



COMMODITY OPTIONS

TRADING AND HEDGING VOLATILITY IN THE
WORLD'S MOST LUCRATIVE MARKET

Carley Garner and Paul Brittain

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Introduction: An Unconventional but Effective Approach to Option Trading

Many books have been written about options on futures, unfortunately we believe that many of them are either contradictory or just a meandering compilation of exchange-generated research and material. In our opinion, much of the available literature leaves you even more confused than you were before you opened the book. With this book we hope that we have taken a step toward changing what has been the norm in this genre.

The biggest mistake that some authors make is to apply stock option theory to options on futures. It is a misguided perception to believe that an “option is an option.” Although they are spelled the same, they aren’t comparable. The nature of the underlying vehicle differs greatly, causing the options to take on completely different characteristics. After all, everybody agrees that trading stocks is different from trading futures, so why would anybody assume that trading options on stocks is synonymous with trading options on futures? It is our observation that authors of such material may simply be looking to capitalize on book and course sales through the recycling of stock option theory.

In the early 1980s the industry was dominated by operations that would now be referred to as a “long option only” houses. At the time, options on futures were not readily available in the United States. The instruments that were being sold were “dealer granted” precious metal options, which were based on actual metal holdings of the option writer at the time of the contract origination.

In the mid-1980s, the various exchanges started introducing options on futures known as *Exchange Traded Options* or *ETOs*. The explosion in this new trading vehicle was nothing short of breathtaking. Based on experience and speaking with others in the industry, during this time many retail customers were still limited to trading long option strategies. What we found is that they were either dissuaded by the brokerage firm or flatly refused permission to employ short option strategies. Several excuses were given, but the arguments

were in our opinion one sided and weak. It has been said that the most common basis for keeping the public away from short options is the perceived risk. However, we believe that in most cases this view holds no merit mathematically or practically. Surely option selling is no more risky than trading futures contracts; after all you get the money up front. Nonetheless, insiders were making a lot of money selling options to individual traders, and they likely wanted to keep it that way.

In fact, much like the world of finance coined the term “cash cow” to describe a business with healthy income but requiring little maintenance, insiders have dubbed option selling the “cash cow” of the futures markets. However, we must point out that in business and trading alike, there are inherent risks, and the risks can be substantial, especially when trading commodities.

Fortunately, things have changed over the years. Option selling is now conveniently available to all traders who want to partake. The result appears to be a more level playing field for market participants.

Years of following the trading strategies and recommendations of the popular option trading gurus forced us to witness the disappointment of strictly long option strategies. Due to time decay and the tendency of markets to stay range bound, the strategy only delivered minimal random profits. Even those recommended by the so-called experts in the field didn't yield better results, at least as far as we could see.

Frustrated by the situation, we chose to take control of our and our clients' destinies by researching, developing, and implementing an option trading method that had the potential to capitalize on both the advantages and disadvantages of long option trading. To do so, we had to disregard the long option strategies instilled into many of us and take into consideration only what was real.

The descriptions of the trading methods used in this book were meant to be easily understood and, even more important, easy to employ. The strategies outlined throughout this book can be effective and efficient option plays; accordingly we and our clients use many of them on a daily basis. In fact, we are so comfortable that our approach to the markets is viable in the long run that we choose to publish our trades on the Internet and distribute them by e-mail *before* we execute them in the marketplace. We like to call this “The Good, the Bad, and the Ugly” because we show it to you without filters. We stand by a simple statement “Seeing is Believing”!!

Open Your Eyes to the Potential of Both Long and Short Option Trading

Commodity futures and options traders can buy or sell in any order without the additional burdens that stock option traders may face.

If you were buying soybean options throughout the spring and summer of 2003 or the summer of 2005 you may have experienced the hazards of a long option strategy. Once a market begins to “run,” the extrinsic value of the options written against it explodes exponentially. This makes long option plays expensive. Along with the price tag, options buyers should be aware of the difficulties of turning a long option into a profit. If you are unfortunate enough to be a buyer after a sudden increase in volatility, you will begin losing money quickly if the volatility dies. It is common for long option traders to lose money as volatility decreases regardless of the direction of the market. Imagine the frustration of being right about the direction of the market and still not make money. Unfortunately, this is a common occurrence.

It has been said that trading futures is a zero sum game. In other words, there will be only one winner and one loser. This is not entirely correct given that the brokerage house always wins due to the transaction costs collected, unless of course there is an error in executing the trade. Essentially, a brokerage firm is paid a commission to ensure that your trade is effectively and efficiently executed. The amount of commission paid is determined by several factors such as the firm you have chosen, the level of service that you require, the funding in your account, and often the volume of trades that you execute. Regardless of whether your trades are winners or losers, the brokerage firm still gets to keep the commission earned by completing the transaction on your behalf.

Of course, a brokerage firm is not without risk. Not only are traders paying commission for the execution of the trade but they are also shifting the risk of error involved in placing the trade. Brokers are human too; errors are possible and in the long run probable. If your broker makes an error during the execution, she is liable for the damages and must make your account “right” again. Those paying online discount commission rates are charged less money per round turn in exchange for assuming the responsibility of their own trade placement and potential self-inflicted error.

However, for our purposes, we can assume a zero sum payout. Given this assumption, it should be clear to you that trading is a game of odds and probabilities.

If trading were easy, we would all quit our jobs and move to the Caribbean.

Simply conducting research, looking at a commodity chart, and picking the right market direction isn't enough to become a profitable trader. Instead, you will have to work hard at putting the odds in your favor. One way this can be done is by using a combination of long and short options to obtain an objective. Keep in mind that in trading simply putting the odds in your favor doesn't ensure success in the short term, but long-term success definitely wouldn't be possible without it.

**"You win some, you lose some. And then there's that little-known category."
Al Gore**

Think about it this way, after you enter a trade the market will either go up, down, or sideways. The way that we see it, this gives you a 33% chance of picking the right direction, and if you are trading long options this probability goes down dramatically because you are working against a strict time frame. Wouldn't it be great if you could make money in two of these instances? Better yet; what if you could profit from a market regardless of the direction, or lack of for that matter? With a comprehensive understanding of options and how they work in conjunction with each other, it can be done. This is not to say that there are arbitrage opportunities, or that it will be easy; it won't. Wherever there is potential reward, you will find risk alongside. With the right techniques, however, you can considerably improve your odds of profitable trading.

We hope that you walk away from this with a better understanding of how to use long and short options collectively to increase your likelihood of triumph in these treacherous markets. Throughout this book we will go into much more detail on how this can be done; but more important, we hope that you can apply the tools that we give you to the commodity markets in a profitable way.

Carley Garner and Paul Brittain

chapter 1

Option Basics: A Crash Course in Option Mechanics

The concept of options has been around for a long time. Ancient Romans, Greeks, and Phoenicians traded options based on outgoing cargoes from their local seaports. When used as a derivative of a financial instrument, an *option* is generally defined as a contract between two parties, a buyer and a seller, in which the buyer has the right but not the obligation to buy or sell the underlying asset at the denoted strike price. In the world of finance and trading, a *derivative* is defined as any asset in which its value is derived, or resulting, from the value of another asset. Likewise, the *underlying asset* is an asset on which the value of the derivative is dependent.

What Is an Option?

There are two types of options, a *call* option and a *put* option. Understanding what each of these is and how they work will help you determine when and how to use them. The buyer of an option pays a premium (payment) to the seller of an option for the right, not the obligation, to take delivery of the underlying futures contract (exercise). This financial value is treated as an asset, although eroding, to the option buyer and a liability to the seller.

There are two sides to every option trade, a buyer and a seller. Traders willing to accept considerable amounts of risk can write (or sell) options, collecting the premium and taking advantage of the well-known belief that more options than not expire worthless. The premium collected by a seller is seen as a liability until the option either is offset (by buying it back) or expires.

- **Call options**—Give the buyer the right, but not the obligation, to buy the underlying at the stated strike price within a specific period of time. Conversely, the seller of a call option is obligated to deliver a long position in the underlying futures contract from the strike price should the buyer choose to exercise the option. Essentially, this means that the seller would be forced to take a short position in the market upon expiration.
- **Put options**—Give the buyer the right, but not the obligation, to sell the underlying at the stated strike price within a specific period of time. The seller of a put option is obligated to deliver a short position from the strike price (accept a long futures position) in the case that the buyer chooses to exercise the option. Keep in mind that delivering a short futures contract simply means being long from the strike price.

	Call	Put	
Buy			Limited Risk
Sell			Unlimited Risk

To understand what an option is, you need to know the various components that comprise it. This next section explains the following:

- Strike price
- Intrinsic and extrinsic value
- Time value, volatility, and demand

Strike Price

Most literature doesn't include strike price as a factor of determining the extrinsic value of an option. It is assumed that the strike price is built into the supply and demand equation of the option. Naturally, a strike price closer-to-the-money will be in higher demand.

The *strike price* is the price at which the buyer of a call option has the right to purchase the futures contract, or the buyer of a put option has the right to sell a futures contract. This is also referred to as the *exercise price*.

The strike price is one of the biggest factors in determining both the extrinsic and intrinsic value of an option. Obviously, the closer the strike price is to the underlying futures contract the more valuable the option will be, even if there is no intrinsic value. This makes sense, because the closer the strike

price is to the underlying market the better the odds are that the option will expire in-the-money and the higher the demand will be for the contract.

Intrinsic and Extrinsic Value: Components of an Option Price

The value of any given option is composed of two components:

- Intrinsic value
- Extrinsic value

Option Price = Intrinsic Value + Extrinsic Value

Intrinsic Value

Intrinsic value is what you would have if the option expiration was today.

The intrinsic value of an option is the amount that the market price is higher than the strike price for a call and lower than the strike for a put. In other words, the intrinsic value is the amount of money

that the option would be worth if it expired today. For the option to have intrinsic value, the option must be in-the-money.

In-the-money and *out-of-the-money* are often falsely used by beginning traders. Many traders refer to a profitable option trade as being in-the-money. However, this is not the case. An option can be in-the-money and not profitable. Likewise it can be out-of-the-money and be a profitable trade.

Call options are described in the following way (see Figure 1.1):

- **In-the-money**—The futures price is above the strike price.
- **At-the-money**—The futures price is at the strike price.
- **Out-of-the-money**—The futures price is below the strike price.

It is important to know and understand the terminology involved in commodity trading; this could help to avoid costly mistakes stemming from miscommunication between you and your broker. In-the-money is a commonly misused term. Many beginning traders use this phrase to refer to a profitable trade rather than the intrinsic value of the position.

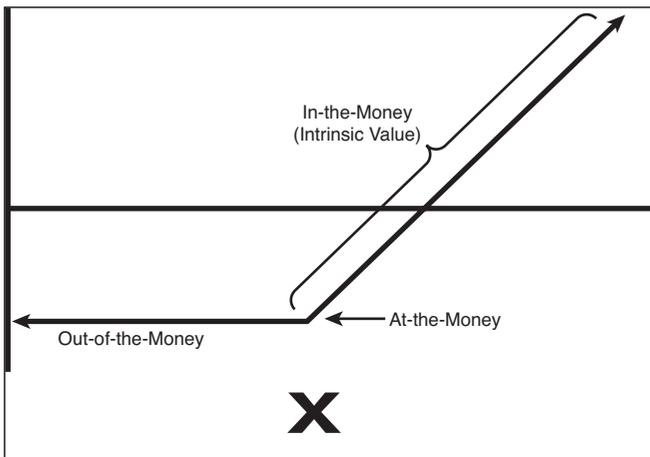


Figure 1.1 The intrinsic value of a call option

Put options are described in the following way (see Figure 1.2):

- **In-the-money**—The futures price is below the strike price.
- **At-the-money**—The futures price equals the strike price.
- **Out-of-the-money**—The futures price is above the strike price.

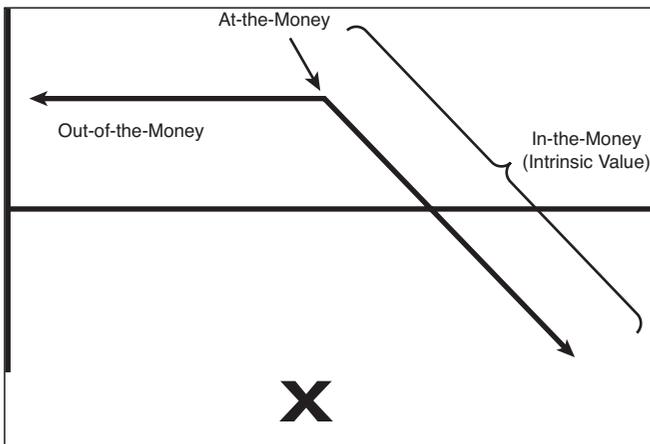


Figure 1.2 The intrinsic value of a put option

As shown in the Figure 1.3, the intrinsic value increases tick for tick as the market moves beyond the strike price of the option. In this case, it is a corn call option with a strike price of \$2.70. With the market at \$2.80 the option has an intrinsic value of 10 cents; with the market at \$2.90 the option has an intrinsic value of 20 cents, and so on. It is important to realize that before expiration the option value will not be equal to the intrinsic value because it will also have extrinsic, or time, value.

The intrinsic value of an option can easily be calculated, but the extrinsic value of an option is impossible to estimate at any given time in the future other than expiration. This is because the extrinsic value is made of a combination of time, volatility, and demand.

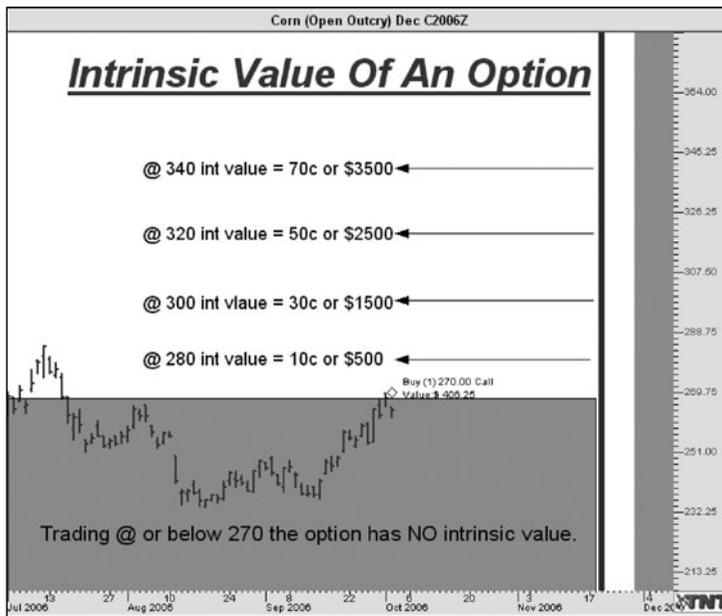


Figure 1.3 The intrinsic value of a \$2.70 corn call with the market at various prices

Extrinsic Value

Extrinsic value is like “icing on the cake.”

Extrinsic value is based on a combination of the strike price, time, volatility, and demand. We like to think of extrinsic value as the “icing on the cake.” Due to the nature of its components, it is impossible to estimate extrinsic value. Beginning traders often ask questions such as, “If I buy a call and the market goes up x number of points, what will it be worth?”

Unfortunately, the answer depends on factors that can’t necessarily be measured quantitatively.

Example

If a trader buys a September \$6.00 soybean call option for 10 cents in June with the underlying futures price at \$5.80 and the market rallies to \$6.00 by the beginning of July, the option will likely be worth much more than the original premium paid. After all, there will still be a lot of time value left on the option and the option is now at-the-money.

Example II

If a trader buys the same option, in the same circumstances, but it takes the underlying futures until August to reach \$6.00, the trade will likely be a loser. More time premium would have eroded from the option value than it would have benefitted from the market being closer to the strike price.

As you can see, it is possible to be right in the direction of the market and still lose money on a long option trade. This is exactly why it is so difficult to make money as an option buyer. It is hard enough to be right, but direction is only the first obstacle.

The *extrinsic value* of an option is based on a combination of the following factors:

- Time
- Volatility
- Demand

Of these factors, time is the only predictable element. You know what they say, “Time waits for no man.”

Throughout this book we will cover several hands-on examples to illustrate the risks and potential rewards involved with each strategy and scenario. It is important to realize that all calculations are based on the assumption that the trade is held until expiration. This is because at expiration the options will have no extrinsic value, which is nearly impossible to predict at any given point. At any time prior to expiration, the profit or loss experienced on the trade may be outside the original profit and loss parameters based on the price of the underlying contract at option expiration. This is especially true in the case of option spreads.

Time Value

The longer the amount of time until an option’s expiration, the greater the time value of a particular option will be. This makes sense, because the longer the

buyer possesses the right to exercise the option the more valuable that right is. Remember, in commodity trading anything can happen. It is not out of the question for a relatively worthless option to come to life and post abnormal gains (or losses for the seller) by expiration. Keep in mind that this is the exception rather than the rule, but it can and does happen.

Time value works against the buyer of an option, but works for the seller. This is because the time value portion of the option is constantly eroding until reaching zero at the time of expiration.

Volatility

If the price of the underlying futures contract is fluctuating considerably, there is both a greater profit and a greater loss potential. Thus options tend to be more expensive to buy when volatility is high. Likewise, sellers will collect more premium for a short option during times of inflated volatility. Of course, premiums are high for a reason—the risk and reward are equally magnified.

Volatility can be a double-edged sword. It can be lucrative if you are in a favorable position, but losses may be substantial if you happen to be on the opposite side. This is the case whether you are holding long or short options.

Trading Volatility

Because of the effect volatility has on option premium, it is a good idea to buy options when the market is quiet and sell them in times of high volatility. Those holding long options during an explosion in volatility have been known to enjoy impressive profits. On the other hand, short option traders may find themselves in a less than desirable position should they be in a market that experiences significant increases in volatility after they have entered a position.

Demand

If the number of traders willing to buy an option at a given price is greater than the number of traders willing to sell the same option, the value of that option appreciates. It is the nature of the option markets to experience high demand of call options in a market that is in an uptrend and high demand of put options in a downtrend. Thus, it is not uncommon to see overpriced options in such scenarios. An interesting phenomenon in the equity indices, put options are almost always priced high to comparative calls. This

Some traders look to be the contrarians of the masses. If everyone else seems to be buying the option, it may be time to sell it.

is partly due to equity holders hedging their portfolios along with the expectation that markets drop faster than they go up. You may have heard the concept of higher put valuation referred to in the context of a “volatility smile” or “skewed volatility.” In the case of equity indices the implied volatility of an at-the-money option is often less than that of an out-of-the-money option, or negatively skewed. This is especially true in the case of distant strike priced puts; interestingly, this didn’t seem to be the case until after the crash of 1987.

If you are unfamiliar with the term *implied volatility*, it is important to note that the term differs greatly from *market volatility* (often referred to as *historical volatility*). Historical or market volatility is a direct measure of price movement, while implied volatility is a function of the derivative value (option premium) itself rather than the underlier. Therefore, options with differing strike prices or expiration dates but based on the same underlier may have differing levels of implied volatility. The formal definition of implied volatility is, in its simplest form, the volatility implied by the market price of the option

Another component of demand is strike price.

Strike price is obviously one of the biggest factors in the market’s determination of option value. The closer to the money an option is, the more valuable it is to the buyer and the riskier it is to the seller. This makes sense; people are willing to pay more for an option that seems to have a better chance of paying out than they would for an option that will most likely expire worthless. As we cover in great detail throughout this book, the delta value of an at-the-money option is 50 and has roughly 50 percent odds of expiring in-the-money.

The Art of Option Trading

It doesn’t matter how you trade, or which indicators you use. The only thing that matters is whether you make money.

In options trading the infamous adage “There is more than one way to skin a cat” holds true. Many traders choose to ignore technical or charting tools and focus on market fundamentals. Yet others look strictly at chart formations to construct trades. Regardless of the market analysis tools used, we have found that traders can increase their odds of success by becoming familiar with option strategies other than buying outright calls or puts.

Over the next several chapters we outline and analyze many of the commonly used option strategies. We offer our opinion on when each strategy should be used and the manner in which we recommend using them. Additionally, we cover the associated risks and rewards of each of the differing

approaches. As you will find, our interpretation of risk may be different than what you might find in alternative literature. For instance, in our opinion limited risk is not necessarily synonymous with less risk. In fact, in most cases limited risk, although it provides a cap to potential losses, may create a scenario in which your probability of loss is extremely great.

Each of the option trading styles mentioned throughout this text may or may not be appropriate for your risk tolerance. It is our goal to provide you with the information that you need to skew the odds away from the market insiders and toward you as a retail trader. Remember, roughly three out of four independent speculators walk away from the futures and options market with less money than he came with. However, only you can decide whether any of these trading methods are suitable for you and your piece of mind.

Although there are only four basic instruments in trading (long, short, call, put), there is a seemingly unlimited number of combinations of these components resulting in various levels of risk and reward. Throughout this book, we highlight some of the most common forms.

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