

The Importance Of A Good Mentor

Adjusting Option Trades With Bill Ladd

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Bill Ladd, a full-time, independent option trader, spent 20-some years in the pharmaceutical industry (Burroughs Wellcome, which became Glaxo Smith/Kline) as a certified internal auditor and a certified fraud examiner. Ladd was one of the early students of 22-year CBOE veteran turned teacher Dan Sheridan, regarded as one of the foremost option mentors.

When he's not trading, Greensboro, NC-based Ladd volunteers for the Service Core of Retired Executives (SCORE) organization and also at a local retirement community. He agreed to answer some questions on August 22, 2008. The interview was conducted by STOCKS & COMMODITIES contributor John Sarkett.



Managing trades once they are on is the heart and soul of option trading, and that only comes with experience.

Bill, when and how did you begin trading?

I was interested in options for several years before I began trading. After I left the pharmaceutical industry and began my own consulting business, I started to trade covered calls on stocks I currently owned, but only had limited success.

How did you come in contact with Dan Sheridan and his option mentoring service?

I met Sheridan through OptionVue. I was using OptionVue software and their representative told me about his mentoring program. So I was introduced to his style of monthly income strategy trading that way.

Some of Sheridan's students seem to specialize in condors. Is that what you do?

No, but I do trade high- and low-probability iron condors, calendars, and broken-wing butterflies. Each strategy has its own entry and exit rules. Managing trades once they are on is the heart and soul of option trading, and that only comes with experience.

What position size do you typically trade? Do you adjust the trade size month to month based on results?

I use a set dollar amount per trade each month to determine the number of contracts for a given trade. If the mar-

ket is more volatile, I scale into the trades. In addition, if there is extreme volatility in the market, I reduce the allocation per trade amount, and in some cases, I just stay out of the market until it settles down.

What is your entry methodology?

It depends on the strategy. Each strategy has its own entry methodology and risk management rules. For example, a high-probability iron condor has different entry methodology than a low-probability iron condor, and they each have different risk management rules. Calendars have their own entry and exit methodology.

Where did you learn adjustments?

When I first started trading, I would just get out of a trade or roll the trade up or down. I learned from Sheridan how to effectively adjust and manage trades, and that being able to manage trades is the key to being a profitable trader. There are maybe four or five different

ABOUT CONDORS

An iron condor is a four-legged credit spread, most easily conceptualized as a put credit spread below the market and a call credit spread above the market. A high-probability condor has a "high probability" of the underlying *not* hitting the short strikes. Typically, strikes with deltas of seven or so are sold, with the next strike further out — that is, the wings — bought as protection. This might equate to something like RUT (Russell 2000 index) at 700, 600/610/800/810, that is, buy the 600 put, sell the 610 put, sell the 800 call, buy the 810 call.

The low-probability condor is sold closer to the underlying at 12–15 deltas. This might be something like 620/630/780/790 condor. It generates a higher credit, but with it, greater likelihood of an adjustment. But that's not necessarily bad; for Dan Sheridan's top students, like Ladd, "adjusting," whether rolling up, rolling down, adding debit spreads, or additional calls and puts to the underlying condor, is almost as natural as breathing. (See the sidebar, "Option adjustment," for more on the method Sheridan teaches to trade these two kinds of condors.)

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things you can do to adjust a trade, including adding a calendar at the at-the-money (ATM) strike to buy time, scaling out, or buying extra longs to cut the delta.

What is your exit methodology?

It depends on the type of trade. Just as with the entry methodology, each strategy has its own risk management rules.

What was your motivation to sign on?

I understood the mechanics of how options worked from reading books on option trading and doing some trading on my own. After discussing the mentoring program with Sheridan, however, I realized I did not know how to trade and it was apparent that was what he could teach me. I don't think most people realize there is a *big* difference between understanding the mechanics of options and being able to trade successfully year after year.

What has been your track record? Pre-Dan, post-Dan.

Prior to working with Sheridan, I only had limited success, mostly on covered calls. In 2007, I had 10 winning months and two losing months, ending the year very successfully. But my sole income for the past three years has come from trading options.

If a trader with the capacity to follow rules undertook condor trading, what kind of annual return could he or she expect?

You do have to be disciplined, but it's more than following the rules. You have to have the personality for trading.

What's that?

Part of it is patience. Some traders start out, put on condors for a few months, then the market moves sideways and the traders beat themselves up that they didn't trade bigger. But they haven't been through all the different

kinds of scenarios the market can throw at you. That's why it's so important to trade small, for six, 12, even 18 months.

Not only that, trading is like any other business or profession — some people will be better at it than others. Generally, I look at the yield per trade. On condors, I'm looking for yields of 10–13% per trade. Calendars will have a better yield than condors. With calendars, I'm looking for something in the 15% per trade range.

Here's how I figure yield:

$$(\text{Margin} - \text{credit received})/\text{gain} = \text{yield}$$

For example, if your trade is a 20-point wide RUT 30 lot iron condor for \$3.27 - margin = \$60,000 - credit received = \$9,810, so that's \$60,000 - 9,810 = \$50,190. That's the yield base. If you made \$7,000 on this trade, your yield would be \$7,000/\$50,190 = 13.94%.

Another way to look at this trade is

Option adjustment is a huge subject onto itself. Each strategy generates trading rules of its own in the Sheridan methodology. Here's how he handles one of the most common — the calendar spread, when the underlying moves against the strategist.

1. Add a calendar. After putting on a calendar spread, you would be pleased if it sat there and did nothing until expiration. Unfortunately, stocks don't do this, and it takes a bit of skill to earn your profit. So when you reach the next strike, up or down, you can consider adding another calendar. This will bring you back to breakeven or even allow you to squeeze out a small profit.

2. Partial repositioning. When the underlying has moved sufficiently for you to reach breakeven on the risk curve, you can reposition. On the move up, your delta has gone from zero, say, to -30. Say you have 10 50 calendars; take five off at 50 and put five back on at 52.50. You have likely cut your deltas now in half, to -15. If the stock starts moving sideways again, this will bring you back to breakeven, or even allow you to squeeze out a small profit. Forecast recap: slightly bullish, split decision between two strikes, 50 and 52.50.

3. Full repositioning. Say you are more bullish than that. The stock has moved up for a reason, and you agree it's worth more. Say again you have 10 50 calendars. Take all 10 off at 50 and put 10 back on at 52.50. Your -30 delta is now back to zero or thereabouts. Again, if the stock starts moving sideways again, this will create a profit opportunity. Forecast: more bullish, you have changed your opinion that the stock is now worth 52.50, not 50.

4. Roll up. Let's say you become straight-out bullish. Take in your short option and roll it up — that is, sell the next strike in the direction of the move. If you are calendar-spread at 50 and the stock increases, buy in your short 50 and sell the 52.50 strike. Keep the 50 strike call. You are now long deltas, in our example here, moving from -30 delta to +15 or +30 delta. You are now diagonally spread — that is, you have gone from a

calendar spread, same strike (50), to a diagonal spread (long 50, short 52.50). You did this because your forecast is now bullish. (By this time, you have changed from a delta-neutral strategy, no movement, to a directional strategy, with a different risk-reward ratio and a different risk curve as well.)

5. Roll down. Say you become straight-out bearish — take in your short option and roll it down — that is, sell the next strike in the direction of the move. If you are calendar-spread at 50 and the stock decreases, buy in your short 50, and sell the 47.50 or 45 strike. Keep the 50 strike call. You are now short deltas, probably moving from -30 delta to -50 delta or so. You are also now diagonally spread — you have gone from a calendar spread, same strike (50), to a diagonal spread (long 50, short 47.50 or 45). You did this because your forecast is now bearish. (By this time, you have changed from a delta-neutral strategy — that is, no movement, to a directional strategy, with a different risk-reward ratio and a different risk curve as well.)

6. Closeout. If there is a material change in the situation of the underlying and you are truly confused, close the trade. Even a large move against you by this time will likely create only a small loss. Worst case: your initial debit — that is, if you put on a calendar spread for \$0.40, that's the most you can lose.

7. When to take profit. Target a 20% yield. When that level is reached, take off the calendar when profit slips back a bit — that is, when it declines to 17%. At that point, either take the entire position off or roll the front month to the next. Go by the yield, don't hang around to see what the market gives you. That's the professional way to trade: *yield*.

If a calendar costs you \$2,000, and you are up \$400 in two weeks, protect your profit now above all else. Watch your profit like a hawk now that you have one — not deltas, thetas, stock price, or anything else. *You are protecting your profit.* If trade profit on a \$2,000 calendar — once \$400 — now declines to \$340, exit, take your gain, thank the trading gods, move on, redeploy funds. That's it.

\$7,000 out of a possible \$9,810, so that's approximately 71% of the maximum amount you could have received on this trade. This is all I want out of a trade. I never carry a trade into expiration week — the delta and gamma risk are way too high for me.

What size do you trade?

In a given month, I might have on positions on the Russell 2000 index (RUT), iShare Russell 200 index (IWM), Diamond (DIA), NASDAQ 100 exchange traded fund (QQQ), S&P 500 Depository Receipts (SPY), and maybe 20 to 30 contracts or so in each — so that's an average of 100 to 150 contracts at a time.

So that would be 10-point strikes in RUT?

No, 20. It generates a little bigger credit, but at the cost of higher margin, and a higher theoretical risk, too. Ev-

erything in trading is a tradeoff.

Which broker do you use?

Thinkorswim. They have an excellent platform, excellent customer service, and a willingness to help.

Any final comments?

You can't overemphasize the importance of a good mentor. Dan Sheridan teaches how to trade — to learn the craft, as he would say. The real strengths of his program are his emphasis on risk management and his desire that each student become a successful trader. Trading options for a living is hard work, but it's nice to know you have someone to call if you have a question.

Dan Sheridan's website and community came after my time with him, but even as one of Sheridan's early students, I still have access to the website and all its features. Trading can be a lonely business, and having someone to

talk to and share ideas and thoughts with is a great help. This is what the Sheridan community provides.

Thanks, Bill.

John Sarkett is the developer of Option Wizard Scan and Scan Wizard software (<http://option-wizard.com>).

RELATED READING

Sarkett, John A. [2007]. "Calendar Spreads With Dan Sheridan," *Technical Analysis of STOCKS & COMMODITIES*, Volume 25: May.

____ [2007]. "Double Calendars And Condors," *Technical Analysis of STOCKS & COMMODITIES*, Volume 25: June.

____ [2007]. "Double Diagonals And Butterfly Spreads," *Technical Analysis of STOCKS & COMMODITIES*, Volume 25: July.

