

The Perfect Kind of Trade for Current Market Environment

The last few months have provided the perfect environment in which to trade options. The month of July has not been an exception and, if anything, given the sharp moves in one direction and then the other, has probably been the best month so far.

To those who are new to options trading, there is often the perception that profits can be made only in one direction or the other (up or down). New options traders are often surprised to hear that they have the ability to use a combination of options in order to implement a payoff structure whereby they can profit regardless of the direction of the underlying stock.

Moreover, there are literally hundreds of combinations that can be utilized, when factoring in the various strategies and ratios that can be chosen from. (Don't be alarmed; one need not learn more than 3 or 4 basic strategies in order to know how to implement effective options combinations that profit in up and/or down markets.)

Take the chart below, for example. It depicts the profit/loss payoff for a recent Options Pick on Amgen (AMGN).

If you're familiar with options, you'll probably figure that the strategy used is a Long Straddle. Well, that's close but, as you'll notice, the p/l line does not show up as a perfect "V", as would have been the case with a Straddle.

Earlier, we spoke briefly about how there are literally hundreds of potential combinations.

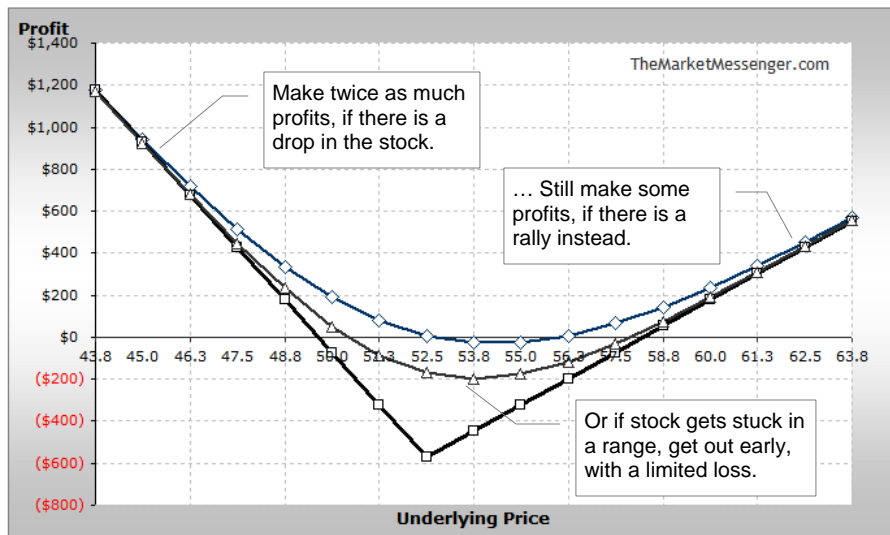
The combination that was used with respect to this trade is actually rather simple and actually has a name.

Just like the Long Straddle, it has one leg on which there are Call Options and another leg on which there are Put options.

Additionally, each leg is placed at the same strike price. So far, it sounds like a plain old Straddle, doesn't it?

Well, there is a small difference.

If you take a look at the Number of Contracts utilized on each leg (see #Shrs/Contracts on bottom left, second column, of the p/l diagram), you'll notice that there are twice as many Puts in the combination as there are Calls.



Option Legs	# Shrs/ Contracts	Expiration Month	Strike Price	Premium (Price)	Contract Expiry	Debut	Original IV	Projected Exit	Max Profit	Max Loss
Long Call	1	Aug	52.5	2.40	15-Aug	17-Jul	33.00%	1-Aug	Unlimited	(\$572)
Long Put	2	Aug	52.5	1.66					Unlimited	(\$27)
Net Debit/(Credit)				5.72					Unlimited	(\$197)

This strategy, wherein there are two Puts to every Call, all on the same strike and of the same expiration month, is known as a **Long Strip** options strategy. We have started to use this strategy, as well as the **Long Strap**, which is similar but uses two Calls to every Put, a lot in the Options Picks section at TheMarketMessenger.com.

In our opinion, this type of options strategy is perhaps the best kind of trades that can be used in highly volatile markets and, as such, are perfect for the current environment. If you choose the wrong side of a stock trade or even of a plain Long Calls or Long Puts trade, you could lose your shirt (in the case of long/short stocks) or your entire capital outlay (in the case of Calls or Puts alone).
..... (Contd. on page 2)

Are you an Active Trader? Take a look at the new 'Active Traders: SPY 5-min Chart Trends' entries and other articles of interest that are covered (free) at the [PurelyTechnical blog](http://PurelyTechnical.com).

By using Strips/Straps, you can place a bias on the underlying market or stock but still cover your behind (and even profit), if the underlying decides to move in the other direction instead. Who wouldn't want that?

... Now let's take you back to the AMGN trading pick for a moment and show you how we were able to garner a big profit from the trade despite choosing the wrong side of the stock.

Let's start off by showing you the chart of the stock, so that you might be able to see why we choose the Long Strip strategy, as opposed to all the other potential choices out there. In fact, let's list some of the other choices and their characteristics.

Long Stock: Pros – Easy to entry/exit (usually). Cons – No protection; an untoward gap can kill the position.

Long Calls: Pros – Limited loss. Works great if there is an up move. Cons – Negative time value. Complete loss if stock falls strongly.

Long Puts: Pros – Limited loss. Works great if there is a down move. Cons – Negative time value. Complete loss if stock rises strongly.

Each of those choices would do extremely well as long as you are spot on about the direction of the impending move.



As you can see, AMGN was showing a potentially sharp move in one direction or the other back on Jul 16th.

A trend trader would look at the chart and say that there is no way he would consider anything but being bullish on the stock. A trader who follows the momentum indicators, on the other hand, would say that she sees the possibility of a bearish reversal, given that the stock was highly overbought as per MACD and was showing a potential negative divergence as per RSI.

Each of them has a point. One probably stands to make a decent profit and other a sizeable loss, if he/she is to enter a long/short position in the stock.

However, for those of us who use trend analysis, as well as technical indicators, when making a trading decision, this stock shows the likelihood of a decent move in one direction or the other.

This knowledge is especially useful when options are brought into the picture, because we can use it to try and arrive at a 'sharp move' or 'long volatility' options trade that will profit as long as there is a move away from current prices.

So which particular options strategy should be use?

If we had absolutely no bias, we could choose a Long Straddle. The long straddle makes a similar profit, given a gain of, say 5 points, as it does a loss of 5 points. There is no directional bias.

Since we tend to be more reliant on technical indicators, our bias was to the bearish side.

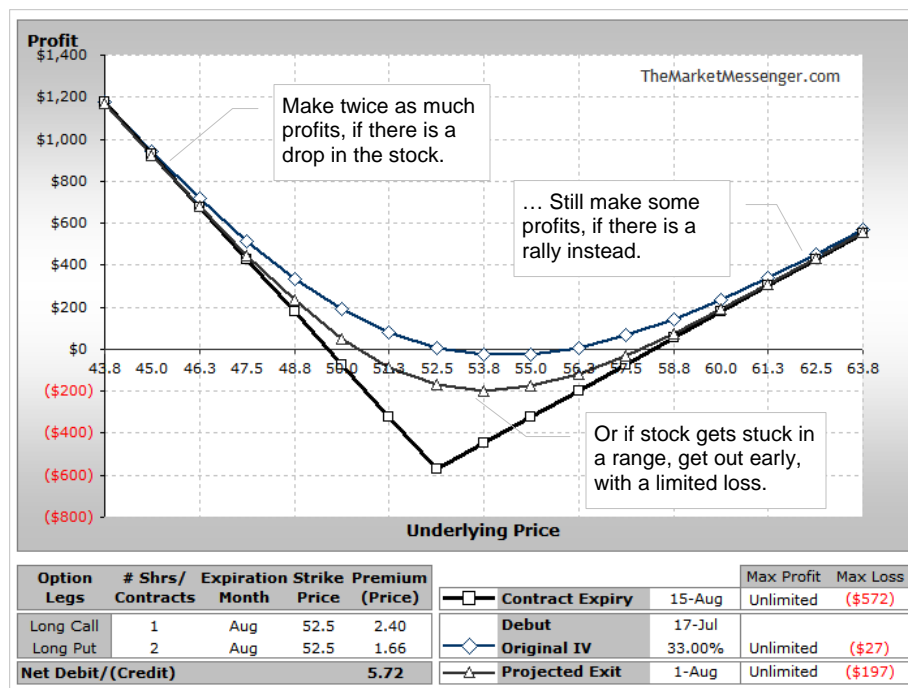
So, you may ask, why not use the basic Long Puts strategy?

That's a good question. We contemplated it but decided against it because of two reasons. One, the trend analysis forced us to give credence to the possibility of a continuation in the upside move. Two, we noticed that the company was due to release earnings in the next few days.

As such, a Long Puts trade was not an option.

In fact, you'll realize that for a stock trader there was absolutely no trade available, unless the trader was foolish enough to hold the stock despite the impending earnings report.

For all these reasons, a **bearish bias, long volatility options trade**, was our choice. The options strategy that most closely fits this parameter is the Long Strip strategy.



As the diagram shows, the strategy provides twice as much profits given a drop in the underlying as it does given a rise in the underlying asset.

The strike that was chosen was the 52.50 strike, since that strike was at-the-money at the time of initiation of the trade (see stock chart on page 2).

Accordingly, one AUG 52.50 Call and two AUG 52.50 Puts were purchased to construct the "Strip". The Call was priced at 2.40 and the Puts at 1.66, which converts to a net debit of 5.72 for the entire Strip.

When the trade was implemented, we actually had a target of 48.00 on the trade. That price level was chosen because it looked like the negative divergence and the overbought conditions could have brought about a decline of about 10% or so and, additionally, the level was an old intermediate resistance point.

The "alternate" target was 58.50, which represented a 10% rise in the stock. That's the great thing about long volatility trades (you can have two targets; one on each side of current price levels).

The stock continued to move slightly to the upside, over the next week or so. That was not what we had preferred but it was not a big problem. After all, there was an earnings event coming and a big move in one direction or the other immediately after that event was possible.

As things turned out, the stock did open with a big gap on Jul 28. In fact, the gap was as large as 8pts+, or 15%+. Moreover, the gap was to the upside.

Despite the fact that we'd have preferred that the stock have made such a gap to the downside, we really couldn't complain much, because the lone Call, in the Strip, was now trading at 10.00 on its own (the whole Strip had cost us 5.72 just a few days earlier) and the Puts still had some residual value.



With the stock opening at 62.00 – nearly 4 point above our “alternate target” - on Jul 28th, the opportunity was taken to close the Calls right away. The Puts will be held for a few more days, just in case there is a chance to add to the profits (if the stock tries to fill the gap).

If not, one can't complain about the 75% profit that's locked-in no matter what.

Trades like the one on AMGN have not been the exception over the past few weeks. In fact, they've been the norm.

The following are fifteen or so selected options picks from the month of July alone. For a lack of space and time, we won't go into detail in each case. Instead, we'll just show you the chart, which will contain brief details on the type of trade chosen and the results. Over the next few weeks, we'll be featuring several educational pieces on our blog and perhaps will get the chance to explain why given options strategies were chosen in each case.



AAPL (Apple, Inc.) Nasdaq GS

© StockCharts.com

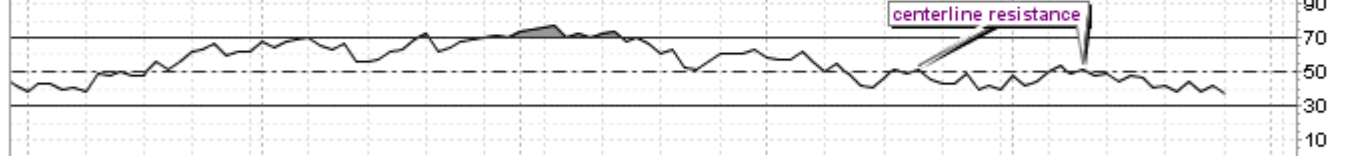
28-Jul-2008 1:42pm

Open 162.34 High 165.50 Low 155.14 Last 156.78 Volume 17.4M Chg -5.34 (-3.29%)

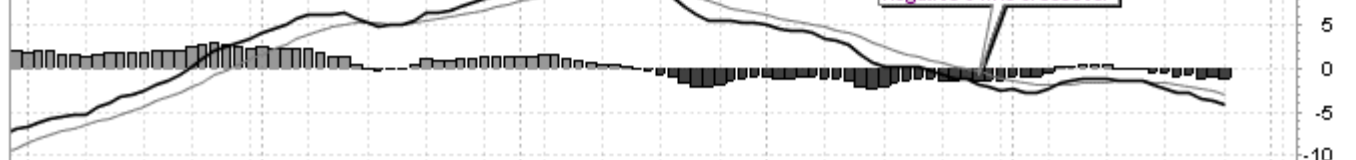
AAPL (Daily) 156.78



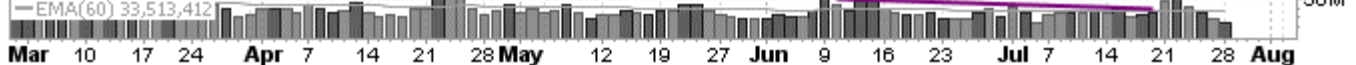
RSI(14) 37.54



MACD(12,26,9) -4.185, -2.964, -1.222



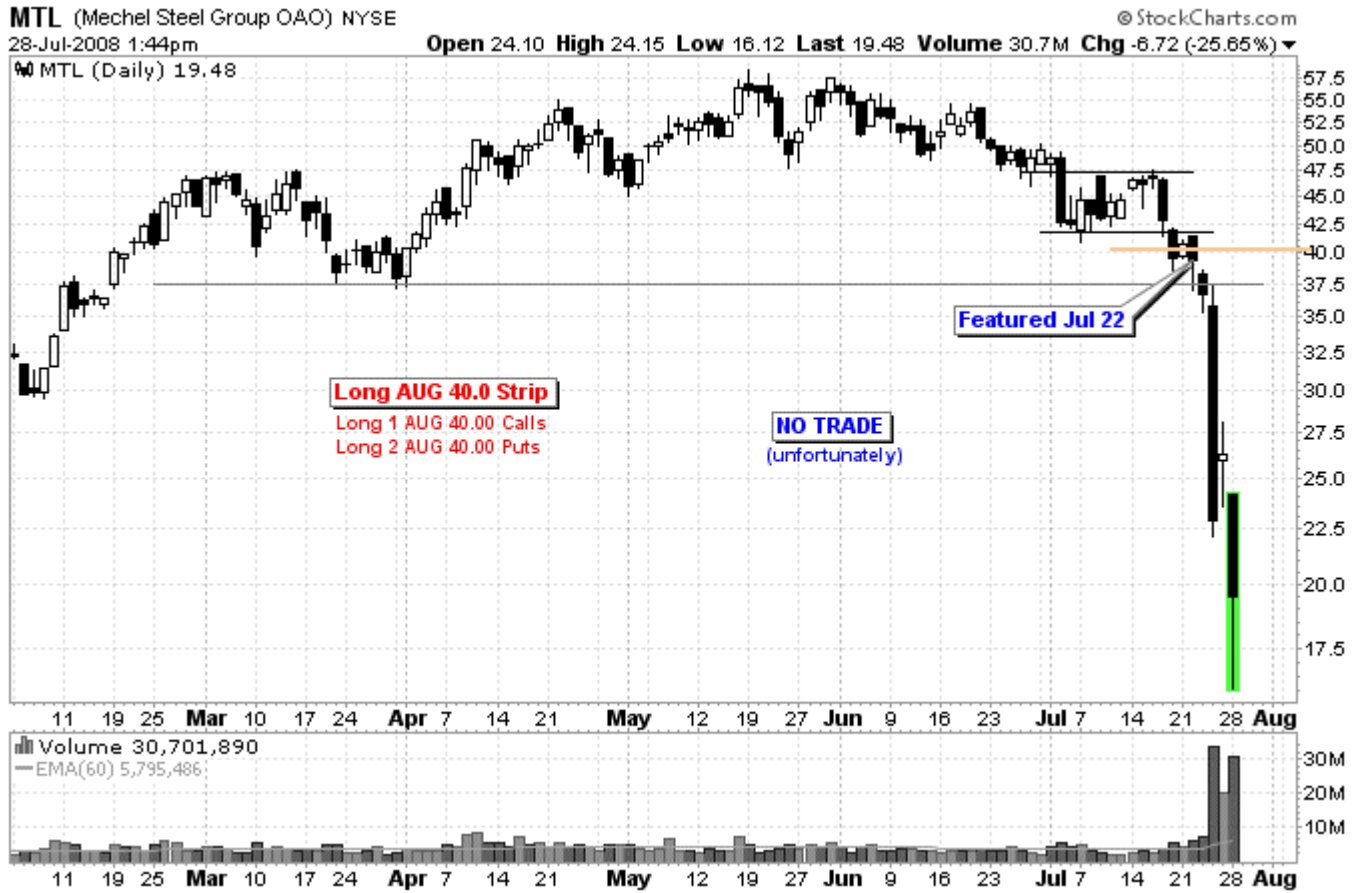
Volume 17,383,420



Here's a trade that we wish we'd partaken off.

A Strip was featured. However, we did not make an entry on the day after the trade was featured on the Options Picks list, because the stock was trading 2-3 points away from the strike.

For members who are not sticklers like we were, this was a blowout trade. Good on them!



JPM (J.P. Morgan Chase & Co.) NYSE

© StockCharts.com

17-Jul-2008 4:00pm

Open 38.05 High 40.99 Low 37.80 Last 40.80 Volume 132.1M Chg +4.86 (+13.52%) ▲

JPM (Daily) 40.80



AMZN (Amazon.com, Inc.) Nasdaq GS

© StockCharts.com

16-Jul-2008 4:00pm

Open 66.94 High 72.75 Low 66.84 Last 71.84 Volume 12.0M Chg +4.81 (+7.18%) ▲

AMZN (Daily) 71.84

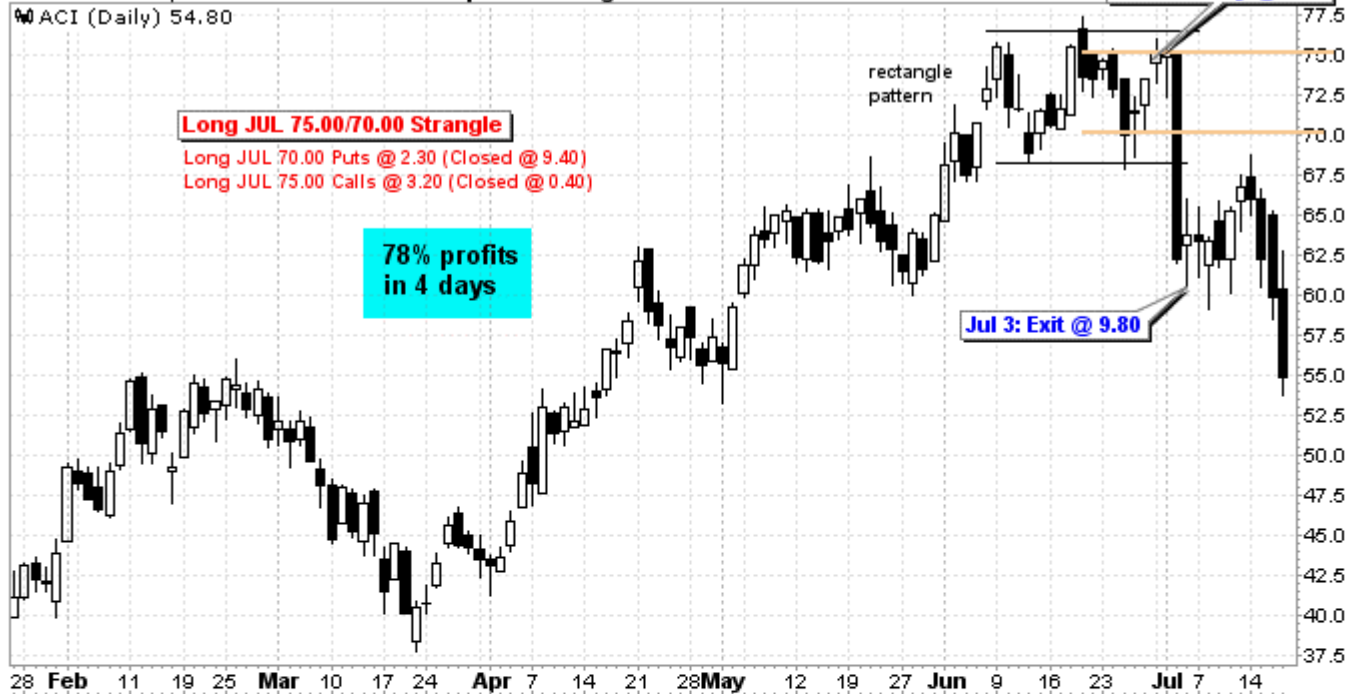


ACI (Arch Coal, Inc.) NYSE

17-Jul-2008 4:00pm

Open 60.31 High 62.70 Low 53.66 Last 54.80 Volume 9.5M C Jun 30: Entry @ 5.50

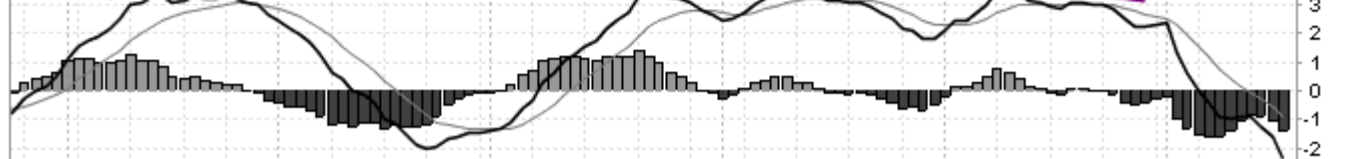
ACI (Daily) 54.80



RSI(14) 31.88



MACD(12,26,9) -2.327, -0.922, -1.405



Volume 9,497,435
EMA(60) 5,785,084



HPQ (Hewlett-Packard Co.) NYSE

© StockCharts.com

18-Jul-2008 4:00pm

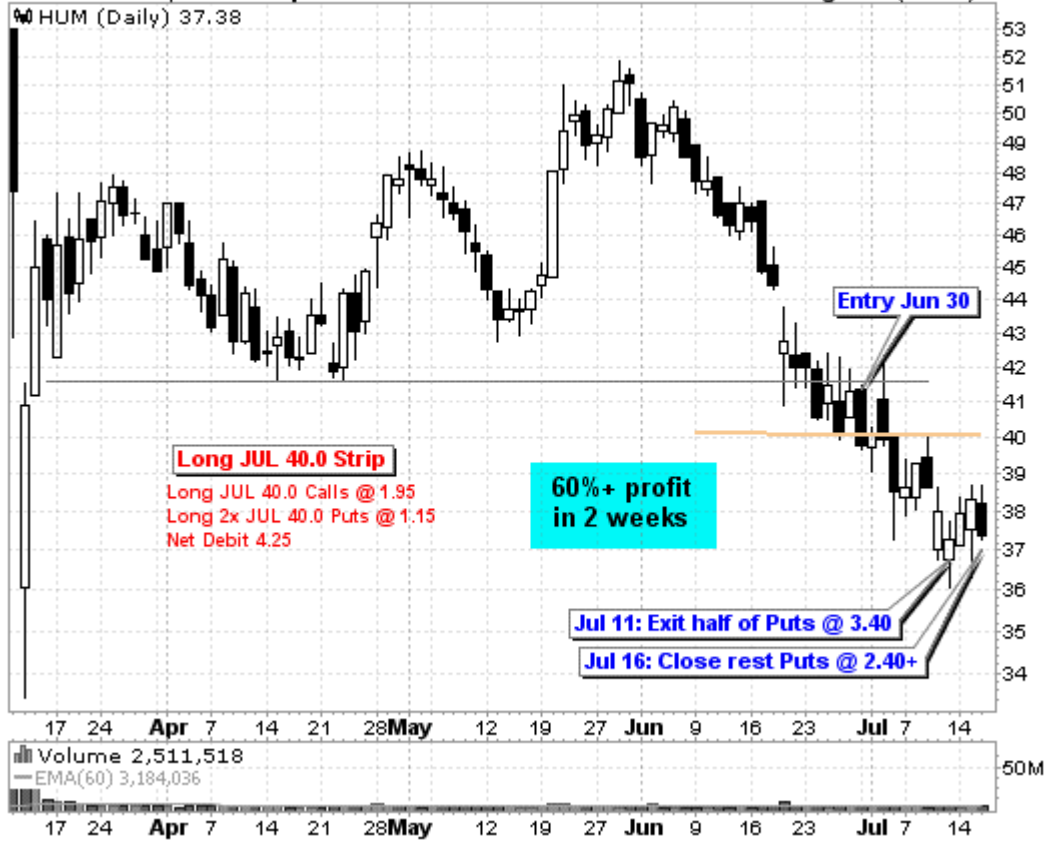
Open 42.99 High 43.95 Low 42.93 Last 43.42 Volume 14.2M Chg +0.19 (+0.44%) ▲



HUM (Humana, Inc.) NYSE

© StockCharts.com

16-Jul-2008 4:00pm Op 38.24 Hi 38.68 Lo 37.29 Last 37.38 Vol 2.5M Chg -0.94 (-2.45%)

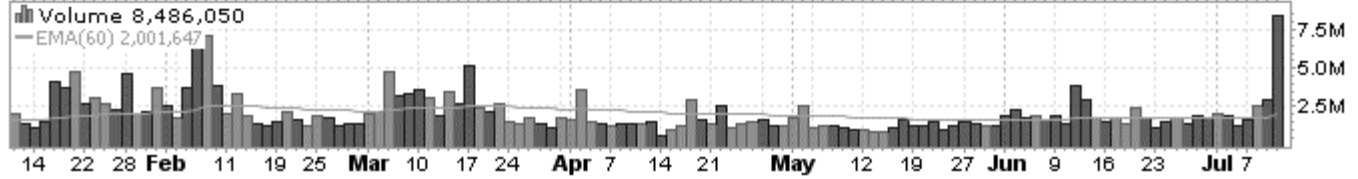


ICE (IntercontinentalExchange Inc.) NYSE

© StockCharts.com

10-Jul-2008 4:00pm

Open 95.50 High 95.50 Low 80.91 Last 85.30 Volume 8.5M Chg -10.09 (-10.58%)



POT (Potash Corp. Saskatch, Inc.) NYSE

© StockCharts.com

18-Jul-2008 4:00pm

Open 210.22 High 215.59 Low 207.00 Last 209.11 Volume 8.9M Chg -4.11 (-1.93%)

POT (Daily) 209.11



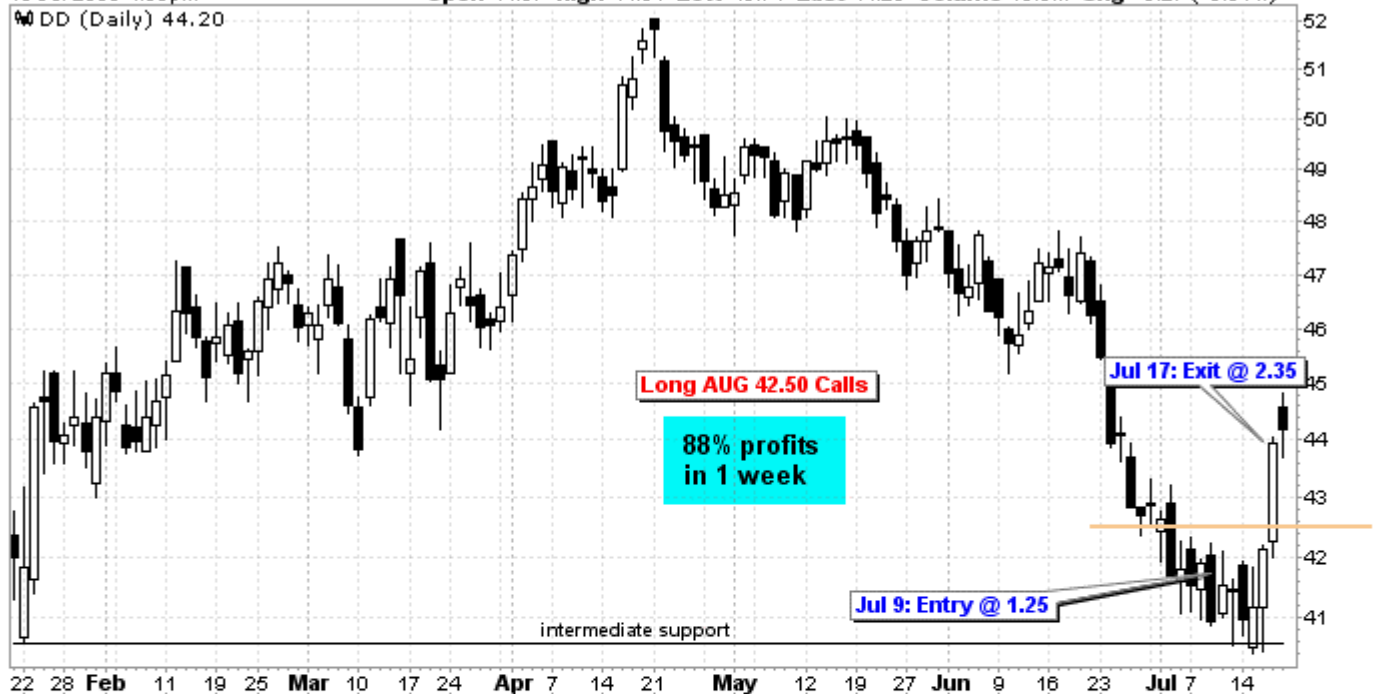
DD (Dupont Co.) NYSE

18-Jul-2008 4:00pm

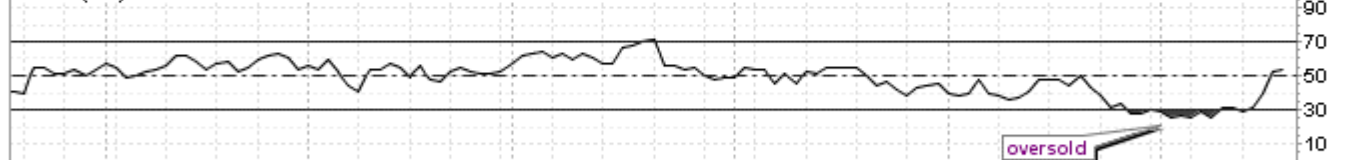
© StockCharts.com

Open 44.57 High 44.81 Low 43.71 Last 44.20 Volume 10.0M Chg +0.27 (+0.61%) ▲

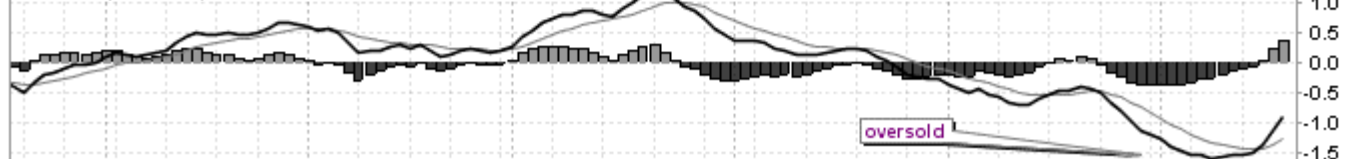
DD (Daily) 44.20



RSI(14) 54.02



MACD(12,26,9) -0.896, -1.279, 0.382



Volume 10,000,132

EMA(60) 7,492,062

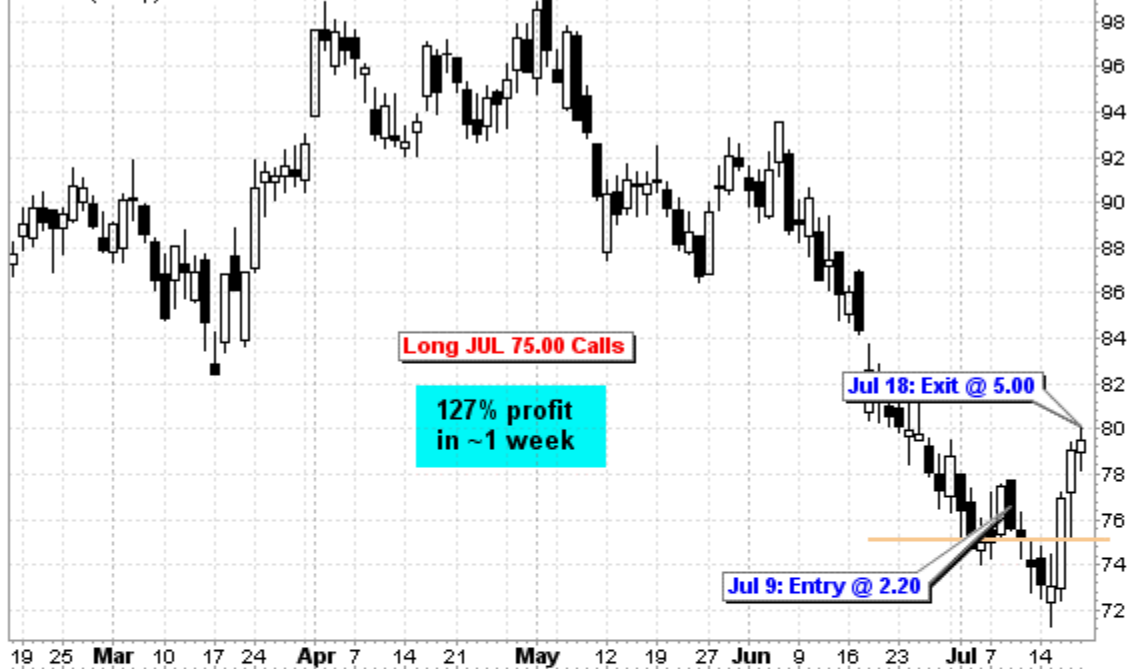


FDX (FedEx Corp.) NYSE

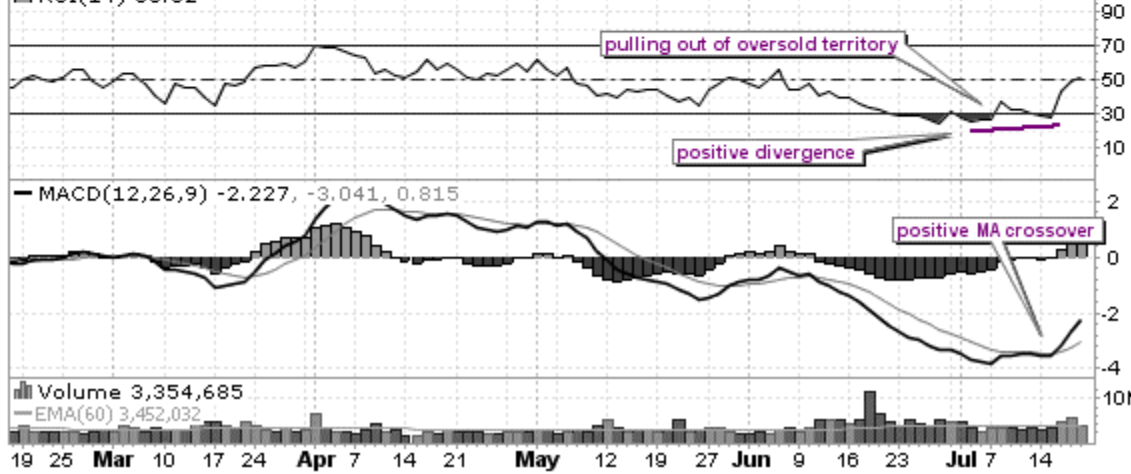
© StockCharts.com

18-Jul-2008 4:00pm **Open** 78.97 **High** 80.10 **Low** 78.19 **Last** 79.52 **Volume** 3.4M **Chg** +0.47 (+0.59%) ▲

FDX (Daily) 79.52



RSI(14) 50.62





That's it for this issue of the *Purely Technical* newsletter.

Good luck with your trading!

Asher Pinto

TheMarketMessenger.com

Are you an Active Trader?

Do you day trade the SPY, QQQQ, other market ETFs, individual stocks? Or do you otherwise watch the markets intraday (perhaps to give you a "feel" for the minor trend in the market, so that you may be able to better implement your swing trades)?

If so, you might find a new pilot feature, *'Active Traders: SPY 5-min Chart Trends'*, which is currently being tested on our blog, to your liking.

Each day, we provide a rundown of the important support/resistance levels and other technical events on the intraday charts of the S&P-500 SPDRs (SPY). Several updates are provided throughout the trading day, starting with a look at the action early in the day, then an update every hour or so when there is a breakout, reversal, or other such technical event, and finally a follow-up is provided after the close summarizing the intraday events and providing a framework for the next day's action.

You are invited to visit the [PurelyTechnical blog](http://PurelyTechnical.com), to review the *'Active Traders: SPY 5-min Chart Trends'* entries and other articles of interest that are covered at the blog.

Disclaimer:

TheMarketMessenger.com is owned by *TheMarketMessenger, LLC*. All material presented within TheMarketMessenger.com website, including this newsletter, has been provided for general informational purposes only. It does not constitute an offer to sell or a solicitation of an offer to buy any security or financial product that may be referenced herein. Further, the information contained in this informational newsletter does not constitute investment advice or investment advisory services. All securities trading, whether in stocks, options, or other investment vehicles, is speculative in nature and involves substantial risk of loss. We shall not be held responsible for any losses incurred as a result of the use of any information provided herein. You are strongly encouraged to seek personal advice from your professional investment advisor and to make independent investigations before acting on any information that we publish.

Subscribe to *Purely Technical* by visiting www.TheMarketMessenger.com
