



Presents

Trading Options[®]

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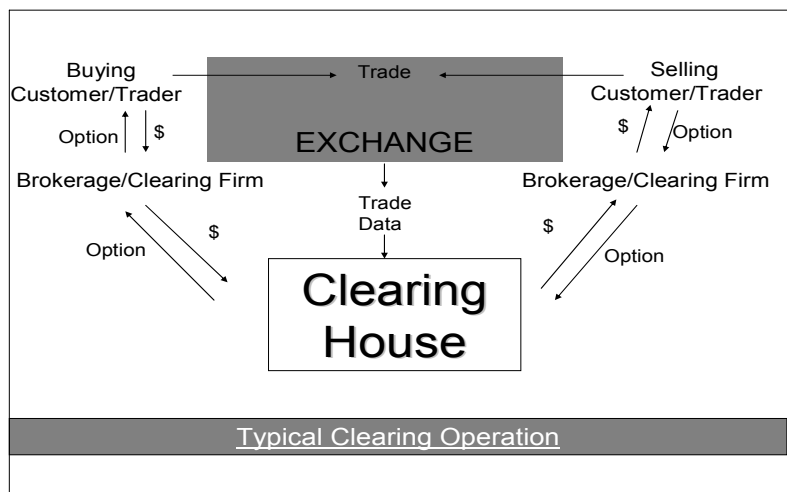
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For every *exercise* there is an *assignment*. Does this mean that when you exercise an option the person that you originally purchased that option from is assigned? No, (although it is possible, but highly unlikely, if the call seller is still short calls) assignment is random.

In order to insure the validity of each trade a general clearinghouse was established for options transactions that is used by all major American Options Exchanges. It is called the Options Clearing Corporation, more commonly referred to as the OCC.

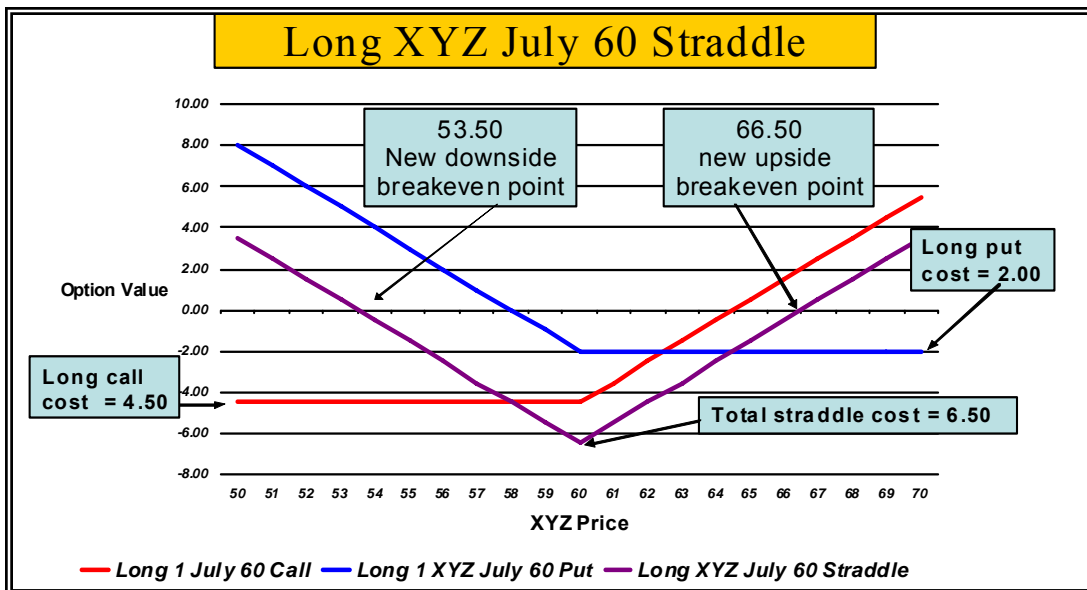
A clearinghouse is an institution that insures that trades clear correctly. In other words, insuring that each customer is given credit for every trade they make and that funds are distributed correctly.



Once you have established a long or short position, then you are thrown into the general OCC hopper. For every option contract that is exercised, the OCC randomly assigns someone who is short that same contract to fulfill the obligation to take (as in the case of puts) or make (as in the case of calls) delivery on that stock. Exercise and assignment can occur on any business day prior to the expiration date for American style options. Exercise and assignment occurs only at expiration for European style options.

Let us say that we purchase 10 XYZ July 60 Puts for 2.00. We have laid out \$2,000.00 for the possibility of seeing XYZ plummet all of the way to zero. Since we would have a short position in XYZ at 60 our position would be in-the-money at any point below 58. If XYZ were to go all the way to zero we would pocket \$58,000. A straight put purchase can only be profitable with a downward movement in XYZ.

What happens when we buy the XYZ July 60 straddle ten times? We then stand to profit whether XYZ goes up or down. We would have to pay a combined 6.50 for the straddle. That would be a total of \$6,500 for the opportunity to experience both upwards and downwards movements in XYZ. We would now be in-the-money when XYZ surpasses 66.50.



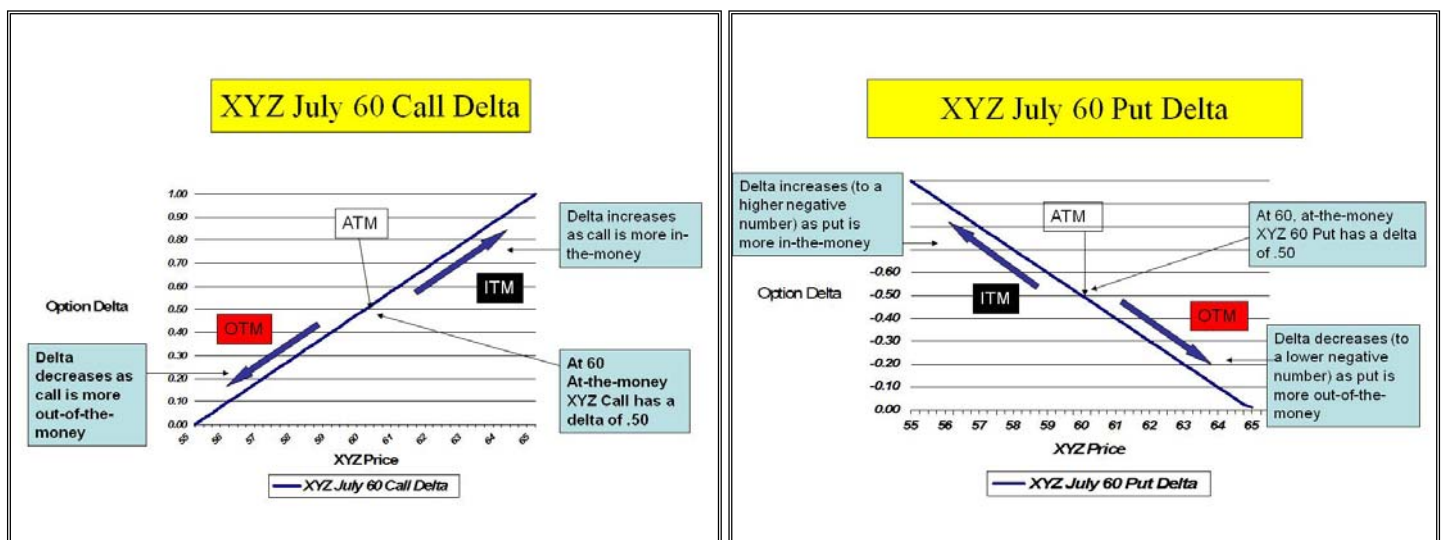
Our new upside breakeven point is now 2.00 higher. One always has to pay to play. We would also now be in-the-money when XYZ trades below 53.50. Our new downside breakeven point is 4.50 lower; again because of the higher premium for the straddle rather than for the put

that for every \$1.00 increase in the value of the stock the put option value will decrease by \$.50. Put options have a delta range from 0.00 to -1.00.

Here are a few more guidelines regarding deltas. An at-the-money option has a delta around .50. The delta for a call option **rises** the further the underlying stock *rises above* the strike price. Conversely, the delta for a put **falls** (to a higher negative number – which is a good thing) the further the stock price **falls below** the strike price. If a call is deep enough in-the-money, its delta can actually approach 1.00. If a put is deep enough in-the-money, its delta can actually approach -1.00. In both of these cases your options are appreciating at the same rate as an equivalent number of actual shares.

The delta for a put option rises (to a lower negative number – a bad thing) the further the underlying stock rises above the strike price. The delta for a call option drops the further the underlying stock drops below the strike price. If a put or call is far enough out-of-the-money its delta can actually approach zero.

A zero delta means that your option is so far out-of-the-money that it would require a drastic change in the price of the underlying stock just to get back near the strike price.

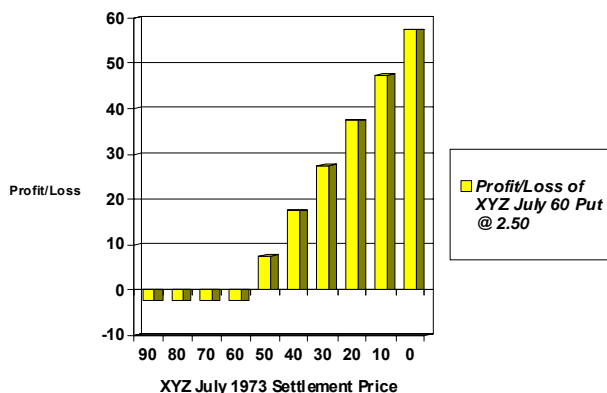


XYZ Synthetic Put, 1973 Settlement Scenarios

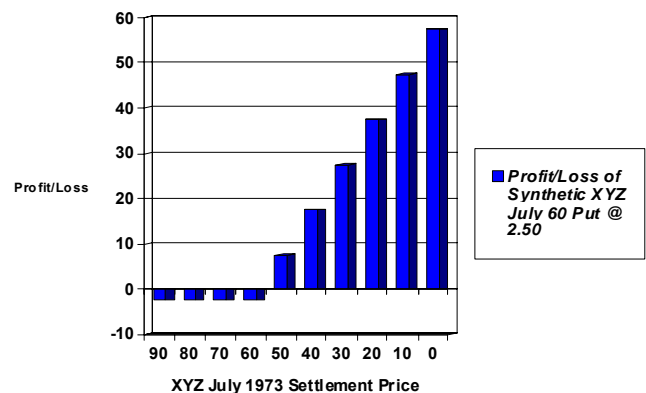
	<u>XYZ @ 40</u>	<u>XYZ @ 50</u>	<u>XYZ @ 60</u>	<u>XYZ @ 70</u>	<u>XYZ @ 90</u>
XYZ	+ 22.00	+12.00	+ 2.00	- 8.00	-28.00
July 60 Call	- 4.50	- 4.50	- 4.50	+ 5.50	+25.50
Profit/Loss	+17.50	+ 7.50	- 2.50	- 2.50	- 2.50

As you can see, it was when XYZ was below 60 that our synthetic put picked up value dollar for dollar. Our breakeven point would have been 2.50 lower at 57.50. OK, now you should be able to see how a synthetic put works. If puts had been available in 1973, and we had purchased an XYZ July 60 Put at 2.50, our profit and loss graph would have looked exactly the same. You are probably thinking that this is an interesting history lesson but since time travel is an unlikely prospect, who really cares? The real puts are listed now anyway.

XYZ July(1973) 60 Imaginary Put



XYZ July(1973) 60 Synthetic Put



Well we care about synthetic puts because of *arbitrage* opportunities involving synthetic and real puts. Perhaps we should first explain *arbitrage*. Arbitrage is the simultaneous purchase and sale of the same product in two different markets at the same time. An *arbitrageur* is trader

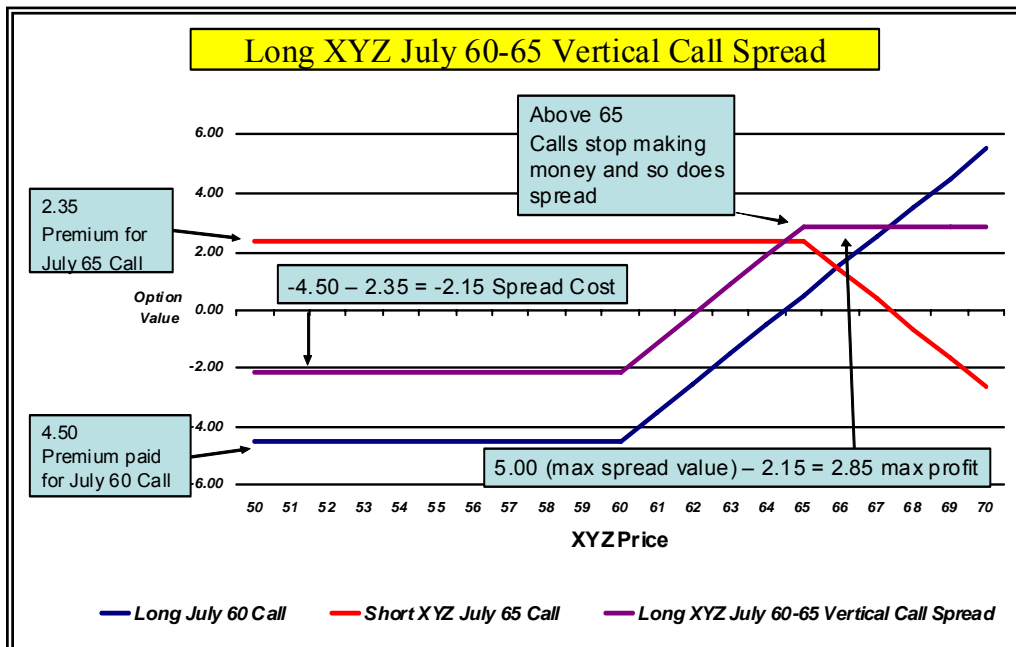
Chapter 15: Boxes

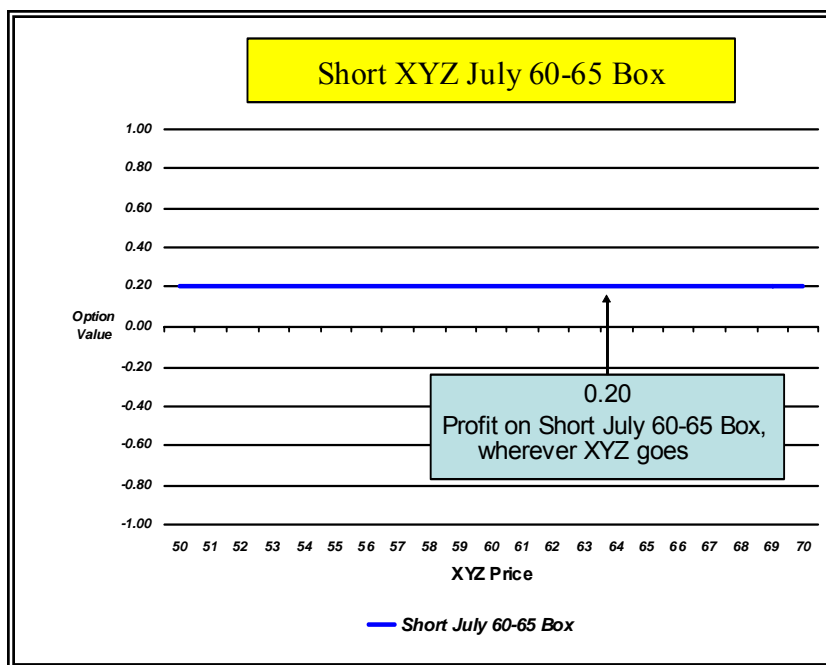
We learned in chapter 6 about the mechanics of vertical spreads. Now we will learn about purchasing call and put vertical spreads of the same strike price at the same time. These spreads are called *boxes*.

Boxes

The simultaneous purchase of call and put vertical spreads of the same stock at the same strike prices in the same expiration cycle

If we buy the XYZ July 60 Calls for 4.50 and sell the XYZ July 65 Calls for 2.35. We have then purchased the XYZ July 60-65 Call vertical spread for 2.15. We can only lose the \$2.15 in premium that we paid for the spread. The highest that the spread can go to is 5.00 for a net profit of 2.85. At 65 or above we stop making money on the XYZ July 60 Calls.





Whenever we can go short a \$5.00 box for greater than 5.00, the difference between 5.00 and our sale price is the amount of profit that we have locked in. Since we collected \$5.20 for the WXYZ July 60-65 *box* we are guaranteed a profit of 0.20.

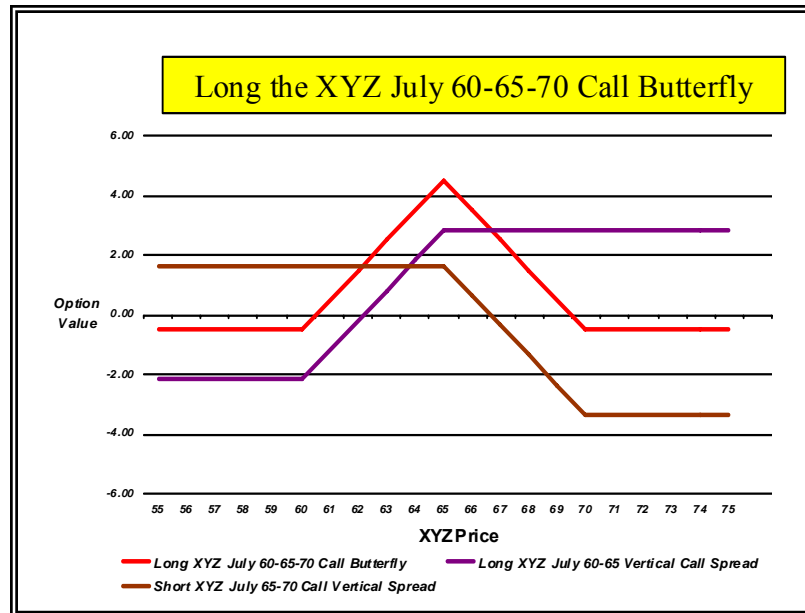
Have you noticed something else about the boxes? When we go long the XYZ July 60-65 Box we are buying the July 65 puts and selling the July 65 calls. That comprises two out of the three legs of the XYZ July 65 conversion. We are also buying the July 60 Calls and selling the July 60 Puts. That comprises two out of the three legs of the XYZ July 60 reversal.

We know that a 5.00 box always goes out at 5.00, so would anyone ever want to pay 5.00 for XYZ July 60-65 Box. If there is no possibility for profit why would anyone want to establish such a position?

Well maybe someone who needed to roll out of an opposite position just might.

For example, which is safer, being long the XYZ July 60 Reversal or the XYZ July 65 Reversal? We are short puts in both positions, and since we are always more likely to be assigned on the higher 65 puts, the July 60 Reversal is safer. If we are assigned on our 65 puts, it

So now we have combined to pay out 2.15 for the XYZ July 60-65 Call spread, and collect 1.65 for the July 65-70 Call spread. We have paid 0.50 for what is called the XYZ July 60-65-70 Call butterfly. We buy one each of the outside strikes (60 & 70) and sell two of the middle strikes (65).



Whenever we buy the wings and sell the middle strike we are going long the butterfly.

Whenever we buy the middle strike and sell the wings we are shorting the butterfly.

Butterfly Spread

Buy 1 July 60 Call
Buy 1 July 70 Call

Sell 2 July 65 Calls

Buying, or going long the Butterfly

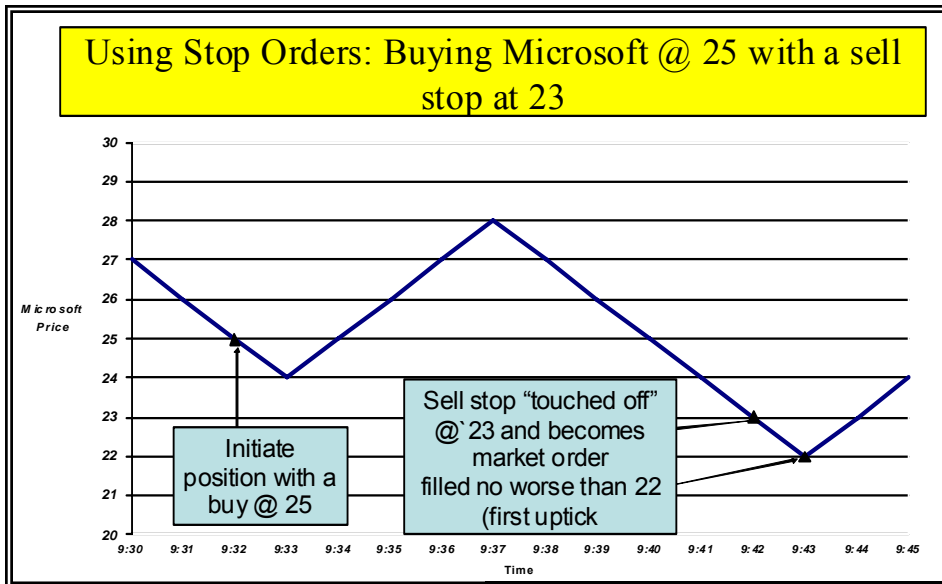
Butterfly Spread

Sell 1 July 60 Call
Sell 1 July 70 Call

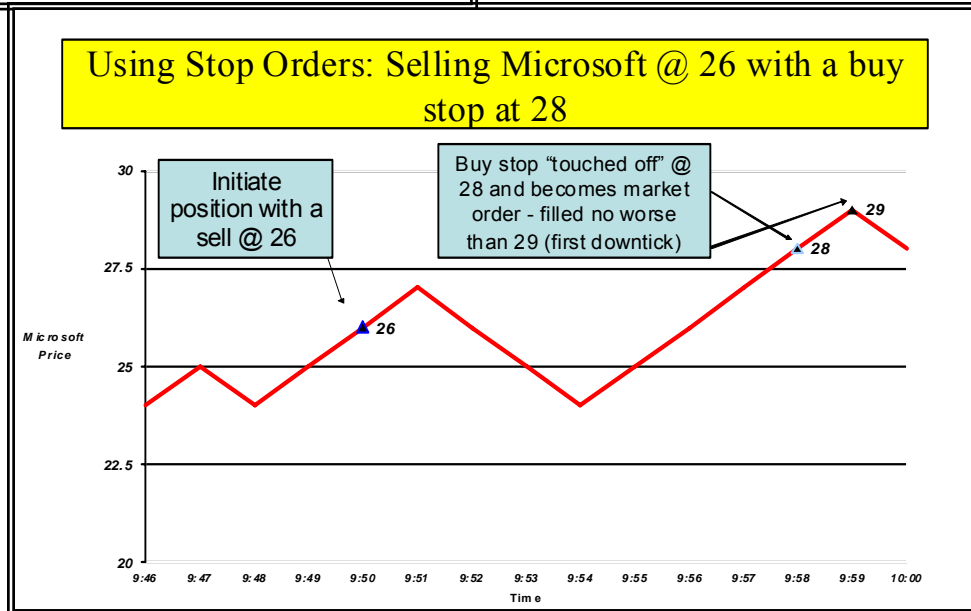
Buy 2 July 65 Calls

Selling, or going short the Butterfly

immediately at the best possible price. Conversely, if you established a short position at 26 and put a “buy stop” at 28.00, a trade at 28 would turn your buy stop into market buy order. Stop orders are used primarily in the stock itself and seldom in options. After all, if you think about it, an option contract is already kind of a stop loss order.

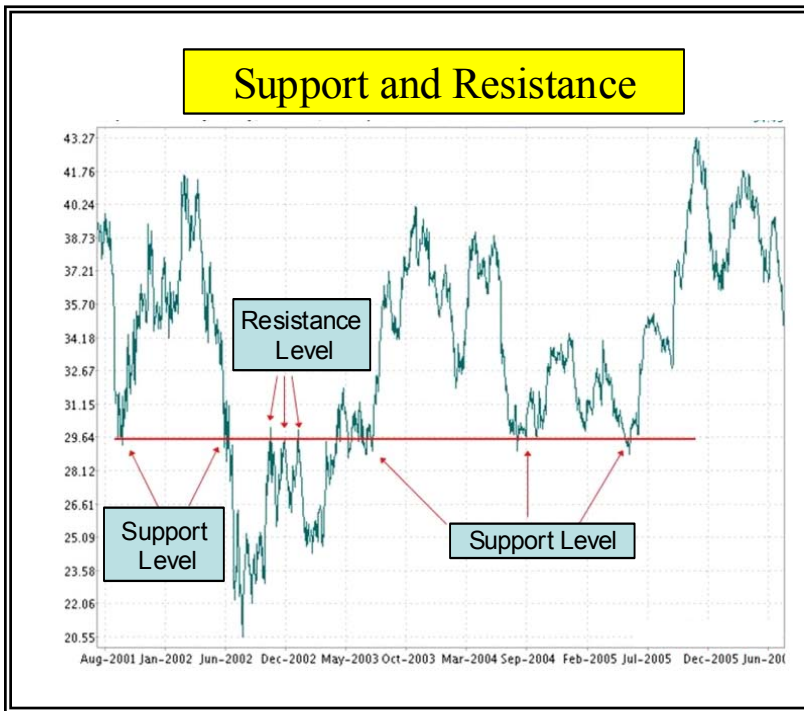


Stop orders are also used to establish new positions. If you were a “breakout trader” you might look at certain numbers or market levels that you deem significant. Price levels that a



stock or other instrument has trouble getting through on the upside are called “resistance levels”. Price levels below the market that hold up a market are called “support levels”. A breakout trader would buy when a market went through or above a resistance level and would sell if the market

went below a support level. Stop orders are, therefore, often used by breakout traders to establish a new position.



Now that you know what kind of orders you can enter, you need to open an account. Nowadays that means an electronic platform capable of trading all exchange traded stocks and options. With an options account, the more money in your account the more flexible

your trading strategy can be. Remember when you purchase an option your losses are limited to the premium you have payed. If you sell premium, however, your losses can be unlimited if you are assigned on a losing position. Your brokerage firm will require more cash in your account to short options or to short stocks.

Remember in chapter one how I told you that floor, or pit, trading is vanishing. When I started almost every option traded was traded on a trading floor. Now it is completely the opposite. Most options are traded electronically, either in sophisticated trading rooms or in home offices around the world. The electronic platform you choose is probably the first major decision that you will make in your trading life.

Okay, now try to execute these trades and others by yourself until you are familiar with the platform. Then you should actually attempt to make trades in options whose stock you have studied and are prepared to employ option strategies. Then contact your mentor so we can begin the process of taking you from simulated trading to real trading. Good luck and good hunting.

