THE TRADE:

We buy 15 AMTD Feb 35 calls for $2.30

we sell 30 AMTD Feb 40 calls at $.95

we buy 15 AMTD Feb 45 calls for $.35

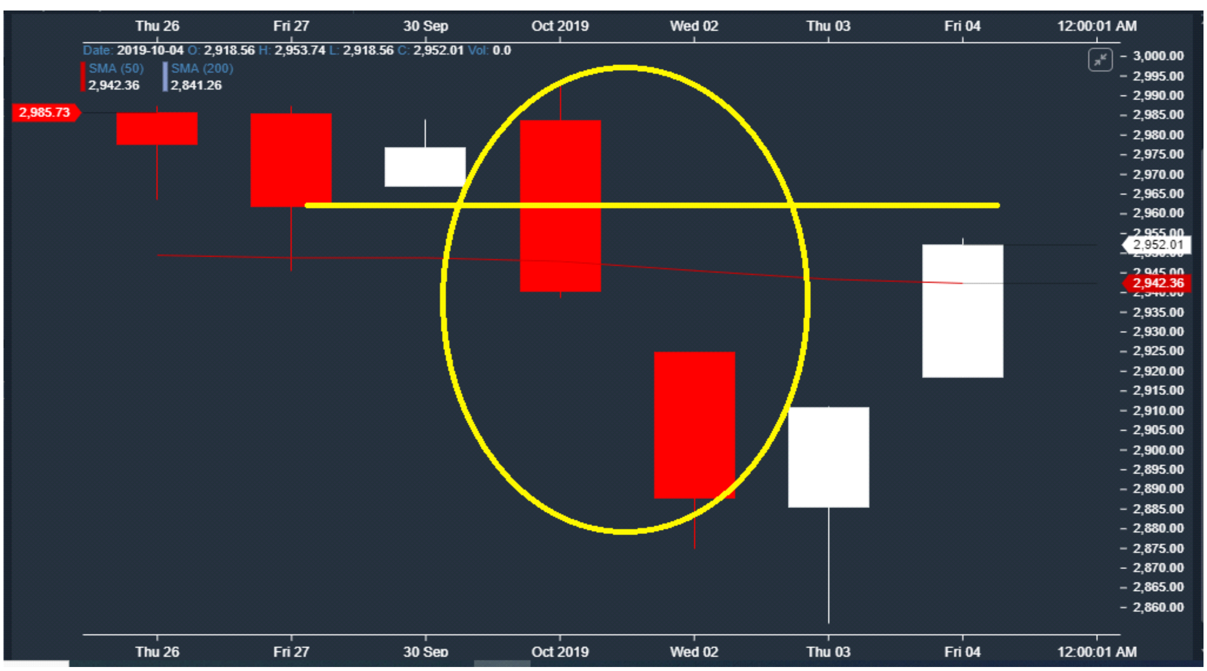
NET WE BUY THE AMTD FEB 35-40-45 call butterfly for $.75

Why Online Brokerage? Aren't they giving up a LOT of Money?

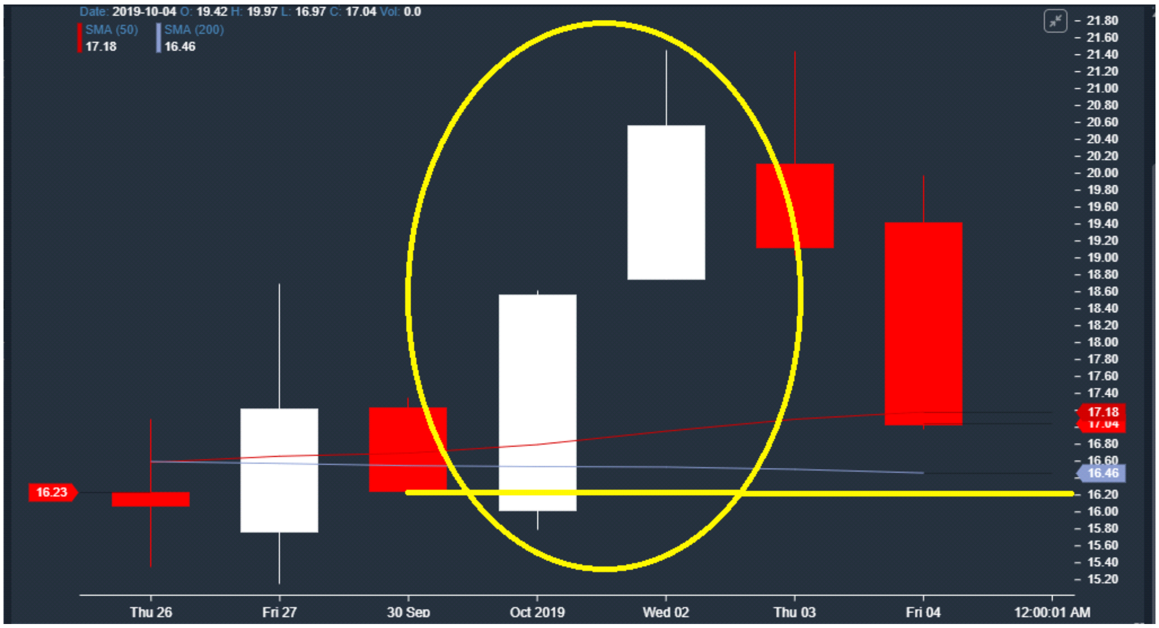
Many average retail traders were surprised when Charles Schwab announced that they would no longer charge commission on many investments; notably dropping all commissions on stock orders and ticket charges on options. TD Ameritrade followed suit and E-Trade quickly followed. The market has taken these changes as a drastic downgrade to long term earnings potential. But is it? I will explore later on in this week's letter. Before that let's start with overall market.

Overall Market: It's the Economy Stupid...

Or so it seemed. The market got a NASTY ISM number last Tuesday followed by an ugly ADP Private payroll number. In two days, the S&P 500 dropped 100 points and the VIX exploded back over 20. On Thursday morning, we saw ANOTHER bad number: the ISM services missed. Initially markets dropped, then they rebounded in a HURRY. There was follow through on a lukewarm non-farm payroll number. Essentially, after a huge economic scare on Tuesday-Wednesday, the S&P 500 gave up a whopping 10 points. A lot of movement, for very little movement in the end:

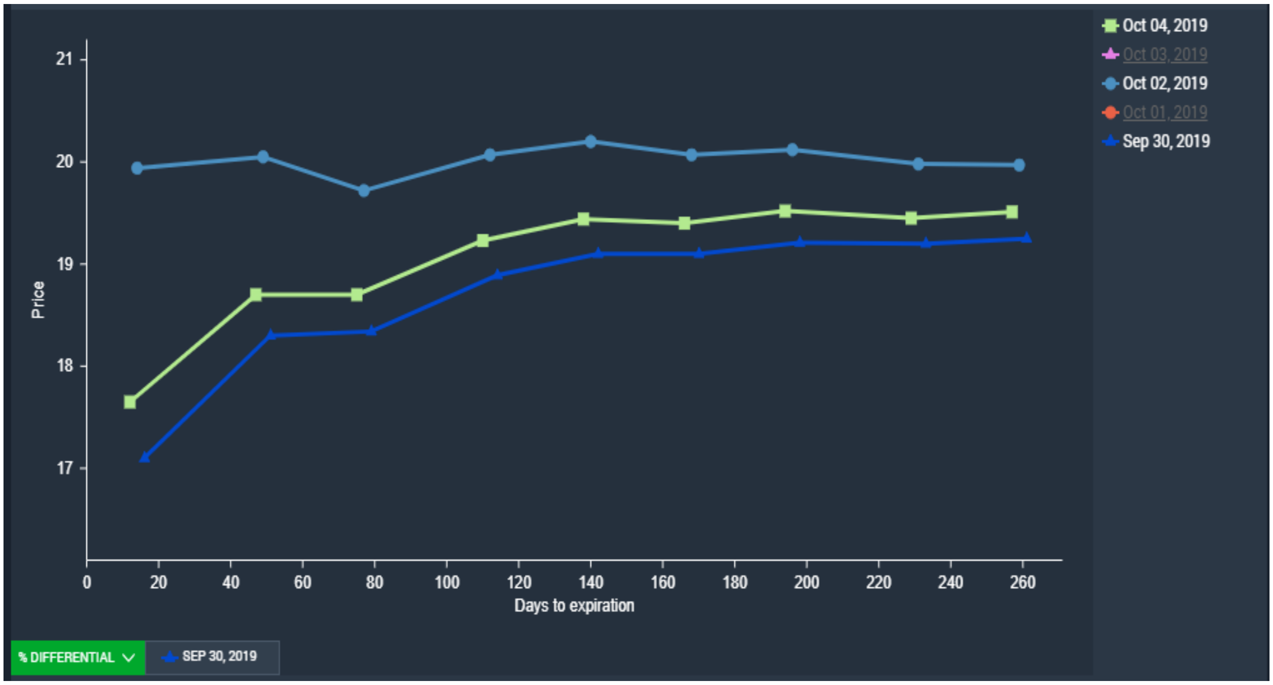


Notice the giant candles above. Then notice how LITTLE space there actually is between the close on Friday the 27th and Friday the 4th. It is literally 10 points. That being said, we DID see a slightly more aggressive move from VIX relative to the SPX. If I told you that the SPX dropped 10 points in a week you would probably think the VIX was flat or even down. But given the realized volatility from day to day, the VIX went from about 16.25 to over 17.00. The peak of about 21.5 coming from 16, was about expected given a 100-point drop in 2 days; nothing shocking there. This is why when looking at VIX, one can't look at long term week to week trends. It's the nitty gritty that drives things.



Basically, VIX did as we would expect given the SPX movement from day to day. NOT what the average person would think on a week to week basis. In fact, given the daily movement, one could argue that VIX may be sold off TOO MUCH.

VIX futures fared no better than VIX itself: FLYING from a contango, to backwardation, to a contango in a 4-day period. VIX futures curve volatility, which I would LOVE to see a study on, is CLEARLY higher than it was 5 years ago before the run up in XIV and subsequent collapse. Take a look at the change at the close on the 30th of Sep, Oct 2nd, and the close on Oct 4th. The 30th and 4th make a vol pop sandwich with the 2nd as the meat (the dark blue is the 30th, the green the 4th).



Looking ahead to this week, China is on the table with talks set to resume on the 10th. Expectations are high for at least a partial deal, with more dealing set to be done long term. We think that the VIX will be stable this week, with potential to collapse next week, if there is some partial resolution, even if it's not a long-term plan.

Option Pit Market Lighting Pattern

(reminder Green means bullish, Yellow means neutral, red menas bearish)

SPX Direction: Yellow

SPX IV Direction: Yellow

VIX Direction: Yellow

VIX IV Direction: Red

ONLINE BROKERS

Now that you know exactly what to do with the S&P 500 and the VIX, one can go to their online broker and trade....for about NOTHING... How is the broker going to turn a profit??

This is a laughable question. As I said on BNN Bloomberg this week, watch those service agreements, they are probably going to change. Brokers are now going to make money in a different way: DATA. If you pay nothing, you are going to, likely, agree to give up your data. Payment for order flow, which is how brokers actually make money (selling your paper to market makers like Citadel) is going to get even more expensive for market makers to buy.

Why? Because it's going to get better and easier to identify the type of paper.

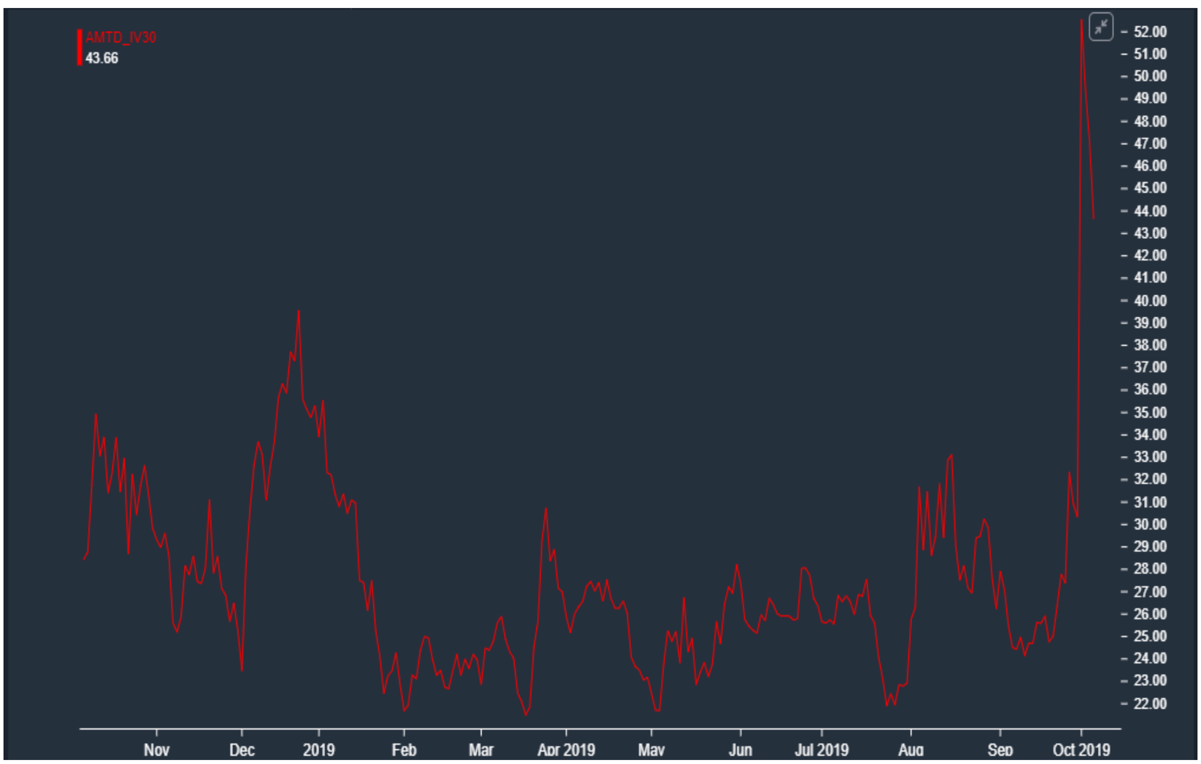
Why? Because brokers will be able to drill down the data on an account to the point where about the only thing they are NOT giving away is your exact personal info, account number, and your ACTUAL trades. Everything else will be sold to the highest bidder, potentially on a per account basis (actually for practicality, more likely broken up into customer profile tranches based on volume and type of behavior).

The point of this is that in the near term, yes, the online brokers took a hit. Long term, until the SEC steps up to the plate on the dubious activity of selling order flow, the brokers are inline to make more money. Basically, it took a Robin Hood to force brokers to do what was best for them anyway. The big brokers going commission free is worse for the startup brokers than it is anyone else, and net a huge plus for SCHW, AMTD, and ETFC.

Of these names, I want to concentrate on AMTD. They have the most active and engaged customers. Their customers on average trade more options, stock, and everything else than the other online brokers. AMTD lost about 25% of its value, in a day, when SCHW made the announcement; the most of any of the brokers on this news. Considering I think this is a long-term WIN for AMTD, buying this stock makes a LOT of sense to me right now. Thus, I am going to construct a bullish trade using options in AMTD for my idea this week.

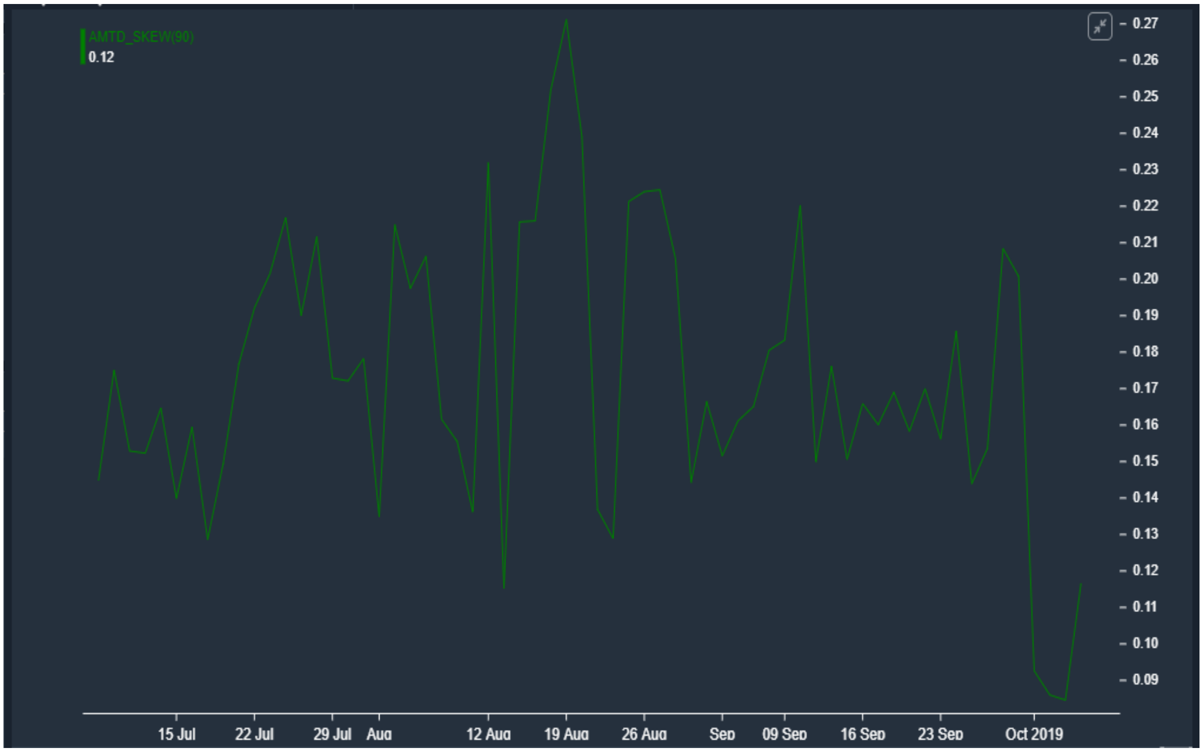
Conditions:

Let's start with the IV of AMTD options. As you can see, AMTD IV is historically through the roof!

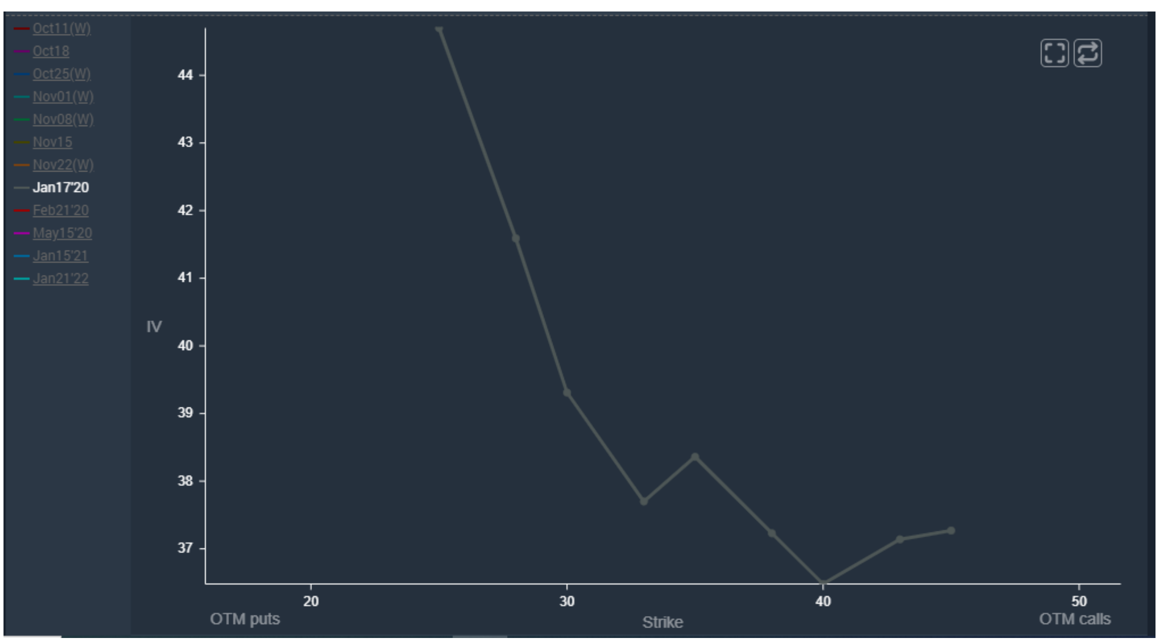


We think this IV is a SALE. For those new to trading, or in love with selling puts, we really like selling puts in AMTD here and see that as an interesting trade idea. The premium collect is nice at 30, 60, all the way out to 180 days to expiration.

However, we see massive upside, so we do want to find a way to buy calls. Unfortunately, skew is pretty flat:



Thus, puts are not that much more expensive than calls. In fact, WAY OTM calls are expensive. Take a look at the skew curve in January for AMTD. Its impressively flat, with an upslope in both way OTM calls and puts.



If I am looking to get bullish long and be short vega, to me, the best trade is a bullish butterfly where I get to sell options above the 40-dollar strike. Because I want more short vega, more time and more space between strikes, I am going to push my trade back as far as I possibly can, while still getting a JUICY premium for selling OTM stuff. This takes me to Feb which has a similar structure to Jan options, maybe even more favorably. We would be a buyer of the AMTD Feb 35-40-45 call fly at a cost of about $.75. THIS IS EXTREMELY cheap mostly because Feb 40 calls are so overvalued. Between now and Feb we see AMTD moving from 33 back to 40, a 20% gain. Once it gets there, we can make a decision on what to do with the stock. This is a slow burning trade, but we see real upside here. And at a cost of just $.75, with a theoretical portfolio of $20k, we can buy A LOT of this fly. We would be buyers of 15 of these flies, which has a cost basis of about $1200.00.

We buy 15 AMTD Feb 35 calls for $2.30, we sell 30 AMTD Feb 40 calls at $.95, we buy 15 AMTD Feb 45 calls for $.35

See risk chart:

Gap	0.0%			2.0%			4.0%		
Vol shock	-30%	-	+30%	-30%	-	+30%	-30%	-	+30%
Underlying	33.51	33.51	33.51	34.18	34.18	34.18	34.85	34.85	34.85
Delta	241	124	69	241	117	63	233	108	58
Gamma	4	-9	-8	-6	-12	-8	-15	-14	-9
Theta	0	2	2	1	2	3	2	3	3
Vega	6	-13	-14	-4	-17	-16	-15	-22	-18
P&L	39	0	-133	205	84	-87	369	162	-45

Risk Management

This trade has two things on its side: time and cost. Our goal is to make at least 25% on this trade. Thus, we will begin selling SOME of the flies back to the market above $1.00. If the butterfly falls below

$.50, we will also make an adjustment. If the stock makes an aggressive move higher, we will close the butterfly and look to set up a new bullish trade.

Have a great week.

Mark Sebastian