Chapter 1

Options Trading and Investing

In This Chapter

- Developing an appreciation for options
- Using option analysis with any market approach
- Focusing on limiting risk
- Capitalizing on advanced techniques

Whether you're new to trading or an experienced investor, listed stock and index options are great vehicles for managing risk and growing your assets. The wide variety of strategies available using these securities make them suitable for just about everyone — providing you understand how they work and apply them properly. I started trading options decades ago and found that by using different strategies I could implement trades with reasonable risk-reward profiles throughout all those years.

Trading and investing are typically distinguished by timeframes. I consider investing to be something you carry out to meet longer term financial goals. Regardless of the plan you personally create to satisfy those goals, options offer a means of protecting longer term assets during periods when the markets work against them. Parts I and III provide you with insights towards these goals. It is also a main focus for Chapters 10 and 13.

Although I primarily use the term *trading* for investing or trading, I consider the latter an approach to the markets aimed at obtaining superior returns to help build those longer term investments. Superior returns mean taking additional risk, but I definitely mean measured risk. If nothing else, the approaches offered in this book should reinforce the focus you must maintain on risk, reward, and effective position management regardless of the financial asset you decide to use. An option specific risk primer can be found in Chapter 4.

The timeframes for trading may be shorter, but don't get the wrong idea . . . I'm not talking about hyperactive day-trading where you're glued to your screen. Stock and index options offer strategies requiring daily management, as well as those that can be reviewed weekly or longer. It's up to you to implement those approaches that are suitable to your risk tolerances and preferences, along with your schedule.

Understanding Options

Options are financial instruments that derive their value from another underlying asset or financial measure — here I focus on stocks and stock market indexes. Because options come in two forms, calls and puts, adding them to your current investing and trading tools allows you to benefit from both bullish and bearish moves in either underlying you select. You can do this to limit your total assets at risk or to protect an existing position.

To truly understand stock and index options, you must also have a solid understanding of the asset in which they're based. This may mean looking at stock or index movement differently — for example, volatility is a key component in option value. By comparing options to its underlying security or other securities, your learning curve is geared toward applying them. Chapter 9 distinguishes this for stocks and index options.

The primary focus for trading any security is to understand its risks including all the following:

- Knowing what conditions to consider when analyzing a trade
- Using proper trade mechanics when creating a position
- Recognizing trading rules and requirements for the security
- Understanding what makes the position gain and lose value

The sections that follow address these key components of options to give you a good platform to create rewarding positions.

Knowing option essentials

A listed stock option is a contractual agreement between two parties with standard terms. When creating a new position, buying an option gives you rights and selling an option leaves you with obligations. These rights and obligations are guaranteed by the Option Clearing Corporation (OCC) so you never have to worry about who's on the other end of the agreement.

A primary risk you encounter with options is time risk because contracts have a limited life. A call option gains value when its underlying stock goes up, but if the move in the stock is too late the call can expire worthless. On the plus side options have expiration periods as late as 9 months to 2½ years.

Your rights as a call owner include all the following:

- Buying a specific quantity of the underlying stock
- Buying by a certain date (expiration)
- Buying at a specified price (known as the strike price)

That's why the call price goes up when the stock price goes up — the price you have rights to is fixed while the stock itself is increasing in value.

A put option gains value when its stock moves down, but the timing issue is the same. The move has to occur before the option contract expires. Your put contract rights include selling a specific quantity of stock by a certain date at a specified price. If you have rights to sell a stock at $60, but bad news about the company pushes its price below $60, those rights become more valuable.

Gaining skill as an options trader means selecting options with expiration dates that allow time for the anticipated moves to occur. This may sound too challenging at the moment, but there are some basic trading rules of thumb that help. Among those rules is proper trade management which means exiting a position if it moves against you and reaches your pre-determined exit point.

Each stock with options available has a variety of expiration dates and strike prices. When researching options you'll find the following:

- An option with more time until expiration is more expensive.
- An option with a more advantageous strike price is more expensive.

Information about all available options can be found on the Internet from a variety of sources, including your broker. Selecting the best ones given current conditions and your outlook for the stock takes a little bit of time, but it's not rocket science. Your biggest challenges are those associated with any type of trading: managing your own emotions and using discipline.

Gaining comfort with option mechanics

Options differ from stocks in terms of what they represent and how they are created. This results in additional rules for trading and decision-making beyond the basic buy or sell considerations. You may decide to exercise your rights under the contract or simply exit the position in the market. Fortunately market prices will help you with those decisions as will some thoughts from Chapters 9 and 18.

Are these extra complications worth it? For many people, yes. The differences in stock and option mechanics are pretty straightforward and manageable. A big advantage to these securities is the way they provide you with leverage. By controlling rights to the stock rather than the stock itself, you significantly reduce your risk.

From the very start of this book, I identify factors impacting the value of an option as well as conditions that are best suited for buying and selling different contracts. By understanding the way options provide leverage and reduce your trading risk, you begin appreciating why I use the term measured risk at the start.

Recognizing option risks and rewards

The primary risk associated with options is time risk. You have the potential to lose your entire investment if the move you're expecting is too small or occurs too late. It's not an all or nothing proposition for you though. You can exit an option position if an adverse move occurs in the underlying stock before expiration. It comes down to disciplined trading.

Assessing stock risk versus option risk for a call or a put builds a solid foundation for understanding the risk and rewards created by more complex option positions. Viewing these risks on a chart develops your skill for evaluating an option trade. Risk graphs, which plot the position value against the price of the underlying stock, is a tool of the trade that will be invaluable to you throughout your trading career. I use throughout the book, especially in Chapters 4 and 10 through 17 which are strategy oriented.

Incorporating Options into Your Routine

Understanding options and what drives their prices gives you an alternate view of the stock market. In addition to sentiment information provided by option trading, the conditions you more thoroughly understand as an options trader can aide your stock market analysis. These market characteristics also help you analyze and select sectors aimed at achieving your goals. Chapter 5 includes specific discussions on this topic.

As with any new strategy or market approach, adding options to your trading means the following:

- Understanding the risks and rewards associated with them
- Testing them out in a no risk or low risk manner

Options can be "test driven" by monitoring price changes, using paper trading strategies, and focusing on a limited number of strategies that are well suited to current conditions. In addition to these steps, it helps to consider the costs of trading associated with this security. See Chapter 7 for more on this.

Adding options to your analysis

Option analysis for trading can readily fit into your current market analysis, even supplementing it with sentiment tools. Market breadth tools and sentiment analysis generally focus on extreme conditions to identify periods when there is a greater potential for market reversals. Basically, when the last person trading turns bearish it's a bullish sign for the future. Option measures that help you recognize such extreme conditions include contract volume and implied volatility readings for major stock indexes. So by adding sentiment analysis to breadth analysis, you get nice confirmation of pending changes. See Chapter 5 for more on this.

Options analysis focuses on two aspects of the market:

- Trending conditions
- Volatility conditions

Although stock traders are also aware of trending conditions, they may be less in tune with volatility conditions. Or perhaps there is a strong emotional sense of increased volatility, but not a quantitative one.

Technical analysis aimed at providing both trend and volatility information helps you whether you're concentrating on option or stock trading. Adding the information to sector analysis enables you to use underlying groups that behave differently so you can better diversify your holdings and spread your risk. The combination of sector and option analysis also provides nice low-risk alternatives for capitalizing on bearish moves through the use of puts. I cover core technical analysis concepts in Chapter 6.

Trying out investing and trading strategies

Option values are not solely based on the price of the underlying stock it tracks. There are other factors impacting an option's market price. Reading about these other factors is a great start, but to a get a better handle on pricing dynamics before you have money on the line, there are additional steps you can take. Chapter 7 highlights this information.

There are different techniques available to you designed to provide the following:

- A better intuitive understanding of the changes in the underlying stock (and market in general) that affect the price of an option
- Improved working knowledge of strategy mechanics through simulation

So becoming proficient with option strategies requires practice through paper trading — similar to trading stocks. But before that, you really have to understand how real market changes impact option values over time. After you accomplish this, you can get a lot more out of paper trading. You can focus on other trading costs including slippage and margin requirements, as well as ways to best execute transactions.

Paper trading is not the only technique you can borrow from stock trading to check out a new strategy. Backtesting an option approach may take a little more time than a stock approach, but it certainly could save you a lot of money. By having a plan that slows down your pace so you address different option trading nuances in advance, you will be setting disciplined trading skills in stone.

Putting Options to Work

Option contracts can be used for financial hedges or tools for speculating. When purchasing an option contract you have the ability to exercise your rights or simply trade those rights away. Different needs and conditions will dictate different actions. You want to be prepared to properly assess the situation so you do what's best. Exercising an option to minimize stock risk is just one way you put options to work for you.

Reasonably reducing risk is the name of the game in investing, so it's very useful to know ways you can protect existing positions and strategies by adding options to them. Protection can be put in place on a position by position basis or by hedging the whole portfolio. If instead of a bearish short-term outlook that requires hedging, your view becomes so negative that you're seeking bearish trading opportunities, options offer a much safer approach than short selling a stock or sector. Chapter 10 identifies some hedging techniques.

Another way options can do some heavy lifting for your investments is through the use of leverage. By spending less on an initial investment you satisfy a reduced risk approach, but that doesn't mean you must realize reduced returns. Basic strategies can help you accomplish both. And if speculating is part of your modus operandi, you can risk even less when willing to cap your profits.

Understanding option styles

There is a primary focus on stock options in this book, but it's hard to ignore another big segment of the stock market . . . that is the index market. The glaring difference between a stock and an index is that stock is a security that can be traded. An index cannot. This means index option exercise takes on a whole new dimension. Because this is not the only difference between the two option types, it's important to grasp how your rights and trading are affected by the style of the option you decide to use. See Chapter 9 if you want to know more.

Using options to limit your risk

Comparing stock and option risk profiles is a nice start to appreciating the value options bring to your investments, but using strategies to capitalize on these securities is that much better. Evaluating the many options available for protection is one of the first steps you take in implementing all strategies. Spending time upfront understanding why some will suit your purposes better than others switches theory discussions to real applications:

- **Risk for an existing position:** Risk for existing positions can be reduced by varying degrees ranging from moderate protection to full hedges that are adjusted as market conditions change. (See Chapter 10.)
- **Risk for a new position:** Risk for new positions can similarly be reduced to a very small amount using a combination of options or less significantly with single long-term options. (See Chapters 1 and 12.)

Account approvals for strategies that use long options combined with stock or individually are generally available to most traders. As you gain experience and have more strategies available to you, you can really customize a position risk profile using option combinations. These include:

- Vertical debit spreads
- Vertical credit spreads
- Calendar spreads
- Diagonal spreads

Access to multiple strategies means implementing approaches that are best suited to existing market conditions.

Applying options to sector approaches

Exchange-traded funds (ETFs) may be one of the best investment products created in decades. They offer great diversification such as mutual funds (MF), but far outshine them in two areas:

- Ability to exit an ETF as needed with a quoted market price during the day (not end of day value calculation)
- Existence of options using ETFs as the underlying security

Needless to say, I really love that second one. Portfolios can be constructed using ETFs and ETF options for protection or using ETF options for the entire portfolio. In keeping with one of the book's objectives to provide both investors and traders with option tools, this topic definitely had to be included and is found in Chapter 13.

Using Options in Challenging Markets

Stocks and ETFs offer a great way to participate in bullish or bearish markets, but there remains a third potential trend for prices — that's sideways. By adding strategies that allow you to capitalize on this third trending alternative, you're taking one more step toward letting the market dictate your approach.

In addition to addressing a third potential market trend, option strategies allow you to reduce directional risk by profiting from moves upward or downward rather than in just one direction. You can create a combination position and adjust it over time as prices change. Such an approach responds to market movement rather than trying to predict it. See Chapter 14 for more on this.

Reducing your directional bias

Stock positions, whether long or short, have directional bias because they rely on movement in one direction for profits. Options allow you to reduce directional bias by creating combination positions that can profit if the underlying moves up or down.

So not only can you better control maximum losses with options, but you can also reduce directional risk by using strategies that can gain from two of three possible directional moves. Such approaches are based on delta neutral trading styles which introduce a whole new way of thinking about the market. Chapter 15 adds to similar strategies introduced in Chapter 14.

Benefiting when the markets go nowhere

A stock can stay in a sideways trending channel for an extended period of time, providing option traders a way to profit when most stock traders can't. Although the sideways pattern may be longer term, the option strategies that capitalize on them are shorter term in nature. These extended patterns also tend to result in strong moves away from the channel that retrace and often test the pattern before continuing on. This sets you up for a strategy change early on in a new trend. Chapter 15 provides more insight to this.

Considering your obstacles

Whether you're trading stocks, ETFs, currencies, or options, there are similar obstacles to success that must be overcome. The main one is your make-up. Trading evokes certain emotions that can wreak havoc on your results unless you actively manage them. There are a variety of ways to do this, many of which are discussed (and reiterated) throughout the book. It seems to me the topic also warrants its own space so consider periodically reviewing Chapter 18 to keep your plan on track.