Introduction To OPTION Trading

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Introduction to Indian Stock Market

Most of the trading in the Indian stock market takes place on its two stock exchanges: the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

The BSE has been in existence since 1875. The NSE, on the other hand, was founded in 1992 and started trading in 1994.

However, both exchanges follow the same trading mechanism, trading hours, and settlement process.

Trading Mechanism

Trading at both the exchanges takes place through an open electronic limit order book in which order matching is done by the trading computer.

There are no market makers and the entire process is order-driven, which means that market orders placed by investors are automatically matched with the best limit orders.

As a result, buyers and sellers remain anonymous.

Market Indexes

The two prominent Indian market indexes are Sensex and Nifty.

Sensex is the oldest market index for equities; it includes shares of 30 firms listed on the BSE.

Another index is the Nifty; it includes 50 shares listed on the NSE.

Market Regulation

The overall responsibility of development, regulation, and supervision of the stock market rests with the Securities and Exchange Board of India (SEBI), which was formed in 1992 as an independent authority.

OPTION TRADING

Options are financial derivatives that give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price and date.

Options are known as derivatives because they derive their value from an underlying asset.

CALL OPTION

Call options are financial contracts that give the option buyer the right but not the obligation to buy assets or instrument at a specified price within a specific time period.

The specified price is known as the strike price, and the specified time during which the sale can be made is its expiration or time to maturity.

A call buyer profits when the underlying asset increases in price.

PUT OPTION

Put options give holders of the option the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time frame.

Put option prices are impacted by changes in the price of the underlying asset, the option strike price, time decay, interest rates, and volatility.

Put options increase in value as the underlying asset falls in price, as volatility of the underlying asset price increases, and as interest rates decline.

Options Risk Metrics: The Greeks

Delta (Δ) represents the rate of change between the option's price and a $1 change in the underlying asset's price. In other words, the price sensitivity of the option relative to the underlying.

Theta (Θ) represents the rate of change between the option price and time, or time sensitivity - sometimes known as option's time decay.

Gamma (Γ) This is called second-order (second-derivative) price sensitivity. Gamma indicates the amount the delta would change given a $1 move in the underlying security.

Vega (V) represents the rate of change between an option's value and the underlying asset's implied volatility. This is the option's sensitivity to volatility.

Rho (p) represents the rate of change between an option's value and a 1% change in the interest rate. This measures sensitivity to the interest rate.

What Are the Main Advantages of Options?

Options can be very useful as a source of leverage and risk hedging.

For example, a bullish investor who wishes to invest $1,000 in a company could potentially earn a far greater return by purchasing $1,000 worth of call options on that firm, as compared to buying $1,000 of that company's shares.

In this sense, the call options provide the investor with a way to leverage their position by increasing their buying power.

What Are the Main Disadvantages of Options?

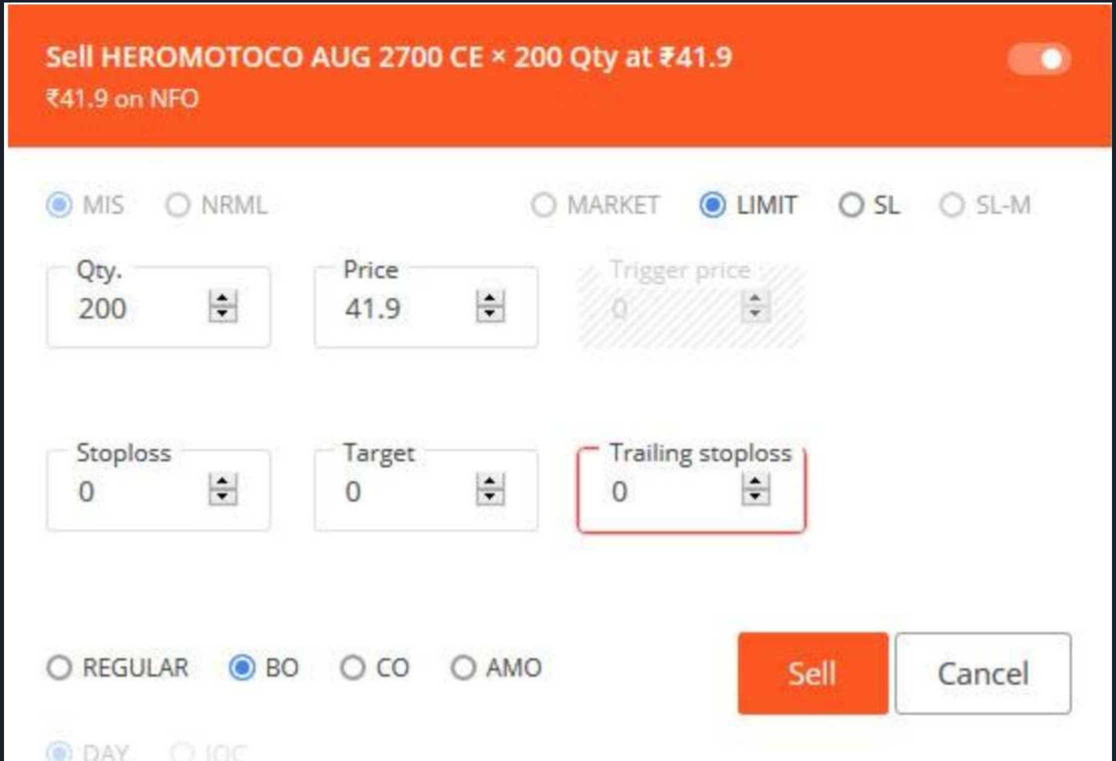
They are considered an advanced investment vehicle, suitable only for experienced professional investors.

Because of their capacity for outsized returns or losses, investors should make sure they fully understand the potential implications before entering in to any options positions.

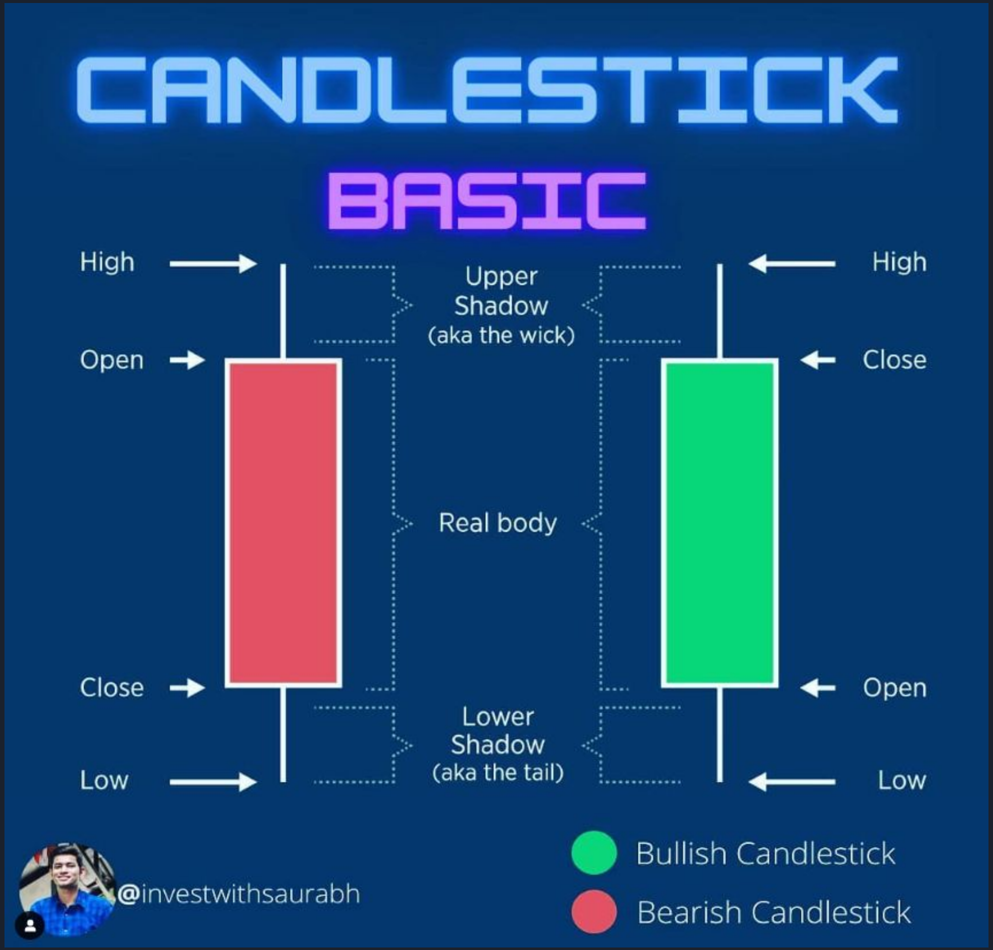
Failing to do so can lead to devastating losses.

Trading Platform

Zerodha



CandleSticks



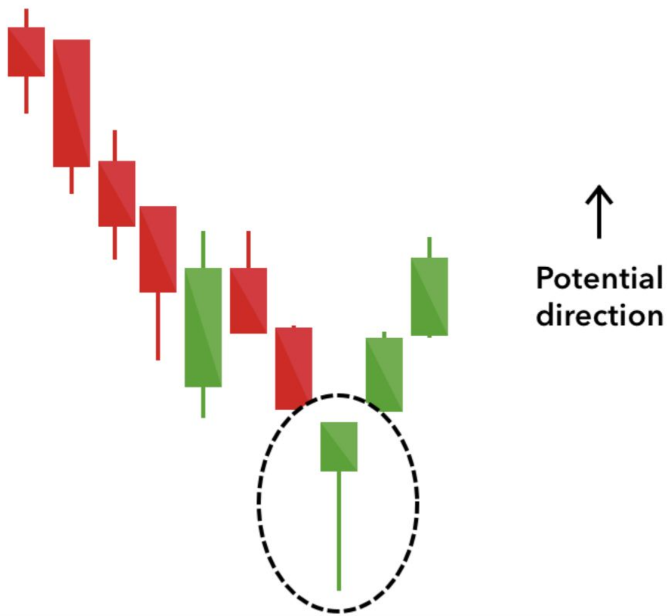
Types of Patterns

Bullish Pattern :-

Hammer

The hammer candlestick pattern is formed of a short body with a long lower wick, and is found at the bottom of a downward trend.

A hammer shows that although there were selling pressures during the day, ultimately a strong buying pressure drove the price back up. The colour of the body can vary, but green hammers indicate a stronger bull market than red hammers.



Bullish Pattern :-

Inverse hammer

A similarly bullish pattern is the inverted hammer. The only difference being that the upper wick is long, while the lower wick is short.

It indicates a buying pressure, followed by a selling pressure that was not strong enough to drive the market price down. The inverse hammer suggests that buyers will soon have control of the market.

Bullish Pattern :-

Bullish engulfing

The bullish engulfing pattern is formed of two candlesticks. The first candle is a short red body that is completely engulfed by a larger green candle.

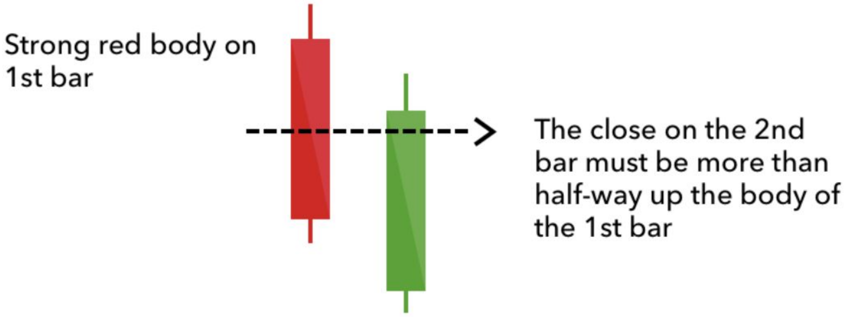
Though the second day opens lower than the first, the bullish market pushes the price up, culminating in an obvious win for buyers.

Bullish Pattern :-

Piercing line

The piercing line is also a two-stick pattern, made up of a long red candle, followed by a long green candle.

There is usually a significant gap down between the first candlestick's closing price, and the green candlestick's opening. It indicates a strong buying pressure, as the price is pushed up to or above the mid-price of the previous day.



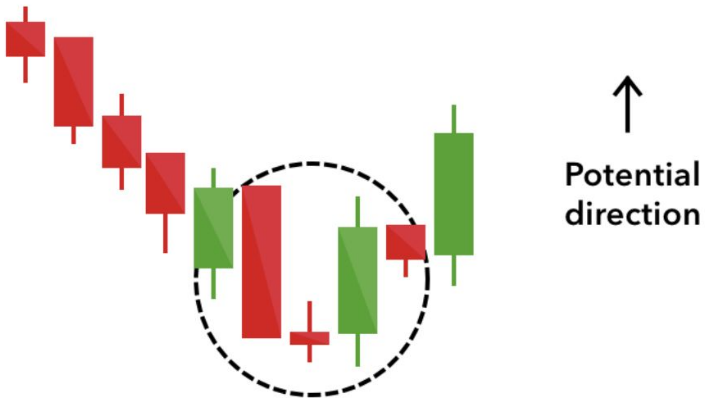
Reversal signal after a down-trend

Bullish Pattern :-

Morning star

The morning star candlestick pattern is considered a sign of hope in a bleak market downtrend. It is a three-stick pattern: one short-bodied candle between a long red and a long green. Traditionally, the 'star' will have no overlap with the longer bodies, as the market gaps both on open and close.

It signals that the selling pressure of the first day is subsiding, and a bull market is on the horizon.

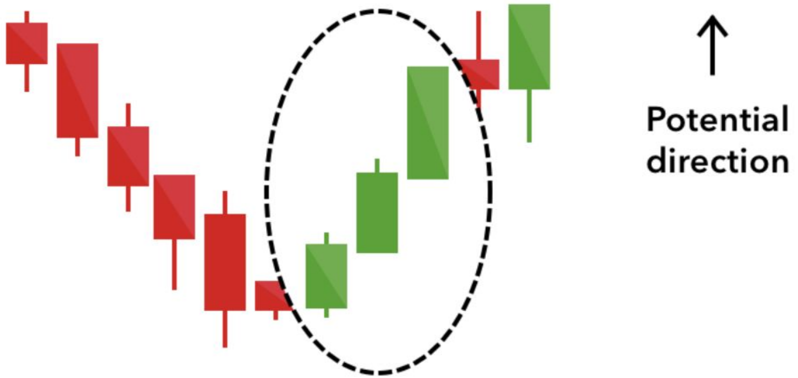


Bullish Pattern :-

Three white soldiers

The three white soldiers pattern occurs over three days. It consists of consecutive long green (or white) candles with small wicks, which open and close progressively higher than the previous day.

It is a very strong bullish signal that occurs after a downtrend, and shows a steady advance of buying pressure.



Bearish Pattern :-

Hanging man

The hanging man is the bearish equivalent of a hammer; it has the same shape but forms at the end of an uptrend.

It indicates that there was a significant sell-off during the day, but that buyers were able to push the price up again. The large sell-off is often seen as an indication that the bulls are losing control of the market.

Bearish Pattern :-

Shooting star

The shooting star is the same shape as the inverted hammer, but is formed in an uptrend: it has a small lower body, and a long upper wick.

Usually, the market will gap slightly higher on opening and rally to an intra-day high before closing at a price just above the open – like a star falling to the ground.

Bearish Pattern :-

Bearish engulfing

A bearish engulfing pattern occurs at the end of an uptrend. The first candle has a small green body that is engulfed by a subsequent long red candle.

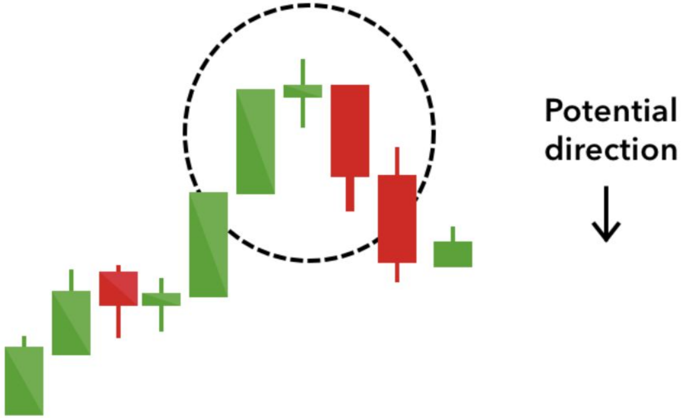
It signifies a peak or slowdown of price movement, and is a sign of an impending market downturn. The lower the second candle goes, the more significant the trend is likely to be.

Bearish Pattern :-

Evening star

The evening star is a three-candlestick pattern that is the equivalent of the bullish morning star. It is formed of a short candle sandwiched between a long green candle and a large red candlestick.

It indicates the reversal of an uptrend, and is particularly strong when the third candlestick erases the gains of the first candle.



Bearish Pattern :-

Three black crows

The three black crows candlestick pattern comprises of three consecutive long red candles with short or non-existent wicks. Each session opens at a similar price to the previous day, but selling pressures push the price lower and lower with each close.

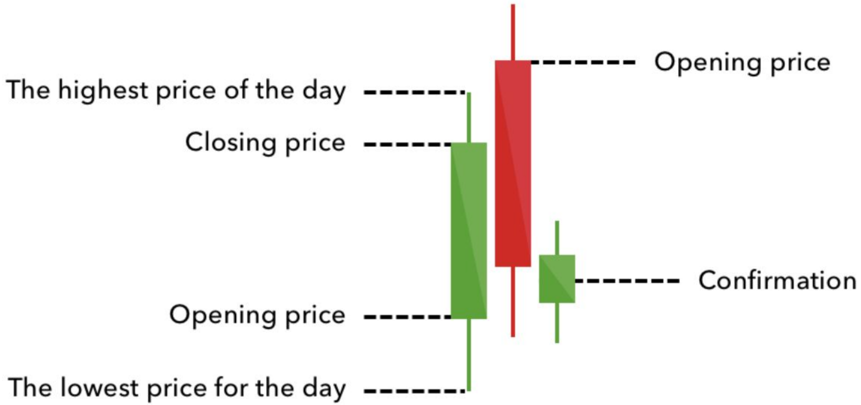
Traders interpret this pattern as the start of a bearish downtrend, as the sellers have overtaken the buyers during three successive trading days.

Bearish Pattern :-

Dark cloud cover

The dark cloud cover candlestick pattern indicates a bearish reversal – a black cloud over the previous day's optimism. It comprises two candlesticks: a red candlestick which opens above the previous green body, and closes below its midpoint.

It signals that the bears have taken over the session, pushing the price sharply lower. If the wicks of the candles are short it suggests that the downtrend was extremely decisive.

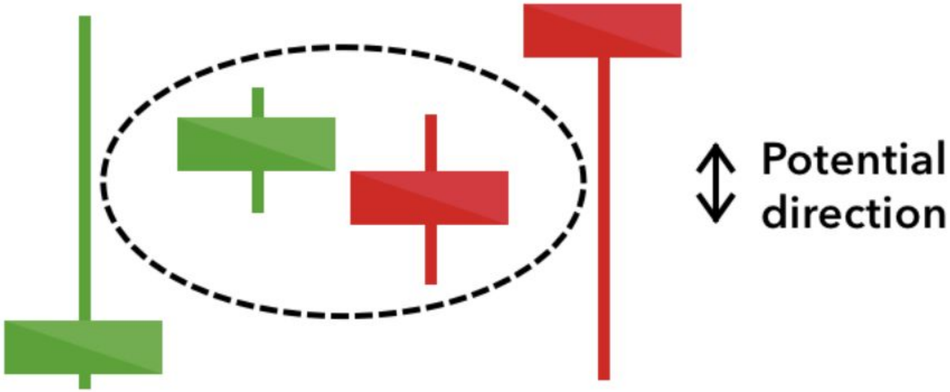


Very Important Candles

Doji

When a market's open and close are almost at the same price point, the candlestick resembles a cross or plus sign – traders should look out for a short to non-existent body, with wicks of varying length.

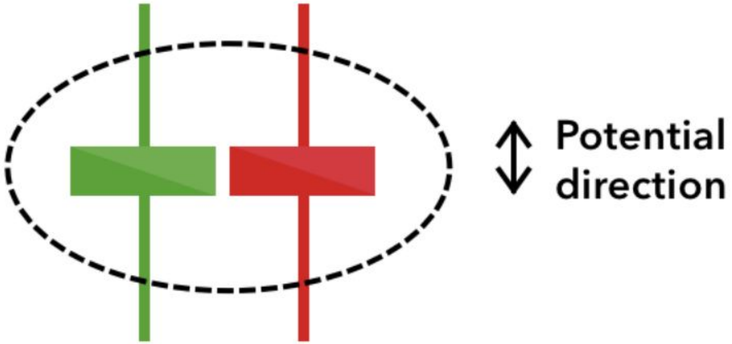
This doji's pattern conveys a struggle between buyers and sellers that results in no net gain for either side. Alone a doji is neutral signal, but it can be found in reversal patterns such as the bullish morning star and bearish evening star.



Spinning top

The spinning top candlestick pattern has a short body centred between wicks of equal length. The pattern indicates indecision in the market, resulting in no meaningful change in price: the bulls sent the price higher, while the bears pushed it low again. Spinning tops are often interpreted as a period of consolidation, or rest, following a significant uptrend or downtrend.

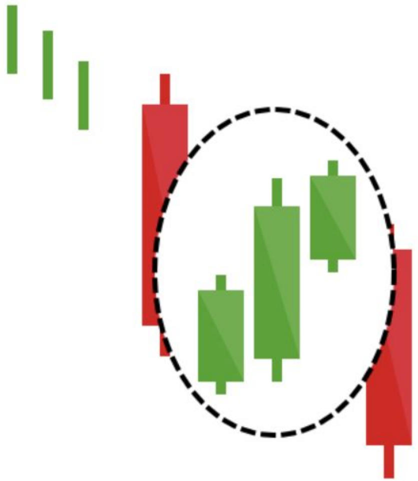
On its own the spinning top is a relatively benign signal, but they can be interpreted as a sign of things to come as it signifies that the current market pressure is losing control.



Falling three methods

Three-method formation patterns are used to predict the continuation of a current trend, be it bearish or bullish.

The bearish pattern is called the ‘falling three methods’. It is formed of a long red body, followed by three small green bodies, and another red body – the green candles are all contained within the range of the bearish bodies. It shows traders that the bulls do not have enough strength to reverse the trend.



Rising three methods

The opposite is true for the bullish pattern, called the ‘rising three methods’ candlestick pattern. It comprises of three short reds sandwiched within the range of two long greens. The pattern shows traders that, despite some selling pressure, buyers are retaining control of the market.

TRADING

80% PSYCHOLOGY AND 20% SKILLS

Thank You!