Dispelling the 'Bin Laden' Options Trades

By Global Research
Theme: Global Economy, Terrorism
Global Research, August 31, 2007
thestreet.com 31 August 2007

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Staff Reporters
8/30/2007 3:23 PM EDT
URL: http://www.thestreet.com/newsanalysis/optionsfutures/10377063.html

Updated from 7:07 a.m. As if the mortgage-market meltdown wasn't enough to spook investors, some market players expressed concerns about unusual options bets that some observers have dubbed "Bin Laden Trades." The blogosphere and options trading desks have been rife with speculation about these trades, which are unusually large bets that the market will make a huge move in the next month.

Some entity, or entities, has taken a large position on *extremely* deep in the money **S&P 500** options, both puts and calls, that won't pay off unless the market undergoes an extremely large price move between now and the options' expiration on Sept. 21. However, Dan Perper, a Partner at Peak 6, one of the largest option market makers and proprietary trading firms, has confirmed that the trades are part of a "box-spread trade." "This was done as a package in which the box spread was used [as a] means of alternative financing at more attractive interest rates" explained Perper.

Simply put, two parties agree to trade the box at a price that essentially splits the difference between current rates. For example, the rough numbers would be that given the September 700/1700 box must settle at a value of 1,000 — it is currently trading around 997 — that translates into a 5% interest rate. For the seller it is a way to borrow money at a slight discount to the prevailing rate, and for the buyer, it is a way to lend money at a low rate of return, but it's better than nothing at a time when others are scared and have painted themselves into a box (ha ha) because they have run out available funds. Currently there are about 63,000 700/1700 boxes open.

Perper expects that once the September options expire, you will see similar boxes established in the December series. As to why the September 700 put has over 116,000 contracts open, Perper thinks a good portion of that was created from the prior rollover when April options expired. The positions in question had option industry experts perplexed to come up with a rational explanation, which are far from the best or most efficient way to profit from what would be outlier events.

Those concerned about the worst-case scenario recalled that large put contracts were placed on airline stocks, notably American, a unit of **AMR** and **United Airlines**, in the weeks leading up to the Sept. 11, 2001 terror attacks. The first area of focus was that open interest September 700 S&P puts had such an unusually high number for such a lowprobability trade. A put is a defensive bet that gives the holder the right to sell a security at a specified price, in this case more than 50% below the S&P 500's current level of 1463 as of Wednesday's close.

For comparison's sake, according to the Option Clearing Corp., the open interest in the July 700 strike some three weeks prior to expiration on July 20 was 790 calls and 7,300 puts, and the August 700 strike showed 1,250 calls and 14,800 puts prior to Aug. 17 expiration. And the volume completely outstrips anything seen last September, when the S&P was around 1300, some 20% below current levels. In September 2006, the 700 strike had 600 calls and 7,500 puts, and no strike below 1000 had open interest surpassing 42,000 contracts, and that was the 900 puts. The bulk of the September SPX trades in question have been put on since June 1.

Similar bets have also been placed on the DJ Eurostoxx 50 index, which won't pay off unless the index tumbles nearly 25% to 2800, or below, by expiration on the third Friday of September. The trades were noted in various online forums, where the worst case scenario is often the first conclusion: "Only an act of terrorism akin to 9-11 — within the next four weeks — could make these options valuable," writes one poster in the TickerForum chat room.

Others, such as the "Just Wondrin What Happened" blog, speculated that "China, reeling over losing $10 billion in bad loans to the sub-prime mortgage collapse presently taking place, is going to dump U.S. currency and tank all of Capitalism with a Communist financial revolution."

Furthermore, the TickerForum posters focused on the 65,000 contracts open on SPX 700 calls, ostensibly bullish bets that give the holder the right to buy the index at that level. Given the fact that these calls are some 700 points in-the-money, and therefore have a delta of 1.0 — meaning the options price moves dollar-for-dollar with the underlying index — "the only advantage to owning them is it would be a more efficient and slightly less capital-intensive way to gain one-to-one exposure" to the S&P 500, Randy Frederick, director of derivatives at Charles Schwab, writes in an email exchange. Frederick noted the **Spyder Trust** (SPY) and other index and exchange-traded products provide a much more liquid, efficient and higher-leveraged way to establish a bearish position quickly.

Plus, it's a lot easier to "hide" a big trade in the Spyders than the SPX options, which are only traded on the Chicago Board of Option Exchange and will be seen and facilitated by a tight-knit group of market makers. Because there are about half the number of open contracts on S&P 700 calls vs. puts, it was also posited that these trades are part of a large strangle. There is also open interest of 61,741 on the September 1700 puts. "Since this is only 11 contracts different from the 700 calls, it is possible that these two positions are making up a very large strangle, which could be either a breakout or neutral strategy depending upon whether or not it is a short strangle or a long strangle," writes Frederick. "If this is a short position, it may be anticipating the market will drop if the **Fed** does not cut rates as many expect" at its Sept. 18 policy meeting. But such a strangle trade, with each leg being so deep in the money, would require a nearly 50% price move, up or down, to turn a profit. Frederick said the position leaves him more confused than scared, although he wouldn't dismiss the frightening conclusion bloggers have come to. "It is also interesting that the anniversary of 9/11 occurs between now and the expiration of these options," he writes.

“Perhaps there is speculation that another attack is in the works.” Brian Overby, director of education at TradeKing, a discount broker that caters to sophisticated option traders, suggested that this could be a box trade before Perper came forth. Overby noted that the September 1700 strike has open interest of 73,745 calls and 61,741 put options. “This could be someone trying to create a box spread, which is a position composed of a long call and short put at one strike, and a short call and long put at a different strike. The position is largely immune to changes in the price of the underlying stock, and in most cases, is a simple interest rate trade.” So the upshot is there is an explanation for this very unusual configuration of open interest in the S&P 500 Index’s September options, but it also shows jitters remain in this market.

Steven Smith writes regularly for TheStreet.com. In keeping with TSC’s editorial policy, he doesn’t own or short individual stocks. He also doesn’t invest in hedge funds or other private investment partnerships. He was a seatholding member of the Chicago Board of Trade (CBOT) and the Chicago Board Options Exchange (CBOE) from May 1989 to August 1995. During that six-year period, he traded multiple markets for his own personal account and acted as an executing broker for third-party accounts. He appreciates your feedback; click here to send him an email.To read more of Steve Smith’s options ideas take a free trial to TheStreet.com Options Alerts.

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