CHAPTER 1

Options Trading: A Primer

Trading is an elusive beast to the uninitiated, filled with mystery and complexity. Although trillions of dollars' worth of stocks, futures, and options change hands every day, learning to trade is a complicated puzzle that takes patience and perseverance to navigate effectively. Perhaps you have a friend who has made money or know other friends who have lost money playing the markets. Learning to trade can be the beginning of an exciting new career, especially if you master combining options with futures and stocks.

Many years of teaching and trading have taught me that the most successful investors are those who do not think of trading as work, but as play. Obviously, a love affair with anything you do will increase your chances of success dramatically. Perhaps that's why I like to call what I do "grown-up Nintendo." Making money is just a natural consequence of my daily play.

My systematic approach to trading emphasizes risk management. I know how to spot optimal moneymaking opportunities to increase my chances of high returns from low-risk investments. I share this trading knowledge with individuals throughout the world through seminars and various innovative products designed to foster a strong foundation in options trading in the stock and futures markets.

Stock, futures, and options trading provide investors with the best opportunity to find rewards that satisfy almost anyone's financial objectives. My investment philosophy is to make money any way we can, in any market we can. It's a matter of working with a matrix of trading strategies, developing a feel for how to trade profitably, and learning the tricks of the trade.

What separates those investors who make consistent returns year after year from those who can't ever seem to make a winning investment? Vision. Simply put, the winning investor has the vision to systematically spot good opportunities, while the losing investor simply never developed this insight. Can this vision be developed? Some say that a great investor has an innate sense that drives his or her ability to make money. However, I believe that although there may be a few individuals with this innate sense, most great investors learn by trial and error until they find what works best for them.

For example, many people refer to Warren Buffett as the greatest investor of all time. He appears to have a knack for turning anything he touches into gold. Is it because he is just so much smarter than everyone else, or has he developed a methodology over the years that works for him on a consistent basis? For someone as successful as he is, I would have to say that he has *both* innate skill and a formula for success. This formula for success can be developed by anyone. The problem is that most investors don't have the persistence and drive necessary to achieve success.

First and foremost, you have to learn how to invest and trade the right way. Typically, most new investors lose money when they first begin due to their lack of understanding of what it really takes to succeed. Many may listen to their stock or commodity broker from the outset and never develop an understanding of the markets. Many more lose money until they realize their main error is taking someone else's investment advice. A word of caution: Just because someone is licensed to take an order and execute a trade does not mean that person has the knowledge to invest your money wisely. Gaining the right kind of knowledge, however, is critical to trading success. Although there is risk in virtually all investments and trades, you can mitigate risks by learning how to protect yourself using innovative option strategies. Once you learn how to manage risk, the rewards come more easily.

If you intend to enter the markets, you'll need to decide what kind of investing/trading you want to engage in. Keep in mind that there is a big difference between investing and trading. An investor is an individual who takes a long-term perspective. For example, if you have $5,000 to invest and you place all the money in a mutual fund—a pool of investments managed by a professional manager—then you are taking a passive role for the long term. If you choose to set up an individual retirement account (IRA), you will more than likely keep it until retirement.

A trader, on the other hand, takes a more active role. Traders may make investments that last for seconds, minutes, hours, weeks, or even years, always looking for an opportunity to move the money around to capture a greater return. Typical traders actively make investment decisions on a continuous basis, never allowing anyone else to control the funds. As a trader, you need to focus on strategies that provide the best chance to create profitable trades. Combining stocks or futures with options provides you with extra leverage; but this extra leverage is a double-edged sword. Options give you the chance to make a very high return using smaller amounts of cash than futures or stocks require, but this leverage also creates an opportunity for you to lose money just as fast.

The losing traders are those who do not respect risk. To survive in this business and have the opportunity to enjoy the fruits of your labor, you must develop a very healthy respect for risk. Before entering any investment, you should ask yourself four questions:

1. How much profit can I make?
2. What is the maximum loss I can take?
3. At what point will I get out if I am wrong?
4. When should I take profits?

As you make the transition to becoming a motivated, knowledgeable, and successful trader, you will have to undertake a realistic examination of your personal goals, habits, dreams, and dislikes. This step is of utmost importance. Many individuals believe that they will enjoy a certain profession, but then give up before the opportunity to achieve success appears.

You must have a good understanding as to why you want to participate in any endeavor. Why are you taking the time to learn a new profession? What are your goals? What are your strengths? What are your weaknesses? Before you can become a serious and successful trader, you need to search for these answers. Make a list and add to it every day as more things become apparent. Try to be honest with yourself. Keep your highest goals in mind and work toward them one step at a time using your list of attributes to strengthen your willpower to succeed.

The three primary reasons for developing trading savvy are:

1. *To achieve more wealth.* The number one reason that most people want to become traders in the stock, futures, and options markets is to attain financial rewards. Stories about the large sums of money to be made and the successes of the rich and famous inspire a desire to achieve the same level of financial success. Just as it is a business's objective to produce more cash flow to pump up the bottom line, a trader's objective is to make more money from money. That is how a trader monitors progress. Although "money doesn't buy happiness," having plenty of money sure helps. However, there is no need to make having money your sole goal in life; as far as I'm concerned, that would undermine your development as a well-rounded individual.

2. *To improve family life.* The ultimate goal, other than trading just to make money, is to create a better life for yourself and your family. The success I have been fortunate enough to achieve through hard work has allowed me to help my family and friends financially when they needed it; I have found this ability to help others very enjoyable. Once you have achieved a financial level where you can live each day without worrying about which bills need to be paid, you will have more freedom to discover your true purpose in life. As an added bonus, you can also afford the time and energy to help others, which will make your life as an investor even more fulfilling.
3. *To gain greater autonomy in the workplace or be your own boss.* The third most common reason is the desire to break away from a day-to-day job that has been emotionally and/or financially unfulfilling. This is the main reason I started trading; I needed more than what real estate offered. As I like to ask my seminar students, "How many of you are here to try to get out of a real job?" More often than not, it's better to describe the day-to-day grind most people subject themselves to as an *unreal* job, since many cannot believe they have to go through the motions each day. In essence, it has become a nightmare.

Whether you enjoy what you are doing today and just want to supplement your income, or you are looking to become your own boss, there is no better profession than that of a trader. For example, I travel extensively and live in various locations. With a small laptop computer, Internet access, and a cell phone, I can conduct my business from almost anywhere, which maximizes my freedom. For me, trading is a dream come true.

THE ROAD TO SUCCESSFUL TRADING

Achieving trading success is not easy. In fact, just getting started can be an overwhelming process. The road to wealth can take many paths. To determine your optimal trading approach, start by making an honest assessment of your financial capabilities. Successful traders only use funds that are readily available and can be invested in a sound manner. It is also critical to accurately assess your time constraints to determine the style of trading that suits you best. If you want to trade aggressively, you can do so using various short-term strategies. If you want to take a hands-off approach, you can structure trades to meet that time frame. All of these choices are less difficult to make if you respect the following trading guidelines.

1. Gain the knowledge to succeed over the long run.
2. Start with acceptable trading capital.

3. Establish a systematic approach to the markets.
4. Be alert for trading opportunities at all times.
5. Develop the fine art of patience.
6. Build a strong respect for risk.
7. Develop a delta neutral trading approach.
8. Reduce your stress level.

Gain the Knowledge to Succeed over the Long Run

You have to have knowledge to succeed. Most new investors and traders enter this field expecting to immediately become successful. However, many have spent tens of thousands of dollars and many years in college learning a specific profession and still do not make much money. To be successful, you need to start your journey on the right path, which will increase your chance of reaching your final destination: financial security. To accomplish this goal, learn as much as you can about low-risk trading techniques and increase your knowledge base systematically.

Successful traders have an arsenal of trading tools that allows them to be competitive in the markets. I have used the word *arsenal* purposely. I believe that as an investor or trader, you need to recognize that each and every day in the marketplace is a battle. You must be ready to strategically launch an attack using all the resources in your arsenal. Your first weapon—knowledge—will enable you to make fast and accurate decisions regarding the probability of success in a specific investment. Is it incongruous to suggest that trading is war and also that to trade successfully one must reduce one's level of stress? I believe not. The most composed and well-armed opponents win wars. The same is true for traders. In most cases, winners will be more comfortable (less stressed) regarding their ability to win. Knowledge fosters confidence. If you are well armed, you will be confident as you go off to fight the battle of the markets. Increased confidence leads to lower stress and higher profits.

Start with Acceptable Trading Capital

Many investors start with less than $10,000 in their trading accounts. However, it is important to realize that the less you have in your account, the more cautious you have to be. Perhaps the toughest problem is to establish a sufficient capital base to invest effectively. If you begin investing or trading with very little capital, you will assure yourself of failure. Making money in the markets requires a learning curve, and incurring loss is part of the trading process. When it comes to trading, "you have to pay to play." You don't need to be a millionaire, but trading does require a certain amount of capital to get started. In many cases, the brokerage firm you choose will determine how much is required to put you in the game. However, no matter how much you begin with, it is a good idea to start out by trading conservatively. If you invest smartly, you can make very good returns and your financial goals will be realized.

Establish a Systematic Approach to the Markets

The third key to successful moneymaking in the markets is to develop a systematic approach that combines all the weapons in your arsenal to compete effectively in the marketplace. Then, and only then, will you be able to reduce your stress enough to believe in the plan and stick with it. A systematic approach diffuses the inherent madness of the marketplace, allowing you to make insightful trading decisions.

Be Alert for Trading Opportunities at All Times

By opening your receptivity to opportunity, you will be able to find many more promising trades than you thought possible. Where do you find opportunities? Everywhere. When you begin to train yourself to automatically look for trading opportunities in everything you do, you are on your way to being an up-and-coming successful trader.

Develop the Fine Art of Patience

Patience is one of the most difficult aspects of trading and investing and extremely hard to teach. I have to work at applying patience conscientiously each and every day, even after years of trading.

As a professional trader and investor, I have the opportunity to sit in front of computers all day long, day after day. This is another double-edged sword. Yes, I have the ability to look for promising trading opportunities because I have lots of information in front of me; however, I also have the opportunity to second-guess great trades due to fluctuations in the market that may be unimportant. Therefore, I have learned that the best investments are those in which I have thoroughly studied the risk and reward and have developed a time frame for the trade to work. For example, if I place a trade with options six months out, I try to stay with the trade for that period of time. This takes patience. Of course, if I reach my maximum profit level before that time, I take that profit and get out.

Do not feel that you are at a disadvantage if you cannot trade and invest full-time. This allows you to avoid the “noise” in the market that occurs each and every trading day. Many of my successful students make more money by not watching the markets too closely.

Build a Strong Respect for Risk

You must respect risk if you are to survive as an investor or a trader. Before you ever place an order with your broker, make sure you calculate the maximum potential risk and reward as well as the breakeven(s) of the trade. This will help you stay in the game so you can achieve your goals. Risk graphs, which are explored in later chapters, are important tools for assessing risk and reward.

Develop a Delta Neutral Trading Approach

Delta neutral trading is composed of strategies in which a trade is created by selecting a calculated ratio of short and long positions that balance out to an overall position delta of zero. The term *delta* refers to the degree of change in an option's price in relation to changes in the price of the underlying security. The delta neutral trading approach reduces risk and maximizes the potential return. Effectively applying these strategies in your own personal trading approach generally requires four steps:

1. *Test your trading systems by paper trading.* Paper trading is the process of simulating a trade without actually putting your money on the line. To become a savvy delta neutral options trader, you will need to practice strategies by placing trades on paper rather than with cash. Although it may not feel the same as putting your money on the line, it will help you to develop practical experience that will foster confidence in your abilities. This will come in very handy in the future. Since there is no substitute for personal experience, you should test all ideas *and* your ability to implement them properly prior to using real money.
2. *Discuss opening a brokerage account with several brokers.* Make sure you have a broker who is knowledgeable and fairly priced. Brokers can be assets or liabilities. Make certain your broker is an asset who will help make you richer, not "broker." Do not sacrifice service by selecting the broker with the lowest cost. Shop around for the right person or firm to represent your interests. Your broker will play a crucial role in your development as a successful trader. Take your time, and if you are not satisfied, find someone else.
3. *Open a brokerage account.* It's best to consider a brokerage firm that specializes in stocks, futures, and options. Then you can easily place trades in any market using the same firm. When it comes to trading, flexibility and precision are equally important. Today, some online brokers specialize in options. We provide examples in later chapters.

4. *Start small.* Any mistakes you make early in your trading career will obviously cost you money. If you start with small trades in the beginning, you will be able to gain the knowledge, experience, and confidence necessary to move on to bigger trades. The bottom line is that a mistake made in a small trade means a smaller loss of capital, which can help keep you in the game.

Reduce Your Stress Level

Successful traders have to find ways to reduce the stress commonly associated with trading. I reconstructed my trading style after experiencing more stress than I had thought I could ever handle. In a typical trading day with the S&P 500 (Standard & Poor's 500 Index, which represents the 500 largest companies in the United States), I found myself buying close to the high of the day. Immediately the market started to tumble so fast that I was down 100 points even before I got my buy filled (i.e., before my order was executed). I finally was able to regain my composure just enough to pick up the phone in a panic to sell as fast as possible. By then the market had tumbled almost 200 points. Worst of all, I had purchased too many contracts for the money I had in my account; and, to top it all off, it was my first trade ever in the S&P.

That was the point in my trading career that I experienced the panic and stress of losing more than 40 percent of my account in three minutes—more than one month's pay as an accountant. I did not trade again for more than two months while I tried to figure out whether I could really do this for a living. Luckily, I did start trading again; however, I reduced my trading size to one contract position at a time for more than a year.

Many professional floor traders and off-floor traders have had similar experiences. However, these kinds of stressful events must be overcome and used as lessons that needed to be learned. Simply put, stress produces incomplete knowledge access. Stress, by its nature, causes humans to become tense in not only their physical being but also their mental state. For years, physicians have made the public aware that stress can lead to many illnesses including hardening of the arteries with the possibility of a heart attack or other ailments. Reducing stress can lead to bigger rewards and can be accomplished by building a low-stress trading plan.

To create your own plan, follow this three-point outline:

1. Define your risk.
2. Develop a flexible investment plan.
3. Build your knowledge base systematically.

Define Your Risk As a trader you have the ability to make large profits with the risk of potentially large losses. This is no secret. Unfortunately, that old maxim "cut your losses and let your profits run" is easier said than done. By defining your risk, you are assured that you cannot lose more money than the amount you have established as being the maximum position loss. You will also be able to develop strategies that create the potential for large rewards by predefining your acceptable risk parameters and by applying strategies that combine stocks and options on stocks, or futures and options on futures.

Develop a Flexible Investment Plan The second step in reducing risk and stress is to develop an investment plan that is flexible. Flexibility allows a trader to cultivate a matrix of strategies with which to respond to market movement in any direction. Erratic market movement can change your position dramatically in seconds. Each price move (tick) rearranges everyone's assumptions about what the market is about to do. This dynamic environment borders on schizophrenia, where the bulls and bears do battle trying to outmaneuver each other. This, in turn, creates profitable opportunities for the knowledgeable investor with a smart and flexible investment plan and creates nightmares for the uninitiated trader without a plan, only a hunch as to where the market appears to be going. Investors and traders have to be entrepreneurial by nature to survive. One of the greatest attributes of entrepreneurs in any industry is the ability to recognize a roadblock and change direction when one is reached. Traders must also exhibit this flexibility if they are to survive in the marketplace.

Build Your Knowledge Base Systematically The third step to creating a successful investment plan is to systematically build a solid base of innovative strategies from which to invest wisely. Most investors start the same way. They read a few books, open a small account, and lose everything very quickly. However, there is one way to differentiate the winners from the losers. Winners persist at learning as much as they can by starting slowly and collecting tools to beat the market consistently. Successful options traders first learn to walk, then to run. Usually traders begin with simplistic strategies such as going long or shorting the market, and using stops to limit losses. Some just listen to their brokers and follow their trading ideas. Once initiated, traders accelerate their learning at the right time to become successful.

Successful traders usually specialize in one area or just a few areas. This specialization allows the trader to develop strategies that consistently work in certain recognizable market conditions. A successful investor realizes that, in all likelihood, these situations will reoccur and the same strategies can be used profitably over and over again. At my alma mater, Harvard Business School, the same systematic approach is used. I never realized what the school was attempting to accomplish until after graduation when I had time to apply this approach to the real world—all those case studies on businesses I had no interest in fostered my ability to learn how to think in any environment. This systematic building of knowledge will enable you to quickly get up and running as a successful trader in the marketplace.

CONCLUSION

Options, the most flexible financial instrument that exists today, provide unique investment opportunities to knowledgeable traders on a regular basis. However, the entire options arena can be a very complex and confusing place in which to venture, especially for the novice trader. The primary reason for this complexity is the fact that options trading is a multidimensional process; and each dimension needs to be understood in order to trade successfully.

Prior to initiating an options position, there are three main issues to consider: direction, duration, and magnitude. Direction refers to whether the underlying security will move up, down, or sideways. Duration refers to how long it will take for the anticipated move to take place. Magnitude refers to how big the subsequent move will be. In order to make a profit, the options trader must be correct in all three of these categories. This is the primary reason that many people lose money when trading options. They do not accurately understand the three dimensions of an options position.

The first step in taking your options trading to another level is to understand and comprehend the interrelation of direction, duration, and magnitude. Additionally, the trader must use these three different variables in order to provide an edge in the market. It is imperative to be able to combine and exploit these three variables in order to give yourself an advantage; otherwise your trading will become no more than an exercise in giving your money away to other traders.

Many times it is necessary to work with combinations of options in order to give yourself an edge in the market as opposed to just buying a call or a put. This is where understanding spreads, straddles, and various option combinations is helpful. There are a few general rules that I always follow when looking for and constructing option positions. The first is that when I am going to bet on the future direction of a security, I want to give myself enough time to be right. That means I will usually choose long-term equity anticipation securities (LEAPS) for directional trades. LEAPS is a name given to options with expiration dates further than nine months away. The second rule is in regard to magnitude or volatility.

When combining different options together, I want to be a seller of expensive options (high volatility) and a buyer of cheap options (low volatility). The third rule is that I want to make time my friend as opposed to my enemy by purchasing options that have plenty of time left to expiration and selling shorter-term options. This allows me to take advantage of the time decay characteristic of an option. These guidelines are a brief summary of the issues that need to be understood when building trades that give you a competitive edge in the market.

To the beginner, these issues may seem complex and convoluted; but with a little bit of practice everything should become quite clear. If you take the time to understand the concepts of direction, duration, and magnitude, you'll soon be able to start experimenting with a variety of different options strategies. For example, if you want to be bullish on a particular stock, then you can take a longer-term perspective by placing a bull call spread using LEAPS. For shorter-term trades, you can take advantage of time decay by using credit spreads, calendar spreads, or butterfly strategies. Increased comprehension of these basic concepts will enable you to combine short- and long-term strategies together to help you become an even more proficient trader.

As you build experience as a trader, you will become more confident in your ability to make money. After a few successes, traders are more motivated to develop the perseverance necessary to stay with the winning trades and exit losing positions quickly. In the long run, you have a much better chance of becoming successful when you start by acquiring a solid foundation of the option basics. In addition, keep a journal of every trade you make—especially your paper trades—as a road map of where you've been and where you want to go on your journey to trading victory. Remember, patience and persistence are the keys to trading options successfully.