Make Money Trading Options

What’s in it for me? Learn the basics of options trading.

All too often, people regret missing out on juicy investment opportunities. But the risks taken – and the money that could disappear in a flash – are never mentioned. The prospect of riches is just too good. Rather than betting your life savings on long-shot gambles, these blinks will show you how to manage your risks. Instead of beating the odds, you’ll learn to follow the trend. You won’t become a millionaire overnight, but if you’re careful, you could discover a way to add to your income consistently: trading stock options. In the end, the market always wins, and you might not profit every single time. But by using these tools, you’ll keep your losses to a minimum. In these blinks, you’ll learn

the difference between stocks and options; how to make money on a losing stock; and why trading options and betting on horse races are not the same.

Trading stock options can be very lucrative.

Imagine you’ve just retired after a fruitful career in teaching. Over the years, you’ve managed to stow away slivers of your monthly paycheck, depositing them into your retirement account. By now, your contributions have grown into a respectable nest egg of $150,000. But here’s the thing: you have big plans for your retirement years. You want to travel the world, stay in fancy hotels, and maybe even pay off your mortgage. So how can you increase your income? Your first thought is stocks. Then you remember how your nephew goes on about the money he makes doing something called trading options. It seems like he always wins. Why not give it a shot? This is the key message: Trading stock options can be very lucrative. Your nephew is right about one thing: you can make money trading options. But just like any investment, it comes with risks. To understand what exactly is at stake, let’s define the stuff options are made of. Officially, a stock option is a type of agreement called an options contract. This gives you the right to buy – or sell – stock at a certain price in the future, without actually being obligated to buy that stock. You’re probably familiar with how stocks work. If you buy one share in Microsoft at $10, you own a tiny bit of Microsoft. If the price of Microsoft shares goes up to $15, and you sell your share, you’ll go home with a tidy profit of $5. But if the share price falls to $1, and you sell, you’ll lose the difference: $9. If you had 100 shares to start out with, you’d need $1000 upfront. And if the market goes south, you’ll be out 900 bucks. When buying options, you’re not required to buy the actual underlying stock. And compared to stock trading, you don’t need as much money to start: one option contract controls 100 shares. The prices – or premiums – of this contract could be as low as a few dollars. Let’s say you buy an option contract for Microsoft valued at $10 per share. If the share price reaches $15, you then have the right to purchase 100 shares of Microsoft at the earlier price – the strike price – and sell them for the higher, market price. So instead of a $5 profit, you’ll be sitting on $500. If the price goes down to $1, you’ll only lose what you paid for the premium. This does sound great – a get-rich-quick scheme that really works! What could possibly go wrong?

Understanding how options work is vital to minimizing risk.

Actually, quite a lot could go wrong in the previous scenario. Many novice traders, eager to make a quick buck, still confuse options with stocks. Instead of purchasing 50 shares, they accidentally buy 50 options. Remember: one option controls 100 shares. So 50 options would come out to a trade of 5,000 shares. You might strike it big – but the alternative would mean a loss of several hundred or several thousand dollars. And therein lies one of the greatest dangers of trading options. If you're not careful, and don't know how much money is at risk before entering a trade, you could lose a big chunk of your savings in a matter of hours or even minutes. Here's the key message: Understanding how options work is vital to minimizing risk. When you buy and sell stocks to make a profit, your decisions depend on the direction in which you think the price is headed. Share prices can go up or down, and for each possibility, there's a type of option. Let's say Apple is announcing its new iPhone model. You're confident that it'll be a hit, and the price of Apple shares will skyrocket. But there's one problem: you can't be 100 percent certain. What if a report comes out exposing a technical flaw? That'd be a disaster for the stock price. So instead of risking your hard-earned cash, you buy a call option contract. If the new iPhone is flawless, and the share price does go up, you can buy 100 shares of Apple at the pre-announcement price. Or you could sell the option to someone else who wants to buy those cheaper shares. As the stock price increases, so too does the price of your call option. The second type of option is a bit more tricky; it involves betting against the market. If you buy stock at $10 and the share value decreases to $1, there's not much you can do about it. You can sell it and cut your losses, or wait until the share value returns to its higher levels. But let's say you think – you know – the price of shares is going to plummet. You can still make money by buying a put option. This gives you the right, but not the obligation, to sell Apple stocks at a certain price – $5, for instance, even if share prices drop to $1. For our purposes here, we'll focus on call options.

Unlike stocks, all options expire.

Now that you have a better grasp of call and put options, you might be anxious to get started. It seems simple enough, as long as you don't confuse shares with options, and you keep track of the money at risk for each trade. But there's one more key difference between stocks and options that influences your profits – or losses – over time. When you buy a stock, you have a choice: keep trading, or hold it long term. For instance, you could buy 50 shares of Google and walk away. Take a vacation. Join a knitting club. Upon your return, if the company still exists, your shares will still be there. Whenever you buy an option, however, the clock starts ticking. The key message here is this: Unlike stocks, all options expire. Life is fleeting, and so are options. The moment you buy an option, you decide when it will become worthless. Most options are set to expire on the third Friday of each month at 4:00 p.m. Eastern Time. You can also choose weekly or quarterly expiration dates. Whichever you select, know this: the farther away the expiration date, the more the option costs. As you approach this date, the price at which you can sell the option rapidly decreases. There's less time for dramatic shifts in stock price, so the option becomes less attractive. That's why some people lose money on options, even if they predict the market correctly. It's immensely risky to wait to sell – or exit – an option position just before it expires. Although the underlying stock price might be higher, the premium you receive could be less than you paid. Consider this scenario. The market price for one Netflix share is $20, but you suspect that it will push past $25 within the next couple of weeks. So you buy one call option, set to expire in a month, and pay $10 for it. Your plan is to sell the option, giving someone the right to buy 100 shares at $20 – the strike price. So you wait, watch, and listen. Fourteen days pass, and Netflix is trading at around $18. You're losing hope. Then, two days before your call option expires, your prayers are answered: the share price reaches $25. Someone buys your option, but because it expires so soon, the premium has plunged to just $2. Here, you made the right prediction, but still ended up with a net loss.

Identify the most profitable stocks with the help of the Test Trading Strategy.

The risks and complications of trading options can be daunting. But if managed correctly, options can be an excellent way to increase your income or savings. In some cases, like gambling on horse races, you're not permitted to change your bet after the starting bell rings. Instead, you place a wager on the horses you think will finish in the top three. If you're right, you win some money. And if you're wrong, you lose the money you bet. What if you could avoid risking so much? If you could, say, place your bet partway through the race, you'd probably win more often, right? While this isn't allowed in most horse races, you can do this when trading options, using something called the Test Trading Strategy. The key message? Identify the most profitable stocks with the help of the Test Trading Strategy. So you're not a fortune teller – and that's okay. Rather than trying to predict the future, you can use virtual trading tools to test theories of the directions in which stocks are heading. Virtual trading, also known as paper trading, uses fake money to practice buying and selling stocks and options. Paper trading isn't just a great way to learn the ropes; used in conjunction with real trading, it can save you a lot of trouble and lost money. The Test Trading Strategy will help you prepare for the trading day, determine which stocks to watch, and decide which days to sit out. After all, not every day is good for trading. For starters, you'll need to set up the test trading account. If you already have a broker, there's a good chance she has her own simulated trading platform. If not, there are plenty of others available for free, such as on the Investopedia website. Once your test account is up and running, it's time to create your Watch List. This is the list of stocks and other securities, such as ETFs – or Exchange Traded Funds – that you'll monitor from day to day on your computer or smartphone. To your Watch List, you should add SPY, which is the stock market symbol for the SPDR S&P 500 ETF Trust. Your list should also include QQQ – the Invesco QQQ Trust; the Dow Jones Industrial Average, or DJIA; and the Standard & Poor's 500 Index, also called SPX, or the S&P 500. Now that you have these ETFs on your list to track the general trends of the stock market, it's time to add individual stocks to the mix. We'll learn how in the next blink.

Add individual stocks to your Watch List. Then, start test trading.

When it comes to your Watch List, the stocks you add should meet a few criteria. Remember that these are the companies whose stocks – or options – you're considering buying and selling. These stocks should be at least $50 per share, and should be among the most actively traded stocks on the market. They should be held in mutual funds, indexes, banks, and hedge funds. A powerful Watch List contains many highly successful companies like Apple, Amazon, IBM, Mastercard, Netflix, or Tesla. Your list should stay away from potentially risky investments, as well as assets like American Depositary Receipts, or ADRs, which can't be sold or traded for cash without significantly diminishing in value. Once you've loaded up the test trading account with your Watch List picks, you can begin making your first practice trades. Here's the key message: Add individual stocks to your Watch List. Then, start test trading. Before the real market opens and trading begins at 9:30 a.m. Eastern Time, take a few minutes to prepare your test trading account and adjust your parameters. Usually, trading simulators provide you with some paper money to play around with – make sure your paper account has at least $100,000 to allow for buying many different stocks without limitations. About 30 minutes before the market opens, check the stock quotes on your Watch List. They'll give you an idea of how the market might develop. Has Mastercard's stock moved up by one point – a dollar – or one percent? What about Tesla? You're not allowed to buy options until after the market opens, so instead, place an order in the test trading account to buy 100 shares of each stock. This should be a market order, which means that you pay the current price of a share when your order is fulfilled, at or after 9:30 a.m. Whether you choose to focus on dollar moves or percentages is a matter of preference. Your priority is to find winning stocks. Lastly, any stocks that jump significantly in the pre-market should be treated with caution: just because a share price shoots up by eight or nine percent doesn't mean it will continue moving up. Once the stock market opens, your job is to watch closely for stocks that reverse direction or don't keep up. Soon enough, the real winners will reveal themselves.

“I'd rather probe with paper money than risk losing real money."

Pick out the winning stocks once the stock market opens.

The clock strikes 9:30 a.m., and the race is on. By keeping a close eye on the purchased stocks in your trading account, you can begin to separate the wheat from the chaff in real time. It's tempting to get caught up in the acrobatics of early morning trends: certain stocks will surge, others will plunge, and some won't move much at all. As the morning progresses, the true winners will emerge with more stable gains. At this stage, patience is crucial, but you also need to know what to watch for. So what makes a winner, anyway? The key message is: Pick out the winning stocks once the stock market opens. A common philosophy in stock trading is to buy low and sell high. The reality shows this is incredibly difficult to pull off, and such miracles of timing can seldom be replicated. Instead, by finding the steadily increasing stocks in the first hour, through the Test Trading Strategy, you can make more modest gains by buying high, and selling higher. If no clear winners emerge by midmorning, it's perfectly acceptable to decide to stop trading for the day. You should be able to pinpoint at least one or two winners pulling away from the rest of the pack. On some days, as many as six or seven spring up. Now, you can start to buy calls in the test trading account. We're going to employ a strategy called the five-call probe. For any winning stock, buy five call options. The price of the calls should be lower than the market price of the underlying stock – this is known as in-the-money. By watching these calls, and their corresponding stocks, we can see which of the early winners will continue, well, winning. For any of these options that keep increasing in value, purchase five more calls at-the-money, or at the current market price. If these calls are also profitable – making anywhere from $100 to $300 – you're ready to leave your trading simulator for the big leagues, and buy call options in the real brokerage.

Use the Five-Minute Rule to manage risks when trading real options.

There's one final check to do before you buy any call options for each winning stock in your real brokerage account. You've left the paper trading account behind for now, and are about to use – and risk – your own money. If you don't dot your i's and cross your t's, you could be in for some very expensive surprises. Surprises can be exciting, but not when they involve losing large sums of money. That's where the Five-Minute Rule comes in. By going through the steps listed in this method before every trade, you can double-check that everything is shipshape before pressing the Enter key. The best part about it? It only takes five minutes, so you probably won't miss out on any life-changing market fluctuations. The key message here is: Use the Five-Minute Rule to manage risks when trading real options. If you're a beginner, it's best to limit yourself to one or two positions – that is, options that have not yet been sold or used – at a time. Otherwise, it's easy to lose track of how many open positions are in play. Once you've decided which position to open, you can get to work tackling the Five-Minute Rule. First, examine the fine print surrounding the option. That means checking the expiration date and the strike price. All of this information is located in the options chain. Many traders get into trouble here: If you enter 100 call contracts when you only meant ten or one, you have a problem. Next, check the bid-ask price, which is the highest price a buyer will pay and the lowest price a seller will accept. This is also in the options chain. If the bid-ask spread is too wide – meaning there's too large a gap between the two – find another stock to trade. It's too difficult to make a profitable trade if the bid and ask prices are too distant. The third step is to make sure you place a limit order and not a market order. Recall that we placed a market order in the test trading account. That was only to track the stock prices. In your real account, it's very risky to buy stocks at market price. Instead, a limit order lets you name your price, which should be somewhere between the bid and ask prices. Lastly, review the stock charts one last time to confirm that your initial observations still hold true. You can always take five minutes – especially when it will keep you from rushing into a problematic trade because of a careless mistake.

Continue managing risks after trading an option.

At this point, you've identified a winning stock trending upwards, and have bought a call option. Of course, like any investment strategy, the Test Trading Strategy has risks, too. A stock might have passed all of your tests. Perhaps it survived your five-call probes, and, thanks to your Five-Minute Rule checklist, everything is set. Here's the truth: you could conduct all the tests in the world, and there's still a chance that your winning stock will reverse direction. Even experts pick the wrong stock sometimes. You can hope for the best – but be prepared for the worst. This is the key message: Continue managing risks after trading an option. Trading options is not for the sentimental. You've bought a winning call option, but if things go awry, you need an exit plan. That's where two instruments – time stops and stop-losses – come into play. All too frequently, even the most conscientious traders lose money by getting distracted after making a trade. If you set a time stop for your trade, you choose a specific time to sell your option automatically – for a gain or a loss. It might be after half an hour, or you might decide to keep it overnight. This way, you can either lock in gains, or make sure $100 in losses don't turn into $500 as the day progresses. Another possibility is to set a stop-loss. Instead of relying on a specific time, a stop-loss triggers an automatic sale once the price of the option reaches a specific limit. For example, if you don't want to lose more than $50 on an option trade, a stop-loss would save you from deeper losses, even if you're on a walk or at the grocery store when the sale is triggered. As for which one to use – a time stop or a stop-loss – it's up to you. Now that you have your call option, and you've put your safety mechanisms into place, there's one last step in your trading day. When the market closes, and you're ready to turn off your computer, take a few minutes to evaluate the day's trades. Take notes on your successes and failures. Which trades went well? Why? Which trades lost you money? By keeping these records, you can learn from your mistakes and triumphs, and become a more proficient options trader.

Final summary

The key message in these blinks: Trading options can be very profitable, but it's easy to make careless mistakes. Many people lose money trading options because they don't understand exactly how it works. By using the Test Trading Strategy, you can identify which stocks take the most profit each day. If you probe the winners with virtual trading, and use the Five-Minute Rule to avoid careless mistakes before every trade, you'll be equipped with the tools to trade options for a profit – without risking your life savings. Actionable advice: Avoid revenge trading. Some traders get emotionally attached to certain options – or to the potential return they represent. This can have a destructive effect on their trades for the rest of the day or even the week. When a trade doesn't come out in their favor, and they lose money, these sentimental traders vow to get revenge. They'll fixate on making back lost profits with the same underlying stock. Usually, this means a series of poorly thought-out trades, adding even greater losses to the tally. If you suffer a loss while trading, leave it where it is, take a break, and move on. Got feedback? We'd love to hear what you think about our content! Just drop an email to with Make Money Trading Options as the subject line, and share your thoughts!