chapter 1

the options market today

trading options today

The Internet has gone from an abstract concept to a global information network with endless applications in everyday life. By 2007, more than 160 million adults (age 18 or older) in the United States were surfing the Net. Almost 75 percent of U.S. households now have Internet access. Odds are you are connected. In fact, there is a good chance that you bought this book online.

People use the Internet in different ways. The rise of online media is giving television a run for its money. People are no longer satisfied digesting spoon-fed TV news or programs. They want to download their own podcasts, you-tubes, music videos, and movies. People want greater control of the content they digest into their systems. In many cases, they have even become broadcasters of their own media.

In addition, e-commerce is altering the way people spend their hard-earned dollars. As this immense shift in control takes place, the nature of the human adventure evolves and entire new industries are booming. Bookstores are trying harder to lure in customers to compete with Amazon.com, car salesmen often look over empty lots because sales are taking place on autotrader.com, and there are very few lines waiting for bank tellers as online banking has transformed the way people handle their finances.

The success of the Internet has also created a maelstrom in the investment world. Conventional brokers, the traditional intermediaries of an investor's game plan, are losing ground as more than seven million investors move to online brokers instead. Reduced commissions and lightning-fast information access have enabled online trading enterprises to redefine the role of a broker.

With a keystroke, traders can access real-time quotes, annual reports, breaking financial news, technical and fundamental analytical data, and investing tips from a multitude of insightful (and not so insightful) market analysts. In seconds you can find out which stocks are hitting new highs or new lows or review an option's volatility. It has become possible to look over charts and graphs, and then, with the click of a mouse, enter an order to buy or sell that stock or option.

Meanwhile, news sites compete for readers by offering daily market analyses, economic reports, and shrewd investment commentary. Market research firms maximize the investment community's ability to track ever-changing fundamentals and technical indicators. Even exchanges offer a variety of free services geared to educate and inform the Net-surfing masses.

In fact, there is so much information available on the Internet that it can be overwhelming. There's just too much to be able to digest it all. The key is to develop a comprehensive game plan that enables you to systematically trade to win. This involves more than just marking your favorites in your Web browser; you have to learn to filter out all the noise and useless information that won't help you make a dime. This book, especially this chapter and the two that follow, is designed to help you cut through the information clutter by highlighting the most important and useful online sources of options-related information.

the exchanges Options trading volume continues to set records year after year. In 2007, six different U.S. exchanges listed put and call options. According to the Options Clearing Corporation (OCC), a total of 2.9 billion contracts traded hands that year, which represents a 45 percent increase over the roughly 2.0 billion contracts that traded in 2006.

How do traders use options? In a variety of ways. A call option can be used to participate in a move higher in a stock. An investor can buy a put option to bet on a decline in a stock price. For example, an investor who bought put options (which give the right to sell a stock) on Intel on December 31, 2007, would have seen the value of the put option more than triple when the stock fell 18 percent over the next few weeks. During that same time, Citigroup fell 3 percent, and put options on its stock rose 32 percent.

So options can be used to profit from price changes in a stock, whether higher or lower. Puts and calls can also be used to profit from price changes in a variety of other assets, known as *underlying securities*, including gold, oil, bonds, the stock market, and specific sectors. Furthermore, there are a variety of more advanced strategies (covered later in this book) that can generate profits if the underlying asset moves higher, lower, or sideways.

underlying asset or underlying security
the security (stock, index, or futures) from which an option (put or call) derives its value.

The versatility of options explains why the options market has become one of the fastest-growing areas of finance today. The seven exchanges that offer options trading—the American Stock Exchange (AMEX), the Chicago Board Options Exchange (CBOE), the International Securities Exchange (ISE), the Boston Options Exchange (BOX), the New York Stock Exchange Arca (NYSE), the NASDAQ, and the Philadelphia Stock Exchange (PHLX)—continue to see steady order flows and strong business. Table 1.1 breaks down the total volume by exchange on a typical trading day in 2008.

In fact, the ISE, which was the first all-electronic options exchange, was acquired by Eurex, a European exchange, in 2007. The year before, the New York Stock Exchange (NYSE) bought out Archipelago and, in the process, acquired the options trading business of the Pacific Stock Exchange, which is now known as NYSE Arca. More recently, the NASDAQ Stock Market launched its own options market and became the seventh exchange to list puts and calls. The all electronic exchange received SEC approval on March 12, 2008, and started trading options shortly thereafter. Like the six others,

table 1.1 percentage of market share by exchange

	Options Contract Totals by Exchange:					
	Equity Total	Equity %	Index/Other Total	Index/ Other %	Exchange Total	Total %
AMEX:	631,058	5.65%	12,373	1.24%	643,431	5.29%
BOX:	576,910	5.17%	1,510	0.15%	578,420	4.76%
CBOE:	3,356,567	30.07%	929,403	93.00%	4,285,970	35.24%
ISE:	3,381,628	30.30%	40,643	4.07%	3,422,271	28.14%
NSDQ:	159,650	1.43%	0	0.00%	159,650	1.31%
NYSE:	1,086,910	9.74%	1,078	0.11%	1,087,988	8.95%
PHLX:	1,969,564	17.64%	14,306	1.43%	1,983,870	16.31%
Total:	11,162,287	100.00%	999,313	100.00%	12,161,600	100.00%

source: the options clearing corp. (9-29-08)

the NASDAQ options market offers trading in equity, ETF, and index options. In addition, the exchanges are becoming more efficient with the help of technology. Options trading has never been easier or more popular among individual investors. It is a strong trend that is showing no signs of slowing.

At the same time, while the exchanges have been growing, they are also competing for investor attention and order flow. Consequently, the exchanges have become important sources of information regarding industry trends. For example, a visit to the CBOE web site provides a plethora of useful options-trading information, much of it free. This includes not only product specifications but also quotes, research, and historical data. The AMEX, NASDAQ, ISE, and PHLX also provide useful information on their respective web sites, listed below and in Table 1.1 for your convenience:

American Stock Exchange, Inc.
86 Trinity Place
New York, New York 10006
(212) 306-1452
www.amex.com

Boston Options Exchange
(866) 768-8845
www.bostonoptions.com

Chicago Board Options Exchange, Inc.
400 LaSalle Street
Chicago, IL 60605
(312) 786-7705
www.cboe.com

International Securities Exchange
60 Broad Street
New York, NY 10004
(212) 943-2400
www.iseoptions.com

NASDAQ Stock Market
One Liberty Plaza
165 Broadway
New York, NY 10006
(212) 401-8700
www.nasdaq.com

NYSE Arca
(Formerly Pacific Stock Exchange)
301 Pine Street
San Francisco, CA 94104
(415) 393-4000
www.nyse.com

Philadelphia Stock Exchange, Inc.
1900 Market Street
Philadelphia, PA 19103
(215) 496-5000
www.phlx.com

reality check for online traders

These days, most option orders are sent electronically to the exchanges. When I first started trading, this kind of technology didn't exist. Customer orders were sent to the brokerage firm by phone and then the order was usually sent from the firm to the exchange through a direct line. Sometimes the order went through several individual brokers before finding its way to the pits of the exchange floor. Electronic trading has changed all that; now customers can often send orders directly to the exchanges where the best prices exist.

Since options are *multiple listed*, the same contract can be listed simultaneously on several different exchanges. For example, the January 30 calls on Intel might be quoted at $3.00 on the ISE and $3.05 on the CBOE. In that case, the customer would want a buy order to go to the ISE. However, that doesn't always happen due to poor execution on the part of the brokerage firm handling the order. For that reason, many active traders prefer to deal with a *direct access* broker, or one that allows customers to direct their orders to specific exchanges.

> **direct access broker**
> a brokerage firm that allows customers to direct orders to specific options exchanges.

Obviously, with the help of technology, online trading is changing the nature of investing more than we can even begin to understand. It remains to be seen whether the proliferation of online trading—especially in options—is a dramatic shift in the way investors trade or just a hyped-up way for investors and traders to lose money faster in the markets. I hope it is not the latter, but I must be realistic. After all, the faster someone can trade, the more likely that person is to trade more often.

Moreover, the ease with which investors and traders are able to move in and out of the market may very well be inversely correlated to the amount of research they actually do to find and manage investment opportunities. It is paramount to your success as a trader to fight against this kind of gambler mentality when it comes to online trading disciplines. Don't try to make up for losses by trading more and more aggressively. Instead, if you have a series of losses, stop trading.

It's important to let the power of the Internet work for you. Online trading services increased the speed of the transaction, lowered the cost, and gave traders unimaginable access to information from which knowledgeable investment decisions can be made.

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Brokerage firms have never offered more objective information to their customers. It's online and often free to customers. At the same time, the costs of trading are still falling. According to the annual ranking of online brokers by *Barron's* ("Making It Click: Annual Ranking of Best Online Brokers," by Theresa Carey, March 17, 2008), "Overall, our analysis puts the average commission at $6.52 this year, up a bit from $6.35 last year, for a 500-share block. A number of firms, meanwhile, cut their options commissions last year." The days of paying $25 or $50 for an options order execution are over.

However, although the trend of falling commissions is clearly working in our favor as options traders, the psychology of trading hasn't changed much. Just like with most jobs, there are fast days and there are slow days in the financial markets. You never know what might happen next. Perhaps it's the uncertainty that's so exhilarating.

For most professional traders, financial markets are exciting. It's the most exhilarating game. Every morning you wake up early and have no idea what might happen next. The key to long-term success is the ability to make good decisions quickly; this is also the backbone to making consistent profits. Time waits for no one, especially the trader. However, the one attribute all traders must learn is *patience*. Many of the best trades take time to mature. So be patient, especially if you have placed a delta neutral options trade. Sometimes it is better to wait than to keep reacting to the market's every whim. In fact, since many other traders are also reacting to the same news, it is almost impossible to get an edge by trading on news alone.

So while, on the outside, trading consists of buying and selling stocks and stock options, on the inside, market sentiment and trader psychology can rip the novice trader apart. Even experienced traders can get caught up in periods of market euphoria or panic. Instead, try to keep your wits and withstand everything the marketplace has to throw at you—from bidding wars to international market collapses. The first rule: Don't panic. By remaining calm, you harness the clarity to make decisions quickly in order to protect your investments against losses.

So what is the key to remaining calm when the majority of other investors are caught up in the chaos? Risk management. I discuss risk management in the final chapter of the book; in the meantime, it cannot be understated. Always look to protect your capital by using strong risk control techniques. Try to place yourself in a position to profit by choosing trades with limited risk and plenty of time to mature to profitability. And finally, have an exit plan already in place before placing a trade. The lack of a profit and loss plan is like not having a fire escape route—don't get burned!

the land of opportunity

Now that I've probably scared you half to death, let's explore some of the great things about trading options online. For one thing, there is no limit to how successful you can become. There is no bias toward race or ethnicity and no glass ceiling. The playing field is absolutely level. You can start with relatively little capital and, over time, build that capital into considerable wealth.

In addition, the opportunities have never been better for investors, even those with relatively little capital, to get started. Some brokerage firms have no restrictions on the amount of money needed to open an account. An investor can start with as little as $500. In short, trading options doesn't require a large capital investment to get started.

In addition, a wide variety of contracts have recently been created to appeal to the smaller investor. Examples include a variety of exchange-traded funds (ETFs), new futures contracts, and the so-called *mini-indexes*. For example, the Dow Jones Industrial Index ($DJX) is a mini-index equal to 1/100th of the Dow Jones Industrial Average ($INDU). You have probably heard stock market reporters talk about "the Dow" on the evening news, especially when it achieves milestones like the 10,000 level. When the Dow breaches key levels, it is a sign that the stock market is performing well. It is also viewed as a good omen for the economic outlook. However, while the fact of the Dow moving above 10,000 might be newsworthy, options traders can't participate directly as the cost of the options would be sky high. Hence, although the Dow is probably the most widely watched barometer for the stock market, there are no options listed on it.

While the industrial average is not practical to trade, the mini-Dow is equal to 1/100th of the industrial average; when the Dow hit 10,000, the mini-index rose to 100, which is a much more manageable level for an options contract. In short, the advent of many mini-indexes (discussed in more detail in Chapter 2) opens up a world of opportunities for options traders looking for ways to profit from moves in the stock market. There has been a lot of innovation in terms of the financial products available to smaller investors. The development of many mini-indexes is just one example.

getting the right stuff

While the cost of trading has come down over the years, so has the cost of technology. It is cheaper and easier than ever to get hooked up to the World Wide Web. In fact, at this point, most readers probably have access to the Internet at home. If so, the following section on computers may not offer much new information.

However, to the uninitiated, getting hooked up to start trading options probably seems like a daunting prospect. Not only does trading options involve a learning curve, but technology is always changing, and getting the right tools to trade is a task in itself. But regardless of all the potential frustrations, getting online to trade is not that difficult. There are four essential products and services that you need: a working computer, a high-speed connection, an Internet service provider (ISP), and a browser.

computers While some traders seem to get by okay with personal digital assistants (PDAs) or handheld devices to trade options online, it makes sense to have either a desktop or notebook computer, or both. The technology to trade with PDAs is certainly in place, with many brokerage firms offering a variety of tools for doing so. However, handheld devices don't offer much screen real estate for looking at charts or doing research.

> **laptop computer**
> a portable personal computer that is small enough to fit in a person's lap. Weighing less than eight pounds, laptop computers usually have a flat screen and LCD display, and are powered by a rechargeable battery. They can be connected to a larger monitor or other peripherals when back at the office.
>
> **desktop computer**
> a stationary computer with a full-size monitor and hard drive.

The next questions: personal computer (PC, meaning IBM or IBM-compatible) versus Apple, and notebook versus desktop? In the past, trading software for Apple computers was practically nonexistent. However, now Apple Computers can run most Windows-based software and the difference isn't that important. It all comes down to individual preference. Either will work fine.

A more important consideration for traders is whether to invest in a notebook or a desktop computer. The cost of desktops has come down considerably in recent years. If you're primarily trading at home, there's really no reason to spend more money on a notebook computer. However, if you travel a lot (like I do), then a notebook is worth the extra money, as having all of your software and research on a portable computer is a very valuable asset. Again, the individual trader must decide: If you're an on-the-go kind of person, then a laptop is probably the ticket.

chip
a microelectronic device that can store copious amounts of information. A chip is comprised of miniature transistors on a very thin silicon or sapphire rectangle. The type of chip you use contributes to a computer's speed.

Obviously, technology is rapidly changing, and computers are becoming not only cheaper but also faster and more efficient. I really can't recommend the best computer for you because your needs are unique and computer technology changes at a dizzying pace. However, as a general rule, I recommend buying a computer that gives you the most bang for your buck. In today's market (which will probably have changed by the time this book is actually in print), you can get a very good computer (with 250 gigabytes of hard drive space, 2 gigs of SDRAM, and an Intel Pentium processor) for less than $800.

random access memory (RAM)
RAM is the memory available for use while you are working (or playing) on your computer. RAM memory controls just how many software applications you can open simultaneously and stores information before it is saved to a disk or the hard drive. When a computer is turned off, RAM memory shuts off as well, and any material not saved is lost into the great beyond.

meg
short for megabyte, which means one million bytes or information units, each consisting of eight bits apiece.

hard drives (storage memory) A hard drive stores all the information on your computer even when the computer is shut down. While the prices of hard drives continue to fall, their memory capacity has been steadily increasing. Most new computers come with 250-plus gigabytes of storage memory. You're probably wondering just how much room you'll need; the answer depends on how many programs you want to run. Comprehensive trading programs may need as much as 350 megs of hard drive space for real-time or delayed data collection. Normally, with new computers today, hard drive space isn't an issue for trading options online. Again, the general rule is the more megabytes the better.

hard drive (HD)
the hard drive is a disk permanently installed inside a computer that acts as a permanent storage area for large amounts of information including programs, files, and graphics. Hard disks are measured by how many megabytes of information they can store.

monitors A good monitor is an essential part of your computer setup. A 17-inch monitor is fairly standard and does the job reasonably well. A 21-inch monitor is the next step up, but at a steeper price. One alternative to buying a 21-inch monitor is to buy a video card (a part that will go inside your computer with one edge of the card showing on the outside) that will allow you to use two monitors on the same computer. The two monitors together give you the same picture that you get on one monitor; it will just be stretched over two screens. If you are a heavy trader, consider two 17-inch monitors or a single 21-inch monitor. Either way, the newer flat-screen monitors thankfully use a smaller footprint.

modems A modem is a small communication device that connects your computer to the outside cyberworld. Modems basically come in two varieties: internal and external. Almost all of the newer computers come with an internal modem, which costs a little less and attaches to the inside of the computer box with one edge on the outside of the computer.

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Speed is one of the most important factors when dealing with Internet connections. Most serious Internet users today are connected through cable, satellite, or DSL. However, dial-up modems, which dial in to the Internet service provider, still exist. While speeds have improved, modems are clearly inferior. If you are serious about trading, a high-speed connection will save you a lot of time and frustration.

In addition, using DSL or cable modems will keep the phone line available to call the brokerage firm when needed. This might occur, for example, if you have a power outage in your home or your ISP goes down. Keep your broker's phone number handy, perhaps attached to your computer monitor on a Post-it note, for those times when you need to phone an order in to a live broker.

DSL
digital subscriber lines use standard telephone wires to carry data at much higher speeds than regular modems, which often require the user to have separate phone lines for outside communication.

WiFi
a wireless networking technology that utilizes radio waves to provide wireless high-speed network and Internet connections.

internet service providers An Internet service provider (ISP) allows you to access the Web through its Internet server. You will want to consider two different types: direct ISPs and indirect ISPs. A direct ISP will hook you directly to the Internet without organizing much material for you to look at. It opens the door and then lets you wander around inside, trying to find what you want. If you know where to find what you want, the direct ISP will get you there fastest. Some U.S. direct ISPs now cover large parts of the country and also provide local access in certain overseas cities. An indirect ISP gives you access to the Internet and provides a large amount of information, search engines, and links to both financial and nonrelated topics. The best-known indirect ISPs are AOL and MSN.

> **internet service provider (ISP)**
> a company that provides a connection between individual computer systems and the Internet.

Direct ISPs and indirect ISPs cost about the same for unlimited access. I prefer a direct ISP because they tend to have less advertising, which helps the screens move faster. This isn't as big a problem as in the past, but a consideration nevertheless.

The most important factor is reliability. Don't wait to get online before finding out how often the server fails. If you are trading online, outages can cost you money. Call a few ISPs and ask them a few questions, such as how much mail can be received before your mailbox is full. Is there an extra charge for a personal Web page? Make sure you keep track of how long you had to sit on hold waiting for a live customer service representative. Ask your friends about their experience with the reliability of their ISP and make an informed choice.

internet browsers If you use a direct ISP, you will need to download an Internet browser. A browser is a software program that hosts your Internet journeys. The most popular and widely used browser is Internet Explorer. While some people swear by it, other browsers, such as Mozilla Firefox, also exist. Again, if you are just starting out, ask friends, family, and fellow traders what browsers they like and why.

> **browser**
> a client program that allows users to read hypertext documents on the World Wide Web, and navigate between them. Most computers come with Microsoft Internet Explorer, but other browsers are also available.

data providers Serious traders need to subscribe to a data provider for real-time, delayed, or end-of-day price quotes. To determine which service fits your trading style best, you need to identify several factors. Do you want to pursue long- or short-term investments? What specific markets do you want to trade? How much money can you commit to your trading account?

Table 1.2 is designed to help you decide which kind of data reception is best suited to your needs. Bottom line: if you're going to trade and compete with commercial and professional traders, you need to have the same data they do. Although the siren song of real-time data feeds and day trading is very seductive, if you are just starting out, delayed feed is more than enough to help you get your feet wet. It has everything you'll need to learn and practice trading systems as well as find, place, and exit trades.

data provider
a source of information that provides you with current price data on stocks, futures, and options, as well as up-to-the-minute news and market analyses. This information can be accessed in a variety of ways including online, cable, FM, satellite, and wireless networks.

Lastly, you need to take a look at price. Trading is a business. If you sign up for real-time data feed, expect to pay (including exchange fees) anywhere from $50 to $500 a month. This monthly expense almost immediately forces you to make trades to generate profits to cover your data cost. Forced trades are seldom profitable. To become a successful trader, you have to learn to walk before running. That's why conservation of capital through controlled expenses is a must. As your experience level increases, you can always increase your data speed.

The good news is that many web sites offer free delayed quotes and charts. Meanwhile, some brokerage firms today offer free real-time streaming quotes. Consequently, paying a lot of money for data today isn't the norm that it once was. If you already have a brokerage account, ask your broker what type of online quotes and charts they offer. It might make sense to shop around for different brokers if their answer doesn't include the words "real time."

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table 1.2 types of quotes

Type of Quote	Description	Advantages	Disadvantages
End-of-day	Anything from paper charts to Internet remote quotes and chart retrieval or a dial-up download of end-of-day data directly to your computer for analysis.	1. Cheapest form of data available. Much of it is even free and readily available online. 2. Many part-time traders can use end-of-day data to find opportunities after the market closes and place trades before the market opens the next day. 3. Available free with some software packages, including ProfitSource (www.profitsource.com).	1. If you are an intraday trader, end-of-day data is of little use to you. 2. Impossible to monitor live quotes and verify the quality of execution on your buy and sell orders.
Delayed	Real-time streaming data that is delayed by 15 to 20 minutes.	1. Available through a variety of web sites at no charge. 2. Can be used by many trading software analysis programs to find longer-term investment opportunities. 3. Available free from many brokers.	1. Comes at least 15 minutes after the actual event. If you are trying to trade during the day using delayed data, you will not enjoy as much success as you would with real-time data, because by the time you see a big move in a stock with delayed data, the big move is over.

(Continued)

table 1.2 ***(continued)***

Type of Quote	Description	Advantages	Disadvantages
			2. Difficult to monitor live quotes and verify the quality of execution on your buy and sell orders.
Real-time	Tick-by-tick streaming data received from a quote service as the prices at the exchange change.	1. Widely available and easy to install. Online collection data is continuous feed, which will be collected and stored at your PC for review and analysis. 2. Receive real-time quotes directly over the Internet from vendors that resell data in real-time format. 3. Can be used by many trading software analysis programs to find various investment opportunities. 4. Sometimes available free from a broker, sometimes for an additional charge. 5. Gives you the ability to closely monitor the market and verify the quality of execution on buy and sell orders. 6. You can create short-term charts using intraday data.	1. Can be expensive depending on the level of service you need. 2. Not necessary for longer-term buy-and-hold investors or occasional traders.

conclusion

This chapter was designed to provide most of the information you'll need to get up and running. Once you decide what kind of information is necessary to your trading process, you can easily find it on the Internet at either a free site or one that charges a small subscription fee. Do not underestimate the importance of choosing wisely when it comes to your Internet connection. Prices on hardware and software have come down so much that it makes little sense to try to trade without the latest technology.

Once you've made your purchases and hooked everything up, you're ready to go online and take your first steps toward financial independence. But don't jump the gun. There are still a number of decisions to make. You have to choose an online brokerage, pick out trading software, and determine which resource sites (if any) are worth the price of subscription. This process can be quite time-consuming, especially when you're champing at the bit to start trading. Practice patience. Take your time. Don't worry about missing some trend or losing out on the next winning initial public offering (IPO). There's always another great trade on the horizon. Take the time to arm yourself well; it'll pay off down the road.

The road to online investing prosperity is an individual experience. On your journey, you will undoubtedly encounter certain obstacles that block your path. Although no one can really tell you how to navigate around these impediments, you can try to learn as much as possible from your own mistakes. No doubt your journey will encompass both victories and losses. I hope you can use some of what I've learned to avoid making the mistakes I've made.