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FTS Real Time System Project: Economic Announcements, Option Trading Strategies and Market Efficiency

Question: How do you use option trading strategies to profit from economic announcements?

Introduction

The market responds to economy wide announcements. In this project you will explore the semi-strong market efficiency question as to whether you can make money by designing and implementing option trading strategies around economy wide announcements.

Major financial web sites provide comprehensive coverage of the calendar of economic events. For example, Yahoo Finance and MSN Money provide this information at:

http://biz.yahoo.com/c/e.html

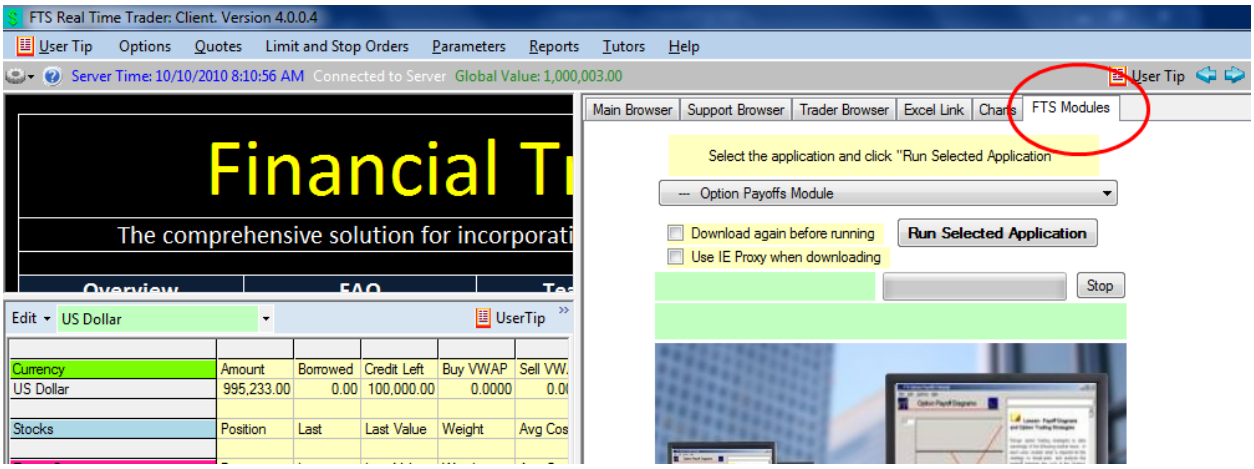
http://moneycentral.msn.com/investor/calendar/econ/current.asp

The objective of this project is to apply option trading strategies using stock index options to economic announcements. To set up this project you need to first work through the following steps:

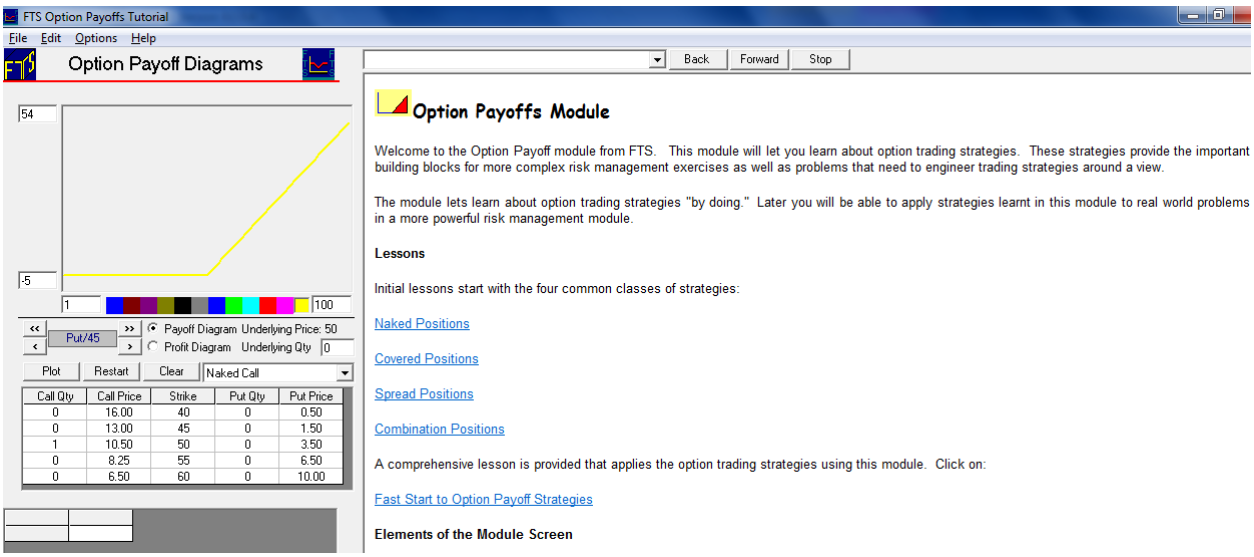
Step 1: First, go to the two sites above and or related sites. This will provide you with forecasts about major economic announcements around the current time (both future and past). Based upon this information or one particular significant forecast form a *short term view* of the general market over a specific time period (e.g., 1 or 2-weeks). This could be a directional view based upon expected unemployment numbers, it may be a volatility view if you cannot predict a direction but you expect that the announcement will either move or not move the market or

it may be a skewed view that you expect the news is more likely to be good (bad) than bad (good). Bottom line form either a directional view, a volatility view or both.

Step 2: Open the FTS Real Time client and click on FTS Modules and select Option Payoffs Module from the dropdown that appears. Your screen should appear as follows:



Next click on Run Selected Application in the above screen to launch the FTS option payoffs module..



You will observe that there are four basic types of option trading strategies. Naked Positions, Covered Positions, Spread Positions and Combination Positions. You should browse through these different types of strategies and the visual calculator on the LHS of the above screen lets

you apply each of the strategies to the default dataset provided. This lets you familiarize yourself with each of the major strategy types.

Based upon this work now select a strategy that you think best matches the view you have formed in step 1. The basic rule here is to keep your view and strategy simple. That is, only add additional complexity if you need to. So for example, the naked position allow you to exploit directional views. The straddles/strips and straps allow you to exploit volatility and skewness views as do the butterfly and related strategies. So no matter what your view is you will find an option trading strategy that will let you implement it.

Step 3: Now search through the index options provided in the FTS Real Time Index Option trading case and implement your view in the most cost effective way. Put your trades on and then at the end of the week or two (whatever your short term horizon is for your view) then analyze the outcomes.

Project Requirements:

All projects should contain a cover sheet that list the full name of each team member.

Required questions:

(1) Describe your view of the market along with the economic indicators that you based this view on.
(2) Describe the option trading strategy you employed along with the reasons why it supports your view.
(3) Report on what happened with the general market and the economic realizations (i.e., the reports announced) was this consistent or inconsistent with your view?
(4) Report on the outcome from your option trading strategy. If your view was correct did your option trading strategy make or lose money (why or why not)? If your view was incorrect did your option trading strategy make or lose money (why or why not)?
(5) Provide a brief summary of 1-4 above and draw some basic conclusions in relation to the semi-strong form of the efficient markets hypothesis.

An important dimension to parts 4 and 5 is aggregate performance of the class as a whole.