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FALL 2009

BERNIE SCHAEFFER'S

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BERNIE SCHAEFFER'S
SENTIMENT

SENTIMENT is published quarterly.

If you prefer not to receive this publication, please call 800.327.8833.

To view SENTIMENT online, go to schaeffersresearch.com/sentiment

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# Letter from Bernie

IN THE WORLD OF OPTIONS, VOLATILITY HOLDS THE KEY TO YOUR TRADING APPROACH.

Bernie Schaeffer has been bringing you trading tips and market timing insight with the **Option Advisor** newsletter for 28 years. For a free copy, go to: www.sentiment.com/OpAd3

THESE DAYS, THE CBOE VOLATILITY Index (VIX) is getting huge media play as an indicator of future market direction. But regardless of whether the volatility expectations of S&P options traders can be used as a market timing tool, we as options traders must be aware at all times of the volatility priced into the options we trade. It is said that options are the only asset class through which you can take a position on volatility. And conventional wisdom holds that if you feel volatility is modest and is headed higher, you'll lean toward buying puts and calls, while premium selling is the preferred approach if you regard volatility as rich and ripe for a decline. But there is a flaw in this line of reasoning that should be understood by everyone who trades options.

When you're buying a call or a put for speculative purposes, you're not betting on future volatility—you're betting that the magnitude of the movement of the underlying stock in your forecasted direction will result in a market value for your option that comfortably exceeds the premium you pay. In other words, as an option buyer, *the premium you pay is based on anticipated volatility, but your payoff is in directional movement*. This may sound like a quibble over semantics, but the fact is that some of the biggest directional moves that produce huge profits for option buyers are accompanied by very modest volatility. And many periods of high volatility result in very little directional price movement.

Viewed from this standpoint, volatility becomes a cost to the speculator, who must evaluate whether the anticipated directional move is worth that cost. And the best way to speculate on directional movement when the volatility cost is on the high side is through buying "long verticals" or "vertical debit spreads"—the subject of our feature article on page 16. Also included in this issue's robust lineup of features is a primer on how to best trade options before and after major market-moving events such as earnings reports (page 12). We're also bringing you the second of three installments in which we reveal the principles underlying our Expectational Analysis approach to trading (page 23).

I'm pleased to point out that we've introduced a new department with this, our third issue: "Confessions of a Trader," in which our own Ryan Detrick walks us through some of the common mistakes made by beginning traders and explains what we can learn from them. All in all, this adds up to yet another content-rich issue of *SENTIMENT* for you!

Bernie Schaeffer
*Founder and CEO,*
*Schaeffer's Investment Research*

>> Please let us know your thoughts. Send your feedback to **Sentiment@sir-inc.com.**

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Photograph by FREDRIK BRODÉN; Illustrations by JOE MORSE

# Recession? What Recession?

WHEN IT COMES TO ONCE-IN-A-LIFETIME EVENTS, TURNING TO HISTORY TO GET IN FRONT OF A MAJOR MOVE IS ALL PART OF THE PLAN.

>> By Todd Salamone

*"But an argument can now be made … that the market has demonstrated sufficiently extreme long-term historical volatility to be consistent with a major bottom, with the caveat that one never knows for sure at what level volatility will ultimately peak."*
—Spring 2009 *SENTIMENT* cover story

WITH THE S&P 500 INDEX (SPX) trading more than 50% above its March lows as summer draws to a close, it's an appropriate time to review and update some of the long-term market indicators discussed in Bernie Schaeffer's "Are We There Yet?" cover story from *SENTIMENT*'s spring issue. Yes, it was just six months ago that the mantra on Main Street and Wall Street called for the advent of a second Great Depression, while stocks plunged into what seemed like a bottomless pit as 10-month SPX historical volatility launched into orbit.

Coincident with the major downdraft in the stock market, "Are We There Yet?" discussed at length the 14-month Relative Strength Index (RSI), a technical indicator developed by J. Welles Wilder that measures the degree to which markets are overbought or oversold. With the 14-month RSI at multi-decade lows, Bernie's conclusion was, "this market is pretty impressively oversold … *the 14-month RSI for the S&P is just above 25, so one could characterize this market as being oversold to an extent that would be consistent with a major market bottom.*"

In the summer issue of *SENTIMENT*, we published research on the Dow Jones Industrial Average (DJIA) going back to 1901, which displayed the expected returns over varying time frames after the 14-month RSI crossed back above 30. (We used DJIA data due to its longer history relative to the SPX).

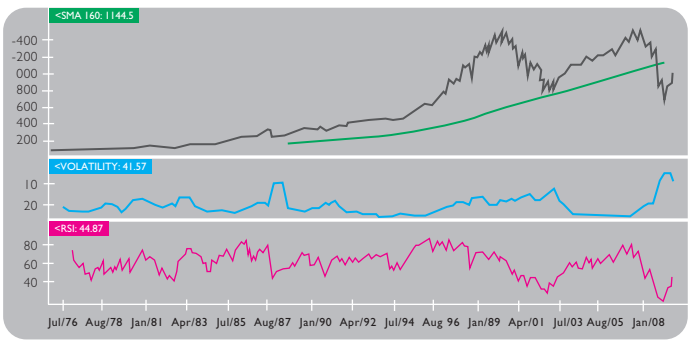


**FIGURE 1:** SPX 160-month moving average (upper pane), 10-month SPX historical volatility (middle pane), SPX 14-month RSI (lower pane). Source: Thomson-Reuters

In the eight instances that this RSI crossover occurred, the DJIA's return six months later was twice that of the typical six-month return. Meanwhile, the 12-month return following the signal was more than three times that of the typical 12-month return. This "buy" signal—triggered at the end of April with the DJIA at 8,168 and the 14-month RSI at 31.23—has so far proven to be extremely prescient.

### Where Do We Go From Here?

Where do we stand now with respect to this indicator? Turning back to the SPX, the 14-month RSI currently stands at only 45. By comparison, there was a reading of 80 ahead of the 1987 crash, and readings in the 70s preceded major tops in 1980, 2000, and 2007. With the SPX's 14-month RSI now significantly below levels that preceded major tops, the skepticism from the "we have come too far, too fast" crowd doesn't seem warranted, and is an encouraging development for the bulls.

Let's turn to the 10-month historical volatility on the SPX. When the spring issue of *SENTIMENT* was published, 10-month volatility was still rising, but Bernie made the case that it was sufficiently high to mark a bottom, with the caveat that one cannot predict with certainty when volatility will peak. Per the second pane on the chart, 10-month historical volatility has rolled over from its peak. Previously, such rollovers from highs have preceded bullish price action amid lower-volatility environments. We find this intriguing, as a contrarian call these days would be for lower volatility in the months ahead.

The market took out huge resistance areas in its impressive rally from the March bottom. Moreover, the indicators above suggest there is room to run even higher. Should this rally continue as we expect, the most significant technical test will be at the 1,150 area on the SPX. This is the site of the index's 160-month moving average, a trendline that acted as major support at the 2002–2003 lows. The 160-month moving average is a major demarcation point of ours between bull and bear markets. Therefore, although skeptics abound, we think the current bear-market rally could have fuel in the tank. But with the SPX's 160-month moving average hovering 12% above the index's current levels, it will require plenty of cash moving off the sidelines for the market to officially move back into bullish mode.

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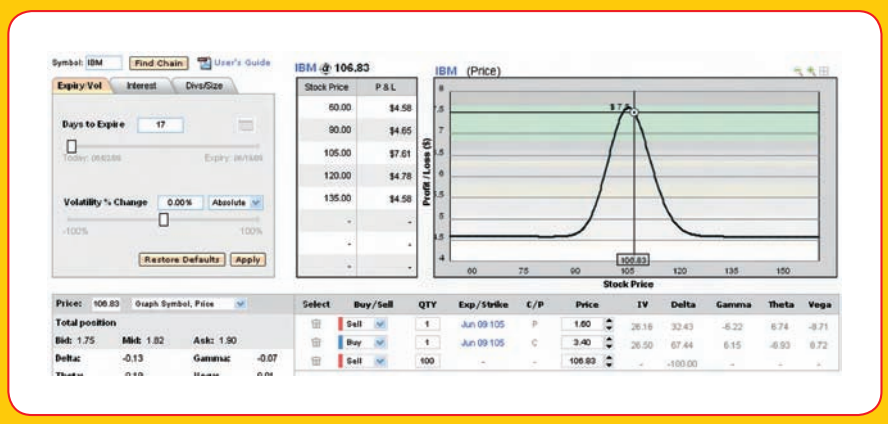


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**For questions, please call 866 400-3427 or e-mail support@ivolatility.com**

# 1

## News @ Schaeffer's

**Web Site**
>The Web version of *SENTIMENT* includes video discussions of our cover features. This month, Richard Sparks and Ryan Detrick discuss trading options around an event, such as earnings. Should you trade before or after the event? What role does volatility play? Does expiration week offer opportunities to traders? Point your browser to Schaeffers Research.com/sentiment and check out the video supplement to this feature article.
>Searching for content at SchaeffersResearch.com is now easier than ever with Google-powered search. We added the search engine giant's capabilities to the site this summer.
>The Daily Option Blog now focuses exclusively on options trading and activity.
>As always, our editorial staff alerts you to news and developments that can help guide your trading in real time, while our education section offers beginners as well as veteran options traders the opportunity to brush up on their skills and knowledge. Schaeffer's tools and filters will give your market research a huge edge over the investing herd.

**Media appearances**
>Bernie Schaeffer will appear on PBS' *Nightly Business Report* on Friday, Nov. 27, the day after Thanksgiving. Check your local listings for the time.
>Financial media routinely turn to the experts at Schaeffer's Investment Research for insights and analysis on the markets. If you missed Richard Sparks on Fox Business Network last month, check our calendar of media appearances at www.sentiment.com/medap.

# 2

## NEW PRODUCTS

Schaeffer's Investment Research has added two new products to its wide array of real-time alert services for option traders.
>SCHAEFFER'S IRON TRADER offers iron condor and iron butterfly recommendations. These trades profit from a sideways trend and decreasing volatility. Although the names sound exotic, traders essentially bet that a stock will continue in its trading channel. For more information, please visit www.sentiment.com/IronCondors, or see our feature on iron trades in the summer issue of *SENTIMENT*.
>SCHAEFFER'S Q FACTOR is an alert program designed to take advantage of the popularity and, therefore, the impressive liquidity of QQQQ options. QQQQ holds all of the component securities of the Nasdaq-100 Index, which seeks investment results that generally correspond to the price and yield performance of the Nasdaq-100 Index. For more information, please visit: www.sentiment.com/QQQQoptions.

# 3

## NEW HIGHS AND LOWS

### Fannie Mae Fears
With two trading days left in August, shares of the embattled mortgage finance company Fannie Mae (FNM) jumped from less than 60 cents per share to almost $2, or 233%! Fear seems to be easing. In fact, fear about Fannie's future had reached such an extreme that, at one point, FNM January 2.5 put options traded for a full $2.50 per contract. For the option premium to equal the strike price is very unusual—there is no profit opportunity. Instead, the stock must fall to zero by January 2010 just to break even! Clearly, some investors had been looking for full downside protection.

### One Man's Garbage...
There have been some huge gains in some high-profile, low-priced stocks recently (Citi, Fannie, Freddie, Crocs). Some say this is a "garbage rally" that marks the end of the market's surge off the March lows. Others (like us) see the skepticism as a "wall of worry" that suggests further upside. We can all agree that short sellers, who piled into these names earlier this year, have been hurt badly and forced to liquidate their bearish bets—which has only added to the upside stampede.

## OPTION MARKET DATES YOU SHOULD KNOW

- OCTOBER 15 — SPX, RUT, DJX Index Options Stop Trading
- OCTOBER 16 — Equity & OEX Index Options Stop Trading
- OCTOBER 21 — Volatility Index Options Expire (VIX, VXN, RXV)
- OCTOBER 23 — Schaeffer's Option Advisor Released
- NOVEMBER 18 — Volatility Index Options Expire (VIX, VXN, RXV)
- NOVEMBER 20 — Schaeffer's Option Advisor Released

# 4

## SIR IN THE NEWS

Senior Technical Strategist Ryan Detrick won over some skeptical *Fox Business LIVE* commentators recently. Ryan was bullish when he first appeared on the show back in the spring, but the Fox reporters had been openly doubtful. When Ryan appeared again on Aug. 10, he spoke bullishly about the casual dining and retail sectors in particular, but also about the general market in general. "Longer-term, bullish is definitely the way to play this here," Ryan told Fox reporters Jenna Lee and Connell McShane. While the unemployment picture remains dismal, he reminded viewers that the market made major advances in the early 1980s when it was even worse. "There are more positives than negatives to this market, especially when you compare it to the early '80s," Ryan said. The Fox response: "You said it a couple of months ago and we doubted you and we're glad you're back to tell us again."

# 5

## Option News

**Option Code Confusion.** If you're confused by option symbols, you're not alone. After all, why is the option ticker for the Fannie Mae January 2010 put at the 2.5 line NJWMY? For many investors, these five-letter symbols are hard to understand.

Help is on the way. Under a new $400 million project, industry leaders are finally taking efforts to revamp the decades-old system used to identify specific contracts. The current symbols, known as OPRA codes, are confusing and simply aren't keeping pace with the fast-growing options market. In fact, some worry about a scenario where, because of the increasing numbers of options contracts trading, the market could run out of combinations for new OPRA codes.

The new system is slated to roll out on February 12, 2010, and is based on work from the Options Symbology Initiative, a group launched in 2006. The OSI is working on a new code that clearly describes all the characteristics of an options contract. The final hurdle is to ensure that all market participants—brokerages, exchanges, and data providers—will be prepared for the new system. It's a Y2K for the options market.

# 6

**VIX vs. CHIX.** The CBOE Volatility Index (VIX) has become the most widely watched gauge of U.S. market volatility. Now, investors have a new tool for tracking premiums and sentiment in China's equity markets. Launched by AlphaShares, LLC, a fund management company founded by Princeton professor and author Burton Malkiel, the CHIX is like the VIX but tracks the action in China and Hong Kong. To be specific, it tracks the implied volatility for Hong Kong's Hang Seng as well as the FTSE/Xinhua China 25 Index. CHIX isn't publicly disseminated in the U.S. yet, but investors can find the latest readings at alphashares.com.

**Betting on Ben** On Tuesday, August 25, 2009, President Obama re-appointed Federal Reserve Chairman Ben Bernanke to a second term. Investors seemed to welcome the news. Stocks rallied. Meanwhile, the CBOE Volatility Index (VIX) stayed around 25 and near multi-month lows. The low readings in the VIX—the market's "fear gauge"—seem to reflect a sense of confidence in Bernanke. But, then again, VIX was near 12.5 when Bernanke took the helm on February 1, 2006.

NOVEMBER 20 — Equity & OEX Index Options Stop Trading

NOVEMBER 26 — Trading Holiday (Thanksgiving)

DECEMBER 16 — Volatility Index Options Expire (VIX, VXN, RXV)

DECEMBER 17 — SPX, RUT, DJX Index Options Stop Trading

DECEMBER 18 — Equity & OEX Index Options Stop Trading

DECEMBER 18 — Schaeffer's Option Advisor Released

DECEMBER 25 — Trading Holiday (Christmas)

DECEMBER 31 — Quarterly Options Expire

# The Magnetic Pull of an Option Strike

CONSPIRACY THEORIES ASIDE, LET'S TACKLE THE TOUGH QUESTIONS ON EXPIRATION TENDENCIES AND OPTION VOLUME.

>> By Bernie Schaeffer

**I'm a speculator who buys options, and I've been extremely frustrated over the years by the obvious tendency of stocks to finish right on a key strike price at expiration. Is there some type of manipulation going on? —Sam**

BERNIE: You are correct that underlying stock prices tend to become "pinned" to strike prices as expiration approaches. In fact, this phenomenon has been confirmed by academic studies. But hold the conspiracy theory—this is basically a natural process based on the way expiring option positions are "unwound."

It has to do with the activity of market makers, who are in the business of facilitating public orders by buying from option sellers and selling to option buyers. These guys have to hedge their positions, too. But they trade at the kind of volume that actually has an effect on the price. A *Wall Street Journal* article by Tennille Tracy on June 18, 2009, explained this phenomenon well:

"When market makers buy call options—the right to buy a stock—they hedge themselves by selling shares. And when they buy put options—the right to sell a stock—they buy shares. On days when options are set to expire, like Friday, market makers adjust their hedges, buying and selling thousands of shares of stock. In doing so, they push a stock toward the strike price of the options they hold."

To this I would add from my own observations over the years: The larger the option open interest at a strike relative to trading volume in the underlying stock, the greater the chances for a "pin."

Note that narrow strike price intervals (one point on many stocks) can diffuse the impact of pinning.

There is an "evil twin" to pinning—caused by a phenomenon called delta hedging—that can cause a stock to make explosive moves as expiration approaches. So never assume that a predicted pin is a sure thing.

**Q: How does option volume affect the underlying stock price? —David**

BERNIE: Although option volume per se doesn't affect the stock price, more often than not, it does act as an important leading indicator for the future price movement of the underlying. You've probably heard the saying, "follow the money." When you see a lot of volume at a particular strike, it's likely someone is placing big bets on the stock around that price. Suppose that in a heavily traded stock, you find that a particular out-of-the-money call strike is suddenly trading 5 to 10 times its normal daily volume. There's a good chance big-money speculators are expecting news for that particular stock, and that strike price will likely play an important milestone in the near future. Likewise, if you see high volume at an out-of-the-money put strike, you could reasonably speculate that someone has reason to expect some imminent bad news. Note, though, that these speculators are far from infallible. Also, those with short positions and long positions in the underlying stock often use out-of-the-money call options and put options, respectively, to hedge their stock.

Something else to consider is that high option volume at a particular strike price could be indicative of resistance or support for the underlying stock. For example, if there is a lot of call selling at a particular strike, the call buyers will typically sell stock to hedge their positions. When the stock begins to move above the strike, overhead resistance will be created as the calls appreciate in value and the hedged call buyers need to sell more stock to rebalance their hedges. So for the stock to "take out the strike", additional buying power is needed to overcome the natural selling from the call buyers.

>> Got a question for Bernie? Send it to **AskBernie@sir-inc.com.**

Photograph by FREDRIK BRODÉN; Illustration by JOE MORSE

## The Man with the Answers: Bernie Schaeffer

Bernie Schaeffer is founder and CEO of Schaeffer's Investment Research, Inc., a leading provider of research and analysis on the stock and options market. He received the Best of the Best Award from the Market Technicians Association for his groundbreaking work on sentiment analysis, and his award-winning SchaeffersResearch.com site is consistently ranked #1 in the options category by Alexa.com. He appears frequently on CNBC and *The Nightly Business Report* and is regularly quoted in the *Wall Street Journal*, *BusinessWeek*, and *USA Today*.

# TRADING THE MAIN EVENT

YOU MAY THINK IT TAKES A CRYSTAL BALL TO FORECAST EVENTS IN THE MARKET—AND YOU MAY BE RIGHT. BUT THAT DOESN'T MEAN YOU CAN'T MAKE MONEY OFF THEM JUST THE SAME.

By Bernie Schaeffer and Todd Salamone

PHOTOGRAPHS BY FREDRIK BRODÉN

THE

*American Heritage Dictionary of Business Terms* defines "event risk" as "the risk that some unexpected event will cause a substantial decline in the market value of a security."

We would expand upon this definition on several fronts. Events such as takeovers and earnings reports can cause stock prices to make huge, fast moves—in either direction. In the traditional, old-line investment world, it might make sense to define the associated "risk" as a substantial decline in the share price. But in the modern trading world with its hedge funds and short-term traders, who may as easily be holding short positions as long positions, and with the added flexibility investors have to profit on bearish views by buying put options, event risk is now "an equal opportunity" phenomenon. A sharp reaction to the upside could be at least as devastating to a short seller or a put holder as a sharp decline would be to a stock or call option owner.

In addition, the dictionary definition of event risk refers to an "unexpected" event. We all know that events (mostly bad ones) can occur out of the blue—terrorist attacks, wars, natural catastrophes, and corporate takeovers would be prime examples—but there are also market-moving events that are scheduled well in advance. The most common are quarterly corporate earnings announcements, but there are others that can have a huge market impact. Our good friend Paul Montgomery, whose weekly Universal Economics market analysis we find to be the most compelling in our business, refers to these events as having "dates certain." As Paul described to us recently:

> What I call "date certain" is a future date, known to virtually all market participants, that is commonly believed to have significance for the markets. Probably the classic example was January 16, 1991, which was the deadline date George Bush Sr. had given Saddam Hussein to abandon Kuwait. The whole world knew about, and watched, that date for six months. Then exactly on that date the troops started to move, and the stock market exploded into one of the strongest bull runs ever.

**You Know More Than You Think**

One fascinating aspect of "date certain" events is that even though they can have an explosive impact on a stock or on the market, you as a trader can plan your strategy in advance and execute it just before the event is scheduled to occur. This means that you can position yourself to achieve big profits in a very short time period—often in less than a full trading day. And such situations can be particularly attractive for option buyers (due to the added leverage and the reduced dollars at risk) versus an outright purchase or short sale of the stock.

Another aspect of trading such events is the critical importance of the psychological component—the expectations ahead of the event. This is often a much more significant driver of post-event price movement than is the information contained within the actual event. If earnings expectations are unrealistically high and this opinion is shared by too many investors, there is almost nothing a company can report that can drive the stock higher. The "expectations bar" is just set too high. Similarly, excessively negative expectations can set a very low bar, and the stock might rally even on a "weak" report. As Paul Montgomery puts it: "The point is not that the event itself is inherently bullish or bearish. In fact, the date certain event may inherently have no fundamental investment significance at all. But because the anticipation of that date prompted behavioral change, these date certain events often show up as inflection points on the charts."

As practitioners of Expectational Analysis® for more than two decades, we at Schaeffer's are uniquely positioned to assess this "sentiment backdrop" ahead of events such as earnings, and to develop option strategies to profit from the post-earnings market reaction.

**Sentiment is Everything**

Perhaps the most important element of an option's price involves the volatility expectation, otherwise known as implied volatility, which directly affects an option's extrinsic value (time premium) based on how much the stock is expected to move prior to expiration. For our purposes, we want to know how much the stock is expected to move immediately following an event. Ahead of known events such as earnings reports, where the outcome is uncertain, implied volatility in the options is typically higher, and thus their premiums are significantly more expensive because the movement in the stock is expected to be greater than usual following the event.

The extra volatility premium going into an event introduces an additional hurdle that the option buyer must overcome: Not only must the stock move in the desired direction, but the magnitude of the move must also be large enough to overcome the volatility "crush" after the event, when volatility recedes and the option's time premium collapses. For this reason, when developing an option buying strategy to trade events, it's crucial to mitigate volatility risk as much as possible.

**Pre-Event Trading: Putting Time on Your Side**

The easiest way for option buyers to mitigate volatility going into a date certain event is to only trade events that occur during expiration week and simply buy front-month options

**For more** on trading events, watch the video at www.sentiment.com/EventVideo.

the day before the known event date occurs—when time premium is nominal, and the stock has a high probability of an explosive move after the event. This may run counterintuitive to other option buying strategies, in which time decay is a concern. However, for event trading, you are only going to be in the trade for a very short period of time (as little as one day). Time decay is not much of an issue. For the event trader, expiration week is the optimal time to make your move: Your leverage is at its greatest, you have the fewest dollars at risk, and the "penalty" of higher volatility premium is minimal.

Using a hypothetical bullish example on stock XYZ at $25, let's take a look at the profit/loss picture on the same call option going into an earnings event. We'll demonstrate how it would react to identical drops in volatility, different time frames, and either no change in stock price or a $1 change after the event (see Table 1).

Note that in the first scenario, with 14 days to expiration, the longer-term call is $0.90. In the second scenario, with 3 days to expiration, the shorter-term call is only $0.41, which is also your maximum risk should the stock move completely against you—already a better deal! The following two examples lay out the profit/loss scenarios depending on if the stock moves or doesn't after the event.

| XYZ @$25 | | | | | XYZ @$26 | |
|---|---|---|---|---|---|---|
| Strategy | Days to Expire | Pre-event Price at 45% Implied Vol | Post-event Price at 30% Implied Vol | Loss | Post-event Price at 30% Implied Vol | Profit |
| Buy 25 call | 14 | $0.90 | $0.58 | -$0.32 | $1.23 | $0.33 |
| Buy 25 call | 3 | $0.41 | $0.23 | -$0.18 | $1.01 | $0.60 |

**TABLE 1:** How a post-event volatility "crush" affects the profit/loss of a straight call purchase, assuming no change in the stock price as well as a $1 move higher after an event.

STOCK DOESN'T CHANGE

Fast-forward to the following morning and the subsequent announcement before the bell—earnings are in line with estimates. The stock reaction is nil and opens up unchanged at $25. Now that the uncertainty of earnings has been removed, the calls suffer a volatility "crush" as implied volatility recedes from 45% to 30%. In the first scenario, the longer-term call opens up at $0.58 for a -$0.32 loss, while the short-term call opens at $0.23 for only a -$0.18 loss. While the stock hasn't changed, you can see that the options certainly have! While they both suffer losses, contract for contract, the short-term options have left you with more capital in your account.

STOCK MOVES $1

Now, imagine the earnings announcement is better than expected, and the stock actually jumps up $1 at the open. While suffering the same volatility crush as in the prior example, all other things being equal, the longer-term call is now $1.23 (profit of $0.33), while the short-term call jumps to $1.01 (profit of $0.66!). Again, options during expiration week have greater leverage ($0.60 profit versus $0.33) with fewer dollars at risk ($0.41 versus $0.91), and don't suffer as much of a loss should volatility get crushed (-$0.18 versus -$0.32). Are we getting through yet?

Of course, ideally, in order to increase our odds of achieving that big post-earnings stock move in our favor, it's good to look to buy call options when pre-earnings investor expectations appear to be very modest. In such situations, the "expectations bar" is often so low that even a mildly favorable earnings report can catapult the shares sharply higher and take those options along with it.

Now, if you're bullish on a company's fundamentals, but less certain about how the market will react to its earnings announcement, you can create various call and put combinations, such as a bullish strangle that could profit from a large move in either direction. The way you set this type of trade up is to purchase a call option in the money (ITM) and a put option of the same expiration, with a higher strike, either at the money or out of the money. In the case of our XYZ example, assuming 3 days to expiration and implied volatility at 45%, you would buy the 22.50 call for $2.51 and the 25 put for $0.41, for a total of $2.91. Because the call option is so deep in the money, it's almost entirely "real value," and thus trades near parity (dollar for dollar) to the stock. The cheap put simply acts as your hedge in case the stock reacts poorly to the earnings. By setting up the strangle this way, your total risk in the trade is just $0.42—the cost of the put plus the penny in time value on the call. This is essentially the same risk as that of the straight ATM call purchase in the prior example, but now you have profit potential on the downside as well.

## Post-Event Trading—Capitalizing on Certainty

In trading "post-events," because the element of uncertainty is removed, you can make decisions based on more factual information, while the options are much cheaper. If the news is sufficient to change the market's perception of the shares, this could create a sustainable move in the direction of the immediate price reaction, and buying options at much cheaper prices when the volatility premiums are minimal might make sense.

A "trade trigger" in post-event situations can occur when the event outcome is counter to the crowd's pre-event expectations. And as with pre-event trading, an option buyer can achieve a tremendous amount of leverage when focusing on trading post-events during expiration week. But also in post-event situations, you can consider buying longer-term options to take advantage of those situations where the immediate post-earnings reaction is the prelude to a much larger and more sustained move. One strategy might be to buy a three-month option with the intention of closing your position before the next quarterly earnings announcement, so you have a pure post-earnings play during your holding period without any event-related "speed bumps."

## Final Thoughts

While we can neither predict nor trade in front of "out of the blue" events like financial catastrophes and terrorist attacks, "date certain" events such as earnings announcements offer a unique opportunity for the option trader to capture potentially explosive stock movements in very short time frames. We don't know what specifically will be announced and/or reported, plus the market's post-event reaction. However, by buying options just ahead of these events during expiration week, you can control your risk and obtain a better reward/risk ratio if the stock has an extreme reaction. And by properly measuring investor expectations ahead of the event, you can help tilt the odds in your favor of getting the post-event direction right.

# The Long Vertical Cure

WHEN YOU'RE LOOKING FOR MORE BANG FOR YOUR BUCK THAN JUST BUYING STOCKS IN A TRENDING MARKET, BUT THE CONDITIONS AREN'T QUITE RIPE FOR STRAIGHT OPTION PURCHASES, PERHAPS THE LONG VERTICAL SPREAD OFFERS THE BALANCE YOU NEED.

By Kevin Lund

ILLUSTRATIONS BY JOE MORSE

IMAGINE THE FOLLOWING SCENARIO: The market has been volatile, but you're still bullish for the next several months and you'd like to trade a diversified group of stocks. You've picked four good candidates from different sectors, all priced around $50, and you want to buy 100 shares of each. Does this seem to be a sound strategy so far? Sure. But suppose you only have $5,000? What are your options now?

A. Take out a cash advance on your credit card to fund the purchase.

B. Buy as much stock as you can on margin and borrow the rest from your friends and relatives.

C. Create a portfolio of long vertical spreads.

Of course, if you picked "A" or "B," then you may need to move out of the house sooner than you think and leave your family and credit cards out of this. If you picked "C," but aren't sure why, read on.

Long vertical spreads (also known as vertical debit spreads, or simply debit spreads) are a relatively conservative option strategy that profits from a directional move in a stock, using much smaller amounts of capital than an outright stock purchase. While there are a number of other options strategies you could use to speculate on a stock's direction, at- or out-of-the-money long verticals can be particularly useful under certain conditions.

PERHAPS THE MOST COMMON QUESTIONS ASKED ABOUT SETTING UP A LONG VERTICAL TRADE ARE: WHAT SHOULD THE REWARD TO RISK BE? AND, WHERE DO YOU PLACE YOUR OPTION STRIKES? IT'S A BIT OF A BALANCE.

## THE MECHANICS

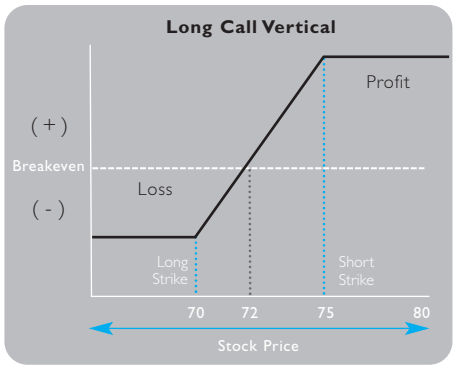
Long verticals are made up of a long (bought) option and a short (sold) option, both either calls or puts, and both expiring in the same month. With long verticals, you incur a debit because you're buying the strike that's closer to the money and selling a cheaper strike, further out of the money. Unlike other option spreads, long verticals are pretty straightforward. If you're bullish, you'd buy a call vertical spread, and if you're bearish, you'd buy a put vertical.

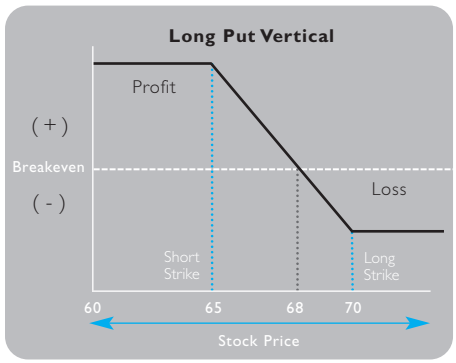
Long verticals are ideal alternatives to buying straight calls and puts when the con-

Which is better for trading vertical debit spreads, calls or puts? What is the optimal distance between strikes? For answers to these questions and more, watch an extended discussion at: **www.sentiment.com/VerticalsVideo**

ditions aren't quite right to do so. The most obvious advantage of buying the call vertical over a straight call position is simply that it's cheaper. But it's a trade-off. You might be paying less for the spread for similar leverage as a straight call, but unlike with the latter, at some point, your profits get capped, depending on where you sell your short strike. (For more on this, see the "Schaeffer's Take" sidebar, below).

The long vertical profits because as the stock moves in favor of the trade, the long strike's option makes money faster than the losses incurred at the short strike due to its "moneyness" or position relative to the stock. Your maximum profit achievable is at expiration, when there is no more time value in the options, but of course, there's no rule that says you need to wait until expiration to cash in and close the trade if you find yourself with a profit before then.




**FIGURES 1 & 2:** Both call and put vertical debit spreads have favorable reward-to-risk profiles in volatile environments where straight call and put purchases are not optimal.

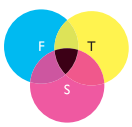
## BUILDING THE TRADE

Let's look at an example using the stock XYZ. Suppose you're bullish on XYZ at $70. You might buy the 70 strike call for $5 outright, or you could reduce the cost even further by turning it into a long vertical. By selling the 75 strike call for $3 to form the 70/75 long call vertical, you've reduced your debit in the trade from $5 to $2, which is also your maximum risk (see Figure 1). Now, unlike the unlimited potential of the call, the most you can close the spread for is $5 (at expiration), so your maximum profit is $3 ($5 – $2). To calculate your breakeven, you simply add your net debit of $2 to the long strike, or $72 on our XYZ trade. Note that if you were bearish on XYZ and bought the 70/65 put vertical for the same $2 debit, your breakeven is $68 (see Figure 2).

Perhaps the most common questions asked about setting up a long vertical trade are: What should the reward to risk be? And, where do you place your option strikes? It's a bit of a balance and ultimately depends on a couple of factors. When it comes to reward to risk ratios for long verticals in low-volatility environments, you should shoot for 3 to 1 or better (in other words, spend $1 to make $3). In higher volatility environments, anything above 1 to 1 is a good rule of thumb.

Among other factors, good reward to risk ratios can have a lot to do with where you set your strikes for the spread. Typically, if you want to be more aggressive and maximize your reward to risk, you would place your long leg of the spread out-of-the money (OTM) by at least one strike. Any more than two strikes and you'll have a very low-delta (low-probability) trade that will not likely profit much, even if the stock moves in your favor. To create a higher-probability, lower reward-to-risk trade, you'd simply set the long strike at-the-money (ATM). The rewards won't be as high as the OTM spread, but you have a better chance of making a profit, so again, it's a trade-off. Ultimately, the final decision will likely have to do with how strong your conviction is on the direction of the underlying prior to expiration of the spread.

On a side note, at some point you may end up asking: Why not buy in-the-money (ITM) verticals? While the answer is a bit more complex than this article has room to answer, part of the reason is that it's a liquidity issue. Options that are ITM are typically less liquid simply because there is less demand for them. When there is less demand, "slippage" increases, which is the spread between the bid and ask prices, and you'll wind up paying too much for that ITM spread. However, that said, the ITM long vertical is the




### Schaeffer's Take: Call or Call Vertical?

>>When trading vertical debit spreads, we at Schaeffer's prefer setups in which we have high conviction on the direction of the underlying stock over the next several weeks or months. Since we have a directional bias, this might ordinarily suggest that a simple call or put purchase is the appropriate strategy. However, there may be reasons to mitigate the time decay risk of the straight option purchase.

For example, consider situations where the option premiums on the underlying might be considered "rich." This "richness" can be defined by higher-volatility expectations (as reflected in the implied volatility of the options) than historical volatility, or by implied volatility being on the high end of its annual range, or by implied volatility being high on an absolute basis because the underlying is extremely volatile. By purchasing a vertical debit spread in these situations, we are partially mitigating the extra time decay risk embedded in the long option portion of the spread by selling a lower delta option against it. Plus, we're lowering the net debit in the transaction, which is important because a smaller move is needed by expiration to realize a profit compared to a straight put or call purchase.

In addition, there are instances where we might be confident about the stock's direction, but uncertain as to how quickly the move will occur. By selling a lower delta option, we can dampen the effects of time decay on the position should the underlying chop around in a range before making the move that we expect. By initiating a vertical debit spread in a breakout situation, you can profit when the follow-through is immediate or when there is an initial period of congestion followed by a resumption of the trend.

TURN THE PAGE FOR MORE

synthetic equivalent to its OTM short vertical counterpart (that is, buying the ITM call spread is the same as selling the OTM put spread using the same strikes), the properties of which can have some distinct advantages under certain conditions. It's worth exploring. (For more on short verticals, see "Going Vertical," *SENTIMENT*, Spring 2009).

## OTHER BENNIES

The beauty of long verticals is that they are very accommodating to a number of market conditions and can act as an effective surrogate for other strategies. To name a few:

**Got Time?** Long verticals are a perfect strategy for moderately bullish or bearish market conditions, particularly when volatility is high or the timeliness of the next breakout is uncertain. By design, debit spreads enjoy a built-in hedge against time passing and volatility risk. If time starts to decay your options, or volatility plummets during the life of the trade, both options lose value. However, while you lose in your long option, you gain some back in the short—mitigating some of that time and volatility risk (for more on this, see the "Schaeffer's Take" sidebar, starting on page 19).

**Easy to Manage** Using long verticals in lieu of a stop loss on a call can streamline your trade management. How? Suppose a call is $5, and you have a $2.50 stop. If you've been trading options long enough, you probably know that the move from $5 to $2.50 is hardly linear and smooth, often gapping from one price to another each trading day. When the market is showing higher levels of volatility, and taking your options along with it, you may find yourself getting whipsawed out of trades unintentionally, or worse, getting filled at a price far below the stop you set in the event that it gaps through it.

So, instead of fussing over stops in a volatile market, next time you buy that $5 call, go ahead and short the strike above it to create the long vertical, with the aim of reducing your overall debit (risk) to $2.50—the same $2.50 you wanted to set your stop for on the straight call. Now (dare I say) you won't need to set a stop at all, and can let the market take your position where it wants to. If the stock falls off a cliff, you can never lose more than the $2.50 you considered an acceptable loss to begin with.

**Small Retirement Accounts** Finally, while regulatory reforms are now in place to curb bad behavior from our beloved financial institutions, the regulatory walls surrounding the use of options in personal IRAs have been torn down for some time. Though you still can't trade on margin in an IRA, many smart brokers now allow you to trade options and option spreads in your retirement account. If the idea of trading shorter-term options in your IRA makes you a little uneasy, consider using longer-term options that can expire as far out as three years, such as LEAPS, to build a long-term, long vertical portfolio. Check that time frame against the average time you hold onto a stock position, and this strategy might just make sense. And since Uncle Sam won't allow you to contribute more than $5,000 this year ($6,000 if you're over 50), this is one way to maximize your contribution without bending any rules. (Suddenly that investment in GOOG doesn't look so far off, huh?)

WHETHER YOU'RE A LONG-TERM INVESTOR OR A SHORT-TERM TRADER, OPTIONS OFFER SO MANY DIFFERENT WAYS TO ACHIEVE YOUR INVESTMENT OBJECTIVES, IT'S A WONDER THEY'RE STILL CONSIDERED AN "ALTERNATIVE" INVESTMENT STRATEGY AT ALL.

WHETHER YOU'RE A LONG-TERM investor or a short-term trader, options offer so many different ways to achieve your investment objectives, it's a wonder that they're still considered an "alternative" investment strategy at all. When you consider that buying call vertical spreads can provide as much or more leverage as a bullish stock position, while cutting your dollars at risk by as much as 90% (or more), they certainly deserve a second look, even by the most conservative skeptic. Despite the argument that such things as time decay and volatility exposure make for a different risk profile than stocks, long spreads can be so effective in mitigating such risks that they can actually turn the standard risk assumption between stocks and options on its head. It's enough to make even the most conservative stock portfolio look like a Vegas casino. Oh, but if you're still actually holding stocks, you probably already knew that, didn't you?

CONTINUED FROM PAGE 19

So the main advantages of vertical debit spreads are: (1) they mitigate time decay risk and the extra challenge of high implied volatility for the option buyer; and (2) they create a more favorable breakeven point.

To be fair, there are some disadvantages to this strategy. First, the maximum gain is usually not fully realized until expiration, as the sold option will have more time premium embedded in the premium than the purchased option. Therefore, in situations in which the underlying makes a fast and aggressive move in the anticipated direction, you must wait until closer to expiration to fully realize your profit potential on a long vertical spread. In playing this waiting game, you run the risk of the underlying moving against you. Second, your maximum gain is capped by the strike of the option you sell, which means you cannot fully participate in explosive moves by the underlying in your favor.

One final, but important, point: Pay attention to the bid/ask spreads (the difference between the bid and ask prices). Since you are buying at the ask and selling at the bid, the negative cumulative effect of wide bid and offer prices when opening and closing vertical spreads can seriously undermine your ability to generate profits.

Todd Salamone
*Schaeffer's Investment Research*

Learn more about harnessing the advantages of vertical spreads with our new real-time alert service at
www.sentiment.com/Verticals

# Special Market Opportunity

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Nicholas J. Bruyer, CEO, First Federal Coin Corp.
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# $4,000 for An Ounce of Silver Bullion? Impossible!

**10 years ago I'd have called you crazy to make such a prediction. Yet today it's a fact. Now our deal with a $4 billion precious metals wholesaler nets you 47% off market price for America's hottest ounce of silver!**

It wasn't more than ten years ago that I was meeting in my office with former U.S. Mint Director Donna Pope. She was speaking with pride about what she considered to be her greatest achievement as Director under President Reagan: Creation of the American Eagle silver and gold bullion coin programs, the first of their kind in our nation's history.

The purpose of these coins was to give people the opportunity to own physical silver and gold in a form certified as to weight and purity by the U.S. Mint. While the bullion coin program was a signal success, nobody took into account the profound effect it would have on the collector market.

## Silver Eagles = Today's Morgan Dollars

In the 1800s and early 1900s, the U.S. Morgan silver dollar was struck year upon year at various mints and circulated at face value. Their core value was in their precious metal content. However, IN TOP GRADES, Morgan silver dollars can sell today for tens and even hundreds of thousands of dollars each!

For the same reason, many collectors today see the Silver Eagle series as a literal "ground floor" opportunity to acquire the top grade coins as they were released. They started submitting Silver Eagles to the leading independent grading services, PCGS and NGC, praying that the coins would come back with the highest possible grade: MS70 (all Uncirculated coins are graded on a point system from a low of 60 to a high of 70, with 70 representing flawless perfection). Of the hundreds of thousands of Silver Eagles sent to PCGS for grading through 2007, only 1 in 20,712 was given the coveted MS70 grade!

## MS70 = $$$$$!

In the rarified atmosphere of MS70, Silver Eagles have soared to market prices that I can only characterize as surreal. Consider this: The PCGS market price guide only ventures to list MS70 values a few of the 21 years of these series so far, with nearly all trading at eye-popping prices:

| | |
|---|---|
| 1986 MS70 Silver Eagle | $4,000 |
| 1988 MS70 Silver Eagle | $4,000 |
| 1995 MS70 Silver Eagle | $4,000 |
| 1997 MS70 Silver Eagle | $3,000 |
| 1998 MS70 Silver Eagle | $2,500 |

## A Fabulous "First Strike" 2009 MS70 Silver Eagle Deal

I was thrilled to lock up a guaranteed supply of Perfect Gem MS70 Silver Eagles from a Primary Distributor who gets them direct from the U.S. Mint. (This is a coin you cannot buy direct from the Mint). Moreover, every coin would be certified and encapsulated by PCGS. But better yet, because we'll get the very first coins released from the Mint, they will have the "First Strike" designation. First Strike certification can turbo charge the value of an already valuable MS70 coin. For example, a 2006 20th Anniversary Silver Eagle from the West Point Mint is valued at $2,000—but add the PCGS "First Strike" pedigree and the value skyrockets to $3,150!


***Needle in a Haystack.*** **PCGS examines over 10,000 Silver Eagles to find the one that earns the coveted MS70 grade.**

## Call Immediately Before They're Gone

There's no telling how much the new "First Strike" MS70 2009 Silver Eagles will be worth five years from now—or even 6 months from today! As I write this I literally don't know how many Perfect Gem MS70 coins we'll get, but I DO know that I have a limited supply of these "perfect" 2009 Silver Eagles for just $159 each! That's 47% off the current market price of $299.95! The only "catch" is that I must limit orders to no more than 5 at this price. I urge you to call immediately, toll free, 1-888-201-7047 and request Offer Code FNL131. **NOTE: Earliest orders get priority so call immediately to avoid disappointment!**

**Call Toll-FREE today 1-888-201-7047 to Reserve Your 2009 First Strike MS70 Silver Eagles!**

Offer Code FNL131
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Expectational Analysis Series: Part 2

# When Opposites Attract

TRADITIONALLY, FUNDAMENTAL AND TECHNICAL ANALYSIS MIX ABOUT AS WELL AS OIL AND WATER. AS TWO KEY INGREDIENTS OF EXPECTATIONAL ANALYSIS®, THEY GO TOGETHER LIKE PEANUT BUTTER AND JAM. BUT THEY'RE STILL ONLY PART OF THE RECIPE.

By Joseph Hargett

PHOTOGRAPH BY FREDRIK BRODÉN

*In our feature article titled "The Extra Edge" in the first issue of* SENTIMENT, *we introduced our unique Expectational Analysis® approach to gaining a trading edge in the market. In this issue, we drill down and focus on fundamental and technical analysis—two of the three major components of Expectational Analysis.*

FUNDAMENTAL AND TECHNICAL analysis are the main pillars of modern security analysis as practiced by Wall Street institutions and investors. The modern incarnation of technical analysis owes much to Robert D. Edwards and John Magee, who first published *Technical Analysis of Stock Trends* in 1948. Fundamental analysis, meanwhile, came into prominence around 1934 following the release of Benjamin Graham and David Dodd's co-authored book, *Security Analysis*.

The fundamental and technical approaches each have fierce adherents, and both styles of analysis include useful tools and provide valuable insights. And although many practitioners tend to line up more in one camp than another, in truth, most analysts employ some combination of these disciplines.

That said, there is often a wide gulf separating these two approaches. It's interesting to note that fundamental and technical analysts can look at the same set of data and arrive at completely contradictory conclusions. Consider this paradox: When a stock declines in price, the fundamental analyst who likes the stock will tend to look at it as an even more compelling "buy" because it's "cheaper," while the technical analyst will likely sell his long position and perhaps even short the stock because of its weakening technical outlook.

Keep in mind, while fundamental and technical analysis are crucial to our method, they're still only part of the picture. Let's attempt to break down each to provide a foundation for how they work together in our Expectational Analysis.

## FUNDAMENTAL ANALYSIS

At its core, fundamental analysis examines factors such as earnings, dividends, price to earnings (P/E) ratios, and projections of the strength of the economy to forecast stock prices. For long-term investors, or the buy-and-hold crowd, these indicators carry considerable weight. But for options traders, who are likely looking at considerably shorter time frames—measured in months, weeks, or even days—these factors have considerably less impact. Options traders shouldn't completely write off fundamental analysis, however, as earnings momentum, corporate restructuring, new products or product recalls, management changes, and stock buybacks can have a dramatic and immediate impact on the underlying shares.

Let's examine how one particular fundamental indicator can offer guidance for options traders looking for an edge in judging short-term or intermediate-term moves in the market.

### Earnings Reports

Earnings reports are the quarterly filings made by public companies to report their financial performance. Earnings reports are filed at the end of each quarter, with most companies filing in January, April, July, and October. A company's earnings report includes items such as net income, earnings per share, earnings from continuing operations, and net sales. Quarterly earnings reports will also often include a forecast for the coming quarter(s) and sometimes for the rest of the fiscal year.

Think of an earnings report as a "report card" for a company. These quarterly reports let shareholders know exactly how well a company has performed during the past quarter. A company's results will be compared versus the same quarter a year ago, but in today's market environment, this comparison takes a backseat to a comparison with analysts' published estimates of these earnings. Surprises can occur to the upside (stronger than expected results) or the downside (weaker than expected results). The magnitude of a stock's positive or negative earnings surprise can be a major short-term catalyst for the equity's performance.

There is also a sentiment angle that we employ when dealing with corporate earnings reactions. For example, everyone is familiar with the example of the "good" quarterly earnings report—i.e., a company that tops its own guidance and Wall Street's forecasts—that meets negative price action. At Schaeffer's, we believe it is important to measure *expectations* surrounding the report. What are retail investors doing? Are they bidding up the price of the stock or buying call options in anticipation of a positive earnings report? Are analysts overly enthusiastic and setting overly ambitious price and profit targets? If expectations are too high, the bar is raised for what the company must report in order for the earnings to produce a positive price reaction.

## TECHNICAL ANALYSIS

Unlike fundamental analysts, whose main focus is calculating and estimating a company's true worth, technical analysts are less interested in determining a security's intrinsic value. Instead, "technicians" focus on stock charts in an attempt to identify patterns and indicators that will provide an edge in determining the equity's future performance. Furthermore, technicians believe that all relevant fundamental information is reflected in the price action of a stock, that past price action can be used to forecast future price action, and that self-reinforcing "trends" can serve to keep stock prices moving in a particular direction. For options buyers, the strength and validity of a stock's trend can make or break a trade. Therefore, our method tends to favor technical indicators that can help confirm a trend and provide insight into its potential duration. Such an analysis can also be very helpful for the timing of non-directional options strategies such as iron condors and credit spreads. (For more on these strategies, read "Fortified with Iron" [Summer 2009 issue] and "Going Vertical" [Spring 2009].)

Let's take a closer look at a few of these indicators and see how options traders can utilize them to judge market trends.

### Moving Averages

One of the most widely used technical tools is a moving average (the average of the closing prices for a stock over a defined number of units of time). This is a trendline that smooths out potentially sharp or erratic price action and helps to visually eliminate "noise" or irregular fluctuations in a security. Moving averages serve as workhorse indicators for many in the industry, and are commonly used to identify trends and their directions. They can also mark levels of support and resistance for a security, making them useful on multiple fronts for options traders.

Time frames for these calculations can range from one minute to several months, with 10-unit and 20-unit time frames among the most common. While there are no hard and fast rules to follow when using moving averages, the short-term nature of daily trendlines makes them particularly ideal for options traders. For example, a stock moving higher above support at its 10-day and 20-day moving averages often has an enhanced probability of continuing its uptrend.

For longer-term options trades, we have

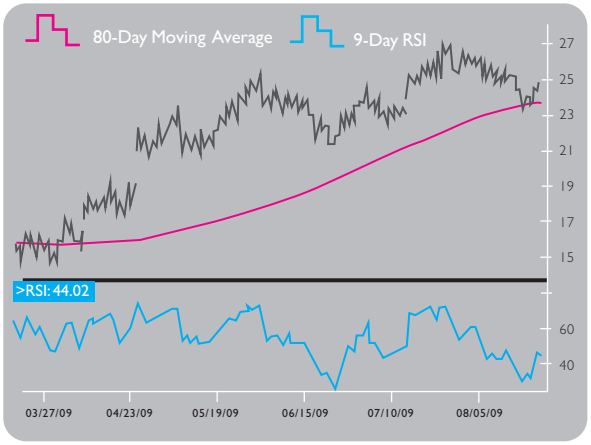



**FIGURE 1:** Trendline support at 80-day moving average with 9-day Relative Strength Index (RSI).

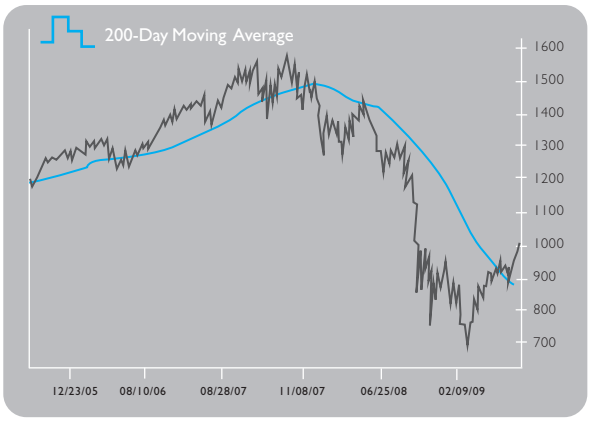



**FIGURE 2:** Daily chart of SPX since October 2005, with 200-day moving average. Notice the critical levels breached in early 2008 as well as early 2009 and the ensuing direction the SPX took.

found that 50-day and 80-day moving averages can be excellent trend indicators (see Figure 1). Specifically, pullbacks to these trendlines can provide opportunities to enter a long position on a stock that has experienced a short-term decline in a longer-term uptrend. Furthermore, rallies into resistance at these moving averages can mark an opening for a short position.

One of the best examples of utilizing a moving average to help confirm a security's trend is the recent encounter between the S&P 500 Index (SPX) and its 200-day moving average (Figure 2). When the SPX approached this trendline in late May, technical analysts cited the potential for major resistance, positioning it as a make-or-break case for the index's uptrend. Indeed, a rejection at this moving average could have confirmed that the SPX's long-term downtrend was still in place. However, the validity of the SPX's uptrend was confirmed when the index moved past this potential hurdle.

### Support and Resistance Levels

Round numbers, "psychological" levels, retracements, Fibonacci levels, century marks, gaps—call them what you will, but they are all ultimately potential areas of support or resistance that can have dramatic effects on a stock's trend. What's more, if these regions have previously altered the course of a security's trend, there is a strong likelihood that they will do so if tested again. For instance, if a stock found support at the $50 level previously, we would expect that area to hold, at least initially, as support on subsequent tests. However, if the region is breached, the $50 level might then switch roles and act as resistance.

More often than not, these levels are also home to heavy concentrations of call or put open interest, creating additional headwinds or tailwinds for a stock when these areas are approached. For example, suppose that shares of XYZ have attracted a considerable buildup in call open interest at the $20 strike. As XYZ approaches $20 per share during expiration week, hedges related to these call options can be unwound, thereby creating selling pressure, or resistance, at the $20 level.

### Relative Strength Index (RSI)

Oscillators, or technical indicators that give readings within a predefined range, can also help confirm the strength of a stock's trend. Arguably the most popular is J. Welles Wilder's Relative Strength Index (RSI). The RSI is derived from a formula comparing upward and downward moves, and provides readings between 0 and 100. A high reading, typically those above 70, is defined as "overbought," and a low reading, usually near 30, is considered "oversold." (See Figure 1.)

Normally, an overbought reading is interpreted as a sell signal, while an oversold reading is viewed as a buy signal. By monitoring these signals, options traders can get a better idea as to whether a stock's trend may encounter a "speed bump" or a correction due to excessive price movement over a particular time interval. When Wilder first wrote about RSI in the late 1970s, he suggested using 14 periods. Since then, the 9-day RSI has gained some popularity, especially among options traders. The shorter 9-day period is a bit more volatile than the 14-day period, and is considered better for looking at shorter time frames, making it more suited to trading options.

## SOMETHING'S MISSING

Fundamental and technical analysis each offer insight to the stock and options trader. But those insights are incomplete—and sometimes contradictory. Even taken in tandem, they go only part of the way toward explaining stock price action. Fundamental and technical analysis each overlook investor psychology. Among technical analysts, the saying is, "The trend is your friend." But we know that the chart of a strong stock can look its most attractive and compelling just ahead of a price peak that occurs because investor enthusiasm reaches such an extreme that buying power is almost completely depleted. In other words, charts often look their most bullish at tops. Likewise, if a company beats earnings expectations and guidance, fundamental analysis dictates that the firm's stock will rise. But we know that stocks often decline on strong earnings due to excessively bullish pre-earnings expectations.

It is here that Expectational Analysis can fill the void. This methodology, pioneered by Bernie Schaeffer, considers fundamental and technical analysis in the context of sentiment analysis. Examining investor sentiment not only helps to fill the gaps, but it can also provide you with an entirely new insight into the market. So, while following the financials and the trend can help improve your trading results, remember that investor psychology is equally important, and the interplay between all three factors is most important of all. Plus, markets and stocks can be irrational, and irrationality doesn't fit neatly in a trend or in an earnings report. We'll examine sentiment analysis more fully in the winter edition of *SENTIMENT*.

# One Stop for Fundamentals and Technicals

STREAMLINING YOUR EXPECTATIONAL ANALYSIS WITH JUST THE RIGHT TOOLS.

>> By Nick Perry

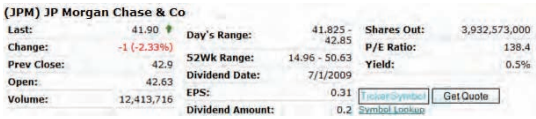
SENTIMENTICIANS HAVE A couple of extra steps to take when it comes to researching trades, and the payoff for doing so is a lower-risk, lower-stress method to trade the markets. But first you have to cut through the noise to find just the right information. SchaeffersResearch.com offers a variety of tools to help you explore the world of Expectational Analysis quickly and efficiently. Here are three you will find useful for your technical and fundamental analysis.

### Quotes Page

If you are looking for a quick overview of the data, our quotes page should be your first stop (see Step 1). With just a glance, you can get a feel for the price action and see some of the key fundamental metrics. Along with current figures related to today's trading, such as the last price, change, and volume, there are a couple of indicators of strength you may want to study. The "Day's Range" shows you the day's high and low. Likewise, the "52Wk Range" shows you the annual high and low. By comparing the last price to these benchmarks, you can easily gauge the stock's short-term and long-term price action. You can also get a snapshot of fundamental data by looking at the earnings per share (EPS) and the price to earnings (P/E) ratio. Information related to dividends is listed on this page as well.

### Interactive Charting Page

If you want a more detailed technical perspective, turn to our charting page (see image, Step 2). There you can explore daily charts and utilize a wide variety of technical indicators, from simple moving averages and the Relative Strength Index (RSI) to more advanced indicators such as Bollinger Bands, average true range, moving average convergence/divergence (MACD), and on-balance volume.



(JPM) JP Morgan Chase & Co

| | | | | | |
|---|---|---|---|---|---|
| Last: | 41.90 | Day's Range: | 41.825 - 42.85 | Shares Out: | 3,932,573,000 |
| Change: | -1 (-2.33%) | 52Wk Range: | 14.96 - 50.63 | P/E Ratio: | 138.4 |
| Prev Close: | 42.9 | Dividend Date: | 7/1/2009 | Yield: | 0.5% |
| Open: | 42.63 | EPS: | 0.31 | | |
| Volume: | 12,413,716 | Dividend Amount: | 0.2 | | |

Ticker Symbol | Get Quote | Symbol Lookup

**STEP 1:** Sentimenticians should go straight to the quote page at SchaeffersResearch.com as your first stop to analyzing stocks (www.sentiment.com/stockquote).


**STEP 2:** View the technical picture from our interactive charting page at www.sentiment.com/stockchart.

Traders will eventually gravitate to their own unique set of technical indicators and ways of researching the market. However, for those new to technical analysis, you may want to start with a simple setup like the one shown. It features the 50-day moving average (green line), the 200-day MA (blue line), and the 9-day Relative Strength Index (RSI; red line).

The 200-day moving average offers a longer-term perspective, while the 50-day MA gives a shorter view of the price action. In and of themselves, these trendlines can be viewed as potential support and resistance zones. However, they can also be viewed relative to each other to help gauge trends. In our example, we first see the stock cross the 200-day MA, and then that move is confirmed when the 50-day MA follows suit.

The 9-day RSI offers a way to gauge when short-term moves are possibly becoming overextended. Oversold readings are often followed by snapback bounces. Overbought readings can warn you to be on the lookout for pullbacks or consolidations. For example, our sample chart shows the recent bullish shift in trend, but the RSI has pushed into overbought territory. Those looking to go long may want to wait for either a pullback or for the short-term MA to catch up to the stock.

### Schaeffer's Contrarian Stock Screener

More advanced traders will want to pay special attention to Steps 2 and 3 of the Schaeffer's Contrarian Stock Screener (www.sentiment.com/stockscreener). You begin using the stock screener by choosing whether you are bullish or bearish (step 1). After that, use step 2 to filter for stocks based on volume, moving averages, historical volatility, annual highs and lows, as well as stocks that are overbought or oversold. Step 3 allows you to see these indicators and sort the results based on them. For example, a bullish trader may screen for stocks with all-around skepticism that are trading above their 200-day moving average and then sort the results to reveal the ones that are the most oversold. This could help you identify good entry points by showing you the stocks that are above long-term support but are pulling back over the near term. Plus, since we've already pre-screened for stocks on which sentiment is skeptical or even bearish, there is the added bonus of knowing that the crowd has yet to jump aboard. (For more on the Stock Screener, see "Idea Lab," *SENTIMENT*, Spring 2009.)

Of course, the tools on SchaeffersResearch.com go well beyond the world of technical and fundamental data. We have data on put/call ratios, short interest, analyst ratings, implied volatility, and more. But that is a discussion for the next issue of *SENTIMENT*.

# Expectational Analysis Q&A

FINE-TUNING YOUR KNOWLEDGE OF FUNDAMENTAL AND TECHNICAL ANALYSIS.

**Q: Fibonacci levels and retracements are often used in technical analysis. So, what are they, anyway?**

**A:** Let's start with a little history. Leonardo Fibonacci was a mathematician who was born around the year 1170. Fibonacci discovered a relationship between a sequence of numbers that now bears his name. The Fibonacci number sequence is a series of numbers beginning with 1 in which each successive number is the sum of the two previous numbers: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, and so on. What is unique about the sequence is that any given number (after the first few very small numbers) is approximately equal to 1.618 times the preceding number and approximately 0.618 times the following number.

There have been studies that show that Fibonacci relationships exist in nature, such as in the formation of tree rings. Within the field of technical analysis, the Fibonacci number sequence is used primarily to gauge price movements. The most commonly used numbers in this form of retracement analysis are 38.2% and its complement 61.8%, but more multiples can be used when needed, such as 23.6%, 50%, and 76.4%. As prices retrace following a significant move in either direction, the underlying may stall at support/resistance near the Fibonacci lines.

For example, if shares of XYZ rallied from a defined bottom of $25 to a high of $50, a pullback to the $40.55 region might be the stock's next move, retracing 38.2% (or $9.55) of its gain. All other things being equal, technical analysis would suggest that XYZ could rebound from this level, with the 38.2% retracement zone acting as a floor of support. Carrying the example one step further, let's assume that momentum is fading fast on XYZ, and the shares breach support near $40.55. The resulting decline may be halted by a 61.8% retracement of the stock's original rally, near $34.55. Note also that 0.382 and 0.618 are complements of each other, with their sum equal to 1.000.

**Q: What is a "gap," and how can I take advantage of these technical formations in options trading?**

**A:** Gaps are areas on a chart where the price of a security moves up or down so sharply that it shows no trading activity in between. As a result, the equity is left with a "gap," or a break in price, in the chart of its price action. These blank regions are often the result of the market's reaction to a fundamental event, such as an earnings report, change in management, or sales data. Technically speaking, gap levels can act as layers of support or resistance. For example, if the shares of ABC gap from the 29 level to the 30 level following the company's earnings report, the 30 region should provide support for the security. Conversely, if the stock gaps from the 35 level to below the 30 level, this region could emerge as technical resistance.

A gap can also upset a trading range, taking the shares outside of an established area of price action. The violation of a defined consolidation range can attract more buyers (if the gap breaches this range to the upside) or sellers (if the gap is to the downside), increasing volume. Gaps of this nature tend to be more effective as support (or resistance) and may not be "filled" for a longer time compared to gaps occurring amid more volatile price action. As such, gaps can be used to gauge entry and exit points in your trading, define new points of support/resistance, or foretell increasing volume and demand.

**Q: The financial media and many Wall Street analysts place a heavy emphasis on price to earnings (P/E) ratios. What impact, if any, do P/E ratios have on options trading?**

**A:** P/E ratios are a fundamental tool—a valuation ratio that compares a company's current share price to its earnings per share. High ratios suggest that investors are expecting higher earnings growth from a company. They can also suggest that the stock may simply be overvalued. These ratios are often compared to other companies within a sector in order to provide a baseline for industry expectations.

While P/E ratios provide a glimpse of investor sentiment, they do so for a much longer time frame than options traders are generally concerned with. For example, LEAPS traders looking for option positions one to two years out may find P/E ratios useful, but they would be almost useless to any investor trading options within a three- to six-month time frame. Think of it this way. When was the last time you saw a stock move sharply simply because it has a high or low P/E ratio?

# The Three Biggest Mistakes New Traders Make

HOW DOES A ROOKIE BECOME A PRO? BY LEARNING FROM EARLY MISTAKES.

>> By Ryan Detrick / PHOTOGRAPH BY FREDRIK BRODÉN

*"The subprime mess is grave, but largely contained."*
—*Ben Bernanke* in a speech before the Federal Reserve Bank of Chicago, May 17, 2007

LOOKING BACK, HOW COULD ONE OF the most powerful men in the world, someone with endless amounts of information on the economy and stock market history, be so wrong? I'm not pointing this out to take a shot at the Fed chairman, but to bring home the fact that everyone makes mistakes. When it comes to options trading, you will make some common mistakes in the beginning, but the key for traders is to learn from those mistakes. The faster we can do this, the better off our portfolios will be.

**Probability of Seeing At Least X Consecutive Losing Trades Within a 50-Trade Period**

| Win Percentage | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|---|---|---|---|---|---|---|---|
| 5% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| 10% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| 15% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| 20% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| 25% | 100% | 100% | 100% | 100% | 100% | 99.8% | 98.9% |
| 30% | 100% | 100% | 100% | 100% | 99.6% | 97.7% | 92.2% |
| 35% | 100% | 100% | 100% | 100% | 97.1% | 89.0% | 75.2% |
| 40% | 100% | 100% | 99.9% | 97.6% | 88.4% | 71.3% | 51.7% |

**FIGURE 1:** A string of losses is not only probable, but expected. It's how you deal with it that makes the difference.

Having been in the research department of Schaeffer's for nearly six years, time and time again, I've seen customers make the same three major mistakes that I made when I first started trading. I'm sharing them with you now in the hope you can learn from them and avoid them in your own trading.

### 1. Inability to take a loss

Taking losses was very difficult for me to accept at first. As kids in school, we all learn that in order to be considered successful, we need to get 95% of the questions correct and earn an A. As it turns out, when it comes to options buying, this isn't the case. In fact, with options buying, the percentage of winning trades required to be successful is more like a baseball batting average. You can have an extremely profitable options portfolio with only a 35% winning percentage.

I had trouble taking even one loser, but when it comes to options buying, the odds are high that you can see numerous losers in a row. In fact, our Quantitative Analysis department has determined that out of a 50-trade period, with a 40% win rate, there is a 51.7% chance of having eight losers in a row (see Table 1). I don't care who you are: losing eight times in a row can do a number on your psyche, especially if you're a new trader. But in the bigger picture, such a streak is not statistically abnormal. Eventually, I was able to become more comfortable with taking losses. I still don't enjoy chalking up losing trades, but thanks to the leverage that buying options provides, I've come to realize that it only takes a few big winners to more than make up for my inevitable losing trades and allow me to be profitable over time.

### 2. Poor money management

The next mistake I was prone to as a beginner was poor money management. It is very tempting as a new trader to load up on one trade if you have high conviction. I needed to learn that the odds of an out-of-the-blue event taking my position to a total loss (and severely depleting my portfolio) are simply too great. Once I had a call option on a company that was unexpectedly raided by the Feds, and the shares sank nearly 80% before I could do anything. Needless to say, my call option was a total loser before I could blink an eye. That unfortunate experience reinforced the fact that I should never load up on any one trade, no matter how certain I was it was going to work. To avoid this problem, at Schaeffer's, we recommend never putting more than 5% of your option trading portfolio into any one trade.

### 3. Betting against the trend

The final mistake I made as a beginning trader was betting too often against the trend. It is tempting to be a hero and try to pick a bottom or a top, but this isn't how you consistently make money. Over time, I learned that as an options trader, betting with the trend is a much safer way to profit. Seriously, who really expected bank stocks to drop as much as they did last year? Numerous traders (of varying experience levels, I might add) lost massive amounts of money trying to catch a falling knife—only to keep getting cut. There is an old saying that "the trend is your friend," and it couldn't be truer. Don't fight it.

# Idea Lab

TURNING TRADITIONAL MARKET R&D ON ITS HEAD



idea #1

## GAUGING TOPS & BOTTOMS WITH GAMMA

IF YOU'RE NOT WATCHING YOUR GREEKS, YOU SHOULD BE.

IF YOU'RE FAMILIAR WITH Schaeffer's Investment Research, then you probably have some experience with Schaeffer's put/call open interest ratio (SOIR)—one of our primary sentiment indicators. SOIR is the ratio of put open interest to call open interest among options set to expire within three months. A high SOIR may indicate pessimism among options traders through heavy bearish put activity; a low SOIR, which indicates heavy call activity, may signal optimism.

However, open interest is just part of the picture. Also important is where this open interest resides relative to the stock price. For example, a security that has experienced a sudden violent decline may have considerable call open interest at strikes far above the current stock price. As a result, these deep out-of-the-money calls may be almost worthless and have little chance of ever regaining any value. Largely untradable, these calls have little effect on the stock price, and tell us nothing about the current sentiment picture. A high number of out-of-the-money calls, resulting in a low SOIR, could in fact lead us to overstate the optimism on a stock, and there is an analogous situation on the pessimism surrounding heavy out-of-the-money puts. So, we added another layer to the SOIR: gamma weighting.

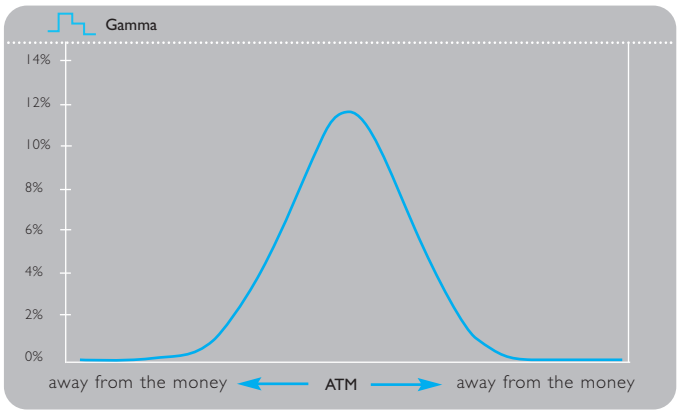



**FIGURE 1:** Viewing the rate of change in gamma as its underlying moves either way.

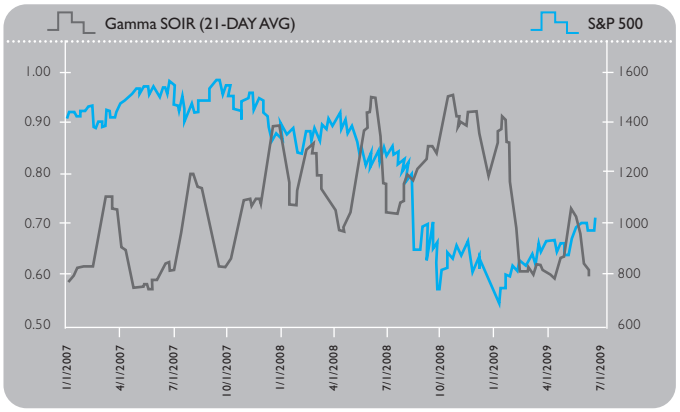



**FIGURE 2:** Comparing the 21-day moving average of the gamma SOIR against the S&P 500 Index has been a good indicator of market peaks and bottoms. Are we at another top?

### What is Gamma?

Greek letters ("greeks") are used to describe how sensitive an option price is to certain variables. Delta, one such greek, is simply the rate of change in the price of the option for each point change in the underlying. Gamma, our primary topic here, is the rate of change in the delta of an option for each point change in the price of the underlying stock (or more simply, the acceleration of change in an option's price as the underlying moves). Adding it to the SOIR can be enlightening, as an option's gamma gives us a good feel for its proximity to the current stock price.

Figure 1 shows how an option's gamma behaves relative to the underlying stock's price. As you can see, an option that is at the money has a very high gamma, and is the most sensitive to changes in price of the underlying.

**Dow Returns After a Negative 10-Year Return**

| | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|
| Occurrences | 21 | 21 | 21 | 21 |
| Average Gain | 10% | 17% | 42% | 112% |
| Percent Positive | 71% | 71% | 71% | 100% |
| Typical Dow Returns Since 1900 | 7% | 22% | 38% | 86% |

F/Y/I

### AFTER A DECADE OF DECADENCE

IT'S HARD TO BELIEVE, but since November 2008, the Dow Jones Industrial Average has had a negative return over the last 10 years! As of August 31, 2009, the index was still down by about 10% from 10 years ago. Does that mean we are due to see the stock market soar higher? Surprisingly, that's not what history tells us. This table compares the average return of the Dow after it posted a 10-year loss to how the Dow has typically performed. The market did not burst higher to make up for those "lost decades." Rather, it simply moved upward at its usual pace out to 5 years. It is not until 10 years later that you see some significant outperformance.

The farther the strike price is from the current stock price, the smaller the gamma. By multiplying an option's open interest by its gamma, we get a gamma-weighted open interest figure. Then we divide the gamma-weighted put open interest by the gamma-weighted call open interest in order to arrive at a gamma-weighted SOIR. The result puts higher importance on near-the-money open interest, while effectively disregarding open interest that is deep in the money or deep out of the money.

### The Secret Sauce

Now let's explore one way to utilize the gamma-weighted SOIR. Compiling all the stocks in our database, we summed the gamma-weighted puts and calls and created a market-wide gamma-weighted SOIR. A chart of the 21-day moving average of this indicator is shown in Figure 2, alongside a price chart of the S&P 500 Index (SPX). Notice that peaks in the gamma-weighted SOIR coincide with short-term market bottoms. When it hits a low and turns higher, it has been a bad sign for the market.

In late March and into April of this year, the gamma-weighted SOIR declined dramatically, reaching its lowest level since July 2007. The ratio has remained near this low, which is not an encouraging sign, as it reveals a sudden increase in call open interest surrounding current stock prices—which is not good news for contrarians. Furthermore, since a buildup of call options above a stock price can act as resistance, the gamma-weighted SOIR may be signaling intense headwinds for many stocks.

However, there is good news to be gleaned from this chart. First, the market still maintains considerable upward momentum. Second, a very slight market pause beginning in late June resulted in a surge of the market-wide gamma-weighted SOIR, meaning that put buyers are on the sidelines and are prepared to jump in on any market weakness.

The gamma-weighted SOIR is also a great indicator for screening individual stocks for potential call or put plays. We show this indicator on a stock-by-stock basis at www.SchaeffersResearch.com—just click on the "Quotes & Tools" tab.

>> **Rocky White** Senior Quantitative Analyst, Schaeffer's Investment Research

idea #2

## TRADING FLOOR BLOG

TIMELY MARKET UPDATES AND FOOD FOR THOUGHT FOR THE HUNGRY TRADER.


**FIGURE 1:** Our research analysts dig deeper so you don't have to. Multiple times per day, the Trading Floor Blog brings you timely market updates, option data news, and new trading ideas in real time (see www.sentiment.com/blog).

**Q:** Where do you find big trading opportunities?

**A:** Follow the money, of course. Nowhere is that statement more true than in the options market. And nobody tracks the information deep within the options market better than Schaeffer's Research. Each day, our team of analysts pores over endless data and scans the universe of optionable stocks, looking where others don't, to unveil opportunities where the big money is coming and going.

The Trading Floor Blog is no exception (www.sentiment.com/blog). With at least eight posts each day, Schaeffer's Research analyst Nick Perry provides plenty of food for thought for any hungry investor looking for real-time market updates and new trading ideas. For starters, the Trading Floor Blog begins each day with a premarket futures update to give you a sense of where the market will open, and shortly thereafter, follows up with posts that provide potential new trade candidates based on some of our favorite sentiment indicators—stocks with unusual volume, stocks advancing amid short interest ("climbing the wall of worry"), and stocks with option skews that are biased toward heavier put or call activity.

Just before the lunch hour is over, the Trading Floor Blog delivers the "Midday Market Check," providing a rundown of where the major market indices are planted mid-session, along with a convenient sector graph to update you on the daily P&L of each major industry index (including sector ETFs).

Perhaps the most anticipated gem of the day comes after lunch, when Elizabeth Harrow steps in and dishes out at least two stock candidates that are showing noteworthy option activity. Complete with sentiment and technical analysis updates, Elizabeth's posts accelerate your due diligence, so you can spend less time researching and more time trading.

In case you're one of those busy traders who forgets to hit "refresh" for the latest updates, the Trading Floor Blog refreshes automatically. And you can always get your Trading Floor posts emailed to your PDA!

# Blogs from the Pros

commentary

**Joseph Hargett**
*Schaeffer's Daily Option Blog*
Finding opportunities where others can't

*E TRADE CALL VOLUME REVEALS UNUSUAL SPREAD ACTIVITY*

*> Call activity has gained momentum on E Trade Financial Corp. lately. [Recently], I detailed a sizable block of what appeared to be purchased September 2 calls. Today , we have an equally bullish trade crossing on ETFC, this time at the stock's April 2 and 3 call strikes.*

*> Specifically, 35,000 contracts traded on the April 2 call at about 11:10 a.m. Eastern time for the ask price of $0.40, or $40 per contract. At the same time, 4,464 contracts traded on ETFC's April 3 call for the bid price of $0.20, or $20 per contract. This appears to be a long ratio spread of some sort. While the ratio isn't exact, there are nearly eight April 2 calls purchased for every one April 3 call sold.*

*> Regardless of the ratio, the trader paid $1,310,720 to enter the trade. Furthermore, the maximum profit is realized if ETFC rallies to $3 per share by the time these options expire in April 2010.*

To visit Schaeffer's Daily Option Blog, go to: **www.sentiment.com/DailyOptionBlog**

## Must Hear Podcast

**INDICATOR OF THE WEEK: The American Association of Individual Investors (AAII) Poll** INVESTOR SURVEYS ARE GREAT FOR THOSE OF US WHO PUT CONSIDERABLE EMPHASIS ON MARKET SENTIMENT. THE POLL CONDUCTED BY THE AAII IS A GREAT WAY TO GET AN IDEA OF HOW INDIVIDUAL RETAIL INVESTORS FEEL TOWARD THE MARKET. AS WITH MOST SENTIMENT POLLS, SCHAEFFER'S HAS A CONTRARIAN TAKE ON THE SURVEY RESULTS. IN OTHER WORDS, WE GROW CAUTIOUS WHEN POLL RESULTS ARE OVERWHELMINGLY BULLISH, AND SEE SIGNS OF A SHORT-TERM MARKET BOTTOM WHEN POLL RESULTS ARE HEAVILY BEARISH. From *Monday Morning Outlook*, 8/29/09. Listen to the podcast or subscribe free at **www.sentiment.com/mmo**

## MUST-READ ARTICLE

**ADVANCED OPTIONS:** EXPLOITING VOLATILITY WITH LONG GUTS
Analyzing a unique way to profit from monster moves on the charts

*WHO SHOULD TUNE IN?* Similar to the straddle and strangle, the long guts strategy is best suited for traders anticipating a dramatic price swing in the stock price. The strategist is neutral on the underlying equity, as the position can make money if the shares make a monster move in either direction.
*HOW DOES IT WORK?* While the long straddle typically centers on a single at-the-money strike, and the long strangle usually centers on two out-of-the-money strikes, the long guts position focuses on two in-the-money strikes. More specifically, the investor would simultaneously purchase one in-the-money call and one in-the-money put with the same expiration.

For more on the Long Guts strategy, go to: **www.sentiment.com/LongGuts**


**DAILY Q&A:** AFTER-HOURS ACTIVITY
Important company news announcements that occur after the closing bell can be catalysts for some big moves in the stocks of these firms. But how do these "after-hours" changes affect the prices of options?

WHEN IS A STOCK OVERBOUGHT?
Hindsight is always 20/20 when looking at the past. But with your eyes on the future, there are a few indicators you can use to help determine if buyers are getting tired and a reversal is near.

*To view these videos and more, go to* **sentiment.com/videos**

## MUST KNOW EDUCATION

*A sampling of our best option content that you'll find at SchaeffersResearch.com*

> THE OPTION COACH: **Short Condor**
Examining the pros and cons: To cash in on a stock that is ready to explode but you're not sure by how much, try this strategy on for size.

> SO YOU WANT TO TRADE OPTIONS: **Four Ways to Hedge Your Bets**
Options are for more than just speculation. They're also an agile form of "insurance" for any investment strategy.

> OPTIONS 101: **Trading Options is Like Fantasy Football**
Despite the obvious differences between trading and fantasy football, the keys to a winning strategy are fundamentally similar.

To find articles and commentary at Schaeffer's, use our Google-powered "KEYWORD" search, located at the top of any page at: **www.schaeffersresearch.com**

Joe Hargett Illustration by TBA+D

# Pro Pearls

JAMES BITTMAN, OPTIONS EDUCATOR AND AUTHOR, REFLECTS ON WHAT IT MEANS TO BE FLEXIBLE, WHY SOME TRADERS AREN'T, AND HOW THEY MIGHT GET THERE.

The word "*flexible*" comes from the Latin word *flexibilis*, which means "willing to yield to the influence of others." In a trading context, we might expand "others" to include market conditions. The result: "Willing to yield to the influence of market conditions."

The spring/summer rally of 2009 was unprecedented in the experience of most of us trading today. The "flexible trader" would have seen that the market was simply climbing a wall of worry. Well, that's easy to say, but not so easy to do.

Why did many of us hold so tenaciously to the bearish view? (Yes, I include myself in this misdirected group.) Undoubtedly it was inflexibility? But the more important question is, "How can we learn to be flexible next time?" Here are four thoughts.

**1 / Know your stocks.** For each stock you follow, do you know the 20-day and 50-day moving averages and the next earnings release date? For option traders, do you know which strike has the largest open interest? If several of your stocks cross their averages, maybe they—and the market—are changing direction.

**2 / Vary your strategies.** I know traders who only sell options and others who only trade iron condors. Some traders only make bullish trades, and others only buy out-of-the-money options. Such behavior exhibits classic inflexibility. Near earnings reports, buying vertical spreads might be appropriate. Between reports, perhaps iron condors would work, and maybe the cross of a moving average indicates a change of direction. At any given time, why not have both long and short option positions? That's being flexible.

**3 / Keep two journals, one for "stock events" and another for "trade positions."** The first will help you know your stocks. The second will help you vary your strategies.

**4 / Flexibility can be learned, but only through hard work.** This is a bummer for those who approach trading as an entertaining diversion from their day job. Traders should master several strategies (an advantage of options) and be able to recognize when each is appropriate. During each expiration cycle, make sure to use several strategies.

Trading is part art and part science. Only by "doing the science" (knowing your stocks, varying your strategies, and changing your directional bias) can you master the art. It's all about being flexible.

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**James Bittman**
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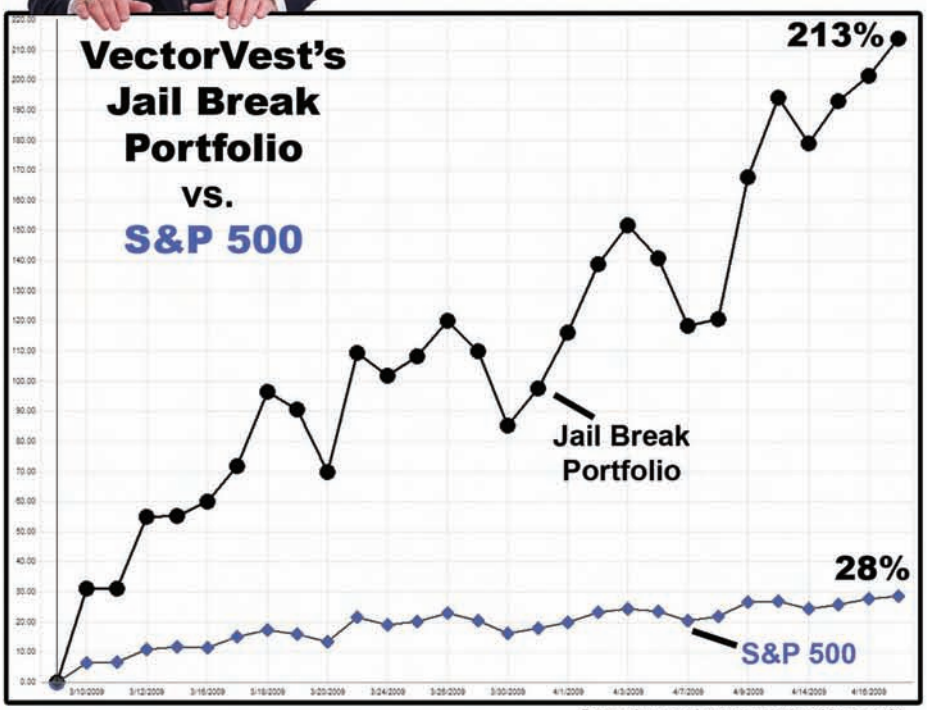
Photograph by FREDRIK BRODÉN

# What A Rally!

## This is the most powerful rally in 70 years and VectorVest Nailed It.

- **3/6/09 -** VectorVest reported that the market was "Itching to Rally".
- **3/9/09 -** We advised our users to be alert for an explosive rally and highlighted 5 bottom-fishing searches including "Jail Break".
- **3/10/09 -** We bought stocks from our "Jail break" Botom-Fishing search in early market trading. UP 213% as of 4/17/09.




Past performance is not a guarantee of future profits.

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## No Guesswork
## No Opinions

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