


NO-HYPE OPTIONS TRADING



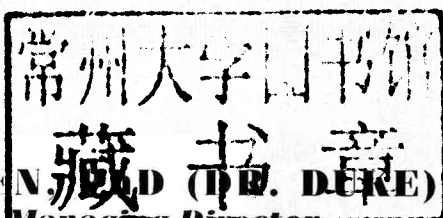
MYTHS,
REALITIES,
& STRATEGIES
THAT REALLY WORK

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No-Hype Options Trading

*Myths, Realities, and
Strategies that
Really Work*

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I owe thanks to many teachers in my continuing journey of options education. The foundation of my options education came from Jim Bittman, Marty Kearney, and Russell Rhoads at the Options Institute of the Chicago Board Options Exchange. Several of my “aha” moments came through conversations with Jim Bittman in hallways and over lunches. Jim was very open about the “real-world” aspects of options trading often overlooked in the options education literature. I also owe a great debt to Dan Sheridan and Casey Platt for the personal coaching that honed my options trading skills. And I thank my editor, Kevin Commins, for his excellent advice and support.

Introduction

Does the world need another options trading book? Before writing this book, I looked at all of the options books available on Amazon and it was daunting. But this book brings a different perspective to options trading. The existing options trading books fall broadly into two categories: (1) how to become financially independent in two weeks, and (2) how I made a fortune trading on the exchange floor. In the first case, it is largely marketing hype, and the second case describes trading options from a perspective that isn't realistic for the retail options trader. I admit this generalization does a disservice to several excellent options trading books, but exceptions do not invalidate generalizations.

My experience learning to trade options was lengthy and often painful. Trial and error characterized much of my learning curve. I spent large amounts of time and energy debunking many of the options trading myths. For those of you new to options trading, we will debunk those myths in the first few chapters of this book. But if you have some familiarity with options trading, you have probably heard or read the adage, *When implied volatility is high, sell credit spreads, and when implied volatility is low, buy debit spreads*. This is a classic example of a commonly taught rule for options trading that is absolutely false. The truth is that the credit spread and the debit spread at the same strike prices will always have the same risk/reward characteristics. Another instructor confidently assured me that out-of-the-money debit spreads would be successful 80% of the time and were "low risk." The truth is that those types of spreads have a very low probability of success—more like 25% than 80%. His options education firm likes to advertise those trades as low-risk trades because they require only a small investment. Lottery tickets are inexpensive as well.

Unfortunately, options education is infamous for outrageous marketing claims and sales pitches; for example, the following was a header on a web site for options education: "When was the last time you made 300% in three weeks?" In the overhyped world of trading education, it is exceedingly difficult to discern reasonable expectations for your returns with

various trading strategies. This book will give you the foundation to develop a trading system with a probabilistic edge.

The end result of my “wandering in the wilderness” was the development of successful options trading systems for steady income generation. My objective with this book is to save you much of the time, effort, and losses that characterized my options trading learning process.

This book is unique in several key aspects:

- The author is a retail trader, just like you. This book describes trading strategies I use every day as a retail trader, not trading techniques that worked in the options trading pits several years ago.
- This book will give you the foundational knowledge of probabilities and options pricing that you need to survive and prosper in the options markets—nothing more and nothing less.
- This book will not clutter your mind with useless information like synthetics. Many instructors will teach you how to build combinations of stock and options to create positions that mimic other positions, thus the so-called *synthetic* position. For example, one may create a synthetic stock position by buying a call option and selling a put option to create a synthetic long stock position (i.e., this option position behaves exactly like owning the stock). Recognizing those relationships is crucial to the market maker on the floor, so he can hedge that position perfectly by shorting stock. However, synthetics aren’t relevant for the retail options trader who is focused on conservative income generation.
- In this book, you have entered the No-Hype Zone. Many options trading education firms advertise examples of several hundred percent gains and claim to have discovered the “Holy Grail” of trading. Those are deceptive claims that have lured many unsuspecting traders into large losses in the markets. We will debunk the options trading myths and give you the basic knowledge necessary to turn your options trading into a profitable business.

Much of the options trading literature has been written by former options market makers and floor traders; many of the options trading instructors come from the same background. But the skills and knowledge necessary to be successful as market makers in the exchanges have little in common with the skills needed to succeed as a retail options trader. In fact, many of the personal characteristics that helped them succeed in those roles may be detrimental to the retail trader. The market maker must take every trade, and he must act quickly; volume is important in that business. But the retail trader can analyze trade candidates and market conditions and patiently wait for the optimal trade setup. Due to the speed and pace

on the floor, market makers tend to be hyperactive personalities; calmly allowing a trade to develop over time would be against their nature. Retail traders can be very patient and deliberate and may trade only a few times per month.

So this options trading book is different. This book is focused on you, the retail trader, and it will give you the knowledge and the strategies to build an options trading business that generates steady monthly income. So let's get started!

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PART I

The Foundations of Options Trading

Option Basics

Stock options are members of a large group of varied financial instruments known as *derivatives*; that is, options are derived or based on shares of common stock or stock indexes. Unlike stock certificates, where there is a fixed number at any given point in time, option contracts are actually created as they are needed in the marketplace. One of the figures you will see in the option price chain on your broker's web site is "open interest," the number of contracts for that particular option that are outstanding at that point in time.

DEFINITIONS OF CALLS AND PUTS

A *call option* is effectively a contract giving the owner of the option the right to purchase a fixed quantity of stock within a particular period of time and at a specified price, the strike price. An example would be a December \$200 call option for Apple Computer. The owner of this option has the right to buy 100 shares of Apple Computer stock for \$200 per share anytime up until the December expiration, the Saturday following the third Friday in December.

A *put option* gives its owner the right to sell a fixed quantity of stock within a particular period of time and at a specified price. Analogous to the call option example, the December \$200 put option for Apple Computer gives the owner of this option the right to sell 100 shares of Apple Computer stock for \$200 per share anytime up until December expiration.

ARE YOU LONG OR SHORT?

In both stock and options trading, we refer to being *long* when we have purchased a security, as in: “I am long 200 shares of Apple Computer (AAPL)” or “I am long 10 contracts of the April \$200 calls for AAPL.”

Short refers to a security I have sold, so I can be short shares of AAPL stock or be short AAPL calls or puts that I have sold. When I am short stock, I have an obligation to buy the security at some future date to close the trade. The same is true when you are short options. However, with options, you may not have to close the position if the option expires worthless, but you would be wise to always remain aware of your obligations when you are short options. Many traders make it their practice to always buy back, or close, a short option position before expiration, even when it appears likely the options will expire worthless.

When we own options, we are said to be long those options, and if I have sold the options, I am said to be short those options. When I am short options, I no longer have a right to buy or sell stock as I did when I owned the options. The person who sold the call option has the obligation to sell the fixed quantity of stock at the specified price anytime before the option expires. If I sold the December \$200 call for AAPL, I have an obligation to sell 100 shares of Apple Computer if that call option is exercised against me. The option’s exercise is similar to the person to whom I sold the option coming to me and saying, “Sell me 100 shares of Apple Computer for \$200 per share,” and I don’t have a choice; I have an obligation when I am short options. In a similar way, if I sold the December \$200 put option for AAPL, I am obligated to purchase 100 shares of Apple Computer at \$200 per share if the put option is exercised. When I am long an option, I always have the right to exercise that option and either buy or sell the underlying stock, but it is entirely my choice. When I am short options, I am obligated to buy or sell the underlying stock if the option is exercised. I don’t have a choice.

OPTION CONTRACT SIZE

Options are bought and sold as contracts that normally cover 100-share lots of stock. There are exceptions, usually created by mergers and acquisitions where two stocks were combined, and an option may cover some other number of shares of the underlying stock. When you are perusing an options chain and see an option that appears to be more expensive than you would expect, based on the other options in that chain, that option

may cover 125 shares (or some other number) rather than the standard 100 shares.

The option contract is priced on a per-share basis. For example, that Apple Computer \$200 call may be offered for sale at \$4.25. Since this contract covers 100 shares, we would pay \$425 for one contract of the Apple \$200 calls. The options contract is priced per share of the underlying stock to make it easier to see the relationship to the stock price.

IS MY OPTION IN- OR OUT-OF-THE-MONEY?

Options have a unique terminology that reflects the relationship of the option strike price to the current price of the underlying stock. If the strike price is close to the current stock price, we refer to that option (put or call) as *at-the-money* or ATM. Often, a stock price will be between strike prices, and the options on either side of the stock price will be considered ATM.

If the price of Apple Computer stock is \$210, then I could exercise my \$200 call option and buy 100 shares of Apple Computer for \$200 per share or \$20,000. I could then sell that stock in the market for \$210 and have a gross profit of \$1,000 (my net profit would depend on what I paid for the option). When the option has a net positive value if exercised, the option is said to be *in-the-money* or ITM. Call options with strike prices below the current stock price are ITM while put option prices with strike prices above the stock price are ITM.

However, if I owned the AAPL \$200 call option and the current AAPL stock price had dropped to \$198, I would not exercise the option; it wouldn't make sense to buy 100 shares of AAPL at \$200 when I could buy those shares for less money in the open marketplace. These options are called *out-of-the-money* or OTM. Call options with strike prices above the current stock price are OTM while put option prices with strike prices below the stock price are OTM.

OPTION TRADE ORDERS

Since option contracts are created on demand in the marketplace, the orders for buying and selling options are more complex than the corresponding stock orders. If a trader wishes to buy an option, she has two choices. She may enter an order with her broker, usually via a web site, to *buy to open* or *buy to close*. These are often abbreviated BTO and BTC. I enter a BTO order when I do not have a position in that option and so I am

TABLE 1.1 Option Trade Order Terminology

Option Order	Shorthand	Action	Result
Buy to open	BTO	Buys a call or a put	Creates a long position
Sell to close	STC	Sells a call or a put	Closes the long position
Sell to open	STO	Sells a call or a put	Creates a short position
Buy to close	BTC	Buys a call or a put	Closes the short position

“opening” that position. At some later date, I might want to sell those options, and I would enter a *sell to close* or STC order.

We discussed short positions earlier in this section. If I sell an option when I do not already own that option, I am entering a *sell to open* or STO order and I will be short those options once this order is filled. When I wish to close that short position, I will enter a BTC order. Table 1.1 summarizes the order terminology used for trading options.

OPTION EXPIRATION

Equity options expire on the Saturday following the third Friday of each month. It is common to hear or read that equity options expire on that third Friday because stock options cannot be traded after the close of the markets Friday afternoon. Saturday expiration allows the brokers to perform all of the exercises, purchases, and sales of stock on Saturday before the option contracts expire at midnight. Thus, traders often refer to “expiration Friday” and speak of the options expiring on Friday because this technicality of Saturday expiration has no relevance for traders.

However, some (but not all) index options cease trading at the close on the Thursday prior to expiration and those positions are reconciled on Saturday based on the settlement price established Friday morning. For example, the Standard & Poor’s Index (SPX) options cannot be traded after the close on the Thursday before expiration, but the settlement price is established Friday morning based on the opening price of each of the 500 stocks that make up the SPX (the S&P 500). Since many stocks do not open immediately at the opening bell, the settlement price will differ from the SPX opening price Friday morning. The specifications for settlement and other characteristics of index options can be found on the web site of the exchange that creates the option. For example, the specifications of the SPX options are published on the Chicago Board Options Exchange web site, www.cboe.com.