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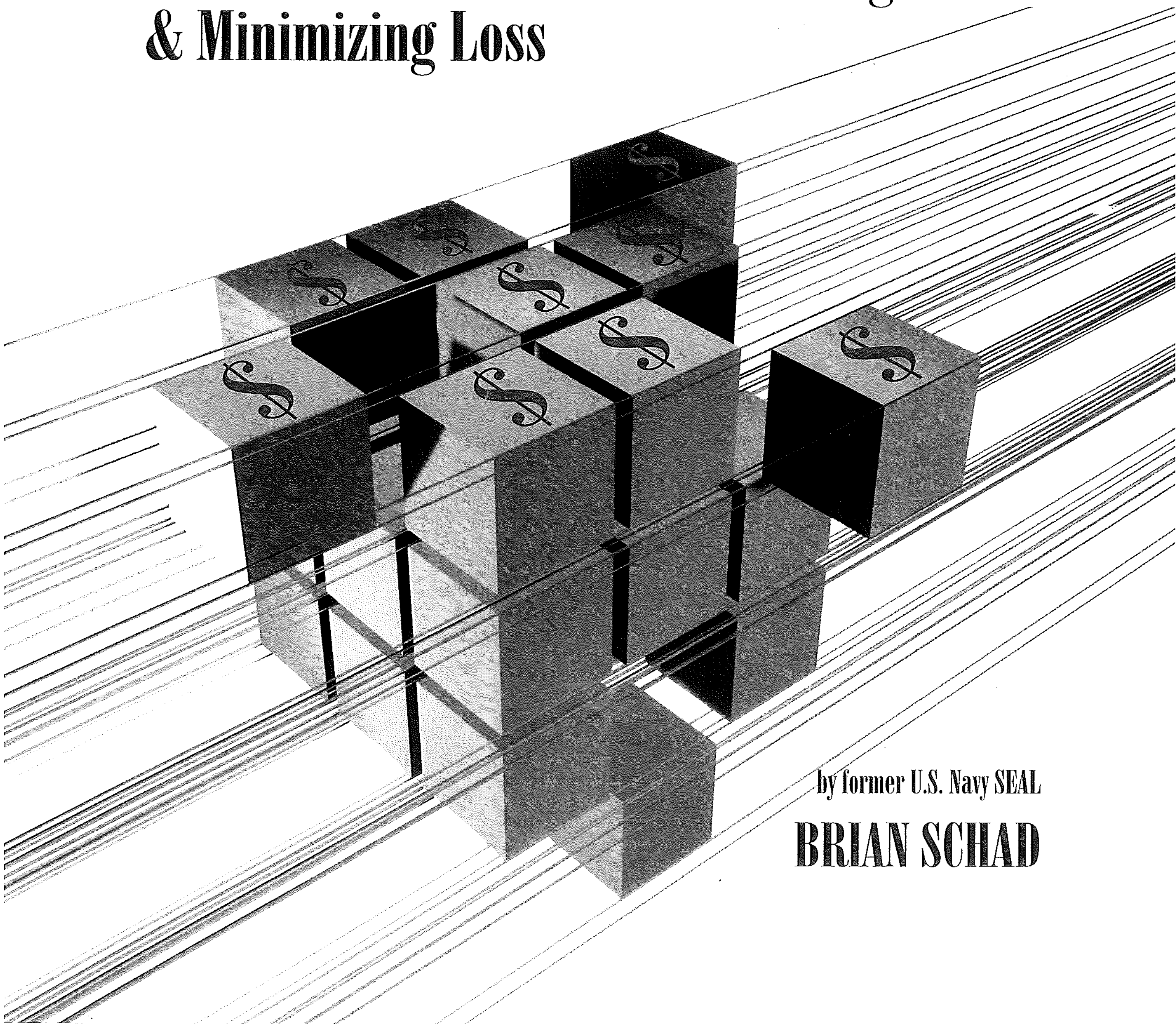

by former U.S. Navy SEAL

BRIAN SCHAD

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The 3-Dimensional Trading Breakthrough

A Definitive Method For Enhancing Profit And Minimizing Loss

BRIAN SCHAD

The 3-Dimensional Trading Breakthrough

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Disclaimer

Please be advised futures / options / stock trading involves inherent and substantial risks in pursuit of the generous profits to be made in the marketplace. The data and research that has been brought forth into this book is believed to be accurate and reliable, but can never be guaranteed for future performance. ***Investors are urged never to position themselves in the market with more capital than they can afford to lose*** – **only trade with risk capital**.

Foreword

Nothing good in life, it seems, ever comes easily. You are about to be an exception to that rule. That is because what you are about to read is very good, practical material for commodity trading...and investing.

To you it is coming relatively easy...you just shelled out a few dollars. But to Brian Schad, the techniques you are about to learn are the product of fifteen years of research and actual market trading. Brian's techniques work, because Brian put in the work so you don't have to!

As a former Navy SEAL, Brian brings a special dedication to this business, a special intensity, and above all, a special form of honor and honesty. But above all, he brings to you what he learned under fire, in the most mentally difficult war one can imagine – live trading. I've been in the trenches with Brian – he's a great warrior to have at your side. Trained to handle all possible situations, it is no wonder he has been able to develop a total approach to using options while mortars are exploding all around us. He is now about to become your personal drill instructor.

Ready? March...

– *Larry Williams*
March, 2008

Preface

When I began trading in the early 90's, I never planned on specializing in the "option contracts" arena. In fact, in those days with the help of Larry Williams, my sole purpose pertaining to the commodity markets was studying if price discovery would lead to the market heading higher, or a market preparing to fall. Using the futures contracts, I would just buy long, or sell short. It was black and white and no "two ways" about it. I would be right or wrong, and my trading account would keep score.

Then I became a commodity broker for a very brief time in 1996 and specialized in futures options contracts. It was an invaluable learning experience to say the least! I soon started to realize the possibilities of incorporating more "trading instruments" available to us (options contracts). By utilizing them to their full potential ***with*** *the underlying (futures) contracts, it could possibly change trading from a passive side hobby to a full-time occupation –* ***just like the full-time career of a professional floor trader!***

I first wrote about this in a private release in 1999, for my personal clientele only. It was a hit...and I could stop trying to teach others over the phone what took me years to piece together! I am now an emerging CTA and only trade for commercial brokerage's houses, and private individuals. My one time trading secrets are about to become very public, and hopefully my benefit will be to add popularity to this crazy, and great business by fulfilling lives the way mine has been blessed.

Dear readers, it is my pleasure to (re-)introduce to you this virtually untapped area of "3-dimensional" trading that will surely open your mind to endless possibilities

Brian R. Schad

Acknowledgments

This material would not be possible without the help of:

My mother, who sat down with me and helped with math homework in the 1st grade.

My father, who kept me out of trouble and inspired me to make a buck at a young age.

My teacher, mentor, and friend – Larry, who taught me to be creative and THINK INDEPENDENTLY early in my trading career.

Dave Caplan, who inspired me to learn all I could about the options market, OR ELSE...!

The late Brother Ed (of the "Christian Brothers" Catholic organization), who helped prepare me for adult life.

My friend "Sam," – a boss of mine at my first "team." Thank you for watching my back.

My friends Dave Cole & Dave Libby. Thank you for helping me put the original material together 10 years ago.

Joel Robbins, Chuck Frank, and the WorldCupAdvisor.com crew in Chicago – I am thankful for your collective efforts and including me as part of your team.

Genesis Financial Technologies, MBH Commodity Advisors, and *Karen Rae at OptionVue.com* for the use of their charts, graphs, and continuing support. Thank you ***big time***!

My loving wife, Julie. – For years of patience and unconditional support.

It is for my wonderful daughters,
Abigail & Grace,
this book is dedicated.
You make your father proud!

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Introduction

Enabling objective: Upon completion of this section, you will understand why it is necessary for those with the knowledge to accept a leadership position in this industry.

"If you are planning for a year, sow rice; if you are planning for a decade, plant trees; if you are planning for a lifetime, educate people."
- Chinese proverb

And so it is for those who are just as enthusiastic as I am about trading the markets. I dedicate the material that follows to you. The markets are not a hobby for me, or a passive interest. They are my life and are in my blood *for a lifetime*. This is the message you should keep in the back of your mind as you read, educate, and practice this knowledge.

"Learn from the mistakes of others.
You can't live long enough to make them all yourself."
- Carlyle

Hello there, this is Brian Schad. I learned to trade the markets independently while serving active-duty in the later days of my Navy experience. Actually, when I returned home from what would be my last overseas deployment, a platoon buddy introduced me to his brother who was heavily involved with trading "stock" options independently. Both my buddy and I opened accounts, permitting his brother to trade at his discretion. By the end of that first month, my small $2,500 investment grew to over $16,500.00 and it was then I became a believer that fortunes could be made in "the markets."

I soon stopped traveling with the Navy and was transferred to a school for instructor duty. That's when I made the decision to learn about the commodity markets and phase out of the stocks. I dabbled in futures and options without much (*if any*) direction, guidance, or success. Before I knew it, I found myself in a "long" coffee position early in the week and, unbeknownst to me, by the end of the week that position would change my life forever!

During that time, I was reading my first book about commodity trading, written by ***Larry Williams***. In his book he mentioned his residence in San Diego and, being long four coffee contracts with a *master of the markets* in my same county, I decided to look him up and speak with him for direction. When I eventually liquidated the coffee positions, I knew I was in this business to stay – *Robusta*! I soon met Larry to thank him in person, and the rest is history.

Now, before I go any further, I must acknowledge that I was *extremely* lucky to meet the single most influential trader around. Larry has provided the market insight, knowledge, and wisdom necessary for me to be the trader, former broker, and CTA I am today. Without direction from Larry's books, tapes, seminars, and without his friendship, I would most likely be lost in the masses and still biding my time in the military or some other governmental organization. He is the only active role model I have had in this business, I am proud to know him, and I thank him for his never-ending, tireless, and unwavering contributions to the stock and commodity industry.

Now *I* have a contribution to make to this business, so I am presenting it to you here and now in this book. One evening, in the summer of 1997, the fictional character *Jerry Maguire* inspired me to sit down and write everything I know about the markets, and how they should be traded correctly (even if it means taking "heat" from others in the industry), especially when you have a longer-term outlook. Now, when I say "longer-term," I specifically mean a position that is at least two weeks or more in time frame. It just seems to me, by looking at the charts, that some of the best money to be made trading is in trends, and the best trends are usually a couple weeks to a month or more in duration. Take a look at any of the accompanying futures charts and draw your own conclusion...the point I am trying to deliver should be crystal clear!

Why this Book Has Been Written

This book has been produced for all traders for several reasons. You may be aware 90% of active traders lose money. Well, why do they lose? I think that a lot of these people are stuck to their quote machines, they're stuck to a hotline, a newsletter, they're thinking short-term, and they cannot handle losses too well. They also can't manage profits as well either. What all of these traders have in common is that they don't have a plan or a "planned" methodology of trading.

"Winning is a habit. Unfortunately, so is losing."
Vince Lomabardi

Well, this is what I want to present to you now. This is not a "black box system." This is a plan. A plan, or methodology of trading, that everybody should have when trading the markets. By sticking with a certain plan, or method of trading, you will be consistent with your trades, you will be able to catch the longer-term trends, you will feel like a winner, and your account statement will reflect it.

Another pressing factor that prompted me to produce this material is the fact that so many off-floor traders are too dependent on their *full-service* broker for direction in the markets. As a former full-service broker, I had many roles:

- I had to know *why each* market my clients were involved with moved the way it did in a particular day.
- I had to know *which* way the market was going to head next.
- I had to know "which type of order" was best suited for current market positions.
- I had to make sure none of my clients were in hot water *each morning* before the open.
- I had to know how to successfully manage a telephone "switchboard" by being able to have *three* different conversations with three *different* people whose accounts I was responsible to handle.
- I had to be an *options specialist* and "market expert."

As a full-service broker, I supervised many people from all over the country and from all walks of life. I had to keep a careful eye on "the gamblers" and provide quality assistance for the "speculators." I was involved with quite a variety of trading backgrounds and I've seen them all. It didn't matter if I had the qualifications listed above or not, traders were going to do what they wanted to do and I was there to write a ticket for their order and provide an opinion *only when asked* - **which is the way it should be**. My clients were also paying dearly for this special "service" in the form of round-turn commission fees! Entirely too much, especially for those who are just starting out and are going to make those inevitable, novice mistakes.

After some time had passed, traders often began to realize that their need for a full-service broker had been reduced to strictly order taking and very little guidance. At the same time, the brokers were gathering more clients (to place more trades). They often became lackadaisical in attending to their existing clients' business in a mutual sort of way. The brokers felt they had their business locked in. This was where full-service brokers deviated from their "full-service" mission and when their bad reputation (which hovered over those full-service brokerages) developed. The clients felt they were getting "ripped off" and they knew it.

I felt this was the beginning of the end of the expensive full-service brokerage industry that did not live up to clients' expectations to justify the excessive fees. Since I originally wrote this literature ten years ago, those firms have shut down for the most part and have been replaced with other firms that successfully compete in today's fast-paced, high-tech, global environment. By having more traders educated with the information you now possess, brokerage firms are now **dependent on their clients** instead of the *reverse*. You will soon LEARN why...

This manual will transform you into an insightful, knowledgeable, and decisive trader by revealing to you what takes most traders years and years of experience to gain - usually in the most costly and demoralizing manner. The philosophy many full service brokers had was that novice traders were incapable of understanding the markets, crop/financial reports, orders to the floor, etc. (...which is true!). Their intentions were to keep you dependent upon their "inside" knowledge. The primary purpose for a brokerage is to land clients with large accounts. Why should this concern you? Well, it affects your pocketbook directly.

Most brokerage firms already have a pretty good idea of how much money they could make from you in commissions, before you even trade. Just as insurance firms have statistics on various clients, many brokerage firms have ratios of commission

income versus account equity. They are not necessarily in the business to foster clients to extreme success. They only make money WHEN you trade. Even when you *don't* trade, their overnight lending of YOUR money to commercial banks *still* yields them generous "risk-free" profits (approximately 3-5% yearly). They are less concerned with HOW you trade.

For example, there are many publications (sometimes offered "complimentary" by brokerage firms) which tout learning all you can about option strategies which can become very exotic and complicated in nature. An "iron butterfly" option spread may require an initial position with four individual option contracts. This may turn out to be a profitable trade, but the real winner is the brokerage that just received four "risk-free" commissions courtesy of your account. Ratio spreads, back-spreads, and other strategies that require a minimum of three commissions up-front may also be excellent strategies. However, the "net" credit received must outweigh the risk involved. Sure, the credit you receive may appear attractive, but take a closer look at how long this position must be held in order to capture that attractive profit. Needless to say, I personally do not speculate the market by purchasing options alone. I prefer contracts/underlying stock because there are no premiums involved - only commission. Options are used as they were intended to be - **insurance** used to *hedge*.

This manual will provide you with the tools and knowledge necessary for a lifetime of successful trading. By the end of this book, the mysterious "smoke and mirrors" of this industry will be revealed to you. Knowledge and proper planning are the keys to success in this business.

My intentions (when I originally wrote this material ten years ago) were to revolutionize the full-service brokerage industry and help to change the reputation of "commodity trading" in general. I acknowledge I may have upset and "riled a few feathers" along the way, but I am not in this business to acquire friends - that's what the Navy was for.

"The ultimate leader is one who is willing to develop people to the point that they surpass him or her in knowledge or ability."
– Fred A. Manske, Jr.

What Can You Expect from this Manual

This book is specifically designed to educate you and transform you into a better independent trader. Be advised that this material has nothing to do with picking market tops and bottoms. That's what the "experts" are for. This course has everything to do with initiating pre-calculated, low-risk trades and maintaining open positions confidently, independently, and professionally. No other material has addressed these critical trading skills. No other book demands their readers reach a higher level of proficiency.

You will be required to demonstrate your skills at the end of each section in this text through a self-administered quiz. The overall goal is to have you demonstrate the understanding and importance of:

- Initiating the lowest risk position trades possible.
- Knowing what to plan for in order to maximize profits and minimize any short-term losses.
- Planning prior to the market reaching critical levels, which may necessitate position adjustments.
- Timely and proper order placement.
- Working with the market instead of constantly trying to "beat" it.

When I first wrote this material, it was considered "ground breaking" and a revolutionary concept. Still, 10 years later, no other author/trader has brought up this trading methodology most commonly used by floor traders. By now, you should know the full extent of my commitment to educate other traders in becoming independent and successful in this business.

To start with, I am going to teach you about determining risk when initiating positions, and the problems with protective stops working in the market. Then I will introduce and examine all instruments available to you as a trader, so that you fully understand what you have to work with in the marketplace to construct and maintain "low-risk-profile" trades. This is especially true with the option contracts. I will dissect an option and determine its true value and the several factors which influence the premiums.

After we are familiar with the instruments we will be using for effective ***3-dimensional*** trading, we will research the execution of trades and every possible trading scenario we may encounter. No market will ever take us by surprise. Our pre-calculated risk is always limited to an amount we deem tolerable. This is accomplished by studying price and price structure exclusively. We are not reliant upon "indicators." We are not reliant upon *fundamentals*. We are not reliant upon newsletters, hotlines, or any other outside source/opinions.
I will teach you proper order placement with your broker in order to:

1) Minimize time spent on the phone;
2) Avoid costly errors;
3) Execute your trade in a timely manner.

This information alone – on order placement – plays a critical part in determining your commission rate. The **less** time we spend on the phone with our broker translates into *more* time the broker has to accommodate as many other clients as possible. They prefer spending the least amount of time possible on the phone with an individual client. The broker's goal is to acquire as many new accounts and order placements as possible. This is in *their* best interest. Remember, they have to make a living *too*.

As the market gyrates in its natural cycles, you will be consistently working with the momentum to maximize profit potential and reduce risk. Many traders tend to hold on to positions, with a protective stop working for them, in order to catch the "home run." Experienced, or seasoned traders, know how to work with short-term market swings to their full advantage in order to acquire profits. This is "working with" the market, by taking advantage of natural market cycles versus the "bull-headed" approach of holding on until a certain profit is realized - *or bust*. Of course, the latter approach contributes to why most traders fall into the 90th percentile of losing money. We want to *work with* the market to be in the remaining 10 percent of traders who consistently *make money*. We will do this by adopting a methodical style of trading.

Overall, you will have a plan every day for your trading. You will not trade the markets until you have a set plan which is good for you. We are not swayed into others "beliefs in the market" such as: the market "experts" on television, news articles, radio commentaries, etc. We are not concerned with following any fundamental reports because *price* will eventually reflect true value. We will trade according solely to our own beliefs. The outside factors do not know what is best for us, or our business.

"The man who reads nothing at all is better educated than the man who reads nothing but newspapers."
- Thomas Jefferson

We will commit to studying price structure, momentum, and retracements. These factors do not lie to us. We will have a plan **prior to** the markets day-session open (DSO), enabling us to have a pre-determined "decision-making" price to execute our strategy everyday, if necessary. If it becomes necessary to act or react, we will be decisive in our actions – free of hesitation.

Why You Need to Know, Understand, and Practice this Information

---

"Even if you're on the right track, you'll get run over if you just sit there."
- Arthur Godfrey

All successful traders I know, including myself, have a specific methodology of trading. **We do not deviate from our plan – *whatsoever*.** First, a successful trader must know all the instruments that are available for trading and how they can be used to their full advantage/potential. The common practice for many beginning traders is to trade *one-dimensional*. By this, I mean going long or short the underlying asset and placing a protective stop below, or above, the entry price. Traders find when they initiate a position, the stop needs to be far away from the market price due to volatility levels in today' markets. Let's not kid anyone here, when I speculate a market (any market), I am not always correct with my initial assumption. The straight dollar losses can amount to a significant drawdown in equity. By knowing the instruments available for us traders, and using them in the natural "rhythm" of the market cycles (trading *"two- or three-dimensional"*) these straight dollar losses can be curbed substantially. I'll show you how.

Second, a trader must understand how to implement these trading instruments to optimize profits and lower risk when the market indicates the most appropriate opportunity. There are many things which we can control in our daily lives. We can control when we wake up, what clothes we wear, and what we have for meals.

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The one thing we must ***assume*** we cannot control is market direction. *Is this fair to say*? In my opinion, the market is either moving up (with positive momentum), or moving down (with negative momentum) at any given time. Let me qualify my next statement by saying that it goes against many established conventional teachings...that the market can also trade sideways. It only moves sideways in retrospect, *after the fact*. Looking at a chart pattern, a sideways pattern is only evident well after the fact. Let me explain. If we were to examine a sideways chart pattern, in closer detail, and using any time length, we would find that it would be composed of miniature cycles going either up or down. Trading is never stagnant - it is always moving in either one direction or another. By understanding how each instrument is affected by market direction, we can incorporate these instruments at the most opportune time in order to minimize our risk, at any given time, while maintaining an open position, initiating a position, or liquidating a position.

Finally, traders must practice this 3-Dimensional methodology because markets rarely move straight up (when long a position) or break straight down (when short a position). All trending markets take "turns" in the opposite direction for an unpredictable amount of time, consistently posing a threat to our position. By practicing the proceeding methodology of *3-dimensional* trading outlined in this book, we can effectively become our own professional risk managers and never let the market catch us by surprise. Currently, most large trading firms and commercial banks employ professional risk managers and pay them hundreds of thousands of dollars to protect investments, trades, and securities. They practice the essential core of what we are presenting to you now. The only thing which will separate us from them is the fact that we will be trading in much smaller positions. In practicing the same fundamental trading discipline, our chances of being "wiped out" can virtually be eliminated and we can finally "let our profits run" and "cut any loss short."

Just ***how*** *will we do it*...you may be wondering? We will be utilizing option contracts with the corresponding futures contract/underlying asset. Instead of merely going long/short a particular commodity, or stock, **we will be going long/ short the underlying asset and simultaneously initiating an option position as a direct hedge against complete underlying asset losses**. Furthermore, when the market trades favorable to our positions, **we will be trading options around the underlying asset to constantly "adjust" and effectively manage the position**.

Most traders that just utilize futures, stock, or option contracts are so used to exiting a position (with or without a profit) only to later see their market trading in their intended direction. There is hesitation to re-enter the market due to technical

analysis, fundamental conviction, or just plain *bad experiences* chasing markets in the past. **By trading *3-dimensional*, the trader maintains a constant presence in the marketplace**, as long as the trader remains bullish/bearish. This allows the trader to ride the unexpected moves in the favored direction while constantly be protected against the financial downside. Powerful techniques once reserved for "floor traders" will now be exposed and completely explained here in ***this*** manual for us folks off the floor.

Motivating Statements and Testimonials

"As a rule, he or she who has the most information
will have the greatest success in life."
- Disraeli

Becoming a professional trader is not an unrealistic dream or goal you may have. I know a small handful of these traders personally. One of them, a former client of mine from my broker days, Jerry, was a construction worker in Houston for 12 faithful years. After learning this breakthrough, he exclaimed, *"I won't work another hot summer (outdoors) in this Texas sun*!" On his twelfth year anniversary he handed his resignation papers to his "boss."

Another client of mine, Bob, had a successful operation in the plumbing business in Idaho. He had several employees, machinery, and all the necessary tools required to operate and run a business of that kind for many years. Once, Bob confided in me his "earnings" after all his employees and overhead were paid. I can't say I was astounded by the figure he presented to me for yearly pay, but I was proud to know I had a role with his S&P 500 profits. From April to July, he made approximately one third of his regular earnings - **per contract**! He has since scaled down his plumbing business to himself and "all the tools he can fit" in the back of his utility truck. Plumbing *part-time* for his faithful clients.

I left the Navy after twelve full years of faithful and honorable service! ...faithful until they screwed up by giving me time off to watch the bonds trade tick-by-tick for seven months. Amen Brother!

Here is what others have said about this style of trading:

". . . Here are my results from just 3 days of their services:

1. *They kept me out of a trade that would have lost $2,200.00. I could have made $2,200.00 if I had listened to them and had placed a "short" on the Yen, but I didn't.*
2. *Placed four orders that are fully protected from loss with unlimited profit potential. All trades, incidentally, are in the black as of Friday's close.*
3. *I HAVE LEARNED MORE IN THESE THREE DAYS FROM PTA [CONSULTATION SERVICES] THAN I HAVE LEARNED FROM THE THREE "FULL-SERVICE" BROKERS THAT I HAVE HAD THE LAST TWO YEARS...COMBINED!*
4. *In just one day of trading, I have paid for their monthly service fee, and the next three weeks are strictly gravy!*
5. *I ACTUALLY SLEPT WELL THIS WEEKEND! (WITH TWO OPEN POSITIONS!)*

If anyone wants to put me on the chopping block because of this post, go ahead! My name is Kerry...and I would enjoy the confrontations!

If, on the other hand, you want to improve your trading, give PTA [Consultation Services] a call... The education you will receive in those two weeks will most certainly pay for the time you spend on the phone. They answer all questions without any fluff. They'll teach you how to be DECISIVE.

Brian and Dave are highly moral, highly ethical businessmen who know the markets like no others I have found. It's the best investment I have ever made in the commodity markets!"

- Kerry B. Neillsville, WI

"Having traded commodities on and off for the past several years, I was fortunate in finding Brian of PTA Consultation Services recently. He is extremely proficient in helping me protect my position from losses with the appropriate help of puts and calls. I am certainly pleased with his assistance and really comfortable with the elimination of much of the trading risk! I am looking forward to Brian's style of trading and I highly recommend his service."

- Lowell W. Hesperia, CA

"I am excited about what has been happening to me (and my bottom line) since working with you. As a therapist, I realize the importance of objective knowledge in successful decision-making. Your market expertise is providing me with the objectivity I have desperately needed! Correct information has taken the "fear" and "panic" factor out of my trading and has brought back excitement, joy, and profit.

In the past, I have liquidated winning positions too early and held on to losing positions too long! Both have cost me money and a lot of emotional wear. Your evaluation of daily momentum and giving me specific entry and exit data has done away with the "toos" [sic] in my trading.

You deliver what you promise! When I began working with you I was in a losing position in the Japanese Yen. You immediately gave a strategy with calls and puts to "stop the bleeding" and position my trade for a reversal. Within 7 days a losing trade turned into a profitable position (+$1,750.00 and growing). If I had not been working with you, fear would have taken over and I would have 'bailed out' for a loss.

Your commitment to my capital preservation with the use of calls and puts has allowed me the freedom to trade more markets with a minimum of drawdown and maximum profits. The suggestion to trade with a discount broker has cut my overhead by 60%. I can make more profitable trades with less dollars and no "hot tips" or anxious phone calls to brokers on 'what should I do?'

I'm gaining insight into the components of a successful trading strategy. Your resources, analysis, and patience with me is making commodity trading exciting, profitable, and enjoyable. You have exceptional insight into all factors that move the market and the gift of sharing this information with others. I look forward to a long and successful relationship."

- Mike D. Louisville, TX

"I am a new trader, but your patience has really helped me in overcoming my hesitation in both trading and dealing with a discount broker...

I must admit that the techniques you have been teaching are much different than what I had been learning from other masters of the markets. Your method of going long a contract, buying a put at-the-market as insurance, then maybe an out-of-the-money call to finance the put, has worked out well. In the last week,

my percentage increase has been 27% of the at-risk monies, even though I had a contract go against me. This also calculates out to 14% increase in total portfolio in one week, annualized to 728%. Thanks I'll take it!

I look forward to making more profitable trades under your tutelage and learning more...

- Mike H. Rapid City, SD

"Before trading with Brian, my futures account had dwindled down to a few thousand dollars. In a matter of five months, I have been able to recoup ALL my previous losses and I am profitable for the first time since starting to trade futures ten months ago.

Brian's system for managing risk works, although I still have losing trades, by managing and reducing the risk when possible I have avoided the large losses I used to incur. Thanks Brian!"

- Anthony C. Hawthorne, NJ

"With 12 years experience investing in the stock market, and after taking Larry Williams course, you [Brian] have guided and lifted me to a higher level of trading. A level that truly minimizes risk with insurance, and maximizes profits with sound money management! My bank account balance and I sincerely thank you."

- Eric K. San Dimas, CA

"I'm a new trader who perhaps like many new traders was introduced to the markets through a mail order course and am grateful for the introduction. After completing the course, at least two things were very clear to me. My first conclusion was that the commodities markets were a source of both fantastic profits and potentially devastating losses. My second conclusion was that the difference between my becoming a gambler and an investor would be made by a combination of both self-discipline and knowledge...

...I would like to thank Brian for the first thing he taught me, how to limit or eliminate my risk in both limited and unlimited profit potential positions, and how to profit even when the market moves against me..."

- Adam B. Santa Cruz, CA

"More than luck, it takes information resources like PTA Consultation Services to succeed in trading... Necessary for making the most intelligent decisions on every trade, saving me hours of research. Not only are the trades profitable, each trade becomes a valuable educational experience, and the cost? Savings on commissions alone makes PTA Consultation Services virtually free."

- Vida B. Brawley, CA

"Just a little update after seven months of trading with your service. I'm in great shape and I feel the education I have gained is invaluable as I didn't know a tick from a flea when I started. ...You have taught me to protect my trades with options, be very selective in trades with capital preservation foremost at all times, and my account is intact with nice gains. Also, I have never had a margin call to date and I believe I will not ever have one as long as I do my homework. Thanks for all your help."

- Bob F. Boise, ID

"Just a note to say thank you for your continued expert advice in regards to my futures contract trading and for education I am receiving with options trading. Those successful options trades have saved me a considerable amount of money. My account continues to grow, thanks to your advice. Thank you for your patience with a novice commodity trader, your guidance has been worth every penny."

- David S. Orange, CA

"I wanted to take this opportunity to express my evaluation of your services. As you know I was very inexperienced in commodity trading when I started with you. In this short time, you have taught me how to limit my risk, recognize price structure and trend moves, and understand net trader positions so that I will be around to trade for a long time.

...Prior to understanding this aspect of trading, I was becoming discouraged because I was not realizing much success. ...During that roller coaster ride on the Swiss Franc, you taught me how to limit my risk by using puts and/or calls with each trend reversal. You helped me turn what I perceived as a big loser into a winning trade which included gains with each trend reversal and a $4,000.00 gain in my basic position.

...Your combination of knowledge, professionalism, and support is non-pareil [sic] in this industry. ...I would heartily recommend your services to experienced or novice traders alike."

- Gus A. Kenai, AK

All of the above quotes are from actual clients. These verbatim motivating testimonials reflect exactly what we are going to teach you in this manual. After this section is over, there will be no more of this type of motivating literature and we will get down to the nuts and bolts of professional trading. Simply by acquiring this book, I am confident you have the underlying desire to succeed at this business.

Everyone who has ever made it in the markets – either made it big or found a successful way to provide a secondary source of income – started out as a novice beginner. This is a fact. Those that have gone on to higher levels went out of their way, at one time or another, to maintain persistence in gaining knowledge and the necessary skills required to survive. By obtaining *this* book, you too have decided to take the next step in building a foundation in successful and consistent commodity trading from which you can develop and grow.

Background on Brian Schad

Schad Commodity Futures & Options Trading Corporation [The name changed in 2000 from ***PTA Consultation Services***] was a real-time personal consultation service which provided personal assistance and guidance similar to that of a full-service broker for clients involved in commodity futures and options trading. PTA was founded with a mission to provide innovative, practical, and expert quality service. It was designed to save traders money while enhancing their trading knowledge and strategies. I started the company in January of 1997 and it expanded exponentially due to the niche it services – that is professional, unbiased advice and position-monitoring for a reasonable flat monthly fee and **deep-discount** commissions from a variety of independent discount brokerage firms. PTA had no connection with brokerage firm commissions either. PTA was designed to provide off-floor traders with two key benefits:

1. *PTA's experience in trading and brokerage combined with personalized training.*

2. *Substantial savings of commissions and fees versus full-service brokerages. I provided unbiased knowledge and advice without the threat of commission-generating "nonsense" trades which plague most novice traders in support of their $100 "*full-service" brokers' salaries.

PTA catered to a wide variety of clients: spread traders, delta neutral traders, position traders, seasonal traders, and day traders. During the course of my many discussions with clients, I discovered a huge void of knowledge and understanding in this area.

"Nobody can be so amazingly arrogant as a young man
who has just discovered an old idea and thinks it is his own."
- ***Sidney J. Harris***

What I will present in this text is certainly not an idea or a creation spawned solely by myself. Rather, it is an *original plan* for trading, derived from years of trial and error, which incorporates all of the instruments that are available to us traders by the exchanges. I do not wish to be classified or labeled as an arrogant person for thinking that this is an idea that no one else has ever thought of. I am sure there are many successful traders aware of this knowledge. However, it has never been

brought to light in any major educational work that I am aware of (*...since first writing this material in 1997-1999*).

I have maintained a constant Internet presence since January 1997. Please feel free to visit me on-line at www.SchadCommodity.com and drop me a note.

Section ONE – The Challenges of Trading

"It is better to be boldly decisive and risk being wrong,
than to agonize at length and be right too late."
*- **Marilyn Moats Kennedy***

Enabling objective: Upon completion of this section, you will be confident in your ability to independently evaluate price structure versus fundamental data when deciding on a position.

Trading commodities is both an intellectual and emotional challenge. It is entirely possible for someone to study and understand virtually every technical and fundamental tool, yet "freeze up" when it comes time to place an order. They can't "pull the trigger" to either get themselves out of a losing trade or protect their profits in a winning position.

"You can't hit a home run unless you step up to the plate.
You can't catch a fish unless you put your line in the water.
You can't reach your goals if you don't try."
*- **Kathy Seligman***

Professional Traders vs. "Non-Professional" Traders

Have you ever wondered what it is the professional traders do all year round to consistently make money? I mean, there are people out there that literally sit in their offices and/or homes and make a living with the money they bring home from the markets. These same individuals take cash out of the market year in and year out. They never have a "bad year" and nothing seems to break them! Do you think they have inside information? *No.* Somebody has to be making money in the markets. *Yes.* "What are these people doing that I'm not doing or should be doing," you may be asking?

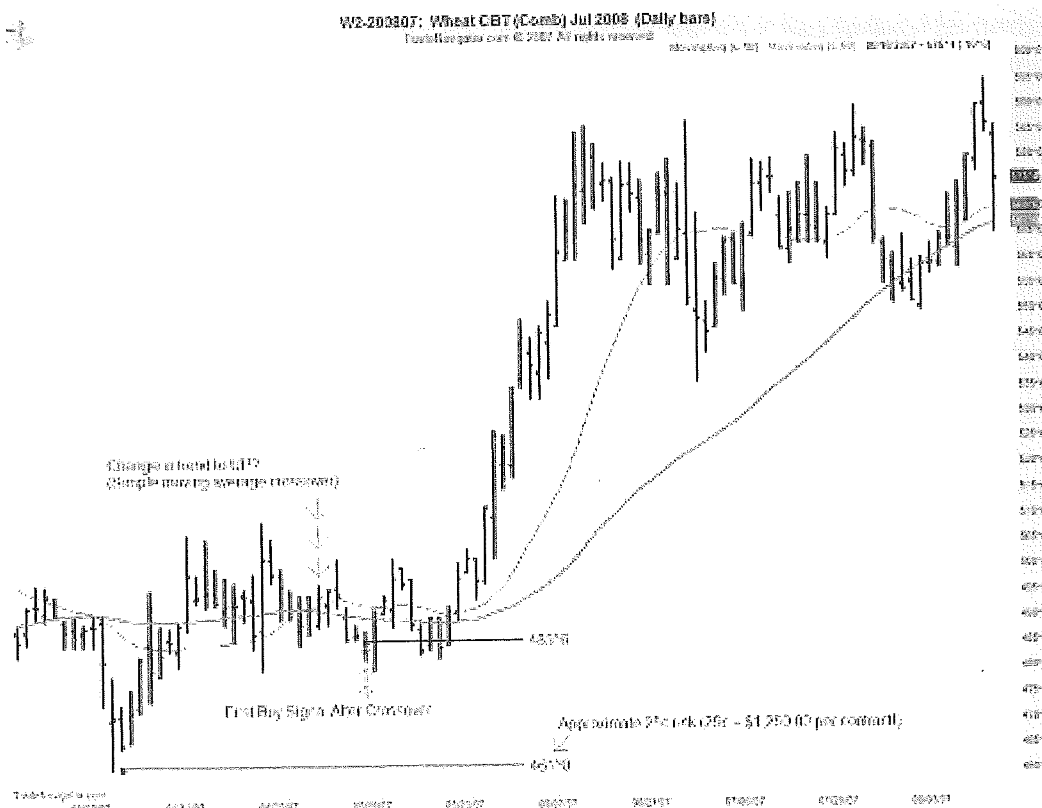
The professional traders who consistently take profit from the markets, confidently *and* unfailingly, know exactly how to control their risk at any given time, on any given day. I will say again,

* * * * * * Know how to control "your risk." * * * * * *

This, my friend, is the simple difference between "being around forever" and "dabbling in the markets" only to hang it up later after getting clobbered.

Identifying Risk

Before any trader takes a position, a certain amount of risk must be pre-determined and will depend upon the amount of time the position will be in progress. Most traders will absolutely refuse to initiate a position if the risk, just by looking at a chart, is too far-fetched.



When a possible trend change in wheat comes to light (from down to up), the first possible trade suggests risking $1,250.00 per contract.

If you had a conviction wheat prices are in the process of changing trends (from down to up), and you thought now is the time to buy wheat because it has come up so far from previous contract lows, you may have a change in heart when you

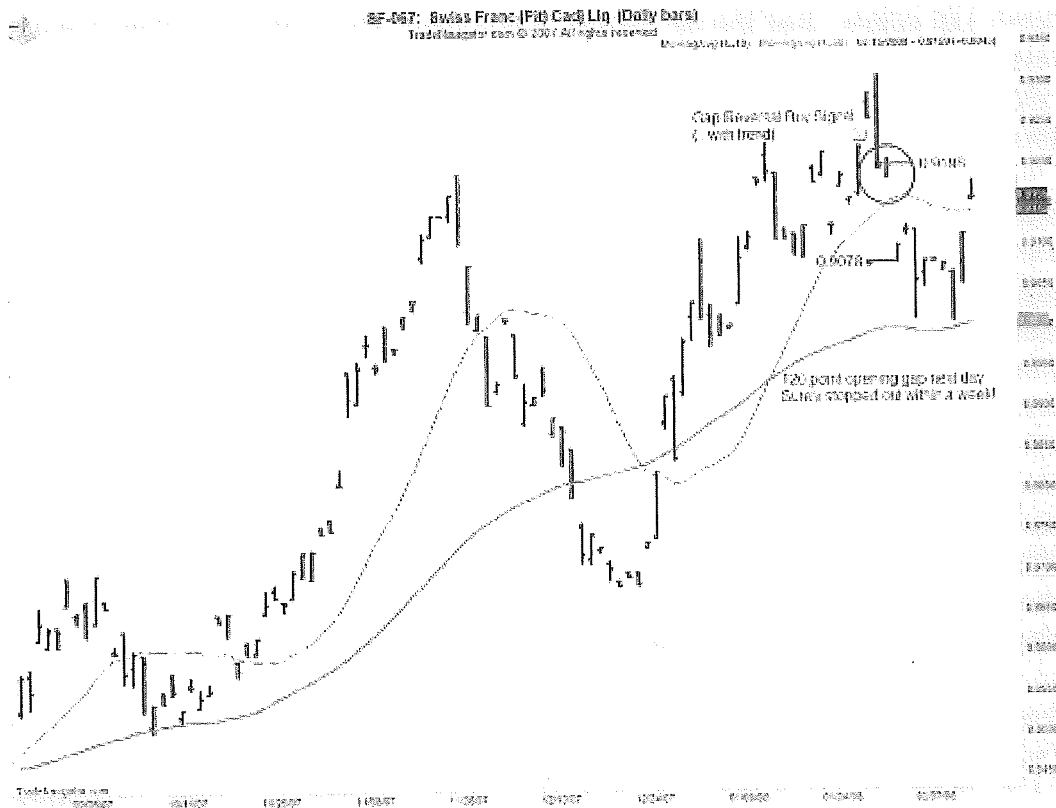
realize that you must risk $1250 below the contract low in order to lessen your chances of getting prematurely stopped out.

My method of trading allows traders much more flexibility when initiating positions and allows traders to manage their positions on a daily basis. The "stop-outs" and losses are a thing of the past. As a beginning trader, you will make errors in judgment and the market may very well go against your position. With more reasonable stops, you (and your account) will live to trade another day. Many "experts" have always advocated limiting your losses and letting profits run. However, the limits of loss will wipe your account out with only a few mistakes.

This manual will teach you what to look for when placing your trade, how to place your trade, how to determine your risk, and when to take your profit. In fact, this method of trading can be implemented through your broker without your need to monitor your trade 24-hours a day. Furthermore, this style of *3-dimensional* trading will always provide a plan for the next day - never letting you get caught with "your pants down."

The Problem with Protective Stops

Having "protective stops" working in the market for your long/short futures position doesn't cut it with today's volatility! Besides that, all markets are "trending" towards trading around the clock (as of this writing, New York soft's markets have just eliminated day pit-session trading. Only *electronic trading* going forward).



A buy signal on one day (at .9198) for the Swiss Franc is followed by a 120 point drop against the position the very next session.

In June of 1997, my client Dan, took a long futures position in the Japanese Yen when the market presented him with a classic gap-reversal/"Ooops! (Larry Williams)" buy signal. We were waiting for this opportunity and the market let us come aboard safely that day and off we went into new contract highs! In a matter of three or four days the market went from making new highs and being up in the neighborhood of $4,000+/contract, to opening ***down*** 255 points the very next morning (yes, he had an at-the-money put option for "insurance" too)!

What if *you* were one of the traders that went long on the breakout of new highs the trading day before? Somebody had to be long! ...*half of all participants*! Would a protective stop provide a way out with a "$550 money-management stop" you had diligently planned for? NO. There was absolutely no way of seeing that downside opening coming. **YOU CANNOT RELY SOLELY ON PROTECTIVE STOPS.**

Most recently, the Swiss Franc gave me a case of déjà vu when the Swissie gapped down 120 points. Just the day before, a buy signal was realized, and on the day session chart the very next morning – BAM, down 120 points. Getting back to relying on protective stops...You never could, you never can, and you never will... Sorry to be the bearer of bad news - ***reality***.

Grains now trade around the clock, thanks or no thanks to "Globex" computerized trading. Are there any safe haven - day session only - markets left? Well, way before grains traded in overnight sessions there was a problem that still exists today with these markets. Do you know what it is? I'll give you a hint . . . What time is the monthly USDA "crop production" report released to the public? (7:30 am CST) What time do the grain markets open? (9:30 am CST) Do you see the potential problem here? Every month some traders are unknowingly, or carelessly, long/short a futures contract with, or without, a protective stop going into the crop report! Traders have two full hours to digest these reports and plan their strategy. Will a protective stop help them in a limit move against them? NO. Never could, never can, never will . . . Do you understand my point? <u>No market is safe from adverse moves</u>.

Now for personal experiences: Chances are you never heard of me by the time I was trading 60-lot Treasury note contracts. This is when I was "watching bonds trade tick-by-tick for seven months". From August of 1994 to March of 1995, I managed to take $130,000.00 out of the Chicago Board of Trade. Are you aware I later lost most of those profits - to the tune of $110,000.00 in a one week time frame? I know that a few of you were with me when I dropped another $20,000.00+ in the bonds when they went down limit in March of 1996! This second loss never should've happened. I knew better by this time but, "*I just knew the market was going to go up*." Have you ever experienced anything like this...?

"There are no secrets to success. It is the result of preparation, hard work, and learning from failure."
- General Colin Powell

If you did, you most likely would not be trading anymore (after a long, lengthy, and loud discussion with your spouse perhaps) because you would always fear the loss potential, never allowing yourself to be at ease while having positions in the market. Well let me tell you what both these losing trades had in common - no protection from adverse moves. Yes, I got what I deserved playing "cowboy" and "riding without a saddle." Would you like to experience this kind of loss? **Continue to trade without "insurance" and it's just a matter of time until you get stung**, especially if you over trade.

Buying Options for Speculation...Watching Ice Melt

Most novice traders tend to purchase options for a couple of reasons. First, when markets are very volatile and look promising for easy profits, but significant risk is inherent, these new traders will *buy options* for the unlimited profit potential, limited risk profile. What most of these traders do not understand is the fact that they are buying these options when the volatility (and premiums) are very overvalued. The approach to the position is usually: "Well, I'll spend $800 for the next two and a half weeks for this wheat option and we'll see what happens..."

When new traders get involved with options I have found they tend to overlook/ underestimate chart patterns of price structure and do not take the appropriate actions when the market opportunity presents itself. Thus, as they're hanging on to their position, premium decays quite rapidly until their option is worth very little and not worth liquidating. Eventually, the option may expire worthless and reality sets in as traders realize that buying options to speculate the markets is very much akin to an expensive lottery ticket. I advise against it.

Unconventional Thinking for Unconventional Trading

The reason why I advocate "don't speculate the market with options" is because there are many factors that must be considered with professional option trading. Other than the option's underlying asset price structure activity/trend, there are such things to consider such as:

❋ The option's *implied volatility* (options in a buyer's market or seller's market)

❋ The option's *Greeks*:

1. **Delta** - the amount of premium change vs. The change in underlying asset value.
2. **Theta** - the amount of premium decay in one day.
3. **Vega** - the amount the option will profit/(lose) when implied volatility changes.
4. **Gamma** - the amount of Delta change according to the underlying asset change.
5. And finally, the "***call/put ratio***."

Did you get all of that? Quite technically intimidating, isn't it? I consider myself an options expert, but the truth of the matter is options are much too complicated to use as a speculative vehicle for either the new or average investor, including myself (and I've been around awhile!) You must know all of the aforementioned elements in order to successfully buy/sell options for consistent profits.

Now, what is the easy way to get around all of this? Very simply, always buy long / sell short the futures contracts and use the options for what they were intended to be, "*insurance*." **All that is required by you is *simple arithmetic*** - addition and subtraction. Read on!

You will find yourself at times hunting down a particular market because the conditions are just right (commercials vs. public relationship, market sentiment, etc.). But when you place your trade, you will not always be right. Accept this, for this is a reality in commodity trading, or any type of investment, for that matter. **When you go long/short a futures contract, do yourself a favor by purchasing an "at-the-money" option in the opposite direction as insurance**. I cannot emphasize this enough. I have seen too many bull-headed traders not want to put in a protective stop on their directional trade for a multitude of reasons: because of fundamental conviction, fear of getting stopped out then having to deal with high commission costs, or just plain being stubborn! Listen, if your long futures position is protected by a "long put," *you still maintain unlimited profit potential.* Furthermore, **the premium you paid as insurance can still be recouped very easily *without* adding additional margin on your position**!

If you are correct about the market and prices go up, **your futures will make more money than your option will lose in value.** Continue to hold the put. When you get a short-term sell signal you have three choices:

1) Liquidate your futures and reset at a lower price when the next buy signal presents itself;

2) Sell short a call option for an equivalent premium to what the put option has lost in value (to recoup your *present* loss); or,

3) Do both 1 and 2! Keep in mind you can also liquidate both the futures and option positions and have a profit and then reset later.

If *your speculation* of the market is incorrect, the maximum loss potential for your position is the amount you paid in premium for "your insurance" plus/minus any amount the option is in/out of the money if you hold the position until the option expires. This, my friend, ***is*** the worst case scenario. When you initially took your position in the market, you thought the market was going to go in a certain direction. Usually within a couple of days or so you'll find out if you are correct, or not, and if you are stopped out with a loss in your futures contract, your option should have made some profit so you will take *half a loss*, or a *partial loss*, instead of a whole loss!

You shouldn't hold the position until option expiration anyway. If you do, that is, hold an initial position for more than a week, I suspect there is some "hoping" involved and you may be disregarding what the market price charts are telling you. The only decision you need to make in considering purchasing the option is, "How much do I want to risk?" Do the option premiums warrant a buyer's market, or a seller's market (are the options cheap or expensive)? You only want to *buy* options with low implied volatility/low premiums. Then you are assured you're getting your money's worth and, if you have to hold this position for awhile, the "sleep factor" is in your favor. Specifically, by purchasing the insurance, YOU CAN BE ASSURED YOU WILL NEVER LET THE MARKET WIPE YOU OUT AND YOU'LL ALWAYS LIVE FOR ANOTHER DAY TO TRADE! This I guarantee.

"A leader takes people where they want to go.
A great leader takes people where they don't necessarily
want to go, but ought to be."
- Rosalynn Carter

Section #1 Quiz

1. "Professional" traders can be distinguished from "non-professional" traders because they:
   A) Know when to initiate a trade.
   B) Understand margin requirements.
   C) Know how to control their risk.
   D) Know where to place protective stops.

2. The potential danger of using protective stops as the sole means of risk management is:
   A) Futures markets trade around the clock.
   B) Traders may be "stopped out" prematurely.
   C) There is absolutely no way to predict a substantial morning gap-opening.
   D) Brokers sometimes cannot submit protective stops for overnight sessions.

3. Many novice traders will buy options for the unlimited profit potential, limited risk profile. When doing so, they tend to:
   A) Overlook the premium they are paying for the option.
   B) Overlook chart patterns of price structure.
   C) Disregard the advice of their broker.
   D) Both A & B.

4. New, or "average," traders/investors should NOT speculate the market with options because:
   A) They are NOT proficient with the application of the Greeks.
   B) They do NOT understand specific option indicators such as the call/put ratio.
   C) They do NOT understand the importance of price structure and chart patterns.
   D) All of the above.

Section TWO - Understanding the Trading Instruments

"Education is a progressive discovery of our own ignorance."
- ***Will Durant***

Enabling objective: Upon completion of this section, you will be able to define underlying contracts (assets) in terms of long and short positions, and define options' value to determine if they are over or under priced.

This entire section should be a review of trading instruments of which you are already aware. If you are very familiar with both the put and call options, and the futures contracts, you may quickly skim through this material. You will, however, be responsible for the material covered in the final test (*real-time* trading).

The Futures Contract and the History of the Markets

In the days of early man, humans generally lived from day to day. Man hunted only when he became hungry. He built a shelter with raw materials only when the weather demanded. As man developed over thousands of years, he slowly learned to stockpile food stuffs, natural resources, and materials in the event of natural disasters, war, catastrophes, etc.

As societies developed, individuals realized it became more productive to specialize in a certain craft or product. Various other sundries could be traded with neighbors. With this concept came the natural establishment of the marketplace, a common gathering of various merchants and tradesmen who could find a wide assortment of products in close proximity. In the days of old, the markets were established as a means to exchange various goods for money (cash).

As economies developed, individuals or businesses became increasingly dependent on ensuring certain resources were available at all times. As such, cash-forward contracts were established so that a physical commodity could be sold in the cash market for delivery at a later date.

Cash-forward contracts generally involve two individuals, buyer and seller, who know each other on a personal basis and make a one-to-one agreement for the sale/purchase of a product at a later date. A cash-forward contract specifically is:

A. Not monitored by any agency.
B. Not guaranteed.
C. Non-standardized.

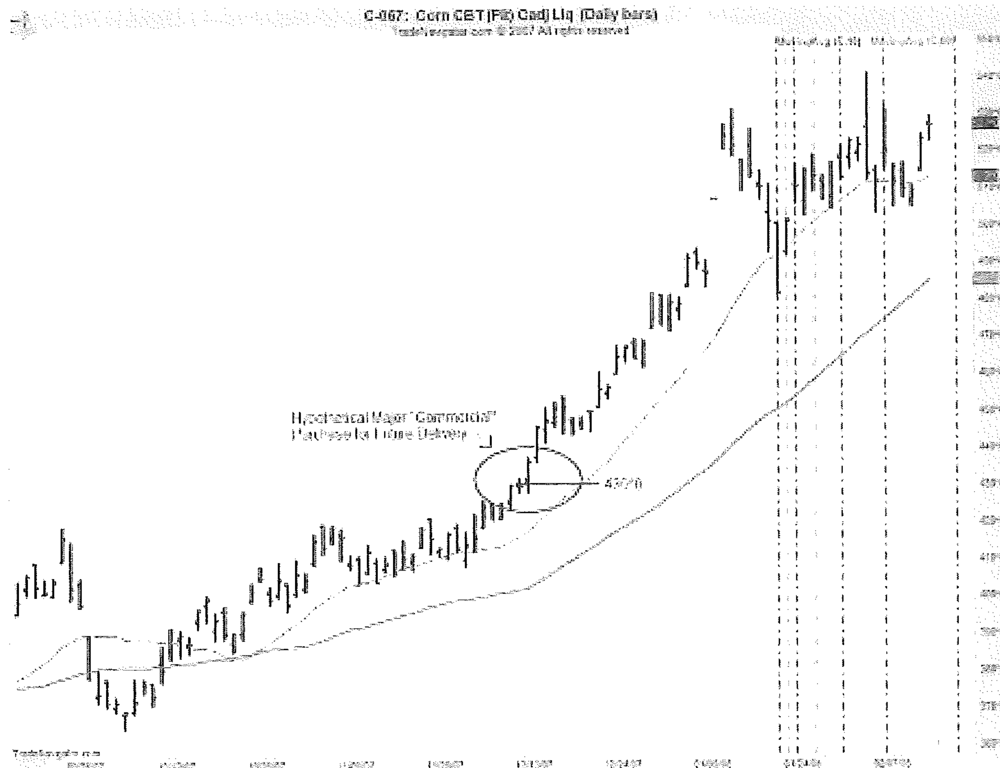
Well, as you may imagine, many buyers and sellers got some pretty lousy deals, received damaged goods, reneged on agreements, etc. Much of this was due to the uncertainty of the future.

Example: If a merchant shook your hand and agreed to sell you a bushel of corn for 3 dollars/bushel two-months from now and the corn suddenly became worth $5.00 tomorrow, do you think he would keep his promise to you? Highly unlikely.

Enter the futures contract. The futures contract is an exchange between anonymous buyers and sellers on the floor of an authorized exchange, monitored by the Federal government, guaranteeing a standardized product to be delivered or sold at a specified time in the future.

If a trader purchases a futures contract, he is "long" that contract. That means he is obligated to take delivery of that contract during the delivery month unless he offsets or closes out his long position.

Example 1 (long and take delivery):



To help keep costs low for their business operations and consumers, commercial users of grain will look to purchase at a lower price now for future use.

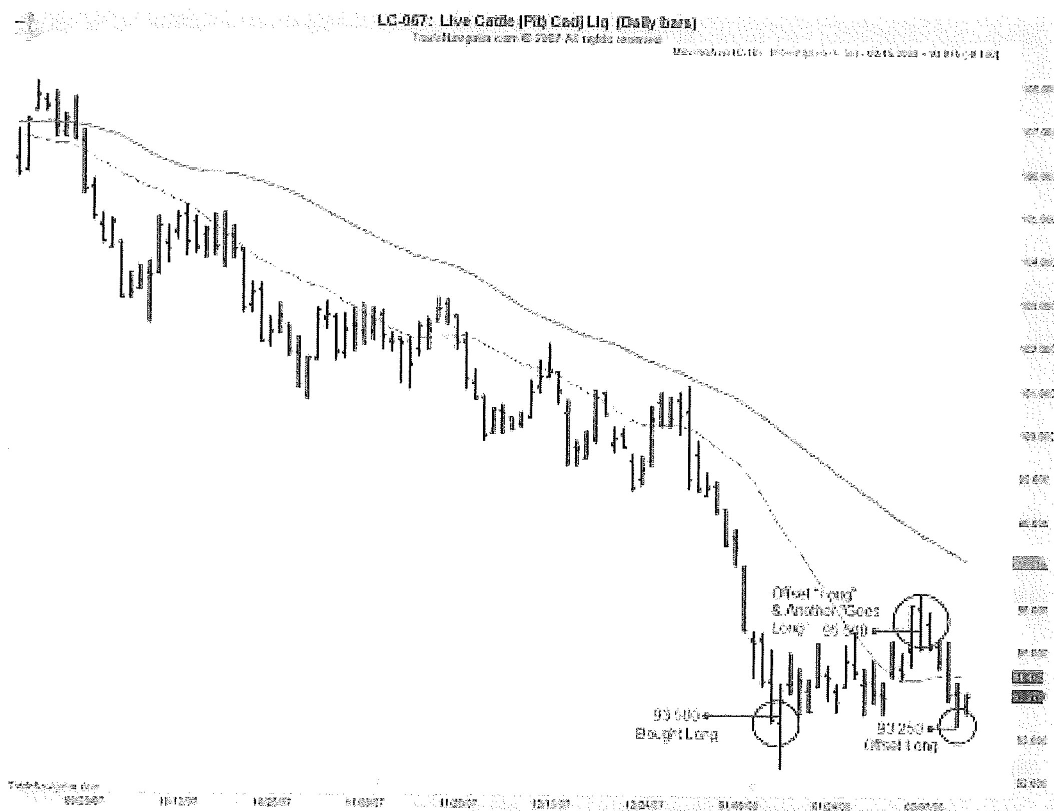
This example demonstrates the financial necessity of futures markets for large commercial users. After harvest time (in the Northern Hemisphere), a large commercial food company purchases 100 contracts of corn for 4.30/bushel. This means the company is "long" 100 contracts of March Corn and will be obligated to take delivery (receive) that amount of Corn in March unless they offset these contracts by selling 100 March Corn. The cereal company needs the corn to produce their product, so they take delivery of 500,000 bushels of corn on their doorstep. The day they take delivery, the price of cash corn is 4.85/bushel. Knowing that corn was "cheap" and could easily rise in price, they bought corn several months prior to needing it - saving themselves:

Company buys 100 March Corn @	4.30
Company takes delivery when cash Corn is@	4.85
Difference	.55

The company saved themselves 55¢ on every bushel of corn to keep their prices from fluctuating greatly. How much did they save? Let's see...

55¢ X 500,000 bushels = $275,000

Example 2 (long and offset with a profit):

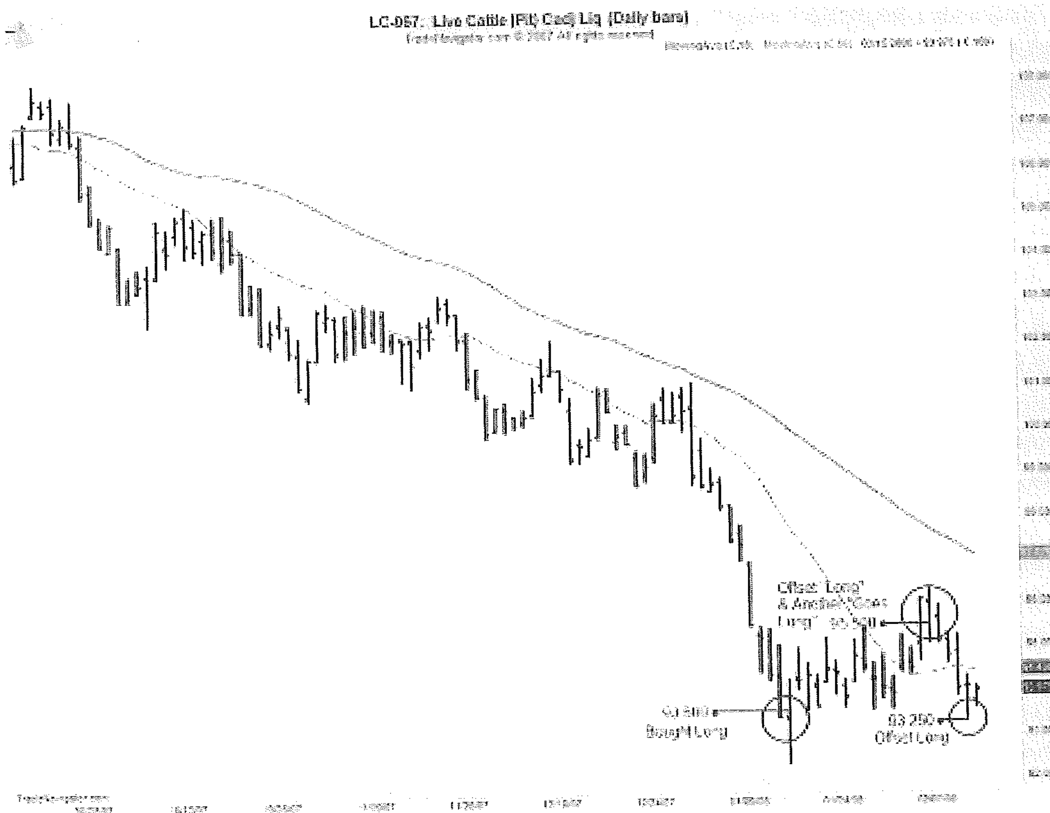


At the beginning of the year, Mike purchases one contract of February Live Cattle at 93.50. This means Mike is "long" 1 February Live Cattle from 93.50. For every cent the price of cattle goes up, he makes money (1 cent/.01 X 40,000 lbs. = $400). If the price declines below 93.50, Mike loses money until he liquidates his open position in the market. In early February, Mike's contract is making money because the price of live cattle is going up to 96.00. Mike does not want to have a herd of cattle on his doorstep in late February, so he decides to offset by selling one contract of February Live Cattle.

Mike buys 1 June Live Cattle @	93.50
Mike sells 1 June Live Cattle @	95.50
Difference	2.00 cents X 40,000 lbs. = $800

Mike is now "zeroed out" in the markets with no open positions and has a nice profit of $800.

Example 3 (long and offset with a loss):



Each transaction is met with another party taking the opposite side of your trade, which means, each time a "trade" occurs there is a buyer and a seller at that particular price.

In mid-February, John purchases one contract of February Live Cattle at 95.50¢/lb. to speculate with. He thinks cattle are about to rally in the next few weeks. This means John is "long" 1 February Live Cattle from 95.50¢/lb. For every cent the price of cattle goes up, he makes money (1¢ X 40,000 lbs. = $400). If the price declines below 95.50¢/lb., John loses money until he liquidates his open position in the market. In the following week, John's contract is losing money because the price of live cattle has gone down to 94¢/lb. John does not want to have a herd of cattle on his doorstep later in the month, so he decides to offset by selling his one contract of June Live Cattle at 93.25¢/lb.

John buys 1 June Live Cattle @	95.50¢
John sells 1 June Live Cattle @	<u>93.25¢</u>
Difference	(2.25¢) X 40,000 lbs. = ($900)

John is now "zeroed out" in the markets with no open positions and has a loss of $900.

The futures contracts are one-dimensional instruments in and of themselves. That is, you can either be "long" or "short" the market on a one-to-one basis and be either correct or incorrect in your speculation. For centuries, this has been the challenge of speculators, hedgers, and users alike. Our challenge for this book is to minimize this risk while maximizing gains. More to come...

The Stock

The stock holdings that we have grown up with have been the most popular investment instrument since its introduction over two centuries ago. You don't need me, or anyone else, to tell you that you must "buy low, sell high" to make money with stocks. Stocks are generally a small ownership in an individual company.

Unlike futures contracts – which can be "sold short" as *easily* as "bought long," – most folks only understand they can buy stocks as an investment with the intent to make money over the longer term. However, they are also assuming the risks associated with the business management and ownership. It is not a common practice "shorting" stocks (as we practice it in the futures markets) – as the ability to borrow shares for shorting varies from stock to stock, *and* from day to day.

Since we are comparing futures contracts with stock ownership, let me add that higher margin is required from the stock trader for similar gains to those in the futures markets. This is why many traders are converting their time and effort (and risk funds!) into trading the commodity futures markets. Also, since the underlying asset of the stock is the company itself, no one knows better the financial soundness, future plans, business outlook, etc. than those who directly run the company. Although "insider trading," which we are alluding to, is a highly illegal practice and carefully scrutinized by the federal government, it still takes place (and always will in one form or another.) If you contrast this with commodity markets, you will know that it is darn near impossible, and highly unlikely, that any one individual or small group of people can direct the market in their favor - there is simply too much corn, cattle, sugar, petroleum, etc. in the world for any one person, entity, or small group to control (although it has been tried!).

It has only been the past decade that stock traders could take advantage of electronic trading through the use of the modern day Internet. This gave brokerage firms the ability to get traders in/out of the market at a very deep discount rate. Granted, the risk of error is "transferred" from the broker (representing the brokerage firm)

to the individual placing the order on their personal computer. Without electronic trading, the commissions on stock trading are traditionally higher in price than the average commodity commission. In my opinion, this is because most people involved with stock "investments" require the expertise of a full-service broker. Commodity brokerage firms have their "version" of a full-service broker. However, I have yet to see or meet a full-service commodity brokerage firm that warrants "three-digit" commissions and are assisting their clients in making money.

Many facets of this book can be seamlessly integrated into your stock trading – from a technical aspect. You, however, must still be a good "picker" of the correct stock **and there are literally thousands of them**. Good luck! The commodity markets, on the other hand, have a greatly reduced amount of underlying assets offered by the exchanges. Yes, there have been a lot more futures contracts introduce in recent years, but the commodity markets have only about 32 major commonly traded futures contracts, all divided into a finite amount of sectors - grains, livestock, food & fiber, interest-rate markets, currencies, precious metals, stock indices, and petroleum. That's basically it. Your focus to make money is considerably narrowed into a small field that can be researched in full much, much easier than individual stocks!

I don't mean to discourage those of you who have been "die-hard" stock investors and traders, nor is it my intention to compare the two types of markets on the same criterion level - they are like apples (stocks) and oranges (commodities). However, **the instruments that are used to trade these different markets are very much the same**. They have an ***underlying asset***, ***call options***, ***put options***, and exhibit ***chart patterns*** for technical traders to analyze. This material will benefit a *stock trader* as well as a commodity trader.

"If you think education is expensive, try ignorance."
- Derek Bok

The Options

Options were primarily developed as financial tools used to manage business risk, because they allow business operators to pay an up-front defined premium (or fee) for the chance to protect themselves from adverse price movements due to unforeseen circumstances (volatility). Many people mistakenly assume that options strictly exist as speculative instruments and have only been created recently. However, the use of options as risk-hedging tools has actually been in practice for many centuries. In the past few decades, options have become popularized. Options continue to be used as a risk-management strategy by professional traders and large commercial firms. I am going to demonstrate how individual traders can successfully incorporate the use of options into a "low-risk" management trading style used in conjunction with futures contracts.

As you should already be aware, an option is simply a method of paying a limited amount of money for the option to execute a business transaction at a certain price and time. Whether or not the buyer desires to execute the purchased option is completely up to the buyer – in *American* markets. The seller, however, is obligated to honor the buyer's option at any given price up to the specified expiration date.

The Call Option:

First, there is the call option. When buying a call option, the trader has unlimited profit potential, limited risk. In buying the call option itself, you are "long" the market, and of course, the risk is limited solely to the premium paid for that option. However, if you sold "short" a call option (because you thought the market may be going down) you have limited profit potential coupled with unlimited risk. Needless to say, if you sold a call option and the market was to go up, the loss potential is unlimited and could be very devastating.

The Put Option:

Next...the put option. When buying a put option, the trader has unlimited profit potential, limited risk. In buying the put option itself, you are "short" the market, and of course, the risk is limited solely to the premium paid for that option. This is not the same as the call option, because each instrument is traded for different directions in the market, and you should know what these directions are.

If you are "bullish" you can:

A. Buy "long" futures contract
B. Buy call option
C. Sell put option

If you are "bearish" you can:

A. Sell "short" futures contract
B. Buy put option
C. Sell call option

For any speculator strictly trading one-dimensional, these are the only choices available. Each has its own risk/reward profile. This manual is going to teach you how to ***combine*** each of these instruments to be used for their maximum potential. Again, this course is NOT ABOUT picking tops and bottoms in the market and/or teaching you the basics on how to trade – other "home-study" courses have served that purpose. This book is all about initiating "low-risk" positions and managing them on a daily basis *confidently*, *independently*, and *professionally*. Let's learn more about options...

How Options Are Different From Futures

At any given time, an option is said to be "in-the-money (ITM)," "at-the-money (ATM)," or "out-of-the money (OTM)." These three categories, of course, depend on where the underlying asset is trading. If you bought a 5600 call option, and the market is trading at 5725, the option is 125 points "in-the-money" (ITM). If you bought the same 5600 call option, and the market was trading *at* 5600, this option is "at-the-money" (ATM). If you had possession of the 5600 call option and the market was trading at 5525, the option is considered 75 points "out-of-the money" (OTM). Whether an option is ATM, ITM, or OTM depends on what strike price the option is and where the market is currently trading.

How Options are Priced with Intrinsic / Time Value

Each option is either ATM, ITM, or OTM. If you examine a table of strike prices and premiums, you will notice each option varies in premium depending on how close the market is relative to the "strike price." For example, let's say that IBM is trading at $110/share. You bought an IBM 100 call option for a premium of 2¾, when IBM was trading at $97/share. Now, that same call option is valued at 11½. $10 of that 11½ premium is the "real" value of the option (intrinsic value). The other 1½ is the "time value."

Next example: IBM is trading at $110/share. You bought an IBM 110 call option for 4½. When that call option was purchased, it was trading "at-the-money." Since the market was trading at the strike price, there was no intrinsic value in this option. The 4½ premium is strictly "time value." Of course "time value" is a premium paid depending on several factors:

❋ How close the strike price is to the "actual market value."

It only makes sense that the closer the strike price is to the actual market value, the higher percentage chance the option has of "realizing" profitability. The underlying asset would have to experience a major market move, in the favored direction of the option, for the deep "out-of-the-money" option to become substantially profitable.

On the other hand, a small favorable market move could easily make a slightly "out-of-the-money", "at-the-money", or "in-the-money" option quickly profitable through actual intrinsic value (or close to intrinsic value).

❋ The length in time of the option contract.

This should be an easy concept to understand... The longer the option has in time until option expiration, the more time the market has to meet or exceed that strike price.

For example:

CRUDE OIL PREMIUM VALUES

APR = $1,850
MAY = $3,200

A vast array of Crude Oil option contracts with their corresponding premiums. Each strike price is represented by a different contract month and premium... but the farther out in time will always reflect a higher premium for buying or selling.

April & May Crude Oil are trading at $97.94 & $97.53 per barrel respectively. A $102 call option that has 57 days until expiration will cost more in premium than the same strike-priced option with only 23 days until expiration.

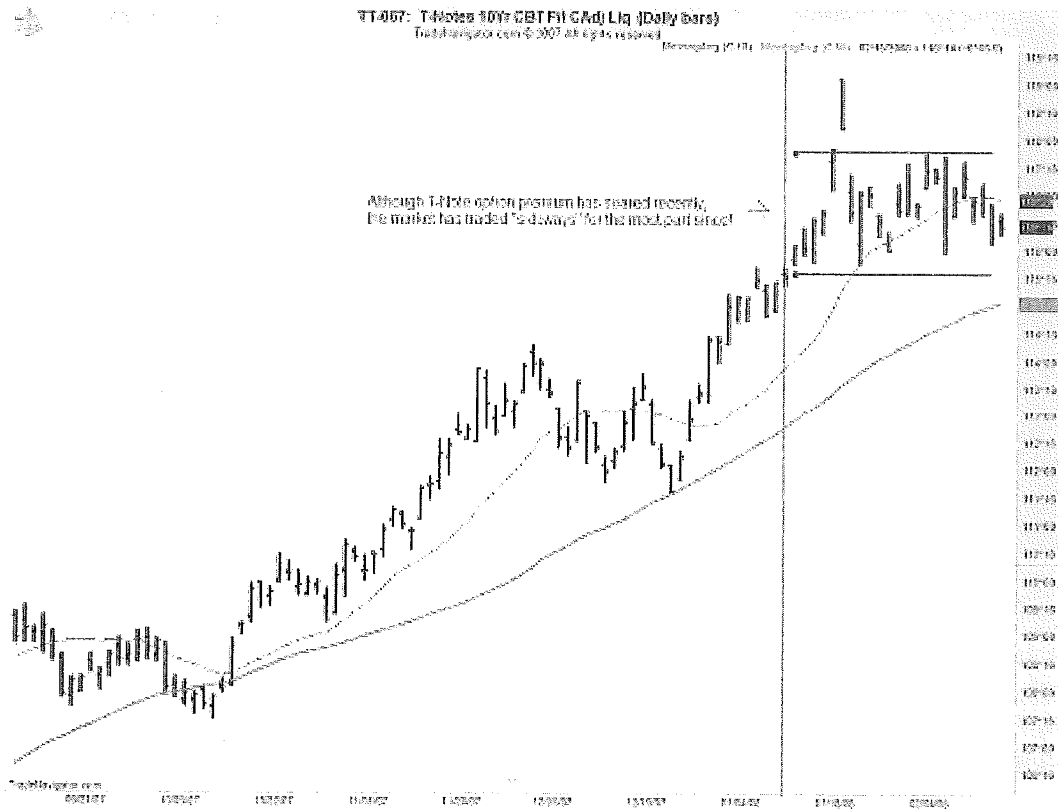
We can also compare this to homeowner's insurance. Would you like to pay for a full year of coverage or six months of coverage? Six months of coverage or one month of coverage? You should now see the relationship between length in time and premiums of option contracts.

❋ The current **implied volatility** of the market.

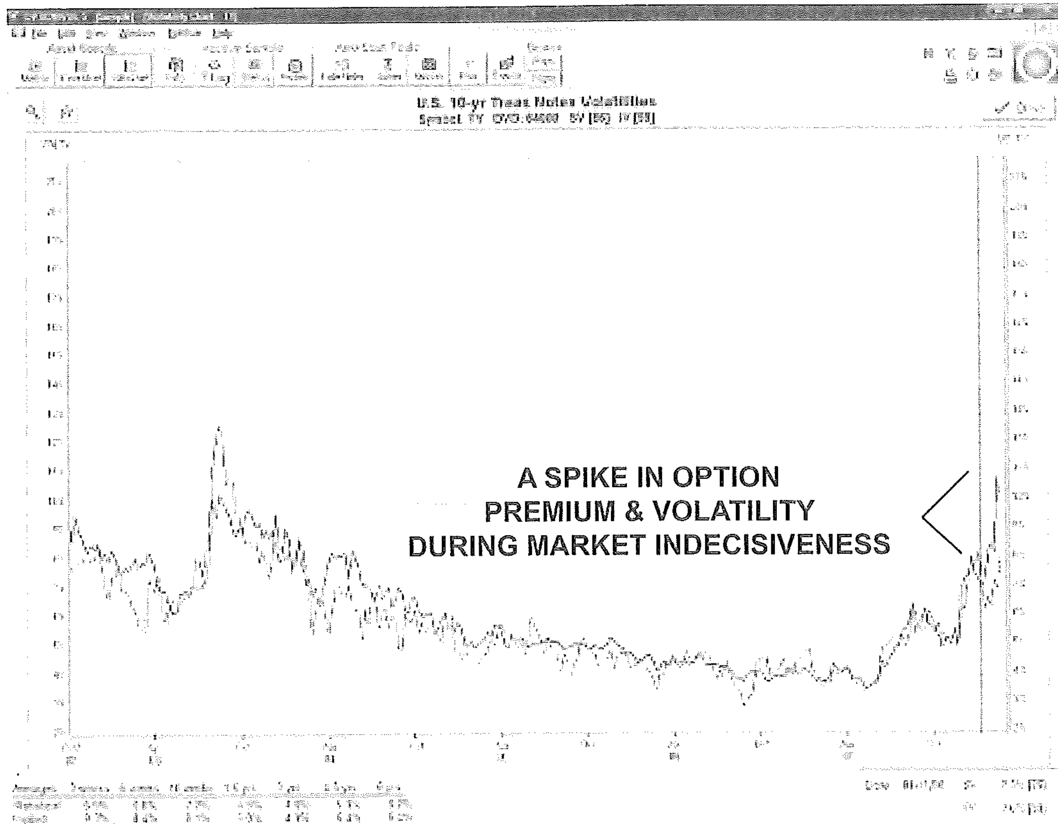
(We will touch on this briefly because we have a more detailed explanation later in this section.)

In brief, if the market has been fluctuating in price erratically, then the premiums will reflect this dramatic change in price of its underlying asset. If the market has recently been in a well-defined trading range, then the premiums *may* be lower than those premiums of a sporadic market.

For example:



When a market illustrates indecisiveness regarding near-term direction, it can be expected the corresponding option premiums will inflate until the market breaks out of its doldrums. In this example it is with 10yr. T-Notes...



...and as you can see, 10 yr. T-Note option premium shot up to over a six year high during the indecisive ("sideways") activity!

After the mid-January spike in price, T-Notes mainly traded sideways for a full month thereafter (between 115^24 and 117^27). When the market was trading in this range, the option premiums continued to inflate and were extremely overvalued, reflecting an *indecisive* market. Once the market eventually broke out of that range, the premiums of the T-Note options were lowered in price because the market resumed trading in a more predictable "trading range" fashion.

If T-Notes were not trading so erratically in such a tight range for a prolonged period of time, the option premiums would be lower in price. Remember, options are like insurance...the more *uncertain* the underlying asset is trading, the **more premium it will cost**.

"Learn, learn, and learn some more."
- Vladimir Lenin

The Greeks

Delta: The Delta Factor of Options (and How It Can Work for You)

The delta factor means that each option that you buy or sell will **not** increase in value on a one-to-one basis with the market. It will change based on a certain percentage of the underlying asset.

For example, if you were to buy a call option that was at-the-money and the market was to go up, you are not moving one for one with the market. As a matter of fact, for the ten cents, or the first full point, you may only be making fifty percent. If the market was to go up one hundred points, the price of your option would only increase in value about fifty points. Of course, if the market was to go against the call option that you bought, and the market went down a hundred points, your option will only go down about 50%.

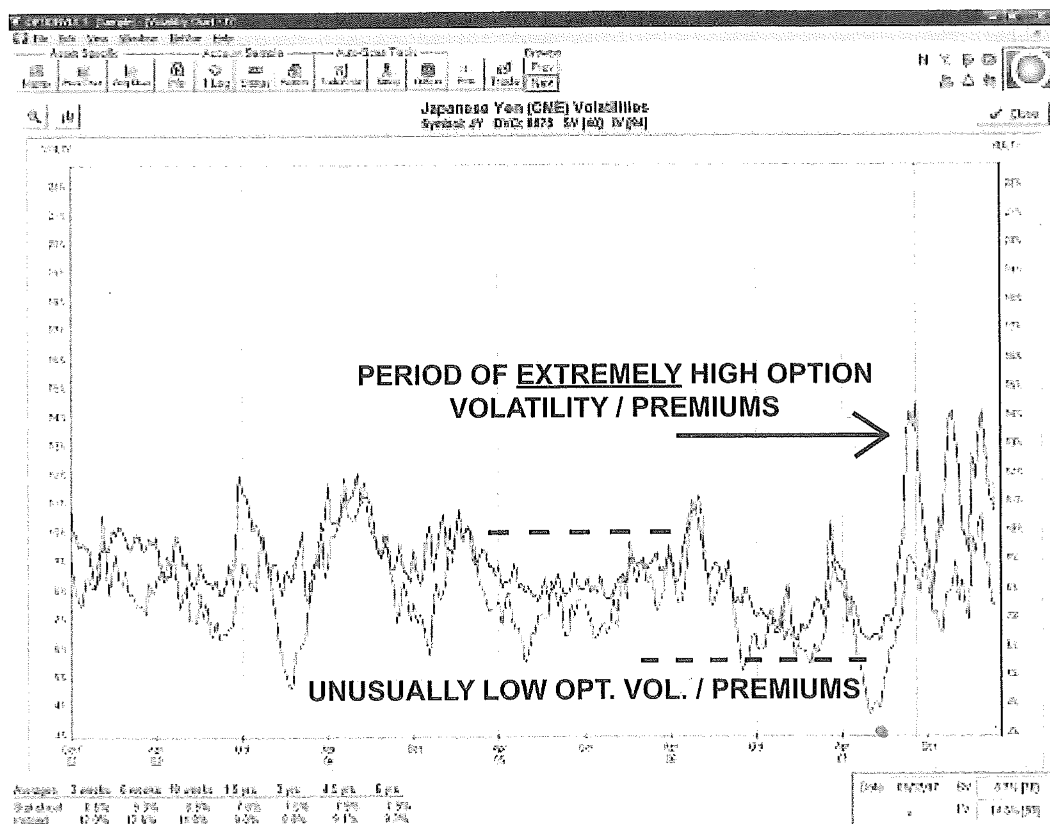
Later, I will discuss the specifics of how to use the delta factor in your favor, but right now I am more interested in introducing this term to you so that you can recognize it later on in this book. I do not want to use options as my **primary** means of speculation – remember when I just mentioned that if you bought a call option and the market underlying asset went up 100 points, then your option would only go up 50% of that amount? Well, I am not interested in that. I want to be one for one with the market, because I want to realize the benefit of the full profit potential. Besides that, when you trade commodities, you are in essence trading price – you buy low and you sell high, or you sell short and you buy back at a lower price. There is nothing new about that, and I certainly do not want to insult your intelligence. However, ***options trade just a little bit differently***. Options trade according to price **and *volatility***.

Implied Volatility

The implied volatility is directly correlated with the change in price of the underlying asset, and more importantly, the **demand for the options themselves**. We touched upon this term earlier in this section, and now we will elaborate a little bit more on it. Implied volatility is an ever-changing facet of an option's premium. Sometimes the options will have a high premium because of erratic market conditions; sometimes the options will have a "cheaper" premium because of mild market conditions.

Implied volatility fluctuates as a rubber band stretches when pulled by an outside force and retracts when the outside force is relaxed/removed. These outside forces (in the case of option premiums) are traders, just like you and me, that are "bidding up" the price of the call options in an up-trending market, or "bidding up" the price of the put options in a down-trending market. If the premiums have been "bid up" very significantly when compared to the recent past, this is known as ***high implied volatility*** - an overvalued status. When unknowing and/or unsuspecting traders buy options in this condition, **the odds are *highly* against them for realizing a profit.**

Example:



Japanese Yen option premiums reached six year highs on and off for a six month period. DO NOT BUY options under these extreme conditions. Instead, look to sell these covered options if/when the implied option volatility of the market appears to have peaked.

Theta

Imagine paying $365 per year in homeowners insurance! Now imagine if you didn't start paying for a full year of insurance, at first, but rather a pro-rated fee for the remaining 2½ months of the year. Very simply, you can divide $365 into 365 days and that comes out to exactly $1 per day. Now, if you are only paying for 2½ months, your insurance premium would be approximately $75. Each day, you can figure $1 is being depreciated from the original premium cost.

The same concept applies towards option premiums. Once you purchase (buy) an option, the premium decays as time expires to a varying degree. I don't want to beat this subject to death. However, as a trader you must be aware of this element. This is a nice concept to understand, but it is not entirely essential to our style of trading. We will buy options no closer than 30 days to option expiration. In the last 30 days, option premiums decay in a most rapid manner and the "theta" factor is most evident.

Options are a "Wasting Asset"

I can wrap up everything that I have just written about options in this paragraph. From the very moment you purchase an option, you have <u>two elements working against you</u>:

- Time Decay (*Theta*)
- Market Momentum

To be specific, once the option is purchased, small portions of the premium are lost (spent) as time progresses towards option expiration. All "time value" of the option will be worthless at the time of expiration.

If you bought a call option and the market was going down (against your position), market momentum is further reducing your option value – and rightfully so. If you bought "insurance" for a certain market price, and the market is moving in the opposite direction, then the person that is obligating the insurance (by selling the option) to you has less of a risk.

This is the primary reason why I prefer not to speculate the market buying options. In my experience, I have never seen an option trader who buys options to speculate the market and consistently profits. On the other hand, I know several traders

who write (sell) options on a consistent basis and show consistent profits – *myself* included.

New traders often purchase options because the lure of "unlimited profit potential" combined with "limited risk" appears as a hard-to-lose profit opportunity. The problem is revealed when the market goes against the position, and the trader (knowing he has "limited risk") tends to hang on to the position longer than he should due to a false sense of security. Before the trader knows it, the option has decayed so significantly it is not worth even selling back! The trader then decides to hold it until the market "comes back" – and we both know what happens next...

The beauty of this course is that you can use options to trade professionally, however you do not need to be intimately familiar with the technical aspects that influence option premiums. You very simply need to know how to add and subtract. That's all! This next section is the "meat and potatoes" of the entire material. I am going to put it all together in one simple trading methodology that is universal for all markets. Please read, reread, and understand this next section. Comprehending and practicing the trading methodology taught in this next section is the "secret" to professional trading. Your trading will never again lack a concise plan. You will be very low maintenance to your deep-discount broker (who will enjoy your business for a long time to come). The mere fact that you will know exactly what to do, a full day in advance, will provide you with emotional relief from the stress, duress, and fear that is caused by uncertainty in yourself and your trading ability. Your newfound freedom from this burden will allow you to devote your attention to other activities besides the ticks flashing on your screen or the "umpteen" phone calls to your broker on a daily basis. Read on fellow trader – discover, and enjoy!

"Knowledge is power and enthusiasm pulls the switch."
- Steve Droke

Section #2 Quiz

1. Futures contracts are also known as *cash-forward* contracts.
   A) True
   B) False

2. The difference(s) between the futures contract and the individual stock as underlying assets is (are):
   A) A trader can easily go "short" the actual futures contract.
   B) The margin requirements are substantially higher with stocks.
   C) A stock trader takes on the risk associated with business management and ownership.
   D) All of the above.

3. The factor(s) that determines whether an option is "at-the-money," "in-the-money," or "out-of-the-money" is (are):
   A) The strike price.
   B) The current asset price.
   C) The strike price of the option and current asset price.
   D) What your broker told you when the option was acquired.

4. The real value of an option is its:
   A) Time value.
   B) Intrinsic value.
   C) The intrinsic/time value *ratio*.
   D) Both A & B.

5. The anticipated forthcoming underlying asset activity is defined as:
   A) Implied volatility.
   B) Option premium.
   C) Media hype.
   D) Delta.

Section THREE – Execution of Trades

"The will to win is not nearly as important as the will to prepare to win."
- ***Bobby Knight***

Enabling objective: Upon completion of this section, you as a trader, will know **what factors to examine** *before* placing your trades. You will be able to assess options for their employment into your risk management strategy.

"Make everything as simple as possible, but not simpler."
- ***Albert Einstein***

Position Initiation/"Pulling the Trigger"

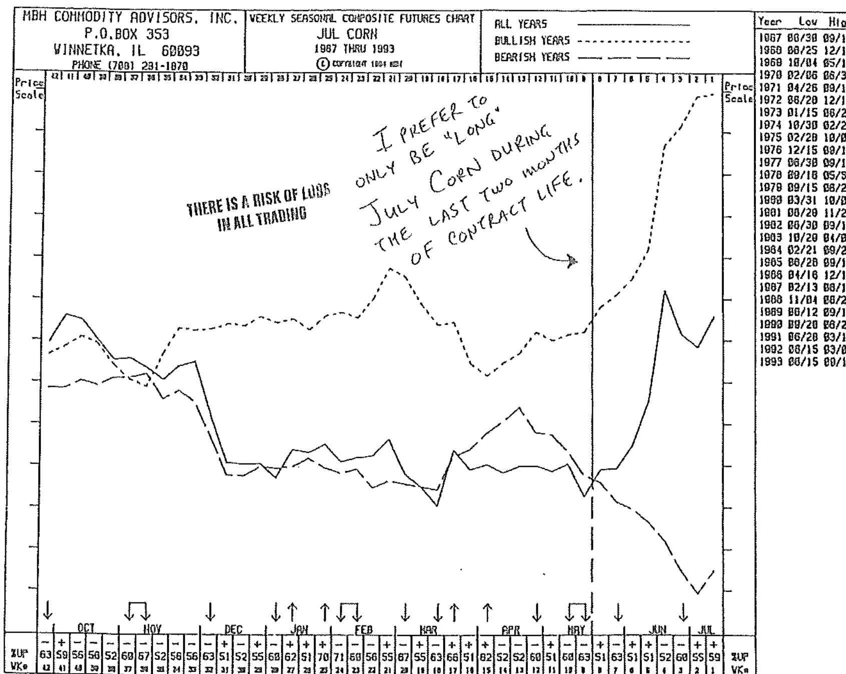
When I initiate a position, I always know a minimum amount of time that I will plan to be bullish or bearish. I look at charts subjectively, looking for higher highs and higher lows (in an uptrend), or lower lows and lower highs (in a downtrend). I look at all the things a professional is supposed to look at:

- Volume and open interest,
- Retracements,
- and of course, price structure as just mentioned.

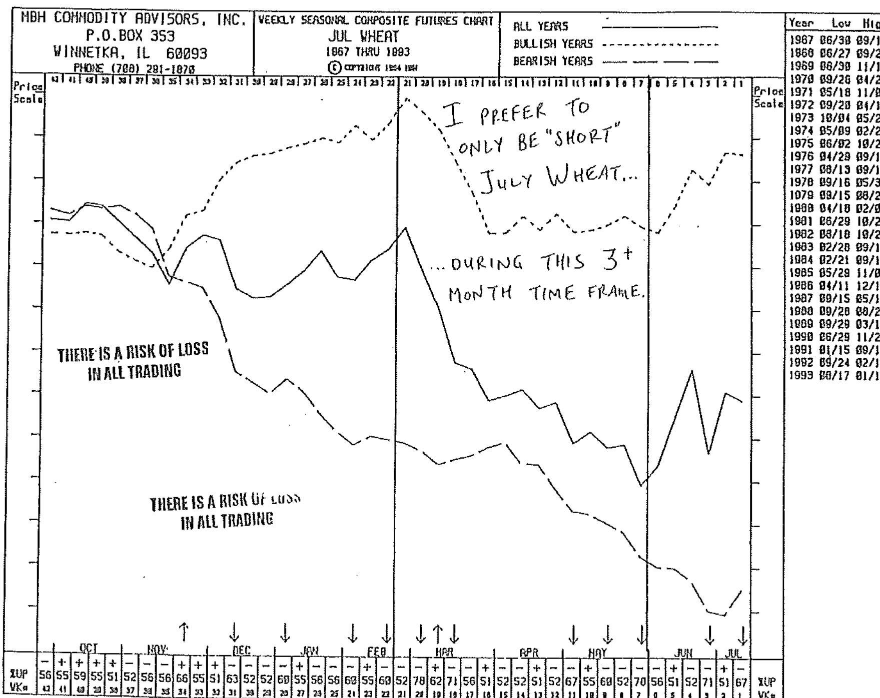
Evaluating charts and picking the trend is actually the easiest part in position initiation. "Pulling the trigger" is an entirely different story!

Seasonal tendencies also assist me in my decision-making process.

MBH Weekly Seasonal Futures Charts



MBH Weekly Seasonal Futures Charts



As you can see, in most seasonal charts there are good trends year-in and year-out that I anticipate. So when I initiate a position, the minimum time I will be in the position is what will be on the seasonal chart. I use seasonal charts for any type of product, as long as it has a computer history of compiled data which can be evaluated for certain historical trends. Of course, if the market continues with the trend, beyond the minimal seasonal time frame, I would continue with it (as would anyone else). Let price structure make the decision. We speculators are along for the ride. I would like to get you in this mind set right now...letting profits run.

Evaluation of Insurance

If you initiate a position with a futures contract only, you MUST have a protective stop working for you in the market. This, of course, is to prevent catastrophe from occurring when you least expect it. I refer to this type of trading as "one-dimensional" – picking a direction, buying long or selling short, and putting in a protective stop.

We have all been taught to risk a small percentage of our total equity for money management purposes – which I agree and endorse whole-heartedly. The problem I have found is where I place those protective stops and how long I keep them there. Eventually, when losses of substantial proportion occur, it can be demoralizing. It is hard to take those losses and be able to "bounce" right back into the market when the appropriate opportunity presents itself. Since I considered myself an "average" trader in those days, I would think other traders may have had similar experiences. New traders just starting out these days are being introduced to these dilemmas (unfortunately, with more money involved with today's volatility). I have developed a method of trading to make those days of unsettling losses a distant memory of the past!

If you were in the restaurant business, knowing that this is a very risky venture (with the competition fierce), wouldn't you feel most comfortable having some type of business "insurance?" If you are in the business of owning your own home, I am quite sure you have a homeowner's insurance policy! It's the right precaution to take, especially in these days of earthquakes, floods, and tornadoes... Well, the same concept applies to commodity trading – after all, you are trading "contracts" between you and another party. When you learned to trade commodities, you were informed that there is substantial risk involved, and I am quite sure that you have heard all the "horror" stories of traders past. We are, after all, trading 100-lot shares of stock, 40,000 pounds of cattle, 1,000 barrels of crude oil, 100 ounces

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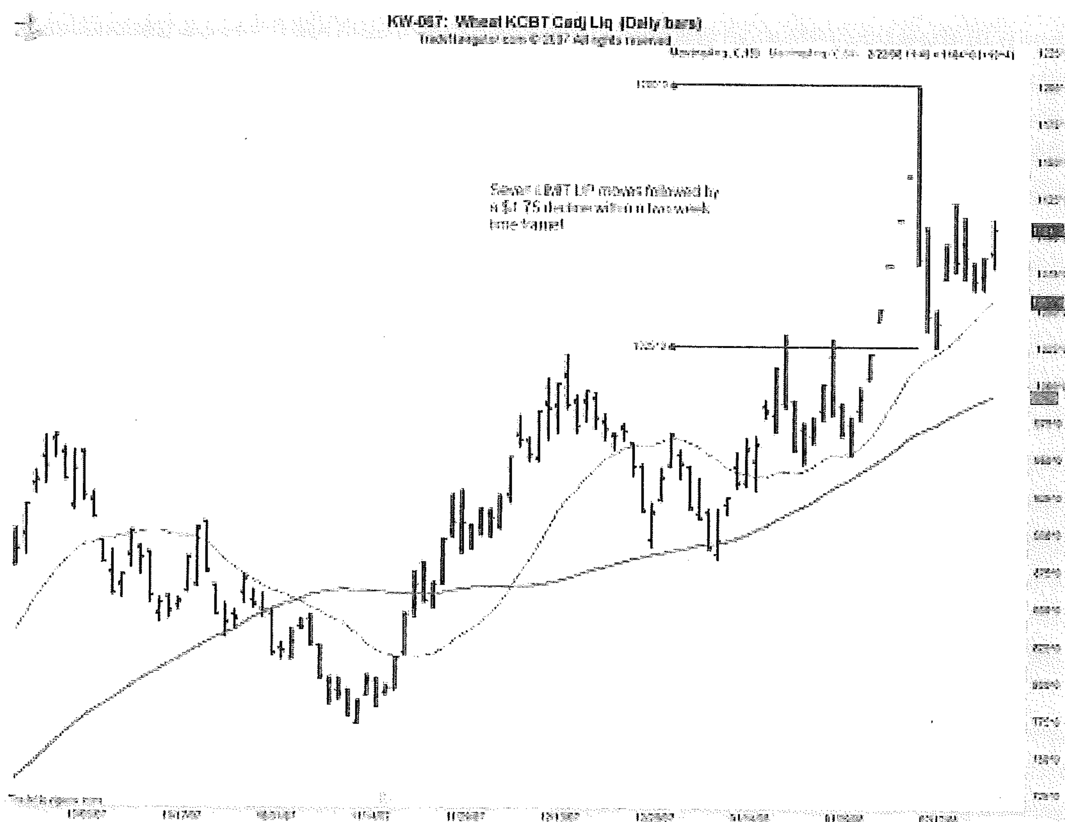
of gold, $100,000.00 of face value bonds... Catastrophes dealing with these proportions will never happen to you after you have successfully completed this book and implemented the professional risk management principles of trading.

You are probably familiar with the "insurance" that I will be instructing on – **utilizing options**! In my opinion, this is what they were intended to be used for. Here is what I am getting at:

1) I look at a chart.

Example:



The Kansas Wheat market has accelerated its uptrend by a series of LIMIT-UP moves - four sessions are locked LIMIT-UP for the entire session!

2) I identify the risk of being long at the area marked on the chart.

Example:

For those planning on being long cocoa on a breakout to new highs, risking below the last low represents a $1,500.00 (per contract) risk!

3) Let's say I pass on the trade because the "risk" (of trading one-dimensionally) is simply too much.

4) *** Enter option implementation. *** Always buy long / sell short the futures contracts and use the options for what they were intended to be, *"insurance."*

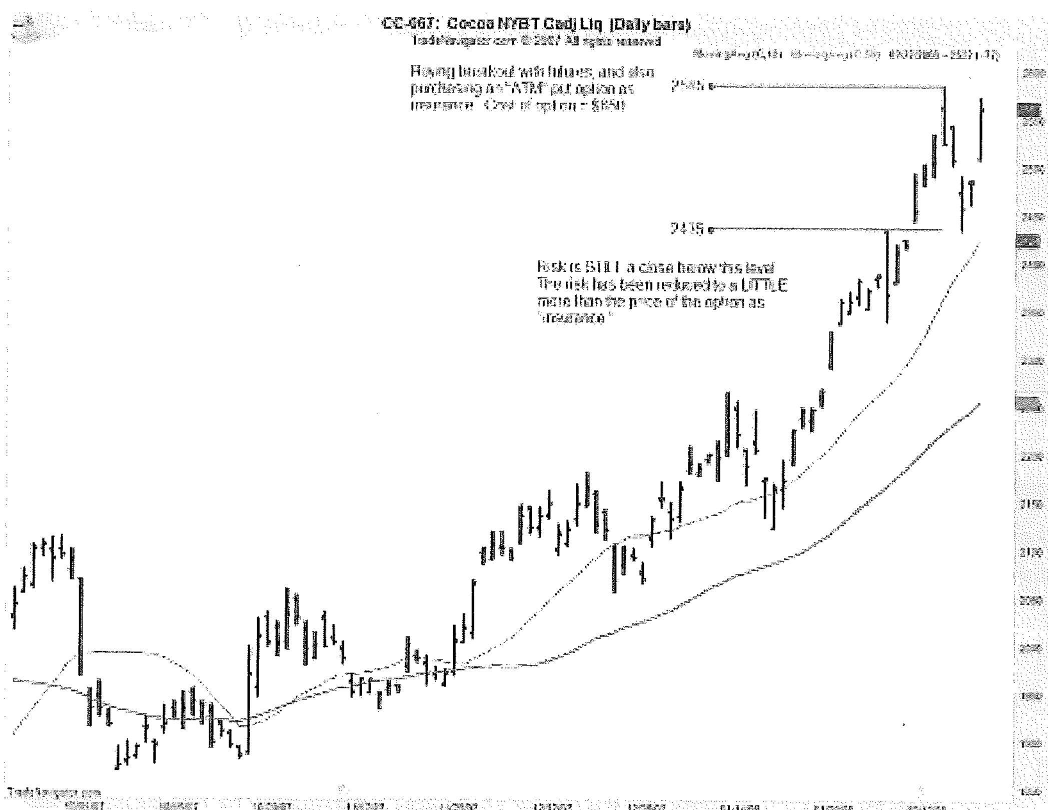
5) I consider going long the futures contract and simultaneously buying an ATM/ slightly ITM put option for a one premium transaction.

You will find times when you are hunting down a particular market with conditions that are just right (commercials vs. public relationship and market sentiment, etc.) that when you place your trade, you will not always be right. Accept this, for

it is a fact in commodity trading. When going long/short a futures contract, do yourself a favor and purchase an "at-the-money" option in the opposite direction **as insurance**! I cannot emphasize this enough. I have seen too many bull headed traders not want to put in a protective stop on their directional trade because of directional or fundamental conviction, fear of getting stopped out then having to deal with high commission costs, or just plain being stubborn!

Look, if the long futures is protected by a "long put," it still has unlimited profit potential!

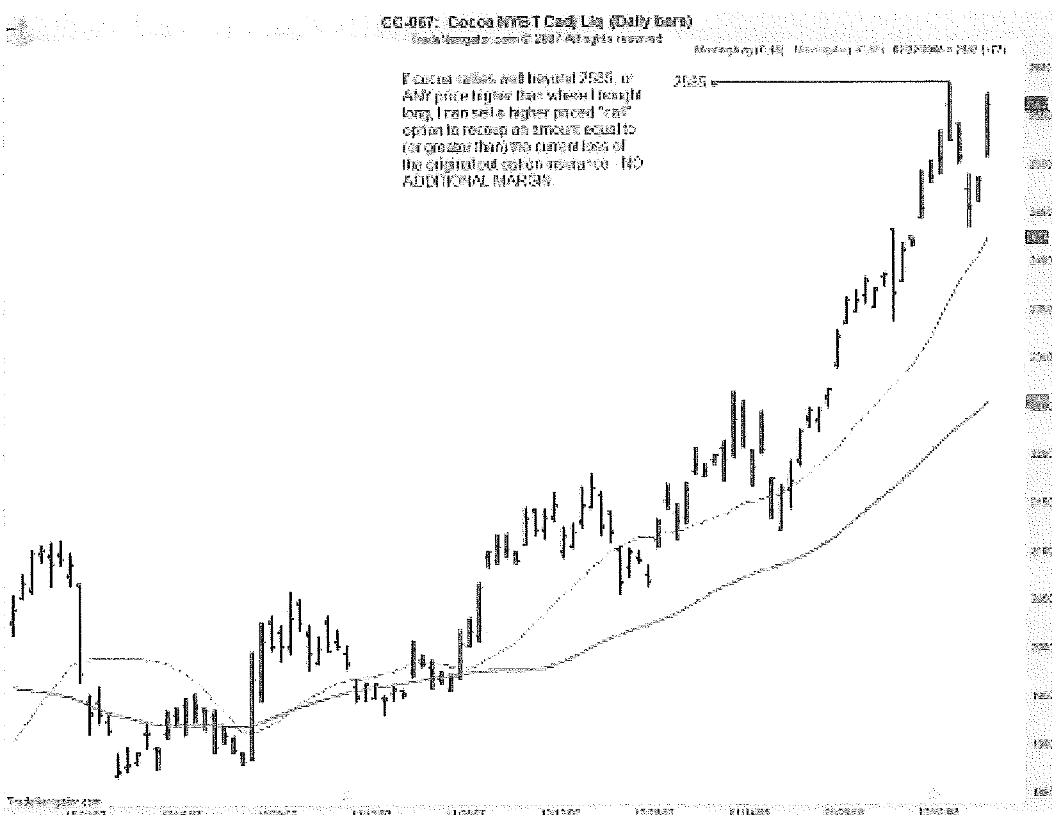
Example:



The very same cocoa trade which (this time) incorporates options as insurance will lower the overall maximum risk by more than half!

6) The premium that I pay (plus/minus the amount that it is ITM/OTM) is now defined as my maximum loss potential, until this particular option expires. Furthermore, the premium I paid as insurance can still be recouped very easily *without* adding additional margin on my position!

Example:



Once in a trade involving options used as insurance, opportunities to sell covered options will surface that, once performed, will actually lower the overall margin (holding requirements) on your position while recouping the cost of the original insurance.

7) Now I am going to become involved in a position that I believe is going to make money and produce a profit. If I am correct about the market and prices go up, my futures will make ***more*** money than my option will lose in value.

If <u>my speculation</u> of the market is incorrect, <u>the maximum loss for my position is the amount I paid in premium</u> (for "my insurance") plus/minus any amount the option is in/out of the money if I hold the position until the option expires. This, my friend, is the worst case scenario. When I initially took this position in the market, I thought the market was going to go in a certain direction. Usually, within a couple of days or so, I'll find out if I am correct or not. If I am stopped out with a loss with my futures contract, my option (insurance) will have made some profit so I will realize ***half of a loss***, or a *partial loss*, instead of <u>a whole loss</u>!

This should give you an idea how the option should work for us. Now, we will investigate the methods of selecting the best value for our option "insurance premium." You will find that if you traded options only (to speculate the market), you would have to be an options expert to consistently realize profits. **My overall technique for options, used as insurance, solely requires the ability to merely add and subtract simple numbers.** I want to give you an education about what the professionals look at in selecting options. Selecting the "right one" will depend on your personal risk tolerance, but at least you will know your risk, up front, before you execute the trade. Let's tie in what you learned in the previous section.

ATM / ITM – *Defining Maximum Risk Up Front*

When selecting an option to be used as insurance (for your futures contract), you must determine the premium to be paid and evaluate if you are comfortable with this premium versus the expected reward (or outcome).

Let's say I wanted to go long June Live Cattle. I want to buy insurance along with it, so I will look for an option with a strike price nearest the price where I plan on going long. Take a look at the example here and you will see the different strike prices for this contract. Remember, since I am going long the futures, I am buying an ATM or slightly ITM *put option* for insurance.

<u>Example</u>: Live Cattle strike prices with corresponding month days until expiration (<in brackets>)

The current live cattle options which illustrate different contract months accompanied with the number of days until option expiration (or option trading days remaining).

As you can see in this Live Cattle example, I am going long the June futures at 94.40 CWT and the put option that I am buying is a June Live Cattle 94 Put (for a total cost of 2.75 in "time value" premium) which is .40 points out-of-the-money. This means if you add .40 points to the 2.75 points paid for the option as insurance, THE MOST YOU CAN LOSE IS 3.15 points!

Days to Expiration

The life of this option contract happens to be 106 days from now. This means we have 106 days to manage the position for profits and we have a maximum 3.15 live cattle points at risk. How do you feel about *this* risk? Not a bad way to approach the markets, eh? The defined risk and 106 days sure gives me a whole lot of leeway!

As I evaluate this position, I must take into consideration how long I plan to stay in this market. Is this a trade that I want to be in for 3-4 days, 3-4 weeks, or anything in between? Next, I must evaluate (if I plan on using insurance) if the life of the option contract will be valid in the entire time frame of my intended position.

All option contracts have an expiration date, that I acknowledge immediately when considering the time frame of the position. *You* need to be aware of the expiration date as well. This is the day I must be out of my position entirely or roll-over my entire position into the next contract month. Your broker may inform you about your position that is preparing to expire, but you are ultimately responsible for knowing the key dates for YOUR trades.

I generally recommend that traders buy options as insurance with **no less than 45 days** left to expiration. As you may or may not know, options that have 30 days and less remaining before expiration will really deflate in value, but having 45 days (minimum) gives you about a good two weeks before "theta" really takes effect. This rapid time decay (theta) process affects the premium on a daily basis more extremely with 30 days, or less, remaining to expiration. Also, when it comes time to "sell" insurance against your position (which you will learn about later), you will want to sell options against your futures position in the same corresponding month, with adequate time remaining to make the premium credit worthwhile to your position.

Selection of Correct Option Contract Month

We have mentioned the importance of selecting an option with an adequate amount of contract life remaining. Most importantly, when taking a position in the futures market, the option you use as "insurance" should be of the same contract month. As an alternative, if the "front" month's corresponding option contract has little time remaining, you can still use the front month for speculating, however you can use the next month out option as insurance.

Example: It is the end of February and I am looking to go long the Swiss Franc. The March contract may be the front month. However, its corresponding options only have 15 days until expiration. I know the time decay (Theta) is going to eat the premium alive, with the short amount of time remaining, so I can elect to do one of two things:

- Go long the March contract and buy an April put option (knowing I will soon "roll" into the June futures in three weeks or so)
- or I can go long the June futures now and buy the corresponding April put options as insurance. (This would be termed a "serial month" option. More on this below.)

JUNE SWISS FRANC OPTIONS WITH 106 DAYS UNTIL OPTION EXPIRATION IN BRACKETS

A snapshot of Swiss Franc options which illustrate different contract months accompanied with the number of days until option expiration (or option trading days remaining). Although the Swiss Franc futures contracts are only available for March, June, September, and December, some markets offer what are called "serial month" options. In this scenario, March options are 15 days out from expiring and the front month futures contract will soon be June. The April Swiss Franc "serial month" options are now available which trade according to the June futures contract. When April serial month options near expiration, then May Swiss Franc Options will become available and will also trade based on June Swiss Futures contract activity.

I don't mean to throw more wrenches into the cluttered toolbox, but I could also choose to purchase the June options (shown in the example above) with the June futures. Keep in mind that the farther out in time the option contract is, the **higher premium** it will cost me. It just so happens there are "serial" month option contracts for select commodities. The Bond markets, currencies, and even some New York ag's have what are termed "serial" month options.

Currency futures are quarterly (as are the bond markets) and a June futures contract will have April, May, and June corresponding (and serial month) options. You can always buy the quarterly option contracts at any time. However, the "serial" month options are only available to trade for a duration of approximately thirty full days.

Implied Volatility in Detail

Initiating a position incorporating options as insurance should be approached in a similar fashion to that of a professional option trader seeking a viable option strategy to speculate the market. The first factor the option trader will consider, when employing options, is the *implied volatility*.

Do you remember the importance the implied volatility has on the probability of profit? Well, it is almost the same here. If you want to hop on board a futures market at a certain price (let's say near the corresponding option's strike price for convenient trade management), if the nearest option has a high implied volatility, then your overall position is at risk. This risk, however, is only at the highest range of risk until you sell "covered" options against your futures position (which we will cover in detail later in this material). The primary objective to keep in mind is *how comfortable you are* with this initial risk.

If you are strictly a one-dimensional option trader (just buying options to speculate a market), you surely would not buy an overvalued call option because of outrageously high implied volatility. However, if you are employing the principles of professional risk management, purchasing overvalued options in conjunction with a futures position will be managed and compensated by selling option premium of equally high implied volatility, thereby keeping the entire trade balanced when necessary. Again, we will explore this in more detail later.

Evaluation of Comfort / Confidence Level

When most traders initiate that one-dimensional position, there is usually a sudden feeling of anxiety about finding out whether you will be right or wrong. That familiar feeling, which we have all shared at one time or another, will be an emotion of the past when you know you are fully covered from catastrophe – no matter what happens. Just as a person with great homeowner's insurance sleeps easy at night, the professional risk manager will also find a comfortable respite and an increased confidence level in the knowledge that his speculation is fully protected from unforeseen catastrophe.

Having this confidence level, I can let the market unfold and make rational decisions based on price structure, momentum, and retracements (all of which are the most important aspects and the bottom line in trading). There is no more picking tops or bottoms in a market with unusual high risk, or cutting ourselves short of profits prematurely. This is a great advantage over the general public, which gets spooked very easily when down a thousand dollars per contract, or *up $1,000.00 per contract*!

"In the middle of difficulty lies opportunity."
- ***Albert Einstein***

Section #3 Quiz

1. What factor must always be considered *before* initiating a trade position?
   A) Indicator reading.
   B) Time in a position.
   C) The day session open.
   D) Dollars spent on commissions.

2. The GUARANTEED method of managing defined risk can only be accomplished by:
   A) Having acceptable margin.
   B) An intra-commodity hedge.
   C) Using options as insurance.
   D) Placing protective stops during overnight trading.

3. When evaluating an option to manage risk in a position, we should prioritize the strike price selection as follows:
   A) At-the-money; In-the-money
   B) Five strikes out-of-the-money
   C) In-the-money; Out-of-the-money
   D) Out-of-the-money; In-the-money

4. When initiating a position with a pre-determined two week outlook, it is strongly recommended to utilize an option with no less than ____ days until expiration.
   A) 15
   B) 30
   C) 45
   D) 60

5. The difference between "quarterly" option contracts and "serial" month options is...?
   A) The difference of premiums.
   B) The serial has only one month "life of contract."
   C) The serial can have a quarterly and a one month "life of contract."
   D) The serials only apply to New York agriculture contracts.

Section FOUR – "In the Trade"/Managing your Position

Enabling objective: Upon completion of this section, you as a trader will know how to manage and effectively control your risk in any market scenario confidently, independently, and professionally, without error or hesitation.

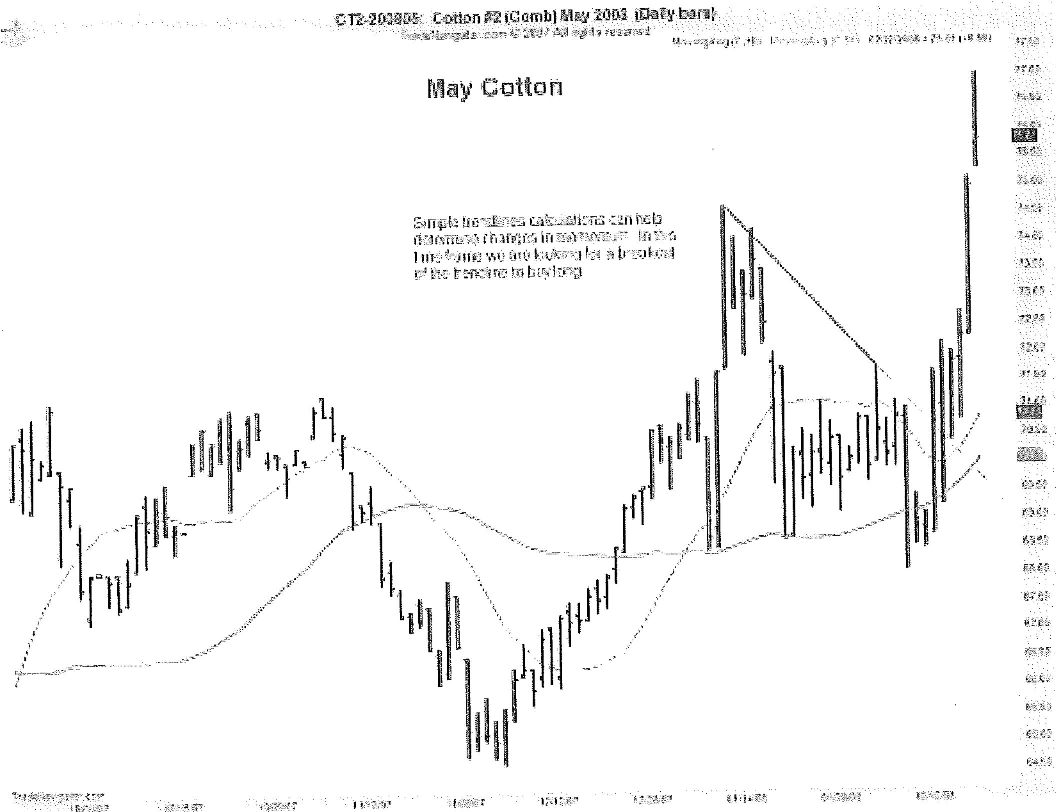
What to Look for in "Price Discovery" and Changes in Momentum

There are many things we can control in our lives. First, we decide what time we are going to wake up and get out of bed in the morning. Then we decide if we are going to shower with warm water or cooler water. We decide what we are going to wear before we leave home that day. The list goes on to about a thousand other decisions in an average day. One thing that we will never be able to control is *market direction!*

As a professional speculator, I make educated decisions regarding direction based on research, and then plan my trade accordingly (just as in my days as a Navy Diver – I'd plan my dive, then dive my plan). This is not difficult to do after two or three trades. Here is how I do it: First, let's consider trendline breakouts.

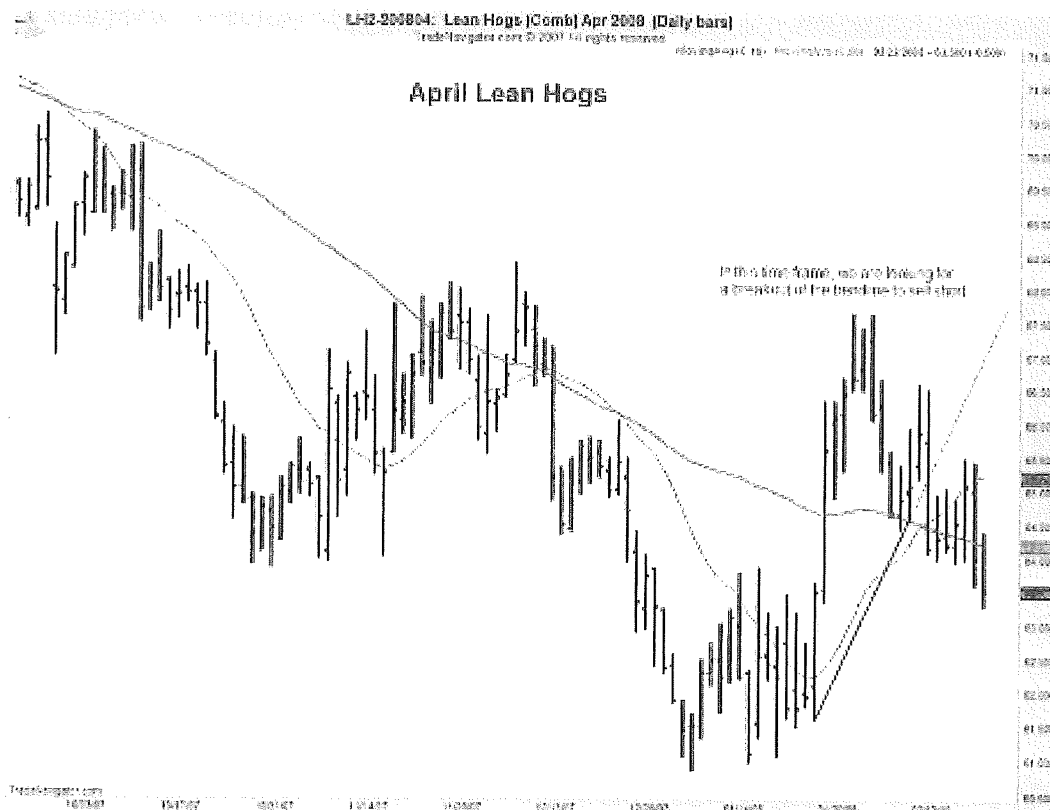
Trend Line Breakouts

Trendline breakouts are a very common way of determining when a market is proceeding to move up or down from its near-term opposite trend. Let's draw a couple of trendlines on the following charts, and you will see exactly how the trendline breakouts can point to a different market direction.



It took much market activity for cotton to reach the recent trend line. By breaching it, look for a continuation of the overall uptrend.

On the cotton chart, you'll see the trendline attempting to catch an upside breakout (as the market is trending UP). The trendline is drawn from the mid-January high in price, sloping down to the early February high. As you can see, when the market finally rallied with enough force to reach the trendline, I felt good about being long this market on this day because of the trendline breach confirming renewed strength with the trend.



In this scenario with lean hogs, we are looking for a continuation of the overall down trend. Using a simple trend line can help determine when the continuation of the down trend occurs.

The lean hog chart illustrates a DOWN trending market. In this scenario, I want to draw my trendline from the late January lows to the next short-term low during the first week in February. When the market eventually breaches the trendline, it is generally a good indication that any temporary strength in the down-trending market may have run its course.

What do virtually ALL trendlines have in common...? This is certainly not a seen one, seen them all type of art! Believe me, there are as many ways to draw trendlines as there are folks drawing them – and sometimes I think I have seen them all (other traders faxing me their work)!! You have to be consistent in drawing them – that's the first step.

Trendlines are generally drawn from **prominent highs, to another prominent high** – when probing for an upside breakout. It's just the opposite when looking for a downside breakout: trendlines are drawn from **prominent lows to another prominent low.**

The question now leads us to defining such prominent highs and lows. A prominent high, such as on the mid-January May Cotton chart, is any high trading bar (a trading day, week, month, hourly unit of time) in the marketplace that is surrounded by lower highs. There are many names for this pattern, and I mentioned one earlier: "short-term high" (as I originally learned from Larry's teachings), then there is the "hook," and "pitchfork," – it goes on and on. One thing for sure, if you look at these highs that have lower highs on the trading day preceding, and also a lower high on the day after, you will conclude these type of highs are a **prominent high in the market**. These prominent highs are eligible for trendline drawing – either beginning a down-sloping trendline with a higher prominent high, drawn to the lower right side (prominent high) ending line segment. **Whatever angle your trendline slopes, the trendline MUST continue at that particular angle into the future for forthcoming trendline breakouts.** When the down-sloping trendline is eventually breached, it may be a signal regarding the next leg up in the market!

...and a prominent low? I'm not going to leave this one out – it would be like putting on one shoe, or being supplied one oar for a rowboat – it just wouldn't be right! **The prominent low**, like those seen on the April Lean Hog chart, are those **lows in the marketplace which are surrounded by higher lows both the day before it, and the day after.** It is these lows where we want to focus drawing our up-sloping trendlines from tip to tip. Remember, when drawing the up-sloping trendline from one prominent low to a higher prominent low, the trendline continues to the right extending out into the future at the very same angle of the trendline. When this up-sloping trendline is eventually breached to the downside, at the point of "breaching" is when you might expect the next leg DOWN in an overall down-trend to be in progress.

As mentioned earlier, I can go on and on about the different ways trendlines can be drawn. For most technical traders, it is the way I describe above. Again, the point is to be consistent in the way YOU choose to draw them!

The way I draw my trendlines today is the exact way I learned from Tom DeMark's original book, ***The New Science of Technical Analysis***[1], published in 1994. Tom's method of drawing trendlines is by far the best way to measure the most recent supply and demand "climate of the market." Tom's subjective method of drawing

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[1] Source: "The New Science of Technical Analysis" by Tom DeMark. John Wiley & Sons, Inc. 1994. Reprinted by permission from Tom DeMark. The following are trademarked by Thomas R. DeMark: TD Lines™, TD Demand Line™, TD Supply Line™.

these trendlines is so respected and precise that his trendlines are actually trademarked by him personally. I am the type of person that when I learn to do something right, I practice it over and over again until I develop my own style from a solid foundation. Tom's original publication came along at a perfect time when I was looking for subjective direction with using other technical tools for charting. I highly recommend any trader (both futures and stock markets) consume themselves with this book and any other material written or videotaped by Tom DeMark.

As you can see in the previous two charts, this is a very elementary (but effective!) way to determine direction from a daily/weekly/monthly chart. It requires patience to allow the market to make the necessary formations/patterns in order to draw the trendlines from short-term highs and short-term lows. By allowing the market to tell us its intention on direction, we can use this as an important factor in our trading.

The most important breakouts, and the trendlines you want to PAY MOST ATTENTION TO, will be in the direction of an established market trend – just as the breakout to the upside is in the above cotton chart (cotton already being in an established UP trend), and the breakout to the downside on the lean hog chart.

This is it for trendlines, folks. A useful tool to use as immediate direction *reference only – and that's where it stops in my work.* **I never use the price at the breakout point of the trendline itself for order placement.** *I have other "trigger-pulling methods" for that purpose. We'll get to those soon enough...*

Volatility Expansion Breakouts

After my third month of being a commodities broker, I had to do something about all my clients doing different things in the marketplace, and me being able to keep track of it all! Many of my clients wanted to "pull the trigger" on trades at current market price after asking me "*what I thought about it.*" This is the last thing you want to ask a broker (...serious conflict of interest here)!

If my clients wanted my honest opinion, and were depending on me for it (as an honest person), I had to dust off my old computer and start analyzing markets like I used to before I agreed to put trading aside and focus on being a broker only. I came up with a simple daily measure of the market using the prior day's/week's

trading range – a concept that Larry Williams introduced me to a couple of years earlier and now approved of for preserving equity.

What most trends (in general) have in common is when they trend up or down for a few days (let's say as little as two days to as long as seven to nine trading days), they usually will not retrace certain percentages of the prior day's range from the day session open ("DSO"). As soon as the market stops going up, after three or four days, when the market finally retraces a certain percentage of the previous day's/week's range from the DSO, the market usually retraces in the opposite direction. This changes the near-term momentum of the market. All markets are very different, and from this point forward I will use a default percentage of 70% of the previous day's range for volatility expansion breakouts unless otherwise noted (55%, 70%, 110%, and 150% are my "go-to ranges" for all my markets).

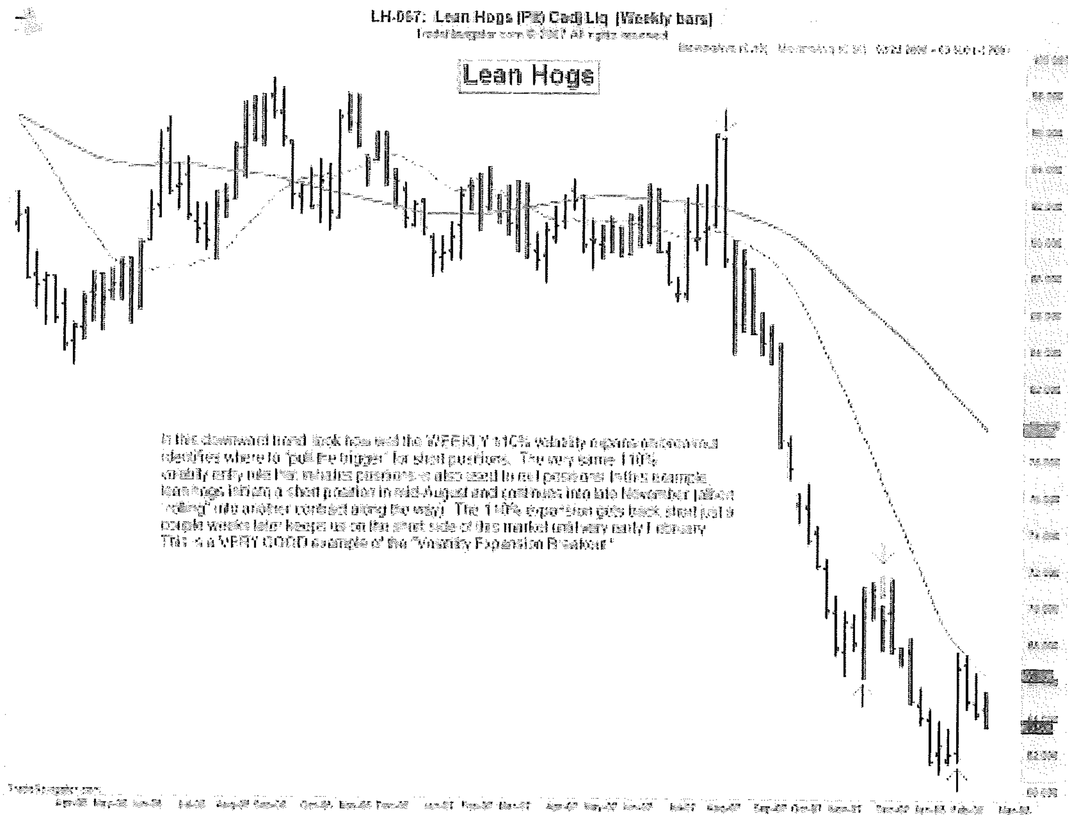
To calculate the possible change/continuation of momentum for tomorrow's trading session, I very simply subtract the prior session's low from the trading session high. For example, if the prior day's high was 7640, and the low was 7590, then the range I would use for the 70% expansion breakout would be 50 points. I will take the 50 points and multiply it by .7 (70%) in order to generate the 70% range in that particular market's unit of measurement (cents, points, or ticks).

Here is an example of this simple calculation:

Prior Day's High	.7640	.7640	.7640	.7640
Prior Day's Low	.7590	.7590	.7590	.7590
Day Session Range [high – low]	50 points	50 points	50 points	50 points
% of Range to Buy/Sell Tomorrow	28 points 55% of range [.55 x range]	35 points 70% of range [.7 x range]	55 points 110% of range [1.1 x range]	75 points 150% of range [1.5 x range]

Now that we know how to calculate the "Volatility Expansion Rule," I would like to show you just how powerful this technique is. Look at how you can tell, with just a simple glance, how the market will open and continue to trend – whichever way the short-term momentum is headed – up or down.

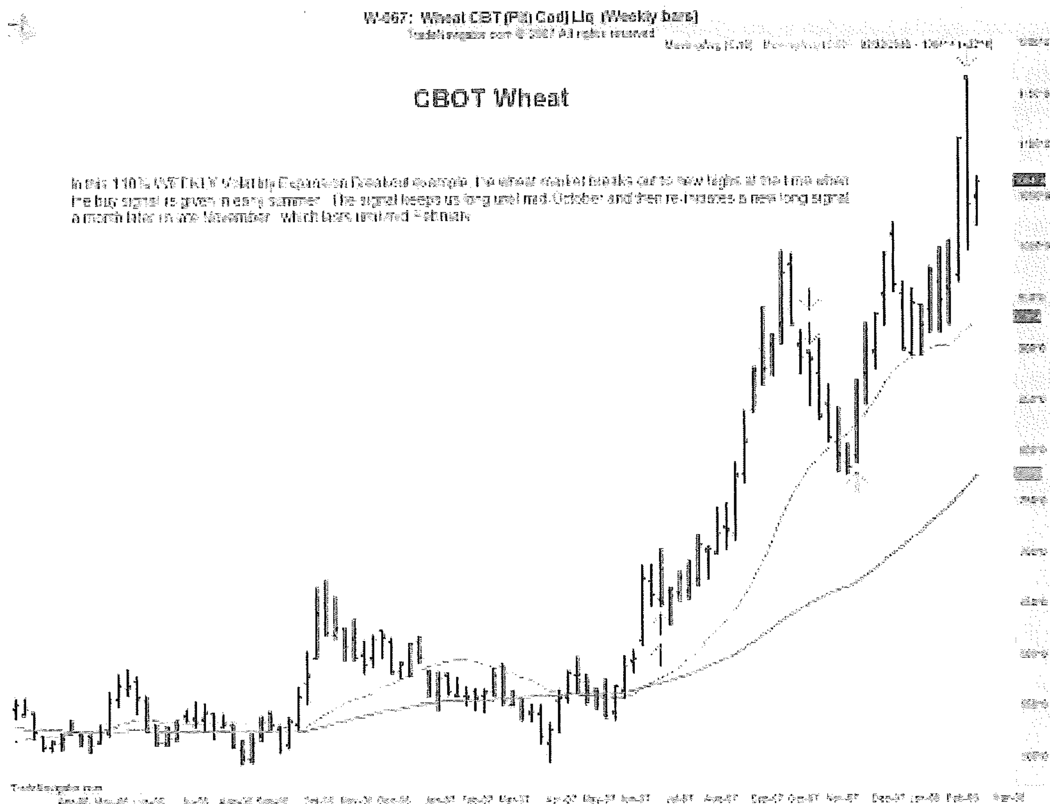
Refer to the following chart:



Volatility expansion breakouts in the direction of the overall trend can help a trader enter trend trades, and a volatility expansion breakout in the opposite direction can likewise get a trader out of that position!

As you can see in the above chart, the major trend is DOWN. When the market completes its corrections to the downside, look how well taking 110% of the previous week's range from the weekly open works in "pulling the trigger." Look how well taking 110% of the previous week's range from the weekly open works in selecting a protective stop, or rather, in determining when the next change of momentum may occur.

Here's another example of what I am describing:



Another example of volatility expansion breakouts helping to get a trader in the wheat market WITH the overall trend, and out when momentum is against the overall trend.

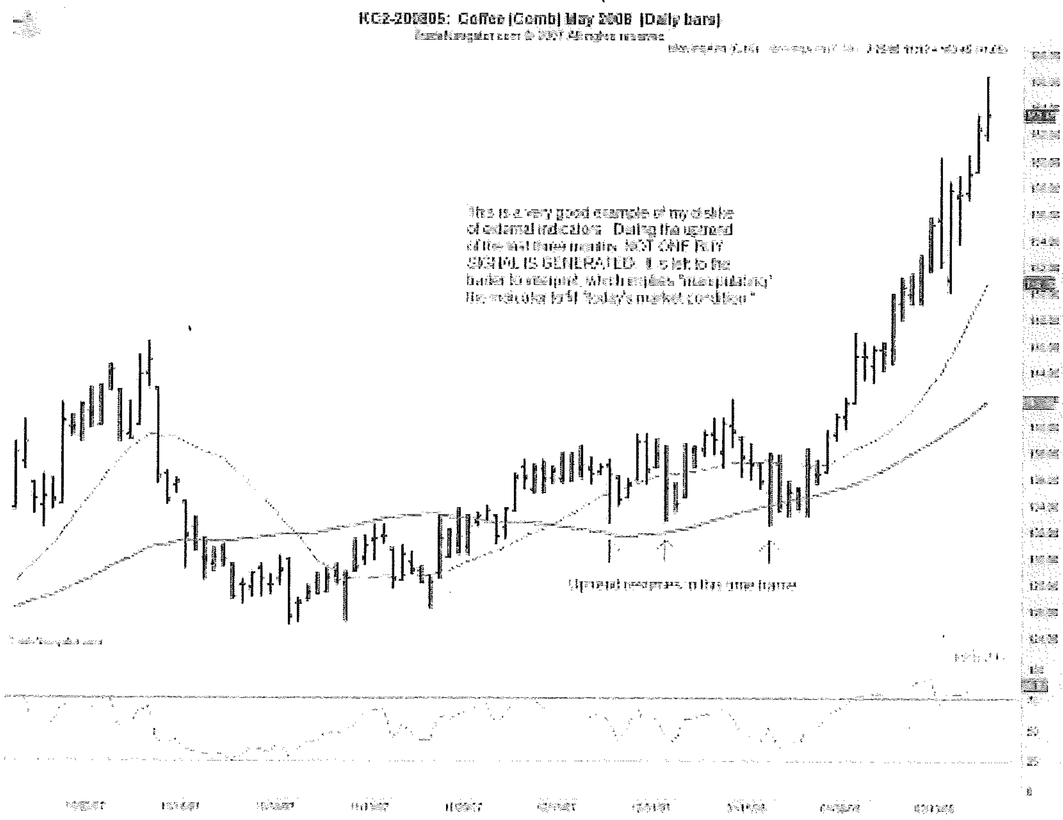
I believe price is the true indicator. Being able to follow price on a daily basis, you will be guaranteed never to miss a major move in either direction. No more having to wait for that top or bottom to completely form! No more having to dissect the news stories or having to monitor every economic report as it affects your particular market. **Let *price* be your guide*!***

"The truth is not always the same as the majority decision."
– Pope John Paul II

Types of Indicators

There are two types of indicators that most traders usually consider in their day-to-day trading activity: "external" and "internal" indicators. First, let's talk about *external indicators.*

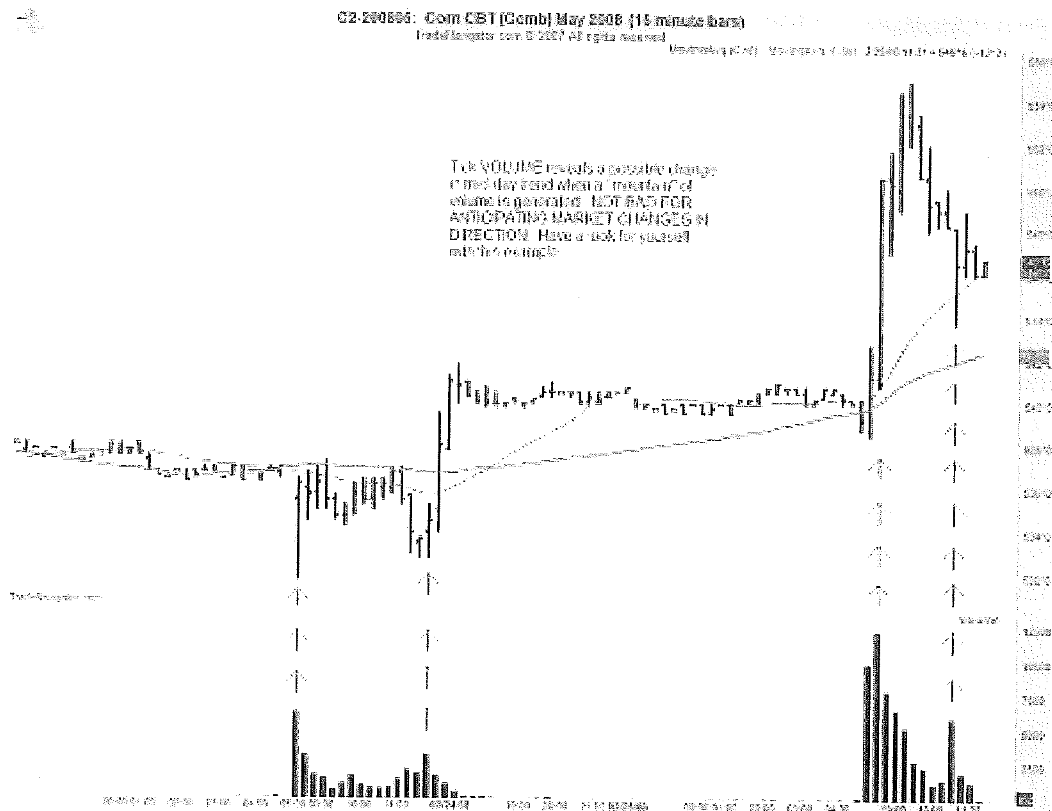
External indicators are those indicators that provide "direction" after it already happens. Simply speaking, it lags after price discovery. What good is that? If you jump on board the market, it is a higher risk trade because the market may be already due for a correction. This in turn could stop those traders who have placed "tight" stops. External indicators are the common indicators such as: RSI, stochastics, and MACD. The following is an example of an external indicator providing direction after the market has already moved.



External indicators (or "lagging indicators") fail to provide trading signals even when the coffee market is in the midst of an all out trend change. There MUST be something better...!

Internal indicators, on the other hand, are indicators that happen within a trading day, providing us traders with direction – now. Larry Williams' "Ooops," volatility expansions (55%, 70%, 110%, 150%, etc.), trading volume, and market sentiment are all internal indicators. Here are a couple of examples:

When looking for trading signals WITH the overall trend, Larry Williams' signature "Ooops" signals have been consistently proven reliable.



Tick volume indicators have little "lagging effect" and are generally a good indication of a short-term high / low in the marketplace.

Two more important "internal" indicators that are most useful in my trading are the ones that Larry Williams introduced me to several years ago in his original publication titled, "***How I Made One Million Dollars Last Year Trading Commodities.***" These are the 10-week moving average and the "%R" indicator.

First the 10-week moving average: Before I take ANY position in the market (long or short), I will first evaluate the 10-week moving average for which direction I should be trading in the marketplace.

What IS a moving average...let alone a "10-week" moving average for that matter? For those of you unfamiliar with a moving average, it is to be considered a "smoothing of price" when compared to the sometimes volatile up/down action on a price chart. If you were to take 10 days of closing prices, let's say 1.00 point incrementally between the prices of 71.00 and 80.00, and you added them all up and divided that sum by "10" (for a 10-day average), then the average price would be considered "75½." Now drop off the first day's price of 71.00, and if the market continued UP at a rate of 1.00 per day, and on the 11th day the market closed at

81.00, then the 10-day moving average between day #2 and day #11 would now be 76½.

Let's see...so far we have 75.5 and 76.5 – what comes next? Well, we need at least THREE DAYS / Units of Time in my book in order to determine a likely direction, or trend, of whatever it is we're examining for decision making purposes. Let's continue with following price for a 12th day...

On the twelfth day the market closed at 82.00, so we drop off the price of 72.00 11 days ago and now include day #3's price of 73.00 and add them all up one-by-one to today's last price of 82.00...and the average price of the last 10 days is now "77.5." Do you now see the pattern here? ...75.5, 76.5, 77.5: It looks to me that the moving average is climbing, and this continuing of climbing moving average prices indicates the trend of the market is UP.

This method of determining a moving average can effectively be applied not only to days, but weeks, months, quarterly, years, and even hourly – any standard of time! Let's use "weeks" from this point forward – specifically the 10-week moving average.

Be aware on the daily charts a measurement of one week in time is actually FIVE DAYS of trading. Thus, a 50-day moving average is synonymous with a "10-week" moving average. Easy enough...? Let's go forward from here...

If the 10-week moving average is trending higher, I will take ONLY "long" trades. If the 10-week moving average is trending lower, I will ONLY take trades to the "short" side. Another popular variation of this simple observation is if the market is trading ABOVE the 10-week moving average, be on the buy-side of the market. If the market is trading BELOW the 10-week moving average, then of course look to be a short-seller. If, in the course of the trade, the 10-week moving average were to change direction on me, my recourse of action would be to simply look to offset/reverse my position. Keep this in mind as we evaluate more charts throughout this material.

In the business of futures trading, I want to keep the decision making to a minimum. I let the indicators that can be relied upon make the decisions for me. My ONLY responsibility is to CALL MY BROKER to manage my trades (These days, after 11 years of the same ol' thing, I email my brokers my instructions the night before – and catch the most beautiful trout the Southern Fork of the Snake River has to offer the next morning.)!

One of Larry's signature indicators I also depend on is the %R indicator. This indicator is a gem when it comes to initiating positions, as you will soon see. It works by comparing today's closing price with the range of closes for the past 10 days. If today's close is in the lower 25% of ranges of closing prices of the past 10 days, then the %R is considered to be signaling buy signals forthcoming. Just the opposite is true of the market closing in the upper 25% range of closing prices of the past 10 days – look for sell signals to follow.

The "trick" with this indicator is that it must be used with a simple moving average, or a directional trend indicator of your preference. For me this is the 10-week moving average.

When the 10-week MA is trending higher, signaling only "long" positions should be initiated, then the optimum time to look for such signals is when the %R is in an oversold status – or in the lower 25th percentile of closes in the past ten days. Again, it is just the opposite with a lower trending 10-week moving average. If I am specifically looking for a "shorting" opportunity, then the optimum time to start looking for one is when the %R indicator is in overbought territory – or the upper 25th percentile of closes of the past 10 days!

By no means am I trying to "re-teach" this basic piece of information. This is merely an introductory explanation of proper use of these two indicators that have been used for over 40 years! Larry still updates his signature "%R" indicator as a necessary trading tool.

More Price Structure

The following two factors also are used as "trigger pulling" indicators:

Gap Opening and Reversals

What I love best about the Day Session Open (DSO) is that once the market opens, within seconds I know what my plan for the day is. If the market opens outside of yesterday's range, I know if the market retraces back into the prior day's range ± 3 market ticks, I know where to get in (or get out of) that market.

For example: If I had been long a market, and for the past 4 or 5 sessions the market was going in my direction, and then the market opens high one morning (above the prior day's high), I know exactly where I'm going to move my protective stop and/or hedge my position accordingly (provided I wish to maintain a bullish posture):

Long market from 110.00 on 25 April

Market closes at 117.50 on 30 April (High for the day was 117.70)
Each Market tick is .05 point

On 01 May the market opens at 117.85 (Now we have a classic Larry Williams Ooops "sell" signal potential – with my special twist added to it!)

HERE IS THE FORMULA TO CALCULATE
MY VERSION OF LARRY'S Ooops TRADE.

For a sell signal:

Formula
Yesterday's high – 3 market ticks = Price to act or react with position

117.70 - .15 = 117.55

117.55 is the price I will take profit/hedge position. More on this later in this section.

Example #2 (Gap open to the downside when short a market):
Short market from 110.00 on 25 April
Market closes at 103.50 on April (Low for the day was 103.45)
Each Market tick is .05 points
On 01 May the market opens at 103.00 (Now we have an Ooops "buy" potential)

***Now for a buy signal*:**

Formula
Yesterday's low + 3 market ticks = Price to act or react with position.
103.45 + .15 = 103.60
103.60 is the price I will take profit/hedge position.

That's it! We'll be referring to Ooops buys and sells throughout this material. This is the official formula for both the buy signals and the sells.

Intra-day Retracements

I remember from my broker days that often a market would just take off, one way or another, after some type of report had just been released. All the brokers would hoot, holler, and yell at the excitement of the market's reaction as viewed on our computer screens. I think I was one of the few brokers sitting down figuring out the math should the market abruptly reverse direction on my clients.

How many times have you witnessed a market explode, which you thought would be to the moon, only to have the market retrace and reverse itself by the close that very same day? If you have never witnessed this phenomenon before, let me forewarn you of this ordeal – it will happen, but it doesn't have to take you by surprise. Just as I originally wrote this, I recalled an incident where I was long a whole bunch of 10-year T-Notes (my favorite market) one morning going into a major report. The report was positive for the notes and the market shot up. As I was patting myself on the back, I then watched in dismay as the market ran its course to the upside, stopped, and began slowly ticking down against me! I am not sure if I offset my position or not at that time, but let me assure you this is how I do it years later, with experience.

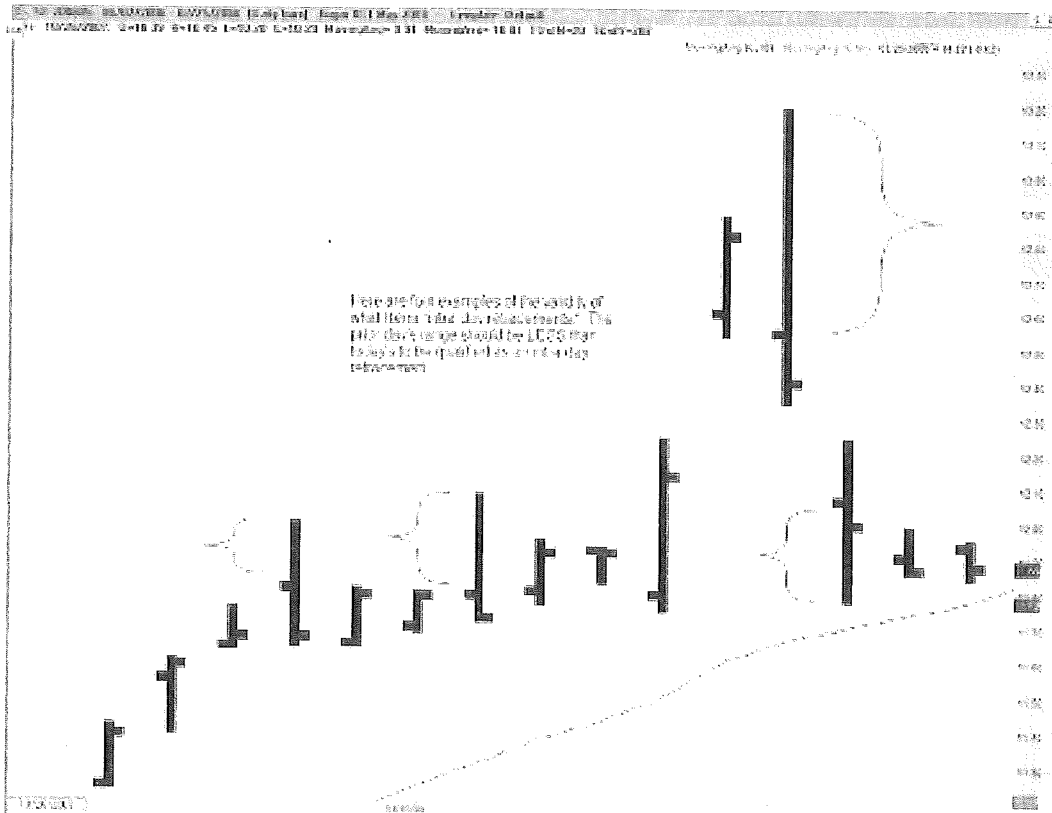
Once the market opens, I immediately look for a gap-reversal / "Ooops" signal, and then I calculate my volatility expansion price from the day-session open. I will then await the report (I will not put in a protective stop because I have the option working as a hedge – more on this later). If the market soars in my direction, I will

observe the range for the day, thus far. If the market retraces, let's say 70% of its intra-day range, this is where I will offset/hedge my position. The market must show evidence of moving decisively in my direction first. Then, if for whatever reason, the market retraces that 70% (or whatever percent volatility expansion I am using with this particular market) – there is something wrong...

<u>*Example #1*</u>:

Here are examples of two signals occurring on the very same trading day - the latter confirms the validity of the prior. I even missed highlighting one in between the fourth and the fifth arrow in early December 2007! Do you see that long-range day UP where the market opened MUCH lower...?

Example #2:



When an up trending market is trading to new highs and suddenly backs off 70% of its intra-day range, it may be a good indication to step aside and reevaluate the position. Just the opposite is true when a market has pulled back from new highs. In this close-up view of sugar, the first three intra-day retracements offer opportunities to exit the market, while the fourth intra-day retracement suggests any more downside may be limited.

The best time, I have found, to check if a market has made a significant 70% volatility expansion retracement (if you do not have the luxury of monitoring the market "real time"), is at least 10 - 20 minutes before that particular market closes. This enables me to observe if the market is going to close, or has been displaced 70% from the direction it was originally trending. If it has, I have plenty of time to do my math, and make the appropriate decision to either offset or hedge my position. In the next section, you will find why I like the *70% intra-day retracement rule.*

Chart Retracements

We have gone over price structure and momentum. Now let's cover what I believe is the third-most important aspect of trading – chart retracements. When a market is trending up, and we're long, of course we want the market to get where it wants to go – immediately. If you are a stock trader, you most likely have to wait longer than we commodity traders for this to happen. But even in the commodity world, we have to wait just like everybody else for the market to go where it wants to go. While we are waiting, the market will make a series of retracements. When a retracement is completed and the market heads in its original direction, it has completed a "cycle."

If you have been trading for at least six months, you have most likely heard the saying "buy dips and sell rallies." I have certainly heard this, and continue to hear this, on a consistent basis. The commentators that say these words, however, never have the courtesy to tell us just exactly where to buy the dip or sell the rally! I will clarify this once and for all, right here and now.

I use the standard Fibonacci retracement areas of 38, 50, and 62%. What this means exactly is, if the market is in an upward cycle (with the overall trend) for a few days, and is breaking out to make higher highs – eventually, the market will stop going up and will have to correct a certain amount. The common areas of retracement are, again, 38%, 50%, and 62% of the entire move. Once the market has reached the first retracement level of 38%, I am looking for the first signs of strength to enter this market by noting any of the following:

<u>In order of precedence</u> –

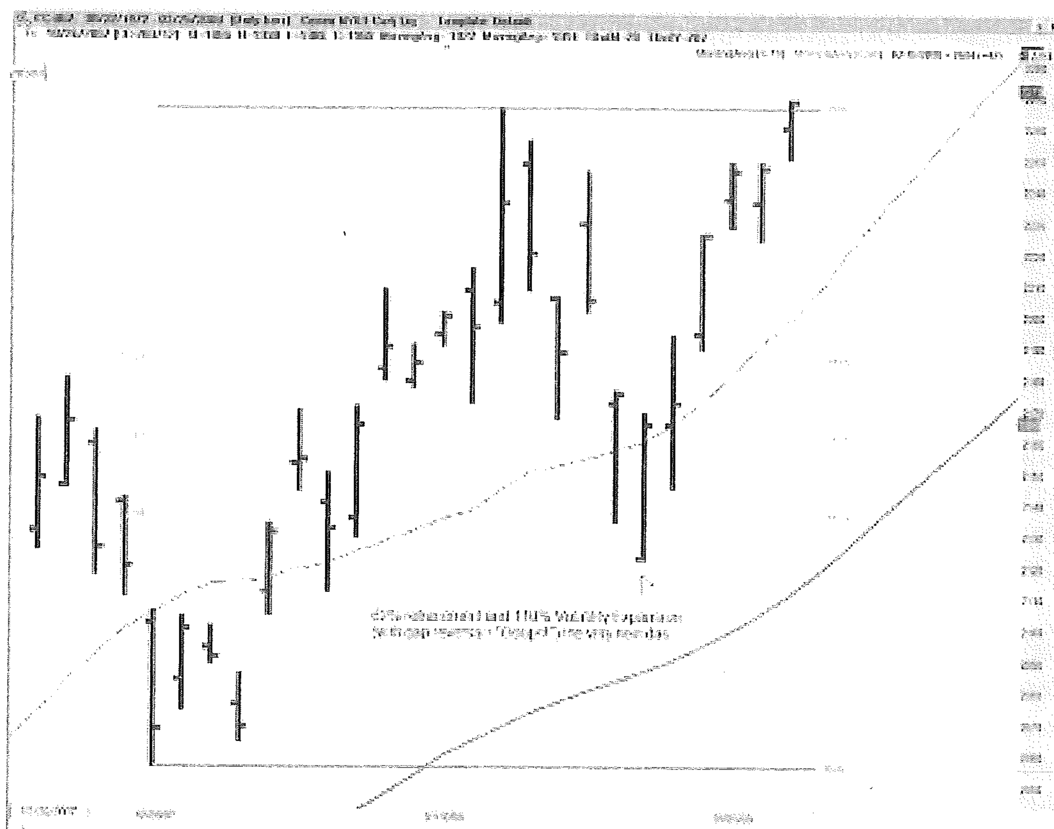
1. An "Ooops" buy signal.

2. An upward move of 70% of the previous day's range above today's DSO.

3. An intra-day retracement back up form a previous sell-off (this is rare).

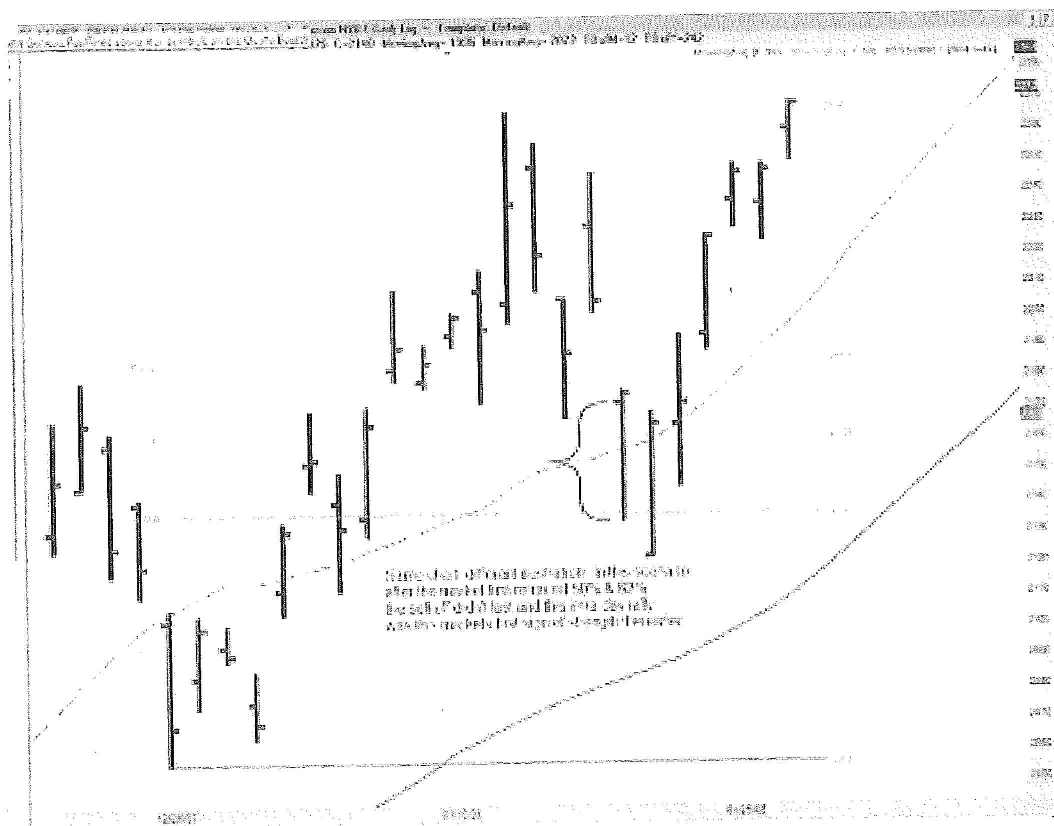
If any of these three occur, after the market has reached a 38%, 50%, or 62% retracement level from the last high to the last significant low, this is a sign that the "smart money" or "strong hands" have reentered the market. This seems to be the safest time, or least risky time, to enter the market or work your position accordingly (again, more on this later).

<u>*Example #1*</u>*:*



Conventional retracements of a market are followed by signals to re-initiate trades with the overall trend.

Example #2:

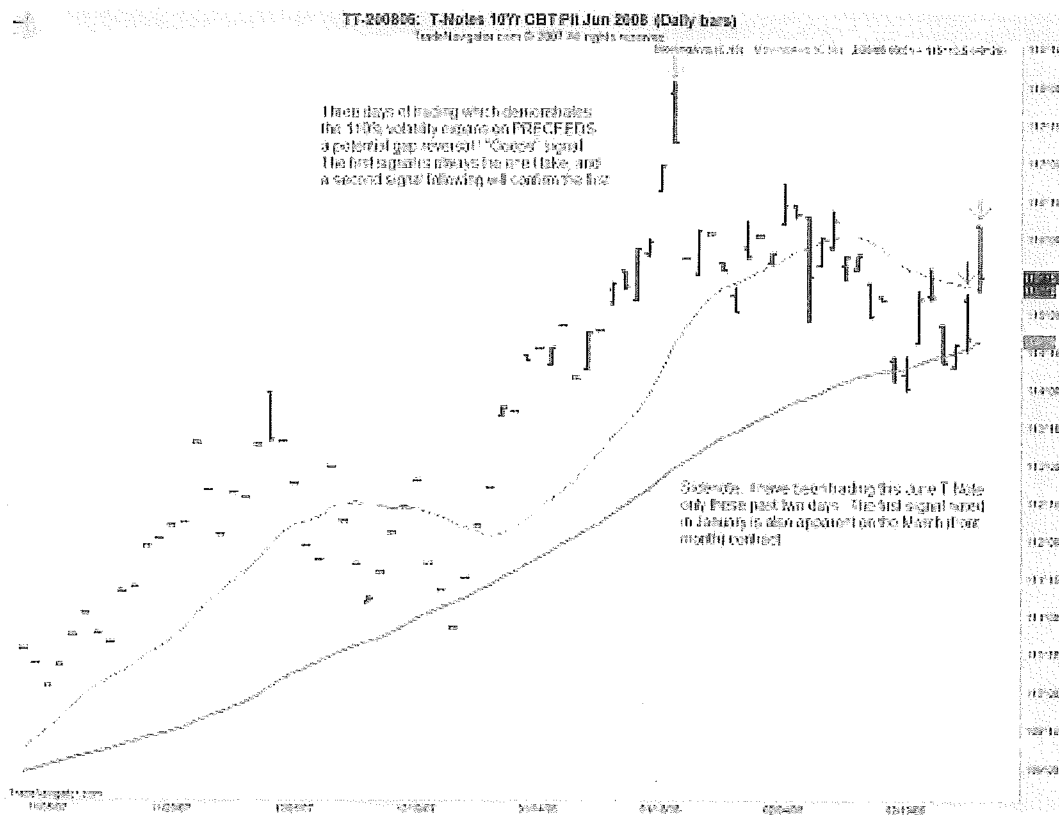


Same chart illustration as the one before, but take notice the 70% intra-day retracement after a pull-back was the markets first sign of renewed strength - the day before the dual signal!

"A pessimist sees the difficulty in every opportunity,
an optimist sees the opportunity in every difficultly."
– Sir Winston Churchill

A good number of market openings will present an "Ooops" opportunity, and chances are this may be the first signal to occur. Sometimes they are reliable, sometimes they are not. One thing for sure, though...from my experiences, if an "Ooops" buy signal occurs at one price (let's say 76.25) and the market continues higher (to a price 70% of the previous day's range – let's say 76.40), well, the second price of 76.40 confirmed that the "Ooops" buy signal *was valid and the market is indeed cycling up.*

Example #1:



Here are examples of possible dual signals to occur in one day, but in this 10 yr. T-Note example the volatility expansion breakout will occur first.

Just the opposite may occur. Let's say the market gaps grossly away from the previous day's range, and you know instantly there is an "Ooops" buy or sell potential, but that's not going to occur until the market moves 65 points from its DSO! If you figured the 70% rule as 35 points from the DSO, and the market does indeed move 35 points from the DSO, well, that changes/reinforces the momentum. Furthermore, if the market moves 65 points that same day (in that direction), you have had ***two*** *determining factors indicating a momentum change/ confirmation.* *Any second signal to occur, of course, confirms the previous signal* **if they occur in the same trading day**.

"Opportunity is missed by most people
because it is dressed in overalls, and looks like work."
– Thomas Alva Edison

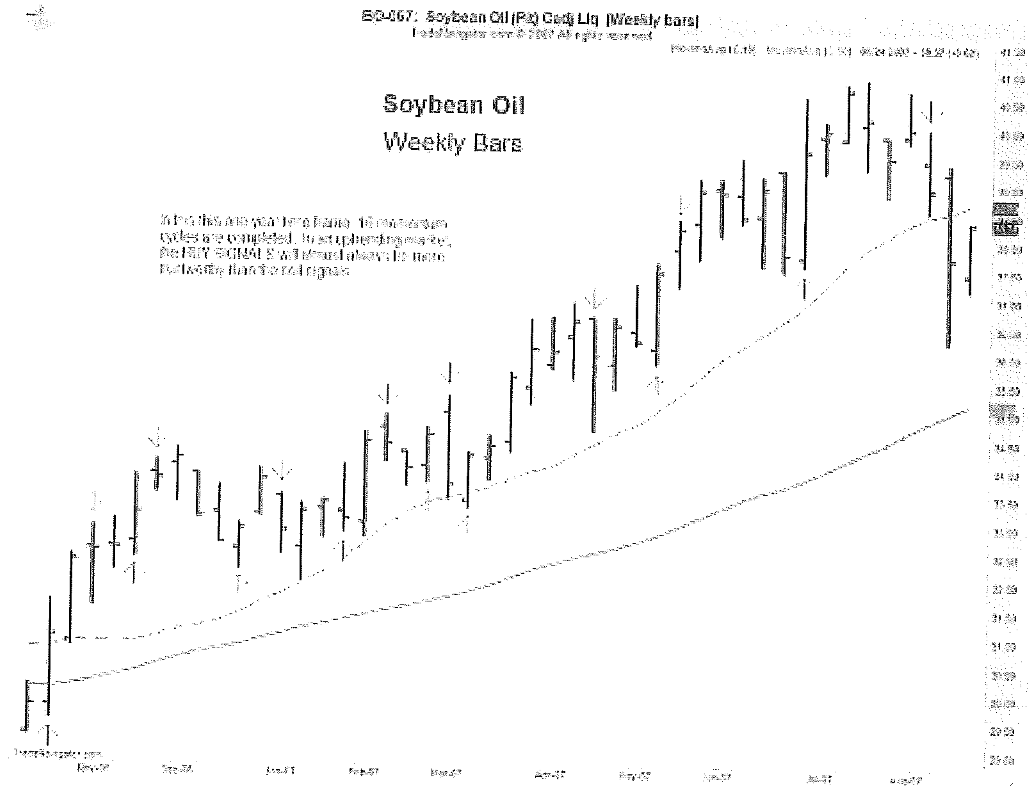
Cycles from which the market can be reevaluated

When the market retraces from a short-term high to a short-term low, I determine this to be a "downward cycle." When the market moves from a short-term low to a short-term high, I call this an "upward cycle." Usually, if the overall trend is up, the upward cycles will be stronger in both the magnitude and/or duration. In trading with the trend, our goal is to initiate/adjust positions when each upward cycle begins, as long as it stays with the overall upward trend. Conversely, our goal is to initiate/adjust positions when each downward cycle starts during an overall downward trend.

In this section, I will discuss how to employ cycles as a general trade timing tool (to within a day). As soon as you have mastered this important indicator, you can then concentrate on initiating your position using price structure as the actual intra-day initiator (pulling the trigger).

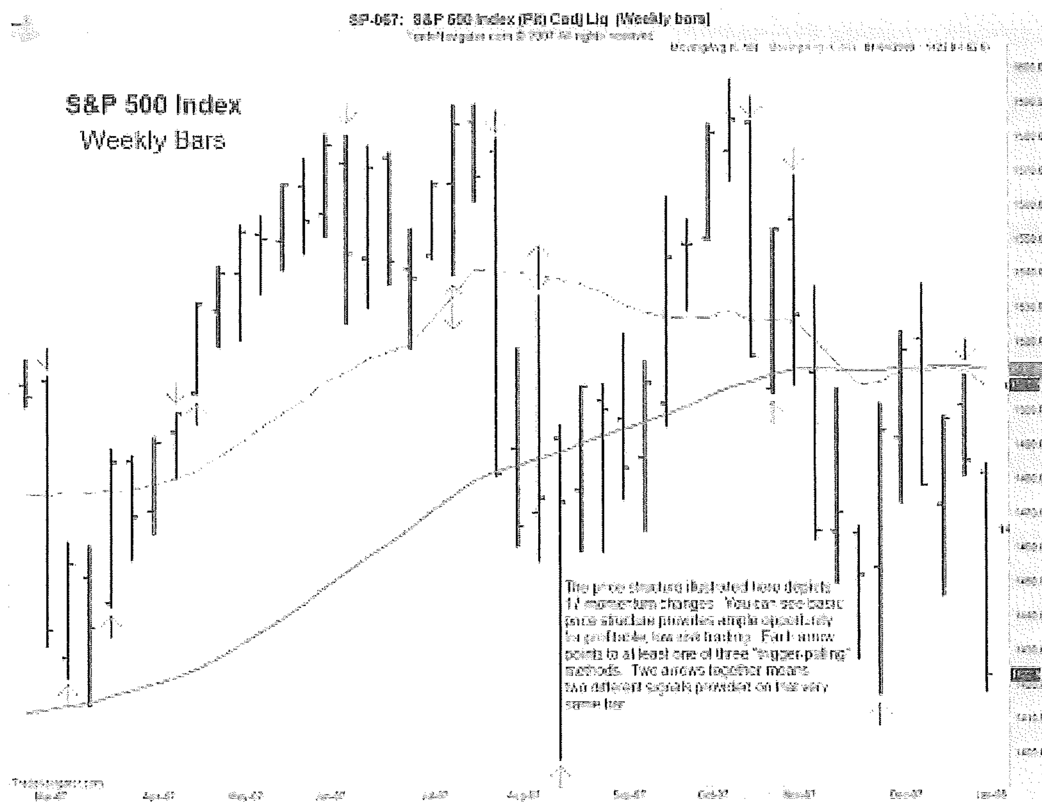
Here are a couple of examples of cycles as I am explaining to you in this section.

Example #1:



A one-year time frame (weekly bars) depicting each momentum change with soybean oil. The buy signals in an up trending market are the ones to pay most attention to...

Example #2:



Another yearly time frame (weekly bars) depicting momentum changes with the S&P 500. Plenty of opportunity.

Higher Highs/Higher Lows? Or, Lower Highs/Lower Lows?

As you can see in the first chart, in an overall uptrending market the upward cycles have produced generally good timing signals while the downward cycles were not reliable money-making signals. This is basic Commodity Trading 101 – Trade with the Trend. You certainly don't need me to tell you this, but I just want to show you that in an upward trend, an upward cycle will produce higher highs and generally higher lows.

Just the opposite is true for a down-trending market. In an overall down trending market, the downward cycles should produce generally better timing signals, while the upward cycles should not be profitable signals. *I* am reiterating the fact that when the trend is down, the downward cycles will produce lower lows and generally lower highs. These higher highs or lower lows are a critical aspect of what we will be looking for to catch major trends with our style of trading.

After we have initiated a trade, and have established a position in the market, we will continue to use these cycles in order to determine whether we will stay with the position, hedge the position, or close the position. Remember, you only make money when you are in the market (...and the challenge for us is to have a strategy that keeps us in the market)!

Reevaluating the Entire Position Based on Cycles

Let's say we have initiated a long position in the bond market. We timed the trade perfectly once a major retracement had been made and the first sign of strength, thereafter, was given. We went long the futures, and we bought an ATM put option as insurance. The market is currently in an upward cycle. Our strategy profile, at this point, is unlimited profit potential/limited risk.

If the market is making higher highs (with the overall upward trend), I know I have a good position, which could last weeks/months! As long as the market continues with the higher highs, I want my position to be that of when I initiated it – unlimited profit potential/limited risk. If the market, however, fails to make a higher high during this upward cycle, then I have to ask myself a simple question: *Am I still bullish?*

If price structure dictates that we are still in an overall upward trend, we may just be in for more corrective action to the downside. I can either liquidate my entire position and reset anew later (when the cycle resumes its "northerly" trek) or, I can very simply sell a (covered) call option above the market to reduce my risk from my original purchase price of the insurance.

As a professional trader, reducing my risk at every possible opportunity is my number one goal while in a position. I know if I can manage the risk of my position carefully, the market cycles, momentum, and price structure will take care of the profits (*if there are to be profits).* I also know most traders fail to realize that reducing their risk is the most critical part of successful and profitable trading. Reducing your risk can come in various forms: moving protective stops closer, hedging with futures contracts, and selling covered options.

Redefining Our Earlier Goals

Let's take a brief moment to reflect on our primary goals with the marketplace. When we discuss technical aspects of trading, often traders become frustrated or engrossed in details and become oblivious to the overall purpose we are trying to attain. In light of this, let's quickly take a moment to reflect on our overall goals and objectives. There are three objectives which I believe form the foundations of most successful, consistent, and sustained trading strategies for profits and are crucial for any professional risk manager.

The first objective should go without saying – make money, whether it be supplemental income or a primary means of income with a high enough account size. Everybody that is making a living with the markets as a primary source of income has started out just like you! Don't ever let the markets or the road to the ultimate goal intimidate you from realizing your dreams.

The second objective is almost as important as the first, and this is to not lose the money you came in with. The key to preserving equity is to have a trading plan that includes initially risking only small amounts of capital. It doesn't matter what markets you trade (stocks or commodities), the important thing is that you have no more than 25-30% of your total account equity margined at any one time. There is no need to have any more than this margined. If you follow the simple rules I am outlining in this section, for successful and competent trading you will find that you only need involvement in a couple of markets to make money.

You need to find a brokerage that charges the least amount possible for commissions. As a small trader, exorbitant commission fees and broker costs may whittle your account equity down quite rapidly. I remember, as a new trader with an account size of $3,600, I made approximately 25 round-turn trades. Commissions were about $108 per trade (commissions plus additional "junk fees") – almost my entire initial account! If it wasn't for the coffee market bull run of 1994 and Larry William's guidance, I am afraid I would have ended up part of that "90% losing statistic" for commodity traders. The information in this course alone will provide the necessary knowledge which should prevent you from becoming part of that 90% statistic too.

The final objective is to perpetually learn more about the markets. By trading the markets with low-risk strategies presented to you in this material, you are able to look at the markets reasonably and <u>without having to make hasty and forced decisions</u>. Knowing that your position is covered at all times and using the natural

cycles of the market trends, you will be able to evaluate your position at all times and see patterns reoccur over and over again. At the same time, your positions should be profitable using prudent risk management techniques, which mean you are realizing your primary objective while learning more about the markets.

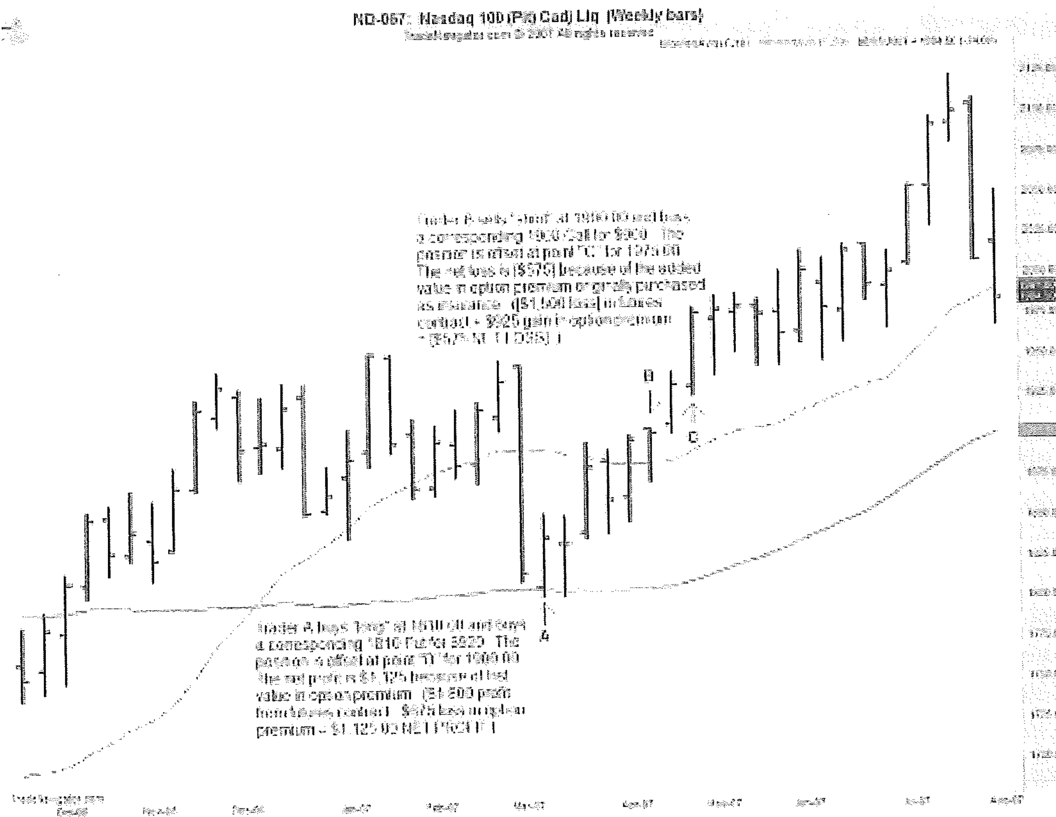
When the Trade/Momentum Goes in Your Favor, Hold What You've Got

We can all relate to the great feeling it is when the position we have put on starts going our way from trade initiation. My style of initiating trades is a common way to get into the market, when these circumstances are most likely to occur (initiate a position and have it go your way immediately). As long as you are positioned in the market and the market momentum is going your way, hold what you've got. Your trading profile is "unlimited profit potential, limited risk." In other words, we're letting our profits run!

When the Market Shifts Momentum

Eventually, the market will change direction in the midst of an overall trend, and the choices that we face as traders are two-fold: offset the position ("exit" entirely), or hedge the position ("adjust" to lower risk)? If I am positioned long, and the market changes momentum downward, I must always ask myself one simple question – Am I still bullish? Eventually, I won't be bullish anymore and I will very simply offset my entire position – futures and options (insurance). If the long futures position that I initiated four days ago is a profitable one, the put option I initially purchased with it will most likely not be worth as much as I originally paid for it. The profit on my futures contract should be greater than the loss on my option (insurance), resulting in an overall net profit to my account.

Example:



The tale of two traders: Trader A buys "long" the NASDAQ at 1,810.00 and purchases a corresponding 1810 put option for $920 for "insurance." The position is offset at point "B" when the market is trading at 1,900.00. The net profit is $1,125 because of lost value in option premium. ($1,800 profit from futures contract - $675 loss in option premium = $1,125.00 NET PROFIT.)

Trader B sells "short" at 1,900.00 and purchases a corresponding 1900 call option for $900. The position is offset at point "C" when the market is trading at 1,975.00. The net loss is only ($575) because of the added value in option premium originally bought as insurance. ($1,500 LOSS with futures contract + $925 gain in option premium = ($575) NET LOSS.)

If the same position that I initiated four days ago is "in the red" and I decide to liquidate this position, the loss on the futures contract may, or may not, be substantial. The option contract (insurance), however, will most likely have a positive value enabling me to realize only a partial loss, or half of a loss, instead of a whole loss (as if a stop loss only had been in place). This is the basic benefit of using options as insurance. There is more to come...

When Momentum Shifts Against Your Position, But You Remain Bullish

Now we are getting into the "meat and potatoes" of this material. If, again, the long position that I initiated four days ago does indeed have a profit and I am still "bullish" the market, I will most likely elect to maintain my bullish posture. But now I can hedge my position by reducing my risk even further! Here is how I will do it:

Let's say I am long the Aug Live Cattle market from 6605 and now (four days later) the market is trading 6945. The Aug Live Cattle 6600 put option that I bought for 1.60 points ($640) is now worth 45 points ($180). Because the futures realized 6945 today, this has shifted the momentum, from up to down, and I must do something with my position. My outlook on cattle is still "bullish" for the next five weeks. If I get out of my position, I risk the chance of the market "gapping" up and having to "chase the market." I will choose to remain long, but **I will now sell a call option** *(as high above the market as possible)* **to recapture an equal amount of premium (or more) as I am currently losing on my original 6600 put option**. If I bought the option for 1.60 points, and it is worth .45 points now, the option I will look to sell will be worth 1.15 points, or more. As I check my option quotes, I notice that the 7000 call is worth 1.17 points. This is the option I will choose to sell to recoup my loss on the original put option (insurance) purchase. Now my overall risk on this entire position is a mere .43 points (1.60 points – 1.17 points = .43 points of risk)! Plus, I am already ahead 3.40 points with my long futures position!

Date	Futures	Option 1 (Original Insurance)	Option 2 (Short/ Covered Option)	Overall Position Risk	Current Profit/Loss
Start Day ("SD")	Bought Long @ 6605	Bought 66 put for 1.60 pts.	N/A	1.65 points [$660]	N/A
SD + 4	6945	.45 points	Sold 70 call For 1.17 pts.	.43 points [$172]	

Keep in mind, this position profile has now changed from "unlimited profit potential, limited risk" to "limited profit potential, limited risk." How am I supposed to "let my profits run" with this new profile, you may be asking? Just remember, the market must be going UP for my "long" position to profit. I determined that the market was shifting momentum (short-term) when August Cattle traded at 6945 for whatever reason – trendline breakout to the downside, heavy volume on a short range day, or volatility breakout to the downside. Whatever the reason, my responsibility as a professional trader is to minimize my risk at every opportunity just as I was taught to initiate a trade at every opportunity! If the trade was meant to be, the profit from higher cattle prices will take care of itself. If not, my risk has been reduced substantially and I will still most likely make a nice profit on this trade. Before we continue with this trading scenario, I will detail this trade in a more concise format now:

"We are what we repeatedly do.
Excellence, then, is not an act, but a habit."
– Aristotle

A Detailed Outline of a Basic Trade

1. Initiated long futures position at 6605. Bought one 6600 put option for 1.60 points.

2. Monitored the position every day for potential downward price movement, which would indicate a possible "shift" in momentum.

3. On the fourth day, I determined that a price of 6945 would shift the momentum, from up to down, and when 6945 was realized I evaluated the overall trend as still "bullish."

4. To maintain my bullish posture with this market, and to further reduce my risk, I evaluated how much my original put option (insurance) was worth NOW. I determined the difference and calculated the net loss as 1.15 points.

5. I then looked to the different strike prices of the call options, and "evaluated" the premiums. I specifically looked for a call option that was worth a minimum of 1.15 points.

6. Once I determined the 7000 call option was the optimal strike price to sell, I sold it short with it being "covered" by my long futures position. (There is no additional margin by selling this call option short when it is covered by a long futures position. In fact, the margin is actually reduced by the credit the short option creates!) Total risk: .43 points for 82 days of protection and trading plus a $1,360.00 open profit!

7. Now that the overall position risk has been reduced even further, this allows me even more time to reevaluate the market as price structure unfolds. I am now letting the market tell me what it wants to do...whilst knowing I am fully covered, I feel like I am really going someplace in the markets with a low-risk / low-stress method of directional trading that can be used in any market!

If Option Premiums Do Not Warrant Selling

If you've been with a position for quite a while, and find you are unwilling to sell call options because the premiums do not warrant selling, you may elect the alternative of buying "cheap" options as additional protection in order to "reduce risk."

Just this week, I went short a Treasury Bond position with an ITM call option as protection (insurance). The market had moved against me (as it has for the past few trades – I have been cold lately with Bonds), and one of my colleagues suggested buying an option that was getting ready to expire in three days. This is the amount of time I thought the market would take to finish its upward cycle. Since the options were so close to expiration, they were not worth selling. Spending $110 on additional protection was definitely worth it for both a good night's sleep and as a prudent reduction of risk at the appropriate time. Instead of being down $968.75, with my purchase of the call option insurance, and the "cheap" option I bought, I am only down a mere 96 bucks!

This short section is intended to highlight trading near option expiration (within 2-3 weeks). The closer I hold my entire position to the actual option expiration, the less premium there will be to sell the options. When you find yourself trading this method I am teaching, you will know whether the options should be used to hedge by selling (the highly preferred choice), or buying "cheap" options (ones that cost less than $200, and maybe one or two strike prices away).

Resetting Your Position

Getting back to our original scenario of trade initiation, once a position is executed, and the momentum has shifted against me, another alternative is to "leg out" of my futures position while holding my option. Let me be more specific...

It is the end of August, and I am looking to go long Dec Wheat. The trend has begun to show signs of turning up, with price structure demonstrating higher highs and higher lows. Other indicators have also turned to the upside. When the momentum has shifted up, as per the "volatility expansion rule" let's say, I am then "pulling the trigger." I am long the Dec Wheat futures contract from 3.11¼¢ per bushel and I have purchased a Dec Wheat 310 put option for 15½¢. I have determined my total risk to be 16¾¢ for the next three months of "protection" (15½¢ of option premium + 1¼¢ cent of OTM distance from strike price = 16¾¢ of maximum potential loss).

Date	Futures	Option 1 (Original Insurance)	Option 2 (Short/ Covered Option)	Overall Position Risk	Current Profit/Loss
Start Date "SD"	Bought Long @ $3.11¼	Purchased 310 put for 15½¢	N/A	16½¢ [$837.50]	N/A

As long as momentum continues to track with my position, I will continue to hold my position intact. Eventually, the market will change momentum back down and, if this still is indeed an uptrend, the downward move could be brief. As per my indicators to measure momentum, when the momentum turns down another alternative (besides selling a "covered" option to reduce my risk) is to very simply offset my futures only. I would only select this alternative if my futures position had a substantial profit at an obvious point of resistance. My strategy here would be to liquidate my futures contract only and reset at a lower price when the next buy signal/change in momentum to back upward presents itself.

This is the objective of most traders – beginner and experienced alike – to catch a trend and **stick with it until the very end**. The problem that some traders, or shall I venture to say, most traders (since most of them are said to lose money) have is they don't have the simple patience to stick with a trend after a significant amount of profits have been realized. The attitude seems to be that "the well has run dry" when, in fact, the market is always in perpetual motion. As long as you can "harness" the natural cycles of the market, profits will always be there for you. Professional traders that make a living from the market are always working in cooperation with these natural cycles in order to generate never-ending profits!

Another problem I have found personally with getting out of a futures position with a significant profit, and then looking to reset at lower prices, is the fact that eventually the market gaps up significantly in the direction I want to go. The challenge is finding just the right place to jump onboard! I think this has been a challenge, at one time or another, to all traders. If you plan on practicing this alternative strategy, you must write down on paper what it is you will do to pull the trigger when the market gaps up, or experiences a "breakout" without you. As long as you continue to practice the same method over and over again, you will succeed in the markets.

"The habit of persistence is the habit of victory."
– Herbert Kaufman

Initiating Anew

To resume the Wheat scenario, I originally went long the Dec Wheat futures contract from $3.11¼ per bushel and purchased a Dec Wheat 310 put option for 15½¢. My total risk was 16¾¢ for three months of "protection" (15½¢ of option premium + 1¼¢ cent of OTM distance from strike price = 16¾¢ of maximum loss potential). Three trading days later, the market continued up to a price of $3.21/bu., and after a couple of cycles of upward and downward momentum, I determine that the market may go down a good amount for the next cycle. I now decide to offset my long futures position and retain the profit. I'll let the market go down as far as it wants to go and when the market finally bottoms out, and momentum shifts back up, I will go ahead and reset my long futures position, holding the original put option as insurance once again.

Three potential scenarios can happen at the price of resetting the long futures position:

1. The option will be Out-of-The-Money (OTM). The long futures position will be ***above*** the put option strike price.

In the case of #1 above, I have to take into consideration the total overall risk. If I reset long at $3.16/bu. and my original put option (purchased at 15½¢) is 6¢ OTM, then my overall risk is now 21½¢. No matter what happens, I have already paid 15½¢ for my put option. If I plan on being long again at $3.16/bu., that means the option won't start the insurance 1:1 until it is ATM – and that is a full 6 cents away (as in, lower in futures price). This is almost 5¢ more overall risk than my original position, but keep in mind I have pocketed almost a full 10¢. This 21½¢ risk may be necessary.

Date	Futures	Option 1 (Original Insurance)	Option 2 (Short/ Covered Option)	Overall Position Risk	Current Profit/Loss
Start Date "SD"	Bought Long @ $3.11¼	Purchased 310 put for 15½¢	N/A	16¾¢ [$837.50]	N/A
SD +5	$3.16	12¢	N/A	21½¢ [$1,075]	9¾¢ $487.50

Another idea would be to evaluate the time value of the Dec Wheat 320 put option. If the 320 put option has a premium of 21¢ (and the Dec futures are at $3.16/bu.), then the intrinsic value is 4¢ and the time value is 17¢. The better choice, in this situation, would be to simply sell back the 310 put option and buy the 320 put option at market (as a spread). There will be a 3½¢ loss that must be deducted from the current closed *profit.* Considering that this is less than the intrinsic value of the new option, this choice is still "the better deal." This is just like starting over again, as the initial position had a 16¾¢ overall risk, but now the overall risk is only 17¢ with about a 10¢ closed profit!

Date	Futures	Option 1 (Original Insurance)	Option 2 (Short/ Covered Option)	Overall Position Risk	Current Profit/Loss
Start Date "SD"	Bought Long @ $3.11¼	Purchased 310 put for 15½¢	N/A	16½¢ [$837.50]	N/A
SD +5	$3.16	Sell back 310 put For 12¢. Buy 320 put For 21¢.	N/A	17¢ [$850]	6¼¢ $312.50

(Here's a "short cut" to figure out the savings by swapping options insurance.)

Overall Position Risk	Current Profit / Loss	Overall Position Risk minus Current Profit
21½¢ [$1,075]	9¾¢ $487.50	11¾¢ [$587.50]
17¢ [$850]	6¼¢ $312.50	10¾¢ [$537.50]

As denoted above, there is a full 1 cent savings per contract by swapping the put option insurance. This 1¢ may seem insignificant, at first glance. However, for corporate trading and hedging – it all adds up. (Do you remember your parents reminding you to save your nickels and dimes?) After all, a penny saved is a penny earned! Also, keep in mind that during the whole time you have been in this trade you have been fully insured! Now if the position was to go against you (in the worst case scenario), your overall risk is now reduced *once again by the magic and power of* **options contracts.**

2. The option will be at-the-money (ATM). The long futures position will be at the put option strike price.

In this case, because the long futures contract is at or near the put option strike price, I will simply keep this position as is and resume trading with the trend.

3. The option will be in-the-money (ITM). The long futures position will be below the option strike price.

In this last scenario, if I reset my long futures contract below the put option strike price, I want to take into consideration the value of the original option I purchased. For example, if I reset at $3.02½/bu. and my put option (that was originally purchased at 15½¢) is now worth 19½¢, I would choose to sell back the 310 put (while realizing yet another profit) and buy the Dec Wheat 300 put instead. If the 300 put is valued at 14¢, and my long futures is 2½¢ OTM, then my overall risk is 16½¢ – almost exactly like it was when I initiated the original position! In addition, I now have about a 14¢ profit! This is what professional trading is all about...taking advantage of price in <u>all of the instruments</u> that are available to us as traders. Here is what this looks like in table form:

Date	Futures	Option 1 (Original Insurance)	Option 2 (Short/ Covered Option)	Overall Position Risk	Current Profit/Loss
Start Date "SD"	Bought Long @ $3.11¼	Purchased 310 put for 15½¢	N/A	16¾¢ [$837.50]	N/A
SD + 5	$3.02½	Sell back 310 put For 19¢. Buy 300 put For 14¢.	N/A	16½¢ [$825]	13¾¢ $687.50

Here is the reason why we want to swap out the ITM option with an ATM option (or as "close to the money" as possible) when the futures have dipped well below the original long price.

Difference in Strike Prices	Overall Position Risk	Current Profit/[Loss]	Overall Position Risk minus Current Profit
Long the futures at $302½/bu. with 310 put	15¾¢ [$787.50]	9¾¢ $487.50	6¢ [$300]
Long the futures at $302½/bu. with 310 put	16½¢ [$825]	13¾¢ $687.50	2¾¢ [$137.50]

In the above table, look at the second row under the column Current Profit / [Loss]. I want to point out that **the 13¾¢ current profit** reflects the 9¾¢ profit from the futures and a 4¢ closed profit from offsetting the original 310 put option.

As a conclusion to this section, I want to enlighten traders to the importance of futures price awareness in relationship to the corresponding options premiums. This requires a very simple procedure of taking a step back to evaluate what the least overall risk is for a position at any given time! Most traders will not do this because they simply just don't know how. You, as a trader seeking more knowledge in this business, will never be second-guessing what position "should have" been taken.

Buying back a "short-option" on momentum change

In the above section, I showed an example of offsetting the futures position and then resetting anew. In this section, I want to demonstrate how selling the option (that is covered by the long futures position to reduce risk) may be an overall better method of trading with the trend.

As you may recall, we are long the Dec Wheat futures from $3.11¼¢/bu. We purchased the Dec Wheat 310 put option for 15½¢. Our overall risk is 16¾¢. As

the market continues higher, each day that passes the chances of the market momentum changing to downward are increased. Eventually, momentum does shift to the downside (five days later) and we determine the price in the above example to be at $3.21/bu. To maintain my bullish posture with the market, I will choose to sell a call option as high above the current market price as possible, in order to recoup an equal amount (or more!) of premium that I am losing from the original put option purchase.

For Example:

1. Long Dec Wheat from $3.11¼¢. Market currently at $3.21/bu.

2. Dec Wheat 310 put currently at 10¢. Originally purchased for 15½¢. 5½¢ loss with Dec Wheat trading at $3.21/bu.

3. Now I must choose which call option above the current market price to sell. Here are three choices:

Dec Wheat Strike Prices	Option Premiums
340 Call	3¢
330 Call	9½¢
320 Call	16¢

As you can see, the best choice in this situation is to sell the Dec Wheat 330 call and collect 9½¢ in credit to my account. What this means, specifically, is that my overall risk is now temporarily reduced to 7¼¢ (16¾¢ initial risk – 9½¢ in collect premium = 7¼¢ overall risk).

To further assess this position, if the market was to continue higher (and never look back), we would still make a profit up to and touching Dec Wheat trading at $3.30/bu. – as per the "short" call option strike price. This would mean an overall profit of 11½¢ (18¾¢ maximum potential profit – the 7¼¢ overall risk, or "net cost of insurance"). Of course the only reason why this position has limited profit potential is because the momentum has shifted down. We wanted to maintain a bullish posture in case the market was to gap up (or trade higher), so we simply allowed for a little bit more profit (by selling a higher strike priced option above the current market price), should the market continue higher.

Nine days after initiating this position ("Start Day + 9"), Dec Wheat ends its downward momentum at a price of $3.14½, at which time the momentum is now up. To revert back to an "unlimited profit potential, limited risk" trading profile, I will buy back the short Dec Wheat 330 call option "at market" (when the market realizes $3.14½). If the call option I sold for 9½¢ is now worth 5½¢, and I buy it back for that price, then I realize a 4¢ closed profit (9½¢ - 5½¢). If my original overall risk was 16¾¢, and I have taken a closed profit of 4¢, my overall risk is now reduced to 12¾¢ (16¾¢ - 4¢).

Example:

Date	**Futures**	**Option 1 (Original Insurance)**	**Option 2 (Short/ Covered Option)**	**Overall Position Risk**	**Current Profit/Loss**
Start Date "SD"	Bought Long @ $3.11¼	Purchased 310 put for 15½¢	N/A	16¾¢ [$837.50]	N/A
SD + 5	$3.21/bu.	Purchased 310 put for 15½¢	Sold 330 call for 9½¢	7¼¢ [$362.50]	8¾¢ $437.50
SD + 9	$3.14½	Purchased 310 put for 15½¢	Buy back 330 call for 5½¢	12¾¢ [$637.50]	3¼¢ $162.50

In the example, we initiated a position with a 16¾¢ overall risk (for three months of "insurance"), and of course no profit. We end the example nine trading days later with a 12¾¢ overall risk and 3¼¢ open profit. This may seem insignificant at first glance, but **this profit was made within a matter of days** resulting in an almost 25% reduction in overall position risk. A cycle of downward momentum could last as long as one to three trading days (for an average short-term trading cycle), to as long as six to nine days (for the longer-term). I can take a position approximately three months out, and realize up to a 25% reduction in overall risk by selling, then buying back, the short options. Just think of how many cycles there will be in three months time!?

Okay, that sounds like hype! However, in the above example, there are two completed cycles and the start of a third. Every time the momentum shifts

downward, this is my opportunity to reduce my risk – at a minimum. Even if I bought back each short option for a mere 2¢ profit when the momentum reverted back up, with as many cycles there would be in a three-month time frame, I would actually have my original put option insurance paid for in full and later have a net credit! What more could a trader want in a low-stress, risk-free trading approach?

Managing a Position – Preparing for Tomorrow's Trade

When the trading day is over, it is time to prepare for tomorrow's events. This is where the brunt of our work is done. I know after a full day of trading it can be quite a tedious chore to do tomorrow's homework today, but I also remember the discipline my Navy SEAL instructors instilled in us trainees to clear our weapons, dive gear, and other equipment when the mission was over. We were ALWAYS prepared! This is my type of discipline that I carry over from the military to my new line of work, and the type of discipline I would like to instill in you in order to develop good trading habits from the start – to last a *lifetime.*

"Trading is a daily battle, but it's not the battles that win the war, it's winning the war that wins the war."
– Larry Williams

To continue with the Wheat Example from above, tomorrow will be S.D. + 10 and the momentum is up going into tomorrow's trade. This means if I have any open position in the market, it should be long.

Let's make our calculations for tomorrow. The first step I take is:

1. Determine which way momentum has trended in the prior trading session (Did the market continue 55% / 70% / 110% / 150% of the prior day's range up? Did it go down...? If it did neither, and momentum was up coming into today, then momentum will be up going into tomorrow).

2. On a piece of scratch paper, or worksheet, write down the commodity and an arrow next to it for directional reference going into the next trading day.

Market / Symbol Dec Wheat / WZ	↑ (Momentum)

3. Write down the prior day's high, the prior day's low, and the close (off to the side).

Yesterday's High	\$316/bu. C:\$315¼
Yesterday's Low	\$312½/bu.

I will personally write down the close, because I like to know if it has closed on or near the high of the day for a possible "Ooops" buy/sell trading signal. In this case the market has closed near the high of the day, which tells me I should prepare for a possible "Ooops" sell signal, dependent upon the market's day session open.

4. Calculate the range for the day by subtracting the prior session's low from the prior session's high.

\$316/bu. - \$312½/bu. = 3½¢ (range)

5. Determine the Volatility Expansion % range of the prior day's session by multiplying the range by its appropriate decimal value. This value is what you will have written down on the worksheet, standing for tomorrow's day session open (DSO). Alternate: Have a trendline breakout value instead.

Prior Day's High	.7640	.7640	.7640	.7640
Prior Day's Low	.7590	.7590	.7590	.7590
Day Session Range [high – low]	50 points	50 points	50 points	50 points
% of Range to Buy/Sell Tomorrow	28 points **55% of range** [.55 x range]	35 points **70% of range** [.7 x range]	55 points **110% of range** [1.1 x range]	75 points **150% of range** [1.5 x range]

6. Now we must wait for the DSO for tomorrow's trade. Once the market opens, I will take the volatility expansion % ranges and both add and subtract that value from the opening price. Here is the importance of coming up with these two prices from the DSO.

First, once the market opens, I will immediately record that price on my worksheet and compare today's opening price with yesterday's high and low prices. I am specifically looking for a classic Larry Williams "Ooops" buy or sell signal. If I am long going into the new trading session, and the market opens above the prior day's high, then I must be aware of the potential Ooops sell signal. It's just the opposite if I am short going into the session. If the market opens below the prior day's low, then I must prepare for a possible Oops buy signal. The opening price will tell you immediately if there is a potential gap reversal ("Ooops") trading signal.

Second, if the trend is up, and the market moves up a certain volatility expansion percentage above the open, then this tells me that there is continued/renewed buying interest in this specific contract. If I am long, I am going to "hold what I got." I will then recalculate my plan for tomorrow once the market closes, or if the market later turns around in the session and moves to the volatility expansion %

range below the opening price, then it's time to "do something with my position" – offset the position, or reduce my risk.
Third, if the market opens with a potential Ooops trading signal, this may be the first signal I will plan for. If the Ooops signal occurs first, followed by a volatility expansion % range move in the direction of the Ooops signal, then the second signal to occur validates the first signal. I use this as sort of a confirmation of momentum, whether it's continued momentum or changing momentum.

Last, and this is a rare one that happens only occasionally, is intra-day retracements. How many times have you experienced a market make a substantial move to the upside only to turn around and retrace the entire move? The next time the market moves up or down, with a range greater than the day before, and when you notice the market has "backed off" about half the move, calculate the range of the move by subtracting the intra-day low from the intra-day high. Next, multiply this intra-day range by 70% (.7). We are now looking for a 70% retracement of this intra-day move to the downside. To find this price, simply subtract (or add) the 70% intra-day value from the intra-day high (or to the low). The resulting price is where I will have to offset the position, or reduce my risk by...you guessed it, <u>selling a call option above the market for a price equal to, or greater than, the premium that I am losing on my original put option insurance</u>.

Just today, I was involved with an Apr Lean Hog position that I had been short for the past three trading sessions. I thought today might be the day that the market would change momentum to the upside, but instead the market was down 190 points from the intra-day high. When the market had backed off almost half of the move, that's when I was alerted to be on the lookout for a 70% retracement upward. This did not happen and the momentum going into tomorrow's trade remains down (...even though my profit target was realized). In addition, I will be looking for a potential Ooops buy signal tomorrow on the open, as the market closed near the low of the day.

Remember, if any two of the possible three signals (mentioned above) occur in any given trading day, the second signal always confirms and validates the initial signal. Having the plan for tomorrow's trade – or <u>any plan that is designed to reduce your risk</u> at the first opportunity of a shift in momentum – is the essence of being your own professional risk manager. Since it has been said that 10% of the traders make 90% of the money, it must be certain traders who know how to use all of the trading instruments to their full potential – and know when to execute these trades. <u>If you know how to reduce your risk at the optimal time, the profits will follow as long as the market allows it</u>. Once you complete this book, you will never

take the approach of waiting to see "what will happen tomorrow." You will act and react when the market tells you so. You see, the market makes these decisions and you are just there to execute the trades accordingly! Do not second-guess the market. The market will always be right in the end.

"Act as if it were impossible to fail."
– Dorthea Broude

Sticking to the plan is the blueprint of any and all professional traders. This is a basic plan presented to you. From this point on, when you start tracking markets on your own, you will be able to find the unique "personalities" of individual markets. They are not all the same.

You will find certain characteristics of markets that appeal to you and you will be able to take this plan and build around your market. Remember, all our job and responsibility really comes down to is anticipating the proper sequence of managing the trade. Specifically, to identify the first opportunity to hedge your position should the market shift momentum against you. It does not matter if you are long or short a position, the DSO will be the first price to use as a reference, just like the traders on the floor.

Trading can be a difficult and somewhat tedious task for most traders starting out in this business. This is simply because they don't have a set plan to follow, nor do they necessarily know how to "read the market" by following the natural cycles or rhythm of the market's momentum accordingly. This method of trading should eliminate 85% to 95% of the time spent idly studying the markets for tomorrow's direction. The bottom line is price, right? **This is how I let the market tell me what it wants to do on a day-by-day basis**. If I get stopped out prematurely, I will always have another point of entry even for that same day if need be (which will be on the other side of the DSO!). The "seat-of-the-pants" trading that you and I have both experienced should now begin to be an event of the past. Of course, the bottom line is profits in the end, and profits are not realized until a position is closed out. The next part of this section, we will examine the various ways to correctly offset positions as the last part of our overall methodology and trading plan.

Liquidating a position

This book is not about picking market tops and bottoms. There are other manuals and masters of the markets that have more expertise than you and I put together that trade these type strategies – and in my experience I've watched them boom and bust. This material is all about initiating and maintaining low-risk positions by allowing the market to tell you what it wants to do. Since you and I will never be smarter than the market, we must have a steadfast trading methodology that fully "cooperates" with the natural rhythm of things. When I feel the market has run its course, or I am on the wrong side of the market for too long (usually from stubborn convictions after a string of winning months – eight consecutive months as of this writing), this is when I must look to offset the entire position. Again, I am not attempting to pick a market high or low. I always strive to trade in the path of least resistance, and that of course is always with the trend.

There are only two reasons to liquidate a position: either you are not bullish/ bearish any longer and/or the option insurance is expiring soon. How I liquidate the position is determined solely where the market is in relation to the option (hedging the position), or options I hold. There can also be only one of two places that the market can be at the time of option expiration/offsetting the position. That is either Out-of-The-Money (OTM), or In-The-Money (ITM). Let's examine in closer detail both scenarios: "rolling-over" positions into farther out contracts and generally offsetting positions.

When the Original Insurance (Options) Will Expire Out of the Money (OTM)

When it is time for options to expire, and I have been long or short a position for some time, the inevitable option expiration date will arise forcing me to "roll over" the spot futures into a farther distant contract. If the futures go off the board some distance away from the strike prices of my options (the original option I purchased as insurance or any "covered" option that I have shorted to reduce the risk), I will very simply offset my position either MOC (if I no longer want to participate in the market) or offset the futures and initiate a farther out futures contract.

If this is the case (I wish to continue the position with a farther out contract) then I must initiate this position anew with the appropriate ATM option insurance, just as if I was establishing a fresh position. I have to keep in mind, however, the time

frame I have on this position in regards to which option I will choose. Selecting the wrong month will tie up more of my money to achieve the same objective.

For example: Some time ago, one of my clients initiated a Sep British Pound position to the short side. When I asked him how long a time he had in mind, he said, "two weeks." I immediately looked at the July option first, to determine how much time remained on the July British Pound 166 call option. The days to expiration were 14 – he thought this was perfect! I gave instructions for him to buy the July call option (currently trading at 105 points) and he contacted me about an hour later informing that he had bought it for "242 points." I immediately thought something was wrong, and upon looking to verify the options, I realized that the Sep British Pound 166 call options were trading at 242 points. This was the error – it's not the first time this has occurred, and it certainly won't be the last (of course, if you write down your orders prior to phoning your broker this type of error may disappear!) When my client asked me, "What should I do?" My response was to hold what he had since there were only two weeks, but realize that you are tying up more of your equity to fulfill the same purpose. We left it at that, chalking it up to a learning experience.

Getting back to the point of this section, if the option contracts are about to expire and they're OTM, I must simply decide if I want to continue with the position, or not. Of course, if I do, I very simply will reset anew according to my appropriate time frame.

When the Original Insurance (Options) Will Expire in the Money (ITM)

This situation requires a little more attention to detail – when dealing with an option that is ITM. When the option insurance positions are preparing to expire and the option I am holding is ITM, opposite my futures position, what I will do is let the option expiration take me out of my futures. Let me explain in detail.

Earlier, I had been long the Treasury Bond futures from 120^16 and in the course of a month and a half, I have moved up my put option to a 122 put. The options will expire tomorrow and the market is currently at 121^05. It looks as if this put option will be ITM upon option expiration. I have two choices:

1. Let the option expire ITM, in which case exercising my right to be short Bond futures at 122^00 will stop me out of the market, as I am already long from 120^16. The two positions offset each other.

2. Just prior to option expiration, I can simply offset the ITM put and reset the entire remaining position anew.

In the case of number 1, if I wish to remain long the Bonds, and I let option expiration take me out, I must buy another futures MOC with the appropriate option insurance to continue this position uninterrupted. This is the method I prefer when the put option insurance is ITM. It is the easiest for me to manage and keep track of.

Another possible scenario for case number one, is if I was short a covered Bond call option (as a reduction in risk), and the put option I bought for insurance was ITM, then the call option I sold short would expire worthless and my account would keep the entire credit!

In case number two, I would not recommend this plan because the floor traders can take advantage of the "bid-ask" and I would not realize the actual intrinsic value for the ITM option I am offsetting. It can be done, but it is simply *not worth it.*

Offsetting

There may come a time in my trading when I feel the market is not going in my direction, or I may wish to realize my open profit. I can always re-evaluate the market and reset at a later time when the chart pattern looks clearer to me. When the day comes that is it time for me to offset, I will not use a protective stop with my futures. If I have been long Crude Oil for the past four days, and I have a 95 point profit with my futures, and on the 5th day I feel the market is about to take an adverse turn in momentum (from up, to down) then I will simply set my computer alarms. If the price of Crude Oil drops to a certain price (an Ooops sell signal, or trendline breakout, volatility expansion breakout of the prior day's range below the DSO), my alarm will notify me that is it time to offset this position. I will call my broker and instruct him/her to offset both the long futures and the put option simultaneously <u>at market</u>.

Just today, ironically, I offset a Treasury Bond position that I had been "wrestling" with for just over a month. I say "wrestling" because when I initiated the position, it soon went against me. The market gave me little chance to reverse direction, so I had to manage the position closely to reduce and/or eliminate my risk. When it was all said and done (after adjusting the options during changes in momentum, and shorting a second futures position to dollar cost average about a month later) I actually realized a $1,340 profit with the original position. Although $1,340 is not a significant profit for us commodity traders when a trade with the trend produced nearly $3,500, the days of big losses can be eliminated or reduced very, very drastically by managing a position properly. When the time came to offset my "problem child" position, I liquidated all positions at market and I was out "clean."

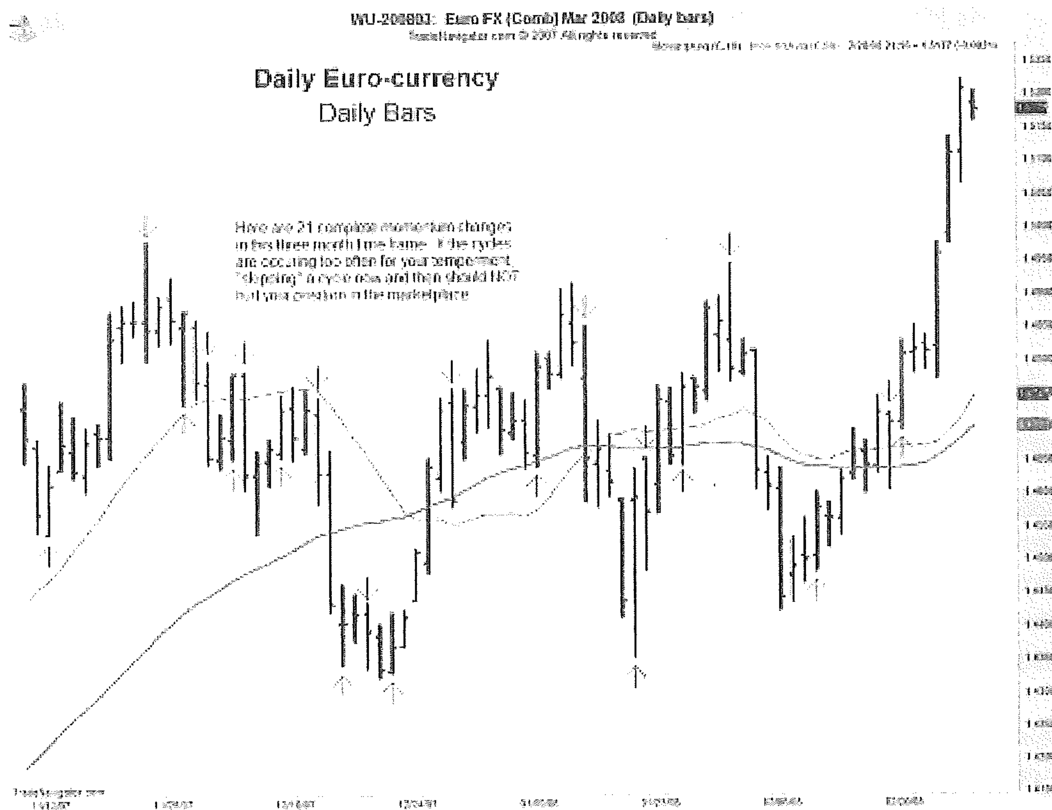
The reason I will not use a protective stop is, if my long futures position gets stopped out and then rallies before I can exit/offset the option insurance, not only will I realize less of a profit from my futures, but I will also realize considerably less with the option premium (as they lost value from the exit price/point of my offset futures contract). In all actuality, and as a personal preference, I never use a protective stop when trading with insurance. If I'm wrong and I feel I am a little early with the position, I will simply sell a call option above the market (as in the case of the Crude Oil example above). Also, if the market moves against me and I sell the call to further reduce my risk, I can easily let the chart pattern evolve to get a clearer picture of what the market really wants to do and what appropriate action to take next. Then, when the market changes momentum to the upside, I can buy back the short call and/or go long another futures contract (with an option insurance) to dollar cost average the overall position.

I realize there will be some traders that, if long a position and the market goes against them, may want to just "leg out" of the futures position and hold the put option as the market goes down (or is perceived to go down). It certainly appears logical. However, the markets do not always make sense and there is no guarantee the market will continue down immediately. Besides that, if you "leg out" of your long future, you are now speculating the market with options only – and that is not what this book is about (as per reasons stated early on in this manual). That is actually an advanced form of trading with this "blueprint" that requires personal work with charting from other methods not taught (or advocated) in this book. I will never leg out, or offset, one side of a position.

Missing/Skipping a Cycle

In the charts below, you can clearly see the market in a steady uptrend/downtrend for the past few months. With that trend in motion, take a close look at the number of cycles the market will make both with upward and downward cycles of momentum. Let's count them from left to right...

Example #1:



A three month view of daily Euro-Currency bars. Many momentum cycles from a daily perspective. Skipping a cycle when no defined trend is evident should NOT hurt the overall trading.

A daily view of Russell Index bars in a defined down trend. Still many momentum cycles from a daily perspective. Even skipping a cycle when a defined trend IS evident should NOT hurt the overall trading. In this example, one very profitable trade with a two-and-a-half week duration may psychologically hurt to NOT be onboard.

In this short section, my goal is to present to you a typical trend that lasts for a good portion of the year and illustrate how many opportunities there are for "buying dips" and "selling rallies." If you are long with the trend and consider yourself either a short-term swing trader, or a longer-term position trader, the actions you take will (or should) be similar in nature.

For example, a short-term trader will buy each dip and look to offset at each change in momentum, from up to down. The objective: Capture as much profit without subjecting your account to an unknown magnitude of momentum downturns. Who really knows how far the market wants to drop upon this inevitable next turn down?

A longer-term trader that is anticipating a forthcoming turn in the market will want to sell a "covered option" to reduce any overall maximum risk with the insurance that was originally purchased. The objective: If the market decides to trade sideways, to down, the time decay from selling the covered option will help to offset the time decay from the insurance that was purchased when the position was initiated. When the market decides to return in the intended direction (by a cycle momentum change), buy back the short option and resume with the trend. Why wait to see how far down the market wants to drop to know where to set your next longer-term stop? You may be stopped out on this drop!

Reevaluating on the Next Opportunity

As each momentum cycle passes, another opportunity awaits me and is my cue to adjust my position accordingly. It only makes sense! There will be a time, however, when the market may not provide a clear picture for me of its intentions and I may decide to "stand aside" to let the market find the next level of support/resistance. When this occurs, I am now able to reevaluate the current chart pattern for higher highs, or lower lows, and then get back on track with adjusting my position. If you find you passed on a trade from the last cycle shift, don't feel as if you missed the last opportunity because the market will ALWAYS set up another trade for you!

"You miss 100% of the shots you don't take."
– Wayne Gretsky

Locking in Profits

For those traders who consider themselves "short-term swing traders" that would prefer NOT to initiate positions with options as protection, but rather put in a protective stop-loss as the alternative, I will describe a method to lock in profits AFTER the position shows a positive return.

Basically, most novice traders will opt to offset a profitable position once the market puts them "in the black" and walk away from the trade only to look for something else...remember now, we are supposed to be trend followers in this business! Don't walk away, or be distracted, with other markets. Focus your attention on your market which is trending and stick with it. As an alternative to walking away (with profit of course, Getting in...getting out...), a simple option strategy can keep you involved with the overall trend while locking in profits.

When to Buy the ATM Option and Sell the OTM Option

My position has a profit. I am long the bond market from 118^18 and immediately bonds trade higher to 120^03. I have a profit just over $1,500.00 and I see in the charts that the objective for this market is 121^02. At the same time, bonds may make a temporary hasty retreat to find support BEFORE reaching that 121^02 price. I can very simply buy an ATM Bond 120 put option and sell an OTM Bond 121/122 call option. The price I buy the put option for will be slightly higher than the premium I am credited for with the call. Keep in mind this is only performed after a momentum cycle change, from up to down, with the underlying futures. Also, this should be performed when the position I am in first makes a change in direction ***opposite*** *of my position. If not, I am NOT "locking in" profit!*

Selling Back Original "Insurance" on Market Reversals

With the position mentioned above, the momentum cycle is now down. My future contract is losing in value, while the 130 put option is gaining in value, and the short 131/132 call option is "decreasing" in value (what we want it to do). As always, there will come a point where at least one of the three momentum-changing signals will be realized and the momentum cycle shifts, from down to up. Time to take profit on the options and let the futures continue in the intended direction. Hopefully, the market has traded down/sideways enough for the put

option I bought to be "sold back" for a profit, or at least break-even. Same with the short call I sold. If I can buy that back for a profit/break even too, then at least I am compensating for the market pulling back against my futures contract.

There will be times when I have sold a call option (against my long futures position) the market will very soon resume its intended direction. When I evaluate the price of the short call to buy it back, it may be for a (slightly) higher premium than what I sold it for – decision time.

Remember now, I can revert back to the "unlimited profit potential" if I feel the market has higher to go (based on my personal technical analysis), or decide to sit on the "hedged" position and await a full market cycle for further reevaluation. If I choose to buy back the call option for a higher premium than what I sold it for, then the futures contract will most likely be at a higher price (in my favor) than where it was when I originally sold the call option short! I may be giving up some profit, but the futures profit will most likely MORE THAN make up for what I am losing in premium with buying back the short call.

For example: Long the underlying asset from 53.00 even. The market trades up to 54.25, allowing a profit, then shifts momentum, from up to down. I sell a "covered" call when the futures are at 54.25 for a premium of 75 points. Within a day or two, the futures resume their upward trend and the momentum shift occurs at a price of 54.55. If I buy back the short call at this point in time, I will have to pay 85 points, for an overall loss of 10 points on the call option "buy back." However, the futures have a 30 point profit, if I want to revert back to "unlimited profit potential," I will have to forfeit 10 points from the loss of option premium – decision time!

Reevaluating the Market for an Option "Buy Back"

What would happen if after the covered (short) options were initiated the market continued in the intended direction (without offsetting the options)? This will happen at times and sometimes unexpectedly with "limit moves." I would simply continue to profit up to, and touching, the strike price of the call option (minus the net cost of the option "hedge") and I would have to wait for another momentum cycle change to be completed before deciding to offset the options, or initiate a new (2nd) position altogether.

Markets to Focus on/Markets to Stay Away From

There are a number of futures traders that take an active role in teaching others about the markets, such as I am doing with this book. As much as we can give insight to others about the markets, the one thing we cannot do is teach experience.

If you have been actively trading for at least six months, you have noticed "some" markets have been better to trade than "others." There is a reason for this and I would like to highlight these markets as I wrap up this section.

Optimal markets to trade

The optimal markets to focus your attention on are the markets that provide the best liquidity in both futures and options contracts. For example: I spent a week in Chicago to visit the exchanges and witness the activity going on in the trading pits/rings. I noticed that some pits, such as bonds, Eurodollars, and soybeans, had an overwhelming amount of participants yelling and screaming (doing business), while other pits had individuals reading magazines and newspapers (waiting for business to come to them). The simple difference between the two observations is that some markets provide an optimum, and superior, amount of opportunity while others just flat out do not.

In this section, I originally intended to point out which specific markets were best to trade in order to best utilize the strategies outlined in this text. Instead, I will add another section to scrutinize the importance of liquidity with our trading and teach you how to uncover these markets and others for yourself!

Liquidity emphasis

In the paragraph above, I described a difference in the trading activity between two pits. The first pit, with many participants, would be a very good market to trade because of better liquidity. The better the liquidity in a market, the better the difference will be between the price of the "bid" and the "offer." You see, if there are a small amount of floor traders willing to take the risk in an ill-liquid market, **they will only take the trade** if they have "the edge." The edge for these floor traders is simply a more favorable price (in their favor, of course) allowing them to offset their position for a profit sooner in time than we "off-floor" traders plan to. Let me show you how to find which markets are best to trade, and which markets to think twice about trading according to the liquidity emphasis.

In the "Investor's Business Daily" newspaper, they have a complete section detailing the price activity for the day concerning futures, stocks, and their corresponding options. If I am going to continue trading using options as part of my overall plan, I want to make sure both the futures and options contracts have plenty of volume and open interest to know I am operating on a more even playing field with the floor traders! The I.B.D. newspaper has helped me with this feat.

What I specifically look for are markets that have their options trade with at least a total volume of 2,000 puts and calls daily! If this is not the case, *the market may not provide the best opportunity.*

Wrapping it Up

In the section you have just read, I have outlined a trading plan from which to learn and grow. In the next section, I will go over a couple of trades in greater detail.

Section #4 Quiz

1. A common trait of a momentum cycle (of several days duration) is that it will not usually:
   A) gap lower on the next day's open.
   B) gap higher from the prior day's close.
   C) retrace a certain percentage of the previous day's range from the day session open.
   D) retrace a certain percentage of the previous day's range from the prior day's close.

2. When examining the price structure of a chart, what "trigger pulling" indicator(s) would a trader look for to initiate/offset a position?
   A) A volatility expansion ("V.E.B.") / trendline breakout.
   B) An "Ooops" signal.
   C) An intra-day retracement.
   D) All of the above.

3. The goal when trading with the trend is to initiate a position when:
   A) the market is oversold.
   B) the market is overbought.
   C) the momentum cycles with the trend.
   D) the momentum cycles against the trend.

4. When managing a position on a daily basis, what is the proper order of precedence when utilizing the following indicators?
   A) An intra-day retracement, V.E.B., the put/call ratio.
   B) The put/call ratio, V.E.B., and intra-day retracement.
   C) The "Ooops" signal, V.E.B., and intra-day retracement.
   D) V.E.B., "Ooops" signal, and intra-day retracement.

5. We do NOT want to use protective stops when trading with options as insurance because:
   A) option premium decays with each passing day.
   B) we would be speculating with options if stopped out of futures.
   C) the option premium can go against you if not offset simultaneously.
   D) both B & C.

6. What benefit does selling a "covered option" serve against a futures position?
   A) A trader can bring in a credit to their account during an adverse momentum shift.
   B) A trader can make a profit when the market moves against the futures position.
   C) There can be NO benefits to selling covered options.
   D) Both A & B.

7. A "liquid" market to trade can be defined as one that has at least:
   A) an average volume of 2,000 puts and calls on a daily basis.
   B) an average volume of 1,000 puts and calls on a daily basis.
   C) an average volume of 200 puts and calls on a daily basis.
   D) an average volume of 100 puts and calls on a daily basis.

Conclusion: Planning

"I expect to spend the rest of my life in the future,
so I want to be reasonably sure what kind of future
it is going to be. That is my reason for planning."
*- **Charles Kettering***

Reviewing the Rules of Professional Trading

It is important to never lose focus on our overall long-term trading goals. As traders, let's define and reinforce these goals.

1) When aspiring to become trader, the primary goal is simply to make money (that goes without saying).

2) When on the path to making money, the second thing that we want to acknowledge is that we don't want to lose the money that we came in with; we don't want to lose our principal. Part of being a professional trader and knowing how to make money is knowing when not to trade and preserving our equity from inevitable drawdown.

3) We want to learn, we want to gain knowledge, we want to gain experience, and the only way we are going to be able to accomplish this (and I am not referring to paper trading either), is to be involved in the markets on a day-to-day basis – because the only way to make money in the markets is to be in the market.

Trade Selection

Lining up trades after finishing this book will be much, much, more simplified and methodical. I always know what I am looking for in selecting trades, and so will you – identifying trends! If there are no evident trends in the market I am wanting to trade, I will pass on the trade and wait... Waiting is free! I will line up my first trade now with you.

I am looking at my charts on the computer program I use and I am looking for a grain contract that is in an established trend – first wheat. The 10-week moving average is now tilting down for the past week and a half after being up for the past two months. This doesn't look so good. On to the next...

On to another grain – corn. The 10-week moving average is slightly up from being flat. My first thoughts are this market has put in a "seasonal low," and it does not look good to trend up. The %R indicator is reading overbought currently and it would be best to wait until that %R reading drops from overbought and ideally becomes oversold. Pass on this for awhile...

Now soybeans. As of this writing, the 10-week moving average is not only pointing in an upward direction, but the angle and degree it is up is rather steep and looks to be the best upward trending market that I have come across lately. Furthermore, accumulation is building immensely from the seasonal low showing in the month of September! To top off this ideal trade selection, the %R reading is oversold and is due for a cycle change back up anytime now. I will take this trade! I will take this soybean trade because all factors are a "go" for a continuation of the trend.

My next step is to find out what price I will "pull the trigger" tomorrow. First I record today's high, low, and last (H = 1498^4, L = 1471^0, C = 1485^4), on my daily worksheet and determine "a volatility breakout price" such as a 110% breakout of today's range – or 55%, 70%, 150%, or any other percentage breakout your work shows best for this particular market. (High of 1498^4 – Low of 1471^0 = Range of 19^2¢. Next, 19^2¢ x 1.10 = 21.175¢. I must round this up to the next market tick which is 21.25¢, or 21^2¢). This will be from tomorrow's day session open. This is also recorded on the worksheet – 21^2¢.

Now that I know what the price is for buying above tomorrow's day session open, I just have to wait for the market to open tomorrow morning – that's all. The next day the market opens at 1466^0 (the number after the ^ symbol represents a fraction of a whole penny in eighths. A ^2 would represent 1/8, a ^4 would

represent ½, and a ^6 would be 3/4... in this case, "^0" represents no fraction of a cent with this price. This is how grain prices read on many screens, such as mine.) I immediately compare this opening price to yesterday's high, and low to see if there is a potential "gap reversal/Ooops" buy signal here. Sure enough, there is! If the market trades up to yesterday's low of 1471^0 plus three market ticks, which would be a price of 1471^6, I can be a buyer there on a stop because this would be enough price change to reverse the momentum of the market, from down to up. Also, I add 21^2¢ to 1466^0 to get a 110% breakout price of 1487^2. If 1487^2 is realized in today's session, and today's session only, that confirms the gap reversal/Ooops buy signal as valid and means I can feel good about being long from 1471^6. <u>If the market did not open below yesterday's low</u>, then the buy signal would have only been the 1487^2 above the open (based on the 110% volatility breakout).

Once I am in the trade, I must determine if I want to put in a protective stop only, or buy an option that is slightly "in-the-money" (because soybean options trade in 10¢ increments – although the back months trade in 20¢ increments). The protective stop is 21^2¢ on the opposite side of the open for a total risk of 26^2¢, or $1,312.50. This is a little too rich for my blood today. Let's look at the options alternative. I can buy a 1470 put option (instead of a protective stop) for a premium of 48¢ (or $2,400 which is also normally very rich for my liking, but my choice) which is good for more than enough days of trading. Again, for me, plenty of time and worth the premium! No protective stop for today.

I am now fully protected to the down side, but I still have to set my alarm to notify me if soybeans trade down 21^2¢ from the open to a price of 1444^6. If this happens today, then this would tell me I may be a bit too early on the trade. I would want to at least reduce my risk until more evidence of a short-term bottom is made/ another chance in momentum cycle is completed from down to up (however, in this case I missed a trade and I am looking to get back on board using my trusty signals!). In my experience, I have found that the best buy/forward signals occur when the risk is the least. As long as the risk remains "too rich for my blood," I may choose to hold on to the option as protection. After all, <u>I can make up for any lost premium as the trade progresses</u>. But if the trade has really taken off, and I determine tomorrow's risk/110% breakout from the day-session open to be, let's say 6^4¢, then I may choose to offset the 1490 put option because I know if the market drops 6^4¢ from the open tomorrow, I may be out of the trade anyway. If the market does not drop from the open tomorrow, but instead continues higher, then I didn't need the option either (Hint: be consistent. Either ALWAYS trade with options as protection, or just short-term swing trade with protective stops.

Don't ever be "wishy-washy" in this business!). I am writing this because I always get many questions about what to do with the options once the trade goes my way. This is the answer. Just determine your risk and listen to your conscience (according to your experience level). I hope not to sound wishy-washy!

From this point, it is a matter of managing the position on a daily basis. All actions of the market each day depend on the "trigger-pulling" factors determined from the day-session open. The market is either going up, or going down. There is no in-between until you look at the market in hindsight. The trigger-pulling factors will inform you when this takes place...!

Account Size

Of course, the ultimate goal all of us traders should have is to trade for a living. Now let's be realistic here when we talk about "trading for a living." The people that you see or admire that are trading for a living – most have large sized accounts. If you want to stop your day time job and trade for a living, let me assure you that you need to have at least a minimum of $50,000. If you are a retired person, and drawing some kind of pension, or retirement pay, and you have benefits to cover you...and you have got the security behind you...maybe you can lower that down to about $25,000 to $35,000. But being realistic, you need to have at least $50,000 – and $100,000 to $150,000 would be more preferable.

Now, I don't know about you, but if I only have a $25,000 trading account and I am a young guy with a wife, children, mortgage to pay, car payments, and responsibilities...trading for me needs to be a secondary source of income. I have to be assured I am going to make the mortgage. I need to be assured that there is going to be food on the table, and that our cars are not going to be repossessed, etc. – for crying out loud. Do not put yourself in a position to make a living off of your life savings. I want to get that straight with you right now. I wouldn't ever want to put myself in that position, but if I had a primary job from which I generate risk-free money, I am free and clear to do what I want with the markets the way I know best. This prevents me from putting myself into a position where I am forced to have to make trades...and start making the wrong trades. So, if you want to trade for a living, just make sure you have the proper financial backing and a steadfast trading plan. Then knock 'em dead.

Best wishes for GREAT TRADING!
*– **Brian Schad**, Idaho*

Epilogue

"The past is behind us and the future lies ahead."
- ***Irwin Corey***

I remember when I first started trading and feeling like a lost country-boy in New York City – not having direction with the trades, not knowing any other traders with whom to discuss trading with, and not knowing how to navigate my way through the markets once I was *filled*.

This methodology is great when initiating positions in the market.

Unlike lack of direction in the early days of my trading, and spending countless hours in front of the charts unsure of what to do next, now it's a simple matter of identifying a market that is trending and determining the correct price/time to "hop aboard" according to the %R and the "trigger-pulling" factors.

"I am a great believer in luck,
and I find the harder I work, the more I have of it."
- ***Thomas Jefferson***

Follow momentum with simple, basic trendlines, or basic *price structure.*

Once in the trade, I have a plan every day that revolves around the day-session open. I am only a buyer when the momentum cycle changes, from down to up, and as long as the market continues to trade in my direction (not reversing 55% / 70% / 110% / 150% from the open in the *opposite* direction), I will hold my position. If the market is making higher highs and higher lows, I have a good trending position here. If the market does not continue with higher highs, but instead makes a lower low, I may have to offset my position to reevaluate, or reduce my risk accordingly. The violation of basic trend lines is also a fantastic way of determining momentum, especially on a short-term basis. Trend lines must *always* be drawn in a consistent fashion.

"Only those who dare to fail greatly can ever achieve greatly."
- RFK

Most importantly, know the *trading instruments* that are available to you.

Not knowing all of the trading instruments and how they function once you buy them, or sell them "short," will be the most detrimental part of trading for most of us traders in the future. Most traders that I start working with all tell me they don't know, understand, or care about the *options*, so they just prefer to stay away or not make a concerted effort to understand their purpose in trading.

The ***secret to managing your risk*** is involving ALL instruments of trading at just the right time to allow yourself to reduce risk when necessary, and be able to reevaluate the market while still holding a "hedged" position. If positions are pulled prematurely, and the markets continue in your favored direction, this can be just as demoralizing as taking large, unnecessary losses as most novice traders do! Each instrument available to us traders has a purpose and we must use these instruments to their fullest potential.

"Education is the most powerful weapon
which you can use to change the world."
- Nelson Mandela

You must have the discipline to make decisions and STICK WITH YOUR PLAN!

I have outlined a complete blueprint for traders from which to learn and grow. By tracking the markets I am involved with each day, I will almost never let a market get away from me! Keep in mind, not *all* trades will be winners. I must learn to keep the losers at a minimum. The only way this can be accomplished is to be involved with the market and let the day-session open be your guide!

As time will pass, each trader that practices this information will develop their own style of trading. Make sure that the foundation is not "uprooted" and a means

for determining changes in momentum cycles is not compromised. Your style of trading must revolve around **knowing when cycles of momentum change occur.** I have shared mine with you. This is what I stick with and I do not deviate from my plan for any reason. The market tells me what it wants to do. I merely *cooperate* accordingly.

"The truth of the matter is that you always know the right thing to do. The hard part is doing it."
- General Norman Schwarzkopf

Now you will know how to control *your risk.*

The amount of capital traders will risk is all relative to their account sizes and personal risk temperament. I have mine, which is rather very conservative, and others think nothing of risking double, or triple, what I normally risk. ***Risk*** in the market place is a personal preference which is blind to what is *right* for risk, or *wrong* for risk. Nevertheless, after completing this material in its entirety, controlling risk will be as natural as calling your broker to have a check sent to you from profits in your account on a monthly basis!

"If people believe in themselves, it's amazing what they can accomplish."
- Sam Walton

What you need to do now...*getting started*!

You're about to close the book and you're all excited about getting started. Once the book is closed, however, I have a peculiar feeling you may be overwhelmed at what you have just read before applying it to your trading plan tomorrow.

Here's my advice...slow down and prepare to read this book a second and/or third time. I didn't mean to make this material so technically methodical, but there are many, many procedures to follow! It may take some time to fully comprehend, understand, and ultimately execute. This time, as you go through the book, take detailed notes! After you feel you have a good handle on my proprietary method of trading, START PAPER TRADING.

I know, I know, paper trading is for the birds! But doesn't a surgeon have to attend many years of medical school before a scalpel is directed at a real, live patient...? Doesn't a lawyer have to go through many mock trials at law school before captivating a sworn jury audience...? And that pilot that flew you to your last destination...what do you think his ***practice*** entailed before uttering the words *"this is your captain speaking...?"* Okay, so you know what I'm getting at!

Be advised this is ***advanced*** trading material. Start paper trading only *after* you have gone over the material enough times until you are in complete understanding of the methodology and procedures for effective and professional trading.

One last thing...I know how hard it may be to ultimately grasp the subject matter. **It took me years to develop the methodology**, but now it is laid out for you step-by-step. I trade every waking day (and now some nights). I am right here with you when you catch on...*enjoy the journey*!

APPENDIX - A

Starting Out Green

Note: The literature below was taken from the original book I planned on publishing before this course was produced. I have sent this to hundreds of new traders just starting out green.

Most new traders starting out with the commodity trading adviser service often ask, "Where do I begin?" I know the commodity markets can be so overwhelming when you are first learning (ie: the different training courses, the books, the brokerage firms, data services, etc.). The list goes on and on! I remember starting out and looking at all the commodities market's charts (monthly, weekly, daily) attempting to sort out which market was poised to trend next. I would pick Live Cattle and take a position then, wouldn't you know it, the Crude Oil market takes off instead! So I get out of my cattle position and jump into crude oil, but then the crude oil market stops moving and then heads the other way . . . Now the currencies get my attention. I don't know about taking a new position because I'm looking at cattle again . . . Now I don't know what to do and I become indecisive. Don't let this happen to you. I have a plan for new traders just starting out to avoid the same mistakes I made.

By initially learning from a beginner's commodity trading course, and most likely subscribing to a commodity charting service, you have in a sense committed yourself to wanting to trade correctly, with discipline, and trade for the rest of your life with successful results. This is what I wanted. Everything I have ever set out to do in life I have achieved because I want to be a winner! This is my "mind set". I was born with it and it'll never go away no matter what happens, because I have experienced it in the worst of times when the chips were down real bad for me overseas as a serviceman. I didn't "lose it" (more about the mind set later).

The first thing I would like to share with you just starting out, especially within your first year, is to narrow your focus on which markets you will trade. Have a goal set for yourself and your account. It doesn't matter how much money you start out with, you need to develop good discipline and trading habits so you don't "blow out" and "burn out." If you set a goal for yourself, say . . . three months, six months, a year, whatever, it is that time that is very critical for you and your trading future to develop good trading habits for the rest of your life. Let's start now!

Plan for New Traders:

1) Trade grains (corn and wheat initially) and livestock (live cattle and lean hogs initially) only.

These are GREAT MARKETS to learn and study from. They have a great relationship with each other too. When feed (corn and wheat) becomes too expensive for the rancher's livestock, the cattle/hogs go to the auction and prices for meat go down. This is just a basic fundamental tidbit of information, but the real reason you should learn from these markets is because they are not that volatile (so you have time to think and make rational decisions), they make great chart patterns that you can learn to recognize (for all markets for future trading) and, when they trend, it is usually for a good amount of time (allowing for decent profits and compensation for you doing your homework). In addition, the initial margin for these contracts is generally some of the smallest you will find, so you are not committing that much capital.

2) Consider trading "mini-contracts" initially.

There is an exchange called the Mid-America Commodity Exchange (MidAm/MACE) that offers smaller-sized contracts of much of the same commodities with even less margin requirements. The downside of trading "mini's" is the payoff's are also much less. The point is, you are just starting out. You want to develop good discipline. You need to develop good trading skills while developing your decision making process. You need to learn how much temperament you have when it comes to putting up your money. If you can just give yourself "X amount" of time to accomplish this "finding yourself" task, <u>I promise you the markets will be there for the rest of your life for you to trade successfully and CONFIDENTLY</u>! Also, if you're only paying $15/round-turn for this learning process, your educational expenses are the lowest available.

"Do it right the first time or don't even bother doing it at all," is what my Navy SEAL Instructors beat into me years ago and, when I left the navy as an instructor, this is what I beat into my students as well. The more you sweat in peace, the less you bleed in war. The markets are only a battle if you don't have a plan or know what you are doing. Find yourself the least expensive way possible. Mini-contracts offer you just that.

3) Never speculate the markets by purchasing options.

Always buy long / sell short the futures contracts and use the options for what they were intended to be, "insurance." You will find at times, when you are hunting down a particular market because the conditions are just right (commercials vs. public relationship and market sentiment, etc.) and place your trade, you will not always be right. Accept this, for it is a fact in commodity trading. When you go long/short a futures contract, do yourself a favor by purchasing an "at-the-money" option in the opposite direction as insurance! I cannot emphasize this enough. I have seen too many bull headed traders not want to put in a protective stop on their directional trade because of fundamental conviction, fear of getting stopped out then having to deal with high commission costs, or just plain being stubborn! Listen, if your long futures position is protected by a "long put," you still have unlimited profit potential! Furthermore, the premium you paid as insurance can still be recouped very easily without adding additional margin on your position!

If you are correct about the market and prices go up, your futures will make more money than your option will lose in value. Continue to hold the put. When you get a short-term sell signal you have three choices: 1) liquidate your futures and reset at a lower price when the next buy signal presents itself , 2) sell short a call option for an equivalent premium of what your put option has lost in value (to recoup your loss), or 3) do both 1 and 2! Keep in mind you can also liquidate both futures and options for a profit. Then reset later.

If your speculation of the market is incorrect, the maximum loss for your position is the amount you paid in premium for "your insurance" plus/minus any amount the option is in/out of the money if you hold the position until the option expires. This, my friend, is the worst case scenario. When you initially took your position in the market, you thought the market was going to go in a certain direction. Usually, within a couple of days or so, you'll find out if you are correct, or not. If you are stopped out with a loss in your futures contract, your option will have made some profit, so you will take half a loss, or a partial loss, instead of a whole loss!

You shouldn't hold the position until option expiration anyway. If you do, that is, hold an initial position for more than a week, I suspect there is some "hoping" involved and you may be disregarding what the market or price charts are telling you. The only decision you need to make in considering purchasing the option is, "how much do I want to risk?" Do the option premiums warrant a buyer's market, or a seller's market (are the options cheap or expensive)? You only want to buy options with low implied volatility/low premiums. Then you are assured

you're getting your moneys worth and, if you have to hold this position for awhile, the "sleep factor" is in your favor. Specifically, by purchasing the insurance, YOU CAN BE ASSURED YOU WILL NEVER LET THE MARKET WIPE YOU OUT, AND YOU'LL ALWAYS LIVE FOR ANOTHER DAY TO TRADE! This I guarantee.

4) Never margin more than 25% - 30% of your total account equity at any one time.

This is a basic money management strategy. Very simply, if you start out trading with a $10,000 account, you should have no more than $2,500/$3,000 of your account margined with positions. Incorporate this rule with the one listed above concerning the options for insurance and you are "good to go!" Break this simple rule and you'll soon find yourself picking up the phone very early in the morning with a "margin call" from your broker. Furthermore, you may have to liquidate some or all of your positions (with a loss no doubt), and you'll have to start all over again with less capital to work with. Now, you will really have to be selective with your trades!

5) Do not trade "New York" markets or other "exotic" commodities.

I may catch a lot of flack for this and I know this is not only my opinion, but I have found New York markets to be very biased towards favoring the "floor traders." It seems the floor traders and the exchanges may not always operate with a high level of professional integrity.

Let me give you an example: When I was a broker, I was involved with many clients that traded all sorts of markets, and with various types of orders. When my clients placed orders in the petroleum markets on stops or "at market", they were always dealt fills with terrible slippage. Clients would be outraged as they (some of them anyway) would monitor their positions along with me and expect decent fill prices. I never once saw decent fills in these markets. We fellows "off the floor" have to deal with very lousy fills on our orders - especially "market orders." It got to a point early in my broker days that I would get involved with time and sales for my complaining clients only to have a certain rule brought to my attention: (Now I do not remember this verbatim) In effect, a market order can be filled at any price within THREE FULL MINUTES AFTER THE ORDER HITS THE FLOOR! This is actually industry wide. However, New York takes full advantage of this GIVING THEM A CONSISTENT "EDGE" IN THEIR TRADING. For this reason, and through experience, I choose not to play on their terms.

Other New York markets such as coffee, orange juice and cotton are also thin markets that, as a beginner, you should stay away from. Hone your trading skills first.

Just a few more suggestions:

1) Do your homework and study proper nomenclature for placing orders! This has the potential to make or break a trade. What are the commercials doing? Market sentiment? Seasonality? Market structure? These are things we can look over during the middle market hours, or after market hours before tomorrow's open. If YOU are not doing YOUR homework, how do YOU expect to make money?

2) Write all your orders down before you call your broker! Just two months ago, while my phones were ringing constantly, I called my broker to place a trade. In the heat of the market action, I mistakenly said "call" when I meant "put." Brokers will do as you say, not as you think. I deviated from my plan and got what I deserved!

3) Have your plan or strategy standing by before the market opens. The day session open is the reference price for the entire day. Knowing this price alone will instantly tell you if there is an Oops (gap reversal) trade, where to bracket your trades, and identify if the market is opening near projected support/resistance. If you have your plan in advance, all you need to know is where the market has opened for which action you will take. THE TIME TO PLAN YOUR STRATEGY IS NOT DURING THE OPENING RANGE! When you call me just after the open, all you should be asking for is the day session open. Please be considerate of others attempting to call me at this crucial time! Don't take it personal if we're blunt with you during this time.

4) Please take note of when specific markets open. They all open at staggered times throughout the morning. When my telephones turn on in the morning (5:00 am PST) I am tuned in to the bond market, currencies, and precious metals. At this time, only questions pertaining to the currently open market can be addressed immediately. This would assure efficiency to better utilize my service!

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APPENDIX - B

Self-Administered Quiz Answers

Section #1 Answers:

1. "Professional" traders can be distinguished from "non-professional" traders because they: (Reference Professional Traders vs. Non-...Paragraph #2)

   C) Know how to control their risk.

2. The potential danger of using protective stops as the sole means of risk management is: (Reference The Problem With...Paragraph #2)

   C) There is absolutely no way to predict a substantial morning gap-opening.

3. Many novice traders will buy options for the unlimited profit potential, limited risk profile. When doing so, they tend to: (Reference Buying Options for... Paragraph #3)

   D) Both A & B.

4. New, or "average," traders/investors should NOT speculate the market with options because: (Reference Unconventional Trading for...Paragraphs #1 & 2)

   D) All of the above.

Section #2 Answers:

1. Futures contracts are also known as cash-forward contracts. (Reference The Futures Contracts...Paragraph #3)

   B) False

2. The difference(s) between the futures contract and the individual stock as underlying assets in (are): (Reference The Stock...Paragraphs #2 & 3)

   D) All of the above.

3. The factor(s) that determines whether an option is "at-the-money," "in-the-money," or "out-of-the-money" is (are): (Reference The Options...Paragraph #6)

   C) The strike price of the option and current asset price.

4. The real value of an option is it's: (Reference How Options are...Paragraph #1)

   B) Intrinsic value.

5. The anticipated forthcoming underlying asset activity is defined as: (Reference Implied Volatility...Paragraphs #1 & 2)

   A) Implied volatility.

Section #3 Answers:

1. What factor must always be considered before initiating a trade position? (Reference Position Initiation...Paragraph #1)

   B) Time in a position.

2. The GUARANTEED method of managing defined risk can only be accomplished by: (Reference Evaluation of Insurance...Paragraphs #5 & 6)

   C) Using options as insurance.

3. When evaluating an option to manage risk in a position, we should prioritize the strike price selection as follows: (Reference ATM/ITM...Paragraph #2)

   A) At-the-money; In-the-money

4. When initiating a position with a pre-determined two week outlook, it is strongly recommended to utilize with no less than ____ days until expiration. (Reference Days to Expiration...Paragraph #4)

   C) 45

5. The difference between "quarterly" option contracts and "serial" month options is...? (Reference Selection of Correct...Paragraph #4)

   B) The serial has only month "life of contract."

Section #4 Answers:

1. A common trait of a momentum cycle (of several days duration) is that it will not usually: (Reference Volatility Expansion Breakouts...Paragraph #3)

   C) retrace a certain percentage of the previous day's range from the day session open.

2. When examining the price structure of a chart, what "trigger pulling" indicator(s) would a trader look for to initiate/offset a position? (Reference Price Structure...ALL)

   D) All of the above.

3. The goal when trading with the trend is to initiate a position when: (Reference Cycles from Which...Paragraph #1)

   C) The momentum cycles with the trend.

4. When managing a position on a daily basis, what is the proper order of precedence when utilizing the following indicators? (Reference Managing a Position...ALL)

   C) The "Ooops" signal, V.E.B., and intra-day retracement.

5. We do NOT want to use protective stops when trading with options as insurance because: (Reference Offsetting...Paragraph #3)

   D) Both B & C.

6. What benefit does selling a "covered option" serve against a futures position? (Reference Selling Back Original...Paragraph #1)

   D) Both A & B.

7. A "liquid" market to trade can be defined as one that has at least: (Reference Liquidity...Paragraph #3)

   A) An average volume of 2,000 puts and calls on a daily basis.

Appendix C

SCHAD'S COMPLETE ORDER PLACEMENT WORKSHOP

Ever doubted your ability to work one-on-one with a discount broker? I sure did when I started out...and I paid a "full-service broker" $100 per round-turn to trade the market according to my "intentions." Did you get that...? We'd talk casually for awhile, and then get into the trade and what I would like to do. After collectively paying the fellow $2,500.00 bucks (for 25 total trades), I still didn't know how to properly communicate with a broker to execute my trading decisions properly and in a time-expedient manner!

One of the most important elements in becoming a professional risk manager is actually effective communication with the broker executing the trade on your behalf. Even with the advent of on-line trading, placing voice orders over the phone remains the most reliable method of getting filled. Competent order placement over the phone is the key to getting good fills, receiving deep-discount commissions, and eliminating costly order errors.

As mentioned above, I had no plan, no idea of proper protective stop placement, and very little knowledge of proper order placement - I guess you could say that I was a broker's worst nightmare. I made mistakes, I placed the wrong orders, and I felt like a true novice. Well, as you already know, I paid dearly for my broker's patience and guidance - $100.00 a round-turn. Maybe I was actually a broker's dream? It took me quite some time just to get the basics down and feel comfortable placing orders quickly over the phone.

If this topic concerns you, I have laid out possibly everything you may need to know about proper order placement – right here, right now. For teaching purposes, let me put this in the perspective of me being interviewed, and you observing the interview process:

Host: Brian, do you know if other beginning traders have problems placing orders over the phone?

Brian: When I was a broker, I absolutely did not have one client who knew how to properly place orders or practiced executing orders in a timely manner. This not only cost them more in commissions, but increased the margin for error in their trades.

Host: Why would that increase commissions?

Brian: Well, it's fairly simple. A broker has to service all of his clients plus generate new client leads in order to make a living. Time on the phone, especially for a broker, is big money. The longer a broker spends on the phone, the less time he has to service his other customers, or check on fills, or call back clients. As such, those clients who need "hand-holding" placing these orders are going to pay a hefty premium for this "full-service" treatment.

Host: Well Brian, now we all know why we have to master this element.

Brian: Yes, this is an important part of becoming a professional risk manager. I thought it would be invaluable for all traders to know when to place certain orders. The best way to learn is to study them on paper and then verbally repeat the various orders actually being placed to my broker.

Host: Brian, that's fantastic. I don't remember any trading course where you could actually read how the various orders are to be placed. I remember studying all the manuals (which listed the definition of each type of order) and still not knowing how to talk to my broker.

Brian: Well, I put this workshop together with the intent of maximizing the practical aspects of trading. All traders need something they can use to gain an edge and this material delivers all that and more.

Host: I wish I had something like this when I started Brian. Okay, let's begin with the types of orders. What are we going to start with?

Brian: We're going to start out with a few basics, at first, and these will be textbook sample orders. All of my orders are written down before hand for expediency and accuracy, clearly spoken, and in sequential order for the broker to be most efficient. I'm never in a rush, so I can avoid errors! Once you learn to place orders, as you will see, you will be more of a pleasure for your broker to work with. Furthermore, you will be rewarded accordingly by receiving the lowest possible commissions.

These simple rules will help every trader:

1. Always have your broker's phone number and your account number handy. Keep a copy in your wallet/purse in case you need to make calls from locations other than your home or office.

2. Write your order down. This is for your records and may help you to convey your order smoothly to your broker over the phone until you have proper order placement memorized. Believe me, this won't take long!

3. Immediately tell your broker what type of order you are placing, either a day order (good for today's day session only) or an open order (good till canceled). Most traders will call their broker and go through all the formalities of a phone call greeting. This is not necessary and is time consuming. When I call to place an order, the first words out of my mouth are, "This is a day order..."

4. Always identify yourself using your account number. This is the absolute fastest method of accurately conveying who you are and getting your order to the floor. I don't tell my broker, "Hey good morning, this is Brian Schad..." I simply say, "This a day order for account #12345..." This immediately tells the broker that the ticket that must be placed is a certain type (day order) and who I am (Brian Schad). This is the most expeditious manner possible.

5. When you are initiating a position, state that you are "buying long, or selling short." This immediately conveys to the broker that this is an initiating position. For example, "This is a day order for account number 12345, to buy long/

sell short..." When offsetting (or liquidating a position) just simply say you are buying or selling. For example, if you were long a position and wished to offset or liquidate that position, you would instruct your broker as such, "This is a day order for account number 12345, to sell..." I don't mean to make this sound complicated. Basically, when you initiate a position you either buy long or sell short. When you liquidate or offset the position, you simply say, "buy or sell." (Just the opposite of the position direction you are currently in).

6. State the number of contracts. Very simply, how many do you want?

7. State the contract month.

8. State the commodity. For options, include both the strike price and the type of option (put or call). Here is an example of each:

- "This is a day order for account number 12345, to buy long two February Live Cattle ..."

- "This is a day order for account number 12345, to buy long two February Live Cattle 68 call options..."

9. State the price you wish to execute your trade. This can vary from buying/selling "at market" (current market price), a "limit" order (above or below the current market price), a market on open" (MOO), a "market on close" (MOC), etc.

- "This is a day order for account number 12345, to buy long two February Live Cattle at market."

- "This is a day order for account number 12345, to buy long two February Live Cattle 68 call options at market."

10. Write down your order confirmation number for future reference. This is important. Please do not overlook this. You will reference this confirmation number if you ever need to call regarding the status of your trade. For example, if you call your broker, and place a trade, your broker will give you a ticket number as a reference serial number for keeping track of their trades.

- "This is a straight cancel order (used to terminate an order that you previously placed with your broker) in reference to ticket number JG1-3035."

At this point, the broker will look in the record log for that ticket number and repeat the order and confirm with you that the order will be canceled.

Host: Well Brian, now that you have walked us through the various parts which make up a telephone order, can you give us some complete examples of orders?

Brian: Sure. There are many types of orders, but I am going to start with the orders most traders will use at least 50% of the time - market orders.

Host: What are market orders?

Market orders: Market orders are placed when a trader wants to initiate or liquidate a position immediately at the current market bid/ask price. You can place market orders for both futures contracts and options on futures. We'll concentrate on futures contracts first.

> Example #1 - Market order (initiating a futures position): I want to go long 3 December Wheat futures contracts immediately:
>
> "This is a day order for account #12345, buy long three Dec Wheat at market."
>
> Example #2 - Market order (initiating a futures position): I want to go short one June Live Cattle futures contract immediately:
>
> "This is a day order for account #12345, sell short 1 June Live Cattle at market."

Example #3 - Market order (offsetting a futures position): I wish to liquidate my June Cattle position in order to take immediate profit:

"This is a day order for account #12345, buy back 1 June Live Cattle at market."

Example #4 - Market order (offsetting a futures position): I wish to liquidate my wheat position in order to cut losses immediately:

"This is a day order for account #12345, sell back 3 Dec Wheat at market."

Example #5 - Market order (initiating an option position): I want to buy long two May 30-year bond call options at a strike price of 114:

"This is a day order for account #12345, buy long two May Bond 114 Calls at market."

Example #6 - Market order (initiating an option position): I would like to sell short two March S&P 500 Index put options at a strike price of 1150:

"This is a day order for account #12345, sell short two March S&P 1150 Puts at market."

Brian: Remember however, when placing market orders you are at the mercy of the floor traders with that particular market. A fast trading market may give you a poorly positioned fill or a costly liquidation. Think twice about placing market orders unless you find yourself in a situation with the market that you would like to remedy immediately!

Host: Let's take these same markets and create different types of orders. Instead of market orders let's make these markets have certain criteria to meet <u>before</u> our orders are filled.

Brian: Yes, this is the way I prefer to place my orders. I like the market to meet specific requirements before I "buy long," "sell short," or offset any position! Having the market meet specific criteria is a way I keep emotionalism out of my trading and at bay! Let's continue with basic stop orders:

<u>Stop orders</u>: Stop orders are placed above the current market price if buying, and below the current market price if selling. The criteria which must be met is the market must simply trade AT a certain price, and then my order to buy (or sell) becomes a market order.

> Example #1 - Stop order (initiating a futures position): I want to go long 3 December Wheat futures contracts when, and if, the price reaches 296^4 (Price is now at 294^0):

"This is a day order for account #12345, buy long three Dec Wheat at 296½ cent stop."

> Example #2 - Stop order (initiating a futures position): I want to go short one June Live Cattle futures contract when, and if, the price drops to 64.55 (Price is now at 65.30):

"This is a day order for account #12345, sell short 1 June Live Cattle at 64.55 stop."

Example #3 - Stop order (offsetting a futures position): I wish to liquidate my June Cattle position in order to lock in profit should the market reverse direction (Price is now at 62.20):

"This is a day order for account #12345, buy back 1 June Live Cattle at 62.95 stop."

Example #4 - Stop order (offsetting a futures position): I wish to liquidate my wheat position in order to cut losses only if wheat trades down to the last short-term low of 291^6 (Price is now at 294^2):

"This is a day order for account #12345, sell back 3 Dec Wheat at 291¾ cent stop."

Example #5 - Stop order (initiating an option position): I want to buy long two May 30-year Bond Call options at a strike price of 114 when, and if, the premium of the options reach 1^48/64 (Premiums are now at 1^36/64):

"This is a day order for account #12345, buy long two May Bond 114 Calls at 1^48 stop."

Example #6 - Stop order (offsetting an option position): I would like to sell the two May 30-year Bond 114 Call options if the premiums decay to one-half the value that I originally purchased them (Premiums are now at 1^12/64):

"This is a day order for account #12345, sell back two May Bond 114 Calls at ^56 stop."

Brian: Keep in mind that when placing buy (or sell) stop orders, the order must be placed above (when going long) or below (when going short) the current market price. That is all that is required! Otherwise your broker may remind you it is a "bad order. . ."

Host: Well that is easy enough to remember, Brian. I know there are many more type of orders I could use. What can we go over next?

Brian: The next type of order we'll cover is limit orders and the variations of them! To avoid confusion, I will go over what I feel is the universal type of limit order.

Limit orders: With this type of order, when used properly, I can initiate, or offset, a position and avoid any and ALL negative slippage. As a matter of fact, I can even receive a gross POSITIVE slippage in my favor! This is not uncommon either.
Example #1 - Limit order (initiating a futures position): I want to go long 3 December Wheat futures contract when the futures test the last low of 261^0 and reach a price of 265^2, but NOT higher (Price is now at 268^0):

"This is a day order for account #12345, buy long three Dec Wheat at 265¼, or better."

Example #2 - Limit order (initiating a futures position): I want to go short one June Live Cattle futures contract when the futures rally to a resistance level of 67.75, or higher:

"This is a day order for account #12345, sell short 1 June Live Cattle at 67.75, or better."

Example #3 - Limit order (offsetting a futures position): I wish to liquidate my cattle position to take profit 2.00 points lower than the price I was filled (Sold short at 67.82):

"This is a day order for account #12345, buy back 1 June Live Cattle at 65.82, or better."

Example #4 - Limit order (offsetting a futures position): I wish to liquidate my wheat position in order realize a profit just below the last resistance level of 295^0 (Price is now at 287^2):

"This is a day order for account #12345, sell back 3 Dec Wheat at 294½ cent, or better."

Example #5 - Limit order (initiating an option position): I want to buy long two May 30-year bond call options at a strike price of 114 when the premiums come down to a price of 1^15 (Premiums now at 1^28):

"This is a day order for account #12345, buy long two May Bond 114 Calls at 1^15, or better."

Example #6 - Limit order (offsetting an option position): I would like to sell the two May Bond 114 Call options when the premium I bought them for doubles:

"This is a day order for account #12345, sell back two May Bond 114 Calls at 2^30, or better."

Brian: These three types of orders are definitely the most common orders placed with brokers and are valid at ALL exchanges.

Host: When you say "valid at all exchanges," do you mean there are other types of orders that are not accepted at particular exchanges?

Brian: That is precisely what I mean. For example, the Chicago Board of Trade will not accept "stop-close-only" orders to be active only if the market was to settle above/below a certain level. The Coffee, Sugar, Cocoa Exchange of New York will accept those orders however. Your broker is a professional and will steer you in the right direction. Our job is to place price-specific orders in a timely manner!

Host: Can we walk through some of these miscellaneous type orders for general knowledge anyway? . . . just to get an idea of what they sound like.

Brian: Most certainly. These other types of orders are variations of the ones we have just gone over. You will hear that there is not much difference in the sentence structure of these uncommon type orders. Hear we go:

> Market-On-Open, Market-On-Close, Market-If-Touched, Stop Limit, Stop-Close-Only, Order Cancels Order: I will explain the circumstances of each one of these types of orders with the appropriate example:
>
> Example #1 - Market-On-Open (MOO) order (initiating a futures position): I want to go long 3 December Wheat futures contracts when the grain markets open tomorrow:

"This is a day order for account #12345, buy long three Dec Wheat market-on-open."

Example #2 - Market-On-Close (MOC) order (initiating a futures position): I want to go short one June Live Cattle futures contract when the market closes:

"This is a day order for account #12345, sell short 1 June Live Cattle market-on-close/M-O-C."

Example #3 - Market-If-Touched (MIT) order (offsetting a futures position): I wish to liquidate my June Cattle position in order to take immediate profit once the market touches support at 61.95 (Price is now at 62.30):

"This is a day order for account #12345, buy back 1 June Live Cattle at 61.95 market-if-touched/M-I-T."

Example #4 - Stop-Close-Only order (offsetting a futures position): I wish to liquidate my "long" sugar position in order to cut losses should sugar close below support at 8.15 (Price is now at 8.42): "This is a day order for account #12345, sell back 3 Mar Sugar at 8.15 stop-close-only."

Example #5 - Stop limit order (initiating a futures position): I want to buy long two March S&P's at/near a price of 1240.10, but I do not want more than 40 points of slippage beyond 1240.50 (Price is now at 1238.90):

"This is a day order for account #12345, buy long two March S&P's at 1240.10 stop, 1240.50 stop limit."

Example #6 - Order Cancels Order/One Cancels Other/OCO (offsetting a futures position): I would like to sell back two March S&P's at a price near 1251.10 above the market (if reached) for a profit, or if price goes against me to 1237.10 as a "protective stop":

"This is an O-C-O order for account #12345, sell back two March S&P's at 1251.10 market-if-touched, O-C-O, 1237.10 stop."

Brian: I have to say, this last order is probably the least one ever used, and also the most complicated. I personally use it almost every time I day trade the fast moving S&P 500 Index! Once I am in the S&P 500 market, I will place two orders thereafter - an order to get out market-on-close, and an order to get out if a certain price is reached as a protective stop. Since I have placed an OCO order, I don't have to worry about getting "double-filled" in case the market abruptly turns the other way.

Host: Does this mean your broker actually cancels the other order "working" in the market?

Brian: Almost. My broker instructs the order clerk on the trading floor to cancel the second order immediately once the first of the two orders is filled. It's a very valuable order that few traders take advantage of. It's not primarily for day traders either!

I have a sample order ticket (in the appendix next page over) that is filled out by our brokers each time we place an order in the market. This may help explain why orders to our broker need to be routine and regimented. Let's take a look at this together:

ABC FUTURES, INC.	
Account#	ORDER NUMBER *413*
BUY	SELL
BRANCH or IB ORDER	

- As the broker takes your order, the first thing that is noted is if it is a day order, or an open order, and it is noted in the upper right hand corner of the ticket.

- The next item recorded by the broker is our account number, and that is written down in the upper left hand corner as you can see.

- Next, the specific order is taken and is recorded in the "buy" section, or the "sell" section.

- Lastly, once the order is verified back to us, the broker will give us an order number (or a ticket number) that is to be recorded by us in case of potential errors. It is our responsibility to document this transaction! Failing to do so could lead to a costly error for us.

Brian: I have gone over each possible order that is most commonly used in trading. I have gone over each one of them textbook style for you to actually see (or hear by somebody "reading" to you) how each order should be directed to the broker. Remember, the broker works for us and will do exactly as we direct her/him to do. It is imperative that we are both speaking the same lingo when getting involved with the markets. I hope that I have helped you with this task. As my former Navy Instructors put it, "We can teach you anything you want to learn concerning diving, demo, shooting, and more, but we can't teach you experience. . ." Good trading to you all!

Glossary of Terms

Adjust: *A trading process by which the trader maintains a delta neutral spread position of zero through a combination of buying and selling options and/or futures.*

American option: *An option which can be exercised at any time on an American exchange, 24 hours a day, prior to and including the expiration date of the option.*

Arbitrage: *A trading technique, usually employed by large financial institutions or floor traders, involving the simultaneous purchase and sale of the same asset in different markets with the intent of profiting from a small price discrepancy.*

Ask price: *The current price of a specific option that market makers, or other traders, are willing to sell at.*

Asset: *The physical underlying cash product, material, or security; i.e. a stock, a commodity, an index, or a future.*

Assignment: *The process by which the seller (writer) of an option is randomly assigned by the Options Clearing Commission that the option holder has exercised the option. The terms of settlement must be met by the seller.*

At-the-money: *An option that has a strike price equal – or approximately equal – to the current market price of the underlying futures contract.*

Automatic exercise: *A process in which the clearing firm, through the Options Clearing Corporation, automatically exercises those options which are in-the-money at expiration. This is done in order to prevent the option holder from losing intrinsic value, and will be executed unless the option holder specifically requests not to.*

Bid: *The current price of a specific option the market makers, or other traders, are willing to buy.*

Black-Scholes: *A mathematical model that calculates the theoretical value of an option, using a complex formula, based on inputs from: underlying asset price, strike price, dividends, option expiration, and volatility.*

Bonds: *Debt instruments used to raise capital for a variety of public government projects or private corporation programs. The biggest commodity market for bonds is the 30-year Treasury Bond.*

Broker: *An individual, licensed with approval of the federal government, who acts as an agent for clients executing their orders in buying and selling securities transactions. Brokers make their profits primarily from client commissions. Brokers are licensed separately for commodities and stocks.*

Buy: *Used by a trader to offset, or liquidate, a short option or futures contract previously sold. This will be done at either a profit or loss.*

Buy long: *Used by a trader to initiate a position going long a futures or an option contract. Option buyers/purchasers have the right, but not the obligation, to enter a futures contact position by exercising the long option at any time until option expiration.*

Call option: *An option that gives the option buyer the right to purchase (go "long") the underlying futures contract at the strike price on or before the expiration date. The call option buyer pays for the option premium, resulting in a limited risk position with unlimited profit potential. The call option seller has the obligation to go short from the strike price, if exercised upon, resulting in potentially unlimited risk. The option seller receives premium as a credit.*

Cash settlement: *The procedure by which option contracts are liquidated through cash for the amount the option is in-the-money instead of taking (or making) delivery of the underlying asset.*

CBOE: *The Chicago Board Options Exchange. The CBOE, established in 1973, is currently the oldest and largest listed options exchange.*

CFTC: *The Commodity Futures Trading Commission. The CFTC is the branch of the federal government responsible for the regulation of commodity futures trading.*

Covered option writing: *Selling (or writing) an option against an existing long underlying futures contract.*

Day order: *An order that is good only for the trading day during which it was placed. Unless it is filled during the day session trading hours, a day order is canceled upon day session close.*

Delta: *The change of the price of an option relative to the change in its underlying futures contract.*

Delta neutral: *A method of trading in which the total instrument deltas of the trader's position(s) add up to a value of zero.*

Execution: *The completion, or fill, of a customer's order by a broker on the floor of an exchange.*

Exercise: *Action taken by the holder of an option notifies the seller of intent to take or make delivery of the underlying futures contract at the specified exercise price. A call holder would purchase the underlying futures contract, while the put holder would sell the underlying futures contract.*

Exercise price: *The same as the strike price.*

Expiration date: *The date and time after which an option may no longer be exercised. Even though options expire on a specified date during the month prior to the named month, the option is stilled referred to the named month because its exercise would lead to the creation of a futures position in that month.*

Extrinsic value: *The price of an option's premium less any intrinsic value. Out-of-the-money option's premium is mostly comprised of extrinsic, or time value.*

Fair value: *The theoretical or actual price an option is worth. This is derived from historical data, volatility, price, etc.*

Fill or kill: *An order which must be filled immediately and completely, or else is canceled.*

Fixed delta: *A delta figure that does not change with the change in the underlying asset.*

Front month: *The nearby contract which is closest to the current date. Contracts farther out are referred to as either deferred or distant.*

Futures contract: *A contract traded on a commodities futures exchange for the delivery of a specified commodity at a future date. The contract specifies the item to be delivered and the terms/conditions of delivery.*

Gamma: *The change of the option delta relative to the change in price of the underlying futures contract.*

GTC order: *An order, Good-Till-Canceled, that is placed and held as an open order until it is either filled or canceled by the trader. After 30 days, most GTC orders are canceled.*

Hedge: *The buying and selling of offsetting positions in order to provide protection against an adverse change in price. A hedge may involve having positions in various instruments.*

Hedger: *An individual or institution utilizing the commodities futures/options markets in order to reduce or remove risk from unforeseen price movements in the future.*

Historical volatility: *A measure of futures price movement/option premium over a specified period in the past.*

Implied volatility: *A measure of trader/market sentiment relative to price movement given a known option price.*

In-the-money: *An option which holds intrinsic value and could be exercised/closed out for a cash credit. A call is in-the-money if its strike price is below the current price of the underlying futures contract. A put is in-the-money if its strike price is above the current price of the underlying contract.*

Intrinsic value: *The dollar amount that would be realized if the option were to be exercised immediately.*

Leverage: *The ability to control large contracts of commodities or stocks with only a small amount of upfront cash.*

Limit move: *The maximum price a commodity can change from the prior day's close. This is regulated by the hosting exchange.*

Limit order: *An order which must be filled at a specified price or better.*

Liquidate: *A purchase or sale that offsets an existing position. This may be done by selling an option that was previously purchased, or by buying back an option that was previously sold.*

Liquidity: *The amount of trading volume in a specific commodity which dictates the ease of entering or exiting positions in an expeditious manner. Greater liquidity usually assists the trader in obtaining easier/quicker fills.*

Margin: *An amount of money deposited in a trader's brokerage account, when buying or selling a futures contract for the purpose of speculating the market. This "good faith" deposit is not a down payment. It is a sign of the traders willingness to observe his commitment should he make or take delivery of the contract.*

Margin call: *Additional funds that a trader with a futures position or an options writer may be called to deposit if the margin account falls below requirements. Buyers of options are not subject to margin calls.*

Mark-to-market: *Posting a credit or debit, of all open positions, based upon the contract value during that specific trading day's session. This prevents losses from accumulating.*

Market-on-close: *An order which is filled in the last few minutes of the day trading session.*

Market order: *An order which is filled on the exchange floor at the current market price.*

Naked option writing: *Writing (selling) a call or put option in which the writer (seller) has no opposite cash or futures position. Also known as uncovered option writing.*

NFA: *The National Futures Association. The NFA is a self-regulatory organization, begun in 1982, which establishes, audits, and enforces standards of professional conduct and practices of futures commission merchants (FCM) and introducing brokers (IB). Provides for arbitration when disputes occur between NFA members and customers, and monitors sales practices.*

Open interest: *The total number of futures or options (puts and calls) contracts outstanding on a given commodity.*

Open outcry: *The method by which traders buy and sell securities on the floor of an exchange. Bids and offers are relayed through a system using both vocal outcries and hand signals. This allows all members to freely participate in a competitive auction, thereby creating a free market environment. Commodities are physically traded in designated zones or "pits" within the exchange.*

Option premium: *The price of a particular option contract that is determined by supply/demand, time value, intrinsic value, interest rates, and volatility.*

Total option premium=intrinsic value + time value.

(Premium does not include related brokerage commission fees. The premium is the maximum amount of potential loss to which the option buyer may be subject.)

Out-of-the-money: *An option which holds no intrinsic value. A call is out-of-the-money if its strike price is above the current price of the underlying futures contract. A put is out-of-the-money if its strike price is below the current price of the underlying contract.*

Put option: *An option that gives the option buyer the right to sell (go "short") the underlying futures contract at the strike price on or before the expiration date. The put option buyer pays for the option premium, resulting in a limited risk position with unlimited profit potential. The put option seller has the obligation to go long from the strike price, if exercised upon, resulting in potentially unlimited risk. The option seller receives premium as a credit.*

Risk: *Any potential loss on a trade.*

Sell: *Used by a trader to offset, or liquidate, a long option or futures contract previously bought. This will be done at either a profit or loss.*

Selling short: *Used by a trader to initiate a position going short a futures or an option contract. Option sellers/writers have the obligation, not the right, to enter a long/short futures contract position upon option assignment or option expiration.*

Speculator: *An individual or institution buying or selling futures in anticipation of a profit when prices go up or down. Speculators do not intend to make or take delivery of the actual contract.*

Spread: *The simultaneous buying and selling of at least two different future contracts, or simultaneous buying and/or selling of at least two different option strike prices.*

Straddle: *A position having a long call and a long put, in which both options have the same expiration date and strike price. This could also be a short call and a short put.*

Strangle: *A position having a long call and a long put, in which both options have the same expiration date but different strike prices. This could also be a short call and a short put having the same expiration date but different strike prices. Most strangles involve out-of-the-money options.*

Strike price: *The exercise price in the underlying futures contract at which an option will be bought or sold. Strike prices can be spaced in irregular increments, but usually in full cent or 100 point increments.*

Time decay: *The amount an option premium loses value due to the amount of time left until option contract expiration. There is no set amount.*

Time value: *The amount by which an option's premium exceeds the option's intrinsic value. If an option has no intrinsic value, its premium is entirely time value.*

Underlying futures contract: *The futures contract upon which the corresponding option month is based upon. In the event an option is exercised, it is this contract which will make or take delivery.*

Volatility: *The amount a futures contract has fluctuated in price within a given time frame.*