



TRADING ON CORPORATE EARNINGS NEWS

PROFITING FROM TARGETED,
SHORT-TERM OPTIONS POSITIONS

JOHN SHON | PING ZHOU

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CORPORATE
EARNINGS
NEWS

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To Mom and Dad and Lucy —John

*To Rong, for having faith in me and supporting
me unconditionally; and to Kelly, for filling
my world with joy —Ping*

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We also thank many of our friends and colleagues in academia and the investment management industry. Although we did not directly interact with them on this project, their intellectual influence on us over the years is certainly reflected in our work. Our book has also benefited greatly from the decades of academic research in accounting, finance, and economics; the list of the individual authors of these studies is certainly too long to be displayed here.

Finally, we want to especially thank our families for their support.

From John: I want to thank my parents for constantly pushing, and Lucy for constantly pulling.

From Ping: I want to thank my wife, Rong, for having faith in me and giving me unconditional love and support, without which I would not have been able to finish this project. This book is also for my daughter, Kelly. She is only six months old and may have limited interest in options trading at this stage of her life, but she inspires me and fills my world with joy.

About the Authors

John Shon is a professor of accounting at Fordham University. He has a PhD in accounting and an MBA in finance from the University of Chicago Booth School of Business. He publishes extensively in academic journals and has received several grants and awards for his research on equity markets. He teaches at the Gabelli School of Business and the Graduate School of Business Administration. He has received several teaching awards throughout his career.

Ping Zhou is a portfolio manager and vice president of the Quantitative Investment Group at Neuberger Berman (formerly Lehman Brothers Asset Management). He manages U.S. and global equity funds for institutional investors. He has a PhD in accounting from Georgia State University. His expertise is in portfolio theory, market anomalies, investor behavior, corporate finance, and risk management. Before joining the industry, he was an accounting professor at City University of New York–Baruch College. He has published numerous studies about the equity markets and corporate finance in academic journals, including *Financial Analysts Journal*, *Journal of Investing*, *Journal of Accounting, Auditing and Finance*, *Journal of Accounting and Public Policy*, and *Review of Quantitative Finance and Accounting*. He has received several awards for his research, including the Distinguished Paper Award at the 2007 annual meeting of the Mid-Atlantic region of American Accounting Association.

Preface

KISS

All books are largely an extension of their authors. So we'd like to briefly describe ourselves and thus inform you, the reader, about our perspective.

Ping Zhou is a portfolio manager for the Quantitative Investment Group at Neuberger Berman, a major asset management firm. He is a true “quant” who uses sophisticated statistical, empirical models to squeeze profits out of the market. His days are spent with fellow PhDs, performing the highest levels of quantitative analysis. He has access to an incredible arsenal of computing power and resources.

John Shon is a professor of accounting at Fordham University. He was formally trained for his doctorate at the University of Chicago's Booth School of Business in high-level theoretical and quantitative analysis, under Nobel laureates in economics and finance. He spends his days performing cutting-edge academic research using sophisticated statistical procedures, and he regularly publishes in top academic journals.

On the surface, the two of us are in very different fields. Yet, one of our commonalities is our exposure to quantitative sophistication. Perhaps ironically, then, one of the key traits we share is our belief that, in certain scenarios, rigorous quantitative analysis can be overdone. We believe in Leonardo da Vinci's famous saying:

“Simplicity is the ultimate sophistication.” Put differently, we believe in the adage commonly referred to as KISS: “Keep it simple, stupid.” This shared philosophy is at the core of our writings. Many options-trading books overwhelm the reader with what we believe are unnecessary complexities. In this book, we whittle to the bare essentials the types of trades that will be profitable. We have made every effort to pare away complexities and show the essence of each trade. As such, we spend very little time discussing the greeks of options analysis—delta, gamma, theta, rho. Don’t get us wrong: understanding the greeks is important for a full understanding of your trades. However, we believe that many of these issues can obfuscate and distract you from our main task at hand, so we suggest that you acquire this information elsewhere to supplement the material we cover here. Two excellent books that cover basic concepts are *Options Made Easy* and *The Bible of Options Strategies*, both by Guy Cohen. They’ll provide you with some of the foundational knowledge you’ll need. Two essential books that cover advanced concepts are *The Volatility Edge in Options Trading* and *Day Trading Options*, both by Jeff Augen. They discuss many of the volatility-related issues that you’ll want to deal with, as well as the details of intraday trading.

The Importance of Theory

The other key trait that we as coauthors share is our firm belief in developing strong, foundational economic understanding of and intuition about the world around us. This arises partially from our doctoral training. But

it also arises from our common interest in simply *understanding* how and why markets function the way they do. We therefore put strong emphasis on understanding the theory behind our trades and why we believe in them. We also put heavy emphasis on findings that are statistically tested and empirically documented, not on conjectures that are backed by cherry-picked trades or hearsay from random investing/trading blogs.

How does this affect the writing in this book? Simply put, if we did not share this philosophy of stressing the economic theory and empirical findings behind our trading strategies, we would not have had to write the underlying theories presented in Chapters 2 through 6 (and, to a lesser extent, Chapters 12 through 15). If you are simply interested in knowing the basic trading strategies that this book recommends, you need look no further than Chapters 9, 10, and 11. However, if you're interested in developing a deeper understanding of the markets and one of the most salient, important, recurring events that occurs in equity markets—earnings announcements—this book provides a wealth of information. *Economic theory. Empirical evidence.* This is the intellectual heavy lifting that we encourage you to do with us.

Not Just for Options Trading

Because of the depth of economic theory and empirical evidence that we cover in this book, you will find that the material is not limited to options trading. Rather, the deeper understanding you gain about the nature of earnings announcements and earnings surprises will also equip you to understand the underlying *stock* price

reactions. Therefore, the material is also suited for readers who do not regularly trade options. This book contains many ideas that stock-based investors will find immensely helpful in their approach to trading.

Preview of Chapters

Chapters 2 through 4 discuss the latest cutting-edge academic research on earnings announcements and earnings surprises. This is theory and empirical evidence garnered from decades of research using millions of publicly traded observations on earnings releases. Chapters 5 and 6 discuss the theory and evidence behind market reactions to earnings announcements, as well as the earnings surprises that these announcements create. The empirical regularities of market reactions to earnings announcements and earnings surprises represent the foundation from which we develop our options-based trades. Chapter 7 discusses some of the empirical evidence on optioned firms and then discusses the specific behavior of options around earnings announcements. Chapter 8 talks about some of the practical issues related to implementing your trades. Chapters 9 through 11 discuss our main options-based trading strategies. These strategies are short-term trades that are targeted at companies' quarterly earnings announcements. These three chapters represent the bulk of the discussion on options trades, using actual examples from recent earnings announcements. Chapters 12 through 15 discuss several other theories and empirical regularities that will help you improve the odds of implementing profitable options trades.

After reading this book, you will be better informed about the theoretical underpinnings of earnings announcements. We believe this foundational work is paramount to being a consistently profitable trader. As trading situations and economic contexts change, your foundational understanding will always be there to help you adapt. As the old saying goes, we don't want to just give you a fish; we want to show you how to fish.

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