LIBERTY TRADING GROUP'S
OPTION Seller NEWSLETTER

James Cordier, President,
Liberty Trading Group/OptionSellers.com

Option Writing Insights and Education for the High Net Worth Investor

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THE BIG PICTURE

The Road Less Traveled

I had a gentleman in my office last week who came to visit us having never read our book. I'm going to call him "Tom" to protect his identity, but I'm sure he'll be reading this issue and know who he is. Tom was a stock option seller, found us on the web and asked for a visit.

When I asked him why, he told me something that took me aback.

He literally pounded the table in front of him and said "because nobody...... NOBODY else is doing this!"

Tom told me of his consistent results in selling stock options and his desire to graduate to commodities options. However, when he tried to explain the option selling concept to friends and colleagues, he got reactions ranging from shrugs to outright shock and dire warnings. When I asked how many of these people had actually sold an option before, he smiled.

"None." he said.

Your accountant probably isn't going to like the sounds of selling options. It's OK. He's been pre-programmed to think "inside the box."

These responses are typical for the ones most of us get when we try to explain to our buddies what we are doing.

You know what they are. The head shake. The look over top of the glasses. The confused squint. It's as though you had just announced you were going to cheat on your taxes or parachute off of a building - depending on who is reacting.

Part of being an option seller is accepting that you will be entering a somewhat exclusive community. Most of the boys at the club aren't going to have a clue, even after you school them on it. Once they hear the words "commodities" and/or "option" they are going to subconsciously begin shaking their heads in the negative. Doubt, fear and skepticism will be the likely reactions. Ditto for your accountant and financial advisor.

It's OK. Forgive them. It's a pre-programmed response. After all, everybody knows that selling options is "risky", right?"

As though buying an index fund today isn't.

I had this exact same argument with a financial advisor friend of mine just this week. In the past, I had always been vague as to the investment strategy I recommended to my clients. But he was especially persistent this time in getting me to "open up" to him. So I did. He of course, was a skeptic at first, as I knew he would be. However, I finally got him to concede that the option game favors the seller.

"Yes," he countered "but you would have to know what you are doing."

Ah....yeah. I'll work on that.

Quote *of* THE MONTH

"Two roads diverged in a wood, and I . . . I took the one less traveled by, and that has made all the difference."

- Robert Frost

Regardless, as an option seller, you must realize that you are choosing the road less traveled. Contrary to Tom's opinion, there *are* guys out there doing this. Most of them just don't talk about it. Your financial advisor certainly isn't going to talk about it. Your accountant will be horrified by it. And the hedge fund manager that is doing it certainly isn't going to reveal how he does it.

Which is exactly why you should feel good about being an option seller. The herd is against it. The same herd that went over the financial cliff in 2008, waiting for their stock portfolios to bounce back. The same herd that got a 0% 10 year return on the S&P. The same herd trying to guess what is going to happen in Europe, or Iran or in the White House, next week, next month or next November.

You'll be satisfied to stay out of the fray. To pick up the money falling off around the edges. In the end, it could truly make all of the difference. -JC

FEATURE MARKET | CRUDE OIL
Waning Global Demand Means Lower Prices Ahead - Or Does It?

Your June issue of the Option Seller suggested that the short side of most commodities would be the more profitable place to be in the coming months as global economies once again begin to slow. For option sellers, this means selling calls.

Nowhere has the commodities downtrend been more pronounced than the energy sector. It is often said that crude oil prices are a gauge of the overall global economy. While we would not say this is 100% accurate, it does hold a ring of truth.

Perhaps a more accurate statement would be that oil prices are reflective of sentiment towards the *future* global economy. They call these *futures* contracts for a reason.

Falling demand for exports of all kinds means fewer trucks on the road.

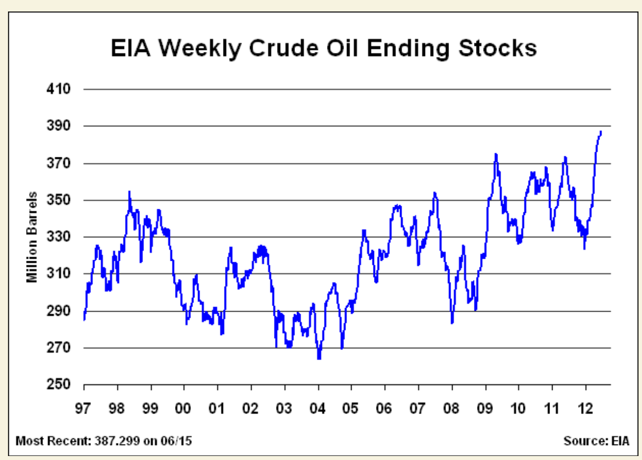
As Europe churns on the abyss, the best case outcome seems to be a long period of stagnant growth. For the present, the European economy as a whole is in recession. And despite arguments that the US can remain above a European slowdown, it cannot. Nor can China or Russia or India. As the ripple effect from Europe washes across the world, trade continues to slow. Less exports to Europe means a smaller piece of export pie for everyone. And the fallout is now starting to be felt.

Some Key Examples:

* **In the US, manufacturing grew at its slowest pace in 11 months in June. US manufactures reported the second largest decline in new export orders since September of 2009.**
* **In China, the world's second largest economy, private manufacturing numbers posted the 8th straight monthly decline in June.**
* **On the home front, unemployment remains stubbornly above 8%. In May, US unemployment rose for the first time in nearly a year.**

Less manufacturing and slower exports mean less energy needed for factories, trains, trucks, ships and planes. Indeed, gasoline demand in the US for the 4 weeks ending June 15th was **down over 5%** from the same time as last year.

The result? Crude stockpiles in the US continue to pile up. Now pushing 390 million barrels, inventories are bulging to their **highest levels in over 20 years**.



Crude oil stocks have surged to their highest levels in over 20 years.

Prices have responded by tumbling **28.4%** in the past 14 weeks, the majority of that coming in the last 60 days.

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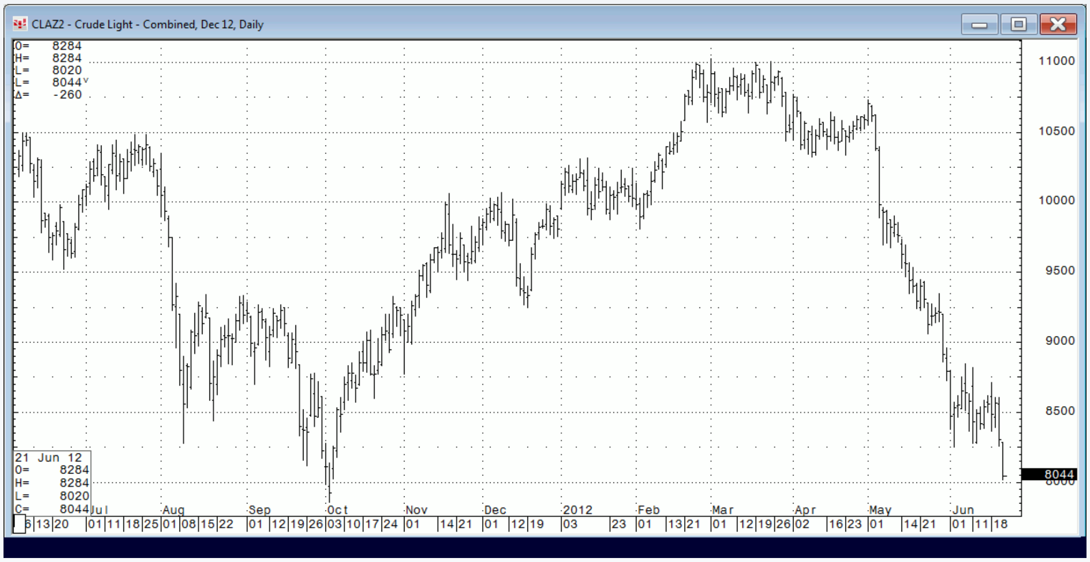
FEATURE MARKET | CRUDE OIL

Waning Global Demand Means Lower Prices Ahead - Or Does It? *continued*

DECEMBER CRUDE OIL



Oil prices have plummeted by over $30 per barrel since March.

The question then becomes, how does one profit from this now?

Conclusion and Strategy

With Europe at the very least slowing, China, the US and the rest of the developed world will continue to feel the effects for at least the rest of 2012.

This should keep the macro picture bearish for oil for the time being.

At the same time, oil prices tend to price in a future projected scenario - one that may or may not play out. With oil already tumbling more than $30 per barrel, <u>you have to wonder at what point the drop in demand has been priced.</u> If oil prices overshoot the downside, a recovery rally could be in the offing.

We are not in the business of picking market tops or bottoms and if you are an option seller, neither should you. However, with Iran still on the table, hurricane season ramping up in the Gulf of Mexico and the US entering the heart of "driving season", there are still enough bullish cards in the deck to prevent a total wash in crude prices this summer.

It is our opinion that barring an all out economic crash, oil prices are likely within $5-$7 of a low. Does this mean we are bullish oil prices from here?

No.

It means we feel the odds are against an additional drop of more than $5 to $7.

But for an option seller, that is more than enough. **Additional weakness in oil prices should be viewed as option selling opportunities at the premium inflated <u>puts</u> now available in crude.**

On the other hand, demand for crude oil is not going to make a miraculous recovery over the next 90 days. To that end, we favor **selling calls on a $3-$5 price rally in crude oil.**

The objective is to establish a ***strangle*** in this market with deep out of the money puts offsetting deep out of the money calls. This gives oil prices a wide range to move, yet allows you to potentially be profitable with options on both sides of the market. In essence, double premium.

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FEATURE MARKET | CRUDE OIL

Waning Global Demand Means Lower Prices Ahead - Or Does It? *continued*

CRUDE OIL STRANGLE STRATEGY

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A strangle is the strategy of selling puts below the market and calls above it. If the market is anywhere between the 2 strikes at expiration, both options expire worthless in favor of the option seller. This example shows the profit zone of selling December Crude Oil 55 puts and 115 calls.

The difference is, due to the volatile nature of prices over the last several weeks, it may be beneficial to "leg on" this strangle. This means **selling your puts on weakness** and **calls on strength** - potentially capturing higher premiums for each.

Our targets? **December Crude 52.00 puts** and **115.00 calls.** Target premium $850. Expiration is November 13th, but look to take profits on either side as time accelerates the premium decay. If crude oil prices are anywhere between $52 per barrel and $115 per barrel at expiration, **both options will expire worthless** and you keep the premiums.

That should give prices plenty of room to move in almost any scenario.

We will be working closely with our private client group in timing and strike selection this month.

by James Cordier, OptionSellers.com

Q: Dear James, I love to read your market commentaries. However, I've noticed that your comments seem to focus on a handful of commodities markets to the exclusion of others. For instance, I have not seen any recent research from you on markets like coffee, natural gas, orange juice or cattle. Is there a reason you don't trade these commodities?

Kyle Anderson
Leander, TX

A: Dear Kyle, Thank you for the compliment. You ask a good question that has multiple answers.

First and foremost, what you read in this newsletter, our blog or our online syndicate network represents only a fraction of what is actually going on in our overall portfolios. These research pieces are meant to give examples to inspire the overall investment community to learn more about the option selling approach. Therefore, we tend to focus on the major commodities when writing these, using easy to understand examples.

The second reason is that I do and have traded all of the commodities you mentioned at one time or another. In fact, coffee and natural gas are two of my favorite markets to trade. At present, both have been in such vicious downtrends for so long that small speculators have stopped paying up for the calls. Yet prices are so low that puts have to be sold too close to the money. In short, I don't feel these markets favor option sellers at this time. But prices can and will eventually recover and even become more volatile. As they do, speculator interest comes back and premium comes back to the out of the money options. That is when you want to consider re-entering these markets. That is also when I will likely start talking about them again.

Thirdly, some commodities markets simply do not support heavy enough volume to trade the options. I trade orange juice about once per year. Hogs, copper, lumber, forget about it. No volume. Cattle is simply too unpredictable to trade these days and require options be sold too close to the money - in my opinion.

To have a candidate for an option sale, you must find markets that sport clear fundamentals, have sufficient volume in the options, and enough volatility to sell options deep enough out of the money.

Believe me, there are more than enough.
Happy hunting.

BACK TO BASICS
Managing Your Option Selling Risk

One of the most common questions I get from new clients starting their option selling portfolios is "How do we manage our risk (protect our downside, limit our exposure, et..)?

It is not only a fair question; it is probably the most important question you can ask. In an investment where 85-90% of your trades should statistically be winners, **your results at the end of the year will depend heavily on how you handle the other 10-15%.**

Managing risk or handling losing trades is not something you should have to worry about. **There are simple, effective ways to do this** with short options and all that it requires is a plan.

That is what this month's *Option Selling 101* column is about.

RISK MANAGEMENT: LAYING THE FOUNDATION

As is true in most areas of life, an ounce of prevention is better than a pound of cure. The same holds true to managing risk in your option selling portfolio. As we have covered in past tutorials, **how you structure your portfolio can have a big impact on your exposure.** If your portfolio is structured correctly from the start, managing risk on individual positions becomes easier.

To Review

1. **50% of your portfolio should be held in cash**. This gives your account a large cushion to absorb any potential margin increases in your positions.
2. **The remaining 50% should be diversified over 6-10 uncorrelated commodities markets.** By structuring this way, if a position should run on you, it will encompass only a small percentage of your overall portfolio. (Recall the submarine example: The hull is comprised of many different compartments. Should a hole be punched in the side of the sub, the compartment can be sealed off, isolating the hold and protecting the rest of the ship. This is how your portfolio should be built).
3. **Sell Options Deep out of the Money.** This allows you to manage risk based on the value of the premium without worrying about when or if your option will get assigned.

If your portfolio is set up this way, your risk management plan is already half done.

THE PREMIUM TRIGGERED BUYBACK

Assuming that you are structuring correctly, we now arrive at the answer that everybody wants to hear. ***Where do we get out?*** Before I answer, lets include some of the related questions that come with this so we may address them all at once.

What if we get assigned?

Do we offset with a futures position if it goes in the money?

How much would we risk on each position?

What is the "rule" on exiting?

Investors like hard, fast, solid rules. They like things quantified. They want to know exactly what to expect.

Managing your risk is the most important piece of the option selling puzzle. If you are managing your own portfolio, having a set stop out point on each option is the safest way to stay on track through the year.

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BACK TO BASICS
Managing Your Option Selling Risk *continued*

Unfortunately, investments are not like that. It is a good idea to have rules for any trading plan. However, add too many rules and your approach becomes inflexible and ultimately, ineffective, unable to capitalize on moving opportunities. Because of this, I like to call my trading rules "guidelines."

And my *guideline* is this: **If the option doubles in value from the point at which you purchased it, buy it back.** Exit the position. (This is known as the "200% rule" for those that read The Complete Guide to Option Selling.) Do not try to "delta neutralize it" or offset it with a futures contract or anything else. In my opinion, the best approach is a simple one. The option doubled. You were wrong. Get out. Move on. Follow the guidelines laid out above and you should be able to recapture that premium somewhere else.

> ***The option doubled.***
> ***You were wrong.***
> ***Get out.***

As listed above, our portfolio strategy sells only deep, deep, deep out of the money options. Options that are not going to go into the money (at least not for a long, long time). This allows you to **manage risk based on premium value.** There is little concern about where or when it will go in the money or if it will be exercised. It's too far away. Again, simplicity.

This is the guideline I recommend if you trade on your own.

ADVANCED RISK MANAGEMENT

Do I always follow the 200% rule in the portfolios I manage? No. I use it as a guideline – a hazard light, if you will, to let me know that I need to address our exposure. If an option hits 200%, I'm likely at least cutting our position in half. But I would consider other factors to help me with the size of the scale back, including:

- *How long until expiration?*
- *How large is this position in regard to the overall portfolio?*
- *Is it hedged? (ie: If it's a call, do we have puts on the other side of the market?)*

I would call these kind of items "advanced risk management" questions because **I would not recommend them to a beginner** or even moderately experienced option seller. These are for the highly experienced trader. How you use them is almost always based on judgment. And that kind of judgment takes time to develop.

If you are selling options in your own portfolio, it is my opinion you would do well to follow the 200% rule at all times.

Remember, in option selling, the winners take care of themselves. Your focus should be on cutting the losers. Set up your portfolio properly, sell deep out of the money and follow the 200% rule. Its the best advice I can give for building a rock solid, high yielding portfolio while allowing you to sleep well at night.

Have a great month of premium collection!

-JC

A N N O U N C E M E N T S

The Smart and Easy Way to Sell Options

James Cordier and Michael Gross will be accepting new members to their private client group during the month of July. This is your chance to have **options written and managed for you** by the authors of *The Complete Guide to Option Selling.*

For inquiries or to see if you qualify, call the Liberty Trading Group main office to schedule a confidential consultation. Written inquiries can be sent to office@libertytradinggroup.com.

New Accounts US **800-346-1949** International **813-472-5760**

Recommended Initial Investment: $1M
Minimum Initial Investment: $250,000

Past performance is not necessarily indicative of future results. Futures and options trading involves risk of loss. Only risk capital should be used.

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THIS MONTH'S FEATURES INSIDE

The Option Seller Newsletter
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