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Options Speculation Techniques

Spot Those Tradable Situations-- Look At Option Volume Activity

By Lawrence G. McMillan

Lawrence G. McMillan, author of "Options As A Strategic Investment", publishes *The Option Strategist, a twice-monthly publication covering equity, index, and future option recommendations and strategy, as well as an educational article.* Go to www.OptionStrategist.com *Mr. McMillan lectures on options trading at AIQ seminars.*

Lawrence G. McMillan

Probably too many traders treat options as pure speculation rather than the theoretically more profitable treatment as a hedging vehicle or as a way to take advantage of pricing discrepancies. Much of my work deals with hedging or volatility trading (which is the generic term describing theoretical value trading), but in this article we're going to talk about speculation – plain old vanilla option buying.

Specifically, we're going to talk about how option activity might denote a potential trade in a stock or its options, and then we'll discuss how to hollow up on the position – setting stops, and letting profits run if they develop.

Option Activity As An "Alert"

It has long been known that when illegal insider information is garnered by some people, they will ignore the law and trade highly leveraged instruments in order to try to profit from the news they know. They often use the option market for these purposes. While it is completely illegal to act on material information that is not public, it is perfectly legal for us – as technicians – to follow along where we see heavy option activity.

Such activity may predict takeovers, earnings surprises, earnings warnings, or any number of other corporate news events. Moreover, it is also useful for momentum trading (its main application in recent years, since takeover activity has diminished).

How can one spot such situations? First, look at today's option volume *as compared to average option volume* for that particular stock. If today's volume is at least twice the average volume and if there were at least 1000 total contracts traded, then you might have something worth investing. If the heavy volume is mostly in *call options*, then take a bullish position – buy the stock or buy some calls.

However, if the heavy volume is mostly in *put options*, then take a bearish position (which normally would mean "buy some puts"). Later, we'll discuss which option to buy.

"While it is completely illegal to act on material information that is not public, it is perfectly legal for us – as technicians – to follow along where we see heavy option activity... if the traders with the (illegal) inside knowledge are not only buying plenty of options, but are willing to pay up for them as well...you might have a tradable situation."

Note that using option volume in this manner is using it as a *direct* indicator, *not* as a contrary indicator. In other words, we are trying to go *with* the smart money in cases such as these – not trying to take a position opposite to the uninformed public opinion, as we might do in a broader sense when we look at put-call ratios, for example.

Of course, one needs to be mindful of the fact that many things can cause a sudden increase in option volume, and many of them are boring – not related to corporate news events at all. These would include arbitrage, hedging (say, buying puts to protect a long stock position), or even perhaps just a large covered call write by an institution. So, one who is looking at these situations must weed out this "noise" – meaningless volume.

One clue that might help find "true" speculative situations is an increase in implied volatility of the options. That is, if the traders with the (illegal) inside knowledge are not only buying plenty of options, but are willing to pay up for them as well, *then* you might have a higher probability of having found a tradable situation.

Technical analysis is also a help. If these traders are buying call options, then the stock should be moving up. In fact, it should probably be breaking through resistance levels – or at least should have the potential to. If the stock is weak, then perhaps this is not a good situation to get into, despite what appears to be heavy call option activity.

It was mentioned earlier that momentum trading is another activity that can be spotted by heavy option activity. Momentum trading is defined as "buy high, sell higher." Generally, what is happening in such situations is that a hedge fund (or other aggressive large trading institution) has a long position and wants to push the stock up so the position can be sold.

They might "advertise" the stock by creating option activity, buying in a sloppy manner, and so forth, so that other traders might notice. Then, when the other traders come in to buy the stock – which appears to be acting very well – the hedge fund will sell into them. This momentum can carry for quite a ways, though – long after the original hedge fund has exited – if enough people pile into the stock and if certain positive technical patterns develop.

"Up-Down Volume is a very valid indicator in many trading situations...For example, if the stock is trending up, then up-down volume can help tell you whether or not the upward momentum is strong. Conversely, if you are looking to short a stock (or buy puts), then you'd want to see poor up-down volume."

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The strategy can be used for short selling as well: the institution has a short position, then it buys puts or otherwise "advertises" a negative trading pattern, which then draws in other short sellers – thereby creating downside momentum.

Up-Down Volume

Editor's note: To create this indicator for TradingExpert Pro, see section at the end of this article.

One very important confirming indicator in this regard is Up-Down Volume – the indicator invented by William O'Neil. Up-Down Volume is similar to "on-balance volume," but is computed over a shorter time frame. Here is how the indicator is computed: look at the most recent 50 days of trading activity in the stock. On any day that the stock closed up, add that day's volume to a running sum of "up volume." Conversely, on any day that the stock closed *down*, add *that* day's volume to a running sum of "down volume." At the end of 50 days, divide the two:

Up-Down Volume = Sum of "up volume" / Sum of "down volume"

The ratio, of course, is always a number greater than or equal to 0. If the ratio is greater than 3.0, that is *excellent* volume; greater than 2.0 is *very good*; 1.0 is *neutral*, of course; less than 0.8 is *poor*; and less that 0.5 is *terrible.*

This ratio attempts to measure whether stock traders (in particular, *large* stock traders) are participating with good buying volume on days that the stock is up (which is what you want to see, if you are bullish). Also, it measures whether traders are selling heavily on days when the stock is down – a bearish indication.

What we'd like to see if we are thinking of a bullish position – after having observed heavy call option activity – is up-down volume of 2.0 or higher. That is an excellent confirming indicator. On the other hand, if we see heavy *put* volume

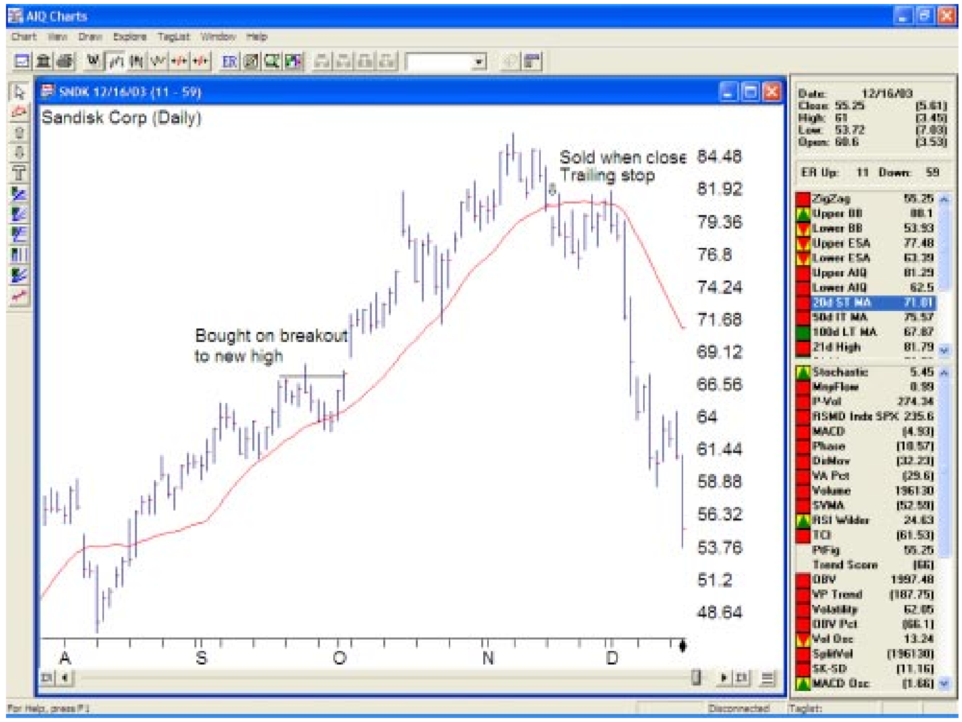

Figure 1. Daily chart of Sandisk showing strong 3-month advance. Long position was entered in September and sold in November after stock closed below trailing stop (20-day moving average).

activity, then we are looking to take a bearish position in the stock, and thus we'd want to see up-down volume at 0.8 or lower.

Up-Down Volume is a very valid indicator in many trading situations. It will generally work best as confirmation in a situation where you are looking to trade a stock that already has an established technical pattern. For example, if the stock is trending up, then up-down volume can help tell you whether or not the upward momentum is strong. Conversely, if you are looking to short a stock (or buy puts), then you'd want to see poor up-down volume.

The indicator is useful in other contexts as well. For example, in covered call writing accounts, we generally want to see reasonably good up-down volume before we buy a stock and sell calls against it. In those situations, we aren't even necessarily looking for positive stock technical patterns – we just want to avoid negative ones.

> ***"We are firm believers in cutting losses and letting profits run…most people find it hard to do – an attitude that is not helped by the media's insistence that this is a difficult task to accomplish. We disagree – cutting losses and letting profits run is actually quite simple if you are a disciplined trader."***

The indicator doesn't work as well when you are going *against* the tide, however. For example, in many of our put-call ratio recommendations, we are looking to buy a beaten-down stock after it has stabilized and perhaps made its first higher high in what we hope will be a series of new highs. Such a "beaten down" stock will likely not have positive up-down volume patterns. Mind you, we don't buy stocks in steep downtrends – put-call ratio buy signals or not – but even after the downtrend ends, you won't find the up-down volume indicator giving a positive reading right away.

What Option Should One Buy?

In these situations, which are likely to be short-term in nature, we prefer to buy a *short-term, in-the-money option* for it behaves much like stock itself. Thus, if the underlying stock makes a small move of a point or two in our favor, such an option will participate nicely as well – for it has a high *delta*, meaning that the option will appreciate nearly as much as the stock does.

It was mentioned earlier that sometimes these options can be expensive because of the aggressiveness of the option traders who are initiating the action. In that case, it's even *more* important to buy a short-term, in-the-money option, for such an option is less likely to be affected by a sudden decrease in implied volatility (should a takeover rumor fall apart, for example).

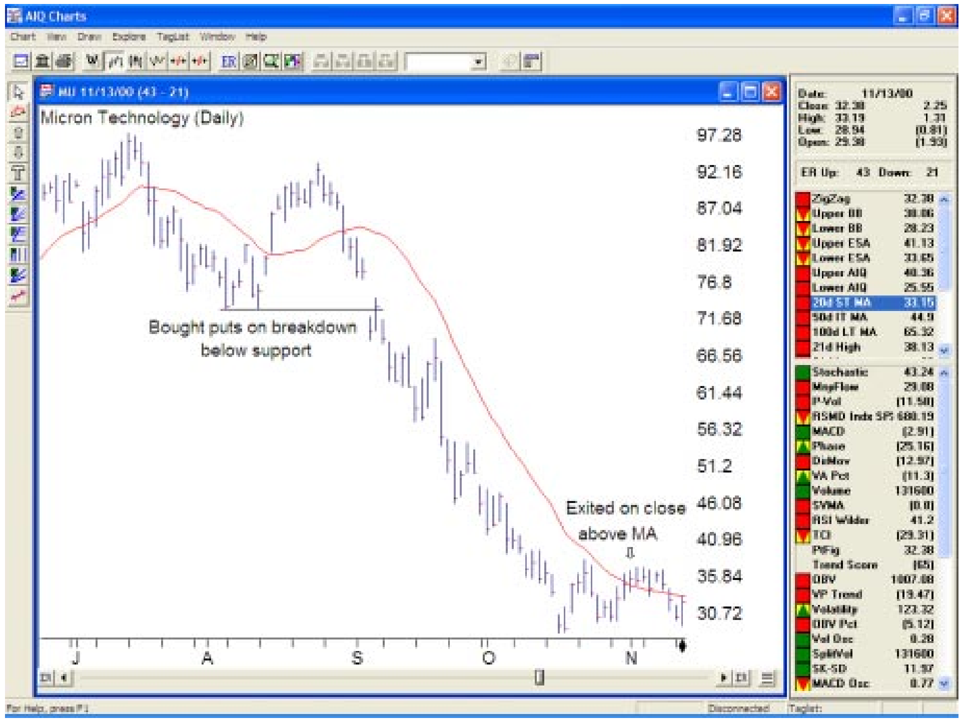

Figure 2. Daily chart of MU, a stock that broke support and then suffered sharp decline. Bearish position was exited after stock closed above trailing stop (20-day moving average).

"Let your profits run by using a trailing stop once the position begins to make money. In this manner, you lock in some profits, and you are able to ride along if a very strong trend develops. This is far better than using targets."

Follow-Up Action

We are firm believers in cutting losses and letting profits run. Of course, so is everyone. However, most people find it hard to do – an attitude that is not helped by the media's insistence that this is a difficult task to accomplish. Actually, we disagree with that assessment – *cutting losses and letting profits run is actually quite simple if you are a disciplined trader.*

You cut your losses by setting a logical stop initially and sticking to it. Alternatively, you buy options and limit your risk by only investing a small, fixed percentage of your account in any one trade – say 3% or less. In either case, your losses are small when they occur.

You let your profits run by using a *trailing stop* once the position begins to make money. In this manner, you lock in some profits, and you are able to ride along if a very strong trend develops. This is far better than using targets. Most of the time, my observation of people that use targets is this: 1) they stay in a position too long waiting for the target to be hit, thus allowing gains to turn into losses, or 2) the stock blows right through the target, and the trader loses out on a major portion of that blow-out move because he exited at the target.

In a more general sense, suffice it to say that most fundamental analysts use targets, and we think that is preposterous – they can barely get "buy" and "sell" straight, much less advise someone on a target price. Of course, what they are really doing is trying to estimate price/earnings *ratios*, but they're woeful at that (even if they're good at the "earnings" part). I'm not saying I can set targets any better; I'm saying don't use targets at all – use a trailing stop instead.

Figure 1 shows a stock that had a strong move. The stock is Sandisk (SNDK) – one of last Fall's big winners, at least for a while. The simple 20-day moving average is drawn on the chart as well, and it is the trailing stop. We recommend that you use it as a closing stop. That is, if the stock *closes* below the 20-day moving average on any given day, then exit your position. SNDK is a stock that we purchased in our *Daily Volume Alerts* newsletter back in September.

The stock then went on a fairly spectacular run – gaining 20 points in about five weeks. This advance was much more rapid than past movements might have led one to expect. That is, if one had been using a target for what ostensibly was to be a short-term trade, he probably would have gotten out after a 6 or 8-point gain. In this case, we stayed with the stock as long as its momentum was intact, using the 20-day moving average as a trailing stop. Eventually we exited when it closed below that stop in mid-November.

Similarly, a 20-day moving average can be used to let profits run in a bearish position, as well. **Figure 2** of Micron Technology (MU) shows this clearly.

There are some other considerations regarding follow-up action, as well. First, one might want to take a partial profit on a fourth or a third of his position on a profitable initial move, just to pocket some gains – and then use the trailing moving average for the balance of the position.

Also, if one is trading options, he might want to roll them to protect gains as well. Look at the chart of MU (Figure 2), in late September. The stock was trading at 46, but the 20-day moving average (the trailing stop) was at about 68. That's not much in the way of protection, is it – with the stop 22 points higher than the current stock price? In this type of situation, we would roll the puts that are owned down to an at-the-money put – thereby taking a big chunk of credit out of the position, and limiting risk on any further rallies.

Specifically, if one had originally bought puts with a striking price of 70 (the stock was near 70 when the position was taken), then he might roll them down to a put with a

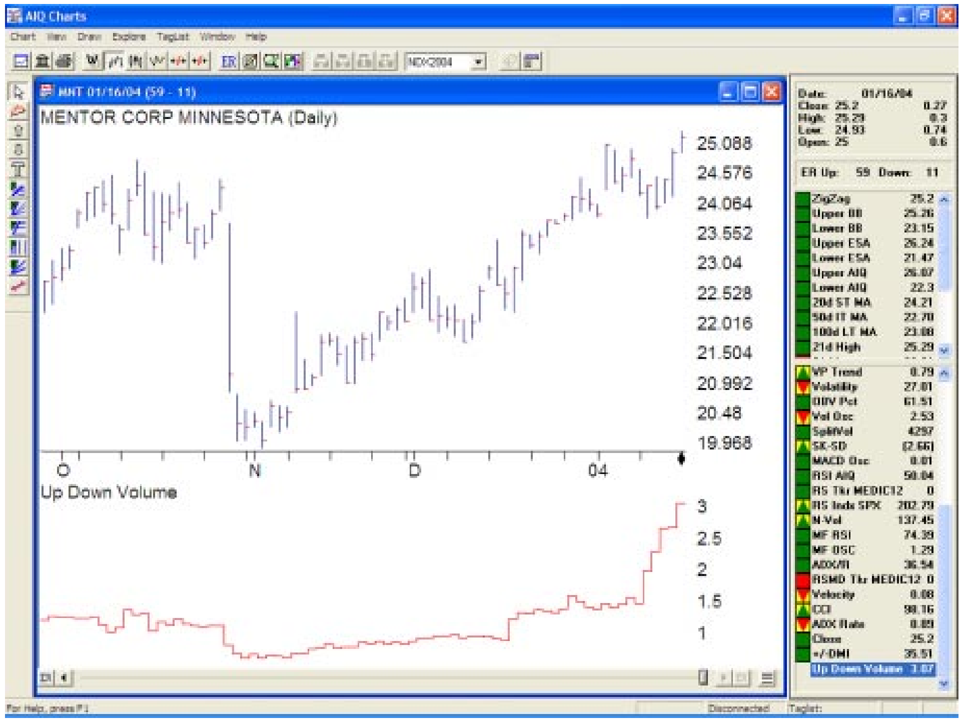

Figure 3. Daily chart of MNT with UpDn indicator plotted in lower window.

striking price of 45 or 50 at this time when there was such a big discrepancy between the current stock price and the trailing stop.

We generally employ these follow-up strategies in our positions. This is how we decide when to roll options, how to set stops, and how to let profits run. These techniques work for any speculative trade – no matter what criteria you used when you entered the position. So they work for "volume alert" trades as well as "put-call ratio" trades, or trades established with your own criteria.

The Option Strategist, by Lawrence G. McMillan (Author of *Options As A Strategic Investment*), is published twice monthly covering equity, index and future option recommendations and strategy, as well as an educational article. www.OptionStrategist.com

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Editor's Note:

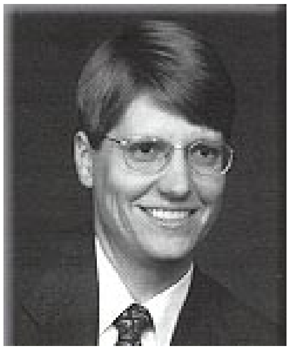
Up-Down Volume Indicator

This indicator can be created in TradingExpert Pro. You can download the Up-Down Volume Expert Design Studio (EDS) file at www.aiqsystems.com. Click on *Educational Products* and *Opening Bell*. Alternatively, you enter the following code:

```
Up if [close]>val([close],1).
Dn if [close] < val([close],1).
UpVol is iff(up,[volume],0).
DnVol is iff(Dn,[volume],0).
Sumup is sum(upvol,50).
Sumdn is sum(dnvol,50).
UpDnVolume is sumup/sumdn.
```

Once the EDS file is saved, you can create the indicator in Charts. On the Charts menu bar, select *Charts, Settings, Indicator Library, EDS Indicators*. Click *Add* and highlight the EDS file. Select *"one line"* and click *Next*. In Description, type *Up-Down Volume* and under UDF to Plot select the *UpDnVolume* rule. Click *Finish* and then *Done*.

Figure 3 shows a chart of Mentor Corp Minnesota (MNT) along with the Up-Down Volume indicator.



DAVID VOMUND

Dogs of the OEX Yield Plays

Our Dogs of the OEX Strategy Can Be Helpful During Value Investing Times

By David Vomund

When President Bush cut the dividend tax rate, it made dividend-paying stocks more attractive. In past research, we found that dividend-paying stocks have less growth potential but they offer more stable returns. The dividend paying stocks shine during times when value investing is in favor. In this article, we'll update the "Dogs" strategy that we first presented in the March 1998 *Opening Bell*.

In the mid 1990s the Dogs of the Dow investing strategy gained great popularity. Mutual funds were formed to follow that specific strategy. Its popularity waned in the late 1990s as growth investing became the rage. The Dogs of the Dow strategy is a value strategy so it underperformed badly at the height of the bubble. Since then, its performance relative to the S&P 500 has improved.

The key to this strategy is that the stocks that are purchased are all high-yielding well-established stocks. The strategy buys those stocks in the Dow that have the highest yield and holds them for an entire year.

In the March 1998 *Opening Bell*, we took the concept of the Dogs of the Dow strategy and modified it to comprise a broader set of large-cap stocks. Our concern was that too many people were following the Dogs of the Dow strategy and for that reason it would stop working. Since the strategy relies on choosing stocks with high yields, in our modified approach we picked the highest yielding stocks in the S&P 100 index (otherwise known as the OEX).

This is how our Dogs of the OEX strategy works: On January 2 of each year, we purchase the 10 highest yielding stocks in the S&P 100 and hold them for an entire year, at which time a new list of high yielding stocks is purchased.

<u>Table 1</u> shows the yearly returns of our Dogs of the OEX strategy. Dividends are included in these returns. Notice that the average yearly return for the Dogs of the OEX strategy is about the same as the yearly return of the S&P 500. The return from the Dogs strategy, however, is more stable than a buy-and-hold approach. Over the nine-year time period, there was only one down year.

Looking closely at the returns in Table 1, the Dogs strategy performed poorly in 1998 and 1999 when growth investing was in favor at the height of the bubble. During the 2000-02 bear market, value investing

"The average yearly return for the Dogs of the OEX strategy is about the same as the yearly return of the S&P 500. The return from the Dogs strategy, however, is more stable than a buy-and-hold approach. Over the nine-year time period, there was only one down year."

Table 1. Dogs of the OEX Yearly Returns

Year	Dogs Return (%)	S&P 500 Return (%)
1995	32.65	37.58
1996	16.23	22.96
1997	27.34	33.36
1998	4.77	28.58
1999	4.72	21.04
2000	9.35	-9.10
2001	19.40	-11.89
2002	-19.45	-22.10
2003	33.89	28.69
Average =	**14.32**	**14.35**

outperformed and this strategy did very well. While the S&P 500 fell nearly 12% in 2001, the Dogs strategy rose 19%.

Figure 1 shows an index of the Dogs stocks in 2003. Notice that the yearly gains came in the spring and in December. In between these times, the index was in a five-month-long ascending triangle pattern. The index saw its strongest gains once it broke above this pattern.

A list of the stocks that make up the 2004 Dogs of the OEX is shown in **Table 2**. For this strategy, these stocks are held through the rest of this year. I realize that holding stocks for an entire year is not a strategy that most AIQ users are interested in. The analysis is still helpful, however, as users may also choose to analyze these stocks individually or buy a basket of these issues during times when value investing outperforms growth investing.

To find the 2004 Dogs of the OEX stocks, we first downloaded a spreadsheet of the S&P 100 stocks which can be found at www.standardandpoors.com. After saving these tickers to a CSV file, we imported them into an AIQ list using the Advanced List Edit tool in the Data Manager.

Figure 1. Daily chart of Dogs of the OEX stock index. Notice that in December the index broke above five-month ascending triangle pattern and has since moved strongly upward.

Table 2. 2004 Dogs of the OEX

Ticker	Stock Name	Yield
MO	Altria Co.	5.1
SO	Southern Co.	4.7
SBC	SBC Communications	4.6
AEP	American Electric Power	4.5
T	American Tel & Telegraph	4.4
VZ	Verizon Communications	4.1
BAC	BankAmerica Corp.	4.0
GM	General Motors	3.7
BMY	Bristol Myers Squibb	3.7
SLE	Sara Lee	3.5
JPM	JP Morgan Chase	3.5
USB	U S Bancorp	3.4
DOW	Dow Chemical	3.3
MRK	Merck & Co.	3.2
DD	DuPont De Nemours	3.2
ETR	Entergy Corp.	3.2

To get the yield for each S&P 100 stock, we used AIQ's Fundamental Module on the first trading day of the year and retrieved yield information for each stock. This information was sorted from highest to lowest. You can't retrieve historical fundamental information so it is important to run this function on the first trading day of each year.

At the beginning of next year, we'll update the performance of the Dogs of the OEX strategy, and we'll list the new set of Dogs of the OEX stocks.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, call 775-831-1544 or go to *www.visalert.com*.

Market Review

Good News for the Bulls -- There's 85% Chance of an Up Year

January began with a strong advance. That's good news for the bulls. Since the market advanced in the first week of the year, history says that there is an 85% chance of an up year (using data dating back to 1950).

The advance continued for most of the month. In January, the S&P 500 rose 1.7% and the Nasdaq rose 3.1%.

The leading sectors in January were Telecommunications (+13%), Energy Services (+9%), and Internet (+9%). The worst performing sector was Precious Metals (-12%), fol-[redacted]terials (-6%).

S&P 500 CHANGES

Changes to the S&P 500 Index and Industry Groups:

There are no changes this month.

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STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split/Div.	Approx. Date
Health Care Prop.	HCP	2:1	02/03/04
Winnebego Ind.	WGO	2:1	02/03/04
Polaris Indus.	PII	2:1	02/08/04
Centex Corp.	CTX	2:1	02/15/04
Donaldson Co.	DCI	2:1	02/22/04
Amphenol Corp	APH	2:1	02/30/04

Trading Suspended:

Footstar Inc. (FTS), General Motors Corp H (GMH), Good Guys (GGUY), Interpool Inc. (IPX), Latitude Communications (LATD), Redback Networks (RBAKQ), Saga Commun. (SGA), SoundView Technology (SNDV)

Name Changes:

Barr Laboratories (BRL) to Barr Pharmaceuticals (BRL)
Calper Technologies (CALP) to Calper Life Sciences (CALP)
Midwest Express Holdings (MEH) to Midwest Air Group (MEH)
Park Place Ent. (CZR) to Caesars Ent. (PPE)
Philadelphia Suburban (PSC) to Aqua America Inc. (WTR)
ROC Taiwan Fund (ROC) to Taiwan Greater China Fund (TFC)
Wackenhut Corrections (WHC) to Geo Group (GGI)

AIQ announces release of TradingExpert Pro v7.3

This release is FREE for all subscribers to the TradingExpert Pro/myTrack monthly lease plan

visit

http://www.aiqsystems.com/TESindex73.htm

to download this release

The new features and fixes list is available on the upgrade site and includes:

Point & Figure on a real-time chart now available in RTalerts.
1, 5, 15, 30, 60, daily or weekly chart.

Vertical Scaling Mode allows the user to specify vertical plot scaling method. Useful on charts where the price action has a considerable vertical range over a short period of time.

Added filter for recurring bad time-stamp in data feed. This should eliminate the real-time chart 'flat lining' and/or failing to update when the exchange sends an incorrect time/date stamp.

Portfolio Manager changes include additions to Risk Analysis Tab, Stop Loss, Transaction, Journal, Closed Tabs, Portfolio Tab and Account Statistics/Analysis Report.