Strangle Strategy

GOAL

The Strangle strategy is rarely mentioned in option trading circles. However, I believe it has the potential to be quite rewarding, especially for the “under capitalized” trader.

As you know, the advantage of trading with options is that they provide a tremendous amount of leverage with known risk. With that in mind, I’m about to share with you a trading technique that lets you have even more control over your amount of risk. It’s easy to implement and it doesn’t need to be monitored every second of the trading day.

CHAPTER ONE
THE NUTS AND BOLTS

When a commodity market makes a new 12-month low, many traders begin looking for some type of bottom formation to shape up. The option trader may even purchase a call option, anticipating that the market’s downtrend will now come to an end and a new uptrend will begin. Technically speaking, however, a move to a new 12-month low means a break of a major support level, and the momentum that carried prices through that critical point could cause the commodity to continue moving down for some time. So, this poses a dilemma: should you purchase a call option, thinking the turnaround is near—or a put option, in the event that momentum carries the market further in the same direction?

The Strangle Strategy puts you in a position to potentially profit from any major move of the underlying futures market, whether the direction of that move is up or down. That’s because with this approach you purchase both a call and a put option in the same market at the same time, making new 12-month lows.

But you have to know exactly how to purchase your options to have the greatest possibility of profit, and this is what I will teach you here. By the way, this strategy is equally effective in markets making new 12-month highs as it is in those making new 12-month lows.
One way to apply the Strangle strategy is to purchase your call and put options at the time when the commodity is making a new 12-month high or low. A more conservative approach would be to wait for prices to “pull back” after making a new 12-month high or low, and then see if the commodity resumes the move and breaks beyond to a new high or low before initiating the strategy.

In either case, your second option is a form of insurance. For example, if you buy a call option to trade an uptrend, then the put option you purchase acts as insurance in case the trend reverses and prices begin moving down. Conversely, if you buy a put option to trade a downtrend, then the call option you purchase acts as insurance in case the trend reverses and prices begin to rally.

Here are the steps to take to set up a trade using the Strangle strategy:

1. Decide on the amount of money you wish to invest (and risk) on a particular option strangle play.
2. Using US Charts Online, find a market that has just made (or is about to make) a new 12-month high or low.
3. Review the US Charts option data for both put and call options with strike prices that are at or near the current price of the underlying futures contract. The options should have at least 90 or more days of time remaining before expiration. US Charts makes it easy for you to identify the at-the-money options because they are highlighted (bolded) on the quote page.

Depending on your budget, try to purchase a put option and a call option with strike prices that are as close to being at-the-money as possible. For example, if the current price of the July Corn futures market is 300, you’ll want to consider purchasing a call option that has a strike price of 300 (or lower). Try to purchase a put option with a strike price of 300 (or higher). These close-to-the-money options have more potential to increase in value as they act more like the underlying futures contract.

If the options with strike prices that are in-the-money are too expensive, an alternative would be to choose a strike price that is slightly out-of-the-money. Keeping in line with the above example, in this case you might try to purchase a call option with a strike price at say 305 or 310. To purchase put options you might look at the 295 or 290 strike prices.

Please note, when you purchase in-the-money options, your call option will be below the current futures price, and your put option will be above the current futures price. On the other hand, when purchasing out-of-the-money options, your call option will be above the current futures price, and your put option will be below the current futures price.

Another approach would be to consider purchasing options with strike prices that are at or near points of support or resistance on a price chart. Options with such strike prices are generally less expensive than the at-the-month or in-the-money options.
It’s interesting to note that quite often you’ll see the underlying futures contract advance or decline to support or resistance levels. If that happens, options with strike prices at these key levels will likely increase quickly in value.

CHAPTER THREE

PRICE OBJECTIVES

Once prices move substantially in one direction, consider liquidating the option that is losing value. You no longer need to hold this option for “insurance,” and you may be able to recoup some of its purchase price.

At the same time, you should consider when you will liquidate the option that is decreasing in value. Actually, this is something you should have determined prior to entering into the trade. You should have a trading plan in place for each trade you make prior to entering that particular market.

One approach might be to liquidate the option once it has doubled or tripled in value. Or you could liquidate it when the underlying futures contract moves to a certain point (such as support or resistance) on the chart.

For example, let’s say you are considering purchasing a Soybean 500 call option and the underlying futures market is trading at 525. Part of your plan could be to consider liquidating the option at a point of resistance — perhaps at 550, if that’s what the chart indicates. After liquidating, you could then use your profits to reinvest in other option strangle plays.

An alternative is to calculate the amount you plan to invest in both the put and call options, and then liquidate if, and when, you can get double that amount out of the trade. For example, if you paid $600 for the call and $550 for the put, your total investment is $1150. You would then try to let the call increase in value to roughly $2,300 before considering liquidating. If the market is moving really well, the option value can easily triple or quadruple. However, if the momentum of the market’s move begins dying, it might be a good time to exit just on that fact.

You might find it helpful to consult US Charts’ Trend Seeker™ to determine trend strength. If the market has been advancing and Trend Seeker identifies an uptrend, but then suddenly switches to indicate a neutral trend or a downtrend, it’s probably a good idea to consider liquidating your position.

You can also decide how much of your accumulated profits you wish to risk and place a “mental” stop at that level. If premium prices fall to that level, consider exiting the trade at that time.

I’ve included a couple of charts below that provide examples of how this strategy might have been applied in recent markets:
March 2007 Corn made a new 12-month high on October 9 when it broke above the high at 296. On October 10 the March 300 call option was trading at 23 cents ($1,150), and the March 290 put option was trading at 21 cents ($1,050). These options are on the expensive side, but keep in mind that if an option doesn’t meet your budget, you can always look at another strike price, or move on to an opportunity in another market.

The Corn market continued to rally, and the March 290 put option dropped in value. It could have been liquidated three trading days after purchase for a little less than half of its value. By October 16, the put was trading at 9 cents ($450). Had you liquidated then, you could have recouped $450 of the purchase price of that put.

Meanwhile, by that day the call option premium had increased in value approximately 70%! It closed on October 16 at 38-1/2 cents ($1,925).

At this point you would have a net gain on your strangle position. The initial cost was $2,200 (not including commissions).
The current value of the call option plus what you got back from the sale of the put option totals $2,375. So the net gain is $175 as of this date.

Now $175 may not seem like a lot of money. But you’re still holding the call option, and as long as its value stays above $2,200, you have a “free trade” in place. The trade will not cost you a dime from this point forward, so you’re basically playing with the house’s money. You just have to sit back and see what happens to the value of the call option as the market advances and manage the trade according to your parameters.

Moving forward in time, a month and a half later (November 30) this option is trading as high as 90-1/2 cents ($4,525)!

CHAPTER FIVE
EXAMPLE TWO

In our next example, March 2007 Cotton broke to a new 12-month low on November 17. This price action potentially triggered an entry using the Strangle strategy. On the next trading day the March 50 put was trading at $625. The March 53 call was trading at $570. Let’s say these options were purchased.

Shortly after making the new 12-month low, March Cotton began to rally. By December 1, the 50 put had dropped in value and was trading at $240. The 53 call had increased in value and was trading at $1,055. At this point the call had almost doubled in value and the put had lost a little over half its value. This may have been a good time to cut losses and liquidate the put option, while continuing to hold the call.

Here, as well as at other critical points in a trade, a quick check of Trend Seeker™ is always a good idea for assistance in trend filtering. Ideally we always want to be holding the option that is on the same side as the Trend Seeker trend.
Had the above steps been followed this strangle position would now have a net value of $1,295, which is $100 greater than the total cost of both options (not including fees and commissions). And there is still the possibility to profit more if the call option continues to increase in value.

As with any strategy there will be times when the Strangle strategy works superbly. However, no approach works perfectly 100% of the time. In the case of the Strangle strategy, for example, you may enter a market which then proceeds to go sideways for the next few months. If this happens, both options will more than likely lose value due to time decay. This is why it’s vitally important that you have an exit plan in place for both options prior to entering a strangle position. If you see both options declining in value, you might liquidate both, recouping as much of their initial cost as possible.

CHAPTER SIX
ANOTHER CONSIDERATION

I would be remiss if I didn’t add one more thought about this strategy. As I mentioned earlier, when a market makes a new 12-month high or low, it’s a technical signal that a major point of support (new 12-month low) or resistance (new 12-month high) has been broken.

Many, many times prices will continue to move in that direction for some time. That being the case, you could purchase just one half of the strangle and simply trade it without purchasing the other half.
of the strangle. In essence, you would then be executing the Hi-Lo Breakout strategy. Your cost would be lower because you are only purchasing one-half of the position, but technically speaking your risk would be greater because you don’t have the “insurance” in place that the Strangle strategy offers. If prices then turn against you, you won’t be protected by an option on the other side.

Now that you have a good understanding of the Strangle strategy, it’s time to get busy and practice the concept via paper trading. The more you practice applying what you’ve learned here, the more your charting abilities will improve.

Take your time and practice the steps on paper until you’re completely comfortable with the technique. Only invest with real money when you are ready to do so.

Remember - for assistance with the Strangle Strategy you can call a GBE Course Counselor at 541-955-2700 from 8:30 AM to 5:00 PM Pacific Time, Monday through Friday.

Notice: Hypothetical or simulated performance results have certain limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not been executed, the results may have under-or-over compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profit or losses similar to those shown.