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Introducing New Spreads Indicator:

Spreads 007

by Lan H. Turner

Playing The Odds...Commodity Trading Vegas Style

by Carley Garner

Pg 8: NEW Autopilot for Track 'n Trade End of Day 5.0

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Editor in Chief:
Lan H. Turner

Managing Editor:
Heather Rich
hschiffman@pitnews.com

Art/Production Manager:
Heather Rich

Controller:
Joseph Chambers

Webmaster:
Jacob Anawalt

Website:
www.PitNews.com

Email:
magazine@pitnews.com

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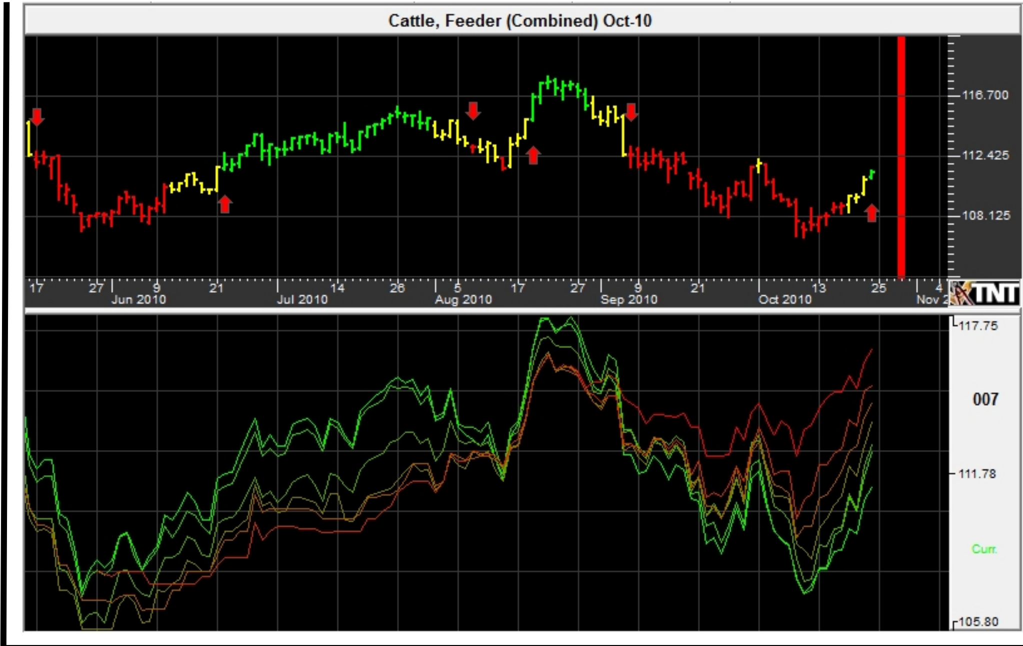
Spreads 007

by Lan H. Turner

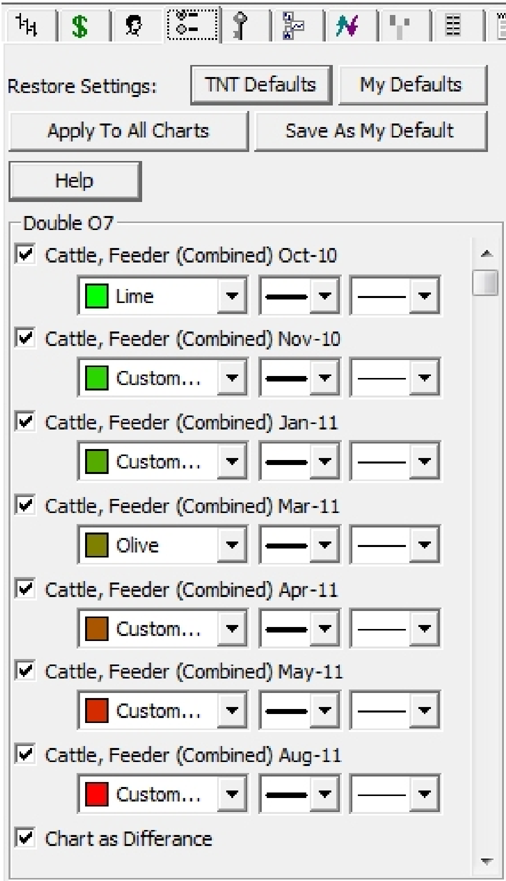
In this Track 'n Trade Spreads Trading Article, I want to introduce you to a new addition to the spreads plug-in.

We call this new indicator the 007.

This indicator is simply, a reflection of the actual close price line of the same commodity, but of each different contract month, plotted over the top of each other; or in other words, a true price spread chart.



We display this indicator below the primary chart, which is listed as the first chart in the 007 setup panel.



In this chart, we're looking at the October Feeder Cattle contract, which is plotted in the main window. The main contract month is also the primary chart listed in the 007 settings tab, and in my example, is colored green.
It's important to note that this is the primary chart, and the other price lines are the same commodity, but further out contracts.

Now where this becomes very important, is when we start finding anomalies in the way these market prices act once vs. the other; what we're doing, is looking for anomalies in price.

This is particularly important, and has great relevants in markets with carrying charges; markets such as wheat, corn, and beans. These

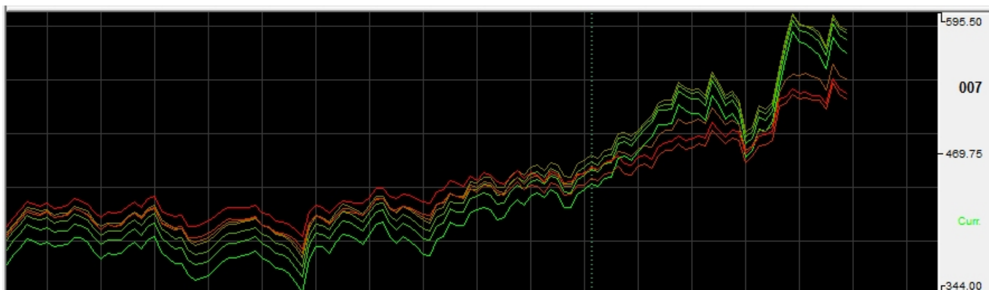
commodities are subject to carrying charges, or in other words, subject to storage fees, transportation costs, and are subject to rot and crop destruction.

Any market can be viewed this way, but those that are subject to carrying charges are particularly vulnerable to this type price action.

What we are looking for is price anomalies, where the further out months actually become less expensive than the closer in months. Now there are a number of fundamental reasons why this might happen, we've got the difference between new crop and old crop, or in other words, the crop that's currently growing in the field, and is subject to crop failure of one sort or the other, and we've got old crop, that is more stable, and sitting in storage bins. Of course there are transportation costs, that also effect contract month prices and the list goes on, but what we as traders are looking for, in particular, is when the further out contract months start to cross above the price of the current contract month. This is an indicator that can help us determine market direction in one way or another.

Here's an example.

If we look down to the bottom of the Double O7 setting panel, you see a selection called "Chart as Difference." This takes the price action of the primary contract month, in this case October, and makes it the baseline of the indicator. This is represented by making the October contract a flat line across the indicator window, and now, you can see how the other contract months reflect price action in regards to the primary month, and in this case, you can see, right around mid August, we had our first crossover of the further out months, and then we had a further confirmation around the first part of September, where the prices crossed over and never looked back.



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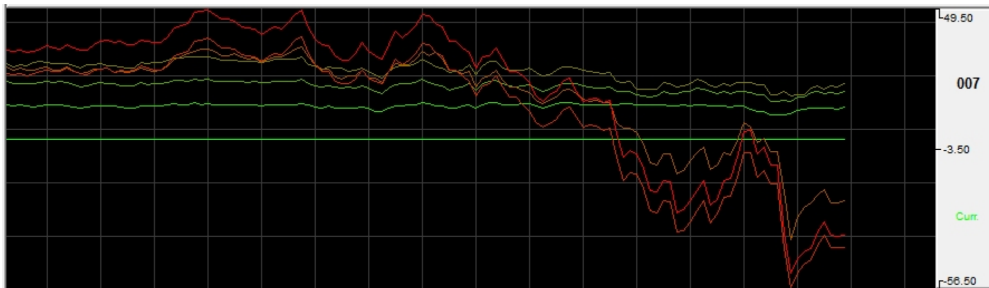
As you can see, this corresponds directly with the overall trend of the primary market. Once those further out contracts made the shift to a higher price, the price trend of the primary market fell dramatically.
This is just one way of using this market spreads filter to analyze the entire market through a single view.



Here's another example of "Chart as Difference" on Corn.

Notice that in the Corn Chart Example, we see the differences between the new crop and the old crop plotted against the primary December contract.

I know that many of you have read Ken Roberts book, who also talked about looking for anomalies in price action between contracts, his theory was that market prices move basically together, in a confluence of price actions, when you see one of the months get out of line, this is an opportunity to trade that contract month, as it is forced back into line through arbitration.

Using the Track 'n Trade Double O7 Spreads indicator, you can see these anomalies in two different ways. One, plotted through the chart itself, or two, through the data tab, as Ken indicated in his book; exporting the data from Track 'n Trade is a simple process as well; feel free to export the data into such programs as Microsoft Excel for further detailed analysis.

.25 2/8 Add Data Export... Customize...

Corn, mini (Open Outcry) Dec

Day	Date	@YC2010Z	@YC2011H	@YC2011K	@YC2011N	@YC2011U	@YC2011Z	@YC2012H
909	9/15/2010	495.250	508.500	513.250	517.000	489.500	471.750	479.250
910	9/16/2010	496.000	508.750	513.500	517.000	490.250	472.000	479.750
911	9/17/2010	513.250	525.750	530.750	533.250	499.750	477.750	485.000
912	9/20/2010	508.250	521.250	526.250	528.750	496.250	473.250	481.250
913	9/21/2010	505.250	518.000	523.250	526.250	497.250	473.750	481.750
914	9/22/2010	505.000	518.250	524.500	527.750	499.750	477.500	485.250
915	9/23/2010	499.250	512.250	518.250	521.250	496.250	475.750	483.250
916	9/24/2010	521.750	534.250	539.750	542.000	510.000	489.750	496.750
917	9/27/2010	512.750	525.250	530.250	532.750	502.750	484.250	489.500
918	9/28/2010	500.000	512.500	518.250	521.250	494.750	477.750	484.250
919	9/29/2010	505.000	517.250	522.250	525.500	499.000	483.000	490.000
920	9/30/2010	495.750	508.250	514.000	517.500	495.250	481.250	488.750
921	10/01/2010	465.750	478.250	484.000	487.500	472.000	460.750	468.500
922	10/04/2010	471.500	483.000	489.250	493.250	476.000	466.250	475.000
923	10/05/2010	491.000	501.750	508.000	511.750	489.500	476.250	485.250
924	10/06/2010	488.500	499.250	505.250	509.250	489.000	476.500	485.500
925	10/07/2010	498.250	507.500	512.500	515.250	493.500	481.250	488.500
926	10/08/2010	528.250	537.500	542.500	545.250	523.500	511.250	518.500
927	10/11/2010	555.750	565.000	570.500	574.000	535.750	514.000	520.000
928	10/12/2010	579.000	588.750	593.500	595.500	540.750	522.500	527.750
929	10/13/2010	569.250	580.250	585.250	586.250	539.250	518.250	523.500

Of course, there are other uses for tracking multiple contracts simultaneously, which we'll discuss, at greater length, in future articles. Videos and details can be found on the web at:

www.LanTurner.com/spreads

Author: Lan Turner is the President and CEO of Gecko Software, Inc.
www.TracknTrade.com

Casinos bring in gaming revenue confident that over time they will collect more that they pay out in winnings. Similarly, insurance companies collect premium in anticipation of the probability of future payouts. Option traders can benefit from the same logic by selling credit spreads, thus capitalizing on probabilities as opposed to entering a position hoping to profit on a "long shot."

Credit Spreads

A credit spread is an option strategy that involves the simultaneous sale and purchase of an option with common underlays and expiration dates. As the name implies, the short options must be higher prices than the long, thus bringing a credit to the trader. For example, you may be able to sell a front month Dow 10300 call option for $650 and buy a 10500 call option for $250 to protect your short position. The trader would bring in a credit of $400 as a reward for accepting the risk of the Dow going up. Unlike selling naked options, the risk of a credit spread is limited to the spread between the strike prices minus the premium collected; in this example it would be $1,600.

Is having limited risk worth the opportunity cost?

Obviously there is a trade off between capping your risk and maximizing premium collected. Armed with the notion that 80% of all options will expire worthless, many traders are tempted to sell naked options. This strategy results in a limited profit and unlimited loss. Even if an investor successfully collects premium 8 out of 10 times, the 2 inevitable losing trades will likely erase previous profits and then some. Have you ever noticed that all insurance policies have a maximum benefit? This is not a coincidence. The insurance firm Lloyd's of London discovered the importance of limiting losses the hard way. They prided themselves on the sale of "no limit" policies, but in the early 90's they were averaging close to $3 billion a year due to asbestos claims. Reinsurance is another way in which insurers limit their risk. After collecting premium on a policy, firms allocate a portion of the proceeds to the purchase of insurance against the sold coverage. Credit spreads can be viewed in the same terms. Following the sale of an option, it is wise to limit potential losses by purchasing protection.

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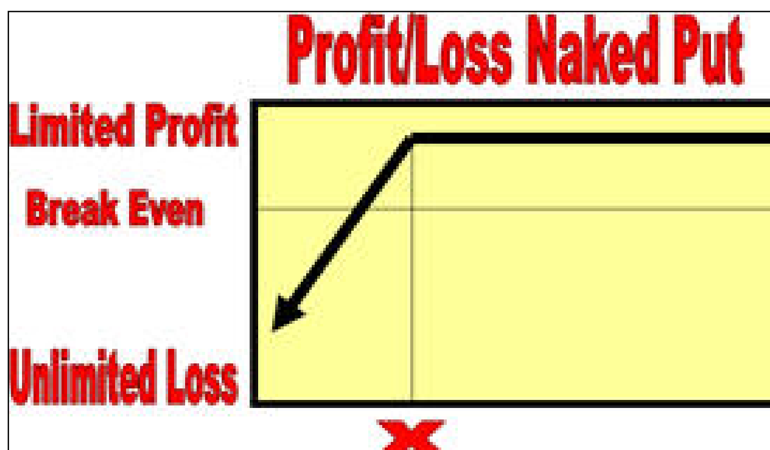
Profit on Probability

Given the overall probabilities involved in option trading, one can expect to collect the premium on credit spreads nearly 80% of the time. Hypothetically, an option trader could sell 10 credit spreads with payout and risk identical to the above example and yield a $600 profit calculated as follows ($475 x 8) - ($1,600 x 2) = $600. While some commodity traders might snuff at such a meager return, in percentage terms, the reward exceeds that of most other investment options, including the stock market. If the above example requires $11,000 of margin, an investor would earn a monthly return of nearly 5.5%!!!



"Conventional" commodity traders would be turned off at the idea of a negative risk reward ratio. Risking $1,600 to make $475 may seem to be illogical on the surface, but if you look at the probabilities involved you will find the exact opposite. Frequency of the outcomes makes it advantageous to participate in trades in which the risk outweighs the reward. This is the exact strategy that casinos have thrived off of for years. The probabilities of options trading are not so different from those in the casino industry. While there are "jackpots" to be paid, over time the expected outcome is always in favor of the house. A simple stroll down the Las Vegas Strip proves that in the long run…it pays to play the odds.

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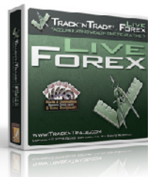

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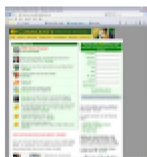

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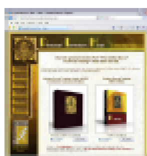

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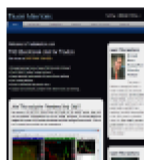

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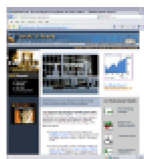

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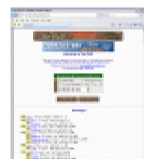

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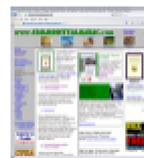

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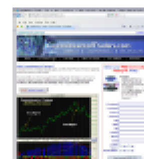

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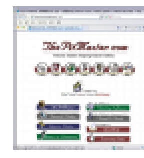

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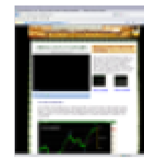

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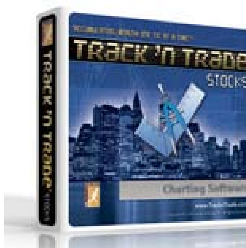

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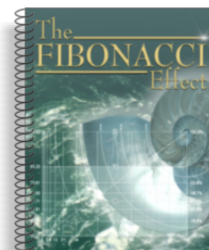

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