A PORTFOLIO FOR ALL MARKETS

12 OPTIONS TRADING PRINCIPLES TO PROFIT IN ALL MARKET ENVIRONMENTS

KARL DOMM

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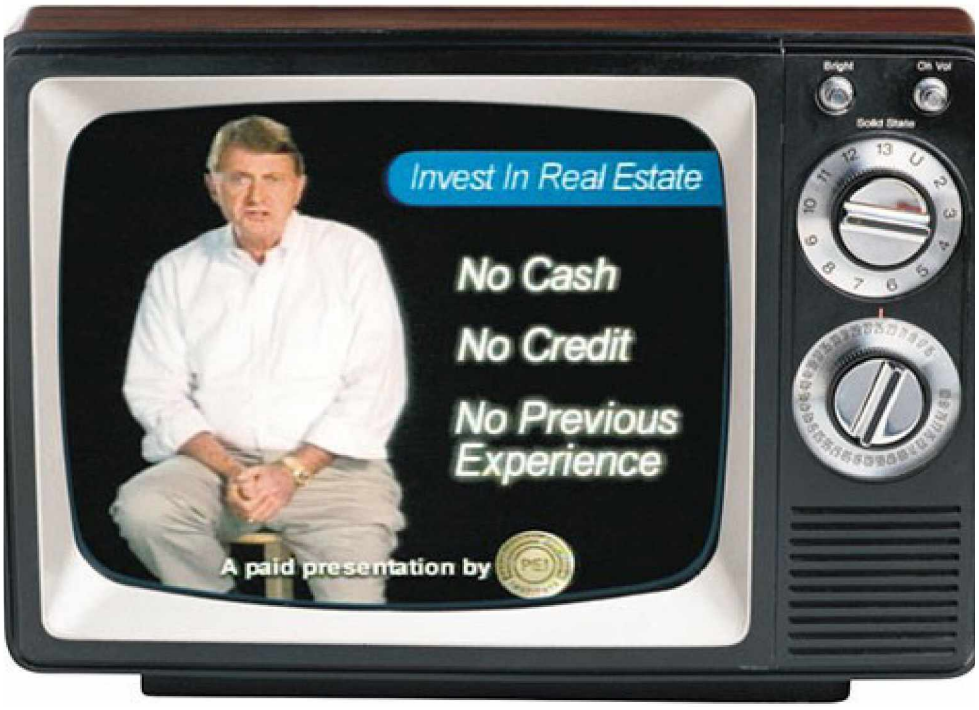
INTRODUCTION: MY START AS AN INVESTOR



I was 14 years old when my mom started to give me valuable stamps and coins for my birthdays. She wanted to encourage me to start a collection and one of the gifts really connected with me. Can you guess what it was?

The stamps didn't intrigue me. I used them to mail letters, but I did continue to collect coins. I put them in those blue coin collector books - the ones with a holder for each coin. I lost the books many years ago. I guess my interest wasn't strong enough to keep collecting coins.

What I really liked was the one share of Reebok Stock she gave me. At the time, it was trading for about $20, a share. I began to check the stock market section of the local newspaper on a regular basis. As a teen in the

80’s, it was the only way I knew to keep track of the stock’s value. A few years later, I sold it for $40.

Nothing much started to click with me until she started giving me books on audio tape. The one I remember best is Harvey Mackay’s Swim with the Sharks. Later I saw an infomercial on real estate from Carlton Sheets. The course was very expensive, but I signed up. At that point, I had never heard the terms passive income or stock option.

After I started to study business my father’s influence came into play. He is a self-made man who started out life being left on a doorstep when he was a baby. He was raised as a foster child in a very modest home and now he owns a multimillion-dollar business and is an expert in his field. My father has the innate ability to solve ANY problem. He taught me how to ask myself the right questions so I could come up with answers to seemingly impossible-to-solve-problems. His main message is you must have grit and perseverance if you are to achieve anything worth accomplishing.

I used that grit and perseverance for 24 years as I studied investing. It took me that long to find consistent success. I thank my mother for her blind support and my father for showing by example what it takes to never give up.

My First Real Estate Deal

It was 1989 when I was 22 years old and still in college, I decided to go down to the Fresno courthouse to see a real estate foreclosure auction. I watched a guy - Jim Smith (yes, that's his real name) bid on and buy a property.

When the auction was over, I approached Jim and began to ask him a lot of questions. This was the beginning of our friendship and business relationship. We later purchased a house together. You can see it in the photo above. It still has the same paint job we gave it in 1992.

It was my first real estate deal. I added value to the transaction because I was able to get the loan in my name. At the time, Jim did not want another mortgage in his name. We purchased the property for $42,000. I borrowed the money from a hard money lender, meaning the interest rate was higher than normal and the loan term shorter - five years. However, the actual payment was amortized over 30 years. I knew that at the end of the five years, the full loan had to be paid off. I was hoping it would increase

enough in value by then so that I could refinance using a more conventional loan.

Jim had a crew that we used to do fix-ups like exterior paint and some flooring. After that, we tried to sell it. A month later, we found a buyer who offered us $62,500. One catch - the buyer didn’t qualify for a loan. We decided to take $5,000, down and create a payment plan or mortgage and wrapped it around the existing mortgage. We paid the lender $550, a month and the new owner paid us $750, a month. It sounds like an easy $200, a month, but it wasn’t. The new owner never paid on time. He was always a month late. Eventually, I didn’t have the money to pay the mortgage. The hard money lender was hard on me - always calling me for the money. The worst part was that the person in charge of my account was a friend! How embarrassing is that?

The one thing that made the deal work was that the $750, per month was significantly HIGHER than the loan payment would be if the new owner got a new loan. Finally, after about a year, the new owner did get a new loan and paid Jim and me off for a nice little profit.

Looking back, the best thing I did was to go in with an EXPERIENCED PARTNER. Without Jim’s help, this deal could never have happened.

These early ventures helped me experience first hand a few different methods of producing income.

CHAPTER 1
THE HOW OF INCOME

«Rich Dad Poor Dad» author Robert Kiyosaki has broken income producing options into four categories:

1. Employed

Working as an Employee. This is your worst choice unless it’s very temporary. You don’t want to trade your time for money.

2. Self Employed

You work for yourself, but you must do the work. It cannot run without your contribution. If you don’t show up, you don’t get paid! Some examples are lawyers, doctors, and consultants.

3. Business Owner

It’s better to own a business than to be an employee or someone self-employed, but you still must supervise employees, problem-solve, and

guide the business in the right direction.

I include «multi-level marketing» in this category. I have been involved in a few multi-level marketing businesses. I spent most of my time holding meetings, making phone calls , and actively meeting new prospects. I was never able to reach a high-status level, but the people that do have to supervise others and continually look for new recruits. To be at the top of a multi-level marketing business means you're working all the time. It's not a venture that will provide you passive income.

If your goal is passive income, DON'T become an employee, self employed or a business owner.

4. The Investor

To me, an investor is anyone who uses a strategy to produce passive income. Some common investment vehicles include the stock market, real estate, royalty income (paid to an owner for the ongoing use of their asset) or a silent partnership.

Let’s Consider the Stock Market: Can Anyone Pick a Stock Direction?

The «experts» think they can tell us WHY a certain stock (or the market itself) is going to go UP or DOWN. But, wait, it’s more complicated than that. Even if you guess the right direction, other concerns pop up. When is the right time to take profits? When is the right time to take losses? How much money is the right amount to use for each trade?

If you take a closer look at some of «the experts» who claim to foresee a market direction, you’ll discover that they do NOT share the results of their TOTAL PORTFOLIO. This means you only see their profitable moves, you don’t see the WHOLE PICTURE of their trades. In my opinion this is proof that no «expert» can trade only in stocks, pick a direction, charge fees, and consistently outperform the market for their clients.

I was excited to find a site that shows TOTAL PORTFOLIO RESULTS. You can find it at Covester.com. Covestor[1] looks at 54 funds and posts their results. It shows ACTUAL portfolio management and the ACTUAL results that were achieved. First, I wanted to know how many of these funds have been profitable as of March 21, 2016, for the last 365 days.

The answer is a surprising 6 out of 54! That's only 11% of the funds. Approximately 9 out of 10 portfolio managers are down. For them, picking a direction didn't work. Picking a direction is obviously flawed.

Over the last 26 years, I have studied the market and done the research. The odds that the market is going up or down is approximately 50-50. (To be precise, it's closer to 53% of the time the market goes up and 47% of the time the market goes down.) I also found that these probabilities can be used effectively when you take advantage of stock option premium selling techniques. The downside is the learning curve. It is possible to successfully invest without guessing the direction of the stock market!

CHAPTER 2

MUTUAL FUNDS

Back in early 2016, I was talking to a good friend about investing for retirement. He mentioned Dave Ramsey. Mr. Ramsey has a show about helping people do the best thing for their financial situation. I'm sure he has a lot to offer when it comes to budgeting and getting out of debt, but when it comes to investing, I'm not so sure. Remember, even very smart people can be duped by the financial industry.

Following Mr. Ramsey's advice, my friend got into five different low fee mutual funds. Because the fees are lower than the average, he is most likely doing better than the average mutual fund investor. Here are the funds and their results along with the results of the S & P 500 benchmark.

Average Returns	2015	5 year	10 year
Euro Pacific Growth Fund® (AEPGX)	-13.84%	1.22%	2.89%
Victory Sycamore Small Company Opportunity Fund (GOGFX)	-1.24%	8.35%	7.12%
MM S&P Mid Cap (MDKAX)	-9.80%	N/A	N/A
Ridgeworth Large Cap Value (SVIIX)	-8.07%	7.68%	5.83%
Alger Capital Appreciation (ALARX)	-2.10%	11.41%	9.76%
S & P 500 (Benchmark)	1.35%	11.58%	7.01%

If you had invested $10,000, into each fund from 2011 to 2016, your investment would have UNDERPERFORMED the S&P 500. I used five years of return numbers and cut out the MM S&P Mid Cap Fund (MDKAX) because that fund doesn't have a five- year track record. You would have made $13,079, MORE if you had just invested $40,000, in the S&P 500 from 2011 to 2016.

Euro Pacific Growth Fund® (AEPGX)	$10,000 at 1.22% for 5 years	$10,628.
Victory Sycamore Small Company Opp (GOGFX)	$10,000 at 8.35% for 5 years	$15,159.
Ridgeworth Large Cap Value (SVIIX)	$10,000 at 7.68% for 5 years	$14,663.
Alger Capital Appreciation (ALARX)	$10,000 at 11.41% for 5 years	$17,643
TOTAL		**$58,093**
S&P (Benchmark)	**$40,000 at 11.38% for 5 years**	**$71,172**

CHAPTER 3
THE LEARNING BARRIER TO OBTAIN PASSIVE INCOME

There are barriers to every way of earning passive income. The one common barrier is acquiring the knowledge you need to earn the passive income. Think of it like driving a car. Before you can competently drive a car, you must learn the rules of the road, practice driving in order to pass the driver's test, and finally, you must learn how to maintain your vehicle. If you want to learn how to drive a large diesel truck or a formula racing car, then you have even more to learn.

One way to accelerate the education process is to use a MENTOR (not a guru or a salesperson). A MENTOR is someone who has a PROVEN TRACK RECORD and is an expert in their field.

Don’t be fooled by the gurus and the salespeople who CLAIM to have great passive income strategies. For example, stock market gurus try to sell their «winning systems» by misleading the consumer. Here’s how they do it: Mr. Guru will place a trade in account A and at the same time place the opposite trade for the same amount of money in account B. Only one of these trades will be profitable. At the end of a certain time period, one account will be more successful than the other. The successful account is one they show to prove how well their system works. They never mention the other unsuccessful account that lost money.

Specifically, let’s say Mr. Guru creates a no win, no lose situation. He spends $5,000 to buy a stock like GE in Account A. He then spends $5,000 to short GE in account B. Mr. Guru tells you that he can pick the direction of GE when it has basically a 50% chance of going higher and a 50% chance of going lower. The customer only sees the winning account. He doesn’t realize that Mr. Guru was hedging his bets and didn’t make any money. In other words, Mr. Guru hid his WHOLE portfolio from you to make it look like he was successful.

On the other hand, a MENTOR will let you see the WHOLE portfolio. He will also let you see how he trades with REAL money in REAL time. A mentor will give you ALL the information. He won’t keep anything from you. A mentor with a proven track record will accelerate your learning process.

CHAPTER 4

MY OPTIONS TRADING BACKGROUND

At the time of this writing, I am 51 years old. After obtaining my business degree from Fresno State, I worked my way up to run a multimillion-dollar chemical water treatment company. I have owned real estate and I am successful in business — most people would have been satisfied with this.

As a young adult, I always felt my money should be put to better and more productive use. I have always been on the hunt for business opportunities, but the opportunities always came with two drawbacks:

1. **The financial investment required was substantial.**
2. **The time investment required was substantial.**

As a married father of four, I didn't have either of these.

I wanted more. I wanted to find a way to invest that would produce passive income for my future so that I could work as much or as little as I wanted and still live the lifestyle I desired. In this quest to build a passive income, I began trading options over 26 years ago in 1993.

From 1993 to 2011, I played in the stock/options market. It was just an experiment because I was focused on other possible income sources. During this time, I learned how difficult it was to invest only in stocks.

Investing in stocks becomes a direction play. I found it impossible to pick a stock's direction then manage money around that concept and be profitable. As I focused more on options, I began to realize that you can be profitable in options without picking an underlying direction. It doesn't matter if the market is going up or going down.

In 2011, I committed myself to option trading. I started to treat trading as a real business. From 2011 to 2017, I had years of

«hit or miss» trading, but I did manage to keep my risk in check. During those years, I personally developed and tested over 198 different trading models. Here were the results:

*154 of my models did NOT produce a profit. I rejected them.

*I thoroughly researched the remaining 44 trading models. I spent months and months back-testing each one of them. The ones that could NOT stand up to back-testing were eliminated.

*My refining process lead to 17 models that were promising enough to forward-test using my own money. Only eight were successful.

*I then took the remaining eight models and tore them apart, turned them inside out and flipped them upside down, looking for ANY FLAW in their design.

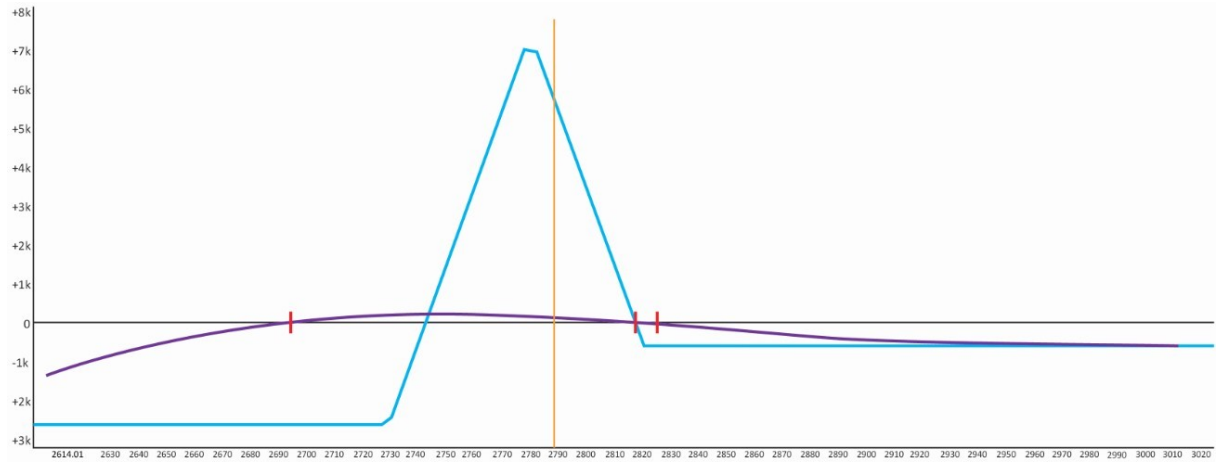
Finally, after the six years of testing, I eliminated all, but a few. These few have become the backbone of my low risk, profitable Modern Options Portfolio.

In 2017, I joined an options trading mastermind group of successful private traders from all over the world. After studying with them, I combined my experience with theirs. In February 2018, I finally created a system that could be used to manage a complete OPTIONS-ONLY portfolio. It reduced risk and reliably makes money, regardless of whether the stock market was going up OR going down! In early 2019 I started a hedge fund Clovis Wealth Partners (https://cloviswealthpartners.com).

CHAPTER 5
WITHOUT THIS TOOL YOU DON'T KNOW OPTIONS

This book contains option trading strategies and concepts that are advanced. It is not for beginners. If you are just starting out, I suggest you take some FREE beginner option trading classes from tastytrade. https://www.tastytrade.com

Options trading strategies are best explained using a tool called a RISK GRAPH representing a profit/loss diagram. To put it simply, a risk graph is a visual picture that shows what will happen to a positions P&L WHEN the underlying price or volatility moves up or down. Below is an example of a RISK GRAPH.

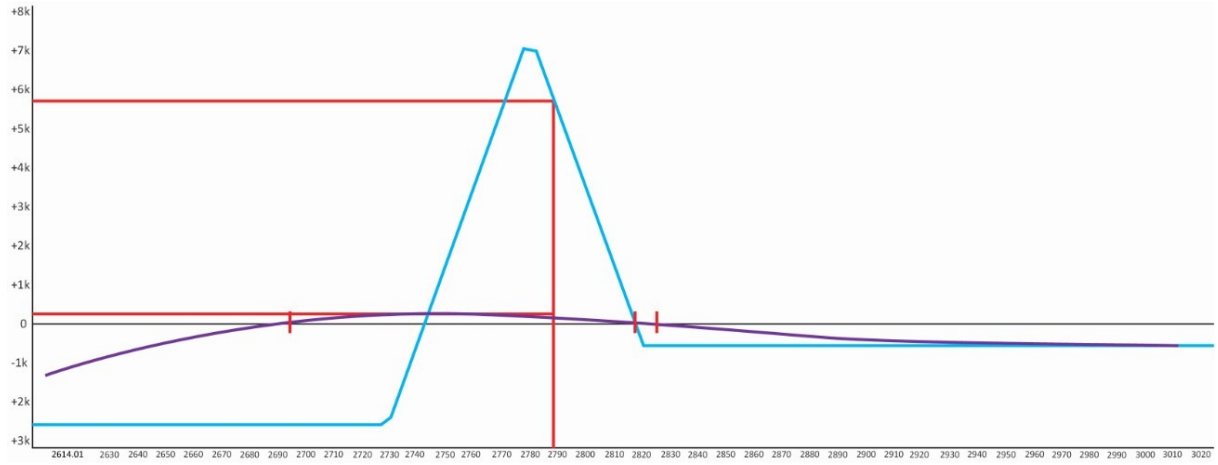


Graph 1

Graph 1 shows a four-legged options position with all the legs set to expire at the same time. The Y axis represents money gained or money lost, the black horizontal line represents zero or breakeven point. The X axis represents the price of the underlying. The blue line is the Expiration line. The purple line is the Time Plus Zero line or T+0. The orange perpendicular

line is the price of the underlying and the black horizontal line is the P&L break-even line.

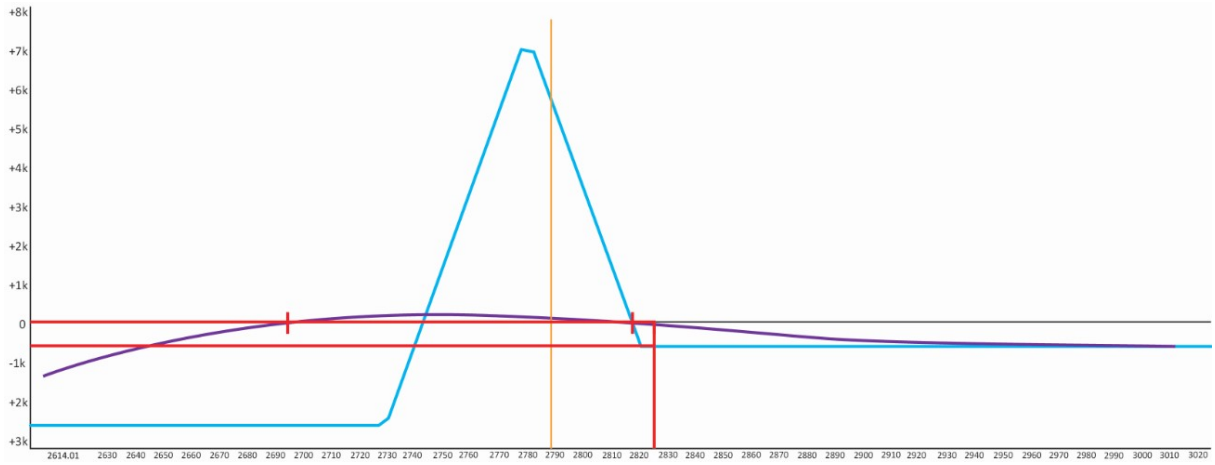
The difference between the expiration line and the T+0 line is time. The T+0 line (time plus zero) represents what is happening right now. The expiration line represents what will happen in the future when the options expire. There could be for example a T+14 line (there is no such line on this graph) which would represent what would happen in 14 days from now.



Graph 2

The red lines on graph 2 highlight key intersections. The bottom intersection is where the T+O lines intersect with the underlying price X-axis of approximately $2,788 per share. The Y-axis is the P&L profit of approximately $200. What it shows is that if the position was closed out today (Time plus zero), it would generate approximately $200 in profit.

The second red line that travels up and meets the teal expiration line is a future possibility. The top intersection is where the expiration line intersects with the underlying price on the X-axis or approximately $2,788 per share and the Y-axis is the P&L of approximately $5,800. This demonstrates that if this position is closed out in the future at a price of $2,788 per share (at the time the options expire), the profit would be approximately $5,800. Odds are that the price will move up or down by the time the options expire.



Graph 3

In graph 3 the red lines represent a possibility based on different time frames. What if the price of the underlying rose to $2825 in one day? The top intersection T+0 intersects with the underlying price X-axis of approximately $2,825 per share and the Y-axis which is the P&L profit of approximately 0 (break even). This demonstrates that if the underlying moved up to $2,825 and the position was closed out today (time plus 0), it would generate 0 profit and 0 loss.

The bottom red line traveling to meet the teal expiration line is a future possibility. The intersection where the expiration line meets the underlying price on the X-axis is approximately $2,825 per share. The Y-axis is the P&L loss of approximately $500. This demonstrates that if this position was closed out in the future at a price of $2,825 per share (when the option expired), it would lose approximately -$500.

The risk graph is an important tool used to map out options positions P&L possibilities.

CHAPTER 6

MILLIONAIRE TRADING MINDS

The first 21 years that I traded options I did so totally on my own without any guidance. I didn't know anyone else interested in options. I may have read a book or two, but I really went at it alone. I developed ideas and tried to execute them for profits, but in every case, I took significant losses in short periods of time.

In 2014, I discovered an online community of options traders at tastytrade.com. tastytrade is an option-trading website developed by ex market-maker Tom Sosnoff. His trading style is a mixture of common multi-legged option premium-selling strategies placed in relatively high volatility with each individual trade placed at a small quantity.

I learned a lot about RISKS, PROBABILITIES, TRADE TYPES and STRATEGY. However, I never felt comfortable enough to apply real money to the tastytrade concept, so I used a fake money account to practice. After a couple of years, I realized there were some flaws in their system that I will get into later in this book. But it's a great place to learn the basics at no cost.

In 2016, I made a friend who had experience with buying online courses from «Options Trading Gurus». He asked me to check out each guru's system to see how profitable it was, I also searched on my own. After searching high and low, I was able to find and vet about 25-30 of them. Most of them were either doing the tastytrade thing or they were trading the underlying directionally. I may have missed a couple, but out of all the online gurus I was able to vet, I found only one with some real merit.

The trader I found was Ron Bertino. He has a course that is extensive and very advanced. Once you finish the course, you can join other graduates in his Mastermind Group.

The Mastermind Group shares strategies and allows you to find YOUR BEST TRADING SYLE. A lot of the members trade options for a living. The members include millionaires, finance professors, ex-market makers, aerospace engineers, code writers, Ivy League graduates, hedge fund managers, and even options trading gurus with their own websites or consulting businesses.

This group is a great place to have all your option trading questions answered. For example:

1. **What are the best platforms for option-trading?**
2. **What can I do to tweak my trading system?**
3. **How do I determine my position size?**
4. **What's the best way to execute a trade?**
5. **What's the best way to back-test?**

Here's an important lesson I want to share with you. When you need the best information possible, find and join a collaboration of experts. This will allow you to grow exponentially. It will take time to find that group, but once you do, all your effort will be rewarded.

If you are interested in Ron Bertino's course, here's the link:

https://bit.ly/TradingDominion

CHAPTER 7
HOW I LIKE TO MEASURE AND COMPARE PORTFOLIO PERFORMANCE

There are many metrics used to measure performance. Some include:

Annualized Return

Cumulative Return

Annualized Volatility

Maximum Drawdown

Sharpe Ratio

Sortino Ratio

Daily GRP (Gain to Pain Ratio)

Monthly GRP

Expected Shortfall

Skewness

Kurtosis

VAR (Value-at Risk)

Monthly Mean Return

Monthly Standard Deviation

Ulcer Index

Calmar Ratio

There are many more that could be added to the list. The explanation of these metrics are all widely available and taught in text books. The purpose of this book is not to teach things that can be learned at most any university it is to provide real and practical principles derived from my own trading experience. If you are interested in some of the industry standard performance metrics this list can be a good starting guide.

Risk Reward Ratio / Risk-Adjusted Return

Here, I want to add my take on risk-adjusted metrics; I like to keep it simple, so I apply a risk-reward ratio to compare portfolio performance. I take the lowest P&L for the time period (Usually monthly returns) in percentage terms and divide them into the annual percentage return.

For example, if I want to compare the 2018 performances of Manager A to Manager B, I see that Manager A had a 13% return and the lowest monthly drawdown of 7%.

My calculation is 13/7 = 1.86

Manager B had a 9% return and the lowest monthly drawdown of 2%.

My calculation is 9/2 = 4.5

Using this simple risk-reward calculation shows Manager B has a higher ratio and therefore, a better return on risk.

I like this risk-reward calculation for a few reasons:

1. It's easy to calculate and can be done quickly.
2. I am interested in the worst case scenario, not an average worst case scenario.
3. The Sharp Ratio and Ulcer Index use a standard deviation which is like an average drawdown. An average drawdown is not a realistic situation. When dealing with an options portfolio actual drawdowns are what can cause a margin call and forced liquidation at losses. Pay attention to actual drawdowns when sizing positions in an options portfolio.

Note that the risk reward ratio is very similar to the Calmar Ratio. The difference is that the Calmar Ratio normally uses a three-year time frame, the risk-reward ratio is not limited to a specific time frame.

Risk Reward Ratio Flaws

You cannot use the risk-reward ratio if the portfolio had a negative return over the test period. A negative number cannot be used when determining the ratio.

The ratio cannot be calculated if the portfolio never had a losing test period. Zero losses cannot be divided by zero to make comparable results.

When one of these two possibilities occurs, you may be forced to look at other metrics, such as the Sharpe Ratio or the Ulcer Index.

Position sizing

Your goal is to have no surprises when it comes to drawdowns. This is especially important in an options portfolio where leverage is involved. I look at actual drawdowns versus actual returns when I calculate the worst case scenario. This process allows me to properly size my positions within the portfolio.

I suggest you use the risk-reward ratio when you compare two similar portfolios, such as two funds that both invest in equity stock. However, the result may not be accurate when you compare two separate types of investments such as an equity stock portfolio and an options portfolio. The options portfolio may contain more leverage. It may look good based on past results, but its leverage may be excessive. Anyone looking at a leveraged portfolio needs to consider the possibility of exponential losses. In Chapter 10 I will go over options and exponential risk and how the right options portfolio can turn exponential risk into exponential returns.

CHAPTER 8
WISDOM IS KNOWING WHAT NOT TO DO

When you assess an opportunity, ask yourself three questions:

- **What can go wrong?**
- **What is it that I don't know?**
- **What don't I see?**

The only way to answer these questions is to make a commitment to finding the answers and then DIVE IN.

Over 26 years ago, I made a commitment to trade real capital. Here is what I learned so that you don't have to.

There will always be people in the field who claim to be experts when they aren't. Here's what I know about how to find an expert. There is a major difference between someone who teaches from a textbook and someone who teaches from his or her own life experience. The one with real-life experience is always the better choice because you will quickly learn what you need and NOT have to waste time wading through garbage.

The experienced teacher has tried everything, made innumerable mistakes, both large and small, and has LEARNED from every mistake. A true trading expert knows the terrible pain of losing hard-earned cash and has vowed NEVER to allow that to happen again.

Making mistakes creates knowledge or database of what NOT to do. When real money is on the line, mistakes hit you at a gut level. After 24 years of mistakes, I can now go out and execute a trade without making any significant mistakes. Knowing what NOT to do is wisdom and wisdom is a MAJOR component to trading success.

One common mistake is lack of diversification. Most money managers trading equities focus on being diversified. They attempt to invest in stocks that are NOT correlated to each other. For example, when one of their stocks (let's say «a tech stock») falls, they want their other stock to rise or remained unaffected, so they might invest in an oil-related stock. The tech stock and the oil stock do not have anything to do with one another causing diversification. But are they truly diversified?

Proper Position Sizing Needs To Account For Volatility?

To properly size a portfolio, it is important to take volatility into account. Position sizing must be based on comparing the volatility of each underlying in the portfolio. For example, using tech and oil underlyings, if the tech stock has a higher volatility, then a lower amount of capital should be invested versus the oil stock. If the tech stock has twice the volatility of the oil stock (meaning it moves twice as much per day), you would use half the amount of capital on the tech stock versus the oil stock.

Here's an example. If you have $10,000 to invest and the tech stock is trading at $10. per share and it typically moves up or down $1 per day and the oil stock also trades at $10 per share and it typically moves $.50 per day, to properly diversify you would want to allocate your capital as follows: $3,333 to the tech stock and $6,666 to the oil stock.

Crash Correlation

To achieve diversification you must consider Crash Correlation. In a crash market, such as August 24, 2015, or February 5, 2018, stocks become correlated.

The other day I looked through a typical tastytrade portfolio, I found an attempt at diversification by trading the following different stocks: SPY (S & P 500 proxy), NVDA (Tech), BA (Aerospace/Defense), COST (Retail), FB (Tech), LUV (Airlines), OXY (Oil), and AMGN (Bio-Tech). These stocks represent very different market sectors so you would think that the

portfolio is diversified. WAIT! First, you must ask yourself, does this portfolio pass the Crash Correlation test?

Let’s look at how these stocks performed on February 5, 2018.

SPY -4.3%

NVDA -12%

BA -9.3%

COST -4.3%

FB -4.7%

LUV -2.9%

OXY -3.5%

AMGN -6.5%

None of these diverse sector stocks passed the Crash Correlation test! They all became correlated in a crash. Most money managers would believe a portfolio like this is diversified but is it? I say, it is NOT.

As I mentioned earlier, I would point out a flaw in the tastytrade methodology. Their methods are based on trading small in many different underlyings using different option selling techniques. Their reasoning is that using many different underlyings will achieve diversification. However, you can see that even when a portfolio of stocks is diversified into different sections; it becomes correlated in a crash market. Imagine you go to bed thinking you are diversified, and you wake up to see ALL your positions moving in correlation with each other!

Not only that, but you will also find that all the options you sold have significantly increased in value, not only due to the price change but due to increased volatility. You just got «double whammied». Not to mention that if a percentage of your options portfolio carries naked puts, your entire portfolio could be wiped out. If you get a margin call and are forced to liquidate at a loss, your portfolio could drop as much as 25% to 50% in value. That means that if you take a 50% loss, you must make a 100% return just to get back to even!

As you can see, understanding diversification can be more complicated than it first appears. Diversification with stocks is different from diversification with an options portfolio.

When it comes to trading options, there are many ways to diversity. Some methods use different underlyings or different strategies such as going long and short on correlated and uncorrelated stocks or by applying different strategies designed to be applied in certain market types or certain market conditions.

Principle #1: Understand Diversification Create Your Plan.

Don’t be one of those newcomers who invests WITHOUT A PLAN. Your plan must answer questions like:

1. What do you do when you are long, and the stock goes down? Do you take a loss, or do you hold on and hope it comes back?
2. How much capital or what percentage of your capital do you risk on each position?
3. How long do you plan to hold each position?
4. If you invested based on the advice of a friend, when do you get out and take your gains or losses? Are you going to check back with your friend so he or she can guide you on what to do next?
5. In an options portfolio, how do you determine position size?
6. When do you take profits? When do you take losses?

If you don’t answer these questions ahead of time, you will hold your positions too long and take large losses or get out to too early and take profits too soon.

It is important to figure out what your risk-to-reward ratio is and how much capital to apply to each trade or underlying. Usually, new traders without a plan tend to lose money because they allocate too much capital to a position and fail to take a loss hoping for the stock to move back in their favor.

Then, they see the stock keeps getting away from them, they hold and hold until it is unbearable and they are forced to take a huge loss.

Principle #2: Invest with a Plan

Don’t Waste Time on Directional Indicators

When this book comes out, I may get a lot of flak for my opinion, but I recommend you take advantage of my 26-year study of directional indicators. I have tried stochastics, moving averages, relative strength indications, volume-weighted averages, candlestick analysis, Eliot Wave theory, Bollanger Bands, W formations, cup and handle formations, head and shoulder formations. There are many more directional indicators I left off the list that I have studied and tried.

I learned that my investment only paid off 50% of the time. So, ask yourself: How much of my money or what percentage of my capital do I want to place at risk when I know I will make money half of the time? However, knowing these percentages can be used to increase the probabilities of profit. I will get into the details on option probabilities in Chapter 9.

Remember only 11% of fund managers on Covestor were able to make a profit by picking the right direction and properly allocating capital. I would be willing to bet that the next year another 10% or so will be successful BUT it won’t be the same money managers!

Principle #3: Use Strategies to Reduce the Impact of Market Direction.

Pay Attention to Commissions

Let’s look at the role commissions play in your decision-making. I have focused my options trading on the most liquid costeffective equity underlying SPX. You can trade options on the SPY which are very liquid but only 1/10 the size of SPX or the E mini futures symbol /ES which are half the size of SPX.

SPX has the advantage of lower commissions because I can pay for commissions to trade 1 SPX contract and get the leverage of trading 10 SPY contracts. If I pay to trade 10 SPY contracts I would pay 10 times the commissions. For example, if I trade one contract of the SPY, I may pay $.65 per contract or I could pay the $.65 per contract for ten times or 10 SPY contracts using just one SPX contract. The /ES contracts are futures and are typically more in commissions per contract. The typical rate is around $1.20 per contract. The /ES is half the size of SPX. Here's how it breaks down if you are to use the same amount of buying power or money to place a trade.

SPY 10 x $.65 = $6.50

/ES 2x $1.20 = $2.40

SPX 1X $.65 = $.65

SPX is the clear winner when it comes to reducing commission costs. Commissions do play a key role when factoring in the cost to do business. Also be aware of exchange fees as they sometimes can be a factor when calculating the cost of doing business.

Principle # 4: Pay Attention to commissions

Pay Attention to Liquidity

Let's look at the role LIQUIDITY plays in your decision-making. Beware of LOW LIQUIDITY. If you have a position in a stock or equity option that doesn't have much volume, you could be trapped into paying an exorbitant amount of slippage. For example, if you buy a stock at $100 a share and it goes to $101 perhaps you decide to sell. The bid/ask spread (The spread is paid to market makers to provide liquidity) could be $99 bid, $101 ask. This means that if you want to get OUT of the position, you may have to sell as low as $99 and take a loss even though you thought there was a gain. Liquidity is extremely important.

Pay Attention to Your Trade Execution

Let’s see how Trade Execution plays in your decision-making.

Trade execution is one of the most important concepts in trading. When you trade stock, it’s always a good idea to place LIMIT ORDERS as opposed to MARKET ORDERS. If you want to buy a stock trading at $100 a share, you can place a LIMIT ORDER at $100 and the most you will pay is $100 per share. The downside of placing a limit order in this example occurs when the stock price moves higher than $100 preventing the order from being executed, and you may end up without any shares.

Use a MARKET ORDER when you want to buy the stock regardless of its price. A MARKET ORDER assures you that you will own the stock, but the disadvantage is that you may pay more than the current trading price when the order is filled. You may pay $100.50 depending on the liquidity of the stock. The $.50 loss is called SLIPPAGE.

With options, SLIPPAGE can be worse compared to SLIPPAGE when purchasing a stock because stocks are typically more liquid than options.

When it comes to trading options trade execution is one of the most important concepts to understand. Bad trade execution can cause losses on order entry and order exits.

Legging Into Positions

Trading options on futures have an advantage over trading options on equities. When you execute a trade with multiple legs with futures options you can place multiple legs all on ONE ticket order. You can add any quantity of legs you want (you may be limited depending on the platform) and they all go into a single order.

For example, leg one has four contracts, leg two has three contracts, and leg three has seven contracts while leg four has nine contracts. If this was an SPX order (Options on equity order), it would need to be broken down into separate legs (or parts) before the order could be executed.

With SPX, the order must be broken down into leg quantities divisible by two or three. Each individual leg must be dividable. The reason for this is because orders (Thinkorswim's broker rules) that are not dividable are typically routed to the trading pit where people do the trade rather than being traded electronically. The brokers I deal with on Thinkorswim («TOS»), Interactive Brokers, and Tradestation all require SPX orders to fit certain criteria so they can be executed electronically rather than by pit traders. In my opinion fills done electronically are preferred because they fill faster and with more efficiency.

If you have an odd lot of legs, SPX trades can be challenging. I have a trade I like with leg contract amounts that do NOT fit inside the SPX single ticket order spectrum. To execute that trade I have to break the order into two separate orders.

Executing a trade that requires two separate executions adds risk to the trade. If you want to put on a position that requires an odd lot of legs, such as leg one, two lots, leg two, four lots, leg three, nine lots, you must create two separate orders. You can put on leg one and leg two together then after those two legs are executed you can add leg three.

A common problem can occur after you put on leg one and leg two together at once because your delta (Directional risk) could be high, for example, +100. If you have a +100 delta trade on and you want to finish putting on your position you still need to execute leg three. For leg three you want to get the best price to avoid slippage so you let it sit to get a good fill. Then, suddenly, the SPX drops 15 points and you are down $1,500. If the market continues to go against you, you are forced to hurry to execute leg three to complete your position and get a bad fill that costs you another $40 in slippage. Now you are down $190 and your profit target, for example, is only $500. On the way out, a similar situation occurs and it costs you $100. After adding in commissions, your back-tested $500 profit is only $200. Now you think, «Was this trade worth the risk?» all because of trade execution. Note that a $500 profit target may be small but I find it best to do calculations at the smallest level then size can be scaled up based on planned capital allocation.

Your next problem is to find a way to break the order down to keep it delta-neutral (non-directional) between trade executions. So, you break the order into three separate orders which can cause even higher slippage. You can now see how order execution plays a KEY ROLE when YOU are trading real money versus backtesting.

I have personally opened trades and lost more than my profit target during the open. I had to hold the trade to where it would have hit its profit target, then close it for an actual loss.

Principle # 5: Understand Trade Execution

Single Ticket Orders

A single ticket order is putting on an entire position with one order rather than breaking the trade into multiple orders. If an SPX order is set up properly with even dividable lots of two or three you can execute multiple legs with a single order (these are Think or Swim order routing guidelines). For example, placing a 3 legged order with an 8 lot, 16 lot and 16 lot would get filled electronically because all legs in their lowest common denominator (1,2,2) are in a ratio of 1,2 or 3. An order with an 8 lot, 16 lot and 7 lot would be rejected and you would need to break the order into multiple separate orders because all the separate legs cannot be broken down into one, two or three lots. I recommend contacting your broker for their specific rules / guidelines on how they route your orders. Your goal should be to place single ticket orders whenever possible.

Single ticket orders eliminate the risk of legging into positions. Using this concept, you can place an order for better than the current market price and wait for the market to come to you to get filled.

In order to get the best price available I want to place a single ticket order. If my strategy is to sell premium on puts, with a single ticket I can just leave my order in until the underlying prices go lower (increasing the price of puts) or volatility rises (increasing the price of puts). If and when my order is filled after sitting for a while I know that I received the best price that I could have at that moment.

Think of it this way. If you want to buy a used car from a private owner who is asking $10,000 and you offer $9,000 and he takes the deal right away, you may be tempted to think that you could have bought it for less. However, if he waits a week to accept your offer, you figure he didn’t get any better offers and the market, in essence, came to you and you got the best price.

Single order tickets have a serious advantage over legging in when you EXIT a position. With a multi-leg order position, you need to track the point where you hit your profit target. Only then, do you take the trade off. This moment of opportunity may only occur for a short period of time. If you miss it, it may take days before it happens again.

If you are fortunate enough to catch the right time to exit the multi-leg order, you will close a portion of the trade, but keep the second part of the trade to be closed as a working order until you get the fill price you want. If you don't keep your deltas flat (or neutral) during this process, the second leg order may need to be filled as soon as possible, just in case the market moves against you. When you are rushed to execute an order you usually get a bad fill which means YOU lose money on slippage.

When you execute single ticket orders, you can determine what price the position needs to fill at in order to hit your profit target. You can place the order as soon as you enter the position. Just let the order sit with a Good Until Cancel type order. Even if the profit target is hit for just an instance, you don't even need to be present for the trade execution. I have seen my orders get filled, then watch the market go right back to what would have been a non-profitable price. There are those times when moments of liquidity come into the market for a flash to fill your order.

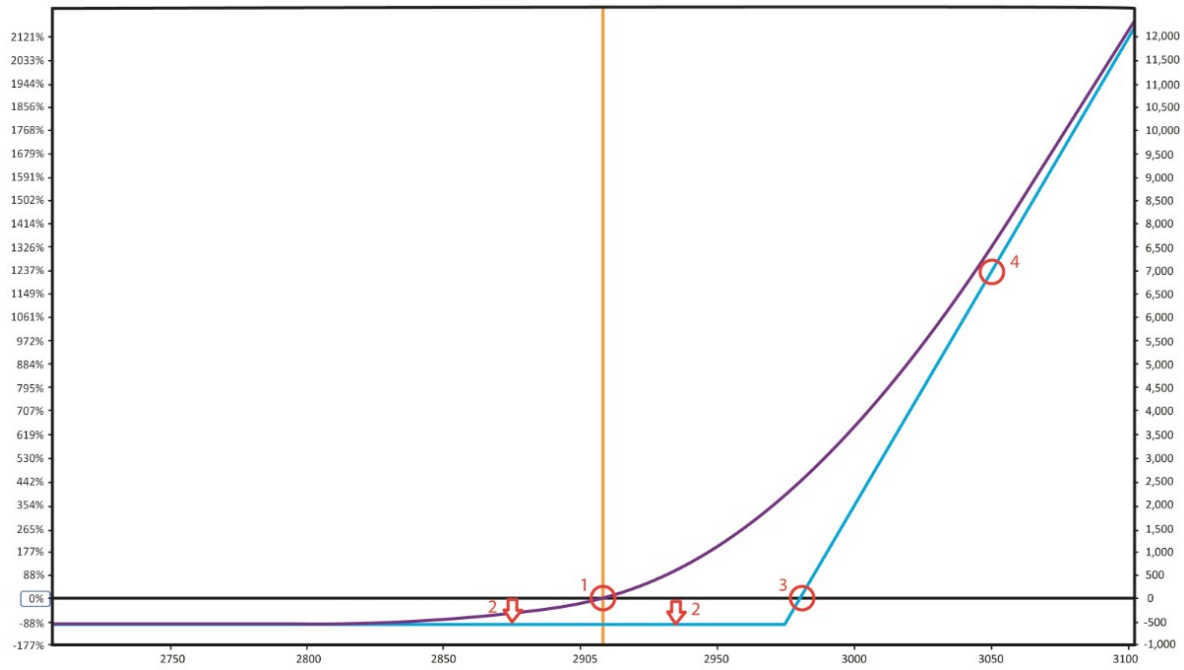
Most of my orders fill when I am NOT in front of my computer. For example, I have gone to lunch and had my orders fill while I was eating. When you can, a good practice is to use single ticket orders. Your goal should be to manage your portfolio using single ticket orders. This will dramatically help with order execution and reduce directional risk and slippage. It is possible to manage an options portfolio without the single ticket order, but I think it's so important that I have included it as a principle.

The E-Mini (/ES) has a single ticket order advantage over SPX. If you trade the E-Mini (/ES) you can execute a single ticket order electronically regardless of lot size. There is no need to plan out the trade to make sure it is dividable by two or three. The order can be odd lots like a 5 lot and a 7 lot for example and still get filled electronically.

Principle # 6: Use Single Ticket Orders Whenever Possible.

CHAPTER 9
SHOULD YOU BUY OR SELL OPTION PREMIUM?

Probabilities



Graph 11

Graph 11 shows the purchase of one call out of the money. The #1 red circle represents T+0 at the time of the purchase. Please notice this is a long position but has yet to show any profits or losses because it was just opened.

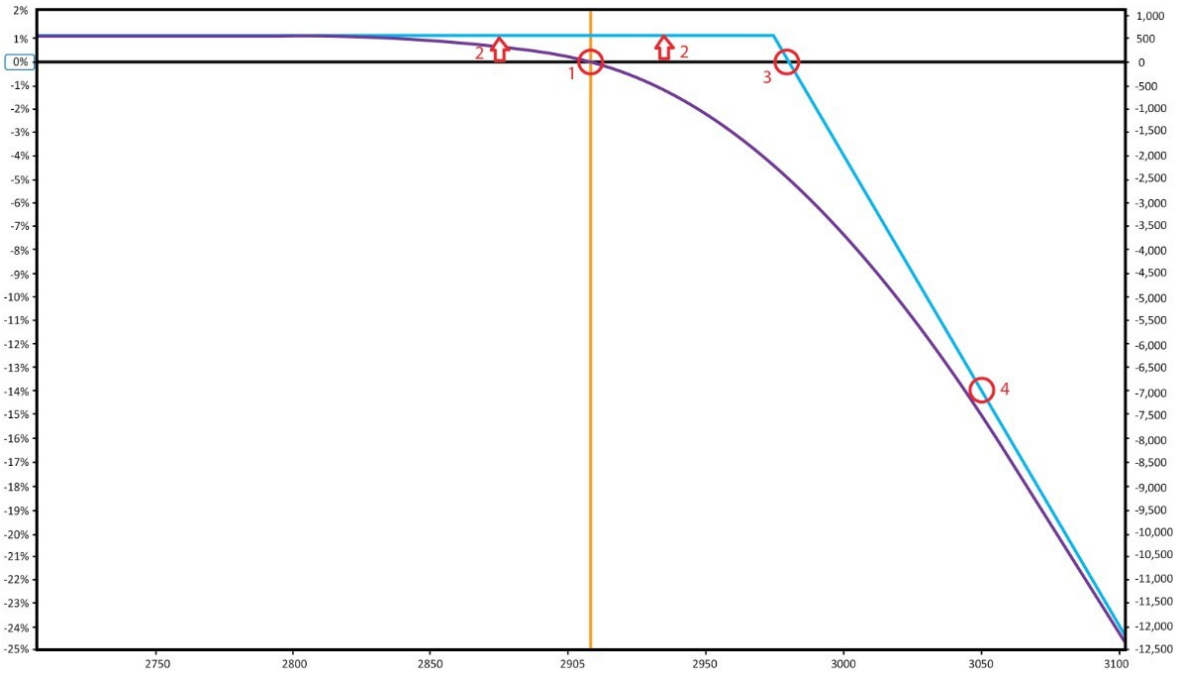
The #2 red arrows represent the P&L IF the price does not exceed approximately 2970 as we move into the future when the option expires. Please notice this will result is a loss of approximately -$565.

The #3 red circle represents the level the underlying price would need to be ($2,980), for the P&L to break even at the time the option expires in the future.

There are many factors that could cause the underlying to move lower or move higher, but no one can predict its direction or how quickly it will get there. The probability it will move lower is 50% and the probability it will move higher is also 50%.

There is a limited amount of time for this position to break even or to make money. The time is limited to WHEN the option expires. In this case, it will expire on May 17, 2019. Looking at Graph 11, you know that you need the price of the underlying to reach the #3 red circle or move higher than $2980 before May 17, 2019. It has a 50% chance of going higher so the odds of the underlying moving all the way up to $2980 are less than 50%. This means that the probability of this option position making money at expiration is lower than 50% which makes it a LOW PROBABILITY TRADE. When you buy premium and spend more money than you bring in or place a debit trade, you are placing a lower than 50% probability bet.

However, placing a LOW PROBABILITY TRADE comes with its perks. It comes with the leverage of asymmetric upside potential. If the underlying goes to $3050 (Circle #4), you could make $7,000 on $565 of maximum risk. That’s a 1,239% return on your money.



Graph 12

Graph 12 represents the sale of one call in the money. The #1 red circle represents T+0 at the time of purchase. Notice this is a short position but has yet to show any profits or losses because it was just opened.

The #2 red arrows represent the P&L IF the price does not exceed approximately 2970 as we move into the future when the option expires. Notice this will be a gain of approximately $565. The #3 red circle represents the level the underlying price would need to be ($2980) for the P&L to break even at the time the option expires in the future.

There are many factors that could cause the underlying to move lower or move higher, but no one can predict its direction or how quickly it will get there. The probability it will move lower is 50% and the probability it will move higher is also 50%.

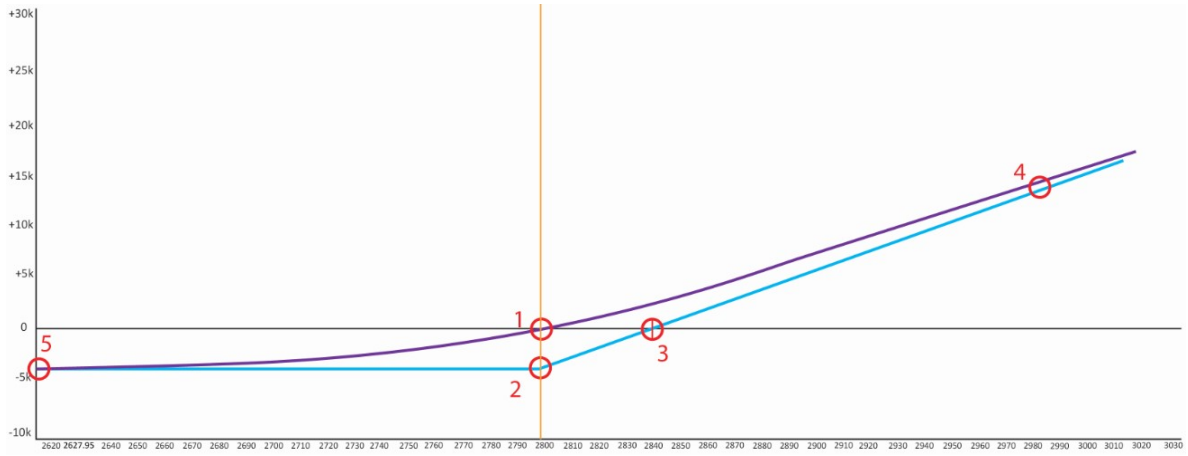
There is a limited amount of time for this position to lose money. The time is limited to WHEN the option expires. In this case, it will expire on May 17, 2019. Looking at Graph 12, you know that you do not want the price of the underlying to reach the #3 red circle or move higher than $2980 before May 17, 2019. It has a 50% chance of going lower so the odds of the

underlying moving all the way up to $2980 are less than 50%. This means that the probability of this option position making money at expiration is higher than 50% which makes it a HIGH PROBABILITY TRADE. When you sell premium and bring in more money than you spend or place a trade for a credit, you are placing a higher than 50% probability bet.

However, placing a HIGH PROBABILITY TRADE comes with a downside. It comes with the leverage of asymmetric downside potential. If the underlying goes to $3050 (Circle #4), you could lose $7,000 trying to make the small amount of only $565.

When trading options, I have found that most successful options traders place higher probability trades. These trade types come with a caveat which is that you must understand and manage the downside risk.

Keep Time On Your Side



Graph 13

Graph 13 shows the purchase of one call close to the money. The #1 red circle represents T+0 at the time of the purchase. Please notice this is a long position but has yet to show any profits or losses because it was just opened.

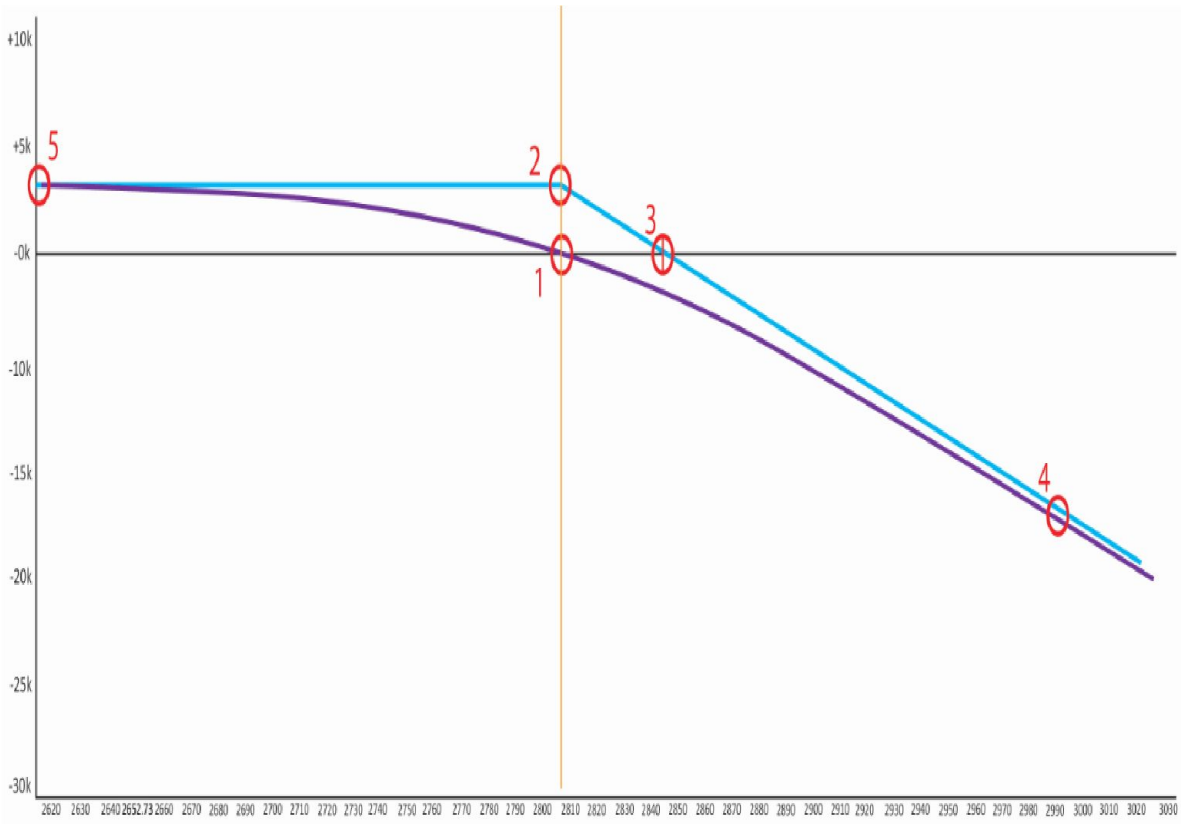
The #2 red circle represents the P&L IF the price does not change as we move into the future when the option expires. Please notice this will result in a loss of approximately -$4,000.

The #3 red circle represents the level the underlying price would need to be ($2,830), for the P&L to break even at the time the option expires in the future.

There are many factors that could cause the underlying to move lower or move higher, but no one can predict its direction or how quickly it will get there. The probability it will move lower is 50% and the probability it will move higher is also 50%.

There is a limited amount of time for this position to break even or to make money. The time is limited to WHEN the option expires. In this case, it will expire on April 6, 2019. Looking at Graph 13, you know that you need the price of the underlying to reach the #3 red circle or move higher than $2830 before April 6, 2019. It has a 50% chance of going higher so the odds of the underlying reaching $2830 are less than 50%. This means that the more time that passes the more the position can turn against you. In this position, time is NOT on your side. Another term for this concept is Negative Theta. When you buy premium and spend more money than you bring in or place a debit trade, time is running against you.

However, opening a Negative Theta position can come with perks. It comes with the leverage of asymmetric upside profit potential. If the underlying goes to $2980 (Circle #4), you could make $15,000 on $4000 of maximum risk. That’s a 375% return on your money.



Graph 14

Graph 14 represents the sale of one call close to the money. The #1 red circle represents T+0 at the time of purchase. Notice this is a short position but has yet to show any profits or losses because it was just opened.

The #2 red circle represents the P&L IF the price does not change as we move into the future when the option expires. Notice this will be a gain of approximately $4,000. The #3 red circle represents the level the underlying price would need to be ($2830) for the P&L to break even at the time the option expires in the future.

For this position to break even or make money, time is in your favor. The more time that passes without moving up, the more potential there is to make money until you reach the cap. This position has Positive Theta. The time is limited to when the option expires on April 6, 2019. You need the price of the underlying to stay below the #3 red circle or below $2830. Remember, when we placed the trade, we had a 50-50 chance of the underlying moving higher or lower than the original trade price of $2797.

The odds that the underlying will reach $2830 and cause a loss are less than 50%. This means you know that the more time that goes by without a move to $2830 the better the position will perform. When you sell premium, you bring in more money than you spend. If you place a trade for a credit, you are placing a Positive Theta trade. Placing a Positive Theta trade comes with its downsides.

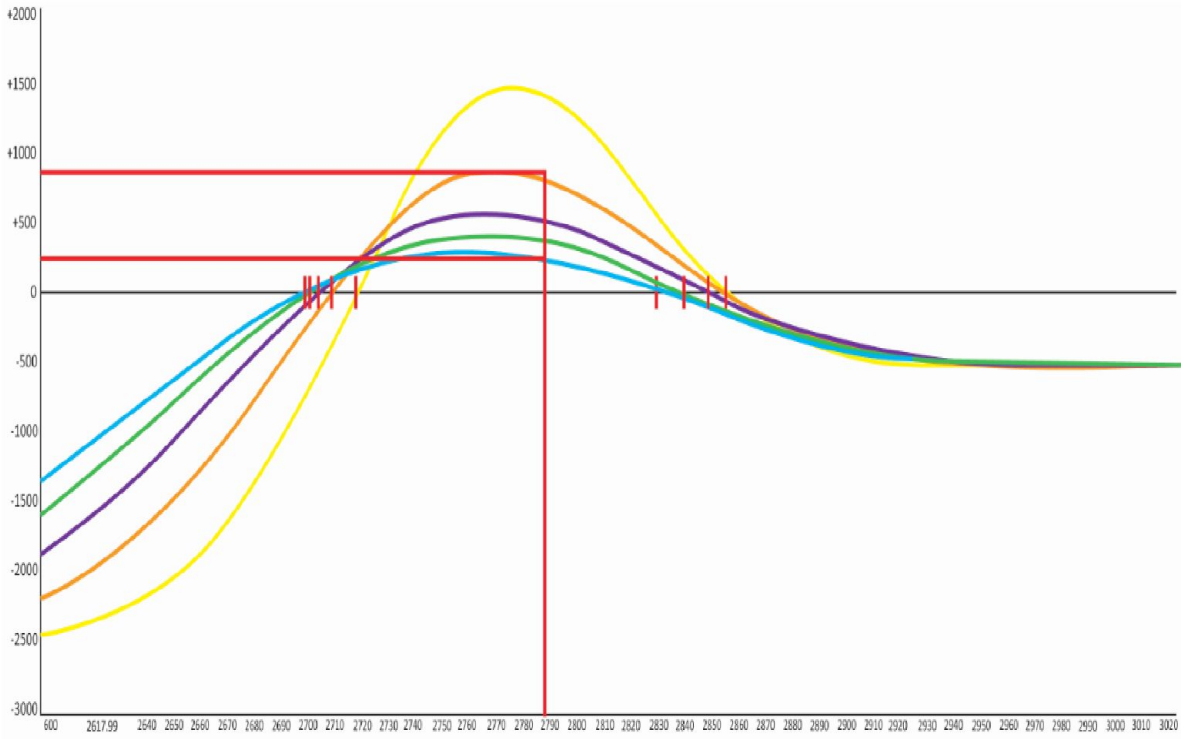
Time is on your side when your position has Positive Theta, but the risk in this example comes with the leverage of asymmetric downside potential. For example, if the underlying goes to $2980 (the #4 red circle), you could lose $15,000 on the trade with a maximum potential payout of only $4,000. You carry unlimited risk trying to capture that $4,000 in profit. The maximum profit is represented by the #5 red circle.

When trading options, I have found that most successful options traders place Positive Theta trades. These trade types come with a caveat which is that you must understand and manage the downside risk.

How to keep time on your side

Positive Theta can work IN YOUR FAVOR by using the best premium selling options strategies. All options have one thing in common: they always expire. Knowing that options can be sold and will eventually be worth nothing or only their intrinsic value, you can sell them and as time passes, buy them back for a profit. PREMIUM SELLING is a term that means you sell more option premiums than you buy.

For example, I can SELL one call for $5.00 and BUY two calls for $1.50 each. I purchased more options than I sold, but I sold more premium than I bought. That is, I sold -$5.00 and bought two times $1.50 equals $3.00 for a total of $2.00 (Credit) in premium. This means I added $2.00 in premium to my account. Now, to make a profit, I buy back the one option I sold and sell the two options I bought for less than $2.00 (Debit).



Graph 15

Graph 15 shows what happens over time. Look at the price of approximately $2784 (the perpendicular line). It shows that if the price does not change, the position makes more P&L as time passes. For example, the T+0 blue line shows a profit today of approximately $250. If the price does not move for three weeks to March 21, 2019 (the orange line), the P&L will be approximately $900.

This combination of bought options and sold options have more sold options premium than the bought options premium. Holding this position for the next three weeks would generate an additional $700 if the price remains the same.

Notice that with this exact combination of options, the risk is that the underlying will move too low or too high within a specific time period. That time frame is specified by each individual line in the graph.

The Options Traders Edge

The price of an option is based on supply and demand. The more volatile the underlying is expected to be by the market, the more the options cost. IMPLIED VOLATILITY is a best guess from the market of how volatile an underlying will be in the future. Implied volatility is a forward-looking metric and correlates to the price of the underlying's options.

I like to think of implied volatility as UNKNOWN volatility. Remember the volatility has a direct relationship to the price of an option. The higher the volatility of an underlying the higher the price of the options related to that underlying. When the future price movement or volatility of an underlying is unknown it carries unknown possible risk. For example, the market could be slowly rising today and out of nowhere crash tomorrow. Because implied volatility is pricing in the unknown, the options have a higher premium or cost. The higher premium is relative to what the premium should have been if it were based on the actual real volatility.

The actual real volatility or REALIZED VOLATILITY tracks the movement of the underlying from the past. It is an accurate look into the past of the actual volatility of an underlying. I like to think of realized volatility as KNOWN volatility. This metric does not have to take into account any potential unknown surprises such as a market crash. Because realized volatility is known it does not have the added premium of the unknown like implied volatility.

Studies have shown that implied volatility is higher than realized volatility 83% of the time. This means that the price of the options is HIGHER than what they should be 83% of the time.

Graph 16

Graph 16 shows the implied volatility (Blue line) versus the realized volatility (Red line) for the SPX in the year 2016. Notice the implied volatility is consistently (but not always) higher in value than the realized volatility. This is a graphical view of the gap between two potential prices for the same options based on volatility. The implied volatility represents the real market price of the options (higher prices) versus the realized volatility (lower prices) which if the volatility was known then the value of the options would have been lower (This is not always the case, but holds true approximately 83% of the time).

For example, if you bought a call based on the expected move of an underlying, let's say $2.00 up or down, then you would pay a certain premium or price for that option. You expect a $2.00 move which would create a profit if you pick the right direction. But when the actual move is only $1.00 you may not profit even if you pick the right direction. The underlying didn't move enough for your option to make a profit. The potential $2.00 move had a price for the option based on the implied volatility and the actual $1.00 move is what the price should have been in hindsight based the realized volatility.

Options are overpriced on average because they can explode in value when unpredictable volatility or price movement occurs in the underlying. This risk can become exponential. For example, when the market crashed on August 24, 2015, the price of puts exploded much higher than expected and that low chance of explosive value needs to be priced into the option. The extra cost for the premium gives credibility to the idea that selling premium is better than buying premium. In fact, this is known as the premium seller's edge! Properly applying the principles in this book are the key to extracting this excess premium.

Principle # 7: Sell Premium and Keep Probabilities, Time and Overpriced Implied Volatility Edge on Your Side

When you SELL a Credit Spread (This means when you sell an option of higher value and buy one of lower value in the same expiration), you can

move the odds in your favor. For example, if you have a stock trading at $100 and you sell a put credit spread, it could look like this:

- 1 100 strike put $2.00 credit

+1 98 strike put $1.00 debit

This structure creates a $1.00 credit and now, you are long. You have created a break-even at $99.00. If the market drops below $98.00, you could lose $1.00. If it stays at $100.00 or higher, you can make $1.00. Remember, if you buy a stock at $100.00 you have a 50-50 chance of making money. After purchasing the stock if it goes to $99.00 you would lose $1.00. The spread is better than 50-50 because even if the stock goes to $99.00 your options position doesn't lose. The probabilities are in your favor.

If you use the tastytrade method, you must consider the expected move of the underlying stock. For example, the expected move could be $4.00 before the options structure you set up is going to expire. This means that the stock is scheduled to move $4.00 up or $4.00 down. Now, you must decide WHEN to take your profits. If you take them early at 50% (for example, if you had a chance to make $1.00 total, but you decide to close out and take profits when you get $.50), you have a higher probability than if you decided to wait until the profits reach the full $1.00.

The problem with selling credit spreads lies in the THETA component. Both options will decay together. For example, the $2.00 option in say 30 days, could be worth $1.25 (That is great; sell something for $2.00 and buy it back for $1.25) but the $1.00 option has also decayed for example from $1.00 to $.50 (this is not so great; buying something for $1.00 then seeing it fall to $.50). When the further out of the money you purchased also decays it significantly slows down how fast the position can profit.

In order to create a trade that hits profit much faster the tastytrade methodology sometimes looks to eliminate the long option in the credit spread and just sell an option without the purchase of another. If you sell an option without purchasing any options, it is called selling naked. Here's how it works:

In the example, selling the $2.00 option, but NOT buying the $1.00 option has two results:

- The advantage is that if you hit your profit target you do so much faster.
- It greatly increases the amount of margin required to make the trade. This causes lower returns because it takes more capital to make the same nominal amount, so your return on capital decreases.
- It can create asymmetric risk in the form of volatility, specifically VOMMA. This is the hidden problem that never seems to be addressed when the gurus talk about their option premium selling systems.

Asymmetric risk occurs when the position losses due to margin requirement expansion. When margin expands or goes higher, you will need more money to cover any potential loses. If you are margin called and you don't have the extra funds, you will be forced to close your position. If you are forced to close at the wrong time, you will take a loss.

The standard tastytrade method to combat asymmetric risk is to trade small and diversify. However, when the market crashes, all equity stocks fall in correlation. A crash market will make a mockery of diversification using stocks. If you are not careful you could be left with a group of correlated naked short puts that explode in value.

Another factor also seldom considered in the studies, is how you can sell a 1SD (Standard Deviation or 16 Delta) strangle to show a profit when its position size is never increased over the life of the study.

For example, one study shows the result of selling a one lot 1SD from 2005 to 2018. If you started with $10,000 trading one lots and worked your way up to $20,000 in capital, would you continue to trade one lot? No, because at some point you would want to scale up.

What if you decided to scale up from one lot to two lots and the next day the market crashes? Now you have two times the risk and twice the loss.

Options carry exponential risk (uncertainty of a large move) or asymmetric risk to naked premium sellers.

Please notice, I said NAKED premium sellers! A naked premium seller creates almost unlimited risk either from the upside or the downside. There are ways to prevent a position from being naked, such as using spreads or purchasing or shorting the underlying, but I recommend that you never create a leveraged position with almost unlimited risk such as selling naked options. The risk is UNACCEPTABLE no matter how small your position is.

Most premium sellers who sell naked don't realize the risk they are taking. They are frequently surprised when they get crushed and blow up their accounts.

Principle # 8: Never Sell Naked Options

Now that you understand option probabilities and overpriced option premium, you are on your way to understanding the edge in options trading. I would not want to buy something that is overpriced so the trick is capturing the overpriced premium. There are a few models that attempted to capture this edge but they can be too risky. The Modern Options Portfolio can be used to properly capture overpriced options premium.

Margin and margin expansion

Some key variables to track are not only the P&L but the margin requirements or margin expansion. Most option traders use Reg T margin (Regular Margin) which usually calculates margin or how much money you need to keep in your account to open the trade based on the lowest P&L point of the expiration line. When you sell naked, they use different calculations. I don't sell naked options so I don't really pay attention to those calculations.

To apply the principles in this book, you must have either portfolio margin or SPAN margin. These types of margin provide more leverage for your

portfolio. You may be able to follow these principles and be profitable using Reg T Margin but I have not found a decent way to do it.

At the time of this writing, to obtain portfolio margin using the Thinkorswim platform, you must have a minimum capital of 125,000 and their permission. You get their permission by passing a portfolio margin test. With Interactive Brokers, the minimum requirement at the time of this writing is to have a minimum of $100,000 in your account.

SPAN margin is used when trading options on futures. The advantage of using SPAN margin (like portfolio margin) is that it has a much lower capital requirement versus regular margin. However, commissions on futures options are higher when compared to options on equities. The above-mentioned brokers are not the only choices available. There are many other brokers and they all have their own margin requirements. You may find a broker that has lower capital requirements than $100,000 to get portfolio margin.

To calculate Portfolio margin and or SPAN margin when back-testing, I like to use a rule of thumb.

Track your P&L of the T+0 -12% down, P&L of the T+0 -20% down divided by two and P&L of the T + 0 +10% up from the underlying's price. This is a good area to check to see how much money needs to be in your account. I would also add a buffer to this number.

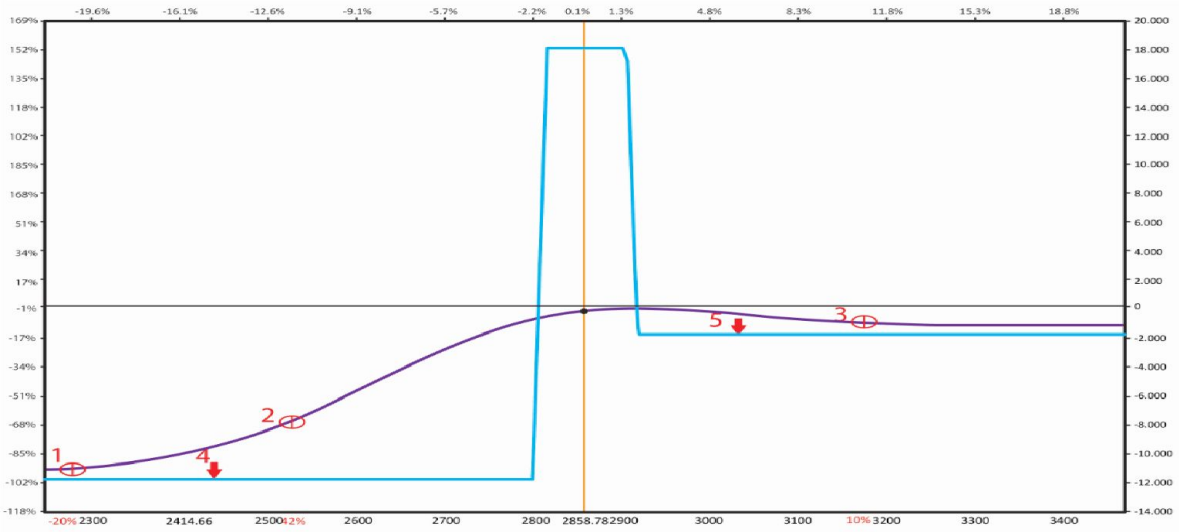
You should always be monitoring the P&L T+0 -12% down, P&L of the T+0 -20% down divided by two and P&L T + 0 +10% up during your back-tests. When running a back-test on a new system and you see a large P&L drawdown (this may be the largest drawdown this system showed during entire backtest) it is common to also see the largest margin requirement during this time frame in the back-test.

For example, if you see a large P&L drawdown and you check your P&L down 12%, P&L of the -20% down divided by 2 and up 10% you notice your 12% down slice is the lowest P & L at -$120,000. Now you know you need at least $120,000 in capital to make this trade. If you only have $110,000 in your account when your requirement is $120,000 you will get

margin called and possibly be forced to close your position at the worst time with the largest loss. In fact, you should always add a buffer amount of money to prevent margin calls.

I keep my worst case scenario margin requirement under 65% of the account's value. For example, if your back-tests show the maximum margin requirement to be $130,000 I would keep $200,000 in planned capital. I strongly recommend taking no chances of losing capital due to margin expansion.

Just because you take your trading system and back-test it through every possible historical scenario and you know the worst case margin expansion ever calculated in all of history does not mean margin expansion will not create a new high in the future. Nobody can predict the future, and the way to compensate for that is to be conservative and keep worse case back-tested margin expansion to 65% of planned capital.



Graph 17: Portfolio Margin

The above risk graph of an unbalanced condor gives a visual picture of the different margin calculations. Using regular margin, the lowest point of the expiration line is used (Arrow 4). Arrow 5 points to the upper expiration line, this line would not be used to calculate regular margin in this example because it has a higher value (Approximately $1,900) vs the lower

expiration line (Arrow4) at approximately $11,500. In this example, a typical regular margin requirement would be $11,500.

To calculate the approximate Portfolio margin OR SPAN margin, three previously mentioned variables come into play.

The variables are the -20% slice at the T+0 (Circle # 1), the -12% slice at the T+0 (Circle # 2) and the +10% slice at the T+0 (Circle # 3). The -20% slice (Circle # 1) has an added calculation of dividing by two. The margin requirement will be based on the lowest of the three variables.

The -20% slice (Circle # 1) is calculated as follows: Approximate P&L value of -$11,000, / 2 = -$5,500. The -12 % Slice (Circle # 2) has an approximate P&L value of -$7,800. The +10 % Slice (Circle # 3) has an approximate P&L value of -$1,000.

The approximate Portfolio margin or SPAN margin for this position is currently the lowest number of the three calculations or $7,800. In order to put this position on, you would need at least $7,800, in the account. If you had regular margin, you would need approximately $11,500 in the account. You can see that Portfolio and SPAN margin allow the account more leverage.

The rule of thumb guidelines used in the example are the actual portfolio margin rules used by Think or Swim. Keep in mind, each broker has their own specific margin requirements so these examples are given as a rule of thumb. You must ALWAYS check with your own broker for their specific margin requirements.

In order to effectively apply the principles outlined in this book, it is imperative to use the available leverage portfolio margin OR span margin provides.

Margin is used to formulate proper position sizing. I know this because of the mistakes I have made in the past. In 2008, the brokerage Thinkorswim did NOT have a true understanding of risk when it came to the VIX (Volatility Index). The VIX has the ability for the front month to be higher in price than the back month. At the time I applied a rule used for equity options that did not apply to the VIX. The rule was that options that expire

closer in time will always be worth LESS than options that expire further out in time.

When applying this universal rule, creating a long calendar spread position is done for a debit and the risk is never more than the debit paid. The pricing of the VIX is based on the futures contract. The closer expiring options in a future can become worth more than the further-dated options because of backwardation. Backwardation occurs when the near-term prices are HIGHER than the far term prices. This occurs during market crashes, such as the one in September 2008. At that time, I was able to buy a calendar spread in the VIX with a large size because the margin requirement was treated the same as the margin requirement for a regular equity options contract.

When I put on the calendar trade for a credit, I thought I had found a foolproof way to make money because I thought that the front month I sold was going to fall in price on its way to expire and the back month I purchased was going to hold its value. So, I sized up.

I still remember that day in 2008 when President Bush was supposed to sign off on the TARP program. When he failed to do that, the market went into a tailspin. The VIX spiked to almost 90! This caused the option I sold in the front month to explode in value while the option I bought went higher, but not nearly as much as the front month. I was margin called. I had to liquidate, and I lost tens of thousands in one day. After that, the brokers increased the margin requirements on the VIX and I had learned my lesson.

Due to the fact that I don’t want to have any surprises when it comes to drawdowns, especially in an options portfolio where leverage is involved, I personally pay close attention to actual worst-case drawdowns. Then I can properly size my positions in my portfolio.

This may the most important point made in this book. In order to prevent a margin call, you must size the positions in the portfolio properly. In order to size the positions properly, it is imperative to understand what the MAXIMUM potential drawdowns are. To find maximum drawdowns

within a potential trade it must be back-tested through normal markets over time and worst-case market type scenarios.

Remember drawdowns need to be looked at the +10% slice, -12% slice and -20% slice divided by 2.

Principle #9: Obtain portfolio margin or use SPAN margin for better leverage.

Principle # 10: Use back-tested worst-case drawdowns found at the recommended slices to properly size your positions in your options portfolio.

Principle #11: Keep maximum margin requirements/max possible margin expansion to a maximum of 65% of the account value.

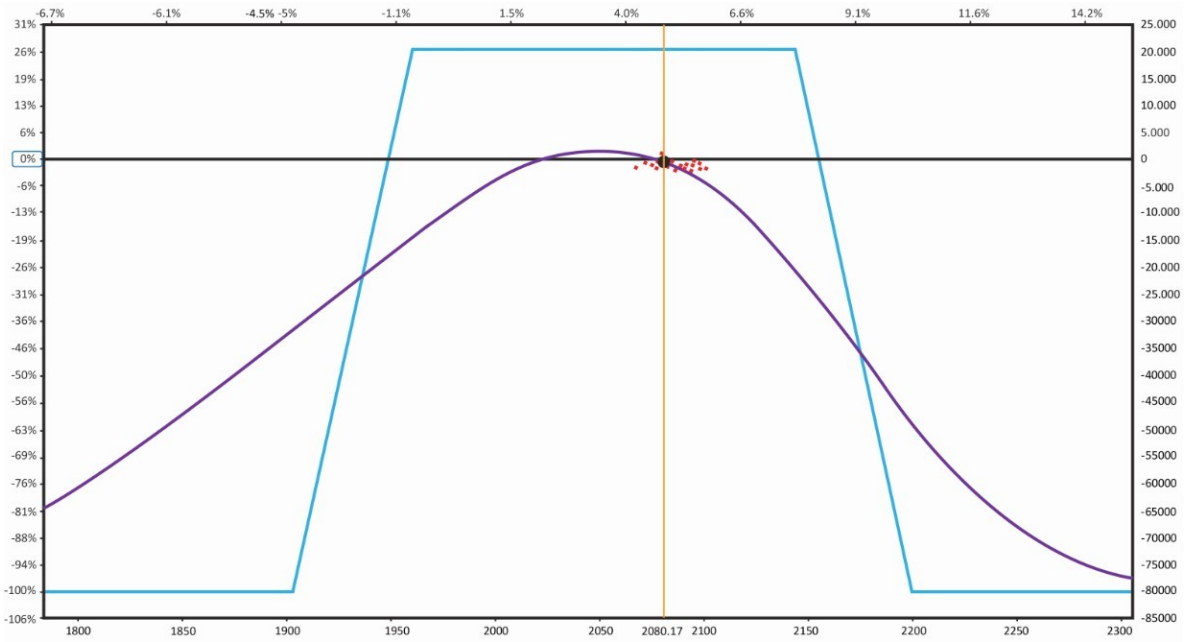
CHAPTER 10
HOW TO USE OPTIONS TO CONTROL RISK AND REDUCE NEGATIVE P&L VOLATILITY

When investors hear the word OPTIONS, they think «risk». They worry that options will only add more risk to their portfolios. In this chapter, I'm going to show you how you can use options to not only mitigate risk but how you can actually increase profits.

There is an important type of risk I would like to expand upon. It is LEVERAGED RISK or EXPONENTIAL RISK. I touched on this subject in Chapter Eight. This type of risk can cause problems even in portfolios that don't include naked options. There are times like August 24, 2015, and February 5, 2018, when investors saw their P&L swing down significantly, got margin called, and saw a large percentage of their portfolio wiped out.

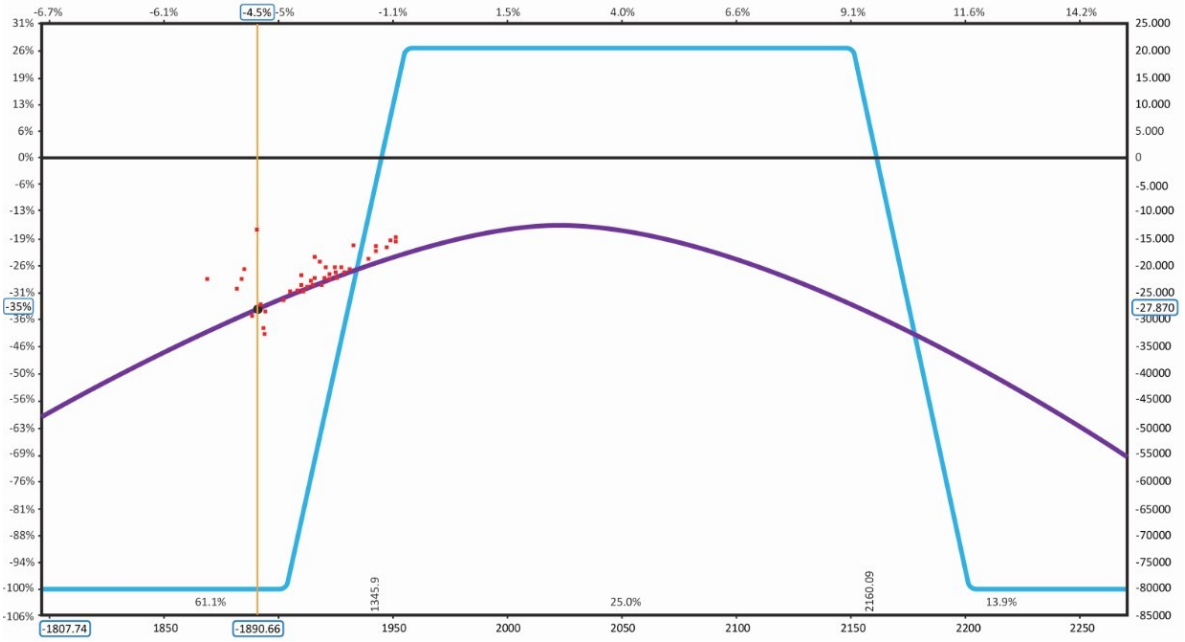
EXPONENTIAL RISK for premium sellers usually occurs when the underlying goes lower rather than higher. When the market or the SPX goes down, it causes fear and then option buyers start buying puts. In addition, when the SPX goes down, it tends to have larger down days compared to slower up moving days. The larger down moves cause the SPX to be more volatile or increase in volatility. (Of course, there are exceptions to the rule and the SPX direction, and the volatility are NOT always inversely correlated.)

An increase in volatility causes risk for premium sellers with open positions because it puts them in the situation where they have sold an asset that is increasing in value. Option traders sell premium in order to maintain positive THETA which is an increase in P&L as the option decays over time. Positive THETA normally comes with negative VEGA which is a decrease in P&L when options prices rise due to increased volatility. An increase in volatility coincides with a crash market and causes option prices to rise. Crash markets are a challenge for most option premium sellers.



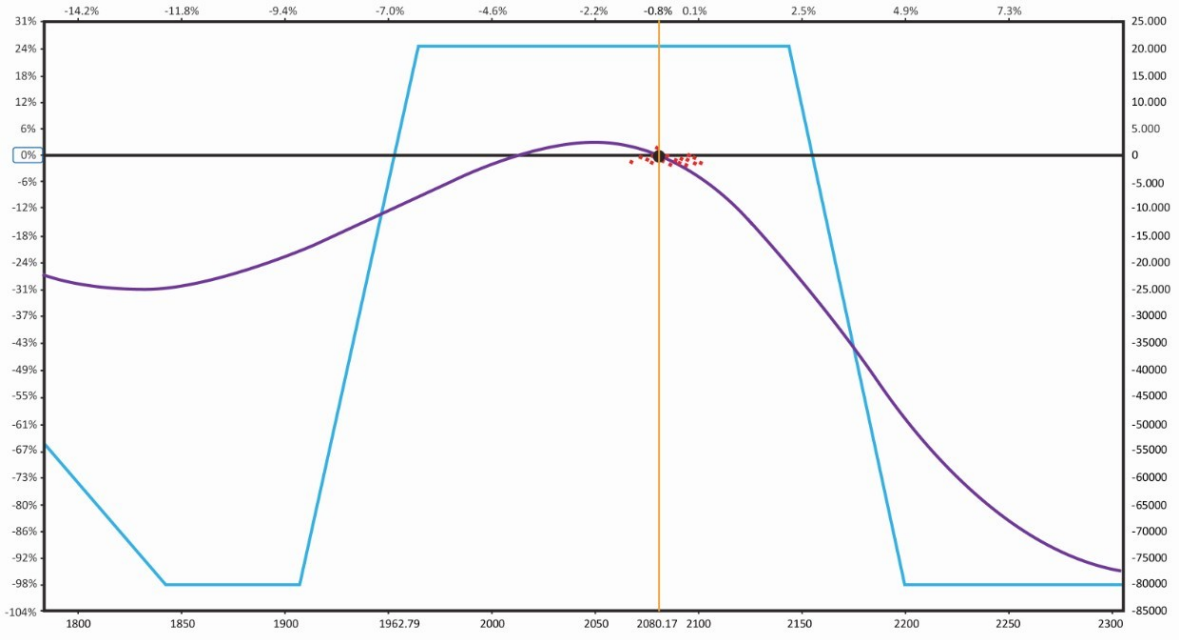
Graph 18

Graph 18 shows a popular option selling strategy call an IRON CONDOR. This trade was placed a few days BEFORE the August 24, 2015 market crash.



Graph 19

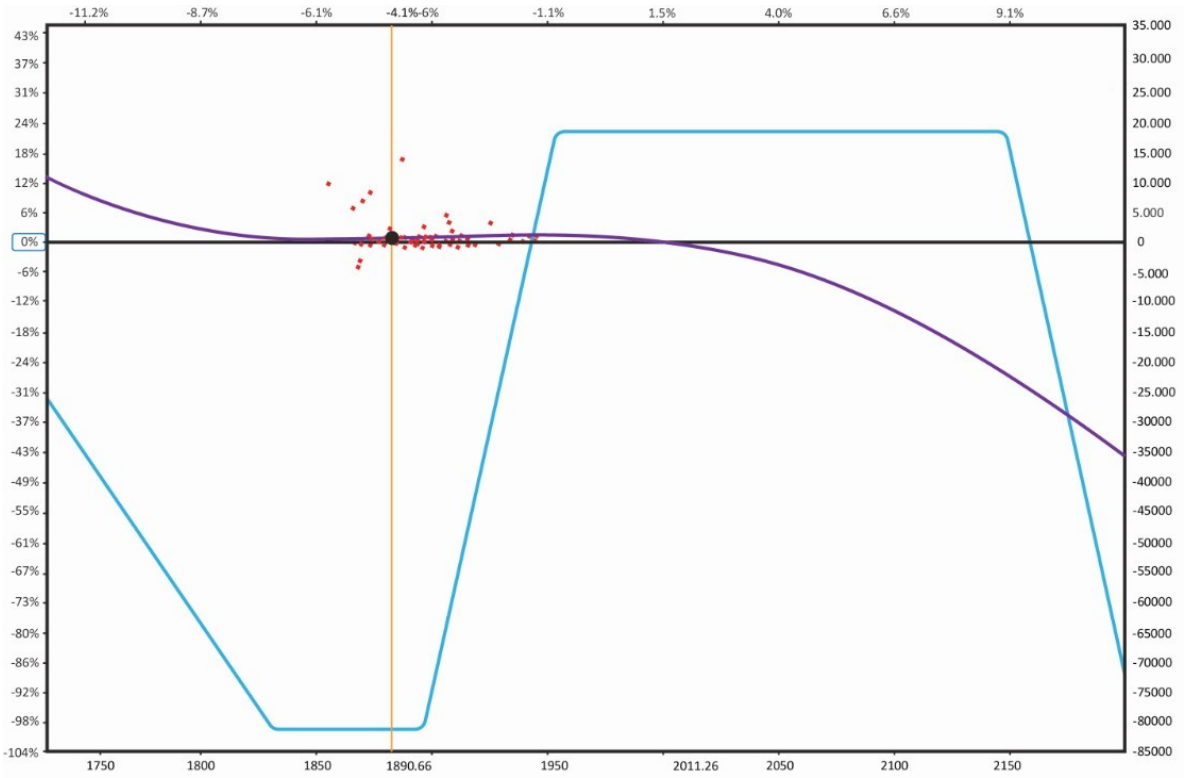
Graph 19 shows the iron condor's position DURING the crash on August 24, 2015. You can see the actual T+0 in red drop down causing the P&L to drop, regardless of the underlying price. The drop is due to holding a position with positive THETA/NEGATIVE VEGA. This position carried a lot of exponential risk partly due to the negative VOMMA. VOMMA is the rate at which the VEGA changes.



Graph 20

Graph 20 shows what happens when I bring in some TEENIES[2] to add positive VEGA and positive VOMMA. The teenies were added to the IRON CONDOR and the position was placed a few days BEFORE the August 24, 2015 market crash.

Graph 20 is the same iron condor position with 20 contracts for each leg, EXCEPT that I added five long puts at the five Delta range (significantly out-of-the-money). You can see the T+0 in light blue. The red shows that in a down move beyond the tent structure, this position will lose money.



Graph 21

Graph 21 shows us what happens when VOMMA kicks in.

Graph 21 shows the market crash of August 24, 2015, when the market went down from around 2080 to 1890. You can see the T+0 line rise as the volatility rises. These five TEENIES created a positive VOMMA and lifted the T+0 line as the market crashed down. The position was protected (or hedged) from VEGA or volatility exposure. Remember volatility exposure can cause exponential losses. However, when you apply the proper hedge, you can turn the tables on exponential risk and in some cases reap the exponential profit.

Savvy option sellers know how to protect themselves from EXPONENTIALRISK by purchasing TEENIES. It is challenging to balance your hedge costs so they don’t become a drag on your portfolio as you wait for a crash that rarely happens. I like hedges, but I don’t like how seldom they actually pay off. It’s like buying fire insurance for your home and never collecting because the fire never happens. It’s money down the drain.

I prefer to purchase hedges that get used for more than one time every two or three years. They may have a higher up-front cost but they can provide value in terms of protecting your portfolio. I use hedges for both crash markets and grind-down markets[3].

In a grind down market, the VOMMA does not really kick in for the TEENIES and you can get caught in a no-man's land where your position is losing money because the market is down, but not enough for your hedge to help. This means your overall strategy needs to take the grind-down market into account. The grind down market along with the other three types of markets will be discussed in the next chapter.

CHAPTER 11
OPTION PREMIUM SELLING
MARKET TYPES

Money managers use different strategies depending on the market environment. Most options traders also consider the market type as they deploy certain strategies or sizing. For example, one of tastytrades mainstays is to execute option selling premium strategies when implied volatility is HIGHER than normal. They search underlyings with higher than normal Implied Volatility («IV») and place trades in those stocks. IV plays a major role when it comes to trading options.

For option premium sellers the market (or trading) environment can be broken down into four categories:

1. The Rising Bull when the market rises and there is relatively low volatility.
2. The Sideways Market when the market goes sideways and there is relatively low volatility with the occasional tamed volatility spike.
3. The Grind-Down Market when there is a falling bear market with tamed volatility.
4. The Crash when there is a fast bear market with a significant spike in volatility.

The difference between a grind down and a crash market can be subjective. Here is my opinion: A tamed spike in volatility is when the VIX increases by less than 30-35 points during the downturn. A crash market requires a significant spike in volatility that can be defined as the VIX rising 35 points or more over a three-to-five-day period.

For the entire year of 2017, there was a Rising Bull Market. The market (SPX or S&P 500 stock market) rose over 19% while the highest VIX

reading was under 17.5.

A Sideways Market occurred in the first six months of 2015 when the market stayed within a 4% range up or down and the VIX high was slightly above 23.

A Grind-Down Market occurred from October 1, 2018, through December 31, 2018, when the market was down 14.5% with a maximum VIX spike of approximately 25 points.

A Crash Market occurred in August 2015 when the market dropped 13.13% in four days and the VIX went from 15 to over 53, a 38-point spike.

Another Crash Market occurred in early February 2018 when the market fell over 10.5% in seven days and the VIX went from 12.5 to over 50 in four days.

Now that the different market types have been defined, let's look at how some different funds performed in these markets. Let's look at some top-performing hedge funds, the S&P 500, and the Modern Options Portfolio to compare their performance in each market environment.

The following study compares the performance of these different fund types. It compares:

1. **The S&P 500**
2. **The Modern Options Portfolio**
3. **Bill Ackman's Pershing Square**
4. **The Top 2015 Hedge Fund**
5. **The Top 2016 Hedge Fund**
6. **The Top 2017 Hedge Fund**
7. **The Top 2018 Hedge Fund**
8. **The HFRX EH Fundamental Value Hedge Fund Index.**

I chose the S&P 500 index because it is the most well-known benchmark.

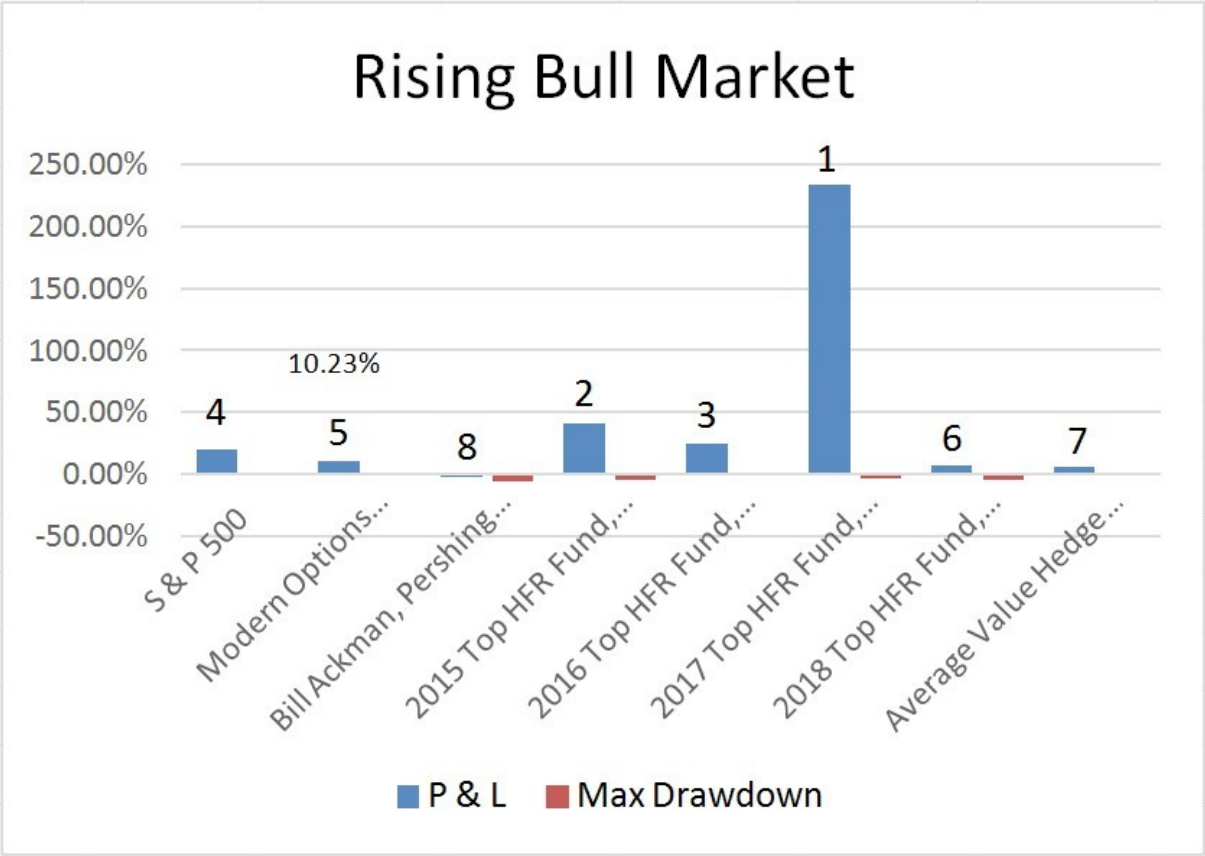
The Modern Options Portfolio is a trading system originally developed by Ron Bertino. It was later upgraded through his Master Mind Group. I took that system and combined it with my past experience of trading and creating systems. I have applied many tweaks and I now manage it based on the principles laid out in this book. The Modern Options Portfolio results have been back-tested from 2015 through July 2018. Since August 2018, I have been trading with real money.

I chose Bill Ackman’s Pershing Square for two reasons. First, he is a high-profile hedge fund manager and second, he is one of the very few managers who provide public performance records. I applaud him for doing what so many others will not. My guess is that other well-known hedge fund managers don’t share their performance records because it would damage their reputations.

Hedge fund managers make it difficult to obtain their performance records. However, I was able to access a database that contains thousands of hedge funds. I chose The Top Ranked Equity Hedge Funds in North America with Assets Under Management («AUM») greater than 25 million dollars.

To see a good representation of the average hedge funds performance, I chose HFRX EH Fundamental Value Hedge Fund Index which shows an average hedge fund performance in the Fundamental Value category of a particular database of hedge funds.

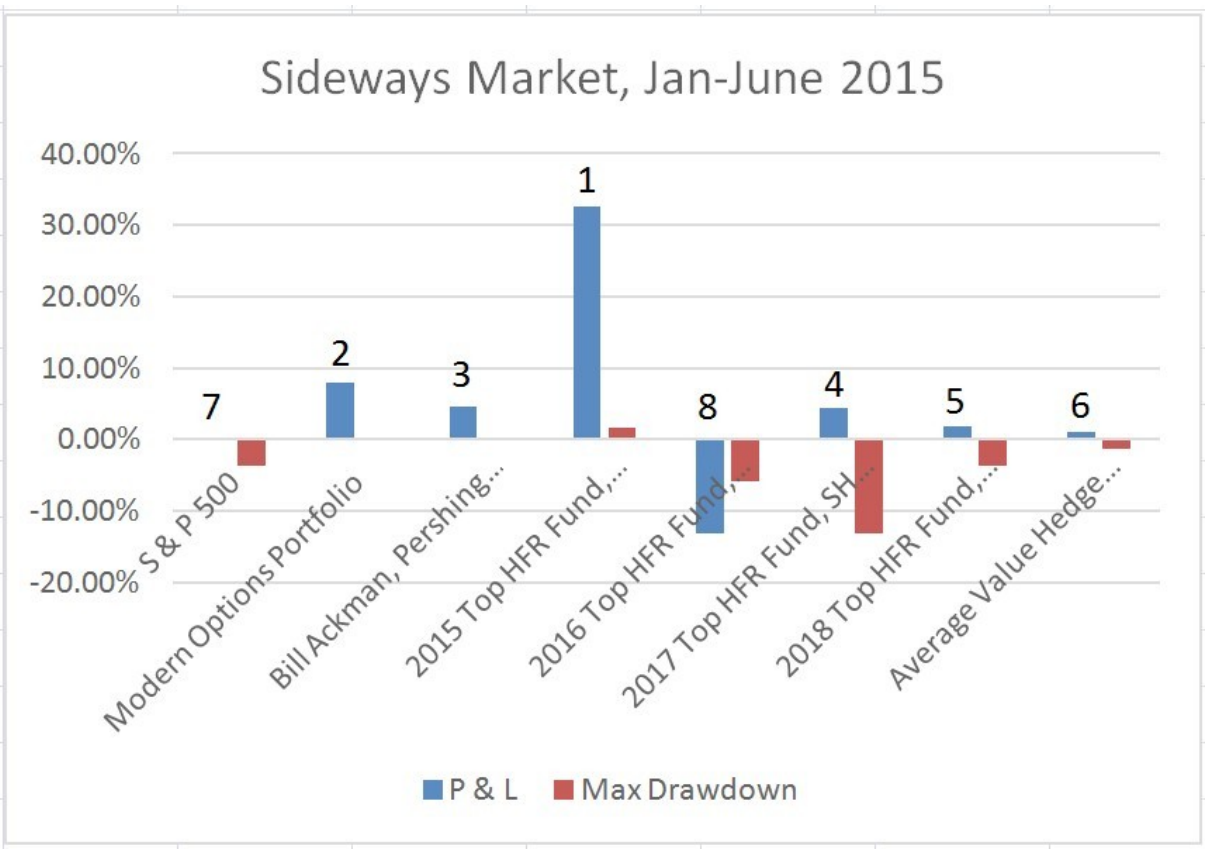
I compared all eight of these funds in eight different scenarios. A comparison was made in all four different market types and then in the following four years, 2015, 2016, 2017, and 2018.



Graph 22

Graph 22 shows the Rising Bull Market which occurred in 2017. The market (SPX or S&P 500 stock index) rose over 19%. The highest VIX spike was under 17.5. Notice that the 2017 top hedge fund had a stellar year over 233%. However, this fund vastly underperformed in the Grind-Down and Crash markets. In 2015, this fund was down over 47%. In 2018, it was down 62%.

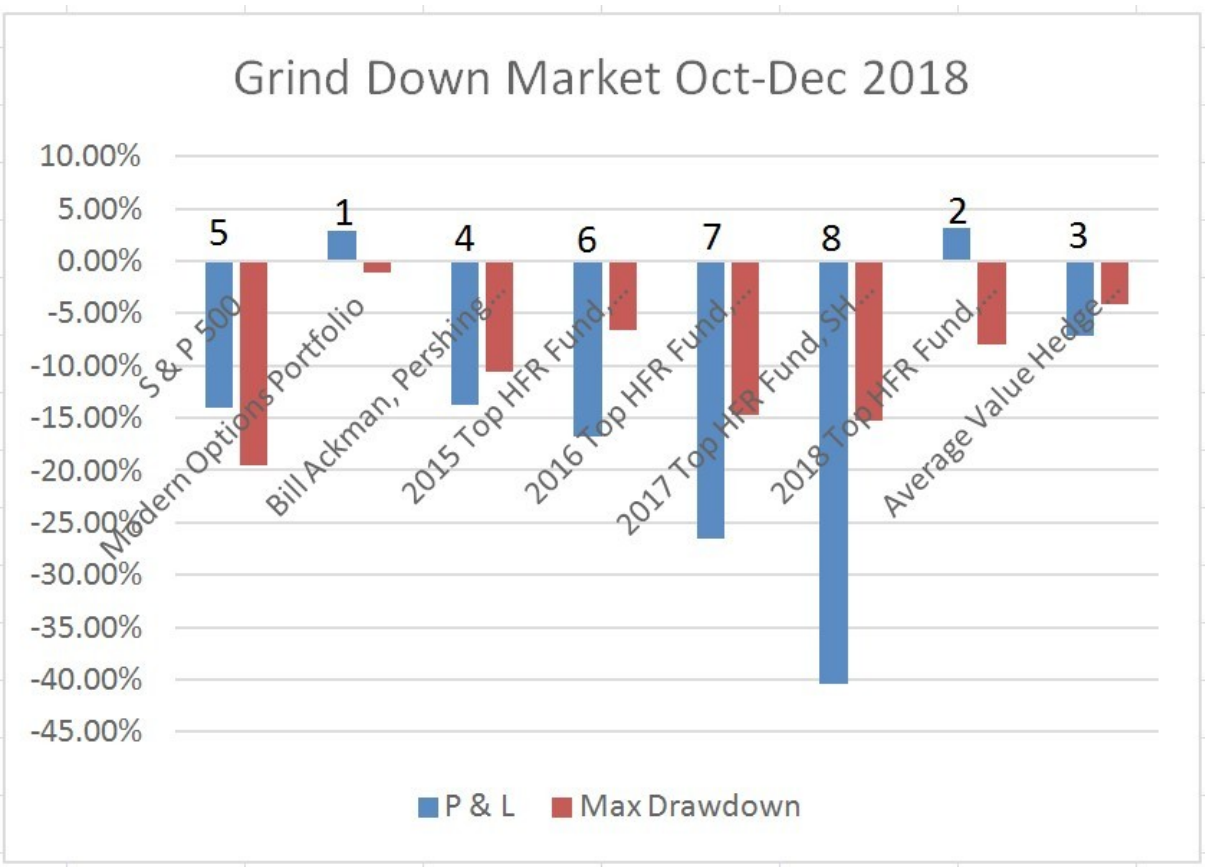
The Rising Bull Market is where the Modern Options Portfolio had its lowest comparative rank of all other market types. It was ranked number five, but it still had a 10.23% return without ANY drawdown months! Not bad!



Graph 23

Graph 23 shows a Sideways Market. It occurred during the first six months of 2015 when the market stayed within a 4% range up or down and the VIX high was slightly above 23. The top 2015 hedge fund out-performed in the first six months of 2015, but it struggled in the Grind-Down and Crash Markets. Overall it performed well in 2015 through 2018. However, it did have some high negative volatility of -8% and -11% monthly drawdowns.

The Modern Options Portfolio placed a respectable second place in this market type with an 8.02% return. Its largest monthly drawdown was only -04%.

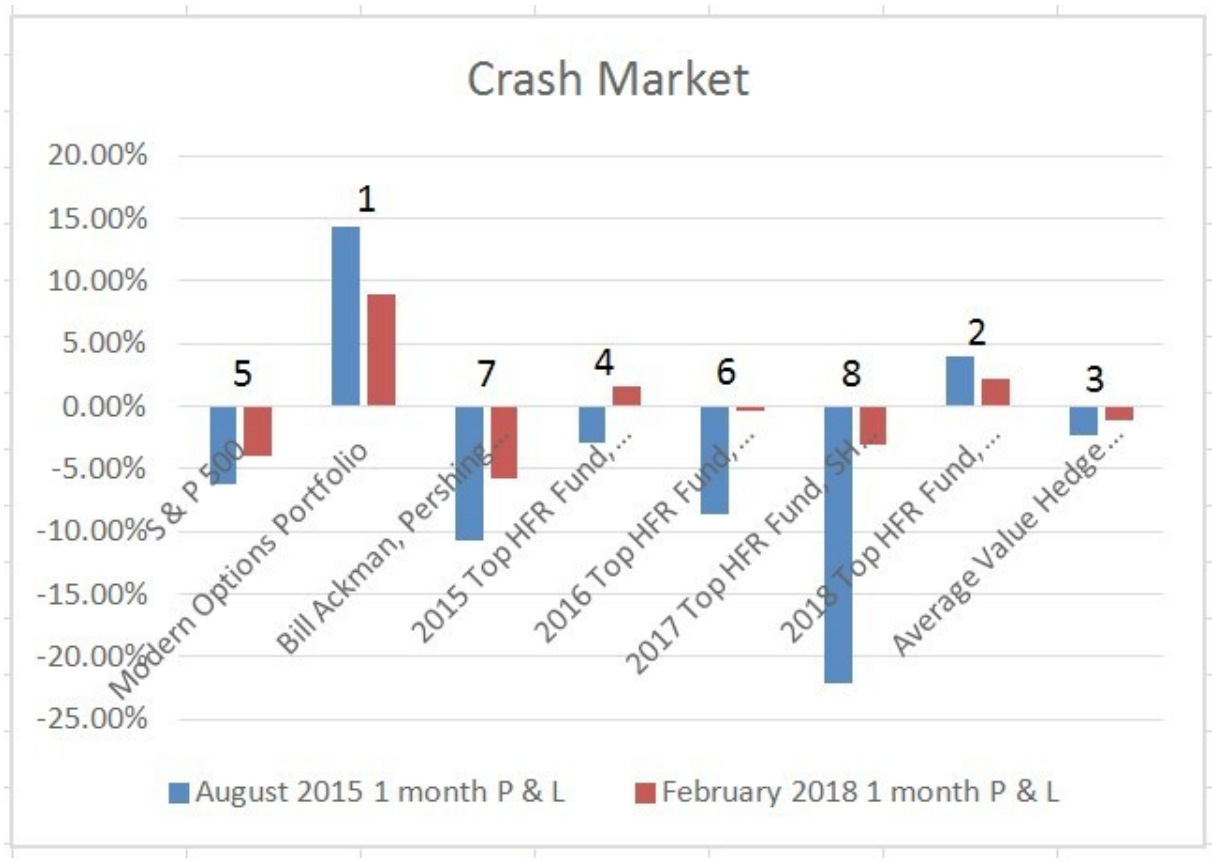


Graph 24

Graph 24 shows a Grind-Down Market that occurred from October 1, 2018, to December 31, 2018. The market was down 14.5% with a maximum VIX spike of approximately 25 points. Since the VIX spike was not high enough, this period was not a Crash Market.

The top 2018 Hedge Fund ranked number two here even though its returns were 3.11% and its drawdowns were -7.97%. The Modern Options Portfolio had returns of 2.90% and drawdowns of only -1.1%

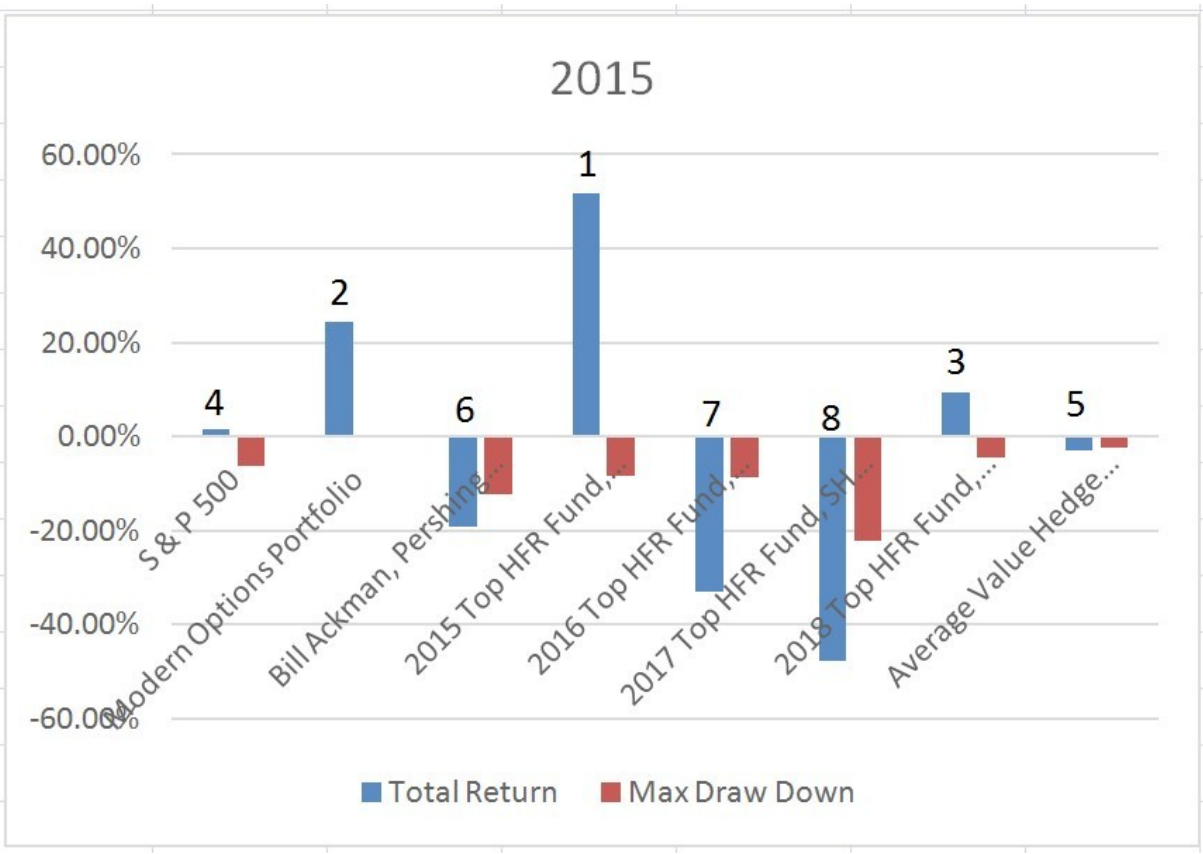
The Grind Down Market is the most difficult market for the Modern Options Portfolio, but even in that tough market period, it outperformed all the other funds. This market type had the highest monthly drawdown period for the Modern Options Portfolio versus any other monthly period ranging from 2015 to 2018. The worst monthly drawdown period for the Modern Options Portfolio was only -1.1%. As Paul Tudor Jones, a top fund manager says, «Defense is ten times more important than offense.»



Graph 25

Graph 25 shows the results of two separate Crash Markets. In February 2018, the market fell over 10.5% in seven days. The VIX went from 12.5 to over 50 in four days. In August 2015, the market dropped 13.13% in four days. The VIX went from 15 to over 53 for a 38-point spread. The time frame compares August 2015 and February 2018. Note, there were no drawdowns comparisons because of the short time periods.

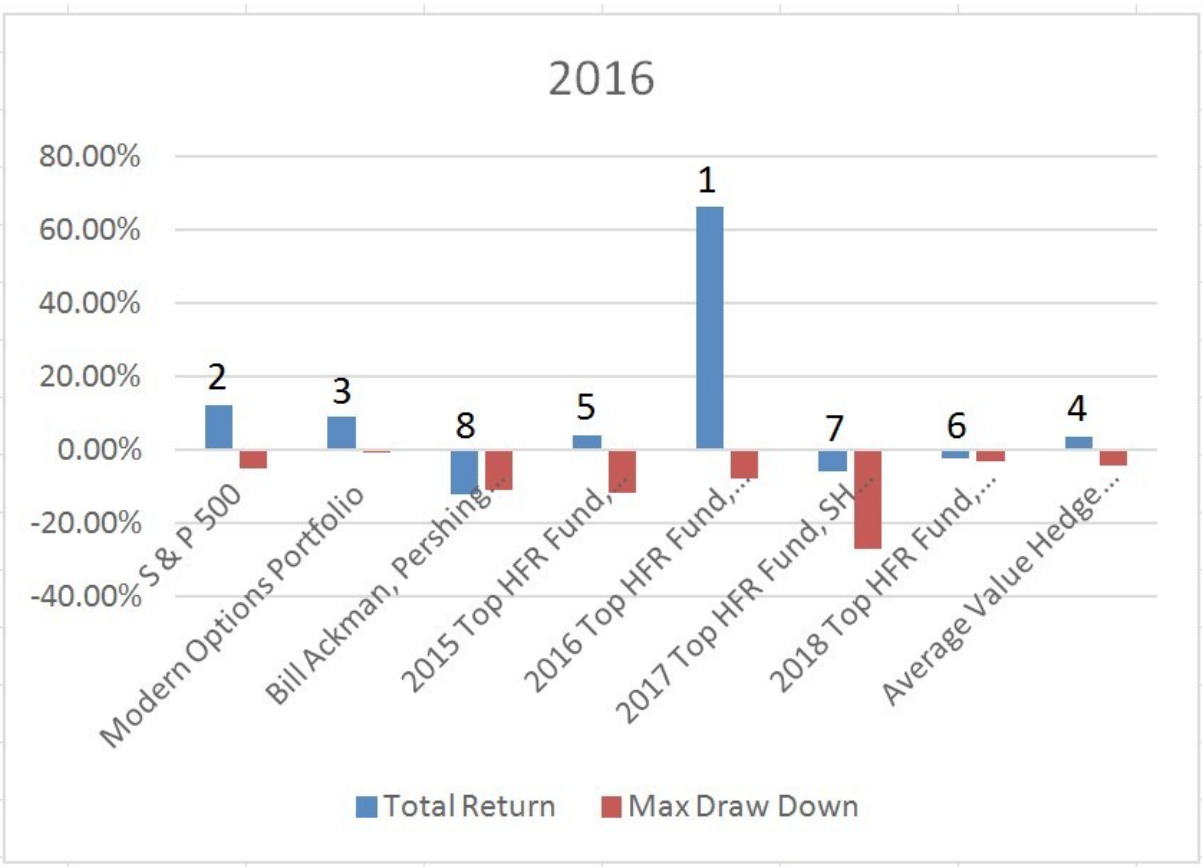
The Modern Options Portfolio strongly out-performs in this market type because it uses options to control risk and create exponential returns even during extreme volatility. This principle was explained in Chapter 10.



Graph 26

Graph 26 shows the year 2015 when there were two of the four market conditions. For the first six months of 2015, there was a Sideways Market. In August 2015, there was a Crash Market. The top 2015 hedge fund out-performed as expected. However, this is the same fund that struggled in the Grind-Down Market and the Crash Market. This fund performed well in 2015 through 2018. However, it had some high negative volatility and -8% and -11 monthly drawdowns.

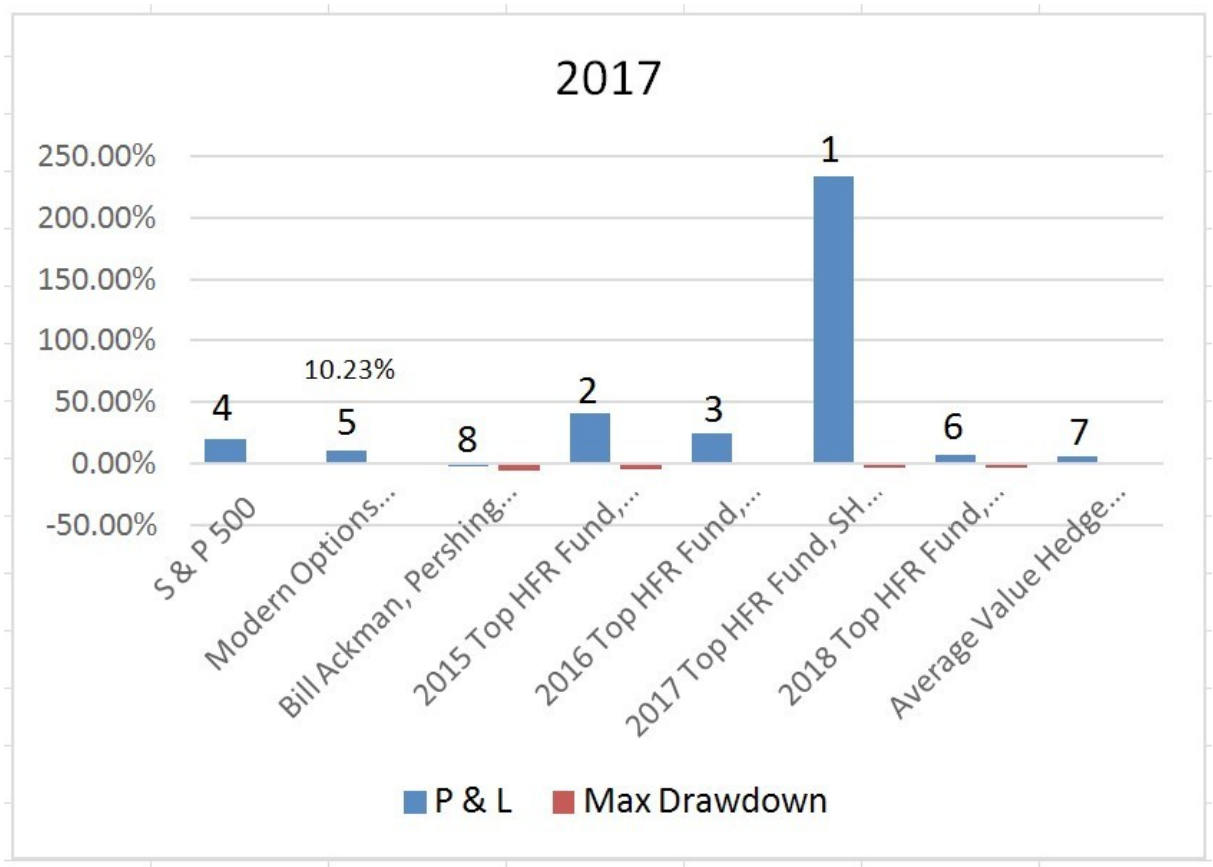
The Modern Options Portfolio placed a respectable second in 2015 with a 24.5% return. Its largest drawdown was only -0.4%.



Graph 27

In 2016, the S&P 500 rose over 9%. Its largest monthly drawdown was just over -5%. The top performer was the 2016 top hedge fund, but remember in 2015, its performance was -33.13% and in 2018, its performance was -13.03%.

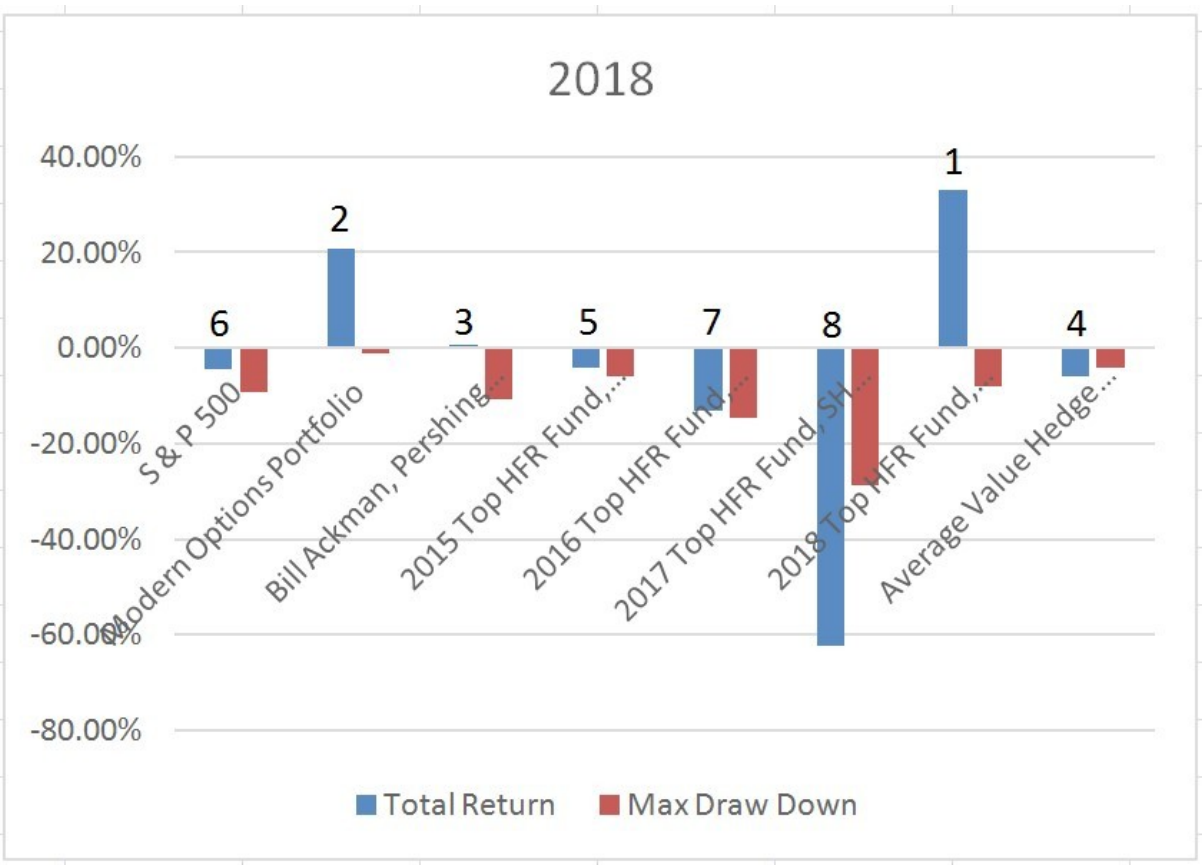
The Modern Options Portfolio comes in at third place with a 9.10% return while maintaining the LOWEST drawdowns of any fund.



Graph 28

The Rising Bull Market in 2017 has already been discussed.

Please review Graph 22 comments.



Graph 29

2018 was one of the minority years where the S&P 500 ended down. The pattern remains, that the top hedge fund of the particular year had the best performance. The top hedge fund in 2018, was up +32.91%. The hedge fund also has decent performance in 2015 +9.2%, 2016 -2.3%, and 2017 +6.85%. It does well in the Grind-Down and Crash Markets, it also survives the Rising Bull and Sideways markets. I would rank this fund second overall behind the Modern Options Portfolio. The Modern Options Portfolio comes in a respectable second place in 2018 with a +20.70% return.

In terms of an overall assessment, the Modern Options Portfolio out-performs all other funds for several reasons. First, it is the ONLY fund with zero losses in all market types from 2015 to 2018. Second, it has a no-loss track record and comes in second or third in six of the possible eight test periods. Third -and most important- it takes the number one

spot in the lowest amount of drawdowns in all eight test periods! Warren Buffet, well known as one of the greatest investors in history, has two top rules of investing. Rule # 1 don’t lose money! Rule #2 refer to rule #1.

CHAPTER 12
HOW TO CREATE YOUR TRADING SYSTEM

To manage an options portfolio, there are basic principles you must understand to be successful. You must be able to see first hand, the actions and reactions multiple options play in your total position. You must track the effects on the P&L from the first order Greeks (Delta, Theta, Vega, and rho) and the second order Greeks (Gamma, Vanna, Vomma, Color, Charm, and DvegaDtime)

The best way to see these effects is to put a position on in the past and run it through a simulation that back-tests it. As a premium seller, it's a good idea to take your potential trade through ALL the different market types BEFORE you spend time back-testing it through long periods of time. This approach will reveal its weaknesses more quickly and show you whether to tweak on it or scrap it altogether. Your GOAL is to determine if the trade has a positive expectancy and then properly size the positions for your portfolio. Once you have calculated the proper size you can then calculate potential portfolio returns.

Return on Margin / Planned Capital

When you use portfolio / SPAN margin, you can put on a position with a certain amount of required capital, but as the market changes, the amount of capital required to hold that position can increase. You must back-test your strategies through all types of market scenarios so you can find the time that it reaches its peak margin requirement. The peak requirement is the worstcase scenario to plan for.

For example, when you open a position, your margin requirement may be $5,000. If there is a crash, the margin may expand to $20,000. If you have back-tested all the scenarios and found the WORST-CASE MARGIN

REQUIREMENT to be $20,000 then you can plan for this contingency. If the position calls for more margin than the amount in your account, you could be forced to liquidate (sell) the position and take a loss.

There are many scenarios where the margin expands and the position P&L goes down significantly. However, if you can stay in, the position may come back and you will make a profit. But if you are forced to sell the position when it has a loss, you will suffer a loss and you will also have missed out on potential gains.

Some traders use the term RETURN ON MARGIN. This means if you make $10,000 in profit and used $50,000 in margin, the return on margin is 20%. However, it is more realistic to calculate in terms of return on planned capital. If your margin requirement could reach $50,000 and you decide to keep $100,000 in the account as planned capital and the profit is $10,000 then your real return is 10%.

Back Testing / Forward Testing

There are many methods used to trade options. One method looks for an “always on type trade”. This means that when one trade hits its profit target you would immediately place a new trade. Another type of trade is only opened when certain market environments exist, this trade is not always on. Some traders use multiple strategies but only apply one or two at a time, depending on market conditions. There are strategies that require adjustments when the market changes. There are slap-on-slapoff trades that don’t require any adjustments other than closing out one position and adding another. The principles explained in this book can be applied to any of the above premium-selling strategies.

I have reviewed and used many back-testing programs. Some put each position in manually and then run a program script like Python or R Language. I have found that scripted back-testing software can churn out results in an hour that would take days to do with manual input software. However, the scripted ones tend NOT to be as dynamic which means it is much harder to add in different sets of rules. Two popular manual back-

testing software products for options are OptionNet Explorer and OptionVue.

Before you can find an option strategy that you like that will actually perform, you must run numerous back-tests over multiple market types and through history. The next step is «FORWARD TESTING» which means trading with real money. I recommend you do forward testing with a minimal amount of money. Forward testing allows you to be able to account for slippage. You may find yourself trading options with hardly any volume which can be a major source of slippage. I have had good results with back tests, only to discover that my forward tests show slippage and commissions make the strategy no longer feasible.

Using Portfolio and or SPAN margin can create higher than normal leverage, it is important to have a very good understanding of how this leverage can work for you or against you. Using this leverage can be extremely risky. Be sure to have a solid understanding of portfolio and or SPAN margin before trading real money using the principles outlined in this book.

Principle # 12: Properly back test and forward test potential strategies

CONCLUSION

In this book, we have looked at how income is produced. I have highlighted the fact that investing is the KEY to achieving passive income. We have looked at Mutual Funds, Stocks and Options.

Mutual Funds are not a good investment vehicle because they have high fees and under-perform the market. Stocks rely on guessing the market direction which is a 50-50 proposition. The best vehicle I have found is Stock Options because you can make money without high fees and you can make money regardless of whether the market goes up or down.

However, to trade options EFFECTIVELY, you need to understand the tools and how to use them in your analysis. Ideally, you would also have access to other knowledgeable traders through a master mind group.

You must understand RISK. For example, selling premium keeps the odds in your favor, but creates more risk. Knowing how to measure risk and controlling it are of key importance.

You also must understand what constitutes GOOD PERFORMANCE and how to measure it. An options portfolio must be treated differently than a stock portfolio when it comes to risk measurement. It is critical to understand the worst-case scenario, not just the average bad case.

In Chapter 10, we turned the table on the exponential risk that most options premium selling positions carry. We looked at how to mitigate exponential risk, and how to change from a disadvantage into an advantage. Our goal is to have a profitable portfolio even in a Market Crash!

When you put an options portfolio together using the principles outlined in this book it is important to back-test the positions through all four specific market types. The goal is to have a portfolio that can withstand and profit in all four market types.

If the portfolio stands up to the market types then it is ready to be back-tested through normal market conditions. Once the portfolio can profit in all

the back-tests you are ready to execute your plan.

The principles in this book have provided a shortcut to help you create your own profitable options portfolio.

FOOTNOTE

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[1] Covestor was acquired by Interactive Brokers. The link will take you to their site.

[2] TEENIES are low priced puts far out-of-the-money

[3] A grind-down market occurs when the market goes down, but not enough to activate the vomma of out-of-money hedges.