COMPLETE GUIDE

PROFESSIONAL OPTIONS TRADING STRATEGIES

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market REBELLION

INTRODUCTION

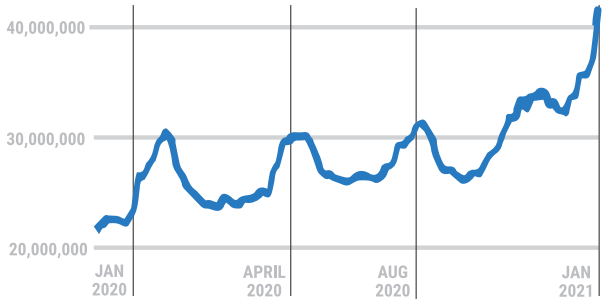
Option volumes have exploded year-over-year. In January 2020, 22 million equity options contracts were traded on a daily basis, according to the Options Clearing Corporation. In January 2021, that number reached an average of more than 41.5 million contracts a day.

This incredible volume is driven in part by new interest in options trading from those who traditionally trade the underlying equities. However, unlike stock trading, options trading is multi-dimensional. It's not just, "I think it's going up, so I'm going to buy." There are strategies to take advantage of the passage of time, an increase or decrease in volatility, and upwards, downwards, and sideways price movement. If you don't pair your trading outlook with the proper strategy, it is possible to be right about what happens in the market and still lose money.

The opposite is also true. If you employ the right options trading strategy, you can minimize your losses when you are wrong and maximize your gains when you are right.

Understanding specific options trading strategies is at the core of building a successful long-term portfolio.

41.5 MILLION **Daily Options Volume** (Rolling 20 Day Average)



DATA SOURCE: OPTIONS CLEARING CORPORATION

If you employ the right options trading strategy, you can minimize your losses when you are wrong and maximize your gains when you are right.

THE MOST IMPORTANT FACTOR TO TRADING OPTIONS

Regardless of what options trading strategy you employ, if you don't have risk management, you will not be successful. Without risk management, trading is just gambling.

Trading (and options trading in particular) is a probabilistic exercise; there are no guarantees. So even if something has only a 10% chance of occurring, it will still occur with some regularity. If you risk a large portion of your trading account on that outcome not occurring, then once out of every 10 trades, on average, you'd have a catastrophic loss. It may go well for a while, but it won't go well forever.

Such poor risk and position management has led to the downfall of many traders and even some trading firms. See: Long Term Capital Management. Though they were ultimately right on their strategy, their risk management led to their downfall.

Risk management helps ensure that you have the ability to trade tomorrow. It can ensure that no matter what happens on this one trade, you will be able to place another one. And then another one. And that is how to secure long-term compounding of your trading account.

If you don't have risk management, you will not be successful.

WHAT ARE SOME RISK MANAGEMENT RULES OF THUMB?

Ultimately, you are going to have to find a risk management strategy that marries your personality, capital, and trading style.

That's because the most important thing with any risk management system is that you stick to it as much as possible. (We say "as much as possible" because even the best traders violate their own risk management rules. It's why large hedge funds and banks have specific departments to measure firm-wide risk.)

Risk management rules have to be particular to you because if you try to fit your trading into too small of a risk management box, then you will struggle to stick with it.

For instance, if you read any of Jack Schwager's Market Wizards series, you will find a lot of professional traders have a 1% or 2% rule for their trading account. That is, they will not risk more on a single trade than 1% to 2% of their overall trading equity. While this makes sense if you are managing seven-figure accounts, if you have a starter $10,000 trading account, you are probably not going to sell out of a position because it lost $100.

That said, understanding these risk management rules of thumb can be helpful in developing your own risk management strategy:

1. **Never risk more than X% of your portfolio in a single trade.** As described above, it's hard to tell you what that percentage should be. It can be large enough to match your trading goals, but it should be small enough so that you don't ever endanger the future of your account if you have a number of losing trades in a row.

2. **Don't lose more than 50% on one options trade.** This is a rule that Jon and Pete Najarian have for their own options trading. What does it mean? If you paid $500 for an option, then you would sell that option when its value declines to $250. If you paid $10,000 for the options, sell when the value is at $5,000.

3. **Never go naked short options.** We dig into strategies a bit later, but for now, just know that at Market Rebellion, we always control our risk. That means that we never go naked short call options. (We also wouldn't go naked short put options in stocks priced above certain levels.) If you do that, your loss is unlimited, but your gain is limited to the amount of premium that you collected. More concerning, your loss is uncontrollable since options markets are closed over nights and weekends.

4. **Have daily, weekly, and monthly limits.** If you are actively trading in the markets each day and week, you may want to establish limits for the amount of losses you will take or the amount of losing trades you'll allow in a row before you take a break from the market. Losses are a sign that your strategy is not favorable in the current market conditions. Stepping back is one way to help regain perspective.

CAN YOU VIOLATE YOUR RISK MANAGEMENT RULES?

The key to risk management rules is that they have to be hard and fast rules—no ifs, ands, or buts. But yes, you will violate them. There is not a trader in the world that hasn't violated (or changed) one of their risk management or trading rules. It's almost a certainty. We're human.

The key to weathering these times is ensuring that you never have on unlimited risk trades. You have to structure your trades such that even if the worst case scenario happens, you have a defined loss. That happens at the point that you put on the trade, not when your emotions are tied up in the position.

While it might not seem like it, the worst thing that could happen is you violate a rule and make a lot of money. For instance, that option that you didn't sell when it was down 50% rallied back to give you profits. That might encourage you to do the same thing the next time. And then again. And again. And one of those times, it's not going to come back… and you're going to risk suffering a catastrophic loss.

The key to weathering these times is ensuring that you never have on unlimited risk trades. You have to structure your trades such that even if the worst case scenario happens, you have a defined loss.

HOW ARE OPTIONS PRICED?

Options are priced using three main components: the relationship of the strike price to the current market price, the amount of time until the option's expiration, and the volatility of the stock. (We can ignore for now the impact of interest rates on equity options' pricing. The likelihood of a sudden change in interest rate expectations is very low, particularly as it relates to U.S. markets.)

Strike price vs. the current price

The strike price can either be in-the-money, at-the-money, or out-of-the-money as it relates to the current price of an equity. If the equity is trading at $100, then a $90 call will be in-the-money, a $100 call will be at-the-money, and a $110 call will be out-of-the-money. If these all have the same expiration date, then we can be sure that the $90 call has the highest value, while the $110 call has the lowest value. The opposite would be true if you were talking about put prices. The $90 put would be out-of-the-money, while the $110 put would be in-the-money.

Amount of time until the option's expiration

Options are contracts that expire on a certain date in the future. That means that the option holder has the right, but not the obligation, to buy (if they own a call) or sell (if they own a put) a stock at a specific price on or before a specific day. All else equal, the farther out in time that an option has before it expires, the more expensive it will be. As the expiration date gets closer to today, the option will lose value — even if the stock price doesn't move.

Volatility of the stock

Volatility is the wild-card of the group. While time moves in one direction and price movements are easily seen in the underlying stock, volatility can increase or decrease at a moment's notice. At times, volatility can be predicted. For example, after earnings reports or major news announcements, volatility typically decreases. But it could spike as well, for instance if there is an unexpected news story or an announcement that major news will be upcoming.

Options are priced using three main components: the relationship of the strike price to the current market price, the amount of time until the option's expiration, and the volatility of the stock.

WHY DOES THIS MATTER TO OUR DISCUSSION ON OPTIONS TRADING STRATEGIES?

In order to choose the right options trading strategy, you must first understand how options are priced. Why?

Let's take a hypothetical scenario. Company A has their quarterly earnings report today. You buy a call option expecting the price of the stock to rise over the next week to a level that is $5 out of the money (that is, $5 higher than the current stock price).

The earnings report happens and tomorrow, the stock is up $2. That should mean that your option has now increased in price, right? After all… just one day has passed and the stock price has moved 40% closer to your strike price. The stock is going higher, just as you expected.

However, you should remember that option prices also incorporate volatility. And given that the earnings report is a highly volatile time, odds are that after the report, the volatility component of the options price shrunk rapidly. That "vol crush" could have easily offset the gains you may have been expecting as a result of the price movement in the stock. In fact, even with the stock trading closer to your call price, the price of the option could have gone down.

In order to choose the right options trading strategy, you must first understand how options are priced.

HOW TO STRUCTURE OPTIONS TRADING STRATEGIES

If you are only trading stock, then your decisions are relatively limited. If you are bullish the stock, you buy; if you are bearish the stock, you sell; and if you are neutral on the stock, you wouldn't buy or sell it.

Options trading strategies, however, can make money in bullish, bearish, and sideways markets. This makes options trading dynamic. But because options trading is dynamic, there are a number of different trading strategies that you could employ for each of those market types.

In addition to just buying, selling, or staying in cash, options require traders to make two major decisions that can determine the difference between a profitable and unprofitable trade. The first is the strike price (or prices) that you trade. The second is the expiration date (or dates) that you select. The choice of strike price and expiration date makes the difference between a trade that is well constructed and one that more closely resembles a lotto ticket.

MASTERING BASIC TECHNICAL ANALYSIS

A little bit of technical analysis can go a long way towards choosing a strike price that maximizes your odds of making a profitable trade. These basic technical analysis tools are moving averages, flat lines, and channels, all of which help determine where support and resistance are located.

Moving averages: The market tends to follow set moving averages, specifically the 10, 20, 50, 100, 200, and 500-day moving averages. Short-term traders will focus on the short-term moving averages, while long-term traders will look at those that are long-term.

Moving averages are particularly useful for a couple of reasons. First, they help visually confirm whether the stock is in an uptrend, downtrend, or sideways market. In an uptrend, the short-term moving averages will be above the long-term moving averages. The opposite is true for downtrends. In a sideways market, the short-term and long-term moving average would be crossing over one another.

Second, moving averages provide a definitive spot that a trade may trigger based off of closing prices. In other words, they not only help with the direction of the trade, but help to indicate the timing of a trade. That is critical information for options traders.

Flat lines: Flat lines connect two points and indicate where, at least historically, demand for the stock exceeded supply or supply of the stock exceeded demand. These are useful in not only choosing times to enter or exit a trade, but also strike prices that can be targeted or used in options positions.

Let's imagine that a stock has been in a solid uptrend and pulled back to the same price level twice, a place with proven flat-line support. If the trader expects the price to once again bounce and move higher, he could buy an in-the-money call as part of a stock replacement strategy. If the price fails to move higher and instead breaks below the flat line support, the trader could sell out of the position at a risk-managed loss.

Trend lines: Trend lines are similar to flat lines, except they connect two or more points on a chart at different price levels. This projects forward the price at which buyers may come in and buy the stock or sellers may come in and sell the stock in the future. If the price breaks a trend line, it indicates that the trend is no longer valid (though it doesn't necessarily indicate that the price is going to reverse).

A little bit of technical analysis can go a long way towards choosing a strike price that maximizes your odds of making a profitable trade.

CHOOSING EXPIRATION DATE

In addition to forecasting where a stock might move, options traders have to forecast when it may happen. That's because option contracts expire. If you own a $100 call and the stock closes at $99 on the day the contract expires, your option has no value… even if the stock opens the next day at $110. You can't retroactively decide to exercise the option because the stock finally moved in the direction you wanted. If, however, you owned the same option that expired the next week, your option now has a lot of value.

As a result, you will want to make sure to know when a stock has its quarterly earnings report when trading options. Choosing one that expires the week before earnings or week after can cause drastic differences in the success of your trade. If you are playing a sideways trade, you might want to choose the week before earnings. If you are playing directional, you may want to go the week after.

Additionally, traders can look at prior trends to determine how long they took to play out. For example, if it took a stock five weeks to move from a trend low to trend high in the last move, then you have a model for how long it might take the current move to play out. It would be an aggressive play to buy calls that expire in three or four weeks.

If you own a $100 call and the stock closes at $99 on the day the contract expires, your option has no value… even if the stock opens the next day at $110. You can't retroactively decide to exercise the option because the stock finally moved in the direction you wanted.

GETTING NUANCED IN YOUR OPTIONS TRADING STRATEGY

Beyond the basics of choosing an options strike price and expiration date, traders also need to understand the Greeks. Specifically, that is a reference to Delta, Vega, Gamma, and Theta. These four terms are mathematical derivatives of price, volatility, and time and will help you understand how the price of your option will move with movements in the underlying stock's price or implied volatility.

Before that scares you off, here are simple definitions:

Delta: How much the price of an option changes with a movement in the underlying stock's price. Long stock has a Delta of 1, meaning that for every $1 move in the price of the stock, your position moves $1 per share. Options have a Delta less than 1 that varies based on the strike price and other factors. An option that is at-the-money has a Delta of 0.50. In-the-money options have Deltas > 0.50, while out-of-the-money options have a Delta < 0.50. Therefore, Deltas are closer to 1 for deep in-the-money options and closer to 0 for far out-of-the-money options.

Gamma: How quickly the Delta of an option changes. Delta changes as the underlying price of the stock moves. For instance, if an at-the-money option moves in-the-money, then its Delta will naturally increase. If the at-the-money option becomes out-of-the-money, then the delta will decline. Gamma is the measure for how quickly the Delta of an option changes as the price moves. Unlike Delta, which is highest deep in-the-money, Gamma is highest at-the-money, declining as the option moves in- or out-of-the-money. High Gamma options trading strategies cause the option to rapidly increase (or decrease) Delta, which ultimately causes the option to perform more or less like pure stock as the price changes. Low Gamma strategies will see an option's Delta change at a slower rate.

These four terms are mathematical derivatives of price, volatility, and time and will help you understand how the price of your option will move with movements in the underlying stock's price or implied volatility.

Vega: How much the price of an option changes with a 1% movement in the underlying stock's implied volatility. As the volatility of a stock increases, the price of an option will increase. As the volatility of a stock decreases, the price of an option will decrease. Some movements in volatility may be predictable. For instance, if Apple stock reports earnings on Thursday, the options in the nearest weeks and month will have a high Vega prior to the earnings report. On Friday morning, following the news, volatility will come out of the options as the price of the stock now includes all available information. That is known as a "vol crush." However, other times, volatility might suddenly spike. This happened with GameStop stock in early 2021 as the equity's price moved from $20 to $350 to $45 back to $300—all in the matter of six weeks. That added volatility will cause the price of both calls and puts to increase over lower volatility measures. In fact, the move higher in Vega could even be enough to offset a move in Delta. Put more plainly, the price of an option might increase even though the stock moved in the opposite direction.

Theta: The rate of decline in an option's price by the passage of time. As time passes, the value of an option—all other things equal—will decline. This should make intuitive sense. If part of an option's price is on uncertainty of what may happen between now and expiration, as expiration gets closer, that level of uncertainty diminishes. Theta only moves an option's price in one direction. Why? Well, because time moves in one direction.

So as time passes, Theta erodes value from an option's price. That's what options traders call Theta decay. However, Theta does not move linearly over time, and the Theta decay curve is not the same for in-the-money, at-the-money, and out-of-the-money options. For at-the-money options, the amount of Theta decay per day rises as the expiration date nears. For in-the-money and out-of-the-money options, Theta decay declines as the expiration date nears. Understanding the Theta decay curve is a critical concept that will allow traders to either take advantage of (or minimize) Theta decay in their trading.

So why do you need to know about the Greeks before you trade options? It all gets back to risk. Understanding these dynamic forces when you trade options helps you manage your risk.

How? Maybe the market moves against you, and you find that your Gamma is rising. As the price of the underlying changes, your Delta changes, causing the price of your option to change at an accelerating pace. That could work in your favor. Or not. But you have to understand it in order to trade like a professional.

TOP 5 MOST COMMON OPTIONS TRADING STRATEGIES

In Market Rebellion's Key Options Strategy Guide, we dissect all of the options trading strategies that you should know. You can download that for free here.

DOWNLOAD

Five options trading strategies would be the most common with professional traders. Those are: stock replacement, vertical spreads, calendar spreads, butterfly spreads, and iron condors.

Stock replacement strategy:

Overview: Directional play that benefits if the stock price moves higher (long calls) or lower (long puts).

Construction: Buy an in-the-money call or at-the-money put option. Our preferred strategy would be to buy an 80-85 Delta call or a 50-60 Delta put.

Bias: Bullish (calls) or bearish (puts)

Breakeven: Buying the option will create a debit to the trader. The breakeven would be the strike price of the trade plus the price paid for the call or minus the price paid for the put.

Max gain: The max gain for a call would be unlimited. The max gain for a put would be the breakeven price times the number of shares underwritten by the options contract.

Max loss: The max loss is the total price paid for the option.

Key concepts: A stock replacement strategy is a cost-efficient, safe alternative to owning or shorting stock. It offers a limited loss scenario where a trader can only lose the money that they spent to buy the option. In addition, a trader has the option to roll the position in the event that the trade starts to make money, locking in profits in the trade. Because you own an option, you do have Theta decay eroding the value of your option.

Vertical spreads:

Overview: Can be used to express bullish, bearish, or neutral trading outlooks.

Construction: Simultaneously enter a position with two separate strike prices but one expiration. For a bullish spread, either (1) buy a call and sell one at a higher strike or (2) sell a put and buy a put at a lower strike. The first would result in a debit from the trading account, while the second would result in a credit. For a bearish spread, a trader would do the opposite. By taking in a credit, the trader adds the opportunity to make money in a neutral market.

Bias: Depends on trade construction. Can be bullish, bearish, or neutral.

Breakeven: The breakeven would be the cost of the spread plus the strike price of the lower call or the strike price of the higher put minus the cost of the spread.

Max gain: In a debit spread (trader pays money), the max gain is the width of the spread minus the cost of the spread. For instance, if the trader paid $2 for a $5 wide spread, the max gain would be $3 per share. In a credit spread (trader gets paid), the max gain is the amount of premium collected.

Max loss: In a debit spread, the max loss is the amount of premium that the trader paid. In a credit spread, the max loss is the width of the spread minus the amount of premium collected. In the same $5 wide spread, a trader that sold that spread for $2 would have a max loss of $3 per share.

Key concepts: This is a defined risk strategy trade where the gains and losses are limited. However, at expiration, the trader could find themselves in a precarious position if the stock is trading between the two strikes. That could cause one of the trades to be exercised, while the other trade is not, resulting in the trader having a net position short or long stock.

Calendar spreads:

Overview: A premium collection strategy that benefits from Theta decay, which is higher for near-term at-the-money options.

Construction: Long a call or put at one strike price in one month, while being short a call or put at the same strike price with a shorter expiration date. (Since we don't go naked short options, Market Rebellion would never be long the shorter expiration while being short the longer expiration. That would set up an unlimited risk scenario.)

Bias: Neutral — at least in the short term.

Breakeven: Difficult to determine at order entry. When the short-term option expires, the long-dated option will still have Theta value.

Max gain: If the stock moves sideways, the position will profit by the nearer month option decaying at a faster rate than the longer-dated option. This will cause the spread to widen and create a profit. The position will also profit if implied volatility rises.

Max loss: The maximum loss is the amount paid for the time spread, no matter where the stock price rises to, so long as the position is closed as a single trade (as it should be).

Key concepts: The strategy is best done by going short at-the-money near-term options, where the extrinsic value is the highest. The strategy works because of Theta decay that results from the passage of time.

Butterfly spreads:

Overview: A premium collection strategy that benefits in sideways markets, with both defined risk and profit potential. Since both sides of the trade are defined, traders can go either long or short butterfly spreads.

Construction: Uses either all calls or all puts. For a long butterfly using calls, you would buy one in-the-money call, sell two calls at-the-money, and buy one additional call out-of-the-money—all with the same expiration date and equidistant apart. The trade results in a debit.

Bias: Neutral.

Breakeven: There are two breakeven points. The first is found by adding the debit to the lowest strike call. The upper breakeven is found by subtracting the debit from the highest price strike.

Max gain: The max gain is found by subtracting the debit from the difference between the long and short strikes. The maximum gain is only realized if the stock price closes at exactly the short strike at expiration.

Max loss: The max loss is typically limited to the debit of the trade. This occurs if the stock price closes above the highest strike or below the lowest strike.

Key concepts: This is a powerful premium collection strategy, even though the trade results in a debit. That's because it benefits if the stock moves sideways and profits occur from Theta decay. The trade is fully hedged and normally Delta neutral.

Iron condors:

Overview: A premium collection strategy that benefits if the stock price moves sideways between now and expiration.

Construction: The iron condor is the simultaneous entry of a credit put spread along with a credit call spread, typically some ways out of the money. The strike prices should be equidistant from the current price and equidistant from each other.

Bias: Neutral.

Breakeven: There are two breakeven prices. The breakevens are the premium collected plus the closest call price or minus the closest put price.

Max gain: The max gain is the amount of premium collected.

Max loss: The max loss is the width of the spread between the two strikes minus the amount of premium collected.

Key concepts: A premium collection strategy where a trader collects a credit instead of paying a debit for the trade. The trader makes a maximum profit if the stock closes between the two short strikes.

CLOSING

The key to trading options like a pro is finding the opportunity and then employing the strategy that is best for that opportunity. Because options can make money in bullish, bearish, and neutral markets, the strategy is critical. Not only can it make the difference between making money and losing money, but it can make the difference between minimizing losses when you are wrong and maximizing profits when you are right.

WHAT'S NEXT?

If you are interested in learning about all the strategies that we teach here at Market Rebellion, download Jon and Pete Najarian's free Key Options Strategy Guide.

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