Unusual Options Volume & Other Clues in - The Stock Replacement Covered Call Strategy

Sometimes, Wall Street has a very convoluted way of looking at things. For instance, consider the term "smart money." One would think the term "smart money" would refer to a professional investor with incredible talent or a fund manager, market strategist or analyst that has had consistent success over different market scenarios, spanning many years.

Or perhaps a trader/investor who has an intimate knowledge of the market and has mastered the tools of his trade, including technical and fundamental analyses, hedging and option theory, and an expert knowledge of the global economy.

Wouldn't this definition be a better fit for the term "smart money"? Maybe, but not in Wall Street's eyes. On Wall Street, the term "smart money" refers to someone with 'privileged' information, who uses it to their advantage. This person, fund, or group doesn't necessarily have any special ability, talent or expertise.

They only know something that the public has not been made privy to. They have a piece of insider information that they sometimes use illegally to profit in the market. It happens all the time. So, on Wall Street, "smart money" is often synonymous with cheating or illegal activity.

For many years, most professional traders and even individual investors have studied long and hard in order to acquire skills that would aid them in their quest to be better, more competent traders or investors. However, not having access to the same level of information as 'smart money' sometimes puts the retail investor at an extreme disadvantage.

A person with insider information has a crystal ball. He knows the outcome of the game before the game is even played. The SEC has rules in place to try to prevent this from happening but these rules haven't eliminated the problem because the SEC cannot always 'prove' their case. Therefore, there is still a lot of "smart money" out there.
Most "smart money" traders try to keep a very low profile for obvious reasons. The easiest way for them to do this is in the options market where there are fewer participants thus fewer eyes and ears to notice any unusual trading.

Further, the options markets offer much greater leverage, allowing "smart money" to reap even greater rewards. For example, If you knew that XYZ stock was going to report bad earnings, and you knew this ahead of the 'market', it would be much cheaper and more profitable buying puts in the options markets as compared to just shorting the stock.

This is exactly what happens, and it happens more than you think. The game is always easier when you know the outcome before everyone else, and these 'smart money' players are out there making fortunes in the options markets because they know what you don't.

"Follow in the footsteps of elephants"

What do we mean by this?

When a stock's option volume and implied volatility increase significantly, it is often a harbinger of things to come. Although the stock's price action may seem quiet and uneventful, not reflecting any unusual activity, the stock's option activity can be telling a very different story.

An unusual and greater than normal increase in option volume or implied volatility can be an indication that large, informed 'smart money' players (the elephants) are placing bets on upcoming events or announcements. These announcements can often have a significant impact on the price of the underlying stock, as with important corporate earnings, or other news.

These "smart money" traders or "insiders" who have privileged information will try to act on this information before it becomes public knowledge. The trading of options allows these "well informed investors" to increase their leverage and enables them to maximize their gains without risking their identity.

So how can we, as retail investors, benefit from this knowledge?

A significant increase or abnormal fluctuation in the trading volume of a stock's options and/or a substantial increase in the daily implied volatility of the stock's options can be a precursor of a major movement of the respective underlying stock.

Sudden changes in options volume and implied volatility can be a tip off to potentially explosive moves in individual stocks. A move of great magnitude is almost always going to be fueled by news, but correct analysis of option order flow can alert one before the news is disseminated to the public.

Often this type of news strikes hard at the heart of a company's future prospects for growth and profitability.

Examples of these types of news are the following:

1 Earnings substantially better or worse than Wall Street expectations
2 New product developments or breakthroughs
3 Mergers and acquisitions
4 Upgrades/Downgrades coverage by Wall Street Analysts
5 Media coverage
6 Products waiting for FDA approval or in clinical trials

And fairly often, this type of news is leaked. The people and organizations who know about this information will use it to their advantage. By looking for this unusual option order flow, traders can spot unique opportunities and bank big profits just by 'following in the footsteps of elephants.'

There is more to this strategy than we will get into here, like making sure that there is not also abnormal options size on the opposite call / put options (usually just indicates hedging), but it still can be a very effective 'clue' to be aware of.

Since wagers are based on irregular movements in respective companies, this strategy's performance is not dependent on interest rate stability, favorable stock market environment or any other market factor. This may present major profit opportunities, and returns can sometimes be far superior when compared to other strategies.

Conclusion: this trading strategy analyzes options data for the purpose of identifying significant increases (or abnormal fluctuations) in trading volume and volatility of the stock's options as an indicator of movement and the timeliness of that movement in the underlying security. Options order flow analysis can be an indicator of "smart money" positioning, prior to publication of significant business announcements.

Another clue traders can look for are 'block trades' on the TOS (Time of Sales) reports. This is a related strategy, and does not necessarily indicate 'insider' buying, but can alert the astute trader to large institutional blocks of options being bought on either side of the underlying stock.

For example, if the average option trade size on a particular stock's options is 5, 10, or 20 contracts, and you suddenly see large blocks of 200, 500 or 1000 contracts going into the close, then this is sometimes noteworthy and worth paying attention to the underlying stock.

For more Information about option trading, please click here:
www.options-university.com