Mistake #1

Relying Solely on Market Timing To Trade Options

WHY TRADERS MAKE MISTAKE #1

Far too many first-time option traders view options as nothing more than a tool for leveraging their market timing decisions. That is, rather than buying or selling short a particular stock or futures contract, they feel that they can buy a call or put option and:

- Commit a great deal less capital than they would to buy the underlying security itself, and,
- Obtain a great deal more leverage than they would if they simply bought the underlying security.

And, in fact, it is possible to attain these benefits via option trading. By putting a relatively small sum of money into an option position, it is possible for a trader to achieve a much higher rate of return on a given trade than if he or she had bought or sold short the underlying security directly. For example, consider a stock that is trading at a price of $55 per share. In order to buy 100 shares of that stock, the investor would need to invest $5,500 (100 shares times $55 per share).

At the same time, a call option with a strike price of 55—which gives the buyer of the option the right, but not the obligation, to buy 100 shares of the underlying stock at a price of $55 a share—might be trading at a price of $3 per contract. In order to buy one call option, the investor need only to put up $300 ($3 per contract times 100). The call option trader's breakeven price in this example is $58 per share (the strike price of 55 plus the premium paid of $3). Hence, the call makes a profit at any stock price above 58. So in this case, the option trader needs to put up only about 5.4% as much capital as the buyer of 100 shares of stock; at any price above $58 per share, the option trader will enjoy point-for-point profit with the more traditional stock trader who invested $5,500 to buy the stock.

That is the good news. Unfortunately, a vast number of market timers adopt the belief that market timing is all they need in order to profit from trading options. Accordingly, they do little or no options analysis—instead adopting the attitude that "if my timing is good, any old option will do." This is invariably a fatal error in the long run.

Market timers take great comfort in their winning trades—perhaps too much comfort. Any winning trades that they experience serve to reinforce their belief that market timing is all that is required in order to succeed, regardless of how few and far between the winning trades may be. Unfortunately, occasionally achieving a high rate of return on a given trade is not the same thing as making money in the long run. The question to ask is not, "Do I achieve a big winner now and then?" (as even the worst traders can occasionally hit a big winner). The relevant question is, "Am I following an approach that is likely to generate profits over the long run?" Traders who rely solely on market timing to trade options must answer no to this all-important question.

The primary reason that relying solely on market timing to trade options fails in the long run is that it completely ignores one of the most important factors in option trading: implied volatility. Before proceeding to explain why market timing alone fails option traders in the long run, let's first discuss what implied volatility is and why an understanding of this important concept is critical to option trading success.

Implied Volatility Defined

The "implied volatility" value for a given option is the value that a trader would need to plug into an option pricing model in order to make the theoretical option price generated by the model equal to the current market price of a particular option. This can be accomplished when the other variables—underlying price, days until option expiration, interest rates, and the difference between the option's strike price and the price of the underlying security—are known. In other words, it is the volatility "implied" by the current market price for a given option. Before proceeding it is important to understand just what implied volatility represents, why it is so important, and the impact that changes in implied volatility can have on your trades.

Calculating Implied Volatility for a Given Option

There are several variables that are entered into an option-pricing model to arrive at a theoretical price, or the "fair value," of a given option:

A) The current price of the underlying security.

B) The strike price of the option under analysis.

C) Current interest rates.

D) The number of days until the option expires.

E) A volatility value.

For stock options, dividends also factor into the model. However, to simplify things here, we will leave dividends out of the following example.

- Elements A through E above are passed to an option-pricing model, which then generates, a theoretical option price.
- Elements A, B, C and D are "known" variables. In other words, at any given point in time one can readily observe the price of the underlying stock (or futures contract), the strike price for the option in question, the current level of interest rates, and the number of days left until the option expires.

Example of Implied Volatility Calculation

To calculate the implied volatility of a given option, we follow this procedure with one important modification. Instead of passing elements A through E to an option pricing model that generates a "theoretical" price, we pass elements A through D along with the actual market price for the option as variable F, and allow the option pricing model to solve for element E, the volatility value. A computer is needed to make this calculation. This volatility value is called the "implied volatility" for that option. In other words, it is the volatility that is implied by the marketplace based on the actual price of the option.

For example, on April 6th the IBM July 2006 85-call option was trading at a price of $2.40. The known variables are:

A) The current price of the underlying security = 83.70

B) The strike price of the option under analysis = 85

C) Current interest rate = 3.5

D) The number of days until the option expires = 106

E) Implied volatility = ?

F) The actual market price of the option = 2.40

The unknown variable that must be solved for is element E, volatility. Given the variables listed above, a volatility of 14.21 must be plugged into element E in order for the option-pricing model to generate a theoretical price that equals the actual market price of $2.40. Thus, the "implied volatility" for the IBM July 2006 85-call as of April 6th option is 14.21.

Different options may trade at different implied volatility levels. If demand in the marketplace is great for a given option, the price of that option may be driven to artificially high levels, thus generating a higher implied volatility for that option. The differences in implied volatilities across strike prices among options of the same expiration month for a given underlying are referred to as the volatility "skew." There are a number of different options strategies that are geared to exploit specific volatility skews.

Why Implied Volatility Matters

The actual price of an option, the premium, is the sum of two quantities: intrinsic and extrinsic value. Intrinsic value represents the amount by which the option's strike price is in-the-

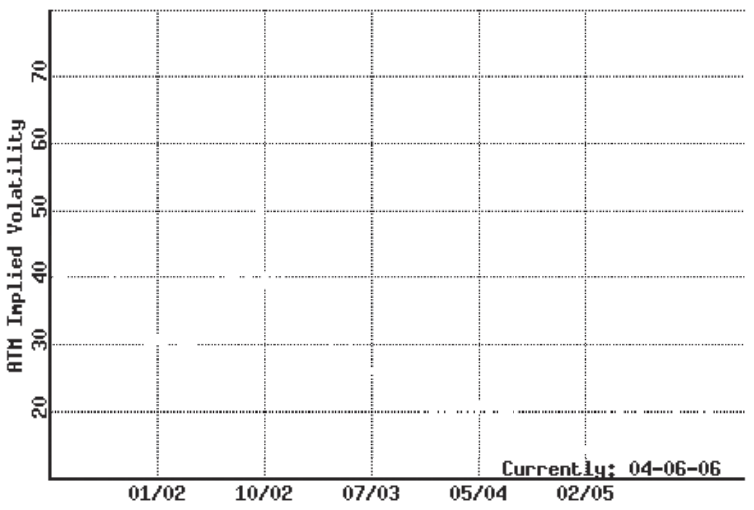
money (ITM). Extrinsic value represents time premium. If an option is out-of-the-money, then the price is comprised solely of time premium, or extrinsic value. The amount of time premium built into any option is directly related to the amount of time left until expiration and the implied volatility for that option. As a result, the higher the current level of implied volatility, the higher the price for the option. Conversely, the lower the current level of implied volatility, the lower the price for the option. This has obvious ramifications for any trader considering buying or writing a particular option. If you buy a given call option when implied volatility is high, you will pay more for the option than you would if implied volatility was low. This in turn implies that you:

- Will spend more to buy the call option;
- Will have a greater dollar risk;
- Will have a higher breakeven price basis the underlying stock for a call option and a lower breakeven price for a put; and,
- May experience a meaningful decline in the price of the option if there is subsequently a significant decline in volatility.

Let's illustrate these factors further with an example. As you can see in Figure 1, over the course of the past five years, the implied volatility for IBM options with more than 90 days left until expiration has ranged from a low of 13 to a high of 54.

To understand the significance of changes in implied volatility, take a look at how the price of the July 85-call option changes given different implied volatility levels as of April 6th (see Table 1). First, let's look at the low end. If the IBM July 85-call option

Figure 1 - IBM Implied Volatility



Source: Optionetics Platinum

were to trade at an implied volatility level of 13, the price of the option would be $2.30. If the option traded at the two-year high for implied volatility of 24, the price of the option would be $4.28. Finally, if the implied volatility for the option were at the five-year high of 54, the price of the option would be $9.65. These differences have significant implications.

It should be clear from the information contained in Table 1 that implied volatility is a critical piece of information for any option trader to consider. Likewise, any trader who completely ignores implied volatility—for example, one who focuses only

Table 1 - Changes in Implied Volatility = Price Shifts

July 85-Call Volatility and Price	Underlying Breakeven Price	% Move Required to Reach Breakeven Price	% Probability of Reaching Breakeven Price
13% / 2.30	87.30	4.3%	31%
24% / 4.28	89.28	6.7%	21%
54 / 9.65	94.65	13.1%	6%

on market timing to trade options—will undoubtedly at times be flying blind. This will lead him to buy options in situations where it is not prudent to do so due to high volatility or writing options when it is not a prudent course of action due to low volatility.

Why Implied Volatility Fluctuates

Much of the fluctuation that occurs for an option price is directly related to changes in the price of the underlying security. Clearly, if a stock makes a huge move up, call prices will increase and put prices will decline across the board for that stock. However, the amount of time premium built into a given option is also determined to a great extent by the current level of implied volatility. As we saw in Figure 1, implied volatility levels can change dramatically. Why is this? There are two primary factors – the volatility of the underlying stock and investor perceptions of future volatility.

In order for any option trade to occur, there must be one buyer and one seller, or "writer." Consider this: if out-of-the-money options had no time premium—in other words, if they were all priced at $0.00—why would anyone assume the risk of writing an out-of-the-money option? The amount of time premium built into each option is essentially the inducement available to a trader to take the risk of writing that option. When the underlying stock price starts to behave in a volatile manner, or if some impending news situation causes investors to think that volatility will rise in the near future, then option writers will essentially demand higher premiums before they will be willing to take the risk of writing options on that stock. This demand for higher premiums is reflected by a higher implied volatility value.

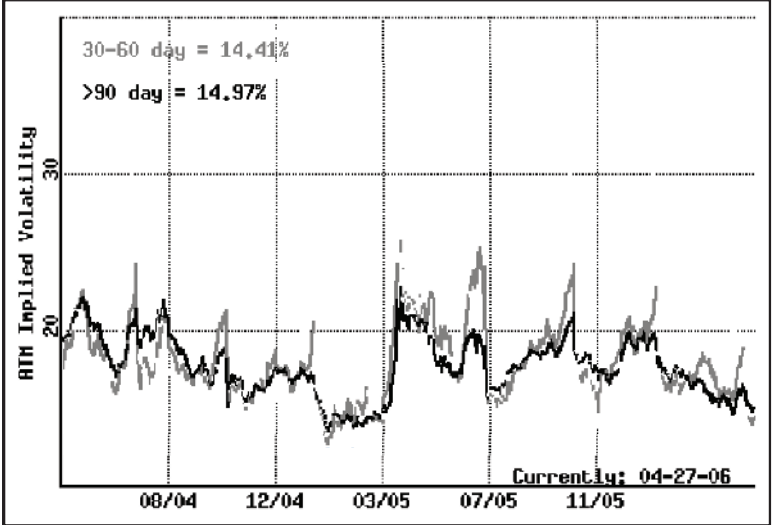
Implied Volatility for a Given Security

While each option for a given market may trade at its own implied volatility level, it is possible to objectively arrive at a single value to refer to as the average implied volatility value for the options of a given security for a specific day. This daily value can then be compared to the historical range of implied volatility values for that security to determine if this current reading is "high" or "low."

Figure 2 displays the implied volatility values for IBM options for different timeframes. Typically shorter-term options are more volatile than longer-term options. This is clearly reflected in the various lines that appear in Figure 2, which displays 24 months of implied volatility history.

One way to reduce the amount of "noise" is to only consider options with 90 days or more left until expiration. Figure 3

Figure 2 - Implied Volatility of IBM Options for All Timeframes



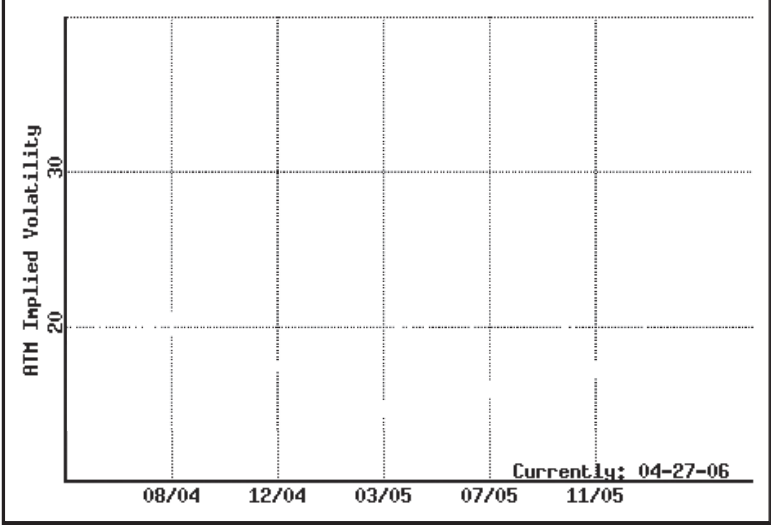
Source: Optionetics Platinum

displays the implied volatility for IBM options with 90 or more days left until expiration for the prior 24 months.

As you can see in Figures 1, 2 and 3, the implied volatility for the options of a given security can fluctuate widely over a period of time. Also, each stock and futures market establishes its own range of highs and lows for implied volatility. Without knowing the range of volatility levels for each security, it is impossible to compare apples to apples when comparing two or more underlying securities. In Figure 4, note how the implied volatility for options on Amazon.com stock has ranged from 28% to 172%, with a current reading of about 32%.

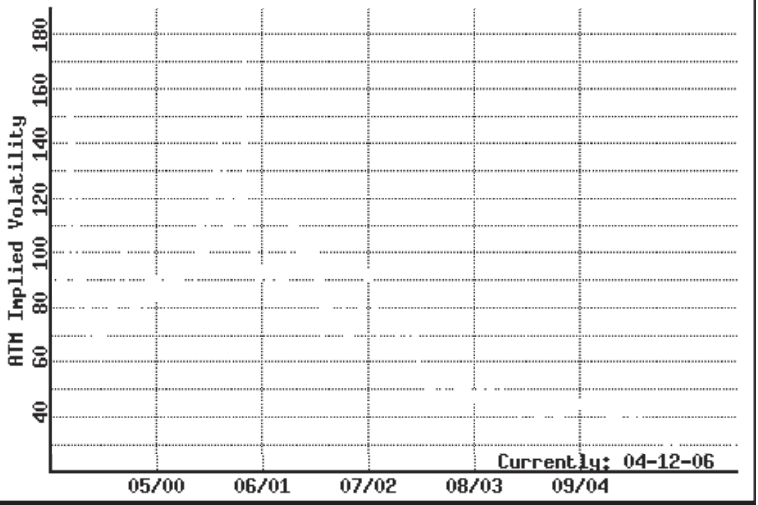
In Figure 5, note how the implied volatility for options on General Motors stock has ranged from 20% to 82%, with a current reading of about 67%.

Figure 3 - Implied Volatility of IBM Options with 90+ Days Left until Expiration



Source: Optionetics Platinum

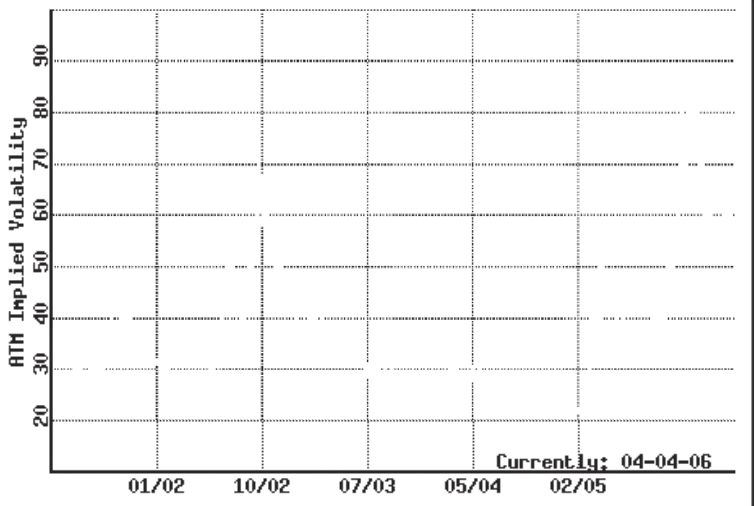
Figure 4 - Implied Volatility for Amazon.com Options



Source: Optionetics Platinum

Knowing whether the current level of implied volatility is relatively high or low for the options of a given underlying security is a key element in long-term option trading success. This, in

Figure 5 - Implied Volatility for General Motors Options



Source: Optionetics Platinum

turn, will tell you if there is a lot of time premium presently built into the option prices for a given security.

WHY MISTAKE #1 CAUSES LOSSES IN THE LONG RUN

There are two primary problems with relying solely on market timing to trade options:

A) First, picking tops and bottoms for a given underlying security is extremely difficult at best. In fact, many would argue that it is impossible to do on a regular basis.

B) Second, the movement of the price of a given option is not always directly proportional to the price movement of the underlying security. As a result, even if you pick the exact low point for a given stock or futures market and buy a call option, it is still quite possible that the call option you buy will not generate a big profit, and in fact, might actually lose money.

These facts of option trading life are summarily dismissed by the market timer and are major problems among this group of option traders.

The Market Timing Flaw

For our purposes here, we will define "market timing" as attempting to time an entry and/or an exit into or out of a position—be it a stock, an option, a futures contract, or the stock market as a whole—at the most advantageous time possible. Market timing—or more precisely, accurate market timing—is the "holy grail" of trading. Virtually every investor in the mar-

kets engages in some form of timing whether consciously or unconsciously. Even investors with a very long-term perspective who buy and sell stocks based on their expectations of the fundamentals for the underlying company over the next several years still hope to buy at the "right" time. And it makes sense to pursue accurate market timing since the lower you buy and the higher you sell, the more profit you garner on each trade. Still, if you step back and consider all of the material available regarding market timing—including books, articles, newsletters, web sites, hotlines, videos, etc.—you come to realize that not everything works equally well. If it did, every investor would be wildly successful. And that is far from the case.

There is a multitude of potential pitfalls associated with market timing. To start with, there are virtually an infinite number of timing methods currently available and even more waiting to be developed. So the process of zeroing in on a useful method can involve a lot of work on the part of each individual investor. Secondly, not all timing methods are suited for all investors and traders. There are day-trading methods that are based on 1-minute bar charts, which require constant attention. At the other end of the spectrum, methods that are based on long-term trends need only to be monitored on a very infrequent basis. And then there is, of course, everything in between.

Once an investor does settle on a timing method, there is the question of how much patience he or she will maintain if that method suffers a period of underperformance. Even the best trading methods can and will occasionally go for a period of time without generating new profits. That is simply the nature of the trading markets. So the issue at hand for the investor using any given technique is simply, "What do I do when

things go sideways, or even down for a longer period of time than I had expected?" One of the most common mistakes that even disciplined, systematic traders make is to abandon their well thought-out trading approach at exactly the wrong time. It is easy to envision how this can happen.

Consider an individual who decides to devote himself to developing a profitable trading technique. He spends days or weeks or months and countless hours determining the optimum criteria for entering and exiting trades. Once the criteria are set and the hypothetical trading results are deemed acceptable, he then begins watching the technique in the markets in real time. For awhile things go very well. Pleased with the real-time results, the trader decides to "take the plunge" and begin trading using his newly developed technique.

For a while things may continue to go well. But, as with all things when it comes to trading, eventually his trading technique goes flat for awhile. After a period of maybe a couple of months of not making any new profits, the trader begins to get a little restless and starts to question if something is "wrong" with his trading technique. Then suddenly, out of the blue, the bottom drops out—even if only temporarily—and the trader begins to lose money at a much faster clip than he is mentally prepared for. At first, he decides to "hang on" in hopes that things will turn around. Ultimately, the fear of losing even more money overcomes him and our trader decides to "pull the plug" in order to stop the pain. So he stops trading using his technique. And if he is like many other traders, in the next few days, weeks, or months, he will watch his technique begin to work well again, quickly earning back the money that had previously been lost and garnering new profits. But while the

system itself is doing well, the trader is left behind, afraid to jump back in now that he has "missed the bounce."

Another common problem among investors who actively utilize timing is the tendency to overrate their ability to time the market. No matter how "accurate" a trader believes his or her market timing method to be, the probability of a given underlying security moving in the predicted direction between the time an option is purchased and the expiration date for that option is exactly 50/50. This fact of probability is true even if you are using a trading system that has been 80% accurate in the past.

This statement has stirred some debate in the past and is not accepted by many ardent traders. Still, consider this question: Pick any stock listed on any exchange and ask, what is the probability that this stock will be higher in one day, one week, or one month from right now? The true odds are always 50/50. So despite the fact that 80% of the previous buy signals from a given system or method have been followed by a price advance, the initial probability of the underlying security rising after the next buy signal remains exactly 50/50. Thus, the ardent market timer enters each trade with the flawed perception that the odds are 80/20 in his or her favor, while in fact they are no better than 50/50.

Making matters worse, this probability figure regarding price movement applies to the underlying security itself, not to the options on that underlying security. Option premiums may fluctuate independently based on several factors that are never considered by the market timer, such as time decay and changes in implied volatility.

Underlying Security Price Movement vs. Fluctuations in Option Prices

The implied volatility of an option is a key variable in how an option is priced. While each option trades at its own implied volatility level, the general level of implied volatilities for the options of a given underlying security can fluctuate widely over time. As a result of these fluctuations in implied volatility, at any given point in time, option premiums may be extremely high, extremely low, or anywhere in between. It is essential to your long-term success to be able to determine whether the current level of implied volatility is high or low for a given underlying security. Lack of this knowledge is the key reason that market timers lose money trading options. At times, they pay far too much when buying options because they commit one of the cardinal sins of option trading: they assume that the price movement of the option they buy will mirror the price movement of the underlying security. Adopting the attitude that "any old option will do" is a sure way to lose money on options.

Ideally, you will focus your option buying on situations in which implied volatility is relatively low and focus your option writing (selling) on situations where implied volatility is relatively high. By so doing, you can profit not only from a favorable price movement by the underlying security but also from a favorable change in volatility. The importance of avoiding option purchases when implied volatility is extremely high cannot be overstated.

Anytime you buy an option, a subsequent decline in volatility can cause losses in your option position. In some cases, this can be true even if the underlying security moves in the fore-

casted direction. This is true whether volatility is high or low at the time you buy an option. However, the higher the implied volatility at the time an option is purchased, the greater the downside risk. It's one thing to be walking down the street and trip and fall, but if you are standing on a mountain top and you trip and fall, then that is something completely different. Clearly, if you are standing at the top of a mountain, you would likely pay close attention to your footing. The market timer who pays no attention to implied volatility levels runs the risk of not only falling off of a mountain top, but of not even knowing he is standing on the mountain top at the time he falls. Ignorance clearly is not bliss.

Less Favorable Risk/Reward Relationship

One factor that is often overlooked when buying options is the expected relationship between risk and reward. Since the probability of making money on a long option position if held until expiration is always less than 50% (because of the inevitable time decay of option premiums as they approach expiration), it is very important to a trader's long-term success that he or she make a lot of money when correct. In other words, if your probability of making money on each trade is less than 50/50 and you always have a risk-to- reward ratio of 1 to 1, then you will lose money in the long run. As a result, it is extremely important to hit a big winner from time to time in order to offset the inevitable losses and allow profits to accumulate over time.

This emphasizes the importance of putting the odds as much on your side as possible for each trade. Unfortunately, the trader who completely ignores implied volatility cannot possibly know whether or not he or she is maximizing the risk-to-reward potential.

Most traders simply expect to make a lot of money any time they buy an option, so they tend to have an overly optimistic idea about their potential reward. Since the purchase of a call option comes with limited risk, they figure that the upside potential is great and the likelihood of losing the entire premium is extremely low. As a result, the perceived risk-to-reward ratio is generally much higher than it actually is in the market place. Let's look at a real-world example.

Most new option traders are trained by prior experience to trade the underlying security rather than the option. When starting out, most traders learn something about technical analysis and/or fundamental analysis. All of this analysis is geared toward determining when to buy or sell a given stock or futures contract. When the decision is made to trade an option on a given underlying security rather than the underlying security itself, many traders mistakenly assume that as long as their timing is good, they can simply buy a call or put and that the option will trade exactly as the underlying does. This type of thinking is actually at the heart of the problem.

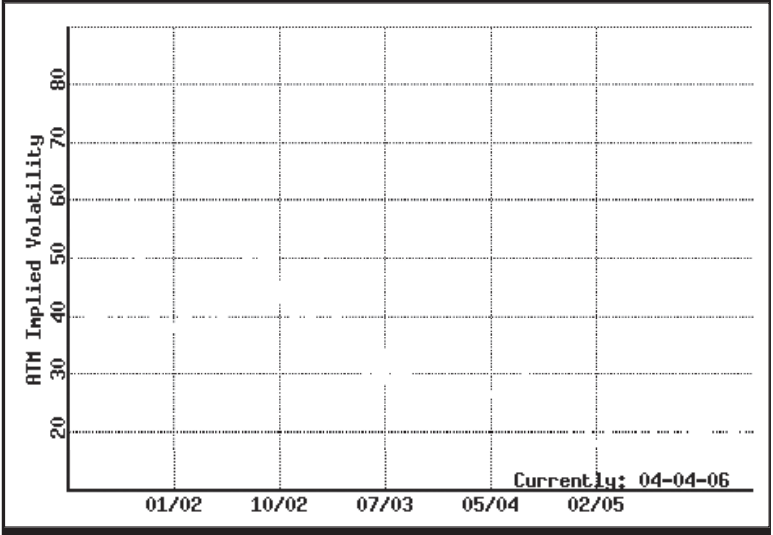
In reality, an option trader's work has only just begun once the timing decision has been made. At this point, the trader must decide which option to buy and/or how to manage the position once it is established. If a trader has two or more underlying securities to choose from, the decision becomes even more complicated. As most traders do not have unlimited capital, very often they find themselves in a situation where they may have to choose between trading one underlying security or another. Making the proper selection among different underlying securities and determining which option strategy to employ and which option or options to trade is the step that separates profitable option traders from the other 90%.

Real-World Example

1. On April 6, a trader's market timing method gives buy signals on two stocks, Merrill Lynch (MER) and General Motors (GM).
2. Based on these signals, both stocks are expected to rise 10% in the next month.
3. In order to maximize profitability, the trader decides to buy a call option on one or the other.
4. The trader has $2500 that she wants to commit to one trade.

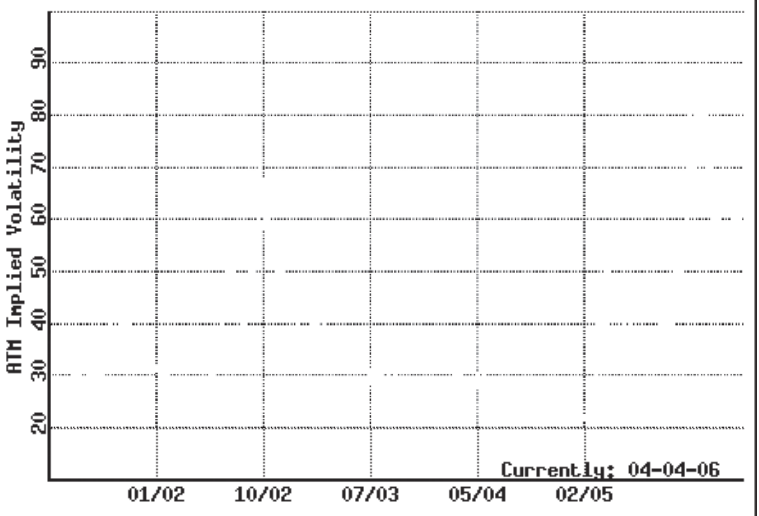
The question is: Which stock offers the better option play? If the trader has no tools other than her market timing method, she has no choice but to flip a coin or make a subjective guess. The trader who looks beyond market timing can make a much more enlightened decision that will give her a much greater

Figure 6 - Implied Volatility for Merrill Lynch Options



Source: Optionetics Platinum

Figure 7 - Implied Volatility for General Motors Options



Source: Optionetics Platinum

profit potential. Figures 6 and 7 display the implied volatility levels for both stocks on the date in question.

Plugging in the following scenario:

1. $2500 of capital.
2. Expecting a 10% advance in price over the next month.
3. Evaluating only "buying calls."

Figures 8 and 9 display the top trades for each stock if the expected scenario plays out—i.e., if Merrill Lynch and GM both rally 10% in the next month. These expected returns are exactly in line with what we would expect.

If Merrill Lynch rallies 10% in the next month, the May 80 call stands to gain 299%. On the other hand, if GM rallies 10%

Figure 8 - Expected Returns for Merrill Lynch Options

Platinum Option Trade Search on: 2006-04-06

Rk	Stock	Click trade below for Options Analysis	Stock Price	Cost	Max Profit	Max Risk	Prob Of Profit	Odds	Days	Vol	Open Interest
1 ☐	MER	Buy 1 MAY06 80 Call@ 2.20	79.91	$220.00	Unlimited	$-220.00	33.93%	0.8 to 1	43	799	2078
2 ☐	MER	Buy 1 OCT06 85 Call@ 2.70	79.91	$270.00	Unlimited	$-270.00	27.86%	1.0 to 1	197	12	1597
3 ☐	MER	Buy 1 JUL06 80 Call@ 3.60	79.91	$360.00	Unlimited	$-360.00	35.57%	0.9 to 1	106	4346	6301
4 ☐	MER	Buy 1 JAN07 85 Call@ 4.00	79.91	$400.00	Unlimited	$-400.00	30.52%	1.0 to 1	288	232	7270
5 ☐	MER	Buy 1 JAN08 95 Call@ 4.60	79.91	$460.00	Unlimited	$-460.00	25.71%	1.1 to 1	652	0	418

Source: Optionetics Platinum

Figure 9 - Expected Returns for GM Options

Platinum Option Trade Search on: 2006-04-06

Rk	Stock	Click trade below for Options Analysis	Stock Price	Cost	Max Profit	Max Risk	Prob Of Profit	Odds	Days	Vol	Open Interest
1 ☐	GM	Buy 1 MAY06 20 Call@ 1.45	19.55	$145.00	Unlimited	$-145.00	30.16%	0.8 to 1	43	3438	11819
2 ☐	GM	Buy 1 JUN06 20 Call@ 2.05	19.55	$205.00	Unlimited	$-205.00	30.27%	0.8 to 1	71	233	29036
3 ☐	GM	Buy 1 SEP06 22.5 Call@ 2.10	19.55	$210.00	Unlimited	$-210.00	25.97%	1.0 to 1	162	155	14474
4 ☐	GM	Buy 1 JAN07 25 Call@ 2.15	19.55	$215.00	Unlimited	$-215.00	24.98%	1.4 to 1	288	136	87493
5 ☐	GM	Buy 1 JAN08 30 Call@ 2.60	19.55	$260.00	Unlimited	$-260.00	24.62%	2.5 to 1	652	161	25603

Source: Optionetics Platinum

in the next month, buying the May 20 call—the top available trade—will gain only 34%. Clearly, traders have much greater potential to get the most bang for their buck trading MER options as opposed to GM options.

One other factor to consider that makes Merrill Lynch options even more attractive in this situation is the fact that the MER option volatilities rise and fall fairly regularly. As a result, one additional benefit of buying options when implied volatility is low is that there is the possibility that implied volatility will rise during the life of the trade, which will inflate the prices of all options for that security. Conversely, if you buy options when implied volatility is high, there is always the danger that implied volatility will decline or even collapse during the life of

the trade, thus depressing the price of the option by reducing the amount of time premium built into the option.

For the sake of illustration, let's assume that the implied volatilities for both Merrill Lynch and General Motors regress to their mean—i.e., both revert to the volatility level that is halfway between their high and low readings. For this to happen, Merrill Lynch volatility would rise to 40%. Conversely, GM volatility would fall from 63% to about 50%. Under this scenario, if the option volatility of both stocks reverted to their mean, the upside potential would be even that much greater for Merrill Lynch options compared to General Motors. The profit potential for the Merrill Lynch May 80 call rises from 299% to 320%. Meanwhile, the profit potential on GM May 20 call drops to just 25%.

At this point, it should be clear that not all option trading opportunities are created equal. This example illustrates the importance of not relying solely on market timing to trade options. In this example, the outlook for two different stocks was equally bullish, yet the trader who bought Merrill Lynch call options had much greater upside potential by virtue of buying "cheap" options and the potential for a bigger rise in option volatility. In contrast, the trader who bought General Motors call options had much less upside potential. There is also the risk that implied volatility will revert to the average, or worse, fall into lower territory, thus deflating all GM option prices.

HOW TO AVOID MISTAKE #1

Market timing can be an essential part of option trading success. Unfortunately, the mistake that too many traders make is that they fail to recognize that there is more to option trading

success than just market timing. If you do not give serious consideration to which option you choose to buy and how much you are willing to pay for it, you will set yourself up for losses that could easily have been avoided. Not only is this kind of trading obviously bad for your trading account, but the experience of making a good market timing call and still losing money can be extremely damaging psychologically.

Many option traders start out by trading stocks or mutual funds first. While there is much to be learned by doing so, the problem is often that many unwary option traders view option trading as the same game as buying and selling stocks. This is simply not the case. Let me illustrate this point as simply as possible. When you buy 100 shares of stock and that stock goes up in price one point, you make $100. If it goes down a point, you lose $100. If you sell short 100 shares of stock and it goes down one point, you make $100. If it goes up one point and you are short 100 shares, you lose $100. It is a simple straightforward process. If you are long, and the stock goes up 1%, you make 1%. If it goes up 10%, you make 10%; if it goes up 50%, you make 50%, etc. This type of straightforward computation does not necessarily apply to option trading. In option trading, there is any number of additional factors that can play a role in affecting a trade's profitability. Such variables include the strike price (or strike prices if entering into a spread) that you choose to use when entering a trade, the amount of time left until those options expire, the current level of implied volatility, and any subsequent changes in implied volatility after you enter the trade.

If you buy a far-out-of-the-money option, typically the underlying security must make a very large move simply to reach the breakeven price let alone to show a meaningful profit. If you

buy an option with one month left until expiration, but the move that you are expecting takes two months to actually occur, you could end up being correct about your expectations yet still end up losing 100% of the capital you committed to the trade. Likewise, as I have illustrated in this section, if you buy an option that is trading at an extremely high-implied volatility, and that volatility level falls significantly after you enter the trade, the amount of time premium in the option that you bought may also collapse.

In order to avoid this mistake, you must make a commitment to go the extra step once your market timing mechanism has generated a signal. That extra step involves determining whether implied option volatility is presently high or low for the underlying security and determining which option trading strategy to employ based on this information. One useful technique is to compare the current level of implied volatility with the historical range of volatility for the particular security you are considering to objectively determine whether the current level is high or low.

In sum, in order to be successful in trading options over the long run, you need to be educated about the critical factors that affect options and option positions. Market timing is only one part of a much bigger picture.

The Concept of Relative Volatility

The concept of Relative Volatility ranking allows traders to objectively determine whether the current implied volatility for the options of a given stock or commodity is "high" or "low" on a historical basis. This knowledge is key in deter-mining the best trading strategies to employ for a given security.

A simple method for calculating Relative Volatility is simply to note the highest and lowest readings in implied volatility for a given security's options over the last two years. The difference between the highest and lowest recorded values can then be cut into ten increments, or deciles. If the current implied volatility is in the lowest decile, then Relative Volatility is "1." If the current implied volatility is in the highest decile, then Relative Volatility is "10." This approach allows traders to make an objective determination as to whether implied option volatility is currently high or low for any given security. They can then use this knowledge to decide which trading strategy to employ, as shown in the following tables (Table 2, 3).

Table 2 - Relative Volatility/Strategy Table

			Relative Volatility Rank (1 - 10)									
STRATEGY	**PROFIT POTENTIAL**	**RISK**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Buy Straddles	Unlimited	Limited	X	X								
Buy Naked Options	Unlimited	Limited	X	X	X							
Backspreads	Unlimited	Limited	X	X	X	X	X					
Buy Verticals	Limited	Limited	X	X	X	X	X					
Calendar Spreads	Limited	Limited	X	X	X	X	X					
Sell Verticals	Limited	Limited						X	X	X	X	X
Sell Double Verticals	Limited	Limited							X	X	X	X
Buy Ratio Spreads	Limited	Unlimited								X	X	X
Sell Naked Options	Limited	Unlimited									X	X
Sell Straddles	Limited	Unlimited									X	X

Table 3 - Relative Volatility/Trading Strategy Reference Table												
Relative Volatility Rank (1 - 10)												
HEDGING STRATEGY	PROFIT POTENTIAL	RISK	1	2	3	4	5	6	7	8	9	10
Buy Underlying/ Buy Put	Unlimited	Limited	x	x	x							
Short Underlying/ Buy Call	Limited	Limited	x	x	x							
Buy Underlying/ Sell Call/Buy Put	Limited	Limited				x	x	x	x			
Short Underlying/ Sell Put/Buy Call	Limited	Limited				x	x	x	x			
Buy Underlying/ Sell Call	Limited	Limited								x	x	x
Short Underlying/ Sell Put	Limited	Limited								x	x	x

As you can see in the implied volatility graphs displayed in this section, implied option volatility can fluctuate widely over time. Traders who are unaware of whether option volatility is currently high or low have no idea if they are paying too much for the options they are buying (or receiving too little for the options that they are writing). This lack of knowledge costs them money in the long run.