ASK THE RISKDOCTOR

LIVE Q&A

MAY 2ND, 2012

Rarely Answered Questions

RI$K DOCTOR

Question 1:

Hi Risk Doctor

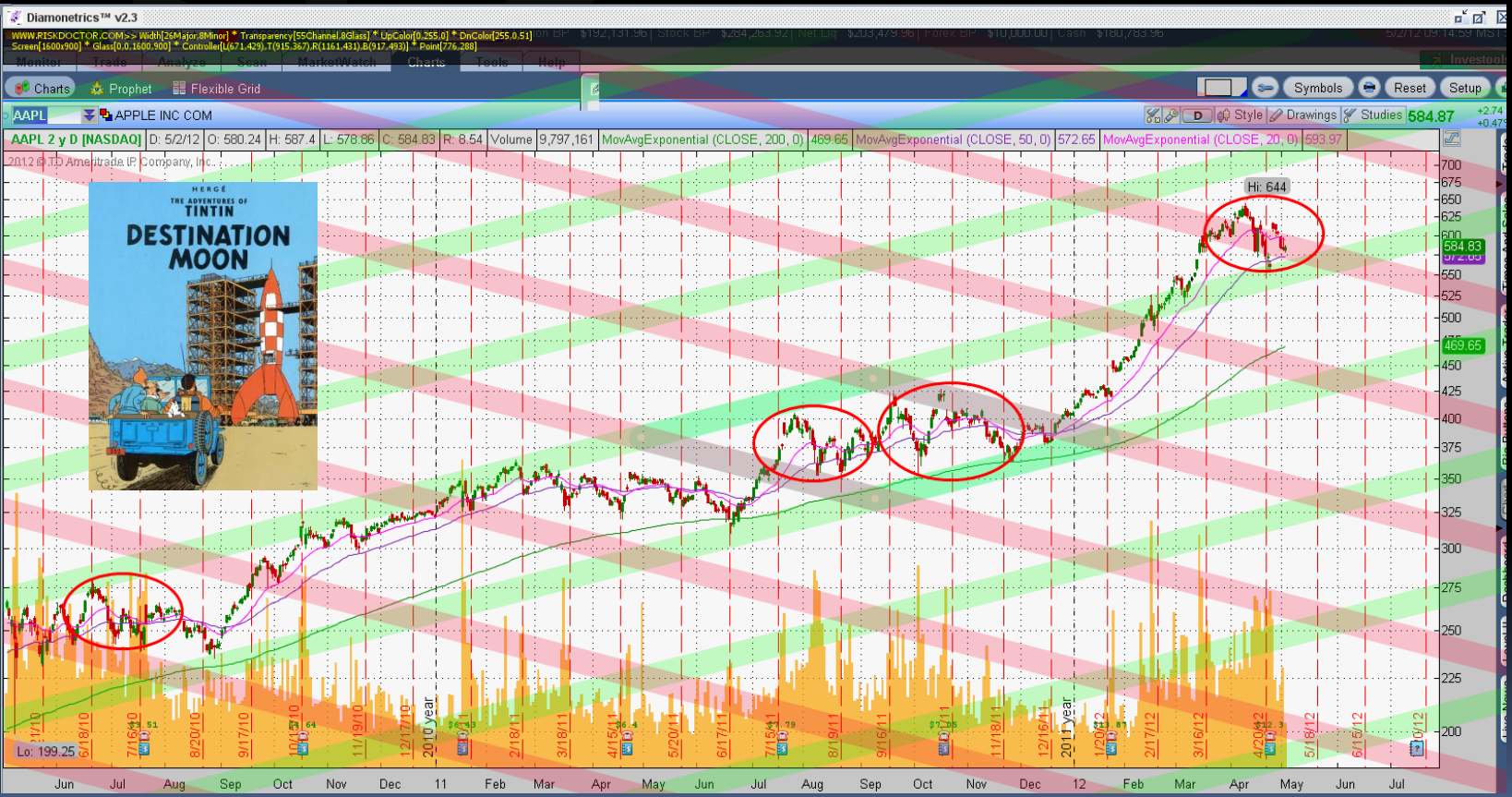
Looking forward to another great Q&A.

1) I don't know if this is appropriate for step 2, but after the surprise Apple earnings earlier in the month with the price going up, I read that "volatility was being crushed." Can you show what was happening after that and what might be the trading implications?

2) Gold seems really different this spring…always fun to see it on your chart.

Many thanks,
James

Answer 1:



It often happens that after a market has peaked and then corrected that the underlying consolidates between the two ***'known'*** extremes, giving traders a comfort zone.

The consolidation means that it should be trading in a trading range and this time, in AAPL's case between 555 and 644.

No one can predict for how long but for AAPL it usually takes a couple of months before "Destination Moon" continues.

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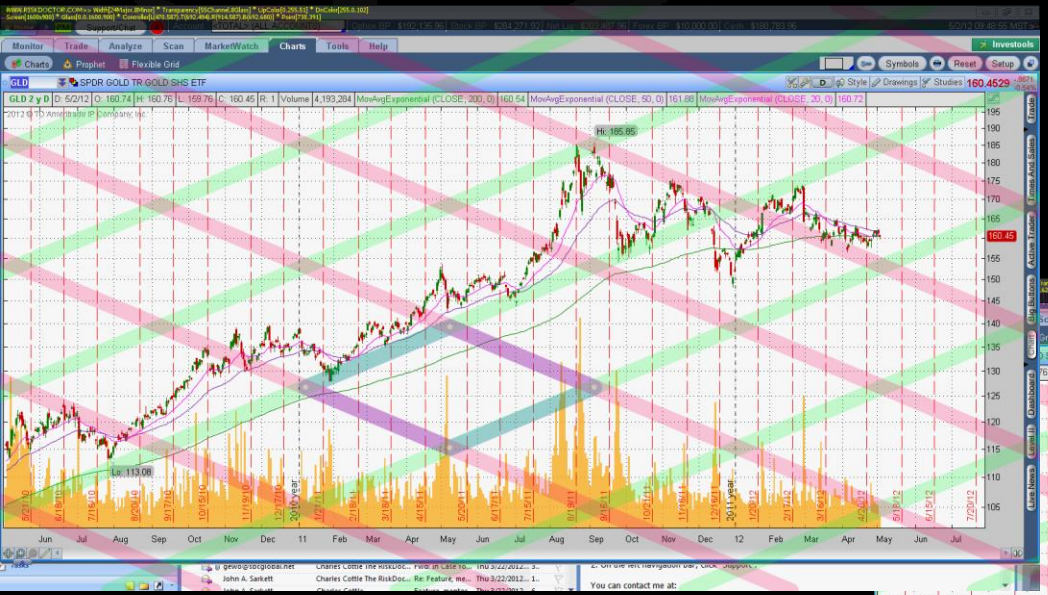
Answer 1 (Continued):



I have been running two Grids on GLD since March 6th and I am leaning towards the original of the 2 (left) as the Grid that is working better for now.

Question 2 & Answer 2:

I asked Dr. Dave Janello (who in my opinion is the smartest guy on the planet) to help me out with this☺ Dr Dave's responses are in the Green Font.

1. How to use newsletter services like ivolatility.com, LiveVol, OptionMonster InsideOptions™ Pro.
Of all volatility services (IVolatility and LiveVol) each require delta neutral trading to capture the volatility edge. This is for professional traders/market makers only. If you are spreading the volatility edge, diffused across the legs then the study of IV is much less important.

Spread trading requires looking at the skew and the spread price rather than the historic Vol or IV. OptionMonster is a directional high risk service so 'gunslinger' traders might use this.

One service not mentioned is the Value Line Options newsletter which is cheap and very effective for directional options trading and Long-Gamma Delta Neutral trading using straddles or strangles (actual or synthetic).

2. Are mutual funds /pensions funds allowed to trade options?
Yes, but pension funds are usually not allowed to sell stock short so any combination trade with short stock e.g. reversals, sell put short stock is a no-no. Mutual funds are allowed to trade options but usually do not because the regulatory and tax treatment is quite complex. Quote

3. Do the abnormal volume in options or abnormal IV provide any information about institutional buying and selling of stocks?
No.

4. How accurate is their statements like "detected the sale of 10,000 calls"? Do they know that the trade happened at the bid?
This means that the 10000 calls traded at the bid.

5. I am asking this because I doubt anyone (other than market-makers) will sell options in huge quantities without holding the underlying. If that is the case then I suspect all these call selling are just covered calls.
It could also be a broker dealer representing a huge shareholder or hedge fund or dark pool, consolidating a large chunk of internalized customer inventory. I would not make trading assumptions based on large trade volumes alone.

I would only add that it can be a huge shareholder holder clicking it by his or herself.

Question 3:

Hello Charles,

For some time now, there seems to have been a move toward complex mathematical modeling, use of advanced mathematics, and all the rest of the tools the so-called ***quants use to price and trade derivatives***. But, as argued by at least one author (Taleb), ***traders have used experience and much simpler tools*** to trade and price options long before the advent of Black-Scholes and other constructs.

So, as I look at it, there would seem to be two ways to approach derivatives:
The ***first is to learn a LOT of complex math and theory*** - stochastic calculus, stats, pricing models, and so on - ala all the physics PhD's.
The second would be to ***take a much more trader/experience-oriented approach*** such as yours (I don't recall a lot of math in the ITI classes (we met in 1994) for the bankers).

This ***first approach*** has been ***called a top-down approach*** where first a theory, then model is used to deal with the world. For example, do prices really behave like a physical system? Is this an accurate model? This approach has been ***blamed for a lot of the hedge fund/financial institution melt-downs*** seen in recent years. ***The quants***, of course, will tell you that it ***is the only way to go, and sneer at most anything else***.

The ***second approach*** has been ***called a bottom-up approach*** that is based on experience and observation. This is an approach ***used successfully in markets for hundreds of years prior to the advent of math-oriented approaches***. There were no small number of floor traders who could hardly do much calculus, but could certainly trade well.

Can you discuss your views on all of this, short of writing another book? Has the market moved to a point where only quant models and advanced math applications can work? ***Is it simply a matter of tweaking the models endlessly, or can a more pragmatic, experience-based approach be equally effective?***

Thank you again for entertaining my, well, excessive attempts at thinking! DS

Answer 3:

OVER-THE-COUNTER (OTC) MARKET:

A securities market made up of dealers who may or may not be members of a securities exchange. In the OTC market, there is no exchange floor, such as the NYSE or CBOE.

[1] OTC

Over the counter options refer to privately guaranteed deals made by and between financial institutions and those customers who apparently have sufficient credit. Counter-party risk is the major consideration, especially for the holder of the option, because he or she must rely on the financial strength of the writer to pay for the in-the-money amount should the option be exercised.

[2] Flex

Flex options are exchange-regulated options contracts with flexible expirations. They are similar to OTC options in nature, but different in that they are guaranteed by the exchange and are backed by the financial integrity of the exchange's membership.

BAD CREDITOR BORROWING GAMES

Story: Thanks for the Loan Dude:

A student of mine in a bank had been trading over-the-counter options in the foreign exchange market for five years. He could not understand why a certain customer was willing to trade $30 million worth of deep in-the-money conversion for a 50-pip*edge to the trader. He thought it was like stealing.

It seemed to me that the customer was selling the deep call options on the conversion and collecting cash at an unattractive implied interest rate, so I asked, "What does this customer do and how is his credit rating?" The student said, "He has a company that is strapped to the gills with debt and he cannot borrow anymore from our bank. What has that got to do with a no-risk European-style conversion?" My reply was, "There is your answer. The bank will not lend him another penny at even three times your rate, but you just lent him 30 million at a half of a percent over your rate." The student was flabbergasted. This cannot happen on a regulated exchange, but it often occurs in the OTC market. **End**

*** Pip**

A pip is a tick in the foreign exchange market representing 1/100th of a basis point.

Question 4

Hello Charles:
I am experimenting with hedging iron condors with futures.

I trade RUT Iron Condors (ICs), initiated with OTM 10 point Verticals with 10 Deltas or less. I have been hedging against large price movements that can force me out of the position by buying or selling TF Futures. I trade on T.O.S. but I also have an account at Interactive Brokers. On TOS, the Russell Futures symbol is /TF. I have traded other variations both farther out from expiration, closer to expiration and with higher short Deltas.

Recently with about 40 Days To Expiration, I put on 8 RUT Iron Condors (long the wings) on April 10th. Actually I legged in first shorting the put spreads on April 9 for .60 . On April 10 I shorted the Call spread for .80.

I traded Russell Futures against that position. I traded a single contract. I watched price and when I was negative Deltas and price moved up , I bought /TF. I made many scalping trades over several days and made almost $300 in net profits. I added that profit to the profit on the Iron Condor. This was an experimental trade as the Iron Condor was never seriously threatened by price movement. The ratio was 8 RUT iron condors to one.

I understand that one TF contract has a Delta of one. I imagine I could use the Delta of the Iron Condor to determine how many TF contracts to trade.

I have traded iron condors for almost three years with mixed results. Price movement is my biggest problem. I like the idea of scalping and hedging IC s with futures contracts rather than other adjustment with options. I have studied a lot of methods of adjusting iron condors.

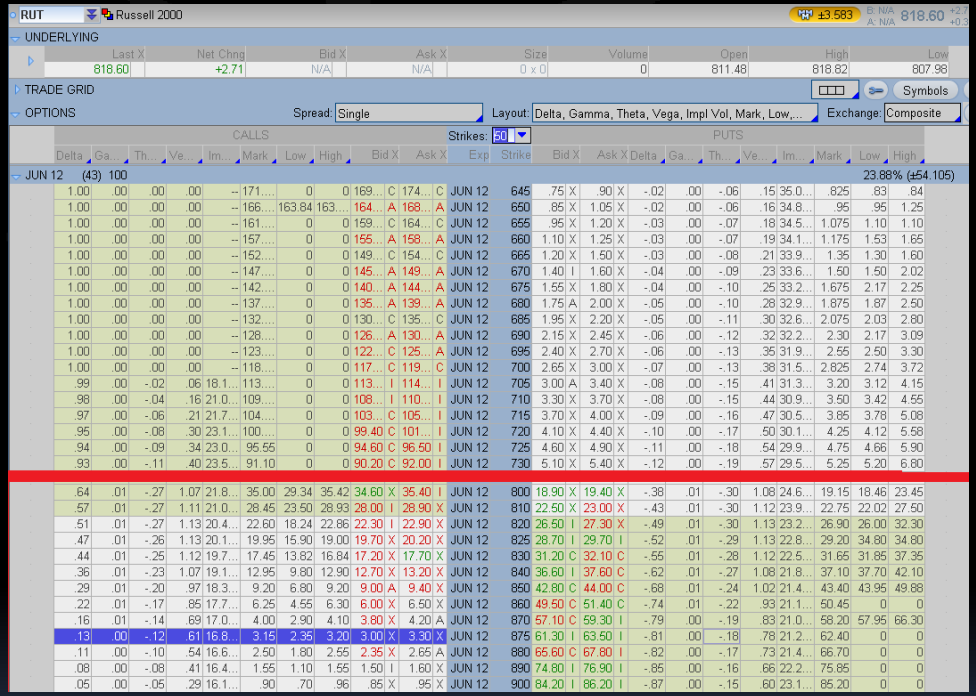
I want to try this with SPX as well. Basically I day-trade the hedges against the Iron Condor. I may make more on the hedges than I would on the Iron Condor.

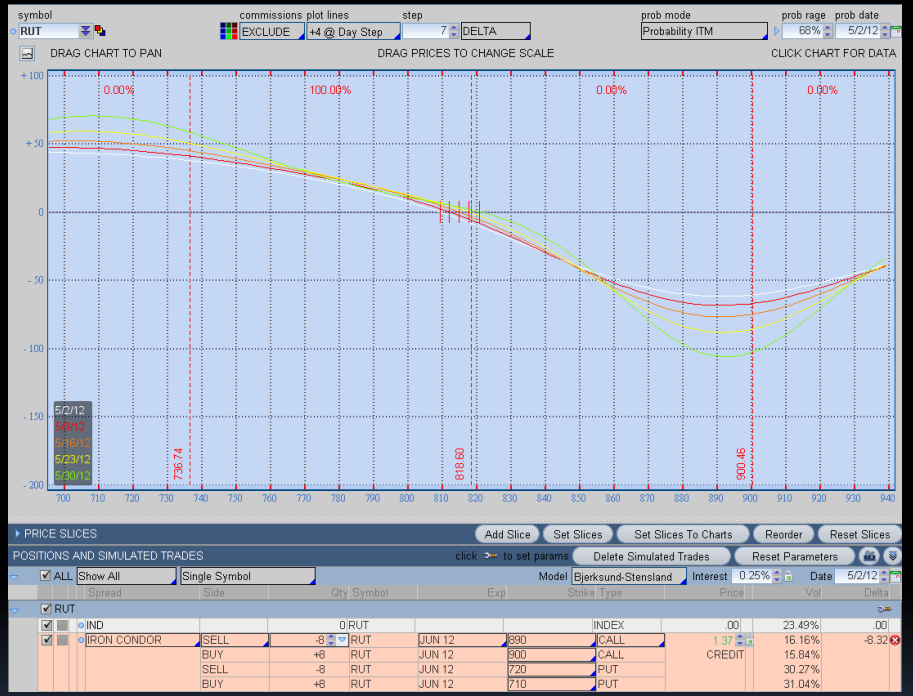
I was reviewing the passage from OTTHR about "Gamma scalping in your sleep". I believe the concept is the same. Is hedging with futures contracts superior to hedging with options.

I believe hedging Iron Condors with futures contracts has advantages over using options to hedge because they are more liquid and the change in dollar values are more apparent and easier to see. What do you think? Am I missing something?

Thanks, Robert

Answer 4:





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Transcript: