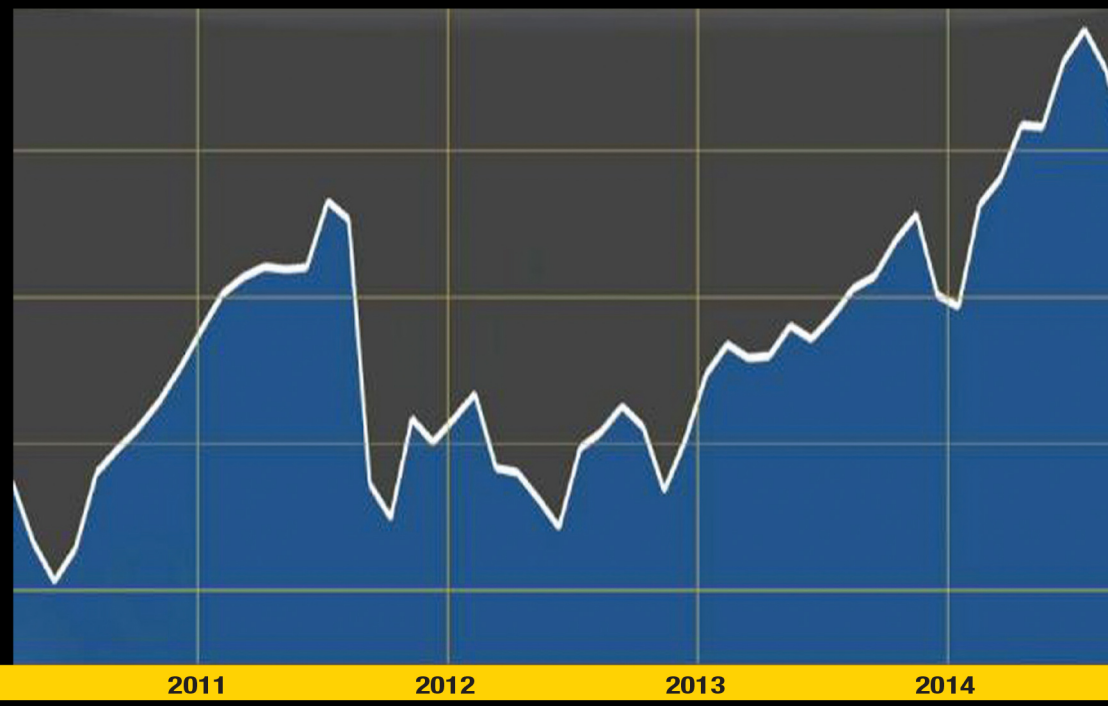
BUBBA'S GUIDE TO TRADING OPTIONS



Todd "Bubba" Horwitz

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INTRODUCTION

Hi, my name is Todd *"Bubba"* Horwitz and I am here to introduce you to **BUBBA'S GUIDE TO TRADING OPTIONS**. The traders that produced this system of learning are former market makers that want to teach you how they have been able to translate their skills of winning trades to the retail option market. We have been involved in the successful trading of stocks, futures, currencies and options both on and off the floor of the world's major exchanges for a combined total of more than 50 years. We have been able to take that knowledge and condense it into simple language is that easy to understand. You will not need to worry about impossible, complex websites, and equally complicated mathematical formulas. You will be taught to make simple decisions. In addition to those decisions, you will be taught how to execute trades with those decision making skills. We built this program off of our own wins and losses.

Because of our experience, we are able to present a unique view of these markets to you. We will give you insight as to how markets work. Also, how professional floor traders discover price, and take that information and use it to produce phenomenal returns on capital. You will not only begin to understand the markets, but will have the ability to successfully analyze any market you want to trade. You will learn which markets can be used to trade, and which markets are traps, traps that are sure to take your money. In short, when you have completed your course, you will be in a position to take advantage of any market opportunity that presents itself. The course will debunk many of the myths about options. You will learn that options trading can be successfully learned by anyone who is willing to take the time and effort to change their investing life.

The course is divided into 10 chapters. The course covers the history and makeup of markets and options, types of

analysis, option modeling, and finally, how to successfully trade options. It is structured on a “building block” method, each chapter building on the previous material. The first chapter will look at market basics: how the market cycle is born, how it grows, and what happens in the end of that cycle. Once you have an idea of what a market is, you will learn how markets actually function. You will learn the terminology used to trade the markets. A complete glossary of terms will give you command of the language used in the options world. In later chapters you will learn information needed to construct trading strategies and how to manage trades once they are in place. Finally you will learn how to open and close trades managing the risk and reward that is inherent in any trade.

At the end of each lesson there will be a short quiz. Before you go to the next section make sure that you have full command of the previous material. If you have trouble with the quiz, go back and review the information until you can pass the quiz.

Let’s begin!

CHAPTER 1: MARKET BASICS

Many beginners don't have the slightest idea of what constitutes a market. So before we learn to trade options we need to learn a little more about markets in general. Success is built one block at a time. If you want to become a pianist, you first learn to play a single key. If you want to run a marathon, you begin conditioning by running a block, then 2, then 5. If you want to be an options trader, you must learn to think like an options trader. One of the best places to start is to examine markets of the past. Later you will learn (that) on a micro, basis these markets trade every day. But unless you are prepared to spot them, *and take advantage of the situation*, they will pass like the proverbial ship in the night. So let's study a specific market cycle to see what happened, and the results.

Panics

Almost all investors are familiar with the Worldwide Great Depression (1929-1939) and many other tough times in history. For our study we are going to consider the Financial Meltdown of 2008. It is fresh in our minds, and is one of the largest panics in the past 100 years. However, it's not unique. The fact is, panics have been part of (almost) every economy dating back to ancient times. If you are going to learn how to trade, hedge or invest, you will need to know a little about economic history. As you will learn, **market dynamics always repeat.**

Panics start in various forms. Usually the market begins with a commodity, or product that will change the way we live or earn an income. The panic starts as a typical market, There will be some interest in a new version of an older product, or some technological revolution, that new, cool widget. As the price accelerates, the common theme of all panics is that during this "time is different," the price can only go higher. In

our case study, it was housing.

Affordable housing has always been part of the American dream. In 1977 with the passage of the well intentioned Community Reinvestment Act, housing was made available to more Americans. Beginning in the early 90's, and extending into the 2000's, the Act was adjusted several times, generally lowering standards for home loan qualification. At the time, the changes were widely applauded. Certainly the Mortgage Business, the Lending Industry, the Building Trades, and the Legal profession were ecstatic. Housing is one of, if not the largest industry in the world.

When the lending limits increased to include many potential home owners that were not eligible before, some economists asked, if housing was made too available, what would happen if the market became overleveraged? They noted that history has shown housing prices could spiral in a downward direction when the economy took a large hit. What might be a typical downturn in the business cycle might also become a full blown depression. The detractors were largely ignored and the initiatives became law.

The government's quasi lending arms: **The Federal Home Loan Mortgage Corporation** ("Freddie Mac" (FHLMC) FRE, NYSE) and **The Federal National Mortgage Association** ("Fannie Mae" (FNMA) FNM, NYSE), purchased conventional loans offered to borrowers with excellent credit, for as little as no money down. The housing market began a boom period that was unprecedented in American history. With new buyers entering the market in record numbers, there seemed to be no end to the market. ***"This time would be different."***

Beginning in 2002 new initiatives passed with even lower standards. After all, if the current market is so good, why not allow more participants? Congress enabled a new class of borrowers, the so-called "Sub-prime" applicants. Sub-prime

borrowers needed to put up a little more cash to enter the market, and pay slightly higher interest rates, but they would be able to realize the dream. The lending requirements eventually allowed so-called "No Doc (No income documentation needed)" loans enabling major loans to be taken out with hardly more than a smile and a signature.

The first years of the eventual bubble passed without notice; ***things were good!*** Housing starts rose, employment in the industry was healthy and real estate values began a gradual upswing. After the Dot com, Bubble subsided. The Fed moderated interest rates to encourage a "soft landing" and renew general growth in the US.

On Wall Street the packaging of mortgages which had been around since the late 1990's began to increase. These "securitization" packages were bundled, rated AAA by all relevant credit agencies, and sold to anyone who would care to purchase them. The securitization became even more successful, as real estate prices continued to rise. Soon, homeowners were allowed to cash out some of their equity by refinancing their purchase. This phenomenon became known as the "wealth effect." Money taken out of the homeowner's equity could be used to buy second and third homes, or it could be used to buy cars, computers, vacations, anything turning one's fancy.

In 2003 stock markets around the world began to rally. Profits from these markets allowed even more people to take advantage of the wealth effect. For scores of citizens that meant taking advantage of the new housing initiatives. Borrowing money from their pension plan allowed them to benefit by participating in the rising price of the real estate market, furthering the wealth effect. This excess of cash was spent on many consumer products, and worldwide consumer markets rallied. Emerging economies such as India and China began to place heavy demand pressure on raw commodities. Globally, price levels started to escalate at all points of manufacturing. Economies world-wide were

prospering with the developed nations driving demand via the wealth effect.

Wall Street, **Freddie Mac** and **Fannie Mae** began buying more mortgage-backed securities, and started to **leverage** even higher in exotic pools. Since the mortgage bundles appeared to be perfectly safe, (how could housing prices decline; they were all rated AAA!) The market in mortgages grew at a tremendous pace. Housing prices began rapid escalation. Few voices were heard to protest that *"prices had gone too far, too fast."* Most were ignored because "***this time is different."*** August, 2006, housing prices reached dizzying heights. Everybody knew someone in the mortgage business, and with quick approval, investors could "flip" houses for substantial profits. Many sub-prime brokers saw their incomes double, triple, or even quadruple in less than a year. TV shows sprang up as reality series, Arab royalty began to develop islands out in the sea to be sold to the highest bidder and real estate ownership became a worldwide frenzy. Nothing could stop the train now! ***"This time will be different!"***

In February, 2007 a small sub-prime mortgage company went under. There was the usual reactionary sell off on Wall Street, but eventually the stock markets resumed their upward spiral. Some grumblings were heard about a liquidity crisis. What liquidity crisis? I'll just sell some of my stock, and buy another house. The doomsayers were scorned as being old fashioned, completely out of touch with "modern economic fact." If you didn't get on the train you'd be left behind. Price levels in raw commodities went vertical. Conventional wisdom was that a fundamental change had incurred in demand for raw commodities; ***"this time it was different."***

In October of 2007 as stock markets around the world peaked, commodity prices began to reach levels that had never been seen before in nominal terms. Some futuristic pundits predicted with the rising powers in India and Asia

having an insatiable appetite for raw commodities, when the earth could run out of hard commodities in less than 20 years. Price levels could never go down again!!! Paper currencies would eventually become obsolete. The only safe way to exist in the economic future was to buy Oil, Gold, and farm commodities.

Finally in the winter of 2008 the first weakness in the bubble started to show. Strangely enough, it happened in the Wheat market, then in Soybeans and Corn. Other commodities started to tumble and finally the price of oil started to retreat. What could be causing this? Of course it was those villains, the profit takers!!! Some fools wanted to lock in their gains. Not to worry the markets would quickly come back.

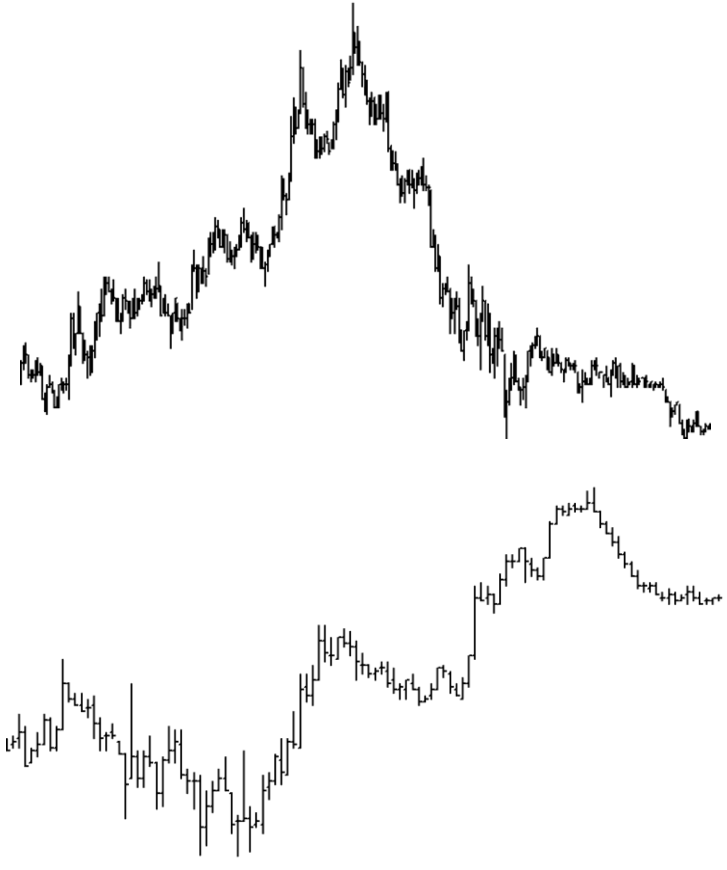
On the Wall Street scene there were other problems. **Bear Sterns** was having problems with some of their AAA rated mortgage pools. Some of the pools were starting to show signs of delinquent payments. Housing prices started to level out, and actually began to fall. The **Bear Sterns** situation became worse. Some of their trading partners would no longer honor their mortgage trades. **Bear Sterns** kept insisting they had some problems, but they had insurance. The world's largest insurance firm **American International Group** (**AIG)** had insured their pools. In a few days **Bear Sterns** filed for bankruptcy. Next it was **Lehman Brothers**, same AAA rated mortgage security problems, same insurer **AIG**. They all started to blowout.

In the summer of 2008 it became apparent the whole financial system was in deep trouble and without a bailout, a catastrophic collapse was inevitable. By November, Oil had lost 70% of its value, grains had lost 50% of their value; the Sheiks who built the islands in the middle of the Ocean went broke. The world economy was in shambles and the housing bubble had destroyed more than 30% of the world's paper wealth. Hundreds of millions of lives were left in economic shambles.

You might be asking, "*What does this have to do with option trading? Everyone knows what happened, who cares? I want to trade options; why do I need to know this information?"*

It has everything to do with trading options. Options reflect market conditions and if you don't know what condition the market is in, you won't be able to trade it!

I want you to look at the following charts.



Ok let's go over them. Can you determine which chart is for oil, which is gold, the S&P 500 and the Dow? In charts 2-4, can you tell the timeframe? What if I told you one is for the Dow over 2 years, one for gold over 10 minutes, one for the S&P for 1 year and the last for oil over 10 days……. now can you tell which is which?

Of course not!

You see, I tricked you. Just like the Housing Panic. It is almost impossible to tell where you are in a market **if you have no reference to time and price!!!!**

This is why before we can learn to trade options; we need to comprehend markets in general. In this section we looked at market basics. We will not use the fundamental cycle to trade, we will only use technical indicators (discussed later), but you will need to be aware of the fundamentals, because you will be bombarded with them on a daily basis. The mass media loves to overplay everything that happens, and certainly you can trust anything that appears on the internet!!!

In this information age we need to be able to separate fact from fiction.

CHAPTER 1 QUIZ

Before we examine how a market works, you are now going to take a small quiz. Make sure to check your answers and review the material again before you go on to the next part.

1) The Housing bubble was caused by the Clinton Administration. T or F.

2) The Bush administration caused the Housing Bubble. T or F

3) Scarcity of Oil will insure that prices will trend higher over time T or F.

4) Rising grain prices can be offset by higher production. T or F

5) Speculators caused the collapse of the Oil market. T or F

6) Housing prices will rise as long as interest rates stay low. T or F

7) Oversupply of housing led to the housing bubble. T or F

8) Wall Street's securitization of mortgages led to the housing bubble. T or F.

9) Subprime lending led to the housing bubble. T or F

10) Bulls and Bears make money, Pigs get slaughtered. T or F

THE SURPRISE ANSWER!!!!!!

All of the above answers are false except number 10.

Greed caused the housing bubble, just as it has caused the downfall of hundreds of markets before, and surely will again. There may be numerous contributing factors, but as proclaimed loudly from the mass media mountain, there are so many *"villains"* in a bubble that it is impossible to name any single source. **WRONG!**

Bubbles are always caused by greed!

CHAPTER 2: MARKET DYNAMICS

In Chapter 1 we learned about markets in general. We looked at the big picture, how all markets will have a tendency to run with a herd mentality, until the herd hits a wall! Has this happened to you? It's happened to anyone who's invested. Can we make money from this information? The answer is yes and no.

It is the first Friday of any month, you are watching cable television and the monthly unemployment figures come out. They are horrendous. Non-farm payroll has risen by 3% and total unemployment is now at 8.2 %. The newscasters are fueling the flames. The market starts to break; you're thinking, *"This is going to be ugly."* You sell 500 shares of Dell Computer. After a brief but violent sell off, the market hits a bottom. It suddenly reverses and rallies for the rest of the day ending up 2.8%.

You own Google. You have been trying to decide what to do with a fairly large position (for you). Google is about to release earnings. You feel that if Google's earnings are good you want to increase your position. If they are poor you will take your profit and look for a new entry. The earnings are released and Google shows record profits for the last quarter. Google immediately rallies 2%. You decide that this is the signal you needed. You double your position in the market. Over the next three days Google declines by 9%.

This can't be right! The numbers didn't lie, but you got barbequed. Could you have seen this coming?

These **FUNDAMENTAL NEWS BOMBS** are quite common. The reaction (or non-reaction) of your stock price performance is referred to as **"MARKET EXPECTATIONS."** No matter what happens to the price after a **fundamental** announcement, it is only what the market has **"discounted"**

relative to the actual released number that matters. For our purposes the term "market discounting" means that all of the news was really in the market to begin with; the price of the underlying stock has already risen (or dropped) leading up to the release date. The immediate price volatility, after the release, is reactionary. Traders tend to talk about a "Whisper Number," the fundamental measurement (earnings, unemployment number, housing starts, etc.) that the street is expecting to be released. That Whisper Number is usually discounted (baked) into the stock price up to the release date. Typically, a News Bomb occurs when the actual number released is significantly different from the Whisper Number.

Let's look at a typical chart pattern illustrating a News Bomb.

In the case of the unemployment number, the **STREET** really felt the number should have been much higher than the 8.2% that was reported. After the initial panic, selling the "strong hands" started to buy and the market finished on the high of the day.

With the earnings of Google, the **STREET** felt that even though the company showed record earnings the results should have been even better. After the initial bullish move the "unexpected results" led to a big sell off.

You should always be prepared to **REACT** to this kind of market **(NOT TO TRY AND PREDICT IT-YOU CAN'T),** Many times the market will have left a footprint that we can see in hindsight. More often however, it will be the new price movement that will be our clue. The only way to make money in this business is to learn from adversity. Don't feel alone, every **good trader** that has lived has had this happen to him or her. As you will learn, your understanding of **technical analysis** will allow you to prosper in trading conditions like these. In fact you will learn to make profitable trades in any market condition!!!

So the answer to our questions is: yes if we want to ride long term trends based on fundamental changes or perceived fundamental changes, but no if we want to be a trader. If you want to trade we will need to use technical analysis. Trading on fundamental data is much too slow, and by the time it hits the market the professionals are already on the other side of the trade. From this point on all of our discussion will be focused on technical factors, we will learn to **REACT TO MARKET MOVEMENT, NOT TO FOLLOW THE NEWS.** But before we can focus on technical factors we need to be acquainted with how markets work. In this chapter we will learn how the market's price themselves, who the parties are in trading, influence the price.

WHAT IS A MARKET?

The English word *market* is derived from the Latin noun *mercatus:* meaning "to trade or exchange." In Old English it was referred to as a *market*, and dates from around the 12th century. Historians know that trade has been the primary

exchange of wealth for well over 5,000 years. It was a logical commercial extension for any group of individuals. Tribe A had fertile soil and could grow crops. Tribe B lived on land that supported game, but the land did not provide abundant crops. Tribe A needed game, Tribe B needed crops, so a deal was struck in which both tribes benefited. This system of barter is also known as a **symbiotic relationship**.

Over the centuries as man progressed, and travel allowed for a larger universe, trade became a great deal more complicated. Bartering face to face was next to impossible. Trade routes became common and **agents** were employed to do the trading for the **principal** parties. Over the centuries, markets progressed to the point that they were conducted all over the world in thousands of different forms. However any successful market still relies on the principal of symbiotic trade.

We have learned how trade began, how it evolved over many centuries, and we discussed how we trade in the 21st century. Now we need to take the next step and look at the markets we will be trading when we begin to use options.

Modern Markets

21st Century financial markets no longer rely on face to face barter, they are conducted through electronic transfers. The markets we will be concerned with are highly sophisticated, and will always result in the exchange of funds. Almost all thriving markets rely on a form of **auction**. When one party wants to procure something, they will place a **bid.** The counterparty will place an **offer**. If no one is willing to yield, the market does not trade. When a trade does occur, it is called **Price Discovery.**

This is one of the most important terms you will

learn in trading. It is the market mechanism that allows the transfer of wealth.

I am fairly sure from time to time that you have made financial transactions. You probably have bought stock. You may have done some currency swaps when you travel, and you may have traded a future or option contract. You know the drill, but do you really know what you have traded?

Let's talk about the process by which these products are exchanged, and who you buy from and sell to. This is important and it will help us to understand **liquidity**. Take a look at a 20 year chart of the **NYSE**; it is the leading stock trading floor in the world.

Enormous amounts of cash change hands on this floor every second and billions of dollars flow through it each day. When you make a stock trade do you ever wonder who you bought the stock from?

When you buy a stock who actually sells it to you? Is it your broker? Is it the underwriter? Is it the mysterious short seller? The answer may surprise you. It is the company that issued the stock!! This is very significant and it will help you to understand the "flow of funds," which we will discuss later. When a company decides to offer stock to the public, they go through a series of steps that will result in an underwriting and an Initial Public Offering (IPO). If it is a small offering it will be conducted in the over the counter (OTC) market or even a smaller stock market known as "penny stocks," sometimes referred to as the "Pink Sheets."

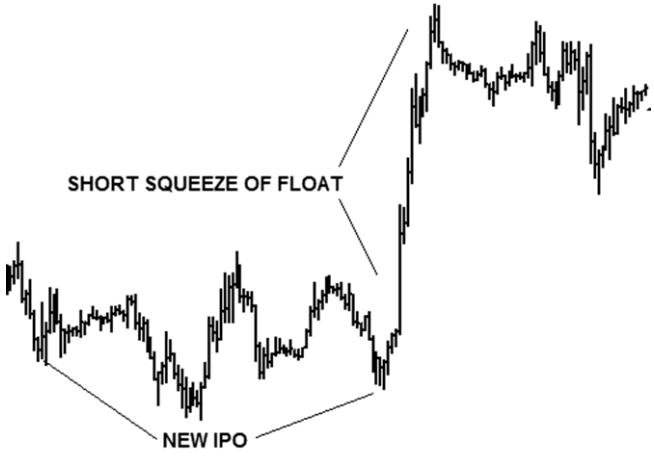
No matter which market the firm uses, when it offers stock, the *originators,* (the original company owners) interest will become "**diluted**." Suppose you come up with an idea for a new internet company. You put together some funds and start your business. It grows and in a couple of years you

need more capital. You meet with an investment banker and go through a process called "**due diligence**" to arrive at a reasonable estimate of your companies net worth.

The Investment Banker then calculates what portion of the company you will need to sell in order to bring in outside capital from investors. The portion that you give up is put into the public offering and is generally referred to as the **"float.**" It is the portion that is available to be bought and sold by the public. Depending on market conditions, the market price of the "float" may be higher or lower. However unless you issue more stock **the float will always be the same**.

Let's examine a chart illustrating a typical price move associated with an IPO in a flat to up trending market.

Note: IPO's can be strange animals. Typically, an issuer will want to issue an IPO in an up trending market and this is probably true in 50-75% of the time. The reason is simple, the issuer wants to acquire capital; price discovery, even in IPO's occurs in an auction market so issuers want to take advantage up increasing prices.



If someone tries to accumulate a high percentage of this float, the price of shares should go up, if they acquire enough shares over a short period of time, the price may explode (see chart above), this is called a **"short squeeze**". If another party feels that the price is too high, they may borrow shares and **"sell short**" in an attempt to drive the price down and buy their shares back at a discounted value. No matter which party is on the other side of your individual transaction, in effect you are buying your shares from the "diluted" shares, shares the company originally issued. Stocks have no specific time for redemption, and will remain on the market until the company either does 1) a **"buy back**", 2) the stock is taken over by another company, or 3) the company ceases' to exist.

If the company has a sufficiently large capital base, their shares may be offered at one of the major exchanges around the world. The company may trade on more than one exchange, and if it does, it is said to be a **"Dual Listing".** You can buy the stock at one exchange, and then sell it at another if you so choose. If the company is smaller in size, it will not be traded on a listed exchange, but will trade over the counter and will be referred to as an Over the Counter (OTC**)** transaction.

The name "over the counter" refers to an earlier time when transactions were conducted at a counter in any place from a Bar to a Drug store. It was a bargain between the two parties and did not have an exchange to guarantee the purchase. This area was, and still is, the Wild West of the trading business.

The size of the float we deal with in stocks, and the open interest when we deal in options, are one of the most important factors we will consider when choosing what underlying vehicle we will use to trade. This characteristic is referred to as **"liquidity**". For our purposes, the term liquidity will be defined as the **"ability to move seamlessly in and**

out or the market". It is quite logical to assume that if the market is too small, it can be controlled by a few insiders. There is no such thing as a market being too big or liquid.

Study the charts below. Recognize the high degree of price action of AAPL relative to the penny stock?

PENNY STOCKS AND LIQUIDITY DISCUSSION

The "**bid offer spread"** and **"commissions"** are vital when choosing which stock, or option. In illiquid stocks or options you may find a quote of **"20c@24c."** Conventional wisdom implies that a 4c spread is immaterial. If you are trading in this market you are in it for big gains. If I buy the offer, it will cost me 4c, no big deal. That is the logic that unscrupulous market makers use, *"The markup on this Penny stock is only 4c"* or *"Commissions on this stock are only 1c".* What are they really telling you? If you buy the Penny Stock it needs to go up by **20% just to break even. Add in a commission and the Stock must rise by 25%!** If there isn't enough open interest the Penny stock can easily be manipulated by **"strong hands".** The **"weak hands"** will be overpowered when the market turns and will have nowhere to exit the market in an orderly fashion. This power play can happen in any market, but it is particularly rampant in the illiquid markets. Illiquid markets should always be avoided. Never consider **"Penny Stocks**" for trading purposes. This market is the all time scam. For every investor that runs a thousand dollars into a million, a million investors run a thousand dollars to zero. You have a better chance at a Casino.

Think about what happened in the meltdown of 2008. How did Wall Street bust out? It was over leveraging, **and the liquidity of the market disappeared**. The major players knew what to do, but when there was no ***"other side of the trade,"*** the big players were forced to throw in the towel. In your lessons you are going to learn how to avoid illiquid markets. You will only trade in markets that have an adequate "open interest" to remain transparent.

OPTIONS DISCUSSION

Now let's focus on the specific vehicle we will specialize in: **OPTIONS.** Options are among the most misunderstood trading vehicles. They are not a mystery once you

understand the basic concept, and learn the terminology. They are by far the most useful of all financial products. First, a basic definition: **Equity** options are contracts between 2 parties to deliver a fixed number of the underlying stock's shares, at a fixed price, at a particular point in time. Before we get more specific, let's look at how they evolved.

It is difficult to say when options first started to trade, but it appears that they have been trading in one form or another for over 3000 years. From archives, we are certain that the Phoenicians and Greeks used them to hedge shipping risk. The option contract was used as a primitive form of insurance. One merchant would receive a Premium for taking some of the risk, and the other would be willing to give up a piece of his profit for bearing less risk on his cargo.

Options were also traded in Europe starting in the 1600's. They played a major role in one of the greatest financial panics of all time, the infamous ***"Tulip Frenzy."*** The issuing of unregulated options allowed speculators to drive the price of Tulips to farcical price levels; the subsequent fallout almost destroyed the national economy of Holland.

In North America, grain options traded as early as the 18th century. Many scandals arose from sellers being unable to meet their guarantees. The first **Exchange Traded** products appeared with the formation of the **Chicago Board of Trade** in 1848. The **CBOT** regulated the contracts in size and term, demanded payment of margin from both the seller and buyer. With these regulated option contracts many of the abuses that had lead to scandals in previous years were eliminated.

Options continued to trade in many forms over the next 130 years. In the late 1970's, the **Chicago Board of Options Exchange** (**CBOE**) was born. Today options are a mainstay in the liquidity of the global economy, and they are one of the largest financial product markets in the world.

This section had a ton of information. Before we go into the section on market analysis, you will take a quiz. This one will not be as silly as the quiz after the first chapter; this one will have some meat. It will consist of 10 questions and you must get at least 9 right before you can go on to market recognition.

Let's go!!!!

CHAPTER 2: MARKET DYNAMICS QUIZ

1. How long have Options traded?
   a) 1982
   b) 1000 BC
   c) 1600
   d) 1894

2. The NYSE guarantees the price of trades executed on the floor.
   True or False

3. The first options traded in North America were Gold options in 1849.
   True or False

4. All Option contracts are liquid.
   True or False

5. Bid-Offer spreads have little effect on the ability to earn money in the Markets.
   True or False

6. Penny Stocks offer excellent opportunities for doubling an investors' money.

True or False

7. Option contracts never act as insurance.
   True or False

8. Option contracts were responsible for the Tulip Frenzy?
   True or False

9. Commissions have little effect on Long Term trading.
   True or False

10. Bulls and Bears can make money, Pigs get slaughtered.
    True or False

CHAPTER 2: MARKET DYNAMICS QUIZ ANSWERS

1. How long have Options traded?
   a) 1982
   b) 1000 BC
   c) 1600
   d) 1894

   b. The Greeks and Phoenicians used options as a form of insurance for shipping as early as 1000 BC.

2. The NYSE guarantees the price of trades executed on the floor.
   True, that is why participants use exchanges, prices and trades are guaranteed.

3. The first options traded in North America were Gold options in 1849.
   False, it was grain options around 1874.

4 All Option contracts are liquid.
   False, OTC options can be very illiquid

5. Bid-Offer spreads have little effect on the ability to earn money in the Markets.
   False, they are one of the most important factors for success.

6. Penny Stocks offer excellent opportunities for doubling an investors' money.
   False, penny stocks are the least favorable game that can be played. They possess none of the characteristics that we look for to trade.

7. Option contracts never act as insurance.
   False, they were first used as insurance for shipping.

8. Option contracts were responsible for the Tulip Frenzy?
   False, **greed** was responsible for the Tulip Frenzy, as many it is for all frenzies.

9. Commissions have little effect on Long Term trading.
   False, commission rates play a huge role in all liquidity issues.

10. Bulls and Bears can make money, Pigs get slaughtered.
    True, nothing is more valid.

As I said before, this is a building block method to trading; you will need to build a solid foundation before you go to the next chapter. By the time we are ready to trade options, the terms and conditions in this section should be second nature.

CHAPTER 3: FUNDAMENTAL VS. TECHNICAL MARKET ANALYSIS

In Chapter 1 we studied a major market event; the financial meltdown of 2008 ranks up there with the greatest panics of all time. The interesting thing is that (as of May, 2010) we are still living with this one. We can look back and see the final score with the other big busts of all time, but no one really knows for sure how this one will play out. Will this be the pinnacle for the US and our form of capitalism? Will this be the start of world financial domination by the Chinese? Does Big Oil continue to dominate the world stage? The US Stock Market as of November 2009 looks frighteningly similar to the market of 1938. After the **second** ***"Great Depression"*** of 1937, (bet you didn't even know it existed did ya'? Study the charts, it's all there.)

Beginning in spring, and continuing thru fall of 1938, the broad stock market **had the same technical appearance as we have today**. Once the panic of '37 hit the bottom, everyone forgot about the second depression. Everyone bought with both hands. The '38 market failed to follow thru, but here is the good news, **IF YOU WOULD HAVE USED THE TECHNICAL TOOLS THAT YOU ARE NOW ABOUT TO LEARN YOU WOULD HAVE MADE A KILLING BOTH COMING AND GOING!**

Next, we looked at how markets originated and learned about price discovery. We studied a lot of definitions that we will use in our trading. However before we start to look at how the market leaves "footprints," (that we can capitalize on) we need to revisit the difference between technical and fundamental analysis and answer some questions.

We have learned that when we have **"price discovery"** the market is in equilibrium. We know this is absolute, because a buyer and seller have agreed on the price, and **an exchange**

of value took place. Stability may only exist for a split-second before price moves on, but at that point in time the market was in balance.

What causes the market to move? **Fundamentalists** would lead you to believe that it is a balance sheet, or P/E ratios, or Inventories, or the Producer Price Index. They believe that future price can be **predicted** from this information. They believe current price is just a function of buyers and sellers meeting temporally. ***"It is indeed technical",*** **but they believe price patterns and tendencies have no effect on the longer term direction of price.**

Technicians believe that price discovery is all that is necessary. Understand this: Traders using technical analysis **only study price movement** and historical price patterns and tendencies to predict future price discovery points. So before we go onto the section on trading markets, let's look at what fundamental indicators tell us.

All investors, traders, and hedgers, use fundamentals, technical's (or some blend of both) to analyze the markets. In this section we will look at some of the classic examples of both styles and further differentiate each to value the market and specific vehicles therein.

Fundamental Analysis

Fundamental traders look at the market, an individual stock or commodity based on various supply and demand functions. They use a number of tools, that they believe will help to **predict the future price**. If they are investing in stocks there are many ways to look at the market fundamentally, here are some of the most common data points.

Price/Earnings (P/E) Ratios: The ratio of net profits to the price of the stock. If a stock is priced at $5 for every $1 of net

profit, it is said to have a P/E of 5. Fundamental theory would then compare that ratio to what other companies in a particular industry are earning. If the industry average is 9, this stock would be said to be **"undervalued."** If the industry average is 4, it is said to be "**overvalued."** Investors would then combine this information with other factors to **predict future price**.

Balance Sheet: A statement of the financial condition of the company at any point in time. It represents the company's net worth. It uses the formula: Assets - liabilities = Equity (Net Worth). When the company has a strong balance sheet the fundamental investor could compare that to industry averages and use it as the gauge to predict price.

Inventory Turnover measures how quickly accumulated inventory can be turned into sales. Generally the faster the inventory turns the healthier the company.

Debt to Equity Ratio measures how leveraged the company is. If the company has too much leverage (debt), a change in the economy could be devastating. If it does not have enough, it is probably not getting full use of its equity.

If the investor were looking to trade commodities they would use a different set of numbers to try and predict price.

Supply/Demand Ratio tells the investor the current supply and the ratio to demand for the commodity. If too much gas is on hand the price should fall. Not enough and it should rise.

Housing Starts: If there are not enough homes being started it could have a dramatic effect on many different commodity prices. If there are too many homes in the market, negative price movements occur.

Producer Price Index (PPI) compares the cost to produce a commodity to a base time period. If this number is rising too

fast it could signal high inflation and commodities sensitive to inflation should rally. Declining PPI should forecast lower prices.

Retail Sales: Exactly what it sounds like, Retail Sales represents the amount consumers are spending in stores. It is said to be a leading indicator. Some see Retail Sales as a forecaster of future trends in spending and the prices related to those commodities used in production.

Unemployment Rate: The granddaddy of all fundamental numbers. Released the first Friday of each month; it measures the annualized rate of unemployment and how it is related to the change in the past month and as well are past year readings.

These are just a few of the fundamental indicators. We could write multiple pages worth of formulas. The interesting thing about fundamental numbers is that it all depends who looks at them. **They are always subject to interpretation; hence the aforementioned <u>News Bombs</u> that often occur after major numbers are released.** Fundamentalists only care about current price as to how it should relate to future price based on their interpretation of the data. The **numbers are factual;** the way they are interpreted by the investor will determine whether he/she is bullish or bearish in the market place. The exact same number that was bullish fifteen minutes ago, will now be viewed as bearish. A different set of experts will interpret what the number says in relation to last month's number, and the market will spin off on its merry way.

Technical Analysis

Technicians discount all of the above fundamental information. Technical analysis is based on price discovery. The current price tells us all that we need to know…. At this point in time, the market is in equilibrium. How can we be sure of that? We know this because the

buyers and sellers have agreed to a stated **EXCHANGE VALUE;** there has been a successful **PRICE DISCOVERY!** It is really quite simple. **No matter what you may believe, the market is never wrong!** It will be your nemesis. It is never tired, sick, or distracted; it never makes a mistake. It will always find a price that inflicts the most pain on the most participants.

Unlike fundamental numbers, which are subject to interpretation, the price is not!! How the price got here, and where it may be going is another story. Technicians use many tools to try **and predict, or react**, to future price movement. Some technicians will try to pick the extent that the price will increase or decline. Some, simply want to follow the price movement that is occurring and don't care where the top or bottom is, **they will let the market tell them what to do.** Technical tools work well in all tradable markets.

Remember, the definition of a tradable market is one that has **liquidity.** Without liquidity it is almost impossible to make money. As you saw earlier, the bid/offer spread, and commissions will eventually wear you down. **When we talk about trading from now on, we will assume that you have studied your definitions from earlier chapters and you know which markets to avoid!!!**

You will be taught to trade in any liquid market condition that you fancy. The market can be bullish or bearish, it doesn't matter. What matters is that you take a specific set of indicators and work with them. **Consistency is the key.**

The Flow of Funds

The flow of funds is the route price takes when the market is rallying or breaking. "Conventional wisdom" says that when we have a rally, there are more buyers in the market, and they push price higher. When the market is breaking there

are more sellers to cause the price decline. **Conventional wisdom is wrong!!!**

Remember we are trading in auctions, not bartered markets. Bear in mind, when you utilize an auction market, **price can only move higher when we have new price discovery.** The **real answer:** in order to move price there must be more **"aggressive" buyers and sellers.** If the market is rallying, buyers are willing to pay more for each purchase; however, they must still find a seller**.** If they cannot find a seller at the next price level they must continue to **"bid"** until "price discovery" finds a new level. In extreme cases, **if there are no buyers/sellers at the next level. The market "gaps" until more buyers/sellers can be found, and there is new price discovery.**

This flow of funds leaves a ***"Technical footprint."*** In later chapters will we learn how to use this information to make profitable, logic-driven, trading decisions.

In the next chapter we will be dealing with technical market theory, and digging deeper into market cycles and price discovery. You do not have to be a mathematician to understand the models, but you must be able to follow logic. You will see that the markets will repeat the same pattern time and time again. It will be proven that time and prices are linked; we will use those patterns to find profitable trading opportunities.

First we will have our next test to see how much you have retained from this chapter. There are 20 questions; seventeen correct is enough to pass. Make sure you understand all the terms before you go to **Chapter 4: Market Cycles and Price Discovery.**

CHAPTER 3: FUNDAMENTAL VS. TECHNICAL MARKET ANALYSIS TEST

1. Price Discovery is a fundamental way to analyze markets.
   True or False

2. P/E ratios over of 5 are always undervalued.
   True or False

3. Balance Sheets are the snapshot of a company's net worth.
   True or False

4. Housing starts are a fundamental look at the housing market.
   True or False

5. The unemployment rate reflects a fundamental number.
   True or False

6. Rising unemployment is a bearish fundamental number.
   True or False

7. Rising retail sales is a bullish fundamental number.
   True or False

8. If the S&P 500 is 3% higher this month than last month the market is bullish.
   True or False

9. Technicians discount **all** fundamental data.
   True or False

10. There must be a buyer for every seller.
    True or False

11. The **NYSE** is an auction market.
True or False

12. Prices rise when there are more buyers than sellers in a market.
True or False

13. An imbalance of offers will force the price lower.
True or False

14. The flow of funds will leave a technical footprint.
True or False

15. Good fundamental data will eventually cause stock prices to rise.
True or False

16. If a company's Balance Sheet is highly leveraged and interest rates rise, the company's stock price should decline.
True or False

17. Because the Technical factors of 2009 resemble the 1938 rally, the 2009 rally should end in a sudden decline.
True or False

18. *"Price Gaps"* are caused by fundamental *"Tape Bombs."*
True or False

19. Technical analysis is subject to interpretation.
True or False

20. The market is always right.
True or False

You must get seventeen correct. If, after checking your answers you do not, please go back and review the material again. It is vital that you understand the terms, before you can advance to the chapters on trading.

CHAPTER 3: TEST ANSWERS

1. Price Discovery is a fundamental way to analyze markets.
   False, price Discovery is the market mechanism which allows the transfer of wealth.

2. P/E ratios over of 5 are always undervalued.
   False, the P/E standard for the industry may be 3 in which case 5 is overvalued. Remember **ALL** Fundamental numbers are in relation to other industry standards.

3. Balance Sheets are the snapshot of a company's net worth.
   True, a Balance Sheet is a true indicator of a company's net worth, but not its stock price; price is determined by the market.

4. Housing starts are a fundamental look at the housing market.
   True, housing starts are a very important fundamental indicator.

5. The unemployment rate reflects a fundamental number.
   True, the unemployment number is a very important fundamental statistic.

6. Rising unemployment is a bearish fundamental number.
   False, all fundamental statistics are subject to interpretation. If the unemployment rate is up 1% but the street expected it to be up 2%, the rising unemployment would be a very **bullish** number.

7. Increasing retail sales is a bullish fundamental number.
   False, see number six.

8. If the S&P 500 is 3% higher this month than last month the market is bullish.

True, the market is always right and is not subject to interpretation.

9. Technicians discount **all** fundamental data.
   True, technicians are only interested in market footprints.

10. There must be a buyer for every seller
    True, auction markets rely on **price discovery:** the meeting of buyers and sellers

11. The **NYSE** is an auction market.
    True, although block trades are permitted, all players are alerted and may participate in a block trade.

12. Prices rise when there are more buyers than sellers in a market
    False, prices only rise when buyers are willing to pay a higher price. There must be a seller for ever buyer.

13. An imbalance of offers will force the price lower.
    False, price will only go lower if sellers are willing to sell for less. An imbalance of orders only indicates that there are more sell orders than buy orders.

14. The flow of funds will leave a technical footprint.
    True, funds can only flow if there is price discovery. This creates a print, and the market is always right.

15. Good fundamental data will eventually cause stock prices to rise.
    False, all fundamental data is subject to interpretation, what may appear to bullish now could be thought to be bearish a day, a week or anytime in the future.

16. If a company's Balance Sheet is highly leveraged and interest rates rise, the company's stock price should decline.
    False, the company may have already hedged their

interest rate risk, in which case rising interest rates are **bullish** for the company in relation to their competitors, who failed to hedge. A classic example would be **Southwest Airlines**. **SWA** successfully used the futures market to hedge off their exposure to the oil markets from 2003 to 2009, and gained a significant advantage over their competition.

17. Because technical factors of 2009 resemble the 1938 rally, the 2009 rally should end in a sudden decline.

False, technical factors only indicate the market's direction and are of no guarantee that the market of 2009 will end as the market of 1938 did.

18. *"Price Gaps"* are caused by fundamental *"Tape Bombs."*

False, they are caused by a temporary lack of liquidity. Buyers and sellers cannot discover price at the next tick and the market keeps rallying or breaking until price discovery takes place.

19. Technical analysis is subject to interpretation.

True, just as fundamental analysis is subject to interpretation, so is technical analysis. Only price discovery is not subject of interpretation. The market is always correct.

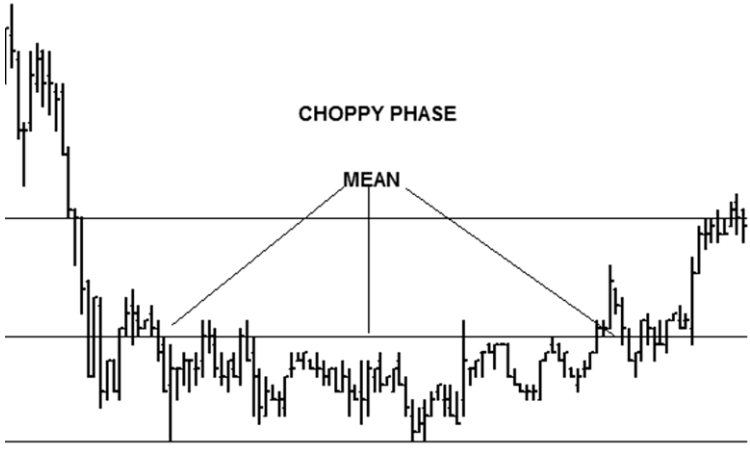
20. The market is always right.

True, the market is a nemesis. It is always right. It is never tired, or not focused. It is always correct. The market process of price discovery guarantees that the market is always right.

CHAPTER 4: MARKET CYCLES AND PRICE DISCOVERY

We are now ready to take our discussion to a higher level. We reviewed market functions, price discovery and how fundamental and technical traders determine pricing expectations and subsequent trading decisions. In this section we look at the "footprint," that price swings "print," and how we will use this footprint as a guide to help us find profitable trading opportunities.

Look at the chart below. It is pretty typical of an average market. The market begins in a very choppy state; it goes back and forth between lows and highs. Note that it hits these levels several times.



You should notice that in this particular case the market enters a **"choppy"** phase from a lower price. In different market conditions it could enter this choppy phase from a higher price. We are not concerned which direction a

particular investable vehicle's price enters the chop, the "congestion phase." We are only concerned with being able to identify the market phase(s). In this particular case, the price goes to a high and **"retraces."** If we were to stop time at this point, it would be impossible to envision which way the market was going to move; we do not have enough information. If we observe price (y-axis) along a time continuum (x-axis), you can see that the market rallies to the previous top, and stops. This second move in price is referred to as an **"upside leg"** and it manifests into a classic **"Double Top."**

A **Double Top** is a critical point in price modeling. It is the first footprint we are looking for that might allow us to make a trading decision. If we draw a line across the two tops, that line is referred to as **"Resistance."** The reason this particular horizontal line is called resistance should be obvious: price is having a difficult time going higher than this level. The chart now shows that after the double top the market again retraces, but stops when it reaches the previous bottom. Can anyone guess what this price point is referred to? Of course, it is called a **"Double Bottom."** When a market cannot take out either a top or bottom it is said to be in **"Congestion."**

CONGESTION IS THE BIRTH OF ALL MARKETS AND IS CONSIDERED THE INITIAL MARKET PHASE.

When we look to initiate a trade the first thing we will look for is a market that is in congestion. Why congestion? **Because congestion graphically illustrates a time of maximum confusion!!! Neither the buyers nor the sellers have control of the market.** If the market is rallying, the buyers will force price higher in an effort to get the sellers to abandon their short positions. When the market is rallying, the buyers are said to be in control and are referred to as the **"STRONG HANDS."**

Study the chart below. Are you able to recognize the domination of the strong hands? This market is in a general uptrend buying. Notice the strong hands bidding up the price. There is apparent position building, buying on dips and buying off recognizable levels. The **bullish strong hands** are in control in this particular illustration.

Sellers in this market are referred to as having (played) the "Weak hand." The reason they are named weak hands should be obvious. The shorts will try to resist the advance of price, and may add to their position. As price goes higher, it may attract new buyers and sellers. If the buyers are unsuccessful in taking out the previous tops, they will start taking profits. As the price begins to fall, sellers will become more aggressive, new sellers will be attracted into the market and now the sellers will become the **"STRONG HANDS."**

The buyers are now referred to as the "Weak Hands," as sellers attempt to drive the buyers out of their positions. If the sellers are successful the market will extend to the previous lows, and it will attract new buyers. If the sellers cannot take out the low, they will begin to take profit, and the process will reverse; prices will again rise. It is **impossible** to tell how long the congestion phase will go on. It may last only 30 or 40 time periods or it could last 200 or more.

KEY POINT: CONGESTION OCCURS MORE THAN THE OTHER PHASES OF THE MARKET COMBINED.

Eventually the market will reach a point at which the Double Tops or Double Bottoms (the congestion phase) fail. At this moment the market reaches **Phase 2: "BREAKOUT."**

The classic breakout formation is the result of two dynamics:

1) The strong hands will be willing to pay a higher/sell a lower price, and will control the market.

2) **Counter trend** traders, or weak hands will continue to try and buy/sell different price points after the breakout in the hope that it is a **"false breakout;"** and the market is still in the original congestion phase.

As the strong hands begin to control the market, prices move beyond the pre-defined congestion range. Breakouts might begin with a sudden burst of price, or it may be gradual. In this phase, the market will no longer make double tops and/or double bottoms. It will make **higher highs** if it is rallying, or (if it is breaking) it will **make lower lows**.

It may be suddenly and extremely volatile or orderly in its move; Like congestion, the length of time it will stay in this phase is impossible to determine. One thing is certain, it will pick up momentum as time moves on. The price curve will begin to steepen as the weak hands cover their losses. If the weak hands are convinced that the market has turned, they may join the strong hands. The steepening curve will also attract new buyers/sellers to join the parade.

Now, all of the players are convinced that the strong hands are correct and weak hands will be run over and the market will go into its final phase: the **BLOWOFF.**

The **blow off** is the final phase of the price cycle. This formation is the classic **"Panic."** It is set off by a couple of

factors.

1) So much wealth has been transferred to the strong hands that they will press their advantage.

2) The weak hands will be experiencing any combination of disasters from margin calls, to lack of capital; **but in any case, they are only getting out because they are being forced to exit the market.**

The pressure on the weak hands will force them to become price **insensitive. Their only concern will be to get enough quantity of** buying/selling in order to stop the pain. This **price insensitivity will cause a massive liquidation of positions referred to colorfully in the business as "*Puking*."** Puking may cause the individual time bars to go parabolic.

Market participants will be in a state of either "unbridled enthusiasm," or "total despair." The strong hands will continue to crush the weak hands and it will appear that price could never go in the other direction.

Then a funny thing will happen, out of nowhere…**the panic stops.** What could possibly stop the panic? For one thing the strong hands greed will be satisfied. Another factor will be the introduction of **New Money.** New Money is defined as capital that had not been involved in the market prior to this moment in time. Suddenly, price will stabilize. The strong hands will continue to take profit. If new money senses that the strong hands have overplayed this one, they will begin to race the strong hands to the other side of the market. A new panic will start as the strong hands become the weak hands. The new money is now the strong hands, and will drive the price in the opposite direction. This is the classic **"V formation."**

When all the bloodletting ends, the market will reach equilibrium, and be reborn with a new congestive phase.

Of course not all markets end with a V formation. Some markets will congest at the higher/lower price as new money will not become the strong hands. This formation is referred to as an ***"L formation,"*** or ***"tree branch."***

Wild volatility will produce a ***"W formation,"*** in which the strong hands and weak hands change and drive the market to more than one V formation.

The W formation will be the new congestion and price will eventually break out. The market could resume the breakout in the original price direction, or it could break out to the other side of the market. In either case the congestion will start the market anew.

A market is very similar to the universe. Depending on our time frame and point of observation, we can see it in many different phases, but it will always resolve itself in the following order. It will have:

1) **a birth,**
2) **a life cycle, and**
3) **an end.**

It will begin with a contraction of price, a movement away from the contraction, an explosion, and will then it begin again. The market will repeat this pattern over and over, knowing when and how to react is the key!!!

We have now explored the lifecycle of a market. Other instructors may choose to add further definitions to describe what transpires as time and price move, but no matter what terms are used to describe it, the cycle will remain the same.

We are now going to examine the most important aspect of the time and price cycle.

Review the charts in chapter 1, pages 7-9. Recall our

discussion on the impossibility of determining which charts were representing a particular asset, when the scaling on the price and time axis were removed. If you studied them carefully, you would notice that all of the charts looked strikingly similar.

We learned the charts represented different time frames. Try to put them in the right order from top to bottom, from the shortest to the longest time frame. Stumped? You should be, it is almost impossible to tell which time frame belongs to which chart. Unfortunately (in real time trading), this is what we see if we only take a snapshot of price and time at equilibrium.

So, how do we know what the market is going to do from this information?

The answer is simple, we don't; it's a coin flip. The markets cannot be analyzed from a single picture. But don't despair. Remember when we started to study the market when it was in the choppy condition, in congestion?

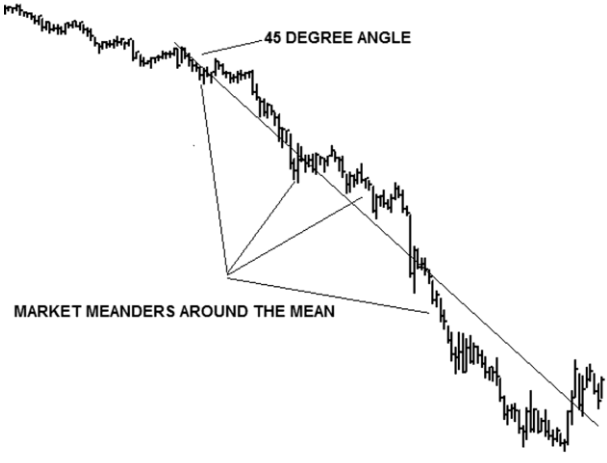
At first, when we observed the trade, it was impossible to discern what the represented market was going to do, but as we revealed more information on the chart, it started to expose a pattern. Now I am going to disclose one piece of information from this new puzzle.

Look again at the chart on page 30. All charts are snapshots. Let's assume the chart on page 30 is the **DJIA** in the past six months or even a year. This "longest time frame" we are observing is bullish; thus, we have more information about the coin. Suppose that each time you flipped a coin and heads hit, you would buy, but when tails hit, you had the option to either pass or sell. In this example the longest time frame is biased to the upside. **It tells us that if we always bought when the coin hit heads, and ignored selling on the tails, we would have made money no matter which time frame we traded in!!**

Sound too good to be true?

It isn't, that is not to say EVERY TRADE WOULD BE A WINNER, BUT THE SUM OF ALL YOUR LONG TRADES DURING THIS <u>PARTICULAR</u> PERIOD MUST BE!!!!

Note the chart below. Imagine this to the longest time frame you are studying to determine your overall trend. The statistical mean (the average price) is shown as a 45 degree line running through the zigzagging price movement over this time frame.



From now on, we will refer to the longest time frame that we are observing as the **<u>MAJOR TREND</u>.**

It does not matter if it is five minutes or five years, it will still be referred to as the <u>MAJOR</u> TREND!

Look at the above chart again. This time, imagine 10 vertical lines drawn from the x-axis every ¼ inch, or so straight up. Notice where the price is in each particular slice, and its direction relative to the mean; depending on which section you look at, the "mini-chart" will be showing an upward or

downward bias. As you know, (and can see) prices **never** move in a straight line.

DEPENDING ON WHICH TIME FRAME YOU ARE OBSERVING, PRICE WILL ALWAYS WANDER BACK AND FORTH ACROSS THE 45 DEGREE ANGLE, BUT WILL ALWAYS END UP IN A POSITIVE MODE!!!!

Clearly, if the Major Trend were downward sloping, the same would be true, but inverted.

THE RELATIONSHIP BETWEEN TIME AND PRICE IS RELATIVE, BUT CONSTANT IN THE MARKET OVER TIME. ALL TIME FRAMES OF SHORTER LENGTH WILL EVENTUALLY RESOLVE THEMSELVES INTO THE LONGEST TIME FRAME OBSERVED (MAJOR TREND). Grasping this concept is vital in all trading, especially in OPTIONS TRADING. If the price of oil has been rallying for a year, not all of the smaller time frames will show an upward bias. They will, however resolve themselves into longest time frame, in this case, a rally mode.

For you Statistics Majors, it's obvious: The standard deviation will always reconcile to the mean given a sufficient sample size and time frame. **If the mean is positive the sum of all smaller time frames will also be positive!**

We've discussed a huge amount of material in this section.

First, we talked about how the market participants' actions leave footprints.

Second, we discussed which participants control the market in different parts of the price cycle and how a market can suddenly change direction for no apparent reason, although now you should have a better grasp on why markets can go parabolic and just as suddenly, reverse violently.

Key Point: We introduced the 2 keys

to our technical analysis.

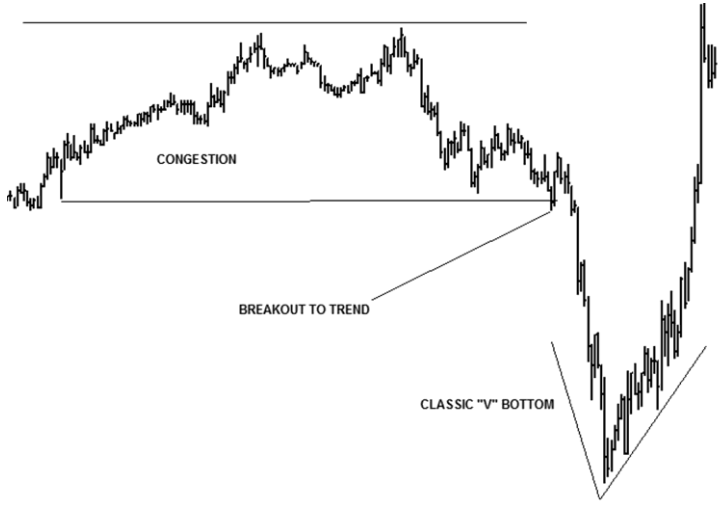
1) We reduced the market cycle to three phases (see the chart below).

a) Congestion (birth).

b) Breakout to a trend (beginning of the life cycle).

c) Blow off (end of the life cycle). Shown above in the classic V formation followed by a selloff, the blow off.

2) We proved that time and pricing are universal. All time frames will resolve themselves into the longest time frame that we are observing.



We saw how these cycles can be identified by technical analysis, and can be explained by the action of market participants. We now understand there are hundreds of ways to measure price changes, and there is enough disinformation of pricing models to fill up 50 volumes of work.

The reason that we are going to deal with only a few variables when we make our trading decisions is…… We are great believers in Murphy's Law.

ANYTHING THAT CAN GO WRONG WILL GO WRONG. THE MORE COMPLICATED A TRADING SYSTEM IS, THE GREATER CHANCE THAT IT WILL IMPLODE.!!!!

For these reasons, we are going to keep our system very simple.

CHAPTER 4: MARKET CYCLES AND PRICE DISCOVERY TEST

The test in this section is going to be longer. It will consist of 50 true or false problems. You must get at least 45 right in order to go on to the next chapter. Good luck!!!!

1. The initial leg of a market helps identify price direction.

2. A retracement always indicates the market is breaking.

3. A double top is a significant price point.

4. Double bottoms have more significance than double tops.

5. All choppy markets begin with a downside movement of price.

6. A double top would indicate resistance.

7. A double top can only occur after a retracement.

8. A double top can only occur after a double bottom.

9. A double bottom can occur without a double top.

10. Double bottoms usually occur within 8 time frames of a double top.

11. A series of double tops and double bottoms signals congestion.

12. Congestion is defined by support and resistance levels.

13. Congestion is limited to time frames of no more than 100 bars.

14. Congestion is the most common phase of the market.

15. Congestion will always end with a breakout to the upside.

16. Congestion is categorized as an extreme period of market uncertainty.

17. Congestion is the birth of a new market.

18. Breakouts generally occur after important fundamental numbers.

19. Breakouts are usually a gradual process.

20. Breakouts usually occur during periods of high volatility.

21. Breakouts can go straight to a blow off.

22. Upside breakouts are always in strong hands.

23. Downside breakouts are always in weak hands.

24. Once a market is in strong hands it will breakout.

25. Strong hands and weak hands never change position.

26. Weak hands generally do better in a breaking market.

27. When a market is rallying there are more buyers than sellers.

28. When the market is breaking there are more sellers than buyers.

29. Auction markets never have price gaps.

30. Countertrend traders always sell the market.

31. Countertrend traders are usually the strong hands.

32. In a blow off the weak hands generally lose money.

33. In a blow off time and price can become one.

34. A blow off to the downside has limited loss potential.

35. In a blow off the strong hands take profit.

36. The blow off is the final phase of a market.

37. Blow offs can trigger a panic market.

38. The longest time frame we observe is one year.

39. Five minute time frames are never the longest time frame we observe.

40. The longest time frame we observe is always termed the *"Major Trend."*

41. Breakout markets leave no footprint.

42. Breakout markets predict future price.

43. Higher highs or lower lows are usually found in a breakout market.

44. Even if the major trend is higher a minor trend could currently be breaking.

45. Five minutes will always be the shortest time frame we observe.

46. Price charts from different time frames will have different patterns.

47. If the Major Trend is bullish every minor trend will be bullish.

48. Knowing the Major Trend gives us an edge on the market.

49. Depending on our observation of price and time, the market may appear to be in a different phase from the longest time frame we are observing.

50. Prices in shorter term time frames will always resolve themselves into the longest time frame's trend direction.

CHAPTER 4: TEST ANSWERS

1. The initial leg of a market helps to identify price direction.
   False, the initial leg does not give us enough information to identify the market.

2. A retracement always indicates the market is breaking.
   False, the term retracement refers to the fact that price is breaking from a high or rallying from a low, direction is not relevant.

3. A double top is a significant price point.
   True, it indicates that price is reaching a resistance level.

4. Double bottoms have more significance than double tops.
   False, they have the same significance as a double top.

5. All choppy markets begin with a downside movement of price.
   False, the market can begin from price either rallying or breaking.

6. A double top would indicate resistance.
   True, this is where resistance begins.

7. A double top can only occur after a retracement.
   True, you must retrace from a lower price in order to make a double top.

8. A double top can only occur after a double bottom.
   False, it can occur after any retracement.

9. A double bottom can occur without a double top.
   True, if can occur after any retracement.

10. Double bottoms usually occur within 8 time frames of a double top.

False, there is no time frame limit.

11. A series of double tops and double bottoms signals congestion.

True, that is the definition of congestion.

12. Congestion is defined by support and resistance levels.

True, that is the definition of congestion.

13. Congestion is limited to time frames of no more than 100 bars.

False, congestion has no time limit.

14. Congestion is the most common phase of the market.

True, congestion occurs more than twice as much as other phases of the market.

15. Congestion will always end with a breakout to the upside.

False, it will end with a breakout in either direction

16. Congestion is categorized as an extreme period of market uncertainty.

True, buyers and sellers constantly trade strong and weak hands.

17. Congestion is the birth of a new market.

True, all markets are born in congestion.

18. Breakouts generally occur after the release of important fundamental numbers.

False, breakouts have nothing to do with fundamental numbers.

19. Breakouts are usually a gradual process.

False, a breakout can be either volatile or orderly.

20. Breakouts usually occur during periods of high volatility.
False, breakouts can occur in any market condition.

21. Breakouts can go straight to a blow off.
True, occasionally, the breakout will be very volatile and go straight to a blow off.

22. Upside breakouts are always in strong hands.
True, all breakouts are in strong hands.

23. Downside breakouts are always in weak hands.
False, all breakouts regardless of direction are in strong hands.

24. Once a market is in strong hands it will breakout.
False, the strong hands may meet resistance and become the weak hands.

25. Strong hands and weak hands never change position.
False, they can change position many times during the market cycle.

26. Weak hands generally do better in a breaking market.
False, weak hands are always on the wrong side when a breakout occurs.

27. When a market is rallying there are more buyers than sellers.
False, buyers are willing to pay more; there must be a seller for every buyer.

28. When the market is breaking there are more sellers than buyers.
False, sellers are willing to sell at a lower price. There must be a buyer for every seller.

29. Auction markets never have price gaps.
False, unless price is discovered at the next tick a gap will occur.

30. Countertrend traders always sell the market.
    False, countertrend traders are always the other side of the strong hands.

31. Countertrend traders are usually the strong hands.
    False, they are always the weak hands.

32. In a blow off the weak hands generally lose money.
    True, the weak hands will be forced to liquidate at any price.

33. In a blow off, time and price can become one.
    True, in parabolic bars, time and price become one.

34. A blow off to the downside has limited loss potential.
    True, zero is the lowest price that a *"non-leveraged"* position can reach.
    .

35. In a blow off the strong hands take profit.
    True, that is what helps to end the blow off.

36. The blow off is the final phase of a market.
    True, the market will enter congestion after a blow off, and begin again.

37. Blow offs can trigger a panic market.
    False, blow offs **<u>are</u>** the panic market.

38. The longest time frame we can observe is one year.
    False, the longest time frame can be any period.

39. Five minute time frames are never the longest time frame we observe.
    False, if the shortest is less than the five minute timeframe, the five minute period could become the longest observed or the **"Major Trend."**

40. The longest time frame we observe is always termed the

Major Trend.

True, the longest time frame observed is always the Major Trend.

41. Breakout markets leave no footprint.

False, they leave a market dominated by a series of higher highs or lower lows.

42. Breakout markets predict future price.

False, they show us where price originated in congestion.

43. Higher highs or lower lows are usually found in a breakout market.

True, that is the hallmark of a breakout or ***"Trending"*** market.

44. Even if the major trend is higher a minor trend could currently be breaking.

True, a smaller time frame can be bearish against the major trend.

45. Five minutes will always be the shortest time frame we observe.

False, we can observe time frames down to individual tick charts.

46. Price charts from different time frames on the same underlying can have different chart patterns.

True, all observable time frames on the same underlying may be in different phases.

47. If the Major Trend is bullish every minor trend will be bullish.

False, all observable time frames on the same underlying may be in different phases.

48. Knowing the Major Trend gives us an edge on the market.

True, trading with strong hands always gives us an edge.

49. Depending on our observation of price and time, a shorter time frame may appear to be in a different phase from the longest time frame we are observing.

True, all observable time frames on the same underlying may be in different phases.

50. Prices in shorter term time frames will always resolve themselves into the longest time frame's trend direction.

True, although all observable time frames on the same underlying may be in different phases the summation of price in all the shorter time frames will resolve themselves into the longest time frame we are observing.

Well, how did you do? Some of the questions were a review of previous chapters. Remember, we're trying to build upon our foundation block by block. By retesting, the information is better comprehended via repetition.

In the next chapter, we are getting to why you took this class in the first place, to begin your understanding of options, option markets, and how to trade them. Take a break; then let's go!

CHAPTER 5: OPTION TRADING TERMINOLOGY

Before we delve into terminology, let's again briefly review what we've covered so far and why it is important to understand the market logic behind **BUBBA'S GUIDE TO TRADING OPTIONS**.

The first four chapters were designed to help you to understand the complex world of markets in general. In the first part we talked about large markets, in particular the financial meltdown of 2008. What transpired that led up to the disaster, who the culprits were, and how a perfect financial storm almost took down the worldwide financial system.

We then learned how markets function; who you will be buying from and selling to. What markets are tradable and which markets should be avoided. We discussed who the major players are and the concept of price discovery. We looked at some fundamental and technical means, and tools to evaluate a market.

Finally we learned the phases of any market, and how the relationship between time and price is universal.

All of this background will prove to be useful as we move into actual trading strategies. Remember you can't fly a 747 until you understand what makes a Piper Cub fly. You could possibly fly the 747 with some help, but if a problem arose, and there was no pilot to help you; most likely you are going to crash. **THE MORE KNOWLEDGE YOU HAVE ABOUT HOW MARKETS FUNCTION, THE GREATER THE CHANCE YOU HAVE FOR SUCCESS!!**

The rest of the Program will be devoted to putting together

your newfound knowledge of market cycles with the specifics involved in trading options.

As in any business, options have their own glossary of terms. **BUBBA'S GUIDE TO TRADING OPTIONS** is not going to complicate matters by making you memorize every term associated with the business. Instead we are going to teach you terms you need to know in order to make money trading. A glossary will be furnished for you to use and learn. **KNOWING THE TERMINOLOGY OF OPTIONS IS A VITAL BUILDING BLOCK IN THE BUBBA'S GUIDE TO TRADING OPTIONS SYSTEM OF TRADING.**

Earlier we learned of the history of options, but learned little to better explain the option contract. Before we look at trading strategies, let's cover some basic vocabulary specific to options.

Options Defined

Options refer to a particular class of assets known as **derivatives**. A simple explanation of a derivative is that it is a contract promising some sort of delivery of an underlying asset at a specific time and price for a stated fee, the ***"premium."*** If an option buyer exercises his right to buy/sell the underlying before expiration, the contract is executed and the underlying asset(s) change hands. Generally, if the price of the underlying asset remains static (no change in price over time) options premium declines in value as the expiration date nears. There is no value in holding a contract that delivers an asset at the same price the spot market is printing; the individual can execute a transaction on the open market at the current market price.

Here's a different, somewhat divergent perspective. If you were to purchase a 20 year life Insurance policy for a 5 year old child, the premium would be very small because the probability of contract execution would be minimal. There is

little uncertainty in this probability. If you were to purchase life insurance for a 75 year old who smokes and has a history of heart disease, the premium would be huge. It's obvious; there is much more uncertainty on whether the individual will live 20 or 30 more years, so the premium would be extremely high.

Look at premium as a value associated with risk of an event happening. In the case of equity options, it's the statistical probability of a specific stock price occurring on a specific date. A stock that has huge price swings is said to be more volatile; does it not follow the promise to deliver that particular stock, at a particular time, for a specific price, is more uncertain? This should be clear to you and you should have deduced that option premium pricing varies according to the volatility of the underlying.

INCREASED VOLATILITY = INCREASED PREMIUM PRICING.

Although almost any asset class can be the underlying in an option contract, stocks, bonds, real estate, precious metals, foodstuffs, **we are only going to trade options on asset groups that are listed on major exchanges, and meet out liquidity criteria. Our criteria for liquidity will be the same as was listed for tradable Stocks.**

Exchange traded options are contracts between two parties in which one party (**the buyer**) has the **right,** but not the obligation, to buy or sell the underlying asset at a specific price (**strike price**) and time (**expiration**). The other party (**the seller**) has the **obligation**, but not the right, to buy or sell the asset at a specific price (**strike price**) and time (**expiration**). Options can be used for almost any underlying asset class, and allow for a wide range of strategies.

The first thing we need to pilot our options trading 747 is to understand the terms used in the industry. Below is a listing of key terms that should eventually be second nature to you

by them time you begin trading. After each term is a clarification of the term. The definitions will be in alphabetical order.

The test on this section will cover some of the previous material, but will focus on the following listing of terms. Some of these terms will be better dissected in the following chapters, but I want you to be exposed to them all now.

You now have a basic understanding of market dynamics, price discovery, liquidity, option basics and different ways to analyze a market. This chapter will serve as the bridge between what we have covered so far and the deeper study of options and how to successfully trade them. For convenience, the list of definitions below is duplicated in the appendix.

ALL OR NONE (AON) ORDER - A type of order that specifies that the order can only be activated if the full order will be filled. A term used more in securities markets than futures markets.

AMERICAN STYLE OPTION - A call or put option contract that can be exercised at any time before the expiration of the contract.

ASK, ASKED PRICE - This is the price that the trader making the price is willing to sell an option or security.

ASSIGNMENT - Notification by **The Options Clearing Corporation** (**OCC**) to a clearing member and the writer of an option that an owner of the option has exercised the option and that the terms of settlement must be met. Assignments are made on a random basis by the **OCC**. The writer of a call option is obligated to sell the underlying asset at the strike price of the call option; the writer of a put option is obligated to buy the underlying at the strike price of the put option.

AT PRICE - When you enter a prospective trade into a trade parameter in the Matrix, the "At Price" (At.Pr) is automatically computed and displayed. It is the price at which the program expects you can actually execute the trade, taking into account "slippage" and the current Bid/Ask, if available.

AT-THE-MONEY (**ATM**) - An at-the-money option is one whose strike price is equal to (or, in practice, very close to) the current price of the underlying.

BACK MONTH - A back month contract is any exchange-traded derivatives contract for a future period beyond the front month contract. Also called the FAR **MONTH**.

BEAR, BEARISH - A bear is someone with a pessimistic view on a market or particular asset, e.g. believes that the price will fall. Such views are often described as bearish.

BEAR CALL SPREAD - This is a net credit transaction established by selling a call and buying another call at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the difference between the strike prices less the credit received, and the maximum profit = the credit received. Requires margin.

BEAR PUT SPREAD - A net debit transaction established by selling a put and buying another put at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the debit paid, and the maximum profit = the difference between the strike prices less the debit. No margin is required.

BELL CURVE - See **NORMAL DISTRIBUTION**.

BETA - A prediction of what percentage a position will move in relation to an index. If a position has a Beta of 1, then the position will tend to move in line with the index. If the beta is

0.5 this suggests that a 1% move in the index will cause the position price to move by 0.5%. Beta should not be confused with volatility. Note: Beta can be misleading. It is based on past performance, which is not necessarily a guide to the future.

BID - This is the price that the trader making the price is willing to buy an option or security for.

BID-ASK SPREAD - The difference between the Bid and Ask prices of a security. The wider (i.e. larger) the spread is, the less liquid the market and the greater the slippage.

BINOMIAL PRICING MODEL - Methodology employed in some option pricing models which assumes that the price of the underlying can either rise or fall by a certain amount at each pre-determined interval until expiration. For more information, see **COX-ROSS-RUBINSTEIN.**

BLACK-SCHOLES PRICING MODEL - A formula used to compute the value of European-style call and put options invented by Fischer Black and Myron Scholes.

BROKER - The middleman who passes orders from investors to the floor dealers, screen traders, or market makers for execution.

BULL, BULLISH - A bull is someone with an optimistic view on a market or particular asset, e.g. believes that the price will rise. Such views are often described as bullish.

BULL CALL SPREAD - This is a net debit transaction established by buying a call and selling another call at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the debit paid, and the maximum profit = the difference between the strike prices, less the debit. No margin is required.

BULL PUT SPREAD - This is a net credit transaction established by buying a put and selling another put at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the difference between the strike prices, less the credit, and the maximum profit = the credit received. Requires margin.

BUTTERFLY SPREAD - A strategy involving four contracts of the same type at three different strike prices. A long (short) butterfly involves buying (selling) the lowest strike price, selling (buying) double the quantity at the central strike price, and buying (selling) the highest strike price. All options are on the same underlying, in the same expiration.

BUY WRITE - See **COVERED CALL**.

CALENDAR SPREAD - The simultaneous purchase and sale of options of the same type, but with different expiration dates. This would include: horizontal debit spreads, horizontal credit spreads, diagonal debit spreads, and diagonal credit spreads.

CALL - This option contract conveys the right to buy a standard quantity of a specified asset at a fixed price per unit (the strike price) for a limited length of time (until expiration).

CALL RATIO BACKSPREAD - A long backspread using calls only.

CANCELED ORDER - A buy or sell order that is canceled before it has been executed. In most cases, a limit order can be canceled at any time as long as it has not been executed. (A market order may be canceled if the order is placed after market hours and is then canceled before the market opens the following day). A request for cancel can be made at any time before execution.

CLOSING TRANSACTION - To sell a previously purchased position or to buy back a previously purchased position, effectively canceling out the position.

COLLAR - A collar is a trade that establishes both a maximum profit (the ceiling) and minimum loss (the floor) when holding the underlying asset. The premium received from the sale of the ceiling reduces that due from the purchase of the floor. Strike prices are often chosen at the level at which the premiums net out. An example would be: owning 100 shares of a stock, while simultaneously selling a call, and buying a put.

COLLATERAL - This is the legally required amount of cash or securities deposited with a brokerage to ensure that an investor can meet all potential obligations. Collateral (or margin) is required on investments with open-ended loss potential such as writing naked options.

COMMISSION - This is the charge paid to a broker for transacting the purchase or the sale of stock, options, or any other security.

COMMODITY - A raw material or primary product used in manufacturing or industrial processing or consumed in its natural form.

CONDOR - A strategy similar to the butterfly involving 4 contracts of the same type at four different strike prices. A long (short) condor involves buying (selling) the lowest strike price, selling (buying) 2 different central strike prices, and buying (selling) the highest strike price. All contracts are on the same underlying, in the same expiration.

CONTRACT SIZE - The number of units of an underlying specified in a contract. In stock options the standard contract size is 100 shares of stock. In futures options the contract size is one futures contract. In index options the contract size

is an amount of cash equal to parity times the multiplier. In the case of currency options it varies.

COST OF CARRY - This is the interest cost of holding an asset for a period of time. It is either the cost of funds to finance the purchase (real cost), or the loss of income because funds are diverted from one investment to another (opportunity cost).

COVERED - A covered option strategy is an investment in which all short options are completely offset with a position in the underlying or a long option in the same asset. The loss potential with such a strategy is therefore limited.

COVERED CALL - Both long the underlying and short a call. The sale of a call by investors who own the underlying is a common strategy and is used to enhance their return on investment. In the **TradeFinder** this strategy is short option (covered) using calls only.

COVERED COMBO - A strategy in which you are long the underlying, short a call, and short a put. Often used by those wishing to own the underlying at a price less than today's price.

COX-ROSS-RUBINSTEIN - A binomial option-pricing model invented by John Cox, Stephen Ross, and Mark Rubinstein.

CREDIT - The amount you receive for placing a trade. This is the net inflow of cash into your account as the result of a trade.

CYCLE - See **EXPIRATION CYCLE**.

DAY ORDER - An order to purchase or sell a security, usually at a specified price, that is good for just the trading session on which it is given. It is automatically canceled on the close of the session if it is not executed.

DEBIT - The amount you pay for placing a trade. This is the net outflow of cash from your account as the result of a trade.

DELTA - Measures the rate of change in an option's theoretical value for a one-unit change in the underlying. Calls have positive Deltas and puts have negative Deltas. Delta for non-futures based options is the dollar amount of gain/loss you should experience if the underlying goes up one point. For futures-based options, Delta represents an equivalent number of futures contracts times 100.

DELTA NEUTRAL - A strategy in which the Delta-adjusted values of the options (plus any position in the underlying) offset one another.

DIAGONAL CREDIT SPREAD - A type of calendar spread. It is a debit transaction where options are purchased in a nearer expiration and options of the same type are sold in a farther expiration, on the same underlying. It is diagonal because the options have different strike prices.

DIAGONAL DEBIT SPREAD - Type of calendar spread. It is a credit transaction where options are sold in a nearer expiration and options of the same type are purchased in a farther expiration, on the same underlying. It is diagonal because the options have different strike prices.

DIRECTIONAL TRADE - A trade designed to take advantage of an expected movement in price.

EARLY EXERCISE - A feature of American-style options that allows the owner to exercise an option at any time prior to its expiration date.

EQUITY OPTION - An option on shares of an individual common stock; Also known as a stock option.

EUROPEAN STYLE OPTION - An option that can only be exercised on the expiration date of the contract.

EXCHANGE TRADED - The generic term used to describe futures, options and other derivative instruments that are traded on an organized exchange.

EXERCISE - The act by which the holder of an option takes up his rights to buy or sell the underlying at the strike price. The demand by the owner of a call option that the number of units of the underlying specified in the contract is delivered to him at the specified price. The demand by the owner of a put option contract that the number of units of the underlying asset specified that must be bought from him at the specified price.

EXERCISE PRICE - The price at which the owner of a call option can buy an underlying asset. The price at which the owner of a put option contract can sell an underlying asset. See **STRIKE PRICE**.

EXPIRATION, EXPIRATION DATE, EXPIRATION MONTH - This is the date by which an option contract must be exercised or it becomes void and the holder of the option ceases to have any rights under the contract. All stock and index option contracts expire on the Saturday following the third Friday of the month specified.

EXPIRATION CYCLE - Traditionally, there were three cycles of expiration dates used in options trading:

- **JANUARY CYCLE** (1): January / April / July / October
- **FEBRUARY CYCLE** (2): February / May / August / November
- **MARCH CYCLE** (3): March / June / September / December

Today, equity options expire on a hybrid cycle which involves a total of four option series: the two nearest-term calendar months and the next two months from the traditional cycle to which it has been assigned.

FAIR VALUE - See **THEORETICAL PRICE, THEORETICAL VALUE**.

FAR MONTH, FAR TERM - See **BACK MONTH**.

FILL - When an order has been completely executed, it is described as filled.

FILL OR KILL (FOK) ORDER - This means do it now if the option (or stock) is available in the crowd or from the specialist, otherwise kill the order altogether. Similar to an all-or-none (**AON**) order, except it is "killed" immediately if it cannot be completely executed as soon as it is announced. Unlike an **AON** order, the **FOK** order cannot be used as part of a **GTC** order.

FOLLOW-UP ACTION - Term used to describe the trades an investor makes subsequent to implementing a strategy. Through these adjustments, the investor transforms one strategy into a different one in response to price changes in the underlying.

FRONT MONTH - The first month of those listed by an exchange - this is usually the most actively traded contract, but liquidity will move from this to the second month contract as the front month nears expiration. Also known as the **NEAR MONTH**.

FUTURE, FUTURES CONTRACT - A standardized, exchange-traded agreement specifying a quantity and price of a particular type of commodity (soybeans, gold, oil, etc.) to be purchased or sold at a pre-determined date in the future. On contract date, delivery and physical possession take

place unless the contract has been closed out. Futures are also available on various financial products and indexes today.

GAMMA - Gamma expresses how fast Delta changes with a one-point increase in the price of the underlying. Gamma is positive for all options. If an option has a Delta of 45 and a Gamma of 10, then the option's expected Delta will be 55 if the underlying goes up one point. If we consider Delta to be the velocity of an option, then Gamma is the acceleration.

GOOD 'TIL CANCELED (GTC) ORDER - A Good 'Till Canceled order is one that is effective until it is either filled by the broker or canceled by the investor. This order will automatically cancel at the option's expiration.

GREEKS - The Greek letters used to describe various measures of the sensitivity of the value of an option with respect to different factors. They include Delta, Gamma, Theta, Rho, and Vega.

HISTORIC VOLATILITY - A measure of the actual price fluctuations of the underlying over a specific period of time. Also known as "statistical volatility".

HORIZONTAL CREDIT SPREAD - A type of calendar spread. It is a credit transaction where you buy an option in a nearer expiration month and sell an option of the same type in a farther expiration month, with the same strike price, and in the same underlying asset.

HORIZONTAL DEBIT SPREAD - A type of calendar spread. It is a debit transaction where you sell an option in a nearer expiration month and buy an option of the same type in a farther expiration month, with the same strike price, and in the same underlying asset.

ILLIQUID - An illiquid market is one that cannot be easily traded without even relatively small orders tending to have a disproportionate impact on prices. This is usually due to a low volume of transactions and/or a small number of participants.

IMMEDIATE-OR-CANCEL (IOC) ORDER - An option order that gives the trading floor an opportunity to partially or totally execute an order with any remaining balance immediately canceled.

IMPLIED VOLATILITY (IV) - This is the volatility that the underlying would need to have for the pricing model to produce the same theoretical option price as the actual option price. The term "implied volatility" comes from the fact that options imply the volatility of their underlying, just by their price. A computer model starts with the actual market price of an option, and measures **IV** by working the option fair value model backward, solving for volatility (normally an input) as if it were the unknown.

In actuality, the fair value model cannot be worked backward.

INDEX - The compilation of stocks and their prices into a single number, e.g. **The S&P 500.**

INDEX OPTION - An option that has an index as the underlying. These are usually cash-settled.

IN-THE-MONEY (ITM) - Term used when the strike price of an option is less than the price of the underlying for a call option, or greater than the price of the underlying for a put option. In other words, the option has an intrinsic value greater than zero.

INTRINSIC VALUE - Amount of any favorable difference between the strike price of an option and the current price of

the underlying (i.e., the amount by which it is in-the-money). The intrinsic value of an out-of-the-money option is zero.

LAST TRADING DAY - The last business day prior to the option's expiration during which purchases and sales of options can be made. For equity options, this is generally the third Friday of the expiration month.

LEAPS - **Long-Term Equity Anticipation Securities**, also known as long-dated options. Calls and puts with expiration as long as 2-5 years. Only about 10% of equities have **LEAPS**. Currently, equity **LEAPS** have two series at any time, always with January expirations. Some indexes also have **LEAPS**.

LEG - Term describing one side of a spread position.

LEGGING - Term used to describe a risky method of implementing or closing out a spread strategy one side ("leg") at a time. Instead of utilizing a "spread order" to ensure that both the written and the purchased options are filled simultaneously, an investor gambles a better deal can be obtained on the price of the spread by implementing it as two separate orders.

LEVERAGE - A means of increasing return or worth without increasing investment. This strategy involves the use of borrowed funds to increase one's investment return, for example buying stocks on margin. Option contracts are leveraged as they provide the prospect of a high return with little investment. The % Double parameter for each option in the Matrix is a measure of leverage.

LIMIT ORDER - An order placed with a brokerage to buy or sell a predetermined number of contracts (or shares of stock) at a specified price, or better than the specified price. Limit orders also allow an investor to limit the length of time an order can be outstanding before canceled. It can be placed

as a day or **GTC** order. Limit orders typically cost slightly more than market orders but are often better to use, especially with options, because you will always purchase or sell securities at that price or better.

LIQUID - A liquid market is one in which large deals can be easily traded without the price moving substantially. This is usually due to the involvement of many participants and/or a high volume of transactions.

LONG - You are long if you have bought more than you have sold in any particular market, commodity, instrument, or contract. Also known as having a long position, you are purchasing a financial asset with the intention of selling it at some time in the future. An asset is purchased long with the expectation of an increase in its price.

LONG BACKSPREAD - A strategy available in the **TradeFinder**. It involves selling one option nearer the money and buying two (or more) options of the same type farther out-of-the-money, using the same type, in the same expiration, on the same underlying. Requires margin.

LONG OPTION - Buying an option. See **LONG**.

LONG STRADDLE - See **STRADDLE**.

LONG STRANGLE - See **STRANGLE**.

LONG SYNTHETIC - See **SYNTHETIC**.

LONG UNDERLYING - Buying the underlying (i.e. stock). See **LONG**.

MARGIN - See **COLLATERAL**.

MARKET MAKER - A trader or institution that plays a leading role in a market by being prepared to quote a two-

way price (Bid and Ask) on request - or constantly in the case of some screen-based markets during normal market hours.

MARKET-NOT-HELD ORDER - A type of market order that allows the investor to give discretion regarding the price and/or time at which a trade is executed.

MARKET-ON-CLOSE (MOC) ORDER - A type of order which requires that an order be executed at or near the close of a trading day on the day the order is entered. A **MOC** order, which can be considered a type of day order, cannot be used as part of a **GTC** order.

MARKET ORDER - Sometimes referred to as an unrestricted order. It's an order to buy or sell a security immediately at the best available current price. A market order is the only order that guarantees execution. It should be used with caution in placing option trades, because you can end up paying a lot more than you anticipated.

MARKET PRICE - A combination of the Bid, Ask, and Last prices into a single representative price. Bid, Ask, and Last are all available, the default formula for **MARKET PRICE** is (10*Bid + 10*Ask + Last) / 21.

MARK TO MARKET - The revaluation of a position at its current market price.

MID IMPLIED VOLATILITY (MIV) - Implied volatility computed based on the mid-point between the Bid and Ask prices. See **IMPLIED VOLATILITY**.

NAKED - An investment in which options sold short are not matched with a long position in either the underlying or another option of the same type that expires at the same time or later than the options sold. The loss potential of naked strategies can be virtually unlimited.

NEAR TERM - See **FRONT MONTH**.

NORMAL DISTRIBUTION - A statistical distribution where observations are evenly distributed around the mean. Studies have shown that stock prices are very close to being log normally distributed over time. When you choose bell curve as a price target in the program, a lognormal distribution based on price, volatility, and time until valuation date is constructed.

NOT-HELD ORDER - An order that gives broker discretion as to the price and timing in executing the best possible trade. By placing this order, a customer agrees to not hold the broker responsible if the best deal is not obtained.

OFFER - See **ASK**.

ONE-CANCELS-THE-OTHER (OCO) ORDER - Type of order which treats two or more option orders as a package, whereby the execution of any one of the orders causes all the orders to be reduced by the same amount. Can be placed as a day or **GTC** order.

OPENING TRANSACTION - An addition to, or creation of, a trading position.

OPEN INTEREST - The cumulative total of all option contracts of a particular series sold, but not yet repurchased or exercised.

OPEN ORDER - An order that has been placed with the broker, but not yet executed or canceled.

OPTION CHAIN - The list of available options for a given underlying.

OUT-OF-THE-MONEY (OTM) - An out-of-the-money option is one whose strike price is unfavorable in comparison to the

current price of the underlying. This means when the strike price of a call is greater than the price of the underlying, or the strike price of a put is less than the price of the underlying. An out-of-the-money option has no intrinsic value, only time value.

PREMIUM - This is the price of an option contract.

PUT - This option contract conveys the right to sell a standard quantity of a specified asset at a fixed price per unit (the strike price) for a limited length of time (until expiration).

PUT/CALL RATIO - This ratio is used by many as a leading indicator. It is computed by dividing the 4-day average of total put **VOLUME** by the 4-day average of total call **VOLUME**.

PUT RATIO BACKSPREAD - A long backspread using puts only.

REALIZED GAINS AND LOSSES - The profit or losses received or paid when a closing transaction is made and matched together with an opening transaction.

REVERSAL - A short position in the underlying protected by a synthetic long. Also the term used to describe a direction change in a given asset or derivative measured against time.

RHO - The change in the value of an option with respect to a unit change in the risk-free rate.

RISK-FREE RATE - The term used to describe the prevailing rate of interest for securities issued by the government of the country of the currency concerned. It is used in the pricing models.

ROLLOVER - Moving a position from one expiration date to another further into the future. As the front month

approaches expiration, traders wishing to maintain their positions will often move them to the next contract month. This is accomplished by a simultaneous sale of one and purchase of the other.

ROUND TURN - When an option contract is bought and then sold (or sold and then bought). The second trade cancels the first, leaving only a profit or loss. This process is referred to as a “round turn”. Brokerage charges are usually quoted on this basis.

SHORT - An obligation to purchase an asset at some time in the future. You are short if you have sold more than you have bought in any particular market, commodity, instrument, or contract, also known as having a short position. An asset is sold short with the expectation of a decline in its price. Can have almost unlimited risk. Uncovered short positions require margin.

SHORT BACKSPREAD - It involves buying one option nearer the money and selling two (or more) options of the same type farther out-of-the-money, with the same expiration, on the same underlying. Requires margin.

SHORT OPTION (COVERED) - See **COVERED CALL**.

SHORT OPTION (NAKED) - Selling an option you don't own. See **SHORT**.

SHORT STRADDLE - See **STRADDLE**.

SHORT STRANGLE - See **STRANGLE**.

SHORT SYNTHETIC - See **SYNTHETIC**.

SHORT UNDERLYING - Selling an asset you don't own. See **SHORT**.

SLIPPAGE - Thinly traded options have a wider Bid-Ask spread than heavily traded options. Therefore, you have to "give" more in order to execute a trade in thinly traded options; less in heavily traded ones. This "give" is what we refer to as slippage.

SPREAD - A trading strategy involving two or more legs, the incorporation of one or more of which is designed to reduce the risk involved in the others.

SPREAD ORDER - This is an order for the simultaneous purchase and sale of two (or more) options of the same type on the same underlying. If placed with a limit, the two options must be filled for a specified price difference, or better. It can be critical in this type of order to specify whether it is an opening transaction or a closing transaction.

STANDARD DEVIATION - The square root of the mean of the squares of the deviations of each member of a sample population (in simple terms, a group of prices) from their mean. In a normal distribution (or bell curve), one standard deviation encompasses 68% of all possible outcomes.

STATISTICAL VOLATILITY (SV) - Measures the magnitude of the asset's recent price swings on a percentage basis. It can be measured using any recent sample period. Regardless of the length of the sample period, **SV** is always normalized to represent a one-year, single Standard Deviation price move of the underlying.

Note: It is important to remember that what is needed for accurate options pricing is near-term future volatility, which is something that nobody knows for sure.

STOP ORDER - **"Stop-Loss"** and **"Stop-Limit"** orders placed on options are activated when there is a trade at that price only on the specific exchange on which the order is located. They are orders to trade when its price falls to a

particular point, often used to limit an investor's losses. It's an especially good idea to use a stop order if you will be unable to watch your positions for an extended period.

STRADDLE - A strategy involving the purchase (or sale) of both call and put options with the same strike price, same expiration, and on the same underlying. A short straddle means that both the call and put are sold short, for a credit. A long straddle means that both the call and put are bought long, for a debit.

STRANGLE - A strategy involving the purchase or sale of both call and put options with different strike prices - normally of equal, but opposite, Deltas. The options share the same expiration and the same underlying. A strangle is usually a position in out-of-the-money options. A short strangle means that both the calls and puts are sold short, for a credit. A long strangle means both the calls and puts are bought long, for a debit.

STRATEGY, STRATEGIES - An option strategy is any one of a variety of option investments. It involves the combination of the underlying and/or options at the same time to create the desired investment portfolio and risk.

STRIKE PRICE - The price at which the holder of an option has the right to buy or sell the underlying. This is a fixed price per unit and is specified in the option contract, also known as striking price or exercise price.

SYNTHETIC - A strategy that uses options to mimic the underlying asset. The long synthetic combines a long call and a short put to mimic a long position in the underlying. The short synthetic combines a short call and a long put to mimic a short position in the underlying. In both cases, both the call and put have the same strike price, the same expiration, and are on the same underlying.

TECHNICAL ANALYSIS - Method of predicting future price movements based on historical market data such as (among others) the prices themselves, trading volume, open interest, the relation of advancing issues to declining issues, and short selling volume.

THEORETICAL VALUE, THEORETICAL PRICE - This is the mathematically calculated value of an option. It is determined by (1) the strike price of the option, (2) the current price of the underlying, (3) the amount of time until expiration, (4) the volatility of the underlying, and (5) the current interest rate.

THETA - The sensitivity of the value of an option with respect to the time remaining to expiration. It is the daily drop in dollar value of an option due to the effect of time alone. Theta is dollars lost per day, per contract. Negative Theta signifies a long option position (or a debit spread); positive Theta signifies a short option position (or a credit spread).

TICK - The smallest unit price change allowed in trading a specific security. This varies by security, and can also be dependent on the current price of the security.

TIME DECAY - Term used to describe how the theoretical value of an option "erodes" or reduces with the passage of time. Time decay is quantified by Theta.

TIME PREMIUM - Also known as **"Time Value"**, this is the amount that the value of an option exceeds its intrinsic value and is a parameter in the Matrix. It reflects the statistical possibility that an option will reach expiration with intrinsic value rather than finishing at zero dollars. If an option is out-of-the-money then its entire value consists of time premium.

TIME SPREAD - See **CALENDAR SPREAD**.

TRADE HALT - A temporary suspension of trading in a particular issue due to an order imbalance, or in anticipation of a major news announcement. An industry-wide trading halt can occur if the **Dow Jones Industrial Average** falls below parameters set by the **New York Stock Exchange**.

TRADING PIT - A specific location on the trading floor of an exchange designated for the trading of a specific option class or stock.

TRANSACTION COSTS - All charges associated with executing a trade and maintaining a position, including brokerage commissions, fees for exercise and/or assignment, and margin interest.

TRUE DELTA, TRUE GAMMA - More accurate than standard Delta and Gamma. Projects a change in volatility when projecting a change in price. Taking this volatility shift into account gives a more accurate representation of the true behavior of the option.

TYPE - The type of option. The classification of an option contract as either a call or put.

UNCOVERED - A short option position that is not fully collateralized if notification of assignment is received. See also **NAKED**.

UNDERLYING - This is the asset specified in an option contract that is transferred when the option contract is exercised, unless cash-settled. With cash-settled options, only cash changes hands, based on the current price of the underlying.

UNREALIZED GAIN OR LOSS - The difference between the original cost of an open position and its current market price. Once the position is closed, it becomes a realized gain or loss.

VEGA - A measure of the sensitivity of the value of an option at a particular point in time to changes in volatility. Vega is the dollar amount of gain or loss you should theoretically experience if implied volatility goes up/down one percentage point.

VERTICAL CREDIT SPREAD - The purchase and sale for a net credit of two options of the same type but different strike prices. They must have the same expiration, and be on the same underlying. See also **BULL PUT SPREAD** and **BEAR CALL SPREAD**.

VERTICAL DEBIT SPREAD - The purchase and sale for a net debit of two options of the same type but different strike prices. They must have the same expiration, and be on the same underlying. See also **BULL CALL SPREAD** and **BEAR PUT SPREAD**.

VOLATILITY - Volatility is a measure of the amount by which an asset has fluctuated, or is expected to fluctuate, in a given period of time. Assets with greater volatility exhibit wider price swings and their options are higher in price than less volatile assets. Volatility is not equivalent to **BETA**.

VOLATILITY TRADE - A trade designed to take advantage of an expected change in volatility.

VOLUME - The quantity of trading in a market or security. It can be measured by dollars or units traded (i.e. number of contracts for options, or number of shares for stocks).

WASH SALE - When an investor repurchases an asset within 30 days of the sale date and reports the original sale as a tax loss. The **Internal Revenue Service** prohibits wash sales requiring (under current tax law) 31 days ownership to take place before a realized loss or gain to take place upon an asset sale.

WEEKLY OPTION – A serial option that expires each Friday. It has fifty-two cycles per year.

WRITE, WRITER - To sell an option that is not owned through an opening sale transaction. While this position remains open, the writer is obligated to fulfill the terms of that option contract if the option is assigned. An investor who sells an option is called the writer, regardless of whether the option is covered or uncovered.

There are many more terms that can be used in trading options. With the basic terms listed above you will have all of the tools necessary to make money in the market. In the glossary, more terms will be listed for you to browse through.

We know that memorizing terms is very boring, but unfortunately if you want to make that big option 747 fly, you want to make sure you are not telling the co-pilot (your broker) to turn off the engines once you reach 500 ft.

Before we can go on to the next lesson we need to pass the Chapter 5 test to insure that you have command of the terms. There are 50 questions. All of the problems are true and false. At the end the answers will be reviewed and explanations given. You need to get at least 45 right before going to the next section.

CHAPTER 5: OPTION TRADING TERMINOLOGY TEST

1. Options can be used as a form of insurance.

2. Options originated in Rome more than 2000 years ago.

3. Options have caused many financial collapses in History.

4. Modern exchange traded options began in at the CBOT in 1848.

5. Financial options were first approved by the SEC in 1938.

6. Financial options are always guaranteed by an exchange.

7. The buyer of an option has the right of exercise.

8. A put allows the seller the right to purchase an asset for less than the current market price.

9. A call seller has the obligation to sell the asset class to the buyer at a specific price and time.

10. All options are worthless after expiration.

11. The seller of put options has unlimited risk.

12. The seller of call options has unlimited reward.

13. An option with no current value is said to be intrinsic.

14. At the money options are all intrinsic.

15. A straddle seller has unlimited risk.

16. A strangle buyer wants price to stay near the current

strike.

17. Time decay insures that out of the money call options will expire worthless.

18. The VIX is a measure of fear in the option market.

19. A seller of puts wants the market to rally.

20. All exchange traded options are guaranteed by the respective exchanges.

21. The buyer of a vertical call spread has limited liability.

22. The seller of a vertical put spread has unlimited liability.

23. Only calls can be exercised prior to expiration.

24. The maximum loss on a credit spread is the amount of the credit.

25. A debit spread has no maximum risk.

26. Sellers of credit spreads have no rights in the option market.

27. Buyers of debit spreads have rights but no obligations in the option market.

28. The at the money (ATM) option has no extrinsic value.

29. Out of the money (OTM) options should always be abandoned at expiration.

30. The **Securities and Exchange Commission** regulates exchange traded options.

31. Selling a straddle has risk limited to the debit paid.

32. At parity an option has no extrinsic value.

33. Puts can be exercised at any time.

34. Puts give the seller the right to put the option to a buyer at any time.

35. **LEAPS** refer to the practice of buying calendar spreads over more than one monthly expiration.

36. Time decay occurs in all option cycles.

37. Selling straddles has less risk than selling strangles.

38. Implied Volatility only goes down as expiration approaches.

39. Writing options is safer than selling puts.

40. Call writers have liability only to the amount of credit.

41. Teenie sellers risk is limited to the debit paid.

42. Call spreads can never include teenies.

43. A strangle is a combination of selling a put and call at different strikes.

44. A strangle can never include in the money options.

45. A straddle risk is limited to the underlying debit paid.

46. Naked puts have unlimited risk

47. Options that reach parity have no extrinsic value.

48. Call writers reward is limited to the credit taken in at sale.

49. Covered calls have no risk.

50. Options spreads that have different expiration dates are called calendars.

CHAPTER 5: TEST ANSWERS

Key Point: Make sure that you understand the underlying concept associated with the answer.

1. Options can be used as a form of insurance.
   True, they have been used for this purpose for over 3,000 years

2. Options originated in Rome more than 2000 years ago.
   False, they were first used by the Greeks and Phoenicians.

3. Options have caused many financial collapses in History.
   False, **greed** caused the financial collapse; misuse of options took the blame.

4. Modern exchange traded options began in at the CBOT in 1848.
   True, grain options were the first regulated options traded.

5. Financial options were first approved by the SEC in 1938.
   False, they were approved in 1973

6. Financial options are always guaranteed by an exchange.
   False, if they are traded OTC they are not guaranteed.

7. The buyer of an option has the right of exercise.
   True, the buyer has the right but not the obligation.

8. A put allows the seller the right to purchase an asset for less than the current market price.
   False, a put seller only has obligations,

9. A call seller has the obligation to sell the asset class to the buyer at a specific price and time.

True, sellers of options only have obligations

10. All options are worthless after expiration.

True, if an option is not exercised, it will be worthless after expiration.

11. The seller of put options has unlimited risk.

False, a put option can only go to zero so the risk is not unlimited.

12. The seller of call options has unlimited reward.

False, the call seller's reward is limited to the credit he receives at the point of sale.

13. An option with no current value is said to be intrinsic.

False, its value is all extrinsic, of the premium it currently contains.

14. At the money (ATM) options are all intrinsic.

False, they are all extrinsic.

15. A straddle seller has unlimited risk.

True, any naked premium is all risk.

16. A strangle buyer wants price to stay near the current strike.

False, the strangle buyer wants price movement. The more, the better.

17. Time decay insures that out of the money call options will expire worthless.

False, price movement is what causes an option to expire worthless.

18. The VIX is a measure of fear in the option market.

True, it is the premium that sellers demand in the market as a whole.

19. A seller of puts wants the market to rally.
    True, the seller of puts is long the market.

20. All exchange traded options are guaranteed by the respective exchanges.
    True, this is why traders use exchange traded products.

21. The buyer of a vertical call spread has limited liability.
    True, he is limited to the debit paid at the point of sale.

22. The seller of a vertical put spread has unlimited liability.
    False, he is limited to the risk between the strikes.

23. Only calls can be exercised prior to expiration.
    False, any option can be exercised prior to expiration.

24. The maximum loss on a credit spread is the amount of the credit.
    False, it is limited to the risk between the strikes.

25. A debit spread has no maximum risk.
    False, it is limited to the debit paid at the point of sale.

26. Sellers of credit spreads have no rights in the option market.
    False, the seller of a credit spread has rights on the debit leg of the spread.

27. Buyers of debit spreads have rights but no obligations in the option market.
    False, they have obligations on the credit leg of the spread.

28. The at the money (ATM) option has no extrinsic value.
    False it has all extrinsic value.

29. Out of the money (OTM) options should always be abandoned at expiration.

True, if they are exercised, you have unlimited risk in the underlying asset.

30. The **Securities and Exchange Commission** regulates exchange traded options.

False, they are regulated by the exchange.

31. Selling a straddle has risk limited to the debit paid.

False, selling a straddle has unlimited risk.

32. At parity an option has no extrinsic value.

True, parity is the definition of an option with no premium.

33. Puts can be exercised at any time.

True, all options can be exercised at any time.

34. Puts give the seller the right to put the option to a buyer at any time.

False, the seller of puts has no rights, only obligations.

35. **LEAPS** refer to the practice of buying calendar spreads over more than one monthly expiration.

False, **LEAPS** are options that expire later than one year after they are issued.

36. Time decay occurs in all option cycles.

True, time decay occurs as uncertainly becomes less with the passage of time.

37. Selling straddles has less risk than selling strangles.

False, both strategies have unlimited risk.

38. Implied Volatility only goes down as expiration approaches.

False, as uncertainty in the market rises volatility may rise to expiration.

39. Writing options is safer than selling puts.
False, they are the same thing

40. Call writers have liability only to the amount of credit.
False, all sellers of premium have reward limited to the credit.

41. Teenies sellers risk is limited to the debit paid.
False, teenies have unlimited risk, their reward is limited to the credit.

42. Call spreads can never include teenies.
False, teenies can be included in all spreads.

43. A strangle is a combination of selling a put and call at different strikes.
True, different strikes are used in any strangle.

44. A strangle can never include in the money options.
True, a strangle is the sale of two out of the money options.

45. A straddle risk is limited to the underlying debit paid.
True, a straddle's reward is unlimited; its risk is limited to the debit paid.

46. Naked puts have unlimited risk
False, the stock can only go to zero.

47. Options that reach parity have no extrinsic value.
True parity is the definition of intrinsic value.

48. Call writers reward is limited to the credit taken in at sale.
True, the call seller has unlimited risk.

49. Covered calls have no risk.

False, the underlying stock can go to zero and the writer will lose his principal.

50. Options spreads that have different expiration dates are called calendars.

True, a calendar is the term for options that expire at different times.

Review your answers. Go back and make sure that you understand the definitions. In the next chapter we are going to look at the option model life cycle. If you don't have the vocabulary mastered, the important trading concepts that are to follow may be confusing.

CHAPTER 6: THE OPTION LIFE CYCLE

We've covered specific option terms we need to know in order to trade. We will now study the option life cycle and how options are priced. In this section we are going to explain the **MYSTERY** of options in plain English that is easy to understand.

BUBBA'S GUIDE TO TRADING OPTIONS is designed to allow you to make profitable option trading decisions without WORRYING ABOUT how to calculate the second derivative of Gamma on a Vega expanding calendar!!

WE'LL LET THE ROCKET SCIENTISTS WORRY ABOUT THAT ONE!

Options are priced differently than any other class of assets. **The auction market is still the mechanism used to discover price, however Volatility (IMPLIED VOLATILITY) will determine the nominal price at any point in time.**

Visualize the option model to be a balloon attached to the spot, or market price of an asset, in this case a stock. As you pump air into the balloon it expands equally in all directions. The more air added, the bigger the balloon's expansion. Think of the air going into the balloon as option "premium". This is the amount that buyers are willing to pay over the "intrinsic value," to own an option at a particular strike price.

If we were to suck all the air out of the balloon, the option price would fall back to a specific "flat" cost relative to the underlying asset (current market price of our stock). Picture the earlier life insurance example: The deflated balloon represents the price of a life insurance policy with almost zero probability of death happening.

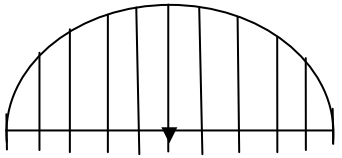
The option model expands in all directions. The **LONGER TIME TO EXPIRATION OR THE HIGHER THE VOLATILITY (MORE "AIR")** for an option with an **"AT THE MONEY"** strike price (which ***remember*** has **no** intrinsic value) the option's absolute value (price) at all strike prices would be higher.

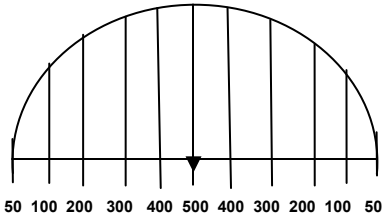
OPTION PRICING IS BASED ON THE STRIKE PRICE, TIME TO EXPIRATION AND VOLATILITY OF THE UNDERLYING ASSET.

Let's look at some examples. For simplicity's sake we are going to use only one underlying asset for all of our examples throughout the remainder of our studies. The options you will be trading will have different underlying asset classes and strike prices, but the principal will remain the same.

In our case we will use Google as our illustration. Google is one of the largest option contracts in the World and can be followed by anyone interested in the markets. Our trading example will use the **nominal price** of 500, making the 500 strike the **ATM** strike price.

Below are graphic representations of our discussion. Think of a bell shaped curve. The first curve shows strike prices along the x-axis in a static, linear progression in $10 increments. The second shows curve the same option, but here we are illustrating the geometric, descending value of the option prices the further you get away from the strike price. See the graphic difference? **Option prices are not linear!**





Now let's look at a tabular representation of our example. Here, we've added volatility increases: 10, 20 and 30%. This is a very simple example, but the concept is clear. Do you recognize the concepts discussed? As the volatility expands for the ATM, it flows over to strike prices. This makes logical sense as the "**at the money option contract has no intrinsic value, <u>it is all premium</u>".**

Strike Price

ATM

VOL	450 P	460 P	470 P	480 P	490 P	500 P/C	510 C	520 C	530 C	540 C	550 C
10%	50	100	200	300	400	500	400	300	200	100	50
20%	100	200	400	600	800	1000	800	600	400	200	100
40%	200	400	800	1200	1600	2000	1600	1200	800	400	200

The letter below the strike represents whether it is a put of call.

The option model functions much like a **"bell shaped curve".** The further the option is from the ATM, the less the probability the option will ever be in the money at expiration. Sellers are willing to write the option for less premium. The "bell shaped curve" functions until buyers are no longer willing to pay any premium for a given strike price. Traditionally, when the buyer will pay only the minimum "tick size," that option is referred to as a **"teenie"or a "stinth" (1/16).**

Although theoretically there are no limits as to how high volatility can go, there are some practical ones. If Volatility were to continue to expand exponentially, buyers of premium would have very little, if any, chance of ever cashing a trade. The sellers on the other hand would have very little risk of price expanding far enough from the **"at the money strike"** to cause the premium that they sold to ever become a loss.

Consequently, for our purposes,
when time and price converge at this extreme,
Volatility is said to be "absolute."

In order for volatility to expand, PRICE DOES NOT HAVE TO CHANGE. It is the anticipation of a price change that drives option Volatility.

THE LEVEL OF VOLATILITY CORRELATES
WITH THE SUPPLY AND DEMAND
FOR AN OPTION.

All options have zero volatility at expiration. Options will either have intrinsic value or they will be worthless, in either case the premium, the extrinsic value of an option at expiration will terminate.

As we know, time and price are linked in any market. Depending on your school of thought, time is either the first or second most important factor in pricing an option. The passing of time is a known dimension. Each day as time passes, the probability of price moving away from the **"ATM"** is slightly condensed. Since the probability of a large price change diminishes with time, the buyer is not willing to pay as much for an option. This is the definition of "**Time Decay." Time decay is not a function of volatility; Time decay is a quantifiable number that increases each day with the passage of time.**

Let's revisit our simplified option model. In this chart we are

using the Google 500 Strike as we did beforehand. A new column has been added (Days) to include **"days to expiration."** In addition, Volatility has been standardized at 40%.

You will notice that as time passes that the amount of premium at any level decreases significantly **even as volatility remains constant. If the volatility were to decrease, the premium would come out of the model at a faster rate. As the time to expiration nears, even if the volatility were to double; the price of the option would no longer double. It would initially inflate the balloon, but eventually time would squeeze the premium out; the balloon deflates.**

					Strike Price						
					ATM						
		P	**P**	**P**	**P**	**P**	**P/C**	**C**	**C**	**C**	**C**	**C**
VOL	**Days**	450	460	470	480	490	500	510	520	530	540	550
40%	30	100	190	360	540	800	1000	800	540	360	190	100
40%	60	160	320	640	960	1280	1600	1280	960	640	320	160
40 %	90	200	400	800	1200	1600	2000	1600	1200	800	400	200

What we have detailed in this lesson is essentially the **LIFE CYCLE** of an option. The inflation of the balloon is **TIME** and/or **VOLATILITY**. The longer the time frame to expiration, the bigger the balloon. The balloon deflating represents **TIME DECAY**. When the balloon is deflated entirely, we have **EXPIRATION.**

EVERY OPTION THAT YOU TRADE WILL HAVE THE EXACT SAME CYCLE NO MATTER WHAT THE UNDERLYING ASSET!!!

I know what you're thinking; *"All the books about options are hundreds of pages long. They are full of math formulas,*

statistical probability, the Greeks; how could even a Rocket Scientist understand it? And you want me to believe that options are this easy? From a couple of charts about balloons and circles you're saying I can make money in the markets?"

The answer is absolutely, positively…..**YES**! **If you can visualize the option cycle in terms of air going in and out of a balloon, you've won half the battle!!**

You should now have an understanding of how the markets work and how options function. The rest of the course will marry your understanding of markets and option structure to strategies and the capital derivatives markets to successfully trade!

Before that, you are going to need to pass a thorough exam on the principals we have studied so far. This exam consists of 100 problems; again you need a score of at least 92 correct to learn how to start making money in the options markets!

CHAPTER 6: THE OPTION LIFE CYCLE EXAM

1) All option contracts are standardized.
True or False

2) Liquidity is an important factor when choosing a trading vehicle.
True or False

3) Bid-offer spreads have a major impact on a market being tradable.
True or False

4) A quote of 20c bid @ 23c offered is considered a tight market.
True or False

5) A quote of $100.20 bid @ 100.25 offered is considered a tight market.
True or False

6) A Penny stock purchased for 10c has very little downside risk.
True or False

7) The VIX will always go up during times of great fear.
True or False

8) The **CBOE** is an exchange.
True or False

9) The **NYSE** does not guarantee trades that are made during electronic trading hours
True or False

10) All Stock markets are pure auction markets.
True or False

11) Commission rates effect liquidity.
True or False

12) Option contracts can be used as insurance.
True or False

13) Gaps in price are caused by unexpected news in the market.
True or False

14) **OTC** trades are guaranteed by the **OTC Exchange**.
True or False

15) The depletion of oil reserves guarantees that oil prices will rise.
True or False

16) Subprime lending caused the financial meltdown of 2008.
True or False

17) Oversupply of houses let to the financial meltdown of 2008.
True or False

18) The **NYSE** guarantees all floor trades but not electronic trades.
True or False

19) The tick size is standardized on the **NYSE**.
True or False

20) All exchange traded stocks are liquid.
True or False

21) All stock indexes are settled in cash stocks.
True or False

22) There is a positive correlation between index futures and stocks.
True or False

23) Derivative contracts led to the fall of **Bear Sterns**.
True or False

24) Price discovery is a fundamental way to analyze markets
True or False

25) Balance sheets are fundamental ways to look at a company's net worth.
True of False

26) Rising unemployment is a bearish number.
True or False

27) Rising retail sales are a bullish number.
True of False

28) If the **OEX** is 4% higher this month than last this is a bullish number.
True or False

29) Prices rise when there are more buyers than sellers in the market
True or False

30) Prices fall when there are more sellers than buyers in the market.
True or False

31) An imbalance of buy orders will force the market higher.
True or False

32) Technical analysis is subject to interpretation.
True or False

33) Price discovery is subject to technical interpretation.

True or False

34) If a Stock has a P/E ration of 3 it is a bullish number.
True or False

35) A highly leveraged business should see a fall in its stock price if interest rates rise.
True or False

36) Good fundamentals will eventually cause a stock's price to rise.
True or False

37) Price discovery is the market mechanism that allows the transfer of wealth.
True or False

38) The market is always right, and is not subject to interpretation.
True or False

39) Technicians discount all Fundamental data.
True or False

40) The initial leg of a market does not help with technical analysis.
True or False

41) When the market is breaking, price is said to be retracing.
True or False

42) Technicians believe that a double top is a significant price point.
True or False

43) A double top can never occur after a market retracement.
True or false

44) A double top would indicate resistance.
True or False

45) A double bottom is the mirror image of a double top.
True or False

46) All Choppy markets begin with downside price movement.
True or False

47) Double tops are usually separated by no more than 25 time frames.
True or False

48) In a rallying market, double bottoms occur more frequently than double tops.
True or False

49) Double bottoms indicate levels of support.
True or False

50) Double tops indicate support for a rallying market.
True or False

51) Congestion is the most common phase of the market.
True or False

52) Congestion is a period of maximum market confusion.
True or False

53) A series of double tops and double bottoms signals congestion.
True or False

54) Strong hands and weak hands never change position in the market.
True or False

55) Breakouts usually occur during periods of high volatility.
True or False

56) Downside breakouts are in control of weak hands.
True or False

57) Gap prices occur after fundamental news events.
True or False

58) Countertrend traders always sell the stock market.
True or False

59) Once a market is in strong hands it will breakout.
True or False

60) Upside breakouts are always in strong hands.
True or False

61) Congestion is the birth of a new market.
True or False

62) A downside blowoff has unlimited loss potential.
True or False

63) In a blowoff time and price can become one.
True or False

64) In a blow off, strong hands generally make money.
True of False

65) A blowoff can trigger a panic market.
True or False

66) Higher highs and lower lows are generally found in a rallying market.
True or False

67) Depending on our observation of price and time the market may appear to be in a different phase than the

longest time frame we are observing.
True or False

68) The buyer of an option has the right of exercise.
True or False

69) The seller of puts is not subject to assignment.
True or False

70) All options are worthless after expiration.
True or False

71) Time decay can overcome volatility doubling in LEAPS options.
True or False

72) The buyer of a strangle wants price to move quickly.
True or False

73) The seller of a vertical put spread has unlimited liability.
True or False

74) The buyer of a debit spread has no obligation in the option market.
True or False

75) In the short run, options may perform different than the underlying asset class.
True or False

76) Options have a life cycle that is different with ever asset class.
True or False

77) At the money options contain all extrinsic value.
True or False

78) If volatility collapses in the out of the money options the ATM will follow.

True or False

79) An option model's life cycle can be compared to a balloon.
True or False

80) All options are worthless at expiration.
True or False

81) If volatility doubles in a LEAP, the nominal price of the ATM should also nearly double.
True of False

82) Time decay in the nearby leg of a calendar spread will always overcome a volatility explosion.
True of False

83) The option model is really a probability model.
True or False

84) Once a teenie has a 0% probability it will expire worthless.
True or False

85) Volatility is the supply and demand for an option at any strike price.
True or False

86) There is always less extrinsic value in a option one strike higher than the ATM regardless of Volatility.
True or False

87) All options expire without premium.
True or False

88) The price of the underlying asset needs to change to have a decrease of volatility.
True or False

89) As time passes, the Time Decay curve increases.
True or False

90) **OEX** options mirror options of any liquid asset class.
True or False

91) All exchange traded options are liquid.
True or False

92) It is possible for volatility to become one with price.
True or False

93) Options can never reach parity prior to expiration.
True or False

94) Historical and implied volatility are important market indicators.
True or False

95) Teenies with a 0% probability should always be sold.
True or False

96) Market conditions should never determine the buying of options.
True or False

97) Out of the money options should never be exercised.
True or False

98) Bid-offer spreads have no real effect on options because of time decay.
True or False

99) Commissions can affect the liquidity of an option.
True or False

100) ATM options generally will have the most premium.
True or False

CHAPTER 6: EXAM ANSWERS

1) All option contracts are standardized.

False, all **exchange traded contracts** are standard, OTC contracts may vary it is up to you to make sure you know what you are trading.

2) Liquidity is an important factor when choosing a trading vehicle.

True, it is one of the most important factors in choosing what vehicle to trade.

3) Bid-offer spreads have a major impact on a market being tradable.

True, the bid-offer spread contributes greatly to liquidity.

4) A quote of 20c bid @ 23c offered is considered a tight market.

False, this would be a typical market in a penny stock it is 15% wide.

5) A quote of $100.20 bid @ 100.25 offered is considered a tight market.

True, this market is less than .005% wide, a tight market is considered to be less than .01% wide.

6) A penny stock purchased for 10c has very little downside risk.

False, it has **100%** down side risk.

7) The VIX always goes up in times of fear.

False, the VIX may either rise or fall in times of fear.

8) The **CBOT** is an exchange.

True, it is an options exchange that is one of the largest in the world.

9) The **NYSE** does not guarantee trades that are made during electronic trading hours

False, the **NYSE** guarantees all trades made on the exchange whether it be during regular trading hours or during electronic trading hours.

10) All stock markets are pure auction markets.

False, OTC or penny stocks negotiate trades between the bid offer spread.

11) Commission rates effect liquidity.

True, commission rates always affect liquidity. A large commission rate will make the market illiquid.

12) Option contracts can be used as insurance.

True, options were first used as insurance.

13) Gaps in price are caused by unexpected news in the market.

False, price gaps are caused by a temporary lack of liquidity.

14) OTC trades are guaranteed by the OTC exchange.

False, the term OTC means Over the Counter, the opposite of an exchange.

15) The depletion of oil reserves guarantees that oil prices will rise.

False, price discovery will determine the price.

16) Subprime lending caused the financial meltdown of 2008.

False, it is impossible to give the root cause of the panic of 2008.

17) Oversupply of houses let to the financial meltdown of 2008.

False, it is impossible to give the root cause of the panic of 2008

18) The **NYSE** guarantees all **NYSE** trades.

True, the **NYSE** guarantees all trades made either electronically or on the floor.

19) The tick size is standardized on the **NYSE**.

True, the ticks on all stocks traded on the exchange are standard.

20) All exchange traded futures contracts are liquid.

False, each individual contract must be examined to make sure it is liquid.

21) Stock index's can be substituted for cash stocks.

True, stock indexes are the underlying cash index plus the basis risk.

22) There is a positive correlation between index futures and stocks.

True, index futures reflect the underlying stock movement

23) Derivative contracts led to the fall of **Bear Sterns**.

False, poor decision making led to the fall of **Bear Sterns**

24) Price discovery is a fundamental way to analyze markets.

False, price discovery is the exchange of wealth at the point of sale.

25) Balance sheets are fundamental ways to look at a company's net worth.

True, a balance sheet is the company's net worth at that point in time.

26) Rising unemployment is a bearish number.

False, it is the interpretation of the number that will be either bullish or bearish

27) Rising retail sales are a bullish number.

False, it is the interpretation of the number that will be either bullish or bearish.

28) If the **OEX** is 4% higher this month than last this is a bullish number.

True, there is no interpretation all sellers at the end of last month that held their

29) Prices rise when there are more buyers than sellers in the market.

False, prices rise when the buyers are more aggressive than sellers. There must be a seller for every buyer in an auction market.

30) Prices fall when there are more sellers than buyers in the market.

False, prices fall when the sellers are more aggressive than the buyers. There must be a buyer for every seller in an auction market.

31) An imbalance of buy orders will force the market higher.

False, an imbalance is only an indication of the buyers and sellers, the market will only go higher if the buyers are more aggressive.

32) Technical analysis is subject to interpretation.

True, all forms of market analysis are subject to interpretation.

33) Price discovery is subject to technical interpretation.

False, price discovery is never subject to interpretation, wealth has been exchanged.

34) If a stock has a P/E ratio of 3 it is a bullish number.

False, if all the stocks in the class have a P/E ratio of 1 it could be very bearish. All fundamental numbers are subject to interpretation.

35) A highly leveraged business should see a fall in its stock price if interest rates rise.

False, if the firm has **hedged its interest rate risk** the rise of interest rates **could be bullish,** as any competitor that did not hedge their risk may see competitive advantage disappear.

36) Good fundamentals will eventually cause a stock's price to rise.

False, fundamentals are always subject to interpretation.

37) Price discovery is the market mechanism that allows the transfer of wealth.

True, it is the point where buyers and sellers agree on price.

38) The market is always right, and is not subject to interpretation.

True, price discovery assures that the market is never wrong.

39) Technicians discount all fundamental data.

True, technicians do not use fundamental data.

40) The initial leg of a market does not help with technical analysis.

True, the initial leg of a market does not give sufficient data to make a decision.

41) When the market is breaking price is said to be retracing.

False, a retracement only refers to price moving from a previous high or low and has no bearing on the overall price movement.

42) Technicians believe that a double top is a significant price point.

True, it indicates that price is having resistance to

going higher.

43) A double top can never occur after a market retracement.
False, a double top **always** occurs after a retracement.

44) A double top would indicate resistance.
True, that is the definition of a double top.

45) A double bottom is the mirror image of a double top.
True, simply turn the chart upside down to prove it.

46) All choppy markets begin with downside price movement.
False, any initial leg either up or down can begin a choppy market.

47) Double tops are usually separated by no more than 25 time frames.
False, double tops may be separated by any time frame. However most technicians do not recognize a double top if it occurs is **less** than 15 time frames, from the previous top.

48) In a rallying market double bottoms occur more frequently than double tops.
False, higher lows and higher highs are the sign of a rallying market. Double bottoms occur in periods of congestion.

49) Double bottoms indicate levels of support.
True, a double bottom is the measure of support.

50) Double tops indicate support for a rallying market.
False, double tops are the resistance in a rallying market.

51) Congestion is the most common phase of the market.
True, Congestion occurs more than twice as much

than any other market condition.

52) Congestion is a period of maximum market confusion.
True, the market constantly moves back and forth between the strong and weak hands.

53) A series of double tops and double bottoms signals congestion.
True, that is the definition of congestion.

54) Strong hands and weak hands never change position in the market.
False, they constantly change hands in congestion, and again at breakout and blow off.

55) Breakouts usually occur during periods of high volatility.
False, breakouts can occur at any time in the market cycle.

56) Downside breakouts are in control of weak hands.
False, a breakout to either side of the market is in strong hands.

57) Gap prices occur after fundamental news events.
False, price gaps are caused by a temporary lack of liquidity.

58) Countertrend traders always sell the stock market.
False, they always take the other side of the strong hands.

59) Once a market is in strong hands it will breakout.
True, all breakouts are caused by strong hands.

60) Upside breakouts are always in strong hands.
True, all breakouts are controlled by the strong hands.

61) Congestion is the birth of a new market.
True, all markets are born in congestion.

62) A downside blow off has unlimited loss potential.

False, prices cannot go below zero.

63) In a blow off time and price can become one.

True, during blow offs parabolic bars will have time and price rising or falling in step on a 90 degree angle.

64) In a blow off strong hands generally make money.

True, the strong hands have caused the blow off and are always on the right side of the market when a blowoff occurs.

65) A blow off can trigger a panic market.

False, t**he blow off is the panic market.**

66) Higher highs and higher lows are generally found in a rallying market.

True, higher highs and higher lows are the trademark of a rally.

67) Depending on our observation of price and time the market may appear to be in a different phase than the longest time frame we are observing.

True, observation of time frames in relation to the longest time frame is the key to trading.

68) The buyer of an option has the right of exercise.

True, option buyers always have the right to exercise.

69) The seller of puts is not subject to assignment.

False, all sellers of options are subject to assignment.

70) All options are worthless after expiration.

False, all options are either at parity or worthless at expiration. Parity options are exercised, worthless options are abandoned.

71) Time decay can overcome volatility doubling in LEAPS options.

False, in options over one year, volatility will always overcome time decay.

72) The buyer of a strangle wants price to move quickly.

True, the buyer of a strangle will only make money if price moves quickly.

73) The seller of a vertical put spread has unlimited liability.

False, the seller is limited to the spread between strikes prices, minus the credit for the sale.

74) The buyer of a debit spread has no obligation in the option market.

False, the buyer of a debit spread has an obligation to the **credit leg** of the spread.

75) In the short run options may perform differently than the underlying asset class.

True, an option may rise or fall in price with volatility without the underlying asset changing price.

76) Options have a life cycle that is different with ever asset class.

False, options always have the same life cycle no matter the underlying class.

77) ATM options contain all extrinsic value.

True, ATM options are all extrinsic value.

78) If volatility collapses in the out of the money options an ATM collapse will follow.

True, a collapse of any option in a serial will lead to the general price collapse in that series.

79) An option models life cycle can be compared to a balloon.

True, it will mimic the inflation and deflation of a

balloon.

80) All options premium is worthless at expiration.

True, all option premiums are zero at expiration, the option is either at parity and is exercised or it is out of the money and is abandoned at expiration.

81) If volatility doubles in a LEAP, the nominal price of the ATM should also nearly double.

True, in longer dated calendars, the volatility controls the premium levels, time decay is a minor factor.

82) Time decay in the nearby leg of a calendar spread will always overcome a volatility explosion.

True, time decay is the primary force on option pricing as they reach expiration.

83) The option model is really a probability model.

True, the option model is a bell curve, the definition of a probability model.

84) Once a teenie has a 0% probability it will expire worthless.

False, the 0% probability is only for the **current** implied volatility. If volatility were to double, the option would probably **not have a 0% probability** at the new volatility level.

85) Volatility is the supply and demand for an option at any strike price.

True, that is the definition.

86) There is always less extrinsic value in an option one strike higher or lower than the ATM regardless of volatility.

True, extrinsic value is always greater the closer the option is to the ATM. The ATM always has the greatest amount of premium, it has **no Intrinsic value**.

87) At expiration all extrinsic options will be assigned.

False, at expiration all extrinsic options will be abandoned.

88) The price of the underlying asset needs to change to have a decrease of volatility.

False, volatility is a function of supply and demand for the option, and the underlying asset does not need to change to have price decline.

89) As time passes, the time decay curve increases.

True, the passage of time makes the curve much steeper, time decay will **accelerate** as time moves toward expiration.

90) **OEX** options mirror options of any liquid asset class.

True, **OEX** options are among the most liquid in the world.

91) All exchange traded options are liquid.

False, each option must be examined to make sure it meets our criteria for liquidity.

92) It is possible for volatility to become one with price.

True, when it reaches the point to where time and price are one it is said to be absolute.

93) Options can never reach parity prior to expiration.

False, as soon as all **premium** is removed, the option will reach parity. This can occur at any point in the options life cycle.

94) Historical and implied volatility are important market indicators.

True, they will help us determine what option trades we will initiate.

95) Teenies with a 0% probability should always be sold, they have no risk.

False, teenies that have a zero probability with a low volatility levels could end up with a 50% probability if the volatility increases. **Selling teenies is a very risky strategy.**

96) Market conditions should never determine the buying of options.

False, market conditions **will always dictate** market strategy.

97) Out of the money options should never be exercised.

True, out of the money options should always be abandoned.

98) Bid-offer spreads have no real effect on options because of time decay.

False, bid-offer spreads have a **huge** effect on time decay. Involvement with and illiquid option will adversely affect any gain in time decay.

99) Commissions can affect the liquidity of an option.

True, commissions greatly affect the liquidity of an option.

100) ATM's generally will have the most premium.

False, ATM's will **always** have the most premium. The ATM is **all extrinsic value.**

If you are unsure of a principal or an answer go back and review all the sections of the program. In the next chapter, we are going to be using all of the materials that we have studied so far. We will assume that you have mastered all of the terms from the previous chapters.

Remember BUBBA'S GUIDE TO TRADING OPTIONS is a building block system. It relies on the fact that you do your homework

We know you have been waiting for action.
In the next section we will put all
of the information together and
develop our trading platform.

LET'S GET STARTED!!

CHAPTER 7: OPTION TRADING BASICS

In this chapter we marry market dynamics, technical analysis and the option life cycle to specific trades. We'll build on the material covered so far, illustrating strategy and scenarios; in chapter 8 we'll present actual trading tactics. Chapter 7 might be envisioned as trade planning and choices; Chapter 8 takes us into the trenches, we're going to look at the nuts and bolts of specific option trading strategies.

Now, let's begin our focus on option trading strategies!

Try to relate the market to something you are familiar with. All successful people will tell you that there are a couple of keys to success.

First, and foremost, you must be disciplined!

It doesn't matter what you are trying to accomplish. If you are a teacher, you want to be able to communicate to your students what they will need to master to complete the course. If you are a salesperson you want to make the same presentation each time to insure consistency. If you are an athlete you prepare for each opponent with the training you know that has brought you success in the past. All successful people agree that the key to success is to do the mundane tasks with the enthusiasm exhibited in the first try. Practice, practice, practice!

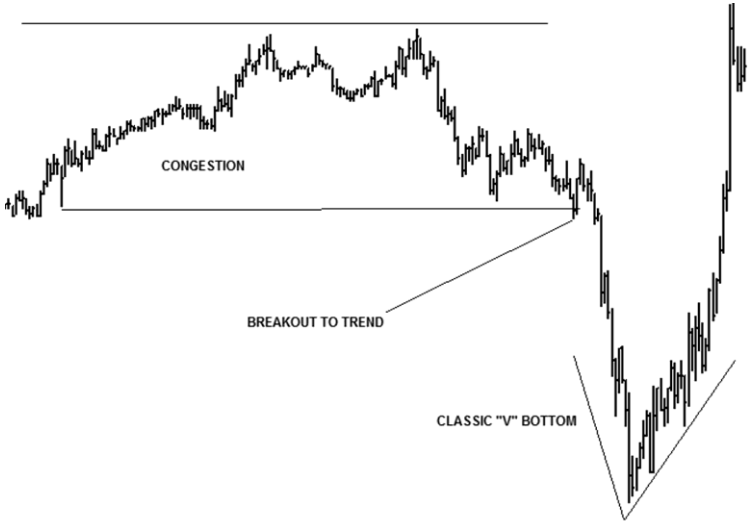
Second, all successful people are able to react to change. They are flexible in their approach!

When a student has special needs the teacher knows how to adjust their lesson plan. When the prospect has a particular

objection the salesperson adjusts their presentation. The athlete adjusts his/her game plan to overcome the opponent's strengths.

Trading is no different.
You will succeed because
you will PREPARE, AND REACT.

Look at the chart on the next page. This chart contains all the information that you will need to know in order to be successful!! The market begins in congestion, makes a breakout, and ends in a blow off. **Why, does this chart tell us everything we need to know? Because we know that Time and Price are Universal. The sum of all shorter time frames must resolve themselves into the longest time frame we are observing. It doesn't matter if we are looking at a one minute chart or a 10 year chart, it is impossible to tell the difference. Knowing this information will allow us to make a profit in any market condition. We are now going to go over the steps to prepare for any market condition, and learn how to trade.**



The first thing we are going to do is to establish the **longest** time frame that we are going to watch. At **BUBBA'S GUIDE TO TRADING OPTIONS**, we suggest that you use a time frame **no longer than two hundred and fifty periods.** Why this number? Two hundred and fifty days is one year's worth of price data. This number is used for **practical** purposes

If you want to become a day trader, and as an example, are using 10 minute charts, your longest time frame should be around two months or forty trading days. **The time frame you use for trading is up to you.**

DAYTRADING IS A FULL TIME JOB,
IF YOU WANT TO DAYTRADE,
YOU MUST BE WILLING TO GIVE UP
ANY OTHER EMPLOYMENT.
THERE IS NO SUCH THING AS
A PART TIME DAY TRADER.

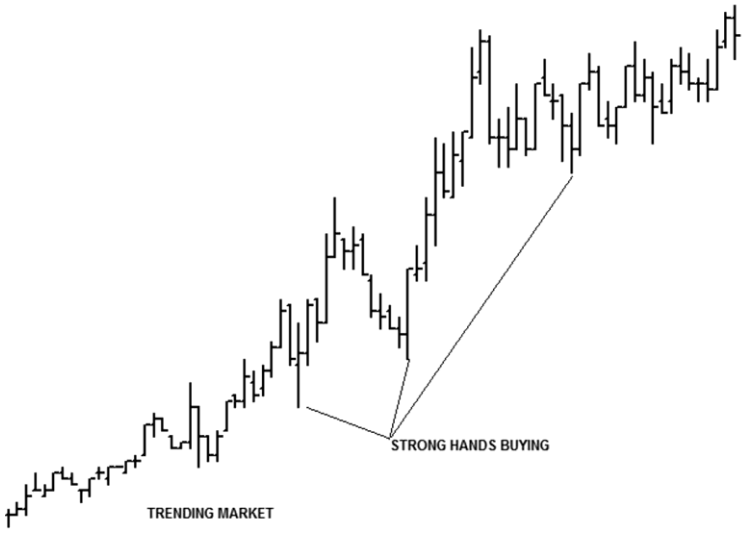
You should have already determined which are tradable: liquidity, spreads, volatility**.**

The more stocks which you can identify as, **tradable,** the more potential action there is. It follows there will be more opportunities, more chances to profit on your trading. **If you can handle 50 stocks, great; just remember, you should make sure that you are following at least 10. Any less will greatly diminish your profit potential. The tradable stocks and their respective markets will be referred to as your PORTFOLIO.**

All of our examples will be based on a daily time frame. This time frame allows you to make constant profits in the market with only a few hours of work each week. It is a very good blend between full time trading, and having a broker make your decisions for you.

STEP ONE: THE LONGEST TIME FRAME

The first step in trading options is to observe the market conditions in our **longest time frame** for the stocks (and options) on your watch lists. **BUBBA'S GUIDE TO TRADING OPTIONS** recommends using approximately 240 periods for your longest time frame. In our example, we'll use a yearly chart. Look again at the chart below. Assume it is a yearly chart. Is the market bullish? Is it bearish? Is it in congestion? We can trade any of these cycles, but we would prefer a market that **is breaking out of congestion.** Congestion is a time of maximum confusion, the market will be looking for direction; **the best trades will be in a market that has a direction already established and has momentum.**



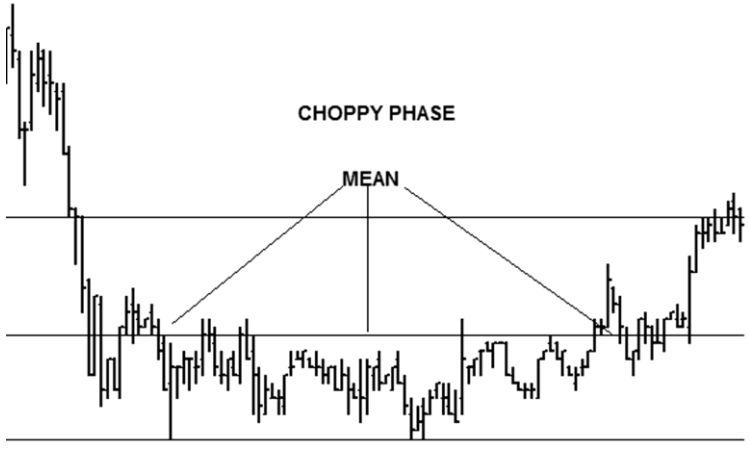
Once you have identified the long term trend (in the example, we see a bullish, long term trend), you will be ready to go to step two.

STEP TWO: THE SHORTEST TIME FRAME

In step two we will narrow our time frame from the longest time frame we are observing **(major trend)** to the shortest time frame we are observing, which will be referred to as our **TRADING TIME FRAME. In our example the trading time frame would be a daily chart.**

In our example, we recognize in the longer time frame, the market is bullish. Now study the chart below, our shorter time frame, or trading opportunity horizon. Notice the shortest time frame does not resemble the longest time frame at all. **The shortest time frame is in Congestion. This is the exact setup we want…..LONGEST TIME FRAME IN MOMENTIUM, AND THE SHORTEST TIME FRAME IN**

CONGESTION!!! Why would we want this setup?



Remember our discussion on the birth of a market; the subsequent phases of the cycle?

Remember, the flip of a coin into infinity, the mean, the average of heads versus tails will be 50/50. That doesn't mean you won't get a string of heads, does it? Or tails?

Remember observing time and price from different points of view?

Are you starting to get excited? Getting it? Are the bells starting to go off?

If they are going off, you are starting to think like a trader.
If they are not, you need to review everything from chapter one on.

We are going to assume that you have studied and that you are starting to think like a trader. The market is always leaving us clues, footprints on which to **react. If you are**

prepared, you can now take advantage of those clues.

STEP THREE: THE TRADE SETUP

We know that the price in each time frame always resolves itself into the longest time frame that we are observing. This has been drummed into you since the first chapter. By now, hopefully you have accepted this principal as fact and can visualize the **set up.** Concentrate on our shorter time frame above.

We know that our longest timeframe is bullish, so in this example we are going to **buy the market.** If our longest time frame was bearish, all of the decisions would be a mirror image of this, and we would **sell the market.** We will look to enter the market at only two positions.

First we can **buy a bounce off a double bottom (DB).** The double bottom is always a point of support, and when we are **trading with the long term trend,** it is a particularly advantageous point to enter the market. It has very low risk, and has the potential to be a big winner if the market breaks out to the upside above the double top.

Second If you are uncomfortable buying off a **DB**, **you can wait until the market breaks out above the double top and buy the breakout.**

"That's all? All of this study is to tell me I should only trade at two spots in the market?"

Yes that is all. You see in trading you only have two choices. You can either buy or sell. All the complicated math, fancy chart analysis, and complicated formulas, all resolve themselves into one thing: **YOU CAN BUY OR YOU CAN SELL. PERIOD.**

The goal of **BUBBA'S GUIDE TO TRADING OPTIONS** is

simple:

<u>*Your* empowerment in option trading decision making;</u>
<u>We want to make your option trading decision made *AS SIMPLE AS POSSIBLE!*</u>

There is no more to it; but we're not quite finished. We haven't looked into the various ways option trading can be profitable, the specific strategies.
In chapter 8, we'll look at option trading specifics.

Chapter 9 will explain risk management and we'll wrap it all up in chapter 10.

Each trade will be done in the same manner, regardless of what the vehicle is that you are using. You will look at the longest time frame to establish momentum, you will then study the shorter time frames looking for congestion, and you will enter the trade with momentum on your side; Each time, every time, with discipline.

Before you can advance to the next section you will need to take another quiz. This one will be short: only 25 questions.

CHAPTER 7: OPTION TRADING BASICS QUIZ

All Questions are True or False.

1. Discipline is an important tool in trading.

2. Successful **BUBBA'S GUIDE TO TRADING OPTIONS** predict future price.

3. Successful traders never react to market changes.

4. Time and price are universal.

5. The longest time frame observed is always trending.

6. The shortest time frame observed is never more than 10 minutes.

7. The longer the longest observable time frame is, the better the information.

8. The shortest time frame is also known as the trading time frame.

9. Day trading is a full time job.

10. The trading time frame will always be no longer than two days.

11. The trading time frame is not always the shortest time frame we observe.

12. The longest time frame we observe should never be over one year.

13. Trading decisions begin with the longest time frame.

14. Establishing a tradable portfolio is the first step to

trading.

15. Ten assets are considered the minimum amount for a successful portfolio.

16. The more assets that can be used in a portfolio the better.

17. Diversification an important key to successful trading.

18. Double bottoms are always a sign of support in a market.

19. Breakouts always occur after periods of congestion.

20. Counter trend traders are always the weak hands.

21. Observing a market from different points in time can give conflicting market views.

22. The shortest time frame we observe is always our trading time frame.

23. Strong hands dominate an upside breakout.

24. Weak hands dominate on a downside breakout.

25. All long term time frames will exhibit breakouts

CHAPTER 7: QUIZ ANSWERS

1. Discipline is an important tool in trading.
   True, discipline is the **first key** to a successful trader.

2. Successful **BUBBA'S GUIDE TO TRADING OPTIONS** predict future price.
   False, **BUBBA'S GUIDE TO TRADING OPTIONS** traders react to price change.

3. Successful traders never react to market changes.
   False, successful traders **always** react to market change.

4. Time and price are universal.
   True, if you missed this one go back to chapter one.

5. The longest time frame observed is always trending.
   False, the longest time frame may be in any of the three phases of the market.

6. The shortest time frame observed is never more than 10 minutes.
   False, there are no parameters stated for the shortest time frame.

7. The longer the longest observable time frame is, the better the information.
   False, an observable time frame that is too long is not practical for trading.

8. The shortest time frame is also known as the trading time frame.
   True, if you missed this one you must be sleeping.

9. Day trading is a full time job.
   True, no comment is needed here.

10. The trading time frame will always be no longer than two days.

False, the trading time frame could be any period shorter than the longest time frame.

11. The trading time frame is always the shortest time frame we observe.

True, no explanation is need here.

12. The longest time frame we observe should never be over one year.

True, for practical purposes we should not observe price and time over one year.

13. Trading decisions begin with the longest time frame.

True, the longest time frame sets up our first trading decision.

14. Establishing a tradable portfolio is the first step to trading.

True, you must have your portfolio in place before you can analyze markets.

15. Ten assets are considered the minimum amount for a successful portfolio.

True, you need a base of at least 10 assets to successfully diversify your trade.

16. The more assets that can be used in a portfolio the better.

True, the more assets you can manage the greater is the potential for profiting.

17. Diversification is an important key to successful trading.

True, different assets in your portfolio will always increase trade opportunities.

18. Double bottoms are always a sign of support in a market.

True, you better not have missed this one!

19. Breakouts always occur after periods of congestion.
True, see number 18!

20. Counter trend traders are always the weak hands.
True, that is the definition of weak hands.

21. Observing a market from different points in time can give conflicting market views.
True, this is the condition we need to identify entry and exit points.

22. The shortest time frame we observe is always our trading time frame.
True, no explanation needed.

23. Strong hands dominate an upside breakout.
True, strong hands always dominate a breakout.

24. Weak hands dominate on a downside breakout.
False, you better not have missed this one!

25. All long term time frames will exhibit breakouts
False, there is no time limit as to how long congestion can last. Therefore just because you are observing a long term period it does not mean it will breakout.

As always make sure that you know the answers to the questions. The logic of what **BUBBA'S GUIDE TO TRADING OPTIONS** should be obvious by now. If you have questions, that's OK; but, do not go on to chapter 8 until you have understood and mastered the material to this point.

CHAPTER 8: OPTION TRADING SPECIFICS

Well if you're current on your training so far, this is the section that you have been waiting for, the meat and potatoes.

First, a couple of notes:

BUBBA'S GUIDE TO TRADING OPTIONS does not emphasize the "Greeks" of trading options even though the authors have over 50 years of experience in their trading application. One of the reasons that we are able to present our trading program in a form that can be easily understood, and is user friendly, is that we have enough knowledge of the mathematical calculation in the option model to be able to incorporate them into our trading system. **You can be sure that the trades which are being recommended in various market conditions will already take Delta, Gamma, Theta, Vega and Rho into consideration before they are presented.**

Some of you may be familiar with these terms. Some are surely asking, *"What in the world do I need to know about the „Greeks," relative to my option trading? Is this about some college fraternity dedicated to trading options; an ancient trading ritual recently discovered in Athens?"*

Actually, neither is true, though it might make for a good novel! In the option vocabulary, "Greeks" refer to different measures of risk associated with option trading. Many new traders are totally confused by these complicated sounding terms (many seasoned traders are as well) believing that they are dealing with a subject outside of their ability. Nothing could be further from the truth, **Option Greeks** are simple concepts hidden in complex, scientific sounding terms.

Before we cover the 4 Greeks used in option trading, I'm going to sidebar and answer a question asked by many students, whether trading stocks or options. Since we are at our Greeks discussion section, it's a good time to define a common "Greek" used in stock and options trading. This is **BETA**.

BETA

Beta measures the rate of change in a stock price relative to the overall market's change. It is developed through regression analysis: a fancy way to say it is predicted based on past price behavior. The index usually used to measure a stock's Beta against is the **S&P 500**. A Beta of 1.0 means that for every given percentage amount the index rises (or falls), the stock price should move in direct, relative correlation. If the **S&P** is up .5%, and a stock Beta is 1.0, the stock price should move by .5%. If a stock has a Beta of 2.0 and the **S&P** rose .5%, the stock should rise 1.0% (2 x .5%). When folks speak of, "High Beta" stocks, they are referring to stocks that tend to move more than the overall market on a percentage basis (either direction).

The primary Greek terms used in options trading are **Delta**, **Gamma**, **Theta**, and **Vega**.

DELTA

This is the most commonly used Greek. Delta is the measurement of how much an option's price changes for every $1.00 change in the underlying stock. An option is said to have positive delta if it goes up when the stock price goes up. Negative Delta is the term used when the option price goes up if the stock price falls. Buying a call (long a call) has positive Delta. Buying a put (long a put), has negative Delta.

A call's delta is measured 0.0 to 1 and a put's delta is measured 0.0 to -1. The closer the delta is to 1 or -1, the

more the option is expected to move in relation to the stock price. A good way to visualize delta is to understand that being long a stock means the delta is 1, short a stock, delta is -1. Therefore, owning a call with a delta of 1 means the call will move exactly like the underlying stock. Delta is largely dependent on the stock's price relative to the strike price of the option. It is important to note that delta is theoretical and assumes that time, volatility and interest rates remain the same.

GAMMA

Gamma is a little more complicated than delta, but still an easy to grasp term. Gamma estimates the degree of change in the delta when the underlying stock moves $1.00. It is used to let the trader know how smooth the delta will be, meaning a small gamma means the delta will stay relatively flat during small stock moves, and a large gamma means the delta will change sharply during small stock moves.

Long calls and puts have positive gamma, short calls and puts have negative gamma. Positive gamma refers to the fact that the delta of long calls will become increasingly positive, moving toward 1 as the stock price rises. It also means that the delta of long puts will become increasingly negative as the stock price falls moving toward -1. Gamma is the highest for an option that is ATM.

Gamma progressively lowers as the option moves away from ATM, in either direction, either deeper out of the money (OTM) or conversely, deeper in the money (ITM). The important thing to take away from understanding gamma is that a position with a positive gamma will move with the stock, deltas will change with the up or down stock movement. Positions with a negative gamma can create deltas that can hurt the position as the stock moves.

THETA

Theta is just a fancy word for time decay. An easy way to remember is both TIME and THETA begin with the letter T. It is the estimate of how much the value of an option changes as each day passes toward expiration. It assumes that there is no change in the stock price. Being long a call or a put means you have negative theta. Short the same call or put means you have positive theta. Think of it this way, when you sell an option, time is working for you therefore it is positive theta. When you buy an option, time is your enemy; therefore the position has negative theta.

VEGA

Vega is a measure of how much the price of the option changes for every 1% change in volatility. An easy way to keep this straight is to remember VEGA and VOLATILITY both begin with the letter V. As volatility increases, so do the prices of options and vice versa. This is due to the fact that increased volatility means increasing stock price swings, thereby increasing the possibility of the option making money by expiration. A long call and put have positive Vega, short calls and puts have negative Vega. Positive Vega means the option price increases when volatility increases. Negative Vega means that the option price decreases when volatility increases.

We described the option model as *"like a balloon,"* and it is. As air is pumped in **(premium)** and the balloon expands it will offer us different trading opportunities at various times in the option cycle. The premium is a very important part of any trade and **cannot be ignored.** There are many ways to measure the premium levels, but you can get a pretty good handle on the level of "fear" in the market by monitoring just one factor, **the VIX.**

The VIX is a product of the **CME Group** and specifically the **CBOE**. It is a simple, but extremely important, barometer of the premium levels of all stocks in the **OEX**.

<u>There is going to be a *positive correlation*</u>
<u>between the stocks that you trade</u>
<u>and the VIX.</u>

By correlation, **we do not mean** that it will either expand or contract tick for tick with the **OEX**, but there will be enough similarity with individual stocks, ***<u>that except in obvious blow off phases of an individual stock,</u>*** you do not need to worry about checking the volatility in each of the stocks in your portfolio.

I want you to bring up 2 charts on your computer(s): the OEX and the VIX, both from July 2008 to July 2009.

Look at these two charts. Notice that the price of the **OEX** went below 420 on November 15th 2008. Four months later on March15, 2009 it went above 420. **So in the four month time period, the OEX price was unchanged.**

The second chart is for the ***exact same time period***, but it is a chart of the **VIX**. Notice that in November of 2008 the **VIX** had reached an all time high of **80** when the **OEX** price penetrated 860, **however four months later with the price exactly the same, the VIX had decreased *"air"* in its premium level by more than 50%!**

How could this happen?

The price is exactly the same as it was four months ago, but ***"the balloon has half the air in it."*** The answer is simple, do you remember the term, "**market expectation?"** In November of 2008, the world was in financial chaos, in March of 2009, ***although it was in the same chaos,*** the market expectation was that the world had become a safer place. **BUBBA'S GUIDE TO TRADING OPTIONS will allow you to prosper, successfully trading options in these extremes, and almost any market condition!!**

Now let's study phases of the market and the specific option strategies that will give us the best opportunities to profit.

THIS CHAPTER WILL NOT DEAL WITH MANAGING WINNERS AND LOSERS; IT WILL ONLY DEAL WITH OPENING A POSITION, OR INITIATING A TRADE. MANAGING THE TRADE WILL BE IN THE NEXT CHAPTER.

We're going to look at 2 volatility scenarios: High and Low.

HIGH VOLATILITY SCENARIOS

STEP 1:

The first step to trading options is ***exactly the same*** as picking our trading opportunity. We look at the longest time frame we are observing. We then go to our trading time frame. We now add an important step. **We check out the level of the VIX**.

AS A "*GENERAL"* RULE, IF THE VIX IS TRADING ABOVE ITS 200 DAY MOVING AVERAGE WE WILL USE STRATAGIES THAT WILL *BUY* PREMIUM. WE WILL DO THIS WHETHER THE MARKET IS BREAKING OUT TO THE UPSIDE OR DOWNSIDE.

THE ONLY TIME WE WILL USE AN EXCEPTION TO THIS RULE IS WHEN PREMIUM IS IN A BLOWOFF PHASE OF THE MARKET. THIS IS A SPECIAL CASE AND IT WILL BE A UNIQUE TRADE.

Generally speaking the **VIX** will be above its 200 day moving average when the market is breaking. A great example of this was the financial meltdown of 2008. In the first quarter of 2008 the **VIX** started to climb, as summer approached it really heated up. Buying air during the first stage of the move worked very well. In the fall the **VIX** entered the Blow Off stage and for some stocks the premium approached infinity.
During a blow off stage of any market, buying premium (long puts or calls, owning "air") is financial suicide. The only people buying options are being forced to liquidate positions.

DO NOT CONFUSE *BUYING* PREMIUM WITH BUYING THE MARKET OR SELL*ING* PREMIUM WITH SELLING THE MARKET, THEY ARE NOT THE SAME THING. PREMIUM LEVELS ONLY DEAL WITH THE AIR IN THE BALLOON, NOT PRICE MOVEMENT.

Look at the **VIX** chart again. Some of you may have already noticed that if we take the time and price axis away from the **VIX** chart it is impossible to tell what the chart represents, and what time and price periods are being observed. If we then shorten our time frame that we are observing, it will be impossible to differentiate the charts. What more proof is needed to again illustrate the universal principal of time and price?

STEP 2:

We have done our homework and we are now ready to go to the second step. We find a stock that meets our criteria for **tradability** and we check the shortest time frame that we are observing, our **trading time frame**. **We find it's in congestion and we are ready to trade.**

Our first trade will be aggressive; we're going to buy a double bottom**.**

The **VIX** is above its 200 day moving average, ***but the underlying market is not in a blow off phase***, so the appropriate trade in this scenario is to ***BUY*** **premium.**

However, we are *NEVER* going to use strategies that use more than two options. Iron Condors, Iron Butterflies, Calendar Condors, Calendar Butterflies, Layered Calendars do not conform to The Average Joe Option Trading System. THESE ARE MULTIPLE LEG SPREAD STRATEGIES. EFFECTIVELY, THEY ARE COMMISSION GENERATORS AND DECREASE LIQUIDITY.

IF YOU ARE TRADING IRON CONDORS OR EVEN MORE COMPLEX CALENDAR IRON CONDORS YOU ARE GOING TO BE USING SPREADS THAT HAVE AT LEAST *4 (AND AS MANY AS 8*) LEGS. SPREADS WITH 2 LEGS OR A STAND ALONE OPTION POSITION ACCOMPLISHES THE SAME GOAL. IF YOU WANT TO

TRADE THESE COMPLEX SPREADS, WE AT BUBBA'S GUIDE TO TRADING OPTIONS BELIEVE THIS IS TANTAMOUNT TO *"BURNING UP YOUR RISK CAPITAL THRU THE TRIPLE AND QUARDUPLE COMMISSIONS PAID TO YOUR BROKER."*

Now let's look at our first trade.

HIGH VOLATILITY SCENARIO I
DOUBLE BOTTOMS AND DOUBLE TOPS
VIX TRADING ABOVE 200 DAY MOVING AVERAGE

THE DOUBLE BOTTOM - BULLISH

We've established the current "condition" of the market: We've identified a double bottom (support) and the **VIX** is above its 200 day moving average. We can execute several types of trades.

A) We can **buy a call outright**. When buying an outright call, you will want to buy the ATM, or the next lower **(first in the money)** strike. Buying teenies is generally a waste of time. We want to use options that have punch and are highly correlated to a price move. OTM options, while exhibiting less risk, can easily lose their correlation if the anticipated rally takes longer than expected.

B) We can buy the **ATM straddle** (Buy call and put options with the same strike price, same expiration, and on the same underlying - both the call and put are bought long, for a debit) **or the ATM strangle** (Buy call and put options with different strike prices - normally of equal, but opposite, Deltas. The options share the same expiration and the same underlying. A strangle is usually a position in out-of-the-money options. A long strangle means both the calls and puts are bought long, for a debit). This trade gives us great potential to an upside price breakout, but if the double

bottom does not hold and a downside breakout takes place we can still cash the trade. **This type of trade has more premium risk but, it has no price risk.**

C) We can sell **a vertical put spread – Bull credit spread** (The purchase and sale for a **net credit** of two puts of the same expiration but that have different strike prices – buy the lower strike, sell the higher strike. Again you will want to use the ATM or the first strike that is in the money. **This spread has no premium risk, and we can win three ways on this spread. If price declines by less than the credit we make money. If price is unchanged we make money, if price rallies we make money.**

D) We can **buy an ATM calendar call spread.** (The simultaneous purchase and sale of a call of the same type – same strike, same underlying – but with different expirations. In this case, selling a call in the front month and buying a call in the deferred month). This spread offers time decay on our side with the possibility of more air going into the balloon in the second leg. **The beauty of buying calendar spreads is not only that they have *unlimited* upside potential, but also have limited risk. Our front leg (premium sell) could expire worthless, and our long calls could explode, giving this spread a double kick!!!!**

Typically students will end up favoring one or two trade types, that is why you are given a couple of choices in each market scenario.

THIS IS AN INDIVIDUAL QUESTION TO ADDRESS…WHICH TRADE WORKS BEST FOR YOUR STYLE, RISK TOLERANCE, EASE OF EXECUTION, ETC.

THE DOUBLE TOP - BEARISH

Now, let's look at the **mirror** image of this trade and how it might be executed.

In this scenario, we've again determined the current "condition" of *this* market: **In this case, we've identified a double *top* (resistance)** and the **VIX** is above its 200 day moving average. Here again, we can execute several types of trades.

A) We can **buy a put outright**. When buying an outright put, you will want to buy the ATM or the next higher **(in the money)** strike**.** As we covered earlier, buying teenies is generally a waste of time. We want to use options that have punch and are highly correlated to a price move. Out of the money options, while exhibiting less risk, can easily lose their correlation if the anticipated break takes longer than expected. Cheap options can also eat commissions.

B) We can buy the **ATM straddle** (Buy call and put options with the same strike price, same expiration, and on the same underlying - both the call and put are bought long, for a debit) **or the ATM strangle** (Buy call and put options with different strike prices - normally of equal, but opposite, Deltas. The options share the same expiration and the same underlying. A strangle is usually a position in out-of-the-money options. A long strangle means both the calls and puts are bought long, for a debit). This trade gives us great potential to an upside price breakout, but if the double bottom does not hold and a downside breakout takes place we can still cash the trade. **This type of trade has more premium risk but, it has no price risk.**

C) We can sell **a vertical call spread – Bear credit spread** - The purchase and sale for a **net credit** of two calls of the same expiration but that has different strike prices – buy the upper strike, sell the lower strike. Again you will want to use the ATM or the first strike that is in the money. **<u>This spread has no premium risk</u>, and we can win three ways on this spread. If price rallies by less than the credit we make money. If price is unchanged we make money, if price breaks we make money.**

D) We can **buy an ATM calendar <u>put</u> spread – Horizontal Debit Spread.** This spread **offers time decay on our side with the possibility of more air going into the PPballoon in the second leg**. **As in the first scenario, t**he **beauty of buying calendar spreads is not only that they have *<u>unlimited</u>* upside potential, but also have limited risk. Our front leg (premium sell) could expire worthless, and our long puts could explode, giving this spread that double kick!!!!**

So for our first market condition, **a double top or double bottom with the VIX above its 200 day moving average,** you have multiple strategies that offer great reward, with limited risk.

BUBBA'S GUIDE TO TRADING OPTIONS could name at least twenty more strategies that could be employed in this phase of the market, but they would not be any more effective. Remember the goal of **BUBBA'S GUIDE TO TRADING OPTIONS** is to keep options trading as simple as possible with the least possible time invested and the most bang for the buck.

Okay you decided not to buy the double bottom or double top, you want the market to prove that it is still **TRENDING (either bullish or bearish)** and you waited for the breakout. This is a perfectly viable style of trading. Some traders want the market to prove itself before they enter; Average Joe's trading style prefers double bottom and/or double top entry points. Our way of thinking is that they (double tops/bottoms) give traders more of a head start ***if you are correct.*** That said, breakouts are a suitable strategy and we want to include those trades and how to successfully deploy your resources on breakouts.

HIGH VOLATILITY SCENARIO II

BREAKOUTS ABOVE RESISTANCE
VIX TRADING ABOVE 200 DAY MOVING AVERAGE

For our second market condition, **a *breakout* with the VIX above its 200 day moving average,** listed below are the preferred choices for the **BUBBA'S GUIDE TO TRADING OPTIONS** trader.

BREAKOUT ABOVE RESISTANCE - BULLISH

A) We can **buy a call outright**. ***This situation is slightly different than the double bottom.*** Recall our discussion on technical analysis; in a breakout, the market has confirmed there is a reasonable probability of the underlying asset's price increasing (or conversely, breaking below support). This time instead of buying the ATM, we'll buy **two identical calls** with premium roughly equal to the ATM. If the ATM is trading at $7.00, we'll purchase **two $3.50ish calls**. This strategy has a bit more market risk (if the breakout takes longer than anticipated), but really packs punch in an immediate blow off.

B) Here, too, we can buy the **ATM straddle** (Buy call and put options with the same strike price, same expiration, and on the same underlying - both the call and put are bought long, for a debit) **or the ATM strangle** (Buy call and put options with different strike prices - normally of equal, but opposite, Deltas. The options share the same expiration and the same underlying. A strangle is usually a position in out-of-the-money options. A long strangle means both the calls and puts are bought long, for a debit). This trade gives us great potential to an upside price breakout, but if the double bottom does not hold and a downside breakout takes place we can still cash the trade. E***ven if we are dead wrong***, **we can still cash the trade**. **This type of trade has more premium risk, but it has no price risk.**

C) And here as well, we can **buy an ATM calendar call spread.** (The simultaneous purchase and sale of a call of the same type – same strike, same underlying – but with different expirations. In this case, selling a call in the front month and buying a call in the out month). This spread offers time decay on our side with the possibility of more air going into the balloon in the second leg. **The beauty of buying calendar spreads is not only that they have *unlimited* upside potential, but also have limited risk. Our front leg (premium sell) could expire worthless, and our long calls could explode, giving this spread a double kick!!!!**

If your strategy is to wait for breakouts, ***BUBBA'S GUIDE TO TRADING OPTIONS does not recommend buying call spreads***. You want to take advantage of the possibility of a runaway market; given that objective, buying call spreads is too conservative.

So far we have discussed trading strategies that can be executed ***when we have a rising volatility levels*****,** but what happens if the market breaks out in ***low levels of volatility, when the VIX is trending lower***? For this scenario we will look at a second type of trade.

LOW VOLATILITY SCENARIOS

STEP 1:

Once again, the first step when trading within a low volatility environment ***is exactly the same*** as it is when picking almost any other trading opportunity. We look at the longest time frame (that) we monitor. We then study our trading time frame. **WE AGAIN CHECK OUT THE LEVEL OF THE VIX.**

WHEN THE VIX IS TRADING BELOW ITS 200 DAY MOVING AVERAGE, IN GENERAL, WE WILL USE STRATAGIES THAT WILL *SELL* PREMIUM. WE WILL DO THIS WHETHER THE MARKET IS BREAKING OUT TO THE UPSIDE OR DOWNSIDE.

HERE AGAIN, TO REITERATE: DO NOT CONFUSE SELLING PREMIUM WITH SELLING THE MARKET AND BUYING PREMIUM WITH BUYING THE MARKET, THEY ARE NOT THE SAME THING. REMEMBER, PREMIUM LEVELS ONLY DEAL WITH VOLATILITY AND TIME DECAY, "THE AIR IN THE BALLOON," NOT PRICE MOVEMENT.

When volatility (**VIX**) is below the 200 day moving average, generally the market will be rallying. It may seem counter intuitive to be selling the premium into a rally, but it works very well in the trending stages of a market. **In fact the during Bull market of 2003 to 2007 the VIX remained at twenty five year lows.**

STEP 2:

We have done our homework; we're ready for the second step. We find a stock that meets our criteria for **tradability** and we check the shortest time frame that we are observing, **our trading time frame**. **We've determined it to be in congestion; we're ready to trade.**

THE DOUBLE BOTTOM - BULLISH

We've established current market conditions. We've identified a double bottom in our trading time frame. The **VIX** is below its 200 day moving average, so **the trade we'll initiate is to sell premium, (sell the air).** ***We can execute several types of trades.***

To begin, we'll start with a more aggressive trade; we're going to sell a double bottom**.**

A) We can **sell a vertical put spread – Bull Put Spread.** In this trade we will **sell the ATM put and buy a put (same type) at the first strike out of the money to the downside.** Our risk is limited to the spread between the strikes minus the credit we received.

B) We can **sell (short) the straddle at the first out of the money strike to the upside.** A short straddle means both the call and put have the same strike price, same expiration, and on the same underlying which are sold (for a credit). This trade may seem counter intuitive, but given the low **VIX** we are trying to be short the most premium when we arrive at the strike. **This trade is not for everyone as you have unlimited risk and limited reward.**

C) We can **buy a calendar call spread – Horizontal Debit Spread.** We could buy the ATM, but ***in this scenario*** we prefer to buy the first ***out of the money strike to the upside***. We'll sell a call in the front month (first OTM) and buy a call of the same type in the back month (first OTM): same strike price, same underlying asset, different expirations.

This spread offers time decay on our side with the possibility of an increase in the option's premium in the second leg

(more air going into the balloon). By now you should be recognizing the advantage of being long calendar spreads; they have *unlimited* upside potential, but also have limited risk. ***Our front leg could expire worthless, and our long puts could explode, giving us that double kick!!!!***

Next, let's look at the mirror image of this trade and how it will be handled.

THE DOUBLE TOP - BEARISH

We've established current market conditions. We've identified a double top in our trading time frame. The **VIX** is below its 200 day moving average, **so the trade we'll initiate is to again sell premium, (sell the air).**

Let's examine our trading choices under this scenario.

A) We can **sell vertical call spreads – Bear Call Spread.** This credit transaction sells a call and buys another call at a higher strike price, on the same underlying, in the same expiration. In this trade we will **sell the ATM call and buy the first OTM strike to the upside**. Our risk is limited to the spread between the strikes minus the credit we received.

B) We can sell the **straddle at the first *OTM strike to the downside.*** A short straddle means both the call and put are sold with the same strike price, same expiration, and are on the same underlying (for a credit). **This trade may seem counter intuitive, but given the low VIX we are trying to be short the most premium *when we arrive at the strike.*** This trade is not for everyone and requires margin as **you have unlimited risk and limited reward.**

C) We can **buy a calendar put spread – Horizontal Debit Spread.** We'll sell a put in front month and buy a put in back month; same strike price, same underlying asset. We could

buy the ATM, but **we prefer the *first OTM strike to the downside***. This spread **offers time decay on our side with the possibility of more air going into the balloon in the second serial**. **The beauty of buying calendar spreads is they have *unlimited* upside potential and limited risk. Our front leg could expire worthless, and our long puts could explode, giving this spread a double kick!!!!**

BLOW OFF SCENARIOS

We have one more condition to look at for possible trades and that is the **Blow Off** phase of the market.

Trading the Blow Off phase is very risky and is not be for everyone. However, with great risk comes great reward!

The blow off in volatility will coincide with the market's price and time blow off phase. When this occurs, market prices will print parabolic numbers. The strong hands will squeeze the weak hands to the breaking point. The only market participants – traders - that will be buying premium are those that are being forced to do so by their respective clearing houses due to position covering and/or margin calls.

Buying premium, entering long option positions at this time is financial suicide. Many unfortunate investors learned this lesson during the financial meltdown of 2008.

Can a trader profit from in this environment? **The answer is pretty simple; we can, but *ONLY* if, *AND WHEN* we use the same steps we follow for any other trade!!**

As always, we begin by studying the longest time frame we are trading. Second we move to our trading time frame. **Nothing changes; to be successful, we stick to our regiment. We remain disciplined, consistent and**

focused on the charts and what they are telling us.

We initiate these trades ***only when our shortest time frame breaks out.***

If the Blow Off is to the downside, when our shortest time frame BREAKS OUT TO UPSIDE, we SELL THE ATM PUT.

If the Blow Off is to the upside, than our shortest time frame BREAKS OUT TO THE DOWNSIDE and we SELL THE ATM CALL.

If your risk tolerance disallows the unlimited risk of being naked premium you can sell vertical spreads. On the upside breakout sell the ATM vertical put spread. On the downside breakout sell the ATM vertical call spread.

THE PREMIUM LEVELS WILL BE SO GREAT AT THIS POINT THAT YOUR RISK IS GOING TO BE VERY SMALL, BUT YOUR REWARDS CAN BE ENORMOUS!!!

We at **BUBBA'S GUIDE TO TRADING OPTIONS** realize this chapter has had a ***considerable*** amount of information. You'll need to review it a couple of times before you have an understanding of the strategies detailed. This entire publication will serve you for years to come, but this and the next chapter will probably be the most referenced. As the material begins to sink in, a couple of basic concepts should become very clear.

1) THE EVOLUTION (AND REPITITIONS) OF THE THREE PHASES OF ANY LIQUID MARKET, COMBINED WITH MARKET VOLATILITY IS THE CORE OF OUR OPTIONS TRADING MODEL AND SUBSEQUENT OPTION LIFE CYCLE.

2) ONCE RELATIVE VOLATILITY (VIX) LEVELS ARE RECOGNIZED, THE TRADING TIME FRAME IS

CONSIDERED AND MARKET CONDITIONS ARE DETERMINED, THE FOUNDATION IS LAID FOR OUR TRADE.

3) THE TRADEABLE STOCK IS SELECTED. THE STRATEGY IS DETERMINED; ENTRY/EXIT POINTS ARE IDENTIFIED.

YOU NOW HAVE THE ABILITY TO PUT ON PROFITABLE TRADES DURING ANY PHASE OF THE MARKET CYCLE!!

WHAT COULD BE EASIER?
THAT'S WHY WE CALL IT
"BUBBA'S GUIDE TO TRADING OPTIONS"!!

One question you may be asking is, *"Why we are not showing the profit potential of each spread?"* The reason is simple; we want you to learn to trade the options market like professional traders. Believe it or not most professional traders do not look at the profit potential from a **spread**. They are more interested in how they are going to **manage winners *and* losers.**

In this chapter we demonstrated how to open positions in the options market using simple methods for putting trades in place. In chapter 9 we'll develop your next skill set: successfully managing your portfolio. Before that, you'll need to pass the test on chapter 8.

CHAPTER 8: OPTION TRADING SPECIFICS TEST

The test on this chapter is going to include true and false questions as well as multiple choice questions. One point for each individual true and false answered correctly. Two points for multiple choice questions. Multiple choice questions graded on a scale of 0-4. There are 88 points; you must get at least 80 points before you are ready to go to chapter 9. If you have trouble with the test the first time, don't worry, when we review the material it will all start to click. All these questions come from this chapter. Longest time frame is 1 year.

1. **BUBBA'S GUIDE TO TRADING OPTIONS** does not consider the Greeks when trading.
   True or False

2. The option model can be compared to a balloon.
   True or False

3. The **VIX** can be used to measure fear in the market.
   True or False

4. The **VIX** does not always have a positive correlation with the **OEX**.
   True or False

5. Nominal price is more important than market sentiment when measuring the VIX.
   True or False

6. The **VIX** correctly predicted the financial meltdown of 2008.
   True or False

7. Market expectation could account for the decline of the **VIX** in the Spring of 2009.
   True or False

8. If the **VIX** is above its 200 day moving average, premium should increase (air should be going into the balloon).
True or False

9. The **VIX** is not an index product.
True or False

10. The **VIX** can go below zero during a blow off.
True or False

11. Which of the following is/are true?
a) The first step in trading options is to observe our longest time frame.
b) The second step in trading options is to observe our shortest time frame.
c) The third step in trading options is to observe the VIX
d) All of the above
e) only a and b

12. Buying premium is the same as buying the market.
True or False

13. Which is true about premium writers?
a) They are always the weak hands.
b) They are always the strong hands.
c) They have unlimited risk.
d) They always receive a credit.
e) all of the above
f) Only a and c d
g) Only c and d
h) none of the above

14. Which of these characteristics describes a tradable market?
a) A **VIX** above its 200 day moving average
b) A **VIX** below its 200 day moving average
c) A tight bid offer spread
d) Low commission rates

e) only a and b
f) only c and d
g) all of the above

15. Writing premium is also known as shorting the market.
True or False

Questions 16 thru 20 refer to the following conditions, each answer is worth 2 points.

Given the following market condition: Double Bottom, VIX above its 200 day moving average; we should execute which of the following trades:

16. Buy an ATM put.
True or False

17. Sell the ATM straddle.
True of False

18. Buy the ATM call.
True or False

19. Sell a calendar call spread.
True of False

20. Buy the ATM vertical call spread.
True or False

Questions 21 thru 25 refer to the following conditions, each answer is worth 2 points.

Given the following market condition: Double Top, VIX above its 200 day moving average; we should execute which of the following trades:

21. Buy an ATM put.
True or False

22. Sell the ATM straddle.
True of False

23. Buy the ATM call.
True or False

24. Sell a calendar ATM call spread.
True of False

25. Buy the ATM vertical put spread.
True or False

26. Buying a vertical put spread on a downside breakout with a high **VIX** is a suitable trade.
True of False

27. Call writers always have unlimited risk.
True or False

28. Calendar call spreads can be bought when the **VIX** is above its 200 day moving average and the market is on a double bottom.
True or False

29. Calendar call spreads can be bought when the **VIX** is below its 200 day moving average and the market is on a double bottom.
True or False

30. Selling premium naked always has unlimited risk.
True or False

Questions 31 thru 35 refer to the following conditions, each answer is worth 2 points

Given the following market condition: Upside breakout, VIX below its 200 day moving average; we should execute which of the following trades:

31. Buy a vertical call spread using the ATM.
    True or False

32. Buy the ATM straddle.
    True or False

33. Sell the ATM vertical put spread.
    True of False

34. Buy a “double call” to the upside.
    True or False

35. Sell an upside straddle.
    True of False

36. We can buy a calendar ATM call spread in any market phase.
    True or False

37. Calendar ATM call spreads should be bought on a double bottom with the **VIX** below its 200 day moving average.
    True of False

38. Calendar ATM call spreads should be bought on a double bottom with the **VIX** a above its 200 period moving average.
    True of False

39. **BUBBA’S GUIDE TO TRADING OPTIONS** never buy serial put spreads.
    True or False

40. **BUBBA’S GUIDE TO TRADING OPTIONS** never sells vertical put spreads.
    True or False

41. Selling an ATM straddle has less risk that selling a

strangle.
True or False

42. When we sell premium short we are shorting the market.
True or False

43. Buying vertical call spreads has no risk as to volatility.
True or False
44. Buying ATM straddles has no risk as to price.
True or False

45. Selling a calendar call spread has unlimited risk.
True or False

Questions 46 to 50 relate to the following market conditions, and are worth2 points each.

Given the following market condition: Double bottom, VIX below its 200 day moving average; we should execute which of the following trades:

46. Buy a serial ATM call spread.
True or False

47. Buy a vertical ATM call spread.
True or False

48. Sell a Vertical ATM out spread.
True or False

49. Sell a straddle at the first OTM strike to the upside.
True or False

50. Sell a calendar ATM put spread.
True or False

Questions 50 to 55 relate to the

following market conditions,
and are worth 2 points each.

The VIX has reached a level of 91 which is the highest level in 41 years. We have observed our longest time frame and recognized the blow off and we are now watching our trading time frame. Which of the following trades is appropriate?

51. When the market breaks to the upside, buy a vertical call spread.
Yes or No

52. When the market reaches a double top, sell the ATM call.
Yes or No

53. When the market breaks out to the downside, sell the ATM vertical call spread.
Yes or No

54. When the market breaks out to the downside, buy the ATM put spread.
Yes or No

55. When the market breaks out to the downside, sell the ATM put.
Yes or No

CHAPTER 8: TEST ANSWERS

1. **BUBBA'S GUIDE TO TRADING OPTIONS** does not consider the Greeks when trading.

   False, **BGTTO** considers all the Greeks in our market recommendations.

2. The option model can be compared to a balloon.

   True, the option model mimics a balloon. Premium and time are the air that fills it.

3. The **VIX** can be used to measure fear in the market.

   True, the higher the fear the higher the **VIX**.

4. The **VIX** does not always have a positive correlation with the **OEX**.

   False, it is a measurement of the volatility of the **OEX**

5. Nominal price is more important than market sentiment when measuring the **VIX.**

   False, nominal price may have little correlation with the **VIX**, ***market expectation*** drives the **VIX**.

6. The **VIX** correctly predicted the financial meltdown of 2008.

   False, the **VIX** ***reacted*** to the financial meltdown of 2008.

7. Market expectation could account for the decline of the **VIX** in the Spring of 2009.

   True, although the nominal price of the market was the same as the all time high in the fall of 2008, market expectation had changed dramatically.

8. If the **VIX** is above its 200 day moving average, premium should increase (air should be going into the balloon).

   True, that is what the moving average is showing.

How much air is going in and out of the balloon at any point in time; premium fluctuation.

9. The **VIX** is not an Index product.
   False, the **VIX** is an index.

10. The **VIX** can go below zero during a blow off.
    False, a zero reading would indicate no fear.

11. Which of the following is true?
    a) The first step in trading options is to observe our longest time frame.
    b) The second step in trading options is to observe our shortest time frame.
    c) The third step in trading options is to observe the VIX
    d) All of the above
    e) only a and b

    a) 1 point. Always our first step.
    b) 1 point. Always our second step
    c) 1 point. Always our third step
    d) 4 points.
    e) -4 points.

12. Buying premium is the same as buying the market.
    False, Buying premium only refers to buying *"the air in the balloon."*

13. Which is true about premium writers?
    a) They are always the weak hands.
    b) They are always the strong hands.
    c) They have unlimited risk.
    d) They always receive a credit.
    e) all of the above.
    f) Only a, c, and d.
    g) Only c and d.

h) None of the above.

a) 0 points. Premium writers could be either, depends on the option cycle phase.
b) 0 points. Premium writers could be either, depends on the option cycle phase.
c) 1 point. Sellers of premium always have unlimited risk.
d) 1 point. Sellers always receive the credit.
e) -4 points. You need to restudy the entire program if you gave this answer.
f) 0 points. Not as bad as e, but still very far off the target.
g) 3 points. This should be easy by now.
h) -4 points. You need to restudy the entire program if you gave this answer.

14. Which of these characteristics describes a tradable market?

a) A **VIX** above its 200 day moving average.
b) A **VIX** below its 200 day moving average.
c) A tight bid offer spread.
d) Low commission rates.
e) only a and b.
f) only c and d.
g) all of the above.

a) 1 point. Any **VIX** number is tradable.
b) 1 point. Any **VIX** number is tradable.
c) 1 point. Always important.
d) 1 point. Always important.
e) -4 points. Think about this answer.
f) 2 points. Partially correct.
g) 4 points. Nice job.

15. Writing premium is also known as shorting the market.

False, they have **nothing** in common, selling

premium only deals with, *"selling the air in the Balloon."*

Questions 16 thru 20 refer to the following conditions, each answer is worth 2 points

Given the following market condition: Double Bottom, VIX above its 200 day moving average; we should execute which of the following trades:

16. Buy an ATM put.
    False, we are looking at an **upside** move.

17. Sell the ATM straddle.
    False, the **VIX** is over its 200 Day moving average and we only buy premium - **buy "air" in this market scenario**

18. Buy the ATM call.
    True, this is one of our preferred trades in this situation.

19. Sell a calendar call spread.
    False, we would want **to buy the calendar call spread** in this market condition.

20. Buy the ATM vertical call spread.
    True, this is one of our preferred trades in this situation.

Questions 21 thru 25 refer to the following conditions, each answer is worth 2 points

Given the following market condition: Double Top, VIX above its 200 day moving average; we should execute which of the following trades:

21. Buy an ATM put.

True, we are looking for a downside break on higher volatility.

22. Sell the ATM straddle.
False, we do not want to sell air in this scenario.

23. Buy the ATM straddle.
True, we want to be long premium in this scenario.

24. Sell a calendar ATM call spread.
False, we want to **buy** the calendar ATM call spread here.

25. Buy the ATM vertical put spread.
True, that is one of our preferred trades in this market.

26. Buying a vertical put spread on a downside breakout with a high **VIX** is a suitable trade.
True, again one of our preferred trades in this market.

27. Call writers always have unlimited risk.
True, all premium sellers have unlimited risk.

28. Calendar call spreads can be bought when the **VIX** is above its 200 day moving average and the market is on a double bottom.
True, this is one of our preferred trades in this market condition.

29. Calendar call spreads can be bought when the **VIX** is below its 200 day moving average and the market is on a double bottom.
True, this is one of our preferred trades in this market condition.

30. Selling premium naked always has unlimited risk.
True, all premium sold naked has unlimited risk.

Questions 31 thru 35 refer to the following conditions, each answer is worth 2 points.

Given the following market condition: Upside breakout, VIX below its 200 day moving average; we should execute which of the following trades:

31. Buy a vertical call spread using the ATM.
    False, we do not want to buy and verticals in this market condition.

32. Buy the ATM straddle.
    False, we do not want to buy straddles in the market condition.

33. Sell the ATM vertical put spread.
    True, this is one of our preferred trades in this market condition.

34. Buy a "double call" to the upside.
    False, we do not want to buy calls in this market condition.

35. Sell an upside straddle.
    True, this is one of preferred trades in this scenario.

36. We can buy a calendar ATM call spread in any market phase even a blow off.
    False, this is one of our preferred trades in any scenario, **except** a blow off.

37. Calendar ATM Call spreads should be bought on a double bottom with the **VIX** below its 200 day moving average.
    True, we can ***buy*** serial spreads in any market condition ***except*** a blow off.

38. Calendar ATM Call spreads should be bought on a

double bottom with the **VIX** above its 200 period moving average.

True, we can ***buy*** serial spreads in any market condition ***except*** a blow off.

39. **BUBBA'S GUIDE TO TRADING OPTIONS** never buys serial put spreads.

False, we can ***buy*** serial spreads in any market condition ***except*** a blow off.

40. **BUBBA'S GUIDE TO TRADING OPTIONS** never sells vertical put spreads.

False, this is a preferred trade in several market conditions.

41. Selling an ATM straddle has less risk that selling a strangle.

False, they both have unlimited risk.

42. When we sell premium short we are shorting the market.

False, we are selling the *"air,"* not the market.

43. Buying a vertical call spread has no risk as to volatility.

False, it has substantial risk from volatility and time decay.

44. Buying an ATM straddle has no risk as to price.

True, it has no price risk, but has substantial risk from volatility and time decay.

45. Selling a calendar call spread has unlimited risk.

True, the front leg may **expire** worthless and the second serial would then ***be short naked premium giving us unlimited risk.***

Questions 46 to 50 relate to the following market conditions, and are worth 2 points each.

Given the following market condition: Double bottom, VIX below its 200 day moving average; we should execute which of the following trades:

46. Buy a calendar ATM call spread.
    True, but we would prefer buying the first out of the money strike to the upside, but any spread would be acceptable.

47. Buy a vertical ATM call spread.
    False, we do not want to buy call spreads in this market condition.

48. Sell a vertical ATM put spread
    True, this is one of preferred strategies in this market condition.

49. Sell a straddle at the first OTM strike to the upside.
    True, this is one of our preferred strategies in this market condition

50. Sell a calendar ATM put spread.
    True, this is one of our preferred strategies in this market condition

Questions 51 to 55 relate to the following market conditions, and are worth 2 points each.

The VIX has reached a level of 91 which is the highest level in 41 years. We have observed our longest time frame and recognized the blow off and we are now watching our trading time frame. Which of the following trades is appropriate?

51. When the market breaks out to the upside, buy a vertical call spread.

No, this is not appropriate in this scenario, ***never*** buy premium in a blow off.

52. When the market reaches a double top, sell the ATM call.

Yes, ***but*** this is only appropriate for those that can **handle unlimited risk.**

53. When the market breaks out to the downside, sell the ATM vertical call spread.

Yes, this is appropriate in this scenario for those that want profit potential, but not unlimited risk.

54. When the market breaks out to the downside, buy the ATM put spread.

No, not appropriate in this scenario, ***never*** buy air in a blow off.

55. When the market breaks out to the downside, sell the ATM put.

Yes, ***but*** this is only appropriate for those that can **handle unlimited risk.**

CHAPTER 9: OPTION TRADE MANAGEMENT

In the last chapter we combined our study of price discovery and technical analysis with the option life cycle and presented specific strategies for successful trading given different market conditions: *"the meat and potatoes!"* Following the food metaphor, we still need to, *"trim out our meal."* Once we have an open position (an opening trade in place), we need to know how to manage risk associated with that trade and reap the potential reward. In this chapter we are going to learn how to manage our trades.

We are going to begin with the hardest step in the process. This step will test our cardinal rule of discipline. We are going to look at the risk in an individual trade, and how to manage losers.

We are going to break all trades down into four categories.

A) Trades in which we are long premium (the air) and long time decay.
B) Trades in which we are short premium (the air) and short the time decay.
C) Trades in which we are long premium (the air) but short time decay.
D) Trades in the blow off phase of the market.

We will then analyze the correct action to take in any market condition.

CATEGORY A: LONG PREMIUM WITH NEGATIVE TIME DECAY.

(Trades in which we are long premium "the air," and long time decay)

You already know that when we **buy an option that our reward is unlimited**. However owning **option premium** can be tricky. As an example let's suppose that we are trading in a scenario where the **VIX** is above its 200 day moving average and we are long premium. From chapter 8, if we are bullish we know we can:

1) Buy the ATM call,
2) Buy the vertical call spread – Bull Call Spread, or
3) Buy the ATM straddle.

If we are bearish, we can:

1) Buy the ATM put,
2) Buy the vertical put spread – Bear Put Spread or,
3) Buy the ATM straddle.

Each situation is handled the same in terms of risk management! In each situation you are long premium.

Two things can go wrong:

1) The market breaks out to the downside/upside, **WHICH WILL BE THE *OPPOSITE* SIDE OF OUR WINNING TRADE.**

2) The market rallies/breaks as expected **BUT IT IS ACCOMPANIED BY VERY LOW VOLATILITY.**

If you bought the ATM call/put outright, or the ATM vertical call/put spread and the market breaks out to the downside/upside, as a general rule, your best strategy should be to the **take your loss** once the premium in (the cost of) the call/put or vertical spread is ***reduced by 30%. This is not the same thing as allowing the stock to move***

by 30%. The ATM option or vertical should never represent more than 10% of the underlying stock, so that when we allow a premium decline of 30%, it is that same as ***taking less than a 3% stop loss on the underlying stock.***

Owning the ATM straddle is a different situation. If the market breaks down/rallies, we do not have to sell out our position.

Even if we are dead wrong, the trade can still be profitable, that is the power of owning straddles!!!

However if the price of the straddle is reduced by 30%, we should take our loss and look for another trade. ***The reason we use 30% on a straddle, is because we are buying double the air, and a loss of 30% in the straddle represents our 5% stop loss in the market.***

If we are stopped out of a position we begin the trading process again. Go back to our longest time frame look to our trading time frame, analyze the **VIX**, and bingo a new trade is born.

You will be stopped out of positions. It will occur more frequently than you expected up to this point in your trading! Understand, this is part of the trading cycle.

You are going to sell many positions out at the exact bottom of the premium cycle, and **YOU WILL BE SURE THAT YOU SHOULD HAVE WAITED A LITTLE LONGER TO TAKE YOUR LOSS.** You will become frustrated when you hit a couple of losers that later turn into big winners. Emotion will lead you to question your decision making. None of this can be helped, if you want to become successful, you are going

to have to control your emotions and maintain your discipline at all times. Remember the market is never wrong, taking losers just makes for better winners.

CATEGORY B: SHORT PREMIUM WITH POSITIVE TIME DECAY.
(Trades in which we are short premium "the air," and short the time decay)

Here we know that when we **sell an option that our reward is limited and risk can be unlimited.** As an example, let's suppose that we are trading in a scenario where the **VIX** is below its 200 day moving average and we are short premium.

If we are bullish, the most aggressive trade is to sell a naked put. If you are bearish, you could sell a naked call. ***When you write a naked option, you have a reward limited to your credit, but your risk is UNLIMITED!***

From Chapter 8, we know if we are bullish, we can:

1) Sell the vertical put spread – Bull Put Spread,
2) Sell the first OTM strike (to the upside) straddle.

If we are bearish, we can:

1) Sell the vertical call spread – Bear Call Spread or,
2) Sell the first OTM strike (to the downside) straddle.

Three things can go wrong:

1) The market breaks out to the downside/upside, **WHICH WILL BE THE OPPOSITE SIDE OF OUR WINNING TRADE.**

2) The market rallies/breaks as expected **BUT IT IS ACCOMPANIED BY VERY HIGH VOLATILITY.**

3) The market gets in tight congestion, **BUT VOLATILITY EXPLODES.**

Each situation is handled the same in terms of risk management!
In each situation you are short premium.

When you sell a spread you have a reward limited to your credit.
Your risk is limited to the spread between the strikes minus your credit.

Case One: If the ***market price*** goes immediately to the ***opposite*** side of our trade we will use ***the same rules as if were long*** **premium**. In this case however it is the opposite of selling our loser's if they lost 30% of their premium. When we are short premium, we will **buy** the credit back if it ***gains 30%. This is not the same thing as allowing the stock to move by 30%.*** The ATM option or vertical should never represent more than 10% of the underlying stock, so that when we allow the premium to grow 30%, it is the same as ***taking less than an approximate 3% stop loss on the underlying stock. When we are short premium a straddle is still considered double premium and we take our loss at an increase of 30% of the value of the straddle.***

Case Two: The market acts as we expect, and price moves in our favor, but on much higher volatility. This will not be the norm as we have set up the trade based on market conditions, but it can happen, albeit rare. This type of scenario will account for less than 5% of our price action, but it will be dealt with the same as in case one. When we are short premium, we will buy the credit back if it ***gains 30%. This is not the same thing as allowing the underlying***

asset to move by 30%. The ATM option or vertical should never represent more than 10% of the underlying stock, so that when we allow the premium to expand by 30%, it is the same as ***taking less than an approximate 3% stop loss on the underlying stock. When we are short premium a straddle is still considered double premium and we take our loss at an increase of 30% of the value.***

Case Three: The market gets in tight congestion, **but volatility explodes.** This too is rare (about 5% of the time) difficult to deal with. The reason that this will be so difficult is that there will seem to be no danger. The market price has not changed, but the options keep getting more and more air.

This is a dangerous situation, the most likely result will be a huge breakout.

Regardless of what the underlying price does, *we will buy the credit back if it gains 30%. This is not the same thing as allowing the stock to move by 30%.* The ATM option or vertical should never represent more than 10% of the underlying stock, so that when we allow the air to expand by 30%, it is the same as ***taking an approximate 3% stop loss on the underlying stock. When we are short premium a straddle is still considered double premium and we take our loss at an increase of 30% of the value.***

Essentially, all possible problems that can occur being short premium will be handled in the same manner. ***We will accept a 30% negative movement in the price of our options, and will then buy our credit back and take the loss.*** The ATM option or vertical should never represent more than 10% of the underlying stock, so that when we allow the air to expand by 30%, it is the same as ***taking an approximate 30% stop loss on the underlying stock. When we are short premium on a straddle, it is still considered double premium and we take our loss at an***

increase of 30% of the value.

CATEGORY C: LONG PREMIUM WITH POSITIVE TIME DECAY.
(Trades in which we are long premium "the air" but short time decay)

The third type of trade that we use is buying **calendar spreads.** This trade has a couple of unique advantages; as you might have surmised, it also has unique risk.

Being long calendar spreads creates a debit spread, but at the same time positive time decay. Hmm, seems like the ideal position, if we stay here you make money from positive time decay, and since it is a debit spread, if we move we know a debit spread makes money, what could be the problem?

The problem with trading calendar spreads is that a couple of events can hurt you:

1) The market breaks out suddenly.

2) The market gets in congestion and **Volatility implodes.**

In a sudden breakout (event #1), the first leg of the calendar will move to parity very quickly. Once the option moves to parity, we know from previous chapters, **that there is no time decay left, the option will fall to the stock price and it will move one for one. If the second leg does not realize enough premium increase, it will become a loser.**

As was the case in earlier scenarios, we will accept a 30% negative movement in the price of our spread, and will then sell our debit back and take the loss.

Volatility implosion (event #2) occurs when the **market expectation** of traders is that will never move again. Clearly,

this is an overstatement, but you get the picture…… the word, *"complacency,"* comes to mind. In this case although we still profit from our time decay, the air may come out of (the premium decreases in) the long leg at a faster rate.

Different event, same solution: we will accept a 30% negative movement in the price of our spread, and will then sell our debit back and take the loss.

CATEGORY D: TRADING THE BLOW OFF PHASE. (Trades in the blow off phase of the market)

This is one more situation to cover: the blow off.

Again we have two ways to get beat:

1) The market breaks out to **THE OPPOSITE SIDE OF OUR POTENTIAL WINNING TRADE.**

2) The market gets in tight congestion, **BUT VOLATILITY GOES EVEN HIGHER.**

In the first scenario, we were just dead wrong on the price direction, after a brief pause the market keeps going in the blow off direction, and our position is a loser. It happens!

SAME APPROACH: we will accept a 30% negative movement in the price of our spread, and will then sell our debit back and take the loss.

NEVER FIGHT A MARKET LIKE THIS. IF YOU REACH YOUR STOP LOSS GET OUT!!!

The second scenario seems to be less dangerous, and it actually is. Very rarely do you see volatility increase when a blow off moves into congestion. The most likely scenario is

the congestion will cause volatility to collapse, but in case it does not cooperate, same rule:

We will accept a 30% loss in the price of our options, and close the position.

We have reviewed the circumstances that could cause us to be stopped out of our trades. A couple of points should be very clear by now.

First: *When trading options, we are not concerned with the price movement of the underlying stock. We are only concerned with the price movement of our options.*

Second: *We never allow our losses to go to unacceptable levels. A 30% move in the option price should never allow us to lose more than 3% of our portfolio.*

That's it; Straightforward strategies to open and manage potential losses in options trading. That is what **BUBBA'S GUIDE TO TRADING OPTIONS** is designed to do. No complicated math formulas, no impossible calculations, no Greeks to worry about.

Manage our risk; the reward will take of itself.

MANAGING WINNERS

Managing our winners will also be broken down into two categories. As we've demonstrated, being long or short premium presents different risk levels and solutions in managing that risk. Likewise, the rewards are different (long vs. short premium) and should be approached accordingly. Buying premium (long "the air") by definition has unlimited profit potential. Conversely, selling premium (short "the air") has a stated, pre-determined reward potential.

CATEGORY I: LONG POSITIONS

A) Outright Options

Anytime we own options outright, we know we have limited risk and unlimited reward, but when is an option considered a winner?

As a general rule, when an option we own increases in value by 30%, it is considered a winner.

Once the option becomes a winner we will keep in place a moving average stop loss of 10%. Let's look at a simple math problem to make sure we understand a 10% profit vs. a 10% stop loss.

We buy an **ABC** call and pay $5 for the option. A quick review: The $5 premium is $5 x 100 shares of **ABC** stock, so we have a debit (cost) of $500. This should be clear to you by now if you studied the chapter on pricing.

If the call price goes in our favor by $150 (to a price of $6.50) we now have a 30% profit in our trade and it is classified as a winner. Once a trade is a winner we will never accept a loss!! We immediately place a stop at breakeven: $5.00.

If the trade goes to a price of $6.50 we would move our stop up to $5.85 which is **90% of current price, and a 10% stop loss** ($6.50 x 10% = $.75). Each time the price moves in our favor we will move the stop up by a corresponding amount of 10%. If the price went to $8.50, our stop loss order would be $7.65.

We manage the position in the same manner until we are finally stopped out and we start all over again with a new trade.

Should the option increase rapidly, even doubling in

value, one can sell half the position managing the remainder until stop out.

B) Long Spreads

In this case, let's look at another example for illustration. We own an ABC $10-$15 vertical call spread. Our cost is $1.00 ($400.00 total debit). Spreads offer a limited profit potential. In this case: $400.00. In this trade, our total profit potential is $400 and our potential loss is $100. Because our gain is limited, we need more profit before the trade can be considered a winner. The trade will not be **considered a winner until it has a gain of 30%.**

Once a trade is a winner
we will never accept a loss!!
We immediately place a stop at break even.

If the trade goes to a price of $2.00 we would move our stop up to $1.80 which is **90% of current price, and a 10% stop loss.** Each time the price moves in our favor we will move the stop up by a corresponding amount of 10%.

We manage the position in the same manner until we are finally stopped out and we start all over again with a new trade.

Should the option increase rapidly, even doubling in value, one can sell half the position managing the remainder until stop out.

CATEGORY II: SHORT POSITIONS

A) Outright Options

Selling (writing naked options) options has **unlimited risk;** the reward is limited to the credit that we take in. In this example we are going to sell the ABC call for $5. A short option is considered a winner when the price decays by

25%. Before writing naked options, understand the risk and enter a concurrent stop loss order with the initial option sale. Due to their high degree of risk, **BUBBA'S GUIDE TO TRADING OPTIONS does not recommend writing naked options for the typical trader;** we cover them in this section to round out your knowledge base. For those that do, however, the same general rules apply.

Once a trade is a winner
we will never accept a loss!!
We immediately place a stop at break even.

If the trade goes to a price of $3.00 we would move our stop ***down*** to $3.30 which is ***110%*** **of the current price, and a 10% stop loss. Remember when we are short options and we are stopping out, the price will be inverted as we will elect our stop *above* the current price; buying the options back at a reduced price from the purchase.** Each time the price moves in our favor we will move the stop ***down*** by a corresponding amount of 10%.

B) Short Spreads

In this example we are going to sell an ABC 10-15 vertical call spread and receive a $4 credit. This example is much different than selling an option outright, but managed like the long vertical position. In this trade, our total profit potential is $400 and our potential loss is $100. Because both our gain and our loss is limited, we need more profit before the trade can be considered a winner. The trade will not be **considered a winner until it has a gain of 30%.**

Once a trade is a winner
we will never accept a loss!!
We immediately place a stop at break even.

If the trade decays to a price of $3.00 we would move our stop ***down*** to $3.30 which is ***110%*** **of current price, and a**

10% trailing stop. Each time the price moves in our favor we will move the stop ***down*** by a corresponding amount of 10%. **Remember when we are short options and we are stopping out, the price will be inverted as we will elect our stop *above* the current price.** Each time the price moves in our favor we will move the stop ***down*** by a corresponding amount of 10%.

We manage the position in the same manner until we are finally stopped out and we start all over again with a new trade.

Should the option increase rapidly, even doubling in value, one can sell half the position managing the remainder until stop out.

Managing gains is the best part of trading. **BUBBA'S GUIDE TO TRADING OPTIONS** hopes you have that task on your To-do List ***daily***! Traders should not err on either side of managing profitable trades. Don't watch a gain while not protecting it with either moving your stops or placing a trailing stop. **BUBBA'S GUIDE TO TRADING OPTIONS** prefers trailing stops be utilized only after a gain is locked in above approximately 40%.

Do not err on the side of hope as well. Stop losses should be at least in your strategy and identified before a trade is entered. We advise the stop loss be entered concurrent with the position open.

Fellow traders, we have covered everything you need to know to initiate options trades from both the long and short side of a trade. You know there will be losses; more important, how to manage and successfully minimize those losses. We know how *and when* to take a profit. This system is designed to manage the options *section* of your investment portfolio.

You have all of the information needed to make money in the options markets.

CHAPTER 9: OPTION TRADE MANAGEMENT QUIZ

Before the final chapter of **BUBBA'S GUIDE TO TRADING OPTIONS**, you'll need to pass a quiz. All of the questions are from this chapter and are true or false. You need to get 22 (of 25) right to move onto Chapter 10.

1. Buying an option gives us unlimited reward.

2. When we buy a vertical call spread, we have both limited risk and limited reward.

3. When we sell a vertical ATM put spread, we are short the market.

4. When we buy a vertical ATM put spread, we a short the market.

5. Once a short naked option has a profit in it, it is considered a winner.

6. A long vertical ATM put spread is considered a winner when it is 10% in the money.

7. Once a naked option has a profit in it, the stop is moved up to 10%.

8. Once a trade becomes a winner, the first stop would be at break even.

9. Owing an ATM call gives us the right for unlimited profit.

10. If we are short a vertical ATM put spread, we should take profit if it decays 30%.

11. If we're short a vertical ATM Call spread, place a stop 30% below our initial price.

12. Calendar spreads are a separate category of risk.

13. Calendar spreads should not be stopped out at a 30% loss.

14. Blow off spreads losers are not subject to the 30% rule.

15. Taking a 33% profit in a blow off market is a considered a winning trade.

16. You should never stop out short options, if the underlying price is in your favor.

17. Short options need 30% decay before they are considered to be a winner.

18. Short option verticals need to realize a 30% decrease to be winners.

19. Winner rules do not apply to calendar spreads.

20. As a rule, all option trades should be stopped out if the underlying asset price goes 30% against our position.
21. As a rule, all option trades should be stopped out if they go 30% against us, regardless if we are long or short premium.

22. Owning options is always safer than selling options.

23. Selling option in a blow off market has unlimited risk.

24. As a rule, short naked options are considered winners when they have a 10% profit.

25. As a rule, short vertical spreads are considered winners when they have a 30% decay.

CHAPTER 9: OPTION TRADE MANAGEMENT QUIZ

1. Buying an option gives us unlimited reward.
   True, buying options gives us a chance of unlimited reward.

2. When we buy a vertical call spread we have both limited risk and limited reward.
   True, all vertical spreads have limited risk and limited reward.

3. When we sell a vertical ATM put spread we are short the market.
   False, we are long the market, but **short premium (the "air")**.

4. When we buy a vertical ATM put spread we a short the market.
   True, we are short the market and **long premium (the "air")**.

5. Once a short naked option has a profit in it, it is considered a winner.
   False, naked option must have a 30% profit before it is considered a winner.

6. A long vertical ATM put spread is considered a winner when it is 10% in the money.
   False, all vertical spreads must be in the money by 30% before they are considered winners. This is true for both ***long*** and ***short*** premium spreads.

7. Once a naked option has a profit in it the stop is moved up to 10%.
   False, once the naked option becomes a ***winner*** the stop is 10%.

8. Once a trade becomes a winner the first stop would be at break even.

True, this is true for any option trade. ***Long Verticals, Short Verticals, Naked longs, Naked shorts, and calendar spreads.***

9. Owning an ATM call gives us the right for unlimited profit.
   True, if you missed this one start over.

10. If we are short a vertical ATM put spread, we should take profit if it decays 30%.
   False, the spread is considered a ***winner;*** the initial breakeven stop is placed.

11. If we're short a vertical ATM Call spread, place a stop 25% below our initial price.
   False, on all option trades we will accept a **30%** loss in (the) premium.

12. Calendar spreads are a separate category of risk.
   True and False; both are correct. Because of its unique long premium, short time decay it is also unique. However it is still managed as any other trade. ***A 30% loss of value is the stop out, and it becomes a winner when it has a 30% increase in value.***

13. Calendar spreads should not be stopped out at a 50% loss of premium.
   False, all options are stopped out at a **30% loss of premium.**

14. Blow off spreads are not subject to the 30% winner rule.
   False, **all** vertical spreads, whether long or short, ***are subject to the 30% rule***.

15. Taking a 33% profit in a blow off market is a considered a winning trade.
   True, it is considered a winner at 30%, therefore a stop at 33% is a winning trade.

16. You should never stop out short options, if the underlying price is in your favor.

False, we do not consider the underlying price when we deal with options. ***Only the premium levels of the trade.***

17. Short options need 30% decay before they are considered to be a winner.

True, all verticals, and short options need a 30% increase in value before they are considered winners.

18. Short option verticals need to realize a 30% decrease to be winners.

True, all verticals need to be in the money by 30% before they are considered to be a winner.

19. Winner rules do not apply to calendar spreads.

False, **winner rules apply to all trades in options**.

20. As a rule, all option trades should be stopped out if the underlying asset price goes 25% against our position.

False, we do not consider the underlying asset price when we use stops.

21. As a rule, all option trades should be stopped out if they go 30% against us, regardless if we are long or short premium.

True, ***we stop out all trades if we have a 30% loss of premium.***

22. Owning options is always safer than selling options.

False, during blow off phases of the market, it is riskier owning the options because of the extreme premium levels associated with blow offs.

23. Selling options in a blow off market has limited risk.

False, ***selling options in any market has unlimited risk.***

24. As a rule, short naked options are considered winners when they have a 10% profit.

False, naked options have a limited reward, and as such they need to have price decay of 30% before they can be considered a winner.

25. As a rule, short vertical spreads are considered winners when they have a 30% decay.

True, ***any vertical spread is considered a winner when it has a 30% decay in value.***

CHAPTER 10: PUTTING IT ALL TOGETHER

At this point, you should have the confidence to put on suitable option trades.

More important, you have a solid, proven set of rules to help you manage your trades, both the winners, and the losers.

If you have taken the time to study all of the material, (and we understand ***there is a lot of information*** in **BUBBA'S GUIDE TO TRADING OPTIONS**, you now have the expertise to make consistent profits trading options. The final chapter of this program will be broken into three parts.

The first part will be a review of the entire program taking some time to reflect on what you have learned. This will further enable you to envision the markets - the trading environment as a professional trader sees it – and focus on the dynamics.

The second part will be a review of portfolio management; the final part will be 250 question exam. So let's start by reviewing what we have learned.

PROGRAM REVIEW

The first thing we talked about were "Big Markets". Any one of 100 markets could have been cited from the past 500 years. These "Big Markets" are the ones that stick in the public' s mind. We drilled down on the financial meltdown of 2008. We discussed how big markets have a tendency to start their life cycle in a non threatening way, grow in intensity, and finally end in a panic. **All panics are caused**

by greed and the greed leaves a footprint.

The principal of universal time and price was introduced. Different time frames were shown to have very similar patterns. We removed the time and price axis for a number of charts to prove that chart patterns are impossible to differentiate when observed from different points in time and price.

After we talked a little bit about greed, we learned how the market can react to very bad news by rallying and very good news by breaking**. Market Expectation** can be a crusher, but we also learned it leaves a footprint putting us on the right trail if we know what to look for. We discussed how that footprint is made by **"The Street", and how we can react to that footprint.**

The concept of **liquidity** was introduced. If you try to trade in an illiquid market the chances of success are greatly diminished. We learned auction markets are indeed, *very* efficient: who the players are, and how the market will leave a footprint as it moves between the strong and weak hands. We contrasted Technical and Fundamental analyses and why **BUBBA'S GUIDE TO TRADING OPTIONS** use technical analysis for decision making.

After the appetizer, we dove into the meat and potatoes: how to define a market's stance and trend, shrinking our long term time frames into our trading frame and identifying set ups. From that study we now better understand observing different time frames allows us to view the exact same market may shed a much different light in direction. We also learned that shorter time frames will always resolve themselves into the longer trend.

We now know the three phases of the market:
Congestion, Breakout to the Trend,
and the Blow Off.

Next we dissected the **Option Life Cycle** and reviewed a glossary of terms that are necessary in order to trade options. We then studied premium movement; what happens when ***"the air goes into the balloon and when air comes out of the balloon,"*** and how the option model mirrors the underlying stock.

In Chapters 8 and 9 we married the option model with **BUBBA'S GUIDE TO TRADING OPTIONS** learning how to open positions and manage those positions successfully: When and where to use the appropriate option strategy relative to phases of the market, how to manage our losers and when to take our winners.

PORTFOLIO MANAGEMENT

Previously we noted that it was necessary to find ***tradable*** stocks. Tradable stocks were defined as stocks with sufficient liquidity: tighter spreads, decent float and higher relative volume**.** In our final chapter we are going to take tradable stocks and show you how to organize them to create a portfolio.

The first step is to select at least 10 and as many as 50 tradable stocks. The reason that we want you to have as many stocks in your portfolio as you can handle, is generally different stocks will be in different phases of their trading cycle. The more phases of the trading cycle the more possible trades and the more chance for profit.

Once we have selected our stocks we want to make sure that they are ***diversified, and not duplicated.*** By this we mean that there should be different industries and sectors represented in your portfolio. The goal is to have a grouping on our watch list(s) that trend countercyclical presenting opportunities in almost any cycle of the macro economy.

For example, a portfolio is not diversified if all 10 stocks are

in banking, or construction or airlines. If you have 10 different stocks from the same sector, they are said to be ***correlated***. If one goes higher they all may go higher and vice versa. If your initial portfolio ***has more than two stocks from the same group, reevaluate and diversify.***
If you can follow 30 **diversified** stocks it will give you many more trading opportunities, the more chances to trade the greater the potential profit.

Finally, to insure successful trading, we must understand the potential risk to our capital that any adverse market condition can produce. ***Those adverse conditions, those "losing streaks" are called draw downs.***

In theory as long as our win rate is positive, the model will return a profit in the long run. However, ***the long run can mask short term problems.*** The following theoretical model will deal with the problem.

Our calculations will take three factors into consideration.

1) Capital
2) Win Rate
3) Volatility

Capital will be defined as our **current** money available to trade.

Win rate will be defined as the average profit on a percentage basis expected from each trade. For our model the **win rate** is assumed to be ½% (.005). In other words if we make 10 trades we will be ahead 5% (10x.005=.05).

Volatility is the **percentage** of price movement annualized over the next 30 days. The following table shows the chances of going broke before running your capital to an infinite amount. Don't worry about doing the math. The table is here to show you that if you follow the principals that you have been taught, you will succeed. It also shows you

something that you need to know:

No matter how efficient a trading model is, you will have losing streaks.

Below, **Table WR 1** shows that if volatility is 10% and we have capital of 20x our win rate (.005%), there is a 98.3% chance that we will never lose our entire capital. It also shows that as volatility increases, the chance of ruin increases at a ***geometrical rate.*** This is logical. As the market becomes more explosive, you may require additional capital to insure that your win rate is sustainable. Of course your .005% win rate will also generate higher profits to offset some of the extra exposure, but it will not be enough to offset all of the additional risk.

Table WR 1

Capital	Win rate	VIX	Risk of ruin
20xWin	.005%	10%	1.7%
40xWin	.005%	10%	.5%
80xWin	.005%	10%	.1%

Capital	Win rate	VIX	Risk of ruin
20xWin	.005%	20%	6.2%
40xWin	.005%	20%	1.8%
80xWin	.005%	20%	.3%

In order to insure against risk of ruin, you should start with capital that is 40 times greater than your maximum loss per trade. This is why we take a stop loss if we lose 30% of our premium, that corresponds to a maximum risk of 3%.

Most of your losing streaks **(draw downs)** will be pretty minor. Occasionally you are going to hit periods where

nothing works. This is when you will need the discipline to stay the course. ***The market will not announce when it is going to start a winning streak, if it did, everyone would show up.*** As long as you stick to your principals that have been established in this program, you will be able to get above average returns on your investment.

CHAPTER 10: FINAL EXAM

We have almost reached the end of our training; only one thing remains, the final exam. It consists of 250 questions and will cover all of the topics that we have presented. The main focus will be on trading, but all of the topics will be discussed. Before you make any trades you should have a score of 235 or better.

1) Price discovery is a fundamental way to analyze markets.
True or False

2) P/E ratios over of 5 are always undervalued.
True or False

3) Balance sheets are the snapshot of a company's net worth.
True or False

4) Housing starts are a fundamental look at the housing market.
True or False

5) The unemployment rate reflects a fundamental number.
True or False.

6) Rising unemployment is a bearish fundamental number.
True or False

7) Rising retail sales is are a bullish fundamental number.
True or False

8) If the **S&P 500** is 3% higher this month than last month the market is bullish.
True or False

9) Technicians discount **all** fundamental data.

True or False

10) The **NYSE** is an auction market.
True or False

11) Price rises when there are more buyers than sellers in a market.
True or False

13) An imbalance of offers will force the price lower.
True or False

14) The flow of funds will leave a technical footprint.
True or False

15) Good fundamental data will eventually cause stock prices to rise.
True or False

16) If a company's balance sheet is highly leveraged and interest rates rise, the company's stock price should decline.
True or False

17) Technical analysis is subject to interpretation.
True or False

18) The market is always right.
True or False

19) A Retracement always indicates the market is breaking.
True or False

20) A Double Top is a significant price point.
True or False

21) Double Bottoms are always have more significance than Double Tops.
True or False

22) A Double Top would indicate resistance.
True or False

23) A Double top can only occur after a Retracement.
True or False

24) A Double Top can only occur after a Double Bottom.
True or False

25) A Double Bottom can occur without a Double Top.
True or False

26) Double Bottoms usually occur within 8 time frames of a Double Top.
True or False

27) A series of Double Tops and Double Bottoms signals Congestion.
True or False

28) Congestion is defined by support and resistance levels.
True or False

29) Congestion is limited to time frames of no more than 100 bars.
True or False

30) Congestion is the most common phase of the market.
True or False

31) Congestion will always end with a Breakout to the upside.
True or False

32) Congestion is categorized as an extreme period of market uncertainty.
True or False

33) Congestion is the birth of a new market.

True or False

34) Breakouts generally occur after the release of important fundamental numbers.
True or False

35) Breakouts are usually a gradual process.
True or False

36) Breakouts usually occur during periods of high volatility.
True or False

37) Breakouts can go straight to a Blow Off.
True or False

38) Upside Breakouts are always in strong hands.
True or False

39) Downside Breakouts are always in weak hands.
True or False

40) Once a market is in strong hands, it will Breakout.
True or False

41) Strong hands and weak hands never change position.
True or False

42) Weak hands generally do better in a breaking market.
True or False

43) When a market is rallying, there are more buyers than sellers.
True or False

44) When the market is breaking, there are more sellers than buyers.
True or False

45) Auction markets never have price gaps.

True or False

46) Countertrend traders always sell the market.
True or False

47) Countertrend traders are usually the strong hands.
True or False

48) In a Blow Off, the weak hands generally lose money.
True or False

49) In a Blow Off, time and price can become one.
True or False

50) A Blow Off to the downside has limited loss potential.
True or False

51) In a Blow Off the strong hands take profit.
True or False

52) A Blow Off is the final phase of a market.
True or False

53) Blow Offs can trigger a panic market.
True or False

54) The longest time frame we can observe is one year.
True or False

55) The longest time frame we observe is always termed the "Major Trend."
True or False

56) Breakout markets leave no footprint.
True or False

57) Higher highs or lower lows are usually found in a Breakout market.
True or False

58) Even if the major trend is higher, a minor trend could currently be breaking.
True or False

59) Price charts from different time frames on the same underlying can have different chart patterns.
True or False

60) If the Major Trend is bullish every minor trend will be bullish.
True or False

61) Knowing the Major Trend gives us an edge on the market.
True or False

62) Depending on our observation of price and time, a shorter time frame may appear to be in a different phase from the longest time frame we are observing.
True or False

63) The summation of price in all shorter term time frames will resolve themselves into the longest time frame.
True or False

64) Options can be used as a form of insurance.
True or False

64) Options have caused many financial collapses in history.
True or False

65) Financial options are always guaranteed by an exchange.
True or False

66) The buyer of an option has the right of exercise.
True or False

67) A put allows the seller the right to purchase an asset for

less than the current market price.
True or False

68) A call seller has the obligation to sell the underlying asset class to the buyer at a s specific price and time.
True or False

69) All options are worthless after expiration.
True or False

70) The seller of put options has unlimited risk.
True or False

71) At the money options are all intrinsic.
True or False

72) A straddle seller has unlimited risk.
True or False

73) A strangle buyer wants price to stay near the current strike.
True or False

74) Time decay insures that out of the money call options will expire worthless.
True or False

75) The **VIX** is a measure of fear in the option market.
True or False

76) A seller of puts wants the market to rally.
True or False

77) All exchange traded options are guaranteed by the respective exchanges.
True or False

78) The buyer of a vertical call spread has limited liability.
True or False

79) The seller of a vertical put spread has unlimited liability.
True or False

80) Only calls can be exercised prior to expiration.
True or False

81) The maximum loss on a credit spread is the amount of the credit.
True or False

82) A debit spread has no maximum risk.
True or False

83) Sellers of credit spreads have no rights in the option market.
True or False

84) Buyers of debit spreads have rights but no obligations in the option market.
True or False

85) The at the money option has no extrinsic value.
True or False

86) Out of the money options should always be abandoned at expiration.
True or False

87) Selling a straddle has risk limited to the debit paid.
True or False

88) At parity an option has no extrinsic value.
True or False

89) Puts can be exercised at any time.
True or False

90) Puts give the seller the right to put the option to a buyer

at any time.
True or False

91) LEAPS refer to the practice of buying serial spreads over more than one monthly expiration.
True or False

92) Time decay occurs in all option cycles.
True or False

93) Selling straddles has less risk than selling strangles.
True or False

94) Implied Volatility only goes down as expiration approaches.
True or False

95) Writing options is safer than selling puts.
True or False

96) Call writers have liability only to the amount of credit.
True or False

97) Teenies risk is limited to the debit paid.
True or False

98) Call spreads can never include teenies.
True or False

99) A short strangle is a combination of selling a put and call at different strikes.
True or False

100) A strangle can never include in the money options.
True or False

101) A straddle risk is limited to the underlying debit paid.
True or False

102) Options that reach parity have no extrinsic value.
True or False

103) Call writers reward is limited to the credit taken in at sale.
True or False

104) Options that have different expiration dates are called calendars.
True or False

105) Time decay can overcome volatility doubling in LEAPS options.
True or False

106) The seller of a vertical put spread has unlimited liability.
True or False

107) The buyer of a debit spread has no obligation in the option market.
True or False

108) In the short run, options may perform differently than the underlying asset class.
True or False

109) Options have a life cycle that is different with ever asset class.
True or False

110) If volatility collapses, the ATM calendar premium will follow.
True or False

111) An option model's life cycle can be compared to a balloon.
True or False

112) All options' premium is worthless at expiration.

True or False

113) If volatility doubles in a LEAP, the nominal price of the ATM should also nearly double.
True or False

114) Time decay in the nearby serial will always overcome a volatility explosion.
True or False

115) The option model is really a probability model.
True or False

116) Once a teenie has a 0% probability it will expire worthless.
True or False

117) Volatility is the supply and demand for an option at any strike price.
True or False

118) There is always less extrinsic value in a option one strike higher, or lower than the ATM, regardless of volatility.
True or False

119) At expiration all extrinsic options will be assigned.
True or False

120) The price of the underlying asset needs to change to have a decrease of volatility.
True or False

121) As time passes, the time decay curve increases.
True or False

122) **Google** options mirror options of any liquid asset class.
True or False

123) All exchange traded options are liquid.
True or False

124) It is possible for volatility to become one with price.
True or False

125) Options can never reach parity prior to expiration.
True or False

126) Teenies with a 0% probability should always be sold, they have no risk.
True or False

127) Market conditions should never determine the buying of options.
True or False

128) Out of the money options should never be exercised.
True or False

129) Bid-Offer spreads have no real effect on options because of time decay.
True or False

130) Commissions can affect the liquidity of an option.
True or False

131) ATM's generally will have the most premium.
True or False

132) Discipline is an important tool in trading.
True or False

133) Successful **BUBBA'S GUIDE TO TRADING OPTIONS** traders predict future price.
True or False

134) Successful **BUBBA'S GUIDE TO TRADING OPTIONS** traders never react to market changes.

True or False

135) Time and price are universal.
True or False

136) The longest time frame observed is always trending.
True or False

137) The shortest time frame observed is never more than 10 minutes.
True or False

138) The longer the longest observable time frame is, the better the information.
True or False

139) The shortest time frame is also known as the trading time frame.
True or False

140) The trading time frame will always be no longer than two days.
True or False

141) The trading time frame is always the shortest time frame we observe.
True or False

142) The longest time frame we observe should never be over one year.
True or False

143) Trading decisions will begin with the longest time frame.
True or False

144) Establishing a tradable portfolio is the first step to trading.
True or False

145) Ten assets are considered the minimum amount for a successful portfolio.
True or False

146) The more assets that can be used in a portfolio the better.
True or False

147) Diversification is an important key to successful trading.
True or False

148) Double Bottoms are always a sign of support in a market.
True or False

149) Breakouts always occur from periods of Congestion.
True or False

150) Counter trend traders are always the weak hands.
True or False

151) Observing a market from different points in time can give conflicting market views.
True or False

152) The shortest time frame we observe is always our trading time frame.
True or False

153) Strong hands dominate on a upside Breakout.
True or False

154) Weak hands dominate on a downside Breakout.
True or False

155) **BUBBA'S GUIDE TO TRADING OPTIONS** does not consider the Greeks when trading.
True or False

156) The option model can be offered as a balloon.
True or False

157) The **VIX** can be used to measure fear in the market.
True or False

158) The **VIX** does not always have a positive correlation with **Google**.
True or False

159) Nominal price is more important than market sentiment when measuring the **VIX**.
True or False

160) Market expectation could account for the decline of the **VIX** in the Spring of 2009.
True or False

161) If the **VIX** is above its moving average, *"air should be going into the balloon."*
True or False

162) The **VIX** is not an Index product.
True or False

163) The **VIX** can go below zero during a Blow Off.
True or False

164) Buying premium is the same as buying the market.
True or False

165) Writing premium is also known as shorting the market.
True or False

Given the following market conditions: Double Bottom, VIX above its 200 day moving average; we should execute which of the following trades?

166) Buy an ATM put.
True or False

167) Sell the ATM straddle.
True or False

168) Buy the ATM call.
True or False

169) Sell a calendar call spread.
True or False

170) Buy the ATM vertical call spread.
True or False

Questions 171-176. Given the following market conditions: Double Top, VIX above its 200 day moving average; we should execute which of the following trades?

171) Buy an ATM put.
True or False

172) Sell the ATM straddle.
True or False

173) Buy the ATM straddle.
True or False

174) Sell a calendar ATM call spread.
True or False

175) Buy the ATM vertical put spread.
True or False

176) Buying a vertical put spread on a downside Breakout with a high **VIX** is a suitable trade.

True or False

177) Call writers always have unlimited risk.
True or False

178) Calendar call spreads can be bought when the **VIX** is above its 200 day moving average and the market is on a double bottom.
True or False

179) Calendar call spreads can be bought when the **VIX** is below its 200 day moving average and the market is on a double bottom.
True or False

180) Selling premium naked always has unlimited risk.
True or False

Questions 181-186. Given the following market conditions: Upside Breakout, VIX below its 200 day moving average; we should execute which of the following trades?

181) Buy a vertical call spread using the ATM.
True or False

182) Buy the ATM straddle.
True or False

183) Sell the ATM vertical put spread.
True or False

184) Buy a "double call" to the upside.
True or False

185) Sell an upside straddle.
True or False

186) We can buy a calendar ATM call spread in any market phase, even a Blow Off.
True or False

187) Calendar ATM call spreads should be bought on a Double Bottom with the **VIX** below its 200 period moving average.
True or False

188) Calendar ATM call spreads should be bought on a Double Bottom with the **VIX** above its 200 period moving average.
True or False

189) **BUBBA'S GUIDE TO TRADING OPTIONS** never buys calendar put spreads.
True or False

190) **BUBBA'S GUIDE TO TRADING OPTIONS** never sells vertical put spreads.
True or False

191) Selling an ATM straddle has less risk that selling a strangle.
True or False

192) When we sell premium short we are shorting the market.
True or False

193) Buying a vertical call spread has no risk as to volatility.
True or False

194) Buying an ATM straddle has no risk as to price.
True or False

195) Selling a calendar call spread has unlimited risk.
True or False

Given the following market conditions: Double Bottom, VIX below its 200 day moving average; we should execute which of the following trades?

196) Buy a calendar ATM call spread.
True or False

197) Buy a vertical ATM call spread.
True or False

198) Sell a vertical ATM put spread.
True or False

199) Sell a straddle at the first out of the money strike to the upside.
True or False

200) Buy a calendar ATM put spread.
True or False

Questions 201-205. The VIX has reached a level of 91 which is the highest level in 41 years. We have observed our longest time frame and are now watching our trading time frame. BUBBA'S GUIDE TO TRADING OPTIONS should execute the following trades.

201) When the market breaks to the upside buy a vertical call spread.
True or False

202) When the market reaches a Double Top, sell the ATM call.
True or False

203) When the market breaks out to the downside, sell the

ATM vertical call spread.
True or False

204) When the market breaks out to the downside, buy the ATM put spread.
True or False

205) When the market breaks out to the downside, sell the ATM put.
True or False

206) When we buy a vertical ATM put spread, we are short the market.
True or False

207) Once a naked option has a profit in it, it is considered a winner.
True or False

208) Owning a vertical ATM put spread is considered a winner when it is 10% ITM.
True or False

209) Once a naked option has a profit in it, the stop is moved up to 15%.
True or False

210) Once a trade becomes a winner, the first stop would be at break even.
True or False

211) Owning an ATM call gives us the right to unlimited profit.
True or False

212) If we are short a vertical ATM put spread we should take profit if it decays 25%.
True or False

213) If we are short a vertical ATM call spread we should place a stop loss 25% below our initial price.
True or False

214) Calendar spreads are a separate category of risk.
True or False

215) Calendar spreads should not be stopped out at a 30% loss of premium.
True or False

216) Blow off spreads are not subject to the 25% winner rule.
True or False

217) Taking a 33% profit in a blow off market is a considered a winning trade.
True or False

218) You should never stop out short options if the underlying price market is going in your favor.
True or False

219) Short options need 25% decay before they are considered to be a winner.
True or False

220) Short option verticals need to see a 25% decrease in premium before they are considered to be a winner.
True or False

221) Winner rules do not apply to calendar spreads.
True or False

222) As a rule, all option trades are to be stopped out if the underlying market goes 25% against our position.
True or False

223) As a rule, option trades are to be stopped out if they go 30% against us, regardless of if we are long or short

premium.
True or False

224) Owning options is always safer than selling options.
True or False

225) Selling options in a Blow Off market has limited risk.
True or False

226) As a rule, naked options are considered to be a winners with a 15% profit.
True or False

227) As a rule, short vertical spreads are considered winners with a 25% decay.
True or False

228) The first step in portfolio management is to choose liquid stocks.
True or False

229) A stock portfolio with 30 tradable stocks is preferable to a 10 stock portfolio.
True or False

230) Duplication of stocks in a portfolio may increase risk.
True or False

231) More than two stocks from the same group may lead to duplication.
True or False

232) In theory, if our win rate is positive, the model can still have short term loss.
True or False

233) Diversification insures very few losing periods when trading.
True or False

234) Duplication is the opposite of correlation.
True or False

235) Long term probabilities can mask short term problems.
True or False

236) Win rate is important in considering which trades to take.
True or False

237) Capital is defined as our current money available for risk.
True or False

238) Discipline is not as important as a rising win rate.
True or False

239) Volatility is always greater in high priced stock.
True or False

240) Draw downs can always be avoided if tighter stops are used.
True or False

241) Doubling of current volatility can increase a trader's chance of loss.
True or False

242) Doubling of current volatility has no effect on profit potential.
True or False

243) To insure your trading, start with at least 10 times your maximum loss per trade.
True or False

244) Price discovery assures that the market is in balance.
True or False

245) Commissions have little effect on market liquidity.
True or False

246) Fundamental analysis is never subject interpretation.
True or False

247) Technical analysis is never subject to interpretation.
True or False

248) Taking losers is the most important form of discipline.
True or False

249) The market is always right, it is a nemesis, it is never tired, not focused, or sick.
True or False

250) Bulls and Bears make money; Pigs get slaughtered.
True or False

CHAPTER 10: FINAL EXAM ANSWERS

1) Price discovery is a fundamental way to analyze markets.

False, ***price discovery is the market mechanism which allows the transfer of wealth.***

2) P/E ratios over of 5 are always undervalued.

False, the P/E standard for the industry may be 3 in which case 5 is overvalued. Remember, all fundamental numbers are relative to industry/sector standards.

3) Balance sheets are the snapshot of a company's net worth.

True, Assets – Liabilities = **Net Worth**; **price** is determined by price discovery.

4) Housing starts are a fundamental look at the housing market.

True, housing starts are a very important fundamental indicator.

5) The unemployment rate reflects a fundamental number.

True, it is a very important fundamental measure of the health of the economy.

6) Rising unemployment is a bearish fundamental number.

False, all fundamental numbers are subject to interpretation. If the unemployment rate is up 1% but the street expected it to be up 2%, the rising unemployment is a very **Bullish** number.

7) Rising retail sales is are a bullish fundamental number.

False, all fundamental numbers are subject to interpretation.

8) If the **S&P 500** is 3% higher this month than last month the market is bullish.

True, anyone short the **S&P 500** for the past 30 days **has lost 3%** of their wealth.

9) Technicians discount **all** fundamental data.

True, technicians rely on the market's foot prints.

10) The **NYSE** is an auction market.

True, although block trades are permitted, all players are alerted and may participate in a block trade.

11) Price rises when there are more buyers than sellers in a market.

False, price only rises when buyers are willing to pay a higher price. **There must be a seller for ever buyer.**

13) An imbalance of offers will force the price lower.

False, only price discovery will force the market lower. An imbalance of orders is an indication only. Bids must come in for price discovery.

14) The flow of funds will leave a technical footprint.

True, funds can only flow if there is price discovery. This creates a print, and the market is always right.

15) Good fundamental data will eventually cause stock prices to rise.

False, all fundamental data is subject to interpretation; what may appear to be bullish now could be thought to be bearish a day, a week or anytime in the future.

16) If a company's balance sheet is highly leveraged and interest rates rise, the company's stock price should decline.

False, the company may have already hedged their interest rate risk, in which case rising interest rates are **bullish** for the company in relation to competitors who failed to hedge. A classic example would be

Southwest Airlines. SWA successfully used the futures market to hedge off their exposure to the oil markets from 2003 to 2009, and gained a significant advantage over their competition.

17) Technical analysis is subject to interpretation.
True, all market data is subject to interpretation.

18) The market is always right.
True, the market is a nemesis. It is always right. It is never tired, or not focused. It is always correct. The market process of price discovery guarantees that the market is always right.

19) A Retracement always indicates the market is breaking.
False, "Retracement" refers to the fact that price is breaking from a high or rallying from a low, direction is not relevant.

20) A Double Top is a significant price point.
True, it indicates that price is reaching a resistance level.

21) Double Bottoms are always have more significance than Double Tops.
False, they have the same significance as a Double Top.

22) A Double Top would indicate resistance.
True, this is where resistance begins.

23) A Double Top can only occur after a Retracement.
True, you must retrace from a lower price in order to make a Double Top.

24) A Double top can only occur after a Double bottom.
False, it can occur after any retracement.

25) A Double bottom can occur without a Double top.

True, it can occur after any retracement.

26) Double Bottoms usually occur within 8 time frames of a Double Top.

False, there is no time frame limit.

27) A series of Double Tops and Double Bottoms signals Congestion.

True, that is the definition of Congestion.

28) Congestion is defined by support and resistance levels.

True, that is the definition of Congestion.

29) Congestion is limited to time frames of no more than 100 bars.

False, Congestion has no time limit.

30) Congestion is the most common phase of the market.

True, Congestion occurs more than twice as much as other market phases.

31) Congestion will always end with a Breakout to the upside.

False, it will end with a Breakout in either direction.

32) Congestion is categorized as an extreme period of market uncertainty.

True, buyers and sellers constantly trade strong and weak hands.

33) Congestion is the birth of a new market.

True, all markets are born from Congestion.

34) Breakouts generally occur after the release of important fundamental numbers.

False, Breakouts have nothing to do with fundamental numbers.

35) Breakouts are usually a gradual process.
False, a Breakout can be either volatile or orderly.

36) Breakouts usually occur during periods of high volatility.
False, Breakouts can occur in any market condition.

37) Breakouts can go straight to a Blow Off.
True, occasionally, breakouts are very volatile and go straight to a Blow Off.

38) Upside Breakouts are always in strong hands.
True, all Breakouts are in strong hands.

39) Downside Breakouts are always in weak hands.
False, all Breakouts regardless of direction are in strong hands.

40) Once a market is in strong hands it will Breakout.
False, the strong hands may meet resistance and become the weak hands.

41) Strong hands and weak hands never change position.
False, they can change position many times during the market cycle.

42) Weak hands generally do better in a breaking market.
False, weak hands are always on the wrong side when a Breakout occurs.

43) When a market is rallying there are more buyers than sellers.
False ***,buyers are willing to pay more, there must be a seller for every buyer***

44) When the market is breaking there are more sellers than buyers.
False, ***sellers are willing to sell at a lower price; there must be a buyer for every seller.***

45) Auction markets never have price gaps.
False, unless price is discovered at the next tick a gap will occur.

46) Countertrend traders always sell the market.
False, countertrend traders are always the other side of the strong hands.

47) Countertrend traders are usually the strong hands.
False, they are always the weak hands.

48) In a Blow Off the weak hands generally lose money.
True, the weak hands will be forced to liquidate at any price.

49) In a Blow Off, time and price can become one.
True***, In parabolic bars, time and price become one.***

50) A Blow Off to the downside has limited loss potential.
True, zero is the lowest price that a "non-leveraged" position can go too.

51) In a Blow Off the strong hands take profit.
True, that is what helps to end the Blow off.

52) A Blow Off is the final phase of a market.
True, the market will enter Congestion after a Blow Off, and begin again.

53) Blow Offs can trigger a panic market.
False, ***Blow offs are the panic market.***

54) The longest time frame we can observe is one year.
False, the longest time frame can be any period.

55) The longest time frame we observe is always termed the "Major Trend."

True, ***the longest time frame observed is always the "Major Trend."***

56) Breakout markets leave no footprint.

False, they leave a footprint of a series of higher highs or lower lows.

57) Higher highs or lower lows are usually found in a Breakout market.

True, that is the hallmark of a Breakout or "Trending" market.

58) Even if the major trend is higher, a minor trend could currently be breaking.

True, a smaller time frame can be bearish against the major trend.

59) Price charts from different time frames on the same underlying can have different chart patterns.

True, all observable time frames on the same underlying can be in different phases.

60) If the Major Trend is bullish every minor trend will be bullish.

False, all observable time frames on the same underlying may be in different phases.

61) Knowing the Major Trend gives us an edge on the market.

True, trading with strong hands always gives us an edge.

62) Depending on our observation of price and time a shorter time frame may appear to be in a different phase from the longest time frame we are observing.

True, all observable time frames on the same underlying may be in different phases.

63) The summation of price in all shorter term time frames

will resolve themselves into the longest time frame.

True, ***all time frames resolve themselves into the price of the longest time frame we are observing.***

64) Options can be used as a form of insurance.

True, they have been used for this purpose for over 3,000 years.

64) Options have caused many financial collapses in history.

False, ***greed*** caused the financial collapse, misuse of options took the blame.

65) Financial options are always guaranteed by an exchange.

False, if they are traded OTC they are not guaranteed by any exchange.

66) The buyer of an option has the right of exercise.

True, the buyer has the right but not the obligation.

67) A put allows the seller the right to purchase an asset for less than the current market price.

False, a put seller only has obligations,

68) A call seller has the obligation to sell the underlying asset class to the buyer at a specific price and time.

True, sellers of options only have obligations.

69) All options are worthless after expiration.

True, if an option is not exercised, it will be worthless after expiration.

70) The seller of put options has unlimited risk.

False, a put option can only go to zero so the risk is not unlimited.

71) At the money options are all intrinsic.

False, they are all **extrinsic.**

72) A straddle seller has unlimited risk.

True, any naked premium sold has unlimited risk.

73) A strangle buyer wants price to stay near the current strike.

False, the strangle buyer ***wants price movement; the more the better.***

74) Time decay insures that out of the money call options will expire worthless.

False, price movement is what causes an option to expire worthless.

75) The **VIX** is a measure of fear in the option market.

True, it is the premium that sellers demand in the market as a whole.

76) A seller of puts wants the market to rally.

True, ***the seller of a put is long the market.***

77) All exchange traded options are guaranteed by the respective exchanges.

True, that is why traders use exchange traded products.

78) The buyer of a vertical call spread has limited liability.

True, he is limited to the debit paid at the point of sale.

79) The seller of a vertical put spread has unlimited liability.

False, he is limited to the risk between the strikes minus his credit.

80) Only calls can be exercised prior to expiration.

False, any option can be exercised prior to expiration.

81) The maximum loss on a credit spread is the amount of the credit.

False, it is limited to the risk between the strikes, minus the credit.

82) A debit spread has no maximum risk.

False, it is limited to the debit paid at the point of sale.

83) Sellers of credit spreads have no rights in the option market.

False, the seller of a credit spread has rights on the debit leg of the spread.

84) Buyers of debit spreads have rights but no obligations in the option market.

False, they have obligations on the credit leg of the spread.

85) The at the money option has no extrinsic value.

False, it has **all extrinsic** value.

86) Out of the money options should always be abandoned at expiration.

True, if they are exercised, you have unlimited risk in the underlying asset.

87) Selling a straddle has risk limited to the debit paid.

False, ***selling a straddle has unlimited risk.***

88) At parity an option has no extrinsic value.

True, parity is the definition of an a option with no premium.

89) Puts can be exercised at any time.

True, all options can be exercised at any time.

90) Puts give the seller the right to put the option to a buyer at any time.

False***, the seller of puts has no rights, only obligations.***

91) LEAPS refer to the practice of buying calendar spreads over more than one monthly expiration.

False, LEAPS are options that expire later than one year after they are issued.

92) Time decay occurs in all option cycles.
True, time decay occurs as uncertainly becomes less with the passage of time.

93) Selling straddles has less risk than selling strangles.
False***, both strategies have unlimited risk.***

94) Implied Volatility only goes down as expiration approaches.
False, as uncertainty in the market rises volatility may rise to expiration.

95) Writing options is safer than selling puts.
False, they are the same thing.

96) Call writers have liability only to the amount of credit.
False, all sellers of premium have reward limited to the credit, and unlimited risk.

97) Teenies risk is limited to the debit paid.
True, teenies have risk limited to the debit paid. Their reward is unlimited.

98) Call spreads can never include teenies.
False, teenies can be included in all spreads.

99) A short strangle is a combination of selling a put and call at different strikes.
True, different strikes are used in any strangle.

100) A strangle can never include in the money options.
True, a strangle is the sale of two out of the money options.

101) A straddle risk is limited to the underlying debit paid.
True, a straddle's reward is unlimited, its risk is

limited to the debit paid.

102) Options that reach parity have no extrinsic value.

True, parity is the definition of an option with **no extrinsic** value.

103) Call writers reward is limited to the credit taken in at sale.

True, ***the call seller has unlimited risk.***

104) Options that have different expiration dates are called calendars.

True, a calendar (spread) is the term for options that expire at different times.

105) Time decay can overcome volatility doubling in LEAPS options.

False, in options over one year volatility (vega) will always overcome time decay.

106) The seller of a vertical put spread has unlimited liability

False, the seller is limited to the spread between strikes prices, minus the credit for the sale.

107) The buyer of a debit spread has no obligation in the option market

False, the buyer of a debit spread has an obligation to the **credit leg** of the spread.

108) In the short run options may perform differently than the underlying asset class.

True, an option may rise or fall in price with volatility without the underlying asset changing price.

109) Options have a life cycle that is different with ever asset class.

False, options always have the same life cycle no matter the underlying class.

110) If volatility collapses, the ATM calendar premium will follow.

True, a collapse of any option in a calendar will lead to the general price collapse in that calendar.

111) An option models life cycle can be compared to a balloon.

True, it will mimic the inflation and deflation of a balloon.

112) All options premium is worthless at expiration.

True, all option premium is zero at expiration, the option is either at parity and is exercised or it is out of the money and is abandoned at expiration.

113) If volatility doubles in a LEAP, the price of the ATM option should also nearly double.

True, in longer dated calendars, the volatility controls the premium levels, time decay is a minor factor.

114) Time decay in the nearby calendar will always overcome a volatility explosion.

True, time decay is the primary force on options as they reach expiration.

115) The option model is really a probability model.

True, ***the option model is a bell shaped curve, the definition of a probability model.***

116) Once a teenie has a 0% probability it will expire worthless.

False, the 0% probability is only for the **current** Implied Volatility. If volatility were to double, the option would probably **not have a 0% probability** at the new volatility level.

117) Volatility is the supply and demand for an option at any strike price.

True, that is the definition.

118) There is always less extrinsic value in a option one strike higher or lower than the ATM regardless of volatility.

True, ***extrinsic value is always greater the closer the option is to the ATM***. The ATM always has the greatest amount of premium, it has **no Intrinsic value**.

119) At expiration all extrinsic options will be assigned.

False, at expiration all extrinsic options **will be abandoned.**

120) The price of the underlying asset needs to change to have a decrease of volatility.

False, ***volatility (Vega) is a function of supply and demand for the option,*** and the underlying asset does not need to change to have price decline.

121) As time passes, the time decay curve increases.

True, the passage of time makes the curve much steeper, time decay will **accelerate** as time moves toward expiration.

122) **Google** options mirror options of any liquid asset class.

True, **Google** options are among the most liquid in the world.

123) All exchange traded options are liquid.

False, **each option must be examined to make sure it meets our criteria for liquidity.**

124) It is possible for volatility to become one with price.

True, when it reaches the point to where time and price are one it is said to be absolute.

125) Options can never reach parity prior to expiration.

False, as soon as all ***the premium is removed, the option will reach parity***. This can occur at any point in the options life cycle.

126) Teenies with a 0% probability should always be sold, they have no risk.

False, teenies that have a zero probability with a low volatility levels could end up with a 50% probability if the volatility increases. ***Selling teenies is a very risky strategy.***

127) Market conditions should never determine the buying of options.

False, market conditions **will always dictate** market strategy.

128) Out of the money options should never be exercised.

True, out of the money options should always be abandoned.

129) Bid-Offer spreads have no real effect on options because of time decay.

False, ***Bid-Offer spreads have a huge effect on time decay. Involvement with and illiquid option will adversely affect any gain in time decay.***

130) Commissions can affect the liquidity of an option.

True, ***commission greatly affect the liquidity of an option.***

131) ATM's generally will have the most premium.

False, ***ATM's will always have the most premium. The ATM is all extrinsic.***

132) Discipline is an important tool in trading.

True, discipline is the **first key** to becoming a successful trader.

133) Successful Average Joe Traders predict future price.

False, ***BUBBA'S GUIDE TO TRADING OPTIONS react to price change***.

134) Successful Average Joe Traders never react to market changes.

False, successful ***BUBBA'S GUIDE TO TRADING OPTIONS always react to market change.***

135) Time and price are universal in a liquid market.

True, if you missed this one go back to chapter one.

136) The longest time frame observed is always trending.

False, ***the longest time frame may be in any of the three phases of the market.***

137) The shortest time frame observed is never more than 10 minutes.

False, there are no parameters stated for the shortest time frame.

138) The longer the longest observable time frame is, the better the information.

False, an observable time frame that is too long is not practical for trading.

139) The shortest time frame is also known as the trading time frame.

True, if you missed this one you must be sleeping.

140) The trading time frame will always be no longer than two days.

False, the trading time frame could be any period shorter than the longest term frame.

141) The trading time frame is always the shortest time frame we observe.

True, no explanation is needed here.

142) The longest time frame we observe should never be over one year.

True, for practical purposes we should not observe price and time over one year.

143) Trading decisions will begin with the longest time frame.

True, the longest time frame sets up our first trading decision.

144) Establishing a tradable portfolio is the first step to trading.

True, ***you must have your portfolio in place before you can look at markets.***

145) Ten assets are considered the minimum amount for a successful portfolio.

True, you need a base of at least 10 assets to successfully diversify your trade.

146) The more assets that can be used in a portfolio the better.

True, the more assets you can handle the more potential for making money.

147) Diversification is an important key to successful trading.

True, different assets in your portfolio gives you more tradable markets.

148) Double Bottoms are always a sign of support in a market.

True, you better not have missed this creampuff.

149) Breakouts always occur from periods of congestion.

True, Breakouts always follow Congestion.

150) Counter trend traders are always the weak hands.

True, that is the definition of weak hands.

151) Observing a market from different points in time can give conflicting market views.

True, this is the condition we want.

152) The shortest time frame we observe is always our

trading time frame.

True, no explanation needed.

153) Strong hands dominate on a upside breakout.

True, ***strong hands always dominate a breakout.***

154) Weak hands dominate on a downside breakout.

False, you better not have missed this one!

155) **BUBBA'S GUIDE TO TRADING OPTIONS** does not consider the Greeks when trading.

False, ***BGTTO considers all the Greeks in our market recommendations.***

156) The option model can be offered as a balloon.

True, the option model is like a "balloon." Premium and time are the air that fills it.

157) The **VIX** can be used to measure fear in the market.

True, the higher the fear the higher the **VIX**.

158) The **VIX** does not always have a positive correlation with **Google**.

True, it ***may*** have a positive correlation, but they are independent of each other.

159) Nominal price is more important than market sentiment when measuring the **VIX**.

False, ***nominal price may have little correlation with the VIX, market expectation drives the VIX.***

160) Market expectation could account for the decline of the **VIX** in the Spring of 2009.

True, although the nominal price of the market was the same as the all time high in the **VIX** in the fall of 2008, market expectation had changed dramatically.

161) If the **VIX** is above its moving average, *"air should be going into the balloon."*

True, that is what the moving average is showing. It is a measurement of where "the air" stands in relation to previous points in time.

162) The **VIX** is not an Index product.
False, the **VIX** is an index.

163) The **VIX** can go below zero during a Blow Off.
False, a zero reading would indicate no fear.

164) Buying premium is the same as buying the market.
False, ***buying premium only refers to "the air in the balloon."***

165) Writing premium is also known as shorting the market.
False, ***they have nothing in common, selling premium only deals with "the air in the balloon."***

Given the following market conditions: Double Bottom, VIX above its 200 day moving average; we should execute which of the following trades?

166) Buy an ATM put.
False, we are looking at an upside move.

167) Sell the ATM straddle.
False, the **VIX** is over its 200 Day moving average and we only **buy premium in this market scenario**

168) Buy the ATM call.
True, this is one of our preferred trades in this situation.

169) Sell a calendar call spread.
False, we would want **to buy the calendar call spread** in this market condition.

170) Buy the ATM vertical call spread.
True, this is one of our preferred trades in this

situation.

Questions 171-176. Given the following market conditions: Double Top, VIX above its 200 day moving average; we should execute which of the following trades?

171) Buy an ATM put.
True, we are looking for a downside break on higher volatility.

172) Sell the ATM straddle.
False, we do not want to sell air in this scenario.

173) Buy the ATM straddle.
True, we want to be long premium in this scenario.

174) Sell a calendar ATM call spread.
False, we want to **buy** the ATM calendar call spread here.

175) Buy the ATM vertical put spread.
True, that is one of our preferred trades in this market.

176) Buying a vertical put spread on a downside Breakout with a high **VIX** is a suitable trade.
True, it is one of our preferred trades.

177) Call writers always have unlimited risk.
True, ***all premium sellers have unlimited risk.***

178) Calendar call spreads can be bought when the **VIX** is above its 200 day moving average and the market is on a double bottom.
True, this is one of our preferred trades in this market condition.

179) Calendar call spreads can be bought when the **VIX** is

below its 200 day moving average and the market is on a double bottom.

True, this is one of our preferred trades in this market condition.

180) Selling premium naked always has unlimited risk.

True, ***all premium sold naked has unlimited risk.***

Questions 181-186. Given the following market conditions: Upside breakout, VIX below its 200 day moving average: we should execute which of the following trades?

181) Buy a vertical call spread using the ATM.

False, we do not want to buy verticals in this market condition.

182) Buy the ATM straddle.

False, we do not want to buy straddles in the market condition.

183) Sell the ATM vertical put spread.

True, this is one of our preferred trades in this market condition.

184) Buy a "double call" to the upside.

False, we do not want to buy calls in this market condition.

185) Sell an upside straddle.

True, this is one of preferred trades in this scenario.

186) We can buy a calendar ATM call spread in any market phase, even a Blow Off.

False, this is one of our preferred trades in any scenario, **except** in a Blow Off.

187) Calendar ATM call spreads should be bought on a

double bottom with the **VIX** below its 200 period moving average.

True, we can ***buy*** serial spreads in any market condition ***except*** in a Blow Off.

188) Calendar ATM call spreads should be bought on a double bottom with the **VIX** above its 200 period moving average.

True, we can ***buy*** calendar spreads in any market condition ***except*** in a Blow Off.

189) **BUBBA'S GUIDE TO TRADING OPTIONS** never buys calendar put spreads.

False, we can ***buy*** calendar spreads in any market condition ***except*** in a Blow Off.

190) **BUBBA'S GUIDE TO TRADING OPTIONS** never sells vertical put spreads.

False, ***this is a preferred trade in several market conditions.***

191) Selling an ATM straddle has less risk that selling a strangle.

False, ***they both have unlimited risk.***

192) When we sell premium short we are shorting the market.

False***, we are "selling the air," not the market.***

193) Buying a vertical call spread has no risk as to volatility.

False, it has substantial risk as to volatility, and time decay.

194) Buying an ATM straddle has no risk as to price.

True, it has no price risk, but has substantial risk as to volatility and time decay.

195) Selling a calendar call spread has unlimited risk.

True, the front leg may **expire** worthless and the

second leg would then ***be short naked premium giving us unlimited risk.***

Given the following market conditions: Double Bottom, VIX below its 200 day moving average; we should execute which of the following trades?

196) Buy a calendar ATM call spread.

True, however we would prefer buying the first out of the money strike to the upside, but any spread would be acceptable.

197) Buy a vertical ATM call spread.

False, we do not want to buy call spreads in this market condition.

198) Sell a vertical ATM put spread (credit spread)

True, ***this is one of preferred strategies in this market condition.***

199) Sell a straddle at the first out of the money strike to the upside.

True, this is one of our preferred strategies in this market condition.

200) Buy a calendar ATM put spread.

True, this is one of our preferred strategies in this market condition.

Questions 201-205. The VIX has reached a level of 91 which is the highest level in 41 years. We have observed our longest time frame and are now watching our trading time frame. BUBBA'S GUIDE TO TRADING OPTIONS should execute the following trades.

201) When the market breaks to the upside buy a vertical call spread.

False, not appropriate in this scenario, ***never*** buy

premium in a Blow Off.

202) When the market reaches a Double Top sell the ATM call.

True, ***appropriate for those that can handle unlimited risk.***

203) When the market Breaks Out to the downside sell the ATM vertical call spread.

True. appropriate in this scenario for those that want profit potential, but not unlimited risk.

204) When the market Breaks Out to the downside buy the ATM put spread.

False, ***not appropriate in this scenario, never "buy air" in a Blow Off.***

205) When the market breaks out to the downside sell the ATM put.

False, ***not appropriate in this scenario, sell the ATM call if you can handle unlimited risk.***

206) When we buy a vertical ATM put spread we a short the market.

True, ***we are short the market and long premium.***

207) Once a naked option has a profit in it, it is considered a winner.

False, a naked option must have a 30% profit before it is considered a winner.

208) Owning a vertical ATM put spread is considered a winner when it is 10% ITM.

False, all vertical spreads must be in the money by 30% before they are classified as a winner. ***This is for both long and short premium spreads.***

209) Once a naked option has a profit in it, the stop is moved up to 15%.

False, once the naked option becomes a ***winner*** the stop is 10%.

210) Once a trade becomes a winner, the first stop would be at break even.

True, this is true for any option trade. ***Long Verticals, Short Verticals, Naked longs, Naked shorts, and serials spreads.***

211) Owning an ATM call gives us the right to unlimited profit.

True, if you missed this one start over.

212) If we are short a vertical ATM put spread we should take profit if it decays 30%.

False, the spread is considered a ***winner*** and our initial breakeven stop is placed.

213) If we are short a vertical ATM call spread we should place a stop loss 25% below our initial price.

False, on all option trades we will accept a ***30%*** loss in the premium.

214) Calendar spreads are a separate category of risk.

True **and** false both are correct. Because of its exceptional long premium, short time decay it is unique. However, it is still managed like any other trade. ***A 30% loss of value is the stop out, and it becomes a winner when it has a 30% increase in value.***

215) Calendar spreads should not be stopped out at a 30% loss of premium.

False, all options are stopped out at a ***30% loss of premium.***

216) Blow Off spreads are not subject to the 30% winner rule.

False, all vertical spreads whether long of short ***are***

subject to the 30% rule.

217) Taking a 33% profit in a Blow Off market is a considered a winning trade.

True, it is considered a winner at 30%, therefore a stop out at 33% is a winning trade.

218) You should never stop out short options, if the underlying price market is going in your favor.

False, we do not consider the underlying price when we deal with options. ***We consider only the premium levels of the trade.***

219) Short options need 30% decay before they are considered to be a winner.

True, all verticals, and short options need a 30% decrease in value before they are considered to be a winner.

220) Short option verticals need to see a 30% decrease in air before they are considered to be a winner

True, all verticals need to be in the money by 30% before they are considered to be a winner.

221) Winner rules do not apply to serial spreads.

False, ***Winner rules apply to all trades in options.***

222) As a rule all option trades are to be stopped out if the underlying market goes 25% against our position.

False, ***we do not consider the underlying asset when we use stops.***

223) As a rule option trades are to be stopped out if they go 30% against us, regardless if we are long or short premium.

True, ***we stop out all trades if we have a 30% loss on premium.***

224) Owning options is always safer than selling options.

False, during Blow Off phases of the market, it is riskier owning the options because of the extreme premium levels. **However, writing options has unlimited risk no matter what market conditions exist.**

225) Selling options in a Blow Off market has limited risk.

False, **selling options in any market has unlimited risk.**

226) As a rule naked options are considered to be winners with a 30% profit.

False, naked options have a limited reward, and as such they need to have price decay of 30% before they can be considered a winner.

227) As a rule short vertical spreads are considered winners with a 30% decay.

True, ***any vertical spread is considered a winner when it has a 30% decay in value.***

228) The first step in portfolio management is to choose liquid stocks.

True, ***the first step in any trade is to look at liquidity.***

229) A stock portfolio with 30 tradable stocks is preferable to a 10 stock portfolio.

True, more stocks in the portfolio provides **less correlation**.

230) Duplication of stocks in a portfolio may increase risk.

True, if stocks are highly duplicated, draw downs can increase.

231) More than two stocks from the same group may lead to duplication.

True, if the portfolio is small, two stocks in the same group can lead to duplication.

232) In theory if our win rate is positive, the model can still have short term loss.

True, ***all trading models have losing periods.***

233) Diversification insures very few losing periods when trading.

False, diversification helps to smooth out periods of loss, it does not lessen losing streaks.

234) Duplication is the opposite of correlation.

False, they are the same concept

235) Long term probabilities can mask short term problems.

True, the long term probabilities have a smoothing effect,

236) Win rate is important in considering which trades to take.

True, a higher win rate negates adverse volatility changes.

237) Capital is defined as our current money available for risk.

True, it is always our current capital, not our overall capital.

238) Discipline is not as important as a rising win rate.

False, discipline is always important, no matter what the win rate.

239) Volatility is always greater in high priced stock.

False, there is not a positive correlation between stock price and volatility.

240) Draw downs can always be avoided if tighter stops are used.

False, ***draw downs are inevitable in any trading model.***

241) Doubling of current volatility can increase a traders chance of loss.

True, higher volatility means higher risk.

242) Doubling of current volatility has no effect on profit potential.

False, ***doubling of volatility will more than double our profit potential.***

243) To insure your trading you should start with at least 10 times your maximum loss per trade.

False, ***ten times your maximum is not sufficient to overcome all losing streaks; you need a minimum of twenty times, and a preferred forty times to overcome all adverse market conditions.***

244) Price discovery assures that the market is in balance.

True, price discover assures an exchange of wealth.

245) Commissions have little effect on market liquidity.

False, commissions have a great effect on market liquidity.

246) Fundamental analysis is never subject interpretation.

False, fundamental analysis is always subject to interpretation.

247) Technical analysis is never subject to interpretation.

False, all technical analysis is subject to interpretation.

248) Taking losers is the most important form of discipline.

True, ***it is the most important form of discipline!***

249) The market is always right, it is a nemesis, it is never tired, not focused, or sick.

True, ***the market never makes a mistake, only traders make mistakes.***

250) Bulls and Bears make money, Pigs get slaughtered.
True! **No statement identifying the market could ever be truer!!**

Check your answers, many of the questions you have seen before. If you missed them a second time you need to keep reviewing the program until you can get at least 94% correct.

If you want to be a successful trader, you must continue to study. This manual should be your constant reference and companion in your trading.

Finally, I want to leave you with a story shared by a contributor to **BUBBA'S GUIDE TO TRADING OPTIONS.** His dad was an **Air Force** pilot. The story is simple, but profound.

Every time the Wright Brothers packed up for Kitty Hawk for a test flight, they included as many extra parts and supplies they could carry to repair their aircraft after they crashed. Think about that. They did not ***expect*** to fly flawlessly the **first** time. They expected, ***and planned for*** crashes!

Professional automobile racing teams load up their transports with entire spare cars as well as enough parts to essentially outfit a second team. They may not have expected the crashes as the Wright brothers did, but they planned accordingly.

The lesson is the same.
YOU WILL NOT WIN EVERY TIME!
EVERY TRADE WILL NOT BE SUCCESSFUL!

The key is to have a pre-determined strategy, plan for success, be

prepared for failure, and be disciplined in the application of your strategy.

Fighter Pilots learn early on:
"Accept your limitations; and act accordingly."

We wish you health, wealth, and happiness!

APPENDIX A: GLOSSARY OF TERMS

ALL OR NONE (AON) ORDER - A type of order that specifies that the order can only be activated if the full order will be filled. A term used more in securities markets than futures markets.

AMERICAN STYLE OPTION - A call or put option contract that can be exercised at any time before the expiration of the contract.

ASK, ASKED PRICE - This is the price that the trader making the price is willing to sell an option or security.

ASSIGNMENT - Notification by **The Options Clearing Corporation** (**OCC**) to a clearing member and the writer of an option that an owner of the option has exercised the option and that the terms of settlement must be met. Assignments are made on a random basis by the **OCC**. The writer of a call option is obligated to sell the underlying asset at the strike price of the call option; the writer of a put option is obligated to buy the underlying at the strike price of the put option.

AT PRICE - When you enter a prospective trade into a trade parameter in the Matrix, the "At Price" (At.Pr) is automatically computed and displayed. It is the price at which the program expects you can actually execute the trade, taking into account "slippage" and the current Bid/Ask, if available.

AT-THE-MONEY (**ATM**) - An at-the-money option is one whose strike price is equal to (or, in practice, very close to) the current price of the underlying.

BACK MONTH - A back month contract is any exchange-traded derivatives contract for a future period beyond the front month contract. Also called the FAR **MONTH**.

BEAR, BEARISH - A bear is someone with a pessimistic view on a market or particular asset, e.g. believes that the price will fall. Such views are often described as bearish.

BEAR CALL SPREAD - This is a net credit transaction established by selling a call and buying another call at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the difference between the strike prices less the credit received, and the maximum profit = the credit received. Requires margin.

BEAR PUT SPREAD - A net debit transaction established by selling a put and buying another put at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the debit paid, and the maximum profit = the difference between the strike prices less the debit. No margin is required.

BELL CURVE - See **NORMAL DISTRIBUTION**.

BETA - A prediction of what percentage a position will move in relation to an index. If a position has a Beta of 1, then the position will tend to move in line with the index. If the beta is 0.5 this suggests that a 1% move in the index will cause the position price to move by 0.5%. Beta should not be confused with volatility. Note: Beta can be misleading. It is based on past performance, which is not necessarily a guide to the future.

BID - This is the price that the trader making the price is willing to buy an option or security for.

BID-ASK SPREAD - The difference between the Bid and Ask prices of a security. The wider (i.e. larger) the spread is, the less liquid the market and the greater the slippage.

BINOMIAL PRICING MODEL - Methodology employed in some option pricing models which assumes that the price of the underlying can either rise or fall by a certain amount at each pre-determined interval until expiration. For more information, see **COX-ROSS-RUBINSTEIN.**

BLACK-SCHOLES PRICING MODEL - A formula used to compute the value of European-style call and put options invented by Fischer Black and Myron Scholes.

BROKER - The middleman who passes orders from investors to the floor dealers, screen traders, or market makers for execution.

BULL, BULLISH - A bull is someone with an optimistic view on a market or particular asset, e.g. believes that the price will rise. Such views are often described as bullish.

BULL CALL SPREAD - This is a net debit transaction established by buying a call and selling another call at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the debit paid, and the maximum profit = the difference between the strike prices, less the debit. No margin is required.

BULL PUT SPREAD - This is a net credit transaction established by buying a put and selling another put at a higher strike price, on the same underlying, in the same expiration. It is a directional trade where the maximum loss = the difference between the strike prices, less the credit, and the maximum profit = the credit received. Requires margin.

BUTTERFLY SPREAD - A strategy involving four contracts of the same type at three different strike prices. A long (short) butterfly involves buying (selling) the lowest strike price, selling (buying) double the quantity at the central strike price, and buying (selling) the highest strike price. All options are on the same underlying, in the same expiration.

BUY WRITE - See **COVERED CALL**.

CALENDAR SPREAD - The simultaneous purchase and sale of options of the same type, but with different expiration dates. This would include: horizontal debit spreads, horizontal credit spreads, diagonal debit spreads, and diagonal credit spreads.

CALL - This option contract conveys the right to buy a standard quantity of a specified asset at a fixed price per unit (the strike price) for a limited length of time (until expiration).

CALL RATIO BACKSPREAD - A long backspread using calls only.

CANCELED ORDER - A buy or sell order that is canceled before it has been executed. In most cases, a limit order can be canceled at any time as long as it has not been executed. (A market order may be canceled if the order is placed after market hours and is then canceled before the market opens the following day). A request for cancel can be made at any time before execution.

CLOSING TRANSACTION - To sell a previously purchased position or to buy back a previously purchased position, effectively canceling out the position.

COLLAR - A collar is a trade that establishes both a maximum profit (the ceiling) and minimum loss (the floor) when holding the underlying asset. The premium received from the sale of the ceiling reduces that due from the

purchase of the floor. Strike prices are often chosen at the level at which the premiums net out. An example would be: owning 100 shares of a stock, while simultaneously selling a call, and buying a put.

COLLATERAL - This is the legally required amount of cash or securities deposited with a brokerage to ensure that an investor can meet all potential obligations. Collateral (or margin) is required on investments with open-ended loss potential such as writing naked options.

COMMISSION - This is the charge paid to a broker for transacting the purchase or the sale of stock, options, or any other security.

COMMODITY - A raw material or primary product used in manufacturing or industrial processing or consumed in its natural form.

CONDOR - A strategy similar to the butterfly involving 4 contracts of the same type at four different strike prices. A long (short) condor involves buying (selling) the lowest strike price, selling (buying) 2 different central strike prices, and buying (selling) the highest strike price. All contracts are on the same underlying, in the same expiration.

CONTRACT SIZE - The number of units of an underlying specified in a contract. In stock options the standard contract size is 100 shares of stock. In futures options the contract size is one futures contract. In index options the contract size is an amount of cash equal to parity times the multiplier. In the case of currency options it varies.

COST OF CARRY - This is the interest cost of holding an asset for a period of time. It is either the cost of funds to finance the purchase (real cost), or the loss of income because funds are diverted from one investment to another (opportunity cost).

COVERED - A covered option strategy is an investment in which all short options are completely offset with a position in the underlying or a long option in the same asset. The loss potential with such a strategy is therefore limited.

COVERED CALL - Both long the underlying and short a call. The sale of a call by investors who own the underlying is a common strategy and is used to enhance their return on investment.

COVERED COMBO - A strategy in which you are long the underlying, short a call, and short a put. Often used by those wishing to own the underlying at a price less than today's price.

COX-ROSS-RUBINSTEIN - A binomial option-pricing model invented by John Cox, Stephen Ross, and Mark Rubinstein.

CREDIT - The amount you receive for placing a trade. This is the net inflow of cash into your account as the result of a trade.

CYCLE - See **EXPIRATION CYCLE**.

DAY ORDER - An order to purchase or sell a security, usually at a specified price, that is good for just the trading session on which it is given. It is automatically canceled on the close of the session if it is not executed.

DEBIT - The amount you pay for placing a trade. This is the net outflow of cash from your account as the result of a trade.

DELTA - Measures the rate of change in an option's theoretical value for a one-unit change in the underlying. Calls have positive Deltas and puts have negative Deltas. Delta for non-futures based options is the dollar amount of gain/loss you should experience if the underlying goes up

one point. For futures-based options, Delta represents an equivalent number of futures contracts times 100.

DELTA NEUTRAL - A strategy in which the Delta-adjusted values of the options (plus any position in the underlying) offset one another.

DIAGONAL CREDIT SPREAD - A type of calendar spread. It is a debit transaction where options are purchased in a nearer expiration and options of the same type are sold in a farther expiration, on the same underlying. It is diagonal because the options have different strike prices.

DIAGONAL DEBIT SPREAD - Type of calendar spread. It is a credit transaction where options are sold in a nearer expiration and options of the same type are purchased in a farther expiration, on the same underlying. It is diagonal because the options have different strike prices.

DIRECTIONAL TRADE - A trade designed to take advantage of an expected movement in price.

EARLY EXERCISE - A feature of American-style options that allows the owner to exercise an option at any time prior to its expiration date.

EQUITY OPTION - An option on shares of an individual common stock. Also known as a stock option.

EUROPEAN STYLE OPTION - An option that can only be exercised on the expiration date of the contract.

EXCHANGE TRADED - The generic term used to describe futures, options and other derivative instruments that are traded on an organized exchange.

EXERCISE - The act by which the holder of an option takes up his rights to buy or sell the underlying at the strike price.

The demand of the owner of a call option that the number of units of the underlying specified in the contract that must be delivered to him at the specified price. The demand by the owner of a put option contract that the number of units of the underlying asset specified that must be bought from him at the specified price.

EXERCISE PRICE - The price at which the owner of a call option can buy an underlying asset. The price at which the owner of a put option contract can sell an underlying asset. See **STRIKE PRICE**.

EXPIRATION, EXPIRATION DATE, EXPIRATION MONTH - This is the date by which an option contract must be exercised or it becomes void and the holder of the option ceases to have any rights under the contract. All stock and index option contracts expire on the Saturday following the third Friday of the month specified.

EXPIRATION CYCLE - Traditionally, there were three cycles of expiration dates used in options trading:

- **JANUARY CYCLE** (1): January / April / July / October
- **FEBRUARY CYCLE** (2): February / May / August / November
- **MARCH CYCLE** (3): March / June / September / December

Today, equity options expire on a hybrid cycle which involves a total of four option series: the two nearest-term calendar months and the next two months from the traditional cycle to which it has been assigned. **In addition the CBOE has added weekly options on certain large stocks and indexes. Before you trade you must check to see which cycle the options that you want to trade are listed on.**

FAIR VALUE - See **THEORETICAL PRICE, THEORETICAL VALUE**.

FAR MONTH, FAR TERM - See **BACK MONTH**.

FILL - When an order has been completely executed, it is described as filled.

FILL OR KILL (FOK) ORDER - This means do it now if the option (or stock) is available in the crowd or from the specialist, otherwise kill the order altogether. Similar to an all-or-none (**AON**) order, except it is "killed" immediately if it cannot be completely executed as soon as it is announced. Unlike an **AON** order, the **FOK** order cannot be used as part of a **GTC** order.

FOLLOW-UP ACTION - Term used to describe the trades an investor makes subsequent to implementing a strategy. Through these adjustments, the investor transforms one strategy into a different one in response to price changes in the underlying.

FRONT MONTH - The first month of those listed by an exchange - this is usually the most actively traded contract, but liquidity will move from this to the second month contract as the front month nears expiration. Also known as the **NEAR MONTH**.

FUTURE, FUTURES CONTRACT - A standardized, exchange-traded agreement specifying a quantity and price of a particular type of commodity (soybeans, gold, oil, etc.) to be purchased or sold at a pre-determined date in the future. On contract date, delivery and physical possession take place unless the contract has been closed out. Futures are also available on various financial products and indexes today.

GAMMA - Gamma expresses how fast Delta changes with a one-point increase in the price of the underlying. Gamma is positive for all options. If an option has a Delta of 45 and a Gamma of 10, then the option's expected Delta will be 55 if the underlying goes up one point. If we consider Delta to be the velocity of an option, then Gamma is the acceleration.

GOOD 'TIL CANCELED (GTC) ORDER - A Good 'Till Canceled order is one that is effective until it is either filled by the broker or canceled by the investor. This order will automatically cancel at the option's expiration.

GREEKS - The Greek letters used to describe various measures of the sensitivity of the value of an option with respect to different factors. They include Delta, Gamma, Theta, Rho, and Vega.

HISTORIC VOLATILITY - A measure of the actual price fluctuations of the underlying over a specific period of time. Also known as "statistical volatility".

HORIZONTAL CREDIT SPREAD - A type of calendar spread. It is a credit transaction where you buy an option in a nearer expiration month and sell an option of the same type in a farther expiration month, with the same strike price, and in the same underlying asset.

HORIZONTAL DEBIT SPREAD - A type of calendar spread. It is a debit transaction where you sell an option in a nearer expiration month and buy an option of the same type in a farther expiration month, with the same strike price, and in the same underlying asset.

ILLIQUID - An illiquid market is one that cannot be easily traded without even relatively small orders tending to have a disproportionate impact on prices. This is usually due to a low volume of transactions and/or a small number of participants.

IMMEDIATE-OR-CANCEL (IOC) ORDER - An option order that gives the trading floor an opportunity to partially or totally execute an order with any remaining balance immediately canceled.

IMPLIED VOLATILITY (IV) - This is the volatility that the underlying would need to have for the pricing model to produce the same theoretical option price as the actual option price. The term "implied volatility" comes from the fact that options imply the volatility of their underlying, just by their price. A computer model starts with the actual market price of an option, and measures **IV** by working the option fair value model backward, solving for volatility (normally an input) as if it were the unknown.

In actuality, the fair value model cannot be worked backward.

INDEX - The compilation of stocks and their prices into a single number, e.g. **The S&P 500.**

INDEX OPTION - An option that has an index as the underlying. These are usually cash-settled.

IN-THE-MONEY (ITM) - Term used when the strike price of an option is less than the price of the underlying for a call option, or greater than the price of the underlying for a put option. In other words, the option has an intrinsic value greater than zero.

INTRINSIC VALUE - Amount of any favorable difference between the strike price of an option and the current price of the underlying (i.e., the amount by which it is in-the-money). The intrinsic value of an out-of-the-money option is zero.

LAST TRADING DAY - The last business day prior to the option's expiration during which purchases and sales of

options can be made. For equity options, this is generally the third Friday of the expiration month.

LEAPS - **Long-Term Equity Anticipation Securities**, also known as long-dated options. Calls and puts with expiration as long as 2-5 years. Only about 10% of equities have **LEAPS**. Currently, equity **LEAPS** have two series at any time, always with January expirations. Some indexes also have **LEAPS**.

LEG - Term describing one side of a spread position.

LEGGING - Term used to describe a risky method of implementing or closing out a spread strategy one side ("leg") at a time. Instead of utilizing a "spread order" to ensure that both the written and the purchased options are filled simultaneously, an investor gambles a better deal can be obtained on the price of the spread by implementing it as two separate orders.

LEVERAGE - A means of increasing return or worth without increasing investment. This strategy involves the use of borrowed funds to increase one's investment return, for example buying stocks on margin. Option contracts are leveraged as they provide the prospect of a high return with little investment. The % Double parameter for each option in the Matrix is a measure of leverage.

LIMIT ORDER - An order placed with a brokerage to buy or sell a predetermined number of contracts (or shares of stock) at a specified price, or better than the specified price. Limit orders also allow an investor to limit the length of time an order can be outstanding before canceled. It can be placed as a day or **GTC** order. Limit orders typically cost slightly more than market orders but are often better to use, especially with options, because you will always purchase or sell securities at that price or better.

LIQUID - A liquid market is one in which large deals can be easily traded without the price moving substantially. This is usually due to the involvement of many participants and/or a high volume of transactions.

LONG - You are long if you have bought more than you have sold in any particular market, commodity, instrument, or contract. Also known as having a long position, you are purchasing a financial asset with the intention of selling it at some time in the future. An asset is purchased long with the expectation of an increase in its price.

LONG BACKSPREAD - A strategy available in the **TradeFinder**. It involves selling one option nearer the money and buying two (or more) options of the same type farther out-of-the-money, using the same type, in the same expiration, on the same underlying. Requires margin.

LONG OPTION - Buying an option. See **LONG**.

LONG STRADDLE - See **STRADDLE**.

LONG STRANGLE - See **STRANGLE**.

LONG SYNTHETIC - See **SYNTHETIC**.

LONG UNDERLYING - Buying the underlying (i.e. stock). See **LONG**.

MARGIN - See **COLLATERAL**.

MARKET MAKER - A trader or institution that plays a leading role in a market by being prepared to quote a two-way price (Bid and Ask) on request - or constantly in the case of some screen-based markets during normal market hours.

MARKET-NOT-HELD ORDER - A type of market order that allows the investor to give discretion regarding the price and/or time at which a trade is executed.

MARKET-ON-CLOSE (MOC) ORDER - A type of order which requires that an order be executed at or near the close of a trading day on the day the order is entered. A **MOC** order, which can be considered a type of day order, cannot be used as part of a **GTC** order.

MARKET ORDER - Sometimes referred to as an unrestricted order. It's an order to buy or sell a security immediately at the best available current price. A market order is the only order that guarantees execution. It should be used with caution in placing option trades, because you can end up paying a lot more than you anticipated.

MARKET PRICE - A combination of the Bid, Ask, and Last prices into a single representative price. Bid, Ask, and Last are all available, the default formula for **MARKET PRICE** is (10*Bid + 10*Ask + Last) / 21.

MARK TO MARKET - The revaluation of a position at its current market price.

MID IMPLIED VOLATILITY (MIV) - Implied volatility computed based on the mid-point between the Bid and Ask prices. See **IMPLIED VOLATILITY**.

NAKED - An investment in which options sold short are not matched with a long position in either the underlying or another option of the same type that expires at the same time or later than the options sold. The loss potential of naked strategies can be virtually unlimited.

NEAR TERM - See **FRONT MONTH**.

NORMAL DISTRIBUTION - A statistical distribution where observations are evenly distributed around the mean. Studies have shown that stock prices are very close to being log normally distributed over time. When you choose bell curve as a price target in the program, a lognormal distribution based on price, volatility, and time until valuation date is constructed.

NOT-HELD ORDER - An order that gives broker discretion as to the price and timing in executing the best possible trade. By placing this order, a customer agrees to not hold the broker responsible if the best deal is not obtained.

OFFER - See **ASK**.

ONE-CANCELS-THE-OTHER (OCO) ORDER - Type of order which treats two or more option orders as a package, whereby the execution of any one of the orders causes all the orders to be reduced by the same amount. Can be placed as a day or **GTC** order.

OPENING TRANSACTION - An addition to, or creation of, a trading position.

OPEN INTEREST - The cumulative total of all option contracts of a particular series sold, but not yet repurchased or exercised.

OPEN ORDER - An order that has been placed with the broker, but not yet executed or canceled.

OPTION CHAIN - The list of available options for a given underlying.

OUT-OF-THE-MONEY (OTM) - An out-of-the-money option is one whose strike price is unfavorable in comparison to the current price of the underlying. This means when the strike price of a call is greater than the price of the underlying, or

the strike price of a put is less than the price of the underlying. An out-of-the-money option has no intrinsic value, only time value.

PREMIUM - This is the price of an option contract.

PUT - This option contract conveys the right to sell a standard quantity of a specified asset at a fixed price per unit (the strike price) for a limited length of time (until expiration).

PUT/CALL RATIO - This ratio is used by many as a leading indicator. It is computed by dividing the 4-day average of total put **VOLUME** by the 4-day average of total call **VOLUME**.

PUT RATIO BACKSPREAD - A long backspread using puts only.

REALIZED GAINS AND LOSSES - The profit or losses received or paid when a closing transaction is made and matched together with an opening transaction.

REVERSAL - A short position in the underlying protected by a synthetic long. Also the term used to describe a direction change in a given asset or derivative measured against time.

RHO - The change in the value of an option with respect to a unit change in the risk-free rate.

RISK-FREE RATE - The term used to describe the prevailing rate of interest for securities issued by the government of the country of the currency concerned. It is used in the pricing models.

ROLLOVER - Moving a position from one expiration date to another further into the future. As the front month approaches expiration, traders wishing to maintain their positions will often move them to the next contract month.

This is accomplished by a simultaneous sale of one and purchase of the other.

ROUND TURN - When an option contract is bought and then sold (or sold and then bought). The second trade cancels the first, leaving only a profit or loss. This process is referred to as a “round turn”. Brokerage charges are usually quoted on this basis.

SHORT - An obligation to purchase an asset at some time in the future. You are short if you have sold more than you have bought in any particular market, commodity, instrument, or contract. Also known as having a short position. An asset is sold short with the expectation of a decline in its price. Can have almost unlimited risk. Uncovered short positions require margin.

SHORT BACKSPREAD - It involves buying one option nearer the money and selling two (or more) options of the same type farther out-of-the-money, with the same expiration, on the same underlying. Requires margin.

SHORT OPTION (COVERED) - See **COVERED CALL**.

SHORT OPTION (NAKED) - Selling an option you don't own. See **SHORT**.

SHORT STRADDLE - See **STRADDLE**.

SHORT STRANGLE - See **STRANGLE**.

SHORT SYNTHETIC - See **SYNTHETIC**.

SHORT UNDERLYING - Selling an asset you don't own. See **SHORT**.

SLIPPAGE - Thinly traded options have a wider Bid-Ask spread than heavily traded options. Therefore, you have to

"give" more in order to execute a trade in thinly traded options; less in heavily traded ones. This "give" is what we refer to as slippage.

SPREAD - A trading strategy involving two or more legs, the incorporation of one or more of which is designed to reduce the risk involved in the others.

SPREAD ORDER - This is an order for the simultaneous purchase and sale of two (or more) options of the same type on the same underlying. If placed with a limit, the two options must be filled for a specified price difference, or better. It can be critical in this type of order to specify whether it is an opening transaction or a closing transaction.

STANDARD DEVIATION - The square root of the mean of the squares of the deviations of each member of a sample population (in simple terms, a group of prices) from their mean. In a normal distribution (or bell curve), one standard deviation encompasses 68% of all possible outcomes.

STATISTICAL VOLATILITY (SV) - Measures the magnitude of the asset's recent price swings on a percentage basis. It can be measured using any recent sample period. Regardless of the length of the sample period, **SV** is always normalized to represent a one-year, single Standard Deviation price move of the underlying.

Note: It is important to remember that what is needed for accurate options pricing is near-term future volatility, which is something that nobody knows for sure.

STOP ORDER - **"Stop-Loss"** and **"Stop-Limit"** orders placed on options are activated when there is a trade at that price only on the specific exchange on which the order is located. They are orders to trade when its price falls to a particular point, often used to limit an investor's losses. It's

an especially good idea to use a stop order if you will be unable to watch your positions for an extended period.

STRADDLE - A strategy involving the purchase (or sale) of both call and put options with the same strike price, same expiration, and on the same underlying. A short straddle means that both the call and put are sold short, for a credit. A long straddle means that both the call and put are bought long, for a debit.

STRANGLE - A strategy involving the purchase or sale of both call and put options with different strike prices - normally of equal, but opposite, Deltas. The options share the same expiration and the same underlying. A strangle is usually a position in out-of-the-money options. A short strangle means that both the calls and puts are sold short, for a credit. A long strangle means both the calls and puts are bought long, for a debit.

STRATEGY, STRATEGIES - An option strategy is any one of a variety of option investments. It involves the combination of the underlying and/or options at the same time to create the desired investment portfolio and risk.

STRIKE PRICE - The price at which the holder of an option has the right to buy or sell the underlying. This is a fixed price per unit and is specified in the option contract. Also known as striking price or exercise price.

SYNTHETIC - A strategy that uses options to mimic the underlying asset. The long synthetic combines a long call and a short put to mimic a long position in the underlying. The short synthetic combines a short call and a long put to mimic a short position in the underlying. In both cases, both the call and put have the same strike price, the same expiration, and are on the same underlying.

TECHNICAL ANALYSIS - Method of predicting future price movements based on historical market data such as (among others) the prices themselves, trading volume, open interest, the relation of advancing issues to declining issues, and short selling volume.

THEORETICAL VALUE, THEORETICAL PRICE - This is the mathematically calculated value of an option. It is determined by (1) the strike price of the option, (2) the current price of the underlying, (3) the amount of time until expiration, (4) the volatility of the underlying, and (5) the current interest rate.

THETA - The sensitivity of the value of an option with respect to the time remaining to expiration. It is the daily drop in dollar value of an option due to the effect of time alone. Theta is dollars lost per day, per contract. Negative Theta signifies a long option position (or a debit spread); positive Theta signifies a short option position (or a credit spread).

TICK - The smallest unit price change allowed in trading a specific security. This varies by security, and can also be dependent on the current price of the security.

TIME DECAY - Term used to describe how the theoretical value of an option "erodes" or reduces with the passage of time. Time decay is quantified by Theta.

TIME PREMIUM - Also known as **"Time Value"**, this is the amount that the value of an option exceeds its intrinsic value and is a parameter in the Matrix. It reflects the statistical possibility that an option will reach expiration with intrinsic value rather than finishing at zero dollars. If an option is out-of-the-money then its entire value consists of time premium.

TIME SPREAD - See **CALENDAR SPREAD**.

TRADE HALT - A temporary suspension of trading in a particular issue due to an order imbalance, or in anticipation of a major news announcement. An industry-wide trading halt can occur if the **Dow Jones Industrial Average** falls below parameters set by the **New York Stock Exchange**.

TRADING PIT - A specific location on the trading floor of an exchange designated for the trading of a specific option class or stock.

TRANSACTION COSTS - All charges associated with executing a trade and maintaining a position, including brokerage commissions, fees for exercise and/or assignment, and margin interest.

TRUE DELTA, TRUE GAMMA - More accurate than standard Delta and Gamma. Projects a change in volatility when projecting a change in price. Taking this volatility shift into account gives a more accurate representation of the true behavior of the option.

TYPE - The type of option. The classification of an option contract as either a call or put.

UNCOVERED - A short option position that is not fully collateralized if notification of assignment is received. See also **NAKED**.

UNDERLYING - This is the asset specified in an option contract that is transferred when the option contract is exercised, unless cash-settled. With cash-settled options, only cash changes hands, based on the current price of the underlying.

UNREALIZED GAIN OR LOSS - The difference between the original cost of an open position and its current market price. Once the position is closed, it becomes a realized gain or loss.

VEGA - A measure of the sensitivity of the value of an option at a particular point in time to changes in volatility. Vega is the dollar amount of gain or loss you should theoretically experience if implied volatility goes up one percentage point.

VERTICAL CREDIT SPREAD - The purchase and sale for a net credit of two options of the same type but different strike prices. They must have the same expiration, and be on the same underlying. See also **BULL PUT SPREAD** and **BEAR CALL SPREAD**.

VERTICAL DEBIT SPREAD - The purchase and sale for a net debit of two options of the same type but different strike prices. They must have the same expiration, and be on the same underlying. See also **BULL CALL SPREAD** and **BEAR PUT SPREAD**.

VOLATILITY - Volatility is a measure of the amount by which an asset has fluctuated, or is expected to fluctuate, in a given period of time. Assets with greater volatility exhibit wider price swings and their options are higher in price than less volatile assets. Volatility is not equivalent to **BETA**.

VOLATILITY TRADE - A trade designed to take advantage of an expected change in volatility.

VOLUME - The quantity of trading in a market or security. It can be measured by dollars or units traded (i.e. number of contracts for options, or number of shares for stocks).

WASH SALE - When an investor repurchases an asset within 30 days of the sale date and reports the original sale as a tax loss. The **Internal Revenue Service** prohibits wash sales requiring (under current tax law) 31 days ownership to take place before a realized loss or gain to take place upon an asset sale.

WEEKLY OPTION – A serial option that expires each Friday. It has fifty-two cycles per year.

WRITE, WRITER - To sell an option that is not owned through an opening sale transaction. While this position remains open, the writer is obligated to fulfill the terms of that option contract if the option is assigned. An investor who sells an option is called the writer, regardless of whether the option is covered or uncovered.

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For more than thirty four years, Todd “Bubba” Horwitz has enjoyed a successful career in the financial industry. He began his profession in 1980 as one of the original market makers in the OEX Trading Pit at the Chicago Board of Options Exchange. He has traded at all of the major exchanges in Chicago and is currently a member of the CBOT.

Adjunct to his trading, for the past five years he has concentrated on writing, education, and a media career. Currently Mr. Horwitz has a number of educational and media ventures.

As the moderator of his daily sixty minute radio broadcast, the “Bubba Show,” he specializes in dissecting the news and educating average investors. The show brings a unique perspective, not only on the financial markets, but also the geopolitical and social events that are influencing the world. The eclectic nature of the broadcast allows Mr. Horwitz to interview a wide range of personalities from championship football coach Philip Fulmer to ex-Fed governor Andrew Huzar, in addition to personalities from the financial community that include many household names such as Terry Savage, Liz Claman and David Asman.

Augmenting his media career, he continues to concentrate on the education and training of would-be investors teaching them the ins and outs of a professional trader who has seen it all in the past thirty plus years. He is also developing an educational program for high school seniors that will allow them to make the transition from the school yard to the business world.

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