The Rational Investor
Opportunities in Options

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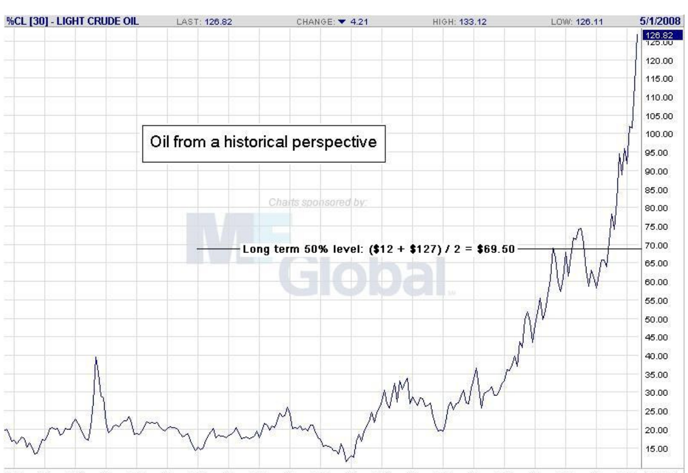
Hello and welcome back to Opportunities in Options, the newsletter about options trading. One commodity has had my (and the market's) attention for some time now - Oil. Readers of <u>The Rational Investor</u>, quarterly newsletter from October 2007 will remember my bullish comments and my upside technical target's - *According to this price pattern [referring to USO:NYSE], our target should be $106.51 [($78.77 - $51.03) + $78.77]*. That target has now been hit and profits should be taken.

From the bulls' perspective, at best one should be looking for a consolidation in prices going forward. At worst, a serious correction. This report looks at the prospects for a serious correction in energy prices going forward and how one might profit from that correction through the use of Put Options.

As the chart above clearly illustrates, energy prices have been in a violent bull market for the past year. After a brief consolidation last fall, prices moved in almost a parabolic fashion into a season peak here in May, 2008. The Chart below tells quite another story. It is a monthly chart of energy prices going back 25 years. As analysts, we don't see charts like this every day. This is in simplest terms - a market *going parabolic*. We saw it briefly during the *Dot.com* days, the *Asian-Tigers* days and even recently during the *US Housing- bubble* days. As technicians we know when to spot an interesting opportunity. If one applies a 50% rule to this long term chart, we see an opportunity, a big opportunity! The problem is risk. Yes this market is way overbought, but exactly when it will come down is really anyone's guess. And it is for that very reason we use options…



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Crude Oil Put Option Strategy…

Cardinal rule: "*An ideal option trade is where the current price of the option is less than or equal to one half the potential value should the underlying move to where you believe it ought to go.*"

Given the fact that there is no weekly top in place for the energy markets, we must assume prices will either continue to rise or go sideways for the foreseeable future. This isn't necessarily a bad thing though. For shrew option investors, a period of a few months of low volatility is perfect for taking a large position. Let me explain. Since we don't know for certain when this market is going to break, it would be foolish to go place all your bets now. Even if you could buy a lot of time, Murphy's law says the market will break the day after your options expire. A smarter approach is to average yourself into the market. Use the next six months to build a position in the energy complex. Once every two months buy the farthest out put option you can buy that still meets the rule stated above. By the end of month six (in this example November, 2008) you will control three separate positions with three different expiry dates. If the market breaks before November then you have on a portion of the intended position, if after, then all of the intended position. As well, because you bought mostly time value, on the next two-month purchase date you sell the option that is nearest to expiry and roll that money into the next farthest out series. If the market hasn't broken within the next 6 months you may take a loss on the sale of the nearest to expiry option but you will consistently maintain your position in the market, while only taking a partial loss on the sale. Let's look at some options then.

Future	Option	Strike	Type	Bid	Ask	Open	High	Low	Last	Chg	Time	Settle	Prev Settle	Volume	Open Interest	DTE
CL H9	CL H9	99.00	Call								15:30:27		33.49	0	100	264
			Put								15:30:27		3.59	0	100	
		100.00	Call								15:30:27		32.72	0	15	
			Put			3.85	3.85	3.85	3.85		09:23:59		3.80	0	1060	
		100.50	Call								15:30:27		32.33	0	225	
			Put								15:30:27		3.91	0	225	
		101.00	Call								15:30:27		31.95	0	14	
			Put								15:30:27		4.02	0	7	

10 Month Crude Oil Options. CL-H9 closed 05/29/07 at $125.90

March, 2009 Crude oil futures closed at $125.90 (5/29/08). The current 50% rule for the March, 2009 contract is $101.55 [(52 week high of $135.40 + 52 week low of $67.70) / 2].

Options will generally trade at the same level it costs to margin a futures contract when they are At-the-Money (ie strike price and futures price are roughly the same). At $101 per barrel (the 50% level and our target) the margin roughly on one futures contract is $5050.00 [(1000 barrels x $101.00) x .05]. Currently the largest open interest in the March, 2009 contract is the $100 put. It traded today at $3.85. Should the market move to the 50% level, we ought to see this option trade up to the $5.00 area. Since we want to pay ½ of what we expect to get for the option at our target, one might consider entering a 'stink' bid to buy this option at $2.50. It may take some time to get a fill, so be patient. Considering the fact that we won't even think about buying another put for four months, we can take a few weeks to get our fill. In two months time we will repeat the process looking at the May, 2009 puts. And in four months time we will do the same for the July, 2009 options…

Future	Option	Strike	Type	Bid	Ask	Open	High	Low	Last	Chg	Time	Settle	Prev Settle	Volume	Open Interest	DTE
CL U8	CL U8	125.00	Call			9.77	9.77	9.77	9.77		15:56:32	9.77	12.07	0	9749	78
			Put			8.00	8.00	8.00	8.02		15:56:32	8.02	6.39	0	2465	
		125.50	Call			9.52	9.52	9.52	9.52		15:56:32	9.52	11.79	0	129	
			Put			8.28	8.28	8.28	8.28		15:56:32	8.28	6.61	0	32	
		126.00	Call			9.28	9.28	9.28	9.28		15:56:32	9.28	11.51	0	1026	
			Put			8.54	8.54	8.54	8.54		15:56:32	8.54	6.83	0	1522	

4 Month Crude Oil Options '*At-the-Money*'. CL-U8 closed 05/29/07 at $126.55

Report conclusions…

While it is very hard to do, investors that can sell when others are yelling and buy when others are crying often do much better than those that follow the heard. Considering the current state of energy prices, the potential political change in the US in 2009 and the parabolic nature of Crude Oil's recent climb, one ought to expect some sort of correction. Should the market correct back to the 52 week 50 percent level, there is a realistic chance to double your money through the use of Put Options. If the correction is larger, the potential profits could be staggering…

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