

CHAPTER 1

Options Trading: A Primer

SUMMARY

Starting to trade options can be stressful and unsettling, but it doesn't have to be. By learning to trade options systematically and by fostering a patient approach, a new trader can become successful. Options trading requires an understanding of the characteristics of options and this takes time to master. Nonetheless, a person who is willing to study and work hard can achieve success.

To become successful at trading options, you need to focus on three important features of options: duration, direction, and magnitude. If understood, the interrelation of these three issues can provide the edge needed to win at options trading. There are, however, some stepping-stones that need to be put in place before jumping headlong into the options game. Following the suggestions in this book will enable you to gain the knowledge and skills necessary to trade profitably. Mainly, a new trader should start small, not placing too much capital in any one trade initially. New traders should also paper trade strategies to get a better feel for how each strategy works. Any trader, new or experienced, should define the risk before entering any trade. Only consistent risk managers make it in the trading profession; so do your homework and follow the steps outlined in this book.

QUESTIONS AND EXERCISES

1. True or False: Just because someone is licensed to place a trade does not mean the person has the knowledge to invest your money wisely.
2. What is the difference between an investor and a trader?

3. Successful options traders use only _____ that are readily available and can be invested in a sound manner.
 - A. Options.
 - B. Funds.
 - C. Futures.
 - D. Stocks.
4. It is critical to accurately assess your _____ to determine the style of investing that suits you best.
 - A. Flexibility.
 - B. Interest.
 - C. Markets.
 - D. Time constraints.
5. How can you minimize your losses when you first begin trading options?
 - A. Start small.
 - B. Learn to paper trade.
 - C. Interview several brokers before picking the one most suited to your needs.
 - D. All of the above.
6. What is the most important factor for building a low-stress investment strategy?
 - A. Understanding your markets.
 - B. Having a good broker.
 - C. Defining your risk in every trade.
 - D. Learning to paper trade first.

7. _____ allows a trader to cultivate a matrix of strategies with which to respond to market movement in any direction.
- A. Flexibility.
 - B. Specializing.
 - C. Computer access.
 - D. Confidence.
8. Successful investors usually _____ in just one or in a few areas. This allows them to develop strategies that work in certain recognizable market conditions.
- A. Specialize.
 - B. Win.
 - C. Go short.
 - D. Systematically invest.
9. To become a successful options trader you have to have _____.
- A. Lots of money to invest.
 - B. Patience and persistence.
 - C. A computer.
 - D. A good sense of market direction.

MEDIA ASSIGNMENT

The Internet is a great resource for new and experienced traders. Not only can traders place trades online, but there is a plethora of free options information that can be easily accessed. For example, the Optionetics web site has a wide range of information and numerous articles that can foster profitable trading for both new and experienced traders. Take the time to become familiar with the Optionetics site in order to benefit from the tools and information found there. This is also a great starting point to find a broker. The site offers a section dedicated to providing in-depth information about the various options brokers out there. Take the time to review this information so you'll be prepared to open a brokerage account when the time comes.

VOCABULARY LIST

Bear	Leverage
Broker	Paper trading
Bull	Put
Call	Return
Capital	Risk
Delta neutral	Risk management
Go long	Stop loss
Go short	Trader
Investor	

SOLUTIONS

1. True or False: Just because someone is licensed to place a trade does not mean the person has the knowledge to invest your money wisely.

Answer: True.

Discussion: Unfortunately, obtaining a license to place a trade does not necessarily make someone a good trader. Like many things in life, sometimes book knowledge isn't enough to create success. When learning to drive a car, someone doesn't just immediately move out onto the freeway after reading a book. Though having a license does teach some important things, it isn't a guarantee that the person will be successful at trading.

2. What is the difference between an investor and a trader?

Answer: An investor takes a long-term, passive approach. A trader takes a more active approach using various options strategies that tend to capitalize on shorter-term market movement.

Discussion: As the term implies, an investor is investing his/her money into a company by buying stock in it. A trader isn't necessarily concerned with ownership, just profits and short-term gains. Most investors are people who buy and hold stock or mutual funds; they are more in step with the Warren Buffett approach to long-term security. A trader seeks profits in the short term, trading stocks and options

with a clear eye on risk management and a friendly ear for volatility. Undoubtedly there are many who dabble somewhere in between.

3. Successful options traders use only _____ that are readily available and can be invested in a sound manner.

Answer: B—Funds.

Discussion: Though Optionetics teaches traders how to use options to limit risk, there still is a chance that the capital used in trading options could all be lost. As a result, it is wise to only use money that is not needed for bills or other important necessities in life. If you trade using capital you cannot afford to lose, it is very difficult to trade without letting your emotions get in the way.

4. It is critical to accurately assess your _____ to determine the style of investing that suits you best.

Answer: D—Time constraints.

Discussion: If the capital you plan on using to trade options is also needed for an important life event in the next year or two, it is unwise to use it. Though quick profits can often be made trading options, we still need to trade with a long-term goal in mind. Even a successful options trader might go through a losing streak, and if the capital is needed during this down time, it can be a difficult situation.

5. How can you minimize your losses when you first begin trading options?

Answer: D—All of the above (start small, learn to paper trade, interview several brokers before picking the one most suited to your needs).

Discussion: All of these issues should be used when first starting to trade options. The nice thing about options is that it doesn't take a huge amount of capital to get started. Nonetheless, even if you have a nice nest egg to begin with, start small. Try to learn how the strategies work before taking a bigger leap. You may want to paper trade a new strategy so you won't lose capital during the learning process. Even so, there eventually comes a time when the trader will not be able to learn more until he or she trades with real capital. Using a broker who gets a trade a good fill and is easy to work with is crucial for the long-term success of an options trader. With the number of brokers available, don't be afraid to change brokers if the one you start with isn't working out.

6. What is the most important factor for building a low-stress investment strategy?

Answer: C—Defining your risk in every trade.

Discussion: Those who pay attention to Optionetics instructors and writers will hear this all the time. Options were first developed to help traders limit risk, and Optionetics still believes this is the key. We need to know the risk of every trade before we enter it so that we are prepared for the worst and know what actions are needed to limit this risk.

7. _____ allows a trader to cultivate a matrix of strategies with which to respond to market movement in any direction.

Answer: A—Flexibility.

Discussion: Though it is a good idea to narrow your choice of strategies, this doesn't mean that a trader shouldn't have a couple of strategies for each type of market. One of the greatest advantages to trading options is their flexibility. You can make money in up, down, and sideways markets using options, so don't limit yourself to just bullish strategies.

8. Successful investors usually _____ in just one or in a few areas. This allows them to develop strategies that work in certain recognizable market conditions.

Answer: A—Specialize.

Discussion: Specialization has become the thing to do in any profession in our day and age. It is no different when trading options. Though we need to have a wide base of knowledge about options and trading, we do not need to become experts in every available options strategy. As you learn about different options strategies, specialize in the ones that best fit your risk tolerance and expertise.

9. To become a successful options trader you have to have _____.

Answer: B—Patience and persistence.

Discussion: This is very important to remember. Too many new traders expect to become millionaires overnight; this is unrealistic. Traders need to realize that where there is more possible reward, there is usually a higher degree of risk. Even the most successful options traders often lose money in individual trades. However, these traders have learned to limit their risk and have developed a sound plan that allows them to be patient and persistent.

MEDIA ASSIGNMENT

Learning to use the Internet to further your understanding of the market and options is a vital part of your trading education. The free Optionetics web site has a plethora of information. Mainly, take the time to search for information dealing with the initial strategies you want to master. As you progress up the learning curve, read the daily articles to gain an understanding of the markets. You can also read about various options brokers on the Brokers Review link. This will provide information about costs, services, and other important data about most of the options brokers available.

VOCABULARY DEFINITIONS

Bear: An investor who believes that a security or the market is falling or is expected to fall.

Broker: An individual or firm that charges a fee or commission for executing buy and sell orders submitted by another individual or firm.

Bull: An investor who believes that a security or the market is rising or is expected to rise.

Call: An option contract that gives the holder the right, but not the obligation, to buy a specified amount of an underlying security at a specified price within a specified time (e.g., if you buy an IBM January 85 call, you have the right to buy 100 shares of IBM at \$85 each by the third Friday in January).

Capital: The amount of money you have invested. When your investing objective is capital preservation, your priority is to try not to lose any money. When your objective is capital growth, your priority is to try to make your initial investment grow in value. Capital also refers to accumulated money or goods available for use in producing more money or goods.

Delta neutral: Refers to an options position constructed so that the profitability of the position relies on the magnitude of the move—not the directional bias; it is relatively insensitive to the price movement of the underlying instruments. A delta neutral trade is arranged by selecting a calculated ratio of short and long positions with a combined delta of zero.

Go long: To buy securities, options, or futures with the intent to profit from a rise in the price of the assets.

Go short: To sell securities, options, or futures with the intent to profit from a drop in the price of the assets.

Investor: A person whose principal concern in the purchase of a security is the minimizing of long-term risk, compared to the speculator who is prepared to accept calculated risk in the hope of making better-than-average profits, or the gambler who is prepared to take even greater risks. More generally, it refers to people who invest money in investment products.

Leverage: Enables a trader to buy or sell a security or derivative and receive fair value for it using borrowed capital to increase investment return.

Paper trading: Simulating a trade without actually putting up the money, usually done for the purpose of gaining additional trading experience.

Put: An option contract that gives the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time.

Return: The income earned or a capital gain made on an investment.

Risk: The potential financial loss inherent in an investment.

Risk management: The process of managing trades by hedging risk.

Stop-loss order: An order to sell when the price of the stock declines to, or below, a stated price. The purpose of this is to reduce the amount of loss that might occur.

Trader: Someone who buys and sells frequently with the objective of short-term profit.