

- » Getting to appreciate options
- » Analyzing options with any market in mind
- » Making the markets work for you

Chapter **1**

Options Trading and the Individual Investor

Whatever your level of experience, trading style, general tendency for holding onto positions, and risk profile, as an individual investor you can add options on individual stocks, indexes, and exchange traded mutual funds (ETFs) to your investment war chest. Perhaps the best reason to add options to your trading or investing strategies is that they allow you to both manage your risk and grow your assets. And because there are so many ways to use options, just about anyone can use them — as long as you take the time to learn the associated risks and rewards and become familiar with the particular strategies that suit your purposes. This is achieved by a process of retraining — rewiring — your brain to think in a slightly different way than your norm. No, rewiring your brain won't hurt. But it will help you to see the markets in a different and more profitable way.

The first step in the rewiring process is to know that there is a difference between trading and investing, especially in terms of time frames. *Investing* is all about using the power of time and the benefits of compounding to build wealth over long periods. The traditional *buy and hold* strategy for stocks is a perfect example, as is the owning of rental properties for long periods to generate income. This long-term-oriented, patient mindset works well for stocks and mutual funds but not always for options because of the time limit in the life of an option, unless you trade long-term options, which is a viable trading tactic addressed in this book.

But don't confuse options trading with some random, haphazard exercise. As you'll find out, options trading is a cautious and very precise exercise.

Trading, as opposed to investing, is by design a shorter-term targeted and closed-end proposition, where you may hold a position for minutes, hours, days, or weeks depending on the specifics of the situation and your trading plan. Options can be used for both trading over the short term as well as for the protection of longer-term investments, especially during times when the value of the longer-term holdings declines or goes sideways. No matter your time frame — whether you hold positions for short or long periods — your goal is essentially the same. You want to have more money at some point in the future than what you have now and increase your wealth using opportunities provided by the markets. This chapter is all about starting the rewiring process by giving you the big picture on options and thus setting the stage for the more detailed chapters that follow.

Giving Yourself a Financial and Strategic Checkup

Before you start any kind of trading or investing program, it's a good idea to know three things:

- » Your risk profile
- » Your financial situation
- » Your time commitment possibilities

Any time you add a new trading strategy, you will face a learning curve. So, as you begin to trade options, be patient and prepare to spend as much time as you need learning the craft, or you will lose money, often in a hurry.

Here are some simple steps in order to get a good start. Even if you are experienced in other forms of investing, or have experience with options, you should still stop and consider the following:

- » **Check your financial balance sheet.** Before you start trading any financial instrument, go over your living expenses, review your credit card, loans, mortgages, and life and health insurances. Put together a financial net worth statement. Make sure it's healthy before you take extraordinary risks.
- » **Set realistic goals.** Don't trade beyond your experience levels, and don't risk too much money in any one trade.



WARNING

- » **Know your willingness to take risks.** If you are a cautious person who thinks that mutual funds are risky, you may not be a good options trader. But you shouldn't count yourself out either. There are many options strategies that could suit you, especially once you understand the built-in safety nets that make some of them really decrease your risk. Just make sure you read through the book and find the ones that make you comfortable before you jump in. The chapters in Part 4 have excellent information on this topic.
- » **Become a good analyst.** If you like to roll the dice without doing your homework, you could get in trouble with options pretty rapidly. In order to maximize your chances of trading options successfully, place a high priority on improving your technical and fundamental analysis skills. You should be both a good analyst of the entire market, especially the dominant trend, as well as be able to analyze the underlying securities that are the basis for your options.
- » **Don't be afraid to test your strategies before deploying them.** Doing some paper trading on options strategies before you take real-life risks is an excellent idea that is certain to provide both practice as well as saving you some headaches. Chapter 7 guides you through this process.
- » **Never trade with money that you aren't willing to lose.** Even though options are risk-management vehicles, you can still lose money trading them. And as you progress to more sophisticated and riskier option strategies, your losses could be significant if your trades are not planned before hand. Bottom line: Don't trade options with your car payment or your rent money.

Understanding Options

Options are financial instruments that are priced based on the value of another underlying asset or financial measure. In this book, the focus is mainly on options with value based on stocks and stock market indexes, although there is also a very useful section on options based on exchange traded mutual funds (ETFs).

There are two kinds of options: *calls* and *puts*. When you add them to your current investing and trading tools and strategies, you can participate in both *bullish* (rising markets) and *bearish* (falling markets) moves in any underlying you select. And although not all stocks have options associated with them, you can use options to limit your total portfolio risk — to protect an individual existing position such as a stock or ETF, and to generate income through specific strategies known as *spreads* and *writes*.



TIP

In the options market, it's acceptable to call the security that an option is based on the *underlying*. I will use this term in this chapter and throughout the book. If you're going to trade options, you have to get used to the lingo.

To fully understand and use stock and index options to limit risk or as a stand-alone trading strategy, you must also have a thorough understanding of the asset on which they're based. This understanding may require a more thorough level of analysis and detail beyond your current approach. For example, because volatility is a key component of option prices, you will have to look at the underlying's volatility more carefully as part of your analysis in order to pick the best possible option for your particular strategy.

This book will help you by focusing on techniques that compare options to their underlying security or other securities. Chapter 9 goes into detail on several approaches that you can apply toward this goal when you analyze stocks and index options.

I like to think of all securities, including options, as risk-management tools and trading them in terms of designing an overall strategy. So, your primary focus is to understand the risks associated with the use of the tools, including all of the following:

- » Knowing what conditions, both in the markets and in the individual security, to consider when analyzing a trade
- » Using proper trade mechanics when creating a position
- » Recognizing, understanding, and following trading rules and requirements for the security
- » Understanding what individual variables make any position gain and lose value

The sections that follow address these key components of options trading to give you a good platform for designing rewarding positions and cutting any losses before they become catastrophic.

Knowing option essentials

A *listed* stock option is a contractual agreement between two parties with standard terms. All listed options contracts are governed by the same rules. When you create a new position, one of two things is triggered:

- » By buying an option, you are buying a specific set of rights.
- » By selling an option, you are acquiring a specific set of obligations.

These rights and obligations are standard and are guaranteed by the Option Clearing Corporation (OCC), so you never have to worry about who's on the other end of the agreement. Chapter 3 provides more information and detail on the Options Clearing Corporation and its central role in options trading.

Time is everything to option traders. Indeed, the one particular wrinkle in options, and the primary risk involved, is twofold: time value decay, which stocks do not possess and leverage, that causes option prices to change in larger percentage moves both up and down. The price of a call option rises when its underlying stock goes up. But if the move in the stock is too late, because it happens too close to the expiration date, the call can expire worthless. You can literally buy yourself more time, though — some options have expiration periods as late as 9 months to 2 1/2 years.

When you own call options, your rights allow you to

- » Buy a specific quantity of the underlying stock (exercise).
- » Buy the stock by a certain date (expiration).
- » Buy the specific quantity of stock at a specified price (known as the *strike price*).

In other words, the price of the call option rises when the stock price goes up because the price of the rights you bought through the option is fixed while the stock itself is increasing in value.

Conversely, a put option gains value when its underlying stock moves down in price, while the timing issue is the same. The move in price still has to occur before the option contract expires or your option will expire worthless. Your put contract rights include selling a specific quantity of stock by a certain date at a specified price. If you own the rights to sell a stock at \$60, but events such as bad news about the company pushes the stock price below \$60, those rights become more valuable.

A significant part of your skill as an options trader is your ability to select options with expiration dates that allow time for the anticipated moves to occur. This may sound too challenging at the moment, but as you learn more, it will make perfect sense because successful options trading is all about giving yourself time and giving the option time to deliver on your expectations. Of course, there are some basic trading rules of thumb that help, including the development of proper trade design and management techniques, such as planning your exit from a position before you trade in order to cut losses. Planning your exit is a simple but required

part of any trade, and it is one good habit that will save you money and heartache if a position moves against you.

All stocks with derived options available for trading have multiple expiration dates and strike prices. There are two important pricing factors to keep in mind:

- » Options with more time until the expiration date are more expensive.
- » Options with more attractive strike prices are more expensive.

Information about options and your available choices are widely available on the Internet, especially from your broker. It takes time and practice to rewire your trading brain to where you can pick the best options based on current market conditions and your outlook for the underlying asset. But as you read the different sections in this book, you will start to adjust and you will get a good feeling for how to go about this. Even more important is how you manage your emotions and how you gain trading discipline. This is best achieved by developing a maximally effective trading plan with easy-to-follow rules that includes planning for different scenarios. For more on this, see Chapter 8.

Trying different strategies before deploying them in real time

Options are different from stocks both in terms of what they represent — leverage, rights, and obligations instead of partial ownership of a company — and how they're created, by demand. These important distinctions result in the need for additional trading and decision-making beyond the basic buy or sell considerations. Part of the learning process, as you transition from direct stock trading to options trading, is developing a new and complementary way of thinking. That includes not just evaluating the price of a stock or an index, but also how the price of the underlying asset along with other factors, such as supply and demand for the option and overall market conditions involved in options prices all come together. Your final decision, as the trade develops, may be to exercise your rights under the contract or simply exit the position in the market. Fortunately, market prices will help you with those decisions, and so will some thoughts from Chapters 9 and 18.

If you haven't traded options in the past, your best approach (as I already mentioned) is to try out some trading strategies on paper and see how things work out. Your goal here is simple: You want to get to the point where you think of your option trades based not just on the option but on the underlying security.

Before you invest real money, you should be able to do the following:

- » Gain a comfortable feel for the activity and characteristics of underlying stocks or indexes on which you are looking to trade options and understand their relationship both to the market and to the options related to them.
- » To be able to mix and match sound strategies to particular market situations while keeping the preceding principles in mind.

Are these extra complications worth it? For many people, the answer is yes — especially when you consider the combined risk reduction and profit potential that options trading offers. And even though making the transition may sound difficult, the actual differences in stock and option mechanics are pretty straightforward and manageable. At the end of the day, the big advantage to options is the way they provide you with leverage while giving you a mechanism to control the rights to the stock rather than the stock itself. Trust me, you'll get used to trading options on expensive stocks that have big dollar moves for a fraction of the cost compared to owning the shares straight out.

But it's not all fun and games. An important aspect of rewiring your brain involves paying special attention to how the real market action affects the value of options over time. Once you get this part of the puzzle locked in, the rest will fall into place more easily, and your paper trading will be more satisfying. Along with paper trading, you can also backtest options trading. And don't worry about how long this rewiring process may take. Any time you spend on decreasing your risk of big losses in the future is worth your trouble.



TIP

Widely available options trading and technical analysis programs let you backtest your strategies. Some brokerage houses offer sophisticated analytical packages to their active traders for low prices or free of charge. *Backtesting* means that you review how a set of strategies has worked in the past.



TIP

Paper trading and backtesting an options-based trading approach may take a little more time than a stock approach. The advantage is that it could save you a lot of money. Consider paper trading as part of your trading plan. And even though it may slow down your pace, and possibly delay your getting started in real-time trading, this type of studious approach will let you address different option trading nuances in advance, and will get you in the habit of being a disciplined trader.

Putting options in their place

There is a time and a place for everything. And options are used best when deployed optimally — meaning when the risk reward ratio offers you the best mix of both profit potential as well as risk reduction.

When you buy an option contract, you have two choices: You can exercise your rights, or you can trade your rights away based on current market conditions and your trading objectives. You can do either one based on what is happening in the markets or to any individual position at the particular time and by executing the best strategy for what the situation calls for. The most important thing is that you know what your choices are before making the trade because you have planned for either situation.

You can use options to reduce your risk by hedging a particular position or by hedging your whole portfolio. The goal of a hedge is that the value of the option goes in the opposite direction of the underlying, thus keeping the total value of the combined position as high as possible when the underlying falls in value. If your analysis of the situation makes you so bearish that you are looking to capitalize from a falling market, options are a much less expensive and have lower risk of dollar losses than selling individual stocks short. Chapter 10 is all about portfolio protection.

Options also let you leverage your positions. Because options cost less than stocks, you can participate in a market for less than if you owned the actual shares. For example, a \$500 investment in an option strategy may give you as much profit potential as a \$5,000 investment in an individual stock. This is an excellent way to reduce risk, as you are spending less capital but potentially getting a similar rate of return to what you might receive if you owned the actual underlying stock, depending on your position size. You can apply this leverage even more astutely if you are speculating and are willing to cap your profits.

Differentiating Between Option Styles

This book is mostly about options on individual stocks. But index options are also an important part of the market, which may be of interest and use to you at some point in your trading life. The most important fact at this point is to understand the major differences between options on indexes and individual stocks. Here are some important general facts:

- » You can trade stocks but you can't trade indexes.
- » The dates for exercise (of your option rights) and the last trading date for the option are the same for individual stocks, meaning that they fall on the same date. These two important dates can be variable for index stocks, meaning that you may be able to trade the option on a different day than the exercise date.

- » There are two types of options: American and European style. Each has its own particular set of characteristics that will affect your ability to make decisions about exercise. Always know which style option you are using and the particular factors associated with it before you trade. Chapter 9 is all about option styles.

Using options to limit your risk

Getting the details of option risk profiles is important and will be useful. But designing and using strategies in trading is even better. You start by evaluating the many options that are available for asset protection. And although, you may not think that is sexy, spending the time up front to figure out what options work better than others in different situations isn't only a good step in your learning process, it's also practical. When using options to limit your risk:

- » You can reduce risk for an existing position partially or fully and adjust the hedging process gradually based on changing market conditions. See Chapter 10.
- » You can reduce risk for a new position to a very small amount by using a combination of options or by using single long-term options. See Chapter 12.

You will need a margin account for these strategies, and you can get one by filling out and signing the margin account agreement that you obtain from your broker. These are complex strategies that you can work toward as you gain experience. Some of these more complex strategies include

- » Vertical spreads
 - Calendar spreads
 - Diagonal spreads

The most influential factor on when to use these spreads will be market conditions. And this book will help you make those decisions.

Applying options to sector investing

One of the best recent advances in the financial markets has been the creation and proliferation of ETFs. Through these vehicles, you can make sector bets without having to drop down to the individual stock level of decision-making or research beyond some basic steps. ETFs are great trading vehicles because

- » **You can trade them like stocks.** That means you can buy and sell shares in them at any time during the trading day instead of waiting until the market closes, as with non-exchange traded traditional mutual funds.
- » **ETFs offer listed options.** That means you can apply all option strategies to sectors of the stock market by trading options on the underlying ETF. This often lets you make index bets without using index options with expiration and last day of trading may cause you some extra steps.
- » **There are ETFs based on commodity indexes.** These let you participate in commodity markets without trading futures. When you add the extra dimension of options being available, you have a nice array of different strategies available.

ETFs are an excellent trading vehicle category, for all those reasons and more. You can design entire diversified portfolios with ETFs and then use options to hedge individual positions or the entire portfolio. Chapter 13 gives you all the details.

Using Options in Challenging Markets

You can participate in rising or falling markets through stocks and ETFs, assuming that you are comfortable with both owning these securities and selling them short. But what do you do in a sideways market, except maybe sitting it out or collecting a few dividends? You can craft option strategies for sideways markets whether you have any underlying positions or not. Chapter 16 tells you all about this great set of strategies with the primary goal of providing income.

Reducing your directional bias and making money in flat markets

Directional bias refers to the connection of profits to the direction of prices. To make money when you are long, you need prices to rise. And to make money when you're short, you need falling prices. When you use option combination strategies, you design trades that let you make money when the underlying stock moves up or down. Consider this:

- » You can set up strategies that let you profit if the underlying rises or falls, depending on your trade setup. Chapters 14 and 15 tell you all about these trades.
- » Options let you set up strategies that can make money in sideways markets.

Controlling your emotions

Perhaps the most difficult part of trading any market is the emotional responses that can be triggered by price movements in things you own, or wish you owned. Let's face it, we are all emotional. It's part of being human. The problem is that emotional trading is usually the path to big losses. That's why we have rules and why you design an anticipatory trading plan, in order to control the emotion that goes along with trading.

A good trading plan has these key characteristics:

- » **Access to the proper equipment:** Make sure you have all the technology you need: computers, mobile devices, and backup systems along with a quiet place to work.
- » **Knowledge of time commitment:** Think about whether you will day trade or be a longer time position trader. If you can't devote a couple or three hours at a time to monitor a position, day trading is not for you.
- » **Access to good information:** Put together a good list of websites and a reliable real-time quote-charting service.
- » **Flawless trade execution:** Pick an online broker that has some scale and can execute your trades in a timely fashion without leaving you in the cold.
- » **An excellent educational component:** Work on your analytical skills, technical and fundamental, every day. You need to be a crack chartist and hone your decision-making skills.

Each chapter in this book reveals new information that is intended to make it easier to appreciate and execute the end game, the successful trading of options. Chapter 2 is all about the different types of options.

