

# Your Trading Edge

THE MAGAZINE FOR TRADERS & INVESTORS IN CFDs, STOCKS, OPTIONS, FUTURES, FOREX & COMMODITIES



## OPTIONS CORNER



Our resident options experts, **James Cordier** and **Michael Gross**, answer readers' questions.

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### WELCOME TO OPTIONS CORNER

The primary focus of this column is to address readers' questions and comments relating to options. All levels of question are welcome and all will receive a response. Given space considerations however, only some will be published. Those that are

published will have personal details withheld. We see the column as an area that will be driven by you, our readers, so please feel free to get involved by emailing your questions to [Options@YTEMagazine.com](mailto:Options@YTEMagazine.com).

Level of complexity

• Beginner •• Moderate ••• Advanced

**Q: I am an equities options trader who sells options for premium. Recently, I have taken an interest in writing futures options. Can you explain the differences? ••**

**A.** If you are already taking advantage of the large proportion of options that expire worthless in the equities arena, you might find the advantages of applying this same strategy to futures can be an awakening of sorts. Think of selling options on futures contracts like the S&P, euro, coffee or crude oil as being like selling equity options on steroids. Higher risk? It depends. Higher returns? You be the judge. Let's take a look at the benefits and drawbacks of selling premium in the futures market.

If you're selling options on equities, you already know the game. Most expire worthless. Time is always on your side. Entry and exit points don't have to be precise. You don't have to guess short-term market direction. The same is true in futures, with a few key differences.

- **Lower margins:** a key factor that attracts many stock option traders to futures. Margins posted to hold short stock options can be 10 to 20 times the premium collected for the option. With the SPAN margin system used in futures, options can be sold with out-of-pocket margin requirements (total margin requirement minus premium collected) for as little as one to one-and-a-half times premium collected. For instance, you sell an option for \$600 and post a margin of \$900.

- **Attractive premiums can be collected for far-out-of-the-money strikes:** unlike equities, where to collect any worthwhile premium options must be sold one to three strike prices out of the money, futures options can often be sold at strike prices far out of the money where adverse short-term market moves will not affect the position, yet time value erosion may be allowed to work while being less impeded by short-term volatility. How far out of the money? Ask anybody who sold June 100 crude oil puts in January or June 2000 gold calls when gold broke through 1000.

- **Liquidity:** many equity option traders complain poor liquidity hampers their efforts to enter or liquidate positions. While some futures contracts have higher open interest than others, most major contracts like financials, gold, coffee, sugar, grains and energies, for example, have substantial volume and open interest offering several hundred to several thousand open contracts per strike price.

We are not bashing equity options – quite the contrary. Many investors have achieved substantial returns with a properly managed option selling approach in equities. Our point is to make equity traders aware that there is another vehicle with similar (in some cases, more desirable) properties that is available for diversification. Gaining higher leverage can carry increased risk in some situations, but at the same time provide for higher returns in an option portfolio.

As with writing equity options, futures options selling can be approached in an aggressive or a conservative manner. Trading plans can range from an aggressive, more leveraged approach to a conservative, lower risk approach (such as low delta options and/or 'covered' credit spreads). On the whole, however, futures option investors are in it for a higher return than those sought by the average equity option trader.

**Q: What is the optimum time span for which you would suggest selling options? •**

**A.** The 'optimum' time may not exist. I have seen short-term and long-term option selling programs succeed. A general school of thought taught in some option textbooks is to sell options with 30 days or fewer until expiration. The general philosophy here is that since this is the time period when options experience their fastest rate of time decay, why not take advantage of that? And many traders do.

However, my philosophy on option selling is different. Many times, newer clients of mine will gasp when I suggest selling options with three to six months of time value remaining until expiration. "Why on earth would we do that," they ask, "when we can sell options that expire in 30 days for my account?"

There is one primary reason. If you sell options with more time remaining until expiration, you can sell them much further out of the money. In my opinion, this translates into a trade with a higher probability of success. Some option gurus may challenge me on this, but then again, many of these guys don't manage option portfolios for long-term returns.

*There is a risk of loss in all futures trading.  
Only risk capital should be used.*

For example, let's assume two traders are bearish crude oil and want to sell calls for their portfolios. Let's further assume it is March and crude oil is trading near \$45 per barrel on the NYMEX. Trader A elects to sell a May Crude Oil 50.00 call (that expires in April) and collect a premium of \$500 (figure 1). Trader B elects to sell the September 100.00 call for the same premium (\$500) (figure 2).

Trader A will profit as long as May crude stays below \$50 for the next 30 days. He will gain the benefit of maximum time decay. However, his option is only \$5 out of the money, a distance that crude oil can move in one day. In addition, prices could move \$5 per barrel on a rumour, an unexpected number in weekly inventories, or the whims of a hedge fund. There is simply too much element of chance in a trade like this for me to be comfortable.

Trader B has the drawback of having to wait until August for his option to expire. However, he has the benefit of a strike price

potent combination.

"But five months is a long time to be in a trade," some will argue. "A lot can happen in five months."

Yes, a lot can happen in five months. Often, trader B will not have to be in his trade this long. Let's assume once again he sold his September Crude \$100 call in March. If his market analysis proves correct and crude moves sideways to lower, chances are his option price will decay substantially. In many cases, the option he sold for a \$500 premium may be worth only a small fraction of his original premium within 60 to 90 days, depending on how far or fast it has moved. Trader B could very well be buying his September call option back for \$50 or less in May or June. He would still reap a \$450 profit (\$500 - \$50) and be out of the trade 60 to 90 days prior to expiration.

On the flip side of this coin, suppose something does 'happen' while the trader is holding his short call. Again, prices of a commodity generally do not double for no reason. To double, they will need a major reason – probably several of them. In fact, a major shift in fundamentals would be necessary to spur this kind of move. The upshot? A trader who studies fundamentals can typically tell when this is happening. He can exit his position at any time. He may not always get out before the move starts. He may not always exit at the optimum time. But fundamentals typically take time to develop. If he does it right, he exits with a manageable loss and moves on to the next trade.

Therefore, while trader A may take a faster profit selling a 30-day option, he may also be taking a bigger risk (or at the very least, leaving more to random chance). Trader B is selling an option that is ten times further out of the money than trader A. And he has a good chance of closing it out and taking profits in fewer than 90 days. **YTE**

*James Cordier and Michael Gross are portfolio managers with Liberty Trading Group/OptionSellers.com, one of the first global futures firms to specialise exclusively in selling options. Located in Tampa, Florida, Mr. Cordier's and Mr. Gross's analysis is featured by several international financial publications and worldwide news services including The Wall Street Journal, FOW, Yahoo Finance, CNBC and Bloomberg Television News. They are authors of the book 'The Complete Guide to Option Selling' (McGraw-Hill 2005). For more information visit [www.OptionSellers.com](http://www.OptionSellers.com).*

Do you have a question for Michael or James? Email [Options@YTEmagazine.com](mailto:Options@YTEmagazine.com)



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that is substantially out of the money. In fact, the price of crude oil would have to more than double to put his option in the money. Crude prices generally do not double on an errant inventory report or on the trigger finger of a nervous hedge-fund manager. For that kind of move, it is generally going to take a massive change in the underlying fundamentals of crude oil.

That is why I feel that an intensive study of the underlying contract fundamentals, coupled with selling options, is such a

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