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The Option Coach
Tutoring Programs for Trading Online

Earnings plays can be like "Falling on a Hand Grenade"

The fast money allure of high volatility one day an impending volatility collapse the next has drawn allot of traders into a false sense of security about earnings plays. Selling volatility into earnings is the most explosive option trading strategies yet one of the most popular trades around. If you think this trade is for you than finding the stock, the right bid ask spread, and the right set up is just part of the luck you'll need to be profitable with earnings plays. Let's look at a couple of ways to use options to indicate what to price movement to expect after the earnings announcement. Look at fundamental indicators to align as a means to aid in your decision as to which set up's are best.

Finding the Right Stock

Use a common stock that's priced greater than twenty five dollars a share. If you don't use a stock that's at least priced twenty five or better the dollar value of the options aren't worth the risk at the sale price. You'll also find yourself with "your hands to close to the fire" and risk getting run over with virtually any price movement. Stock price and option price are related in that lower priced stocks generally have lower price options and the risk of selling small dollar value options does lend itself to a greater risk without enough reward.

A stock that has recently been acquired or made a large acquisition is not a good candidate. The terms of the deal will complicate and convolute the earnings report so eliminate names with special situations. Exaggerated price movement is more likely in these instances.

Use a quality name stock with a solid record of earnings and earnings growth. Find a stock with an earnings record off consistently reporting within a couple cents of the mean estimate of the advisors that follow or cover the stock.

Sometimes you can use names in the same industry to get an indication of industry post earnings price movement. However there are no absolutes about how earning will move a stock.

In the recent quarter Goldman Sacs earnings gave a great indication that other banks would be reporting great earnings. That profit report lead a lot of people to believe that the financial stocks would be higher after earnings and they were.

Not so similar when you look at the price movement with Caterpillar (CAT) and John Deere (DE). Both absolutely “knocked the cover off the ball” yet one moved up and the other down on the day they announced earnings. Bottom line is that it’s somewhat of a “crap shoot” trying to figure how a stock will move after earnings.

Finding the Right Set-up

An example of a good set up starts by being able to sell far enough out of the money, or away from the underlying, at the same time collect enough option premium. The strategy of selling a high volatility into a potential gap move is very risky so “play ball” only if you expect a big decline in option implied volatility. I like options that are that are $1.00 to $1.50 because generally they can fall ten to thirty percent in value and give me a reasonable profit. The decrease in dollar value will be enough to profit reasonable with the impending collapse in volatility. That said high dollar value stocks like GOOG, GS and BIDU which have big dollar value options and are popular choices. However they also have a history of moving around a lot on earnings announcements. Sell options far enough out of the money to prevent getting “run over”.

GOOG by far the favorite of these three has announces earnings on Thursday night before a Friday of expiration. This can be an ideal situation if the stock behaves itself after the announcement. The right set up means the right time in the expiration cycle to get a massive volatility collapse, big enough dollar value options and enough liquidity to get out with minor slippage.

Earnings plays are one of the few times you want "step up to the plate and hit a homerun". The strategy of selling a high volatility into a potential gap move is very risky so "play ball" only if you expect a big decline in option implied volatility. Anticipate or bet on only a big volatility collapse in the range of 10 and hopefully closer to 20 or more volatility points. An anticipated decline of 3 to 5 points of volatility is not a "collapse". Further with the possibility slippage in option price exiting you may find yourself allot smaller profit than you ought to get for such a risky trade.
Compare the front month option volatility to the second month out implied volatility. The difference there will give an indication of the volatility decline you can expect.

Liquidity and Slippage

Choose an option series that has the narrowest bid ask spread and has huge volume. Track the price movement of the strangle you anticipate using. The best trade often takes might take an hour or an afternoon to execute correctly.
The fairest option trade and earning play to execute is the one with the narrowest bid ask spread. Option price slippage during execution will be mineralized based on the width of the spread. If your wrong and the stock really move against you the best friend you have is narrow market width.

Once you've chosen a stock and an option series watch the price movement and the option volume in that series over half or the whole day. The traders' edge is how closely you track an option series to get the highest price.

The volatility decline is usually right after the open on the day of (or the morning after the prior evening announcement) so if the stock hasn't moved very far, notice the decline in volatility from where you put the spread on, than get out or at the very least exit half the trade. The only reason I say usually is that some conference calls give information going forward not put forth in the original announcement. You are literally "looking a gift horse in the mouth" if you don't get the heck out of this trade because so many bad things can happen.

Directional Indicators

Check out the volume and open interest of the options. If you notice several option series that have extraordinary big volume notice which direction they're betting. If you notice put trades that hit your radar and they're not balanced off by call trades or other option trades beware.

The footprint that can't be erased is option volume and open interest. The day before or the day of the pending earnings announced check out unusually large single prints of just calls or just puts. If there is an excess of one or the other it's a directional indicator.

Watch the at the money straddle for an indication of how supply and demand prices the expected move. It's a market makers job to price options based supply and demand of options. If the demand for the straddle is aggressive traders back off, market makers raise the price. Professional traders see order flow first hand and get paid to profit more often than not from earning trade. They have models that price the expected move based on indicator that are sometimes so arcane that no one would ever considered it.

If you want to do an earning play in IBM with the stock 115; at the money in the front month straddle is 5.50$ bid; you want to sell the 125 and 105 strangle. You might consider selling the 120/125 spread call and the 110/105 put spread to limit your risk. Either trade is fine depending on recent sentiment about the stock.

Align Several Indicators to Build Confidence

If the volatility in the front month is bid twenty percent higher than the next month and stock has an earnings reporting history of hitting consensus estimates you have to "connect the dots". Stocks like KO, WMT and GE have had a consistent record for a long time.

If the company has already given guidance for the entire year going forward and has a history of quite post earnings price movement this is a really good indication. Find other signs to confirm your view. Drug stocks aren't as revenue driven as growth stocks, but are rather product driven and therefore are good candidate for earnings plays. Mature drug names with several products and a revenue stream from all of them are prime targets.

The riskiness of this trade makes it have to be the smallest portion of your portfolio. It's a gamblers play so plan ahead and play it small and learn from your experience. Certain names tend to move often than others consistently when announcing earnings. Remember that once every three months publicly traded companies "step up to the confessional", reports earnings, and tell those of us who bet their common stock is headed higher how they see the business environment in which they operate going forward.

That's why this trade ought to be at the outskirts and a very small portion of your trading portfolio. What's the percentage of time Albert Pujols' hits a homerun for every time he bats? That's the comparison and that's the proportion of your portfolio this trading strategy ought to be used.

