



ASK THE RISKDOCTOR:

LIVE Q&A

APRIL 12TH, 2011

Rarely Answered Questions

1st Question:

Hi

Charles,

Butterflies & Condors are usually cheap positions and perfect for range plays. Aren't they, risk/reward wise, also good positions for playing downward moves 1 or 2 weeks before expiration?

Regards,

MR

Intro to 1st Question's Answer

Certainly buying an out-of-the-money (OTM) Butterfly, and in this case, below the money Put Butterfly, can win if the market goes down towards the middle strike and time goes by. However, you should be mindful of a few things to base your ultimate decision of which strategy suits your opinion and in what quantity.

You may be better served with a bear vertical spread, because of couple of different reasons;

Part I of 1st Question's Answer

The underlying can drop significantly below the Butterfly range leaving your spread in the dust. Read the Ugly Butterfly saga, in Chapter 6 of "Options Trading: The Hidden Reality" where directionally, I was a genius but foolishly lost over \$300,000 because I chose to manifest my bullishness with an OTM Call Butterfly instead of a lesser quantity of Bull Verticals that could have cost the same amount of money. The Butterfly lost while the Vertical would have gone on to Deep ITM victory.

Images from Chapter 6

EXHIBIT 6-13

U.S. T-Bonds Monthly Chart: Reverse Head and Shoulders Pattern
with Price Projection to 88

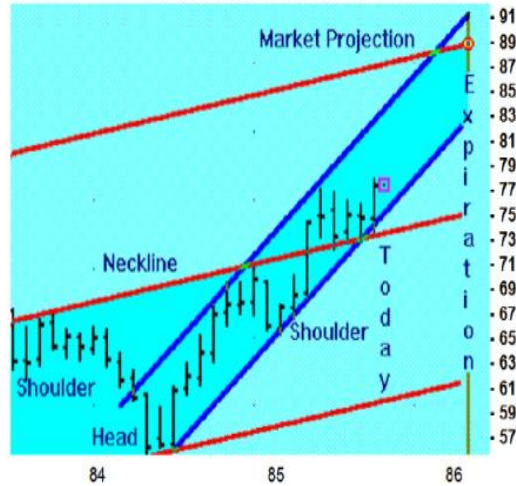


EXHIBIT 6-14

Bonds Met the Projection a Few Months too Soon.



EXHIBIT 6-16

The Bonds Never Looked Back.

The arrow points to where the 200 Straddles should have been bought.



Ouch, I hated that.

Part II of 1st Question's Answer

On one hand, the Bull Spread aspect of your bearish Butterfly may be too cheap to sell against the Bear Spread element of your bearish Butterfly. A Butterfly (in this case bearish OTM Put Butterfly) should be looked at as a Put Debit Vertical (Bear) Spread financed, to a reasonable extent, by the Put Vertical Credit (Bull) Spread. You should, therefore, look at the Debit Vertical Spread's price and the Credit Vertical's price, separately and determine whether you may be better served by a lesser quantity of Bear Spreads for the same amount of money.

Perhaps with Longer Dated Options:

Risk Illustrator																
Risk Illustrator		RI v4.01 / Euronext			VKR					11					VKR	
Spread Dissection		QQQQ	Expiry	20-May-11	8.00					VKR > 11					Mid - K	
Underlying	QQQQ	Expiry	20-May-11	Option Chain	K	48	49	50	51	52	53	54	55	56	K	
ImpFwd Price	55.20	Today	11-Apr-11		Calls	7.54	6.64	5.76	4.91	4.10	3.36	2.68	2.09	1.59	Calls	
Volatility %	30.50%	Actual DTE	39		Puts	0.36	0.45	0.57	0.71	0.91	1.16	1.48	1.89	2.39	Puts	
CoC %	0.00%	Aged DTE	39		IV %	36.2%	34.8%	33.4%	31.9%	30.6%	29.5%	28.5%	27.8%	27.2%	IV %	
					Call Veal	0.92	0.90	0.88	0.85	0.80	0.75	0.67	0.59	0.50	Call Veal	
					Put Veal	0.08	0.09	0.12	0.15	0.19	0.25	0.32	0.41	0.50	Put Veal	
					Butterfly	0.01	0.02	0.03	0.04	0.06	0.07	0.08	0.09	0.09	Butterfly	
Skew/Kurt	Equity	Pt Mplr	100		U Price											
Includes Adjustment	Y				PivotK 3											
PivotKuse	55	PivotK 3			PivotK 3 = PivotK 1											
					U Price							55.2		U Price		
					PivotK 3							x		PivotK 3		
Adjusted Position (Net)					Premium\$	LiQ Val \$	Net Q									
Profit / Loss					\$0	(\$181)	\$181	Net Calls		C						
								Net Puts		P						
Lock Basket [SD]						LiQ Val \$	Net Q									
									C							
									P							
Spread Basket						LiQ Val \$	Net Q									
Spread Dissection 1					LSA	\$445	\$445	SD1		C						
										P						
Spread Dissection 2					LSA	(\$265)	(\$265)	SD2		C						
										P						
SD Total					LSA	\$181	\$181	TOTAL		C						
										P						
Remnant Basket					LSA											
						\$0		C								
								P								

Different Consideration for Shorter Dated Options:

Risk Illustrator		RI v4.01 / Euronext				VKR		11				VKR							
A Spread Dissection		QQQQ	Expiry	15-Apr-11		8.00		ok		Mid - K									
Underlying	QQQQ	Expiry	15-Apr-11	Option Chain		K	48	49	50	51	52	53	54	55	56	K			
ImpFwd Pric	55.20	Today	11-Apr-11			Calls	7.20	6.20	5.21	4.22	3.27	2.35	1.48	0.76	0.30	Calls			
Volatility %	30.50%	Actual DTE	4			Puts	0.01	0.01	0.01	0.03	0.07	0.15	0.28	0.56	1.10	Puts			
CoC %	0.00%	Aged DTE	4			IV %				40.1%	39.1%	36.0%	31.8%	28.5%	26.7%	IV %			
Skew/Kurt	Equity	Pt Mplr	100			Call Voal	1.00	1.00	0.99	0.98	0.95	0.92	0.87	0.72	0.46	Call Voal			
						Put Voal	0.00	0.00	0.00	0.02	0.04	0.08	0.13	0.28	0.54	Put Voal			
						Butterfly	0.00	0.00	0.01	0.03	0.03	0.06	0.15	0.26	0.25	Butterfly			
Includes Adjustment		Y		QQQQ 11-Apr		U Price								55.2	U Price				
PivotKuset		55	PivotK 3	PivotK 3 = PivotK 1		PivotK 3								x	PivotK 3				
Adjusted Position (Net)		Premium\$	Liq Val \$	Net Q		K		48	49	50	51	52	53	54	55	56	K		
Profit / Loss		\$0	(\$147)	\$147	Net Calls												Net Calls		
				Net Puts						10	(20)				10	Net Puts			
Lock Basket [SD]		Liq Val \$		Net Q		Liq Val \$		K		48	49	50	51	52	53	54	55	56	K
																		Sick Calls	
																		Sick Puts	
Spread Basket		Liq Val \$		Net Q		Liq Val \$		K		48	49	50	51	52	53	54	55	56	K
Spread Dissection 1		LSA	\$207		\$207	C		SD1						(10)		10			SD Calls
						P													SD Puts
Spread Dissection 2		LSA	(\$60)		(\$60)	C		SD2				10		(10)					SD Calls
						P													SD Puts
Spread Dissection 3		LSA	\$145		\$145	C		SD3								7			SD Calls
						P								(7)					SD Puts



Conclusion of 1st Question's Answer

In the end, if the underlying does go right to the center Strike, you will still make money, just not as much. But lower than the bottom Strike, the Vertical wins while the Butterfly is toast.

2nd Question

After buying a Call contract, and the underlying goes against the position, how best to exit the position to minimize loss?

1) Exit Call position with a market order if the underlying falls below the 20 Day Moving Average (MA)?

or

2) Place a limit order to sell the Call option if the Call price falls 50% below the original purchase price. Also, will I be taken to the cleaners doing this? I mean, will the market maker just buy my call at 50% off the current option price?

PW

Part I of 2nd Question's Answer

Market Timing and Stop Placement are two of the hardest aspects to master in any kind of trading and there is no correct answer. For example, how can there be any consensus regarding whether to use 20 day or 30 day or simple MAs vs. Exponential MAs vs. RSI, MACD or any other indicator for that matter? Even if you gravitate to one, such as the 20 Day Moving MA, does it work for every underlying, stock or futures market? No.

Part II of 2nd Question's Answer

The type of “Stop” Order, whether a Call or any other Options Spread is an entirely different matter. In general, there are many successful options traders that use the concept of getting out when they ‘Double’ (Win-100%) or ‘Halve’ (Lose-50%) their money. I myself use different criteria, covered in many of my lectures but I will not profess that it is right or wrong. It is just the preference that I gravitate to. I think it is more important to address the question of the Order Type, right now.

RiskIllustrator™ ‘What-If’?

[illegible]

Profit / Loss (\$0)	
Expiring	20-May-11
Today	12-Apr-11
Actual DTE	38
Aged DTE	38
Premium\$	\$2,219
Liq Val \$	\$0
Net Units	1
Actual	56.52
Adjstmnt	0.00
Lock (R)	0.00
Adjusted	56.52

Graph Controls	
MaxScale	2,000
MinScale	(3,000)
MajorUnit	500
Show Aged	Y
Include SAT	Y
Show SAT	Y
ShowSA#2	N

U Price Diff ATM	
U Price	570
Diff ATM	0.0%

Profit / Loss (\$1153)	
Expiring	20-May-11
Today	12-Apr-11
Actual DTE	38
Aged DTE	38
Premium\$	\$2,219
Liq Val \$	\$1,066
Net Units	1
Actual	35.61
Adjstmnt	0.83
Lock (R)	0.00
Adjusted	36.44

Graph Controls	
MaxScale	2,000
MinScale	(3,000)
MajorUnit	500
Show Aged	Y
Include SAT	Y
Show SAT	Y
ShowSA#2	N

U Price Diff ATM	
U Price	545
Diff ATM	0.0%

Part III of 2nd Question's Answer

Very few, if any, options traders use "Stop" Orders, not because an order of "1.00 Stop" when the Option is bought for 2.00 will get filled immediately by unscrupulous MMs but because of the manipulation when later the option is trading for around 1.00, say .90 Bid at 1.10, the Stop Order can be triggered very easily even though the price of the option could have bounced. There is a lot of room for hanky-panky there. Most options traders have learned that using a mental stop is more appropriate and by using the option's or spread's delta can help to roughly estimate where the underlying will be trading at the time the option should be trading around the 50% level and simply set an alert for the underlying price and log on when the alert notifies.

Conclusion of 2nd Question's Answer

Because 'Stop Limit' Orders can be missed due to gaps and 'Mental' Stops can be missed owing to other general busyness, I prefer to use strategies where I can lose the whole amount. However, I personally use technical analysis and select actions points to adjust or liquidate when there has been a closing underlying price violation for two days in a row on my chart.

3rd Question

What are good strategies for condor adjustments at the edges? I typically get into condors with the short legs at what I think are support/resistance. As the security trades there I'm always torn guessing true breakout or test. How shall I think about this?

DC

3rd Question's Answer

You are setting yourself up for being 'torn...' is your short strikes were beyond your support and resistance then you would have more room to maneuver – perhaps buying a closer strike in order to slingshot the troubled vertical or still being able to cover it profitably.

Diametric™ Grid



4th Question

Hi Charles,

The converting exercise, #3 in Lesson Two has me confused. Please cover:

Thank you.

RB

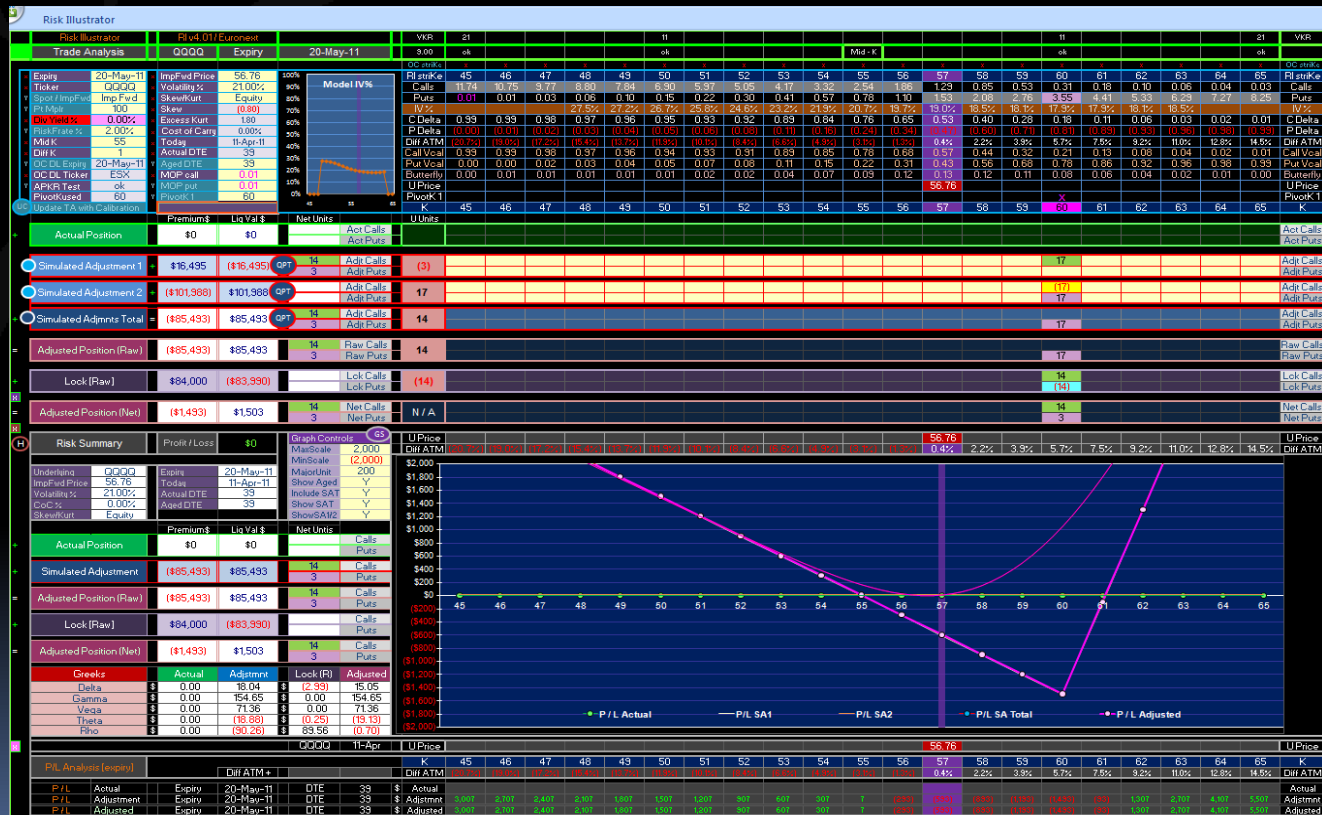
3. Converting Exercise Each of the following **Original** Positions have 2 Synthetic Equivalent Positions Syn 1 and Syn 2. Fill in the Blanks (Hint: Check your Net Calls and Puts)

	Calls	Und	Puts		Calls	Und	Puts		Calls	Und	Puts
Original	+17	(300)		Original	(14)	(1000)		Original	+22	+2000	
Syn 1:				Syn 1:				Syn 1:			
Syn 2:				Syn 2:				Syn 2:			
Syn 1:				Syn 1:				Syn 1:			
Original		+1300	+13	Original		(1800)	(33)	Original		+500	(5)
Syn 2:				Syn 2:				Syn 2:			
Syn 1:				Syn 1:				Syn 1:			
Syn 2:				Syn 2:				Syn 2:			
Original	+17		+17	Original	+44		+33	Original	+22		6

Part of Answer Key for 4th Question

	Calls	Und	Puts	nC	nP		Calls	Und	Puts	nC	nP		Calls	Und	Puts	nC	nP
Original	+17	(300)		14	3	Original	(14)	(1000)		(24)	10	Syn 1:	+13	0		13	0
Syn 1:		+1400	+17	14	3	Syn 1:		(2400)	(14)	(24)	10	Original		+1300	+13	13	0
Syn 2:	+14		+3	14	3	Syn 2:	(24)		10	(24)	10	Syn 2:	+13		0	13	0

Discussion Point I for 4th Question



[illegible]

Discussion Point III for 4th Question

13												Adj't Calls
						13						Adj't Puts
(13)						13						Adj't Calls
						(13)						Adj't Puts
						13						Adj't Calls
												Adj't Puts
						13						Raw Calls
												Raw Puts
												Lok Calls
												Lok Puts
N/A						13						Net Calls
												Net Puts