The slingshot strangle

Catching market bottoms is a great approach — for traders with crystal balls. If you're like most traders, though, the odds are that you'll miss the reversal point while waiting for confirmation of the trend change. A variation of the option strangle trade gives you more time to "fish" for a market turnaround while simultaneously capping your risk level.

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It's one thing to believe a market reversal is coming, but it's something else predicting exactly when it will occur.

Most of the time, trying to catch tops and bottoms results in getting caught on the wrong side of the market. Unfortunately, although phrases such as "Don't catch a falling knife" are mantras in the trading world, some traders stubbornly continue to try to outsmart the market.

There is a useful technique, however, for bottom-fishers with a little patience and market insight: the "slingshot strangle" (slingshot for short), a reversal strategy using options that can be entered with minimal risk even when extreme pessimism is rampant in the market. It is an often-neglected option strategy that is worth dusting off the next time you find yourself close to a market rebound.

The greatest advantage the slingshot strangle has over other reversal strategies is it retains most of its value until a major move occurs in the underlying market. Its drawback is that profits initially come more slowly compared to other short-term strategies.

Strangle basics

A traditional strangle is nothing more than the simultaneous purchase of a call option and a put option with the same expiration date but different strike prices. Typically, the call and put are both out-of-the-money (OTM). An example would be to buy a 45 call and a 35 put on a stock trading at 40.

Traders use strangles when they expect an imminent breakout in the underlying issue but are unsure in which direction it will occur. When the breakout occurs, either the call or the put profits on the move, while the other side loses. If the move is large enough, the winning side will gain much more than the losing side loses.

There is really no hard-and-fast rule about the options being out-of-the-money. Strangles can contain options that are both in the money (ITM), or one in and one out, depending on a trader's degree of bullishness or bearishness. The slingshot strangle consists of a call and a put that are both in the money.

Setting the stage: Panic at market bottoms

Just before a broad market sell-off bottoms out, the selling is largely indiscriminate and driven by panicky investors "throwing in the towel." The selling pressure becomes so extreme the market typically becomes oversold, like a rubber band that has been stretched too far.

At some point a positive catalyst emerges to release this pressure, replacing pessimism with optimism. What follows is a high-volume rally as traders cover the short positions they established when the market was selling off. The momentum of this reversal is analogous to the catapult action of a slingshot.

During such heavy selling periods — and prior to the appearance of the catalyst — some aggressive traders attempt to pick up stocks at cheap levels. Not surprisingly, they wind up losing large sums of money when, as we've seen many times in the last couple of years, a rebound never occurs.

Making the trade: Finding the right stocks

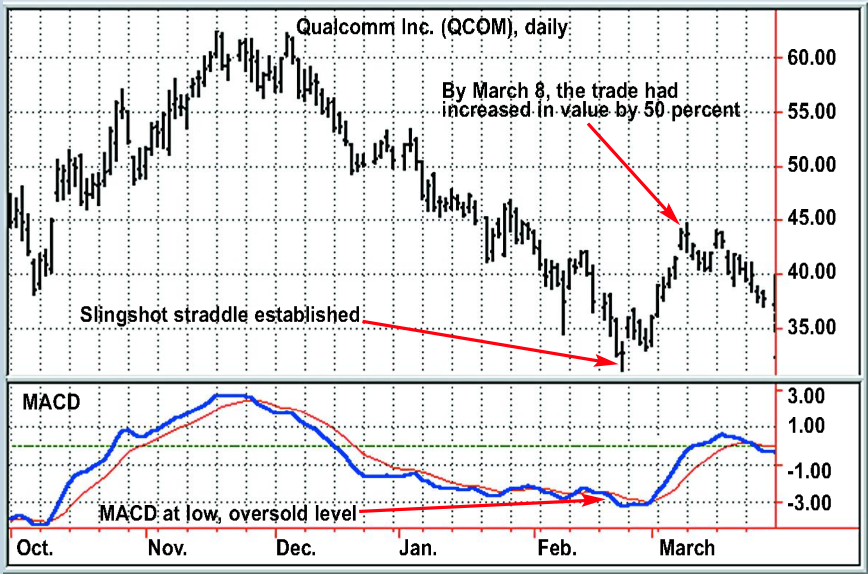
The slingshot strangle allows you to enter a trade without confirmation of an upside reversal, while limiting risk to only a couple hundred dollars. In addition, you can profit if the market continues to drop, provided you follow a few simple rules:

1. **Look for stocks that have been beaten down severely.** Find solid stocks that have declined as a result of a broader market sell-off, rather than those that have tumbled because of their own specific problems. When the broader market rebounds, usually it's the beaten down "darlings" that are the first to bounce back.
2. **Choose stocks that have high historical volatility.** In other words, focus on the big movers. A stock with a history of going from 20 to 40 and back to 20 over a six-month period is a much better candidate for a slingshot strangle than a stock that moves only $5 in either direction over the same time frame.
3. **Establish appropriate risk parameters:** Trade options that are no more than two strike prices in the money, while keeping the combined time value (also known as extrinsic value) of the put and call under $2 to $3, depending on how far out you buy the options. (Tip: Although this rule will generally preclude you from buying options with more than 30 days until expiration, you'll increase your edge if you can buy options that are two or more months out for less than $3 combined time value. This will allow you to get out of the trade with minimal time decay if the stock fails to make a significant move.)

Because you are simultaneously buying an ITM put and call, the options' intrinsic values are never in jeopardy. If the stock price waffles back and forth a little, one option will gain as much as the other loses (aside from the time decay present in both options). When the upside reversal occurs, the call's profit will be greater than the put's loss: As the stock moves higher, the call's delta remains high while the put's delta shrinks. In other words, as long as the stock continues to rally, the put's delta will eventually reach 0 while the call's (nearly) 1.00 delta will produce dollar-for-dollar gains relative to the stock. If the stock continues to sell off, the same phenomenon would occur because the put would gain on a nearly one-to-one basis with the stock.

FIGURE 1 — SLINGSHOT: CAPTURING A BOUNCE

A relatively oversold market sets up for a slingshot strangle: Buying a March 25 call and a March 35 put produced a 50-percent return by March 8.



Source: TradeStation Platform by TradeStation Group

Exiting the trade: Taking your time and your profits

To exit slingshot strangle trades, use either a "profit stop" or a "time stop." A profit stop consists of taking profits when the open profit is 25 percent of the cost of the trade. For example, if you entered a slingshot strangle at a cost of $10, take profits when the position's value is $12.50. Profits will sometimes exceed this level, so if you choose to let them run, trail your stop — i.e., move your stop up as the trade moves in your direction. Your first stop level (at the 25 percent profit-taking level) should be at the breakeven point; at the 50-percent profit-taking level, move the stop up to the former 25-percent profit-taking level, and so on.

The time stop is designed to hold on to some of the options' time premium in the event the stock goes nowhere. Exit the trade within two weeks if no upside reversal or downside continuation move occurs. This can help salvage some of the time value of the options. If you placed the trade with options that expire in less than two weeks, your time decay will be minimal, and you can exit at any time.

Trade example

During most of January and February 2002, Qualcomm (QCOM) was in a solid downtrend (Figure 1). It had traded from approximately 40 in October 2001 to 62 by December 2001, and back to 32.50 on Feb. 21, 2002. Assume your analysis indicated a reversal was imminent because the current down move had already lasted significantly longer than the previous August-September 2001 sell-off, and var-

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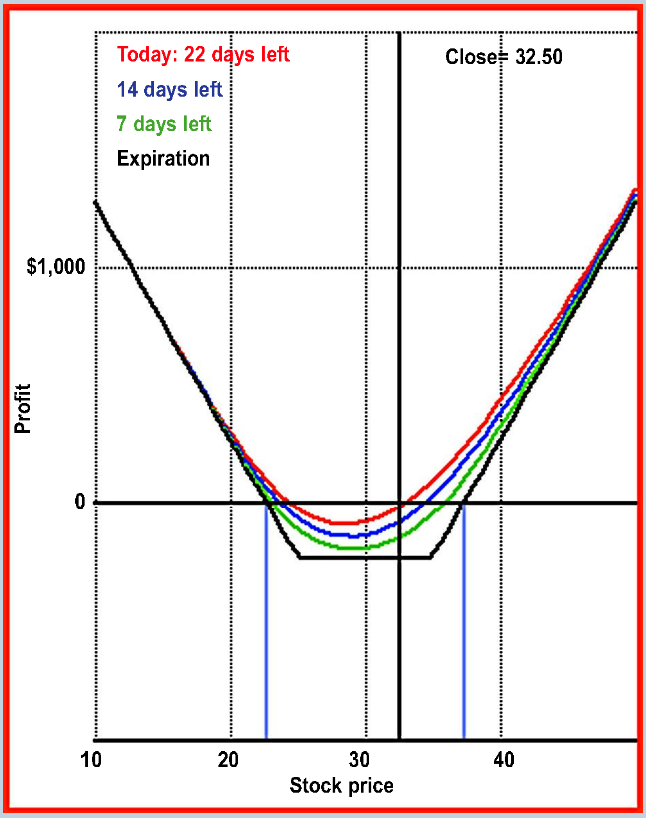
FIGURE 2 — SLINGSHOT PROFILE

This profile shows the straddle's profit at different points in time.



Source: Optionetics.com Platinum

ious indicators, including the moving average convergence-divergence (MACD) indicator, were suggesting the market was oversold and due for a bounce.

On the Feb. 21 close, a "March 25/35" slingshot strangle could have been placed by buying a 25 call and a 35 put for 12.30, or $1,230. With the stock trading around 32.50, the call and the put are in the money 7.50 and 2.50, respectively. The remaining 2.30 is time value, which is also your total risk on the trade (2.30*100 shares per contract = $230). Because the call is more in the money than the put, it will have the higher delta of the two options.

The risk curve in Figure 2 shows that just a $5 up move will produce a nice profit on the position. For a stock like QCOM, which has a history of moving $20 every few weeks, a $5 move in either direction is a relatively high-probability proposition.

A continuation of the downtrend also would generate a profit, but because the put's delta is smaller than the call's, it would take a larger move (about $7 to $8) to get in the

TABLE 1 — QCOM PROFIT PROGRESS

Day-by-day profit and loss figures for the slingshot strangle trade.

Date	Stock	Quote	Profit
2/21/02	32.50	12.12	-.18
2/22/02	32.70	12.26	-.44
2/25/02	35.91	13.08	.78
2/26/02	34.77	12.44	.14
2/27/02	33.57	11.65	-.66
2/28/02	33.25	11.38	-.92
3/1/02	35.97	12.38	.08
3/4/02	38.87	14.38	2.08
3/5/02	38.86	14.34	2.04
3/6/02	39.95	15.22	2.92
3/7/02	41.44	16.57	4.27
3/8/02	43.80	18.87	6.57

Source: Optionetics.com Platinum

black. Regardless of the direction the stock moves, though, your risk is very minimal while you wait.

The stock staged a sharp upside reversal in early March. As Table 1 shows, by March 7, the trade had profited 25 percent; one day later, it had gained 50 percent. Notice, though, the position incurred a small loss in the first five days of the trade, until the reversal occurred on March 1.

Use the advantages, but remember the risks

The greatest advantage the slingshot strangle may have over other reversal strategies is that it retains most of its value until a major move occurs in the underlying market. This allows you to enter the trade with minimal risk, and little in the way of technical confirmation that a reversal or continuation is underway.

One of the drawbacks of the slingshot strangle is that profits initially come more slowly compared to other short-term strategies. But if you consider how many times you've probably been hurt trying to catch a falling knife, this strategy can help you hold on to a few fingers in turbulent market conditions.