SECTION 1: INTRODUCTION TO OPTIONS ON FUTURES

The concept of options trading has been around longer than most realize. The practice dates back to 350 B.C. by some accounts; ancient Romans, Greeks, and Phoenicians traded options based on outgoing cargoes from their local seaports. These were credit contracts in which the seller of the contract agreed to purchase the cargo if the ship carrying the cargo didn't come in on time for the intended purchasers' needs. Thus, the buyer of the contract had the "option" to execute the contract or not. Of course, he would only do so if it was advantageous. If this sounds a lot like an insurance policy, you are correct. In their simplest form, options are insurance policies in which the buyer is acquiring the right to be able to purchase the underlying asset if the circumstances are favorable and the seller of the contract is collecting premium in exchange for the liability to pay out if the buyer files a claim. In a nutshell, an option pays out to the buyer if something (a stipulated event) *happens* but pays the seller if that same something *doesn't* happen.

> Commodity trading isn't for everybody. In fact, it isn't for most people.

Nobody said it will be easy, but opening the door to options trading and the opportunities they present will be worth the extra effort. It's human nature to favor convenience and simplicity, but those are not always the optimal choices. For instance, it is possible to purchase a loaf of bread at a convenience store to save time and effort, but the selection will be dismal, and the price will be high relative to less handy alternatives. Commodity trading is no different.

Despite the fuzzy math, blood, sweat, and tears that come with using complex strategies, I believe traders owe it to themselves to fully understand the relationship between the futures markets and the options written against them. Doing so arms traders with the tools needed to cope with hardships and react to the ever-changing market environment. Further, the focus of this book is to outline various options on futures strategies used in speculation, but we mustn't forget the same strategies can be used by farmers, ranchers, and portfolio managers to hedge price risk. After all, the futures markets were initially created to shift risk to the speculator from the hedger, not the other way around.

INTRODUCTION: AN UNCONVENTIONAL BUT LOGICAL APPROACH TO OPTION TRADING

Many books have been written about options on futures, but unfortunately, I believe most of them focus on the academic side of options suggesting there are black and white answers, and profit and loss potential can be figured with a reliable mathematical formula. However, options traders must be ready and willing to deal in gray areas, approximations, and guesswork.

Commodity option values are primarily derived by price action in the underlying asset it was written against, such as gold, corn, crude oil, live cattle, or the e-mini S&P 500. For this reason, options are known in the world of finance as *derivates*. Yet option pricing is highly complex; option values, as well as the underlying assets they are written against, are influenced by human emotion and simply cannot be predicted or quantified. As a result, most of the literature on the subject chooses to focus on commodity futures while ignoring the messy component of options trading. Those books, courses, and forums that do attempt to delve into options trading often leave traders even more confused than they were before setting sail on their quest to learn commodity options. Even worse, many novice options traders have been misled into believing buying calls and puts outright is a low-risk venture in which making money is as simple as getting the market direction right. I hope to change that trend with this book. *Trading Commodity Options with Creativity* is intended to introduce the reality of options trading, which isn't always as neat and clean as many assume it to be, nor is it a place to achieve easy profits.

To be fair, writing and teaching options trading is a nearly impossible task. The subject matter can become dense and convoluted. There are an unlimited number of strategies, and each trading scenario might call for a variety of approaches; there is no clear right or wrong answer without the luxury of hindsight. Some educators attempt to oversimplify the practice of options trading while others take the opposite approach of creating overly intimidating material. I hope I can find a happy medium capable of helping traders of all types, sizes, and skill levels. Whether you have traded for decades or have yet to place your first trade, I believe I can offer an alternative perspective on how to use options to alter the landscape of the commodity markets.

The objective of this book is to introduce various options trading strategies, their advantages and disadvantages, and how to calculate risk and reward; it is not intended to be a comprehensive book on commodity trading. However, I have written other titles to meet the needs of most information seekers. Those interested in learning from the ground up should consider *A Trader's First Book on Commodities;* taking things a step farther into market analysis and strategy development, *Higher Probability Commodity Trading* is a great source (in my biased opinion). Let's get started.

WHERE OTHER BOOKS GO WRONG

The biggest mistake some authors make is to apply stock options theory to options on futures. It is a misguided perception to believe that an "option is an option." Although they are spelled the same and have similar components, they are not comparable. The nature of the underlying vehicle differs greatly, causing the options to take on completely different characteristics. After all, everybody agrees that trading stocks is distinct from trading futures, so why would anybody assume that trading options on stocks is synonymous with trading options on futures? The answer is simple; the trading industry is full of career educators whose job is to provide options trading education in the form of books, newsletters, and courses. Those educators have an incentive to package stock and commodity options into the same box because it means keeping costs and efforts low, while appealing to a larger audience. Further, in the most recent decade, we've witnessed brokerages joining in on the fun. As the popularity of trading commodities has grown, stockbrokers have slowly started offering futures and options on futures trading to its customers in a limited way. These brokerages presenting clients with the ability to trade in both arenas are known as *broker-dealers*. Later, we will talk about whether it is a good idea for such brokerages to try to be everything to everyone, but for now, it is enough to realize commodity trading vehicles are readily available to nearly anybody with a trading account, but having access is only a small step in the process. There is a steep learning curve; even the best stock option traders will find commodity options to be a painful task without the proper acknowledgment of differences between trading instruments.

> Stock Options ≠ Commodity Options

WHERE SOME BROKERS GO WRONG

In the same manner in which educators and broker-dealers are incentivized to ignore the unique nature of the commodity markets to increase interest and ultimately revenue, broker-dealers and conventional commodity brokerages generally shy away from encouraging its clients to trade options on futures in any manner outside traditional call and put option buying. As we will discuss in detail, this approach involves limited risk and unlimited reward to traders, which is an easier "sell" for the brokerage industry. In addition, it requires less hands-on risk management to house clients who are simply buying options outright relative to clients' trading strategies that involve both buying and selling of options. Most brokerages either don't allow short options trading at all or highly discourage the practice through charging shockingly high margins and other risk management limitations such as unreasonable quantity limits or requiring clients trade spreads rather than naked short options. We will cover each of these items in detail throughout the book. That said, I believe brokerages who operate with an anti-options selling agenda are denying their clients access to strategies that can greatly reduce their risk and increase their odds of success.

WHERE SOME INDUSTRY INSIDERS GO WRONG

In addition to the risks that options spread trading and options selling pose on a brokerage service, among brokerage employees there is a lack of interest in allocating the time and effort to commodity option education. Some are surprised to know that this includes brokers, risk managers, desk clerks, and others. Throughout my time in the commodity trading industry, I've run across numerous commodity brokers and industry professionals who make a living supporting clients' trading endeavors but barely know the difference between call and put options. Further, they have little knowledge of how they work, how to assist clients in trading short options and spreads, and how to help clients manage risk or margin in doing so. Even self-directed online traders will need a helping hand now and then; if so, they had better be trading with a proper brokerage service.

Even worse, I've run into a handful of risk managers employed at large brokerage houses and earning a relatively large salary for their risk management skills who have little or no experience in options strategies. These risk managers are often quick to forbid a trading approach they don't understand because that is the easy solution and they would prefer to not reveal their lack of skill and understanding.

Ironically, many industry representatives (brokers) are unwilling to educate themselves properly to enable an environment in which their brokerage clients have access to various options strategies and so that the brokerage firm's risk management department can sleep at night. In my opinion, this is a lazy and selfish way of doing business that doesn't have the clients' best interests in mind. As we discuss throughout this text, I firmly believe the failure to sell options either as a spread or to hedge futures positions poses more risk over the long haul than trading long options outright or futures outright. In my view, giving all brokerage clients access to such strategies is key to long-term success for the brokerage and ideally the client. Options selling and spread trading shouldn't be a strategy reserved for the highly capitalized industry insiders. Granting properly prepared retail traders permission to participate in option spreads and short option strategies levels the playing field for all involved and makes for a better trading environment beneficial for all parties.

WHERE TRADERS OFTEN GO WRONG

> "No matter how great the talent or efforts, some things just take time. You can't produce a baby in one month by getting nine women pregnant."— Warren Buffett

Years of having a front-row seat to both big and small traders and industry professionals, experienced or green, successful or not, I have concluded that hedged options selling in some form generally performs better than options buying or outright futures trading. Despite a widespread push by brokerages for a long-only approach to options, time decay and the tendency for markets to trade sideways are often obstacles that traders can't overcome over time. That isn't to say that an options buyer or a futures trader who happens to have impeccable timing on a venture doesn't stand to make a boatload of money, but the truth is that those types of stories are rare. A more normal outcome for option buyers is a slow and painful depreciation of a trading account. Futures traders, on the other hand, generally aren't lucky enough to see their trading account bleed slowly; instead, they are often slapped in the face by the hand of reality.

I've concluded that perhaps the optimal trading approach will be the use of strategies capable of benefiting from the advantages posed by long options and futures, namely profit potential, while mitigating the disadvantages of time value erosion and the need for nearly perfect timing by using short options. Let's face it, we are all human and our crystal balls are generally cloudy; the more room for error a strategy allows, the better off a trader will be.

Perhaps the biggest mistake that traders make is not utilizing options to mitigate risk and volatility. Few people can enter speculative positions with perfection; despite our best efforts, we simply cannot see into the future. Thus, being savvy to the possibilities of options trading, or combining options with futures, will come in handy for traders partaking in most strategies and time frames. Not only are options flexible trading vehicles enabling traders to adjust position risk, and even purpose, in an instant, but they are also an effective way to reduce the overall account volatility that comes with trading commodities. Simply put, if utilized correctly, options allow traders to de-leverage the futures markets and to slow trades down to a more manageable level. Yet, if used incorrectly, such as trading large quantities and abusing leverage, some option trading endeavors might be riskier than futures. Thus, having access to the tools isn't enough; they must be used properly.

> If trading were easy, we would all quit our jobs and move to a private island.

I assume some readers of this book are already proficient in options strategy and terminology, but others might have intentionally avoided options trading education due to the perceived complexity. In any case, I am confident this book will deliver. For those in the latter category, I can assure you, understanding how options function isn't as overwhelming as it seems on the surface; in fact, with a little practice, it will become second nature. Unfortunately, I'm referencing the concepts, not trading results.

> "If you personalize losses, you can't trade."—Bruce Kovner

I hope to be able to convey the trading strategies in this book in a clear and easily understandable manner with a comprehensive list of advantages and disadvantages for each speculative approach. Keep in mind that not all strategies are appropriate for all environments; further, not all strategies make sense for all types of traders. As humans, we are each dealing with our own personal demons. It is just as important for a trader to choose and implement a trading plan that works well with their personality as it is correctly analyzing the markets. In this book, we discuss strategies that have the potential to return profits even if a trader's directional speculation is off course. The key to trading in the green is managing emotions and choosing a strategy conducive to keeping stress at bay.

BENEFITS OF TRADING OPTIONS ON FUTURES RELATIVE TO STOCK OPTIONS

Later, we will explain the benefits of trading options over futures, but I want to start by outlining the benefits of trading, not investing, in the commodity markets relative to the stock market. In other words, why traders who wish to employ speculative options strategies might be better off doing so using options on futures rather than stock options. It should be noted that any reference to commodities or futures markets includes both futures and options on futures. Here are the primary advantages enjoyed by commodity traders:

> Trading ≠ Investing

- **Around the clock market access**—Most commodity futures and options markets trade 23 hours per day from Sunday evening through Friday evening (or afternoon if you are on the West Coast). This gives traders the ability to play either offense or defense at nearly any time of the day as global events unfold.

Stock traders, on the other hand, are generally restricted to the open and close of the New York Stock Exchange, which is inconvenient as well as potentially costly in certain situations.

- **Free leverage and margin accounts**—Commodity accounts of all sizes are automatically granted leverage (the freedom to trade on margin). If you are unfamiliar with leverage, it is the ability to buy and sell assets valued higher than the funds being used as collateral. Stock traders typically must apply for the privilege and are often required to have six-figure trading accounts to be granted permission; further, they are charged interest for the opportunity to use margin.
- **Liquidity and efficient execution**—Commodity futures and options on futures are more liquid and efficient than commodity-related exchange-traded funds (ETFs). This is because most commodity market ETFs are simply pooling investor funds to buy futures contracts; fund rebalancing and administrative costs work against the effectiveness of these vehicles. The futures markets, on the other hand, are pure price speculations.
- **Buy or sell in any order at any time without additional rules/restrictions**—Whether futures or options on futures are being traded, the instruments can be bought or sold in any order (assuming the brokerage allows option selling). This gives traders a vehicle for speculation on price declines as well as price increases.
- **Low account minimums**—Most commodity brokerages allow traders to open an account with $2,000 to $5,000. These accounts are provided all the leverage and portfolio margining benefits much larger accounts enjoy. Stock traders will find the same luxuries generally require an account of $100,000 or more.
- **No interest charges or borrowing fees**—Unlike stock traders who are charged interest on leveraged positions, futures and options traders are granted the use of margined trading at no cost. This is because it is the exchange offering leverage, not the brokerage.
- **Level playing field—**Futures market participants receive the same execution priority regardless of account size and volume traded; this isn't necessarily the case in stock trading. Specifically, commodity market orders are treated on a first-come, first-serve basis by the exchange's electronic trade-matching software.
- **Favorable tax treatment**—Regardless of the length of time a trade is held, futures and options traders enjoy a lower tax rate than most stock traders face. Gains are taxed at a 60%/40% blend between long-term and short-term capital gains. Also, commodity traders need only to report a single figure to the IRS to declare profits or losses. There is no need to report each trade; this makes for a more convenient tax filing.
- **Excitement**—There is nothing like being on the right, or wrong, side of a futures or options trade. Depending on the trading strategy and amount of aggression being employed, profits and losses can be substantial. This is exciting at times but torturous at other times. Nevertheless, the potential for outsized profits keeps traders interested. I once witnessed a trader take a $10,000 account to about half of a million dollars in a few weeks during the stock market collapse of 2008; unfortunately, in time the same trader gave all the money back plus some.

FACTORING IN COMMISSION

Transaction costs can vary widely depending on factors such as the chosen brokerage firm, the level of service requested, trading volume, trading strategy, and account size. Because there is such a broad range in commission paid, for the sake of simplicity, I have opted to leave commission out of the calculations throughout this book. Of course, in the real world, there are costs to executing trades.

On top of the commission charged, the exchange also requires that a fee be paid on every option or futures contract executed. These are known as *exchange fees* and are non-negotiable and are somewhat substantial unless you have deep-enough pockets to purchase a seat on the exchange, but that isn't feasible for most retail traders. However, if you are a sizable player, your brokerage firm may absorb some or all the fees for you. This doesn't mean that the fees don't have to be paid; it simply means that your broker is using part of the commission charged to you to pay the exchange fee. If this is the case, the brokerage is said to be quoting an all-inclusive rate. We will talk more about the smoke and mirrors that come with commission quoting later; for now, just understand that the examples we discuss in this book will not consider transaction costs.

It is no secret that US futures exchanges have a great business model. Each commodity market has a different fee structure. The exchange fees for most products are $1.00 to $2.00 per side, or $2.00 to $4.00 round turn. If you are unfamiliar with the term, *round turn* refers to both getting in and out of a position. In some instances, you will hear it called a *round trip* because it covers a trip around the market. The exchange fee for options is generally less than that of futures. For instance, e-mini S&P 500 futures traders face a charge of $1.18 per side ($2.36 round turn) but an e-mini S&P 500 options trader is subject to a mere 55 cents per side in exchange fees ($1.10 round turn). Again, this is the exchange fee, not the commission. Thus, if your broker is charging you $5.00 round turn plus standard exchange fees, the total cost of an e-mini S&P 500 futures contract would be nearing $8.00. Similarly, if a discount brokerage is charging you an all-inclusive rate of $4.00, the brokerage is allocating over half of that toward exchange fees (and that doesn't even consider the clearing fee the brokerage pays in addition to the client's exchange fee). As you can see, discount brokerages operate on thin profit margins; as a result, they cut some dangerous corners. In this business, you will always get what you pay for. Again, we will get into more detail later in the book.

Regardless of what your transaction costs are, for every option purchased, the commission and fees add to the cost; for every option sold, the commission and fees subtract from the amount collected. While the examples contained in this text do not include transaction costs in the calculations due to the diverse nature of available rates, I will remind you throughout the book to include commission and fees into your figures.

WHY TRADE OPTIONS RATHER THAN FUTURES?

Traders interested in venturing into commodities often ask whether they should trade options or futures. My answer is always the same: Options are a versatile tool enabling traders to create an unlimited number of strategies to match their needs and comfort level; futures traders are not afforded these luxuries. Even if the chosen speculative vehicle is futures, I believe options should be used to hedge the risk.

The options markets enable creative traders to build strategies that can be used to express any opinion they might have on price with adjustable degrees of risk and reward. For instance, options traders can construct strategies intended to make money if nothing out of the ordinary happens. Or they can be highly directional plays, but with substantial risk buffers. Here are a few distinct benefits to options trading relative to trading futures outright:

- Ω **Flexibility—**The use of various option types, strike prices, and expirations allows pin-pointed speculations.
- Ω **Less volatility—**Position and account profits and losses will move less, providing traders with a smoother experience.
- Ω **Room for error—**Option spread traders or premium collectors don't have to have perfect timing or price speculation.

- Ω **Lower margin and risk—**Depending on the strategy, options trading is generally less risky than trading futures outright.
- Ω **Lower cash outlay—**Option spread traders can often get a foot in the door with little out-of-pocket expense.
- Ω **Time value erosion—**When selling options, time value can work in favor of the trade to offer a directional hedge or reduce the cost/risk of a spread.

STARTING THOUGHT

> "You can't teach talent."—Adam DeMouy

Regardless of the chosen trading strategy or even the instruments traded, the results generally cycle from feast to famine. When things are going well, it seems like easy money but inevitably the opposite experience occurs. A friend of mine, trader Linda Raschke, once said: "The minute you think you have found the key to trading, I promise you the markets will change the lock." Falling in love with a market approach because it has been working or disregarding one that has gone on a cold spell is probably the wrong move. Traders must always keep an open mind and attempt to trade what they see rather than what they want to see. This is easier said than done.