"The OEX (S and P 100 index) trading that I teach is that we are not watching whether the market moves up or down to buy or sell, rather looking at the normal ebb and flow of the market, and observing how the market breathes. ***I use a method to identify whether the market is at the end of inhalation or exhalation and exercise the option that will move enough with the inhalation and exhalation to take advantage of it to make a profit****. So it really doesn't matter if the market is in an up trend, down trend or sideways trend. Traders typically never really trade the trend, and are trading contrarian, and it's why most lose. We are making money on the respirations of the market, no matter what the overall direction."*

Floyd at www.oexoptions.com
www.bluechipoptions.com

TRADING TERMS / THEORIES & DECIPHERING THE TECHNIQUES

- The Dow is 30 blue chip stocks that trade daily, and is used as the overall indicator of market performance. The higher priced stocks command a greater weighting within the Dow Jones Industrial Average

- Dow Theory is a tool for gauging whether the stock market is in a bear cycle (a prolonged period of falling prices) or a bull cycle (a sustained period of rising prices) by considering whether the transports and industrials are moving together.

- To a Dow Theorist, in order for a market advance or decline to have staying power, the two averages must confirm each other's rise and fall. www.dowjones.com says, "*If the industrials reach a new high, the transports would need to reach a new high to confirm the broad trend. The trend reverses when both averages experience sharp downturns at around the same time. If they diverge-for example, if the industrial average keeps climbing while the transports decline-watch out! The underlying fundamentals of the theory hold that the industrials make and the transports take. If the transports are taking what the industrials are making, it portends economic weakness and market problems.*"

Effectively Dow theory states that there is a precise signal based on the price action of the two indexes. **Do the transports take what the industrials make?**

- Each ETF (Exchange Traded Fund) is unique and will behave far differently than another. This is NOT as true as the core DJIA, OEX and SPY indexes

- DIA (or "diamonds") hold the same 30 stocks as the Dow, and is thusly a tool for reading the Dow. The S and P 500 (SPY) spiders are an ETF that holds the same stocks as the S and P 500 index. When the SPX reaches 1200, the SPDRS will trade near $120 a share. The ishares S and P 100 Fund (OEF) attempts to mimic the performance of the S and P 100 index ($OEX)

- Sector trading can be used as an investment vehicle also by HOLDRS (holding company depository receipts) that allow investors to buy/sell entire baskets of a sector in one transaction. HOLDRS are a type of ETF for particular industries, sectors and groups. There are 17 different types of HOLDRS

- At BlueChip Options we pay particular attention to Gold. The streetTracks, Gold Shares Exchange Traded Trust (GLD) is an ETF that trades gold bullion. This makes it unlike gold funds or indexes which hold shares of gold mining companies…..a pure play on the price of gold. The price is set at 1/10th the value of gold. So, if the metal is near $441.00 the fund will trade at 44.10.

- Correction - more than 5, less than 20%
  Pullback - 5% moves or less
  Bear - 20% or greater declines, from a previous high
  Bull - 20% or greater advances, from a previous low
  Retracements - 23.6, 38.2, and 61.8%, Fibonnaci Retracements, move counter to the prevailing trend.

- A moving average is simply the average, or mean, of a price over a fixed number of days. The average is computed using the closing price of the day, and cover 20, 50 to 200 days. The shorter the time frame, the more sensitive the moving average will be to price changes in the index. At www.bluechipoptions we use a moving average of 7 to 9 days. At the same time we watch when the DJIA crosses above or below the 50 d.m.a, as trigger moves are more likely.

Using the Moving Average:

- Many traders use a 15-minute chart, with an exponential moving average (EMA) of 5 units for the fast line, and EMA of 9 or 10 for the slow line. This can show up to 85% of the move. Good chartists will couple this with candlesticks, and MACD. If the market is flat lining, consider using a 5-minute chart.

- Index traders should explore using linearly weighted moving averages. This type gives greater weight to the latest data. For example, to compute the 10-day linearly weighted moving average you would take the closing price of the 10th

day, multiply by 10, the 9th day by 9, etc. Then the prices should be divided by the total number of multipliers (using a 10-day example there are 55 multipliers. Similar to the exponential moving average, we see this type of study as best for studying new rather than old data

- Stock, ETF and OEX options settle American Style. This means that one can exercise their option anytime up to expiration. However, most indexes settle European style, meaning exercise takes place only at expiry. To trade the OEX European style, trades follow the XEO that does not exercise early. Further, most sector indexes settle European style. Always find out also if the sector or index you are trading settles on a Thursday or Friday.

- Covered calls are used to generate calls from selling options on an existing position such as a stock or ETF. This is also called a “buy write” strategy. By selling a call premium, the trader first gains income by selling. Second, the sale of the call provides some downside protection by decreasing the effective purchase price of the stock or ETF, and thusly decreases the total capital at risk. To create the position one buys the shares and sells calls against those shares. One call is sold for every 100 shares purchased. Range bound trading is most advantageous to this type of trading, and only work in non cash indexes. Traders should want to see modest and regular appreciation in their stock position.

- This can also be accomplished for traders with a protective put. Again you own one contract for the put for every 100 shares you own.

- Rolling UP - when the trader substitutes a call option with the same expiry date for a call with a higher strike point. This often means selling a position at a loss, rolling it up, and moving to a higher strike point to try to profit.

- Rolling DOWN - rather than a call as above, it’s now the put the trader is moving down in strike to. Again, the trader is exiting a put at breakeven or loss, and rolling down to a lower strike point to regain profits.

- Delta - the measure of the change in the price of an option relative to the price change of the underlying asset. The delta factor addresses the factor “how much does the option value change for a move in the underlying asset?” A delta factor of .50, for example, indicates the option price will increase at half the rate of the stock price. This happens the most with ATM (at the money) options. An in the money option often has a delta approaching 1.00, and will move almost one for one with the movement of the underlying asset. The greater the delta factor-positive or negative (for puts), the more expensive the option and the higher the loss can be for buyers.

- Burton Malkiel, Random Walk Down Wall Street: *“A random walk is one in which future steps or directions cannot be predicted on the basis of past actions. When the term is applied to the stock market it means that short run changes* *cannot be predicted….taken to its logical extreme it means that a blindfolded monkey throwing darts at a newspapers financial pages could select a portfolio that would do just as well as one carefully studied and selected by the experts"* This is called efficient market theory. We believe, however, that the market is not efficient, and that the emotions of fear and greed are instrumental in moving markets. Having an understanding of "random walk" coupled with noting the catalysts of news, earnings, and FEAR and GREED is what makes an option trader see the "breaths in the market".

- ETF's have two huge advantages:
  1. When an index mutual fund sells a large position in a stock, the capital gain is passed to the shareholders and a tax liability is occurred. This is not true of exchange traded funds.
  2. ETF's are optionable, and can be sold short and with stop loss

- Using interest rates in conjunction with earnings is another effective way to study movement. There is a formula used to measure the impact of rising rates on valuations of the stock market as a whole. It's the reciprocal of the US 10-Year Treasury ($TNX) multiplied by the expected earnings of the S and P 500 companies. www.sp-global.com leads to the Standard and Poor website. Find the expected projected earnings of the S and P 500 and multiply by the reciprocal of the yield on the 10- year note.

  Ex: The TNX yield is 4.1%
  Earnings for the whole S and P 500 is projected at 67.40
  divide by .041 x 67.40= (24.40 x 67.40) = 1645

  In this example if the SPX is trading near 1220 it is 36.50 undervalued by this formula. If the SPX were near 2000 it would be 21.5% overvalued.
  TNX is a valuable tool for review.

- Watch the TICK. The tick refers to the price change of an investment. If, for example, IBM is at 80.00 and moves to 85.00, the stock is on an uptick.
  The tick index ($TICK) helps the trader know best when program trading is overly influencing the market. Program trading is over 57.9% of the trading of the NYSE (*Dow Jones Newswires, Dec. 16, 2005, page C9*). If more than half of the total trading on the NYSE is program trading, it helps explain why the market sometimes experiences sharp, sudden intraday swings and why large institutional investors often have the power to move the market.
  The TICK Index can be either + or -. Typically is runs -900 to +1100. When TICK increases, upticks are outnumbering downticks. If so, buying pressure is increasing and the bulls are in control. When the bears are leading, or gaining control, the tick index is falling, and selling pressure is increasing.
  Pay little attention when $TICK is +400 or -400, but begin watching + or – 600 as it leads to + or -800. As the TICKS increase to +1200 or -1200, institutional traders are aggressively in the market; the goal is to trade on the same side as the institutions….and know when the large buy/sell orders hit the stock market.

- Dogs of the Dow - $MUT is a great index to track the Dow dogs, and options can be traded. These are European style options.

- ATR (Average True Range) - first we must compute the true range of movement.
  1. H – L
  2. Previous Close -Current High
  3. Previous Close -Current Low

  True Range (TR) is the greatest value derived from these calculations. The true range is computed as the difference between the high and the low when the day's trading range is large.
  If a large gap down: When the previous close is greater than the current day's high, the TR is the difference between the previous day close and the current day high.
  If a big gap higher: When the previous close is lower than the current day's low, the TR is computed as the difference between the previous days close and the low of the current day.
  The ATR is simply the average of the true ranges over a period of days. As each day of new data is calculated, the last is dropped.   The ATR calculation is the number of days divided by the sum of the number of TR. Typically chart services begin with an ATR of 14.
  Higher ATR valuations often occur at market bottoms. Low ATR values are often found also during sideways periods, such as those found at tops, and after consolidation periods.

- The Volex System Entry
  Create bands around the ATR.
  Upper-H plus ATR
  Lower-L minus ATR
  When the option reaches the upper or lower bands of the ATR/Volex, a position is established.
  A break to the upside initiates a call longside.
  A break to the downside initiates a put longside
  If a trade isn't established, the system resets itself with new triggers

- Point and Figure (PnF) Charting reflects price movement only, or supply or demand.
  Using a 3 box reversal the market must move 3 points in the opposite direction before a change in settings. Using the original ATR chartists can find reversals in a point and figure chart.
  When the chart reverses down to a column of 0's, the long position is closed. A short position is closed when the PnF chart shifts from a column of 0's to a column of X's.

- Establishing a system
  1. When to get in the market
  2. When to exit profitably

3. When to exit with a loss

- Put and Call Ratios:
  1. ISEE (International Securities Sentiment Index) falls when bearish sentiment increases and rises when bullish. This index typically stays 125 to 200. Consistent moves above 200 show a market topping, and below 140 often a market that is oversold.
  2. Bollinger's Put Volume Indicator (PVI). Here the trader uses put option volume history, the entire CBOE (www.cboe.com) put volume for the day. The indicator is equal to the 10-day moving average of put volume. If the ratio rises, it indicates that puts and bearish bias are on an increase.

     EX: A reading of 2.00 tells us that the day's put volume is two times greater than average.

     If the reading is, in turn, low, it means there is high bullishness, or complacent.
  3. CBOE Put Call Ratios - another way to study excessive fear and greed in the marketplace. Calls are typically higher volume on this exchange, but when the put to call ratio rises it means buying is on the rise.

     Readings of 1.25 or greater reflect oversold. When the indicator drops below .50, it shows bullish sentiment is still quite high, and overbought, and likely to shift bias.

- Floyd's Folly Sector Trading:
  1. At the end of each month identify the 5 sector funds that have advanced the most in the last 240 trading days.
  2. Buy and hold these five funds until the end of the next month.
  3. Repeat the process each month

Learn to trade around how the market breathes©