

[How I Trade Options - Introduction](#)

In today's option trading blog I will introduce you to my methods. There are many option trading approaches. No matter which one you adopt, you have to have confidence in it. It is in that light that I will start this series of articles. My approach fits my trading personality and after 17 years, I have formed very strong opinions about what works and what doesn't.

In this first article I just want to outline some of my option trading philosophies.

Be flexible - There is not a silver bullet strategy that will always work. The tactic is a function of my market bias, my stock opinion and the overall trading environment. I need to monitor changing conditions and adapt. For instance, right now the option implied volatilities are near historic lows. This is not a time to be selling premium. I should be looking for buying opportunities.

Be directional - Form an opinion on the stock and be confident enough to tell the world. Big returns come from being on the right side of a move, not from hedging all of your risk away. Solid research is the key. This mentality comes from my desire to make good money, not scrape by. Neutral trades are very hedged and months of consistent performance can be taken away by one bad trade.

Start with the market - All analysis must start with the market. Seventy-five percent of all stocks follow the market and if I'm on the wrong side I will lose money three out of four times. Watch for seasonal patterns, end-of-month/beginning-of-month strength, holiday trading, and expiration tendencies. For instance, we are heading into the end-of-month cycle and there is a chance for market strength. After that, September is typically one of the worst performing months of the year. Given my comments so far, you might conclude that I will use any rally to buying cheap put premiums towards the end of the week.



Keep it simple - Complex positions mean I'm hedging my risk away and I'm uncertain about the outcome. The commissions and bid/ask slippage will reduce my profits. It will also be difficult for me to take profits since there are multiple legs to the trade. Ever had a trade where you were right but you didn't make money because it was a spread? You hung on to the trade and the profits vaporized. The "keep it simple" philosophy helps me reduce that frustration.

Commit to the position - When I trade options, I'm paying a premium to increase leverage and reduce risk. That premium comes in the form of time premium, bid/ask slippage and commissions. When I enter an option trade, I have a higher level of commitment. The stops are wider and I know I can't jump in and out. Normally, once I'm out on an option trade it's done and I won't consider getting back in.

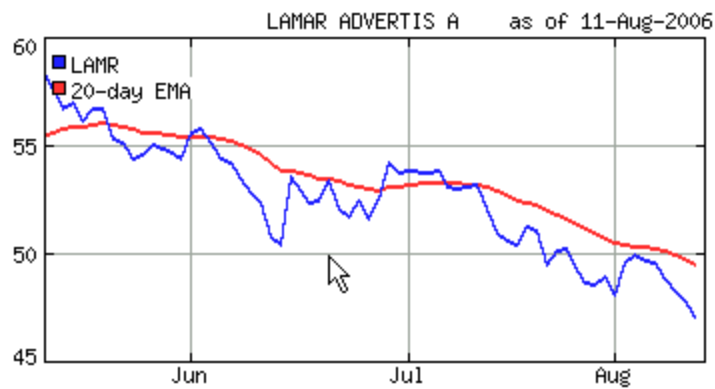
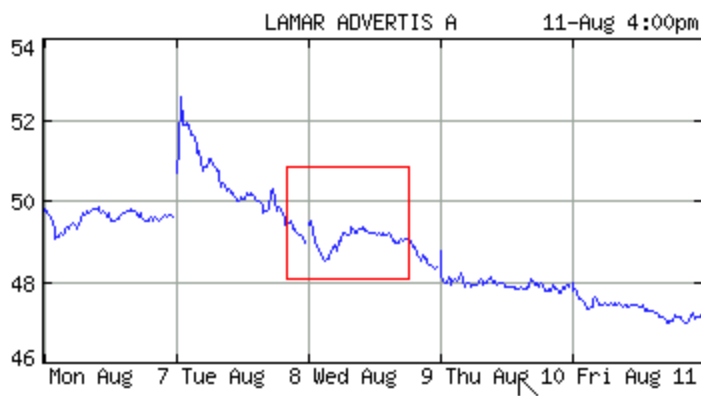
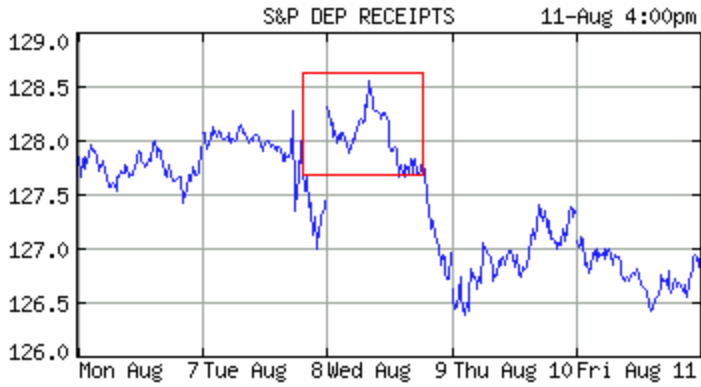
Form a strong opinion of the stock This is perhaps my most important rule. If I can't form a concrete opinion, I'd better keep looking. My opinion is critical since it will determine the option strategy. I will write extensively on this topic in the coming weeks.

Try to stay balanced - Balance in terms of market bias means I'm carrying bullish and bearish option positions on stocks with relative strength and weakness. In doing so, I reduce market risk. Balance can also mean a balance of long and short option premium strategies if the implied volatility environment is not at an extreme. For example, I may be long calls and puts and I may have put credit spreads and call credit spreads all on different stocks.

These are some of my general option trading philosophies. In the next post, I will discuss what I look for when I'm forming my market opinion and how my conclusions influence my approach.

Posted on Friday, August 25, 2006 at 05:36PM by  [Pete Stolcers](#) |  [1 Comment](#)

[Short The Weak - A Current Example!](#)



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In this option trading blog, no consideration has been given to your suitability for this trade. It is intended for educational purposes only.

1. First you have to get a feel for what the SPY has been doing. For the last 5-days, it has been relatively flat with a \$.50 change for the week.

2. This is a 5-day chart of LAMR. Notice how it gapped up 4-days ago and it has been drifting lower all week. In fact, that day it had an intraday reversal and closed down for the day. Look at what the stock did the next day. Reference the two red boxes. The market gapped higher and the stock could barely rally. By the end of the day, the market was unchanged and the stock was down. Then, Friday the market was flat and the stock declined steadily to finish near its low of the day.

3. In the last chart the relative weakness is obvious. This stock is in a very orderly down trend. It has not been able to poke above the 20-Day EMA. The company posted weak earnings Tuesday - hence the gap and reversal. This stock had EPS of \$.18 and analysts expect it to make \$.52 this year. With revenue growth of 8% and a forward P/E over 90, this looks like a short.

Be prudent. This stock appeared in the [Daily Report](#) Thursday.

Posted on Saturday, August 12, 2006 at 06:44PM by  [Pete Stolcers](#) |  [2 Comments](#)

[Long Term Relative Strength and Weakness - Example](#)

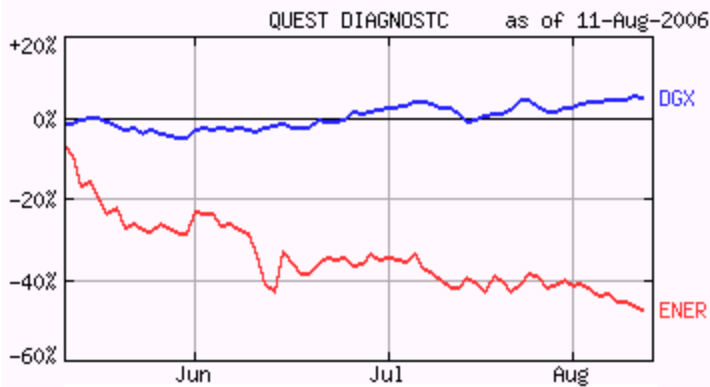
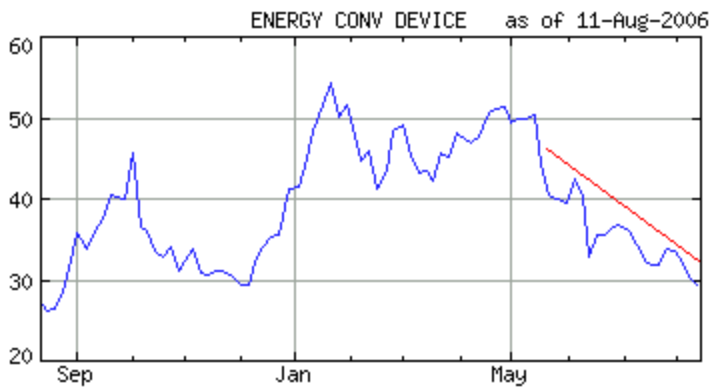
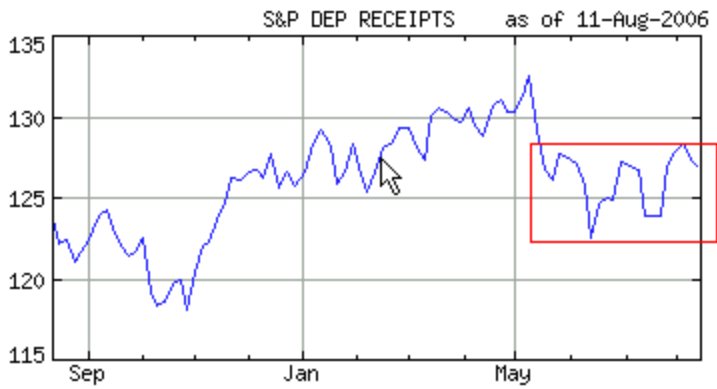




Chart 1 - This is an example of relative strength. Notice how Quest Diagnostics has been in a major uptrend while the SPY (Chart 2) has been range bound for the last three months. While the market was selling off, DGX was holding its own. When it rebounded, DGX moved higher.

Chart 2- If you were bullish and you went long the SPY, you could have been whipsawed out of a position and lost money. If you were long DGX, you would have been able to stay with the position because you never had reason to bail.

Chart 3 - Notice how ENER has been in a steady down trend. At a time when the market has been range bound this stock could not find a bid. It can't even generate a small short covering rally. If you were bearish and you shorted ENER, you would have done very well. Not so with the SPY.

Chart 4 - Now, suppose you went long DGX and short ENER. You would have made money on both stocks and more importantly, you would have reduced market risk. Both of these stocks still look good and they were in recent reports.

Posted on Saturday, August 12, 2006 at 04:36PM by  [Pete Stolcers](#) |  [2 Comments](#)

[Relative Strength and Weakness - Defined](#)

In this option trading blog I will describe my advantage. I trade stocks that have relative strength and weakness to the market - that's my edge. In my own simplistic way, I define relative strength as a stock that wants to move higher regardless of what the market is doing. In the nastiest market, this stock holds its own. At worst, it might be down 1% intraday on a big market slide, but it is the first stock to rally if the market stops going down. The opposite is true for a stock with relative weakness. It can't find a bid no matter how much the market rallies. It gets dragged higher by its hair and at the first sign of trouble, it is ready to crumble.

I have programmed over 70 searches that help me find these stocks. Collectively, I call them the [OneOption Scanner](#). The searches are categorized so that I know what I'm looking for in the results (i.e bullish/bearish, reversal/continuation, ...). The stocks are posted to an interface where I can click on a symbol and quickly look at charts. Here's what I look for.

Before I start, I look at a 1-Week chart of the SPY. I try to refresh my memory of what's happened the last week - day by day. Any big market days up or down get etched in my mind.

Next, I start flipping through the 1-Week charts in my Scanner. In a bullish situation, I'm looking for a nice tight grind higher with very little volatility. If there was a weak market day, I take particular interest in the price action the stock showed that day. If it hardly even budged, it tells me the bid is very strong. In some cases you'll see it momentarily dip and quickly rebound. This information tells me that the natural sellers that were

lightening up positions were immediately met by buyers. When you look at the chart, that is why the stock exhibits such an orderly march upward. If you had to find an ideal pattern, it would look like someone drew a 45 degree angle with a ruler. You won't find this very often, just be aware of it when you see it.

Next I zoom out to a 1-Month chart to see if that shows a similar pattern. If it does, I will zoom out to a 1-Year chart. Again, identify major trend lines and try to visualize a relationship to the overall market. If you prefer, you can do an overlay with the SPY and the relationship will be more obvious.

As you zoom out there are a few things to keep in mind. If a chart is going parabolic, avoid it. It usually signals that it is getting over bought (don't short it either). You may also run across stocks that are collectively strong and belong to the same group. Always go with the strongest/best of breed stock. If a stock has moved considerably higher and all of a sudden it gets choppy and the daily range expands - beware. The whippy action might be signaling that the buyers are getting tired or more sellers are present - hence the volatility.

Often, stocks that are strong need a day or two of rest after a big move. You just want to make sure that they are not getting too far ahead of themselves. Let's take a look at a stock with relative strength and one with relative weakness.

The first stock is a bullish candidate. UST is a tobacco company and there has been a rotation into the group. If you look at a 5-day chart, you will see a nice grind higher. Normally, I would like the price action to be tighter. A closer look at UST shows that it was strong out of the gate last Friday and even after the market reversal it was only off a little. Today, it is up in a weak market. I picked this stock for two reasons. One is that it has recently taken on a parabolic look when you look at the 1-Year chart. That means extra caution should be used. Another reason I picked this stock is to compare how strong it has been during the recent 2-month market sell-off.



LEE is a bearish example and the stock is relatively weak. Don't bother with the 5-Day chart on this one. Just look at the 1-Year chart. This is about as weak as it gets. It signifies long term persistent weakness. Think about all of the market rallies that have taken place during this slide and not one of them generated a short covering rally. This tells you that the sellers are ready to hit any decent bid and the stock never has a chance to get off the deck.

When I talk about relative strength/weakness, it should not be confused with the RSI indicator which measures a stock's relative strength or weakness to itself. Although I don't use it in my studies, Alpha is a measure of a stock's performance relative to the market. On a 6-8 week basis, weighted Alpha places more weight on the most recent activity and I would consider it a decent measure. If you have a source for Alpha you might consider giving it a try with the observations I've provided.

UST and LEE may have run their course and I would not suggest taking a position in either. However, imagine you were bearish on the market the first four months of 2006. If you were short LEE, you would have made money even though you were wrong on the market direction. Conversely, think about how you would have done with a long position in UST the last four months had you been bullish. That is the “edge” that I trade.

In the next article I will find a couple of live examples and I will try to add some charts to drive home the points.

If you have any that you think might fit the bill, send me a comment.

Posted on Monday, August 7, 2006 at 08:21AM by  [Pete Stolcers](#) |  [2 Comments](#)

Why I Trade Relative Strength and Relative Weakness!

In today’s option trading blog I will discuss relative strength and weakness. This concept is critical to my trading system. Every day I search for stocks that are strong or weak relative to the market. If I’m successful at identifying this trait I can build a basket of long and short positions and reduce my market risk. This is my “edge”. I can actually get the market wrong and still make money.

When I turn on my screen in the morning I hope for a big market move in either direction. I’ll bet most of you have never had that feeling. Can you remember a trade where you were long a stock (or calls) and you were horrified when you saw that the market was tanking? You bring up the quote on your stock and your heart rate returns to normal when you realize it has not participated in the sell-off. That stock has relative strength. Now imagine you have combined it with a short position on a weak stock. You bring up that quote and a smile comes to your face as you watch it dive. That is the crux of the system.

This strategy is used extensively by hedge funds. Many have a goal of making 12% a year no matter what the market does and a portfolio like this helps them achieve that. I have a few advantages as an individual that they don’t.

1. I’m willing to consider smaller less liquid stocks than they are.
2. I add my market opinion to the equation and I weight my longs and shorts.
3. I’m able to trade options on stocks that they would consider too ill liquid.
4. I can adjust quickly and not impact the price of the stock.



Their models are much more rigid and they don’t have the latitude to deviate from the trading system.

Does my method mean that I don’t bother with market analysis - no. In fact, that is where my research starts and ends everyday. I have to keep my finger on the market’s pulse and

watch for sector rotation. I also weight my positions according to my market opinion. It does mean that I don't have to compete with the largest financial institutions in one of the most liquid markets in the world. If ever there was "fair value", it is the price of the S&P 500 futures at any given moment. My "edge" is much smaller in that arena. Even in a flat market there are stocks that are up and down 20%. That's where I want to be.

In my next article I will define "strong" and "weak" and I will present examples. I'll also give you some pointers on what to look for.

You need to be comfortable shorting to make this work. If you have any questions about shorting a stock or about the long/short concept, comment.

Posted on Wednesday, August 2, 2006 at 07:27AM by  [Pete Stolcers](#) |  [2 Comments](#)

[How I Trade Diagonal Spreads!](#)

For purposes of this option trading blog, I will refer to diagonal spreads in the traditional sense. The position consists of an equal number of contracts where the long leg of the spread (the anchor) is closer to the money and it is further out in time than the short option. Let's look at a bullish position.

Let's say that I like a stock that is trading at \$52.50 and I think it will grind \$6 higher for the next 3 months. I decide to buy an October 50 call for \$5.00. Let's also assume that there are 3 weeks left until August expiration and the August 55 calls are trading for \$.80. If I feel that the stock is on a slow and steady path, I rationalize that it may not reach \$55 in 3 weeks. So, I decide to sell the calls and bring in some premium. At expiration the stock can actually rally to \$55.80 and I'm no worse off. In that case, I can buy in the August 55 calls back for \$.80 and sell the October 50 calls for a nice profit. The sale of the premium helps offset the time premium decay of the October options and it provides some protection.

The key is to make sure the diagonal can't lose money if the stock really takes off. This can happen if the debit for the diagonal is greater than the difference in the strike prices. For example, let's say that I bought a January 50 call for \$8 and sold the August 55 for \$.80. The debit for the spread is \$7.20. If the stock goes to \$65, it is likely both options will be trading near parity (\$16 and \$10) and the trade will lose money even though I was right on the direction of the stock.

If you were long term bullish on a stock and you wanted to take a position, you might consider buying a long term option (maybe a LEAP). You might also want to generate some income while you wait for the stock to move up. You take advantage of accelerated time premium decay and sell an out-of-the-money (OTM) near term option against it. This is another example of a diagonal spread. There are people who will convince you it is similar to a covered call on a stock that does not pay a dividend. There are some key differences. The LEAP carries premium, it does not have a delta of 1 (like the stock does) and the bid/ask spread is wider on the option than the stock. You may also run the risk

associated with a diagonal where the debit for the spread is greater than the difference in the strikes. One final note, if the stock moves through the short option on a covered call position, you simply let the stock get called away and you are flat. In a LEAP diagonal, you have to buy-in the shares of stock that you are short from assignment and sell the LEAP. You do this because there is premium in the LEAP and you do not want to exercise it. There are more transactions involved and hence more slippage.

I have NOT found LEAP diagonals to be an effective strategy although many seminar companies “spin” it to sound good. To buy an in-the-money (ITM) LEAP option that trades at parity, you have to go so far ITM that you will almost put up as much money as you would to buy the stock on margin. One could argue that the risk is limited on a LEAP diagonal. While that may be true, if you are buying a LEAP you are putting up a lot of money too. Hopefully your long term investments are not speculative stocks that have the possibility of going to zero. At some point, weather you are long the stock or the LEAP, you have to stop out the losing trade. Consequently, the “limited risk” argument doesn’t resonate with me.

If you like to trade diagonals, share your experiences.

Posted on Friday, July 28, 2006 at 08:21PM by  [Pete Stolcers](#) |  [Post a Comment](#)

[What Is A Diagonal Spread?](#)

In today’s option trading blog I will discuss diagonal spreads. A diagonal spread combines an equal number of longer term options and shorter term options with different strike prices. The term actually comes from the way the options were listed in the newspaper. If you connected the two strikes, a diagonal line would run across the page. In a traditional sense, you are long the longer term option (the anchor leg of the spread) and it is closer to the money. By rule and regulation any other combination would involve considerable margin.

For instance, if you were long a May 65 call and short an August 80 call, the August 80 call would be considered naked. That would require the highest level of option trading approval from your brokerage firm and considerable margin would be posted. If you were short the May 65 calls and long the August 80 calls, the position is covered, but you would have to satisfy the 15 point margin requirement (difference between the strike prices).

Let’s take a final look at the PCAR trade I have referenced during the last two articles. At one point in the trade, I was long the August 65 calls and short the June 80 calls. That is a traditional diagonal spread and it is the type I will be discussing.

From my perspective, the intent of the diagonal is to take advantage of front month time premium decay while still giving the trade some room to move. Using a bullish example, it would be similar to a covered call position where you are long the stock and short an

at-the-money (ATM) or out-of-the-money (OTM) option. In order to achieve this, the back month option needs to be deep in-the-money.

Given that there is more time until expiration on the anchor leg of the spread, the option will carry more time premium. In order for me to reduce that I have to go further and further ITM to find an option that is trading close to intrinsic value. The more volatile the stock, the richer the premiums, the deeper you must go for the long leg of the trade. Again, with reference to the PCAR trade, I bought the August 65 calls (\$9.80) that were two strikes ITM and I still had to pay \$2.80 in time premium (stock was \$72). The disadvantage was that even with an ITM option, I still had to pay time premium. The advantage was that the front month OTM options that I might sell, also carried a lot of premium.

In the end, this strategy if properly constructed will act like a covered call where you are long stock and short a call option. However, there are a few distinct advantages to the diagonal spread.

1. You don't have to put up the stock margin, you just have to pay for the spread.
2. The risk on the position is limited to the price paid for the spread (not the price of the underlying stock less the call credit).
3. The ITM option will eventually implode with time premium if the position moves against you. To learn more about this concept read [Buying In-the-Money Options - A Hidden Benefit](#).

Keep in mind that you are not entitled to dividends with this strategy and that the bid/ask spread of the ITM option will probably be much wider than the underlying stock. Slippage and dividends are two possible limitations.

In the next article, I will write about how I trade diagonal spreads.

If you've tried one, share your experience and comment. It makes my blog tighter when I can respond to comments and bridge the gaps.

Posted on Tuesday, July 25, 2006 at 06:37AM by [Pete Stolcers](#) | [Post a Comment](#)

[Trading Back Month In The Money Options!](#)

In my last option trading blog, "Buying In-The-Money Options - A Hidden Benefit" I described the advantages of doing so. I did not write about which month to buy. As with all option trades, your opinion of the underlying move will determine the strategy. If you are looking for a longer term move, a back month option usually makes the most sense.

Let me use the previously referenced PCAR trade I did in April. I felt the stock could move \$10 higher from its price of \$72 over a period of months so I bought the August 65

calls for \$9.80. I bought ITM options so that I could realize gains on a small move and “jump off” at any time if I wanted to. I also felt the stock was just above strong support and \$9.80 “rug” would not get pulled from under me. A back month option displays the properties I discussed in the last posting, but to a greater degree than a front month option. If my assumption was wrong and PCAR fell, the options would implode with time premium and retain more of their value.

Imagine that PCAR dropped in a day and it traded down to \$65. A May option that would expire in a few weeks would retain some value, but not as much as an option that expires in another 3 months. The reason for this is that there is time for the stock to “snap back” and an earnings release was due within that time frame. The uncertainty that caused the supposed sell off would actually help the option retain value and the company would have a quarter to correct the problem. Mind you, the hypothetical event stinks because I’m losing money on the trade.



Back to the original line of thought. The move was going to take place over a few months so I had the latitude to look at back month options. What if I was just looking for a \$2 gain to unfold in a week? In that case, given the wide bid/ask spread in the options, I would have traded the stock. If you are looking for a \$2 move and there is a \$.30 bid/ask spread, you are giving up \$.60 out of your \$2. Don’t line the Market Maker’s pocket. You are giving up too much edge. For the same reason, you don’t buy front month ITM options and “roll” them each expiration. There is too much slippage. Usually, a back month ITM option won’t cost you that much more (\$1-\$2) and it has a big benefit.

When you buy back month ITM options - you can sell front month premium against them to generate income and take advantage of accelerated time premium decay. In the case of PCAR, the stock ran up and I was able to sell the June 80 calls for \$1.30. There was no margin requirement since I owned a deeper call with more time and it generated free cash flow. The stock was holding up well in a declining market so I did not want to close the trade (sell the August 65 calls). I just wanted to take in some premium and add a little protection. The June options expired and the stock rallied again. I could have sold July options against the position, but I did not like the market action and I decided I needed more protection. I sold the August 80 calls for \$3.70. Now I’ve collected \$5 in premium and I own a 15 point August 65 - 80 call spread for \$4.80. The stock is at \$77 so it has been a nice trade. It has spent a lot of time over \$80 recently and with a little help from the market it will get there again so that my [Level 3 Option Report](#) subscribers can “max out”.

One note of importance! If the June 80 calls had finished in-the-money, I would have bought them and sold the August 80 calls.

Remember, if you’ve found a longer-term grinding move of \$5 or more on a stock with good support, back-month ITM options. During the PCAR trade, I legged into a diagonal spread. In the next posting, I will use the strategy as an entry position.

Send me your comments. It helps me write better content and it gives me a chance to “fill in the gaps”.

Posted on Saturday, July 22, 2006 at 07:33AM by  [Pete Stolcers](#) |  [3 Comments](#)

[Buying In-the-Money Options - A Hidden Benefit.](#)

In today's option trading blog I will discuss why I often like to trade in-the-money options. When I find a stock that looks like it will move higher/lower for a few weeks or more, it's a preferred alternative to taking a position in the stock. Let me explain by using a bullish example.

In April I felt that PCAR was an attractive stock that could move higher over the course of the next few months. It had formed a solid base at the \$70 level and it had been as high as \$75 in 2005. The earnings were very consistent and the P/E was very reasonable. If the stock could get through \$75, I felt like it could steadily move higher. I did the trade in the [Level 3 Option Report](#).

The options were fairly expensive from an implied volatility (IV) standpoint and I did not want to “buy” a lot of time premium. After a looking at the options, I decided to purchase the August 65 calls for \$9.80. They were \$7.80 in the money and I was paying \$2.00 over intrinsic value. Here is why I like selected that those options.



If the stock moved a bit higher, the deltas were fairly high (.80) and I would be in a position to take profits if I wanted to. If I purchased an out-of-the-money option, the low deltas would require a big move for me to overcome the bid/ask spread and the commissions. The ITM call options would act like a surrogate stock position on the upside and at some point they would move in tandem with the stock. Most traders are drawn to the leverage and limited risk features of options and I'm no different. However, here's one thing that most retail traders don't consider. If I was wrong (really wrong) and the stock dropped, the options would reach a point where they would start picking up implied volatility. They would lose money at a slower rate than the stock.

If the stock fell to \$65 and the options were at-the-money, they would still be trading for around \$4. I had every intention of stopping the trade out if the stock dropped below \$70, but stocks do gap on news. If this scenario had unfolded, there may have been a “kicker”. The options might actually be trading for more than \$4 because the quick drop in the stock price spikes the option IV's.

Here's the take-away. With ITM options trading near their intrinsic value, you can gain point-for-point with the stock on the upside and not lose point-for-point on the downside. You also get the benefit of leverage and limited risk. Wide bid/ask spreads are an obstacle and it can cost you \$.20 on each side of the trade. These positions are not intended for day trading.

In the next article, I'll tell you the benefit of buying an August option instead of May option in this instance.

If you trade ITM options, share your experience with us and I'll comment.

Posted on Wednesday, July 19, 2006 at 03:22PM by  [Pete Stolcers](#) |  [7 Comments](#)

[Short Term Market Analysis - Things To Consider.](#)

In today's option trading blog I will discuss my short term market analysis. I consider a one month perspective to be short term. Having a market opinion is critical to my trading success since 75% of all stocks follow the market. Let me nail that point home. If you are on the wrong side of the market, it is likely that you will lose money on 3 out of 4 trades. It is the daily starting point for my analysis and I won't run my proprietary searches until I'm done. During the day I continually look at the intraday SPY chart in the center of my screen - it's my gyroscope.

I could write a series of books on market analysis and still not do the topic justice. In general, I'm trying to evaluate which influences might have the greatest impact. Here are some things I consider"

Horizontal Support and Resistance - On a day-to-day basis I identify 5-Day and 10-Day horizontal support and resistance levels feeling that a breakout/breakdown will signify a move that might have "legs" for at least a day or two. As the time frame lengthens, so does the significance of the breakout/breakdown. I have found that these price levels work better than trend lines drawn within a short-term period.

Intraday Price Patterns - I watch price behavior on a daily basis and I try to identify patterns. For instance, last month the market would start the day on a positive note and once the buying subsided, it would reverse and slide in the afternoon. Currently, if the market makes a move (after the first 90 minutes) and sustains it going into the afternoon, there is a good chance it will continue into the close.

Key Influences - It is critical to know the driving forces and to be aware of any related news that might hit. Interest rates, inflation and the Fed. are the "hot buttons" right now. The key news events are FOMC meetings, statements by Fed officials, CPI/PPI and the wage inflation component of the Unemployment Report. The recent FOMC meeting did not provide any new information. The "dovish" interpretation created a bounce and it was just a matter of time before the market reversed those knee-jerk gains. These "hot points" change over time and we are currently seeing that global political instability is carrying more weight. At other times it might be the strength of the US dollar.

Sectors - I always want to know which sectors are leading the market and I want to know the macro events that are contributing to the strength in those stocks. Currently, it concerns me that energy and defense contractors are two of the strongest groups. They are tied to inflation and war - neither is bullish for the market. Conversely, technology is

one of the weakest sectors right now. Corporations are using cash flow to re-purchase shares and they are not reinvesting. Low cap ex spending is taking its toll on the tech stocks and there does not seem to be a catalyst to turn that around. My short-term conclusion is that a meaningful rally will not take place until this mix “flip-flops”. Each day before the market opens I check to see which sectors will be on the move and why. I make this tool available for everyone. Take a look at today’s [Pre-Open Movers](#).

A/D Ratio - After the first hour of trading I want to know the breath of the move and the A/D ratio lets me gauge that. I also monitor the indicator over the last few weeks to see if a trend is forming.

Expiration Week - Option expiration can have a very meaningful impact on short-term prices. I look for a material market move that has happened prior to expiration week and I look at the open interest of in-the-money (ITM) index options. A program related move will be biased toward the current trend. For instance, prior to March expiration the market had moved higher and it created a large open interest for in-the-money calls. If the trading during expiration week yielded a day where there was nice steady price action higher, arbitrage related programs would “goose” the market and it would close near the high that day. We actually saw two such days and the market made a multi-year high as a result. I believe in 1996 the market was up over 15% for the year. If you excluded expiration week, it was actually down for the year. This influence can be very powerful. Expiration week will also contain one day with a big move. It is usually Tuesday or Wednesday.

End-of-month Buying - This is one of the strongest market anomalies I know of and it happens every month. During the last two days of the current month and the first two days of the next month the market has a tendency to rally. Most analysts believe it is because pension fund money “comes to market” and needs to be placed. Managers are putting the funds to work in anticipation of the actual deposits. As I recall, there was a study that determined that if you had bought the DOW stocks the last two trading days of the month and held them the first two days of the next month, you would have made more money over the last 70 years than just being long the index the whole time (buy and hold). That’s powerful. Imagine, you only have 4 days of market risk each month and you outperform.



Seasonality - When I look at the market I need to know the seasonal trends that are in play. “Sell in May and go away” is one seasonal pattern that has worked well this year. September/October can be very weak and November/December are traditionally the strongest months of the year. Earnings season also has an impact as it increases market volatility.

Options - I look at the VIX (option implied volatility indicator) to gauge the amount of fear in the market place. I use it as a contrary indicator once the extremes are reached and they start to reverse. For instance, in April the VIX was at historic lows and it had been for months. Once it started to move higher in May, it was apparent the the market

environment might be changing and uncertainty was creeping in. I also use put/call ratios in the same manner. My friend [Larry McMillan](#) has taught me all I know in this area.

There are many influences and the relevance of each changes continually. Market forecasts are a multidimensional undertaking. Mind you, my trading style is not completely dependent on my ability to predict market movements. I trade relative strength and weakness within the market - that is my edge. If you want to see my market analysis in action, just read [One Hour In](#)everyday.

If you have an indicator that “works” share your thoughts.

Posted on Saturday, July 15, 2006 at 10:11AM by  [Pete Stolcers](#) in [Trading](#) |  [2 Comments](#)

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