

Here's The Plan From Dan (Part 1)

Calendar Spreads With Dan Sheridan

In the first part of a series based on a seminar on option strategies with Dan Sheridan, we take a look at calendar spreads.



Options and seminars go together like yin and yang, baseball and hot dogs, Abbott and Costello. Can't separate 'em, wouldn't want to. Ten or more years ago, some of the prominent seminars focused on straightforward strategies like put selling or vertical spreads. In a surging NASDAQ market, these one-day affairs served their purpose in helping retail stock traders become more knowledgeable and comfortable with options.

Then after the 2000–01 stock market crash and with the equity markets in the doldrums came delta-neutral strategies, making money in options when stocks weren't moving — timely and helpful. You might have seen infomercials for these “wealth creation” seminars.

But not all the attendees were successful, nor even the gurus themselves. One notable “expert” expanded from giving seminars to managing an option trading fund. The fund lost 40% in six months before closing. There are and have been many, many other seminars and countless newsletters, and we've all been invited by direct mail to attend or subscribe. Or both. Some of us have, or at least been tempted.

WHAT'S TO RISK?

Now streaking across the option-trading-and-seminar sky comes trader Dan Sheridan and his Options Mentoring series sponsored by OptionVue. He focuses on the missing dimension of most options

seminars: risk management. That alone makes him different. Something else does, too: Dan Sheridan doesn't propose doing the education job in one or two days, like many of his predecessors; his is an ongoing program, with access to him anytime.

We've been taught that inventor Thomas Edison tried some 8,000 substances before chancing on tungsten and finally being able to devise the revolutionary light bulb. There haven't been that many options seminars, but there have been quite a few. For those who stuck around long enough (and there are those who have attended just about every option seminar given in the last 10 years), Sheridan just might be the tungsten everyone has been looking for.

But he might not seem like it, at least not at first. A natural comedian, “Trader Dan” affects a regular Chicago guy demeanor, because, as he would say, “I am one.” Sheridan survived and thrived for 22 years in the rough-and-tumble CBOE pits. His superb risk management skills protected him and allowed him to grind out profits in markets both up and down, and those are the skills he wants to share. He's generous with his time and he tells the truth, flattering or not. What more could you ask?

Not just a market maker, though he's got lots of war stories from the pits to share and some good trading tips, Sheridan successfully traded thousands of income strategy trades for his own account over the past two decades (some 3,000 calendar spreads alone, he estimates). He also mentored a number of traders who went on to major success, some to head large trading firms.

GENERATING INCOME

Dan Sheridan brought his expertise to a recent Futures Industry Association (FIA) meeting, where he spoke on how to generate monthly income in the options markets. Sheridan began the FIA session by going a few sacred cows: “Make the odds work for

you, not against you. Income generation is a superior strategy for 99% of traders.”

When trades are managed, not just put on and forgotten, Sheridan says a trader can generate as much as 100% annualized. Some may scoff, he says, but he sees his best students doing it, grinding out 5% to 15% per month. (Not everyone does this, he says. Others make up to 7%, and those who can't follow instructions lose.) Sheridan believes if he can keep a new trader in the game for six months, earning a small percentage each month, learning the craft, adjusting the trades, and keeping the enthusiasm high, he or she will make it as a successful trader in the long term.

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That's the goal. To achieve it, Sheridan recommends a portfolio of six or seven income strategies each month that don't require a stock to move to be successful. He also believes in staying small, keeping the account at \$5,000 to \$6,000 in capital for six months, whether or not the trader can afford more.

He told the story of one trader who went large on a calendar spread, lost big, got negative on calendar spreads in particular and options in general, and then quit.

“Why did you do it?” Sheridan asked about his decision to trade big.

“Because I could,” the trader, a Houston oilman, replied.

Sheridan believes if the individual had kept the faith, grinding out the profits month by month instead of going for the big score, he would most likely have been profitable and still be in the game. “This is a craft,” Sheridan says. “We do it over and over.”

He says he now does everything in his power to slow down his prospective traders, urging them to begin with paper-trading, then graduating to small trades. “Why do you think you can trade a \$100,000 account if you can't trade a \$5,000 account? Learning a craft takes time. We don't say to our college sophomore, ‘Are you making money yet?’ We shouldn't say that to new option traders who are learning their craft, either.”

Perhaps the best thing about Sheridan's approach: It does not require a full-time commitment. Most of his traders work full-time, and he dissuades others with the available time from becoming screen jockeys. Once up and running, he estimates his students spend only seven to eight hours per month at options. “This is not daytrading,” he says. “Our best students have full-time jobs.” These success stories have limit orders in the markets that automatically actualize at key points. Sheridan advises traders to become expert on the contingent order capability of their brokerage platform.

TRADING VEHICLES

Dan Sheridan favors these income strategies. All are spreads — no naked options:

- Calendars
- Double calendars
- Condors
- Double diagonals
- Butterflies

If you can follow directions and apply good management, you can make a business, Sheridan believes. “If I had a group of sixth-graders, and I taught them for two to three months, and they did what I'm telling them, they'd be successful. But too many retail customers know too much. They bring in Fibonacci, and Andrews pitchfork, and this and that, and pretty soon they are overthinking, and losing.”

It takes one other thing, too, Sheridan says — commitment. “Some people say, ‘I'm going to try a calendar spread and see what happens.’ This makes me crazy. Am I going to ‘try’ to open a beef stand in Chicago? No, it's a business. It's a commitment. You don't give up on calendar spreads because one doesn't work. This does not provide the diversification or the time it takes to be successful.”

INCOME STRATEGIES

In the FIA meeting and during a follow-up web seminar, Sheridan provided the meat and potatoes of his income strategies. First, the definitions: “An income strategy is one where we don't need the stock to move to make money.” These strategies are also known as *nondirectional*, also known as *delta neutral*.

Best candidates for condors, double diagonals, and other neutral strategies, are channeling stocks, steady, sideways movers, Sheridan says.

Like a pilot looking over his aircraft before takeoff, here's how he looks for stock candidates:

- 1 *Volatilities*. Less than 30 is the desired range.
- 2 *Industry*. Predictability. Kellogg's stock would be better than an unpredictable biotech startup.
- 3 *Price chart*. If there was a 10% move last week or month, ask why.
- 4 *When to be there*. If there are upcoming earnings dates or other special events, stay out of the market.

CALENDAR SPREADS

A calendar spread is a strategy where the nearby option is sold and a farther expiration bought — for example, sell May, buy August. Calendars give the trader an edge in decay, probabilities, risk/reward ratios, and yields:

Guerrilla Calendars

What are they? Sell one month and buy next month out.

Example:

Citigroup: \$50 buy 10 November 50 calls and sell 10 October 50 calls

Is this an income spread? Yes, we hope to make money by the near-month time premium decaying faster than the second month and the stock staying in the vicinity of the short strike.

How to find guerrilla calendars: Implied volatility is between 14 and 28. You're looking to pay as little as you can for the spread.

Most desirable time to put on: 25–35 days from expiration.

Are commissions important? You bet — \$1 and under should be the norm and not the exception.

Is execution important? Absolutely crucial! Don't cave in more than 0.05 off mid-prices, and be very patient at mid-prices before caving in.

Is volatility an important consideration in guerrilla calendars?

Yes, but not as important as in campaign calendars (calendars with more than one month between the near and far months). We can compromise and take implied volatilities in the middle of the one-and-a-half-year implied volatility range.

How much should we pay? When we think of guerrillas we think of paying \$0.10–\$0.50, which is great. There's nothing wrong, however, about paying up around \$0.90. Remember the term *guerrilla calendar* refers to a one-month calendar where our idea is to take a small dollar profit and run for the hills.

Time premium: You want a time premium of short option more than 50% of long option.

Minimum I should receive for my short option: You want at least \$0.30, which will usually be all time premium. Just remember the time premium of short should be at least 50% of time premium of long. That means if you sell an option for \$0.30, you won't pay more than \$0.60!

Picky execution: Never cave in more than \$0.05 off mid-prices. Execution is crucial with these spreads.

When to take off for profit: When you've made 40% versus what you paid. If you pay \$0.50, you can take off for \$0.70, typically in two to four weeks.

Volatility: Implied volatility (IV) in the low to middle volatility range lasts one to one and a half years. If IV is at the high end of the range, do the stress test in the analysis page of OptionVue.

Industry: No oils, biotechs, or other volatile industries

Price: When trying to detect too much speed in underlying vehicle:

- Last week, was there more than a 5% move in one direction?
- Last month, was there more than a 10% move in one direction?
- In the last three months, was there more than a 15% move in one direction?
- In the last nine months, was there more than a 25%–30% in one direction?

If you answered “yes” to any of these four questions, consider waiting.

Earnings:

- No income spread in an earnings month. The exception would be stocks with implied volatility under 25 in the last three earnings.
- No gap over 3%

Skews: There should be no positive skew over four to five points before you put on a position. If a four- to five-point skew develops after you put on a position, take it off.

News: Check the company website and some news services. Here are the words you don't want for income strategies: “merger,” “takeover,” “split in the stock.”

Risk management: If you pay less than \$0.40 for the guerrilla calendar, leave it alone till expiration day unless you take off for 40% profit or more any time before that. On expiration day, take off the complete spread on both sides. Be careful if short option is in-the-money and time premium hits \$0.05; you may get exercised on the short call. If you pay greater than \$0.40 for the guerrilla calendar, take off when time premium of short options hits \$0.05 unless you take off for 40% profit or more any time before that. —J.S.

Checklist for finding and filtering candidates

- 1 Use a software program that has spread-searching capabilities.
- 2 Short side would have 25 to 30 days to expiration to achieve maximum decay speed. (You want the option you sell to lose value as fast as possible.)
- 3 Keep implied volatility (IV) on both sides: buy and sell sides is less than 30. That means the stock will probably move less than 30% in one year. Typically, large stocks like IBM, UPS, GE, AIG, and JNJ fit the bill here.
- 4 Keep the short side out of earnings months, typically January, April, July, and October, but know your stock. Some report earnings in off months.
- 5 Avoid major news in a selling month — for example, an FDA event or mergers.
- 6 Aim for a long option near the low of its implied volatility range. This gives it room to rise, positive for the spread.
- 7 Sell in a near month, buy two to three months out for opportunity to roll. (Rolling is buying in the near month, and selling a month farther out, or buying in a nearer strike and selling a farther strike.) The farther out the long option, the lower its volatility should be. If the volatility on the far option declines, your asset declines and you lose.
- 8 Short option should bring minimum \$0.50.
- 9 If there is a positive skew (sell minus buy) that is greater than 6, investigate. This is somewhat different from what some teach — that is, sell high-volatility near option against buying a lower-volatility far option. The bigger the skew, the bigger the anticipated move. “If you see a big skew, picture yourself on the beach in Florida a day before a hurricane is expected,” Sheridan says. “That’s your reality. Do you *really* want to be there?” If there is more than a skew of 6, he suggests asking why. And probably avoid that trade.

Place the trade

- 1 As a limit order at midpoints of buy and sell
- 2 Wait five minutes. If you don’t get it, give in a nickel, no more.

Manage the trade

- 1 99% of being successful is risk management.
- 2 For risk management points — that is, breakeven points — place your adjustment orders in advance. At the very least, have your adjustment plan *in writing* in advance. Sheridan usually adjusts calendars by adding another calendar one strike up or down.

Pain avoidance

How do you get hurt with a calendar spread? There are two ways:

- 1 If volatility goes down, *or*
- 2 Stock moves big, up or down, thus squeezing the values of the short and long options together.

For the first, pick options that are low in their implied volatility range. For the second, avoid selling months where news can make the stock move — for example, earnings. Sheridan says that 99% of the time when there is a big move, it is earnings-related. Since you can control the timing of your trade, stay out of the period that can whack you with change.

Adjustments

If something can go wrong, it will. If the spread moves against you, what can you do?

- 1 On the upside, volumes come down, put another calendar spread on, higher strikes *or*
- 2 Take your short strike and roll up *or*
- 3 Close the trade. Sheridan notes that the structure of the calendar spread is such that even a fairly sizable move creates only small losses. In a larger move, the worst case is quantified at the initial debit. If you put a calendar spread on for \$0.40, say, that’s the most you can lose.

What about using a LEAP for the anchor, long option versus two or three months out? “The farther out, the more demanding I am on volatility,” Sheridan says, meaning he wants lower and lower volatility for the LEAP anchor. “If you’re long a LEAP and volatility declines, it can make a grown man cry,” he quips.

Calls vs. puts

Should the strategist use calls or puts in a calendar? Calls trade more, so Sheridan tends to favor calls.

Case study: The guerrilla calendar

In Sheridan’s FIA seminar, he showed his personal variation on the calendar theme: a “guerrilla” or one-month calendar spread example. (See sidebar, “Trader Dan on guerrilla calendars,” for details.) He used Bank of New York (BK) as his example (Figure 1). On October 26, he:

Sold 10 December 35 calls	0.79
Bought 10 January 35 calls	1.10

Net debit: \$0.31, plus \$20 commissions = \$330. If BK went to \$1 million or zero the next day, the most Sheridan could lose would be \$330.

What happened next? BK did *not* go to \$1 million, nor did it

REAL WORLD

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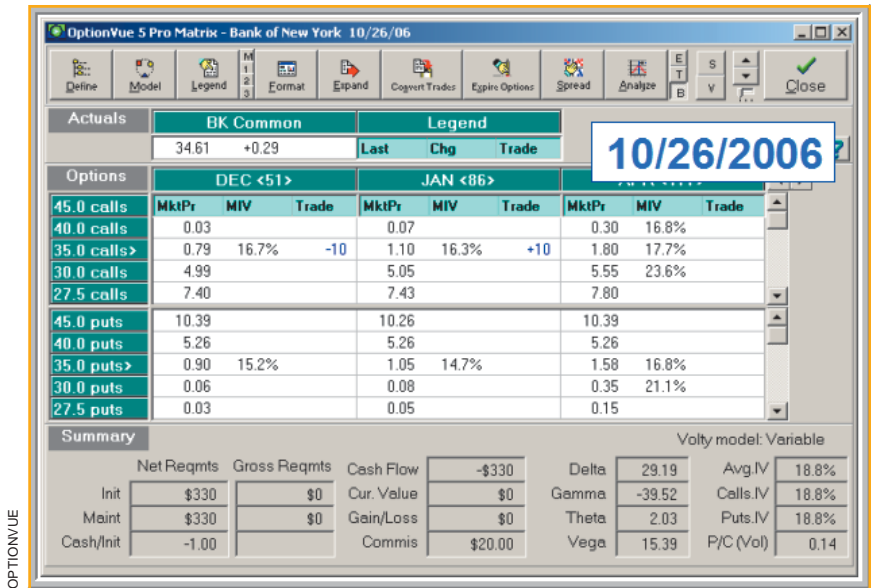


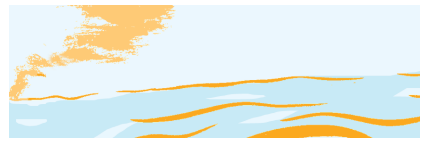
FIGURE 1: GUERRILLA CALENDAR. On October 26, 2006, Sheridan sold 10 December 35 calls and bought 10 January 35 calls. The net debit on this position was \$330.

go to zero; instead, it went from \$34.61 to \$35.10 in the next 20 days, and Sheridan offset the trade:

Bought 10 December 35 calls	0.75
Sold 10 January 35 calls	1.15

Net credit: 0.40 minus \$20 commissions = \$380 net credit, \$50 profit (Figure 2). Yield: 15.15% in 20 days. Small in dollars, yes, but large in yield, and Sheridan says there's plenty of time later to trade larger when you learn the craft.

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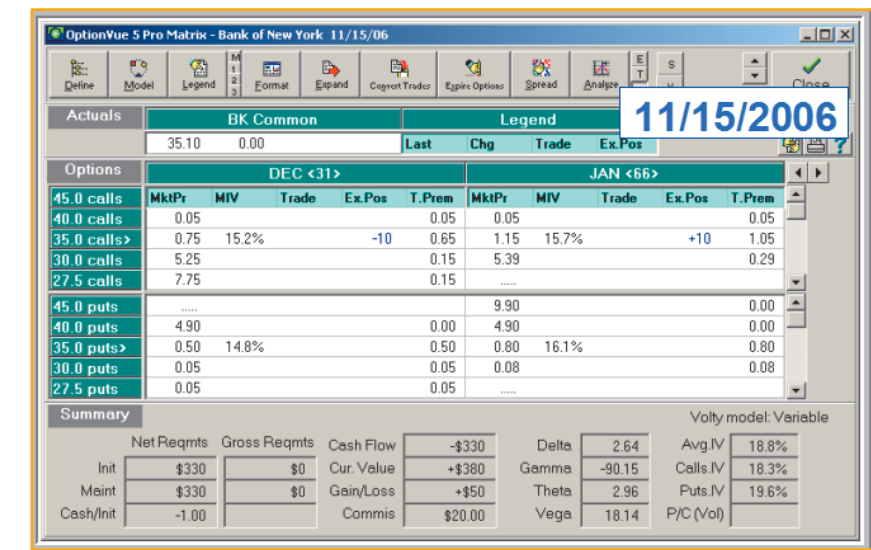


FIGURE 2: WHAT HAPPENED NEXT? BK went from 34.61 to 35.10 in the next 20 days. The trade was offset by buying 10 December 35 calls and selling 10 January 35 calls.