5 BASIC PLAYS OF TRADING OPTIONS

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The 5 Basic Plays of Trading Options

PREFACE

The market can be a cruel master. Emotional distress and mental anguish can occur at the simplest level, oh, say, tracking your 401k in the midst of the market gyrations of the last few years. Then again, the market can inflict real pain, as in financial pain, when you trade the market. It is a fickle creature with no compassion or empathy, and it cares not one ounce for what you know, or what you think you know, about it.

On the flip side, the market is only your master if you allow that to happen. If you come at the market thinking it is an easy mark for a quick buck, it will own you. If you think you have found a sure-fire way to beat the market, it will own you. If you go after your trading without learning all you can about the market (in general and specific markets), without gathering the proper tools to trade the market (analytic software that really works), and without the proper mental approach (the goal is to win more than you lose), then the market will own you.

So, don’t become the slave longing for freedom. Get on even terms with the market; level the playing field by educating yourself, finding legitimate analytic software and getting your head into the game. If you take the time to do the above, you have a shot at making money, to get a decent return-on-investment (ROI), to beat the odds.

Options trading is one avenue to accomplish a decent ROI or to protect your other investments. It ain’t an easy path, and it is fraught with risk, but so is Life. Go about it carefully, methodically, and with diligence and you just might beat the odds.
The Basics

You might trade options to make a living, to augment your retirement, or to pay for your child’s college experience, or you just might utilize options to mitigate risk on your portfolios as many professional investors do. No matter why you trade options, you need to understand the program.

Options trading can seem complicated, in part because it relies on a certain terminology and system of standardization. But there’s an established process that works smoothly anytime a trade is initiated.

An Investor’s Guide to Trading Options

First of All …

The first thing to understand is that as an option writer you give up control; you give up control over whether or not a contract is exercised. Until that expiration date arrives, you have no control. But so what? To mitigate that lack of control, all you have to do is buy an offsetting contract to terminate your obligation in the contract.

Okay, maybe I jumped ahead a bit, but I thought it important to establish up front the reality of trading options … it is all about the risk.

Option Trading Defined

An option is a financial derivative that represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date).

Investopedia
Are you still with me? Remember, options trading relies on “a certain terminology and system of standardization.” Once the basics are firmly engrained in your brain, the rest gets easier. Hold on. I have one more thing to throw at you before we move on – the difference between trading options and trading futures. These two are often confused because they both involve the price of a thing in the future.

Futures and options contracts are often confused, but they are similar in that each involves subsequent events. A futures owner has the obligation to buy or sell a specified quantity of an asset at a specified price on a specified date. In contrast, an options holder has the right (but not the obligation) to buy or sell a specified quantity of an asset at a particular price over a specified time period.

Investopedia

Rights and obligations in the future is the difference. As an options trader you have the right to buy or sell without obligation, which means you have more options to make money or mitigate risk. Yes, "options" trading...

WHAT IS AN OPTION?

Now, to trade options, you need a contract on an underlying financial instrument, such as an equity (stock) or an index, such as an ETF (exchange-traded fund). There are other, more exotic, instruments to trade, but for the purposes of this e-book, “stocks” are the focus.

The contract for the option establishes a specific price and time upon which the contract will be exercised. That would be the strike price and the expiration date. Keep in mind that when that option expires, its value becomes extinct, along with the option itself. As well, keep in mind, every option contract has a price called a premium.

As stated earlier, trading options can be complex, but if you learn the process from the basics up, it can be quite simple. So, here it is. There are only two types of options – calls and puts. You can buy or sell either. Empirically, this is it. You choose to buy or sell (either a call or put) a stock in the future with a contract.
WHAT'S THE PRICE?

Options pricing is established by supply and demand in a specific market. Well, okay, as it is with the broad market, other factors unrelated to supply and demand affect options pricing as well. Volatility is a big one, but hold that thought for a moment. As it is with stocks in general, economic conditions around the world and investment sentiment also affect options pricing. The thing about options trading though, much like swing trading, is one needs to have some handle, a tool if you will, on what will happen in the near future. In both cases (swing trading and options trading), one important tool is volatility, both implied and historical.

IMPLIED VOLATILITY

*Implied volatility is a statistical measure that reflects the likely range of a stock’s future price change. It is calculated using a derivative pricing model, which is a fancy way of saying it connects the dots between the stock’s options pricing and the market’s expectations of the future. The Ticker Tape*

– TD Ameritrade

Implied volatility is, perhaps, the leading indicator for options trading as it reflects the collective sentiment of future pricing for a stock. For example, if the implied volatility is high, the options price will most likely be high, as it suggests the expected price change will be large. Do not confuse this correlation with an expectation that implied volatility suggest direction in the pricing. It does not. It points to probability and size, and that is it.

Make no mistake, though, understanding and utilizing implied volatility is key to successful options trading.
HISTORICAL VOLATILITY

Historical volatility is a lagging indicator, as it is the actual volatility over time, but it can be a useful one when compared to the implied volatility of a stock. The comparison can help one assess the relative value associated with “expected” volatility, meaning, how inflated or deflated is the future price relative to the implied volatility price. Simply, higher implied volatility compared with historical volatility likely points to an expensive option, while lower implied volatility suggests an inexpensive option. Historical volatility is a tool that can help one determine fair future value.

THE WAY IT WORKS …

Writing or buying a contract means you are opening a position. You are then on one side of the contract and there is an anonymous buyer or seller on the other side. Closing a position simply means you either sell the option you own or buy the option you sold.

TERMS TO UNDERSTAND

✓ An options buyer purchases a contract to open or close a position.
✓ An options holder buys a contract to open a long position.
✓ An options seller sells a contract to open or to close a position.
✓ An options writer sells a contract to open a short position.

RISK MANAGEMENT

If you are looking to pay for your child’s college education in one trade, perhaps you should not trade options. Just sayin’ ...

At the other end of the spectrum, options can be and are utilized to mitigate risks in an existing portfolio. Think of trading options as an insurance policy against a drop in stock prices. “Hedging” is a widely utilized tool in the investment world, and one to consider if you are an active investor.
HOW IT WORKS ...

The market is often irrational, so, even with the best due diligence, an investment can drop in price for no parent reason, or, there well might be a rational reason you did not see coming. Either way, trading options can give a hedge against a drop in price for any reason.

Simply, an investor can purchase a put that gives the right to sell the stock at the strike price, no matter how low the market price drops before expiration. Risking only the cost of the option’s premium (the option price quoted when the contract is written), the investor has insured against losses below the strike price. Not a bad option, right?

Here is one more potential benefit of hedging. If the stock price goes up before the expiration of the option, the premium goes up as well. At that point, an investor can make money on the rising stock by selling the option and make money on the underlying stock owned as well.

As stated earlier, this e-book focuses on stocks. The reason for that is that stocks offer the best chance for making money trading options. Current information about large, widely-held companies is easy to track down which gives the investor the advantage of a more informed position regarding how the stock might perform over long periods of time. That singular piece of the options game is, arguably, the most important piece. Yep, it is a wise idea to get very good at trading options in the stock market.
The 5 Basic Plays of Trading Options

THE RISKS

The fact of the matter is this: your risk can be as small as the premium paid on an option or it can be your whole bank account. For example, if you choose to use options to provide leverage, your losses can be quite extreme. What your losses or gains are depends on your ability to be in control in a situation in which you have no control. Make sense? Okay, let me put it this way.

Maybe you have no control over the expiration date, what the other side of the deal will do, or what the underlying stock will do, but you do have control over everything else, which means you control the risk factor. Remember, it is all about the risk. Do your due diligence, utilize analytic software that really works, make informed decisions, and then risk only that which you can afford to lose.
The Five Basic Plays of Trading Options

The five plays below are the most basic of all options trading. Not only are there derivatives of the five, but there are plays beyond these. If or when you master these five, up the ante and move on to others, but be prepared more complexity and more risk.

**Call Buying**

One of the simplest, most popular, and least risky ways to trade options is buying calls. Simply, you can go one of two ways:

1) If you believe a stock will rise in value above the strike price plus the premium by the expiration date, you buy a call.

2) If you believe the premium on an option will rise faster than the time decay (expiration dates increase diminishing value), you buy a call.

*Risk factor: low. All you can lose is the premium.*

**Call Writing**

If you want cash up front, write a call. If you want a bit more risk for a bit more return, write a call. The bet is that the option is not exercised.

*Risk factor: low or high, depending on whether your position is covered or uncovered.*

**Put Buying**

This is the risk management strategy (protect your portfolio) many professional investors utilize, and, like the other two above, it is simple and straightforward - Don’t sell your stocks and don’t short stocks in a bear market. Instead, buy a put.

*Risk factor: low. All you can lose is the premium.*
**PUT WRITING**

If you are thinking about buying a specific stock, locking in a purchase price for a specific number of shares can be advantageous. Now, the advantage also extends to a hedge against the stock price rising. If it goes up, you still receive the premium, which might, in fact, be profitable.

*Risk factor: higher.*

**SPREAD STRATEGIES**

Of the five basic plays, spreads are the most complex. They require two separate usually simultaneous transactions. Basically, you purchase an option and then write an option on the same stock. What differentiates the options transaction is either the strike price or the expiration date. Vertical spreads are the most basic. In the vertical spread, one option has a higher strike price than the other, which is the spread.

*Risk factor: higher.*
Thanks to An Investor’s Guide To Trading Options, there is a straight-up chart that helps investors interested in trading options more comprehensively understand the five basic plays iterated above. As luck would have it, here it is. Thank you Virginia Morris.

### A CHART TO LIGHT THE DARK

<table>
<thead>
<tr>
<th>Possible Objective</th>
<th>Your Market Forecast</th>
<th>Potential Risk</th>
<th>Potential Return</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Call Buying</strong></td>
<td>Profit from increase in price of the stock, or lock in a good purchase price</td>
<td>Neutral to bullish</td>
<td>Limited to the premium paid</td>
</tr>
<tr>
<td><strong>Call Writing</strong></td>
<td>Profit from the premium received, or lower net cost of purchasing a stock</td>
<td>Neutral to bearish, though covered call writing may be bullish</td>
<td>Limited for covered call writing</td>
</tr>
<tr>
<td><strong>Put Buying</strong></td>
<td>Profit from decrease in price of the stock, or protect against losses on stock already held</td>
<td>Neutral to bearish</td>
<td>Limited to the premium paid</td>
</tr>
<tr>
<td><strong>Put Writing</strong></td>
<td>Profit from the premium received, or lower net purchase price</td>
<td>Neutral to bullish, though cash-secured puts may be bearish</td>
<td>Substantial, as the stock price approaches zero</td>
</tr>
<tr>
<td><strong>Spreads</strong></td>
<td>Profit from the difference in values of the options written and purchased</td>
<td>Bullish or bearish, depending on the particular spread</td>
<td>Limited</td>
</tr>
</tbody>
</table>
TRADING OPTIONS WITH VANTAGEPOINT

Utilizing analytic software for trading options is one of the keys to succeeding. As stated earlier though, you have to utilize software that produces forecasts with leading indicators and the most current technology. When you review analytic software for trading, you will see this is the case. Precious few fit the bill, but one that does is VantagePoint from Market Technologies.

THE TECHNOLOGY

The most current technology in market forecasting is neural networks. Although neural networks technology has been around for some time, not every market-analysis software utilizes it, which is a shame because neural networks do the work no human could. Not to put too fine a point on it, but crunching the numbers with the “brain” power of neural networks is what gives VantagePoint its incredibly high accuracy rate of up to 86% on short-term forecasts.

And the thing about Market Technologies is the company is really good about keeping its neural networks in VantagePoint current with the latest innovations in programming, which is good because it is the neural networks that collect, compile, and compute the data from lots of related markets – intermarket analysis.

Intermarket analysis is important in today’s global market because whether it be gold, currencies, or IBM, all market behavior is relative to other market behavior. What one market does has a ripple effect on another, and another, and so on, which then creates patterns. This is what the neural networks do – crunch the numbers from relative markets to produce short-, medium-, and long-term forecasts based on patterns.

VP’s predictions are so accurate because the neural networks analyze data from thirty different but relative markets to come up with the prediction for the single market (intermarket analysis). With the click of your mouse, you can see the markets relative to any specific market VP uses in its intermarket analysis.
For over 25 years, Market Technologies has incorporated the latest and best technology into VantagePoint to find patterns. Thousands of traders around the globe have successfully utilized it for decades and over 15,000 utilize it today. It is a track record for sure, but it also a testament to the commitment of traders to both master the elements of trading and to learn how to utilize VantagePoint to its fullest. To succeed, you have to do both.

**A SIMPLE TRADE EXAMPLE**

Learning how to fully utilize VantagePoint (VP) will take some time, but that does not mean it is difficult and complex to use. Quite the opposite. The software is intuitive and straightforward, which is what you want when trading options.
In the chart above, the black line represents the actual 5-day SMA (simple moving average) and the blue represents VantagePoint’s proprietary predicted moving average. The black is what has already happened (lagging) and the blue line is what probably will happen (leading). Remember, independent testing has shown up to 86% forecasting accuracy with VantagePoint’s proprietary predictors.

Okay, so here is an example of how you could have made an options trade with VantagePoint and made money.

In the chart above, note the blue line crossing over the black line on May 18th. This “crossover” predicts a trend change. On May 18th, VP predicted the price of Micron would go up in the next 1-3 days. With another mouse click, you can produce the historical predicted high and low for Micron (See the red line below.), which is the key to assessing your entry point for an options trade.
Going to the next screen below, note on May 19th, the predicted high is $10.49 and predicted low is $9.82.
Now, had you made this trade, you could have taken an out-of-the-money call or put just slightly out of the money by using the predicted high. You would have looked for a strike price at $10.50, just above the predicted high. Doing a weekly option, the 27th would have been the expiration date, and you would have gotten in at only 5 cents per share, five dollars per contract (100 share lot), and 10 contracts would have only been $50. Your risk would have been $50.

Every day, you would have checked your position, seeing that the trend was not changing you would have stayed in, and then on the 27th, the expiration date, you would have exited your position making $2.24 per share, which means you have made a $2240 gain on 10 contracts for a $50 risk.

The above example is a simple one, but that is how you can play the options game with VP – easy and simple.
I am not sure one can overplay the need to say that when trading options, there is a higher level of risk. So, again, if you go about it carefully, methodically, and with diligence and you just might beat the odds.

Finally, the above is just an introduction to a complete arena in which many compete but only the smart survive. There is a whole lot more to the world of trading options, but here three more thoughts to take away with you as you contemplate the reality of trading options.

1) Always have a way out. Prepare an exit before you enter. Your exit strategy could mean the difference between a profit and a loss or the size of your profit or loss.

2) Understand, so much of “winning” at the options game is about timing. A small change in the price of the stock might be the deciding factor between sitting tight and closing out.

3) Even though you “give up control” when you trade options, as you fundamentally do whenever you play the market, you never give up control over your decision-making. Every choice you make should be founded on due-diligence, hard work, and, most of all, clear thinking, meaning, emotion-free, when it comes to the market. Remember, the market does not have a single emotion about your investment or you, Treat it with the same respect.