

# The Top Technical Indicators for Options Trading

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There are hundreds of technical indicators traders can utilize depending on their trading style and the type of security to be traded.

This article focuses on a few important technical indicators popular among options traders. Also, please note that this article assumes familiarity with options terminology and calculations involved in technical indicators.

## KEY TAKEAWAYS

- RSI values range from 0 to 100. Values above 70 generally indicate overbought levels, and a value below 30 indicates oversold levels.
- A price move outside of the Bollinger bands can signal an asset is ripe for a reversal, and options traders can position themselves accordingly.
- Intraday momentum index combines the concepts of intraday candlesticks and RSI, providing a suitable range (similar to RSI) for intraday trading by indicating overbought and oversold levels.
- A money flow index reading over 80 indicates that a security is overbought; a reading below 20 indicates that the security is oversold.
- The put-call ratio measures trading volume using put options versus call options and changes in its value indicate a change in overall market sentiment. The open interest provides indications about the strength of a particular trend.

## How Options Trading Is Different

Technical indicators are often used in [short-term](#) trading to help the trader determine:

- Range of movement (how much?)
- The direction of the move (which way?)
- Duration of the move (how long?)

Since options are subject to time decay, the holding period takes significance. A stock trader can hold a position indefinitely, while an options trader is constrained by the limited duration defined by the option's expiration date. Given the time constraints, momentum

indicators, which tend to identify overbought and oversold levels, are popular among options traders.

Let's look at a few common indicators—momentum and others—used by options traders.

## Relative Strength Index (RSI)

The [relative strength index](#) is a momentum indicator that compares the magnitude of recent gains to recent losses over a specified period of time to measure a security's speed and change of price movements in an attempt to determine overbought and oversold conditions. RSI values range from 0-100, with a value above 70 generally considered to indicate overbought levels, and a value below 30 indicating oversold levels.

RSI works best for options on individual stocks, as opposed to indexes, as stocks demonstrate overbought and oversold conditions more frequently than indexes. Options on highly liquid, high-beta stocks make the best candidates for short-term trading based on RSI.<sup>1</sup>



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## Bollinger Bands

All options traders are aware of the importance of volatility, and [Bollinger bands](#) are a popular way to measure volatility. The bands expand as volatility increases and contract as volatility decreases. The closer the price moves to the upper band, the more overbought the security may be, and the closer the price moves to the lower band, the more oversold it may be.

A price move outside of the bands can signal the security is ripe for a reversal, and options traders can position themselves accordingly. For instance, after a breakout above the top band, the trader may initiate a long put or a short call position. Conversely, a breakout below the lower band may represent an opportunity to use a long call or short put strategy.<sup>2</sup>



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Also, in general, keep in mind that it often makes sense to sell options in periods of high volatility, when option prices are elevated, and buy options in periods of low volatility, when options are cheaper.<sup>2</sup>

## Intraday Momentum Index (IMI)

The [Intraday Momentum Index](#) is a good technical indicator for high-frequency option traders looking to bet on intraday moves. It combines the concepts of intraday candlesticks and RSI, thereby providing a suitable range (similar to RSI) for intraday trading by indicating overbought and oversold levels. Using IMI, an options trader may be able to spot potential opportunities to initiate a bullish trade in an up-trending market at an intraday correction or initiate a bearish trade in a down-trending market at an intraday price bump.

It is important to be aware of the “trendiness” of the price moves. When there is a strong visible uptrend or downtrend, momentum indicators will frequently show

overbought/oversold readings.

To calculate the IMI, the sum of up days is divided by the sum of up days plus the sum of down days, or  $ISup \div (ISup + IS\ down)$ , which is then multiplied by 100. While the trader can choose the number of days to look at, 14 days is the most common time frame. Like RSI, if the resulting number is greater than 70, the stock is considered overbought. And if the resulting number is less than 30, the stock is considered oversold.<sup>3</sup>

## Money Flow Index (MFI)

The [Money Flow Index](#) is a momentum indicator that combines price and volume data. It is also known as volume-weighted RSI. The MFI indicator measures the inflow and outflow of money into an asset over a specific period of time (typically 14 days), and is an indicator of "trading pressure." A reading over 80 indicates that a security is overbought, while a reading below 20 indicates that the security is oversold.

Due to dependency on volume data, MFI is better suited to stock-based options trading (as opposed to index-based) and longer-duration trades. When the MFI moves in the opposite direction as the stock price, this can be a leading indicator of a trend change.<sup>4</sup>





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## Put-Call Ratio (PCR) Indicator

The [put-call ratio](#) measures trading volume using put options versus call options. Instead of the absolute value of the put-call ratio, the changes in its value indicate a change in overall market sentiment.

When there are more calls being bought than puts, the ratio is above 1, indicating bullishness. When put volume is higher than call volume, the ratio is less than 1, indicating bearishness. However, traders sometimes view the put-call ratio as a contrarian indicator, opting to trade against market trends in hope of an impending reversal.<sup>5</sup>

## Open Interest (OI)

[Open interest](#) indicates the open or unsettled contracts in options. OI does not necessarily indicate a specific uptrend or downtrend, but it does provide indications about the strength of a particular trend. Increasing open interest indicates new capital inflow and, hence, the sustainability of the existing trend, while declining OI indicates a weakening trend.<sup>6</sup>

For options traders looking to benefit from short-term price moves and trends, consider the following:

| Price   | Open Interest | Interpretation                   |
|---------|---------------|----------------------------------|
| Rising  | Rising        | Market/security is strong        |
| Rising  | Falling       | Market/security is weakening     |
| Falling | Rising        | Market/security is weak          |
| Falling | Falling       | Market/security is strengthening |

## Can I Place Limit Orders on Options?

Yes, [limit orders](#) are common for trading single options as well as spreads. Market orders are also used when an immediate fill is needed.

## What Determines the Price of an Option?

Options prices can be modeled in a number of ways, but each value an option based on the following variables: the underlying price, the strike price, time to expiration, interest rates, and volatility.

## What Are the Risk Measures Used with Options?

The risk content of options is measured using four different dimensions known as "the Greeks." These include the [Delta](#), [Theta](#), [Gamma](#), and [Vega](#).

## The Bottom Line

In addition to the above-mentioned technical indicators, there are hundreds of other indicators that can be used for trading options (like [stochastic oscillators](#), average true range, and cumulative tick). On top of those, variations exist with smoothing techniques on resultant values, averaging principals and combinations of various indicators. An options trader should select the indicators best suited to his or her trading style and strategy, after carefully examining the mathematical dependencies and calculations.