IN THIS CHAPTER

» Getting to appreciate options

» Analyzing options with any market in mind

» Making the markets work for you

Chapter 1

Options Trading and You, the Individual Investor

Depending on your level of experience and risk profile, whether you're a trader or a longer-term investor, you can trade options on individual stocks, indexes, and exchange-traded funds (ETFs) after you master the craft or improve your skill set. Of course, the best reason to add options to your trading or investing strategies is the fact they allow you to both manage your risk and grow your assets while using less money per trade rather than by owning individual stocks.

No matter what your options strategy or your time frame are at any time — 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.

Rewiring Your Thinking

Trading options certainly has a learning curve, so make sure you take the time to study the trading techniques that suit you best and the associated risks and rewards. Throughout this book I give you the information to rewire your brain and think in a slightly different way about the markets and how your trading fits into what's happening at any time during the trading day. More important, the rewiring also includes how the market is affecting your trading and how you can turn this knowledge into your advantage. And no, rewiring your brain doesn't hurt. But it does help you to see the markets in a different and more profitable way. Chapter 7 is an excellent rewiring chapter.

REMEMBER

Keep these points in mind about the rewiring process:

- **Options trading, as all types of trading, is an adversarial process — a fight if you will.** In other words, whomever or whatever is on the other side of your trade has one goal in mind: to take your money. Of course, whether you realize it or not, you have the same goal. After all, unlike central banks that create money out of thin air, trading profits for one side come at the expense of trading losses for the other side.
- **Trading algorithms dominate the market, making trades lightning fast.** In the past, stocks were the key to options; however, in the present, the options market influences the stock market more because 80 percent of all trades in the stock and related markets are now made by trading algorithms. These machine traders are also known as *algos.* In effect they're computer programs, also referred to as *artificial intelligence (AI)* or *bots.*

  REMEMBER

  In this book I refer to them as *algos.* But no matter what I call them, they're the major influence on prices, and they're everywhere in the markets just waiting for your order. In fact, the market makers, the entities that match buy and sell orders, are all computerized. As a result, events in the markets now happen literally at the speed of light due to the involvement of algos.

  I examine this dynamic throughout the book. I show you how to spot them and how you can prepare to trade against them with frequent success. For now, my goal is to plant this thought in your mind and thus start the rewiring. Chapter 5 discusses the technical aspects of trading with the algos.

WARNING

Algos day traders, and whomever else is trading at any time, don't have your best interest in mind. Moreover, you don't have their best interest in mind either, which means you should prepare well before trading.

In addition, because algos move fast, prices also change rapidly in the market, especially in options. As a result, there is little room for investing over the long term in options. Let me be clear: *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 mind-set often, but not always, works well for stocks and mutual funds, but it doesn't work for options because of the way the algos move the markets and because of the time limit in the life of an option. One partial exception, that of trading long-term options, is a viable trading tactic that I address in this book (see Chapter 11).

The bottom line is that you may trade any option for a few minutes, a few days, or a few weeks, but no matter how long you're in an options position, even if it's part of your long-term investment plan, it's a trade. At the same time, don't confuse options trading with some random, haphazard activity. Options trading is a cautious and very precise exercise, which it's why it's an exercise in risk planning. Chapter 8 shows you how to design a "killer" trading plan.

Preparing to Trade: Take a Pre-Trading Flight Check

You wouldn't fly a plane before doing a pre-flight check, so 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

As you begin to trade options, be patient and prepare to spend as much time as you need learning the craft, or you'll lose money, often in a hurry, because the algos aren't your friend.

Even if you're 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 and 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. ***Bottom line:*** If you have $1,000 in your account, don't trade more than one options contract at any one time and don't expect to be a millionaire in a few days. Instead concentrate on learning the craft and adding money to your account. But don't be discouraged with patience, attention to detail, and time because the odds are in your favor.
- **Know your willingness to take risks.** If you're a cautious person who thinks that mutual funds are risky, you may not be a good options trader. But don't count yourself out either. Many different options strategies may suit you, especially after 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 can 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. Part 2 is a must-read in order to strengthen your market analysis chops.
- **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.

WARNING

- **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, especially with the algos in the mix. And as you progress to more sophisticated and riskier option strategies, your losses could be significant if you don't plan your trades beforehand. ***Bottom line:*** Don't trade options with your car payment or your rent money. Part 4 is all about advanced trading strategies.

Understanding Options

Options are financial instruments that were designed to be priced based on the value of another underlying asset (known as the *underlying*) in the language of the markets. At the same time, because of the way algos work, the price in the options markets is also a major influence on the price of the underlying asset. As you plan a trade, you must think in terms of three things:

- The underlying
- The option
- What the algos and other market participants such as day traders may do at any time during your trade

Incidentally, in this book, I focus mostly on options on individual stocks, but you can apply these general concepts to all markets.

The following sections 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.

Getting the complete picture

To fully understand and use options to limit risk or as a standalone 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 routine. For example, because volatility is a key component of option prices, you'll have to look at the underlying's historical volatility more carefully as part of your analysis in order to pick the best possible option for your particular strategy.

This book helps 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 portfolio strategy. In other words, I always ask myself three questions before I make any trade:

- Am I trading with the trend? (Chapter 5 helps you.)
- How will this trade affect the overall value of my account? (Refer to Chapter 7 for more information.)
- Can my account handle the potential loss for this trade? (Check out Chapter 8.)

In other words, your primary focus is to manage your risk (lose as little as possible if things go wrong). You do this by making sure you can and should make the trade as well as by understanding the risks associated with the use of any trading instruments (stocks, options, ETFs), by

- 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

Trading anything, especially options, is complex. But I'm talking about yours and my hard-earned money.

Knowing option essentials

The two kinds of options are *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*.

Making quick work of definitions

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're buying a specific set of rights.
- By selling an option, you're 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 — assume it's an algo. Chapter 3 provides more information and detail on the OCC 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:** Where the time value of the option falls on a daily basis until the expiration date — stocks don't possess it.
- **Leverage:** The factor that causes option prices to change in larger percentage moves both up and down than stocks.

Pricing relationships

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 2½ 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, some basic trading rules will 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. Moreover, planning your exit is a simple but required part of any trade, and it's a 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. The two important pricing factors to keep in mind are

- 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.

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, especially in the context of AI and the complexity of the markets. This is especially important because the activity in the options market is a major influence on the price action of individual stocks. In fact, in many instances the price action of options is more of an influence on the underlying stock than the opposite, which is what is the accepted norm.

In order to successfully transition from direct stock trading to options trading, you have to think like an options trader, which means not just evaluating the price of a stock or an index, but also evaluating 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. As you gain knowledge and experience, you need to know how your trade fits into the market maker's trading decision and how all these factors taken together affect your trade.

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.

TIP

If you think you're reading a familiar concept, you probably are. Repetition is an important part of rewiring your brain. Indeed, the more you hear or read something, the more it's likely to stick.

Crawling before walking

If you haven't traded options in the past, your best approach (as I mention repeatedly throughout this book) is to try 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 and what the trader on the other side is doing in order to try to take your money.

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're looking to trade options and understand their relationship both to the market and to the options related to them.
- Be able to mix and match sound option 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 trading options may sound difficult, stock and option-trading mechanics have more similarities than actual differences. At the end of the day, the big advantage to options trading is the combination of leverage and the ability 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.

Relying on paper trading and backtesting

Certainly, trading options isn't all fun and games. For instance, an important aspect involves paying special attention to how passage of time affects the value of options over time. After 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. Chapter 7 is all about paper trading.

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.

REMEMBER

Paper trading and backtesting an options-based trading approach may take a little more time than a stock approach. The advantage is that they can save you a lot of money. Even though paper trading may slow down your pace, and possibly delay your getting started in real-time trading, this type of studious approach lets you address different option-trading nuances in advance and gets you in the habit of being a disciplined trader.

Putting options in their place

Don't be in a hurry when trading options. 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.

Because options are primarily a risk-management tool, you can use them to reduce your risk either by hedging a particular position or by hedging your whole portfolio. The goal of a hedge is to reduce the potential loss when the market turns against you. That's because a properly designed hedge is one in which 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. What that means is that if your analysis of the situation makes you so bearish that you are looking to capitalize from a falling market, options are 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, because you're 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're speculating and are willing to cap your profits.

TIP

When used properly, options make more sense than stocks in small accounts.

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, especially in the context of what the big money traders are doing at any one time that could affect you.

That's because even if you don't trade index options, by analyzing what those traders are doing, you may be able to have a better idea as to what the stock market is thinking at the moment. For now, the most important thing 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.

TIP

Even if you don't trade index options, big traders do. Therefore, make sure you know how they work so that you can at least keep track of where the big money is moving and consider whether it makes sense to follow them.

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, and you start by evaluating the many options that are available for asset protection. Sure, you may not think that asset protection is sexy, but if the market turns on you and you're prepared, spending the time upfront 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. Refer to Chapter 12.

You'll 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 (refer to Chapter 11)
- Calendar spreads (check out Chapter 12)
- Diagonal spreads (head to Chapter 12)

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 nonexchange-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're comfortable with both owning these securities, selling them short, or using options to do either depending on the market's direction. But what do you do in a sideways market, except maybe sitting it out or collecting a few dividends?

Guess what? You can craft option strategies such as condors and butterflies (but not animal crackers) like I discuss in Chapters 14 and 16 for sideways markets, whether you have any underlying positions or not.

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're 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 whether 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. Face it, everyone is emotional. It's part of being human. The problem is that emotional trading is usually the path to big losses. That's why option traders 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, reliable Internet, and backup systems along with a quiet place to work.

- **Knowledge of time commitment:** Think about whether you'll day trade or be a longer time position trader. And although options trading isn't always day trading, sometimes a position can turn an excellent profit or hit your sell point in a short period of time. Thus, if you can't devote the appropriate time to monitor a position, day trading in options or stocks, for that matter, isn't 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 is 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.