Cannon Trading Education

Options 101

First Steps

1. 100% of futures options lose all their time value.
2. Futures options expire worthless.
3. Most of the time, markets have no trend.

Bullish Market Strategies

Option Spread Strategy	Description	Reason to Use	When to Use
Buy a call	Strongest bullish option position	Loss limited to premium	Undervalued option with volatility increasing
Sell a put	Neutral bullish option position	Profit limited to debt	Small debit, bullish market
Vertical Bull Calls	Buy call, sell call of higher strike price	Loss limited to debt	Small debit, bullish market
Vertical Bull Puts	Buy put, sell put of higher strike price	Loss limited to price difference	Large credit, bullish market

Bearish Market Strategies

Option Spread Strategy	Description	Reason to Use	When to Use
Buy a put	Strongest bearish option position	Loss limited to premium	Undervalued option with volatility increasing
Sell a call	Neutral bearish option position	Profit limited to premium	Option overvalued, market flat, bearish
Vertical Bear Puts	Buy at the money put, sell out of the money put	Loss limited to debt	Small debit, bearish market
Vertical Bear Calls	Sell call, buy call of higher strike price	Loss limited to stroke price difference minus credit	Large credit, bearish market

Neutral Market Strategies

Option Spread Strategy	Description	Reason to Use	When to Use
Strangle	Sell out of the money put and call	Maximum use of time value decay	Trading range market with volatility peaking
Arbitrage	Bull and sell similar futures options simultaneously	Profit limited to debt	Any time credit received
Calendar	Sell near month, buy far month, same strike price	Near month time value decays faster	Smell debit, trading range market
Butterfly	Buy at the money call (put), sell 2 out of the money calls (puts), and buy out of the money call (put)		Any time credit received
Guts	Sell in the money put and call	Receive large premium	Futures options have time premium and market in trading range
Box	Sell calls and puts at same strike price		Any time credit received
Ratio Call	Buy call, sell calls of higher strike price	Neutral, slightly bullish	Large credit and difference between stroke price of option bought and sold
Conversion	Buy futures, buy at the money put, and sell out of the money call		Any time credit received

Special Market Situations

Option Spread Strategy	Description	Reason to Use	When to Use
Straddle Purchase	Buy put and call	Futures options will lose time value premium quickly	Futures options undervalued and market likely to make a big move
Covered Call	Buy future, sell call	Collect premium on calls sold	Neutral, slightly bullish
Covered Put	Sell future, sell put	Collect premium on puts sold	Neutral, slightly bearish
Synthetic Futures Position	Buy call (put), sell put (call)	Neutral, slightly trending market	Receive credit, option sold far out of the money

Futures Options Writing

Have you ever wondered who sells the futures options that most people buy? These people are known as the option writers/sellers. Their sole objective is to collect the premium paid by the option buyer. Option writing can also be used for hedging purposes and reducing risk. An option writer has the exact opposite to gain as the option buyer. The writer has unlimited risk and a limited profit potential, which is the premium of the option minus commissions. When writing naked futures options your risk is unlimited, without the use of stops. This is why we recommend exiting positions once a market trades through an area you perceived as strong support or resistance. So why would anyone want to write an option? Here are a few reasons:

1. Most futures options expire worthless and out of the money. Therefore, the option writer is collecting the premium the option buyer paid.
2. There are three ways to win as an option writer. A market can go in the direction you thought, it can trade sideways and in a channel, or it can even go slowly against you but not through your strike price. The advantage is time decay.
3. The writer believes the futures contract will not reach a certain strike price by the expiration date of the option. This is known as naked option selling.
4. To hedge against a futures position. For example: someone who goes long cocoa at 850 can write a 900 strike price call option with about one month of time until option expiration. This allows you to collect the premium of the call option if cocoa settles below 900, based on option expiration. It also allows you to make a profit on the actual futures contract between 851 and 900. This strategy also lowers your margin on the trade and should cocoa continue lower

to 800, you at least collect some premium on the option you wrote. Risk lies if cocoa continues to decline because you only collect a certain amount of premium and the futures contract has unlimited risk the lower it goes.

Cannon Trading Co. Inc. believes in writing futures options, but advises against doing it without the advice and expertise of a knowledgeable broker or specialist. Be strict when choosing futures options to write and don't believe in writing futures options as your only strategy. Using the same strategy every month on a single market is bound to burn you one month, because you end up writing futures options when you shouldn't. Cannon Trading Co. Inc. believes you should treat option writing just like futures trading. We believe you should stay with the major trend when writing futures options, with rare exceptions. Use market pullbacks to support or resistance as opportunities to enter with the trend, by writing futures options which best fit into your objectives.

Volatility is another important factor when determining which futures options to write, it's generally better to sell over valued futures options then under valued futures options. Remember not to get caught up with only volatility, because futures options with high volatility could always get higher. The bottom line is, pick the general market direction to become successful over the long-term. We also believe in using stops based on futures settlements, not based on the value of the option. If a market settles above or below an area you believed it shouldn't and the trend appears to have reversed based on the charts, it's probably a good time to exit your positions. We can help you understand the risks and rewards involved, as well as how to react to certain situations, i.e.,: if/then trading scenarios. We can either assist your option writing style or recommend trades and strategies we believe are appropriate, using the above guidelines.

Option Buying & Spreads

Most futures options expire worthless and out of the money, therefore most people lose when buying futures options. Cannon Trading Co. Inc. believes there is still opportunity in buying futures options, but you must be very patient and selective. We believe buying futures options just because a market is extremely high or low, known as "fishing for options" is a big mistake. Refer to the guidelines on our "Trading Commandments" before purchasing any futures options. Historic volatility, technical analysis, the trend and all other significant factors should all be analyzed to increase your probability of profit. All full-service accounts will receive these studies, opinions and recommendations upon request. Cannon Trading Co. Inc.'s "Trading Commandments" can be used as a guideline to assist you in the process and decision making of selecting the right market and futures options to purchase.

A common strategy we implement involves the writing and buying of futures options at the same time, known as bull call or bear put spreads. Ratio and calendar spreads are also used and are recommended at times. Please do not hesitate to call for help with any of these strategies or explanations. Here are a few examples we use often:

1. If coffee is trading at 84, we can buy 1 coffee 100 call and write 2 135 calls with the same expiration dates and 30 days of time until expiration. This would be in anticipation of coffee trending higher, but not above 135 in 30 days. We'd be collecting the same amount of premium as we're buying, so even if coffee continued lower we'd lose nothing. Our highest profit would be attained at 135 based on futures options expiration. To determine risk we'd take the difference between 135 and 100, which is 35 points and divide it by two, because we sold two calls for every one purchased. You'd then add the 17.5 points to 135 and this would give you the approximate break-even point based on option expiration. Risk lies if coffee rises dramatically or settles over 152.50, based on expiration.
2. A typical calendar spread strategy we use often would be to write 1 option with about 25 days left until expiration and buy 1 with 60 days left. Example: If coffee was trading at 84 and we thought prices might be heading slowly higher. We can write 1 130 coffee call with less time and buy 1 coffee 130 call with more time in the anticipation that the market will trend higher, but not above the 130 strike before the first futures options expiration. Some additional risk here lies in the difference between the two contract months. The objective is, if coffee trades higher over the next month but not above the 130 strike price, we'd collect the premium of the option we sold by letting it expire worthless. In addition, the option we purchased may also profit if coffee rises higher, but it may lose some value due to time decay if coffee doesn't rally enough.

*Note: Some futures options trade based on different futures contract months and should always be considered in your trading. Don't hesitate to call for help with any of these strategies or explanations. Remember, the key is still going to be picking the general market direction correct. Therefore, you must analyze and study each market situation with several different trading scenarios and determine which one best suits your risk parameters.

The art of trading these strategies is deciding when, where, which markets, and what ranges to use. If you are an inexperienced trader use these strategies through the broker assisted program.

Disclaimer