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**BY DEREK CHING**

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## How to Trade Powerful Options Strategies: Gaining an Edge with Futures and FX options

Derek Ching, registered commodity trading advisor and NFA member (National Futures Association)

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What you will gain from this eBook is an understanding of basic principles that are important in structuring option spreads in futures markets. Since there are many well written books on futures and options, I will not be going into option theory. Rather, my objective is to provide a practical and simple framework of discussion allowing you to gain enough information and interest to get started with a broker, review quotes and consider trading effective and powerful strategies with options on futures around your view of potential market behaviour.

Many traders new to options or “futures options” are intimidated by what sounds like a complex series of instruments. A common perception is the subject is too complicated and overly “risky” on highly volatile instruments. Hopefully, this article presents helpful insight where proper use of these instruments can open doors to strategies that improve your trading edge.

One’s learning curve on options doesn’t have to be a painful and long, drawn out experience either. Taking time to learn simple steps with adequate guidance can strengthen your trading arsenal with knowledge. Baby steps are always a great start with a helping hand.

- First, we’ll start our discussion by examining some common perceptions or “myths” held by traders. You might find common ground in this section with your own beliefs.
- Second, we’ll examine advantages a trader could gain through using futures options as spreads versus trading the underlying futures or outright options. We’ll look at the Crude Oil market with a few simple examples. This section is meant to answer the question, “Why should I learn futures options?” Sometimes, simply trading the underlying or outright option could be a more suitable strategy for you to consider depending on your objectives. I’ll discuss a few points on this near the end to help you decide what may best suit your risk tolerance.
- Third, we will look at a simple step-by-step process you can use to evaluate a trade through modelling a specific type of strategy called a Ratio Backspread as an exercise. This section is titled “An Example of a Trading Process.” We will walk through steps of a trade using the EuroFX market. In this section, I will introduce a few helpful tools that can help you create and plan your own trades on futures options.
- Last, we’ll look at an example of the eMini S&P futures markets in the final section of our discussion on “gaining a theoretical edge.” We’ll go through the same comparison format above looking at a directional and touching on the concept of a non-directional strategy. We’ll compare how these strategies would perform around a trader’s given market expectation against trading the underlying or outright put/call in each scenario.

This eBook is a different version of the original article *How to Structure Powerful Options Trades* by Paul Forchione. I’ve only highlighted some of the key points in Paul’s original article which focuses on a handful of examples designed to get you familiar with futures options concepts and kept simple. Paul’s article contains detailed insight from the view of a professional floor trader. You can [email us](#) to get the original article written by Paul which has much more detail.

If you find this article perks your interest on wanting to learn more on futures options basics and advanced strategies, we've put together a free series of helpful weekly lessons in our newsletters.

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One of our secretaries had a daughter named Kiana who would always be at our office. She was a special kid who learned to read at age 7 and often came by my desk asking what I did.

I used what I knew of the markets as a tool to help guide her learning in math and explore a general interest in products like corn and soybeans. We started her learning journey with industry websites on planting and harvest cycles for corn and soybeans and slowly relating it to what I do on trading futures.

In the process, I developed a new appreciation in finding ways to break down concepts and principles to meet her level of understanding. How do you teach a child how to calculate gains and losses in an auction environment for soybeans?

Beyond simple lessons, eventually I had set Kiana up with a paper trading account with the whirl of excitement of prices moving. At 9 years old, she began to appreciate the concept of risk and financial consequences that followed if it weren't adequately managed. There is still much for her to learn with myself and as her guide in this business.

My point is that concepts aren't difficult if you're willing to put in the time. The benefits to adding sophisticated strategies using options are enormous and open ways to manage that aren't available to those trading simply the underlying stock, futures or similar assets.

What you'll receive in the series of free lessons are some of the similar practices and information I've found helpful on breaking down concepts as I did for Kiana. I hope this article and lessons that follow allow you find value in exploring the use of futures options to help you optimize your path in trading.

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## Common Perceptions & “Myths” held by Traders

The original article, “*How to Structure Powerful Options Trades*” was authored by Paul Forchione while he was at PFGBest as an options strategist. Below are some of the insights he shared from his long career as a floor trader on the Chicago Board of Trade (CBOT) and market-maker on the Board of Options Exchange (CBOE).

The more experience you acquire in the commodities and options business, the more you grow to appreciate the incongruity of it all. In other words, if you trade on the basis of what’s known and what’s obvious you lessen your chances for success. The 'obvious' includes the news and price charts.

Traders are eventually separated from their money if they think commodity futures move in response to news because over the long term there’s little correlation between them. It’s like many things in life; you need to get beneath the surface to find meaning.

Many traders understand this yet can’t resist acting in response to the obvious. That’s why it’s so important to use a trading plan based on guidelines and decision points that aren’t affected by news or other distractions of the moment.

A trading plan (if followed) prevents you from reacting in a 'Pavlovian' way.

Many who attend our classes on futures options, primarily focus on intraday directional strategies they’ve acquired from a tradeshow, technical educator or work with systems. Those who have some experience with options typically use a software that models probability of profit. That said, let’s look at a few commonly held myths as explained by Paul which I’ve placed as excerpts here. If you’d like his original full article, simply send us an email and we’d be happy to forward that to you.

### MYTH #1

“I can make a fortune once I find the right system for trading options.”

### REALITY

Be wary of any system that promises to deliver profits. It’s naïve to believe there are trading systems or people who can regularly “outsmart” the market. Everyone is entitled to their guesses and opinions, but market prognostications should be accepted for what they really are: guesses and opinions.

Experienced traders operate according to the premise that there’s no substitutes for risk control and money management. They know they must work at the process of trading options. They learn about the markets, option behaviour, trade-offs, and probabilities.

This means you must learn to use option strategies that give you a mathematical advantage wherever possible. You must also manage open positions and close them in accordance with predetermined guidelines for action.

These are indispensable elements of a well-constructed trading plan and while this should be obvious, no one wants to hear it. Instead, there’s a desire for an esoteric explanation, a secret that “strikes his or her fancy” and that’s known by only a select few.

As traders, we should strive to implement a trading plan with components that serve us well as opposed to searching for secrets that don’t exist.

## MYTH #2

“My software program tells me the ‘probability of profit’ for any options position. So I’m confident I’ll make money if I initiate only trades that show a probability of profit of 90%.”

### REALITY

There are no guarantees of profits. If you like trades that have a high probability of making money, then you must recognize there’s a “price” to pay. And the possibility you’ll incur large losses.

The reason for this is that a high probability options trade is a trade that’s short out-of-the-money options. The probability you’ll lose a lot is low (because the market must make a large move or implied volatility must increase a lot), however, these are risks that do exist. So it’s an inescapable trading reality that the potential profits on a high probability trade are much smaller than possible losses.

So, how should a trader choose the type of trade to do? My advice is to match your expectations for the market (in terms of direction and implied volatility) to an option strategy that will profit if your expectations are correct. Don’t base your decision on high or low probabilities alone.

When you trade options, you’re engaged in a game of mathematics, more specifically, the mathematics of statistics. Proper interpretation of statistical concepts is crucial when making trading decisions. And one of the most misunderstood concepts in my view is “probability of profit”.

## MYTH #3

“The technical and fundamentals support my bullish position. And since the commercials are also long, I’m sure I’ll make money.”

### REALITY

Traders often hear that commercials drive the commodity markets, so the way to make money is to align their positions with the commercials. While the commercials do play a large role, it is a quantum leap to conclude that you can make money by mirroring their bullish or bearish tendencies because long term positioning by commercials is not nearly as important to a speculator as short term market movement and changes in implied volatility.

Hedgers use the futures markets to lock-in prices for future delivery of their products. For them, the futures markets are a mechanism to reduce risk. Floor traders and other market participants take on that risk by frequently buying and selling in anticipation of making money. This is speculation in the purest sense of the word. It is not investing.

In addition, what works for successful stock investors does not necessarily work for successful speculators who trade options on futures.

## Conclusion on Common Myths & Perceptions

Who can forecast the timing and incremental effect of these orders? No one, in my opinion. That's the primary reason that directional trading is so tough, and why I believe using non-directional option strategies that take advantage of volatility are more productive in the long run.

It's dangerous to make options trading decisions based on fundamentals because they play out over the long term while options are short term financial instruments. Take the monthly Crop Production Report issued by the USDA. The report is issued at 7:30am CST and the grain markets open at 9:30am CST. Grain market traders wait for the report each month to see if their expectations will be confirmed. When the reported figures are bearish, for example, the various news services report "early calls" from floor traders about how low each of the markets is expected to open.

What you sometimes see, however, is a strong opening. Why? Because expectations for traders as a whole may have been for more bearish figures. And since the reported figures are a "disappointment," traders place orders to cover their short positions causing the market to open higher.

Whatever the "real" reason may be is always a matter of guesswork and the important thing to acknowledge is that markets behave in more unpredictable ways than a simple reading of the facts would lead you to believe. And, in addition to the unpredictability of market movement, options traders need to consider expansion and contraction of option premiums as implied volatility changes.

... My point is that the human mind looks for logical reasons to explain what's happened. Think about this need for logical reasons. I personally feel it steers many traders down the wrong path because much of what occurs in markets cannot be explained except to say, "selling pressure broke the market" or "buyers pushed prices higher."

This is the most important reason for employing rigid money management rules. After all, the market will do what it wants to do, and attaching reasons for its behaviour after the fact doesn't help you anticipate future market direction.

(The full original article *How to Structure Powerful Options Trades* written by Paul Forchione can be obtained by emailing us at: [ebook-contact@oahucapital.com](mailto:ebook-contact@oahucapital.com))

## Final Thoughts

I remember when I first met Paul Forchione and after reading his article felt a sense of relief. From what? My answer is relief from the burden I placed on myself with being overly attached every trading decision and trying to justify or fix it.

When I look at markets, the thoughts I keep in mind are:

"No one knows, everything is an opinion."

"So, how are you going to play that opinion and adequately manage the risk behind it?"

When you have accepted the fact that you cannot be right all the time and your trades are an expression of an opinion, a psychological battle is won. The awareness gets you away from the need to be right as the market will do as it will with many disappointments to the best of trading plans. One of the biggest fallacies of creating trading systems in my mind is curve fitting historical data to convince yourself the future can be consistently predicted. Someone who needs to be right keeps searching for the holy-grail on creating opinions. It's like a parent once told me, "when you're wrong, admit it and move on." Translation – close bad trades & move on.

All we can realistically do is form an opinion, create a plan and manage a situation as time unfolds. As I go through examples on technical analysis, you'll see I use a combination of indicators to form opinions. When I craft option strategies around opinions, I am applying an independent step that mathematically offers a theoretical edge over a number of outcomes. When you think of trading as a game of statistics, over attachment to a single trade opinion isn't the best way of going about things long term. For each individual occurrence, make a plan, monitor and exit when you should. That's it.

## Why Futures Options

Before going into a discussion on specific markets with examples of strategies, below are a few highlights on how futures options can be a helpful addition to one's trading arsenal. A more detailed list can be found on our website under 'Why Option Spreads.'

1. Lower margin requirements on spreads versus trading the underlying or outright option
2. Be Positioned to Stay in a Trade to Weather Unfavourable Conditions
3. Gain a "theoretical edge" with probabilities based on historic valuations of volatility

To illustrate each of the points above, I will create scenarios across Crude Oil, EuroFX and the eMini S&P markets. I will touch lightly on each product's specifications to provide some background for discussion. However, more information on product specifications can be found directly on the Chicago Mercantile Exchange (CME) website at: [www.CMEGROUP.com](http://www.CMEGROUP.com). For those who would like further assistance with exercises, our classes help further your education on trading futures options spreads.

### Lower Margin on Spreads versus Futures or Outright Option

The official definition of "margin" in Wikipedia is "collateral that the holder of a financial instrument has to deposit to cover some or all of the credit risk of their counterparty (most often their broker or an exchange). Most of the exchanges today use SPAN ("Standard Portfolio Analysis of Risk") methodology, which was developed by the Chicago Mercantile Exchange in 1988, for calculating margins for options and futures. It's an automated process where you can simply use an electronic platform or tell your broker what you want to do and get the "initial and maintenance" margin requirements.

As an example, suppose a trader with a bullish view were looking to go "long" one Aug CL futures contract of Crude Oil, the Initial margin or deposit collateral could be around \$5,738 USD to put on the position as shown below. Margin requirements change daily depending on market conditions.

Summary						
	Net Reqmts	Gross Reqmts	Cash Flow	\$0	Delta	100.0
Init	\$5,738	\$5,738	Cur. Value	\$0	Gamma	0.00
Maint	\$4,250	\$4,250	Gain/Loss	\$0	Theta	0.00
Cash/Init	0.00	0.00	Commis	\$0.00	Vega	0.00

An alternative to entering a long position on the Crude Oil futures contract for the bullish trader would be to purchase a call option. The buyer of a call option has limited risk and would pay the option premium to enter a bullish position.

Below shows the premium cost or margin of \$2,660 USD for purchasing 1 Aug 58 Crude Oil call option. It is significantly lower than purchasing the futures contract by comparison.

Summary						
	Net Reqmts	Gross Reqmts	Cash Flow		Delta	
Init	\$2,660	\$0	Cur. Value	-\$2,660	Gamma	50.08
Maint	\$2,660	\$0	Gain/Loss	\$0	Theta	7.17
Cash/Init	-1.00		Commis	\$0.00	Vega	-32.54
						78.22

Finally, below is a Bull Put Spread (buying 1 Aug 55 Put and selling 1 Aug 57 put) which creates a bullish position with multiple options. You can see the Initial margin requirement below is the lowest of the 3 scenarios. Interestingly, with the option spread below, the trader would also see a cash credit inflow of +\$760 in the account at the time the position is put on. It is mainly because he would be collecting a larger premium from the Aug 57 put option sold than what is being spent on buying the Aug 55 put.

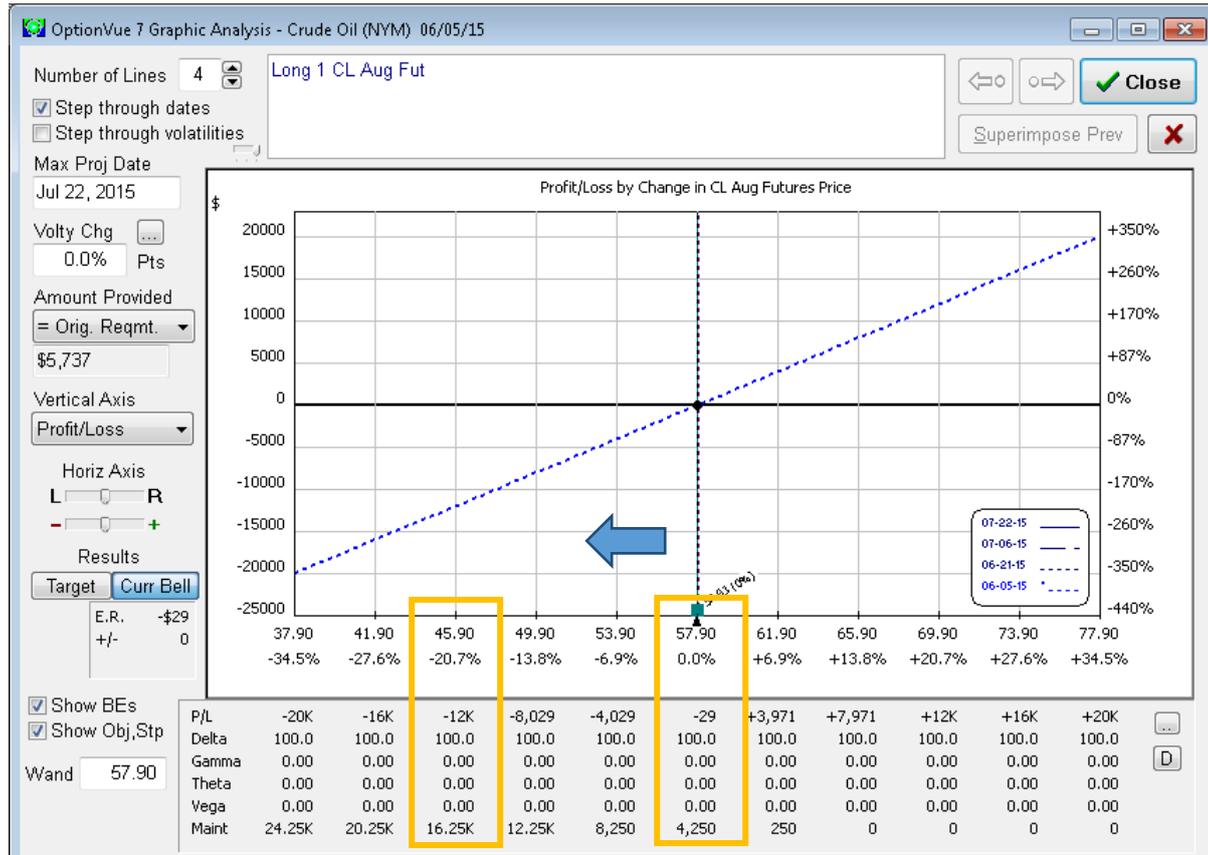
Summary						
	Net Reqmts	Gross Reqmts	Cash Flow		Delta	
Init	\$798	\$1,558	Cur. Value	+\$760	Gamma	11.68
Maint	\$593	\$1,353	Gain/Loss	\$0	Theta	-0.74
Cash/Init	0.95	0.49	Commis	\$0.00	Vega	2.01
						-6.77

So, reduction in the amount of “margin” required as a deposit to put on a trade can certainly be an advantage in working with multiple options to create strategies known as “spreads”.

Before discussing our next point, let’s look at some profit & loss graphs comparing each position (futures contract, outright call option, bull put spread (using multiple options)).

Below is a profit & loss graph showing 1 long Aug Crude Oil position. Each one cent move in the price per barrel quote above would be a \$10 USD move in the trader’s account. The trader theoretically has unlimited risk where his position is impacted greatly by strong moves in the price of Crude. If price dropped to \$45.90 per barrel the loss would be (\$12K) per futures contract which is a tough pill to swallow supposing one were to blindly hold onto a losing speculative futures position.

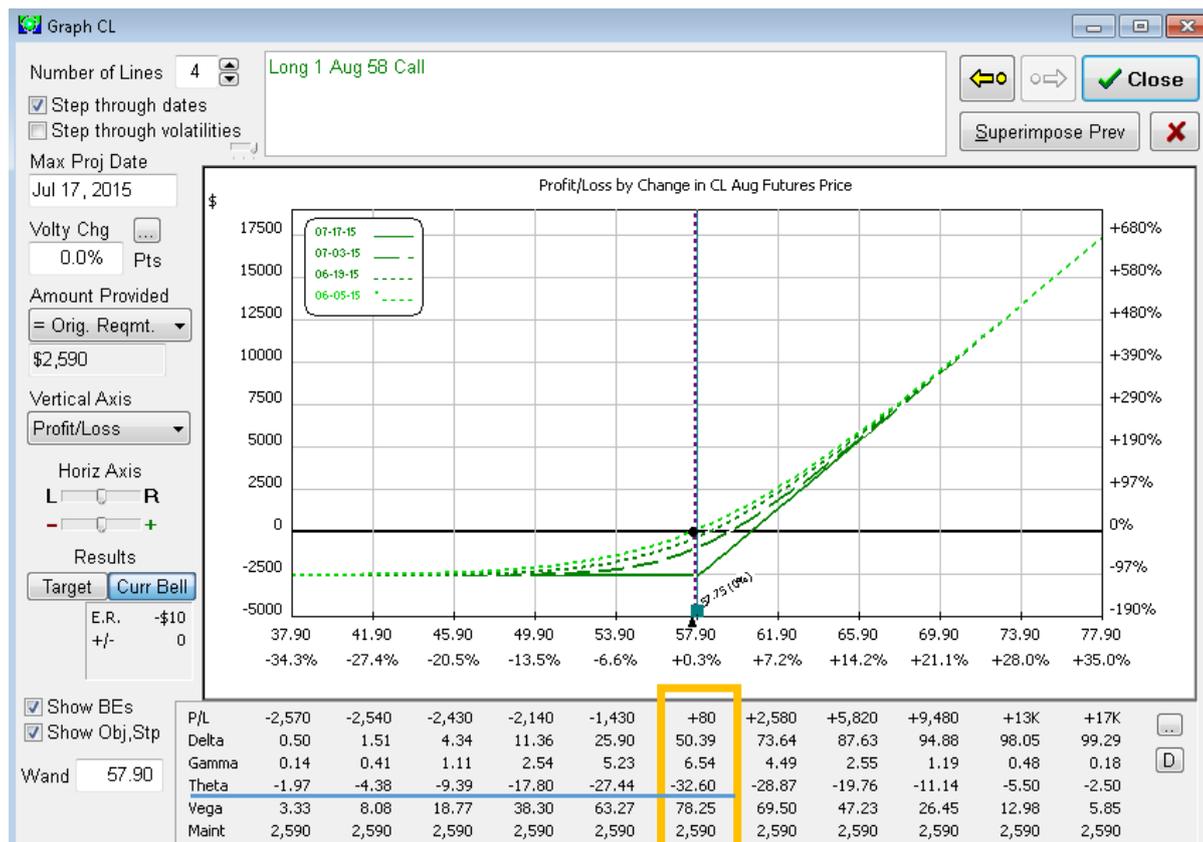
# LONG 1 AUG CRUDE OIL FUTURES



Below shows a profit and loss graph on purchasing 1 Aug 58 CL call option where the premium is around \$2,590. A trader has limited risk with this position as can be seen with price moving down (to the left of the horizontal price axis). The most he could lose is the amount paid for the option, in this case \$2,590 (plus commissions & fees). There is also a lower margin requirement in comparison to the long futures contract we just looked at.

However, one inherent characteristic of purchasing options is an aspect called time decay (Greek variable Theta). What this simply means is when you purchase the option, each day the position is held, it loses time value each day until expiration. A purchased option is a “wasting asset” meaning it loses value and depreciates over time. In the case below, the call option loses around (\$32) per day which increases as time nears expiration.

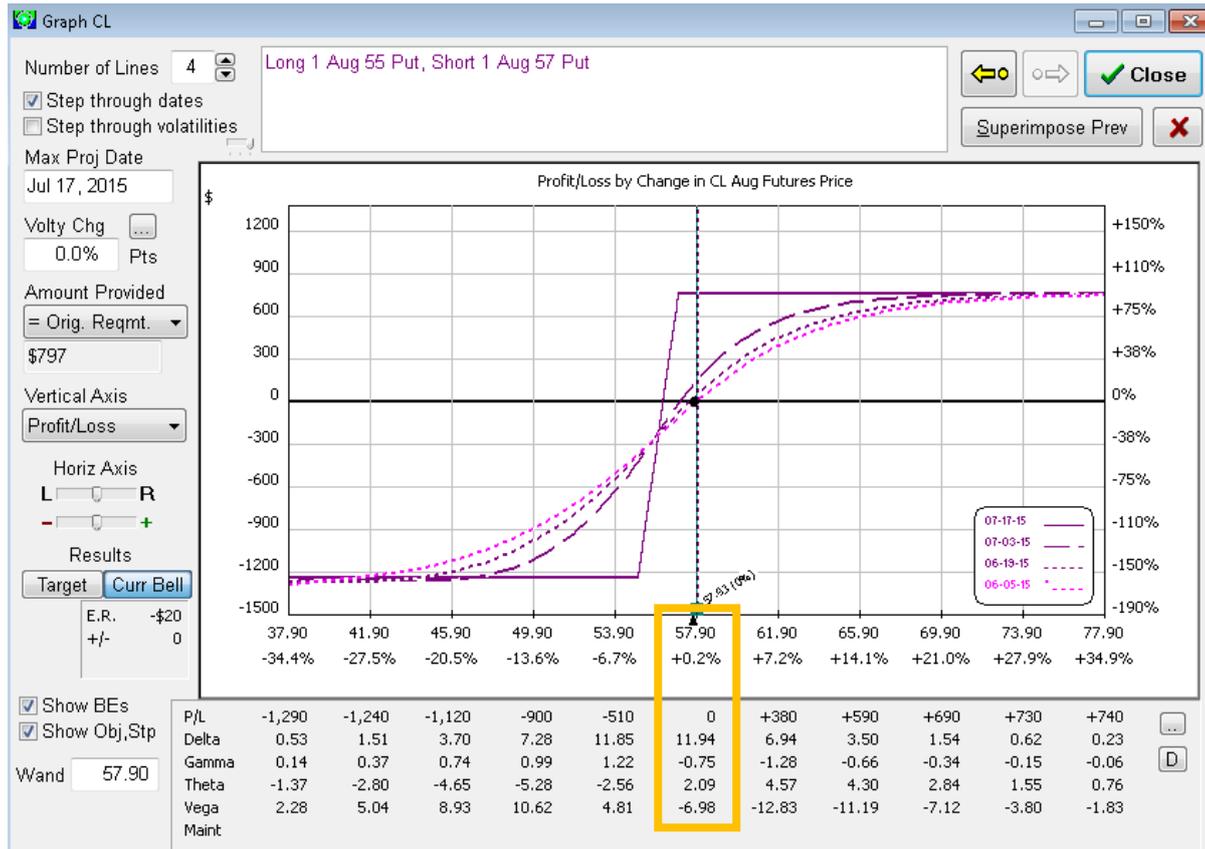
### LONG 1 AUG CRUDE OIL CALL OPTION



Lastly, below is a profit and loss graph of the Bull Put Spread purchasing 1 Aug 55 CL put option and selling 1 Aug 57 CL put option. One has limited risk with this position and a significantly lower margin requirement.

The factor of “time value” in this case is not significant meaning by holding spread, one doesn’t lose money from time decay on the options. In fact, the position below shows a positive \$2 per day which isn’t much. However, one isn’t losing money each day while waiting for an anticipated market move which isn’t the case purchasing the outright call in our previous example.

## BULL PUT SPREAD (BUY 1 AUG 55 PUT, SELL 1 AUG 57 PUT)



### Be Positioned to Stay in a Trade

Having looked at the above PNL graphs comparing each position, we can now further our discussion on additional advantages with option spreads over trading the futures or an outright call option.

Most retail speculative traders look primarily at directional trades – up or down. However, when certain markets tend to trend long term (like the currencies), often you'll hear where traders were unable to withstand the drawdown (stay in the trade) while the market went against their view and were suddenly disappointed from being "stopped out" when the market turned and moved in their favour.

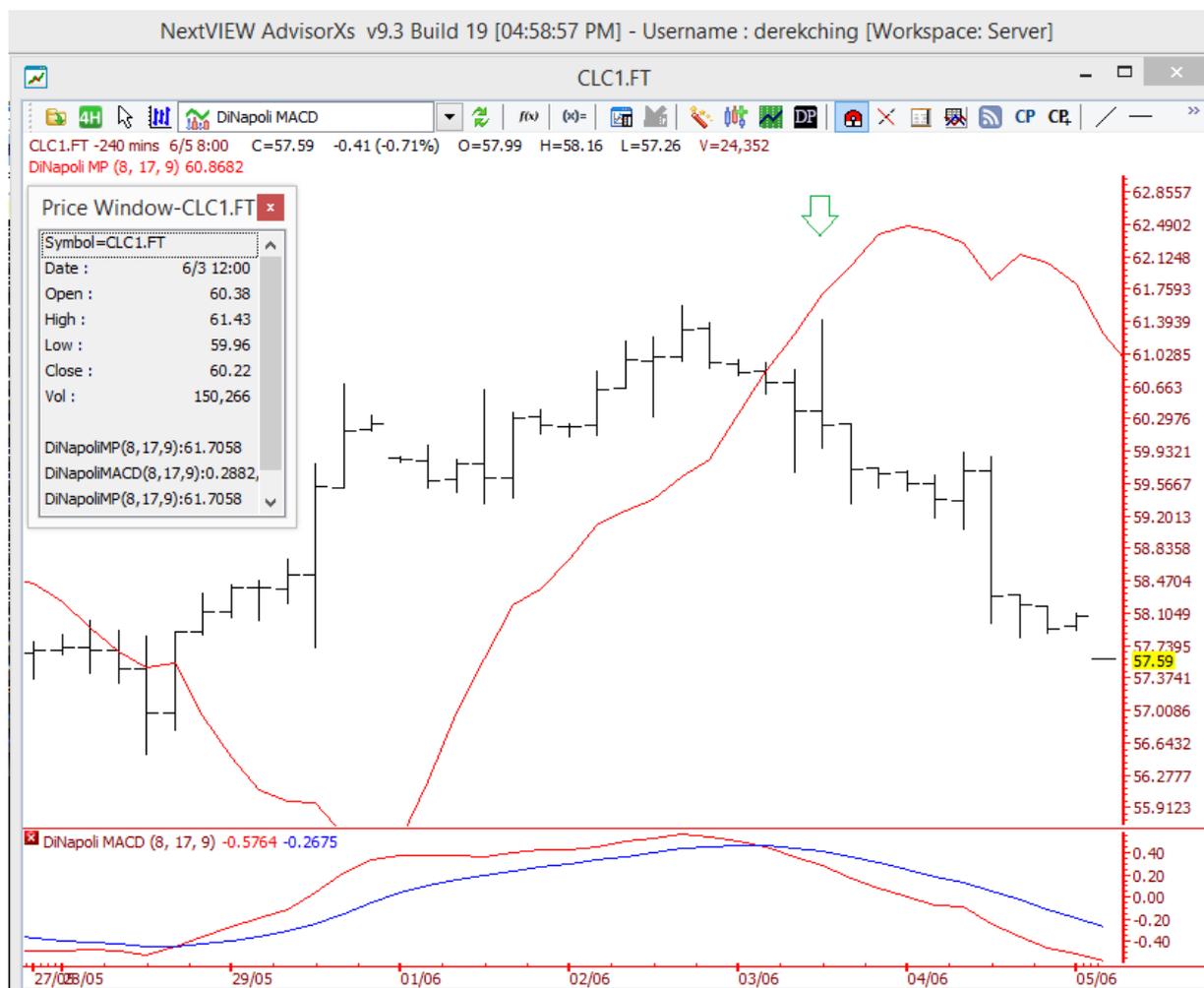
For the following simple illustration, suppose a retail trader had \$10K in his trading account and decided for money management purposes that they could only stand a (\$300) loss or 3% of account size on any given trade based on their plan.

Consider the 4 hour chart of Crude Oil below. The red line is a technical indicator called the DiNapoli MACDP which shows crossover points on the MACD (lower indicator in the diagram below) when price bars close above or below the red line. Generally the MACD is sometimes used to support the notion of price trends.

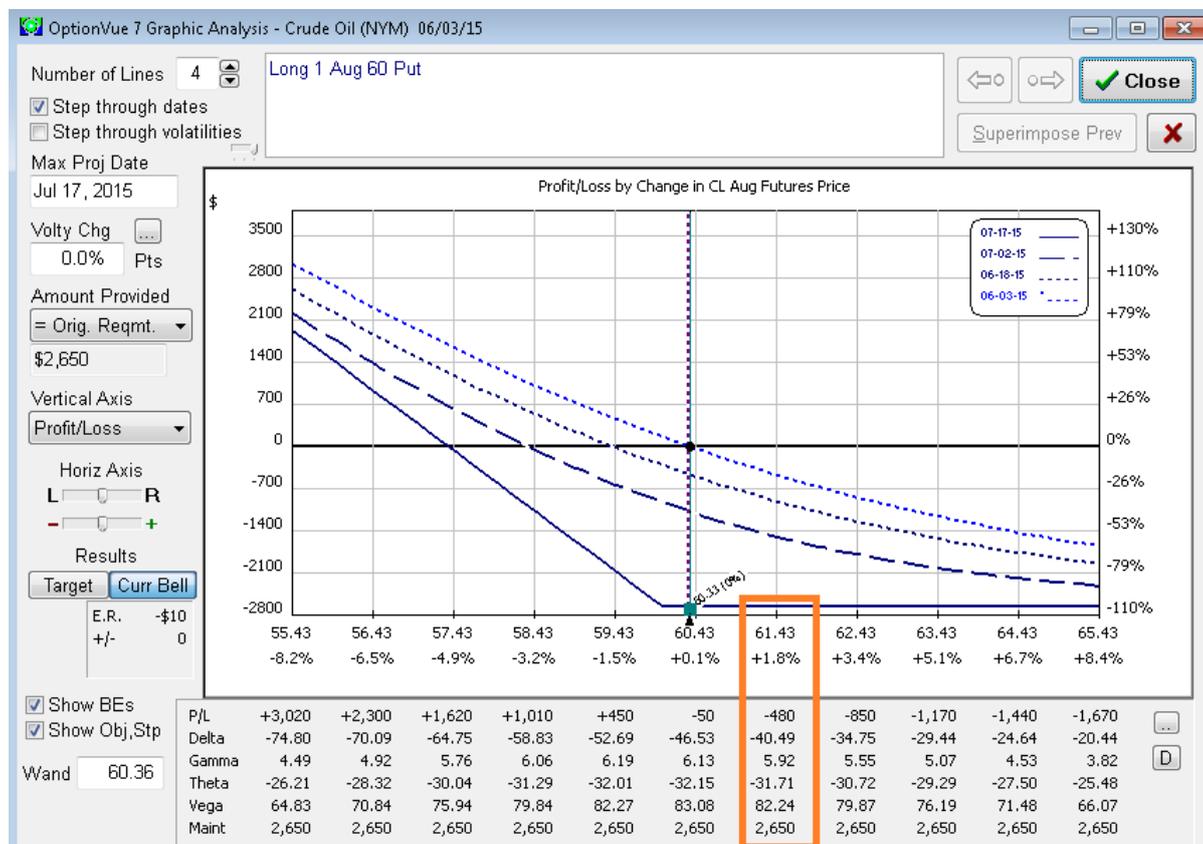
### Scenario – Sell a futures contract for a bearish oriented trade

For simplicity of illustration, suppose a trader waited for confirmation to sell 1 crude futures on the 3<sup>rd</sup> of June (bar under green arrow) where the price open per barrel of crude oil is indicated here at 60.38. Suppose a trade to sell was at the opening price of 60.38. The high over that day shows at 61.43 so the difference is 1.05. With each futures contract being 1,000 barrels, the short position would have drawn down by \$1,050 per contract (1.05 x 1,000 barrels). Suppose from a technical standpoint, the trader only wanted to be in the trade while the MACD pointed down. Under these circumstances, his stop would need to be placed above the red line by the green arrow. The DiNapoliMP value (red line) is 61.70 in the info box. The difference of 61.70 – 60.38 is 1.32 per

barrel x 1,000 barrels = (\$1,320) per contract drawdown which is likely more than one would want to watch as a loss considering size of account.



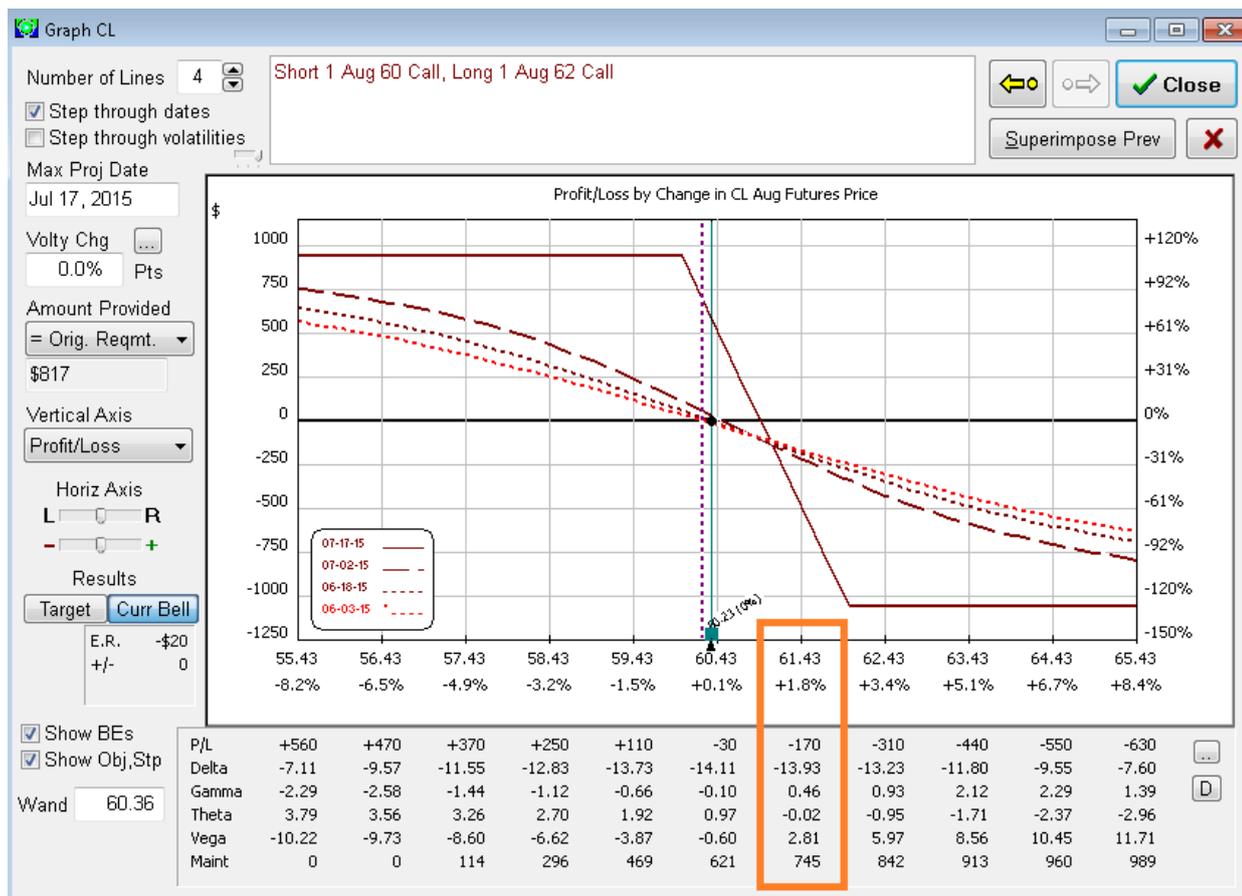
Below is an illustration of purchasing a put option as an alternative for the trader to take advantage of a declining market. Note, at a high of 61.43, the drawdown on that trade would be (\$480) which is less than our prior example on selling a futures contract. However, buying the outright put also incurs negative time value each day around (\$32).



Lastly, the diagram below is a Bear Call Spread which is opposite to what was shown earlier as a Bull Put Spread which took advantage of a decline in market prices. Here, you can see a significant improvement on a trader's ability to weather draw down on the trade in relation to his account as price rose to 61.43. The drawdown would be at (\$170) per lot of the spread.

In this scenario, you'll note that the margin requirement for the spread is \$817 as compared to \$2,650 as required to purchase the outright put option. One could manage their participation by simply purchasing multiple lots of the spread given the lower margin.

Looking at our original technical price bar chart above where we can see in hindsight that price had fallen to around 57.59 per barrel. At a price per barrel of 57.43 if you reference the spread diagram below, you can see yield would exceed a 40% return on margin (P/L divided by margin or \$370/\$817 = 0.45). Comparing margin size between the spread and purchasing a put option, the spread required less margin (about a third of the size). So, a trader could rationalize purchasing 3 lots of the spread in comparison to the outright put option.



To conclude, working with options and spreads can help a trader manage downside exposure in their trade. The example above can also be shown on daily and weekly charts where a trader is able to lessen the sensitivity of their position using options in relation to movements in the underlying asset. If price were to go against their view, they could potentially weather out temporary unfavourable moves in anticipation of the market trending in their favour over time.

### An Example of a Trading Process

Now that we've had a chance to go through a discussion on a few of the advantages behind using futures options strategies, let's walk through the process of creating a simple futures options strategy from start to finish. In writing this article, the following is an actual trade I am creating on the EuroFX market. Following is the step by step process which can be done through asking yourself some simple questions:

- 1 – Market direction bias – Price direction “up”, “down” or “sideways” (using technical or fundamental analysis)
- 2 – Implied Volatility bias – In your trade horizon, will volatility, increase, decrease, not change much?
- 3 – Spread Selection – For our example, we will look at a Ratio Backspread.
- 4 – Trade Plan – Decide on your entry, stop loss and target based around a dollar value.
- 5 – Execute and monitor your trade
- 6 – Adjust or Exit according to your plan

Let's start . . .

## EuroFX – Product Specification Basics

Before I go into the actual process, I'm going to cover a few basics for those who may not be familiar with trading FX or FX futures markets. Product specifications on the EuroFX can be found on the Chicago Mercantile Exchange's website at: [www.CMEGROUP.com](http://www.CMEGROUP.com)

A few basics in simple layman terms for EuroFX as follows:

- 1 contract is 125,000 Euros valued in USD
- Quote convention is in "pips". Just look at the 4<sup>th</sup> decimal place denoted by X: "0.000X"
- A 1 pip move up or down shown by the "X" above is a gain or loss of \$12.50 USD
- Electronic quote platforms may show different conventions. (1.1206 vs. 112.06). Just covert to above.

One can find a chart of EUR/USD on most charting platforms. Some additional notes are worth mentioning here before getting into the process.

In my attempt to create a simplified explanation as a "hands-on" approach to trading the FX futures and options market, similarities to what I discussed with margin would apply. One could buy or sell a futures contract, a call or put option, a spread consisting of multiple options. An alternative is also the "spot" market which is beyond our scope of discussion here.

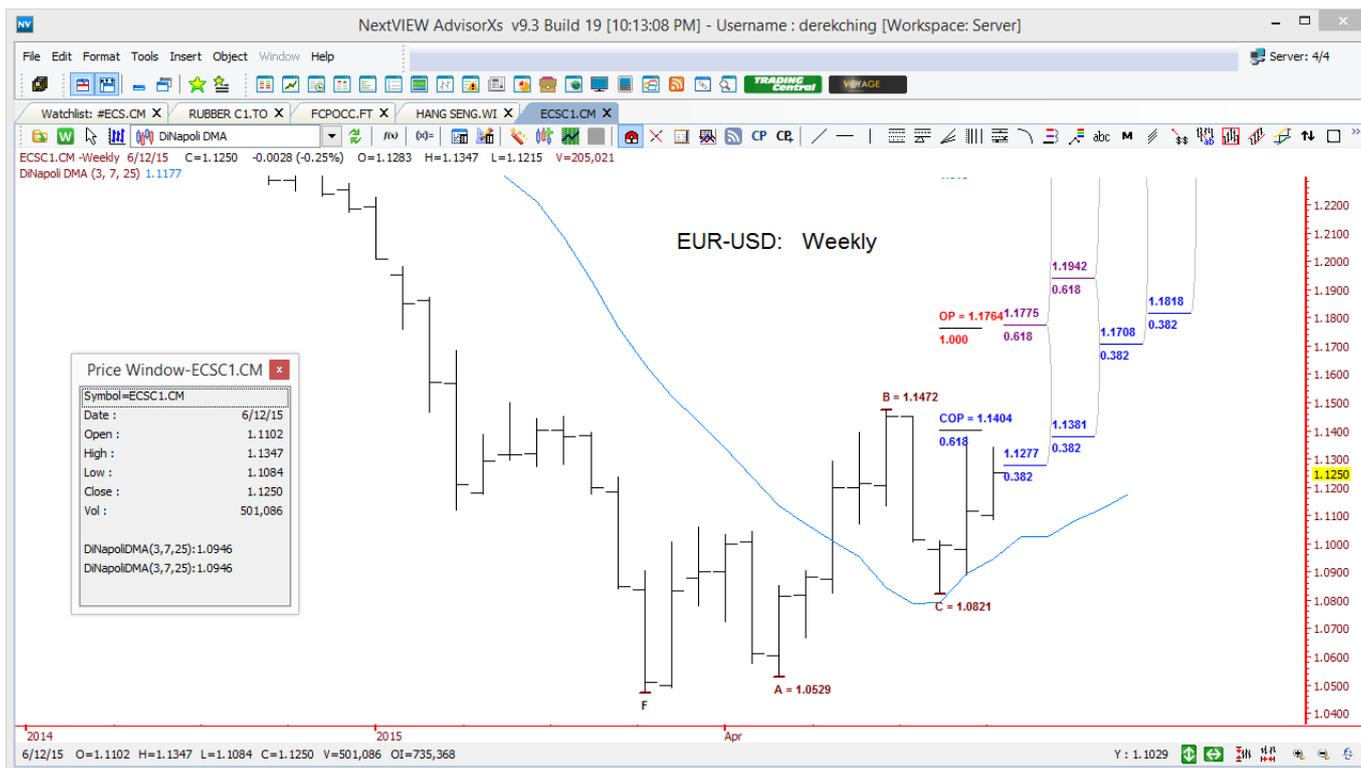
Finally, in my last point above on electronic quotes, some trading platforms have different conventions for their users. To keep it simple, a pip for the EuroFX market is typically always with 4 decimal places being the 4<sup>th</sup> digit where a change is \$12.50 USD. If you saw a quote as 112.06, simply think of the decimal 2 places to the left or 1.1206 where a change in the "6" is a 1 pip move up or down.

### Step #1 – Market Direction Bias

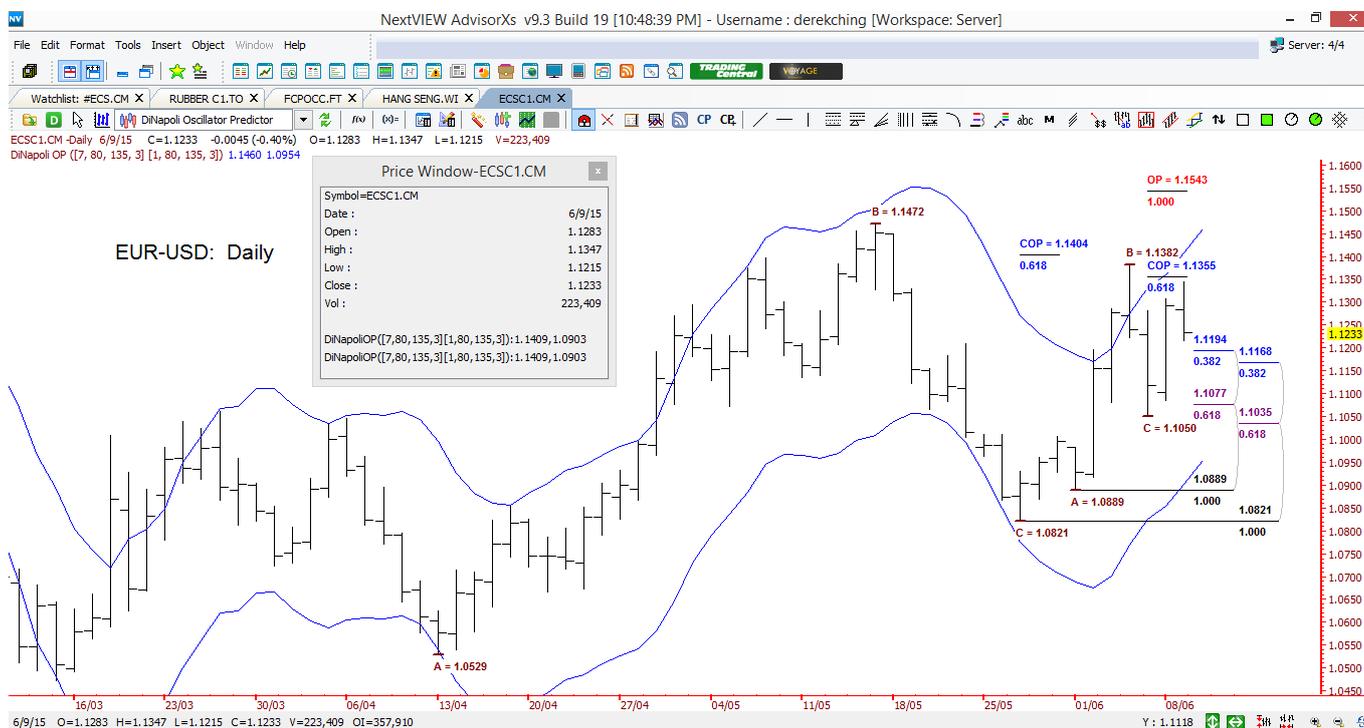
Now, let's move on to the first step in our process – creating an opinion. The first step is having a market bias whether you use technical or fundamental analysis. For purposes of this article, I will use Joe DiNapoli's method of Fibonacci analysis with his tools illustrated on DZH NextVIEW's charting software. You can use whatever method you wish to determine your own bias which is the purpose of this first step. As covered in the introduction of this article, a market bias is simply an opinion based on your own view of market behaviour. Creating a futures option spread to help manage your trade with a statistical edge is a function of your overall spread strategy.

Below is a weekly chart of the EuroFX. With anticipation of the U.S. dollar weakening further I will create a simple trade illustration reflecting my market opinion. I will use the DiNapoli indicators to identify a technical set of parameters for a bullish trade using both a weekly & daily chart of EUR-USD.

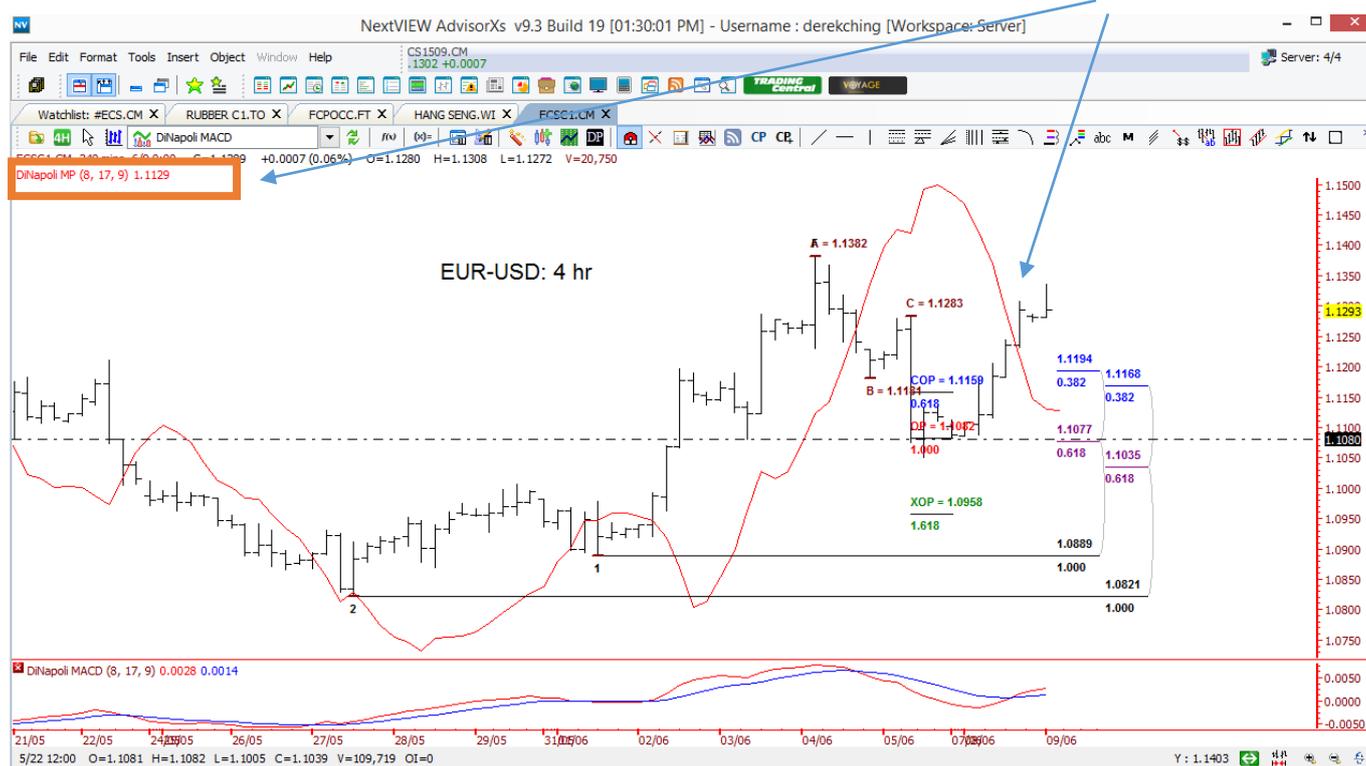
Starting with a weekly chart, I am using the DiNapoli displaced moving average (blue line) to identify a shift in trend. The red, blue and purple levels comes from using the DiNapoli Fibonacci retracement tool to forecast possible levels of resistance.



Below is a daily chart of the EUR-USD where I am using the DiNapoli Fibonacci tool to create additional support and resistance considerations. The outer blue band called the Oscillator Predictor is generally used to identify zones for profit targets when used in conjunction with other tools.



Below is a 4 hour chart. Price crossed the MACDP (red line) at 1.1129 where the MACD has turned up.



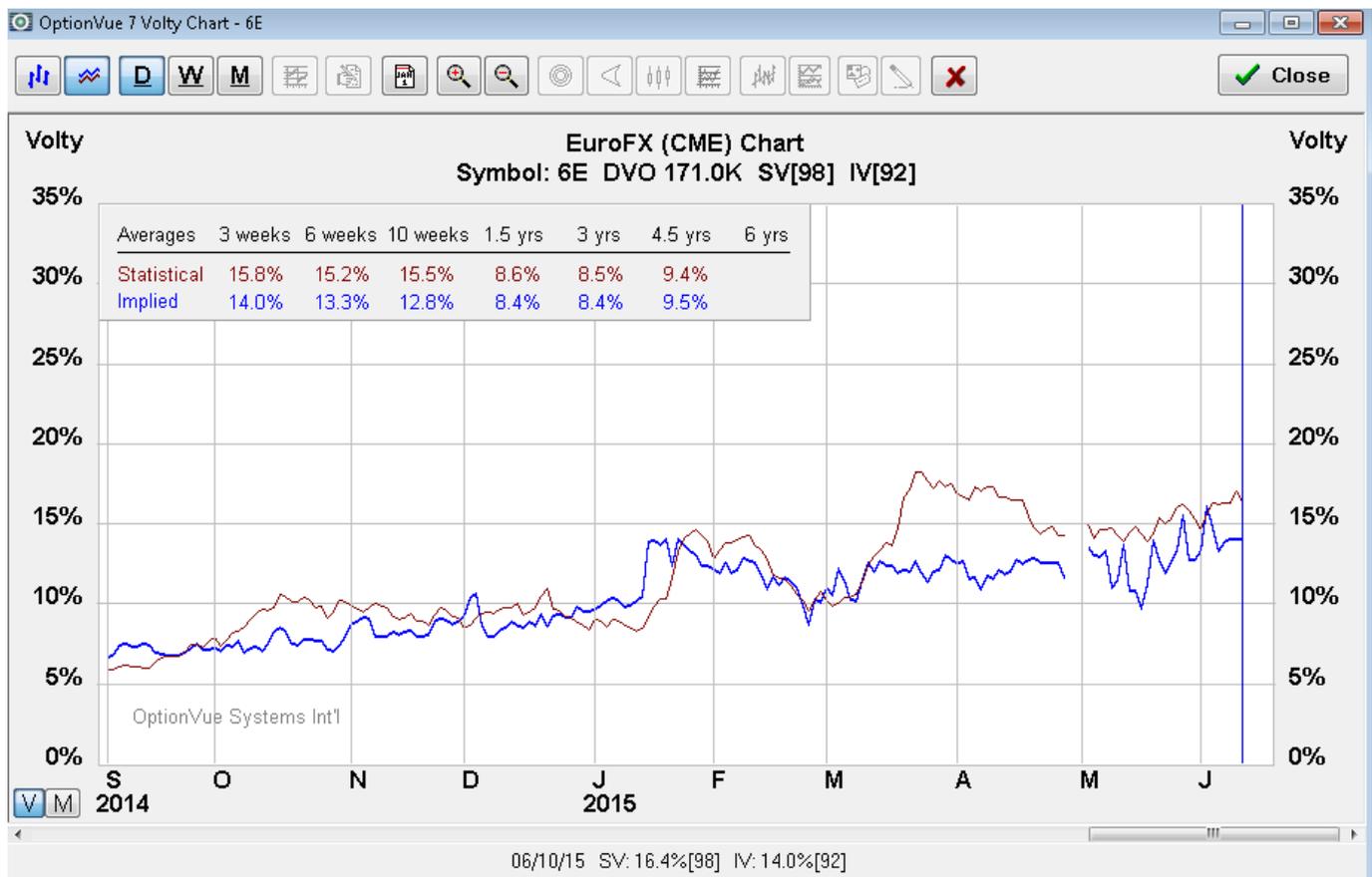
For this illustration, my technical trade is bullish with exits to cut below 1.1130 (below the MACDP red line on the 4 hour chart) and light blue support levels on the daily chart. I will select a directional target above 1.1540 shown on the daily chart in red as “OP”.

### Step #2 – Implied Volatility Bias

Now that we have a directional bias based on price action, the next step is coming up with a bias (opinion) on implied volatility within your trade horizon. To come up with this bias, we need to look at volatility charts like the one below. In the chart below, the blue line is implied volatility which is what we’re interested in. The brown line is historic or statistical volatility meaning what’s happened in past. What you’re trying to answer is whether the blue line of implied volatility will revert to its historic levels or whether it’s trending higher or lower with a mind of its own.

For our example, we’ll assume implied volatility over a 4 to 6 week period (trade horizon) will moderately decrease or be around the same within a 6 week horizon ranging somewhere between 12% - 14%.

We also consider factors as IV rank and devise assumptions on probability based on a bell curve of normalized distribution (as opposed to log-normal) which are outside the scope of this article.



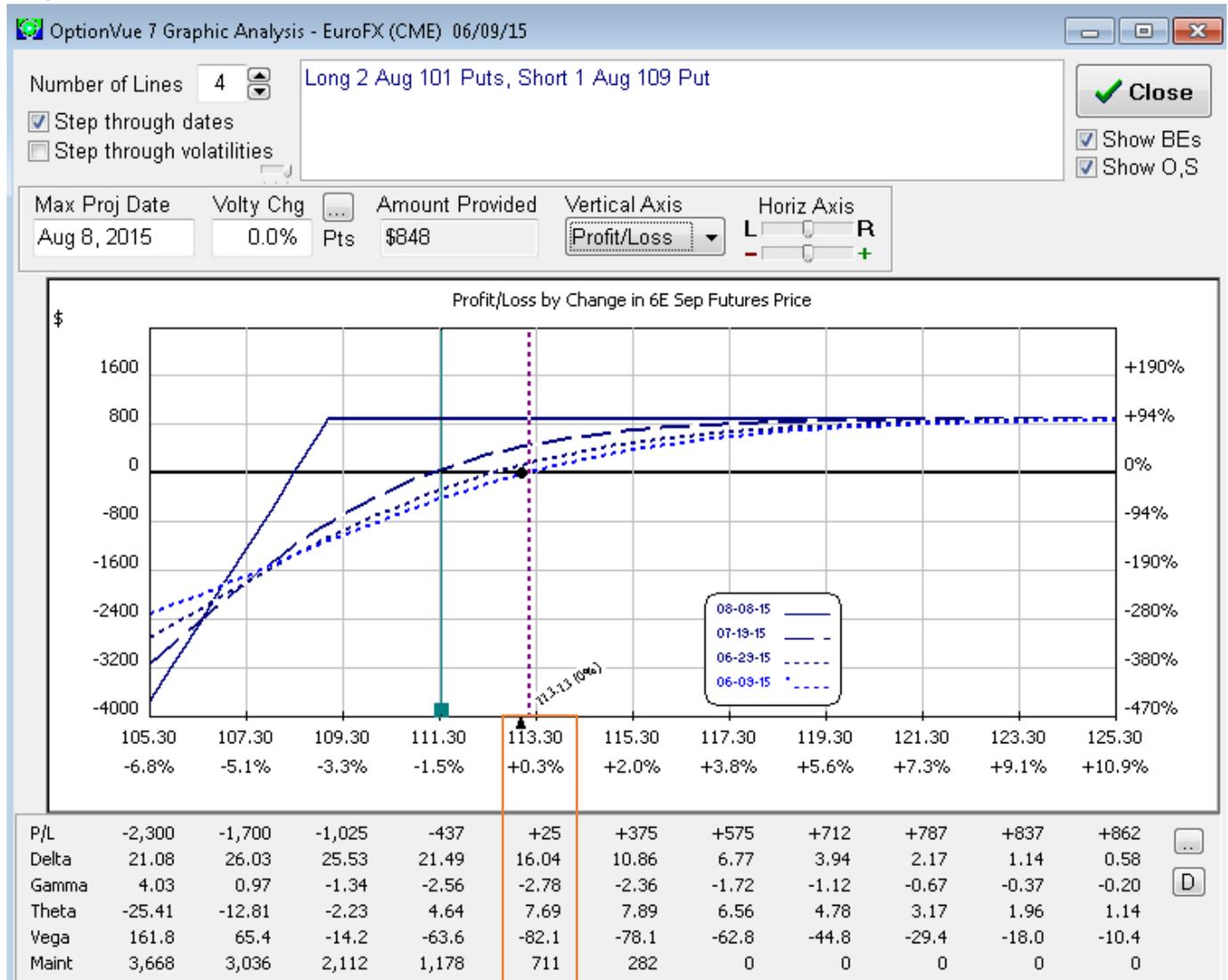
### Step #3 – Spread Selection

Now that we have our 2 biases – price direction and implied volatility, we can now look at selecting suitable spread strategies. There are many different strategies to choose from. I'm going to diverge from our discussion a moment for a quick plug. In our classes, we have designed "The ACE Program" known as the encyclopaedia of option strategies along with "MarketPlus" which expands the encyclopaedia across different futures markets. One simply inputs the 2 biases – market direction and implied volatility (increase, decrease, unchanged) and the encyclopaedia spits out various strategies that are the best fit. One then narrows the selection by looking factors like margin requirement and other variables we discuss in class known as "The Greeks".

Going back to our example here, we will select a strategy known as a "Ratio Backspread" which visually looks like the diagram below. By definition, a Ratio Backspread is constructed by selling a slightly in-the-money option (or close to at-the-money) along with purchasing 2 (or more) further out-of-the-money options.

In our classes, we show how to use a modelling software so you can easily select the options that best fit your risk profile.

Diagram 1

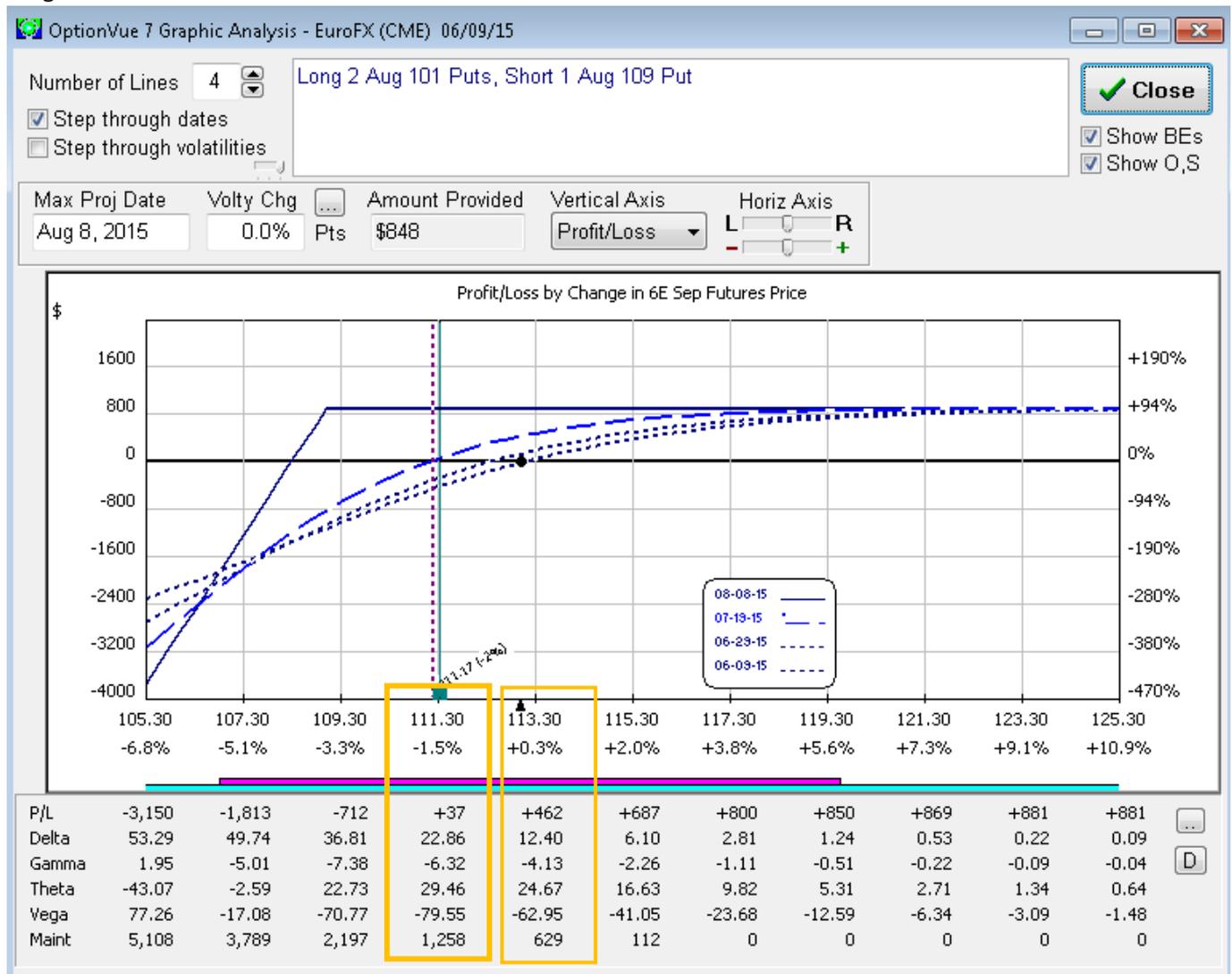


You'll notice where price was around 1.1293 on the price chart and I'm setting a directional stop loss 163 pips away at a price of 1.1130 to exit if I were incorrect. There are many different ways to structure spreads and the range they encompass where a modelling software is helpful for this purpose as we show in our classes. The loss that would be taken at 1.1130 (move decimal 2 places to the left) is estimated (\$437) on the option spread. If one were trading the futures contract, 163 pips x \$12.50 = (\$2,037.50) loss per 1 lot contract.

As time progresses, you'll see with the passage of time where profits can actually build. The option spread diagram illustrates a forecast if the position were held till mid-July. Notice where if price hovered close to 1.1300, profits build from positive time decay to over \$400. If price were to move near 1.1530, an estimated gain of +\$637 would exceed an 80% return on margin (\$637 / \$848 margin) within 60 days.

Many retail traders opt to simply trade the futures or "spot FX" markets where their account size forces them to exit with small stop loss parameters on directional trades. Many times traders are quickly "stopped" out of small trades only to see markets turn in their favour and frustrated by intraday trading environments. One can easily see where this type of strategy lessens sensitivity of your position (Delta) to the underlying price movement allowing time to work in their favour.

Diagram 2



Here on the EuroFX market with the above parameters, we are looking at option strikes that around 8 strike intervals apart. A modelling software allows you to create many different scenarios on managing your own risk parameters. Ask your broker to replicate it for you or drop us an email where we can set up a trial on modelling software for you.

A helpful hint is to watch our Weekly Market Education videos. On one of the earlier videos, I cover the elements of a Ratio Backspread using the EuroFX market.

#### Step #4 – Trade Plan

This step is actually interchangeable with the above. As a suggestion, one would determine their “cut” points for exit based on money management parameters. For example, a trader looking at a 160 pip stop loss on a directional trade might see that the Ratio Backspread option strategy (refer to Diagram 1) offers around a (\$400) risk per 1 lot spread on a move against him. Given his size of account, he may feel that the risk on the option spread is suitable since a 1 lot trade of futures with this risk would produce over a (\$2K) drawdown. He weighs the risk against the potential upside and time for his view to work out. On a side note, you’ll see a “Theta” value of 7.69 which means by holding the option spread, one earns \$7.69 / day as positive time decay. A buyer of a call option would have negative time decay of around (\$25) each day by holding an outright option waiting for a market move to happen.



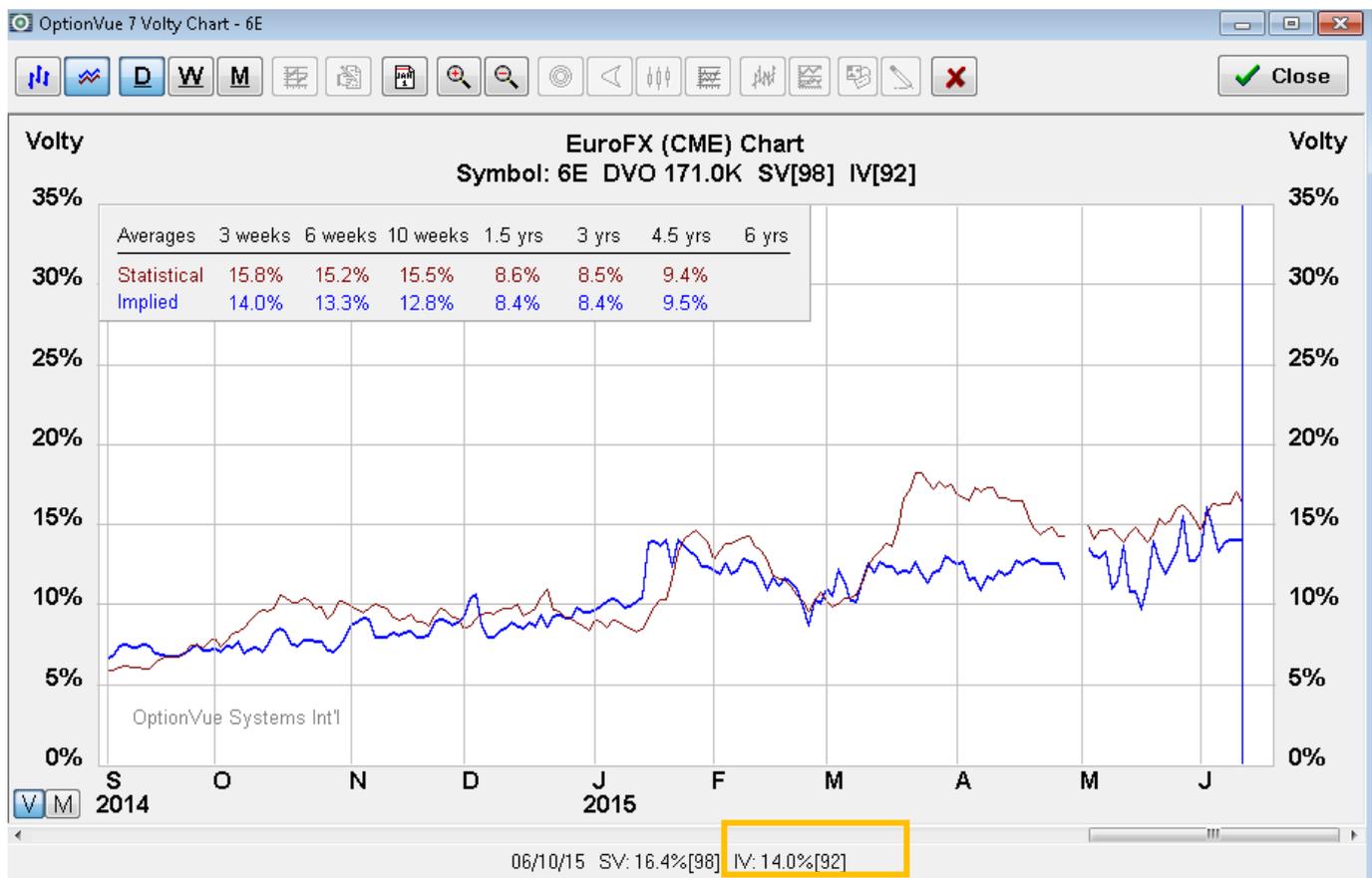


## GAIN A THEORETICAL EDGE

The last section of our article focuses on, “how do you gain a theoretical edge” with option strategies? Referring to our Euro trade above, we need to look back at our volatility chart below and the assumptions I made.

EuroFX –

Earlier, I mentioned that we need two inputs – a bias for price direction and a bias on whether implied volatility (blue line). My bias for implied volatility is that it might decrease over our trade horizon (time frame). The August Put options I used in the Ratio Backspread expire 60 days from time of this writing on Aug 7<sup>th</sup>. Without going into a sophisticated explanation on implied volatility, if I simply look at the historical diagram in the chart above, one can see where the last 3 – 10 weeks, implied volatility (blue) ranged somewhere between 12.5% - 14% on average.



Mathematically, 14% implied volatility falls in the 92<sup>nd</sup> percentile meaning only 8% of historical values over the last 6 years have averaged higher. Without going into a complex explanation, the “Ratio Backspread” strategy is designed to benefit from each 1% decline in implied volatility. In other words, if implied volatility falls to previous levels in the last 6 – 10 weeks, the position will gain an additional \$81 aside from profits we looked at based on direction. This component is known as the “Vega” Greek variable discussed in our classes.

E-Mini S&P -

Let’s look at an example using the S&P500 market in our discussion of gaining a theoretical edge. The discussion uses a slightly different option spread strategy to take advantage of changes in volatility.

### E-Mini S&P – Product Specification Basics

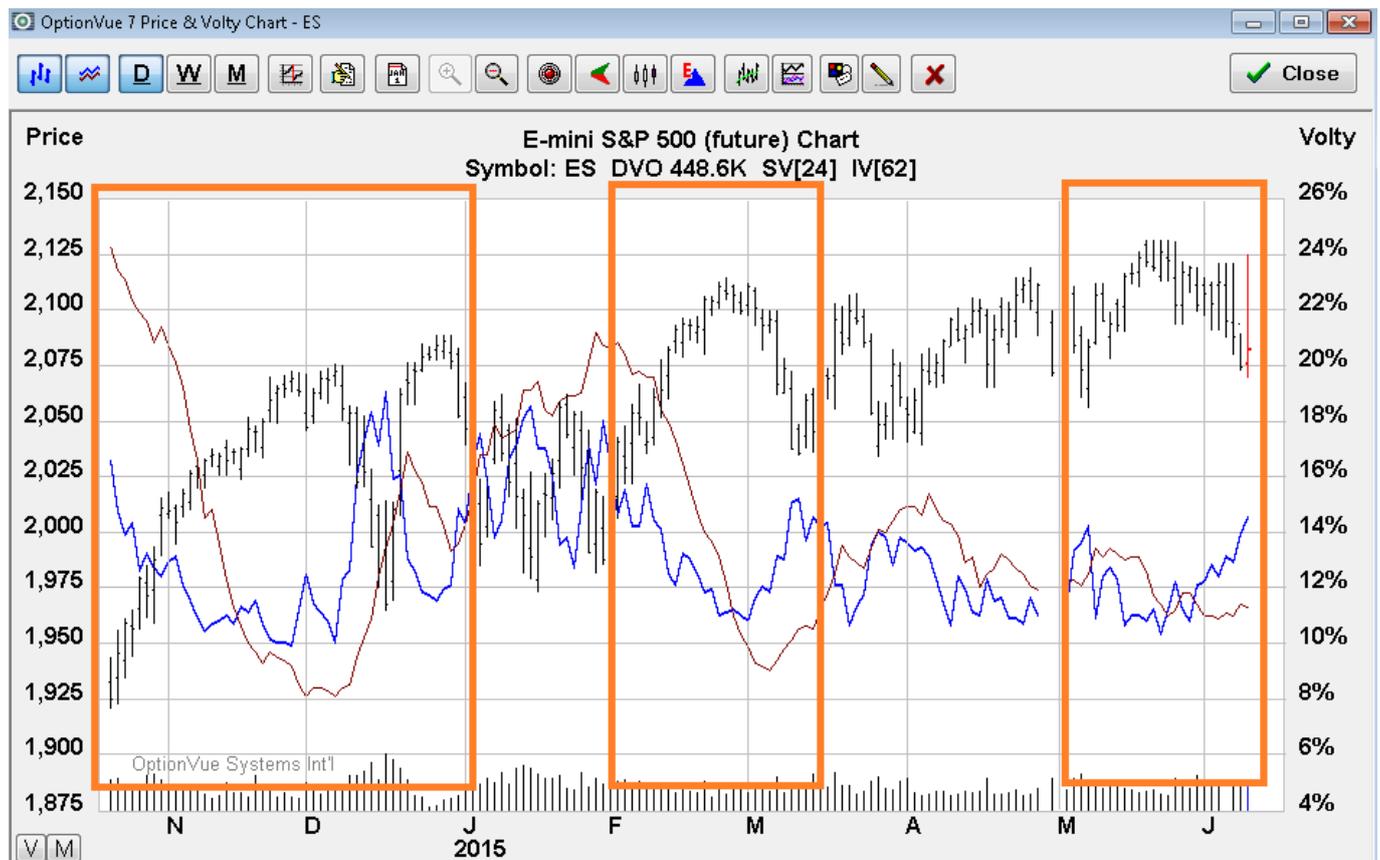
Before I go into the actual process, I’m going to cover a few basics for those who may not be familiar with trading the E-Mini S&P Equity Index futures. Product specifications on the E-Mini S&P (ES) can be found on the Chicago Mercantile Exchange’s website at: [www.CMEGROUP.com](http://www.CMEGROUP.com)

A few basics in simple layman terms for E-Mini S&P (ES) as follows:

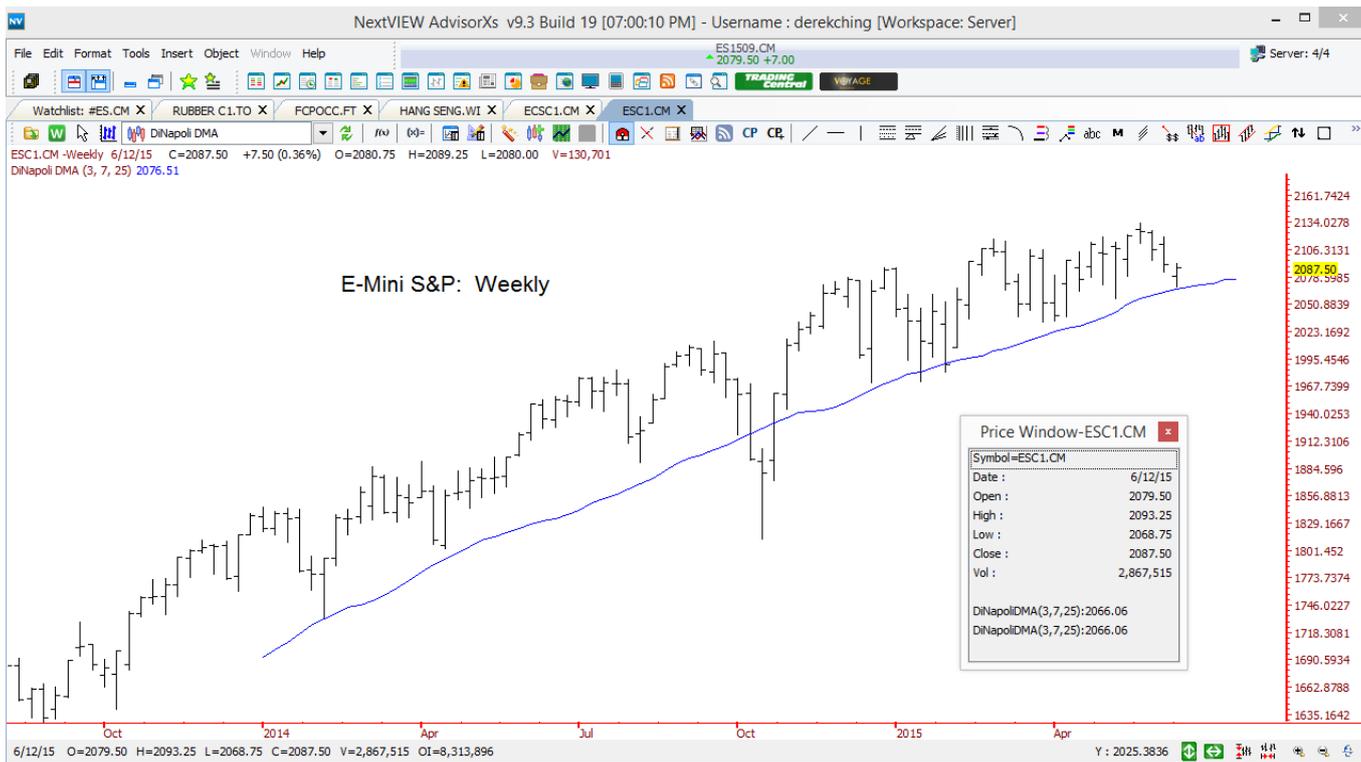
- 1 contract is \$50 x S&P Index
- Four months in the March Quarterly Cycle (Mar, Jun, Sep, Dec)
- Three Serial Months (i.e., Jan, Feb, Apr)
- Tick size: 0.25=\$12.50 for premium

Typically, in an Index related market like the S&P volatility tends to have an inverse relationship with price direction as can be shown from the chart below.

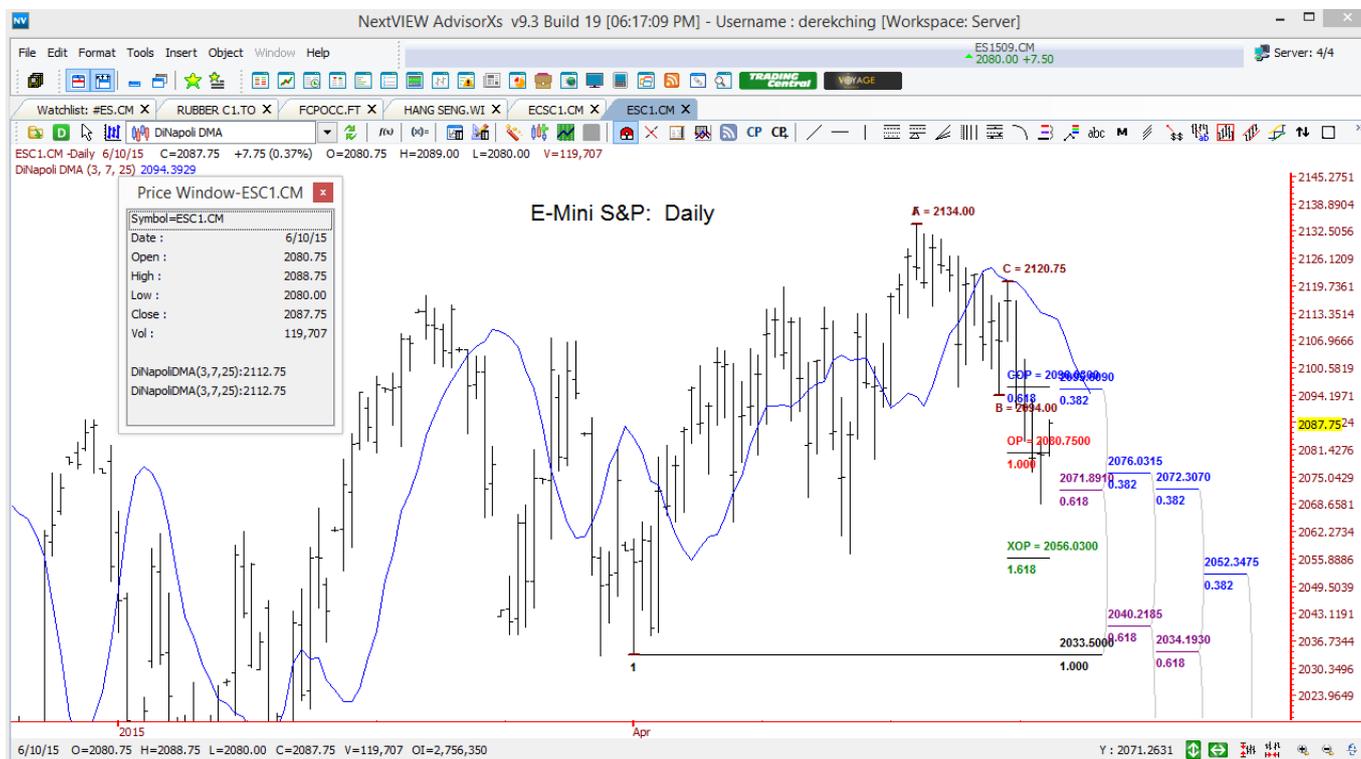
You can see where I made boxes highlighted in orange below where implied volatility (blue line) falls as price rises and increases as price falls. I won't go into an explanation on reasons as these can be found with simple research Google. The point is that there is a certain predictability of implied volatility behaviour based on price movement.



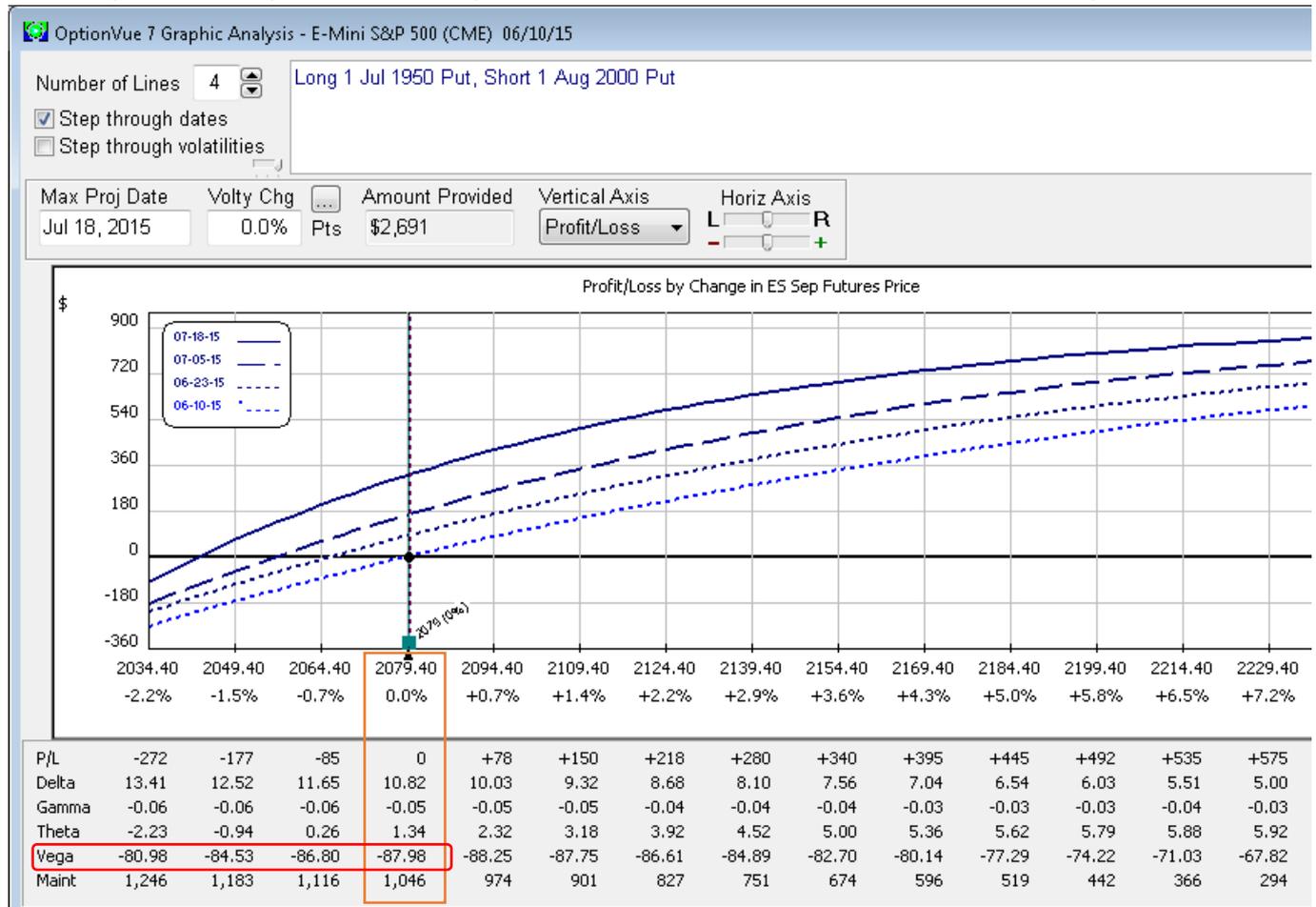
For this example, suppose my assumptions with the upcoming June 17<sup>th</sup> meet with the FOMC low to nil impact and prices will continue to rise. I'm also going to assume a reversion of implied volatility (blue line) to lower historic levels (brown line) given the inverse relationship above between price direction and volatility. Below is a weekly chart illustrating the bullish trend contained by the DiNapoli displaced moving average (blue).



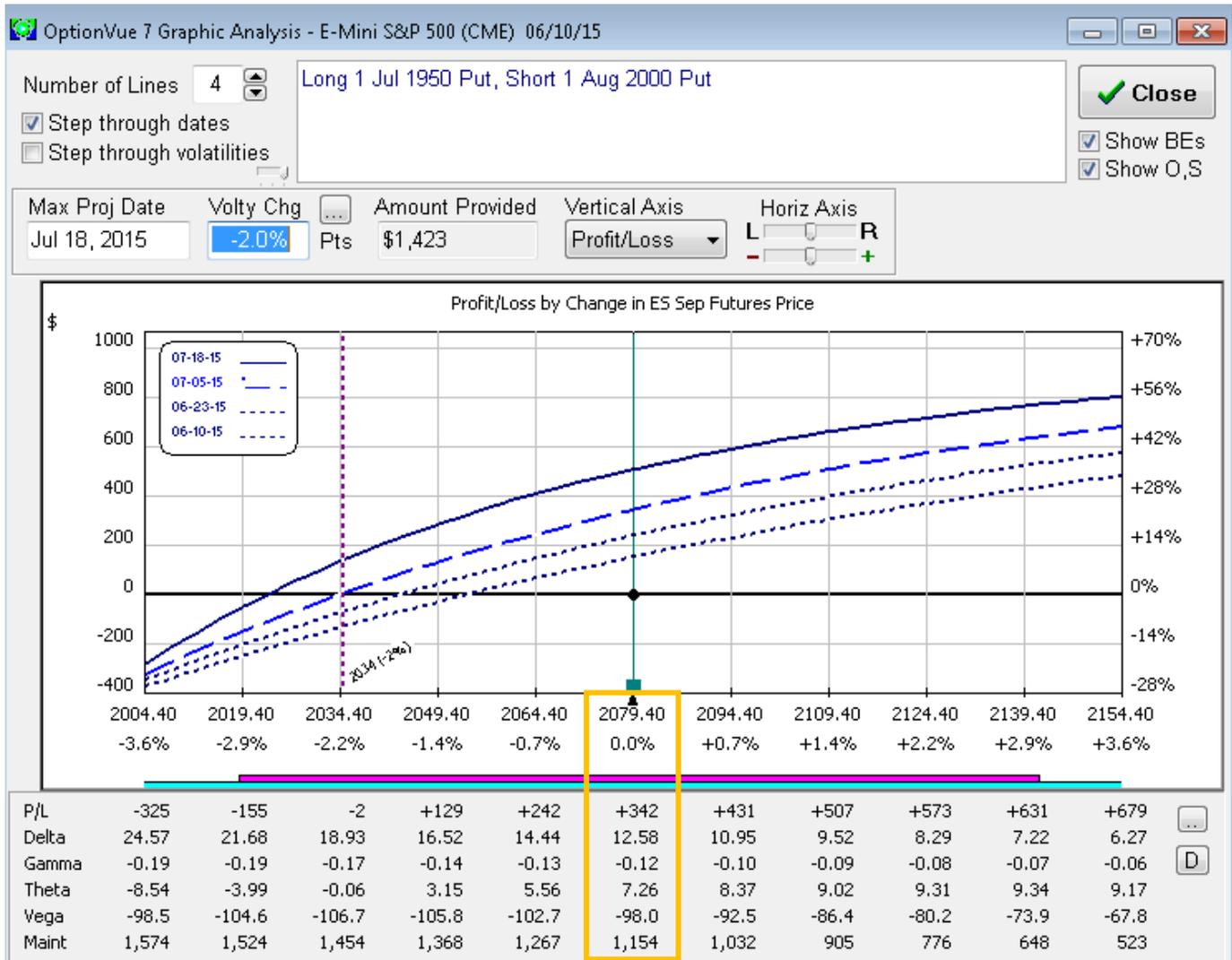
Below is a daily price chart of the E-mini S&P. I've also included the DiNapoli Fibonacci indicators forecasting price support levels. Going back to the first step of our process, suppose my view is where price will rise from support and hold above 2071.



To express my view as a trade, below I've constructed a spread with multiple options defined as a "Reverse diagonal calendar put spread". It sounds like a mouthful but is a simple and effective strategy. Notice the sensitivity to moves in price direction is quite small where a move near 2064.50 results in a very small loss.



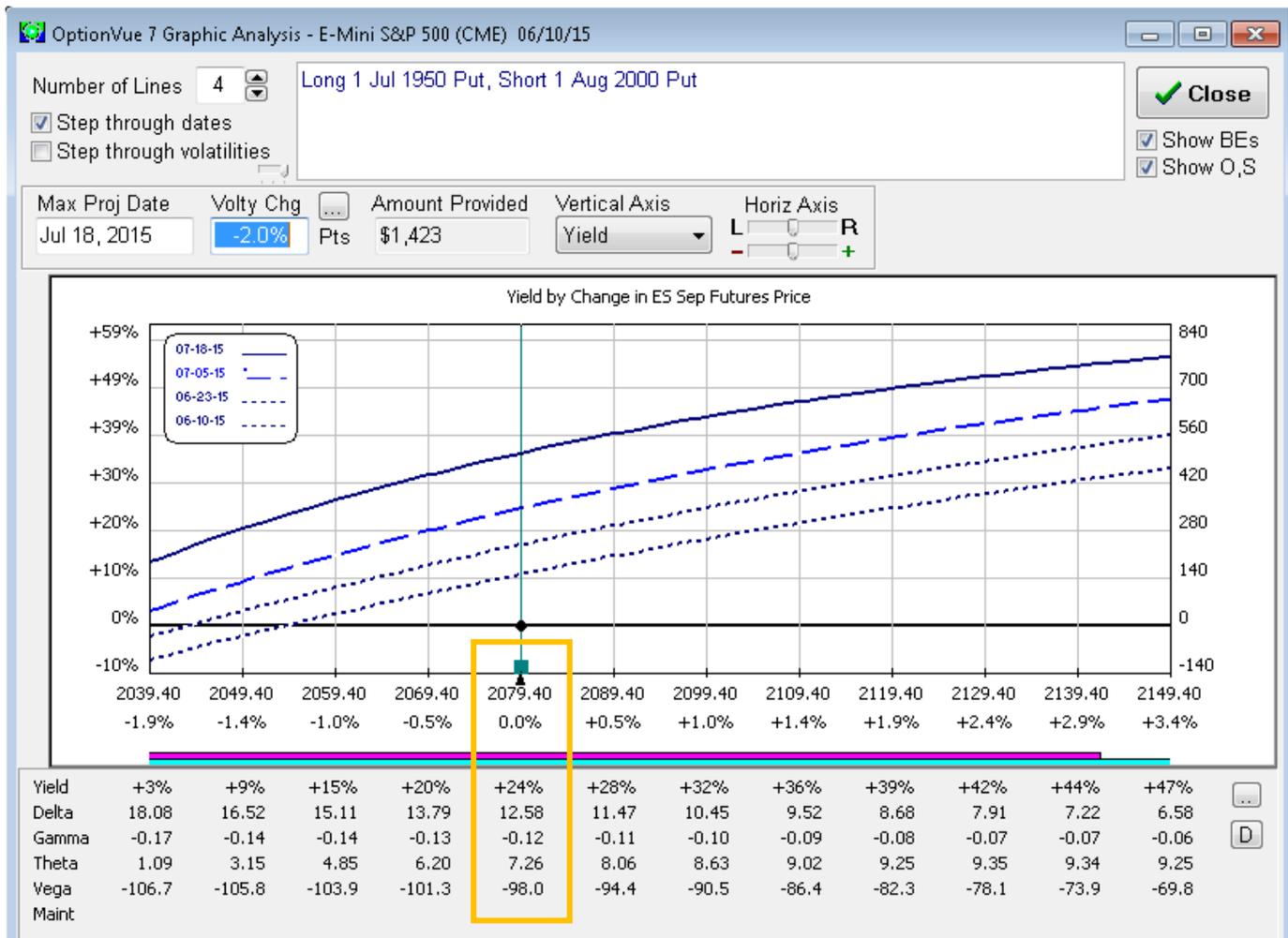
The strategy does not incur negative time decay unlike the purchase of an outright call option. Notice in the red box above, the line value for "Vega" as -87.98 which I will explain in a bit. In short, the strategy based on price movement alone doesn't appear overly exciting. However, the following diagram illustrates what could occur over time. Profits build from positive time decay and more importantly, if implied volatility reverts to historic levels with a moderate rise in option premium, additional profits build. These come from the "Vega" component as \$88 per 1% point change in implied volatility (blue line from volatility charts). The upper dashed line represents a shift in time forecast to July 5<sup>th</sup>.



Below is the same graphical illustration above but expressed as a percent yield or return on margin required to put on the trade. One can see there is a wide range of prices to profit from. Exceeding a 24% return on margin within a 30 day period would certainly be more than a reasonable return per dollar risked if market conditions were favourable. Above the 2100 price level, a trader could exceed a 30% return on margin in a month.

A “theoretical edge” on the above is based on the idea that volatility levels can be easier to predict than price movements and tend to revert to its mean at historic levels. The “Vega” component of options is a key component of volatility trading allowing a trader to create strategies independent of price movement.

Working with the component of volatility strategies present mathematical objectivity based on statistics rather than price patterns which can be somewhat subjective.



## Conclusion

There are many types of strategies that can be formed using options traded as spreads. I've barely nicked the surface in our discussion which is really meant as an introduction to the world of futures options.

Some helpful resources we offer is the book, *Trading Options Visually* and the *ACE Program* which was created as the "encyclopedia" of basic option strategies that covers all fundamental building blocks used in spread strategies. You can also watch free Weekly Market Education videos on our website which help you gain an understanding.

A strategy beyond the scope of this article called "Delta Neutral" spreads can allow one to eliminate guesswork of price action and focus instead on their perception of volatility levels. This moves our discussion into "Probability Trading" which is the heart on what professionals do. Trade positions created with these type of spreads are insensitive to price movement of the underlying futures contract.

So, trades of this nature rely on changes in volatility levels for position gains/losses and decisions on how to manage positions. As discussed in the outset of our article, these strategies can present an "edge" based on probabilities.

Lastly, I mentioned in my introduction where one might find that trading the underlying futures is a better fit for their risk tolerance. Using a combination of futures and options together can be a very effective way to capitalize on short or long term market action.

It can be frustrating when using options or spreads to see large movements in the underlying and comparing what could have been realized by simply trading the underlying. That's simply one of the downsides to trading options and spreads. However, directly trading futures or spot markets have significant downsides with very few methods of limiting risk and dealing with short term volatility. The same large moves against a futures trader can devastate an account very quickly. "Stop orders" are basically market orders and in a fast environment, you could get filled far below what you intended, known as "slippage." Options can be used to help limit risk or even eliminate the need for a stop order.

There is another advantage to options trading worth mentioning here in comparison to a futures trader. A futures trader is a "directional" trader. He makes decisions based on market direction and lives or dies by the sword of that decision – right or wrong.

Depending on the type of strategy used, an options trader can "adjust" their position at times giving a second chance to fix how their strategy performs. A futures trader cannot do this and either cuts profits short or is "stopped" at a loss.

If you're not currently looking at futures options, I hope this article has offered some helpful insight. If you are inspired to learn more, I'd like to encourage you to sign up for our weekly videos & newsletters with free lessons if you did not receive this eBook from signing up on our website. You'll gain from instructions in a similar manner as I had covered concepts in steps while teaching my daughter on concepts on futures trading.

It's not to say I'm explaining in a manner as taught to a 9-year-old. Rather, the explanations are in a simple step by step fashion that can help you better understand the bulk of concepts I've covered here to clarify how you can trade with an edge.

Feel free to email us with any questions at: [info@oahucapital.com](mailto:info@oahucapital.com)

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### About the Author



Derek Ching is a registered CTA (commodity trade advisor) and member of the National Futures Association (NFA ID: 0359688). He is a trader specializing on futures options strategies and manages training programs in Singapore, Australia and North America. He maintains a Series 3 & 30 license with Oahu Capital Group. Prior to becoming involved in the financial markets, he managed operations and physical trade bulk commodities.

Derek has served clients as a commodities broker in developing client strategies and training education. He is has worked with technical analysis in proprietary Fibonacci techniques by Joe DiNapoli and combines this approach with futures option strategies. [Check out our Online Courses & eBooks at OahuEducation.com](#)

Derek comprises weekly market commentary with Paul Forchione a former floor trader on the Chicago Board of Trade (CBOT) and prior market maker on the Board of Options Exchange (CBOE) teaching futures option spreads through the ACE Program. He has contributed published articles on trading and risk management. As managing director for Oahu Capital, his responsibilities include market analysis on U.S. futures markets and trading option spread strategies. Derek received his BA in Finance from Marquette University.

For more information, visit our website at: [www.OahuEducation.com](http://www.OahuEducation.com)

You can email questions to: [info@oahueducation.com](mailto:info@oahueducation.com)

There is a substantial risk of loss in trading commodity futures, options and off-exchange foreign currency products. Past performance is not indicative of future results.