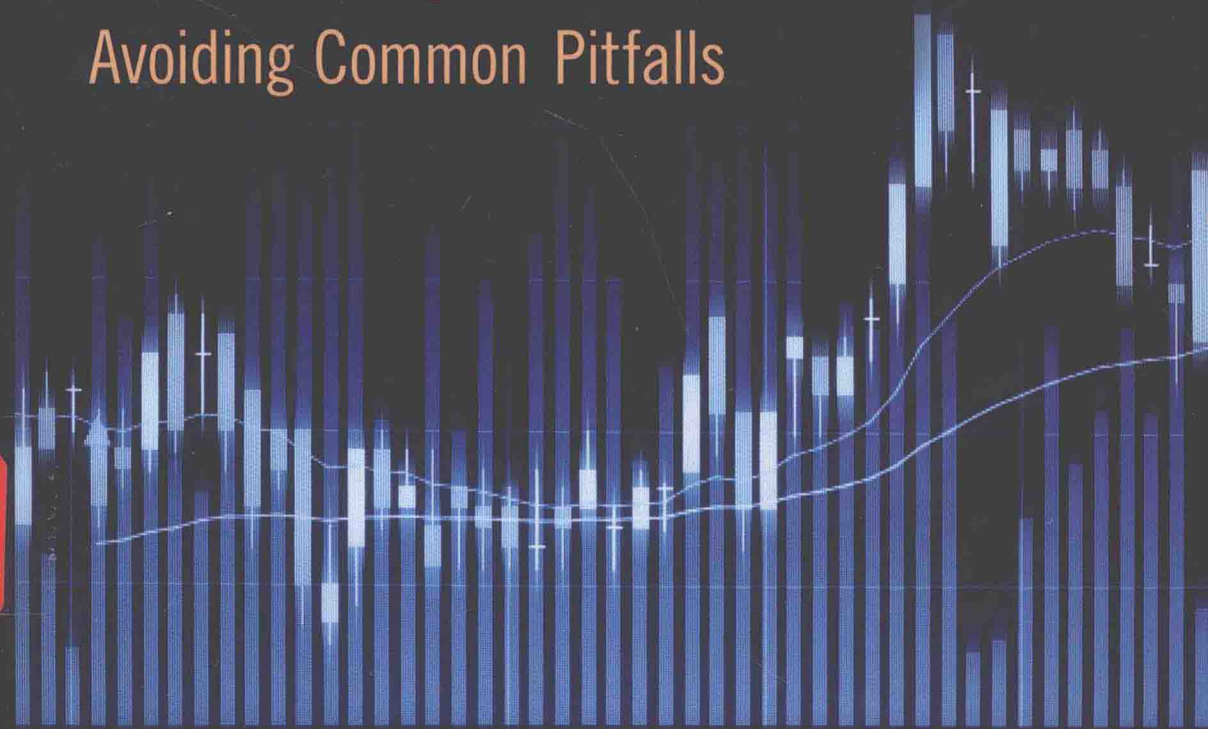


JJ Kinahan

# ESSENTIAL OPTION STRATEGIES

Understanding the Market and  
Avoiding Common Pitfalls



WILEY

# Essential Option Strategies

UNDERSTANDING THE MARKET  
AND AVOIDING COMMON PITFALLS

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.  
Published simultaneously in Canada.

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*Library of Congress Cataloging-in-Publication Data is available.*

Names: Kinahan, J. J., 1963- author.  
Title: Essential option strategies : understanding the market and avoiding common pitfalls / J. J. Kinahan.  
Description: Hoboken : Wiley, 2016. | Includes index.  
Identifiers: LCCN 2016021570 (print) | LCCN 2016036186 (ebook) | ISBN 9781119263333 (hardback) | ISBN 9781119291541 (ePDF) | ISBN 9781119291510 (ePub) | ISBN 9781119291541 (epdf) | ISBN 9781119291510 (epub)  
Subjects: LCSH: Options (Finance) | Investments. | BISAC: BUSINESS & ECONOMICS / Finance.  
Classification: LCC HG6024.A3 .K556 2016 (print) | LCC HG6024.A3 (ebook) | DDC 332.64/53—dc23  
LC record available at <https://lccn.loc.gov/2016021570>

Cover Design: Wiley  
Cover Image: Stock market candle graph © Butsaya/iStockphoto

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*To Karen, Kaitlin, Kevin, and Kelly. Your love and support  
make all things possible.*

## Foreword

I began trading options on the floor of the CBOE in the early 1980s, just a few years before JJ. Back then, we were trader indifferent, which meant we would trade anything with anybody. Today, we would say the same about our approach to the products and strategies that we choose. These days, the counterparty to our trades is a computer with theoretical algorithm with unlimited funding. Back then, it was some kid just like us—nervous and sweating while trying to make a few eighths.

JJ and I traded together, played together, worked together, and learned together. Luckily, we were among the survivors. We excelled at our craft by managing our egos and not getting caught in the fat tails (volatility) of a few explosive moves. But the business changed as it grew exponentially, and open outcry faced certain extinction around 2000.

Now, the original trader cowboys are gone. Billions of new dollars, lightning-fast servers, and hard-coded theoretical models have taken over. Still, JJ, myself, and a handful of others decided we still had a lot left to learn and to share publicly. The same customers we lived off of were now our partners. And with strong beliefs that options remain the greatest strategic instrument in the world, our new mission was clear: Let's gather the gang together and share our stories. First came the technology to facilitate our mission, and next came the content.

In his first book, JJ reviews, discusses, and critiques almost every progressive strategy available. He puts great context around those ideas, so they are usable in real time. You'll see through his stories that the trader spirit remains in his words and transcends decades and advancements in technology.

Tom Sosnoff

## Preface

A lot has changed in the options world since I started my career as a floor trader on the Chicago Board Options Exchange (CBOE) thirty years ago. Obviously, technology has transformed the exchanges, and with one or two exceptions, the live pits with crowds of screaming traders, like in Figure P-1, are largely a thing of the past.

At the same time, options markets are no longer confined to industrial countries or limited to instruments such as stocks and commodities. Contracts are now listed on a wide array of different asset classes, including fixed income, precious metals, energy, and even volatility. In addition, sufficient advances in technology have enabled many emerging economies to offer options as investment opportunities and as tools to manage risk.

My focus in this book is helping you, the retail client, understand some of the more actively traded securities in the U.S. markets, where options on equities and futures trade on more than a dozen different exchanges today, and only two—the Chicago Board Options Exchange and the Chicago Mercantile Exchange—are hybrid markets with both electronic and floor-based pit trading.

Technology is not only driving how instruments are traded, but it has changed how information flows as well. It has leveled the playing field for individual investors. When I started my career, professional traders largely relied on the same sources for price information and financial news. Research was at a premium, and analysts provided reports only to their investment advisers, salespeople, and selected clients.

Today, real-time price quotes are readily available by looking online, through brokerages, and with mobile apps. Wall Street research faces competition from financial websites, blogs, and independent analysts. While information flows freely, social media drives increased interaction among individual investors and encourages the sharing of experiences and ideas.



Figure P-1 Live trading pits like this one are largely extinct

Source: Shutterstock

I have seen the evolution firsthand and from a unique vantage point. Prior to joining TD Ameritrade, I worked for thinkorswim® (TOS), a Chicago-based brokerage firm with a focus on options trading. It was a revolutionary standalone trading platform specifically designed for individual traders. At that time, average daily volume across the listed options market in the United States was about 2 million contracts. Just ten years later, in 2009, that figure had increased to more than 14 million.

That same year, TD Ameritrade acquired thinkorswim and has continued to develop and improve the thinkorswim trading platform. This book includes many charts, examples, and ideas that have been developed over the years by the great team I am on at TD Ameritrade. As the markets change, so do our technology and tools.

Despite the fact that the number of trading instruments has increased exponentially, buying and selling is faster and more efficient, and information is more readily available than ever, some

things in the options market are the same today as they were thirty years ago. For example, the determinants of an option price are the same today as in the 1970s. As you will see, there are basic tenets of investing that don't really change, and once you learn them today, they are likely to still apply thirty years from now.

The aim of this book is to share my experiences to help readers better understand the options market and explore the opportunities that exist today. I want to do it in a way that offers a commonsense approach without overwhelming the reader with numbers. But, at the same time, the book won't accomplish its objective unless the reader fully understands key concepts.

In summary, the fundamentals of the investment process don't really change, but the advances in technology have created an environment where individual investors have better information and tools than they did in the past. In fact, there has never been a better time to learn the options strategies that were once the domain of only the smartest professional traders.

The book kicks off with Part I, appropriately titled "Getting Started in Investing." Chapter 1, "The Opening Bell," begins with very basic information you need prior to investing in stocks or options. For many, this is merely review, but for those of you who are newer to trading options or newer to investing in general, it offers basic information about financial markets today, how to get started, and suggestions for creating a trading plan.

From there, the discussion continues with a list of indicators to track in Chapter 2, "First Days of Trading." Understanding underlying instruments such as stocks, futures, and indexes is important and covered in Chapter 3, "Know the Underlying." I conclude Part I with a discussion about "Avoiding Mistakes," the focus of Chapter 4.

Part II takes a basic understanding of investing to the options market. Chapter 5 covers options basics. Call and put options are defined in Chapters 6 and 7. Chapter 8 explains the determinants of options prices, and the math gets a bit more advanced when I talk about probabilities in Chapter 9. But don't worry, all of the examples are intuitive, and no advanced math is required.

Part III dives into more advanced options strategies. The basic strategies of covered calls and protective puts are covered in Chapters 10 and 11. Then my focus turns to spread trading. Long vertical spreads are the topic of Chapter 12, and short verticals are discussed thoroughly in Chapter 13. Calendar or time spreads



are discussed in Chapter 14. Chapters 15 and 16 explore two advanced strategies—butterflies and condors. Chapter 17, “The Close,” concludes Part III and covers the important concept of risk management.

For reference, Appendix A offers a look at delta, gamma, and the other Greeks. It offers definitions of each measure and serves as a quick reference. Appendix B shows different charts and basics of technical analysis. It also includes the payoff or risk graphs for the options strategies covered in Chapters 6 through 12. Appendix C is a primer on stock charts and volatility studies. A Glossary is provided at the end of the book as well.

I really hope this book helps you understand the fundamentals of the options market while also providing the confidence and tools you need to begin using strategies as part of a longer-term trading plan. Importantly, while I use real-world examples in this book, they are for educational and illustrative purposes only.

The securities depicted are sometimes real and sometimes hypothetical. They are specifically not solicitations or recommendations to trade a specific security or to engage in a particular trading or investing strategy. In addition, transaction costs, such as commissions and other fees, are important factors that should be considered when evaluating any trading opportunity.

The book starts at a very basic level, and for experienced traders, Part I might seem like a 101 material. But in the end, the reader will come away with a thorough understanding of options, techniques the pros use, and why the industry has experienced exponential growth since I started my career on the trading floor.

Please use this book to help you and your family pursue your investing and trading goals. Keep in mind that options trading entails significant risk and is not appropriate for every investor. Complex options strategies can carry additional risk. And futures and futures options trading is speculative and not suitable for all investors.

For me, the options business is something that I love and am passionate about. Hopefully, after digging through the early chapters, you will share the same appreciation about this business . . . and how it can provide tremendous opportunities for anyone willing to work hard and learn.

# Acknowledgments

I was very happy to be given the opportunity to write a book designed to help retail investors as they embark on their journey into options investing. My goal was to provide information that demystified much of the difficulty by making the approach straightforward, using common sense rather than complicated math. I have been lucky to meet so many of you who are out there day after day working to get better. I admire your desire to learn and your commitment to improving your lives through investing. You are the inspiration for this book, and I hope you find it useful.

This was a large undertaking, and so many TD Ameritrade partners helped make it a success. A big thank you to CEO Fred Tomczyk, President Tim Hockey, and EVP Trader Group Steve Quirk for allowing me to pursue this undertaking. Thank you to the Active Trading Team for letting me work alongside you every day and seeing all your amazing accomplishments. I want to thank the Compliance Team. This took many hours of your time, and I greatly appreciate it. Thanks to the Marketing Team for all the help getting started and the constant guidance along the way. CAPAE Team, you are always a pleasure to work with, and Legal Team, thank you for your trusted counsel.

Fred Ruffy, it was great working with you. Thank you for the insight and suggestions. Thanks to the folks at Wiley. You are wonderful partners who made the process easy.

Thanks to both Zack Fishman and Paul Picchietti for taking a chance on me straight out of college and beginning to teach me the world of options. And also, thanks to Tom Sosnoff, from whom I have learned so much.

Most importantly, I want to thank my family—my late parents who did an amazing job of showing me the meaning of work ethic and sacrifice; my brothers and sisters for helping their youngest sibling every step of the way; and, of course, my wife, Karen, and our children, Kaitlin, Kevin, and Kelly.

## About the Author

An options industry veteran, JJ Kinahan started his trading career in 1985 at the Chicago Board Options Exchange (CBOE). As a market maker, he traded primarily on the floor in the S&P 100 (OEX) and S&P 500 (SPX) pits. Later, he worked for ING Bank and Blue Capital. He then became managing director of options trading for Van der Moolen, USA.

In 2006 JJ joined the Chicago-based options trading brokerage firm thinkorswim where he served many roles, including developing educational content and helping build the tools that are integrated into the thinkorswim® platform today. JJ is now chief market strategist for TD Ameritrade, which acquired thinkorswim in 2009.

JJ is a frequent CNBC guest, a *Forbes* contributor, and often quoted in *The Wall Street Journal*, *Financial Times*, Reuters, and many other respected media outlets. He is on the Advisory Board at the CBOE. When not busy working or trading, he is an avid Chicago sports fan who enjoys reading, fishing, and spending time with his wife and three children.

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P A R T

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## Getting Started in Investing