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DAS MAGAZIN FÜR PROFESSIONELLE ANLEGER – GEGRÜNDET 2010 AUSGABE 01/02 2014

INTERVIEW SHELDON NATENBERG, CHICAGO TRADING COMPANY

„There is no secret in trading volatility“

Sheldon Natenberg is one of the most sought-after speakers on the topic of option trading and volatility strategies. As Director for Chicago Trading Company, he has helped many institutional investors and mutual fund managers better understand volatility and utilize it in valuing and pricing options of all types. His book "Option Volatility & Pricing" is a standard on the trading floors all over the world. **alternative investor information** met Mr. Natenberg by the invitation of Eurex, one oft the world's leading derivatives exchange.



Sheldon Natenberg
is responsible for the education of the trading staff of CTC. His reputation is so well known in the international markets that Sheldon is often invited by other trading companies and stock exchanges to educate their employees.
He is the author of the book "Option Volatility & Pricing" that was published in August 1994.

Chicago Trading Company (CTC)
is a highly analytical trading company with offices in Chicago, New York and London. The firm is acting as a market maker and trading state of the art derivative models and strategies.

altii: CTC has traders all over the US and in Europe. You are acting as a market-maker in several markets. How can you make sure one trader is not doing the opposite of the other?
Sheldon Natenberg: *CTC is organized somewhat differently than most other proprietary trading firms. At most firms each trader acts as an individual profit center, with the trader's remuneration depending almost solely on the profits which he personally generates for the firm.*
CTC has no truly individual traders. Each trader is part of a team, and the trader's goal is to help maximize the team's profits. A trader can obviously contribute to the team by making profitable trades. But a trader can also contribute to the team by making trades which will protect potential profits generated by other team members. A trader might, for example, make a trade which loses a small amount of money. But if, in so doing, the trade protects a larger but potentially risky trade or position taken on by other team members, the trader has made a significant contribution to the team's success.
Members of each team are in constant communication with each other, either over phone lines or through a computer network. This gives each team access to as much information as possible. It also protects CTC against the possibility of a "rogue" trader, since any trade made by a team member immediately becomes known to all other team members.

altii: What are the markets CTC is right now active in and do you plan to look after new grounds?
Natenberg: *CTC focuses almost solely on exchange-traded products. We are most active in stock indexes, interest rate products, and energies, but we also have smaller operations in agricultural products, precious metals, and foreign currencies. We are of course always looking for new products, and will consider any product which we feel offers sufficient profit potential.*

altii: CTC is a company well known for volatility trading and you are well known in educating people in volatility classes. What is the secret? Can traders buy volatility directly and how does it work?
Natenberg: *There is no secret to the traditional method of trading volatility – buy or sell options and then dynamically hedge the position, delta neutral, using the underlying contract. A description of this process can be found in almost any good option text.*
The problem in the real world is that the results are not always consistent with the theory. There are costs to the dynamic hedging process, and the theoretical pricing models which are used to price options and calculate the delta, are not always reliable. In order to facilitate volatility trading, and eliminate the problems associated with dynamic hedging, exchanges have introduced volatility contracts, such as VSTOXX® and VIX Futures and Options. The value of these contracts at expiration depends solely on volatility. Volatility

contracts have become one of the major success stories for exchange-traded derivatives. VSTOXX® and VIX contracts are contracts on implied volatility, which means that they have some unusual characteristics compared to more traditional stock and commodity derivatives. If a trader doesn't make an effort to become familiar with these characteristics, he may be surprised, and perhaps disappointed, at the results of a VSTOXX® or VIX strategy. There are also contracts on realized volatility, such as variance swaps, but these are primarily an OTC product.

altii: It happens quite often that a trader offers a derivatives price on request and some moments later the same trader quotes a different price in a market that has not changed. The world and the model is the same only some time dropped. How can that be explained?
Natenberg: *All exchanges receive complaints from customers about a market-makers quoted prices. But there would be far fewer complaints if customers better understood the market-makers approach to trading. When an option market-maker quotes a price in the form of a bid-ask spread, he usually has to consider three points:*

1. *What does the market-maker think the option is worth?*
2. *What does the marketplace think the option is worth?*
3. *What risks is the market-maker already carrying?*

It's this last point, the risk considerations, which seems to confuse customers. If there are no changes in market conditions, a customer will assume that a market-makers quote will remain unchanged. But the customer needs to realize that in the intervening period the market-maker may have acquired a position which carries additional risks. If a market-maker has sold a large number of contracts at the previously quoted price, his new quote for the same contract will almost certainly be higher, even if no other market conditions have changed. He would be foolish indeed to keep selling more and more contracts at the same price without any consideration of risk.

altii: That sounds promising. Is there anything that worries you?
Natenberg: *Since almost all option traders use a pricing model to make decisions, traders typically worry about two things: having the wrong inputs into the model; and using a model which is not realistic, or which has built-in weaknesses.*
Weaknesses usually show up when a trader finds that the values he is using seem to be different from the prices in the marketplace. When this happens at a market-making firm the trader will probably sit down with a financial engineer to determine why this is occurring, and decide what corrections need to be made to the model. Of course, a trader might conclude that his values are right and everyone else is wrong. But this is a very dangerous assumption to make. For the most part markets are reasonably efficient.

altii: CTC as a firm had good times when the volatility in the market is high. What is the rational behind that?
Natenberg: *A large part of the profits at a market-making firm come from trading the bid-ask spread, constantly buying at the bid price and selling at the offer price. The more times this can be done, the greater the profits. Options are basically volatility sensitive products, so the more volatile the market, the more activity, and the greater the trading volume. CTC doesn't necessarily make money because we are "long" or "short" volatility. We make money from the higher trading volume which tends to occur in a high volatility market.*

altii: Volatility is one aspect to look after the markets and its risks. Is correlation important for you and how do you cover this topic?
Natenberg: *CTC, like many firms, trades a variety of similar products. Depending on market conditions, and the perceived correlation between markets, we may buy contracts in one market and sell contracts in the related market. If markets are correlated, but have different contract specifications, an option trader needs to understand his cross-market risks – his delta, gamma, and vega. This is something we include in the education process.*

altii: Markets are becoming more efficient. What comes thereafter?
Natenberg: *I doubt that I am any better than the average person in making predictions, so if your readers are looking for some brilliant insight, I'm afraid they will be disappointed. I just try to keep an open mind and deal with conditions as they occur. However,*

„There's no shame in failure. fter all 'He who tries sometimes fails; he who never tries always fails'"

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I might recommend a book which I found very interesting and which has circulated widely in the U.S.: "The Signal and the Noise: Why So Many Predictions Fail — but Some Don't" by Nate Silver.

altii: Are there new markets developing? What kind of advice would you give the big stock and derivatives exchanges?
Natenberg: *In order to keep up with, or ahead of, the competition, traders need to constantly try new strategies. Exchanges need to take the same approach by constantly looking for new products. Many products, like many strategies, will end in failure. But there's no shame in failure – that's part of how we learn and progress. After all "He who tries sometimes fails; he who never tries always fails".*

The interview was conducted by Christian Salow, altii.de



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