



HOW TO

GENERATE INCOME

FROM RUBBER BAND STOCKS



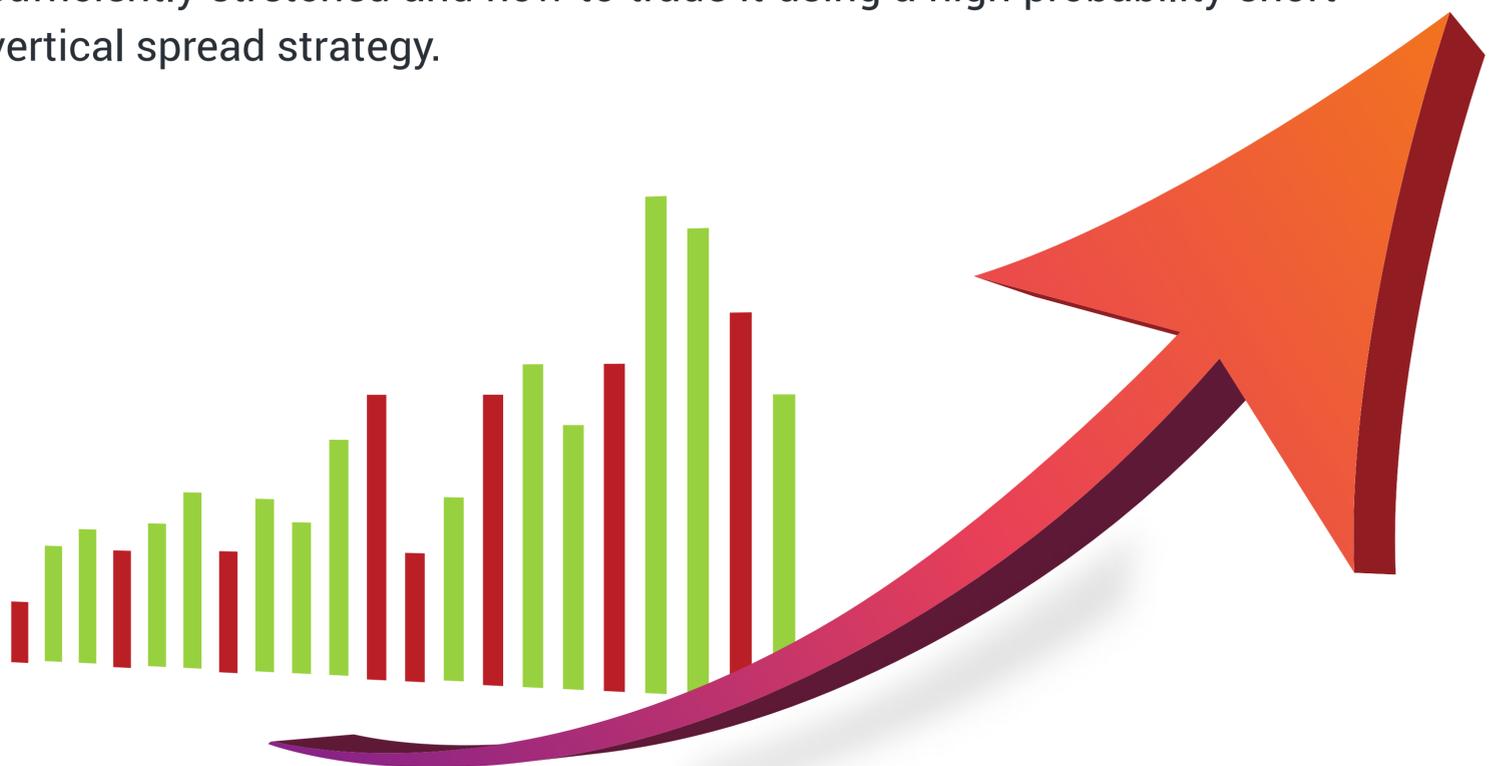


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As you've probably seen, stocks move in cycles. These cycles, at times, reach extremes as the price deviates from its averages for a while and then eventually comes back to test them whether at a higher or lower price. The concept of price moving away from its averages is called "detrending" and the process converging is called "mean reversion."

This concept of price detrending to a significant level from its averages and then snapping back conjures up images of a rubber band. When you stretch a band and let go, the band comes snapping back. It's this process of detrending to extraordinary levels and then experiencing significant positive and negative mean reversions is what defines rubber band stocks.

From a trading standpoint, there needs to be a process of defining what constitutes a significant deviation from its averages and how to trade it. In this tutorial, you will learn how to determine when the rubber band is sufficiently stretched and how to trade it using a high probability short vertical spread strategy.



THE INDICATORS

The amount of “stretch” a stock can take is determined by the amount of volatility a stock typically experiences. More volatile stocks can stretch more significantly than low volatility stocks. As a consequence, it’s important to use an indicator that reflects the individual stock price volatility.

1 *Keltner Channel*

There are various measures that measure volatility. However, one indicator that doesn’t vary as wildly is the **Average True Range (ATR)**. The concept of “true range” is because there are price gaps that the daily range won’t account for. The ATR seeks to correct this by taking the greater distance between the following:

- ▶ high and low for the period
- ▶ Previous day’s close to the next day’s high
- ▶ Previous day’s close to the next day’s close

By taking an average of these daily values, it gives a trader an idea of how much movement to expect daily.

When price swings from a support to resistance or resistance to support, it’s not uncommon to see swings of 2-3 times the ATR. In order to isolate more extreme movements, it’s necessary to take a multiple that is greater than three times the ATR. Also, for average purposes, it is common to take a 14-day average of the ATR.

An indicator that incorporates both the ATR multiple and a moving average are **Keltner Channels**. Keltner Channels incorporate an exponential moving average with volatility bands that are above and below the average. A common setting is a 20-period exponential moving average with 2 ATR volatility bands. However, remember that we’re looking for extremes.

For the purpose of this system, we’re using a 50-day exponential Keltner Channel with 4 ATR volatility bands. The ATR setting would be set to a simple average of the daily ATR.

2

Stochastics RSI

The Relative **Strength Index (RSI)** is a momentum indicator that takes into account the average gain and loss for a given look-back period. The root calculations for the RSI uses the following:

- ▶ Average Gain = Sum of gains over the past n periods / n
- ▶ Average Loss = sum of losses over the past n periods / n

If the price is experiencing more frequent and/or large moves up relative to the down periods, the indicator rises. If the stock is experiencing more frequent and/or large moves down relative to the up periods, the indicator will fall.

The RSI is also bound between 0 and 100, which makes it helpful for understanding overbought and oversold conditions.

The **Stochastics (STO)** indicator is a sentiment indicator that compares the closing price of a security to its range over a predetermined look-back period. If the price is closing in the upper end of its range for a given look-back period, the indicator will rise. If the price closes in the lower end of its range for a given look-back period, the indicator will fall. The STO is also range bound between 0 and 100.

The **Stochastics RSI (STO RSI)** incorporates both the RSI and Stochastics in a single indicator. Instead of using the price for the STO calculation, the STO RSI uses the RSI. Therefore, as the RSI closes in the upper end of its range, the STO RSI rises. If the RSI closes in the lower end of its range, it falls. Since the STO is bound between 0 and 100, it makes it possible to see when the RSI is reaching relative extremes on its own.

For this strategy, the RSI will be set to 10 periods. The STO will have a K-period value of 10, a D-period value of 3 and the slowing period set to 1. As part of this strategy, we're looking for values above 90 for bearish trades and below 10 for bullish trades.

3 Aroon Oscillator

Before you can interpret the Aroon Oscillator, you have to understand the underlying indicator.

The Aroon Indicator consists of two lines, the Aroon Up and the Aroon Down. The Aroon Up measures the number of days since the price has achieved a new high for a given look-back period. The Aroon Down measures the number of days since the price has achieved a new low for a given look-back period.

For example, a 5-day Aroon indicator looks back at the prior days, and if a new high has not been reached over the prior 5 periods, the indicator will be at 0. If in the prior 5 days, the price had a new high 4 days ago, the indicator will have a value of 25. If the price hits a 5-day high, the indicator will be at 100.

The opposite is the case for the Aroon Down. If the high price was 5 days ago, the indicator will be at 0. If the price just hit a new high for the 5-day period today, it will be at 100.

The Aroon Oscillator just subtracts the Aroon Up indicator from the Aroon Down indicator. As a result, a value of 100 means the the Aroon Up is 100 and the Aroon Down is 0, and value of -100 means that the Aroon Up is at 0 and the Aroon Down is at 100.

For this strategy, the Aroon Oscillator will be set to 5 periods and the relevant values are the extreme readings of 100 for bearish trades and -100 for bullish trades.



THE RUBBER BAND STRATEGY

The combination of the Keltner Channel, the Aroon Oscillator and the STO RSI is attempting to identify extreme movement with capitulation. The price trading above the Keltner tells you that the price is over 4 ATR above the 50-day moving average. But how did it get there?

The inclusion of the Aroon and the STO RSI looks for stronger movement into the peak. The more furious buyers are coming in, the greater fatigue occurs as the demand gets exhausted and the price falls back.

1 Bullish Signals

The following criteria must be met:

- ▶ The price must close below the 50-day, 4 ATR Keltner Channel
- ▶ The 5-period Aroon Oscillator must be at -100
- ▶ The 10-period STO RSI must have both lines below 10
- ▶ The Aroon and the STO RSI must reach their extremes on the same day.

In the image below, you'll see an example of this signal.



2

Bearish Signals

The following criteria must be met:

- ▶ The price must close above the 50-period, 4 ATR Keltner Channel
- ▶ The 5-period Aroon Oscillator must be at 100
- ▶ The 10-period STO RSI must have both lines below 10
- ▶ The Aroon and the STO RSI must reach their extremes on the same day.

In the image below, you'll see an example of this signal.



THE TRADE

When the signal is given, the trade will be executed using an option strategy called a short vertical.

Bearish signals would incorporate a short call vertical and bullish signals will incorporate a short put vertical. A vertical is an option strategy where either calls or puts are both bought and sold for the same expiration and different strike prices. Since the option being sold in a short vertical is closer to the stock price and more expensive, the vertical is sold for a credit.

1 *Strike and Expiration Selection*

The intent of this option strategy is to trade out-of-the-money (OTM) options. In order to balance how far to sell OTM and getting sufficient return to close early, we're going to sell the strike price that has between a 0.30 and 0.40 delta. The long strike will be 1 to 2 strikes further OTM. For the expiration, you'll want to sell about 20-50 days to expiration. This will give some time for the trade to come back if the price initially runs against you.

THE IMAGE BELOW IS AN EXAMPLE OF A SHORT CALL VERTICAL.

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price	Order	TIF	Exchange
VERTICAL	SELL	-1	SPY	27 MAY 20	295	CALL		.74	LMT	DAY	BEST
	BUY	+1	SPY	27 MAY 20	297	CALL		CREDIT			

THE IMAGE BELOW IS AN EXAMPLE OF A SHORT PUT VERTICAL.

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price	Order	TIF	Exchange
VERTICAL	SELL	-1	SPY	27 MAY 20	279	PUT		.63	LMT	DAY	BEST
	BUY	+1	SPY	27 MAY 20	277	PUT		CREDIT			

The use of delta provides an ability to consistently choose strike prices that have a similar probability of success. Since the delta is derived, in part, by the option implied volatility, the distance that you are selling from the price will vary from stock to stock. By selling a delta of 0.30, it indicates that there is a 70% probability of the spread expiring worthless and the trade reaching max gain by expiration.

When selling the vertical, try to make sure the credit has a 30% ROR minimum. The ROR is calculated by taking the max gain (the initial credit) divided by the max loss (spread between strikes minus the credit) times 100.

Look to close the trade early if you can buy the vertical back for 30% of the initial credit or less. For example, if the credit is \$1 per share, consider buying the vertical back if it is \$0.30 or less.

CONCLUSION

The foundational concept of the rubber band strategy is identifying points of capitulation or potential exhaustion on the part of buyers and sellers. By its nature, it's a contrarian strategy. The approach that you've just learned is relatively simple to apply, but it combines a higher probability technical strategy with a high probability option strategy. Bringing those two approaches together should help you to generate consistent option income.

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