TIME to explore

OPTION TRADING

INTRODUCTION

I think it would be safe to assume that if you are reading this right now, you have some interest in learning more about options trading. Chances are good that you will most likely fall into one of three camps. My intent over the next several pages is to offer some value to each camp, and hopefully make you smile in the process. Simply stated, options are choices about TIME!

CAMP 1

Perhaps you are brand new, and this whole journey seems daunting and grossly overwhelming. You are curious, but do not even know where to begin. I vividly remember how overwhelmed I felt at the beginning – hang in there, come join the journey. I can assure you that this is the place to be, and option trading is absolutely possible to learn.

CAMP 2

Or, you have been trading (unsuccessfully) for a period of time, and are looking to turn that corner into consistent profitability. You may have strings of wins, peppered by one or two catastrophic losses, that elicit and reveal all the core obstacles of trading – FEAR, ANXIETY, DOUBT, ANGER, HOPE, EXCITEMENT, ADVENTURE. I can assure you that trading options will offer an elevated level of safety, consistency, & profitability.

CAMP 3

The final camp will most likely be the (successful) trader who has been consistently trading in options, futures, currencies (forex), or stocks. This trader understands the mental and emotional discipline demanded of them to make it as a trader. Their capacity to define and accept risk is measureable. I can assure you that this camp will find value in here as well.

My goal and desire is to help navigate ALL levels of traders across this minefield of options trading, and teach some core basic principles that exist in trading. In my opinion, options trading will offer something unique, powerful, and special that is not available in any of the other markets I have referenced above. I have learned that those who are the most skeptical of options trading often become the traders who recognize and see the greatest benefit. If this sounds like you want to learn more, scroll down, and let's get started. I intend to make something that seems complex, difficult & intimidating, very simple to understand and implement.

WHY

With any great challenge, (trust me options is going to be a challenge), you must first address the "WHY".

Why do you want to trade options?

Why are you willing to sacrifice time to learn this?

Why should you expect to succeed where so many others have not?

Why does the options market even exist in the first place?

Why trade options at all?

The "why" is absolutely going to be pivotal for everyone reading this, and it has to be the single biggest, as well as the first question you ask yourself. When you truly understand and begin to unpack the "why", then trust me, the what, the how, the when, all becomes systematic and procedural. Simply stated, begin with the why.

Options exist to transfer risk

Period

Simple

That's it! Options offload risk. Try and not make it any more complicated than it needs to be.

WHAT

Now that we have the "why" out of the way, let's discuss WHAT exactly is an OPTION.

Life Definition: OPTION is anything that offers a choice.

Financial Definition: A derivative (derives value from something else) that represents a legal contract from one party to another. This contract offers the buyer of an option the right, but NOT the obligation to sell something. Conversely, this contract obligates the seller to provide something at a pre-determined price, over a pre-determined time period.

Option contracts can simply be thought of as a legal binding contract between two parties, a buyer & a seller. This is no different than any other legal binding contract where something of value is exchanged. In the case of options, the value is derived from an underlying asset, or more specifically, 100 shares of stock. This is the leverage of 1:100 that the options market offers. Option contracts exchanged are either CALL options or PUT options.

OPTION BUYER

A CALL option permits the owner of the option the right (but not the obligation) to "call" away shares of stock at a pre-determined price, over a pre-determined amount of time. A PUT option permits the owner of the option the right (but not the obligation) to "put" the shares of stock back to the owner who sold them, over a pre-determined amount of time. For now, we are only discussing the purchase of option contracts. Any time you are the NET OWNER of a CALL/PUT option, the risk being transferred is specifically limited to the amount of premium paid to own the CALL/PUT option. If you own a CALL option, you desire the underlying asset to appreciate in value. If you own a PUT option, you desire the underlying asset to decline in value.

CALL OPTION Real life example:

Think of owning an option contract similar to owning a coupon you have clipped out of the Sunday newspaper. The coupon gives the holder the right, but NOT the obligation, to buy something advertised, at a discounted price with a pre-determined expiration date.

In this example however, you paid nothing for the coupon in your possession, but will receive something of value before the coupon expires. There is a fixed price, and a fixed time period (expiration date). This translates exactly to an option chain on thousands of underlying assets – stocks, bonds, futures, commodities, indices & currencies.

PUT OPTION Real life example:

Consider for a moment insurance coverage on your automobile or your home. You own a specified contract, that allows you the ability to "put" something worthless (in the case of a fire or car accident), back to the insurance company for current market value. The cost of owning the PUT option can be viewed as the premiums you pay to own that contract.

The easiest way to remember the difference between CALLS & PUTS is this…

If you own a CALL option, you want the underlying asset to increase in value greater than the cost of the option.

If you own a PUT option, you want the underlying asset to decrease in value greater than the cost of the option.

OPTION SELLER

Remember what was said earlier, that the option contract is an agreement between a buyer and a seller. The reverse is now true if you are the option seller. You no longer own the rights to use your contracts, you now have obligations to make good on those contracts.

BUYERS HAVE RIGHTS

SELLERS HAVE OBLIGATIONS

While there are benefits and drawbacks to both, let me use a real world example to explain a CALL option in as simple terms as possible.

The house built on an undiscovered oil field.

Here is a commonly used analogy to help understand a real world example of how the option market works.

You are the owner of 10 acres of remote rural farmland. One day, a stranger comes to your door and offers to give you $10,000.00 USD along with a legal binding contract to buy your property. The contract states that anytime between now and the next 3 months, he/she has the right (but NOT the obligation) to buy your property for $500,000.00 USD even though your property is worth substantially less. In exchange, you as the property owner, keep the $10,000 premium received to sell this contract. You can say no, or you can say yes. Once you say yes however, the legal binding contract is in force.

Two months elapse, and the stranger comes back to your home with $500,000 and tells you to hit the road. He now owns your property, and you receive a check for $500,000.00 for your time. It was discovered that your property was situated on an undiscovered oil field, and valued in excess of 10 million dollars. Doh!

The STRANGER paid you a premium to become the BUYER of a CALL option contract. He paid a net debit of $10,000 to have the right (but NOT the obligation) to buy your property at a "pre-determined" price (500,000), over a "pre-determined" time period (3 months). His true risk in the transaction was only the premium paid for the contract (10,000).

YOU owned something of value, and became the SELLER of a CALL option contract. You received premium (10,000) to hold the obligation to sell something at a "pre-determined" price (500,000), over a "pre-determined" time period (3 months). Your true risk as an option seller was immeasurable.

The bottom line is this…

OPTIONS = CHOICE

When this is fully understood, the flexibility that options offer is immeasurable. Consider for a moment the implications of being wrong on a direction when thinking a stock is going to go up versus down, and still making money. By utilizing options, the trader can be completely and entirely wrong on direction, and still make money. Sounds intriguing, maybe we should continue the investigation.

QUICK BASIC FACTS

1 option contract controls 100 shares of an underlying asset.

Option contracts are standardized contracts regulated by the CBOE.

Owning CALL options, desired move is UP.

Owning PUT options, desired move is DOWN.

Selling CALL options, desired move is DOWN.

Selling PUT options, desired move is UP.

Every single day that passes in TIME, the value of an option changes!

Option contracts are wasting assets.

Time decay hurts option owners. Time decay helps option sellers.

Option contracts are used to protect and hedge large portfolios.

QUICK ADVANCED FACTS

Open Interest = Actual amount of contracts that are currently eligible to be traded.

Volume = Number of contracts actively traded on a specific date.

Spread = Distance and difference between the bid/ask.

American Style options can be exercised and closed earlier than the expiration date.

European Style options can never be exercised prior to the expiration date. (*massively important for sellers*)

LEAPS = Long-Term Equity Antici Pation Securities

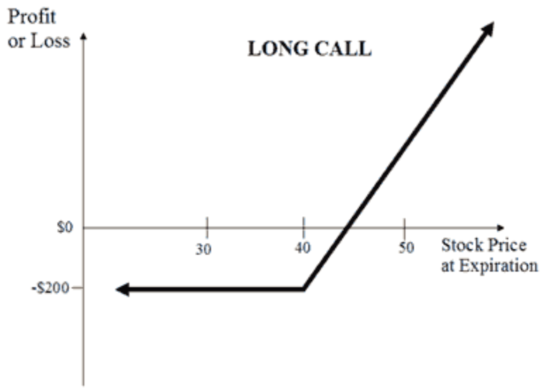
Volatility = A measure of option prices that change dependent on changes in market sentiment.

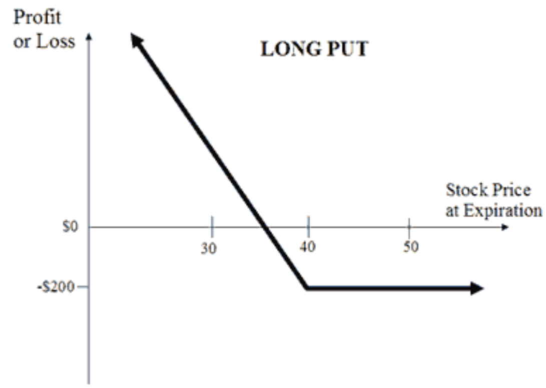
Directional trading using options is hugely speculative.

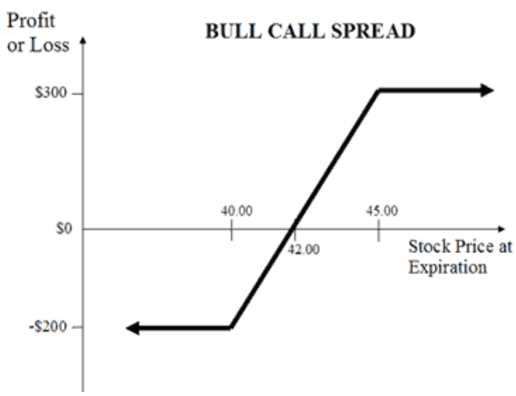
Non-Directional trading using options is geared towards income generation by exploiting time decay.

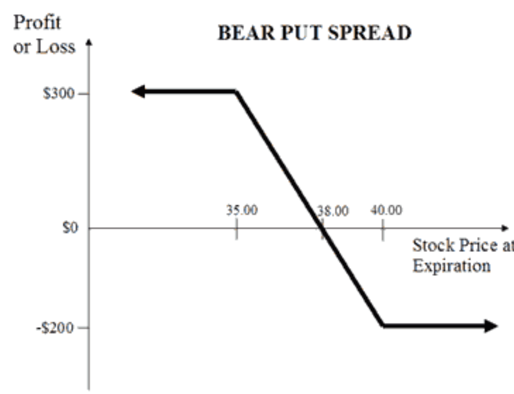
Multiple strategies can take advantage of movements in price, changes in volatility, and range bound markets.

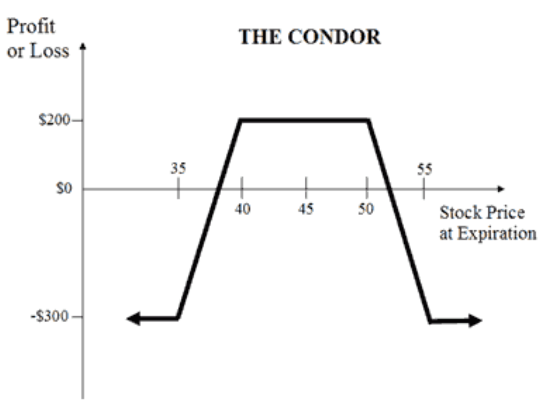
RISK PROFILES

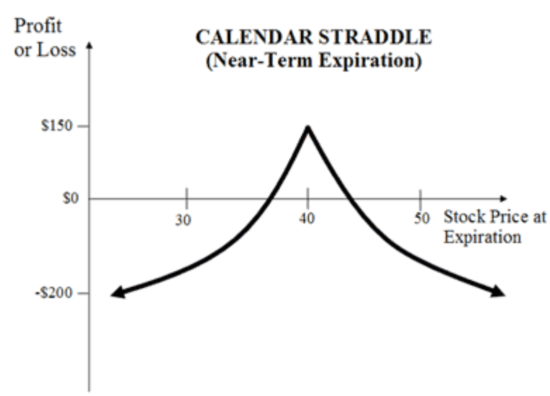












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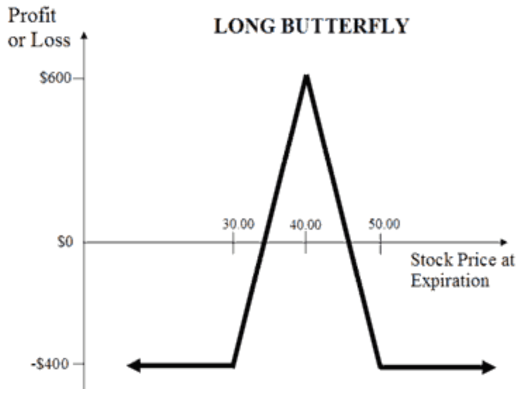
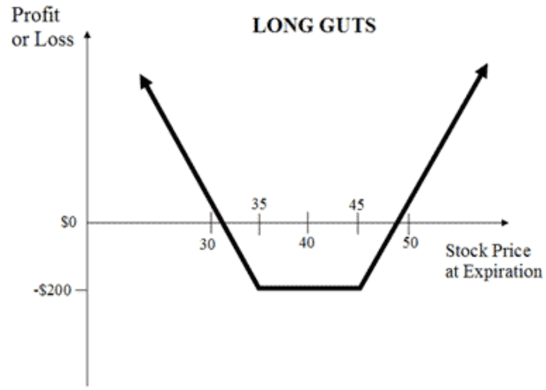




The choices available to an option trader are literally endless. The simple mechanics of picking a "direction" are over. Some of the most profitable traders I have ever met, have zero opinion, yes ZERO opinion on which direction the market is going to move, and still make consistent profits month after month. The elegance of not having to form a correct opinion about which direction the market will move, is what eliminates the greatest obstacle most traders struggle with – direction.

Just remember, the market can do

ANYTHING

at

ANYTIME

for

ANY REASON

Let's just consider for another moment the trader who actually can excel at picking direction successfully. Do you begin to see opportunity for combining a directional option trade, with limited risk, and potential huge reward? Ten baggers and larger, are commonplace all the time for option traders who understand how to combine the two concepts.

WHAT ABOUT THE "GREEKS"

Delta: The amount of change (positive or negative) that an option will experience with a move in price of $1

Gamma: The speed, or momentum at which Delta will change. Gamma can be viewed as a "derivative of a derivative".

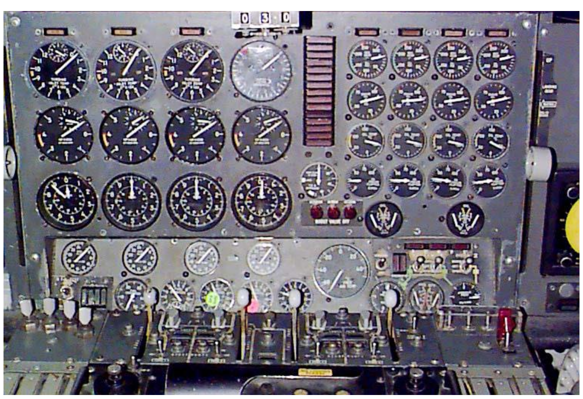
Theta: The time value, or measurement of the rate at which options lose their value.

Vega: The measurement that changes in volatility will have on the option premium.

Rho: The measurement that changes in interest rates have on premium.

UGH. Do I really need to master the "GREEKS"?

Greeks are instrument gauges that help monitor individual options, as well as complex option spreads. Greeks are LESS important for newer traders learning conceptual ideas, & MORE important for traders who are trading options for a monthly income.



VOLATILITY IS DANGEROUS! (or is it)

Waking up and getting out of bed can be volatile sometimes. ☺

Entire books have been written on volatility alone, and rightfully so. Volatility can instantaneously destroy a profitable trade, and price action will have not moved a penny. Of course the reverse is true, but volatility is sensitive to so many variables, that to try and explain it here in a few short sentences would be impossible. My intent here is to keep it as simple as possible and not overcomplicate. Just be advised, that volatility is something to respect, understand, and never take lightly. The death nail to volatility, is a predetermined trade plan, remember that. Volatility is no different than price action – uncertainty about future movement is the norm.

When discussing volatility, two important distinctions need to occur.

HISTORICAL VOLATILITY

IMPLIED VOLATILITY

HV (historical volatility) reflects the actual movement of the underlying stock or asset. It can be measured, and is a rear-looking indicator. It is a specific measurement that is calculated as a standard deviation of a stocks return over a fixed number of days. Typical days measured are 30, but can be any time period. This formula is complex, and does NOT need to be memorized for our purposes.

IV (implied volatility) reflects the perceived or anticipated movement of the underlying stock or asset. This is an "anticipated" move, and is forward looking. Obviously this is a measure of uncertainty, and thus is more sensitive to stocks that have a wider range of movement. This implied volatility, is what makes an option trader go insane trying to predict price movements. Entire strategies are utilized that exist solely to take advantage of these changes in volatility.

Suffice it to say, that once you accept these volatility movements are "uncertain" in nature, just as the actual price action is uncertain, then a specific plan can be constructed around that.

Spot VIX is what measures and represents the market's expectation of the overall stock market volatility over the next 30 days. For those interested, the index (VIX), takes as inputs the current market prices for all OTM (out of the money) S&P 500 CALLS and PUTS for the first and second month expirations. It then calculates the square root of the risk-neutral expectation of S&P 500 variance over the next 30 calendar days. The VIX is then quoted as an annualized standard deviation in percentage points. Blah, blah, blah, blah.

Here is what is important!

Research and price action reveals that VIX hits the highest levels during periods of market turbulence and is often times referred to as the "fear gauge". This becomes incredibly important later on in the discussion about when to buy and sell options.

Money management / Trade PLAN

This could easily be the single biggest factor that eliminates any trader, options or otherwise, from ever achieving long term success and consistency. **It is my opinion that perfect money management, when coupled with proper position sizing, is the single most important item for a trader to understand.** Without those two, you stand zero chance at making it long term. Yes, I said ZERO. Money management is where it all begins, and this is a core component of a trade PLAN. Proper position sizing will maximize the growth, while regulating losses. If there are no funds to trade with, trading is over. Can we agree on that? It has been said that trading is in fact a zero-sum game, for every winner there is a loser, for every loser there is a winner. The only fact I know to be true about trading is that if you try to trade without have a pre-determined, sound money management plan in place, you will never make it, and fall immediately into that loser column.

The main point of a trade PLAN is to reinforce calmness, relaxation, and objective control during the course of a trade. It will not matter if the trade lasts 5 minutes, or 5 months, the trade PLAN is your compass. Without having that compass to guide you, you are not trading – you are GAMBLING!

Three core bullet points should constitute a solid money management piece of this trade PLAN.

- % of Net account risked PER TRADE (position sizing)
- Accuracy or Win Rate
- Risk:Reward Ratio on every trade

Pay attention to bullet point #1, this is how professional traders trade. This will not only grow an account at maximum efficiency, but it will also minimize the account drawdown when the inevitable string of losing trades occurs. Just remember, that a 20% loss of account equity requires a 25% return on capital just to return to the original starting point. **Reread that again and again until it fully sinks in.**

Pre-Determined, honored, and respected guidelines are what every trade PLAN should include. The categories and headings should be simple, straightforward, and easy to follow. The trade PLAN is something that will constantly evolve, but at minimum it should address the following topics.

- Objective Goals along with approach
- Which market / underlying is traded
- Timeframe and setup
- **Maximum Allowable Loss**
- **Entry rules, adjustment guidelines, uncle point**
- **Target Profit (be realistic)**
- Post Mortem Trade Analysis after Trade is over (what was done well, what can be improved)
- Mindset during life of trade (extraneous life circumstances or abnormal conditions)

- "Am I Disciplined to follow these 10 Rules?"
    1. Protect capital
    2. Honor stop loss
    3. Let profits run
    4. TRADE WHAT YOU SEE, NOT WHAT YOU THINK
    5. Never chase losses
    6. Never average down unless prepared for that at the beginning
    7. Keep excellent records and daily screen shots
    8. Maintain positive ATTITUDE & DISCIPLINE
    9. Keep it SIMPLE
    10. Plan the trade, trade the PLAN

It was not until I made it a priority of understanding, and calculating not only a Sharpe ratio by hand, but also a Sortino ratio, did I become consistently profitable. This single exercise became the key turning point in my trading career, and I am saddened that it took me so long to realize that. I cannot emphasize it enough that relentless attention to details, along with a good money management routine, is the biggest limiting factor to those who desire to trade for a living.

Sharpe Ratio: Examines performance by using standard deviations to measure investment returns.

Sortino Ratio: A variation of the Sharpe ratio, which differentiates harmful volatility from volatility in general.

Google these two and learn how to calculate them. Do it by hand, and take your time to fully grasp the implications.

When the trade PLAN is working, this becomes the result.

"OBSESSION WITH ACCUMULATION"

NEVER QUIT

Do not EVER QUIT if trading is what you want. The rewards are worth the sacrifice, but maximum commitment is mandatory. When all the physical, emotional, and psychological facades are stripped away, you may for the first time in your life, meet the real "YOU". Trading simultaneously exposes strength and weakness, and forces you to deal with them head-on. Are you prepared for that?

Finish Strong

GRATITUDE is power

PERSPECTIVE is everything

LOVE conquers all

WORD FUN WITH ALPHABET SOUP

Consider for a moment some of the most important assets a trader must possess.

ATTITUDE

DISCIPLINE

Eliminate either of those, and the chance for long term, consistent success drops significantly. These are not just words in my opinion, they are the secret. The secret to trading, to life, to everything.

I would like you to assign a number to each letter of the alphabet. A=1, B=2, C=3, etc. until Z=26. Next I would like you to write down each of the above three words.

Is this coincidence, design, or possibly something important?

Corny, maybe. Important, YES!

Will you remember this?

"Obstacles are those frightful things you see when you take your eyes off your goal."

– Henry Ford –