



ASK THE RISKDOCTOR:

LIVE Q&A

JUNE 8TH, 2011

Rarely Answered Questions

1st Question:

Please explain what the market maker must do with orders whose price may be near the mark but not on it. What ~~rules must~~ [will motivate] the market maker follow to determine if he will / will not fill my order?

Let's say I have placed an [sell] order for a vertical spread like RUT ~~MAY 880/890~~ [JUN 870.880] bear call spread. The current mark [Bid] price is say ~~1.05~~ [1.20]. I place my order and enter a price of ~~1.10~~ [1.25]. I have seen circumstances where my order will sit there for hours while the price of the RUT does not move much. I have heard people say my order would have to be filled so the market maker can fill more orders.

Don P.

1st Question's Answer

Market Maker Widths and Where is your Order?

| | | | | | | | | | |
|--|--------|-------------------|--------|---------------------|--------|---------------|---------|--------|--------|
| RUT | | Russell 2000 | | B: .00 813.56 -7.13 | | A: .00 -0.87% | | | |
| UNDERLYING | | | | | | | | | |
| | Last X | Net Chng | Bid X | Ask X | Size | Volume | Open | High | Low |
| | 813.56 | -7.13 | 0 | 0 | 0 x 0 | 0 | 820.68 | 820.68 | 808.17 |
| OPTIONS Spread: Single | | Layout: Delta | | Exchange: Composite | | | | | |
| CALLS | | Strik... 32 | | PUTS | | | | | |
| | Delta | Bid X | Ask X | Exp | Strike | Bid X | Ask X | Delta | |
| JUL 11 (41) 100 | | 23.06% (±152.382) | | | | | | | |
| | .13 | 3.00 I | 3.30 C | JUL 11 | 870 | 60.80 I | 63.10 I | -.81 | |
| | .09 | 1.75 I | 2.05 X | JUL 11 | 880 | 69.20 X | 71.70 X | -.85 | |
| OPTIONS pread: 1 month x 2 strike / Vertical | | Layout: Delta | | Exchange: Composite | | | | | |
| CALLS | | Strik... 25 | | PUTS | | | | | |
| | Delta | Bid X | Ask X | Strike | Bid X | Ask X | Delta | | |
| JUL 11 (41) 100 | | 23.14% (±152.918) | | | | | | | |
| | .04 | .95 | 1.55 | 870 / 880 | 6.10 | 10.90 | -.04 | | |

1st Question's Answer (continued):

Were you long it or initiating it? You may be far away (1.00 on the RUT).

RUT trading 813.56

Bid TV Ask

870 / 880 Vertical .60 Wide, .04Δ

When Offered: 0.95 **1.25** 1.55

870 Call .30 Wide, .13Δ

880 Call .30 Wide, .09Δ

Average Delta per .30 Wide Single Option is about .11Δ.

So the .04Δ Vertical should really be about a third as wide:

Bid TV Ask

870 / 880 Vertical should be .10 Wide, .04Δ

When Offered: 1.20 **1.25** 1.30

In this case you are middling the market and you can expect to be filled on a rally when 1.25 is closer to what would be the Market Makers' TV of 1.30 and that will be when RUT is trading closer to **814.81** (same day), **1.25** higher (**\$0.05 / .04Δ**).

2nd Question:

A.) Is it better to always buy calendars with puts, rather than calls, as Don Kaufmann has suggested and why?

B.) How many days until expiration do you recommend opening positions by selling verticals or buying calendars?

C.) What ROI do you recommend before closing? 10%, 80%, etc.?

Daniel R.

2nd Question's Answer

A.)

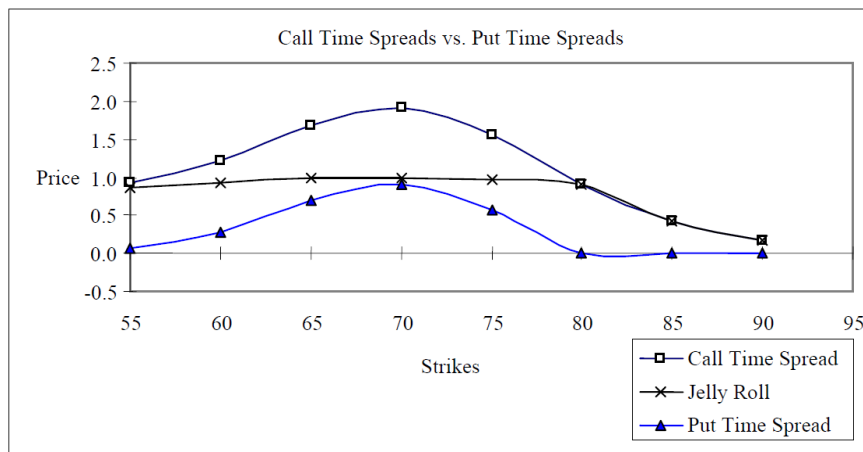
Options Trading: The Hidden Reality

183

The differences between the call and put time spread prices become larger as the strikes increase, and then they start to collapse.

EXHIBIT 7-4

Plot of Values from Exhibit 7-3



B.) Time Frame is everything. Verticals Maximize and Minimize with fewer days to go. Calendars are cheaper the further dated because they are harder to predict the further away they are from Expiry.

C.) ROI depends on your style of trade. High Volume Low Mark-Up vs. Low Volume High Mark-Up.

3rd Question:

- A) When the underlying stock is breaking out of a consolidation to the upside, what do you look for to improve the probability that breakout is real?
- B) And what would be the preferred option strategy?
- C) The option position would need to have positive Delta, but choice of positive or negative Gamma appears to be more subtle.

HCC

3rd Question's Answer

A.) This is a technical analysis question more than an options question and basically is asking for methods of confirmation of a move. A bone fide break-out vs. a fake-out. In conjunction with symmetrical intersecting and parallel trend analysis, I monitor 3 exponential moving averages along with Volume verification.

B.) I usually opt for a bull vertical or if I have confidence in the identified likely expiration range and the prices make sense, opt for a higher strike butterfly.

Long or short Premium would depend on the target and risk/reward.

4th Question:

How to best use position sizing, with a portfolio of Vertical Option Spreads?

Dana C.

4th Question's Answer

The Diversified approach that I encourage starts with a basic allocation that can be tweaked to individual preferences.

\$100,000 Account Size Example:

30% Bullish / 30% Bearish / 30% Sideways-ish / 10% Explosive-ish.

No more than 7% (\$7000) Value At Risk (VAR) on any one trade.

Keeping \$30,000 Powder Dry for adjustments, etc.

5th Question (Part A):

A.) Is there a trade or trades that you specialize in mentoring?

B.) I seem to remember that you do a lot with butterflies and harvesting baby butterflies. Is it a profitable trade to adjust butterflies?

C.) I primarily do OTM credit spreads, usually both sides but not necessarily at the same time. I aim for roughly 50 cents (with a range from 30 to 75 cents) of credit on a 5-strike spread. Can you do anything to help me trade. How would you expand my trading beyond spreads?

Ken J.

5th Question's (Part A) Answer

A.) Vertical, Butterflies and Skip-Strike WingSpreads and BrokenWings as they relate to Position Dissection, Harvesting and Adjusting.

B.) Yes and No. Yes but not necessarily more profitable than letting the butterfly ride un-adjusted onto victory. However, oftentimes the harvesting is taking money and risk off the table (early) with additional profit potential, allowing for capital to be used for another diversified opportunity.

C.) I get that you are playing keep away but it seems very general and High Risk to your reward. I would get more specific with Action Points and vary your proximities to the money.

5th Question (Part B):

The following is a trade I'd like you to mentor after-the-fact:

RIMM MAY 52.5/47.5 put spread for 74 cents (Tuesday, April 26th with RIMM trading at \$55 or so)

RIMM has been in the 56 to 52.50 range now for 16 days. The short put* has \$3 of theta (premium gain) each day. I am also considering going long RIMM when it breaks out of its funk.

A.) What would you have said when this trade was initiated? Do you review trades as I do them or do I have to ask for a review?

Then on April 28th after hours, RIMM announced out of the blue earnings yield 15 cents downward (after having just guided down during an earnings announcement a month earlier. RIMM gapped down on April 29th.

I have closed my RIMM put spreads because I don't want to chance **being put the stock at the end of the day**. Looking at a chart, there is support here for RIMM in the 47 - 49 range. So, I think it's likely RIMM will trade in that range if not descend to 42.50 (**[like in]** September 2010) or 35 (early 2009).

Then I sold the MAY 52.50/55 call spread for 30 cents, using the idea the support becomes resistance.

(B.) How would you have mentored this series of trades?

5th Question's (Part B) Answer

A.) You have to look at the Theta of the whole spread instead of what is simply the short portion. Your positive \$3 Theta is actually less than \$2. I do mentor during live positions. I will show you how I would have speculated differently.

| | | | | | | | | | | | | | | | | | | | | | | | |
|-----------------|-------|----------------------------|------|------------|---------|--------|------|--------|--------|---|------|------------|-------|------------|------|--------|---------|-----------------|--|-------|--|----------|--|
| RIMM | | Research In Motion Limited | | | | | | | | | | ETB NASDAQ | | 4/26/11 | | 55.20 | | +1.76 +3.29% | | | | | |
| UNDERLYING | | | | | | | | | | | | | | | | | | | | | | | |
| Last | | Net Chng | | Volume | | Open | | High | | Low | | | | | | | | | | | | | |
| 55.20 | | +1.76 | | 11,629,972 | | 53.60 | | 55.55 | | 53.23 | | | | | | | | | | | | | |
| OPTIONS | | | | | | | | | | | | | | | | | | | | | | | |
| Spread: Single | | | | | | | | | | Layout: Delta, Gamma, Theta, Vega, Mark, Impl Vol | | | | | | | | | | | | | |
| CALLS | | | | | | | | | | Strikes: 7 | | PUTS | | | | | | | | | | | |
| Delta | Ga... | Theta | Vega | Mark | Impl... | Bid | Ask | Exp | Strike | Bid | Ask | Delta | Ga... | Theta | Vega | Mark | Impl... | | | | | | |
| MAY 11 (24) 100 | | | | | | | | | | 33.46% (±15.299) | | | | | | | | | | | | | |
| .96 | .02 | -.01 | .01 | 7.80 | 34.53% | 7.75 | 7.85 | MAY... | 47.5 | .09 | .11 | -.05 | .02 | -.01 | .01 | .10 | 35.13% | | | | | | |
| .88 | .04 | -.02 | .03 | 5.50 | 33.33% | 5.45 | 5.55 | MAY... | 50 | .26 | .28 | -.11 | .04 | -.02 | .03 | .27 | 32.57% | | | | | | |
| .74 | .07 | -.03 | .05 | 3.45 | 31.63% | 3.40 | 3.50 | MAY... | 52.5 | .72 | .74 | -.26 | .07 | -.03 | .05 | .73 | 31.40% | | | | | | |
| .53 | .09 | -.04 | .06 | 1.895 | 31.11% | 1.88 | 1.91 | MAY... | 55 | 1.66 | 1.69 | -.46 | .09 | -.03 | .06 | 1.675 | 30.92% | | | | | | |
| .32 | .08 | -.03 | .05 | .89 | 30.78% | .88 | .90 | MAY... | 57.5 | 3.15 | 3.20 | -.68 | .08 | -.03 | .05 | 3.175 | 30.68% | | | | | | |
| .16 | .05 | -.02 | .04 | .38 | 31.30% | .37 | .39 | MAY... | 60 | 5.10 | 5.20 | -.84 | .05 | -.02 | .04 | 5.15 | 30.84% | | | | | | |
| | | | | | | | | | | | | | | | | | | | | | | | |
| Spread | | Side | | Qty | | Symbol | | Exp | | Strike | | Type | | Trade Date | | Price | | Delta | | Theta | | P/L Open | |
| VERTICAL | | SELL | | -1 | | RIMM | | MAY 11 | | 52.5 | | PUT | | 4/26/11 | | .63 | | 21.02 | | 1.90 | | \$0.00 | |
| | | BUY | | +1 | | RIMM | | MAY 11 | | 47.5 | | PUT | | | | CREDIT | | | | | | | |



RISK DOCTOR



6th Question

I have a full time job with only a couple of hours available per week to manage my investments. I prefer to buy naked calls and puts, and have had moderate success, as I am only risking the cost of the option. Please explain (A) the advantage of selling options strategies with (B) adjustments, as opposed to the limited risk of buying naked options.

John R.

6th Question's Answer

For (A), I would never recommend selling anything naked. All limited risk credit sales are synthetically limited risk, limited gain debit purchases. So the differences between your naked option buying (with “**risking the cost of the option**”) is that you have unlimited gain potential that might, in fact, be a luxury that you do not use if you are taking small profits. Alternatively, you can be represented by more contract (spreads) for less money spent with greater profit potential using verticals and have more ways to win.

(B) Again, adjustments often take money and risk off the table (early) with additional profit potential, allowing for capital to be used for another diversified opportunity.

EXHIBIT 6-17

Options Matrix

| | | | | | | | | | |
|--------|------|-----------------|-------|------|------|-------|-------|-------|------|
| | | Pregnant C-Bfly | 3.70 | 4.00 | 3.35 | 2.30 | | | |
| | | Call Condor | 1.65 | 2.05 | 1.95 | 1.40 | 0.90 | | |
| | | Call Butterfly | 0.75 | 0.90 | 1.15 | 0.80 | 0.60 | 0.30 | |
| | | Call Vertical | 4.65 | 3.90 | 3.00 | 1.85 | 1.05 | 0.45 | 0.15 |
| | Call | 15.15 | 10.50 | 6.60 | 3.60 | 1.75 | 0.70 | 0.25 | 0.10 |
| Strike | 85 | 90 | 95 | 100 | 105 | 110 | 115 | 120 | |
| Put | 0.15 | 0.50 | 1.60 | 3.60 | 6.75 | 10.70 | 15.25 | 20.10 | |
| | | Put Vertical | 0.35 | 1.10 | 2.00 | 3.15 | 3.95 | 4.55 | 4.85 |
| | | Put Butterfly | 0.75 | 0.90 | 1.15 | 0.80 | 0.60 | 0.30 | |
| | | Put Condor | 1.65 | 2.05 | 1.95 | 1.40 | 0.90 | | |
| | | Pregnant P-Bfly | 3.70 | 4.00 | 3.35 | 2.30 | | | |

7th Question

What is the best strategy for buying LEAPs?

What is the best strategy for sell LEAPs?

CV

7th Question's Answer

I do not see any reason to trade LEAPs

Disadvantages:

Wide Bid / Ask Spreads

When long, they crawl due to low Gamma

When Short they erode slow due to low Theta

Because illiquid, prime candidates for Market Maker Manipulation

8th Question

- (A.) How does an iron condor differ from a just long or short condor?
- (B.) Is it possible to adjust an iron condor into a long, cheaply and easily?
- (C.) How would I apply the question "If I had no position, would I have this position" to an Iron condor trade that be on the verge of breaking out of the range and how could I adjust the trade to reduce loses or turn the trade around?

Ronnie

8th Question's Answer

EXHIBIT 6 – 6

An Iron is: a Call Butterfly and a Lower Strikes Box OR a Put Butterfly and a Higher Strikes Box

