As I’ve stated in the past, I have adopted Bollinger Bands for use in analyzing stocks and in making decisions about selling calls and puts on the stocks I study. So, what are Bollinger Bands and why should you be motivated to also use them? Hopefully, the following explanation and examples will enable you to understand why you should consider employing Bollinger Bands too.

John Bollinger, a financial analyst and writer, created Bollinger Bands about 25 years ago. He is the author of *Bollinger on Bollinger Bands*, a book that explains his informative indicator (actually an oscillator). Even better, since it was available at a much lower cost, is the 8.5 x 11 pamphlet *Understanding Bollinger Bands* by Edward Dobson. Unfortunately, this pamphlet is out of print. Fortunately, there is a lot of information on Bollinger Bands available on the Internet if you’re interested in pursuing this topic. If so, you can start with the explanation and examples found in the free Chart School at the StockCharts site or at the many web sites that offer technical analysis education.

Following their introduction, Bollinger Bands quickly became a frequently used tool and favorite of technical analysts. This is quite a tribute to John Bollinger’s indicator, especially when you consider that Bollinger Bands, according to their creator, give no buy or sell signals themselves. Instead, he and other writers in the field teach that Bollinger Bands should only be used in conjunction with another indicator to confirm what the bands are indicating. Bollinger suggests the use of RSI or MACD for this purpose. Many technical analysts use stochastics. I favor RSI. However, if you adopt Bollinger Bands, you should experiment with these and other indicators you like to find one you that best match your preferences.

The use of bands or envelopes positioned around a price chart was not a new approach when Bollinger Bands were first created. J. M. Hurst, in *The Profit Magic of Stock Transaction Timing*, had described the use of smoothed envelopes around price to identify cyclical movements. Marc Chaiken (of Chaiken’s Money Flow indicator fame) then created, described and used bands constructed to contain a fixed percentage of data from the preceding year. Chaiken stuck with Hurst’s 21-day SMA and thought that capturing 85% of the prior data would be effective.

Building on what Hurst and Chaiken had taught and developed, Bollinger studied the use of bands or envelopes for analytical purposes, deciding to focus on the effects of volatility on future price movement. His approach employs two bands that show the likelihood of short to intermediate term price movements by a security based on its volatility over a predefined look back period.

More specifically, Bollinger Bands are plotted with one band two standard deviations above and a second band two standard deviations below a 20-day simple moving average. Bollinger believes the 20-day SMA is most descriptive of an intermediate trading trend that is suitable and effective for trading options. These are the default parameters used for Bollinger Bands in StockCharts and all other charting sites that I am aware of.

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Note that a 20-day SMA approximates one month, the length of option trades we favor. I have found that a 20 day SMA also works fairly well for those situations where you want to sell options in the middle of a trading period and decide to go out in time for 40 to even 60 days before expiration rather than wait for a new option period to begin. Remember that the extra two or so weeks can mean more premium if you act sooner. It also means you will usually have a longer holding period and therefore more risk. I’ll take the larger premium <g>.

The upper band represents overbought territory when price touches it, while touching the lower band indicates a security is likely oversold. Keep in mind that a stock can stay overbought or oversold for long periods of time, certainly greater than a one month or longer option and this factor needs to be considered in option trading. The use of plus or minus two standard deviation bands captures 95% of possible data between the bands. Other Bollinger Band parameters are used for different look back periods, shorter or longer term trading windows. According to Bollinger, his bands “can be applied to virtually any market or security.”

Most of what you read about using Bollinger Bands to trade is directed to trading various items including stocks or options. I remember two trader pals who used Bollinger Bands to help them trade commodities and currencies. I have read that Bollinger Bands are used on an intra-day basis. I have difficulty imagining the use by day traders of a 20 minute moving average for Bollinger Bands, but I believe they wouldn’t use Bollinger Bands for that short a period unless such bands were of value. A helpful description of stock trading using Bollinger Bands can be found in the Investopedia article at <http://www.investopedia.com/articles/trading/07/bollinger.asp>.

Remember the advice in the Investopedia article to use stop orders as a safety net if you decide to adopt a Bollinger Bands based trading strategy. Don’t treat this advice on the use of stop orders as a mere suggestion. It is much more like a command. I have employed Bollinger Bands for trading stocks and I still do, but always with a stop order at the ready.

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Here are some important characteristics of Bollinger Bands to focus on. The width of the bands varies as a function of volatility. The wider the bands, the greater the volatility at that time. The narrower the bands, the lower the volatility at that time. Just based on this paragraph alone, at what point would you want to be selling options? When the bands are wide or narrow? The answer to these questions should also tell you why Bollinger Bands are useful with respect to option trading.

Charts, especially longer term charts, illustrate that even a moderately volatile stock doesn't remain in a narrow trading range for long, as effectively depicted by Bollinger Bands. Thus, when Bollinger Bands start narrowing around a stock, we look for a price change, usually of a significant nature, in the near future. History has taught us this, but unfortunately history has been remiss in one critical respect; we don’t know what direction the price change will take.

As you will note from charts that include Bollinger Bands, a stock will tend to hug its expanding upper or lower band as volatility increases and fall away from the band as volatility levels off or falls. The initial move off a band may only be back toward the 20 day SMA or eventually to the opposite band, but the move off the band is usually a signal that the trend has slowed or perhaps even changed. A confirming indicator should help in making determinations in this context.

As indicated, a narrowing Bollinger Band indicates that a change in price and direction is likely to occur. Since we don’t know the direction this move will take, we must be prepared for any scenario. This raises another question for the reader. If you are considering a covered call on XXX and it has just entered what appears likely to become a narrow Bollinger Band, would you sell the CC at this point, all other things being equal? If so, why? If not, why?

Another characteristic of Bollinger Bands to keep in mind is that of “stray data.” You will recall that I mentioned Bollinger Bands capture 95% of price data. So, when you see one or more tick bars or a candlesticks above the upper band or below the lower band, what I call “stray data,” that means unusual volatility, greater than two standard deviations, is taking or has taken place. Instances of price movements outside a band are short lived, but are often followed by another move in the same direction. In other words, a move outside a band signals the probability of trend continuation, not an end of the trend! On the other hand, a sharp move outside a band, followed by an immediate retracement, signals exhaustion and a probable trend change.

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As noted in Wikipedia with respect to stock trading relying on bands – “The use of Bollinger Bands varies widely among traders. Some traders buy when price touches the lower Bollinger Band and exit when price touches the moving average in the center of the bands. Other traders buy when price breaks above the upper Bollinger Band or sell when price falls below the lower Bollinger Band [based on the belief that the trend will continue].Moreover, the use of Bollinger Bands is not confined to stock traders; option traders, most notably implied volatility traders, often sell options when Bollinger Bands are historically far apart or buy options when the Bollinger Bands are historically close together, in both instances, expecting volatility to revert back towards the average historical volatility level for the stock.”

The use of a confirming indicator when using Bollinger Bands is a necessity. When the indicator acts in the same fashion as price movement relative to a band, it confirms the Bollinger Bands message and allows an analyst to act accordingly with greater confidence. It is indicator confirmation that provides buy and sell signals for many traders although, as previously noted, some will trade on price to band movements alone without taking notice of indicator action. Note that the indicator can confirm a move to lower or higher prices, the continuation of a trend or a change of trend. Divergences between price action and the indicator are important and well worth looking for. However, despite how confident a trader feels looking at Bollinger Bands and a confirming signal, a trader should (must) use appropriate stops.

Now I’m sure all of this information can be confusing to TA newcomers, option traders or those meeting Bollinger Bands for the first time, but trust me when I tell you that this all will become clearer when we look at charts and see the interplay between Bollinger Bands and price action for ourselves. So, before we move on to specific charts and option strategies derived from the charts, take a look at the material in the Chart School.

I’ll be back mid-week or so to continue this explanation of Bollinger Bands. I plan on using charts that illustrate their application to a few of the trades that have been reported here.

I will be posting a short, 5 slide presentation to the Group’s file section on Yahoo. The presentation covers the application of Bollinger Bands to a chart of BIDU with a focus on selling covered calls on BIDU. I didn’t have enough time to do more than some minor editing so if there is something you don’t understand, please let me know and I’ll do my best to correct it.

I’m still working on my set of presentations so I’ll be busy for a few days, returning in mid-week.

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