

Options for Risk Averse Traders

Paul Forchione, CTA

Options offer many alternatives:

Futures traders can use them as a substitute for protective stop orders to prevent gyrations in the market from taking them out of what may ultimately become a profitable position.

Options traders can establish positions that make money if their forecast for market direction is correct. In addition, they can establish positions that perform like "a fractional futures contract" if they don't want to take the risk of a full futures.

Most interesting of all, however, option traders can speculate on factors other than market direction.

What am I referring to? To the factors of *implied volatility, statistical volatility, and time decay*. The flexibility and range of alternatives is very broad. Combining a directional forecast with a forecast for implied volatility, for example, opens up a multiplicity of possibilities.

In fact, there are 15 scenarios when you consider five possible directional opinions (very bearish, bearish, neutral, bullish, or very bullish) along with three possible opinions for implied volatility (decline, hold steady, or rise). And there are three to seven strategies for each scenario!

If a trader wants to act only on his forecast for statistical volatility, then there are four trading possibilities. In this case, it's only the magnitude of moves in the futures that matters. Implied volatility and market direction are irrelevant.

Clearly it's important to learn which options positions are suitable for each scenario. And it's also vital to understand the possible outcomes of each position as market circumstances change. That's the reason I wrote Trading Options Visually. It's a Trading Manual that not only explains these things in ways you've probably never heard, but it also shows you with pictures how your positions will perform.

As a former floor trader, I can attest to the fact that the pros are intimately familiar with this material, so traders who don't have this knowledge are at a distinct disadvantage.

In this article I'll discuss a favored strategy for risk-averse traders: the long strangle. Here's the bottom line: *Buying strangles using undervalued options in deferred months when the underlying commodity is trending or exhibiting high statistical volatility is a safe way of earning money.*

Why is this "safe" and why would you expect it to generate profits? It's safe because you lose only through time decay and only if implied volatility declines. Time decay is only moderately negative for options far from expiration. And it's unlikely implied volatility

will decline further if you buy options when it's already low. It's more likely implied volatility will rise to an average level.

In addition, market movement in either direction is favorable for holders of long strangles, so buying them in trending markets or markets exhibiting high statistical volatility increases the likelihood of profits.

Here's a trade example in Coffee from an issue of "The O.W.L." (The Options Wisdom Letter), my advisory service available on the Internet. On October 13, 1998 I recommended buying a March Coffee 130 call and a March Coffee 85 put for a debit of 305 points or less. At \$3.75 per point, and assuming \$60 commission per contract, this is \$1,264. March futures were at 101.95.

The cost of these options is the margin on the position. It's \$1,264. The "real cost" however is only \$15 per day in time decay. And a 1-percentage point increase in implied volatility compensates for about 7 days of time decay. That's because the vega factor is +\$115.

The "Greeks" for this strangle are as follows:

Delta = +4, Gamma = +2, Vega = +\$115, and Theta = -\$15

The performance graphs for this strangle show that in 30 days it can earn about \$1,200 if March Coffee rallies or declines 18.00 points. That equates to a 100% return on investment (ROI) in one month.

What's the trading plan? I recommend closing the position with a \$600 profit. Large accounts can establish a 2 X 2 strangle (\$2,528 cost), sell a 1 X 1 at this profit target, and let the other position "ride" for the possibility of much larger profits. Selling the remaining strangle if it shrinks back to breakeven, however, will avoid losses.

Here's another alternative for aggressive traders seeking more profits who start with a 1 X 1 position that achieves a \$600 profit: Sell only the option that's increased in price, and then purchase a new strangle with the sale proceeds such that the new strangle and the existing option that's shrunk in price is delta neutral. This means the remaining position that consists of 3 options can achieve additional profits regardless of which way the market moves.

If, on the other hand, time decay and/or declines in implied volatility cause losses of \$500, then close the position by selling the 130 call and 85 put.

What about buying long straddles? By definition, a long straddle is the purchase of a put and call at the same strike price. Traders usually buy at-the-money options when establishing a long straddle so it starts delta neutral.

There are a few differences between long straddles and long strangles: Straddles cost more (and therefore experience greater time decay), and they are more responsive to changes in implied volatility (vega) and to market movement (gamma). So long straddles simply possess greater profit potential along with higher risk.

What about selling strangles or straddles using overvalued options in deferred months when the underlying commodity is not trending and is exhibiting low statistical volatility? This also places the odds in favor of generating profits. It's inevitable, however, that at some time a sudden market move will cause large losses. And this possibility is enough to discourage some traders from ever holding naked short positions.

So some of them decide to "buy insurance" by purchasing further out-of-the-money options. This limits the maximum possible loss but it also reduces possible profits so much that it's often not worthwhile.

Paul Forchione is a registered Commodity Trading Advisor who specializes in non-directional volatility based trading. He is also a Senior Options Broker in Oxnard, CA for Opportunities In Options and works with clients of varying experience levels. You can contact Paul via e-mail at owl@west.net as well as by phone at 800-926-0926 ext 350.

Paul is the author of Trading Options Visually, a book that presents a graphical and mathematical approach for trading options. He also produces a weekly advisory service that's accessible on the Internet. It's called "The Options Wisdom Letter" (The O.W.L.).