking, next direction is to the downside. The options player is thinking, this is time to accelerate my gain. I'm either going to short the stock, buy the put, or sell the calls. Or maybe I will do something a little fancier like a spread strategy or even a straddle.

Options Tools

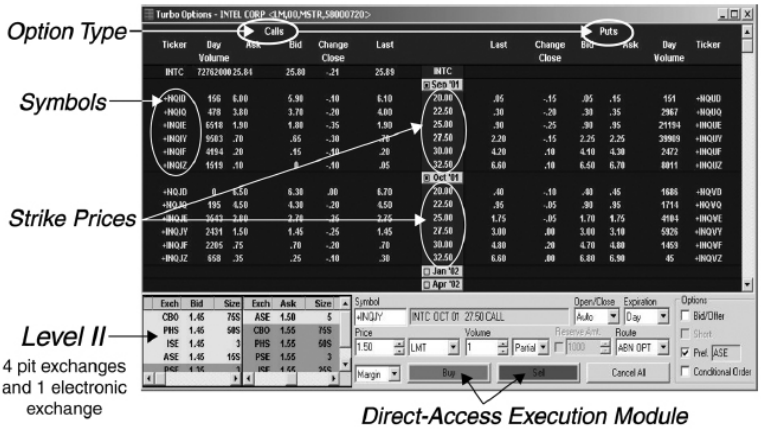
There is one other set of tools. I have options tools. First all I want direct access options trading. While direct access has been available for stocks for quite some time now, you don't

have to go back very far to find a time where direct access for options was fairly rare. By direct access of course, I mean the ability to go into the market on a level two screen to bid or offer or purchase directly the options you desire. Many brokers offer this for both stocks and options in today's market.

In order to purchase or sell options, I need access to the quotes. Just like I can receive stock prices in various forms, I can also receive option prices for every level through my charting platform (Figure 2.6).

Figure 2.6 - Options Execution Tools

For color charts go to www.traderslibrary.com/TLEcorner



The last options tool I will be discussing is a kind of option analytics program. This is something I would consider to be

optional because I believe in finding the proper stock pattern first, then applying the proper option technique. Analytical programs are meant to search out various option prices per your request. For example, they may search out the highest call value time premiums of all the stocks in its universe. This may be helpful for someone looking to sell calls to earn option premium. I am not a strong believer in relying on options analytics because your decision-making should come from your ability to read the stock, not on your ability to read numbers or crunch complex mathematical formulas.

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Self-test Questions

1. Which is one of the main purposes of volume as a technical indicator?

a. Increases in volume can help reveal the beginning of new moves.

b. Decreases in volume can help reveal the end of old moves.

c. Volume shows who won or lost the battle between the bulls and the bears.

d. Volume shows when a market is overbought or oversold.

2. Japanese candlestick charts are:

a. No longer used by serious traders.

b. The best way to read a price chart.

c. Also known as “bar charts.”

d. Too complex for most traders to use without a professional.

3. Bollinger Bands are:

a. A way to diversify your stock portfolio.

b. A technical indicator designed to measure trends.

c. A technical indicator that measures how overbought or oversold a stock is.

d. Usually based on four standard deviations from price.

4. When it comes to using technical indicators:

a. It is better to get multiple signs in the same direction.
b. It is better to get a variety of different signals to choose from.
c. It is better to let the indicators, not the price itself, be your guide.
d. Try to avoid using them as much as possible.
5. If you are using the CCI as a technical indicator, then you would look to buy:
a. When the CCI climbs above +100.
b. When the CCI goes flat.
c. When the CCI crosses over the lower Bollinger Band.
d. When the CCI falls below -100.
For answers, go to www.traderslibrary.com/TLEcorner
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3

The Pristine Method

Who Won the Battle?

It is time for a little introduction to the Pristine Method™. Now we're going to delve into several important and exciting topics. Let's start off by learning how to determine who won the battle, a very necessary step. If you do not know how to step into the market and quickly determine who is in control of the stock, then you are really operating in the markets with a handicap.

We already began this discussion in the last chapter. Refer back to the beginning of the chapter where we discussed the introduction to Japanese candlesticks. There we learned the emphasis is placed on the color of the bar, either red (black) or green (white), depending upon whether the bulls or bears won the battle for that particular bar. Well, let's take it to the next step.

Japanese candlesticks answer the question of who won the battle for that particular time period.

The next step in determining who won the war, not just a battle, is to count the white bars and to count the black bars. Then note the size of the white bars and the size of the black

bars. There is no way to hide what is happening with a stock when you look at a chart. When the majority of the bars are white, and the white bars are the largest of the bars, then on the chart, the bulls are dominating the stock.

I can eliminate 85 to 90 percent of your losses as a trader inside of five minutes. I do it all the time. People come to me from all over the world in any one of our offices, and we run them through a program. The first thing that we teach a new trader is that they will never, ever trade a stock to the long side that is not being won by the bulls. Eighty-five to ninety percent of their losses will be gone just like that. Then of course we tell them that they will never short a stock that is not being dominated and controlled by the sellers. This is not the Bible. David beat Goliath in the Bible. In the market, Goliath always wins. We're going to bet with the power.

When the majority of battles are being won by one side, that side is winning the war. A white or green candle means the bulls won that battle. Mostly green or white candles and very few red or black candles mean the bulls are winning the war.

Count Your Way to Profits

The next concept is a simple but interesting one. It is a fact that forms the crux behind the whole Pristine philosophy. Simply stated it is this; the bulls or bears cannot consistently win more than five battles in a row. Fourteen years of market study, play, winning, losing, and trial and error has brought me to this one simple fact. Each side typically surrenders to the other after three to five battles. I want you to drill this in

your minds. This is probably the most important sentence in the entire book. Bulls and bears cannot consistently win more than five battles in a row. Each side typically surrenders to the other after three to five battles won. This is true and applies to any timeframe.

However, if the bulls or bears win significantly more than five, because that can happen and it does, a catastrophic reversal will be the price paid for such an abnormal streak. Eighty-five to ninety percent of all moves stop after three to five consecutive bars in one color. One white bar, two white bars, three white bars, and you are close to the end. Four white bars, you're really close to the end. Five white bars, start rubbing your hands and get ready to short or play a bear's strategy. The same is true with three black bars to the downside.

Just the simple yet powerful understanding that stocks rarely move more than three to five bars consecutively is known as "counting your way to profits."

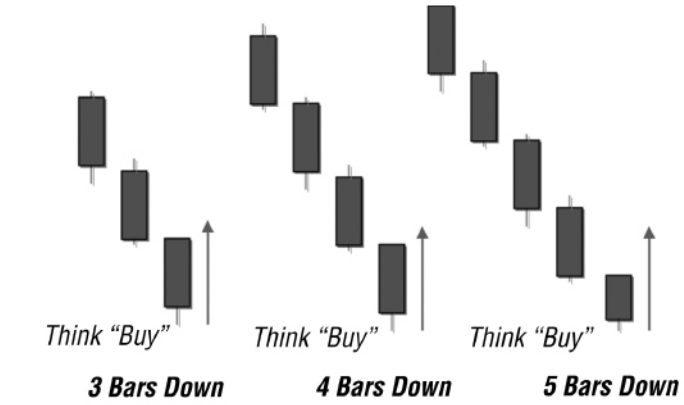
When to be a Bull

If you follow the thinking from the previous section, that it is difficult for any stock to fall more than three to five bars, it leads us to a very simple conclusion of when to be bullish or bearish. In Figure 3.1 we have three consecutive black bars (or days depending on the timeframe) where the bears have just dominated the action. I want you to be thinking buy. Notice a very important distinction, you do not buy this, you should just be thinking about buying. In general it is too late;

the bears already had their day. The next move will be up the proper entry if there is going to be one.

Figure 3.1 - When to be a Bull

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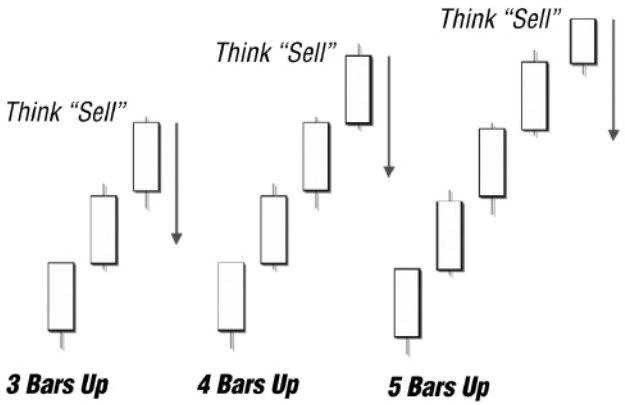
I want you to put yourself into a buying mindset. It does not mean act. I want you to really think buy. As we develop more black bars, the concept becomes even truer. As we get to four and five black bars we really, really are thinking about buying. Whether or not we actually buy will depend on a lot of other things. It will depend in part on the bigger timeframe, as well as all the other requirements of our strategy. The point is here that we will filter out any discussion about shorting a pattern that looks like this.

When to be a Bear

If you have a scenario where the bulls have won three or more consecutive bars (or days depending on your timeframe), I want you to think sell (Figure 3.2). If there are four or five consecutive white bars, I want you to think sell in a fairly big way.

Figure 3.2 - When to be a Bear

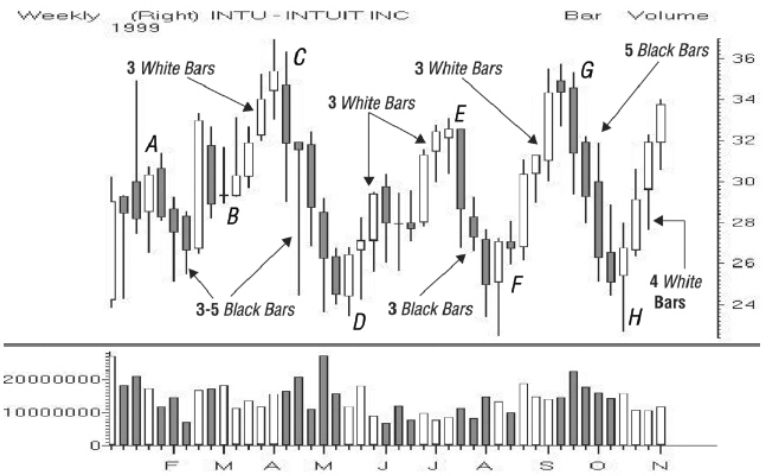
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The bulls have just run five consecutive marathons in a row, and they are tired. The bullets that they were using are just about gone; the clip is near empty. You need to be lingering in the woods just waiting for the signs that say that the bulls have given up. We will be talking about just what those signs are.

Now this seems very simple, and it is. You bet with the dominant force in the market. That is the number one reason most people lose money. They bet against the power. How many people do you find trying to buy a stock because it is cheap now? Cheap stocks usually get cheaper. Take a look at the the process of counting your way to profit in Figure 3.3.

Figure 3.3 - Weekly- Count Your Way to Profits



Let's look at this weekly chart. We start off on the left-hand side of the chart by the letter A with three black bars. That is quickly reversed by that long white bar. Shortly after, we find we have four white bars in row at B. The bulls are tired and it's time for them to rest. We get five black bars in row at C. That is immediately reversed with a three bar rally at D. Notice this time that after the rally at D, we go sideways for three bars but cannot reverse. This is within the concept we are discussing. Remember there are three types of trends.

Stocks can go up, they can go down, and they can go sideways. The rally was ended with a three bar sideways move. After that, we get three more bars to the upside. Next we see a three bar decline at E, we reverse, and have a three bar rally at F. The three bar rally was almost a five bar rally and goes all the way to the prior high on the chart just before C. That exceptional rally paid a price as we see a five bar decline at G, and then we end this chart with a four bar rally at H.

Naturally this chart shows this concept nearly perfectly. However, I challenge you to go out and randomly select charts of stocks on your own to test this concept. Remember the rallies must be three to five and must be consecutive bars. Also, remember you will see that a pattern is beginning to emerge. As you look at this chart, you can see that it is fairly neutral in terms of the total white bars versus total black bars. It is also fairly neutral in terms of the size of the white bars verses the size the black bars. This is a sideways trending chart, and it does a very good job of counting profits both up and down.

When you find a chart where the white bars are dominating the black bars both in size and number, you'll probably notice the other changes taking place when counting profits. When you are in a strong uptrend, it is more likely that three white bars may be followed by three sideways bars. Or the black bars may be small as compared to the white bars. It is also more likely that you'll be seeing five white bars in row more often than you see three. This is all indicative of the fact that you are in an uptrend.

Now, understand that I have not talked about options in great length yet. Why? Again I want to emphasize that we need to understand the movement of the underlying stock first. Find your point in the market. Find a three to five consecutive white bar run up in a row, with big volume, hitting the upper Bollinger Band, and a CCI that is above plus 100. I will tell you that 85 percent of the time, 7 to 8 times out of the 10, the next direction is down. And if the next direction is down, we then turn to one of many bearish strategies that range from shorting the stock itself to a variety of option combinations to minimize risk and maximize our gain for each individual strategy.

Pristine Combinations

Pristine combinations are extremely important. I told you I am a big believer in combinations. I like having confirmation from different events that occur over and over.

Now that you know that three to five bars consecutively in one direction, controlled by one side, is an extended stock, let's add a few other things that tell us now's the time to strike. You see, I did not tell you that after three bars up you sell, or after five black bars down, you buy. That would be irresponsible. But I did say, think about buying. Get ready to buy. Now let's take a look at what we need to actually buy or sell.

After three or four or five bars in one direction, we're now on the starting line waiting for the "GO" signal. Here are some of the signals we look for.

Topping and Bottoming Tails

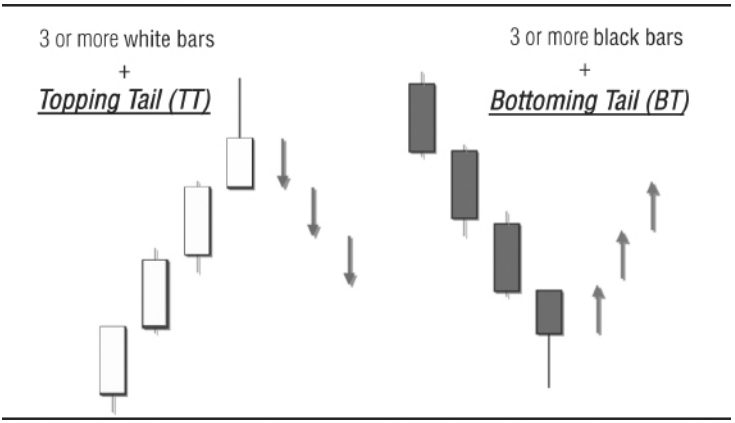
The first signal, and perhaps most important in my book, are topping tails and bottoming tails, also known as bull and bear tails. We're going to get into some really interesting things now because I'm going to add some phenomenal things to the three to five bar concept.

I have written several articles on bottoming tails and topping tails. It is an extremely important event. I have some traders who make their entire living off of this one concept. The concept of finding bottoming tails and topping tails and going the other way is a very powerful concept. Let's talk about it.

Let's take a look at Figure 3.4. Four consecutive up bars and look what happens on the last bar. I want you to note that this is what I call a topping tail. It is a relatively long tail pointing to the top after multiple white bars. To qualify as a topping tail, at least half the bar must be tail; half or less body. The second very important requirement; it must follow at least three white bars. It is not a topping tail if there are not three or more white bars preceding it. A topping tail indicates where large amounts of selling have occurred. Topping tails indicate major institutional sellers trying to sell quietly but the astute chartist recognizes their action. This stock is about to do what? Drop. We already know it is about to drop because it is four white bars in a row. But four white bars plus a topping tail? You are rubbing your hands together getting ready.

Figure 3.4 - Bull and Bear Tails

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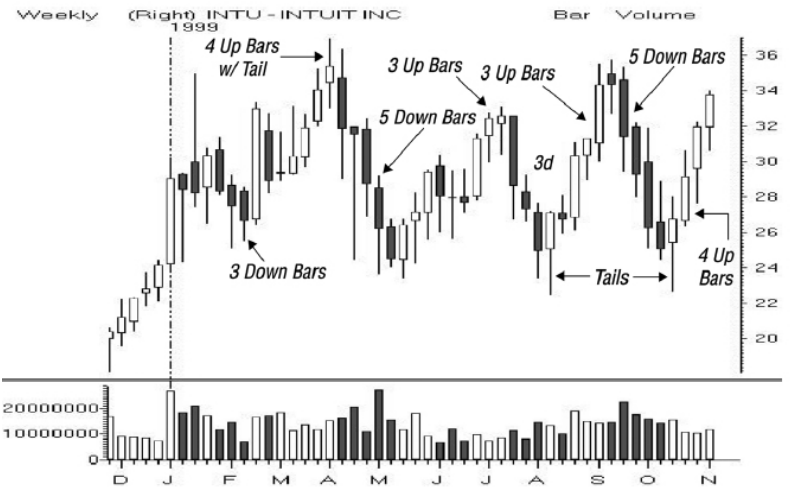
Bottoming tails are the graffiti marks of big buyers, and they should be respected.

Look at the right side of Figure 3.4. Four consecutive black bars plus a bottoming tail. So I know just by virtue of having four black bars in a row that I'm ready to rally but the bottoming tail tells me I'm ready to rally right now. Multiple black bars in a row, bottoming tail, rally. Multiple white bars in a row, topping tail, time to fall.

While bottoming tails and topping tails are excellent signs of reversal, they have to be played with a wider stop as we will find out later.

Take a look at Figure 3.5, which is a weekly chart showing the power of bottoming tails (BTs).

Figure 3.5 - Bottoming and Topping Tails



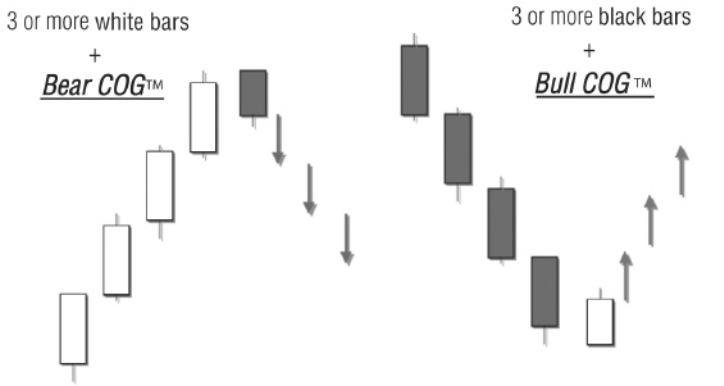
Notice the power. Even though the stock was often trending down, every bottoming tail made a sharp reversal. Not always permanent because for part of this chart the stock was falling. All the bottoming tails on this chart are marked. Remember, they must follow three or more white bars. They all produced immediate results. Check this out on your own charts. Start looking for these things.

Changing of the Guard Plays

Let's talk about the next possible signal. It is called the bullish and bearish changing of the guard (Figure 3.6). It's a name that I've given to a frequently occurring concept in the market.

Figure 3.6 - Bull and Bear COG

For color charts go to www.traderslibrary.com/TLEcorner



Four consecutive white bars in a row and look what happens. A black bar happens. This is an indication that the balance of power has shifted from the buyers to the sellers. After four white bars in a row in this example, (it must be three or more), a black bar forms, which tells you that the sellers have regained control of the market. They are now in control of the war, and you should be looking for multiple black bars to follow. This is called a bearish changing of the guard.

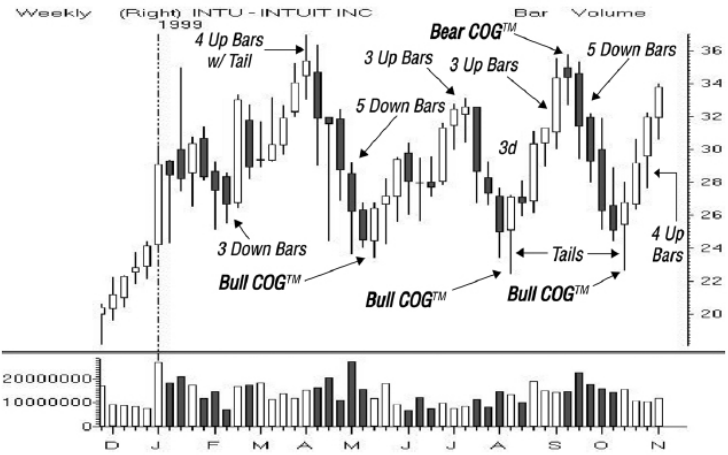
Look at the right side for the bullish changing of the guard. We have four consecutive black bars followed by a white bar. This changing of guard at the door of your money has happened. The guard at the door was a seller, but he's given up and handed the controls to the buyers here. Now we're looking for multiple white bars to follow.

Look at some Changing of the Guard (COG) plays. An example is shown in Figure 3.7. Here's a weekly chart that

has all of the bullish and bearish changing of the guards marked. Remember, to be a changing of the guard, it must follow three or more of the opposite color. There are three bullish COGs and one bearish COG. All do their job of halting the stock and reversing its direction for several bars.

Figure 3.7 - Bull and Bear Changing of the Guards

For color charts go to www.traderslibrary.com/TLEcorner



A changing of the guard means the momentum has already shifted. If the bulls were in charge, they are tired, and the bears have just taken over.

It is now time to take a look at this chart and combine the three to five black or white bars with what we know about topping/bottoming tails and bullish/bearish changing of the guards. Start on the left of Figure 3.7 with "three black bars." They come in a row and the last one has a bottoming tail. This

propels the stock like a rocket. Then we have four up bars in a row plus a topping tail. What does that lead to? Five down bars in a row, of course. Now look at this. There are five black bars in a row plus a bullish changing of the guard. The guard flipped. It just went from black to white after five black in a row. That's a powerful sign. We rally three bars, and then a bearish changing of the guard stalls the stock for three bars. Three more white bars, and we reverse to the downside again. Next comes three down bars in a row plus a bullish changing of the guard plus bottoming tail. What more can we ask for? Three up bars in a row and another bearish changing of the guard. Then five bars in a row down, a bullish changing of the guard plus bottoming tail—step on board and get ready for the ride.

These combinations happen every single day in the market and all you have to do is know the combinations and just sit and wait for them to happen. That is the number one problem of market players. They feel they must be active at all times, but no, you find several events that happen over and over again, and all you do is play the waiting game and the number game over and over and over again.

Time to Strike

This next section will be key to your trading regardless of what style or type of trading you do. I have a fairly short time to give you the tools needed to determine when a stock is likely to turn and change directions. This is known as the setup. The next step we need to discuss is exactly when to strike. While all of these clues give us an indication that we

are ready to change directions, we need to find a moment in time when we will execute our plan.

There are in fact four items that must be planned out for every single trade. The first one is called the entry. Once we have determined our entry, we need to find a spot where we will draw a line in the sand in case we're wrong. The second item is known as a stop loss point. The number one reason that traders fail to make it is because they do not have or honor their stop-loss points. Despite all of the information we will use to find turning points in stocks, it sometimes will not work. You cannot throw away the profit of many good trades by staying with a bad trade that has not worked.

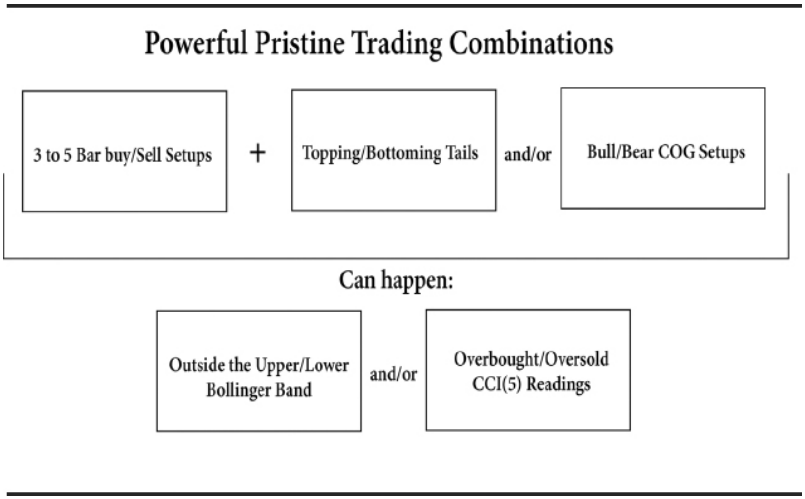
The third item we need for every play is known as the target. There may be more than one target, though we need to identify areas in which we will exit all or part of the position and consider it a success. Last, we need a way to manage the trade during the time it is open. Sometimes the events may happen that will make it desirable to preserve profits along the way by bringing the stop in tighter.

There are four necessary steps to every play you consider entering. You must identify the entry point, the stop loss point, the target area, and the way to manage the trade.

I want you to remember that we're going through many highlights of technical analysis in a very short time. There is much more to be said on each of these topics. However, for the purposes of this book, we just want to arrive at a point where we have identified possible turning points in stocks so that we can use options to best capture the potential gain.

In order for us to find an entry point, we're going to keep things fairly simple. Once all of our criteria are in place, we're going to wait for the final sign of reversal. That is where the price actually trades beyond the high or low of the last bar going in our new direction. Take a look at the simple diagram in Figure 3.8.

Figure 3.8 - Pristine Trading Summary



Imagine that you have a four bar drop that fills the requirements. It is three to five bars in one direction. Then, imagine that the actual chart shows a CCI reading of -100 or less and we are touching the lower Bollinger Band. We may have a bottoming tail or changing of the guard as well. Our entry is going to be when the price bar trades above the high of the prior bar, as you see in this example. Naturally this will all be reversed for a short position. If you were buying the stocks, you buy over that prior bar's high. In the next chapter we will discuss option positions to play this out.

Our line in the sand, or the stop loss, will be if the stock trades under that last black bar. At that point in time, we will concede that we were wrong about the stock reversing directions, take our losses, and move on. As for target areas we will be aiming for the first area of significant resistance. On this chart that would be the high of those four black bars. As for management of this position, that will vary some depending upon the option strategy we use. Many option strategies are meant to be left alone, some require more management. We'll discuss this in more detail as we get into the option plays themselves.

Summary

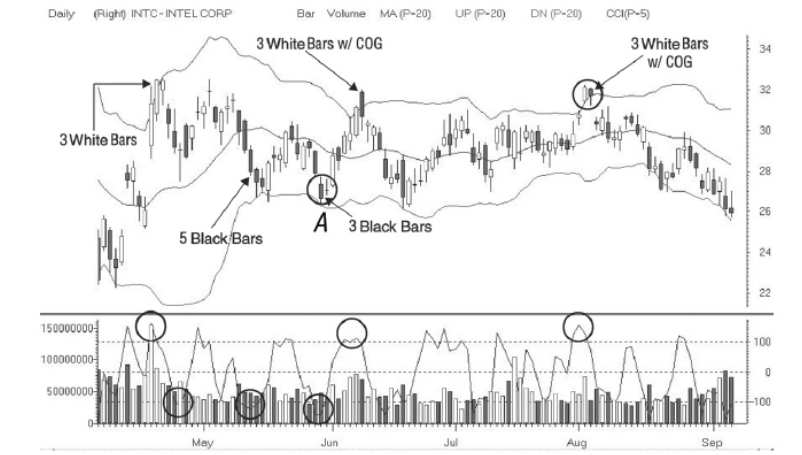
If this book were to end here, those of you who have basic option strategies already under your belt would know how to play them more accurately as of this moment. You know how to play stocks more accurately because you have learned the basics of what makes stocks move.

We have the three to five bar concept. Then we have bottoming and topping tails. We also learned what we call a bullish or bearish changing of the guard. These are three things that tell us the next likely move of the stock. Now, if I had a CCI reading greater than 100 or less than -100, we should be starting to get excited about the odds of that stock turning around. Finally, if I am touching the Bollinger Bands there, I would have everything pointing in one direction, the new direction.

Look at this at work in Figure 3.9.

Figure 3.9 - Putting it all Together

For color charts go to www.traderslibrary.com/TLEcorner



You can see that with all our criteria in place, virtually every time we have a multiple bar rally that approaches a Bollinger Band with the CCI agreeing, the stock reverses. Though we have not yet discussed the option strategies, we will be entering them when a reversal happens as is signified by the prior bar being violated. For example, take a look at the play by letter A. We have a three black bar drop that is touching the lower Bollinger Band. The CCI has dropped below -100. We would be entering our play as that white bar trades above the very thin bar that looks like a cross. We call that thin bar a "Doji." We would be looking to take profits as the stock traded above the prior highs at 30, or into the prior highs at the 32 dollar area.

Now we have an excellent understanding of when to play the underlying security. Let's move on to the option strategies that make this work.

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Self-test Questions

1. The benefit of Japanese candlesticks is that they:

a. Show who is winning between the bulls and the bears.

b. Show whether or not volume is overbought or oversold.

c. Show which timeframe is best for trading.

d. Show what will happen to prices before it actually happens.

2. After a stock has fallen for three, four, or five days in a row, traders:

a. Begin to panic.

b. Begin to "think buy."

c. Begin to "think sell."

d. Wait, because three, four or five days mean little in the long-term.

3. "Topping and bottoming tails" refers to:

a. The first and last trade of the day.

b. Volume that is either very large or very small.

c. When a stock shows signs that it has moved too far in one direction.

d. The best way to take profits from a winning or losing position.

4. "Changing of the guard" refers to:

a. Switching from one timeframe to another.

b. Allowing one technical indicator to overrule another technical indicator.

c. Moving your stop level to breakeven.

d. When a stock shows signs that it is ready to move in a another direction.

5. The number one reason why traders fail is:

a. Poor sportsmanship.
b. Failure to honor their stop loss levels.
c. Poor math skills.
d. Failure to follow financial news on a regular basis.
For answers, go to www.traderslibrary.com/TLEcorner
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4

Pristine Options

We've spent the first half of this book getting to the point where we can now discuss option strategies to use. This was necessary because option techniques do not exist in a vacuum. While different strategies will have varying degrees in which they rely on the underlying security, all of them require knowledge of the price pattern.

Options Defined

So what is an option? Let's say I want to buy a Ferrari 360 Modena Spider. You find a dealer with the car in stock. You wire transfer $275,000. The dealer, after receiving the wire, delivers the car to you. You've just traded a "commodity." That is a simple concept, one we are all familiar with.

Now, let's say you want this Ferrari, but you prefer to purchase it four weeks from now, because you're in store for a huge bonus, or you've got this large options trade on that is going to expire. The reason doesn't matter, the point is that you are going to collect the money four weeks from now. So what do you do?

You enter into an agreement with the dealer to purchase the car for $275,000 four weeks from now. You just traded a futures contract.

Now let's say you like this car, but you actually ask the dealer to put it aside for you because you think you can get it cheaper elsewhere, potentially. But the dealer says that if he puts the car on hold, it will deny him from selling the car.

So you and the dealer agree, that for a nonrefundable fee of $2,000, he will hold the car for two weeks, and you, during that two week period, can purchase the car anytime for $275,000 less your $2,000. You are under no obligation to buy it, but if you don't, you sacrifice your $2,000. You've just traded an options contract.

The Advantages of Options

As it applies to options on stocks, let's talk about the advantages of trading options. First of all, there's limited risk. This is one of the reasons why I like trading options and why once our traders learn the Pristine Method™ of predicting price movement, we immediately move them into options. If a trader doesn't play correctly, he can't lose like he can with stocks. If an option contract costs only $400, then that is the maximum the trader can lose—$400. If a put costs $1,600, you can only lose $1,600 when you're buying the option. This is what we mean by limited risk. In a sense, it is an automatic stop feature. We know most people are not disciplined enough to apply their stops. They draw a line in the sand, and

when the stock is coming down, they erase the line and draw it lower.

Next, the risks are calculable risks. This simply means that not only is a risk limited, but also I can decide exactly how much I want to risk ahead of time. When you buy a put or call for a certain amount of money, it is exactly the amount of money you are risking. That's not necessarily the case with just stocks.

Options Advantages

- Limited Risk
- Calculable Risk
- Higher Levels of Leverage
- Higher Potential ROI
- Tri-directional vs. Bi-directional
- Versatile Strategies
- No Up-tick Rule Required
- Conservative or Speculative
- Less Accuracy on Entries Needed
- Guaranteed by Options Clearing Corporation

There are higher levels of leverage, which means that if you are accurate with predicting a stock's move over the next two, five, ten days, why not play options. Why not leverage that talent and make more through options. Options give us the ability to do that. Another way of saying this is that options provide a higher potential return on equity.

The interesting thing about options is that they are tri-directional items versus a stock which is a bi-directional item. You can make money three ways with an option. You can only make money two ways in stocks. If you buy stock at

$40, and it stays at $40 for 3 years, you have not made any money. But you can sell an option and collect the premium (price of the option), and if the stock does nothing, you win. So options are tri-directional. There is a third direction from which you can profit.

There are versatile strategies. With stocks, you pretty much buy or sell them. With options, you have many other choices. You can limit your risk and adjust your rewards almost at will by selecting various option strategies.

There is no up-tick rule and no borrowing requirements to go short. Let's review that for a second to make sure we all understand what that means. When you short a stock, it means that you are literally selling it before you buy it because you want to make money from the stock decreasing in price. There are two disadvantages of selling stock short as compared to buying a stock long. The first one is that there has been a rule in effect called the up-tick rule. It was created by the SEC under the theory that it would prevent fast falling markets. It means that if you want to enter a new short position, the stock must trade up toward you and not be falling away from you. The rule gets a little more complicated; suffice to say, it makes it difficult to get short at times. At the time of this writing, the up-tick rule has been all but abolished in most markets. However, the other requirement to short a stock is that your broker must have it available to borrow. In order to short a stock, you literally borrow the stock from your broker and then sell it as your first transaction. It is the rule that the stock must actually be physically available to borrow. Sometimes brokers are out of shares and if that is the case, you cannot short the stock. You

may have run into this problem with your broker; it is not uncommon.

The point is that these problems are avoided through the use of options. By buying a deep in the money put, you may have the same effect as being short the stock except you do not have to worry about borrowing the stock or the up-tick rule. As another benefit, the transaction may also require less margin.

Another advantage is that you have great control and variety in being conservative or speculative. You can be speculative where your risk is unlimited, or you can be conservative where you know precisely that you are going to make this money and only this amount of money, no doubt about it. Did you realize that selling naked puts are safer than buying stocks? We will discuss that briefly.

There is less accuracy on entries needed. This is a very interesting thing. Most people have very bad entries. Entry is about 80-85 percent of the whole trading game. Get the entry right, and you've got 85 percent of the trading game pretty much down pat. Most people have a sloppy entry game. With options you don't have to be as precise as trading stocks.

Of Course, There are Disadvantages

If you are a buyer of an option you need to understand that an option is a time-depleting asset. For buyers of options, time is

their enemy. For sellers of options, time is their friend. This is something we will discuss more shortly.

Options are less liquid than stocks. By being less liquid I mean that there are far less option contracts available than there are shares of stock. It is just a simple matter of supply and demand. This causes the difference between the bid and the ask to be further apart, which means there's more slippage in entering and exiting option positions. To make matters worse, whenever you have low liquidity with wide spreads (the difference between the bid and the ask), you'll find that the specialist who is making the market in that option will have more control over the price, which is only to his advantage.

Options Disadvantages

- Time-depleting asset
- Less Liquidity
- Wide Bid/Ask Spreads
- Slippage in Fast Markets
- Not all brokers allow options trading
- Higher Levels of Leverage
- Relatively Higher Commissions
- Delayed Openings
- Can lose despite being right about direction of stock

Electronic direct access systems are helping to shrink the spreads just as they did in the stock market. The only reason spreads have been reduced to where they are now is because of the competition brought on by direct access trading platforms. Without that competition, specialists have a monopoly on the option markets they run.

Not all brokers allow options trading, and those that do don't necessarily allow all of the available strategies to be executed. Different brokers may also use different margin requirements; however, they all need to be at least as strict as a guideline set by the SEC.

Here is another disadvantage of options. Higher levels of leverage. Remember, that was actually a positive; but, leverage is like a knife. It is sometimes a friend and sometimes an enemy, especially in the hands of someone who does not know how to use it.

Options do have relatively higher commissions than stocks. This has been getting better every year as more liquidity pours into the markets and more competition comes into the options market for brokers.

Options are often subject to delayed openings. This means that you may not be able to enter or exit positions on options during the early minutes that the market is open.

Of course, you can lose in an option despite being right on the stock. This happens when you are a buyer of options, and the stock moves in your direction but not far enough. You lose because the time value decreases in the option, and the option did not move far enough to make money, even though the stock may have moved significantly in your direction. In extreme cases the stock could make a very significant move, yet an out of the money option may never come to fruition.

The Types of Options

There are two types of options contracts, and the first are call options. This type of contract gives the holder, the buyer of a call, the right to buy that stock from the seller at a specific price. Just like you may pay $2,000 to lock in the price of a Ferrari, you may also pay $2 to lock in the price of XYZ to $35. The $2 price is going to be determined by the current price of XYZ and how long you get to hold that option. There are other things involved as well, in determining the price of an option, but these are obviously the two big ones.

You only make money when you acquire the right to buy something at a fixed price if you think that something is going up. If you think stock XYZ is going to be way below $35 in the near future, you can simply buy it at a cheaper price in the near future. If you think XYZ is going to be at $40, you have the right to buy it at $35 anytime within the terms of your option contract. Even after you throw in the $2 you paid for that right, you'll still be $3 ahead if you can sell at $40. It is that simple.

Two Types of Options Contracts

Call Options	Put Options
This type of contract gives the holder (buyer) the right to buy ("call away") the underlying stock from the seller (writer) at the specific price (strike) but only for a specified amount of time (expiry).	This type of contract gives the holder (buyer) the right to sell ("put") the underlying stock to the seller (writer) at a specific price (strike), but only for a specified amount of time (expiry).

Buyers (holders) of calls are bullish.	Buyers (holders) of puts are bearish.
Sellers (writers) of calls are bearish.	Sellers (writers) of puts are bullish.

But the sellers are bearish. The sellers are saying, I don't think the price is going up. I'll sell them this options contract and collect the change. I'll collect the $2,000 because Ferrari, or stock XYZ, is about to decline. If they are correct, they will get to keep the $2,000 without any penalty.

Now, I've always called options a game of hope. I would much rather be a seller of hope than a buyer of hope. There are times when buying options properly can be done, but believe it or not, sellers of options win about 66% of the time. Buyers win the other third. So selling has the advantage, especially if done properly.

Put options are the other type of option. This type of contract gives the buyer the right to sell at a specific price. This means that if the price drops, the buyer of a put can still sell it at the locked-in price. I think that my stock at $40 is about to drop, but I'm not sure. I am going to buy a put with a strike of $40. I'm going to lock in $40 so that I know I can sell it at $40 any time. Now the stock drops to $30. I bought the right to sell my stock at $40, even though it is $30.

So buyers of put options are bearish. They are expecting the price to drop and will make money as the stock drops just as call buyers will make money as the stock increases in price. You think Intel is dropping because it's run up four white bars in a row, has a topping tail, a bearish changing of the

guard, and is outside of the Bollinger Band, with an overbought CCI. This stock is going down. I am going to buy a put. Give me the right to sell the stock at a higher price than it will be at a later date.

The sellers of puts are bullish. This is a little tricky. Buyers of puts think the stock is going to drop. The sellers say no, the item is going to rise. I'll take that bet. I'll sell the premium. I'll sell the option to you.

Calls in Everyday Life

Now, let's look at some examples of calls in everyday life because we do options everyday. Yet somehow, when we get to the market, we think it's all so complex.

We use them everyday, or you hear of their use like in this scenario. Let's say you now are interested in buying a quaint $25 million house. But you don't know if your tax advisors will approve the purchase yet. You want to secure the property because you're on vacation when you spot this, and you have to have it. There are a lot of people at the open house, so you enter into an agreement with the owner. You pay him $10,000 to lock in your price. So you give him the $10,000 and tell him that you want him to hold the house for you. Don't let anybody take it for the next 45 days. Twenty-five million dollars is going to be the sale price if you buy it, and you are going to give $10,000 to hold it. If you don't buy the house, he can keep the $10,000.

If you choose not to buy, the owner keeps the $10,000. If someone offers him $27 million for the house, he will not

profit from that, you will. You can deal with the new buyer or you could actually buy it from the owner at $25 million, because you're under contract with him, and immediately sell it to the new buyer for $27 million, for a quick $2 million dollar profit. Or you could actually buy the house for $25 million, go through the closing process, then immediately go through another closing process with the new buyer who wants to buy it for $27 million. Or you can sell him the piece of paper, the contract, for $2 million dollars.

Puts in Everyday Life

Everyone in this room deals with puts every single year whether you know it or not. Puts are the same as buying an insurance policy.

The premium paid guarantees that if your car is stolen or wrecked beyond repair, you will get the full value that's in the contract, the agreed upon value. So you pay an insurance company a certain amount of money for a contract that says that if something happens to this car, you're going to give me this price for it. The insurance companies are like option sellers.

They receive premium for assuming the risk of the obligation to make good. They're willing to bet that you will not get into an accident. You're saying, you know what, just in case I do, I want you to be responsible, and I'll pay you for being responsible. So you buy the contract. You give the company a premium, and in exchange for the premium, you have the right to transfer all the risk to the insurance company. Now

the insurance company has the risk. Your risk is just the premium you pay. We use puts in everyday life.

What They Have in Common

Here are some common characteristics of both puts and calls. The buyer purchases a right from the seller in both puts and calls. The seller incurs an obligation in both scenarios. Whether it's a put or a call, the seller incurs an obligation, and the buyer purchases a right from the seller. A fee or premium is exchanged in both contracts.

Common Characteristics of Puts & Calls

- The buyer purchases a right from the seller.
- The seller incurs an obligation.
- A fee or "premium" is exchanged.
- The contract is for a limited time.
- The buyer & seller have opposite profit/loss positions.
- The buyer & seller have opposite risk-return potentials.

The contract is for a limited time. It will expire. And, of course, the buyer and seller have opposite profit loss positions, and the buyer and seller have opposite risk return potentials.

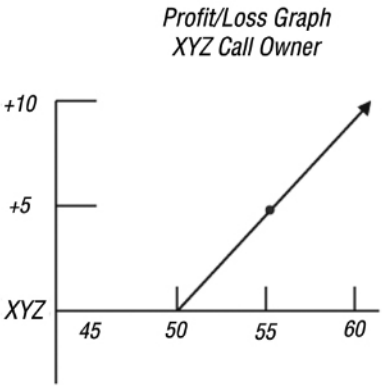
How the Numbers Work

Let's look at a generic example of owning a call (Figure 4.1), and then we're going to get into a specific example. Let's say

stock XYZ is trading at $50, and you purchase a $50 call that will expire next month. This gives you the right to buy this stock. You don't own it, but you've been given the right to buy it at $50 for the next 30 days. You now have the right to buy the stock at $50 even if it is trading at $60, $70, or $80. For this privilege you have paid a certain price for that call option. When you chose $50 as the price you want to buy it at, that is known as the strike price. You could have chosen from several dollar amounts, usually every $5 or every $2.50.

Figure 4.1 - Owning a Call

For color charts go to www.traderslibrary.com/TLEcorner



You chose to go out 30 days. Options expire on the Friday before the third Saturday of every month. You may also choose the expiration date in any month that they are offered. You chose the $50 strike price for the next month, which we are assuming is about 30 days away. Note that 30 calendar days is only going to be 20 trading days, approximately.

The stock price that you choose to purchase stock in the future is known as the strike price. The date at which the option comes to an end is known as the expiration.

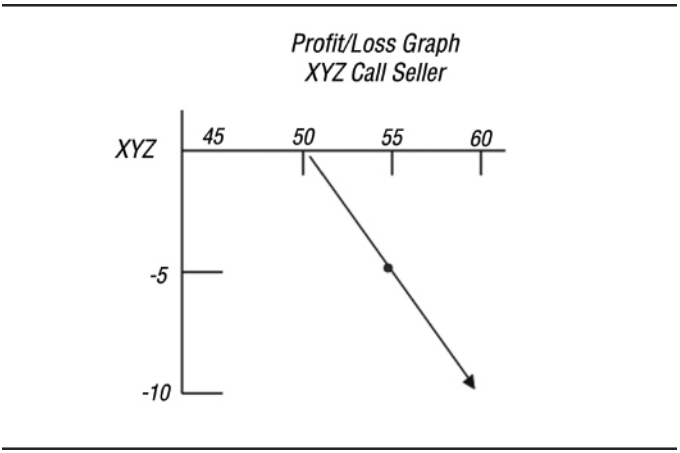
So if XYZ stays at $50 or declines, you have no use for that piece of paper. This is known as the option expiring worthless. You have already spent your money on the option, and you'll be getting none of it back. There is no action you have to take; you have lost all of the money spent on the original option contract. Figure 4.1 is simply showing you your potential gain at expiration not including the original cost of your option.

If XYZ rises to $55, you can do any of the following. You can buy XYZ for $50 and then sell it for a $5 profit. You can buy XYZ for $50 and hold it and not sell it. Or you can actually sell the piece of paper for $5. It is that simple.

Let's look at this from the side of the person who sold you the call (Figure 4.2). He is going to be required to sell you the stock at $50 even if it is trading above that. He has received a price you paid for the option and that is in his account. The stock is trading below $50, you will have no desire to buy it at $50. The option will expire worthless, and he will keep the premium you originally paid. To the extent the stock has rallied over $50, that will be a loss to him as he will have to sell it to you at $50.

Figure 4.2 - Offering a Call

For color charts go to www.traderslibrary.com/TLEcorner



If he doesn't own XYZ, he will actually have to go out in the market and buy the stock at market price, and he will take a loss as he sells it to you for $50. Alternatively if you decide you do not want to actually own the stock, he will have to pay you what the option contract is worth at expiration.

Now for a real example. Figure 4.3 is a daily chart of QCOM, which has suffered a bit of a setback over the last few days on this chart. All of our tools are here: we have color-coded candlesticks, Bollinger Bands, color-coded volume, CCI, and a 20-period moving average.

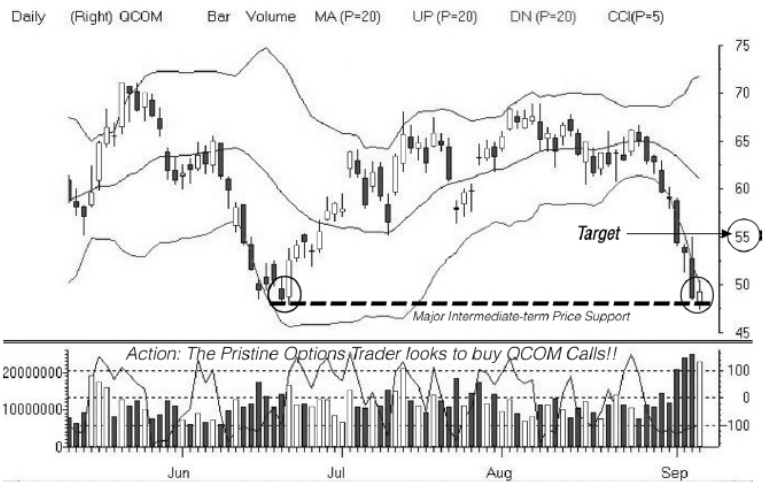
Figure 4.3 - Example of a Call Purchase (qcom)

1. QCOM down 8 black bars in a row

2. QCOM punctures lower band

3. QCOM puts in a BULL COG™

4. QCOM on prior price support



We notice that QCOM has experienced eight consecutive black bars in a row. Eight. Not four or five, but eight. We also notice that QCOM punctures its lower Bollinger Band, and the CCI is below -100. We also know that QCOM puts in a bullish changing of the guard and see that QCOM has revisited a prior area where the buyers were rewarded. This is called a major support. The Pristine options trader looks to buy QCOM calls.

Now if you want to create something close to a synthetic stock—it's not quite a synthetic stock, but will almost mimic the stock—go two strike prices in the money and the current monthly option will act very close to the stock. Plus, you don't have to spend $50 for the stock. By going two strike prices in the money, we mean that we're going to buy the $40 calls. That is because a $50 stock would commonly have strike prices every $5. Since the stock is at about $50, the calls will cost an amount somewhere over $10. How much

over $10 will depend on several things, but largely, how much time until expiration. You'll pay a premium for that amount of time. For example, if the next expiration is about a month away, you may pay $13 for that call option. Ten dollars of that premium is for what we call the intrinsic value, which is a difference between $40 and $50. The extra $3 fee paid of that option is known as the time value.

Our target, let's say, is going to be $55. We don't want to be greedy. We're going to take this drop, which is severe, and cut it in half, and use that as the target.

We said in this example we're going to use the $40 strike price to try to mimic the stock as close as possible. Let's take a look at what the other choices are.

Figure 4.4 shows you the three terms used in describing the actual strike price purchased. Note that since the strike prices come every $5, there will be varying degrees of being deeply in the money or deeply out of the money. So if I choose an at the money strike price, I'm going to choose the QCOM $50 calls. That is at the money. That means the option is very close to the actual price of the stock.

Figure 4.4 - Choosing Your Strike

- **At-the-money (ATM)** options have a strike price at or near the current price of the stock (QCOM $50).
- **In-the-money (ITM)** options have intrinsic value. For call options, ITM options have strike prices below the current price of the stock. For put options, ITM options have strike prices above the current price of the stock (QCOM $45 Call).
- **Out-of-the-Money (OTM)** options have no intrinsic value. All the value of the option is time value. For call options, OTM options have strike prices above the current price of the stock. For put options, OTM options have strike prices below the current price of the stock.

Note: The strike you select depends on your risk tolerance and on how bullish/bearish you are.

If I want the option to act more like the stock, I will go in the money, and I will perhaps choose the $45 calls or the $40 calls. We say the option will act like the stock because for every $1 increase in the stock price you will get close to a $1 increase in the option price. But you are only spending $10 rather than $50 to control the stock.

If I'm really bullish, I'm going to use out of the money calls. That means I'm going to pick a strike above the price, because I think there is a huge move to the upside in the stock. This will make the call price cheaper because it will not have any intrinsic value. That is obvious because you are buying a strike price that is greater than the actual price of the stock.

Buying out of the money call options should be done sparingly as they expire worthless most of the time. Make sure you understand your chart pattern and are expecting a big move.

What you are paying for then is all time value. This is the problem. These are the options that most traders lose on most of the time. They are the big gamble; but, when they do pay off, the gain can be huge. Notice, however, that the stock could move up, and if it does not move enough to cover the premium you paid, you'll still lose money.

Remember, the rule I have my traders following is two strikes in the money when you really just want to buy the stock, and so you want an option to act like the stock.

The expiration date you choose will depend on the amount of time you expect to be in the trade. If you are using a daily chart like in this example and expecting your move to occur in the next three to five days, you generally will be going to the next expiration date. However, it may be possible that you are in the last week before expiration. This last week has the greatest decrease in time value of option prices. Therefore, if you are too close to the current expiration, it is better to go to the next month.

Figure 4.5 is the graphical analysis of your profit or loss on the QCOM call. Every option contract to buy is for 100 shares of stock. So if you want to buy one contract, it will cost you $300 for the right to control 100 shares of that stock. Since we are buying a call, we're spending $3 per share or $300 for the one contract and starting off with a $300 loss. If Qualcomm is at $50 or less at the time of expiration, that will be our loss, $300.

Figure 4.5 - Buying a QCOM (atm) Call

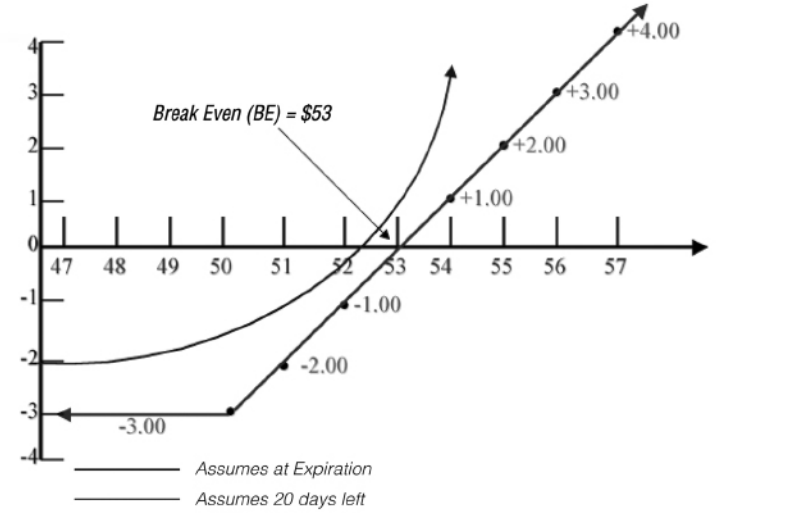
• The QCOM Sept 50 call costs you a $3 premium.

• To cover cost, QCOM must rise to $53.

• Your maximum loss is $3 cost of call.

• Your lose part of the $3 if QCOM remains between $50 (strike) and $53 (BE).

• Your profit above $53, which is unlimited.



Now if the stock is at $51, we will make $1 per share because we have the right to buy it at $50. This will take $1 away from our $3 loss, giving us a total of a $2 or $200 for the 100 shares. Following this pattern you can see that Qualcomm needs to close at $53 in order for us to receive our initial premium back. This is the breakeven number, $53.

Buyers of options have unlimited profit potential with limited downside risk; however, they lose more often than they win.

Also note that here in the United States you are allowed to sell your option contract at any time you choose. This means that if the stock rallies to $55 before expiration, the option may be worth $6 or $7, and you may sell it for that amount of money. Just so you know, there are European Options that are required to be held until expiration.

Note also that your gains are unlimited. You pay an initial $3 fee to enter the game, and if the stock does not close above the $50 strike price, you'll lose that entire original fee. As the stock rallies above $53, you'll make a dollar for dollar profit with no limit.

Now, let's look at it from the eyes of the seller (Figure 4.6). You bought QCOM because you took the Pristine Method™. You said, look, eight bars in a row on prior support, bullish changing of the guard, a puncture through the lower Bollinger Band, CCI sell signal, and climactic volume; so, this stock is going higher. But the seller of the option says, you know what, I don't think so. So the seller of the QCOM $50 call says all right, all right. I'll sell you the call.

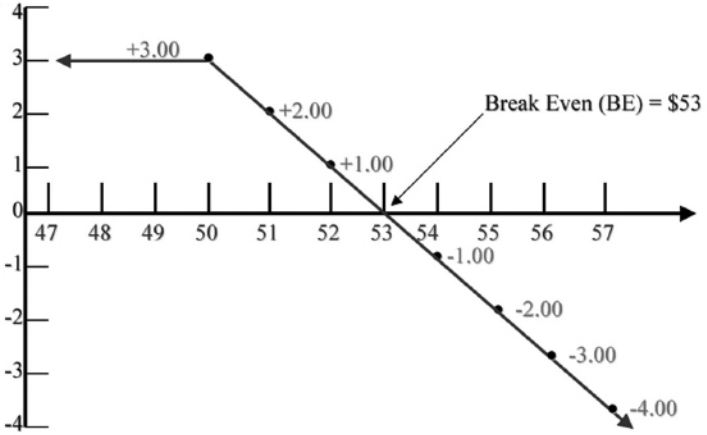
Figure 4.6 - Selling a QCOM (atm) Call

• Call seller profits if QCOM stays below $53 (BE).

• Seller loses if QCOM rises above $53, which is unlimited.

• Seller keeps part of the $3 if QCOM remains between $50 (strike) and $53 (BE).

• Seller keeps maximum gain ($3) if QCOM remains at $50 (strike) or below.



Sellers of options have unlimited loss risk with limited upside potential; however, they win more often than they lose.

Now remember quite simply, the seller's profit and loss will look exactly the reverse of the buyers profit and loss. He collects your $3, so now he starts off up $3. As the stock rises from $50 to $51, he has now lost a dollar. At $53, he has hit his breakeven point. If the stock rises to $54, he is down a dollar, which of course would be $100 for the one contract. Note that he will make his full gain of $300 if the stock stays at or below $50. In other words, he wins if the stock does two of the three things. If it goes sideways or if it drops any amount of money, he makes his maximum gain; however, if the stock rallies he has unlimited losses.

Summarizing Call Options

A call is the right to buy the underlying asset (stock) at a specified price (strike) for a specified period of time (expiry).

- The call buyer pays a premium for the right, but not the obligation to buy the underlying asset (stock).
- The call seller receives premium and assumes the obligation to sell the underlying asset (stock) at the buyer's discretion.

Keep in mind:

- The call contract is for a limited time period.
- A call is used to capitalize on upside market movement with leverage.
- A call serves as an alternative to buying the underlying stock to limit downside exposure.
- Buyers have unlimited profit; sellers have maximum gain.

Naturally, as a seller of an option you must have a management plan to cover just that situation. You may simply opt to buy the option back some point and take your losses, or you can buy the stock to offset your losses and continue to hold the option in case it returns back to the strike price. This way you'll still capitalize on the value of the time premium, which will be decreasing toward expiration.

Remember, you can be either the buyer or the seller of the option. We will discuss this more shortly, but you can see now that if a distinct move up is coming, you want to be a buyer. If you see sideways trendless action or a down move coming, you want to be a seller. Note the big difference in the profit potential between a buyer and seller of a call option. The buyer has limited downside risk and unlimited profit potential. The seller has unlimited downside and limited profit potential. While this sounds like a good deal for the buyer, remember that most options expire worthless, so the seller wins two-thirds of the time.

Now let's look at an example of using puts from both the seller's and buyer's point of view. Figure 4.7 is a daily chart of Intel inc. (INTC), which has been in a sideways trend during most of the chart pattern that we can see here. We have color-coded candlesticks, Bollinger bands, color-coded volume, CCI, 20-period moving average; all of our tools are here.

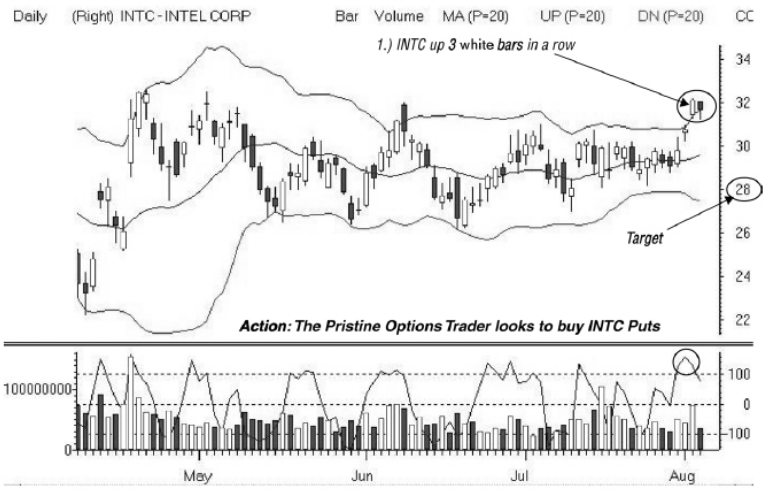
Figure 4.7 - Example of a Put Purchase

1. INTC up 3 white bars in a row.

2. INTC punctures upper band.

3. INTC puts in a black bar.

4. CCI(5) is oversold.



Intel has been sideways on this chart and has just rallied to an area of prior resistance. We have three white bars in a row and a CCI reading of greater than 100. We also have punctured the top Bollinger Band. We have a changing of the guard, and the Pristine-trained trader now expects pullback in Intel to around the $28 level, the low of the base. We want to use a bearish strategy, so we can either buy puts or, as you saw in the prior example, we could sell calls. Let's look now at the strategy of buying puts to capture the move down and also how that affects the person who sold the puts.

Now again, if you want to mimic the stock price, it is recommended that you go two strike prices above. This would mean buying the $40 puts. This would have a similar effect to being short the stock; in other words every time the stock moves down $1, the put will increase by almost $1.

For this example, let's say we are a lot more bearish and expect the full move down to our $28 target area. So we are going to buy at the money puts (Figure 4.7). There are strike prices here every $2.50, so we will be buying $32.50 strike price puts for the current expiration months. Let's say those are priced at $2.50.

Remember all of the things we discussed regarding buying calls for Qualcomm applied to buying puts for Intel. If we use in the money or out of the money options, we will have the same risk parameters regardless of whether we're buying calls to capture an up move or puts to capture a down move.

Figure 4.8 is the graphical analysis of your profit or loss on the INTC put. Every option contract you buy is for 100 shares of stock. So if you want to buy one contract it will cost you $250 for the right to control 100 shares of that stock. Since we are buying a put, we're spending $2.50 per share or $250 for the one contract and starting off with a $250 loss. If Intel is at $32.50 or more at the time of expiration, our loss will be $250.

Figure 4.8 - Buying an INTC (atm) Put

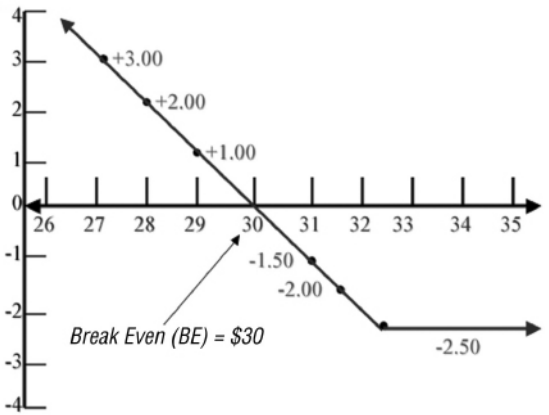
• INTC Aug 32.50 put costs you $2.50.

• To cover cost, INTC declines to $30 (BE).

• Your maximum loss is the $2.75 cost of put.

• Your profit below $30, which is not unlimited.

• Your lose part of the $2.75 if INTC remains between $32.50 (strike) and $30 (BE).



Now if the stock is at $31.50, we will make $1 per share because we have the right to sell it at $32.50. This will take $1 away from our $2.50, giving us a total of a $1.50 loss or $150 for the 100 shares. Following this pattern, you can see that Intel needs to close at $30 in order for us to receive our initial premium back. This is the breakeven number, $30.

Buyers of puts have unlimited profit potential with limited downside risk; however, they lose more often than they win.

Just as with calls, you are allowed to sell your put option contract at any time you choose. This means that before expiration if the stock falls to $28, the option may be worth $6 or $7, and you may sell it for that amount of money.

Note also that your gains are unlimited. You pay an initial $3 fee to enter the game, and if the stock does not close below

the $32.50 strike price, you'll lose that entire original fee. As the stock falls below $30, you'll make a dollar for dollar profit with no limit.

Now, let's look at it from the eyes of the seller of the put (Figure 4.9). You bought puts on Intel because you felt it was heading lower. But the seller of the option says, you know what, I don't think so. So the seller of the Intel $32.50 puts thinks it is going higher.

Figure 4.9 - Selling an INTC (atm) Put

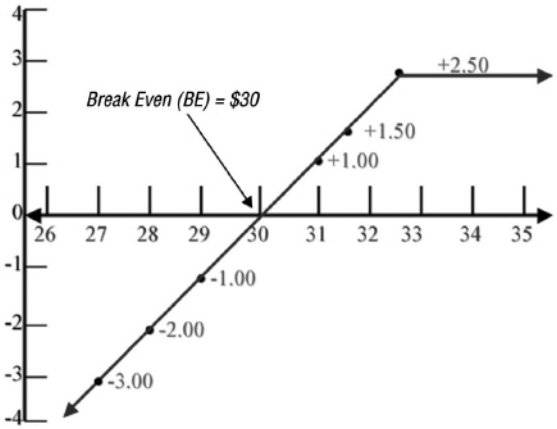
• The seller of the INTC Aug 32.50 put receives your $2.50 premium.

• Put seller profts if INTC stays above $30 (BE).

• Seller loses if INTC declines below $30, which is not unlimited.

• Seller keeps part of the $2.50 if INTC remains between $32.50 (strike) and $30 (BE).

• Seller keeps maximum gain ($2.50) if INTC remains at $32.50 or above.



As long as Intel stays above $32.50, the seller of this put will keep the full premium. As Intel drops below $32.50, he will begin losing part of that premium. Once Intel is below $30, he will be negative and losing money dollar for dollar as Intel drops below $30. He has the potential for unlimited losses if Intel continues to fall.

Summarizing Put Options

A put is the right to sell underlying asset (stock) at a specified price (strike) for a specified period of time (expiry).

- The put buyer has the right, but not the obligation, to sell the underlying asset (stock).
- The put seller has the obligation to buy the underlying asset (stock) at the put buyer's discretion.

Keep in mind:

- The put contract is for a limited time period.
- A put is used to capitalize on downside market movement.

- A put serves as a safer alternative to selling (shorting) the underlying stock, as it limits the potential loss.

Sellers of options have unlimited loss risk with limited upside potential; however, they win more often than they lose. This applies to seller of BOTH puts and calls.

Naturally, as a seller of an option you must have a management plan to cover such a situation. You may simply opt to buy the option back at some point and take your losses, or you can short the stock to offset your losses and continue to hold the option in case it returns back to the strike price. This way you'll still capitalize on the value of the time premium, which will be decreasing toward expiration.

Remember you can be either the buyer or the seller of the option. If a distinct move down is coming, you want to be a buyer of puts. If you see sideways trendless action or an up move coming, you want to be a seller of puts. Note the big difference in the profit potential between a buyer and seller of a put option. The buyer has limited downside risk and unlimited profit potential. The seller has unlimited downside and limited profit potential. While this sounds like a good deal for the buyer, remember that most options expire worthless, so the seller wins two-thirds of the time.

In Figure 4.10 you have an excellent summary of the difference between buying and selling puts and calls. We have covered all of these points in detail, but this picture serves as an excellent matrix to summarize all the important points.

Figure 4.10 - Option Matrix

Calls	
Buyers (Bullish)	**Sellers (Bearish/Neutral)**
• Pay a premium for right to buy stock • Buy to open (long) • Owner/holder of asset • Max gain = unlimited • Max risk = premium paid	• Receive premium for the obligation to sell stock • Sell to open (short) • Max gain = premium received • Max risk = unlimited unless covered
Puts	
Buyers (Bearish)	**Sellers (Bullish/Neutral)**
• Pay a premium for right to sell stock • Buy to open (long) • Owner/holder of asset • Max gain = strike price - premium paid • Max risk = premium paid	• Receive premium for the obligation to buy • Sell to open (short) • Max gain = premium received • Max risk = strike price - premium received

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Self-test Questions

1. Which is NOT one of the advantages of trading options?

a. Limited risk

b. Less liquidity

c. Higher potential return on investment

d. Trades may be conservative or speculative

2. Which is NOT one of the disadvantages of trading options?

a. Being a “time-depleting asset”

b. Higher levels of leverage

c. Calculable risk

d. Not all brokers allow options trading

3. Which of the following trades represents a bullish opinion on a stock?
a. Selling puts
b. Buying puts
c. Selling a stock short
d. Buying calls
4. To create a "synthetic stock" a trader using options should:
a. Buy or sell options two strikes in the money.
b. Buy or sell options two strikes out of the money.
c. Buy or sell options at the money.
d. Buy a call and a put at the same strike price.
5. Which of the following describes the risk/reward for a seller of options?
a. Unlimited risk and unlimited reward
b. Limited risk and limited reward
c. Limited risk and unlimited reward
d. Unlimited risk and limited reward
For answers, go to www.traderslibrary.com/TLEcorner
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5

Putting it all Together

As mentioned in the very beginning of this book, no one can effectively master any complex topic by reading a single book. The goal of using options is to increase your wealth by using options alone or in conjunction with stocks. The most important concept in using options properly is to understand the movement of the underlying security. All of the rest of the complex numbers will not help you if the stock goes in a different direction than you anticipated.

As you grow in your understanding of options always remember that your basic technical skills and your analysis of the stock's pattern will ultimately determine your success. Technical analysis of stock patterns is an incredible tool. The use of options in conjunction with the analysis of stock patterns can be very beneficial. One of the reasons is because as good as technical analysis is, it is not meant to be extremely accurate. While we can see trends and general areas of support and resistance, it is not realistic to assume we can hit exact prices.

Many option strategies require less precision in entering and exiting, which can be very beneficial and can reduce your transaction costs.

One of the stumbling blocks for new traders is falling victim to the imprecision of technical analysis. Stops are often taken

out by pennies only to have the stock reach its ultimate target without the trader on board. This leaves a trader to wrongly assume that stops are not needed and, soon after that, a devastating loss comes along. Use of options requires less precision. This is especially true when we are the seller of an option where we benefit from the stock movement as long as it goes in two of the three possible directions.

Think about a stock that has fallen to a support area and has been sideways for a period of time. It is starting to get some volume and looks like it may begin a move upward. If you ever tried to play a stock like this, you probably understand that this is a volatile time for the stock and after starting a move up, it may quickly retrace back to where it started or even lower. It is not uncommon for a stock trader to enter and exit a position like this several times and eventually quit in frustration. Now think about one of the strategies you just learned. If you were to sell puts at a strike price at or below the current consolidation, you'd be making money by capturing time premium even if the stock continued sideways the entire time you were involved with the stock.

Manage Your Positions

It does not matter what type of position you hold, you must be aware and follow the proper management policies. There are certain option positions that may require no management; but, some have unlimited liability. Make sure you enforce the proper management for the strategies you use.

Make sure you manage your positions properly. If you have sold a put as in our example, you must react if the stock begins to fall again. Remember, you have unlimited liability if the stock drops, just as if you own the stock. As you grow

your options understanding, you will find that there are more complex strategies that can be used in situations like this. There is spread trading, or using the stock in conjunction with the option, to expand the strategy that is used.

Another example of a common use of options is to sell calls on stocks that you own in long term accounts. This is known as covered call writing. If your stocks have rallied, you're happy with the current price, but do not necessarily want to sell them, you may consider selling calls at an out of the money strike price and keeping the premium. If the stock does not rally anymore, you get to keep the premium. If the stock rallies but does not go above the strike price you selected, you again get keep the premium. If the stock falls, you will be losing money as the stock falls; but, you would be losing money anyway. The premium received for selling the call offsets some of that loss. Finally, if the stock does continue to rally, you may either buy back your call to keep the stock, or simply let the stock be taken away from you at the higher price of the strike price you selected.

Let's say you're considering buying a stock at $11. Instead of simply buying the stock outright, consider selling a $10 put. Now if the stock rallies, you get to keep the premium from the put you sold. If the stock price drops below $11 yet stays above $10, again you get to keep the premium for the put sold. Now, if the stock drops below $10, you may simply hold a put into expiration and be forced to buy the stock at $10 even though the current price may be below that. Remember, though, that you were willing to buy the stock at $11. If you bought it at $11 and it is currently at $9, you lost $2. If you sold a $10 put and the stock is at $9, you're able to buy the stock at $10, and you received the premium when you sold

the put. You'll likely be near break-even. You may consider buying all of your stocks in this manner and actually be paid to purchase the stock at a lower price.

As with any kind of trading, make sure you start off on paper and practice any strategy before you put it to use with real money. Even then, start off very small until you understand the strategy and have experienced any possible affects from trying something new. Start off slowly and continue to increase your knowledge in both technical analysis and the use of other option combinations. The tools given to you in his book should get you well on your way to successful option trading.

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Self-test Questions

1. The most important concept in using options properly is:

a. Buying strength and selling weakness.

b. Understanding the movement of the underlying stock.

c. Following your technical indicators religiously.

d. Greater leverage means greater chance of success.

2. The "imprecision" of technical analysis is:

a. Not as much of a problem for options traders as for stock traders.

b. One reason why technical analysis doesn't work.

c. Why traders rely on Japanese candlestick charts.

d. Not as much of a problem with today's modern, electronic markets.

3. Selling options tends to require:

a. The same amount of position management as buying options.

b. More position management than buying options because of unlimited risk.

c. Less position management than buying options because of the market's upward bias.
d. The same amount of position management as buying the underlying stock.
4. What is a covered call strategy?
a. Buying a put and a call at the same strike price.
b. Buying calls against stocks you already own.
c. Selling puts and buying calls.
d. Selling calls against stocks you already own.
5. Trying your options trades on paper first is:
a. Important before risking real money.
b. A poor way to see if you have what it takes to be a trader.
c. The same as trading with small amounts of money.
d. Only important for guerilla or micro trading strategies.
For answers, go to www.traderslibrary.com/TLEcorner
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Appendix

Option Pricing

The details and strategies available on option trading can get extremely complex. The information available can fill hundreds and hundreds of pages in a book or many hours of classroom study. There are several other mathematical numbers that are considered part of option pricing. I am presenting you here with a quick summary of some of the key terms used in option pricing. There is also an extended glossary of terms following this supplement.

Modern option pricing techniques are often considered among the most mathematically complex of all applied areas of finance. Most of the models and techniques employed by today's analysts are rooted in a model developed by Fischer Black and Myron Scholes in 1973. This method of option pricing is known as the Black and Scholes' model and is the standard used today. It is a very complex formula that takes up several pages of text. It incorporates all the variables that affect option prices.

Without getting into a complex formula such as that, the following figures are some of the most important basics on option pricing and the terms used to describe them.

Figure A.1 - "3 Determinates of Price"

Options theory is able to calculate the exposure to three variables:

- A change in the *underlying*
- A passage of *time*
- A change in *volatility*

The terms that apply to the calculations are called the **Greeks**:

- Delta
- Theta
- Gamma
- Vega

Figure A.2 - "Time Premium Decay"

• Options are time-depleting assets.

• Time premium will decay as time passes.

• The closer the option is to maturity, the more rapid the premium decay.

• Time premium is greatest for at-the-money options.

• Deep in(out)-of the money options have small premiums.

• Decay accelerates rapidly during the last 15 days.

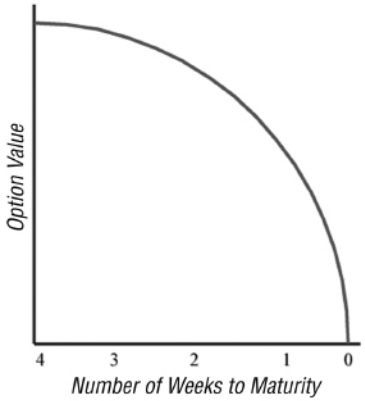


Figure A.3 - The Greeks: Delta

Delta:

- It is the amount that an option changes with respect to a smal change in the underlying.
- **Deep, in-the-money** options will often change one for one with the underlying. In this case, the option's delta would be 1.00
- **At-the-money** options generally change price at half the rate, and therefore have deltas of .50
- Options so far **out-the-money** are often considered worthless, and therefore have deltas close to 0.00. This means the option will not move in price, no matter what the underlying does.

TIP:

Think of delta as the probability of an option expiring in-the-money. If an option has a delta of .10, it has a 10% chance of expiring in-the-money.

2 strikes in-the-money = high Delta

Figure A.4 - The Greeks: Gamma, Theta, Vega

Gamma:

- Quantifies the rate of change of the delta with respect to a change in the underlying.
- Measures how quickly or slowly delta responds to a change in the underlying.

Theta:

- It is the amount that the option decays in one day.
- A writer (seller) receives income from time decay and therefore has "***positive theta***." A buyer incurs an expense from time decay and therefore has "negative theta."

Vega:

- It is the amount that an option changes if the "***implied volatility***" changes by one percentage point (1%).
- A long options position profits from an increase in implied volatility, and therefore has "***positive vega***." A short options position profits from a decrease in implied volatility, and therefore has "***negative theta***."

Glossary

American-Style Option—An option contract that may be exercised at any time between the date of purchase and the expiration date. Most exchange-traded options are American-style.

Arbitrage—The process in which professional traders simultaneously buy and sell the same or equivalent securities for a riskless profit. See also Risk Arbitrage.

Ask Price—The price at which a seller is offering to sell an option or stock.

Assignment—The receipt of an exercise notice by an option writer (seller) that obligates him to sell (in the case of a call) or purchase (in the case of a put) the underlying security at the specified strike price.

At-the-money—An option is at-the-money if the strike price of the option is equal to the market price of the underlying security.

Automatic Exercise—A protection procedure whereby the Options Clearing Corporation attempts to protect the holder of an expiring in-the-money option by automatically exercising the option on behalf of the holder.

Bearish—An adjective describing an opinion or outlook that expects a decline in price, either by the general market or by an underlying stock, or both. See also Bullish.

Bear Spread—An option strategy that makes its maximum profit when the underlying stock declines and has its maximum risk if the stock rises in price. The strategy can be implemented with either puts or calls. In either case, an option with a higher striking price is purchased and one with a lower striking price is sold, both options generally having the same expiration date. See also Bull Spread.

Beta—A measure of how a stock's movement correlates to the movement of the entire stock market. The Beta is not the same as volatility. See also Standard Deviation and Volatility.

Bid Price—The price at which a buyer is willing to buy an option or stock.

Box Spread—A type of option arbitrage in which both a bull spread and a bear spread are established for a near-riskless position. One spread is established using put options and the other is established using calls. The spread may both be debit spreads (call bull spread vs. put bear spread) or both credit spreads (call bear spread vs. put bull spread).

Break-Even Point—The stock price (or prices) at which a particular strategy neither makes nor loses money. It generally pertains to the result at the expiration date of the options involved in the strategy. A "dynamic" break-even point is one that changes as time passes.

Broad-Based—Generally referring to an index, it indicates that the index is composed of a sufficient number of stocks or of stocks in a variety of industry groups. See also Narrow-Based.

Bullish—Describing an opinion or outlook in which one expects a rise in price, either by the general market or by an individual security. See also Bearish.

Bull Spread—An option strategy that achieves its maximum potential if the underlying security rises far enough, and has its maximum risk if the security falls far enough. An option with a lower striking price is bought and one with a higher striking price is sold, both generally having the same expiration date. Either puts or calls may be used for the strategy. See also Bear Spread.

Butterfly Spread—An option strategy that has both limited risk and limited profit potential, constructed by combining a bull spread and a bear spread. Three striking prices are involved, with the lower two being utilized in one spread and the higher two in the opposite spread. The strategy can be established with either puts or calls; there are four different ways of combining options to construct the same basic position.

Buy-write—See Covered Call.

Calendar Spread—An option strategy in which a short-term option is sold and a longer-term option is bought, both having the same striking price. Either puts or calls may be used.

Calendar Straddle or Combination—See Calendar Spread.

Call—An Option contract that gives the holder the right to buy the underlying security at a specified price for a certain, fixed period of time. See also Put.

Capitalization-Weighted Index—A stock index which is computed by adding the capitalization (float times price) of each individual stock in the index, and then dividing by the divisor. The stocks with the largest market values have the heaviest weighting in the index. See also Float, Divisor.

Capped-Style Option—A capped option is an option with an established profit cap or cap price. The cap price is equal to the option's strike price plus a cap interval for a call option or the strike price minus a cap interval for a put option. A capped option is automatically exercised when the underlying security closes at or above (for a call) or at or below (for a put) the option's cap price.

Carrying Cost—The interest expense on a debit balance created by establishing a position.

Cash-Based—Referring to an option or future that is settled in cash when exercised or assigned. No physical entity, either stock or commodity, is received or delivered.

Cash Settlement—The process by which the terms of an option contract are fulfilled through the payment or receipt in dollars of the amount by which the option is in-the-money as opposed to delivering or receiving the underlying stock.

CBOE—The Chicago Board Options Exchange; the first national exchange to trade listed stock options.

Class—A term used to refer to all put and call contracts on the same underlying security.

Class of Options—Option contracts of the same type (call or put) and Style (American, European or Capped) that cover the same underlying security.

Closing Purchase—A transaction in which the purchaser's intention is to reduce or eliminate a short position in a given series of options.

Closing Sale—A transaction in which the seller's intention is to reduce or eliminate a long position in a given series of options

Closing Transaction—A trade that reduced an investor's position. Closing buy transactions reduce short positions and closing sell transactions reduce long positions. See also Opening Transaction.

Collateral—The loan value of marginable securities; generally used to finance the writing of uncovered options.

Combination—Any position involving both put and call options that is not a straddle.

Commodities—See Futures Contract.

Contingent Order—An order which can be executed only if another event occurs; i.e. "sell Oct 45 call 7.25 with stock 52 or lower."

Conversion Arbitrage—A riskless transaction in which the arbitrageur buys the underlying security, buys a put, and sells a call. The options have the same terms. See also Reversal Arbitrage.

Conversion Ratio—See Convertible Security.

Converted Put—See Synthetic Put.

Convertible Security—A security that is convertible into another security. Generally, a convertible bond or convertible preferred stock is convertible into the underlying stock of the same corporation. The rate at which the shares of the bond or preferred stock are convertible into the common is called the conversion ratio.

Cover—To buy back, as a closing transaction, an option that was initially written.

Covered—A written option is considered to be covered if the writer also has an opposing market position on a share-for-share basis in the underlying security. That is, a short call is covered if the underlying stock is owned; and, a short put is covered (for margin purposes) if the underlying stock is also short in the account. In addition, a short call is covered if the account is also long another call on the same security, with a striking price equal to or less than the striking price of the short call. A short put is covered if there is also a long put in the account with a striking price equal to or greater than the striking price of the short put.

Covered Call—An option strategy in which a call option is written against long stock on a share-for-share basis.

Covered Call Option Writing—A strategy in which one sells call options while simultaneously owning an equivalent position in the underlying security or strategy in which one

sells put options and simultaneously is short an equivalent position in the underlying security.

Covered Put Write—A strategy in which one sells put options and simultaneously is short an equal number of shares of the underlying security.

Covered Straddle—An option strategy in which one call and one put with the same strike price and expiration are written against 100 shares of the underlying stock. In actuality, this is not a "covered" strategy because assignment on the short put would require purchase of stock on margin. This method is also known as a covered combination.

Covered Straddle Write—The term used to describe the strategy in which an investor owns the underlying security and also writes a straddle on that security. This is not really a covered position.

Credit—Money received in an account. A credit transaction is one in which the net sale proceeds are larger than the net buy proceeds (cost), thereby bringing money into the account. See also Debit.

Cycle—The expiration dates applicable to various classes of options. There are three cycles: January/April/July/October, February/May/August/November, and March/June/September/December.

Debit—An expense, or money paid out from an account. A debit transaction is one in which the net cost is greater than the net sale proceeds. See also Credit.

Deliver—To take securities from an individual or firm and transfer them to another individual or firm. A call writer who is assigned must deliver stock to the call holder who exercised. A put holder who exercises must deliver stock to the put writer who is assigned.

Delivery—The process of satisfying an equity call assignment or an equity put exercise. In either case, stock is delivered. For futures, the process of transferring the physical commodity from the seller of the futures contract to the buyer. Equivalent delivery refers to a situation in which delivery may be made in any of various, similar entities that are equivalent to each other (for example, Treasury bonds with differing coupon rates).

Delta—The amount by which an option's price will change for a one-point change in price by the underlying entity. Call options have positive deltas, while put options have negative deltas. Technically, the delta is an instantaneous measure of the option's price change, so that the delta will be altered for even fractional changes by the underlying entity. See also Hedge Ratio.

Delta Spread—A ratio spread that is established as a neutral position by utilizing the deltas of the options involved. The neutral ratio is determined by dividing the delta of the purchased option by the delta of the written option. See also Ratio Spread and Delta.

Depository Trust Corporation (DTC)—A corporation that will hold securities for member institutions. Generally used by option writers, the DTC facilitates and guarantees delivery of

underlying securities if assignment is made against securities held in DTC.

Derivative security—A financial security whose value is determined in part from the value and characteristics of another security, the underlying security.

Diagonal Spread—Any spread in which the purchased options have a longer maturity than do the written options as well as having different striking prices. Typical types of diagonal spreads are diagonal bull spreads, diagonal bear spreads, and diagonal butterfly spreads.

Discount—An option is trading at a discount if it is trading for less than its intrinsic value. A future is trading at a discount if it is trading at a price less than the cash price of its underlying index or commodity. See also Intrinsic Value and Parity.

Discount Arbitrage—A riskless arbitrage in which a discount option is purchased and an opposite position is taken in the underlying security. The arbitrageur may either buy a call at a discount and simultaneously sell the underlying security (basic call arbitrage) or may buy a put at a discount and simultaneously buy the underlying security (basic put arbitrage). See also Discount.

Discretion—Freedom given to the floor broker by an investor to use his judgment regarding the execution of an order. Discretion can be limited, as in the case of a limit order that gives the floor broker .125 or .25 point from the stated limit price to use his judgment in executing the order. Discretion

can also be unlimited, as in the case of a market-not-held order. See Limit Order and Market Not Held Order.

Divisor—A mathematical quantity used to compute an index. It is initially an arbitrary number that reduces the index value to a small, workable number. Thereafter, the divisor is adjusted for stock splits (price-weighted index) or additional issues of stock (capitalization-weighted index).

Downside Protection—Generally used in connection with covered call writing, this is the cushion against loss, in case of a price decline by the underlying security, that is afforded by the written call option. Alternatively, it may be expressed in terms of the distance the stock could fall before the total position becomes a loss (an amount equal to the option premium), or it can be expressed as percentage of the current stock price. See also Covered Call Write.

Dynamic—For option strategies, describing analyses made during the course of changing security prices and during the passage of time. This is as opposed to an analysis made at expiration of the options used in the strategy. A dynamic break-even point is one that changes as time passes. A dynamic follow-up action is one that will change as either the security price changes or the option price changes or time passes.

Early Exercise (assignment)—The exercise or assignment of an option contract before its expiration date.

Escrow Receipt—A receipt issued by a bank in order to verify that a customer (who has written a call) in fact owns the stock and, therefore, the call is considered covered.

European Exercise—A feature of an option that stipulates that the option may only be exercised at its expiration. Therefore, there can be no early assignment with this type of option.

Ex-Dividend—The process whereby a stock's price is reduced when a dividend is paid. The ex-dividend date (ex-date) is the date on which the price reduction takes place. Investors who own stock on the ex-date will receive the dividend, and those who are short stock must pay out the dividend.

Equity Options—Options on shares of an individual common stock. See also Non-Equity Option.

European-Style Options—An option contract that may be exercised only during a specified period of time just prior to its expiration.

Exercise—To implement the right under which the holder of an option is entitled to buy (in the case of a call) or sell (in the case of a put) the underlying security.

Exercise Limit—The limit on the number of contracts that a holder can exercise in a fixed period of time. Set by the appropriate option exchange, it is designed to prevent an investor or group of investors from "cornering" the market in a stock.

Exercise price—The price at which the option holder may buy or sell the underlying security, as defined in the terms of his option contract. It is the price at which the call holder may exercise to buy the underlying security or the put holder may exercise to sell the underlying security. For listed options, the

exercise price is the same as the Striking Price. See also Exercise.

Exercise settlement amount—The difference between the exercise price of the option and the exercise settlement value of the index on the day an exercise notice is tendered, multiplied by the index multiplier.

Expected Return—A rather complex mathematical analysis involving statistical distribution of stock prices, it is the return that an investor might expect to make on an investment if he were to make exactly the same investment many times throughout history.

Expiration cycle—An expiration cycle relates to the dates on which options on a particular underlying security expire. A given option, other than LEAPS®, will be assigned to one of three cycles, the January cycle, the February cycle, or the March cycle.

Expiration date—The day on which an option contract becomes void. The expiration date for listed stock options is the Saturday after the third Friday of the expiration month. Holders of options should indicate their desire to exercise, if they wish to do so, by this date. See also Expiration Time and Automatic Exercise.

Expiration time—The time of day by which all exercise notices must be received on the expiration date. Technically, the expiration time is currently 5:00PM on the expiration date, but public holders of option contracts must indicate their desire to exercise no later than 5:30PM on the business day

preceding the expiration date. The times are Eastern Time. See also Expiration Date.

Facilitation—The process of providing a market for a security. Normally, this refers to bids and offers made for large blocks of securities, such as those traded by institutions. Listed options may be used to offset part of the risk assumed by the trader who is facilitating the large block order. See also Hedge Ratio.

Fair Value—Normally, a term used to describe the worth of an option or futures contract as determined by a mathematical model. Also sometimes used to indicate intrinsic value. See also Intrinsic Value and Model.

FLEX Options—Exchange traded equity or index options, where the investor can specify within certain limits, the terms of the options, such as exercise price, expiration date, exercise type, and settlement calculation.

Float—The number of shares outstanding of a particular common stock.

Floor Broker—A broker on the exchange floor who executes the orders of public customers or other investors who do not have physical access to the trading area.

Fundamental Analysis—A method of analyzing the prospects of a security by observing accepted accounting measures such as earnings, sales, assets, and so on. See also Technical Analysis.

Futures Contract—A standardized contract calling for the delivery of a specified quantity of a commodity at a specified date in the future.

Gamma—The rate of change in an option's delta for a one-unit change in the price of the underlying security. See also Delta.

Good Until Canceled (GTC)—A designation applied to some types of orders, meaning the order remains in effect until it is either filled or canceled. See also Stop Limited and Trading Limit.

Hedge—A conservative strategy used to limit investment loss by effecting a transaction that offsets an existing position.

Hedge Ratio—The mathematical quantity that is equal to the delta of an option. It is useful in that a theoretically neutral hedge can be established by taking offsetting positions in the underlying stock and its call options. See also Facilitation and Delta.

Holder—The purchaser of an option.

Horizontal Spread—An option strategy in which the options have the same striking price, but different expiration dates.

Implied Volatility—A measure of the volatility of the underlying stock, it is determined by using option prices currently existing in the market at the time rather than using historical data on the price changes of the underlying stock. See also Volatility.

Incremental Return Concept—A strategy of covered call writing in which the investor is striving to earn an additional return from option writing against a stock position which he (she) has targeted to sell—possibly at substantially higher prices.

Index—A compilation of the prices of several common entities into a single number. See also Price-Weighted Index, Capitalization-Weighted Index.

Index Option—An option whose underlying entity is an index. Most index options are cash-based.

Institution—An organization, probably very large, engaged in professional investing in securities. Normally a bank, insurance company, or mutual fund.

In-the-money—A term describing any option that has intrinsic value. A call option is in-the-money if the underlying security is higher than the striking price of the call. A put option is in-the-money if the security is below the striking price. See also Out-of-the-Money and Intrinsic Value.

Intrinsic value—The value of an option if it were to expire immediately with the underlying stock at its current price; in other words, the amount by which an option is in-the-money. For call options, this is the difference between the stock price and the striking price, if that difference is a positive number, or zero otherwise. For put options it is the difference between the striking price and the stock price, if that difference is positive, and zero otherwise. See also In-the-Money, Time Value Premium, and Parity.

Last Trading Day—The very last full day of open trading before an options expiration day, usually the third Friday of the expiration month.

LEAPS®—Long-term Equity Anticipation Securities, or LEAPS®, are long-term stock or index options. LEAPS®, like all options, are available in two types, calls and puts, with expiration dates up to three years in the future.

Leg—A risk-oriented method of establishing a two-sided position. Rather than entering into a simultaneous transaction to establish the position (a spread, for example), the trader first executes one side of the position, hoping to execute the other side at a later time and a better price. The risk materializes from the fact that a better price may never be available, and a worse price must eventually be accepted.

Letter of Guarantee—A letter from a bank to a brokerage firm that states that a customer (who has written a call option) does indeed own the underlying stock, and the bank will guarantee delivery if the call is assigned. Thus the call can be considered covered. Not all brokerage firms accept letters of guarantee. Also: letter issued to O.C.C. by member firms covering a guarantee of any trades made by one of its customers, (a trader or broker on the exchange floor).

Leverage—In investments, the attainment of greater percentage profit and risk potential. A call holder has leverage with respect to a stock holder—the former will have greater percentage profits and losses than the latter, for the same movement in the underlying stock.

Limit—See Trading Limit.

Limit Order—An order to buy or sell securities at a specified price (the limit). A limit order may also be placed "with discretion". In this case, the floor broker executing the order may use his (her) discretion to buy or sell at a set amount beyond the limit if he (she) feels it is necessary to fill the order.

Listed Option—A put or call option that is traded on a national options exchange. Listed options have fixed striking prices and expiration dates. See also Over-the-Counter Option.

Local—A trader on a futures exchange who buys and sells for his own account and may also fill public orders.

Lognormal Distribution—A statistical distribution that is often applied to the movement of stock prices. It is a convenient and logical distribution because it implies that stock prices can theoretically rise forever but cannot fall below zero.

Long Position—A position wherein an investor's interest in a particular series of options is as a net holder (i.e., the number of contracts bought exceeds the number of contracts sold).

Margin—To buy a security by borrowing funds from a brokerage house. The margin requirement—the maximum percentage of the investment that can be loaned by the brokerage firm—is set by the Federal Reserve Board.

Margin Requirement (for options)—The amount an uncovered (naked) option writer is required to deposit and

maintain to cover a position. The margin requirement is calculated daily.

Mark-To-Market—An accounting process by which the price of securities held in an account are valued each day to reflect the last sale price or market quote if the last sale is outside of the market quote. The result of this process is that the equity in an account is updated daily to properly reflect current security prices.

Market Basket—A portfolio of common stocks whose performance is intended to simulate the performance of a specific index. See Index.

Market-Maker—An exchange member whose function is to aid in the making of a market, by making bids and offers for his account in the absence of public buy or sell orders. Several market-makers are normally assigned to a particular security. The market-maker system encompasses the market-makers, floor brokers, and order book officials. See also Order Book Official and Specialist.

Market Not Held Order—Also a market order, but the investor is allowing the floor broker who is executing the order to use his own discretion as to the exact timing of the execution. If the floor broker expects a decline in price and he is holding a "market not held buy order," he (she) may wait to buy, figuring that a better price will soon be available. There is no guarantee that a "market not held order" will be filled.

Market Order—An order to buy or sell securities at the current market. The order will be filled as long as there is a market for the security.

Married Put and Stock—The simultaneous purchase of stock and the corresponding number of put options. This is a limited risk strategy during the life of the puts because the stock can be sold at the strike price of the puts.

Married Put Strategy—A put and stock are considered to be married if they are bought on the same day, and the position is designated at that time as a hedge.

Model—A mathematical formula designed to price an option as a function of certain variables—generally stock price, striking price, volatility, time to expiration, dividends to be paid, and the current risk-free interest rate. The Black-Scholes model is one of the more widely used models.

Naked Option—See Uncovered Option.

Naked writer—See Uncovered Call Writing and Uncovered Put Writing.

Narrow-Based—Generally referring to an index, it indicates that the index is composed of only a few stocks, generally in a specific industry group. See also broad-based.

Neutral—Describing an opinion that is neither bearish nor bullish. Neutral option strategies are generally designed to perform best if there is little or no net change in the price of the underlying stock or index. See also Bearish and Bullish.

Non-Equity Option—An option whose underlying entity is not common stock; typically, it refers to options on physical commodities and index options.

"Not Held"—See Market Not Held Order.

Notice Period—The time during which the buyer of a futures contract can be called upon to accept delivery. Typically, the three to six weeks preceding the expiration of the contract.

Opening Purchase—A transaction in which the purchaser's intention is to create or increase a long position in a given series of options.

Opening Sale—A transaction in which the seller's intention is to create or increase a short position in a given series of options.

Opening Transaction—A trade which adds to the net position of an investor. An opening buy transaction adds more long securities to the account. An opening sell transaction adds more short securities. See also Closing Transaction.

Open Interest—The number of outstanding option contracts in the exchange market or in a particular class or series.

Option Pricing Curve—A graphical representation of the projected price of an option at a fixed point in time. It reflects the amount of time value premium in the option for various stock prices, as well. The curve is generated by using a mathematical model. The delta (or hedge ratio) is the slope of a tangent line to the curve at a fixed stock price. See also Delta, Hedge Ratio, and Model.

Options Clearing Corporation (OCC)—The issuer of all listed option contracts that are trading on the national option exchanges.

Order Book Official—The exchange employee in charge of keeping a book of public limit orders on exchanges utilizing the "market-maker" system, as opposed to the "specialist system," of executing orders. See also Market-Maker and Specialist.

Out-of-the-money—A call option is out-of-the-money if the strike price is greater than the market price of the underlying security. A put option is out-of-the-money if the strike price is less than the market price of the underlying security.

Over-the-Counter Option (OTC)—An option traded off-exchange, as opposed to a listed stock option. The OTC option has a direct link between buyer and seller, has no secondary market, and has no standardization of striking prices and expiration dates. See also Listed Stock Option and Secondary Market.

Overvalued—Describing a security trading at a higher price than it logically should. Normally associated with the results of option price predictions by mathematical models. If an option is trading in the market for a higher price than the model indicates, the option is said to be overvalued. See also Fair Value and Undervalued.

Parity—Describing an in-the-money option trading for its intrinsic value; that is, an option trading at parity with the underlying stock. Also used as a point of reference—an option is sometimes said to be trading at a half-point over parity or at a quarter-point under parity. An option trading under parity is a discount option. See also Discount and Intrinsic Value.

Physical Option—An option whose underlying security is a physical commodity that is not stock or futures. The physical commodity itself (a currency, treasury debt issue, commodity) underlies that option contract. See also equity option, index option.

Position—As a noun, specific securities in an account or strategy. (A covered call writing position might be long 1,000 XYZ and short 10 XYZ January 30 calls). As a verb, to facilitate; to buy or sell—generally a block of securities—thereby establishing a position. See also Facilitation and Strategy.

Position Limit—The maximum number of put or call contracts on the same side of the market that can be held in any one account or group of related accounts. Short puts and long calls are on the same side of the market. Short calls and long puts are on the same side of the market.

Premium—The price of an option contract, determined in the competitive marketplace, which the buyer of the option pays to the option writer for the rights conveyed by the option contract.

Price-Weighted Index—A stock index that is computed by adding the prices of each stock in the index, and then dividing by the divisor. See also Capitalization-Weighted Index, Divisor.

Payoff Diagram—See Profit Graph.

Profit Graph—A graphical representation of the potential outcomes of a strategy. Dollars of profit or loss are graphed

on the vertical axis, and various stock prices are graphed on the horizontal axis. Results may be depicted at any point in time, although the graph usually depicts the results at expiration of the options involved in the strategy.

Profit Range—The range within which a particular position makes a profit. Generally used in reference to strategies that have two break-even points—an upside break-even and a downside break-even. The price range between the two break-even points would be the profit range. See also Break-Even Point.

Profit Table—A table of results of a particular strategy at some point in time. This is usually a tabular compilation of the data drawn on a profit graph. See also Profit Graph.

Protected Strategy—A position that has limited risk. A protected short sale (short stock, long call) has limited risk, as does a protected straddle write (short straddle, long out-of-the-money combination). See also Combination and Straddle.

Public Book (of orders)—The orders to buy or sell, entered by the public, that are generally away from the current market. The order book official or specialist keeps the public book. Market-Makers on the CBOE can see the highest bid and lowest offer at any time. The specialist's book is closed (only he knows at what price and in what quantity the nearest public orders are). See also Order Book Official, Market-Maker, and Specialist.

Put—An option contract that gives the holder the right to sell the underlying security at a specified price for a certain fixed period of time. See also Call.

Ratio Calendar Combination—A strategy consisting of a simultaneous position of a ratio calendar spread using calls and a similar position using puts, where the striking price of the calls is greater than the striking price of the puts.

Ratio Calendar Spread—Selling more near-term options than longer-term ones purchased, all with the same strike; either puts or calls.

Ratio Spread—Constructed with either puts or calls, the strategy consists of buying a certain amount of options and then selling a larger quantity of more out-of-the-money options.

Ratio Strategy—A strategy in which one has an unequal number of long securities and short securities. Normally, it implies a preponderance of short options over either long options or long stock.

Ratio Write—Selling of call options in a ratio higher than 1 to 1 against the stock that is owned.

Resistance—A term in technical analysis indicating a price area higher than the current stock price where an abundance of supply exists for the stock and, therefore, the stock may have trouble rising through the price. See also Support.

Return (on investment)—The percentage profit that one makes, or might make, on his investment.

Return if Exercised—The return that a covered call writer would make if the underlying stock were called away.

Reversal Arbitrage—A riskless arbitrage that involves selling the stock short, writing a put, and buying a call. The options have the same terms. See also Conversion Arbitrage.

Rho—The expected change in an option's theoretical value for a one percent change in interest rates. See also Theoretical Value.

Risk Arbitrage—A form of arbitrage that has some risk associated with it. Commonly refers to potential takeover situations where the arbitrageur buys the stock of the company about to be taken over and sells the stock of the company that is effecting the takeover.

Roll Down—Close out options at one strike and simultaneously open other options at a lower strike.

Roll Forward (Out)—Close-out options at a near-term expiration date and open options at a longer-term expiration date.

Rolling—A follow-up action in which the strategist closes options currently in the position and opens other options with different terms, on the same underlying stock. See also Roll Down, Roll Forward, and Roll Up.

Roll Up—Close out options at a lower strike and open options at a higher strike.

Secondary Market—A market that provides for the purchase or sale of previously sold or bought options through closing transactions.

Series—All option contracts of the same class that also have the same unit of trade, expiration date, and strike price.

Settlement Price—The official price at the end of a trading session. This price is established by The Options Clearing Corporation and is used to determine changes in account equity, margin requirements, and other purposes. See also Mark-to-Market.

Short Position—A position wherein a person's interest in a particular series of options is as a net writer (i.e., the number of contracts sold exceeds the number of contracts bought).

Specialist—An exchange member whose function it is to both make markets—buy and sell for his own account in the absence of public orders—and to keep the book of public orders. Most stock exchanges and some option exchanges utilize the specialist system of trading.

Spread Order—An order to simultaneously transact two or more option trades. Typically, one option would be bought while another would simultaneously be sold. Spread orders may be limit orders, not held orders, or orders with discretion. They cannot be stop orders, however.

Spread Strategy—Any option position having both long options and short options of the same type on the same underlying security.

Standard Deviation—A measure of the volatility of a stock. It is a statistical quantity measuring the magnitude of the daily price changes of that stock.

"Static" Return—The return that an investor would make on a particular position if the underlying stock were unchanged in price at the expiration of the options in the position.

Stop-Limit Order—Similar to a stop order, the stop-limit order becomes a limit order, rather than a market order, when the security trades at the price specified on the stop. See also Stop Order.

Stop Order—An order, placed away from the current market, that becomes a market order if the security trades at the price specified on the stop order. Buy stop orders are placed above the market while sell stop orders are placed below.

Straddle—The purchase or sale of an equal number of puts and calls having the same terms.

Strategy—With respect to option investments, a preconceived, logical plan of position selection and follow-up action.

Strike Price—The stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Striking Price Interval—The distance between striking prices on a particular underlying security. Normally, the interval is 2.50 points for stocks under $25, 5 points for stocks selling

over $25 per share, and 10 points (or greater) is acceptable for stocks over $200 per share. There are, however, exceptions to this general guideline.

Sub-Index—See Narrow-Based Index.

Suitability—A requirement that any investing strategy fall within the financial means and investment objectives of an investor.

Suitable—Describing a strategy or trading philosophy in which the investor is operating in accordance with his (her) financial means and investment objectives.

Support—A term in technical analysis indicating a price area lower than the current price of the stock, where demand is thought to exist. Thus a stock would stop declining when it reached a support area. See also Resistance.

Synthetic Put—A strategy equivalent in risk to purchasing a put option where an investor sells stock short and buys a call.

Synthetic Stock—An option strategy that is equivalent to the underlying stock. A long call and a short put is synthetic long stock. A long put and a short call is synthetic short stock.

Technical Analysis—The method of predicting future stock price movements based on observation of historical stock price movements.

Terms—The collective name denoting the expiration date, striking price, and underlying stock of an option contract.

Theoretical Value—The price of an option, or a combination of options, as computed by a mathematical model.

Theta—A measure of the rate of change in an option's theoretical value for a one-unit change in time to the option's expiration date. See Time Decay..

Time Decay—A term used to describe how the theoretical value of an option "erodes" or reduces with the passage of time. Time decay is especially quantified by Theta..

Time Spread—See Calendar Spread.

Time Value—The portion of the option premium that is attributable to the amount of time remaining until the expiration of the option contract. Time value is whatever value the option has in addition to its intrinsic value.

Time Value Premium—The amount by which an option's total premium exceeds its intrinsic value.

Total Return Concept—A covered call writing strategy in which one views the potential profit of the strategy as the sum of capital gains, dividends, and option premium income, rather than viewing each one of the three separately.

Tracking Error—The amount of difference between the performance of a specific portfolio of stocks and a broad-based index with which they are being compared. See also Market Basket.

Trader—An investor or professional who makes frequent purchases and sales.

Trading Limit—The exchange-imposed maximum daily price change that a futures contract or futures option contract can undergo.

Treasury Bill/Option Strategy—(90/10 strategy) a method of investment in which one places approximately 90% of his funds in risk-free, interest-bearing assets, such as Treasury bills, and buys options with the remainder of his assets.

Type—The classification of an option contract as either a put or a call.

Uncovered Call Writing—A short call option position in which the writer does not own an equivalent position in the underlying security represented by his option contracts.

Uncovered Option—A written option is considered to be uncovered if the investor does not have an offsetting position in the underlying security. See also Covered.

Uncovered Put Writing—A short put option position in which the writer does not have a corresponding short position in the underlying security or has not deposited, in a cash account, cash or cash equivalents equal to the exercise value of the put.

Underlying Security—The security subject to being purchased or sold upon exercise of the option contract.

Undervalued—Describing a security that is trading at a lower price than it logically should. Usually determined by the use of a mathematical model. See also Overvalued and Fair Value.

Unit of Trading—The minimum quantity or amount allowed when trading a security. The normal minimum for common stock is 1 round lot or 100 shares. The normal minimum for options is 1 contract (which normally covers 100 shares of stock).

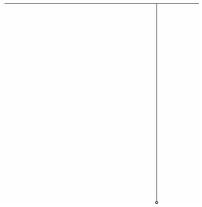
Variable Ratio Write—An option strategy in which the investor owns 100 shares of the underlying security and writes 2 call options against it, each option having a different striking price.

Vega—A measure of the rate of change in an option's theoretical value for a one-unit change in the volatility assumption.

Vertical Spread—(1)Most commonly used to describe the purchase of one option and sale of another where both are of the same type and same expiration, but have different strike prices. (2)It is also used to describe a delta-neutral spread in which more options are sold than are purchased.

Volatility—A measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.

Write—To sell an option. The investor who sells is called the writer.



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