OPTIONS TRADING

FOR BEGINNERS

A CRASH COURSE ON HOW TO BUILD A PASSIVE INCOME IN 2020 AND HOW TO TRADE STOCKS FOR A LIVING BECOMING A SWING TRADER RIGHT NOW

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Introduction

If you were to find an investor and ask to look at their portfolio, you will be able to see that they have a large variety of investments that they are working on. They don't just put all their money on one company all the time. Instead they have many different types of investments they can work with such as bonds, stocks, mutual funds, and more. Besides, there are times when a portfolio will include options, but it is not as likely to be there as some of the others.

This is like getting a key where once you use that key to open the front door of a house, then it belongs to you. You may not technically own the house because you have the key, but you can use that key whenever you would like and if you choose, you could purchase the house later on.

Options are set up so that they cost you a certain fixed price for so much time. This length will change based on the option that you are working with. Sometimes you will have an option that only lasts for a day and then there are some that you may hold onto for a few years. You will know how long the option is going to last before you make the purchase.

Options are nothing new. It's a well-known term in trading, and even though it might be overwhelming for some people to think about, options are not hard to understand. The portfolios of investors are generally composed of different classes of assets, which can be bonds, mutual funds, stocks or even ETFs. One such asset class are options, and certain advantages are offered by them when used accurately, which other trading stocks and ETFs cannot offer. Like many other asset classes, options too can be purchased with brokerage investment accounts.

Options can be considered as an investment that gives you more "options."

But that does not mean that there are no risks involved. Almost every investment entails a multitude of risks. The same goes for options. An investor ought to know of these risks before proceeding with trade.

Options are a part of the group of securities called derivatives. The term derivative is many a time associated with huge risks and volatile performance. Warren Buffett once called derivatives “weapons of mass destruction,” which is a little too much.

Options are a kind of derivative. Investors are often talking about different derivatives. Options derive their value from an underlying stock or security. Options belong to the class of securities known as derivatives. For a long time, people associated derivatives with high-risk investments. This notion is not true.

Derivatives obtain their value from an underlying security. Think about wine, for instance. Wine is produced from grapes. We also have ketchup which is derived from tomatoes. This is basically how derivatives function.

One can gain a real advantage in the market if they know how options work and can use them properly since you can put the cards in your favor if you can use options correctly. The great thing about options is that you can use them according to your style. If you’re a speculative person, earn through speculation. If not, earn without speculating. You should know how options work even if you decide never to use them because other companies you invest in might use options.

Options are an attractive investment tool. They have a risk/reward framework, which is unlike any other. They can be used in a multitude of combinations that make them very versatile. The risk factor involved can be diluted by using these options with other financial instruments or other option contracts, and at the same time opening more avenues for profits. While many investments have an unbound quantum of risk attached, options’ trading, on the other hand, has defined risks, which the buyers know about.

Now, several options will work when you are dealing with options. Some of the ones that you will come across regularly include:

- Bonds: A bond is going to be a debt investment where the investor can loan out their money to the government or company. Then this money will be used for a variety of projects by the second party. But at some time, usually determined when the money is given over, the money will be paid back along with some interest. Most of the time you will work with a government bond and these bonds are even found on the public exchange.
- Commodity: Commodities are another choice that you can make when you are working with options. These will be any basic goods that will be used in commerce and can include some choices like beef, oil, and grain. When you trade these, there will be a minimum of quality that they must meet. These are popular because commodities are considered tangible, which means that they represent something real.
- Currency: Currency is going to talk about any type of money that is accepted by the government and can include coins and paper money. Of course, cryptocurrency and Bitcoin are starting to join the market as well. The exchange rate of these currencies, especially when it comes to the digital currencies, will change quite a bit in very little time. Hence, it is important to be careful with these.
- Futures: These are going to be similar to what you found with commodities, but they have some different guidelines on how they can be delivered, the quantity and quality, and more.
- Index: An index is going to be a group of securities that are imaginary and will symbolize the statistical measurement of how those will do in the market.
- Stock: You can own a certain percentage of the share, but instead of

running that company, you will let other management do that while you make some profits each quarter when the company does well.

Options may sound complex but are pretty easy to understand if you pay keen attention. You will come across numerous traders' profiles with different security types including bonds, stocks, mutual funds, ETFs, and even options.

Options are another asset class. If applied correctly, they will offer numerous benefits that all other assets on their own cannot. For instance, you can use options to hedge against negative outcomes like a declining stock market or falling oil prices. You can use options to generate recurrent income and for speculative purposes like wagering on the movement of a stock.

When Should You Use Options?

As an investor, you will have some opportunities to use options. However, there is a truly beneficial number. Here is a brief look at them.

- Options buy you time if you need to sit back and watch things develop.
- You require very little funds to invest in options compared to buying shares.
- Options will offer you protection from losses because they lock in price but without the obligation to buy.

Always keep in mind that options offer no free ride or a free lunch. Trading in options carries some risks due to their predictive nature. Any prediction will turn out one way or another. The good news here is that any losses that you incur will only be equivalent to the cost of setting up the option. This cost is significantly lower than buying the underlying security.

Differentiating Options from Stocks

While there is no expiration date in stocks, Options contract has one. This expiration period can be as long as a week or months or even years, and it is determined by the kind of options you are practicing and other related regulations.

Stocks are not a part of derivatives, while options are which means their value is derived from something else.

While stocks are a well-defined numerical quantity, options are not.

One can even profit with a drop-in price of the underlying stock, which is dependent on the type of strategy they are following.

Stock owners have a right in the company either for dividend or voting or both. Options owners have no such rights.

There are several parties involved in a trade. It isn't possible to trade directly with everyone, and it isn't even practical. This is why, for the sake of convenience, stock exchanges were formed. This is a channel where all the stocks are being traded.

You cannot work directly with the stock exchange as this would create great confusion. It would mean too many people making deals at the same time. This is where brokers come into play.

Brokers work as the mediators, as the channel of communication between you and the exchange. They charge a commission for their service. In the stock exchange industry’s early stages, most of the transactions were carried out by the brokers on behalf of their clients. Brokers nowadays still carry out transactions on behalf of their clients. Still, the clients now have the option to manage their accounts easily. You will have to open a trading account with a broker, and the broker will give you access to that trading account.

Currently, many software programs have been successfully developed where you can directly trade on stock exchanges. The program recommendation, as well as the access credentials, will be provided by the brokerage firm you’ll choose.

Like a bond or stock, an option is a tradable security. You can purchase or sell options to a foreign broker or trade them on an exchange within the United States. An option may allow you to leverage your cash. However, it may be high risk because it eventually expires (expiration date). For stock options, each option contract represents 100 shares.

An instance of an option is if you want to buy a car/house, but for whatever reason, do not have immediate cash for it but will get the cash next month. You can now buy the asset at the agreed price and sell it for a profit. The value of the asset may also depreciate perhaps when the house develops plumbing problems or other problems or in the case of a vehicle, gets into an accident. If you decide not to buy the asset and let your purchase option expire, you lose your initial investment, the $2,500 you placed for the option.

This is the general concept of how option trading happens; however, in reality, option trading is a lot more complex and involves more risks.

What kind of investor are you?

Trading has its strategies, its techniques and its secrets. Different things apply to different people. What works for someone else may not work for you. Why? Because you are two different kinds of investors. Aggressive personalities invest in a completely different manner than conservative personalities. People who are not afraid to take risks are entirely different investors than those who are methodical and play it safe. There is no better or worse here. It is just the style of doing business.

Chapter 1
Options Trading Basics

What is an option?

An option is simply a contract between two parties which is based on an underlying asset. You can create an options contract for any type of asset, but our focus is on options contracts for stocks. They are called options because one party of the contract will have the option to buy or sell stocks depending on whether or not certain conditions are met.

An option is a type of derivative. While they've been around for a long time, the general public didn't become aware of the concept of derivatives until the 2008 financial crash, when a particular type of derivative, mortgage-backed securities, caused financial havoc when vast numbers of bets went terrible at the same time. A derivative sound fancy but all it means is that it's an asset whose value depends on the value of something else. In the case of options, the options contract is based on the value of the shares of stocks that the contract is based on.

One option contract represents 100 shares of stock. The contract will cost the buyer a much smaller sum than it would cost to buy the shares of stock. In a sense, an options contract is a bet that the stock will move in a specific direction over a given time. That is why they can be used for speculation. Like most contracts, an options contract has an expiration date or "expiry". In the United States options can be exercised on or before the expiration date, if the agreed-upon condition is realized. In Europe, they can only be exercised on the expiration date.

Trading Options

Now like anything else, you can buy and sell an option itself. What is an option worth? The premium! Depending on various factors, the premium can go up or down. The person who buys the options contract is the owner of the contract. The seller still has their obligation, if the share price meets the required conditions against the strike price in the contract.

The owner of the option is considered to be long in the position. If you are short on the position, that means you've sold an option you didn't own at the time of sale.

The buyer of an option has three possible outcomes:

- They can hold the option until it expires, and the strike price is not exceeded, so the option expires worthless.
- They can sell the option at some point before it expires. In this case, you are said to "close out your position".
- They can exercise their rights under the option. This means you will buy the underlying shares of stock or sell the underlying shares of stock, for a call or a put, respectively.

The buyer of the option is the person with the right but not the obligation to buy or sell the shares. The seller of the option contract (also sometimes called the writer) should buy or sell the shares. Their possible outcomes are:

- You can repurchase the option and close out your position.
- Take "assignment", which means buy or sell the shares as required if they have met the condition set by the strike price.
- If the strike price condition isn't met, you let the contract expire worthlessly, and keep your premium.

Of course, remember that in all cases the seller always keeps the original premium.

An option can be in the money or out of the money. If an option for ABC stock has a strike price of $50 and shares of ABC stock are trading for $55, the option is in the money $5. If the shares are trading for $47, the option is out of the money $3.

For a call, it works oppositely, since you earn money as the buyer of the option if the stock falls below the strike price. For ABC, a put option with a strike price of $50, if the stock price is trading at $55, the option is out of the money $5. On the other hand, for a put contract, if it's trading at $40, the option contract is in the money $10.

The intrinsic value of an option is the amount that it is in the money.

We also need to know the so-called time value of the option. This is the difference between the intrinsic value and the premium per share paid for the option. That is:

Time value = premium paid – value in the money

If you paid $7 for an XYZ option and it’s in the money $2, the time value is $7 - $2 = $5.

When an option is out of the money, it has no intrinsic value. So the time value is given by the premium paid. Still, it declines at increasing rates as the expiration date gets closer. In other words, the options contract will be worth less and less to a potential buyer since its likely to expire worthlessly.

Long vs. Short

There are four basic options available:

- Long call: this is the right to buy shares. An example would be buying a covered call option as described earlier. This means you are bullish on the stock, that is you expect its value to increase, possibly by a significant amount.
- Long put this is the right to sell shares of stock. You're bearish on the stock, but it's long because you expect to profit from the options contract by being able to sell the shares at the strike price which is higher than the share price on the market.
- Short call: An obligation to sell a stock. You're bearish on the stock, and don't believe the share price will increase enough to beat the strike price. It can be covered, meaning that you already own the shares (lower risk) or naked, which means you don't own the shares when you write the contract (high-risk trade).
- Short put: This is an obligation to buy shares of stock. You’re bullish on the stock and believe the share price will stay above the strike price.

Now let’s size up potential profits and losses for the different options.

Long Call (role: buyer)

For our long call, let’s assume we have:

Long 1 ABC Aug 50 Call @ $1

This means the option contract is for 100 shares (the value 1 = 100 shares, or one option contract) of ABC stock. The option expires the third Friday in August. The strike price is $50, and the premium is $1. This is a low-risk strategy with your only risk limited to the premium, with high potential upside (thought the probability of going above the strike price may not be high). It's also low risk for the seller since they keep the premium. The worst-case outcome is selling the shares at the strike price which was higher than the price of the shares at the time the contract was written, but lower than the market price at the time of sale.

For the buyer of this contract:

- The maximum loss is limited to the premium, which is the quoted price multiplied by 100 for the total number of shares, or $1 x 100 = $100.
- Maximum gain: Theoretically unlimited, depending on how much the share price exceeds the strike price.

Short or Naked Calls (role: seller)

We began our discussion with covered calls. In that case, as the seller of the option, the call was "covered" by the underlying stock. A naked call is one that is uncovered. That is, you write call options without owning the underlying stock. Remember for a call option, if you are forced into an assignment, you must sell the underlying shares. With a naked call, you face potential losses since you don't own the shares when you write the call. On the market, naked calls are known as "shorts". The ticker might look something like this:

Short 1 ABC Jun 25 Call @ $2

This tells us that the option contract expires the third Friday in June. The strike price is $25, and the premium is $2. In this case:

- The breakeven point is strike price + option premium = $25 + $2 = $27.
- Maximum gain is 100 shares x premium = $200.
- Maximum loss is unlimited, depending on how high the stock goes because you would have to buy the shares if assigned. Since this is high risk and you'd need the capital available to take care of the deal if the need arises, brokerages assign levels to options traders to determine whether or not they are allowed to participate in such high-risk trades. When you open an account to trade options, you’ll need to know what your assigned level is to determine which types of trades you can make.

Short Puts (role: seller)

A short put, like a naked call, is a risky trading strategy and you'll be required to have capital available to risk. This is a small possible gain with a large possible loss option. Consider the following put:

Short 1 ABC Jul 30 Put @ $2

This option expires the third Friday in July, has a strike price of $30 and a premium of $2.

- Maximum gain: $2 premium x 100 shares = $200.
- Maximum loss: ($30 strike price - $2 premium) x 100 = $2,800.
- Break even: ($30 strike price - $2 premium) = $28.

Long Put (role: buyer)

For a long put, we're betting that the stock price is going to drop below the strike price. This is a lower risk strategy than a short put for the buyer. If the price fails to drop below the strike price, then you're only out the premium. Of course, to exercise your right to sell the shares, you'll have to have access to the capital necessary to buy them. We'll say our example is:

Long 1 ABC Sep 40 Put @ $3

The contract expires on the third Friday of September. The strike price is $40, and the premium is $3, so the cost to buy the contract is $3 x 100 = $300.

- Maximum loss: The maximum loss is the cost of the premium, so $3 x 100 = $300.
- Maximum gain: The maximum gain is given by (strike price – premium) x 100 = ($40 - $3) x 100 = $3,700.
- The breakeven point is strike price minus the premium, or $40 - $3 = $37.

So, this is a lower risk strategy – since the maximum loss is much smaller than the potential gain.

Chapter 2
Why Options Trading is Worth the Risk

There is often confusion about why traders choose options when stocks and bonds do just fine. What some tend to miss out is the vast difference in the earnings potential. Stocks generally return a profit of 8% - 12% per annum which is pretty impressive in and of itself. However, options are a lot more lucrative with much larger potential.

Some options trades typically generate profits upwards of 50%. Making 100% profits within a short time and even more, is not unheard of. This is why a lot of experienced traders choose options. They are extremely lucrative and highly profitable. It is also possible to make money trading options in any market conditions. Traders can make money when the market is bullish, bearish, and even when it is stagnant. As such, you do not need specific market conditions and hence profitability throughout the year is very possible.

Experts agree that trading options offer plenty of benefits that are not offered by other types of securities. While not all traders may want to engage in options trading, there are certain aspects of it that other traders find attractive.

1. Potential for Astronomical Profits

One of the main reasons for trading options is the opportunity of making significantly large profits compared to all other forms of trade in the markets. This is possible even without large sums of money. The principle behind this approach is leverage. A trader needs not have large amounts of funds to earn huge profits. For instance, with as little as $10,000, it is possible to earn amounts such as $300,000 or even $800,000 simply by using leverage.

Take the example of a trader whose trading fund is $10,000. The trader wishes to invest this amount in Company ABC. Now the current stock price is $20 though this price is expected to rise. The trader could use the funds to purchase the shares directly and receive a total of 500 shares for his money. If the stock price was to rise to $25 within a month, the trader will have made $5 per share or a total of $2,500 in profits.

Alternatively, the trader could purchase call options of XYZ stocks with the same amount of money. The options allow the trader to purchase back the underlying stocks within a certain time. Now, options contracts cost between $1 and $4 depending on certain factors such as the value of the underlying security. In our example, one call options costs $2 so for the $10,000, the trader receives 5,000 options contracts.

If the trader chooses to exercise the right to sell the underlying shares in the next month, then he stands to make a profit of $5 per share. Remember that he has a right to a total of 5,000 shares for a total profit of $25,000. This demonstrates the capacity and power of options as well as how profitable this kind of trade can be.

2. Great Risk vs. Reward Consideration

Like all good traders, it is essential to weight the risk posed by a certain trade compared to the possible rewards. When trading using options, then the style adapted will indicate the type of risk inherent in the trade. The above example clearly shows how profitable options trading process is. If a loss were to be incurred in the above instance, then the total loss would have been the cost of the options.

In this instance, the risk is well worth the reward because the amount set to be lost is insignificant compared to the amount of profit to be made. In general, the higher the risk than the higher the potential return. Any time that a trader considers a trade, then the risk versus reward ratio should be taken into consideration.

As an options trader, you should learn how to benefit from volatility. Volatility needs to be your friend and partner as you can benefit from sharp and sudden movements in the markets. Options are mostly affected by implied volatility which is essentially the most crucial factor affecting options prices. You need to learn to be on the lookout for implied volatility and determine whether it is low or high. This way, you will easily be able to get a sense of direction regarding the type of options to engage with.

3. Versatility and Flexibility

Another extremely appealing benefit of trading in options is the inherent flexibility. Options offer lots of flexibility with dozens of different strategies to pursue. This compares well with numerous other trade and investment options out there. Most of these do not offer as much flexibility as options do. Also, most other securities have limited strategies, and this tends to limit the flexibility that a trader has on that security.

Take stocks for instance. Even stock traders encounter certain limitations that are not inherent in options trading. There are plenty of strategies ranging from simple to compound to complex strategies. Stock traders generally buy, hold, or sell stocks. There isn’t much else that they can do. This contrasts greatly with options because of the tens of strategies available to them. The versatility and flexibility inherent in options trading far surpasses that of most other securities.

Firstly, options’ flexibility allows them to be traded based on a wide variety of underlying securities. The variety and range of options strategies are massive. Also, the spreads provide real flexibility in the manner in which they can be traded. Traders have flexibility and versatility when it comes to limiting risks of assuming market positions when it comes to hedging, and even simply trying to benefit from stock movements, there are numerous opportunities available.

Downsides of Options Trading

While options trading can be extremely profitable, it can also be extremely disastrous. This is why beginners need to stick to the basic strategies until they acquire sufficient knowledge, understanding, and experience. After a while, it will be possible to apply more advanced and even complex strategies that are very likely to make a profit regardless of market conditions. Risks remain though so it is always better to be cautious at the onset.

Traders must understand the risks and cons associated with trading options. The numerous benefits have seen more and more traders, including amateurs and pros, venture into the world of options in the hope of cashing in on this lucrative trade.

Not an Easy Task

First of all, it is advisable to note that trading options is not as simple as it sounds. Options are complex securities. They are contracts, that come with certain terms. These terms need to be clearly understood and taken into consideration at all times. Part of the options contracts has to do with time. Unlike stocks and other securities, options have a time limit. This time decay factor makes them extremely short-lived. If a trading strategy does not work out, then the options could expire worthless.

One of the most prohibitive factors about trading options is its complex nature. Numerous numbers of traders avoid options because they are difficult to master. The basics are quite okay and relatively simple to comprehend. However, they have a limited scope as well as limited profitability. Real profitability lies in the compounded strategies which can be quite complex.

Traders can lose a lot of funds if they do not master options correctly. It is possible even to lose more money that invested because trading options are a complex affair. Trading can, therefore, be an ominous and intimidating task. More traders lose money that those who do make money. The main challenge is in understanding the complex nature of options. Learning how to trade options is possible but it is a process that takes both commitment and time. Only traders who are dedicated and invest their time and effort will be rewarded with success.

Trading Options is a Risky Venture

Options trading process is considered an extremely risky affair. Basically, all investment opportunities and even trading ventures carry a certain element of risk. The traders most at risk are beginners and novices. These groups are generally not as well versed or sufficiently experienced to deal with options. Knowledge is crucial in options trade, but experience is absolutely essential. Rather than hemorrhage money, traders prefer to avoid options trading altogether.

Yet the options trading process has been popularly utilized in the management of risks. Traders with stocks and other securities often buy options in order to protect themselves from inherent losses. Let us say a trader is holding stock ABC and predicts that its value will fall by 30% in the next one month. This trader has two options in this case. The first one is to sell the stock and hope to attract a great price. The other is to purchase a call option as a form of hedging against any market risks.

Trading options is a highly risky venture. Even seasoned traders sometimes lose money. Chances of making huge profits exist but chances of losing large amounts also exist. It all depends on the strategies applied, a trader’s experience, and amounts involved. Trading options can be a highly risky venture mostly for inexperienced persons.

The best advice is to learn as much about trading options as possible and understanding the basics as clearly as possible. Plenty of practice also helps. Traders with little or no experience need to put their skills to practice as often as possible. There are plenty of platforms that provide dummy trading platforms where prospective traders can try out different strategies.

There are also plenty of tools and solutions that make options trading easier. All these when applied to different strategies can result in better performance at the markets. Once the basic strategies are well understood and practiced sufficiently, a trader can then proceed to implement and finesse them until the confidently execute them flawlessly. This is how a trader goes from beginner to novice, to advanced, and eventually professional trading levels.

One of the most prohibitive factors about trading options is its complex nature. Numerous numbers of traders avoid options because they are difficult to master.

Real profitability lies in the compounded strategies which can be quite complex. This is why learning as much as possible about options can be really profitable. Plenty of excellent traders have seen their fortunes turn around by simply applying these strategies after taking months and sometimes years to perfect them.

Chapter 3
How to Get Started

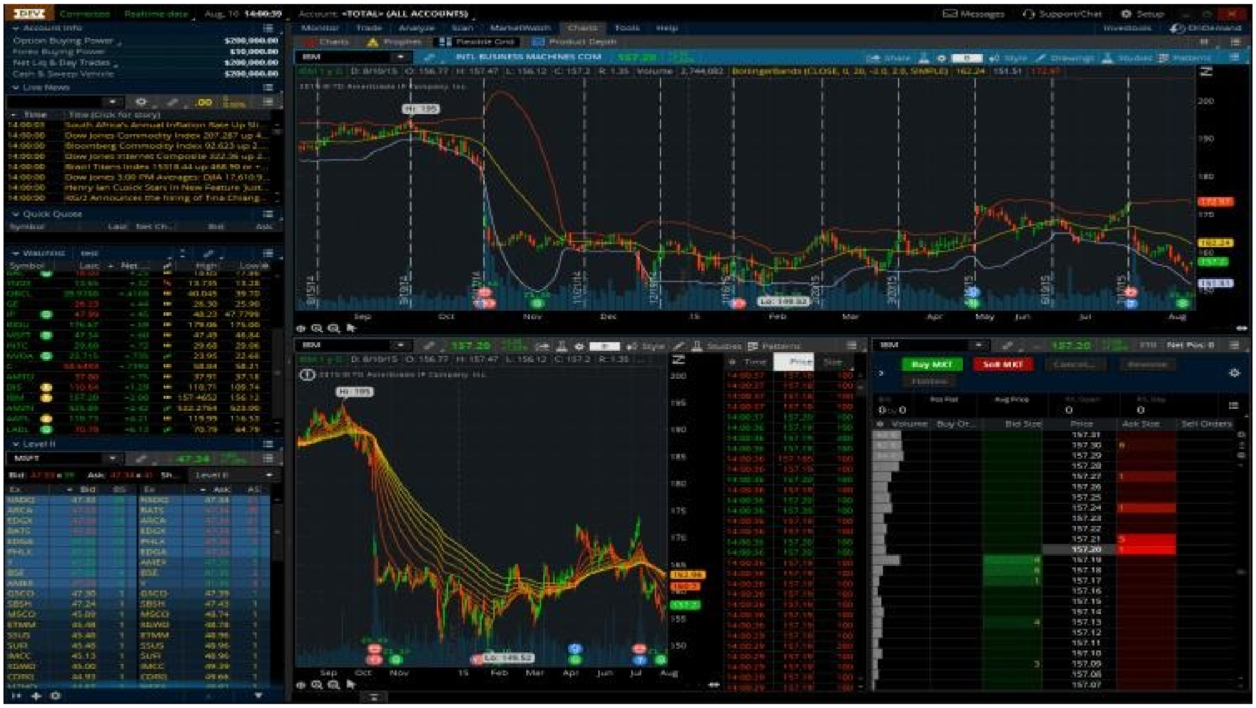
What is a Broker

A broker is a "middleman". Although there are actual trading floors for options just like there are stock exchanges, you don't actually call in your trading orders directly to the exchange. Instead, a broker does that on your behalf. A broker will provide several things for you, and different brokers provide different levels of support.

At the core, a broker is going to provide you with an account. This is like a bank account of sorts, but it's devoted strictly to trading. Options trading is not separate from stock trading, so you will open a brokerage account that will be used to fund trades of both stocks and options, should you decide to invest in both. A brokerage account will be connected to a personal banking account that you provide so that you will connect a bank checking account to the brokerage account. This will be used to transfer funds in and out. So, when you want to buy options, you will need to transfer money into your brokerage account. When you sell options to get money, you may have to wait several days before being able to transfer that money into your bank account. Please check with the broker you select for details.

Choosing a Broker

There are many different brokers to choose from, and there are many factors that will influence the selection of a broker. The first factor to consider is the interface that the broker uses for trading. You might want to get on YouTube to look for videos posted for different brokerages to see what their trading interface looks like. Some have been designed to be extremely user friendly on mobile, such as Robin Hood. However, that may come at a cost. That cost is on the information side of the system. One of the factors to consider when opening a brokerage account is what tools they provide that can help you manage your trades. In particular, you will be looking for a trading system that will help you get the most information about a trade as possible. Two systems that options traders prefer for this purpose are "Think or Swim" which is run by TD Ameritrade and Tasty Works. These systems were designed by professional options traders to facilitate the trading of options, and so they will contain a lot of the information you will need in order to get a good handle on the potential profitability of a trade, and look at things such as how the expiration date will impact a given trade.



The Think or Swim interface.

Some readers will find the interfaces provided by these platforms to be too complex, and they might prefer the simplicity of Robin Hood. Indeed, many beginning traders are gravitating to Robin Hood primarily because of its simplicity and ease of use. The Robin Hood platform makes it very easy to find options and execute trades, and it also has many setup trades for you to consider and execute with one tap on your smart phone.

Another factor that will be important to some traders is how long a company has been in business and its reputation. If this is important for you, then you can consider a more traditional broker like Charles Schwab or Fidelity. E-Trade, which is not nearly as old as those two companies, has been around for several decades and it has a good reputation among traders as well.

It is important not to sweat your choice of broker too much. If you are attracted to the simple interface of Robin Hood, you can actually use other tools in order to do your research. In fact, there are many free tools that can be found on the internet that include using stock charts and calculators that will estimate options values at different dates based on changing stock prices. You can even download fairly accurate calculators for options that are built in Excel spreadsheets. So, while the complete platforms of Think or Swim and Tasty Works suit many traders, you can get a great deal of the information they provide from other sources.

Trading Commissions

When I first got in this business, commissions were a big issue to consider. A commission is a fee charged by the broker each time you place a trade. Commissions need to be considered in order to determine whether a trade is profitable or not, and although commissions are not very large in an absolute dollar amount, it can have a major impact in many scenarios.

The good news is that commissions are rapidly disappearing from the industry. In fact, zero commission's options trading was one of the first selling points that was promoted by Robin Hood when it came on the scene a few years ago, and this selling point helped to elevate its popularity. This also put competitive pressure on many of the older brokers in the industry.

As a result, many have decided to take the zero commission's route. In fact, Charles Schwab recently introduced zero commissions trading. So, the choices available to traders who are looking for a zero commission's brokerage have massively expanded just in the past year alone. While this used to be a major selling point for Robin hood, that isn't necessarily the case today. But be sure to check with brokers you are interested in to find out the details of their policy with respect to commissions.

Brokers used to rely on commissions as a major source of revenue, so some readers are probably wondering what they are doing now in order to make money. Most brokers offer enhanced services for a fee and this is one way that they make the income they used to make from charging commissions. For example, Robin Hood offers a "gold" service with more features for a small monthly fee. Large and established brokers like Schwab may offer professional financial advice to those who are willing to pay for it.

Margin

As you go forward in your trading career, one of the concepts you will need to become familiar with is called margin. In short, margin refers to the ability to borrow from the broker. To do this, you will need to open a “margin account” that will allow you to borrow cash and shares and enter into certain types of trades that customers without margin accounts cannot do. In order to open a margin account, you must deposit at least $2,500 in cash.

One of the examples of what a margin account allows is that you can do day trading with a margin account (however, day trading requires $25,000 in capital). Margin accounts also allow you to sell “naked” options that are not fully backed by hard cash or stocks in your account. For large traders, margin accounts also allow them to borrow shares of stock in order to “short” the stock that is bet against the stock or bet that the price of the stock is going to drop, and then pocket the profits. That is not something we are going to consider, you will use put options to short stock as an options trader, which is much simpler and something that can be done for a $100 investment rather than having to borrow large numbers of shares of stock, but it illustrates one of the ways that a margin account can be used.

Trading Levels

It is also important to familiarize yourself with the different trading levels that exist for options traders. Every broker, however, will have four trading levels for options traders. These are based on your level of experience and your trading goals. When you want to increase your trading level, the broker will require you to go through a quick interview. These interviews are automated so you will answer a few questions on the website or in the brokers mobile app. Something to keep in mind when going through the interview is that you need to make clear that you understand what options are used for and what the regulators expect.

Trading Level One

A level one options trader must back options with cash or assets. A level one options trader is not allowed to buy options in order to trade, you can only sell options. You can sell a covered call, which means you need to own the 100 shares of stock behind the option before selling the call option. Alternatively, you can sell a protected put, which means you must have enough cash in your account in order to buy 100 shares of stock at the strike price, should that become necessary.

Trading Level Two

This level is what most people think about when they are getting into options. Level two trading means that you can buy to open an options contract, and then trade it for a profit. Most readers are going to want to become level two traders. This is usually easy to do. You will just have to open an account and deposit a few hundred dollars, and then go through the broker interview. Level two trading status means that you will be able to buy call and put options.

Trading Level Three

When you start doing options research, you are going to hear about various "strategies" that are used by professional options traders. These include iron condors, strangles, and credit/debit spreads. In order to use these strategies, you will have to be a level three options trader. To do so, your broker will probably require you to have a few months of experience doing level two trading. You will also have to go through another interview.

Trading level Four

Level four options trading is the highest possible level that can be attained by an options trader. A level four options trader is going to be able to engage in any options trade. This includes selling “naked” call and put options. You will also have to open a margin account in order to become a level four options trader. Typically, your broker may also require you to gain some experience first as a level two options trader and then as a level three options trader before they allow you to move up to this level.

Chapter 4
Passive Income

Options are perfectly capable of providing you with passive income, but what is passive income really? People seem to think that passive income is easy money and in some ways it is. However, the term easy misleads most people to think that passive income doesn't involve any work. This is not the truth at all.

Understanding the nature of passive income will help you figure out a lot about how options trading works since it cuts right to the heart of successful options trading. So, let's begin by defining and taking a look at passive income.

There are, broadly speaking, two ways of making money. The first is to exchange your time for money and the second is to exchange your money for money. The first way is to undertake something like a job or to freelance. You're investing your time into a project and in return you get paid. Yes, you're really getting paid for a result if you're freelancing but my point is that it takes time to produce that result.

The more time you spend on such tasks, the more your earning ability is. If you're a freelance writer, for example, the greater the number of high-quality words you produce, the more you're going to get paid per month. Thus, one of the important things to note about this sort of income is that when you go to sleep, so does your income stream.

When asked about one of the key things that rich people do that poor people don't, Bill Gates responded by saying that the rich leverage their time a lot better (Bodnar, 2017). What does leverage time mean? Well, Gates' point was that the only thing that is truly limited in our lives is time. We cannot get back the time we’ve lost, no matter how much we would like to believe that time machines exist.

So ultimately, being financially successful comes down to how well you manage your time. The fact of the matter is that a rich person manages to get paid more for a unit of their time than a poor person does. So how do you get paid more per hour?

Leveraging Time

One easy way is to upskill yourself. Simply learn a higher skill and work in a more lucrative field. However, even this doesn't fully leverage your time since once you go to sleep, your money tap is switched off. Hence, the thing to do is to create multiple streams of income. If you have two streams of income paying you at the same time, you can double your hourly wage.

The problem is that you can only do so much at once. You can't perform two jobs at the same moment of time. So, what you really want is another source of income that doesn't place demands on your time which will detract you from your job or hourly source of money. This is precisely what a passive income stream is.

Passive streams leverage your time by simply providing you with an additional amount of money for no additional input of time. I want to make something clear at this point; you will need to spend time creating and maintaining the passive income stream. My point is that your earning ability with this stream doesn't directly depend on how many hours you put into it.

If you spend five hours writing, you're going to get paid for the words you produced in those five hours. If you spend five hours on a passive income stream, you're not going to get paid for those five hours necessarily. You could get paid less, you could get paid more, who knows? The point is that whatever comes, adds to your income as long as you spend the time to do things correctly.

Active and Passive Trading

As far as the SEC is concerned, all trading is active. Passive actions are reserved for the investment world. Whatever the good folk of the SEC might think, in reality, there are active forms of trading as well as passive forms. The diversity of the markets means that there exist many ways in which you can divide trading activity. Active versus passive simply happens to be one method of doing so.

Active trading refers to what you think traders actually do. This is where people sit glued to their terminals waiting on tenterhooks for news items to be released and then acting like hotshots when they make money. All of this is accurate except for that last bit which is a caricature. Either way, active trading usually involves taking directional bets on the market and usually hedging that with some other financial instrument.

Institutional traders, the kinds that trade for hedge funds, big banks and proprietary trading firms (prop shops), are all active traders. No matter what sort of strategies they employ and no matter which instruments they trade, they're always in touch with the markets. They need to be this way because their objective is to squeeze every ounce of money available.

In order to do so, they have to follow the market's every move. They need to know the market backwards and cannot have things sneak up on them. What's more, they need to deal with unexpected things that happen over holidays or weekends. For example, as of this writing, oil traders around the world have had to deal with the repercussions of a couple of Saudi Arabian oil fields being attacked.

Pros and Cons of Passive Income

While there seem to be a lot of positives from passive income, I must warn you that it isn’t all a bed of roses. Even roses have thorns, after all. The negatives that lend themselves to passive income almost entirely have to do with how people approach it. A lot of people think that this is lazy money and that things run on autopilot.

Well, this is not the case at all. Every passive income stream, including the ones to do with trading require investment of either time or money or both. In the case of passive trading income, you need to invest both. Time is needed to learn and study the markets and to develop your skills.

The markets are not easily deciphered mainly because they are chaotic. Our brains are designed to handle linear environments and understand step by step patterns easily. However, patterns that present themselves intermittently, rhyming with one another instead of replicating themselves exactly, are an alien language.

Thankfully, our brains are learning machines and over time, we can learn to spot such patterns. This is really what trading is all about. Time is needed to train your brain to get used to this new world where everything happens at random but plays out according to a perfectly predictable bigger picture.

Therefore, you need to spend time learning the markets and understanding the ins and outs of options. You need to learn their characteristics to such an extent that you should instantly be able to decide whether to adjust a trade or not. Options trades are complex on the surface since they involve at least two legs. Adjustment is a case of removing both legs or just one and establishing another leg elsewhere.

Generating Passive Income Through Options

A directional strategy is one where you are expecting the market to move in a certain direction and if it moves against you, you lose money.

Directional bets in the market are fraught with risk. This is because of the fact that there is very little downside protection for most directional bets involving stocks and spot FX. I'll discuss options shortly but for now, understand that traditional methods of trading are almost always directional.

There are advantages, of course. If you're good at it, then the amount of money you can make placing directional bets is quite large. A lot of traders tend to stick with such strategies intensely for a while and then scale back in terms of time invested by trading higher time frames.

So, while this is about passive trading, understand that active trading isn't something bad or something to be avoided. It all comes down to your goals. In contrast, passive trading strategies are either market neutral or market agnostic.

Either way, neither of these strategies care too much about which way the market moves. All they care about is the degree with which the moves occur. In other words, the market can move up or down, but it is a lot better if it moves a hundred points instead of ten.

Contrary to popular perception, trading strategies do not lie on either side of a firm line that divides the methods of trading. If anything, they exist on a spectrum from active to passive. If we have a scale running from one to ten with one being the active end of the scale and ten being the passive, options strategies for passive income lie somewhere between four to eight.

Why am I not listing any strategies that are a nine or a ten? Well, mainly because it isn't possible to have pure passive income from options. You'll have to keep checking it at one point or another to maintain your trade. For perspective, a pure ten would be something like a savings account where you just park your money and it earns interest.

No trading strategy is ever going to give you a return on that scale of passivity. However, options can help you earn money on your existing stock purchases as well as help you earn money by setting up situations where you literally don't care about the direction the market is going to move in.

Thus, the strategies in this are extremely versatile and if you can master a few of them, you'll be able to handle pretty much any sort of market environment easily. I do want to caution you that it is easy to use leverage and to try to boost your returns beyond normal levels.

As I mentioned before, you need to build your skills up to the point where this becomes a good idea. By themselves, options have an element of leverage within them but defining the risk of this leverage is pretty straightforward. When you borrow money to generate higher returns, and if you don't know what you're doing, you're asking for trouble and the market will give it to you in spades.

So, understand that the strategies are powerful, but you need to take the time to learn them well. Options can generate outsized returns, but it is also possible to lose a lot more than what you invested if you don't set things up correctly.

The way the trades will be setup is also not how traditional trades are setup. What I mean is that usually trading is just about buying an instrument or shorting it. Well, here you will have to set up multiple legs.

Chapter 5
Understanding the Strike Price

Options prices are determined in part by the price of the underlying stock. But options prices are also influenced by the time left to expiration and some other factors. We are going to go over all the different ways that the price of a given option can change and what will be behind the changes. It’s important to have a firm grasp of these concepts so that you don’t go into options as a naïve beginning trader.

Market price of shares

The largest factor that impacts the price of an option is the price of the investment known as the stock that is behind the option. However, it’s not a 1-1 relationship. The amount of influence from the underlying stock is going to change with time. Furthermore, it depends on whether the option is in the money, at the money, or out of the money. The fraction of the options price that is due to the price of the underlying stock is called the options intrinsic value.

If an option can be exactly the same as the market pricing or not be comparatively favored, it has zero intrinsic value. An option would have to be priced in the money in order to have any intrinsic value.

- For a call option, if the market price is lower than the strike price or the same, the option will have no pricing at all from the intrinsic value. If the share price is higher than the price used to trade shares via the option, the option will have intrinsic value.
- For a put option, if the share price is at or above the strike price, the option will have zero intrinsic value. If the share price is below the strike price, then the option will have some value from the stock. This is called intrinsic value.

However, to confuse matters, even when an option is at or out of the money, the price of the underlying stock has some influence that can change the value of the option. The amount of influence that the market price of the item known as the stock has on the price of the option is given by a quantity that is called delta. You can read the value for delta by looking at the data for any option that you are interested in trading. It is given as a decimal value ranging from 0 to 1 for call options, and it’s given as a negative value for put options. The reason it’s given as a negative value for put options is that this reflects the fact that if the stock price is found to increase, the price of a put option will be reduced. In contrast, if the stock price declines, the value of the put option will increase. It’s an inverse relationship, and thus, the delta is negative for put options.

To understand how this will play out, let’s look at a specific example. Suppose that we have a $100 option. That is, the strike price is set to $100. If the price of the underlying stock is $105, delta for the call option is 0.77.

That means that if the dollar value of the stock increases by $1, the value of the option will rise by approximately 77 cents. This is a per-share price change. So, for the option that you are trading, there are 100 underlying shares. So, a 77-cent price rise would actually increase the value of the option by $77.

For a put option with the same strike price, the option would be out of the money, because the share price is higher than the strike price. In this case, for the put option, the delta is given as -0.23. That means that the put option would lose approximately $23 if the share price went up by $1. On the other hand, if the share price dropped by $1, the put option would gain $23.

The intrinsic value of the call option described in this theoretical exercise would be $5 per share. The total cost of the option would be $6.06 per share, reflecting the fact that the call option has $1.06 in extrinsic value. In contrast, the put option has zero intrinsic value. It has almost the same extrinsic value, however, at $1.03.

I have used a 45-day time frame prior to expiration for this exercise. Options prices are actually governed by mathematical formulas, so it's possible to make estimates of what the option price is going to be ahead of time. There are many calculators and spreadsheets that are available free online for this purpose.

Implied Volatility

One of the most important characteristics of options after considering delta and time decay is the amount a stock price varies with time. Volatility will give you an idea of how wild the price swings of stock are. If you look at a stock chart, I am sure that you are used to seeing the price go up and down a lot giving a largely jagged curve. The more that it fluctuates, and the bigger the fluctuations in price, the higher the volatility. Of course, everything is relative and so you can't say that any stock has an "absolute" level of volatility. What is done is the volatility for the entire market is calculated, and then the volatility of a stock is compared to the volatility of the market as a whole. When looking at the stocks themselves, this is given by a quantity called beta.

If the stock generally moves with the stock market at large, beta is positive. If beta is 1.0, that means that it has the same volatility as the entire market. That is a stock with average volatility.

If beta is less than 1.0, then the stock doesn't have much volatility. The amount below 1.0 tells you how much less volatile the stock is in comparison to the market as a whole. So, if the beta is given as 0.7, this means that the stock is 30% less volatile than the market average.

If beta is greater than 1.0, then the stock is more volatile than the average. If you see a stock with a beta of 1.42, that means the stock is 42% more volatile than the average for the market.

If beta is negative, that means the stock, on average, moves against the market. When the market goes up, it goes down and vice versa. Most stocks don't have a negative beta, but they are not hard to find either.

Volatility is a dynamic quantity, so when you look it up, you are looking at a snapshot of the volatility at that given moment. Of course, under most circumstances, it's not likely to change very much over short time periods like a few weeks or a month. There are exceptions to this, including earnings season.

Implied volatility is a quantity that is given for options. Implied volatility is a measure of the coming volatility that the stock price is expected to see over the lifetime of the option (that is until the expiration date).

Time Decay

If an option is valued so that it is the same as the share price, or if it is out of the money, time decay is going to have a significant influence over the value of an option at any given time. For an option that can be said to be in the money, the influence of time decay is going to be much less. The closer you get to the expiration date; time value exerts less influence on the overall price of the option. In that case, it’s going to be more influenced by implied volatility and the underlying share price. To take an example, at four days to expiration, a $100 strike price on an underlying stock when the market price is set equal to $110 per share will have $10 in intrinsic value with $0.56 in extrinsic value and a total price per share of $10.56. So, the price is heavily weighted to the underlying price of the shares. However, theta is -0.23, meaning that on a per-share basis, at market open the following day, the option will lose $0.23 in value, all other things being equal. Of course, all other things are not equal, and changes in share price and implied volatility may wipe that out or add to it.

The important thing to do is check theta every afternoon so you can estimate what the cost is going to be for holding the option overnight. Time decay is an exponential phenomenon, so it decays faster the closer you get to the expiration date. The important path for the trader is knowing when other factors are going to be more important than time decay, you are not simply going to sell off your option because it’s going to lose value from time decay the following morning.

Risk-Free Rate

You are also going to see the risk-free rate quoted for an option. This is the interest rate that you could earn on an ideal safe investment. Generally speaking, this would be the interest you could earn from a 10-year U.S. treasury over the time period of the option. In normal times, this is an important factor to consider. Rising interest rates (that is significantly rising) can lower the value of options. In recent years, interest rates have been very low, and changes in interest rates have been small and very conservative. So, at the present time at least, this is not really something to worry about.

Chapter 6
Intrinsic Value and Time Value

As an options trader, you need to learn about the variables that can affect the price of an option and the ins and outs of implementing the right strategy. A stock trader who is familiar and good with predicting future stock price movement might think that shifting to options trading is easy, but it's not. There are three changing parameters than an options trader must deal with – the underlying stock's price, the time factor, and volatility. A change in any of these factors will affect the price of the option.

The price of an option is also called the premium and the pricing is per share. The option seller receives the premium which in turn gives the buyer any right that comes along with the option. The buyer is the one paying the premium to the seller and they can exercise this right or just allow the option to expire without any worth in the end. The buyer is obliged to pay the premium whether the option is exercised or not which means the seller will keep the premium, in the end, no matter what.

Let's have a simple example. A buyer paid a seller for purchasing rights to stock ABC for 100 shares and a strike price at $60. The contract expires by June 19. If the option position becomes profitable, the option will be exercised by the buyer. If it does not seem to bear profit, the buyer can just let the contract expire. The seller then keeps the premium.

There are two sides to the premium of an option – its intrinsic and time value. You can compute for an option's intrinsic value by getting the difference between strike price and stock price. For the call option, it is stock price minus strike price. For the put option, it is strike price minus the stock price.

To value an option, at least theoretically, you will need to consider multiple variables such as the underlying stock price, volatility, exercise price, time to expiration, and interest rate. These factors will provide you a good estimate on the fair value of an option that you can then incorporate into your strategy for maximum gains. we will only be discussing the time and volatility factors in detail. The primary goal for option pricing is to compute the possibility that a particular option will be ‘in the money’ or exercised by the time it expires.

The value of puts and calls are affected by underlying stock price movements straightforwardly. That means when the price of a stock rises, there should be a corresponding rise in call value as well since you can purchase the underlying stock at a reduced price compared to the market’s, while there is price decrease in put. Conversely, there should be an increase in the value of put options when the price of the stock takes a dive and a decrease in the value of call options since the holder of the put option has the option to sell the stock at above-market prices. This pre-set price at which you can sell, or buy is called the strike price of the option or its exercise price. If the option’s strike price gives you the advantage of selling or buying the stock at a cost that gives you immediate profit, that option is considered ‘in the money’.

With the underlying stock price and strike price out of the way, we can now discuss the other two major factors that can significantly affect the price of an option – time and volatility.

Time

Time is money. This adage still holds true and even applies to options trading. Thus, understanding how the Greek theta works is very important and how it affects the pricing of options. If you still remember, the Greek letter theta represents the effect of time decay on the value of an option. All options, call or put, lose their value as the contract expiration nears but the value loss rate of an option contract is a function of the amount of time remaining before it expires.

The extrinsic part of the value of an option is the only factor affected by time decay. That means an option that's 'in the money' will have the same intrinsic value until the contract expires. For example, if a stock trades at $3, a call for a 30-strike price will retain its intrinsic value of $3 from the start until expiration but any value that exceeds $3 is considered extrinsic value and will be affected by the time decay.

Theta represents the loss of value over time, so it's typically represented by a negative value. And since time is irreversible, time only decreases and never stops or goes back. For example, if theta is set to -0.28, the corresponding option contract loses $0.28 in value daily.

However, theta does change over time. Let's assume that a stock's price remains unchanged, a $2.75 'out of the money' option with a -0.15 theta will have a reduced value of $2.60 by the following day. The theta then may only be set to -0.12 which means the cost of the option will be down to $2.48 the succeeding day if stock prices remain unchanged. The option's value will gradually approach zero while it's still 'out of the money'.

You also need to remember that the effect of theta becomes more and more apparent as the expiration nears. You should anticipate a rapid acceleration of the time decay within the remaining few days before the contract expires.

Options that are 'at the money' possess the highest value, extrinsically. That's why these options have their thetas set to highest. Options that are deep ‘in the money’ or ‘out of the money’ have their thetas lower because compared to ‘at the money options’, they have lower extrinsic values. And the less extrinsic value an option has, the less they will lose as time decays.

The only way for the theta position to be positive is to have short options. This is because short option positions work best when the market is stable. Wide swings both up or down hurt option positions and only time will help as it passes by. Other strategies also benefit from time’s passage such as neutral strategies, e.g. long butterfly. The less time there is before the contract expires, the less probability for the underlying stock to rise up or go down and reach unprofitable territories.

There will always be a trade-off between market movement and time for every option position. It’s impossible to benefit from the two at the same time. If time is helping your option position, it will be negatively affected by the price movement. The same applies the other way around. Revisiting our Greeks, gamma (or price movement) is theta’s flip side. A positive theta position (position benefitting from time’s passage) will incur a negative gamma. Conversely, a position with a negative theta (position negatively affected by time’s passage) will incur a positive gamma.

Volatility

Volatility affects most investment forms to some degree and as an option trader, you should be familiar with this element and how it affects options pricing. By definition, volatility is the tendency of something to fluctuate or change significantly. In general investment, volatility refers to the rate a financial instrument's price rises or falls.

A low volatility financial instrument has a price that is relatively stable. Conversely, a high volatility financial instrument is prone to dramatic price changes, either way. In general, financial market volatility can be broadly measured. So, when the market becomes difficult to predict and prices keep on regularly and rapidly changing, the market is volatile

Volatility can affect option pricing significantly. Many beginning options traders tend to ignore the implications which can lead to huge investment losses.

Before entering any kind of trade, options trading included, it can be useful to have an idea about its volatility. For options, volatility is a key factor on how they are valued and priced. There are two volatility types that are relevant – historical volatility and implied volatility.

Historical Volatility

Historical or statistical volatility is used to measure the changes in the price of the underlying option, so it's based on actual and real data. Let's refer to it as HV for the rest. HV shows how fast the stock price has moved. The higher HV is, the more the stock price has moved during a certain period. So, when a stock has a high HV, the price is more likely to move, at least theoretically. It's more of a future movement indication and not a real guarantee.

On the other hand, a low HV might indicate the stock price hasn't moved much but it might be going in one direction steadily.

You can use HV to predict somewhat how much a security's price will change based on how fast it changed in the past, but you can't use it to predict an actual trend.

HV is measured over a certain period such as a week, month, or year and you can compute for it in various ways.

Chapter 7
Risk Management

Professional informal investors utilize a hazard the executive strategy called the 1-percent hazard rule or change it marginally to accommodate their exchanging strategies. Adherence to the standard downplays capital misfortunes when a dealer has an off day or encounters unforgiving economic situations, while as yet taking into account incredible month to month returns or salary. The 1-percent hazard principle bodes well for some reasons, and you can profit by comprehension and utilizing it as a feature of your exchanging system.

The 1-Percent Risk Rule

Following the standard methods, you never hazard more than 1 percent of your record an incentive on a solitary exchange. That doesn't imply that on the off chance that you have a $30,000 exchanging account, you can just purchase $300 worth of stock, which would be 1 percent of $30,000.

You can utilize the majority of your capital on a solitary exchange, or much more in the event that you use influence. Actualizing the 1-percent hazard principle implies you make chance administration strides with the goal that you counteract misfortunes of more than 1 percent on any single exchange.

Nobody wins each exchange, and the 1-percent hazard standard shields a broker's capital from declining fundamentally in horrible circumstances. In the event that you chance 1 percent of your present record balance on each exchange, you would need to lose 100 exchanges a line to crash your record. On the off chance that learner brokers pursued the 1-percent rule, a lot a greater amount of them would make it effectively through their first exchanging year.

Gambling 1 percent or less per exchange may appear to be a modest quantity to certain individuals, however it can in any case give extraordinary returns. In the event that you hazard 1 percent, you should likewise set your benefit objective or desire on each effective exchange to 1.5 percent to 2 percent or more. When making a few exchanges every day, picking up a couple of rate focuses for you every day is totally conceivable, regardless of whether you just win half of your exchanges.

Applying the Rule

By gambling 1 percent of your record on a solitary exchange, you can make an exchange which gives you a 2-percent return for you, despite the fact that the market just moved a small amount of a percent. Also, you can chance 1 percent of your record regardless of whether the value normally moves 5 percent or 0.5 percent. You can accomplish this by utilizing targets and stop-misfortune orders.

You can utilize the standard to day exchange stocks or different markets, for example, prospects or forex. Expect you need to purchase a stock at $15, and you have a $30,000 account. You take a gander at the outline and see the value as of late put in a transient swing low at $14.90.

You put in a stop-misfortune request at $14.89, one penny beneath the ongoing low cost. When you have recognized your stop-misfortune area, you can figure what number of offers to purchase while taking a chance with close to 1 percent of your record.

Your record hazard likens to 1 percent of $30,000, or $300. Your exchange hazard approaches $0.11, determined as the distinction between your stock purchase cost and stop misfortune cost.

Separation your record hazard by your exchange hazard to get the best possible position size: $300/$0.11 = 2,727 offers. Round this down to 2,700 and this shows what number of offers you can purchase in this exchange without presenting yourself to misfortunes of more than 1 percent of your record. Note that 2,700 offers at $15 cost $40,500, which surpasses the estimation of your $30,000 record balance. Thusly, you need influence of in any event 2:1 to make this exchange.

On the off chance that the stock value hits your stop-misfortune, you will lose around 1 percent of your capital or near $300 for this situation. In any case, if the value moves higher and you sell your offers at $15.22, you make right around 2 percent on your cash, or near $600 (less commissions). This is on the grounds that your position is aligned to make or lose just about 1 percent at each $0.11 the cost moves. In the event that you exit at $15.33, you make very nearly 3 percent on the exchange, despite the fact that the value just moved around 2 percent.

This strategy enables you to adjust exchanges to a wide range of economic situations, regardless of whether unpredictable or quiet and still profit. The strategy likewise applies to all business sectors. Prior to exchanging, you ought to know about slippage where you can't get out at the stop misfortune cost and could assume a greater misfortune than anticipated.

Rate Variations

Merchants with exchanging records of under $100,000 ordinarily utilize the 1 percent standard. While 1 percent offers more security, when you're reliably gainful, a few merchants utilize a 2 percent hazard rule, gambling 2 percent of their record esteem per exchange. A center ground would be just gambling 1.5 percent or some other rate underneath 2 percent.

For records over $100,000, numerous merchants' hazard under 1 percent. For instance, they may hazard as meager as 0.5 percent or even 0.1 percent on a huge record. While momentary exchanging, it winds up hard to hazard even 1 percent in light of the fact that the position sizes get so enormous. Every broker finds a rate they feel great with and that suits the liquidity of the market wherein they exchange. Whichever rate you pick, keep it beneath 2 percent.

Withstanding Losses

Following the 1-percent guideline implies you can withstand a long series of misfortunes. Expecting you have bigger winning exchanges than failures, you'll locate your capital doesn't drop in all respects rapidly however can rise rather rapidly. Before taking a chance with any cash—even 1 percent—practice your procedure in a demo record and work to make steady benefits before contributing your genuine capital.

What should your position size be?

Not gambling an excessive amount of cash on some random exchange is fundamental for any informal investor. Tragically, when a great many people begin exchanging, they don't consider the hazard that they are taking – just about the potential prizes.

Each exchanging methodology must think about the most extreme level of the all-out exchanging capital that ought to be gambled in any one exchange. Truth be told, a broker's capacity to confine his misfortunes is similarly as significant (or much increasingly significant) as his accomplishment in overseeing winning positions.

Consider it. On the off chance that a merchant misfortune a modest quantity on each exchange, won't he remain in the game much more? Taking immense misfortunes is one of the essential reasons why such a large number of dealers don't make do around here. For what reason do brokers submit money related suicide along these lines, you may inquire? In the event that every single enormous misfortune begin little, shouldn't it be anything but difficult to keep a little misfortune from getting to be unmanageable? The appropriate response is a resonating "YES."

Restricting misfortunes in day exchanging includes a great deal of good judgment. In the first place, I don't figure any merchant should hazard more than 2 to 5% of his exchanging capital on some random exchange. Why? In the event that a dealer adheres to a 1% to 2% most extreme misfortune rule, his odds of remaining in the game are incredibly expanded in light of the fact that it will take numerous continuous misfortunes to clear him out and he will have more cash making openings accessible to him.

In the event that a merchant will deal with a $10,000 account, he ought not lose more than $100 to $200 (1% to 2%) on each position taken. Utilizing a similar thinking, on the off chance that we are managing an exchanging account that is $100,000 in size, the most extreme suitable misfortune can be expanded to $1,000 or $2,000 per exchange. In light of these rates and on the sum the cost can move against the broker (decided from the graphs), he can compute the most extreme size his position ought to have. This turns out to be much clearer with a numerical model:

Position Sizing Example utilizing Currencies (to get familiar with monetary standards, read this segment)

Accept that a financial specialist can exchange a ton of one hundred thousand United States Dollars starting out with a nest of two thousand dollars (that's a fifty against one influence) and that the trader has ten thousand dollars in a record. With this record size, he can exchange a limit of five parcels (2000 dollars per five parcels in his edge store = ten thousand) at any given moment – however is this a savvy activity? We should investigate this somewhat further.

Suppose that dependent on his approach, the dealer breaks down the graph and discovers that with the end goal for him to take a long position with a potential reward of $800 per part, he should be happy to lose $200 per parcel. He understands that on the off chance that he takes a 5-parcel position, and all goes well, he could have an increase of $4000 or 40% (five segments per eight hundred dollars per parcel equals a whopping four thousand dollars) on his $10k account. Your size positive of five individual parcels means therefore that he will lose out on one thousand dollars (five segments for two hundred dollars per parcel equal one thousand dollars). Would it be a good idea for him to take the exchange? Perhaps, however not with 5 parts!!!

Lost $1,000 speaks to 10% of his exchanging capital!!! To what extent will anybody be ready to go after a couple of back to back ten percent loses? In this model, the trader's most extreme size of position should just be one part. With one part, the trader will try and chance two hundred dollars (two percent of his record size) to make eight hundred dollars (or an eight percent return). He might them want to try and attempt to make the four thousand dollars on one exchange, but most investing experts would advise that this is not a savvy activity. Exchanging is about your likelihood of survival. To endure, you can't hazard beyond what you can manage. Gambling an excess of isn't savvy cash the board.

Take for example, this scenario of position sizing: utilizing assets (remember that in today’s market, to legally be considered a day trader in the United States of America, you are required to have a minimum of $25,000 in your record by law. For the purposes of this example, we’ll use a balance size of $35,000 in the example following.

Chapter 8

Beginners Common Mistakes

Many online discount brokerages provide potential investors with the means to trade in stocks at the click of a button. This easy access to investing is excellent as people now feel more encouraged to try their hand at investing in the markets, rather than having to depend on fund managers.

However, there are numerous pitfalls that a first-time investor has to watch out for, before attempting to choose stocks.

Rushing In Headfirst

The fundamentals of investing are simple – buy when low and sell when high. However, you have to be aware that what you might consider to be high might be considered low by another investor. In the financial markets, everything depends on different metrics and ratios, so it is quite possible for different conclusions to be made from the same market information.

What you have to do is train yourself to study the basics. You should at least understand some terms such as dividend yield, book value, and price-earnings ratio, while learning how to calculate them and what weaknesses they have. There are online stock simulators that you can use to practice and gain trading skills before delving into the real thing. Sure, the real market is more complicated, but at least you will be in a better position to understand what is happening and how to react.

Using Brokers Who Charge Too Much

When you are investing, it is crucial to cut down your costs as much as possible. While you do not want to be cheap and cut corners, there are some brokers who will charge way more for their services compared to others. You can choose to go with another option that will save you some money.

You do need to do some research ahead of time. Just because a broker charges less doesn’t mean that they are the best ones for you. There are many brokers who will charge you a fair rate, but make sure that you look at some of the features that each one offers and pick one that will provide you with the results that you would like.

As you can see, there are some common mistakes that beginners can make that will cost them a lot of money on options trading. But when you learn about these mistakes and how to avoid them, you have a head start to make money with your options trading

Investing in Penny Stocks

It may seem like a good idea to invest in cheap, penny stocks. With penny stocks going for as little as $1 per share, you might be tempted to buy more of them instead of blue-chip stocks going for $50 per share. An increase of $1 in penny stock share price might double your money, but the volatility associated with them makes them a poor choice.

Penny stocks can go up rapidly, but they can also crash at any time, not to mention their exceptional susceptibility to illiquidity and manipulation. For an investor who is still learning, it is challenging to obtain any credible kind of information about penny stocks, so steer off penny stocks until you have adequate market knowledge.

Now that you know all you need to know about the basics of investing, let’s see how you can go about creating an investment plan.

Buying an Option with High Volatility.

Another mistake that you can make is to purchase options in a time of high volatility. During these times, option premiums will often get overpriced, and if you purchase an option, you could still lose. There are times when the stock can move sharply in line with what you are expecting; a significant drop in the implied volatility could make the price of the option fall quite a bit, resulting in you losing money.

You want to make sure that you are purchasing options when the price is not so volatile. This will ensure that the price of the option or the stock doesn't go down further than you were expecting and that you will not pay too much for your options premium.

Basing Your Investments on 'News'

Maybe you've heard of a revolutionary new product or a rumor of an investment that offers earth shattering returns and have decided to base your investments on such information. For a first-time investor, this is a horrible move. Sure, you might hit the jackpot and repeat the trick, but the worst-case scenario is that you will be investing on a false rumor or putting your money in late.

The best investments for beginners are companies that you are familiar with, as this will make it easier for you to spend time researching that particular investment option.

Investing Your Cash Reserves

According to market studies, you will earn a better return on investment if you put your cash into the market in bulk instead of in small increments. However, do not take this to mean that you should invest to the point where you don’t have any cash reserves left.

Whether you are a trader or an investor who buys and holds, investing is a long-term game that requires maintaining cash for opportunities and unforeseen emergencies. If all you have is cash to invest with no emergency reserves, then you are probably not ready to seriously invest in the market.

Putting All Your Eggs in One Basket

It is totally unwise to invest all your capital in one specific market, be it commodities, Forex, bonds or the stock market. As a first-time investor who does not have adequate know-how of market operations, it is better to diversify and risk small amounts of capital at a time. You may choose to put all your investment in one vehicle once you are familiar with the markets. However, this is still not advisable.

There are going to be times when you will make a bad trade, no matter how much time you have spent in the options market. An experienced trader knows that they should never place all of their bets on a single trade. If you do this and the trade goes wrong, it means that you are going to lose a lot of your capital all in one place.

Professional traders know that they should spread out their risks across at least a few different trades so that they won't lose all their money in one place. It is best to keep no more than five percent of your available capital in one trade in order to keep things safe. So, if you have $10,000 to invest total, it is best to never enter into a trade where you will risk losing over $500 if things go wrong. If you are able to follow this practice, it will ensure that losing on occasion is something that can happen without you eating up all of your cash reserves. If you do not follow this advice, you can easily place too much of your money into one trade, and if it goes wrong, you will lose a lot of your capital.

Not Cutting Out On Your Losses When Needed

A good saying that you should stick with when it comes to options trading is to cut your losses short and let the winners run. Even those who have been working in options trading will find that one of their trades has poorly gone on occasion. The difference between the novice and a more experienced trader is that the experienced trader knows when they have lost and when they should get out of the market. Many beginners keep holding on to trades that are losing in the hopes that these options will bounce back and they will make money.

The issue with this is that when they hold onto these options, they hold onto them a lot longer and lose a big chunk of their capital. Rather than losing a lot of money, an experienced trader will know when to admit that they were wrong, and they will pull out early when the losses are low. Then they will still have some capital leftover in order to spend on another options contract.

Being able to cut your losses in time is crucial, especially if you are working with a directional strategy and you make the wrong call. The most practical thing that you can do is exit your losing position once you notice that it is moving against your expectations and it erodes over two to three percent of the total capital you want to earn.

If you are someone who likes to use the spread-based strategies, the losses that you have will always be more limited wen you have made a wrong call. However, no matter what strategy you are using, once you notice that your trade is not going to profit you well, it is time to cut off the losses and choose to reinvest in a different position that can bring in better profits.

Failing to have an exit plan

You should have an exit plan for every one of your trades. I prefer to have an overall exit plan and have every trade follow the same basic rules. An exit plan will help you minimize your losses. This goes back to the problem of beginning traders holding onto an option until the expiration date. That is more likely to happen if you haven't formulated a strategy to exit your position. You can be helpful to keep a notebook to record all your trades and write down the rules for each trade. That way you can refer to it when things are fluctuating about, and possibly putting you into a situation where there are catastrophic losses. Now, of course, they aren't really catastrophic, assuming that you are reasonable in the number of options contracts that you trade in a single move. But you want to have some kind of rule so that you will exit the trade if the losses exceed a certain amount. Of course, sometimes, you're going to make a mistake. So, in other words, if you have some kind of rules such as you are going to sell to close if the loss reaches $ 50, something I can guarantee is at some point, you are going to do that but the stock is going to rebound and if you had stayed in, you would've made $ 200 or something like that. You just have to accept that, sometimes, if you are going to miss out on situations like that. But on average, that's not really likely to happen. So, if an option is going south and you have a $ 50 exit rule, it's a good idea just to follow it and live with the consequences.

A similar situation happens on the other side. So, as I suggested, I maintain a $ 50 profit rule. So, whenever I've invested in options and it reaches $ 50 dollars per contract profit, I exit the trade. There are going to be times when the profit could've been $ 100 or even $ 200. So, when you have a rule like that you are going to miss out on some upside once in a while.

Chapter 9
Mindset

Trading psychology is the mental state and emotions that determine the success or failure of trading options. It represents the aspect of your behavior that dictates the decisions you make when faced with a trade. The psychology is vital to any trade and can be compared to experience, knowledge, and skills in determining your success as a trader.

The Basics of Trading Psychology

We associate trading psychology to some behaviors and emotions that are often the triggers for catalysts for decisions. The most common emotions that every trader will come across is fear and greed.

Fear

At any given time, fear represents one of the worst kinds of emotions that you can have. Check in your newspaper one day, and you read about a steep selloff, and the next thing is trying to rack your brain about what to do next even if it isn't the right action at that time.

Many investors think that they know what will happen in the next few days, which makes them have a lot of confidence in the outcome of the trade. This leads to investors getting into the trade at a level that is too high or too low, which in turn makes them react emotionally.

As the trader puts a lot of hope on the single trade, the level of fear tends to increase, and hesitation and caution kick in.

Fear is part of every trader, but skilled traders have the capacity to manage the fear. There are various types of fears that you will experience, let us look at a few of them:

The Fear to Lose

Have you ever entered a trade and all you could think about is losing? The fear of losing makes it hard for you to execute the perfect strategy or enter or exit a strategy at the right time.

As a trader, you know that you need to make timely decisions when the strategy signals you to take one. When fear is guiding you, the level of confidence drops, and you don't have the ability to execute the strategy the right way, at the right time. When a strategy fails, you lose trust in your abilities as well as strategy.

When you lose trust in many of the strategies, you end up with analysis paralysis, whereby you don't have the capacity to pull the trigger on any decision that you make. Making a move becomes a considerable challenge.

When you cannot pull the trigger, all you can think about is staying away from the pain of losing, while you need to move towards gains.

No trader likes to lose, but it is a fact that even the best traders will make losses once in a while. The key is for them to make more profitable trades that allow them to stay in the game.

When you worry too much, you end up being distracted from your execution process, and instead, you focus on the results.

To reduce the fear in trading, you need to accept losses. The probability of losing or making a profit is 50/50, and you need to accept this fact and accept a trade, whether it is a sell or a buy signal.

The Fear of a Positive Trend Going Negative (and Vice Versa)

Many traders choose to go for quick profits and then leave the losses to run down. Many traders want to convince themselves that they have made some money for the day, so they tend to go for a quick profit so that they have the winning feeling.

So, what should you do instead? You need to stick with the trend. When you notice a trend is starting, it is good to stay with the trend until you have a signal that the trend is about to reverse. It is only then that you exit this position.

To understand this concept, you need to consider the history of the market. History is good at pointing out that times change, and trends can go either way. Remember that no one knows the exact time the trend will start or end; all you need to do is wait upon the signal.

The Fear of Missing Out

For every trade, you have people that doubt the capacity of the trade to go through. After you place the trade, you will be faced with many skeptics that will doubt the whole procedure and leave you wondering whether to exit the strategy or not.

This fear is also characterized by greed – because you aren't working on the premise of making a successful trade rather the fact that the security is rising without you having a piece of the pie.

This fear is usually based on information that there is a trend which you missed that you would have capitalized on.

This fear has a downside – you will forget about any potential risk associated with the trade and instead think that you have the capacity to make a profit because other people benefited from the action.

Fear of Being Wrong

Many traders put too much emphasis on being right that they forget that this is a business they should run the right way. They also forget that being successful is all about knowing the trend and how it affects their engagement.

When you follow the best timing strategy, you create many positive results over a certain time.

The uncanny desire to focus on always being right instead of focusing on making money is a great part of your ego, and to stay on the right path; you need to trade without your ego for once.

If you accommodate a perfectionist mentality when you get into trades, you will be after failure because you will experience a lot of losses as well. Perfectionists don’t take losses the right way, and this translates into fear.

Ways to Overcome Fear in Trading

As you can see, it is obvious that fear can lead to losses. So, how can you avoid this fear and become successful?

•Learn

You need to find a way to get knowledge so that you have the basis for making decisions. When you know all there is to know about options, you know what to buy and when to sell, and learn which ones to watch. You are then more comfortable making the right decisions.

•Have Goals

What are your short term and long-term goals? Setting the right goals helps you to overcome fear. When you have goals, you have rules that dictate how you behave, even in times of fear. You also have a timeline for your journey.

•Envision the Bigger Picture

You always need to evaluate your choices at all times and see what you have gained or lost so far for taking some steps. Understanding the mistakes, you made gives you guidance to make better decisions in the future.

•Start Small

Many traders that subscribe to fear have lost a lot before. They put a lot of funds on the line and ended up losing, which in turn made them fear to place other trades. Begin with small sums so that you don’t risk too much to put fear in you. Once you get more confident, you can invest larger sums so that you enjoy more profit.

•Use the Right Strategy

Having the right trading strategy makes it easy to execute your trades successfully. Make sure you look at various options trading strategies so that you know which one is ideal for your situation and skills.

Many strategies can help you succeed, but others might leave you confused. If you have a strategy that doesn’t give you the returns you desire, then adjust it to suit your needs over time. Refine it till you are comfortable with its performance.

•Go Simple

When you have a strategy that is simple and straightforward, you will be less likely to lose confidence along the way because you know what to expect.

Additionally, the easier the strategy, the faster it will be to spot any issues.

•Don’t Hesitate

At times you have to jump into the fray even if you aren’t so comfortable with the way it works. Once you begin taking steps, you will learn more about the trade.

However, you need always to be prepared when taking any trade. The more prepared you are, the easier it will be for you to run successful trades.

•Don’t Give Up

Things might not always go as you expect them to do. Remember that mistakes are there to give you lessons that will make you a better trader. When you lose, take time to identify the mistake you made and then correct it, then try again.

Greed

This refers to a selfish desire to get more money than you need from a trade. When the desire to get more than you can usually make takes over your decision-making process, you are looking at failure.

Greed is seen to be more detrimental than fear. Yes, fear can make you lose trades, but the good thing is that you get to preserve your capital. On the other hand, greed places you in a situation where you spend your capital faster than you return it. It pushes you to act when you shouldn’t be acting at all.

The Danger of Being Greedy

When you are greedy, you end up acting irrationally. Irrational trading behavior can be overtrading, overleveraging, holding onto trades for too long, or chasing different markets.

The more greed you have, the more foolish you act. If you reach a point at which greed takes over from common sense, then you are overdoing it.

When you are greedy, you also end up risking way much more than you can handle, and you end up with a loss. You also have unrealistic expectations from the market, which makes it seem as if you are after just money and nothing else.

When you are greedy, you also start trading prematurely without any knowledge of the options trading market.

When you are too greedy, your judgment is clouded, and you won’t think about any negative consequences that might result when you make certain decisions.

Many traders that were too greedy ended up giving up after making this mistake in the initial trading phase.

How to Overcome Greed

Like any other endeavors in trading, you need a lot of efforts to overcome greed. It might not be easy because we are talking about human emotions here, but it is possible.

First, you have to know that every call you make won’t be the right one at all times. There are times when you won’t make the right move, and you will end up losing money. At times you will miss the perfect strategy altogether, and you won’t move a step ahead.

Secondly, you have to agree that the market is way bigger than you. When you do this, you will accept and make mistakes in the process.

Hope

Hope is what keeps a trading expectation alive when it has reached reversal. Hope is usually factored in the mind of a trader that has placed a huge amount on a trade. Many traders also go for hope when they wish to recoup past losses. These traders are always hopeful that the next trade will be the best, and they end up placing more than they should on the trade.

All About Buying Covered Calls

The answer is yes, there are some serious benefits to be had when you buy covered calls, but it’s a little different than selling these bad boys, so here, we’ll go into deeper detail about buying covered calls, and why it may be beneficial to you.

Chapter 10
All About Buying Covered Calls

What is buying a Covered Call

Buying a covered call means that you're buying a stock at a certain price. For example, let's say that you are looking to buy some IBM stock. Instead of writing to get it at a certain price, you are buying it from the trader at a certain price, when the stock falls below a certain level.

So, let's say the IBM stock is trading at $45 currently. You buy a covered call that says the stock will be sold at $40 a share. So, the stock goes up to $47, and you get that stock for $40, and essentially, you're saving $700 on the stock price. If it goes down to $39 somehow, you can't exercise this, and then, you end up losing out on the premium, whatever that may be.

The benefits of Buying Covered Calls

There are a few major benefits of buying covered calls, and here, we'll discuss how these purchases can benefit you.

First and foremost, if you're an investor looking to have more stock under your belt, you will want to buy covered calls. While you will have to pay a fee for those options, here is the thing: if the stock is predicted to drop super low, you can catch this up. At this point, you can have it under your belt for a fraction of what it might be otherwise.

Selling stock usually is a bit pricier than the covered call option, and if you're looking for options to arrest this stock, then this is something you should consider.

What many don't realize, is that while yes, the investor can make some serious bank selling these, buying these from right under their noses has benefits too. When you buy them, you own them, which means you can do whatever you want with them.

So, that brings us to the second point. One way to invest in a smart manner is to buy the stock for cheap, and then turn around and then sell covered calls to this for a higher price. That way, you get the options fee from the next person, and you also can cash in on this.

That is the third benefit of this. You can cash in on this stock at any time too. So, let's say that the stock falls, you buy it for the covered call price, let's say the covered call price is .37 per share, so 370 dollars. If you then see the stock price immediately go up to say .50 a share, so 500 if you sell it, there you go, and you made a 130-dollar profit. You also can cash in on the dividends of your stocks too.

There is also another benefit to buying covered calls: the type of stock you're getting. These stocks aren't just sitting in limbo not doing a darn thing. Instead, they are fluctuating a lot, and this will, in turn, mean that you can potentially cash in on this, or even sell more covered calls based on what you’re doing. You will realize over time that the stock you get with this is actually very volatile compared to others, or it has a lot of impact on our economy somehow. These are also industries that won’t be leaving anytime soon, such as energy industries.

Buying covered calls also adds to your portfolio. If you want to be taken seriously as an investor, I do suggest that you start adding to your portfolio. This will, in turn, showcase to other investors, and even your broker, your potential. You also can sell these at any time, net the cash, put it in the options account, and it could help you potentially get to level 5 on investment.

So yes, buying is a great way to set yourself up for success essentially. While you have heard a lot about how selling essentially puts you in control and generates a great retirement, you can really take advantage of buying too when it comes to options trading. Covered calls are bought for a reason, and while you may not see the advantages now, there are quite a few advantages that are ready to be exercised.

All about Open Interest

Let’s talk about open interest. This is the total number of outstanding contracts, in this case, options, that haven’t been settled for the asset. This doesn’t count every buy and sell contract, but instead, this is a picture of the trading activity on the option, and whether the money is flowing about, and if the underlying stock is increasing, or decreasing under it all.

So, what does that mean? Well, open interest is one of the data fields that you see when you look at the option, and that also includes the bid price, ask price, the implied volatility, and the volume too. Many traders ignore this, and this is actually a really bad thing to ignore.

Why is that? Well, essentially it doesn’t update during the trading day, and you may not realize it, but sometimes this causes contracts to be exercised without you knowing it.

Let us use an example. You have 1000 shares of stock ABC, and you want to do a covered call, selling 10 of these calls, and you essentially would enter this into open. It is an open transaction and add 10 of these shares to the open interest. You’re essentially entering the transaction to buy from closed, and that would decrease the open interest of this by 10 as well.

So, let’s say you are buying 10 of the ABC calls to open, and the other will buy 10 calls to close, the same number, so it won’t change.

But why does this matter? Well, if you’re looking at the total open interest, you won’t know immediately whether the options are sold or bought, and this is why many ignore this. But, the truth is, this also has important information, and you shouldn't assume there is nothing there. One way to use this is to look at the volume of the contracts that you trade. When this starts to exceed the existing open interest, it does suggest that trading in that option is super high, which means lots are acting on it. You should potentially act on this if you feel that you’re going to get a profit from acquiring that underlying stock.

Let us take another example. You see the open interest on a stock, such as maybe IBM, is 12,000. This does suggest that the market in this is active, and there might be investors that want to trade at this point. You see the bid price is just $1, and the option is $1.06, which means you can buy one call option contract at the price that is mid-market.

But, let’s say that the open interest is like 3. This is practically no activity on those call options, and there isn’t a secondary market because people aren’t interested, so you will struggle to enter and exit this at a reasonable price.

Let us take maybe looking at say GameStop for example. After their recent reports, their stock is probably at an incredibly low open interest. That means you shouldn’t try to act on that. But, Apple is currently putting out more products and is getting ready to shell out more flagship products, so their stock has a huge open interest on it, and that means, you should potentially consider entering and exiting it, and possibly buying covered calls on that stock for a good price.

Open interest doesn't get updated as much, but it is still of an important case to understand, and it can affect you rush in and approach a trade. It gives you a good indication of the overall trading volume on the stock; which makes it very significant.

The Risks of Covered Calls

With buying covered calls, you essentially are betting that the stock will go high enough that you can get it at the price you’re trying to get it for. That is your number one risk.

But, how is that a risk? Well, whenever you’re buying a call, you have to pay the person who is putting out the covered call a fee. Now, this fee may be a little bit; it may be a few hundred dollars.

In essence, you’re betting that the stock will go up high enough that you can get that stock from them.

Now, let’s take, for example, you see the stock currently at 100. Let’s say the covered call is for 105, and you decide you want to get an options contract for that. So, you choose that, the time that elapses happen, but the stock never reaches 105, and it stays at 103. Well, unfortunately, you just lost out on some cash there because of that, because you were betting on t to go up so you could get a deal, and unfortunately, that didn’t happen.

The thing with buying covered calls, is you need to make sure that you’re getting stock that is going to increase within that timeframe, is at a price that you’re willing to pay, and has a chance of potentially netting you a profit. If it does have all three of these then get into it and take that risk. But, what can be worrisome is how much you can potentially lose.

For example, let’s say that you are interested in getting a stock that has the potential for growth. You decide to purchase some of the stock from investor X. Investor X has a covered call written out where you’ll pay .95 per share, so after 100 shares, it’s 950 dollars. You decide you go for it, and you get that 300-dollar fee paid to him. Swell, right?

Well, unfortunately, that stock does not increase. It doesn't decrease either, it just stagnates. You thought you had a chance to do this, but then, it ends up potentially doing nothing to help you. Lo and behold, you just lost that 300 dollars, the investor gets to keep that, and their shares too.

If you do that five times, with five different stocks, that’s $1500 right there down the drain.

So, remember that when you’re looking into covered calls because this can potentially wreck you if you aren’t careful.

Finding the Right Stock and Strike Price for a Covered Call

So how do you find the right stock for this? Well, again you want to find a stock that is going to have enough volatility where it will get to the price that you want it to be, pays decent dividends, and also is a field that will actually be around for a while.

One that currently is thriving is DSL actually. You may think that it isn’t going to do as well, but it still holds an impressive number of dividends. That means if you can find stocks that are being sold, that have the potential to change the game for the better later on possibly, and also are worth investing in, you should do that.

Chapter 11

Rolling and Managing Option Positions

Sometimes, as a trader, you want to make adjustments to your positions and trades. You make these changes and adjustments when you notice changes in the market that will affect your trades but had not been predicted. There are several ways of managing trades, and one of these methods is known as rolling positions.

Rolling Positions

As a trader, you can roll a position in order to improve your chances of success. The term rolling refers to making adjustments to an existing position in the markets in order to improve the profit outlook or to prevent losses.

When you roll down a position, you basically close down an existing position then open a similar position with the same number of options contracts with a lower strike price. This will generally improve the outlook of your strategies.

There are basically three basic ways of rolling options positions. You can roll forward, roll down, or even roll up a position depending on your goals. The term “roll an option” is derived from the phrase “roll down an option until it is at a lower strike price.” Traders will from time to time need to make changes or adjustments to an existing position.

Anytime that a trader closes existing position and proceeds to immediately open a similar position with a similar number of contracts but at lower strike prices, we consider this to be a roll down process. As a trader, learning the art of rolling down a position could be crucial to your strategies and could determine your performance and profitability.

Rolling Down a Position

It is possible to manage both short and long positions using rolling techniques. The same is true for both put and call options. When it comes to call options, the rolling technique will send the option more into the money. However, with put options, rolling tends to send them more out of the money.

When you are holding a long position in the market, then you need to create a similar order which is a sell to close. You can expect to fill out an order form with your broker in order actually to perform a roll-on procedure. Some of the orders would require you to include a BTO or buy to open or an STC or sell to close a position.

Purposes of Rolling Down Options

There are reasons why traders often roll down positions they hold in options spreads. The first is to avoid assignment. When a trader rolls down a short-put option, the main aim is to prevent any in the money options assigned. This is often the case where a trader is dealing in naked put writing which is an extremely dangerous approach reserved only for experienced traders. Therefore, in one case, a trader will roll out a position to avoid assignment.

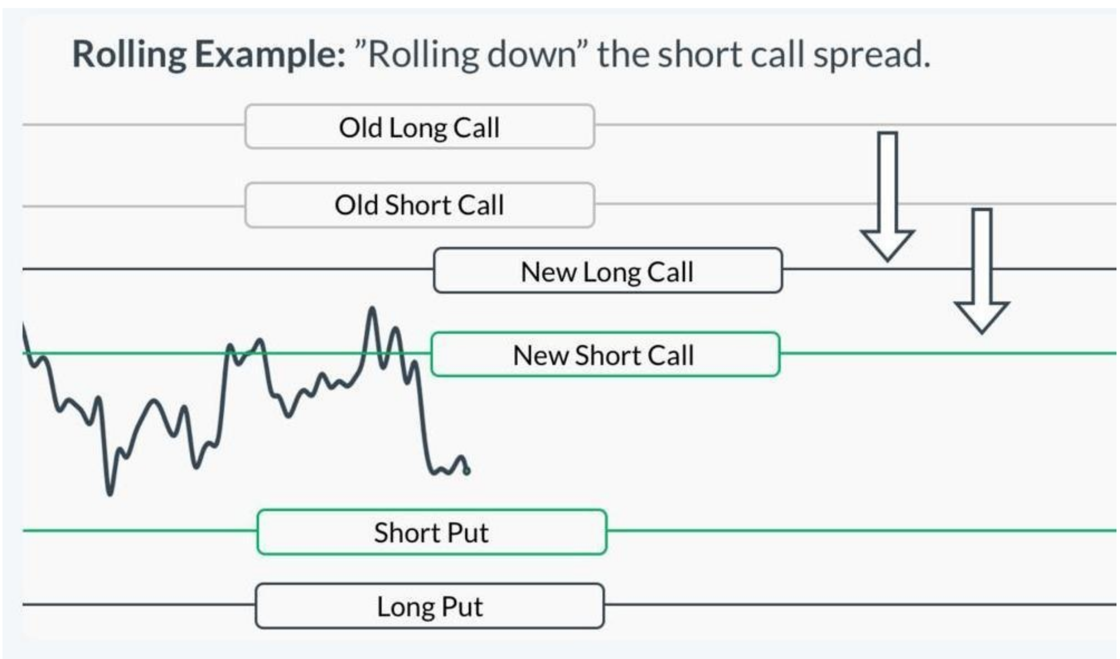
In other situations, a trader will roll a position in order to make adjustments that improve its outlook. They do so first when they wish to collect profits on a long position especially one that is too deep in the money. In this instance, they will be rolled down to positions that are too deep in the money.

Traders also enact roll down positions in order to stop a loss. When traders hold long call options that begin to lose money, then it is wise to roll those positions and make adjustments to stop the loss and make money instead. It is also advisable to use rolling techniques in order to salvage some value that is still left in a position that is losing money.

Rolling the Iron Condor

There are some opportunities that traders have, and one of these is rolling positions. We roll out certain positions in order to allow time for correction. For instance, should you be holding a position in the market that is not generating profits as it nears expiration, then you can roll this position so that it expires an extra month later. This can happen with a naked short put, a short straddle or a short strangle.

Rolling is also available to more complex positions such as the short iron condor. A short iron condor is generally a short premium trade whose risk is clearly defined. However, it is a lot more difficult to roll these positions compared to more straightforward ones.



When you roll down the iron condor, you may want to begin with the short call spread. Do this especially when the price of the underlying stock begins to fall and heading towards the short-put spread. Ideally, a short condor position often begins with no risk in regard to exposure as the position delta is basically at zero.

However, as the trade begins to take shape, the stock price will quickly become bearish and in the process, begin to approach the strike price of the short put. In this situation, the position delta will grow indicating that the trade is generally bullish in terms of its direction.

One of the best ways to adjust the iron condor is to purchase the old call spread in order to close the trade. This is the best approach to roll down the shirt call spread. We will also then sell a new call option with a lower strike price. This will open another trade which is desirable.

Accomplishments of the Iron Condor Adjustment

When you perform this rolling process on the iron condor spread, you will be able to collect more premiums. This happens because there is a net credit that results from call options with a higher strike price. Such options are generally cheaper and will result in a net credit.

You will also be able to stop and possibly neutralize the directional exposure that the iron condor would expose you to. When you roll down the call option, then the iron condor will gain positive delta and hence rolling ensures that the direction exposure changes direction from one that is bearish to one that is bullish and also closer to a neutral position.

Rolling Down a Short Call Position

If you want to roll down a short call position, then what needs to occur is to create two simultaneous orders. These orders are STO or Sell to Open and BTC or Buy To Close. The BTC is set up in order to close the current short position. The STO will then be used to open a new short position but at a strike price that is lower.

As it is, most option brokers offer traders a chance to roll down their positions. Direct roll downs on brokerage platforms allow you to fill out orders so that you can roll down a position that needs additional management techniques. Therefore, when you finally decide that you need to roll down the position, you will log onto your brokerage platform and fill out the necessary rolling forms then roll out your desired position.

Example: Rolling Down a Short Call Position

The shares of ABC Company are trading on the markets at $50. You have call options in the market with a $50 strike price and hoping that there will be a short pullback. A couple of days later, ABC shares drop to $45, so you hope for a further drop in price. As such, you opt to roll down the call options that you own to a new price of $45 rather than the initial price of $50.

By rolling down the option, you will position yourself for further profits should the stock price continue to drop. By successfully lowering your strike price from $50 to $45, you will have in essence rolled down your position and basically positioned yourself to earn more money.

Rolling Down a Short Put Position

Rolling down a put position is very close to rolling down a short position. Such an options management technique is a bearish strategy. The procedure is essentially the same. As a trader, you will execute both legs at the same time so as to minimize the chances of slippage. Slippage in this instance refers to the erosion of profit which happens where the underlying security's price changes.

When rolling a put option, the new position will be cheaper as the strike price will be lower. The new contracts will cost less compared to the old ones. Even then, the result could end up being a credit or a debit to an account. It is the price difference that will determine how much credit or debit this will be to an account.

Reasons for Rolling Down a Short Put

There are a number of reasons why you would roll down a position. One of these is to prevent the exercise of an options contract by a buyer. Put buyers reserve the right to buy the underlying stock at the stated price, so if you have a naked put, you could end up seriously exposed.

Another reason why put options are rolled down or managed could be a desire to increase the bearish stand of an option with a long position in the market. A long put that is in the money will lose value and hence the need to perform a rolling procedure. By rolling out a position, traders get the opportunity to recoup any losses and receive a lot more profits for their positions in the market.

Holding a long call position in the market can possibly lower the strike price if the position is rolled especially when the underlying security loses value even as the trader has a bullish outlook on the price. As such, the position will continue to be in place after a roll out and any possible losses eliminated.

Example of Rolling a Short Put Position

The shares of ABC are trading at $50 in the market and so, you decide to write a short-put option at a strike price of $50. Your outlook is bullish on this position to ensure that you profit should the price go up. However, the price falls to $45, and this does result in losses in some of your options. The option itself is in the money, so you now think it will rally back with time. To benefit from the expected upward trajectory in the price of the underlying stock, you will have to roll down this position.

Rolling a Short Straddle

A short straddle is among the most profitable strategies available in the market today. However, from time to time, traders need to adjust their positions based on market needs and outlook. This is a technique that should only be left to experienced and advanced traders.

Sometimes, intermediate and other traders think that adjusting a position is challenging and a complex affair. This is not the case at all because it is possible to make adjustments to most positions in the market.

A short straddle is sometimes created as part of an iron butterfly. It involves the sale of option that is at the money and consists of put and a call option.

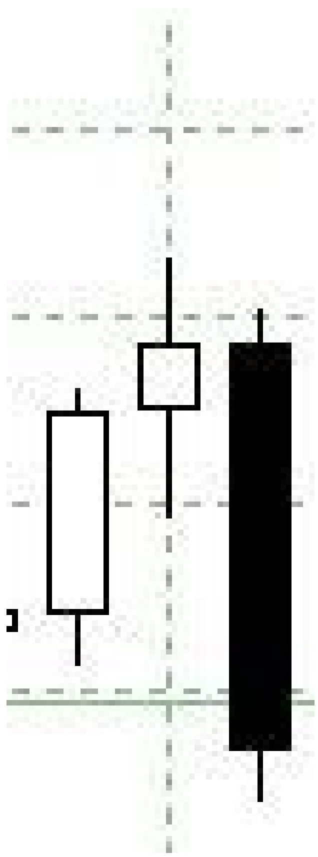
Chapter 12

Technical Analysis

Price Charts

The very first thing you will need to learn is to get familiar with a price chart. Technical analysis charts are very different from the usual price charts you see on TV. When carrying out fundamental analysis, odds are you will never have to glance at a price chart. However, technical analysis revolves around it.

The most common, and best, method of representing price that you will encounter is candlesticks. Figure 1 below illustrates a few candlesticks.



A candlestick chart is comprised of a number of individual candles or bars as they're sometimes called. Each candle represents what happened with price over a given interval. The interval depends on the time frame you're looking at. For example, on a daily chart, each candle represents what happened to price over an entire day.

Every candle has three parts that it is made of:

1. The body
2. The wick
3. The tail

The body refers to the solid colored portion you see in all candles in Figure 1. A bearish bar, or one where price reduced during the time interval, is represented by a solid black colored body. A bullish bar, where price increased over the time interval, is represented by a solid white body.

In bearish bars, the level at which price began the interval (open) is indicated by the upper end of the body and the level at which price ended the interval (close) is indicated by the lower end of the body. The pattern is flipped in the case of bullish bars, with the lower end of the body indicating the open and the upper end the close.

The wick refers to the vertical line that protrudes over the top of the candle's body. This indicates the highest level to which price moved during that interval. The tail is the vertical line that sticks out from the bottom of the body and indicates the lowest point to which price moved in that interval.

Size

The relative sizes of all three elements can give us a lot of information on what happened during the time interval.

After all, the greater the extent to which price moved, the greater is the strength behind that move. The sizes of the wick and tail provide important clues as well. A long wick indicates that bulls tried pushing prices up but were rejected by bears. If this rejection hadn’t happened, we would have seen a large candle body in that direction instead of a smaller body and a large wick.

Similarly, a long tail indicates that bears tried pushing prices down but were rebuffed by the bulls. All the charts in this, from here on out will use candlesticks to represent price. While individual candles give us clues as to what happened in a single interval, the trick to making technical analysis work for you is to be able to chunk candles into manageable portions and then evaluate what is going on there.

This means you’ll need to learn all about trends and ranges.

Trends and Ranges- The Basics

Most beginner traders assume technical analysis equals indicators. This is just not true. Indicators help you decipher what is going on in the market, but they are always lagging behind the market.

After all, they are a derivation of something and as a result, you can never expect an indicator to tell you ahead of time what's going to happen. That is just unrealistic. Instead, the best thing to do is to go to the source itself, which happens to be the price chart.

The price chart can seem intimidating but by figuring out the two broad principles it operates on, we can make much more sense of it. These two principles are the trend versus range axis and support and resistance. If you've ever traded before you've probably heard of these terms, but I can guarantee you that you've never learned them or applied them the way you should.

The fact is that you don't need indicators to trade well. If you can figure out the trend versus range position of the market and the relevant support and resistance levels, you'll be able to trade successfully. This seems like a tall order but it's not as complex as you might think. The key is to understand the basics of all of these terms so that you can figure out the price chart inside out.

Let's take a look at them one by one.

Ranges

Ranges are the beginner's best friend.

Price is said to be in a range when it moves sideways. When you think of sideways you might be thinking of price moving in a neatly defined boundary, but this is not quite the case. As you can see from Figure 1, price seems to hit the same lower level repeatedly but on the upper level, the peaks don’t quite line up with one another, with one peak prominently higher than the rest.

This is the thing that makes ranges intimidating for most beginners. The key to solving this confusion is to recognize the upper and lower boundaries of a range are zones. You’ll understand the implications of this better when you learn about support and resistance. For now, just keep in mind that it isn’t necessary for a sideways movement to have clean boundaries on the top and bottom.

Ranges can occur in two places: The first is within a trend and the second is at the end of a trend. The ones that occur at the end of trends tend to be huge and often indicate order redistribution between both sides of the market. There are always two major side to the market: The bullish and bearish side. The bullish side seeks to push prices higher while the bearish side aims to push prices lower.

The tug of war that both of them engage in plays out on price charts and this is what results in price moving the way it does. Every step of the way, through every single tick of the price chart, the two forces are fighting against one another. Sometimes, one is in complete control while most of the time, the force is balanced in some proportion between the two.

Trends

Trends on the surface of it seem simple enough. Every trader wishes to capture the major part of a trend and understandably so. After all, this is where price moves in a given direction and the greater the degree of price movement, the more money you stand to make.

The problem is that trends tend to run away from beginner traders quite a lot. They require decisive entries and most importantly, require the trader to hold on for a long as possible. This means that the ability to pull the trigger on a trade and then having the patience to hold on to the position until the time is right to exit are important skills to have. Needless to say, most beginners do not have such skills.

The trick to trading trends is to identify how much longer it has to run. In other words, if you could figure out that the current trend doesn't have much gas left in it, you would know that you should be seeking to get out of it soon.

Chapter 13
Credit and Debit Spreads

How Credit Spreads Work

A credit spread is advantageous because the seller collects more in premium than what is paid out in the options. For example, if the trader sells an option for $1000 and buys another option at a lower strike price of $75 then he or she will have a net result of $25. We refer to this as a credit because he or she is collecting more then he or she is paying out.

The call credit spread is approached with bearish outlook and it too relies on time decay. Profits are realized when stock prices decrease. Profit for 100 shares of stock is calculated with this formula:

Credit Received x 100 = Profit

The loss for 100 shares of stock is calculated with this formula:

(Width of the two Strike Prices - Credit Received) x 100 = Loss

Breakeven is calculated with this formula:

Short Call Strike Price - Credit Received = Breakeven

Types of Credit Spreads

Bull Put Spread

This is a great options strategy for beginners to implement. It is a bearish technique that relies on the price of the associated asset going down significantly enough but not by a huge jump. Two transactions are required with an upfront cost. The trader:

- Buys 1 out of the money put
- Sells 1 on the money put

They are implemented by buying a lower-premium out of the money put option while simultaneously selling one in the money put option that is of a higher premium.

Profit is achieved when the price of the associated asset is equal to the credit received from the options. The formula for this is:

Premium Received - Commissions Paid = Profit

Loss occurs when the stock prices go below the strike price on or before the expiration date. This is calculated with this formula:

Strike Price of Short Put - Strike Price of Long Put Net Premium + Commissions Paid = Loss

Breakeven formula:

Strike Price of Short Put - Net Premium Received = Breakeven

Bear Call Spread

This type of option works similarly to the one stated above, and profit is reliant on the prices of the associated asset falling moderately. The trader:

- Buys 1 out of the money call
- Sells 1 in the money call

Profit is calculated with this formula:

Premium Received - Commissions Paid = Profit

Loss occurs when the stock prices go above the strike price on or before the expiration date. This is calculated with this formula:

Strike Price of Long Call - Strike Price of Short Call - Net Premium Received + Commissions Paid = Loss

Breakeven is calculated like this:

Strike Price of Short Call + Net Premium Received = Breakeven

This bearish strategy is slightly more complicated and is not typically recommended for novice options traders.

Short Butterfly Spread

This is a volatility-based strategy that is typically practiced by medium to advanced options traders. This applies to both call and put options of this type. Three transactions are involved. They are:

- Buying 1 in the money call/put
- Selling 1 out of the money call/put
- Buying 1 as the money call/put

This is not an options trading strategy that a trader should jump into lightly. This requires careful thought and consideration. Thus, this is a strategy that is best employed by intermediate and advanced options traders. However, when done right, this strategy offers benefits like increased flexibility and the ability to profit no matter which direction the price of the asset goes. Both the profit and loss of this type of strategy are limited. This limitation is great for managing risks.

Iron Butterfly Spread

This is a neutral strategy that entails 4 transactions. The trader:

- Buys 1 out of the money call
- Sells 1 at the money call
- Buys 1 out of the money put
- Sells 1 at the money put

The two calls and puts of this options strategy are equal and the associated asset and expiration date of all of these components are the same. Due to the complexity of this strategy, it is not suitable for beginners. The higher commissions also make it less appealing to most traders. However, the benefits include a higher potential profit. This strategy is useful for making a huge payout. Thus, on such a sizable contract, the commissions' increase may be worth pursuing this strategy.

Debit Spreads

How Debit Spreads Work

Unlike a credit spread where the seller receives cash into his or her account, debit spreads instead carry an upfront cost. The premium is paid from the investor's account when the position is opened, and this is referred to as a debit. This type of strategy is mostly used to offset the costs associated with having long option positions. This result because the premium received from long components is more than the premium received from short components. As a result of this, the net debit is the highest possible value for loss in this type of options strategy. Losses are thus limited.

Despite this upfront cost, debit spreads are generally considered safer to create and less complicated than credit spreads. Debit spreads are therefore more commonly used by beginners compared to credit spreads.

Just like the credit spreads, there are at least two options involved in the transaction. The trader pays for a higher premium option while selling a lower premium option. However, just like with credit spreads the number of transactions executed in this strategy can exceed 2.

Just like with credit spreads, there are call and put versions. The basic call version is set up like this – the investor:

- Buys 1 call
- Sells 1 call (this is the higher strike)

Profit is calculated with this formula:

Width of the two Strike Prices – Premium – Commissions = Profit

Loss is calculated with this formula:

Premium Paid + Commissions = Loss

With the put option, the set up looks like this:

- Sell 1 put
- Buy 1 put (this is the higher strike)

Profit is calculated with this formula:

Width of the two Strike Prices – Premium – Commissions = Profit

Loss is calculated with this formula:

Premium Paid + Commissions = Loss

All of these equations will be x100 to prepare a contract with 100 shares as the associated asset.

Types of Debit Spreads

Bull Call Spread

This is a relatively simple strategy to implement as it only requires 2 transactions. The trader:

- Buys 1 at the money call
- Sells 1 out of money call

This is a bullish strategy that is implemented when the trader believes that the price of the associated asset will rise moderately.

Profit is achieved when the price of the associated asset is equal to the strike prices of the short call. The formula for this is:

Strike Price of Short Call - Strike Price of Long = Profit

Loss occurs when the stock price goes below the strike price on or before the expiration date. This is calculated with this formula:

Net Premium Paid + Commissions Paid = Loss

Breakeven is calculated like this:

Strike Price of Long Call + Net Premium Paid = Breakeven

Bear Put Spread

This is a bearish strategy that is used when a trader believes that the price of the associated asset will go down by a moderate amount. It only requires 2 transactions and is, therefore, suitable for beginners. The trader:

- Buys 1 at the money put
- Sells 1 on the money put

This is a straightforward strategy that has limited losses and profits with comparatively low upfront costs.

Profit is achieved when the price of the associated asset is equal to the strike prices of the short call. The formula for this is:

Width of the two Strike Prices - Net Premium Paid - Commissions Paid = Profit

Loss occurs when the stock price goes above the strike price on or before the expiration date. This is calculated with this formula:

Net Premium Paid + Commissions Paid = Loss

Breakeven is calculated like this:

Strike Price of Long Put + Net Premium Paid = Breakeven

Reverse Iron Butterfly

This is a volatile strategy that is used when a trader believes that the price of the associated asset will move sharply in price but is not sure in which direction. Thus, this strategy is created to gain a profit no matter the direction. It requires 4 transactions and they are:

- Sell 1 out of money put
- Buy 1 at the money put
- Buy 1 at the money call
- Sell 1 out of money call

The profit gained in this type of strategy is limited and is achieved when the associated asset price drops below the strike price. The formula for this is:

Width of the two Strike Prices - Net Premium Paid - Commissions Paid = Profit

Loss occurs when the stock price is the same as the strike price on the expiration date. This is calculated with this formula:

Net Premium Paid + Commissions Paid = Loss

The 2 breakeven points for this strategy are calculated like this:

Strike Price of Long Call + Net Premium Paid = Breakeven

Strike Price of Long Put + Net Premium Paid = Breakeven

Butterfly Spread

This is a neutral strategy that involves 3 transactions. The trader:

- Buys 1 in the money call
- Sells 2 at the money calls
- Buys 1 on the money call

The profit gained in this type of strategy is limited and is achieved when the associated asset price remains unchanged on the expiration date. The formula for this is:

Width of the two Strike Prices - Net Premium Paid - Commissions Paid = Profit

Loss is also limited. It occurs when the stock price is the same as the strike price on the expiration date. This is calculated with this formula:

Net Premium Paid + Commissions Paid = Loss

Chapter 14
The Greeks

There are four Greeks called delta, gamma, Vega, and theta that quantify how the pricing of an option is going to vary when the fundamentals change. You don't need to understand how the Greeks are calculated; you only need to know what they mean, so you can look up an option and use their calculated values to make estimates of coming price changes.

Delta

Getting to know the Greeks and what they mean, when it comes options trading, can help you become a more educated and effective trader. A more educated trader is one that is more likely to make profits. So, let's start with the first Greek which is called delta. It is also known as the head's ratio, but that term is not used very frequently, and in order to look it up you have to find delta.

The concept behind delta is actually pretty straightforward and easy to apply. It tells you how much the price of an option is going to change if the price of the underlying stock changes by one dollar. Consider a delta of 0.68. If the underlying stock changes by one dollar, that tells us that the price of the option will change by $0.68.

The way the Delta changes with time depends on a few factors. Let's take an in the money call option first. When it is in the money, delta increases with the passage of time. The reason why this happens is that extrinsic value is decreasing, while intrinsic value remains directly proportional to the price of the stock. Therefore, delta will increase. At first, this effect is barely noticeable if at all. The less time remaining for the option, the more noticeable it will be.

Now let's consider a call option that is out of the money. In that case, Delta will decrease.

For comparison suppose that we have a call option with a strike price equal to $100. Suppose further that there are 10 days left to expiration. If the underlying stock price is $99 (so that the call option is out of the money) delta is 0.43. On the other hand, if the share price were $101, (so that the option was in the money), delta would be 0.59.

This demonstrates that when the option goes in the money, with all else being equal, it is more heavily influenced by the price of the underlying shares.

To see how this works, let's continue with this scenario. Under the conditions specified with the price of the stock at $101, the price of the call option is $2.54. Suppose that the price of the stock goes up to $102. Since Delta is 0.59, we expect the $1 rise in share price to raise the price of the option by $0.59, to $3.13.

Actually, it raises it a little more, to $3.16, so it was a pretty good estimate. As the price changes delta changes as well. In this case, it jumped to 0.66, meaning that an additional rise in price by $1 will have a greater impact.

Gamma

Now, let’s have a look at the next Greek, which is Gamma. This one is a little bit more obscure. Gamma can be thought of as the second derivative if you have experience with calculus. If you have no experience with calculus or you want to forget it, I apologize for the headache.

Basically, what that means is that Gamma gives the rate at which delta will change if there is a one-dollar change in the underlying stock price. As a side note, if you do remember from calculus - a derivative of position with time is speed or velocity. So, you can think of Delta as giving the speed or velocity in the change of price of the option.

Gamma, in this analogy, would be the acceleration in the change of the option price. Understanding the details and all the mathematics is not important for most options traders. However, you can keep some basic rules of thumb in mind. The key point is this. The higher gamma is, the more responsive the option is going to be to changes in the underlying stock price.

Another way to think of this is to know that Delta changes every time the underlying stock price changes. So, Delta is only as good as the value that we see at a given instance. You can use Gamma to estimate how Delta will change when there is price movement. The further you are from expiration, the higher the Gamma will be.

The more an option goes in the money, the smaller Gamma will get. What that means is that Delta won’t be changing as much for a given change in the price of the underlying stock if the option is in the money. If Delta goes to 1.0 then Gamma will go to zero.

Theta

It is a fact that the extrinsic value of an option is going to decrease as time passes. There is simply no way around this. When an option is further away from the expiration date, there are more opportunities for the stock price to fluctuate. This means that fluctuations in the stock price over a longer period of time could put an option that is currently out of the money, in the money. As you get closer to expiration there are simply less opportunities for that to happen. So, an out of the money option is not going to have as much value as days pass.

If you just play around with options prices using a calculator or watch them on the markets, it might seem a little bit mysterious how the extrinsic value changes. But you can use Theta to get an idea of what is happening. Theta gives an estimate of how much the price of the option will decrease each passing day. Specifically, it tells you how much the extrinsic or time value of the option will decrease.

Since Theta is telling you how much the extrinsic value is going to decrease, it is listed as a negative number. Consider an option with a $50 strike price and a share price of $53. At 15 days to expiration, Theta is -0.027 for a call option, and

-0.026 for a put option. Let’s look at the call option; the principle is about the same for both. This tells us that the extrinsic value at 14 days will drop by about $0.03. At 15 days to expiration, the extrinsic value is $0.29 for the call option. So, we are going to expect it to drop to $0.26 the following day. As a matter of fact, this is exactly what happens.

Time decay is exponential and not linear. If an option is in the money, Theta will decrease in value as the expiration date approaches. If it is out of the money, then it will get larger. This indicates that an out of the money option is going to lose value rapidly, the closer you get the expiration date.

An in the money option will smoothly lose extrinsic value as the expiration date approaches. At the money, options will gain in value as the expiration date approaches. For at the money options, extrinsic value represents a higher proportion of their price as compared to other options. Even though Theta will be smaller for out of the money options, it still represents a greater percentage of losses in price, because extrinsic value represents 100% of the total worth.

In any case, options always lose extrinsic value as the expiration date approaches. No matter where your option is relative to being at the money, in the money, or out of the money, you can take the value of Theta and subtract it from the extrinsic value to determine what it will be the following day.

Vega

Now we are entering territory that is a little more obscure. Vega is related to changes in implied volatility.

So, if there is a one-point change in implied volatility, the implied volatility will alter the extrinsic value of the option. This will be in direct proportion to Vega. Therefore, if Vega is 0.42, that would tell you that if the implied volatility went up one point, the price of the option would go up by $0.42. More volatility means higher option prices. The converse is true as well; if the implied volatility drops by a point - if Vega were 0.42, the price of the option would drop by forty-two cents.

So just remember that Vega would tell you how influential implied volatility is on the price of the option. The higher the value of Vega, the more critical changes in the implied volatility will be on the price. Financial advisors suggest that the best time to buy an option is when Vega is lower than what is considered average or typical. So, if the implied volatility is historically low, that would be an indication that the option is a better buy. On the other hand, if the implied volatility is high in comparison to the historical volatility, that would mean that Vega is higher than average. This would be a sell signal for the option. But to be honest most options trading does not get that deep in the woods. You will be making your buy and sell decisions based directly on whether you are profitable or not.

More practically, consider that if Vega drops consequently the prices of options will drop. If Vega increases, prices of options will increase too.

Rho

The final Greek that we will look at in relation to options is called Rho. This measures the sensitivity of an option to changes in interest rates. If you pull up an options calculator, you are going to notice that it will include the so-called safe interest rate value (or “risk-free”). This is the interest rate that you would receive from the safest possible investment, which is usually considered to be a 10-year US Treasury.

Generally speaking, prices of call options will go up if the interest rate goes up. On the other hand, a rising interest rate would mean a decline in the value of put options. That means that Rho is positive for call options and is negative for put options.

Since interest rates do not change all that much except when the Fed makes a quarterly announcement, it is not really going to be much of a factor in your options trading. Consider that months will go by before there is a change in interest rates (if there is at all), but most options are short-term investments lasting only a few weeks. Generally speaking, options traders are not going to be sitting around worrying about Rho these days. The only time that it might be necessary would be in the case of a LEAP, or long-term option. Even then, it might not matter that much, because the changes in interest rates these days tend to be relatively small.

Chapter 15
Tools and Rules for Options Trading

The Tools Used in Option Trading

In the past days, to invest in stocks, you had to call a stockbroker to help you in stock trading, and they were too expensive. With today's technology, there are tools like the stockbroker's websites and trading apps to help you in stock trading. Both professional and emerging traders would like to monitor the market and new opportunities actively and to manage their accounts and their trading activities. With the right tools, trading will be effortless and effective. We will go through the tools you can use for options trading to make trading much more relaxed and hassle-free. We will go through the apps available and describe which the best for options trading are. A trader can access these apps on your laptops, tablets, and smartphones. The apps are tailor-made to assist option traders and other investors using options trading.

Go Options: This app is free, and the app shows the fun of options trading. The app does not involve any real money, so there are no trade restrictions. These app offers cryptocurrency for trading using options, also stocks and commodities. This app is excellent for emerging traders because it provides a 30 minutes guide for new traders to learn the trading basics. Go Options is available for Android and IOS smartphone users.

IQ Option: This app is for the more experienced traders who are adventurous. This app requires real money to use it. IQ option is available for Android and IOS smartphone users. A minimum deposit of $10 is required and a $1 investment price for real money trading. The app offer VIP and pre-VIP accounts for users who would prefer these services. The advantage of the IQ option is, you can access your money and profits at any time since no minimum amount is required for withdrawal. The downside of the app is that you will be risking your capital.

Robinhood: Robinhood has a website and a mobile app. The app is one of the best trading apps available in the market. The app's main feature is to track your stocks and the stocks you have added to your watch list. The app is user-friendly. To start trading, tap on the stock you which to trade, enter the trade in the app, and own the stock without any trading fees. For a regular account, you will not get access to some investments, for example, mutual funds. You will have access to stocks, ETF's and the now added Bitcoin. However, you can upgrade to a premium gold account. This upgrade gives you access to margin trading, and the trading hours are also extended.

Acorns: Acorns are the best for emerging traders. The app requires you to link your bank account with the app. It tracks your spending and purchases then transfers the data to the Acorns account for investment. This process can also be manually done. When money is deposited in the account, the app will build a stock portfolio and bond investments and bond investments. The portfolio will be based on the questionnaire you filled when signing up in the app. The app focuses on ETFs to build a portfolio to go parallel with the investment goals you have set.

Stash: The best app for beginner level trading for their investment decisions. It is a trading and investment app. This is the best choice for your needs. Stash charges $5 to start investing, it offers assistance in what to invest and gives you more information on your investments. The app also has essential articles and tips to help you improve your investment knowledge. Your finances go into single stocks and ETF's, which are incorporated into different investment themes. Stash also has a built-in investment coach.

Stockpile: With Stockpile, you will be able to buy and sell stocks. You can also gift single shares or buy a part of the shares with a minimum of 99-cent trade fees. Using your account, you can be able to purchase high-valued stocks like Google, and Amazon using the fractional trades. And you won't have to pay $1,000 or even more per share. You will also have the option of buying a portion of stock for the lower cost of your investment. Stockpile is very suitable for families because of the buying and gifting shares of a stock feature. Kids, teenagers, and the whole family can have portfolios and can be able to teach your family the importance of investing, and this can become a family activity. Teach your children about money and investment at an early stage and buy shares or gift them with some stocks. By engaging them, they will be able to grow a valued portfolio.

Charles Schwab: The app enables you to manage your investment and also bank accounts all in one app. Schwab also has a feature to allow you to transfer funds, deposit your checks, and manage your finances. You are also able to buy and sell stocks, ETFs, and mutual funds. Schwab is a favorite with international travelers because it offers a checking ATM card whenever the travel with no extra fees. Schwab is user-friendly; you can log in to your Android, Apple, and Kindle fire devices to check your investments. You can also pay bills on the app.

TD Ameritrade: The app is very user-friendly and straightforward to navigate. It is suitable for new option traders. TD Ameritrade offers 24/7 access to customer support via the phone and also through email support. The user can also visit their many local branches to get assistance, and the service can provide research to their users. TD Ameritrade has no hidden charges, and it does not charge platform fees, and also there is no minimum trade fee. The app charges a flat-rate commission of $6.95 equity trade and $0.75 per contract.

TradeStation Mobile: This app is one of the high rated apps, and it is free for all TradeStation clients. The users can see different options contracts with different prices and expiration dates. TradeStation app offers up-to-date information which the traders can access, and they can run options analysis, and also, the traders can view charts with various technical indicators. The app has notification features, and the traders can monitor the price changes and other indicators. TradeStation is a full-service trading app that offers access to stocks, futures options, and also forex trading.

The Rules Used in Option Trading

What are the guidelines to follow in options trading? What are the rules? These are essential questions new traders should be able to answer correctly. We will go through the rules that you should follow in options trading. And by the end of this topic, you will have the knowledge needed to trade efficiently. For a new emerging trader, these rules will be an eye-opener, while for an experienced options trader, it will be as a reminder. These rules won't be a get-rich tip, and the rules will help you stay out of trouble, increase your capital, and improve your money with options. Here are some of the rules used on options trading:

1. Trade small positions. When you get into the market, it's obvious to assume the worse. It only makes sense to make smaller trades and avoid big trades to reduce the risk of losing a significant amount of the money you had invested. The best tip is to make lots of small positions because if you make just one large, you risk being knocked out when you hit a loss. About 90% of options traders do not succeed because they trade large position sizes. Trading over 5% is considered a great position, and the trader risk affecting their accounts from a bad loss.
2. Don’t be emotional. The market doesn't care what you think; one of the ways to be successful in trading is not to be emotional. Don't allow your emotions to lead you, the opinions or thoughts on the market.
3. Have a high trade count. By knowing your estimated percentage chance of success, you will make a lot of trades. The higher the trade count, the higher the chances of leveling out at that expected percentage. Options trading is a number game and math, and you can pinpoint your probabilities of success in a given position. You can see your percentage chance of success; however, this can be the reason for your failure as you will have the same expectation in all your trades. So, the high trade count you make, the more consistent your percentage success

rate will be.

4. Balance your portfolio. You can bet the price direction if it goes up or down when you invest in options trading. Traders tend to focus on the investment value going up; however, you have to learn how to balance your portfolio with positions going down too.
5. Trade according to your comfort level. If you are not comfortable trading naked options or if hedged positions give you sleepless nights, then you should trade options as a speculator forming opinions and act on them accordingly. Once you are in tune with your strategies, you will realize it will be much easier for you to make money. Each strategy is unique and individual, and it might not work for all traders. By doing this, you will lower the individual's risk level.
6. Always use a model. Failure to check the fair value of the option before it's sold or bought is one of the biggest mistakes option traders make. It can be hard, especially if you don't have an exact real-time evaluation capability. These are the basis of the strategic investment and also be aware of the bargains and the amount you are paying for the option.
7. Have enough cash reserve. It's essential to have a lot of your investment money in cash. It might be useful for brokers as they need a margin requirement when trading. They partition some amount to cover potential losses on your position. Try to keep about 50-60% of your investment portfolio in cash.
8. Reduce commissions and fees. Paying commissions and fees to transact and rebalance your portfolio might be crippling you. One of the ways to lower the percentage of the charges is by using low-cost ETF's. But for a beginner, you shouldn't pay any fees to invest in stocks.

Chapter 16
Covered Calls

We'll investigate a trading strategy that is an excellent way to get started selling options for beginners. This strategy is called covered calls. By covered, we mean that you've got an asset that you own that covers the potential sale of the underlying stocks. In other words, you already own the shares of stocks. Now, why would you want to write a call option on stocks you already own? The basis of this strategy is that you don't expect the stock price to move very much during the lifetime of the options contract, but you want to generate money over the short term in the form of premiums that you can collect. This can help you generate a short-term income stream; you must structure your calls carefully.

Setting up covered calls is relatively low risk and will help you get familiar with many of the aspects of options trading. While it's probably not going to make you productive overnight, it's an excellent way to learn the tools of the trade.

Covered Calls involve a long position

In order to create a covered call, you need to own at least 100 shares of stock in one underlying equity. When you create a call, you're going to be offering potential buyers a chance to buy these shares from you. Of course, the strategy is that you're only going to sell high, but your real goal is to get the income stream from the premium.

The premium is a one-time non-refundable fee. If a buyer purchases your call option and pays you the premium, that money is yours. No matter what happens after that, you've got that cash to keep. In the event that the stock doesn't reach the strike price, the contract will expire, and you can create a new call option on the same underlying shares. Of course, if the stock price does pass the strike price, the buyer of the contract will probably exercise their right to buy the shares. You will still earn money on the trade, but the risk is you're giving up the potential to earn as much money that could have been earned on the trade.

You write a covered call option that has a strike price of $67. Suppose that for some unforeseen reason the shares skyrocket to $90 a share. The buyer of your call option will be able to purchase the shares from you at $67. So, you've gained $2 a share. However, you've missed out on the chance to sell the shares at a profit of $35 a share. Instead, the investor who purchased the call option from you will turn around and sell the shares on the markets for the actual spot price and they will reap the benefits.

However, you really haven't lost anything. You have earned the premium plus sold your shares of stock for a modest profit.

That risk – that the stocks will rise to a price that is much higher than the strike price - always exists, but if you do your homework, you're going to be offering stocks that you don't expect to change much in price over the lifetime of your call. So, suppose instead that the price only rose to $68. The price exceeded the strike price so the buyer may exercise their option. In that case, you are still missing out on some profit that you could have had otherwise, but it's a small amount and we're not taking into account the premium.

In the event that the stock price doesn't exceed the strike price over the length of the contract, then you get to keep the premium and you get to keep the shares. The premium is yours to keep no matter what.

In reality, in most situations, a covered call is going to be a win-win situation for you.

Covered Calls are a Neutral Strategy

A covered call is known as a “neutral” strategy. Investors create covered calls for stocks in their portfolio where they only expect small moves over the lifetime of the contract. Moreover, investors will use covered calls on stocks that they expect to hold for the long term. It’s a way to earn money on the stocks during a period in which the investor expects that the stock won’t move much at price and so have no earning potential from selling.

An Example of a Covered Call

Let’s say that you own 100 shares of Acme Communications. It’s currently trading at $40 a share. Over the next several months, nobody is expecting the stock to move very much, but as an investor, you feel Acme Communications has substantial long-term growth potential. To make a little bit of money, you sell a call option on Acme Communications with a strike price of $43. Suppose that the premium is $0.78 and that the call option lasts 3 months.

For 100 shares, you’ll earn a total premium payment of $0.78 x 100 = $78. No matter what happens, you pocket the $78.

Now let's say that over the next three months the stock drops a bit in price so that it never comes close to the strike price, and at the end of the three-month period, it's trading at $39 a share.

The options contract will expire, and it’s worthless. The buyer of the options contract ends up empty-handed. You have a win-win situation. You’ve earned the extra $78 per 100 shares, and you still own your shares at the end of the contract.

Now let’s say that the stock does increase a bit in value. Over time, it jumps up to $42, and then to $42.75, but then drops down to $41.80 by the time the options contract expires. In this scenario, you’re finding yourself in a much better position. In this case, the strike price of $43 was never reached, so the buyer of the call option is again left out in the cold. You, on the other hand, keep the premium of $78, and you still get to keep the shares of stock. This time since the shares have increased in value, you're a lot better off than you were before, so it's really a win-win situation for YOU, even though it's a sad situation for the poor soul who purchased your call.

Sadly, there is another possibility, that the stock price exceeds the strike price before the contract expires. In that case, you're required to sell the stock. You still end up in a position that isn't all that bad, however. You didn't lose any actual money, but you lost a potential profit. You still get the premium of $78, plus the earnings from the sale of the 100 shares at the strike price of $43.

A covered call is almost a zero-risk situation because you never actually lose money even though if the stock price soars, you obviously missed out on an opportunity. You can minimize that risk by choosing stocks you use for a covered call option carefully. For example, if you hold shares in a pharmaceutical company that is rumored to be announcing a cure for cancer in two months, you probably don't want to use those shares for a covered call. A company that has more long-term prospects but probably isn't going anywhere in the next few months is a better bet.

How to go about creating a covered call

To create a covered call, you'll need to own 100 shares of stock. While you don't want to risk a stock that is likely to take off in the near future, you don't want to pick a total dud either. There is always someone willing to buy something – at the right price. But you want to go with a decent stock so that you can earn a decent premium.

You start by getting online at your brokerage and looking up the stock online. When you look up stocks online, you'll be able to look at their "option chain" which will give you information from a table on premiums that are available for calls on this stock. You can see these listed under bid price. The bid price is given on a per share basis, but a call contract has 100 shares. If your bid price is $1.75, then the actual premium you're going to get is $1.75 x 100 = $175.

An important note is that the further out the expiration date, the higher the premium. A good rule of thumb is to pick an expiry that is between two and three months from the present date. Remember that the longer you go, the higher the risk because that increases the odds that the stock price will exceed the strike price and you'll end up having to sell the shares.

You have an option (no pun intended) with the premium you want to charge. Theoretically, you can set any price you want. Of course, that requires a buyer willing to pay that price for you actually to make the money. A more reasonable strategy is to look at prices people are currently requesting for call options on this stock. You can do this by checking the asking price for the call options on the stock. You can also see prices that buyers are currently offering by looking at the bid prices. For an instant sale, you can simply set your price to a bid price that is already out there. If you want to go a little bit higher, you can submit the order and then wait until someone comes along to buy your call option at the bid price.

To sell a covered call, you select “sell to open.”

Benefits of Covered Calls

- A covered call is a relatively low-risk option. The worst-case scenario is that you’ll be out of your shares but earn a small profit, a smaller profit than you could have made if you had not created the call contract and simply sold your shares. However, you also get the premium.
- A covered call allows you to generate income from your portfolio in the form of premiums.
- If you don’t expect any price moves on the stock in the near term and you plan on holding it long term, it’s a reasonable strategy to generate income without taking much risk.

Risks of Covered Calls

- Covered calls can be a risk if you’re bullish on the stock, and your expectations are realized, and there is a price spike. In that case, you’ve traded the small amount of income of the premium with a voluntary cap of the strike price for the potential upside you could have had if you had simply held the stock and sold it at the high price.
- If the stock price plummets, while you still get the premium, the stocks will be worthless unless they rebound over the long term. You shouldn’t use a call option on stocks that you expect to be on the path to a major drop in the coming months. In that case, rather than writing a covered call, you should simply sell the stocks and take your losses. Alternatively, you can continue holding the stocks to see if they rebound over the long term.

Chapter 17
Money Management

Investing can seem incredibly difficult. You might get intimidated when you start investing. There is also the choice to choose from thousands of shares and at least as many funds. And then you still have to determine when it is time to buy and sell. For beginners, the stock market can seem incredibly lucrative, risky, and confusing. Some basic lessons about the stock market can already save you from the most common mistakes and pitfalls. This way, you remain motivated to learn more about investing and investing.

Do you find it difficult? Or maybe there is a simple strategy that can help starters on their way. Who wants to invest successfully keeps it simple. Follow those simplified guides as you start your investing adventure. It could mark the beginning of something truly amazing in your life. The only thing that separates successful investors from failures is the amount of actionable step they took on the valuable information that's available to them.

Start with a diversified basis

Leonardo Da Vinci stated in the famed Wolf of Wall Street movie: "Simplicity is the ultimate sophistication." A good portfolio excels in a good diversification strategy. A portfolio does not have to contain 30 items, but a correctly balanced mix that keeps risk and returns in balance. Or, as John Templeton said:

“Diversify. In stocks and bonds, as in much else, there is safety in numbers." There is plenty of options: from gold, over ETFs, to real estate, currencies, index funds or shares. Create a clear portfolio where you, as an investor, know how to deal with the risk.

Build in a buffer for yourself

Investing is never without risk. The risk-free investment does not pay off; it only costs money. To avoid jeopardizing your healthy financial situation, put some money aside in advance. We usually assume that six months of fixed costs is enough to bridge worse times. If there are indispensable opportunities in the financial markets, you can still use part of this capital to participate. Do estimate whether these opportunities are worth your buffer.

Search for the adventure and discover

If there is still some financial breathing room, you can still look for the adventure. A more aggressive investment means more risk but also a potentially greater return. Again, you can limit the risk here by diversifying. As they say about the channel: "Don't put all your eggs in one basket."

Limit losses and cash your winnings

Every investor experience it sometimes. You have a fantastic share in your portfolio, and week after week, it performs better. And suddenly there is a turning point, you have hope for recovery, but the decline continues. Until it gets to a phase where you get to make decisions. If you are not prepared to undergo such a rollercoaster, then be wise. Is your investment doubling? Then sell half and secure your investment. When you purchase a share, you can work with a stop-loss order. A percentage of 20 percent is common.

This means an automatic sale when the acceptable limit of loss has been exceeded. It limits your loss and allows you to reinvest with your new capital in what will hopefully become a more successful business. A perfect strategy does not exist because you may have to grind and watch how the stock wins again after the sale. A strategy that helps to start investors to keep their night's sleep.

View the total financial picture

Making a profit on an investment is quite a pleasant feeling. But investments are not alone, not on an island, or floating in a vacuum. Investments are part of your total financial life. Many asset managers give their clients wise advice: you have to manage your accounting as a business.

That may mean that you have to monitor your debt ratio properly. For example, some investors try to counter a lesser investment with a more robust (and often riskier) investment in the hope of making up for one misconception with an absolute jackpot. With that, they naturally run even more risk while this wasn't necessary—a sad side effect for someone who loses sight of his total accounting. Slowly trying to solve the debts of that misconception and at the same time, creating an emergency fund would certainly be a more solid approach to the problem. In this way, you create a sustainable solution, and you learn from a mistake while correcting it. It is especially important to have a sound financial basis before you venture into the stock market. Every other aspect of that personal financial accounting must be perfect.

Feel comfortable with your investment

Many people who invest and invest today grew up in a different spirit of the times. Thirty years ago, it was fashionable to get as much return as possible. Thanks to the internet, the declining pensions and changes in the banking landscape, a lot has changed over time. Modern investing and investing is mainly focused on risk and no longer on returns. Most people who invest because of a supplementary pension are focused on avoiding losses instead of making big profits. So their hope is not to become rich or richer per se, but to have enough capital in their old age to survive.

The stock market is not a casino

Whoever plays poker knows that "all-in" already dare to pay all. You bet all your money on one game in the hope of surviving or winning the jackpot. Don't count on that opportunity when you talk about the stock market. To go all out on a single stock with all your money is never a good idea. Even the most experienced stock traders diversify their portfolio to minimize losses. In recent times, many interesting IPOs have sprung up. Although the attraction is very high among investors and investors, the lion's share among them is aware that this is not the best choice. Novice investors are often blinded by the atmosphere, the hurray mood, and the influence of others. Therefore, always realize that you do not play with money; you invest it for a specific purpose in mind.

Investing is not a hobby

Don't get us wrong: investing can be incredibly fun, but you cannot view it as a non-binding hobby. Of course, big banks see investing as a very competitive business. That's why it's best to look at your portfolio through the eyes of a professional. It is important to understand your portfolio well, understand where your profit but also loss comes from. You must also be able to understand the companies in which you invest. Once you have completed this entire process, everything becomes so much easier. "Will this investment or investment earn me money, or will I tear it off?" An obvious question is not always asked.

Beginners often invest in stocks that seem attractive to them—a wrong motivation with often the wrong result. In the beginning, investing can sometimes have great similarities with gambling, and many starting investors want to understand how the stock market works. They soon realize the movements of large indexes, but the real work only starts when they take the investment fully seriously. Benjamin Graham said it a few decades ago: "You only do smart investment if you look at it as a business." Fund managers, analysts, traders, and other experts in financial centers take stock trading very seriously and so you better take up the challenge.

Financial resources

Before you start investing, you should better inform yourself about economic developments and prospects, the markets, and the shares that interest you. You don't have to look far: read the newspaper every day. Financial newspapers such as De Tijd, Financial Times, Wall Street Journal, can help you keep up with the most important issues. You can also consult financial websites such as Yahoo finance. Professional investors also use accounts on services such as Bloomberg and Reuters. Since everyone learns the same things at the same time, these may not be the places to make the distinction. And yet you should not try to follow in the footsteps of the experts too much. Some of the best-known investors, such as Peter Lynch, suggested that hints from daily life could provide more inspiration.

Form a Strategic Daily spending patterns

For example, Lynch "used" his wife's shopping habits to analyze which brands gained popularity. According to Lynch, traders and stock traders spent too much time in an artificial bubble. Peter Lynch's views are not old-fashioned. In 2012, a financial nitwit put the test to the test and succeeded in suddenly making 2 million dollars during a difficult stock market period of $ 20,000. Everything but a cold trick.

According to the amateur investor, there were clear trends in the spending patterns of women, young people, and low incomes. The man invested in shares that everyone could own and noticed trends before bankers saw them and made substantial gains.

How can you monitor your stock portfolio?

If you decide to invest in shares, drawing up an investment plan is the first step. However, once you have compiled your equity portfolio, you are not yet ready. Monitoring your equity portfolio to monitor whether it still meets your original objectives is just as important. Some investors like to check the status of their investments every day. But for many investors, this is not desirable or necessary. In other words, monitoring your equity portfolio depends on both the type of investments in your portfolio and the type of investor that you are.

Monitor shares

The moment you have invested not in funds, but self-selected individual shares, it is interesting to monitor these continuously. The most important goal here is to check if a share still meets your initial criteria. In almost all cases, this will depend strongly on your estimate of the future expectation for the underlying company or the estimate of the stock market. Many of these estimates are based on company income. You have to monitor the changes that affect income.

Newspapers, press releases, and reports

Check the financial news and announcements about your shares daily, weekly, or monthly. This includes new products, changes in management, or news about competitors. If analysts report on your share, it is wise always to read it immediately. Since these can be of great importance for market sentiment.

Online sources of news

Many brokers allow you to monitor your stock portfolio online. In some cases, there is even a direct link to news and analysis of the relevant share. This way, you not only see at a glance how your portfolio is doing, but you also have an overview of relevant news sources that can influence the price. Many brokers also offer the option to receive alerts by e-mail or text message when certain developments occur on the market. Does your broker not have such an option? After which they will provide you with a large number of relevant news sources. Both through your broker and financial websites such as Yahoo Finance, Morningstar, and Bloomberg, you will be provided with information in real-time. Since the stock market also responds to developments in real-time, this information can enable you to react promptly to developments to maximize your returns.

Chapter 18
Collars Strategy

The collar strategy is an extremely flexible way of trading that you can use for either short term or long-term positions. Mind you, when using it for long term positions, make sure you have substantial unrealized gains already present. This is because the collar imposes a maximum gain limit.

On the flip side, it also caps your downside loss, so this lends itself very well to short term speculative strategies. Mind you, when I say short term, I'm still talking about holding onto the position for at least a month to take advantage of the time decay. From a longer term investment perspective, if you have a position which has made you a lot of money but you're either unsure of how it's going to perform over the short term or are not sure if it will move much further over the long term, you can use the collar to squeeze out the last drops of income from the trade or let it take you out.

This strategy introduces an additional layer on complexity since it has three legs to it:

1. A long stock positions

2. A long protective or married put

3. A short-covered call

We're adding a long protective put to the covered call strategy. This helps cover the downside and adds to the advantages that a covered call has.

Execution

The first leg to establish is the long stock leg. Like with the covered call, this is an income generator and is entered with the thought of having it increase in value. The second leg to enter is the married put. A married put is a put that covers your downside. Think of it as a stop loss order. Your maximum loss is capped to this level.

The put is bought at an out of the money price (that is below current market levels) at a price that is equal to your maximum risk limit for that position. So, if you think you want to risk a move of just 5 points, then the put is purchased at that price.

Lastly, you need to write an out of the money call just like with the covered call. This call is covered by your long stock position. Make sure you execute your position in this exact order so that you minimize your risk. Let's work through the scenarios on this trade.

If your stock decreases in value, the put below it caps your maximum loss. Once the stock goes below the put's strike price, thereby moving it into the money, that leg is going to be in a profit no matter how low the stock's price goes. If you wish to exit, you sell your stock and you can sell your put which would have increased in value.

Alternatively, if the stock increases in value but doesn't hit your call's strike price before expiry, you earn the premium and the capital gain but are out the amount you paid to buy the put. If the stock does hit the call's strike price, this is your maximum gain possible on the stock leg and you'll have to sell your stock at the call's strike price.

In this case you again earn the capital gains on the long stock leg and the premium on the covered call leg but are out the premium you paid for buying the put. In addition to this, there are alternative scenarios you can encounter.

Let’s say the stock declines in value but you’re not sure that this is a long-term thing. You feel it’s a temporary blip and it’ll soon turn upwards. So, what do you do? Should you exit all three positions? Well, this is where the decision to adjust your trade comes into play. You can either reestablish the collar at different prices, which is change the strike prices of the call and the put, or you can exit altogether.

Technical and fundamental analysis should play a part in your decision. For now, just keep in mind that the collar is a wonderfully flexible strategy and with adjustment you can make money even when the trade goes against you or if something unexpected happens.

Now, let’s look at an example with real numbers to see how it all plays out.

Example

Sticking with GOOG, we see that the market price is still $1229. So, as a first step, in case this is a speculative position, we establish the long stock leg. Next, we establish the long put or protective put. Which price should you choose? Remember, this is an option purchase, so you'll need to pay to enter the position.

The temptation will be to enter at as low a price as possible since you're going to lose this money no matter what happens (if it moves into the money or remains out of the money you lose the option premium no matter what). Resist the temptation to look at this in monetary terms.

Instead look at it in terms of risk involved. Your put's strike price will dictate your maximum position size. You need to decide what your necessary risk per trade amount is going to be. This can be a function of either a percentage of your overall capital or a fixed amount.

Once this is done, you divide this amount by the points between your put and the long stock entry point and this gives you your position size. Simple math really. Place your put at a level beyond the closest support which you think is going to hold. The idea is not to have this put move into the money, not minimize the cost you pay.

Remember that this trade is only going to last a little beyond a month so don't go searching for the stronger support out there. Simply pick the most appropriate one given the current balance in the market. For example, if it's in a range, simply pick a level which is beyond the lower range boundary.

Let's say you decide to enter GOOG at the current market price and that an appropriate put level is 1200. Looking at GOOG's option chain, we see that the October 25th, 1200 put is selling for $25.20. So, this amount is going to go out of pocket, in addition to whatever you paid for the long stock.

Now, we search for an appropriate level to write our call. It is yielding the same price as before and that is $16. We will receive this amount no matter what.

Hence, our cost of entry equals:

Cost of entry = cost of long stock price + cost of put premium - premium received from short call = 1229+25.2-16 = 1238.20 per share

You'll notice how the cost on entry increases with this method as opposed to a straight long stock purchase. Well, this is the price you pay for the additional protection. If you were to protect your downside via a put merely, your breakeven price would increase by the value of the put premium. In this case, that works out to $25.20.

So, the covered call reduces your breakeven price quite significantly while maintaining your downside as intended. All in all, you pay a few dollars more for this privilege which is a good deal overall. Now that we know our cost of entry, what is our maximum loss?

Maximum loss = Long stock entry - Put strike price - premium from call + put premium paid = 1229-1200-16+25.2 = $38.20 per share.

If you placed a stop loss order at the put's strike price wouldn't that cover your downside for a lesser amount? Yes, but remember that the put insulates you from the possibility of the market price jumping your stop loss level thanks to a lack of liquidity or excess volatility. So, there is a price to pay for this protection. Let's see how your maximum gain is affected.

Maximum gain = Call strike price - Long stock entry price - put entry premium + call writing premium = 1270-1229-25.2+16 = $31.80 per share

In these calculations, the premiums you pay and receive for the options skew the numbers quite a lot. A lot of options strategies do not take the premiums paid into account when figuring out the maximum gain and risk because this is a cash expense. However, I'm illustrating these here just to show you how it affects the numbers.

Adjustments

So, you’ve entered a collar and promptly the price dives below your entry and brings your put into the money. What now? You were envisioning holding onto the position for at least a month but here you are, less than a day in the trade, and you’re already facing the prospect of hitting your maximum loss.

The first thing to do is to evaluate whether your technical assumptions are still valid. If your technical analysis was spot on, usually there will be some fundamental event you have overlooked. Is your stock dependent on the bond market, unbeknownst to you? Check your assumptions once again and see if your entry logic still holds water. If it doesn’t, eat the loss and move on. Chalk it up to the cost of tuition of learning how to trade.

By the way, expect to do this sort of thing quite a lot when you’re starting out. Trading is not an easy endeavor, and therefore you should make as many of your mistakes in simulation, while demoing your strategies, instead of jumping into a live account and sabotaging yourself.

Assuming your initial conclusions are still valid, perhaps this is a temporary downswing to shakeout the weaker long traders. In such cases, you can seek to reestablish your collar. First, sell your put position and determine what will be a more appropriate level to reenter. When you sell your put, you’ll make money on that leg since it would have moved into the money. Hence you can profit from the temporary downswing in the market.

When determining a secondary put level, keep in mind your average risk. Remember, you’re not selling your long position so your average risk amount per trade is still based on your initial put levels. The profit you earn from selling the put will add to your account balance so take this into account and determine a level which satisfies your new risk per trade amount.

For example, if you earn $450 from selling the put, add this to your initial account balance. So, your new account balance is now x+450 where x is the original balance. Let’s say your original put level was 5 points away and your position size is 10 shares.

What should the new put level be given the increased account balance and existing position size so that your risk per trade remains similar? Well, this is simple arithmetic. Divide your new risk per trade with your position size to arrive at the stop loss or put strike price distance.

Once the secondary put has been established, you need to check whether you wish to leave your covered call in place. If you choose to close this leg of the trade, you’ll still clear a profit since the call’s price would have decreased. Hence, you can simply cover your position by buying it back at a lower price.

Chapter 19
19 Differences Among Forex, Stocks and Options

Forex and Options

Forex trading, often known as FX trading or Foreign Currency Exchange, is basically a market of finances where any person can easily trade the national currencies for making certain amounts of profits. Perhaps some people feel that the U.S. dollar will actually be stronger when compared to the British pound or euro. You can easily develop a strategy for affecting this form of trade and if your research turns out to be correct, you can actually make a good deal of profit.

In the case of options trading, you will be buying and selling options on large scale futures, stocks, etc. You can invest by determining whether the price will go up or down over a fixed time period. As with trading of Forex, one can easily leverage their power of buying for controlling a greater number of future or stock for instance, that he/she could have generally. But, there are certain differences between options trading and forex which has been described properly below.

24 Hour Trading

An advantage that you can get with forex trading when compared to options trading is that you will be having the capability of trading for 24 hours in a day and five days in a week if you feel like. The market of forex is generally open for a longer period of time than any other trading market. If your target is to make profits in double digits in the market, it is actually a great thing when you have an unlimited amount of time every week for making all those trades. Whenever any form of big event takes place anywhere in the world, you can turn out to be the first individual in taking full advantage of that very situation with the trading of forex. You are not required to wait for a long time for the market to open during the morning as you would have to do in case of options trading. You have the power of trading directly from your PC, each and every hour of the day.

Rapid Execution Of Trade

With the trading system of forex, you can receive immediate executions of trade. You will be facing no form of delay which is in the case of options trading or for other forms of the market as well. Your order will get filled at the price that is best possible in place of just guessing the price in which you should fill up the order. The order of your choice will not just slip which can happen with options trading. In forex trading, the rate of liquidity is a lot more for helping with the slippage which is present in trading of options.

Liquidity

Forex trading generally comes with the added advantage of having more liquidity than any other trading market that also includes options trading as well. There is no comparison of forex trading with a daily average volume in the market reaching about 2 trillion. The liquidity rate of forex trading can easily surpass that of options trading. In simple terms, when it comes to trading, the forex trades will get filled much easily than options trading. This also indicates more rate of potential profit. When you couple this up with instant execution of trade in forex, you have the capability of making a greater number of trades much quickly.

No Commissions

FX trading or forex trading is generally free from any form of commission. It is mainly because, in forex trading, everything takes place between banks that also match the buyers with the potential sellers and that too super quick. So, in short, in forex trading, the market is inter-bank. Thus, there are no signs of brokerage fees or middleman fees which is the case with the other sort of markets. There is a huge spread between the asking price and the bid. This is where the firms of forex trading tend to make some of their profits. In options trading, you are required to pay out brokerage fees, whether you want to buy or sell. So, you can save a lot of money if you trade in forex markets when compared to the markets of options trading as there are no commissions.

Greater Leverage

In forex trading, you can get greater leverage when compared to options trading. But, with options trading, you will also be able to manage calls and put options in a way for greatly increasing the leverage. Leverage might turn out to be very important when you actually know what is going to be done by a currency. It is possible to achieve 200:1 or even greater in forex trading when compared to options trading, but it can also reach close. So, it can be said that with forex trading, one can make more profit if the right move is made.

Limited Nature Of Risk Is Guaranteed

As the traders of forex need to have limits of position, the risk associated with it is also limited as the capabilities of the online system of forex trading can automatically start a margin call when the amount of margin turns out to be much greater than the account value in dollars. This helps the traders of forex from losing not so much if by chance their very own position tends to go the other way. It is actually a great feature of safety which is not available all the time in other markets of financing. How are options different from forex in this aspect? In the options aspect, you can only have a limited amount of time for trading right before the expiration of the options.

Timelines

In the case of options trading, the trades generally operate on particular timelines. You will have no control when a trade starts or ends. Right before the trade of options begins, the users are required to select the expiry time. Each of the options comes along with a starting time and an ending time. At the time of expiry, the trade will close on its own. Some of the brokers also permit closing early, however, you will be exiting the option at a percentage of the return that you expect. You need to remember that all brokers will not be offering the same option.

Stocks and Options

If you really want to be a successful investor, you will need to have a proper understanding of the various opportunities of investment first. Most people allow their advisors of investment to take the decisions instead of them. While talking about opportunities of investing, options and stocks are two of the most common markets of investment. It is true that both are traded in a similar way, but there still lies some difference between the two. Stock is an instrument of financing. It shows up ownership of a business and it also helps in signifying a proper claim on the business profits and assets. In simple terms, when you have the stocks of a certain company, you actually own a part of it which is proportional to the total share numbers that the company has. For instance, when you own about 100 shares of a company that has in total 1000 shares, you actually own 10% of that company.

Well, as you already know, options are the contracts of selling or buying an asset, at a fixed price and within a fixed time. Unlike the case of stocks, the contracts of options will not provide you with direct ownership of any company, but it will permit you with the right of selling and buying a great number of the stocks of the company.

Leveraged Profits

The holders of options contracts can take full advantage of the leveraged nature of profits. For instance, when the price of any stock rises by one percent, the price of the options is most likely to rise by ten percent. So, it can be stated that the profits of options are ten times more than the stock price in this case.

Downside Earning Of Profits

For earning profit from the decline in the prices of a stock, the traders can easily short the instruments of financing. This generally results in going through the unlimited nature of losses along with margins if, by chance, the stock price tends to rise again. A trader can only short any stock with the given margin that is enabled with the accounts of trading. On the other hand, if you choose to trade options, you will be able to earn profits even from the decline of prices of the underlying assets by simply purchasing a put option. The value of the put options tends to rise as the overall value of the underlying assets tends to decrease. So, any holder of options can easily take full advantage of the reduction in prices as well. As you buy any put options, you are not required to pay any kind of margin. The losses will be limited only up to the value of the option that was previously paid for buying all the securities.

Limitation Of Time

Options come with a limited time frame. Thus, options can be held by any holder of option only till the expiration time. But, in the case of stocks, if the user opts for a short or long position, he/she can keep the stock for an indefinite frame of time.

Movement Of Price

When there is variation in the overall price of any stock, the price of the options will also tend to vary. But, the value variation of the options is comparatively low. The extent of how close the variation of price of the options matches along with the variation of stock variation can be calculated by the strike price which is generally defined in the contract of options.

Worthless Expiry

The primary reason why a majority of the people who are holders of options end up in losing their entire investments in a short period of time is mainly because all these derivatives tend to end up with a worthless nature of expiry in case the underlying assets fail to perform in the way as expected within a fixed time frame. That is the reason why the trading of all these instruments of finance is considered as a high profit-high risk activity. But, if you end up buying stocks, you have the power of keeping all the underlying securities within your portfolio as long as you want them to if the price of the same does not tend to rise up. It is possible to easily benefit from the rise in the price of stocks even if it actually takes several years to happen.

Price

In this world, everyone is trying to save money. In that case, options are much cheaper when compared to stocks. But, in the case of stocks, they are actually very expensive. Each contract of an option can give you overall control of about 100 shares of equity, but still, the cost that is needed for purchasing contracts of options is actually far away from the expense of buying an equal amount of stock.

Chapter 20
The Techniques of Trading Options with Fundamental Analyses

Options trading involves analyzing the movement of the market, the direction or no direction of the market. Options involve predicting where the market will move, easy as it may sound; this will involve analyzing the market with the right parameters.

This begs the question, what moves the market, and how can we follow these parameters to predict the next move of the market?

You must have watched CNN, BBC, CNBC, or other top world news channels during breaking news that affects the markets. At times you may wonder about some unrelated business news driving markets as the new analyst begins discussing how some political or natural disasters have driven the market up or down.

Yes! Natural disasters such as earthquakes, wildfires, floods, and hurricanes usually affect the market and may drive stock prices high or low in huge volumes. This news affecting the market is known as the fundamentals of trading the market. However, no one can predict such disasters to take a position before they happen and make huge profits.

News that you can use for Proper Fundamental Analysis

We have some important news coming up that will have a high impact on the market. It will cause high volatility in the market during that period. What we do when trading using fundamentals is to search for high or medium impact news. There is no point in trading low impact news, for when this is released, it rarely causes high volatility movements in the market.

So we are going to look out some of the high impact news that you should read and show you how you can trade using the news. Take note that not all news is important or drives the market as you would want them to drive the market. There are some news releases that are expected to cause huge volatility in the market that will come up regularly on the market calendar.

Trading of news is known as fundamental analysis, and, as a trader, I set my alarm to be aware of these important news items coming up. Most of them are financial reports of some of the top companies in the world. Like you would expect, there could be a big move in the market when the United States financial institutions are set to make an announcement about the economy. Investors will be waiting by the sideline to get the information and input that information into the market while small-time traders will be waiting to see how the big investors and the market react to the news and take advantage of the trend in the market.

There are some investors and institutions that can direct the flow of the market, while traders like us use the historical reaction of this news to predict the market. If you are new to fundamental analysis, I would like you to do some back-testing on when important news was released on the market and the huge impact it had on volatility. The good thing about trading financial instruments is that we have a backlog of information that you can study from using your charts.

The Non-Farm Payroll

The nonfarm payroll is one of the news releases fundamental traders' lookup every month, and it is released on the first Friday of each month. The non-farm roll is the number of people that gained employment in the economy of the United States, and it is one of the highest impact news items on the market. This report can send the market in waves in any direction, depending on how favorable the news is to the economy.

Because of its high volatility, some traders who are core fundamental traders will trade only when this report is released. This is because they are sure that the market will be active, and they can predict the direction of the news. Traders are happy when the market is active, and this is one of the periods we have a huge number of traders watching the news and ready to dive in to take advantage of the high impact news.

You may be asking yourself, why is the non-farm report so important?

Many traders will not be able to answer this question, mainly because they do not care and are just happy to see the market move so fast. But to help you understand how you can take advantage of this report, which will help you predict the right direction, we are going to shed light on the importance of this report.

The economy of the United States is the biggest in the world, and the global markets respond to whatever is happening in this economy. A rise or drop in the value of the dollar will affect other major currencies like Euro, Yen, Aussie, and the Pound. So, this will affect shares, stock, and commodities in all the major economies in the world and determine the direction of stock and share prices. So those economists who understand the impact of such major moves in the market can quickly take a position in anticipation of the movement in the market based on the report that was just released.

The Interest Rate by the Central Bank

Another important item of news I love to follow for my fundamental analysis of the market is the interest rate. The interest rate is the rate at which borrowers will pay to the bank for funds, and it is closely watched by investors to determine the health of the economy.

The Central Bank of a country usually meets at a certain time to determine the interest rate, reviews it, and determines what it should stand at, during a particular time. One of the reasons the interest rate is very important is that it will have an effect on the economy for a long time. The Central Bank has the capacity to increase the interest rate, decrease it, or keep it at the same rate depending on the economic situation at the time. Certain factors must be considered in determining the interest rates, and this is what they will do to improve the economy.

As we have said, the interest rate can have a huge impact on the economy of a country, and important interest rates to follow are those of the United States, the European Union, Japan, and the United Kingdom. The interest rates are closely watched by investors, as this will determine interest to investors to invest in a company. It will determine the growth of the economy as people will be willing to borrow money from the bank and invest in the economy.

Commodity Investors Using Fundamental Analysis

Trading commodities can be easy with fundamental analysis and will be profitable with options trading using fundamentals in the market. Gold, silver, copper, and other major commodities move in the market based on news and other happenings in the world.

The prices of gold usually surge after there is a great demand for the commodity, especially when investors are nervous. Gold is regarded as a safe haven in the financial market when there are uncertainties in the market, and we can trade gold using options.

There are instances when it is better to trade gold as you can detect that the commodity will rise and go higher in the near future. Commodities can also be traded when there is high impact news as you can easily detect that the prices will either fall or rise based on the economic situation.

We have explained some disasters that happen in the world, such as the Tsunami that happened in Japan and Hurricane Katrina. These disasters set uncertainty in the market as traders could not predict the direction of the market, and they were nervous about investing. In such cases, the market lacks direction as traders could not fathom the direction of the market or the future of the market.

Trading Oil with Fundamentals

Oil is another commodity that drives the economy, and the fall and rise of the prices of oil can be determined by the market. Oil is in high demand, and big economies like the United States, China, and other industrialized nations have a high demand for oil. The prices of oil are connected with supply and demand, which is driven by the economies and in some cases, by politics. The price of oil can go up when there is a reduction in the supply of the commodity which can arise due to war, politics, damage to oil facilities in oil-producing countries, or when OPEC decided to cut supplies.

In the case of politics, oil prices fell sharply after they lifted sanctions on Iran, which was one of the top oil-producing countries. With the lifting of the sanctions, there will be an expected surplus of oil in the market, and thus smart traders would have cut options on oil for a period of time. We saw the price of oil fall down way below $30 per barrel after the Iranian oil hit the world market. This is an example of how politics drives the oil market on a global scale and how options traders can take advantage of news releases to make money oil option derivatives.

In another case, an industrialized nation that demands oil on a large scale may decide that they want to switch to other energy sources like renewable energy. This news release will drive oil prices down as there will be fewer buyers for the product, and investors would choose to put their money elsewhere. In this case, taking a put option on oil in the near future would be a wise move to make some profit in the long run.

Advantages of Trading with Fundamental Analyses

Fundamental analysis is one of the ways of trading financial instruments, although not many are conversant with this analysis. If you understand the process of trading with this type of analysis, you can reduce your chances of losses with fundamental releases.

At this point, we are going to list out some of the advantages of trading with fundamentals, and they include:

● You will not over trade with fundamental analysis as you will be online to make a trade when there is high impact news.

● With fundamental analysis, there is a reason for each trade, which puts you in a good position to make correct decisions.

● The news causes high volatility in the market, which gives you a high probability of getting the right direction of your trade at the time the contract expires.

● You get prepared to trade since you are aware of the time the market will make a move.

● With fundamentals, you can get an idea of where the market will be heading with expert analysis.

The disadvantages of using fundamental analyses include:

● You will need to have a deep understanding of how the market reacts to fundamental news to trade options and make a profit.

● The news may be highly unpredictable, and it may move in any direction with the slightest change in data.

● It is hard for a newbie to trade with fundamentals.

● You can go days without trading.

Chapter 21
Why Is Leverage Riskier?

Another significant risk to be aware of is that of leverage. Because Options don't cost much as stock as they are simply a contract, this means that they experience disproportionately larger percentage price gains in reaction to the far more expensive underlying stock's very small price movements. The huge benefit of this is that it results in large percentage gains when the underlying stock moves in the anticipated direction by even a small amount. The downside though is that it also results in a 100% wipe-out of the investment if the stock moves by even the smallest amount in the wrong direction. This is not necessarily an issue with beginners or at least it shouldn't be as the risk manifests itself mainly through trading too large a position size. However, you need to be aware that as beneficial as leverage clearly is, it can also be a double edge sword, so be aware that leverage is a risk that needs to be addressed. One simple way to nullify or minimize this level of risk is to keep your position size small.

Lastly, Options as we know possess a time value (extrinsic value) in addition to their inherent intrinsic value (in the money value), which is also another double-edged sword. For option buyers, time-decay acts as a headwind because it is continually decreasing the value of the option. By doing so this increases the dependency on greater stock price movement to break even on the trade. For option writers, it acts as a tailwind because it allows a profit to be generated through steady premium incomes regardless of whether the stock moves or not.

The Advantages of Leverage in Options Trading

The options exchanges play a critical role in ensuring that there are enough securities to base options contracts on. Following are some of the significant functions of an options exchange (VAIDYA, 2017).

Liquidity

Perhaps the biggest function of options exchanges is to ensure ready markets for options contracts. The markets ensure that holders of options can exercise their options and that there are enough buyers to purchase the options. Traders are looking for avenues to increase their earning potential, and liquidity helps them achieve that. Options contracts have a time limit unlike other securities such as shares, which necessitates liquidity. The existence of market makers is particularly responsible for liquidity.

Gauging a country’s economy

The state of an options market can reliably inform us what the country’s economic situation is like. The most common underlying assets that traders base their options on our shares. The prevailing economic conditions are always reflected in the share prices of various companies. If the country is experiencing prosperity, the share prices will be up, and if the country is experiencing market crashes, the share prices will go down. Thus, the options exchanges play a critical role in ensuring that traders have a sense of how their country is performing economy-wise. Stocks are the pulse of an economy, and they are accurate predictors of a country’s economic state.

Securities pricing

Options traders have a wide pool to choose from when it comes to underlying assets. However, the value of an underlying asset is determined by the options exchange according to the forces of demand and supply. The financial securities of prosperous companies are worth more than the securities of moderately successful companies. The valuation of securities is important not only for traders but also for governments. Governments levy taxes on earnings drawn from options trading, so they first have to get the value of the securities.

Safety of transactions

Traders want to be sure that they can trust all the parties that they are getting into business with. Therefore, it is the work of an options exchange to ensure the players are trustworthy. For one, most options contracts are based on financial securities of publicly listed companies, and these companies must operate within stringent rules and regulations. Thus, the trader is assured of security when dealing with other parties. The options markets should provide all relevant information about options contracts and securities to discourage the trader from making a move out of ignorance.

Providing speculation scope

Speculation of securities is critical in order to ensure a healthy balance of demand and supply of securities. Many traders earn their profits from purely speculative risk. They have developed a skill of determining the movement of prices. The options exchanges provide traders with the resources and tools of speculating on the securities performance, thus allowing traders to earn profits.

Promotes investment culture

Options exchanges are critical in promoting the culture of investing in valuable securities like stock as opposed to unproductive assets such as precious metals. Traders have a wide selection of underlying securities to base their options contracts on; thus, they are not limited in the range of their strategies. A strong saving and investment culture is critical for the economic advancement of a country.

Continuous market for securities

Options exchanges allow traders to base their options on a wide range of underlying securities, and in case of any risks, traders are at liberty to switch from one security to the next. This is different from purchasing stocks wherein you are stuck with the consequences of poor decisions.

Capital formation

Options exchanges promote the pooling together and redistribution of resources. The exchanges create a win-win situation for both sides. Companies raise capital when their stocks are publicly listed, and their securities act as the underlying. On the other hand, traders stand to benefit from the high earning potential and low-capital requirements for options contracts. So, options exchanges play a critical role in ensuring that the parties are in a position to generate capital.

Control companies

The significance of transparency within the derivatives market cannot be overstated. If a trader has the misfortune of working with shady companies, they could easily lose their earnings. Options exchanges make it hard for shady companies to spoil the market. For instance, publicly traded companies have to submit relevant documents and adhere to certain performance standards as doing so will boost investor confidence. Companies that refuse to cooperate with exchanges are blacklisted from the market.

Fiscal and monetary policies

The fiscal policy and the monetary policy of the government must not hurt the players in the financial industry. Options exchanges facilitate the creation and execution of key policies that will govern the financial markets.

Proper canalization of wealth

Options are a great way of putting capital into great use, as opposed to having the capital just sitting around. Thus, the economy benefits from an injection of capital which would otherwise have been inactive. The injection of capital into the economy promotes wealth distribution and fights off economic disgraces like unemployment.

Education purposes

Options trading features complex processes. Even people who claim to understand options trading might be low-key deluded. Thus, the importance of education cannot be overstated. Many traders just get the hang of things and set about purchasing and selling options contracts, forgetting that it is critical first to educate one’s self. Options exchanges provide a wealth of resources and information that are meant to enlighten traders. Empowered traders improve trading activity.

Disadvantages of Leverage in Options Trading

Again, I won’t bore you with elaborate explanations of the disadvantages of options trading. Instead, here’s another helpful list that clearly outlines why traders might choose to shy away from potential options trading opportunities:

• Options are time-sensitive investments. Yes, you can pick and choose options based on expiration dates, but you’ll always be confined to a certain expiration date where you must choose to act or choose to exit.

• Successful options trading requires your attention and time. Without it, you risk losing out on potential profit generating opportunities that come from buying or selling your call or put option at the right, most profitable time.

• Options are without a paper-trail. With stocks and bonds, for example, you’ll receive some sort of paper certification regarding your investment. Options are “book-entry” investments, meaning you receive no paper certification that shows your claim to an option or your ownership of an option.

• You’re working in the stock market, a highly volatile place where changes occur suddenly and dramatically. You’ll need to be on constant alert, or at least hire a broker who will.

• You’ll need to be in a somewhat stable financial situation before you can successfully trade. Establishing and frequently adding to some sort of “trading fund” before you begin your options trading endeavors will somewhat remedy an unstable financial situation, however.

How Much Leverage Do You Need in Options Trading

Two other option cost factors should be considered:

1. Costs associated with the trading process

2. Cost of exercising the stock

By understanding the basic cost structure for an option, you can see how options also add through leverage an element of risk, despite the fact that options also provide leverage at a reduced risk.

To complicate the matter a little is the fact that Option prices are partially based on probabilities. For stock options, you want to consider the likelihood that a particular option will be in-the-money before or at expiration given the type of price movements the underlying stock has recently undergone. The way an Option is valued takes into consideration 6 factors; Stock price, strike price, time to expiration, interest rates and dividends but there is a wildcard factor – volatility.

How to Trade Smarter Using Leverage

While investing is a rapidly growing hobby for some traders, it's a career for other traders. Despite your personal trading situation, however, you'll need to enter the options trading arena with the understanding that you'll be just one of thousands and thousands of traders seeking to generate a substantial profit through options trading. But who are those thousands upon thousands of individual or corporate traders that you'll encounter and perhaps even battle over an investment with? Well, simply put, those individuals and organizations are your competitors. They are ambitious individuals just like you who wake up each and every morning with the intent of generating meaningful profit, the expectation of making quick, educated decisions, and the understanding that they need to take calculated risks.

It's always an excellent idea to gather like-minded people in the trading arena, to discuss current positions, and to bounce ideas around between each other. I'm completely for this, and you should strongly consider doing so, too. But at the end of the day, your success depends upon being able to make quicker, more educated decisions, and approach calculated risk-taking in a safer, more knowledgeable way than other traders. When you do all of this better than other traders, you discover greater financial opportunities, generate bigger profit, and achieve more success.

I'm not saying, however, that you need to turn your back on everyone you meet, or that you should view your time trading in the options arena as a one-person or one-woman mission. Creating lasting connections and friendships with fellow traders is ideal, of course. But, what I am suggesting is that you keep in mind that, at the end of the day, your success rests upon your shoulders, and your shoulders only.

Chapter 22

Buying and Selling Puts

Let's talk about buying and selling puts. Puts, of course, allow you to sell the stock that you have or the underlying commodity that you have underneath it all. There are different reasons why people may want to buy or sell puts, and here we'll go over what it is, how to do it, and the advantages of such.

What is Buying and Selling Puts?

Selling/buying puts essentially is giving someone the option to buy the stock at a certain amount of money.

If you sell a put option, you're selling the chance for someone to buy that stock at a price.

If you buy a put option, you're giving someone the option to buy that stock for that price and the person is obligated to sell it.

So, let's say that you're planning on getting a put option to buy that stock at a certain amount of money. You can put that option down, and from there, wait for it to fall, and from there you can exercise it. Maybe you want to buy shares from a really good railroad company. You essentially notice it's increasing the earnings on this, and you decide to buy the stock when it's under 30 potentially. By buying a put option, it basically makes the seller obligated to sell you the stock when it falls below 30 dollars.

You want to exercise these in falling markets since you'll generate a profit when the market is falling, rather than rising.

Selling Puts in this Market

Here's the thing, when you want to sell puts, you should only do so if you're comfy with the owning stock that's under it at the price that's there because essentially, you're assuming the obligation to buy it if the person does decide to sell. From this, you should also only enter trades where the net price paid for the security is good. This is the most important part of selling puts profitably in the markets that you have. There are other reasons to sell it to the person. You also can own the security below the market price that is currently there, and you'll definitely want to be careful when you do choose to sell this.

An Example of Buying a Put

Let us now move onto buying these puts. One thing to note is that you're not going to see the commissions, taxes, margins, and other charges factored into any of these equations for a reason. That starts to get it a bit more complicated, and right now, we are just showing you the cut and dry of all of the ways you can buy a put option that can be considered. But, you should definitely consult with your tax advisor or broker before you go in.

So let's say you've got company A, which is overvalued currently at $50 bucks a share, and you decide to bet on a decline at this point, getting a put contract that's at $35 a share, and it costs $2 per share, so the "breakeven" price is $33 a share. This is deduced from basic math, since you're taking the contract price of 35 minus the 2 making it $33 for this. Since each of these represents 100 different shares. That's $3500 in total of what you'll buy, and then of course it'll cost you upfront $200 for this (cause of the options contract and the shares) and from there, you enter the trade. Now, let's say that the option contract is for August 2019, and from there, you fast-forward and watch the market. Below is a table of what can happen

Action of stock	What happens to you	Your return	Outlook
Soars all the way up to $60	The option expires, becomes worthless, and you lose the $200 premium, but you're basically losing nothing else	(100%)	Okay
	Same thing		

Falls slightly to $38	happens, stock falls but you don’t make a profit	(100%)	Okay
Drops all the way to $25	You make some cash! 800 dollars to be exact ($35-25) and then the $2 premium	(800%)	Nice!
Drops to $0 (basically going bankrupt)	The ideal situation, and you’ll get $3300 from it (0 at expiration, so 3500-200 from the premium)	(1500%)	Ideal!

So, the best time to use these is when you have a sinking ship in terms of stock. Otherwise, they aren’t worth your time, and it’s better not to have these stocks, and there is always a chance you could end up losing money. But, if the person sells the stock, and you turn around and cash in on it, you’ll have more money, and you don’t have to worry about the burden of a stock.

If you choose to buy it when it declines, you’re essentially going to get money from this. You want to do it when it's declining and nothing more. It is very important that you don’t choose to act on these types of options until it’s that time.

That’s it, that’s all buying put options is, and you want to make sure that it falls to the level that you want it to be at.

The risks of it

Risks are still there in both cases. Options are risky due to the complex nature of this, but once you know how these works, it can reduce the risk a whole lot. Put options, in particular, can be quite risky, especially for the seller, since they may have to spend more money buying back the option that they once had.

One other aspect of this, especially for buyers is the break-even aspects of it. So, let’s assume that you got a stock today for $46 and this was at $44, which is two points down what it is there, so you’ll be profitable in the trade. But, here’s the thing, you’re going end up losing out on money due to the fee for the option. It would make the option worth $2 since you spent $4 on it, so that means you’re losing out on it.

But there is also the fact that if the option does expire and you’re in-the-money, you’ll get the right stock immediately. You may not realize it, but these can be quite good, especially for plunging markets, especially if you know they will bounce back.

If you end up seeing it go high, you’re going to end up paying for that premium to get the right to buy it, and that’s money that can rack up to a couple of thousand dollars. Do make sure that you understand that when you do choose to figure out your own stock, and how you can easily rectify.

The Advantages of Buying Puts

Buying puts, which gives you an option to sell the stock at a given price, is good if you're looking to protect yourself. So, let's say that you have this stock, or you've been eyeing a stock that will probably fall, and then rise over the next few months. There are those out there, and usually, it's due to lulls in the market at the time. So, you decide to buy the put that's there, which gives you the option to sell that stock when the market decides to resurface at a higher level.

For you, you're taking a gamble on this, because the market may not recover, but if you notice a stock that could potentially have the power to fall possibly, this may be a good one. That way, you can get the stock for cheaper. From there, you can sell the stock again, and you have the right to sell that stock at the price that you're looking for.

It essentially allows you to form that extra security in his, which is a nice little advantage for the person who wants to sell it. Long puts are good for this, especially if you want to sell these.

Put options let you sell this asset at the strike price that's there. With this, the seller is then obligated to purchase these shares from the holder. Now, how can this help? Let's say that you buy a stock at 20 bucks, and then you compare it to 20 dollars at the edge that's there. If the price is below 20 at any point, you can actually then exercise the options and reduce the losses. This can definitely help, especially if you're willing to buy an option, and from there, sell it in order to avoid lots of trouble.

Naked Puts

There are also naked puts, which is an advanced put options strategy, so I don’t suggest trying this till you’ve worked with basic puts. The reason for that is because of their incredibly risky.

What does it mean to trade an option naked though? It doesn’t mean that you're going to the stock exchange in the buff, but rather, you’re selling the options without having a position in the underlying instrument. For example, if you’re writing a naked put, you’re selling a put without having the stock.

The covered call is probably the most basic stock trading strategy. This strategy provides an ideal entry point for those who are new to options trading and allows them to turn their existing investment activities into a gateway for trading options. The premise of the covered call is quite simple. The idea behind this strategy is to minimize your cost basis on your stock purchases.

Let’s take a look at how this works.

Other Considerations

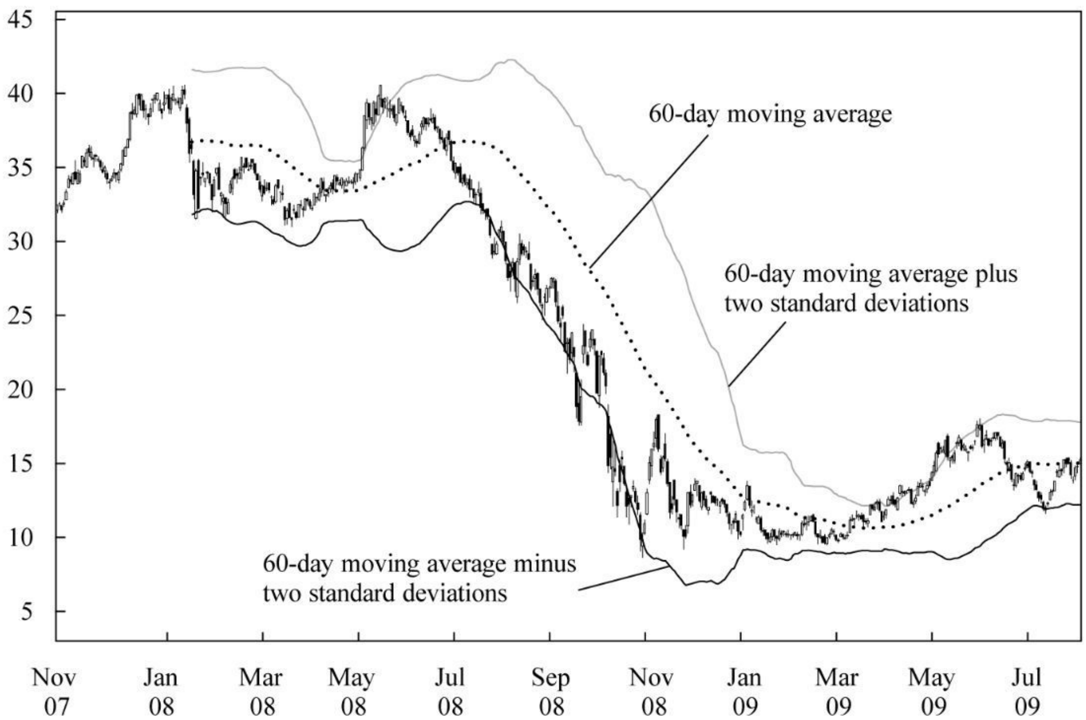
The biggest income generator in this strategy is the time value that's built into the option. Consider this: Let's say we stick with the 1270 strike but play around with the expiration date. What are the premiums we would earn for strike dates that are closer than the one on October 25th?

Well, the calls expiring on September 20th, which is less than a week away, will yield you a princely sum of $0.19. September 27th will yield you $1.40. Things get a little better in October. October 4th gives us $4.80. October 11th nets us $6.90 and finally, October 18th, which is about a week apart from our choice of October 25th, will yield us $9.91.

So, a difference of a week results in a premium decrease from $16 to $9.91. That's a 38% price drop! Hopefully now you can see my point about the value of time decay. It decreases exponentially and thus you should take full advantage of it. If time decay decreases exponentially, surely it makes sense to pick an expiry date that is as far away as possible? Well, let's see how this plays out.

Chapter 23
Technical Indicators

Bollinger Bands



Bollinger Bands is an indicator that shows the volatility of options. It is taken up to indicate the high and the low volatility levels on a price chart. This indicator cannot be used on its own; traders use it to complement oscillator-type, trend-following indicators, and this makes their trading activities more effective. For example, when there is little or no market activity, it is often difficult to predict the direction the price will take in the future, but with Bollinger Bands, traders can foretell the prevalent market phase.

Bollinger Bands are made up of a moving average and two lines that are extrapolated from the two standard deviations on whichever side of the central moving average. The two lines you extrapolate make up the band. If the band is narrow, the market is quiet, and if the band is wide, the market is loud. Therefore, the Bollinger Band can be used both in a trending and a ranging market.

When the market is trending, use the Bollinger Squeeze to mark your trade entry so that you can catch breakouts early enough. The Bollinger Squeeze is when the bands are close together, it appears like they are squeezing.

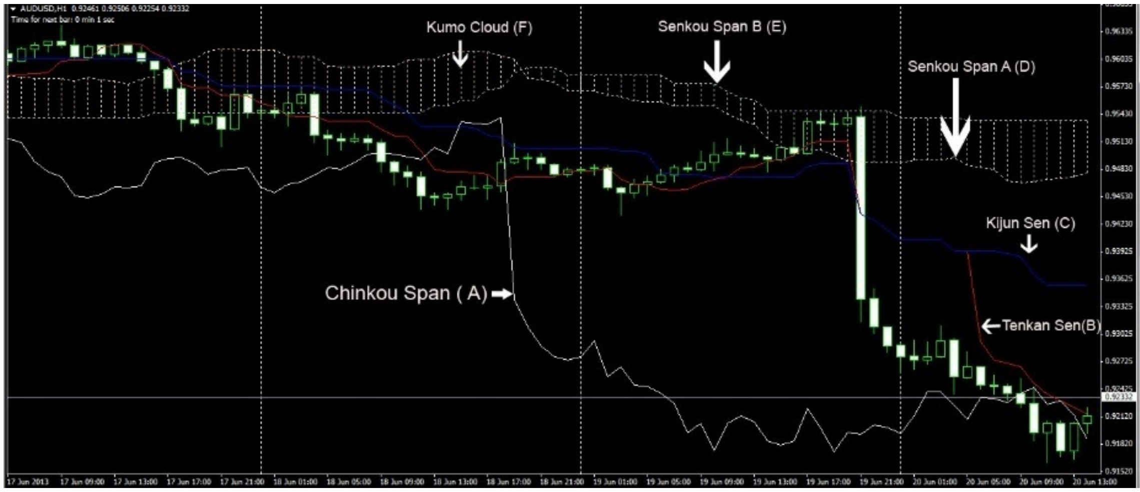
Relative Strength Index (RSI)

The RSI is an indication of the momentum, giving buy or sell signals to the trader. This indicator works under very simple logic: when the underlying asset is oversold, its price will be lower than what would be considered normal. An oversold asset is most likely to appreciate in the nearby future. If the underlying asset is overbought, the price will be higher than it usually should be, and it is expected to deflate in the near future. Therefore, with the RSI, you will differentiate the oversold and the overbought positions.

The setup of the RSI is relatively simple also. Usually, the indicator is plotted on a different scale, and a single line, with a scale ranging from 0 to 100, is used to identify the oversold and the overbought market conditions. If the readings are beyond 70, that is an oversold market, and if the evaluations are below 30, know that the market is oversold.

The idea behind using the RSI is to correctly identify the tops and bottoms so that the trader moves into the market just when a trend is reversing. The early entry allows the trader to take advantage of the entire market move before another cycle begins.

Ichimoku Kinko Hyo



The Ichimoku Kinko Hyo, also called the Ichimoku Cloud, is a momentum indicator that shows future price momentum and indicates areas that are likely to provide support or resistance in the future. By its name and description, in addition to the number of lines that are plotted, it may appear like a complex indicator, but it really isn't.

Here's what each of the lines on the graph means:

- The green line called the lagging line, or the Chikou Span is the closing price of the day plotted 26 periods behind.
- The red line called the turning line, or the Tenkan-Sen is one that is derived by getting the average of the highest highs and the lowest lows for the last 9 periods.
- The blue line, called the Kijun-Sen, the baseline, or the standard line, is a line determined by calculating the average of the lowest low and the highest high for the last 26 periods.
- There also is a red or green band called the Senkou Span. Its first line is computed by finding the median if the Kijun-Sen and the Tenkan-Sen, plotted 26 periods ahead. Its second line is calculated by averaging the lowest low and the highest high over the last 52 periods, but it is plotted

26 periods ahead.

The lines described above, it would seem, are difficult to translate when trading. However, that is not the case. The Senkou Span takes the role of offering dynamic resistance and support because if the prices go above the Senkou span, the top of the line will act as the first support point while the bottommost of the line will be the second support point. If the values fall under the Senkou span, its bottom line becomes the first resistance point while the top line becomes the second resistance point.

Traders use the Kijun-Sen to confirm trends. If the price breaks out at a point above the Kijun-Sen, the price will likely even go further up. In the same way, if the price drops below the line, it will unmistakably go lower.

The Tenkan-Sen is another line used to confirm trends. You will know that the market is trending when you see the line moving up and down. If it changes sideways, understand that the market is fluctuating. Take note that this red line indicates the price trend.

The Chikou Span, the colored-green one, is plotted 26 periods following the present period. It indicates trends of all sorts. Whenever this line crosses the price headed to the top from the bottom, know that the price will likely follow and go up. If the line crosses the price from up headed downwards, the price is likely to follow that direction too and will go from up to down.

As you see, this indicator shows quite a lot of information about a trade; you only have to recall what each line means. If you mixed up the colors, you could make a mistake and end up losing your investment, bringing down your portfolio.

Simple Moving Average (SMA)

This indicator is great for assessing the trend prevailing. There will be times when the direction a trend is taking will not be so obvious. The span a trend takes to complete also varies (there are medium-term and long-term trends). In cases like this, the SMA helps the trader to understand the market trends.

Traders can also combine the SMA with other indicators to get some clarity on some buy and sell signals.

Stochastic Indicator

This is the momentum indicator. It is aiding in helping determine the point at which a trend could end. The trader could use the end of a trend to pick an entry point so that he can get into the next trend at the very beginning. Just like the RSI indicator, it is used when the underlying stock or other asset has been oversold and overbought.

The stochastic indicator is made up of two lines, plotted on different charts. Once the lines are plotted above 80, it means that the market is oversold, there is possible to a downward trend. If the stochastic lines are plotted below 20, it means that the market is overbought, that there's about to be an uptrend.

As you try to get into trades early, be on the lookout because there are many fakeouts in the market. To prevent too much loss in the case, the market does not go in the predicted direction, install stop-losses.

Therefore, let the stochastic indicator only give you a clue of where the market is most likely to go; don’t base the entire investment on it. Take on various risk management practices to keep your portfolio safe.

Money Flow Index (MFI)

Is the momentum indicator. It works by bringing together data regarding the price and volume of the underlying asset. Some investors call it the weighted-volume RSI.

The MFI measures how money is flowing in and out of an asset over a specified period, usually 14 days. The outcome it gives indicates the trading pressure in regard to the asset being traded. A reading beyond 80, just as with other indicators, is a sign that the asset is oversold whereas an analysis below 20 means that the security is overbought.

Since the MFI indicator deals with volume data, best suitable for stock-based options as against to index-based options, particularly the long-duration kind. Whenever the MFI moves in the direction reverse to that of the stock value, know that a trend change is impending.

Open Interest (OI)

The Open Interest is an indicator of the unsettled or open contracts in options trading. It does not indicate any specific information about where a trend is heading, but it does offer information about the strong point of the trend you are observing.

An increasing open interest is a sign that there is a new capital inflow, and this shows that the existing trend is sustainable. A declining open interest shows that the trend is weakening.

Options traders who seek to benefit from short-term trends and movements should take in the following scenarios:

- If the price is rising and the open interest is rising, the market or the security is strong.
- If the price is rising, but the open interest is falling, the market or the security is weakening
- If the price is falling, but the open interest is rising, the market or security is weakening
- If the price is falling and the open interest is falling, the market or security is strengthening.

Intraday Momentum Index (IMI)

This is an excellent indicator that high-frequency options traders use to wager on the price moves of the day. The indicator brings together the RSI and intraday candlesticks, creating a suitable range, like that of the RSI, for intraday trading; hence, it can accurately indicate what has been oversold and what has been overbought.

Using the IMI, an options trader will be able to take note of possible chances that could help him to initiate a bullish trade in a market that is trending upwards at an intraday correction. The trader is also able to initiate a bearish trade in a market whose trend is headed downwards at an intraday price bump.

Traders compute the IMI by finding the sum of up days and dividing it by the sum of up days plus the sum of down days (Sum of up / (Sum of up days + Sum of down days). The result is then multiplied by 100. The trader has the liberty to choose the number of days from which to look, but the most commonly used number is 14 days.

Chapter 24 Trading Varying Time Frames

Weekly Options Trading

Weekly options are listings which provide an opportunity for short-term trading as well as plenty of hedging possibilities. As the name states, they have an expiration time of exactly one week; in general, they are listed on Thursday and expire the following Friday. While they have been around for decades, in the past they have primarily been the domain of investors who work with cash indices. This level of exclusivity changed in 2011 when the Chicago Board of Options expanded the number of ways they could be traded, especially to make them more easily acceptable to traders like you. Since then, the number of stocks that can be traded weekly has grown from 28 to nearly 1,000.

In addition to having a short time frame, weekly options differ from traditional options in that they are only available 3 weeks out of the month. They are also never listed in the monthly expiration style. In fact, the week that monthly options expire, they are technically the same as weekly options.

Advantages of weekly options: The biggest benefit of buying into weekly options is the fact you are free to purchase exactly what you need for the exact trade you are looking to make without having to worry about coming up with extra capital or dealing with more options than you currently need. This means if you are looking to start a swing trade, or even an intraday trade, weekly options will have you covered. For those looking to sell, weekly options provide the ability to do so more frequently, rather than having to wait a month between sales.

Weekly options trades are also useful in that they lead to reduced costs for trades that have longer spreads, such as diagonal spreads or calendar spreads as they can sell weekly options against them. They are also useful to higher volume trades as they are useful when it comes to hedging larger positions and portfolios against potential risky events. Also, when the market is range bound the weekly options, market can still be utilized through means such as the iron butterfly or iron condor.

Disadvantages: The biggest disadvantage when it comes to weekly options is the fact that you will not ever have very much time for a trade to turn around if you make the wrong choice in the first place. If you are selling options, then you will also need to know that their gamma will also be much more sensitive than it would be with more traditional options. This means that if you are planning to short options, then a relatively small move overall can still lead to an out of the money option entering into the money very quickly.

Buying weekly: Because you are always going to have much less time when it comes to turning a profit with a weekly option, your timing for when to move on a specific decision is going to need to be much more precise than it would otherwise have to be. If you choose poorly at either strike selection, time frame or price direction then you can easily find yourself paying for an option that is generally worthless. You will also need to take into account your level of acceptable risk as the option is going to be cheaper per unit, but you are going to need to purchase more in a week’s time than you otherwise would.

Also, it is important to avoid making naked calls or puts when trading on a weekly basis as these typically work out to be lower probability trades as a whole. If you have a bias when it comes to the direction you want your trades to move in, then using a debit spread or structured trade is generally preferred.

Selling weekly: Selling reliably for the long-term can generate steady profits if done properly. It only works this way if you are defining your profits up front, which means it is important always to know what your options are worth to prevent you from selling yourself short. Selling trades weekly will make it easier to collect the full premium if they guess correctly while still leaving you exposed to unmitigated losses if you choose poorly which requires an extra margin.

Spreads: Spreads are a great way of making a profit in the weekly market. The overall level of implied volatility is going to be much higher in the weekly market than in the monthly variation so the spread can help you when you find yourself dealing with an unexpected directional change quickly enough that you can actually do something about it. Selling an option against a long option will naturally decrease the role volatility plays in the transaction. The best point to use the debt spread will be near where the price currently is, providing you with a 1 to 1 risk and reward ratio.

Intraday Trades

While options are frequently left out of day trading strategies, this trend is slowly changing. Traders are slowly but surely realizing that they can apply many standard day trading techniques when it comes to selling and buying options successfully.

Intraday trading challenges: When attempting to day trade options, you are likely going to run into some unique challenges, that you should be able to best with the proper consideration.

1. Price movement will decrease value more significantly due to the time value naturally associated with options that are only near the money so close to their period of expiration. Remember, while their inherent value is likely to increase along with the underlying stock price, which will be dramatically countered by the time value loss.

The bid-ask spreads are typically going to be wider than they would otherwise be which is due to the reduced liquidity that you will typically find with the options market. This will frequently vary by as much as .5 of a point which can cut into profits if things move at an inopportune time.

Some types of options are naturally a better fit when it comes to day trading than others. Perhaps the most effective is the near month in the money option which is appropriate for those traders who are a fan of trading stocks with a high level of liquidity. The premium on this type of option is based more closely on its overall value as it is already in the money and getting close to its expiration date. If this occurs, the time value drain is decreased dramatically. This type of option is generally traded most effectively in periods of high volume which tends to result in a decrease in the gap between asking price and bidding price.

Protective put: The protective put is a type of option that is useful when you purchase put orders along with shares of the related underlying stock. This is a reliable strategy when the underlying stock is likely to experience a high degree of volatility. It is especially effective when used to purchase the same option throughout the day to continue to capitalize on short bursts of positive movement. It is also useful when it comes to providing insurance when purchasing shares of a risky underlying stock as you will always be limited in your potential losses to the price of the options you purchased.

Protective puts are also useful in a strategy known as bottom fishing. It is common for many underlying stocks to regularly break through existing support levels and continue moving down into an entirely new lower trading range. When this occurs, it is in your best interest to seek out the bottom point of the downturn so that you can catch it before it starts moving back up. This is easier said than done, however, as it is possible for a stock to give off false signs of having hit bottom and buying in at that point will only lead to serious losses. This is where the protective put comes in, however, and limits the possibility for risk substantially.

While there are models that can be used to calculate the likelihood of the bottom of a given trend, they too can be fooled by the exhausted behavior, which can indicate a false bottom. As such, when you feel that a given stock has bottomed out, then you can buy in with a protective put and then be protected regardless of the ultimate outcome.

Directional options trading: The most effective directional strategies when it comes to intraday options trading are those which have the overall highest degree of making it possible to make quickly moves time and again. These moves are typically going to occur at specific retracement levels or around breakouts.

- Trades that are based around the Fibonacci retracement on the charts for time frames less than 10 minutes. Fibonacci retracements can be used to determine reasonable reward/risk levels either by selling a credit spread to the level in question or through buying options that are already in the money that are likely to experience a bounce at these levels. It is generally going to be in your best interest to look for Fibonacci levels that are likely to overlap at multiple time frames as well as corresponding to the most recent trend experienced by the underlying stock. If you are so inclined, you can also utilize candlestick price patterns as a means of confirming a buy at specific Fibonacci levels.

- Alternately, you may find success with oversold or overbought indicators when it comes to range-bound or trendless stocks. You can then sell credit spreads or buy into options that are already in the money and near the current level of resistance and support with tight stops. It is important to keep in mind that a given stock might not move quickly enough to make these levels worthwhile, so it is important to do your research ahead of time to have a reasonable expectation about the future movement.
- Indicators that are used to signal lower than average volatility such as Bollinger bands are especially useful when it comes to place trades that you anticipate big moves from. Breakout indicators time, especially for the shorter charts, are also especially useful.

High volatility options intraday strategy: Trading volatility by selling options with high volatility, such as credit spreads that are currently out of the money will allow you to make a profit when anticipating a volatility drop. This is a commonly used professional strategy to employ when it comes to earning season or other scenarios where the underlying stock has developed a big price gap. The front month short-term options will then have an extra-large amount of volatility that makes it easier to generate a positive reward and risk ratio when selling. The most common way to take advantage of this fact is through utilizing an iron condor with strike prices of the earning move that is expected to be forthcoming.

Chapter 25
Bonus Strategies

Strangles and Straddles

The best companies to use strangles or straddles on prior to an earnings call are companies that are actively traded, growth companies. Examples include Amazon, Netflix, Tesla, Apple, Google, and Facebook, the so-called FANGS. Any actively traded company is good for this procedure, however. You can also use this strategy on index funds like SPY. The time to invest in strangles on SPY or other highly traded index funds is before a major economic announcement. This can include an announcement by the Federal Reserve regarding changes in interest rates, unemployment reports, or GDP growth reports. Each one of these can lead to big movements in the stock market, and you don't necessarily know which direction the price movements are going to go. But using a strangle or a straddle, you don't need to know which direction the stock price is going to move.

Setting Up a Strangle

A strangle is a trade where you buy a call option and a put option simultaneously. They will be options on the same stock, with a similar deadline set but with a differing predetermined price. If you set up the so-called strangle, your goal is to create a range or boundary around the current stock price. By doing this, you hope that the stock price is going to move outside of the boundary. In this case, you are buying both options, so the total risk is the total cost required to buy both options.

Let us say the stock price is around $98-$100; you could set up a strangle by purchasing a call option with a strike price of $105 and a put option with a strike price of $95. If the share price were to stay within $95-105, you would lose money on the trade. A maximum loss would occur if you were to arrive at the deadline, still holding the same strategy. You could cut your losses by selling the position early in the event you could find a buyer.

The maximum profit on the upside of a strangle is unlimited in theory. If the market value remains superior to the predetermined price, which is used to buy a call option as a part of the trade, plus the cost of the call option, then you make profits. And if it keeps surpassing the strike price, in principle, you will make more profit. Your profit will be reduced by the total cost required to buy the two options.

In reverse, you will start to earn profits in a put if the market value dives underneath the predetermined price, less the price paid for it. This would be the breakeven price for the put option.

When there is a large price movement after the earnings call, this kind of setup ensures that you are going to make profits, no matter what direction the stock moves. The key to setting up the trade is picking the right strike prices. The larger the difference between the strike prices, the lower the total cost of entering the trade, but there’s a lower probability of earning a profit because a larger spread in prices means that the stock must move a larger distance before you make profits on the trade.

Straddles

A straddle is a variation on the strangles trade. So, in this case, you are also going to be buying a call and a put option at the same time. They will also be for the same stock and have the same expiration date. The difference between a straddle and a strangle is that they will have the same strike prices. A straddle narrows the range of the trade. Since they have the same strike price, you increase your odds of the stock moving in such a way to earn more substantial profits.

Let's set up two examples. For the first example, we will set up a straddle. This will be hypothetical, but we will start out with current Apple prices as an example, using $240 strike prices for the call and the put. With 14 days to expiration, a call option with a $240 strike price will cost $6.20, and a put option will cost $6.17. So, the total investment required to open the position would be $1,237. Now, suppose that the earnings call is at 10 days to expiration and the stock price rises by $20 a share. The put option drops to $0.43 or $43. The call option spikes to $20.45, so we could sell the call option for $2,045. We could also sell the put option to get rid of it and recover the $43. So, our net profit would be $43 + $2045 - $1237 = $851.

On the other hand, if the stock price were to drop $20 in the case of a bad earnings call, the put option would rise to $20.28, while the call option would drop to $0.30. So, we see that it would produce similar results no matter what direction the share price was to move.

Now consider a strangle with a $240 call option and a $235 put option. In this case, it would cost $393 to buy the put option, while the call option would cost $6.20. So, the total investment would be $1,013. So, it's a little bit cheaper to set up the strangle. The results are basically the same on the upside. If the price rises to $260 a share, the call option will generate the same profits as before, but the put option would drop to $17. We could just let it expire worthlessly or try and sell it to recover the $17. The strangle would have a disadvantage on the downside unless the stock dropped more since we have selected a lower strike price. If it drops to $220, the put option would be worth $15.67. So, our profit would be $1,567 - $1,013 + $30 = $584, assuming that we could sell the call option for $30.

Iron Condor

This means that you are going to be selling the position for a net credit. The purpose of the iron condor is to profit from the stock price, staying within a bounded range of prices. So, for example, Facebook is trading at about $190 a share. If there is no dramatic news, we expect it to trade between around $186 to $195. So, we could set up an iron condor that bounds the range to $185 to $195. If the stock stays within that range, then the iron condor will earn a profit.

An iron condor is a setup of four options. However, it’s not that complicated. In short, an iron condor is constructed using the two types of credit spreads simultaneously (call and put). The range of profits is set up between the inner strike prices. So if you sell a put option on Facebook for $185 and buy a put option on Facebook with a strike price of $180, and you sell a call option with a strike price of $195, and buy a call option with a strike price of $200, then as long as the share price stays in between $185-$195, you will make a profit equal to the net credit received for entering the position.

The maximum risk is different for the upside and downside unless you select the same gap between the two predetermined strike prices. On the upside, the maximum risk is the difference in strike prices minus the total net credit received. In our case, the difference in strike prices is $5. If the net credit received were $2, the maximum loss on the upside would be $5 - $2 = $3 or $300 when considering all 100 shares.

The risk on the downside is computed in the same manner. In the example that we used, the strike prices are the same difference on both sides of the trade, but that isn’t a requirement. If you think there is a lower risk on one side as compared to the other, you can adjust your strike prices accordingly to minimize the costs or to increase the credit received. If you opt for increasing the credit received, that might increase the maximum possible loss because the difference in strike prices will be larger. However, that might not matter if the probability of loss is relatively low.

Many traders use iron condors to make regular income from selling options. You won’t want to use iron condors when there is a change for a large movement in share prices. If there is an earnings call coming up, for example, using an iron condor would be a poor choice of strategy. But most of the time, unless there is dramatic news after the share price settles down after the latest earnings call, you can utilize iron condors to earn profits for several months because odds are, the share price won’t vary too much. But you have to stay on top of the stock to know how it’s going to be behaving.

Iron Butterfly

The iron butterfly is not as popular as the iron condor. The difference is that you select put and call options to sell that have the same strike price. This sets up a center strike price. It’s a riskier type of trade because maximum profit occurs when the share price stays equal to the center strike price. You incur losses if it moves off this value. Since this trade requires the share price to stick to a particular value in order to earn maximum profits, it means that this is a riskier type of trade. The maximum profit would be the net credit received on the trade.

Conclusion

Understand Market Basics

In the modern world, investment has been made accessible to the average person. Most employers who offer retirement savings plans often sponsor an education day, so employees can gain some familiarity with the types of retirement plans and options that are available to them. In addition, with the proliferation of cable news networks, specialized programming, the internet, and social media, there is no shortage of information widely available to virtually anyone, anywhere.

Especially in the information age, knowledge is power. Before you jump right into trading on the options market, take some time to familiarize yourself with the basics of market dynamics. Options traders use a language that is unique to their niche in the investment world, and many outsiders may be completely perplexed and unable to understand much of what they say. In addition, the ability to tolerate a certain amount of financial risk is an inseparable component of successful investing. Thus, by understanding not only the terminology of the options market but also the fundamental dynamics of the stock market in general, investors can exponentially increase their chances of assembling a profitable career in options trading.

Always Have an Exit Plan

Picking a stock, formulating an options strategy to generate income from the stock's performance, and then contacting your broker to initiate an opening transaction is a good beginning. But this plan is not a complete strategy. The most important part of any options strategy is not how to get in—it's how to get out.

The payoff of an options strategy may result from buying the underlying stock at below market value, from accepting a cash settlement deposit for a put option on stock with declining value, or even from profiting from an increase in the cost of the options premium by selling the contract before it expires.

However, you believe the asset you have identified may provide you with an opportunity to construct a profitable options trading strategy, conjecture and hope should not be part of that strategy. Before you complete an opening transaction, make sure you are very clear about your specific goal for entering the contract. After you complete the opening transaction, you will be faced with one of three possible outcomes:

1. The market and the target stocks moved in the direction you predicted.
2. The market or the target stocks move in a direction you did not predict, resulting in unexpected losses.
3. The market or the target stocks move in a direction you did not predict, resulting in unexpected gains.

Similarly, you should have three responses ready for each of these developments:

1. If you are faced with the first result, you should have an exit strategy already prepared. Whatever else is happening around you, as long as your assets are on

the right track, do not deviate from your plan.

2.If there are unexpected changes that are not favorable to your position on the underlying asset, what plan did you formulate to exit the contract so you can minimize your losses?

3.If there are unexpected changes that are favorable to your position on the underlying asset, what plan did you formulate to exit the contract so you can capitalize on these gains?

No matter what happens, make sure you can answer all 3 questions before you enter an options contract. Then, once you have laid the groundwork for a successful options trade, stick with your plan, even if you think you could make a few more dollars by improvising.

Adapt Your Strategy to Market Conditions

Once you’re up and running in the world of professional options trading, you will gain confidence as you see your efforts pay off in returns to your options account. As you move from a Level 1 trading account to a Level 2 trading account, you will likely develop a preference for a certain type of options trades—maybe covered calls or married puts. Familiarity with the language and mechanics of the options trading profession is definitely something that will work in your favor. However, it is important to remember that as you move up the ladder, you will gain access to a wider array of trading tools and strategies. As you gain knowledge and experience, remember that no matter how comfortable you have become with a select number of options trading strategies, there will always be additional aspects of nuance that can enhance your skill as a trader and increase the profitability of your efforts. The key to ensuring success is not just in choosing the best strategy in relation to the performance of the underlying asset. You must also consider the overall market conditions and whether those conditions may have an effect on the future performance of that asset. Although one strategy may have worked in the past under similar conditions, considering changes in current conditions will help you adjust your strategy to ensure you continue to build on your past success.

Play by the Rules

As an options trader, you will be in competition with other traders and investors. Much of your success in investing--including making valuable connections in the investment world--will result from your ability to play by the rules. The stock market is a living thing, and the activity of traders has a huge impact on its health and volatility. We are all tempted to be maverick investors who leave a legacy of innovation but understanding the fundamentals will work in your favor.

Specifically, option prices increase or decrease as a result of changes in share prices and volatility.

So, when share prices increase, call options make money and put options lose money; when share prices decrease, put options make money and call options lose money. Options also move in relation to volatility; when share prices are stable, greater volatility can increase the options pricing. So, when volatility increases, buying options makes money; when volatility decreases, selling options makes money.

What Every Investor Should Avoid

Doubling up to Cover Losses

“Doubling up” is a prime example of how an options trader may ignore his original exit strategy if the market or the underlying stocks fail to perform the way he had expected when he originally constructed his strategy.

For example, let’s say a trader buys a call option for 100 shares of Company B, with a strike price of $45. At the time he purchased the call option, Company B was trading at $44. The trader expects the share price to rise to $47 before the contract expires. Immediately after the opening transaction, though, the stock price slips to $43.

The premium for a call option with a strike price of $45 is further out-of-the-money now than at opening, In addition, there’s still plenty of time before expiration. As a result, to compensate for any potential losses if the stock rises to only $46, the trader may be tempted to “double up” by buying another $45 call option at the reduced premium price.

If this trader were only purchasing stocks, he may have celebrated the unexpected drop in share value and immediately purchased as many additional shares as possible, with a goal of greater long-term return. But options trading works differently. The options trader is focused on short-term returns, and if the stock price fails to put the contract in-the-money by the expiration date, the trader loses on not only one contract, but two.

The smart trader will remember that he created an exit plan for this scenario and will stick with it. Though it may be tempting to purchase an additional call option, he should judge the wisdom of such a purchase by asking himself if he would buy the second call option if he were not already in the middle of a trade. If this is not ordinarily a contract he would enter into--and it isn’t, because that was definitely not his strategy in his opening transaction--then market conditions and stock performance that defy expectations are probably the worst reasons for him to change that view.

Instead, he should either stay in his contract to see if the stock eventually rebounds and makes the contract profitable, or sell the contract immediately, cut his losses, and look for another opportunity that makes more sense.

Investing in Illiquid Options

The last time you prepared your company’s balance sheet, filed your taxes, or reviewed your investment portfolio, you may have considered your “liquid assets” as part of the calculation of your total assets. Your liquid assets are those assets—such as cars and trucks, office equipment, or real estate—that can quickly be converted into cash by selling them. Assets that have value may not be considered liquid unless you can sell them for cash quickly. Selling assets for cash quickly requires a market, whether you have a garage sale, sell at an auction, or advertise in the media; but it also requires a large enough number of potential buyers that you will not have to wait for the right buyer to come along to pay you the asking price. The more buyers, the more competition, and the greater number of opportunities to make a sale, hence the liquidity of the asset. Obviously, if you are selling an obscure or unique item, regardless of its value, it will be inherently less liquid.

Liquidity in the context of options trading is similar. In order for a stock to be considered liquid, it should be trading at 1,000,000 shares per day. Most "blue chip" stocks—like Microsoft or General Electric--are liquid stocks. Smaller, less well-known companies may not only trade at a lower volume; they made not even trade on a daily basis. Such stocks are considered illiquid.

Like assets and stocks, illiquid options contracts have a relatively small market of buyers and sellers competing for their purchase and sale. All stock traders buy and sell the same stock for any given company; whereas a single stock can give rise to countless options contracts, each with different strike prices and expiration dates. As a result, options are more likely to become illiquid than stocks.

Furthermore, the size of the market for any given options contract may vary from illiquid to liquid even if the stock itself is generally regarded as a liquid stock. A stock is considered to be illiquid if it is trading at less than 1,000,000 shares per day; similarly, you should consider an option to be illiquid if it has an open interest of less than 50 times the number of contracts you will be trading. For example, if you are trading 5 options contracts on XYZ Company, there should be an open interest in options trades for that company of at least 250 contracts.

The primary reasons for avoiding illiquid options markets are cost and return-on-investment. Every time you complete an opening transaction, there will be a buyer and a seller of a contract. That contract will have an ask price (the amount an investor is willing to pay for the contract) and a bid price (the amount for which an investor is willing to sell the contract). But the actual value of the contract lies somewhere between.