TRADERS´ Interview

Charles Cottle

Charles Cottle taught in Europe for the International Trading Institute for five years before writing his first book, Options: Perception and Deception. *While trading, writing, and consulting, this husband and father of two had a vision of an online options brokerage firm – and later realised that dream, co-founding thinkorswim, inc. Since that time he has developed some patent pending electronic one-click Hybrid Hedges called DARTs. He is currently providing education for electronic traders and investors by holding weekly live webinars (web-based seminars) and some in-person seminars.* TRADERS´ *met with Charles to find out more about what makes this trader tick.*

TRADERS´: What did you think of trading/traders before you got involved?
Cottle: When I was ten years old, a Corn Trader, (father of a friend of mine) came and spoke to the 5th grade on commodities, but it did not have much meaning for me. I never realised how wealthy traders really were until I went into the business 13 years later and saw that, in fact, this man and his son were gazillionaires. I was just out of college when I made some new friends who happened to be traders. I thought that futures trading was dangerous and really did not understand what it was that they did. Later, after I went into the business, I realised that most traders are simply entrepreneurial, hard working, analytical risk takers.

TRADERS´: What enticed you to start trading and when did options come into play?
Cottle: Options trading inspired me when in 1980 I visited a new friend on the floor of the CBOE and he showed me about spreads, theoretical values, limited risk and control attributes. He introduced me to some folks that put on free seminars. I ate it up and gave my family-run accounting firm a year's notice.

TRADERS´: Were you successful at the beginning?
Cottle: No. I raised $50,000, rented a seat and ran out of money in 6 months trading GM (General Motors) options. I was always bearish. I thought that American cars were junk. They probably still are; I have never owned one.

TRADERS´: What is the sexy thing about options?
Cottle: The thing that excites me the most is that the electronic realm offers unlimited potential, especially in Hybrid Hedging. DARTs are Dynamic Adjustable Risk Transactions. Imagine getting on a 3 or 4 legged hedge in a single click and a second or two for the fill. Imagine rolling that 3 or 4 legged hedge to the next month in a single click for a single price without the transactional exposure of legging. Answering this question was so sexy, I need a cigarette right now and I don't even smoke.

TRADERS´: What are some of your market concepts or trading ideas?
Cottle: OOs and AHHs. Using the Market Maker Paradigm to impart the simplicity of taking control of a portfolio using Artistic Hybrid Hedge strategies (AHHs) to achieve and emulate the coolest Options Only strategies (OOs). All we be revealed in my newest book, *Hybrid Hedging in a Click*.

TRADERS´: Are systematic approaches useful for option traders?
Cottle: Absolutely. Whether OOs or AHHs, it starts with an opinion. I base my opinions using Diomonetrics™ (a proprietary technical analysis method) incorporating market symmetry and time until expiration. I like to stay with highly liquid optionable stocks, indexes and futures. I always ask myself, "what would I put on ('the desired position') if I had no position?" If the price of the 'the desired position' strategy is acceptable, given a certain set of criteria, that is what I go for. If I already have a position but it is not the same as 'the desired position', I adjust into with the necessary trades, and usually I can avoid trading too many contracts (giving up too much edge and paying too many commissions) by trading the synthetics (positions with the same risk profile).

TRADERS´: How do you find your trades?
Cottle: I pull up an options chain (quotes for many strikes simultaneously) and the pricing just jumps out at me, but there is some great spread hunting software available like from spreadhunter.com that scans the market for almost anything you can think to look for.

TRADERS´: In general, do option traders search for higher or lower volatility?
Cottle: We find opportunities for all volatility scenarios and mingle them with technical analysis opinions, so it really does not matter if volatility is high or low.

TRADERS´: What are the differences in options trading between now, 5 years ago and 15 years ago?
Cottle: Options trading has just gotten better and better for the screen trader and worse for the floor trader. It is about to get a whole lot better for both because of innovations like DARTs where everyone wins.

Why? These Hybrid Hedge packages will trade on tighter and tighter bid/ask spreads for the end user to trade in and out of when initiating and rolling (switching months). In turn, the market makers' volume will expand as these new hedges give them great inventory and two-way order flow with greater edge per delta, in spite of the tighter spreads.

TRADERS´: What separates your book *Coulda, Woulda Shoulda* from other books?
Cottle: Firstly, it is in full color and totally free for the downloading at *www.riskdoctor.com*. Secondly, by explaining how the options theory mixes with practical trading experiences, it shows the reader the

Butterfly

A combination spread strategy entailing (in the case of a Long Butterfly) the writing (shorting) of two calls against two long calls with different strikes and the same expiration date. The strike price of the short calls lies between the strikes of the long calls. The maximum profit is reached when the short calls expire worthless and the long calls, purchased more of less as security, are liquidated without profit or loss. The spread's loss is limited to the net debit paid plus transaction costs. Overlaying the profit/loss profiles (at expiration) of a bull- and bear butterfly results in the diagram of a butterfly. A combination of calls and puts can also be used. 3. Hedge: A hedge in which calls are written against a stored cash commodity or its equivalent futures contract so that the value of the written calls is greater than the stored commodity. The premium exceeding the value of the stored commodity is used to purchase higher strike calls. The goal of the strategy is gradually increasing prices.

Source: Lexikon Terminhandel, Gabler Verlag

Collar

A hedge combining an option spread strategy using calls and puts with a position in a cash commodity. In addition to the underlying cash commodity, an at-or near-the-money call is written for a premium. A cheaper out-of-the-money put is then purchased to secure against any sharp price break. If a price break occurs the call premium covers the first part of the loss, while the put moves farther into the money covering the rest. If prices increase gradually time value decay improves the results of the short call. The collar offers similar advantages to the purchase of an out of the money call. The advantage of the collar is its low cost. A reverse collar entails shorting a near-the-money call and purchasing an in-the-money put.

Source: Lexikon Terminhandel, Gabler Verlag

Market Maker Paradigm. Market makers use insightful tools to manage risk and the reader learns and becomes better prepared to co-exist with the market makers and motivate them into taking the other side of their trades without giving up too much edge (the market makers built in profit on the spread).

TRADERS´: We always hear about your SlingshotHedge. Please explain.
Cottle: It is a hedge invented to replace the limited gain collar as a hedge. In the old days when commissions were cheap and quotes took too long to get, collars made more sense. But soon collars will become obsolete. Many of the DARTs, which include several SlingshotHedgeVariations, will be auto-quoted and will be filled in a second with cheaper and cheaper commissions as time goes by giving the hedger a boatload of alternative risk profiles (about different 60 choices). Certain DARTs can be achieved that will result in positive time decay (option value eroding resulting in profit) with unlimited gain potential in one direction or the other or both. The simplest one is like a collar in that one leg buys a single put placing a floor to protect the downside of a stock, future, or index, etc. But unlike the shorting of a higher strike call to provide the proceeds in order to pay for the put, twice as many call credit vertical spreads are shorted that stop losing at some point when the underlying takes off to higher levels. The whole position behaves like a long "the wings" butterfly with an extra embedded long call for unlimited upside potential.

Another favorite is adding a second put for a big win to the downside. A whole Chapter (#10) is devoted to Slingshots in *Coulda Woulda Shoulda*.

TRADERS´: You run the webpage *www.riskdoctor.com* and *www.riskillustrated.com*. What is happening there?
Cottle: *www.RiskDoctor.com* provides risk management services and live online courses (webinars) to empower traders, investors and money mangers to take control of their assets.

www.RiskIllustrated.com provides follow up to all the classes with illustrated forums to discuss content involved with real trading questions and the course discussions, 24/7. Many of the postings are updated to include graphic illustrations of whatever is being discussed, i.e. charts of underlying or volatility or skews, options chains to see attractive alternative opportunities, 2D or 3D risk profiles of the Greeks, position dissections, etc.

TRADERS´: Is trading in options more speculative than directional trading in stocks?
Cottle: Options trading can be much more risky than directional trading in stocks due to leverage, but most of the risk lies in a lack of understanding of what is being payed for. Many times an options speculator is right about his market opinion, but loses because he does not fully understand how certain positions make and lose money. I cannot tell you how many times students have said to me that they wished they had read my book or taken my course a long time ago. The market's emotive power sucks traders into what seems to be anunbelievable deal at first glance. When viewed using synthetic equivalents (positions that have the same risk profile), the trader would realise that it is not such a great deal and would rather go for a position that has a higher probability to make a profit.

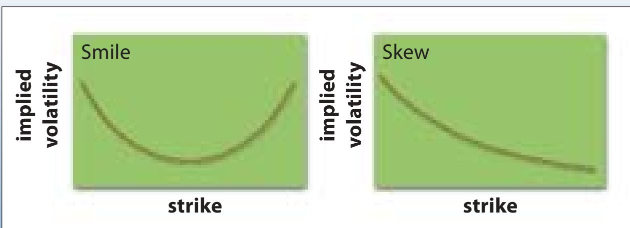
TRADERS´: Which are the criteria for finding the right option if you want to trade a breakout when you expect a strong move? Let's say the duration of the move will be a few weeks up to 9 months and you want to optimise the leverage and you just trade straight calls or puts.
Cottle: Straddles, strangles, long calls and long puts are all sucker trades that can win big only very occasionally. Consistent profits don't come from betting on 99 to 1 long shots, homeruns and grand slams. Most cannot ride such a winner even when they get lucky enough to get one. Consistent earnings come from grinding out the high probability trades that are risking a little more than you can make and doing it all with limited risk / short premium strategies and growing your size as profits dictate (calendar spreads, diagonals, verticals, butterflies, condors, slingshots straddle strangle swaps, calendarized irons, double diagonals).

TRADERS´: With which option strategies could one minimise the dangers of directional trading? Why?
Cottle: Range trades, such as, calendar spreads, butterflies, condors, slingshots, straddle strangle swaps, calendarized irons and double diagonals are targeted to win in a specified range and have time on their side (short premium with limited risk).

TRADERS´: What exactly is a box and how do you build it up?
Cottle: A box is a vertical in calls (bull spread or bear spread) spread against a vertical in puts aiming in the opposite direction (bear spread or bull spread). It is usually the result of getting into a trade one way and getting out another way.

A box should be no one's intended position but the result of a better way to manage a position. Example (full example in CWS Chapter 5): you get long a call vertical – a bull spread. It goes your way – you are profiting. You've had enough – either you would not buy the call spread at its current price because it is too expensive and not worth owning any longer, or you are no longer bullish. You buy a put of the same strike as the higher strike call to have a "3-way", and now you are synthetically long the lower strike put. The market drops and you short the lower strike put resulting in a box. You let it all go through

Smile and Skew



Most derivatives markets exhibit persistent patterns of volatilities varying by strike. In some markets, those patterns form a smile. In others, such as equity index options markets, it is more of a skewed curve. This has motivated the name volatility skew. In practice, either the term „volatility smile" or „volatility skew" (or simply skew) may be used to refer to the general phenomena of volatilities varying by strike. Indeed, you may even hear of „volatility smirks" or „volatility sneers", but such names are often as much whimsical as they are descriptive of any particular volatility pattern.

Source: www.riskglossary.com

the exercise/assignment process (exceptions to this rule in CWS Chapter 3).

You could not leg out of the call vertical by selling the lower strike first because that would leave you naked short. You could leg out of the short upper strike call, but that would be getting long between legs when you are bearish.

Therefore, legging the put vertical (especially if you are bearish) may be a wise decision. Otherwise you can get out of the call spread in one order if the pricing is favourable.

TRADERS´: Which are the criteria to define the position size in option trading (based on the amount of capital available)?
Cottle: I have found success in grading my trades to determine size and risk capital. The criteria are: technical analysis set-up, fundamental analysis set-up, price, risk reward and past experience with the particular strategy. If the scenario is technically and fundamentally motivating and there has been a lot of past success with a particular strategy, and if the price is attractive compared to past opportunities, and the risk reward ratio is palatable given the set up, then it is a Grade A trade warranting maximum allocation. If some of these criteria are missing, it moves down to perhaps a Grade B or a Grade C trade, where some capital is withheld until the missing criteria are in place.

At that point more can be added to the size. Some may consider this adding to a loser, if the first lot is down. It is, but lower grade trades make money and it may be worth putting something small on to avoid missing an opportunity. You can't always wait for the perfect trade scenario and even when you find one it can become a losing trade.

TRADERS´: People often think that selling options is more dangerous than the purchase of options because of the unlimited loss. Is that a wrong assumption?
Cottle: There are, of course, safe ways and dangerous ways to be short premium and still manage it successfully. Bottom Line: Limited-Risk-Short-Premium is the only way to go. Shorting premium is a way that many derivatives traders consistently make money. On average they win more often than they lose. However, when they lose, it is usually by a much greater amount than their average gain, owing to the high-risk nature of selling naked premium. Selling naked premium should only be for the too wealthy or the too crazy. Too wealthy could be defined by taking a severe beating in the market and it still makes no material difference to the wealth of the individual. The only other reason to sell naked premium is if the person is too crazy. There will be times when there is no chance to manage it, for example the huge gapping market situations. Insight: Wings. By owning, that is being long cheap wing premium (either 1 for 1 or ratioed long), one is given permission to short closer to the money, beefier premium. The proof is in the implied volatility (IV) skew…you know…the smile. To John Q. Public and speculators high implied volatility represents an over-priced opportunity motivating them to sell OTM options. The smile is caused by options inventory guys, that is, market makers, hoarding the wings. Did you ever notice the price, in terms of dollars and cents, of those high implied volatility options?

They are the cheapest options available in those underlying instruments and this is the reason that market makers can sell premium across all sectors, and the reason that the banks can back them and remain comfortable with the firm's exposure. They may lose money, here and there, but when the nightmare hits, these institutions with extra long wings score big. They avoid getting destroyed like victims of derivatives debacles. Why? Their wings kick in and it rains money.

TRADERS´: How do you test your trading ideas?
Cottle: When new to options, it is great to have an analytical software solution to test the theory and perform 'what-if' scenarios. One can see where and when profit and loss areas lie as the underlying and implied volatility fluctuate over time. A good analyser may become necessary the more convoluted a position becomes. Having tested and experienced almost every kind of position, I no longer need an analyser for simple positions such as calendars, verticals, butterflies (a vertical against a vertical) and condors (two or more adjacent butterflies). By dissecting out, that is putting aside, these simple spreads, the remainder of the position becomes more transparent so that the highest exposure elements can then be managed by priority.

TRADERS´: Are you still looking for new set-ups, strategies, hedges, etc.?
Cottle: Options were really designed for people who need them (hedging and insurance), and the bigger picture for the future of options market is in Artistic Hybrid Hedge Strategies (AHHs) that can be gotten into without having to be a rocket scientist or the best trader.

This groundwork is almost complete. There is more work to be done getting the exchanges to build their infrastructures to process such orders. The market maker groups that I have worked with are ready to auto-quote and trade all the DARTs that include about 20 OOs and 60 AHHs, and I have about 10 more to add to both sides in a new filing. There is always a possibility that new ideas will come to me.

TRADERS´: How many different set-ups do you use for your trading?
Cottle: My favorite positions are high probability, short premium

strategies such as calendars, verticals, butterflies and condors. However, often, two or more trades will intersect resulting in diagonals, or calendarised wing spreads (double diagonals, straddle/strangle swaps…ratioed, etc.). They also evolve into one or another over the life of the various expirations. The beauty of these alternatives is that you don't have to be so right about the direction of the market. You can even be wrong and still profit.

To optimize the account, it is best to have about 33% of trading capital placed on bullish strategies, 33% on bearish strategies, 33% in strategies playing for a sideways movement and 1% on cheap shots that can pay off big.

TRADERS´: How do you manage your risk?
Cottle:

1. Predetermine strategy based on market opinion.
2. Predetermine point of entry based on an attractive price level.
3. Predetermine profit-and-loss objective based on pain threshold.
4. Enter the market.
5. Ongoing "live" reassessment of the position at current price levels.

At this point, I ask myself, "Would I execute the same trade now if I were not already in the market? If the answer is yes, then I do nothing and stay in the position. If I would never execute the trade at this point, this is where I should either exit the trade or change the nature of the beast. When looking to adjust, the prevailing prices must represent a good value as if it were a fresh new initiation price. If it is not good value, I exit. If I adjust the position that I am managing, I follow the rules 1 – 5 above without consideration of the accumulated profits or losses to date.

TRADERS´: When and how do you determine when you are wrong in a trade?
Cottle: Right after I put it on. No, that was a pure attempt at humour. I like to have positions that don't need to be liquidated because the defined loss potential has already been allocated to the trade. That way the market cannot scare you out of a trade that often comes back to profit or reduces the loss at what would otherwise be at a stop-loss point.

TRADERS´: Is money management an independent topic?
Cottle: Money management is totally integral to the process.

TRADERS´: How much of your equity do you risk per trade?
Cottle: Having positions in stock uses up a lot of equity. When the stock is hedged however, there is a different calculation for total "at risk" equity. So for equity at risk, 50% is left in cash for possible/necessary adjustments including stock or futures, but on a pure OOs play I would risk no more than 7% of at-risk equity on any one single play.

TRADERS´: How do you manage your open trades? Do you use repair-strategies?
Cottle: The term "position adjustment" to me means a repair-strategy and that happens very often. It is the core of the live curriculum in the RD3 webinar and most of the subject matter in the postings at Ri$k Illustrated.

TRADERS´: In terms of executing trades, is that a subjective process or do you do that mechanically?
Cottle: Subjective mostly, but some trades are an automatic do.

TRADERS´: What do you find most frustrating with trading?
Cottle: When servers go down.

TRADERS´: When did you realise that trading wasn't going to be a just an attempt in the markets, but was going to be a full-time career for you? Or did you sense that from the beginning?
Cottle: I sensed it from the beginning when I realised that I would be able to work independently.

TRADERS´: Where does the psychological element come into play?
Cottle: Keeping your emotions out of your trading is imperative. The emotional roller coaster taxi likes to take you for a ride, but it takes you to losses or gains that will not last long.

If you want to make money trading so that you can go and do something else, quit now. You will lose all of your money because you do not want to be trading. To be successful at trading, you have to love it.

Do not bring your trading into your relationships (your haven) because you need to completely get away from trading now and then. Your relationship cannot be a haven if your relationship is laced with trading thoughts and discussions.

TRADERS´: Any words about fear, greed and self-esteem?
Cottle: A healthy amount of fear is more like respect than being frightened or timid, and that kind of fear is vital to contain the self destructive attributes caused by the ego.

I have seen greed really take people down. There is nothing wrong with trying to make money, but when taken too far it can spell disaster.

Self esteem and seeing yourself in a positive light (certainty) are very necessary components of confidence. This manifests itself in taking risk with conviction and enables you to follow your trading rules.

TRADERS´: When not OO-ing and AHH-ing, how do you enjoy your free time?
Cottle: I very much enjoy spending time with my family, traveling (mountains, beaches, scuba, art museums, city architecture, etc.) and studying Kabbalah. I would like to spend more time rollerblading and snowboarding, and as my children start to get into it that will happen. I continue to have a passion for writing and helping people, and enjoy the fact that wireless technology allows me to stay connected when I am traveling.