# The Earnings Season Trade


**The Optionomics Group LLC**

Weekly options give a trader the best chance to make a profit during earnings season. They allow you to do very highly correlated, vertical and horizontal spreads with minimum risk. Before the advent of weeklies, the only choice a trader had was to do monthly spreads. The problem was that the difference in premium levels added an extra level of risk to the trade. Weekly options have greatly reduced that risk. What follows are a couple of trades that will allow you to profit during earnings season no matter what type of market environment exists.

## What Is Earnings Season

Earnings season is the first few weeks of each quarter when the Securities and Exchange Commission mandates that all publicly traded companies report their current financial position. Generally, the two biggest numbers that the public pays attention to are the total revenues for the company, as well as the profit or loss that has occurred on those revenues in the last quarter.

Major banks and hedge funds keep track of how a company is performing and publish their forecast of expected revenues and earnings. Many times, these numbers are accurate and when the earnings report is released it has very little impact on the price of the stock. However, a principal known as “market expectation” is always in the formula and it is the main component that can send prices flying up or down after the number is released. Many times, the banks “hedge” their numbers slightly but even if they hit the “expectation” dead on, the price of the stock could have a wild move. The first reaction may be a move to the downside, but after consideration traders decide that they were too pessimistic and the stock suddenly reverses course and heads in the other direction. Or the number was too bullish, the stock reverses and ends up on its low. In either case, earnings season represents a chance to make a nice winning trade in a short period of time.

By now you should know that I never advocate strategies or trades that involve unlimited risk. You can do limited risk - limited reward trades or you can do spreads that offer limited risk and unlimited rewards. But you should never do trades that have unlimited risk. As always, the strategies listed below include the Market Edge Opinions when selecting the underlying stocks for the trades. These Opinions are always valuable in the stock selection process since a major component of their structure is to spot near-term accumulation or distribution in the stocks. Believe me. If there is ever a time when smart money is at work in the market place, it is during earnings season.

## Pricing The At The Money (ATM) Straddle

In order to understand how air (Vega) comes in and out of the option chain you must understand the concept of the **AT THE MONEY** straddle. The ATM is always the current strike price minus any intrinsic value. Assume that you are trading XYZ and it is priced at $200 a share, If the $200 call was priced at $12 then the $200 put would be priced at $12.This is because each option has a 50% chance of ending up in the money at expiration. As the price rolls up and down across the mean it will create a new ATM. As an example, if the price rallied to $210 then the $210 put and the call would have the same value. As time goes on and we move closer to expiration even though the $200 put and call would have the same amount of air, it would be less every day. Let’s assume that we are now trading with four days until expiration, but we are still trading at $200. If the call is trading at $8 what would the price of the put be? If you said $8 you would be correct.

Each serial has its own amount of premium attached to it. The only constant is the deferred serial will have more air in the balloon because there is more time until expiration. In the above example, if the expiring ATM were to have $12 in both the put and call the next serial would have more Vega (air). The size of that Vega is determined by the supply and demand for the deferred option. We will use this principal of the air coming out of the balloon (theta) as the time to expiration shortens to create our winning trades.

GS | GOLDMAN SACHS GROUP INC COM | 268.14 | 0 0.00% | B: 267.56 A: 268.08 | ETB | ±0.542 | Company Profile

Underlying

| Last X | Net Chng | Bid X | Ask X | Size | Volume | Open | High | Low |
|---|---|---|---|---|---|---|---|---|
| 268.14 N | 0 | 267.56 P | 268.08 P | 1 x 1 | 0 | 0 | 0 | 0 |

Trade Grid

Option Chain | Filter: **Off** | Spread: **Single** | Layout: **Last X, Net Change**

| CALLS | | | | Strikes: 15 | | PUTS | | | |
|---|---|---|---|---|---|---|---|---|---|
| Last X | Net Chng | Bid X | Ask X | Exp | Strike | Bid X | Ask X | Last X | Net Chng |
| 2 FEB 18 (6) 100 (Weeklys) | | | | | | | | | 21.93% (±6.399) |
| 18.22 I | 0 | 17.75 M | 18.60 M | 2 FEB 18 | 250 | .08 Q | .14 M | .14 E | 0 |
| 14.59 C | 0 | 15.30 X | 16.05 M | 2 FEB 18 | 252.5 | .12 X | .18 P | .18 C | 0 |
| 13.43 I | 0 | 12.80 M | 13.65 M | 2 FEB 18 | 255 | .21 Q | .27 M | .26 C | 0 |
| 11.30 N | 0 | 10.70 N | 11.45 M | 2 FEB 18 | 257.5 | .35 Q | .47 M | .40 H | 0 |
| 8.77 I | 0 | 8.50 Q | 9.15 X | 2 FEB 18 | 260 | .57 Z | .70 M | .66 C | 0 |
| 6.56 C | 0 | 6.65 Q | 6.90 M | 2 FEB 18 | 262.5 | .97 Q | 1.17 M | 1.09 Z | 0 |
| 4.90 Z | 0 | 4.80 Q | 5.05 M | 2 FEB 18 | 265 | 1.60 Q | 1.84 M | 1.70 N | 0 |
| 3.29 B | 0 | 3.25 N | 3.55 M | 2 FEB 18 | 267.5 | 2.58 Q | 2.83 H | 2.72 I | 0 |
| 2.15 X | 0 | 2.16 Q | 2.26 Z | 2 FEB 18 | 270 | 3.85 H | 4.25 M | 4.11 C | 0 |
| 1.31 C | 0 | 1.32 Q | 1.44 M | 2 FEB 18 | 272.5 | 5.50 X | 5.80 M | 5.80 Z | 0 |
| .75 B | 0 | .76 Z | .87 M | 2 FEB 18 | 275 | 7.35 Z | 7.85 M | 7.75 Z | 0 |
| .53 X | 0 | .44 Z | .53 M | 2 FEB 18 | 277.5 | 9.50 Z | 10.00 M | 9.90 C | 0 |
| .28 B | 0 | .25 Q | .32 M | 2 FEB 18 | 280 | 11.70 M | 12.30 M | 12.70 Z | 0 |
| .18 A | 0 | .15 Q | .22 H | 2 FEB 18 | 282.5 | 14.05 M | 15.05 M | 15.20 M | 0 |
| .15 E | 0 | .10 Q | .17 Z | 2 FEB 18 | 285 | 16.50 M | 17.55 N | 14.80 E | 0 |
| 9 FEB 18 (13) 100 (Weeklys) | | | | | | | | | 21.85% (±9.107) |
| 18.85 C | 0 | 18.15 M | 18.90 M | 9 FEB 18 | 250 | .32 X | .39 M | .37 C | 0 |
| 16.90 E | 0 | 15.85 M | 16.50 M | 9 FEB 18 | 252.5 | .44 H | .53 M | .48 Q | 0 |
| 15.53 C | 0 | 13.60 M | 14.20 M | 9 FEB 18 | 255 | .66 H | .74 M | .74 I | 0 |
| 11.88 E | 0 | 11.40 M | 12.00 M | 9 FEB 18 | 257.5 | .93 M | 1.04 M | 1.03 Z | 0 |
| 9.48 E | 0 | 9.60 M | 9.90 M | 9 FEB 18 | 260 | 1.37 H | 1.49 M | 1.49 Q | 0 |
| 7.77 I | 0 | 7.70 M | 8.00 M | 9 FEB 18 | 262.5 | 1.96 H | 2.11 M | 2.10 Q | 0 |
| 6.15 C | 0 | 6.10 M | 6.25 M | 9 FEB 18 | 265 | 2.76 M | 2.92 M | 2.87 I | 0 |
| 4.64 C | 0 | 4.55 Q | 4.90 M | 9 FEB 18 | 267.5 | 3.75 X | 4.05 M | 3.95 Q | 0 |
| 3.40 Z | 0 | 3.35 M | 3.55 M | 9 FEB 18 | 270 | 5.05 X | 5.35 M | 5.23 X | 0 |
| 2.57 E | 0 | 2.44 Q | 2.61 Q | 9 FEB 18 | 272.5 | 6.55 H | 6.90 M | 7.75 Q | 0 |
| 1.82 I | 0 | 1.75 M | 1.85 M | 9 FEB 18 | 275 | 8.35 M | 8.80 M | 8.30 Q | 0 |
| 1.30 A | 0 | 1.23 M | 1.31 M | 9 FEB 18 | 277.5 | 10.10 M | 10.85 M | 11.69 C | 0 |
| .90 C | 0 | .85 M | .93 M | 9 FEB 18 | 280 | 12.20 M | 13.00 X | 0 | 0 |
| .53 H | 0 | .59 M | .67 H | 9 FEB 18 | 282.5 | 14.60 M | 15.35 M | 0 | 0 |
| .47 P | 0 | .40 M | .52 M | 9 FEB 18 | 285 | 16.95 M | 17.70 M | 0 | 0 |

Above are two option chains for Goldman Sachs (GS). The first one is the weekly option chain that will expire on Feb 2, 2018. The second is the deferred weekly option that expires on Feb 9, 2018. The closing price for GS on Friday, 01/26/18 was ***$268.14.*** The price settled in between strikes, so you would have to decide which strike represents the ATM option. The closest strike is the 267.5 so that is the strike you should use for your trade.

The front, Feb 2 (expiring) straddle closed at $6.01 (267.5 call @ $3.29 plus 267.5 put @ $2.72 = $6.01) with the call being $0.64 in the Money. If the stock were to close next Friday at ***$268.14*** the straddle would close at $0.64 ($268.14 – 267.50).

The back, Feb 9 (deferred) straddle closed at $8.69 (267.5 call @ $4.64 plus 267.5 put @ $3.95 = $8.69 with the call also being $0.64 in the money (intrinsic value). If the stock settles at ***$268.14*** on Feb 2, 2018 the 267.5 straddle will be worth $0.64, its intrinsic value. The second straddle would lose time decay but should still be worth around $6. Since Vega is very tough to predict, it could be more or less but $6.00 is a reasonable price. The reason for the difference in the price of the straddle is our old friend time decay (Theta). As expiration nears the chance of having a wide divergence of price narrows since traders are willing to sell the calls and puts for less premium. The front straddle will lose $5.37 of value while the Feb 9, 2018 straddle will lose approximately $2.69 of value. This difference in the amount of time decay is why you want to buy horizontal debit spreads. The logic is that since the buyers will pump air into the balloon in the hopes of a large price move if the earnings come in anywhere near as expected, the premium will come out of both the expiring and the deferred weekly options, but it will leave the expiring serial at a faster rate.

**Earnings Season Trades**

There are several trades that can be used in anticipation of an earnings release. They all involve a certain amount of risk and reward. Rather than confuse you with a slew of complex trades, I will give you a trade which will mimic 99% of all of the earnings-related trades without complicated rules or the need for sophisticated execution. Each trade uses the Market Edge Opinion for the underlying stocks when constructing the transaction. The trade has limited risk and limited reward. If you elect to have the winning side of the trade run, it could turn into unlimited reward. Remember, no matter which trade you initiate, the first step is always to buy the long side of the spread to insure that you have limited your risk. Once that is complete, you can sell the credit side of the trade. Also, the trade should be completed as close to the earnings release date as possible.

**Directional Off-Strike Horizontal Earnings Trade**

The risk and reward are both limited for this trade unless you elect to have the winning long option leg run, then it can have unlimited reward. This trade is used when Market Edge has a either a ***Bullish*** or ***Bearish Opinion*** for a stock. In either scenario, you would use off-strike horizontal call and put spreads. As always, you would buy the debit side of the trade first to ensure that you don't have unlimited risk. You can choose any combination of strikes that you want. However, the wider the spread the more risk you assume and of course the more reward you receive. I prefer to use the ATM +2 or +3 strikes for the calls and the ATM -2 or -3 strikes for the puts. Whichever strikes you use is a 'traders' choice'. There is no right or wrong answer. It is simply a matter of how much risk you want to take.

In this example we will once again use the option chain for Goldman Sachs (GS) located above. Let's assume that Market Edge has a Bullish Opinion for GS. You would ***buy*** the Feb 9, 2018, deferred - weekly ITM 267.5 call and ***sell*** the Feb 2, 2018 expiring - weekly ATM +3 call - 275.0 call to create a horizontal spread. You would have paid approximately $4.60 for the Feb 9, 2018 - 267.5 call and received around $0.87 for the Feb 2, 2018 - 275 call for a ***$3.73*** ($4.60 - $0.87) debit which is your Max Risk. The trade would look like the following:

| Stock | Open Date | Market Edge Opinion | Open Stock Price | ATM | Long One ITM Deferred Call | Short One ATM +3 Expiring Call | Debit | Max Risk |
|---|---|---|---|---|---|---|---|---|
| GS | 01/31/18 | **Bullish** | $268.00 | 267.5 | 267.5 | 275.0 | $3.73 | $3.73 |

On the surface, this trade may seem illogical since you are creating a large debit. However, you are doing this trade because you have a bullish opinion for the stock. If the stock rallies the call that you bought **(*deferred option*)** will have intrinsic value and the call that you sold **(*expiring option*)** will become all air. The market expectation will be met, and the traders will take the air out of the balloon. The long side of the trade will start to become intrinsic while the short side of the trade will gain value. However, it will not be enough to keep up with the long side of the trade. If Market Edge is correct, the more the stock rallies the bigger the winner will become until it maxes out at $7.50 for more around 100% over your maximum risk ($3.73). If you are wrong, you will lose money but because of the air in the balloon your risk is limited to $3.73. It is highly unlikely that you would lose that amount because there will be more premium in the Feb 9, 2018 options than in the Feb 2, 2018 serials.

If Market Edge is bearish on the stock, you would do the exact same trade, but you would use ***puts*** instead of ***calls.*** You would want to buy the deferred ITM put and sell the expiring ATM -3 put. Again, your risk will be limited to the debit you paid while your reward could be about 300% of the maximum risk ($3.29).

| Stock | Open Date | Market Edge Opinion | Open Stock Price | ATM | Long One ITM Deferred Put | Short One ATM -3 Expiring Put | Debit | Max Risk |
|---|---|---|---|---|---|---|---|---|
| GS | 01/31/18 | **Bearish** | $268.00 | 267.5 | 267.5 | 260.0 | $3.29 | $3.29 |

**Managing The Directional Off-Strike Horizontal Earnings Trade**

Once you have an Off-Strike Horizontal Trade in place whether it is a bullish or bearish transaction, it is managed in the same manner since they are mirror images of each other. Most earnings releases are either before or after the market opens or closes. Usually, if there is going to be a favorable price move, it will occur by 11:00 am. For reporting purposes, we close the position at this time. If the trade is a winner right off the bat and the spread ***doubles*** in price**,** we will also close the position. You can hold the position if you want to make more but that increases your risk. On the other hand, if the trade is not immediately a winner, it can be held since we know that the m*aximum risk* is limited to the original debit. If you are very adventurous, you can buy back the short call or put and let the long leg run. The only wrong way to manage this trade is to take off the long leg which creates maximum risk since you now would have an unprotected, short or naked option position.

## What You Can Expect

| | |
|---|---|
| Frequency Of Play: | Quarterly |
| Investment Option Time Horizon: | One – Two Days |
| Maximum # Of New Plays Per Week: | Three - Five |
| Maximum # Of Open Positions: | Five |
| Risk Tolerance: | Medium |

| | |
|---|---|
| Option Experience: | Medium |
| Suggested Amount Of Risk Capital To Trade All Of The Short-Term Recommendations: | $20,000 |

## Summary

The above trades are similar to most of the more complicated trades that can be made during earnings season. The idea behind the trades is to take advantage of the Market Edge Opinions to forecast a stock's probable direction once the earning news is released. The trade has limited risk and either a substantial or unlimited reward over a short-term time frame. When wrong, your risk is limited. As with all Optionomics strategies, you should keep your dollar allotments to no more than 3-4% of your risk capital.

The Earnings Season Trade is great for those who like a lot of action over a short period of time. The problem is they are only available on a quarterly basis. The average price for the stock selections is around $150 per share while the maximum number of potential trades on any day is less than ten. Therefore, a fully invested cash account would require risk capital of around $20,000 if all selections were played. The trade is designed to be open for less than twenty-four hours so you should never have more than three to five positions in play at any time. Finally, it is not necessary to trade all of the selections. Each stock has similar technical characteristics so the performance should be comparable. That being said, diversification into a number of selections is always recommended.

# Earnings Season Positions - Worksheet

**Bullish Horizontal Earnings Trades**

| Open Date | Report B - A | Symbol | Stock Price | Short One ATM +2 Expiring Call | Long One ITM Deferred Call | Open Debit Spread | Close Date | F-Close Or 11:00 AM Stock Price | Close Debit Spread | Spread P/L |
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**Bearish Horizontal Earnings Trades**

| Open Date | Report B - A | Symbol | Stock Price | Short One ATM -2 Expiring Put | Long One ITM Deferred Put | Open Debit Spread | Close Date | F-Close Or 11:00 AM Stock Price | Close Debit Spread | Spread P/L |
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