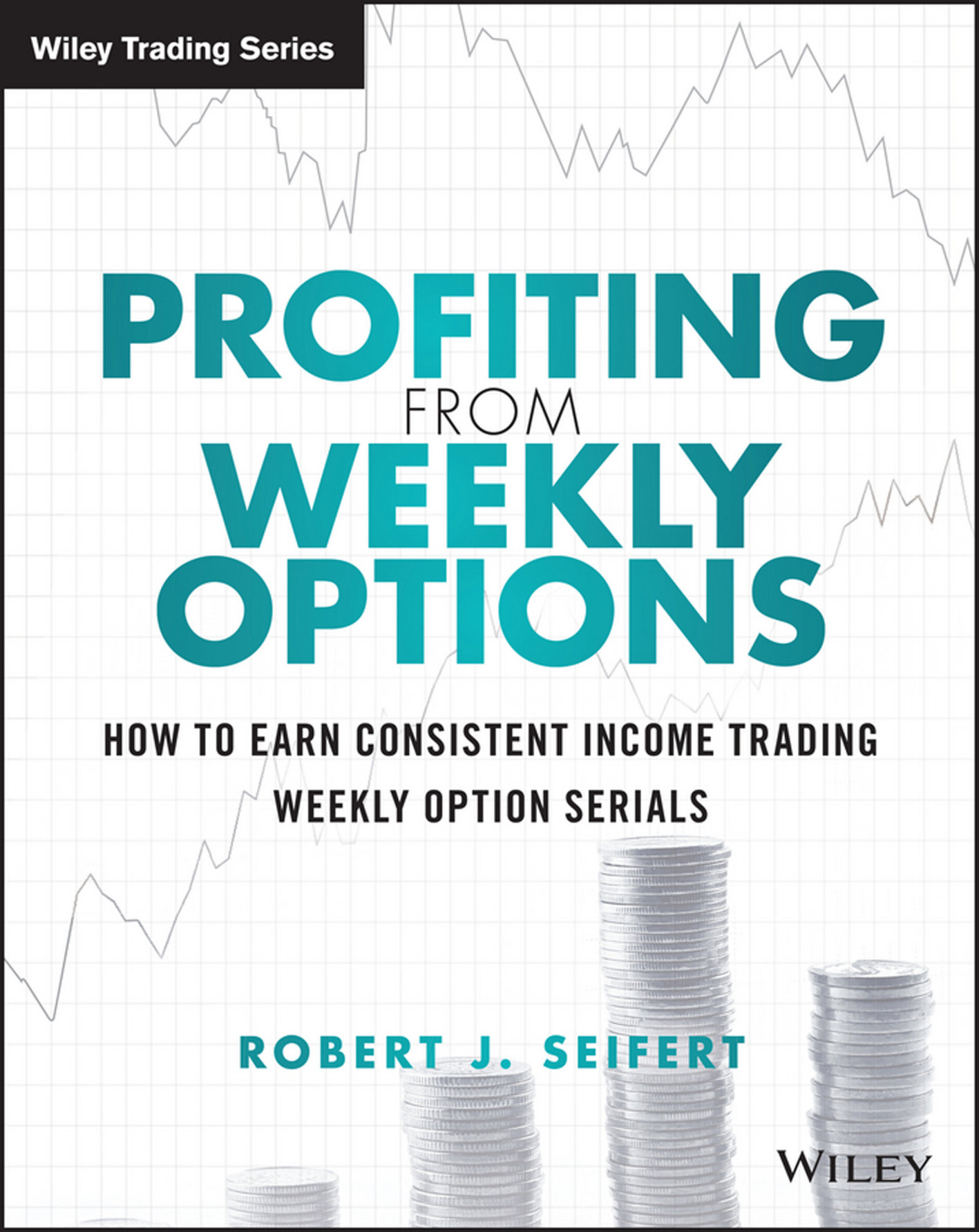


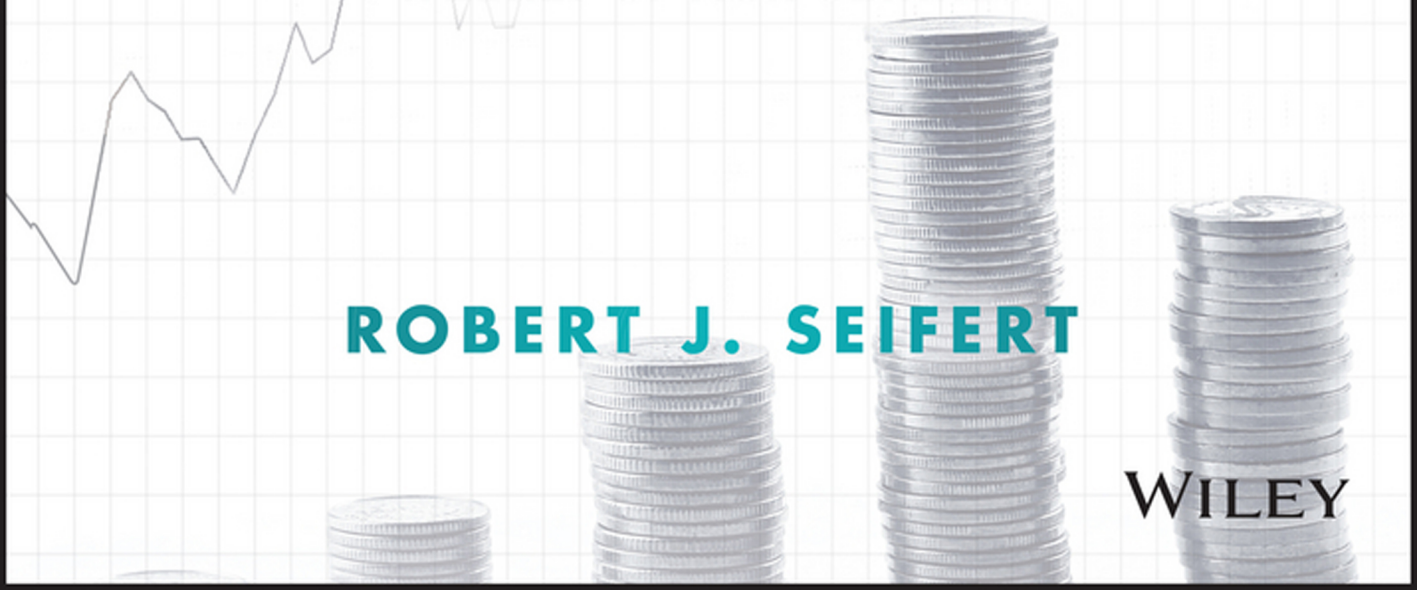
Wiley Trading Series



PROFITING FROM **WEEKLY OPTIONS**

**HOW TO EARN CONSISTENT INCOME TRADING
WEEKLY OPTION SERIALS**

ROBERT J. SEIFERT



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PROFITING FROM WEEKLY OPTIONS

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PROFITING FROM WEEKLY OPTIONS

How to Earn Consistent Income Trading
Weekly Option Serials

Robert J. Seifert

WILEY

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To Ryan, Aly, and Steph, how could I be so lucky?

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FOREWORD

Todd “Bubba” Horwitz

I first walked onto a trading floor at the CBOE in September of 1982. I was 24 years old and I knew that I wanted to be involved in the option market. I was one of the original market makers in the SPX, and it was quite a thrill. When you trade for a living, every day is a new adventure; you never know what is going to happen next but you know that it will be interesting. Over 30 years later, I still can't wait for the opening bell!

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So much has changed since I started to trade that it isn't the same business anymore. Now there is really no open outcry, the markets have shifted upstairs to the electronic platforms, and the trading pits are almost empty. When I started to trade, the option markets only had four expirations per year. Gradually, the powers that be figured out that if you had an expiration each month, that would bring more customers into the markets and provide greater liquidity. Another major policy change was to narrow the bid–offer spreads to \$1, and that brought even more business into the market. All of the changes made it better for the retail customer.

In 2010, the SEC decided that it would allow customers to trade options on a weekly basis, bringing the expiration total to 52 times a year. Finally, three years ago, the exchanges were approved to list weekly options that would fill out the rest of the month so that they could be used for calendar spreading and rolling positions back one week instead of one month. The weekly option market has grown so much in the last year or so, it is now liquid enough to allow the retail trader to compete with the giants of Wall Street.

I am very pleased to have helped to educate scores of students on how to successfully integrate weekly options into their arsenal of trading tools, and I am

very happy to be a part of this book. I have known Bob Seifert for more than 25 years, and we have collaborated on a great number of projects. I personally think that weekly options are the best investment tool that I have seen in that time. They are so versatile it is hard to believe that it took so long to bring them to the marketplace. If you have a stock position in place, the weekly options can be used to hedge your risk. If you have cash that is on the sidelines and you want to enhance your yield, weekly options offer you that opportunity, and if you want to speculate, the weekly options offer you the best possible opportunity.

When you read this book, you will probably need to study the material several times to take full advantage of the concepts presented. Anything that is worthwhile takes effort, and learning to trade weekly options is no different. Although the trades are very basic, they will offer you the chance to make money in any market condition.

I wish you good luck in your trading, and I can assure you that if you have the patience to learn the principles presented in this book, you will make your own luck!

PREFACE

For many years, it was difficult for individual option traders to compete with the banks and professional market makers in the derivative market. The bid–offer spreads were too big, the premium levels were so high that a retail trader could not afford to be involved, and finally, if their trade of choice was spreading, they had to wait months for the trade to mature.

Four years ago, weekly options didn't exist, and now they represent more than 30 percent of all options traded. There must be a reason for the phenomenal growth in such a short period of time. There is a reason, and it is very simple: Weekly options offer the best opportunity for any retail trader to get involved in the derivative market. This book is designed to reach any level of option trader, from the novice to successful traders that have yet to learn the power of weekly options.

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The book is organized into sections, and after each part there is a quiz that reviews the key points that are emphasized in the chapter. The first section deals with market psychology and is designed to help you learn “the other side of the trade.” If you think you can just pick up a book and magically defeat your opponent without understanding the psychology of the market, then you must also believe that if you can hit a golf ball you could beat Tiger Woods. In both cases, you are only fooling yourself.

The second section teaches you that underlying asset groups have different characteristics, and it is important to learn how each type of asset can be traded. It will show you that some markets are ideal for trading and other markets are simply impossible to beat. Once you learn what markets can be played, you need to see how they look when you study them, the patterns that constantly repeat, and how to spot those patterns. In addition, you must be able to communicate to the broker or to your software execution platform the trades that you want to make. Options have

a distinct vocabulary and you must learn certain terms in order to participate in the market.

The third section is devoted to the option model, how it is unique in the world of finance, and why you must familiarize yourself with how it is priced in order to succeed. Simple mathematical examples are given to help you adjust your vision of markets to the viewpoint of an option trader. The option chain is introduced and how comprehension of this vehicle will be all-important to your trading success.

The second-to-last section deals with four simple trades that you can continuously make. It explains when and how the trades should be initiated, what market conditions give you the best chance for the individual trade to succeed, and how to manage the trade once it is in place.

The final section demonstrates how to manage your greatest asset—cash. It clarifies how to utilize your capital in a manner that will ensure that you don't run the risk of ruin when the inevitable capital drawdown occurs, and it identifies which trades can be employed using your available capital levels.

After the final chapter, there is a final exam made up primarily of questions that you have been asked before. If you can score 90 percent or better, you should be ready to tackle the big players in the option market!

ACKNOWLEDGMENTS

I would be remiss if I didn't start this section with mentioning the influence of my parents on my life and trading career. My father, "Lefty," and mother, Rita, introduced me to the wonderful world of numbers when I was a small child. My parents would best be described as "characters," immense personalities with a positive view on living that enhanced my life and all those who were fortunate enough to meet them.

Cards were the pastime in our house, and it was my father who introduced me to probabilities and odds. At the time I didn't know what they were, but Lefty taught me that if you held a pair of aces, you were a big favorite going into the draw. That simple explanation helped me to understand how to make certain decisions based on probability. I had a magical childhood, great parents, and have had good luck throughout my life.

I want to thank **Ablesys Corporation**, Dr. John Wang, Grace Wang, and Jesse Wang for their help in getting this book to be printed and for their permission to use the charts and graphs from the **AbleTrend** and **Abledelta** platforms as illustrations.

I want to thank Todd "Bubba" Horwitz for his Foreword section and for all of our years together working with students on how to trade, as well as for his input into many of my trading models.

I want to thank Ryan Seifert for his contribution and the time that he spent editing the manuscript. And finally, Bonnie Pittenger, without whose support this project would never have been completed. Not only did she help me with the text of the book, but her positive attitude toward life and her ability to overcome adversity continue to inspire me and all who know her.

Market Psychology: The Mind-Set of a Trader

“90 percent of the game is 5 inches wide, the length of the space between your ears.”

—Bobby Jones, Golfer 1932

“Anyone who has never made a mistake has never tried anything new.”

—Albert Einstein, Scientist 1937

“You can observe a lot by just watching.”

—Yogi Berra, baseball player, New York Yankees 1956

“Greed is good.”

—Gordon Gekko, *Wall Street* 1987

“Bulls and bears make money; pigs get slaughtered.”

—Anonymous

“Coulda, woulda, shoulda.”

—Every Investor 5000 BC to Present

■ The Herd Mentality: Bubbles

History is our great teacher. As Yogi Berra, the Yankees great, once said, “You can observe a lot just by watching.” The past is the key to the present; if we do not learn from observing past events, we are doomed to repeat them.

In the spring of 2014, we still have a vivid memory of the financial meltdown in the summer and fall six years ago. TV commentators pleaded with investors to “get in there and sell, Wilson sell.”irate investors looked to hang their broker. Pictures of hysterical homeowners seeing years of hard work going out the window in a matter of months were gut-wrenching. Fingers pointed and tongues wagged. Crooked politicians, dishonest mortgage brokers, greedy Wall Street traders, shady rating agencies—there was enough blame to spread around.

Who could have possibly seen this one coming?

Comedians had a field day. Internet cartoons of stick figures explained to other stick figures where their money went. Hitler learning that his generals had tied up all of his cash in AIG and Lehman Brothers stock. Surely, this was the first time such a financial disaster had affected so many so quickly.

Or was it?

Because of its impact, it is crucial to recognize that the Great Recession was not an isolated incident. The market psychology that triggered this disaster goes back at least as long as history has been recorded. The panics will come in all forms and will start with many different patterns. Usually, the common thread is that some commodity or new technical revolution has no upper end. Demand for the product will be so great that it can only get bigger. There will be no upper limit to price, and any naysayers will regret their doubt. The thought process is:

“This time will be different.”

Let’s review a few of these “bubbles” that have occurred in the past 300 years and see what they have in common.

■ The South Sea Bubble 1711–1721: Trade, War, and Government Collusion

The South Sea Company was established in 1711 as a partnership between the British Treasury and the merchant class. England had been in a battle with Spain since the early 1700s in what is referred to as the “War of Spanish Succession.” The war had been very costly; the Crown need to finance its debt, and the Lord Treasurer Robert Harley came up with a good idea: **Sell a franchise!**

He granted exclusive trading rights to a group of merchants in the “South Seas.” It is a common misconception that the “South Seas” were in the Pacific, but in eighteenth-century Europe, the term referred to South America and the Caribbean Sea, not the Pacific.

The first round of financing granted the company “exclusive” trading rights for the sum of £10 million (approximately £500,000 million in 2014 £). In effect, the merchants convinced investors to take stock in the company and replace the bonds issued by the English Treasury. In exchange, the government granted the company a permanent annuity paying a little more than 5 percent. The merchants quickly resold the notes and guaranteed a profit to investors from the Treasury “in perpetuity.” Today, we would call this *arbitrage*, and it is the way many investment banks generate billions in profit: Buy debt for one price, sell it for a discounted amount to investors, and take the difference and put it in their pocket.

The British government viewed the transaction as a layup. It would charge tariffs on trade from the “South Seas” to fund the interest and pocket the difference.

When the war with Spain was finally settled in 1713 by the treaty of Utrecht, the terms were not as favorable as the Crown or the merchants had hoped. Although there is no evidence the company had ever made dollar one, the Treasury was able to float another round of financing in 1717 for £2 million. The original notes were converted to the new debt and the government continued to pay the interest. Nowadays, financiers call this type of sovereign debt replacement *Brady bonds* in honor of the US Secretary of the Treasury whose ingenuity bailed out US banks and Latin America in the 1990s.

The new debt funded the original loans from 1711. Nevertheless, as time passed and the company still did not flourish, the Crown needed to raise more capital. In 1719, the company conceived of a new idea.

Exchange the existing debt for equity in the Crown!

The company proposed to buy the majority of the Treasuries debt for £30 million. In exchange, the government guaranteed to pay interest on the shares at a preferred rate of 5 percent for a period of eight years, and then 4 percent “in perpetuity.” To sweeten the deal, the shares were allowed to be traded, and any “appreciation” could be used to buy more shares.

Needless to say, this arrangement benefited the company and the Crown. Rumors circulated that the trading rights granted the South Sea Company in the “New World” were far in excess of what was being revealed (can you say “new economy stocks”?), which caused frenzied speculation. Trading in the winter and spring of 1720 drove the price of the stock up almost 400 percent. Greed pulled in even more investors anxious to be in on the big payoff. Insiders and the Crown were rumored to have made a killing.

In June 1720, after scores of joint-stock companies joined in the feast, Parliament—fearing a revolt by the general population—passed the “Bubble Act,” which forbade joint-stock companies from participating in unregistered issuance of stock. Unfortunately, this did not curb the bubble, but triggered even more aggressive buying of the South Sea Company stock. In a perverted way, the South Sea Company was viewed as a flight to quality!

Shares prices exploded, peaking at 1,000 percent of their issuance price from the final conversion of debt to stock in 1719. Finally, in August 1720, “No greater fool could be found,” and the prices started to tumble. In six weeks, it was all over. The price was back to £150.

What became of the South Sea Company?

It continued to exist until 1763, when it was disbanded. In between wars, it continued to serve as a front for the Crown’s debt. In times of war, it virtually disappeared.

The hangover lasted for decades. Scores of ordinary citizens were broken. Bitterness was unbridled and knew no class. One of the biggest losers in the scam was Sir Isaac Newton, one of the most brilliant minds of all time. He never recovered financially and died in virtual poverty March 31, 1727, in an apartment with his niece and her husband.

■ The Cotton Panic of 1837: Land, Commodities, and Government

The first bubble addressed took place in Europe. Let’s turn our attention to the original panic in the United States. This bubble is not nearly as celebrated as its European counterpart, but it was equally as deadly. It occurred during the presidency of Andrew Jackson, 1829–1837. When the bubble burst on May 10, 1837, Martin Van Buren was the president, but make no mistake—the stage was set in the prior 10 years.

The war of 1812 was really America’s second Revolutionary War. The British invasion was almost successful, and the United States came very close to being “the colonies” again. As with most wars, there is a positive effect on the economy, as manufacturing and commerce in general have a tendency to grow. Capital goods must be replaced at a far greater rate than during times of peace. Usually, the prosperity lasts a few years; however, once the “war effect” ends, a general slowdown is almost sure to occur. In the United States, it manifested itself with the downturn of 1819–1821.

By the middle of 1821, the country was on its way to a recovery. The United States was expanding its western borders; new agriculture opportunities and trade brought in an era of exceptional wealth. The population went up by almost 60 percent, primarily shifting to the West, where commerce flourished North and South along the Mississippi River valley.

When the Jacksonian Era began in 1829, the United States had expanded its borders, and had also built an infrastructure of roads and canals that allowed for a flow of goods not only North and South on the Mississippi but also from the East Coast ports to the western colonies as far as Ohio.

Jackson was a very tough and vengeful man. He had been a war hero, a US senator, a landowner—and his nickname “Old Hickory” said it all. It was the merciless streak that helped to set the wheels in motion for the disaster that was to follow.

As with any time of prosperity, the demand for commodities and the land to produce them continued to increase. By law, public land in the West and Mississippi Valley could be purchased for \$1.25 per acre. Sales of land increased steadily in the 1830s, and landowners started to feel the first *wealth effect*. Land in some prime growing areas of the Mississippi more than quadrupled in value in five years (Iowa farmland in 2014?).

In government, a nasty personal feud between President Jackson and Nicholas Biddle, the owner of the Second Bank of the United States, resulted in the revocation of its charter. Jackson replaced the Second Bank of the United States (lender of last resort) with “Specie Circular” (gold and silver coins bimetal standard) and began to deposit money in state-chartered banks.

Unfortunately, the move to gold and silver coins did not allow for any expansion of the banking system. Consequently, when individual banks needed credit to cover land transactions, there was no institution to loan them the funds. This put banks in a huge dilemma. To counter the problem, the state banks actually exacerbated the situation by lending in “paper,” or “kiting” their own notes to cover the land speculation. The thirst for “King Cotton” in Europe was thought to be unquenchable. Conversely, with inflation on the rise, signs of darkness started to emerge in late 1835. Cotton prices doubled and it fetched nearly 20 cents a pound, and inflation was headed toward double digits.

In 1836, Britain forced new and punitive trade agreements on the United States, and greatly reduced exporting and importing with America. For any trade that did take place, the British demanded payment in hard currency, not cotton. As it turned out, the demand for cotton was not infinite. By the winter of 1837, rising inflation led to social unrest. On February 14, a large assembly of angry men met in New York City to demand that the government curb exploding prices. When their demands for lower prices fell on deaf ears, the meeting turned ugly. The assembly turned into a mob and took to the street with torches. The military was called out to quell the violence, but before peace could be restored, several warehouses filled with grain were burnt to the ground. One of the unfortunate flour merchants noted with sarcasm that “burning the goods would not have a tendency to lower price.”

Commencing in April, a number of large dry-goods companies went under. These companies were the nineteenth-century equivalent of Walmart, and their demise shook the foundations of American finance. The price of cotton began to collapse; in less than six weeks, it lost 50 percent of its value. By the first week in May, the banking system was in a state of panic. On May 10, 1837, with cotton and land prices collapsing and with nowhere to turn for “a lender of last resort,” all banks in New York City stopped paying in Specie. Within two months of the New York

Bank failure, 40 percent of the banks in the United States went broke. Interest rates turned negative as the ensuing panic drove the country into a financial depression.

Although not as famous as the Great Depression of the 1930s, the collapse of the banking system in 1837 led to six years of “unprecedented misery” in the United States. By some estimates, in the industrial areas of the Northeast unemployment reached a staggering 30 percent. It took another war to pull the nation out of the funk.

■ The Panic of 1893: Railroads Have No Upper Limit

Railroads had been a reliable form of transportation for nearly a quarter of a century in Europe before they arrived in America in the late 1820s. Between 1830 and 1860, America saw a great period of expansion when the country more than doubled in size. The nation needed a way to move goods and people to new markets quickly, and the railroad was the perfect vehicle. It combined the ability to move bulk goods, as the river and canal system had, and it added the value of speed. It could move goods up to 400 miles a day; a trip that used to take weeks could now be accomplished in a couple of days.

Prior to 1850, most of the railroads were short lines that joined with other short lines to form an irregular system. However, in 1850 the US Congress decided it was time to try and establish longer-haul routes that were contiguous and made available the first railroad land grants. During the next 20 years, legislators granted 170 million acres to roughly 85 railroad companies. Although substantial portions of the grants were never developed, the country still had enough track in place to circle the globe.

One of the problems that Congress had not foreseen was the standardization of track. There was no Bill Gates to figure out that if one railroad had a different width of track than the next, it could create a problem, and, unfortunately, it created a massive one. With hundreds of railroads across the land and several different gauges, it became increasingly difficult to move goods over large areas without transferring to a new railroad each time the track size changed.

The problem gradually resolved itself in the decades after the Civil War as the standardization of track took place and Congress continued to extend free land to the railroads in an attempt to connect the West to the rest of the country. As with any new technology, it seemed that this time was different and the market for railroads had no limit. It allowed for both a revolution in commerce as well as a social revolution. By 1880, you could travel from New York to San Francisco in less time than it took to go from New York to Washington, D.C., 50 years earlier.

With innovation came the need for financing the next project, and who was better suited for that than Wall Street? By 1890, there was more than \$12 billion

(nearly \$300 billion in 2014 dollars) invested in the industry. As with any successful product, competition came into play. Within 10 years of Leland Stanford driving the “golden spike” that completed the transcontinental railroad on May 10, 1869, at Promontory Summit in the Utah Territory, there were four competing railroads carrying passengers and goods across the country. Revenues began to shrink, but the cost of infrastructure continued to climb, latecomers started to have troubles, and some smaller railroads went under.

On February 23, 1893, a major carrier, the Philadelphia and Reading Railroad, declared bankruptcy. This created a crisis of confidence (Lehman Brothers?), and investors began to panic and withdraw their money from the banking system. The federal government sought to stop the run by repealing legislation that tied the price of silver to the dollar, but that effort failed when more major railroads ceased to do business.

The final result was that hundreds of railroads went broke; over 500 banks, the majority of them in the West, closed; and 15,000 other businesses went under. Unemployment in major manufacturing cities moved above 18 percent at the peak of the depression in 1894 and remained in double digits until the recovery began in 1897 with the Klondike Gold Rush.

■ September 11, 2001: Price Can Never Go Up Again

Although the three bubbles that we have observed were from different times and different places, they all had a common origin: speculation fueled the bubble. In each case, the perceived opportunity overcame rational thought. Even one of the most brilliant men in recorded history fell victim to the mass hysteria. So now the question must be asked: Is it possible to have a deflationary bubble?

Could the price of an asset class be deflated with the same logic that causes the inflationary bubble?

Consider Tuesday, September 11, 2001.

I doubt that any living American will ever forget that morning. The impossible had happened; terrorists were able to take down American financial icons, the World Trade Centers in New York City. The markets reacted swiftly and viciously. If you were not lucky enough to close your positions, there was no way to reach financial safety.

Within minutes of the second tower being hit, the exchanges were forced to close. The infrastructure damage was immense, and it would take a full week before they could reopen. Although authorities pleaded for calm, as a professional trader you sensed the result before the markets reopened: panic.

When the markets resumed trading on Monday, September 17, the financial devastation of the attack was immediately apparent. The DJIA plummeted more

than 4 percent on the opening bell. When the carnage stopped at 4:00, the Dow was down more than 7 percent.

Rumors on the street flourished. Bin Laden was not only the mastermind of the attack but he had purchased millions of dollars of puts on the OEX. New attacks were on the way. The economies of the Western Allies had lost hundreds of billions, and it would take decades to recover. The rest of week was even worse. Every day, the decline accelerated. Investors refused buy any US asset. Treasury Bonds, which had been used as a “flight to quality” for more than 80 years, joined the rout.

Friday morning, September 21, the economic news was horrible. There was no tomorrow; in a single stroke of violence, Bin Laden had realized his dream to bring the decadent Western world to its knees. The market opened down almost 5 percent from Thursday’s close. The worst week in over 140 years was in the making. The futures markets were locked limit down. Economic Armageddon had arrived, and this time there was no bottom!

And then it stopped.

Some anonymous investor stepped up to the plate and bought. The market rallied the rest of the day to finish marginally lower; by December 31, 2001, it had rallied 23 percent from the bottom. Bin Laden did not accomplish his goal.

The United States not only survived but continues to flourish. The masterminds of the plot are either dead or in captivity.

■ The Commodity Bubble of 2008: Price Can Never Go Down Again

The housing bubble has gotten extensive coverage in all forms of media, so it will not be discussed here. But one of the largest meltdowns in world history was in the works in a parallel universe, the commodity bust of 2008.

The commodity panic was not limited to a specific country or a specific product. Modern trade and the speed of information allowed the panic to spread quickly across the world. The list of culprits is long. Evil speculators, farmers who overplanted fields, hoarders who withheld goods from the market, consumers who raced each other for more goods than they could possible use, and, of course, the pigs on Wall Street. Rather than take the time to go over each individual market, the focus of this story will be placed on the biggest commodity market in the world—crude oil.

Crude oil has been a major source of energy for more than 150 years. Fortunes have been made and lost acquiring it. Nations have been built on its back. Nations have gone to war to acquire it. It is a god of wealth to some and the devil for others, but one thing is clear: Twenty-first-century society needs crude oil.

The bubble in crude oil started as countless panics that preceded it, with a gradual inflation of price. Less than 10 years before the bubble burst, the price of crude oil was \$17 a barrel.