# The Art of Option Selling

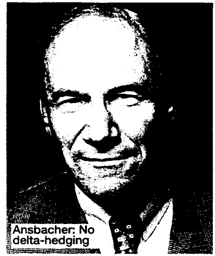
Not many commodity trading advisers actively trade options. And those who do typically use them only as an occasional leveraged supplement to a broad directional view.

So it comes as a surprise that one successful commodity trading adviser, **Max Ansbacher** of New York-based Ansbacher Capital Management, makes his living exclusively by trading options. Moreover, contrary to what most people consider prudent, he never buys options—he only sells them. And only one variety at that—options on Standard & Poor's 500 futures.

Now, the kicker that will make risk managers run screaming for the exits: Ansbacher never delta-hedges his positions and rarely engages in spreads. He considers that stuff too complicated and expensive. His approach, by contrast, is astonishingly simple: he sells an option—usually a put, but sometimes a call—then places a stop-loss order above his option entry price. Then, he kicks back and watches.

Most options aficionados would consider him unsophisticated and naïve. He has none of the fancy risk management systems or net synthetic sensitivity reports so common in options trading operations today. But before you write him off as a crank, keep in mind that Ansbacher has made a lot of money as a CTA, and has been doing so for a long time.

The author of one of the first books on options, *The New Options Markets* (published in 1975 and soon to be updated), Ansbacher was a successful Bear Stearns broker for two decades, using his options approach to trade for clients as well as his own account. He was so successful he wanted to shout his record from the rooftops, but being a broker, New York Stock Exchange



Ansbacher: No delta-hedging

rules wouldn't allow it. So in 1995, he set himself up as an independent CTA.

His first two years as a CTA were successful, bringing in annual returns of 24.85 percent and 19.52 percent respectively. In 1997, he hit a home run, returning 94.93 percent. The extreme volatility in the summer of 1998 brought him back down to earth—he suffered a 19 percent drawdown at that time—but he still lived to turn in a 25.68 percent performance on the year. Last year, he racked up another 23.54 percent positive return.

But don't pure short-selling strategies always end badly, like *The Art of Speculation* author Victor Niederhoffer's famous 1997 blowup? Not at all, says Ansbacher.

"From what I understand of that situation, the difference between me and Victor Niederhoffer is pretty simple," he announces. "In 1997, Niederhoffer had already lost half of his money betting on the Thai baht. All the clients that could leave him already had. But Niederhoffer had other clients under a lock-up agreement where they could only leave his fund at year-end. He needed to make back a great deal of money in a short period of time or risk the rest of his clients fleeing. Selling S&P put options was effectively a double or nothing way to try to make himself whole by year-end. He knew exactly what he was doing, and he just kept selling more options on the way down because he knew the game was effectively over anyway, unless the market came roaring back." It did, of course, but a tad too late for old Vic.

Ansbacher claims that he would never consider trading in such a fashion. "When I sell an option, I immediately place a good-til-cancelled stop-loss order," he says. " I also use far less margin than most people. When I get stopped out, that's typically nature's way of telling me to slow down, retreat for a while. I'll stand aside for a bit in such instances. Maybe just a few days or a week—but with such a trading defense system, you avoid having your heart in your throat in a crash environment. I had a 13 percent drawdown when Niederhoffer lost 120 percent. It was nothing particularly unusual on the way to a great year."

Choppy, volatile markets such as the ones we've seen this year have also caused Ansbacher some duress, but since he only trades a maximum of 25 percent of his available capital at any one time, he has always survived long enough to prosper when a volatile market finally snaps back to a normal trading range. Ansbacher explains that he has tended to have some of his best periods immediately after some of his worst: "As long as I can avoid too many stop-losses getting elected back-to-back, expanding premium levels that previously hurt on a mark-to-market basis finally start to die on the vine."

Through the years, Ansbacher's success has boiled down to a decidedly contrarian philosophy: "sell options as much as you can."

"If you really feel compelled to buy options," he says, "be realistic about it, and sell out half of your position if the option price doubles." Ansbacher claims that this advice was reinforced while watching his clients at Bear Stearns engage in a wide variety of options strategies. "Strangely enough, almost all of the option buyers ended up losing money," he says. "Sooner or later they'd guess wrong on a directional move and their long premiums would evaporate."

One nice benefit of his contrarian style: he often gets a large cushion between his short striking price and the current market when selling out-of-the-money puts or calls on S&P futures. "Unlike most traders," he says, "Within a range, I typically don't care where the index ends up, but simply how it gets there. If it gets extremely choppy like this past April, I'll likely elect a few stops and drop some money. But years like 1997 were just marvelous. Beside a small hiccup in October of that year, the steady grind higher in the market was just perfect for my style of trading."

But is his secret really this simple? Not quite. There are four additional rules he follows closely. First, he never trades individual equity options. He considers their jump potential too dangerous when compared with selling options on a broader index.

Second, he always tries to sell against the consensus. To help do this, he constructed his own index that measures the degree of richness or cheapness in out-of-the-money index options. He takes the price of a put approximately 30 points below the current price of the S&P 100 Index (OEX) and divides it into the price of a call the same amount above the OEX. The index uses a weighted average of the first two option maturities to keep a constant average maturity life. Ansbacher has found that on a few occasions the index has reached an extreme toward 0.3 (the puts thereby trading at three times the value of calls a similar distance out of the money)—typically a bullish signal. Conversely, Ansbacher claims that an index value toward 1.0 is singularly bearish, with calls hardly ever reaching a greater premium than similar out-of-the-money puts. The index gives him a flavor for sentiment and the relative attractiveness of premium levels all in one blow.

Ansbacher's third rule: only trade options in the first two delivery months. "I'm going after time decay," he says, "and have no ambition to get involved with six-month options where you can hardly see this decay at all. The market could be anywhere in six months." Much to his pleasure, short-dated options decay quite quickly. He often likes to sell options directly in front of economic numbers, risking being hurt by a large directional move in the S&P in return for some fast time decay once the numbers become public information.

The final rule he uses to keep himself out of trouble is to occasionally double-down on a trade with a tightened stop. "Suppose I first sold an option at $6," he says. "Initially, I might leave a stop at $12. If the option I sold then declines in value to $3, I might sell another round of them, but tighten the overall stop on the entire position down to $6." Ansbacher thereby ends up risking $3 net for a potential $9 winner.

If this approach seems somewhat unsophisticated, perhaps it is. Ansbacher clearly stands at some risk of a 3-sigma overnight event, since stops on index options currently do not trade overnight. Some might even argue that he represents a good example of "survivorship bias"—one person just lucky enough to be left standing after scores of other short-sellers have long since blown up.

Nonetheless, he fervently believes in his approach and continues to bemoan too much spread-trading or delta-hedging as a dangerous and unattractive alternative. And who can argue with his success? He's made lots of money over the last quarter-century and has yet to be caught egregiously offside. —*Barclay T. Leib*