Taking Advantage of Corrections in Gold with Options

By: Przemyslaw Radomski
Chief Investment Strategist
Sunshine Profits
Tools for Effective Gold & Silver Investments

This essay is a part of the Sunshine Profits Option Calculator knowledge base.

Did you know that at times options get cheaper even though they are more likely to bring profits?

Indeed, that's true... And making those profits yours is just a matter of buying the right option at the right time.

In this essay we will focus on buying call options when the market seems to have bottomed, and buying put options when the market approaches its top.

Taking into account the size of the 2008 decline in gold and silver , and the top around the $1000 level right before that, we will focus on what could have been achieved if one had bought put options around the top (as a side note, we did). We will use the 2008 top and pre-top action as an example for the whole technique. First, we'll tell you what we assume about the precious metals market , then we'll get to theory and practice behind options, and, finally we will show you how combining the above-mentioned can boost your profits.

The precious metals market can be very tricky at times, to say the least. We've seen many cases when gold and silver were stuck in a trading range for a couple of months. We've seen situations when both precious metals surged for a couple of months and ended uplegs with a spike top (the one that is shaped like a "spike" – with very sharp upswing preceding it, and a very sharp downswing right after the top is reached). Finally, we've witnessed situations when gold stopped rising despite the US Dollar's fall, and there were also times when gold stocks did not make new highs while gold did.

Let's say (theoretically - just for the sake of this essay, as the fundamental situation is way more complicated) that the main factor that determines the price of gold is the value of the US Dollar Index. Gold is priced in the USD and, therefore, responds to its up- or downswings, by moving in the opposite direction. Obviously this is an oversimplification since at times gold moves along with the USD Index, and this technique can be reliably applied only when gold and USD are negatively correlated (move in the opposite direction on average).

Generally, the logic between negative correlation and USD Index is this - if the value of gold was perceived as constant by the investors from all over the world and the value of the currency in which it is priced, falls, then in order for the price of gold in their respective national currencies to be stable, it has to rise in terms of US Dollars. If the price of gold did not rise as the US Dollar falls, then foreign investors would see price of gold fall in their national currencies. Unless foreign investors changed their mind about the value of gold, they would start buying gold, as it now is cheaper for them than it was when they thought the price reflected gold's value. As they would begin to purchase, the price of gold in all currencies would go up (including USD). For people who make transaction in the US Dollar it would seem as if the price of gold as just went up out of the blue, when in fact it would be their Dollars that lost value, while gold's 'real' price was not affected.

As we stated earlier, there's more to this correlation between USD and price of precious metals but it's enough to make a few key points in this essay. As indicated earlier, there are times when gold stops rallying when dollar keeps falling. How could this be possible, especially, taking into account the mechanism from the last paragraph? Ultimately (at least in most cases), price is settled at the market when people willing to buy from people who want to sell. Please note the words 'willing' and 'want'. There could be powerful fundamentals behind one side of the market, but at times people just don't act according to fundamentals. The reality is more complex than logic, data and mathematical transformations can express. The decision making process always involves emotions whether we like it or not. People make rational decisions in the long run, but we focus on the temporary situations where market participants are blinded by emotions and fail to recognize gold or silver's true value.

In case you read our other report about juniors, you might recall our spring theory. If not, here's a quick reminder:

This sector [juniors] may be metaphorically compared to a collapsed tightly coiled spring. The fundamentals are one end of the spring. The other end represents emotions. As the fundamentals (for following analysis we will assume that the main fundamental factor is the price of gold) improve, the spring gets more and more collapsed, unless the emotions follow the price of gold. That is mostly - but not always - the case. If the emotions are in tune with the price of gold, the spring does not shrink and in fact does not seem to matter much. However if - for any reason - fear prevails despite improving fundamentals, the spring gets really tight, ready to uncoil. Unless the fundamentals deteriorate, once the fear is removed, we would expect juniors to go ballistic in no time! The longer and the harder this spring tightens the bigger the move that will follow.

A situation in which gold stops rising as the USD keeps falling is somewhat similar to the case from the article about juniors that we've just quoted, only this time one end is represented by gold's fundamentals (here – USD Index), while the other end is the overall market perception towards gold and its willingness to respond with action to fundamentals. As the USD Index plummets, the spring gets pushed from one side, and as long as investors are able and willing to instantly adjust to new fundamentals, the other part of the spring will keep moving at the same pace. Now, the situation gets interesting as all those who were interested in the market at that given time frame are already very close to being 100% invested. If everyone is already in, then who's left to buy to make the price go even higher? The general public, of course. Yet, they too run out of the money. Naturally, there are people who are buying, but some of those who were already in the market sense something weird is going on and they start to sell. The spring uncoils pushing gold prices down. Price goes lower, more people sell and so on and so forth. Another top has materialized. What exactly happened before that? USD Index was falling but gold did not rise anymore. Just as if the foreign investors got fed up with gold and changed their mind about it's worth. Perhaps they have. The fundamentals

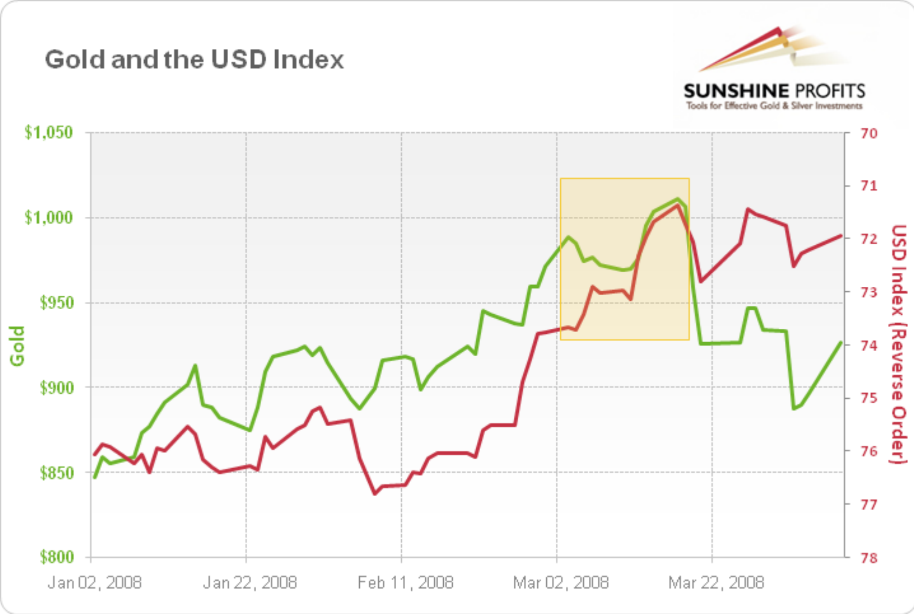

Chart 1: Gold stops reacting to dollar's weakness

ceased to influence the market, as emotions (fear and doubt) replaced them.

The chart below proves that this analysis really has practical implications. This mechanism worked even better during the May 2006 top, but we decided to show you the price action before most profound of the declines (*Chart 1*).

Don't be confused by rising USD Index – we have reversed the order on its axis, so that you can better see how gold's reaction toward changes of the USD decreased. The marked rectangle allows you to see just how much influence dollar's final fall had on the yellow metal. Please note that these are closing prices. The increase in the price of gold from March 3-rd to March 17-th did not respond to dollar's fall during the same time frame with the same magnitude. This is clearly visible on the chart above. If you had a ratio of Gold to the Anti-Dollar index (shaped like USD Index in reverse order), it would surely confirm that this rally is nearing its end. We have created such a ratio and you can see it on the chart (*Chart 2*) below.

The assumption from the last paragraph is correct. You can see that contrary to all previous tops in gold, the top preceding the sell-off did not manage to achieve a high higher than the top before it. Observing a situation like this should make you suspicious of this new top. Add to it the media hype when the gold price breached $1000, and you get high probability that the smart money will sell gold to the general public, which entered the market after they saw gold 'in the news'. After that is completed, the price will very likely to plunge. In our view that is exactly what happened.

Why does it work? It's always a tough call in any tool related to mass psychology, especially, when it comes to investment. We think that by 'dividing an asset by its main fundamental factor' we might get quite good representation of the emotional status of that particular market's participants. This is a very rough estimation, as the dollar is not the only factor behind the price of gold, nor do we have a very large sample to test this analysis (taking into account the second stage of this bull market only). However, it was never supposed to be one and only super-indicator, but rather another tool that we might use to better understand market's behavior and profit from it.

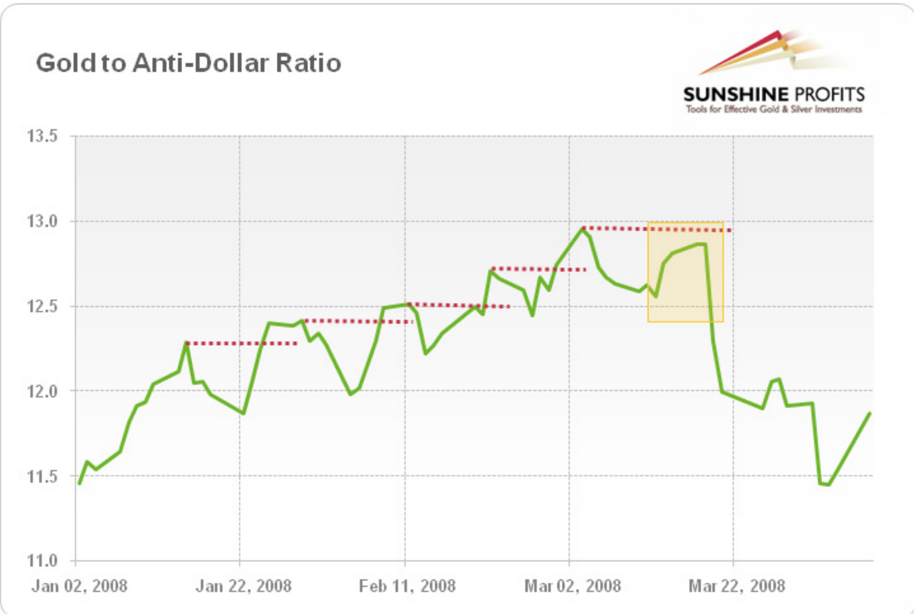

Chart 2: Ratio fails to move above previous highs

The point here is that unlike each investor's unique emotional status, we can directly see on the charts when gold's price stops rising despite the dollar's fall! Knowing what psychological mechanism takes place behind this particular price action in the USD Index and gold, we are able to infer that there is higher probability of a sell-off than before. This works both ways. When gold, after declining for some time, stops reacting to dollar's rally, it indicates that this move is overdone. Obviously, it is not certain that the top will immediately follow, but the **probability of this happening is considerably higher**.

What is even more interesting is that the same type of analysis can be applied to gold and silver stocks . This time we will narrow the reasoning behind the swings in the price of particular precious metals stocks to the metals themselves. Of course this makes sense only for stocks that have a high exposure to the price of gold or silver (for details see the Golden StockPicker and Silver StockPicker tools on www.SunshineProfits.com). When precious metals stocks stop declining despite the falling price of respective metals and seem to bounce each time you would expect them to fall hard, you may expect that this sell-off's days are numbered. Again, this works both ways – if stocks simply refuse to achieve new highs, as gold rises, it is a strong indication that stocks are ready for a correction. Still – it is not obvious or certain that it will happen, but the probability is higher.

The really powerful combination is when gold stocks stop reacting to gold rise , and gold starts to ignore dollar's fall. Combining these two springs gives you a strong suggestion that this rally is over and one should prepare for the sharp sell-off. How can one do it? Most popular strategy would be selling all or part of your holdings and waiting for prices to fall a certain amount of percent, reaching a particular moving average etc. Here, we would like to present you another possibility and give particular arguments for it, but before we do, we will tell you more about options. Those of you, who are familiar with and use options, may skip the next few paragraphs.

Basically, an option is a derivative that can be used either to hedge one position's, or to speculate on the outcome of a particular situation in the underlying equity, magnifying gains that can be achieved through purchasing or selling a particular security short. Each of the above can be made by either writing an option or by buying it. There are put options, whose value increases along with falling prices of the underlying security, and call options, which gain value along with the underlying security.

Not always the same move in the underlying equity means the same gain on the options as there are more factors influencing the price of a particular option than just the price of the security. Other factors (according to the Black – Scholes Options Pricing Model) include the strike price, time left to option's expiration date, the risk-free interest rate and the volatility. For the purpose of this essay we will focus on the influence that the volatility has on the price of a particular option.

All other things being equal, option's value tends to rise along with the volatility and decline when volatility is decreasing. There is a special coefficient called Vega (sometimes being referred to as Kappa or Tau), which tells you how much (in dollar terms) will the price of a given option rise,

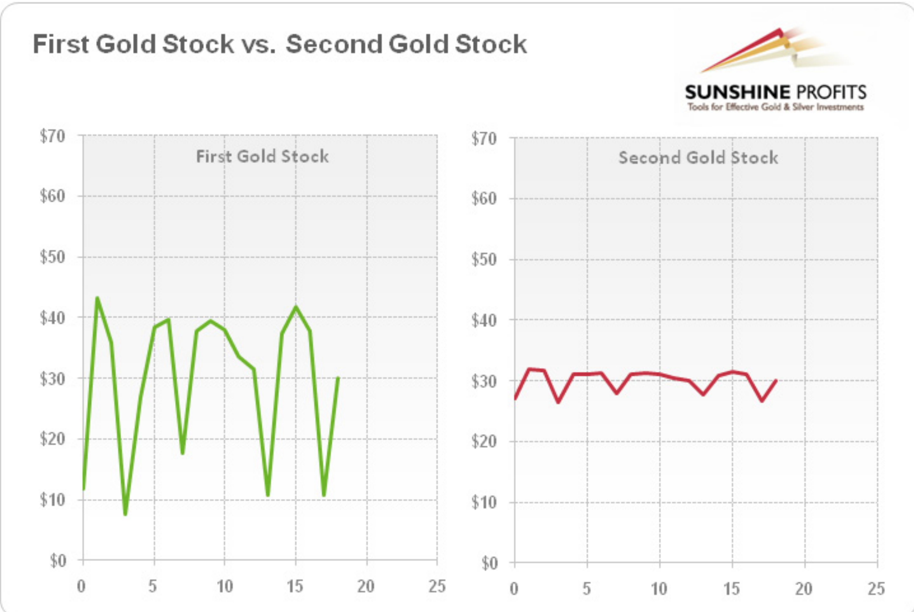

Chart 3: Stocks with different volatility - example

when the implied volatility of the underlying security rises by one percentage point, and nothing else (interest rate, time, price of the underlying security) changes. Although this might seem to be rather complicated, you can see on the chart (*Chart 3*) above that it is really intuitive.
The last price for both stocks is $30, and this is also the average value of each of the stocks in the analyzed time frame.

Which stock is **more likely** to surpass the thick, black line at $35? Of course, the First Gold Stock. Since its daily trading range is so wide, it would be surprising not to see this stock occasionally getting past the line. The Second Gold Stock, on the other hand, would most likely need to rise consequently for a few days, before it would have chance to get beyond marked level. As you see, the probability for the stock price to go above certain level is higher if the stock is more volatile. Now imagine that this line represents the strike price of a particular option. Not taking into account the time value (at the day when the particular option expires), the call option's value is the difference between the current price of the underlying security and the strike price. If the chance for the underlying security to go past the strike price is higher for the First Gold Stock than for the Second Gold Stock, all other things being equal, than the options on the First Gold Stock should be worth more than options on the Second Gold Stock.

To sum up, **options on stocks that are less volatile are cheaper than those on more volatile stocks** . If a particular company's shares become suddenly more volatile, then options on this company will become more expensive. And, if these shares calm down and trade in a close range, then the value of options will decrease (all other things being equal).

Now we're ready to get back to the previous part of this essay, in which we dealt with precious metals' tendency to minimize its natural reaction towards fundamental factors at the end of rallies or sell-offs. We ended this part with statement that when gold stocks or gold stabilize despite improvement in the fundamental situation (here: gold and USD Index respectively), then the chances that the trend reverses, at least temporarily, are rising. Now put this into different perspective – what will happen to options on these gold stocks or gold itself, as the price stabilizes, meaning that the volatility decreases?

From a quantitative point of view, as the volatility declines, the chances of a decline or of further rise will be lower, so the options on precious metals and their stocks will be priced lower. That is precisely contrary to what the previous, psychological analysis would tell us. Surprised? Remember – as we stated earlier – the reality is more complex than pure mathematical transformations. **Being able to recognize technical patterns that are influenced by psychological mechanisms gives you an advantage over the vast majority of market participants**.

How can you use this information? If you spot a situation like this in the future (which is relatively common in the precious metals market), you can either short the market with a small part of your capital, or use it to hedge your positions. You can also sell part and hedge the rest, or use any combination of the above, depending on your risk preferences and the time you have to manage your portfolio. Either way you use this strategy, combining the advantage that the technical (here: psychological) analysis gives you with understanding how options work, gives you the ability to massively increase your holdings or substantially decrease losses.

In our view, **hedging your portfolio in this way is superior to simply selling your holdings**, since it gives you the opportunity to gain additional profits thanks to the increase in options' value after dramatic (volatility rises) sell-offs. This means risk reduction if you decide to put less capital into this strategy, as less money is needed to give you the protection similar to the one you would get without 'the bet on volatility'. The fact that options have time value can be seen as an advantage (yes!) here. It's counterintuitive, as the time-decay causes options to lose value, but we really think that it may prove profitable for some investors. The reality is that when people get out of the market, they sometimes fail to get back in at lower prices, as they start feeling the same emotions as other market participants. The prevailing emotion after a sell-off is fear, which prevents people from reinvesting in the shares they have just sold. After shares start to rally, people wait for a pullback, which either comes or doesn't come and even if it does, it doesn't seem to be deep enough to make them purchase their favorite PM stocks. Finally people often get back into the market at prices higher than those at which they sold their shares in the first place. Since options have a 'time limit', it means that you will get back your exposure to rising gold and silver prices sooner rather than later. Although this theory is questionable, we view this feature of put options as highly practical.

Those of you, who believe that ultimately paper gold or paper silver (meaning anything else than physical bars or coins in your own possession) will become worthless or at least trade at a discount to the real, tangible gold and silver, might be interested in this form of temporary decreasing your exposure to metals. After all, you would keep your gold and silver in the physical form, safe and sound, ready to protect you in case of any financial disorder. In case there is no dramatic change in the financial system, and metals simply plunge temporarily, as was the case in the past, you would be able to minimize or even prevent losses. From a different perspective, you would temporarily minimize your exposure to particular metal by being long the physical form of the metal and being short its 'paper' form. This might appeal to you as it corresponds to the assumption made in the first sentence of this paragraph.

Usually you can use short-term options , as sell-offs in the precious metals market are generally rapid. For most cases you should be fine with options, which expire at least one or two months after your initial forecast when the low might take place – e.g. options that expire three months from the moment you decide the top is almost in. Please note that the less time these options have until expiration, the more profitable this transaction might be. This means that you can use less capital for hedging your positions.

Summing up, thanks to options you can at times seriously profit from corrections in gold; and by combining knowledge of option pricing mechanisms with the analysis of psychological mechanisms on the gold market seen right before a top, you can achieve even bigger gains!

Which options should you exactly use? What strike price is optimal? How much would an option cost be, given a particular stock/ETF price? You'll find the Option Calculator and the Pyramid Optimizer helpful in answering these questions precisely and quickly.

For more information on using the Pyramid Optimizer, view the tutorial.

For more information on using the Option Calculator, watch the video tutorial.

Open the Option Calculator, and start profiting more from corrections in gold right now!

SUNSHINE PROFITS
Tools for Effective Gold & Silver investments

Sunshine Profits
228 Park Avenue South
New York, NY 10003

Phone: 1-347-602-4349
Fax: 1-347-602-4560

www.sunshineprofits.com