Trading Weekly Options – The Confidential Handbook

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Published by
TradeWins Publishing
528 N, Country Road
St. James, NY 11780

Printed in the United States

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Chapter 1: Understanding Markets and Yourself

Where do we start?

Starting out in options can be a scary and unfamiliar place, but it doesn't have to be! This book will give you all the tools you need to be a successful weekly options trader. There are so many theories and strategies out there, and I have tried all of them. I've found that the method I will show you in this book is the simplest and most effective to make money trading weekly options. The biggest gripes on options trading are all things I'm sure you've heard before; "They're too complicated!" or "They're too risky!" These are things you will hear from people who either haven't taken the time to learn options or don't really understand how they work. Options are not only a great way to use small amounts of capital to control large positions of stock, but they allow us to do things we wouldn't be able to do with just normal stock. By the end of this book, you will be able experience the joy and simplicity of options that 99% of the population will never understand. And that's a great thing for us! However, before we get down to the numbers and strategies, we must understand where it all begins.

Trading is a tough business just like anything else. If it were easy, everybody would be doing it! We'd all be sitting at home in our underwear in front of our computers without a care in the world. But you know as well as I do that this just isn't the case. One of the biggest flaws in the average investor is that they will buy at the top and sell at the bottom. Don't let fear and greed creep into your trading. Have a plan, throw your emotions out the window, and keep things in perspective. Everybody will make losing trades, that's just part of the business.

Ignore the experts and ignore the pundits. Everybody on TV has an agenda (except me of course). By the end of this book, you will know the players and you will know the plays, you just have to call the game. Focus on how you play the game and not on the scoreboard, and I promise you will be successful. Don't get outside of yourself and take a deep breath. You can do this, and I'm here to help you every step of the way.

Key Guidelines

There are some things in trading options and trading in general that you must adhere to in order to be successful. We can't master weekly options until we first master these concepts.

1. Have a plan, and stick to it

It's hard to know where we're going if we don't know where we started. Before making a single trade, you must have a plan of attack. What do I want to get out of this trade? How can I accomplish my goal? These are the kinds of questions you must ask yourself before any given trade. Every trade is different, but the concept remains the same. The key is to stick to your plan. When you make exceptions, you are doomed. Know that there will be winners and losers, but if you stick to your plan you will be a winner in the long run.

2. Treat trading like a business

Whether you are trading weekly options for a living, part-time, or just as a way to create some extra income, you must treat it like a business. Make a commitment to being the best trader you can be! Trading can be stressful since there is no regular paycheck (not yet!). You will experience losses, taxes, uncertainty, and stress, but you can't give up. As a trader, you are essentially like a small business owner when it comes to your account. Do your research and be confident in your ability to maximize your business's full potential.

3. Control you emotions

All these guidelines build off of each other. They fit together like pieces of a puzzle. Don't try to make pieces fit where they don't! The worst thing you can do is let your emotions get the best of you. We make the worst decisions when we become too emotional. Treat your trading like a business partner, not a girlfriend. Make your decisions with your head, not with your heart. I promise your account won't break up with you!

4. Know your risk/reward on every trade you make

There are thousands of different types of trades you can make, and each on has its own risk/reward profile. Don't go into a trade blind! Know where you got in, and know if/when you need to get out. If you don't know what you're putting into each trade, you can't possibly keep track of your results.

5. Don't force trades

Sometimes the greatest way to learn how to trade is to observe markets. If the levels aren't there and you don't feel comfortable making a trade, just wait until the next one. Missed money is better than lost money, so wait patiently for the opportunities to arrive.

6. Take profits when you see fit

There is nothing wrong with taking profits. Nothing! Will you ever take profits and end up missing out on some more? Sure. But in the grand scheme of things you can't lose the money that you put in your pocket. Don't be afraid to scale out of winning positions when they work for you. Even if the move continues, you're still along for the ride.

7. Technology is your friend

There are plenty of trading platforms out there, use this to you advantage. Have a list, mark your charts, and trade off of you charts. There are so many great tools out there that you can use to become a better trader. Trading is a competitive business, so use the necessary tools to be the best trader you can be.

8. All charts are the same

If you took away price and time from any given chart, would you be able to tell what chart you're looking at? Of course not. The takeaway from this is that all charts are the same. Don't trade the product or the name, trade the chart. Know your levels of where you want to get in and stick to those levels.

9. Monitor your Profit/Loss

You don't keep track of your trading record by how many trades you make, or when you make them. You keep track by monitoring your profit and loss. Don't judge yourself on a day by day basis, but set an appropriate time frame to check your results so you can see how you're doing. Just like a diet plan, don't live and die by what you see on the scale every morning.

10. Trade in liquid markets

This rule is meant to keep you safe when it comes to trading weekly options. When you trade in illiquid markets, you put yourself at unnecessary risk because it's not a guarantee that you'll be able to get out of your position. There are plenty of liquid stocks out there to choose from, so stay away from the penny stocks!

No matter how simple these guidelines may seem, they are the most important. Do not forget that. I have taught thousands of students the same, simple method that makes money in any time frame. In this book we are focusing on weekly options and anybody who is eager and willing to learn can be successful no matter what their experience is.

The Herd Mentality: Bubbles

History is our greatest teacher. The famous quote we've all heard at one time or another is "Those who do not learn from history are doomed to repeat it." The past is the key to the present. One of the most infamous events in recent memory would be the bursting of the housing bubble in the summer and fall nine years ago. So many were affected and people were left wondering what had gone wrong this time. Surely, this was the first time such a financial disaster had affected so many so quickly. Or was it? Well as a matter of fact it was not, as the Great Recession was not an isolated incident.

The fact is, panics and bubbles have been part of (almost) every economy dating back to ancient times. If you are going to learn how to trade in any capacity, you will need to know a little about economic history. As you will learn, **market dynamics always repeat.**

The market psychology that triggered the Great Recession goes back at least as long as history has been recorded. Some famous market panics include:

- Tulipmania in Holland (1636-1637)
- The South Sea Bubble (1711-1721)
- The Cotton Panic of 1837
- The Dot-com Bubble (1998-2002)

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 **"This time will be different"** and price can only go higher. Let's dive a little deeper into what occurred in 2008.

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") and **The Federal National Mortgage Association** ("Fannie Mae"), 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 the real estate value 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 U.S.

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 form 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 and 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."** In 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, and 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!

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 the 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 2007 the first weakness in the bubble started to show. Strangely enough, it happened in the Wheat market, then in Soybeans, and then in 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 though, 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. It wasn't but a few days later that Bear Sterns filed for bankruptcy. Next, it was **Lehman Brothers**, who had the same AAA rated mortgage security problems, with the 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, and grains had lost 50% of their value; the Sheiks who built the island 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 ruin.

What's the common thread here? There are a few of them. At market extremes, emotions drive the market, not rational thought. Investors become overwhelmed by greed and then they become paralyzed by fear. All market extremes are driven by two forces – fear and greed. Don't ever fall into the trap of **"This time will be different."** History has proven to us time and time again that this time will not, in fact, be different.

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

What is a market?

The market is never wrong, no matter how much we want it to be. The most famous words in trading are, "You can't fight the tape", with the tape being the market. The biggest enemy you will ever face is the one in the mirror.

Options are a function of the stock market, and we must learn how the market functions and what it actually is to develop a meaningful understanding of the products we are working with. Many beginners don't have the slightest idea of what constitutes a market. So before we learn how to trade weekly options, we need to learn a little more about markets in general.

A market is a place of exchange that allows buyers and sellers of a specific good or service to interact in order to facilitate an exchange. The price that individuals pay during the

transaction may be determined by a multitude of factors that we will discuss later.

Although there are many types of markets in the world, the one we are going to focus on is the stock market. The stock market is a place in which shares of publicly held companies are issued and traded through either exchanges or over the counter markets. Also known as the equity market, the stock market is one of the most vital components of a free-market economy, as it provides companies with access to capital in exchange for giving investors a slice of ownership in the company. Although it may not seem like it, if you buy one share of the company Apple (AAPL), you are indeed a part owner of the whole company! There are many different companies that make up the stock market, over 9,000 of them. We can split the stock market into two main sections: the primary market and the secondary market. The primary market is where new issues are first sold through initial public offerings (IPOs). Institutional investors typically purchase most of these shares from investment banks. All other trading goes on in the secondary market, the market we will trade in. Participants in this market include both institutional and individual investors.

Chapter 2: Today's Market

The market we have at our disposal today has grown throughout time. Today, virtually every country in the world has its own stock market. Every day, trillions of dollars are traded on stock markets around the world and they're truly the engine of the capitalist world.

Twenty-first century financial markets no longer rely on face-to-face barter, as they have for centuries; they are conducted through electronic transfers. They are highly sophisticated, and will always result in the exchange of funds. Almost all thriving markets rely on a form of auction. The party who wants to buy something 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 value.

Price Discovery

Price discovery is the tool that makes stock prices go up and down. It is where buyers and sellers agree to exchange wealth. At that moment where the exchange happens, the market is in equilibrium. It may last for only a second or may last for a minute or longer but we know this is the point where buyers and sellers have agreed on price. Most people would tell you that supply and demand make stock prices go up and down, and most people would be wrong. Since price discovery can be difficult to understand, it is too often referred to as supply and demand. Although the two are similar, they are not the same. We can technically prove supply and demand wrong as the reason that stocks go up and down by picturing a supply and demand graph.

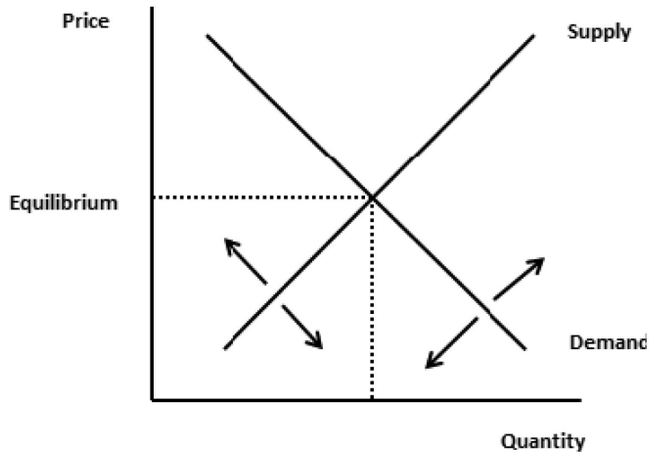


Figure 2.1 Supply and Demand Graph

The supply and demand curves can increase or decrease, but when a company issues a share count, the number they issue is a **finite** number of shares.

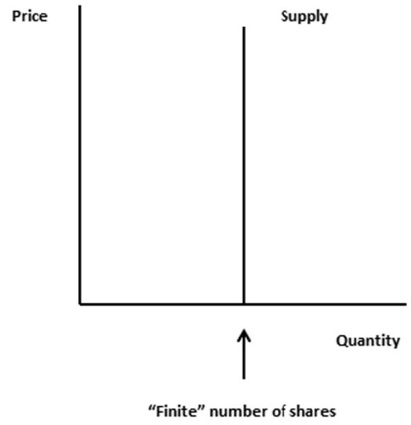


Figure 2.2 Supply is "Finite"

This means that supply can't increase because there is not an unlimited amount of shares available, only the amount that the company has issued. Price determination (supply and demand) is the interaction of the broad forces that determine the market **price level**, not the market price.

Remember, we are in an auction market. Price can only move higher or lower when we have new price discovery. Price discovery is the process of buyers and sellers arriving at a transaction price for given quality and quantity of a product at a given time and place. The real answer is, 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.

Price discovery involves a few concepts: market structure (number, size, location, and competition between buyers and sellers), market behavior (pricing and obtaining methods), market information (amount, reliability), futures markets, and risk management alternatives. Price discovery begins with the market price level. Because buyers and sellers discover prices on the basis of uncertain expectations, transaction prices usually fluctuate around that market price level. In extreme cases, the market **gaps** – there are no buyers or sellers at the next level. The market **gaps** until more buyers or sellers can be found, and there is a new price discovery.

Because of information uncertainty and for lack of a better term just differing opinions, buyers and sellers never truly know the price of a product. Therefore, buyers are willing to bid

and sellers are willing to offer different prices on any given day. Now that we've learned about both supply and demand and price discovery, we can articulate how they both relate to stock prices.

Market Dynamics and Expectation

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 6.8%. 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 barbecued. Could you have seen this coming?

These **FUNDAMENTAL NEWS BOMBS** are quite common. The reaction (or non-reaction) or 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 (the "street" is just a broader term to describe Wall Street in general). 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.

Figure 2.3 Earnings Rally Followed by Sell Off

In the case of the unemployment number, the **STREET** really felt the number should have been much higher than the 6.8% 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 t**echnical analysis** will allow you to prosper in trading conditions like these. In fact you will learn to make profitable weekly options' trades in any market condition!

So the answer to our question 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, which I will cover later in the book. 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 FOLLOW THE NEWS.**

Liquidity

Liquidity is the third piece of puzzle, and is arguably the most important ingredient when we look at today's market and markets that we want to trade in. An easy was to start thinking about liquidity is by picturing a water bottle with one of two things in it, water or concrete. If you took a water bottle with concrete in it, twisted off the cap and flipped it upside down, nothing would come out right? That is correct, because concrete in this case is an illiquid item, meaning it can't easily get out of the bottle. If we took a bottle with water in it, twisted off the cap and flipped it upside down, the water would easily pour out of the bottle. In this case, water is a liquid item (not the main definition of **liquid** that we are used to using), because it can easily get out of the bottle.

We can take the same concept of water and concrete liquidity into assets, stocks, and options. Do you know how much easily accessible money you have in the form of cash? This is a measure of your liquidity. Liquidity is the term used to describe how easy it is to convert assets to cash. The most liquid asset, and what everything else is compared to, is cash. This is because it can always be used easily and immediately.

Stock or option liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Stocks and options that can easily be bought or sold are known as liquid assets. We must be involved with liquid assets when we trade weekly options. 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 this book you will learn how to avoid illiquid markets. You will only trade in markets that have an adequate "open interest" to remain transparent.

Chapter 3: Technical vs. Fundamental Trading

There are so many different ways to trade the markets. The two main methods that you have surely heard before are fundamental analysis and technical analysis. Fundamental traders attempt to measure the intrinsic value of a stock. They study everything from the overall economy and industry conditions to the financial condition and management of companies. They try to **predict** where price will go based on certain economic data and geopolitical events. Fundamentalists would lead you to believe that the balance sheet, or P/E ratios, or Inventories, are the key factors that make prices move. The weird thing numbers is that they never lie, but sometimes people do. The numbers all depend on who is looking at them! They are always subject to interpretation. That's why we see major swings after key numbers are released. Although there are plenty of fundamental traders out there, **we will not be!** Technical analysis is the method that we are going to use.

We are going to ignore the fundamental data. We do not care why the price is moving up or down, and we will not try to predict the direction it will be taking! As technicians, price discovery is the only necessary tool that we will need. Understand this: traders using technical analysis only **study price movement** and historical price patterns and tendencies to determine what kinds of positions they want to put on.

As technical traders, 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 that because the buyers and sellers have agreed to a stated **exchange value,** there has been 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.

The trades that I cover in this book will always be **reactive in nature.** We are not going to try and predict market price action. We have already learned that when we have price discovery, the market is in equilibrium. Unlike fundamental numbers, which are subject to interpretation, the price is not!

Chapter 4: Phases of the Market

There are three phases of the market that you need to know to understand how markets move and work. We will talk about not only the patterns that emerge within these three phases, but the psychology of market participants and why these patterns constantly repeat. You might notice that the candles look a little different on each chart. They have been formatted to display each individual concept I am conveying. It doesn't matter what time frame they represent, and I have left them off for that reason. Remember, **without price and time, all charts are the same!**

Congestion

The first phase of the market is congestion. The market is in congestion more than 65% of the time. In this phase, the market is trading between a level of support and resistance. Picture yourself in a room; if you put a balloon in the room and turned the fan on, the balloon will continue to bounce up and down between the floor and ceiling until it finds a place to break out to either the upside or the downside. In the case of the room, the floor is acting as support and the ceiling is acting as resistance. Look at the chart below and notice how the market moves back and forth between a level of support (floor) and resistance (ceiling). Although congestion involves a lot of back and forth in the market, it will give us plenty of opportunities to trade

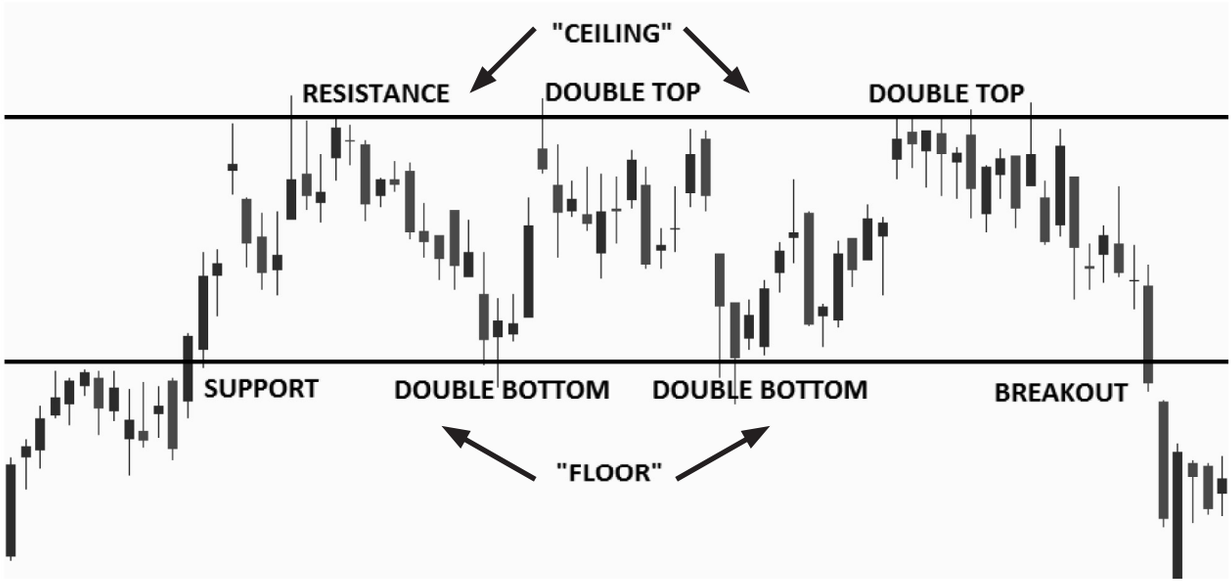


Figure 4.1 Congestion Phase

You should notice that in this chart above, 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.” If we were to stop time at this point, it would be impossible to envision which way the market was going to move; we don’t have enough information. If we observe price on the y-axis along a time continuum on the x-axis, you can see that the market rallies to the previous top, and stops. This second move in price is referred to as a “double top.” We can observe a **double top** when we have a clear top (within a certain level), followed by a clear bottom, followed by a climb back up to that 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 that this line is referred to as resistance is because price is having a difficult time going higher than this level.

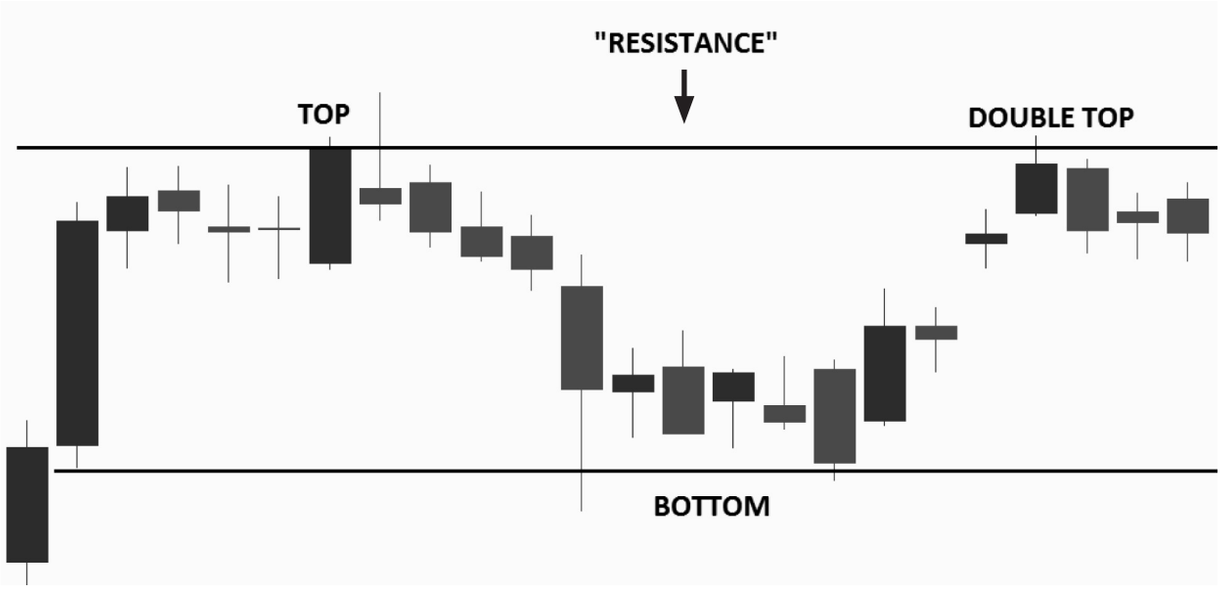


Figure 4.2 Double Top

The chart below now shows that after the double top, the market again retraces, but stops when it reaches the previous bottom.

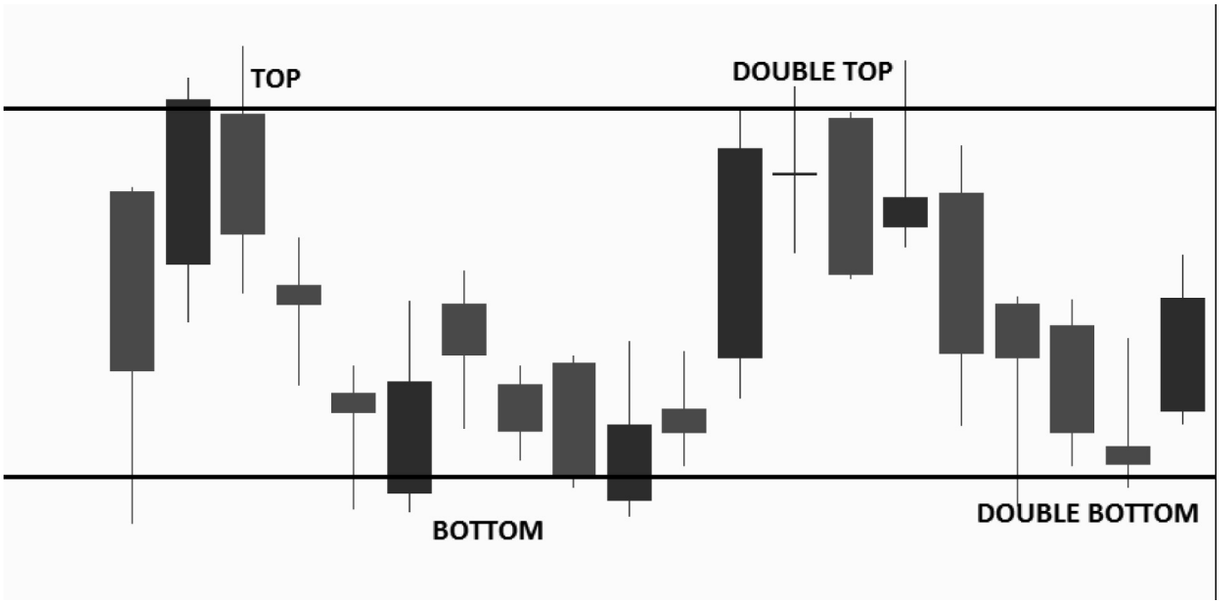


Figure 4.3 Double Bottom

Now what do we call the price point when the previous bottom is reached? It's not rocket science! We call this a **"double bottom."** When the market continually bounces back and forth between tops and bottoms, it is in congestion! Congestion is the birth of all markets, which is why it is considered the initial market phase. When we look to initiate a trade, the first thing we will look for is a market 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."** Sellers in a rallying market are referred to as the **"weak hands"** because they are trying to resist the advancement of price. 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 the weak hands as sellers attempt to drive them 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 begin to take profit, and the process will reverse. Prices will rise again. You can't try and time the congestion phase because it may last for 10 time periods, or it may last for 100 or more!

Eventually, the market will reach a point at which the double tops or double bottoms (the congestion phase) fail. At this point, we have reached the second phase of the market, referred to as a **"breakout."**

Breakout

The breakout begins when the previous support and resistance levels fail to hold. New money comes into the market in the form of breakout and trend traders. The balloon has finally found a way out of the room is breaking out to the upside (a breakout can also be to the downside but for example's sake we are going to adhere to the laws of physics). The balloon has left its level of congestion and is now moving upward. If we think of a chart, we can imagine that the chart has been trading between a level of support and resistance and is now moving in the upward direction past the level of resistance.

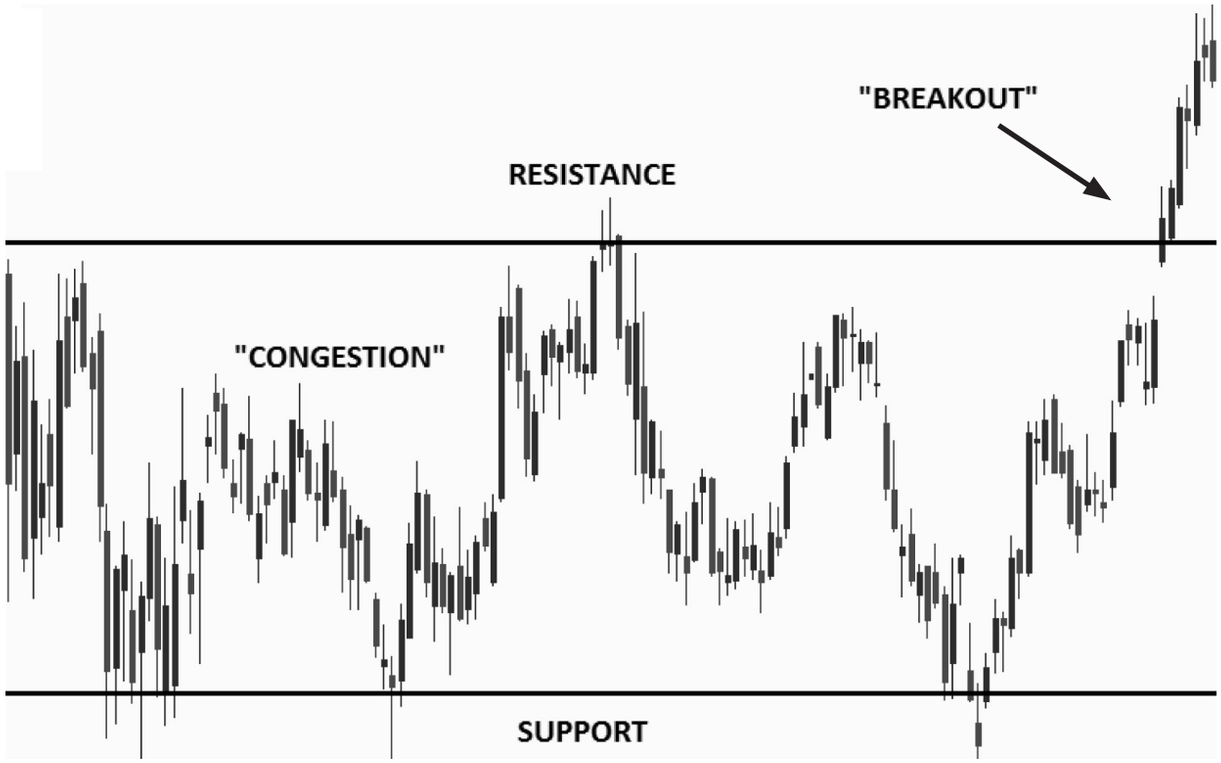


Figure 4.4 Breakout

The classic breakout formation is the result of two dynamics: either the strong hands will be willing to pay a higher/sell a lower price, and will control the market, or the 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. Figure 4.5 shows a false breakout to the upside. After the high was made, the market reversed and made a series of lower highs and lower lows. Price eventually rallied back into the congestion phase and broke out to the trend on the downside when the double bottom failed to hold.

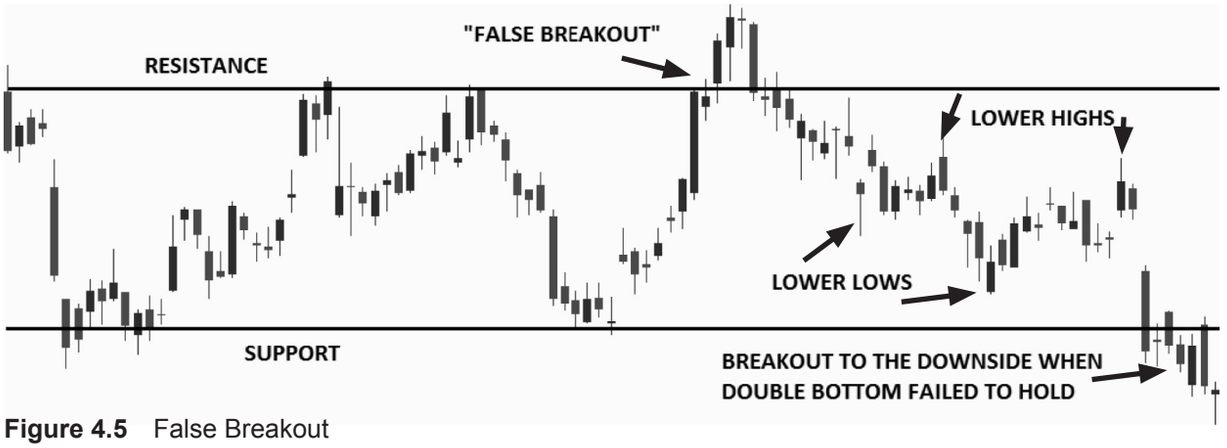


Figure 4.5 False Breakout

When we see a real breakout, the strong hands begin to control the market (in whichever direction the breakout is occurring). Prices move beyond the pre-defined congestion range. Breakouts might begin with a sudden burst of price, or it may be gradual. In the breakout 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's breaking) it will make **lower lows**. The chart below represents a breakout to the trend. We have a level of congestion in an uptrending market, and the market eventually breaks out to the trend, being controlled by the strong hands.

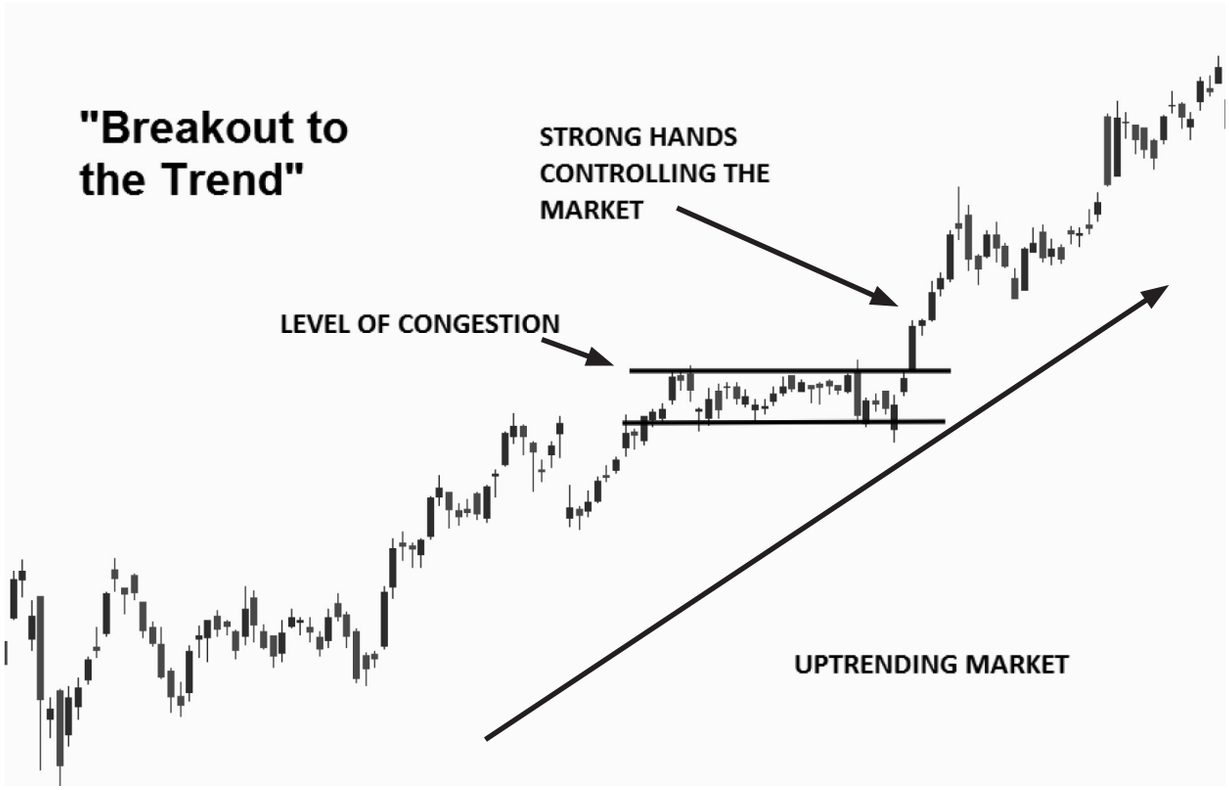


Figure 4.6 Breakout to the Trend

The breakout may be suddenly extremely volatile, or orderly in its move. Like congestion, the length of time it will stay in this phase is impossible to determine. A breakout to the downside is a mirror image of a breakout to the upside, the chart below is a great example.

Figure 4.7 Breakout to the Trend

One thing is certain, a market that is breaking out 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/seller to join the party.

Now, all of the players are convinced that the strong hands are correct and the weak hands will be run over and the market will go into its final phase: the blowoff. The blowoff is the final phase of the price cycle. This formation is the classic “panic.”

Blowoff

Let's go back to the balloon example. There is a point in every chart (or market) when the balloon will reach the third phase of the market which is a blowoff. The balloon has been traveling upward for too long and will eventually pop and spiral downward (this is a blowoff to the downside, but like each previous example this can happen to the upside as well). A blowoff to the downside happens when the market finds a top which we call a major level of resistance and starts breaking down without a level of support in sight. We have all seen a balloon pop before and know that when it pops, all of the air starts to rapidly escape the balloon. The balloon will ultimately fall to the ground, but not before it has minor upswings with the air inside of it blowing in all different directions. When a market hits its top, it does not just go straight down as there will be some minor up movements. But if we look at a chart a couple weeks after a blowoff, we will see that it bottoms out to a new floor (or ceiling) just like the balloon would if we were to pop it in mid-air.

Figure 4.8 Blowoff to the Downside

The same principles apply when we have a blowoff to the upside. The market will not go straight up; there will be a few minor down movements. Then, like magic, the market will find a top and begin the cycle over again!

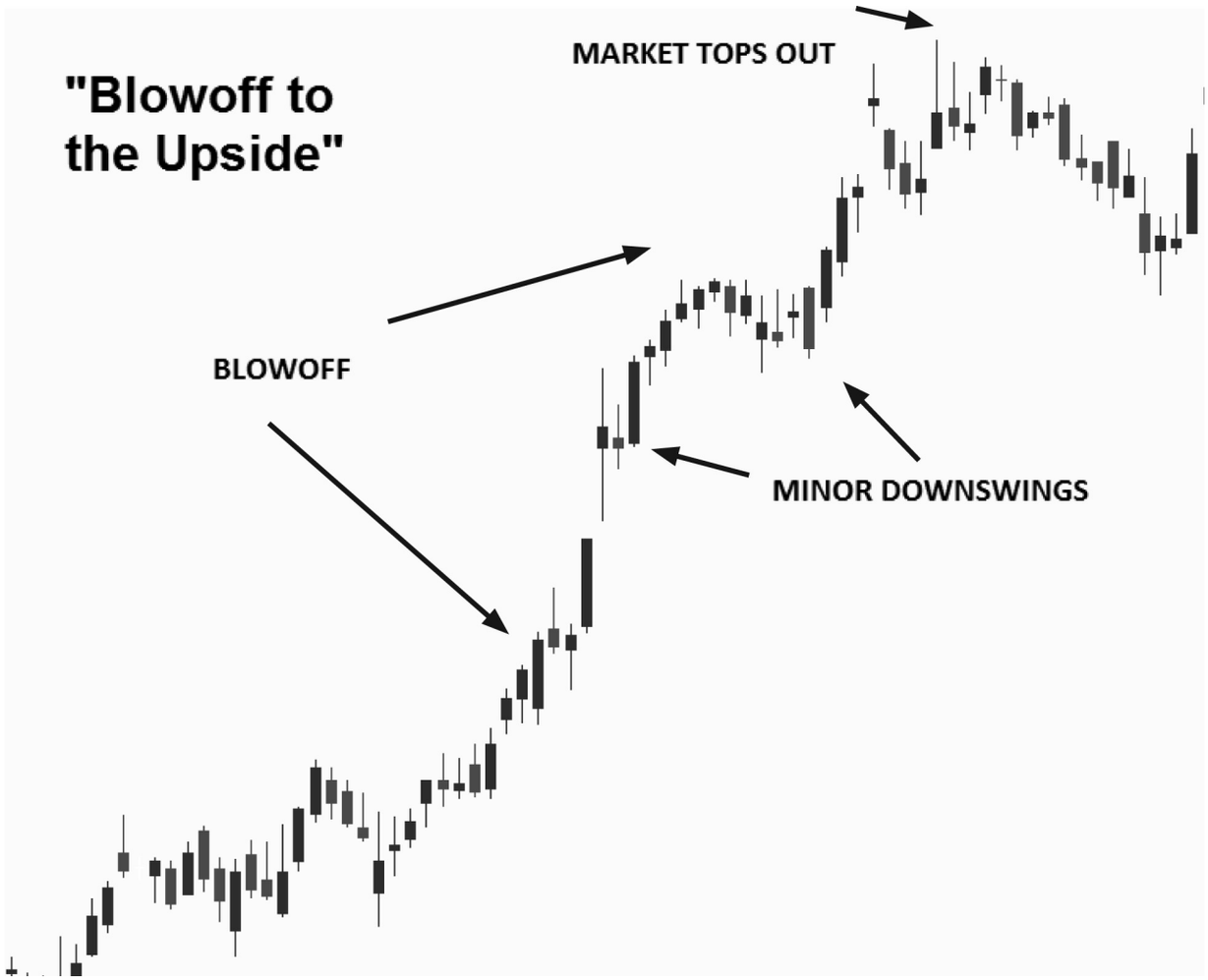


Figure 4.9 Blowoff to the Upside

The blowoff can be caused by a couple of factors. In the first case, so much wealth has been transferred to the strong hands that they will continue to press their advantage. They are the gust of air that is causing the balloon to fall through ground or fly through the ceiling and they are in control. In the second case, the weak hands will be experiencing any combinations 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. They are being squeezed to the limit.** The weak hands will become insensitive to price, and the only thing they are concerned with is ending their pain.

This price insensitivity will cause a massive liquidation of positions referred to colorfully in the business as **"puking."** 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. To best illustrate the concept of puking, let's take a look at a chart of DOW ($DJI) during the collapse of 2008.

Figure 4.10 DOW Collapse of 2008

We call it the collapse of 2008, and that's really what it was. The market was essentially in a free-fall for the entire year. When you look at the great market collapses in our history, 2008

stands right next to 1929 and 1987 as the worst we've ever seen. The market lost over 50% of its value in a period of a little over a year. As a trader, and most importantly an American, it's something I will never forget. So many people's lives destroyed, and it all ties back into the first chapter when we talked about the herd mentality. It's almost impossible to stop.

Then a funny thing will happen, almost out of nowhere… **the panic stops**. You can see it in the chart in early 2009. The market bottomed out and was born anew. 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. When 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."**

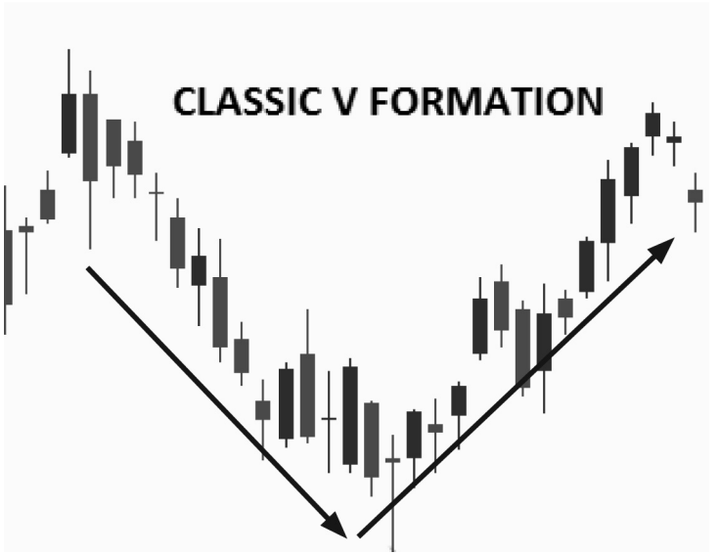


Figure 4.11 V Blowoff Formation

When all the fighting stops, 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."**

Figure 4.12 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 direction, or it could break out to the other side of the market. In either case the congestion will start the market anew.

Figure 4.13 W Formation

Overview of the Three Phases

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, and explosion, and will then begin again. The market will repeat this pattern over and over, knowing when and how to react is the key! Now that we've learned about the three phases, we have to examine the most important relationship of the cycles, the relationship of time and price.

Relationship of Time and Price

I mentioned before how **it is impossible to determine which charts represent a particular asset when the price and time axis are removed**. Almost every chart I've used in this book so far is a testament to that! However, in liquid markets, all time frames that are observed share similar characteristics.

We have learned that charts represent different time frames. Try to put these four charts in the right order from top to bottom, from the shortest to the longest time frame.

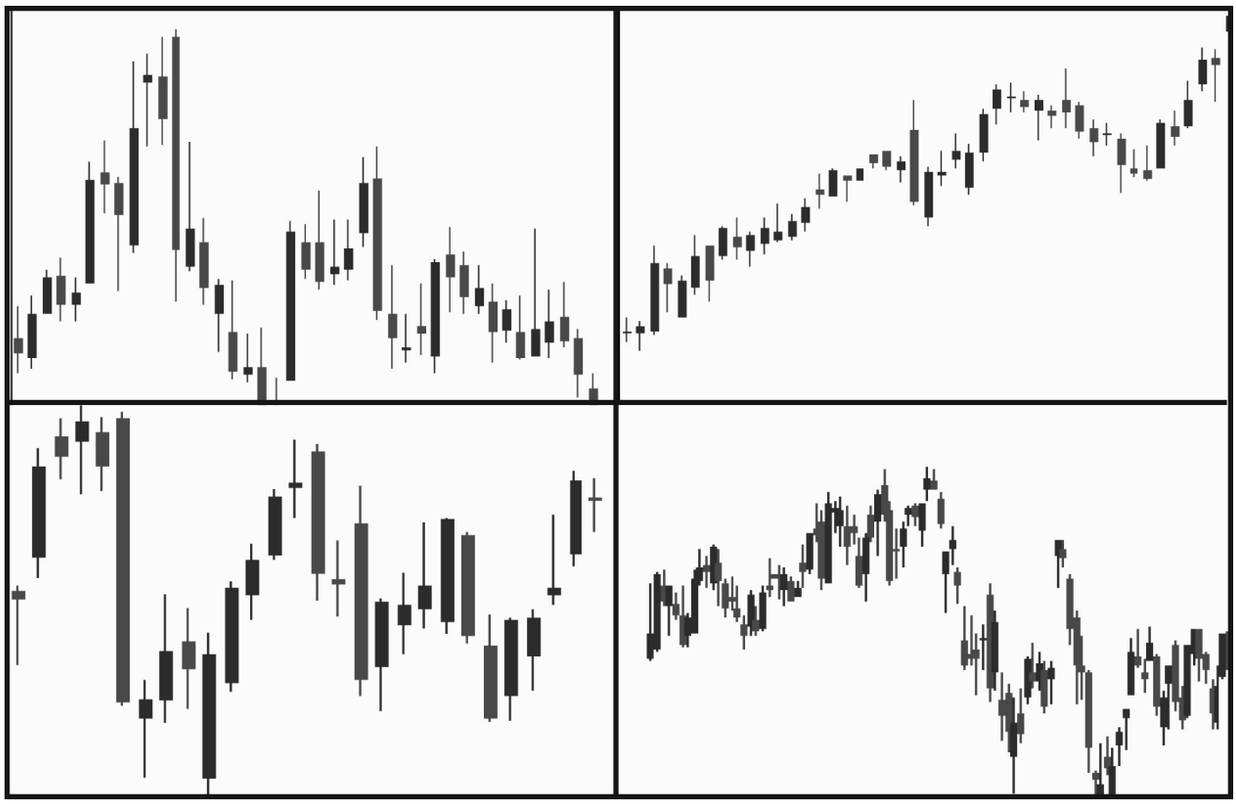


Figure 4.14 Four Charts in Diffferent Time Frames

Stumped? You should be, it is 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. Don't be worried though. Remember when we started to study the market when it was in the choppy condition, in congestion?

At first, when we observed the chart, 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. Look again at the chart below.

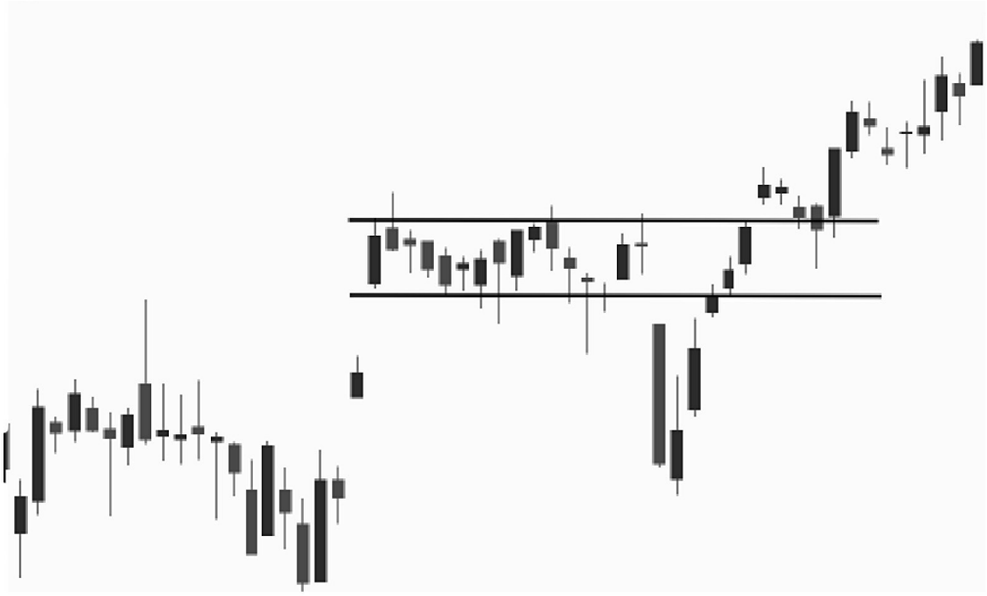


Figure 4.15 Bullish Chart in Longest Time Frame We are Observing

All charts are snapshots. Let's assume this chart is the **DJIA (which it actually is!)** 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 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!** Does this 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 PARTICULAR PERIOD MUST BE!**

One of the most important aspects of price and time when observing charts is this: the sum of all shorter time frames will equal the longest time frame. If the market has been in an uptrend for a year, all of the shorter time frames will also be in an uptrend. If you don't believe me, just look at these four charts below.

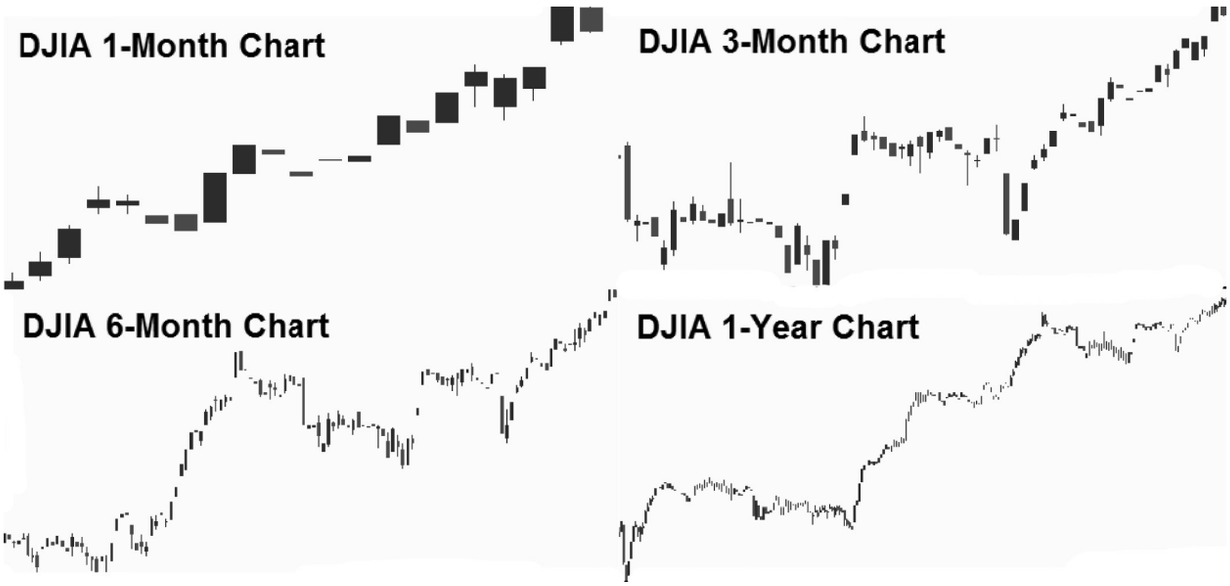


Figure 4-16 Sum of All the Shortest Time Frames Equals the Longest Time Frame

The longest time frame you are observing will always be the guiding chart; the shortest is the execution time frame. Using more than one time frame will always improve your trading, as it gives you an additional market perspective. Picture this example: you are driving into the city of Chicago and need to arrive at the Willis Tower. You finally make your way into the city, but your GPS dies and you are not sure of where the Willis Tower is anymore. You know that you are at most five minutes away, but with no sense of direction what should you do? There are four directions you can choose to go in: north, south, east or west. Can you get to the Willis Tower given your current situation?

The answer is no, but you could get lucky and guess the right direction and wind up running into your destination. As you are deciding what to do, a news helicopter flies overhead. From the pilot's vantage point, he can see that you're just a mere five blocks west of the Willis Tower. But since you are trapped between the confines of all the tall buildings, you can't see how close you are. Look at Figures 4.17 and 4.18. They are the exact same market but with a different perspective. Figure 4.17 has no time and price axis (you in the car). Figure 4.18 shows the same chart from a different point of view (time frame), and it includes the time and price axis labels (the pilot). As you can see, if you were attempt to trade off of Figure 4.17, not only would you have no idea what you are trading, but you would have no idea where you are in the market.

Figure 4-17 Market View with No Perspective

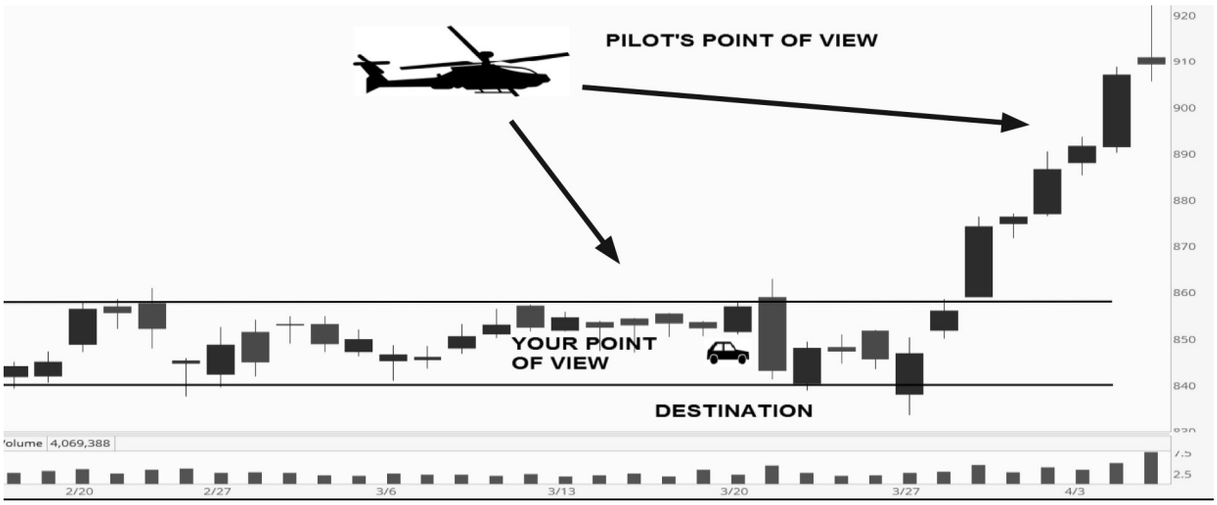


Figure 4-18 Market View with Perspective

Although you had no idea where you were, the pilot could see that you were very close. It's all about perspective! Let's relate these two figures into trading terms. In 4.17, you had no idea where you were in the market. You didn't know price, time, or any levels that you were trying to trade off of. In 4.18, the pilot could see that you were in a level of congestion and had a perfect opportunity to get long the market with the destination being a double bottom! The market then broke out to the upside.

Chapter 5: Options for the Beginner

What is an option?

An option is contract to buy or sell a specific financial product known as the option's underlying instrument. It grants the buyer the right to buy or sell an asset for a specific price and at a specific time in the future. Options refer to a particular class of assets known as derivatives. Options are called derivatives because the option derives its value from something else (stocks/ETFs in our case). Call options give the option to buy at a certain price, so the buyer would want the stock to go up. Put options give the option to sell at a certain price, so the buyer would want the stock to go down. A simple explanation of a derivative (basically the same as above) 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) an options premium declines in value as the expiration date nears.

An option contract is defined by the following elements: type (Put or Call), underlying security, unit of trade (number of shares), strike price and expiration date.

Options Symbology	
Example	Call MSQKO $75 Nov.
Call/Put	Call
Symbol	MSQKO
Nubmer of Shares	1 contract (100 shares)
Strike Price	$75
Expiration Date	November

Figure 5.1 Sample Option Contract for MSQKO

In this chart, we are buying an MSQKO call that expires in November. Remember that this picture is just an example; we could substitute any other stock in for MSQKO. The only difference would be the stock symbol and the strike price.

An important concept to understand is that each contract you buy is like controlling 100 shares of the underlying stock. So if we were to buy 10 contracts, we would control 1000 shares of stock. The expiration date can play a role in this option trade if we hold our option until expiration. Options trade just like stocks, so if we buy a call option on MSQKO, we can sell it at any time before the expiration date. However, if we do hold our option until expiration, we will

have the right to buy the stock at $75. If the stock has risen to $80, then of course we would choose to buy the stock at 75$ because we would be making profit. If the stock has fallen to $70 at expiration, then we would choose to let our option expire worthless because we would be gaining no value by exercising our right to buy the stock. We would only lose the premium we paid for the option if we decide to let it expire worthless. This is one of the main differences between buying stocks and options. We can control much larger amounts of stock with options for a lot less cost.

Volatility

Volatility is a critical concept to understand when trading weekly options and just options in general. The volatility in the market place can give us a lot of information regarding how we should be trading options. So many people trade options without evaluating the true market value of the options they are trading. This is a peculiar phenomenon because these people would not approach buying a home or a car without looking at the fair market price of these assets. Too often, greed and haste prevent traders from making a more careful assessment.

Unfortunately for many option traders, the expected move of the underlying may already be priced into the option's value. Indeed, many traders sorely discover that when the underlying makes the anticipated move, the option's price might decline rather than increase. To understand how this works, we must understand volatility. Volatility is a measure of the rate and magnitude of the change of prices (up or down) of the underlying. If volatility is high, the premium on the option will be relatively high, and vice versa. The best way to understand volatility in its most basic form is to compare two stocks, priced relatively similar, with two completely different volatility spectrums.

Let's compare Coca-Cola Co. (KO) and Ambarella Inc. (AMBA). Now we've all heard of Coca-Cola. They've been around for over 100 years and are one of the most iconic companies in the world. Now ask yourself, what are the chances of Coke, or one its competitors (Pepsi?) making an earth shattering announcement that will drastically affect the price of Coke's stock? Not very high right? That's correct. Now if we look at AMBA, a developer of low-power, high definition compression and image processing products, you'll notice a difference in the two markets that these companies are competing in. AMBA has been around a little over 10 years, and has been very successful. But by reading the description, you can already tell that the market AMBA operates in faces a lot more competition than Coke does in its own market. Qualcomm and GoPro are just two examples. GoPro effectively dominates the wearable camera segment that's causing AMBA a lot of grief right now. Chip supplier Qualcomm is hitting AMBA from the other side of the market as of late in higher-end products, but also from high-volume, low-priced chip providers. All this information is great. But how does it relate to options? Look at the two figures below:

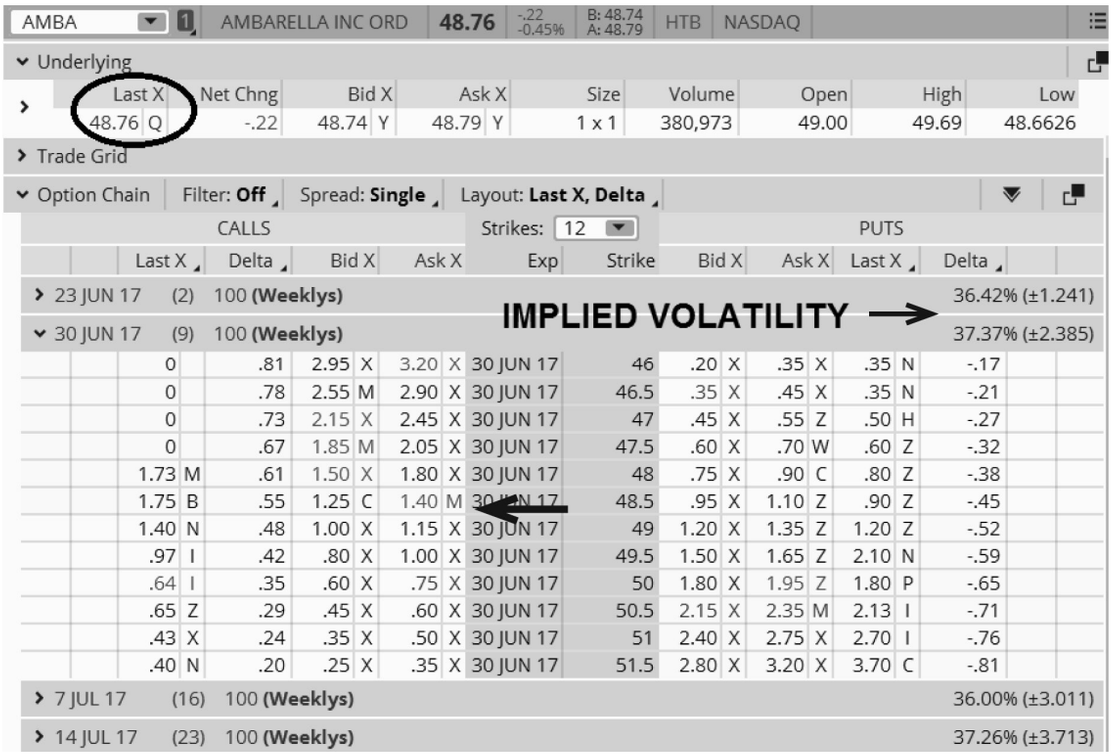


Figure 5.2 KO Weeklys Option Chain

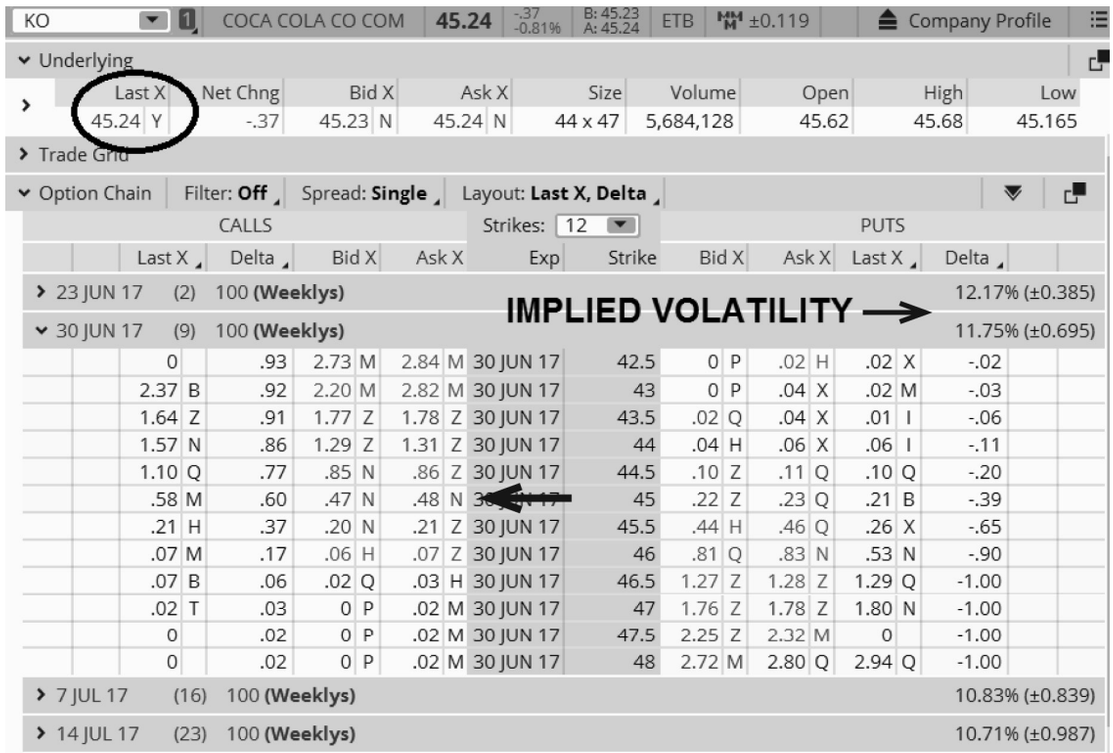


Figure 5.2 AMBA Weeklys Option Chain

I have the current price (Last X) of both KO and AMBA circled. They are pretty similar. KO is trading at $45.24 and AMBA is trading at $48.76. The first thing I want you to notice is the difference in implied volatility in both stocks. Pretty big difference right? The exact reasons I mentioned above are the reason for the difference. AMBA has a much bigger expected move in the near future compared to KO. The third and final piece of the puzzle is how this affects option prices. Look at the ATM calls for both stocks (45 in KO and 48.50 in AMBA). If I wanted to buy one ATM JUN 30 call in KO right now expiring in 9 days, I could pay $0.48. If I wanted to take the exact same position in AMBA and buy one ATM JUN 30 call expiring in 9days, I would have to pay $1.40! **That's almost three times as much for two stocks that are basically at the same price.** The implied volatility is reflected in premium I would have to pay for both options. Don't worry about the rest of the numbers on the screen; we'll break down the option chain in more depth in chapter 8.

There are two types of volatility, historical and implied. Historical volatility (also known as statistical volatility) is the actual measure of the volatility of the underlying for its entire existence. Historical volatility is constantly compared with implied volatility to determine if options prices are over- or undervalued.

Now what is implied volatility? IV is the estimated volatility of an option's price. In general, implied volatility increases when the market is bearish and decreases when the market is bullish. The more volatile an option is, the faster the underlying stock price moves up or down, and the same goes for the price of the option. Why? A volatile stock has a better chance of hitting the strike price than a stock that moves 5 cents a day. But, keep in mind that this attribute is already built-into the price of option. You only benefit if the stock becomes more volatile than expected during the options period (term).

What if we just want to know if options as a whole are generally more expensive or less expensive than usual? There is a perfect tool for this and it is called the VIX index. The VIX measures how expensive the options on the S&P 500 stock index are. When investors are fearful, and markets are bearish, VIX will rise. When fear recedes, VIX declines. However, long-term low levels of the VIX have been associated with bull markets, where VIX at extreme lows signaled a major market advance, as seen in Figure 5.4. In 1994 and 2004, VIX remained below 20 and the market developed significant bullish trends.

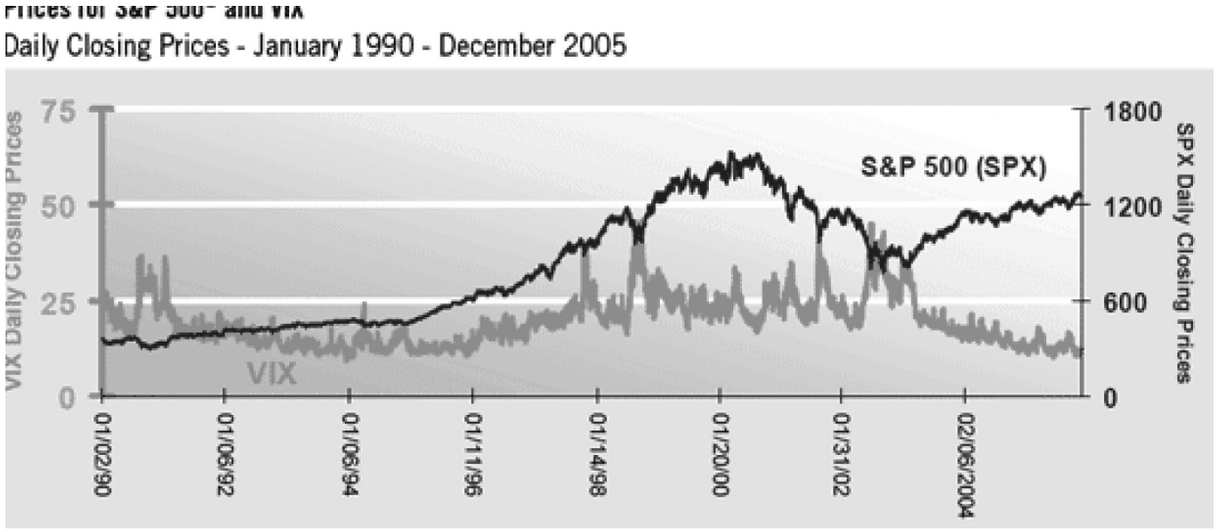


Figure 5.4 Comparing S&P 500 and VIX

Here's a different, somewhat divergent perspective on options. 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. However, if you were to purchase life insurance for a 75-year-old that smokes and has a history of heart disease, the premium would be huge. The reason is obvious; there is much more uncertainty on whether this individual will live 20 or 30 years more, which is why the premium is so high (think back to KO and AMBA).

Look at premium as a value associated with the 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.

INCREASED VOLATILITY = INCREASED PREMIUM PRICING

Although almost any asset class can be the underlying in an option contract, stocks, bonds, real estate, precious metals, foodstuff, **we are only going to trade weekly options on asset groups that are listed on major exchanges, and meet our liquidity criteria.**

I am going to give you some essential terms you must master before you can attempt to trade. This chapter will deal with essential vocabulary and a complete glossary of terms is included in the back of the book. Once you master the vocabulary, you will be prepared to learn how the option model functions.

Basic Option Glossary

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

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 asset.

ASSIGNMENT - The obligation an option writer has to deliver the underlying asset at the specific price and time. If it is a call, the writer must sell the buyer the underlying asset at the specific strike called for in the contract. If it is a put, the writer must buy from the buyer the asset at a specific price called for in the contract.

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.

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.

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).

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

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.

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.

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.

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.

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.

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

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.

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".

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.

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.

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.

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.

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).

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

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.

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.

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.

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.

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.

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.

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.

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).

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.

Working Option Vocabulary

The previous list detailed some terms you will need to be aware of when trading weekly options, but this next section of vocab details the terms in the order that you will need to know in order to start trading (some are the same, and some are new).

EXPIRATION - The date on which an option contract is terminated.

SERIAL - The specific group of options that have the same expiration date.

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.

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.

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). For example, if you were to buy the FB October 2017 140 call, you have the right to exercise the underlying stock any time before the third Friday of October 2017. Buying a call always gives you unlimited reward, with limited risk.

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). For example, if you were to buy the FB October 2017 140 put, you would have the right to sell the underlying stock any time before the third Friday of October 2017. Buying a put always gives you unlimited reward (to zero) with limited risk.

BID-ASK PRICE - This is the price that you would be charged to buy or sell the option. If you want to buy the option, generally you must pay the asking price and if you want to sell you must hit the bid. The SPREAD between these prices determines if the option is liquid. If the spread is too large, it is much harder to overcome commissions.

AT-THE-MONEY STRIKE (ATM) - The strike price nearest to where the underlying stock is currently trading. It will always have the most premium. It is also the most liquid.

IN-THE-MONEY OPTION (ITM) - An option that if the current market price were to hold would have value after expiration.

IRON CONDOR (IC) - Two vertical credit spreads made up of a put and call spread. One must end up in the money, and both can end up out of the money if the price expires in between the short strikes.

OUT-OF-THE-MONEY OPTION (OTM) - An option, which if the current market price were to hold would have no value after expiration.

PREMIUM (AIR) - The supply and demand for a specific option.

DELTA - The percentage chance of the option to expire in the money with current market price. If the option were currently at the money, it would have a 50 percent chance of expiring in the money, as it has no intrinsic value. It would therefore have a 50 delta.

GAMMA - The rate at which an options delta would change as price moves away from the (ATM) strike. Generally speaking, at the money will change the fastest as price moves.

VEGA - Is the amount of premium “air” in the option at any point in time. It is the supply and demand for the option. Generally speaking, deferred options have more VEGA, as there is more time to expiration and therefore more uncertainty.

THETA (TIME DECAY) - The loss of premium “air” as time to expiration grows nearer.

LONG - The buyer of an option. Longs have limited risk and unlimited reward.

SHORT - The seller or writer of an option. Shorts have unlimited risk and limited reward.

ASSIGNMENT - The obligation of an option writer has to deliver the underlying asset at the specific price and time. If it is a call, the writer must sell the buyer the underlying asset at the specific strike called for in the contract. If it is a put, the writer must buy from the buyer the asset at a specific strike price called for in the contract.

EXERCISE - The act by which the holder of an option exercises the right to buy or sell the underlying asset at the designated strike price.

VERTICAL SPREADS (CREDIT SPREADS) - Allows the seller to take advantage of time decay and price movement without unlimited risk.

60/40 CREDIT SPREAD - A directional vertical credit spread that is created on a Vega neutral basis. It is initiated by selling one option that is slightly in the money and buying one that is slightly out of the money.

RISK REVERSALS / SYNTHETIC LONG / SHORT - These allow a trader to take a directional position in the market with limited risk and unlimited reward.

BACK SPREAD - Selling an option closer to the at the money strike and buying two at a strike further away from the at the money.

RISING/FALLING VOLATILITY ENVIRONMENT - The implied volatility of the VIX in relation to the current market. If the VIX is rising above its 60-period moving average, it is a *rising volatility* environment. If it is below its 60-period moving average, it is a *declining volatility* market.

Like I mentioned before, these terms are very important. They will be the stepping stones you will use to master trading weekly options.

Chapter 6: Options and Similar Mathematical Games

In this chapter I will introduce the option model for you. 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.**

The first mathematical model used to create options was introduced by Fischer Black and Myron Scholes in 1973, and from that the Black-Scholes Model was born. The math behind the model is very complicated, but it essentially describes a bell-shaped curve.

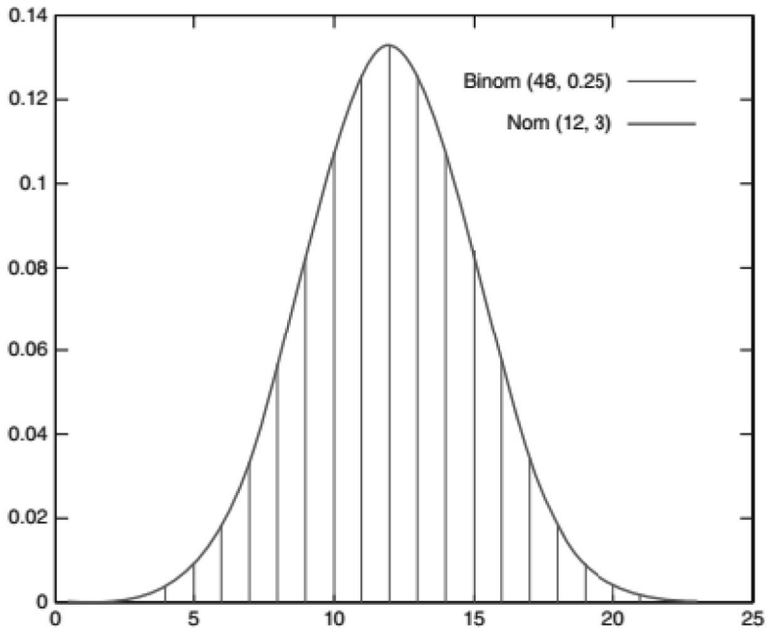


Figure 6.1 Black-Scholes Options Curve

In a bell curve, the highest degree of uncertainty exists at the current market price. The ATM calls and puts each have a 50 percent chance of being in the money at expiration. The uncertainty will decrease as price moves higher or lower from the current price. As options go deeper ITM, the probability that they will end up with a 1.00 delta continues to increase until it reaches a point at which there is no premium left in the option. That price is referred to as **parity**. As options go further OTM, they reach a point at which they no longer react to the

underlying asset. In this case, their delta reaches zero and a maximum loss is established. This option is now classified as a **teenie**, and it will have a value of $1. It can have the opposite effect of the 1.00 delta option if price were to suddenly change direction. This option will begin to pick up deltas, and if the price moves far enough to the other side of the model it could reach a delta of 1.00, it then could be substituted for the underlying asset again.

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 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. An option's absolute value (price) at all strikes would be higher the longer time to expiration or the higher the volatility (more "air"). Think about KO vs. AMBA! **Option pricing is based on the strike price, time to expiration, and volatility of the underlying asset**.

If you have ever played a game involving chance, you've been exposed to options in some sense. The option game involves a combination of luck and skill that you can find in many popular games such as poker, backgammon, blackjack, and craps.

Pat McCauley, former head of the Susquehanna trader-development program, perfectly describes what trading options and playing poker have in common. He says that "what professional poker players are really good at is taking this information that's relatively subjective, quantifying it and making it objective, and that's what trading is about." In poker, as the hand moves closer to being played out, more information is revealed. Our opponent's play gives us information (or disinformation!) as to what lies beneath the hidden cards. A single card can completely change the delta of your hand in the terms that we used to describe delta earlier. Many unskilled poker players (and option traders alike) believe that game is essentially only based on luck. Well, in the short run this can be true. An unskilled player can get lucky and beat a superior opponent in any given hand. But, in the long run, a more skilled opponent will make more correct decisions over time and come out on top.

Just like you have very limited information in poker until the hands gets played out, the same goes for trading options. You have the current value of the stock and option prices, but

no real idea of what the market will do next. With partial information, the way to put yourself in a position to win is by using the information provided to your advantage. Can we pick out the perfect double bottom in an uptrending market and have a trade not go our way? Of course we can. But just like a professional poker player will not win every hand that he is a part of, we will not make winning trades every single time we put a trade on. However, if we put ourselves in the right position, we will win in the long run. And that is what the "game" is all about.

Backgammon is another game involving mathematics in which two players move their pieces around twenty-four triangular points according to the throw of dice, the winner being the first to remove all their pieces from the board. It differs from poker because you can see your opponent's position in advance of your turn, but it still involves a ton of strategy similar to the strategy we use when trading options. There are 36 possible combinations of dice, so your position can go from a near 1.00 delta of winning to an almost zero delta with one throw of the dice. I'm obviously not going to get into backgammon strategy in this book, but it's important to note the similarities to our trading. Just like trading options, you must have a plan. Are you running, priming/roadblocking or are you playing an intentional back game? You need to review your plan prior to making your move – does your roll help or hinder what you are doing. Did your trade look suddenly different from its planned start? These are all questions we must ask ourselves when playing games of probability, and specifically trading options. The key is still that the better player will win in the long run. No matter how much bad fortune they run into, if they stick to their plan and stay confident and emotionless in regards to how they play the game, they will be successful.

Blackjack is similar to poker in the sense that some of the cards used are known to the players, and one card is unknown, the dealer's whole card. Every player is playing against the dealer himself, and players (are supposed to!) make decisions according to the mathematical probabilities of the game. Most people know the basic rules of the game; if the dealer is showing a 10 and you don't have 17, you should hit! Although this is the most basic facet of the game, there are many more decisions that you will be forced to make at the blackjack table when it comes to different combinations of cards. Very skilled players can possibly beat the house if the rules are slightly in their favor and they have the ability to "count the deck" (like Dustin Hoffman *Rainman*, or Zack Galifianakis in *The Hangover*), but this is no easy task. The unskilled player has no chance to beat the house's edge in the long run, but can get a phenomenal hot streak and win for brief periods of time. Again, we are brought back to the concept of delta. So much can change when the dealer's hole card is revealed! That single card can send your hand from a very high delta to zero, which I'm sure we've all seen before.

Craps is another very popular casino game, and just like backgammon, all of the information is revealed to the player. Like blackjack, each individual player is playing by himself against the house, although each person around the table gets to roll the dice. Just like all these games of chance, a single throw of the dice can change a player's delta on a bet from very high to zero. Craps can yield some crazy winning streaks, but the opposite can also happen. If the roll gets hot, a player can add odds to the flat bets and get a true odds payout if the numbers repeat. What's the common thread between blackjack and craps you might ask? The house **always** has the edge.

We've observed four games so far: poker, backgammon, blackjack, and craps. The first two games are examples of **favorable games**. They require skill, and this means that in the long run, the players with more skill will win. The games played against the casino are **unfavorable games** because no amount of skill can overcome the casino's edge in the long run.

When we trade options, we want to be the skilled poker player or the skilled backgammon player – or better yet, we want to be the casino! I will teach you trades that give you an edge in the market, but that doesn't mean every trade you have an edge in will produce a winner. To be a good trader, you must learn how to take the losses that come along with the wins.

Chapter 7: How to Read the Option Chain

Before we make any trades, we must familiarize ourselves with the option chain and understand how it works. The option model expands in all directions. The greatest volume of air (Vega) in the model will be at the spot that has the least degree of certainty, which will be the at-the-money strike (ATM). As we move further away from the ATM strike in either direction, the uncertainty will become less, and we will have more information to make our decision. The ATM option has no intrinsic value, and therefore it is all air. The more air that is pumped into the ATM, the more that spills into other parts of balloon, or other strike prices.

The standard definition of an option chain is simply a listing of all the put and call option strike prices along with their premiums for a given maturity period. We briefly went over what a call option was in a previous chapter, but let's make it a little clearer. When you buy a call option, you are a betting that a stock will go up. Here are three important components that affect the price of an option.

Strike Price – the price at which you are allowed to buy (call) or sell (put) the stock
Time to Expiration – the time remaining before the option expires
Implied Volatility – Estimated volatility of a security's price

The Option Life Cycle

Let's look at some examples. For simplicity's sake we are going to use one underlying asset for the remainder of this chapter. 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 Facebook as our illustration. Facebook 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 150, making the 150 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 $5 increments. The second curve shows 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!**

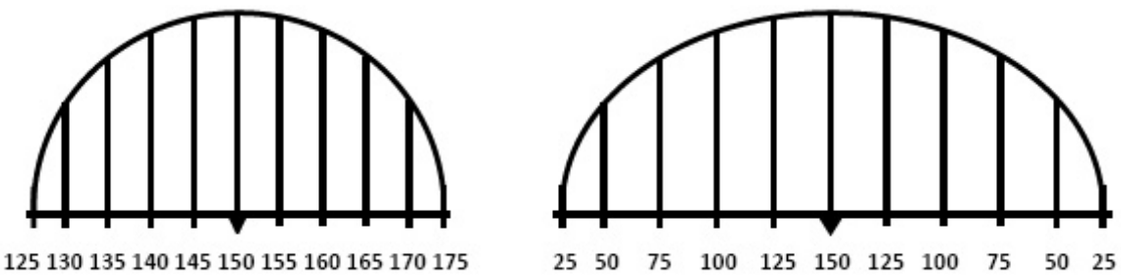


Figure 7.1 Illustration of Option Prices

Now let's look at a tabular representation of our example. Here, we've added volatility increases: 10, 20 and 40%. This is a very clear example, but the concept is clear. Do you recognize the concepts discussed? As the volatility expands for the ATM, it flows over to the strike prices (Again, KO and AMBA!). This makes logical sense as the **"at the money option contract has no intrinsic value, <u>it is all premium</u>".**

	Strike Price					ATM					
	125	**130**	**135**	**140**	**145**	**150**	**155**	**160**	**165**	**170**	**175**
VOL	**P**	**P**	**P**	**P**	**P**	**P/C**	**C**	**C**	**C**	**C**	**C**
10%	125	130	135	140	145	150	145	140	135	130	125
20%	250	260	270	280	290	300	290	280	270	260	250
40%	500	520	540	560	580	600	580	560	540	520	500

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

Figure 7.2 Expanding Volatility (10%, 20%, 40%)

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 curve functions until buyers are no longer willing to pay any premium for a given strike price. Traditionally, when the buyer will pay on the minimum "tick size", that option is referred to as a **"teenie"**.

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 C~~ORRELATES~~ 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, or the extrinsic value of an option at expiration will terminate.

We talked about the relationship of time and price before, and how they are linked in any market. 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 Facebook 150 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, and the balloon deflates.**

		Strike Price					ATM				
		P	P	P	P	P	P/C	C	C	C	C
VOL	Days	125	130	135	140	145	150	155	160	165	170
40%	30	250	260	270	280	290	300	290	280	270	260
40%	60	375	390	405	420	435	450	435	420	405	390
40%	90	500	520	540	560	580	600	580	560	540	520

Figure 7.3 Decreasing Premium across Days Until Expiration

What we have detailed in this lesson is essentially the **LIFE CYCLE** of an option. Understanding the life cycle is key to reading the option chain. 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!

The Option Chain

This information is great, but let's see what it looks like on a trading screen. (Insert FB trading screen with option chain)

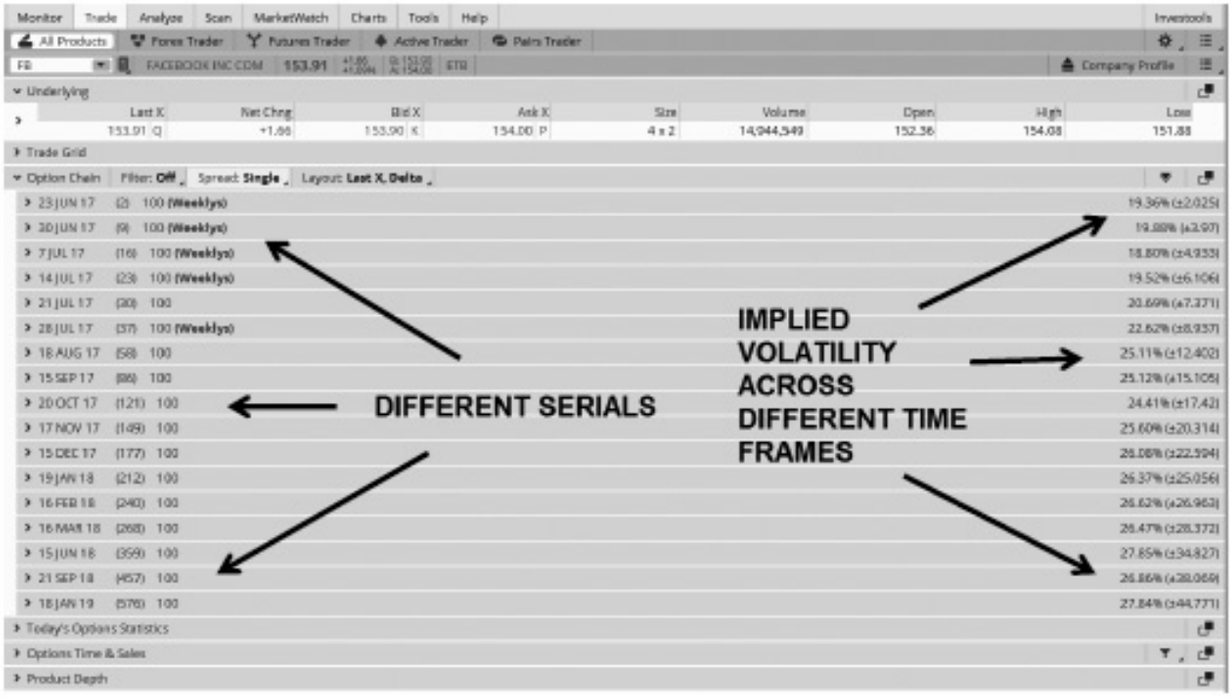


Figure 7.4 Facebook Trading Screen

As you can see, we are looking under the trade tab, and we are looking at the trading screen for Facebook (FB). Instead of looking at the underlying (stock), we are now going to focus on the option chain. There are so many different categories to choose from (23 JUN 17, 30 JUN 17, 7 JUL 17, 14 JUL 17, 21 JUL 17, etc.) so how do we know which one to choose? Think about the title of the book! We're to focus on the "Weeklys" option categories and more specifically the category with the closest expiration to a week. In 7.4, that would be the 30 JUN 17 option chain which has 9 days until expiration.

We can tell how close the option chain is to expiration by looking at the number in parentheses. The 23 JUN 17 Weeklys expire in 2 days, while the 15 SEP 17 chain expires in 86 days. All options expire on Friday! So what day is 7.4 representing? The answer is Wednesday, and you can figure this out by seeing that the 23 JUN 17 Weeklys expire in 2 days. Let's click the black arrow next to the 30 JUN 17 Weeklys chain and see what happens.

Figure 7.5 FB 30 JUN 17 Weekly Option Chain

Wow! Those are a lot of numbers to look at. But let's take this one step at a time to find out what this screen is really telling us. What do we know so far? We know that this screen is showing an option chain for FB for the 30 JUN 17 Weeklys. Because FB is trading at 153.91, we could consider either the 152.5 strike or the 155 strike the **"ATM"** strike. Don't get hung up on the pricing of a stock if it's not **EXACTLY** in line with any particular option strike. All of the other chains are still on the screen, this is just the only one expanded right now. Right above the 23 JUN 17 chain, there are four categories, Last X, Delta, Bid X, and Ask X (you can customize these categories however you want, it's all personal preference). Above those four categories is the call bar! This is telling us that we are looking at the call side of the 30 JUN 17 FB options rather than the put side (which is located on the other side of the screen.) Here's a brief explanation of the four categories:

Last X: This is the last traded price of the option at that current strike price
Delta: Measures the rate of change in an option's theoretical value for a one-unit change in the underlying.
Bid X: The "bid" price is the latest price offered by a market maker to buy a particular option
Ask X: The "ask" price is the latest price offered by a market maker to sell a particular option

There are still a few more very important things to learn about option chains. If you look to the middle of the screen, you will see **"30 JUN 17"** twelve times in the column. If you look directly to the right of each 30 JUN 17, you will see a number starting with 146 and ending with 167.5. These numbers are

the strike prices! If we look to the top of the screen, we can see that FB is currently trading at 153.91. If we then look at the call chain again, we'll see that half numbers are highlighted in yellow. Does the stock price of FB have to do with half of these numbers being yellow? Absolutely. The numbers that are highlighted in yellow correlate to the strike prices that are in the money for this particular chain. For a call option, when the option's strike price is below the market price of the underlying asset it is considered **in the money**. If the strike price is above the market price it is considered **out of the money**. Take a look at the call chain again. The 30 JUN 17 152.5 strike option is highlighted in yellow because 152.5 is below the market price of 153.91. The 30 JUN 17 155 option is not highlighted because 155 is above the market price of 153.91!

Greeks

My weekly options trading system does not emphasize the "Greeks" because I can present the system to you in a form that can be easily understood, and is user friendly. We also have enough knowledge of the mathematical calculation in the option model to be able to incorporate them into our trading system. However, as complicated as the terms may sound, I want to simplify them for you so that you can gain a better understanding of them.

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 is against 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 0.5%, and a stock's Beta is 1.0, the stock price should move by 0.5%. If a stock has a Beta of 2.0, and the **S&P** rose 0.5%, the stock should rise 1.0% (2 x 0.5%). When people speak of "High Beta" stocks, they are referring to stocks that tend to move more than 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 that 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 call and puts have positive Gamma, short calls and put have negative Gamma. Positive Gamma refers to the fact that the Delta of long call 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 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 that the option price increases when volatility increases. Negative Vega means that the option price decreases when volatility increases.

Chapter 8: Weekly Option Trading Strategies

We have all the information we need when it comes to **understanding** weekly options. Now we need to implement strategies to start trading them! There are a few key strategies I use when trading weekly options. Of course there are thousands of strategies one can use, but limiting yourself to a few choices will allow you to be consistent and confident in the trades you are making. While trading weekly options revolves around a number of conditions, **the most important is your ability to handle risk**. You can be aggressive or conservative as you want, but you must leave your emotions at the door when making trades. Otherwise you will end up in financial ruins, something that undisciplined traders experience because they don't stick to their plan.

The trades I will detail in this chapter all have one thing in common: **They never have unlimited risk**. We will always have the option to exit a trade when we see fit.

We are NEVER Going to Sell Naked Options

Selling (writing naked options) has **unlimited risk**; the reward is limited to the credit we take in. Due to their high degree of risk~~, we are never~~ going to sell naked options. While you can make money selling naked options, eventually you will get caught in a disastrous trade and lose all of the potential profit you made in previous trades.

Our Focus

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 has brought you success in the past.

Second, all successful people are able to react to change. They are flexible in their approach! When a student is having trouble and the teacher notices this, they must know how to adjust their lesson plan. When the prospect has a particular objection, the salesperson must adjust their sales plan. The athlete must adjust their game to overcome the opponent's strengths.

Trading is no different. You will succeed because you will prepare, and react.

Preparation

The first thing we are going to do is establish the **longest** time frame that we are going to watch. I suggest using a time frame **no longer than 250 periods**. Why this number? 250 days is one year's worth of price data. This number is used for **practical** purposes. I personally like to use a 6-month chart to start off because it gives me the information I need to initiate a trade. **The time frame you use for trading is up to you.** When I initiate a trade, I like to have a 6-month chart and a daily chart up side-by-side. I have already identified a level in the 6-month chart, and use the daily chart to initiate a trade when price hits the level I am observing.

Take a look at the two charts of Las Vegas Sands Corp. (LVS) below. We recognize in the longer time frame, the market is bullish. Notice the shortest time frame does not resemble the longest time frame at all. You might be thinking, "Wait, didn't you say before that all the shortest time frames equal the longest time frame?" Almost, but not quite. The **SUM** of all the shortest time frames will always equal the longest time frame. But that doesn't mean that if we break down each individual time frame that we can see something different.

Figure 8.1 (LVS) Two Time Frames Setup

The shortest time frame is in congestion. This is the exact setup we want… LONGEST TIME FRAME IN MOMENTUM, AND THE SHORTEST TIME FRAME IN CONGESTION! Why would we want this setup?

Think back to 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? If the bells are starting to go off, 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.

A final point I want to make on technical analysis is also a very important one. Old **resistance becomes new support, and old support becomes new resistance**. This will be made apparent in the first trade example I'm going to show you.

Option Trades YOU Can Use

There are five strategies we will use when trading weekly options. They are as follows:

- **Outright Purchase of an Option (Call/Put)**
- **The Credit Spread (Bear/Bull Vertical)**
- **The Inside/Outside Credit Spread (60/40 Spread)**
- **The Risk Reversal/Conversion (Synthetic Long/Short Stock)**
- **The Ratio Backspread (1x2)**

For each individual trade, I will show you 3 things: the specific chart I am making the trade off of, the order screen for the trade, and the risk graph detailing your potential profit/loss for the trade. I know we talked about using two time frames for our trades, but for simplicity's sake I am just going to show one 3-month time frame to give you a general idea of what I'm looking at.

Outright Purchase of an Option

This is the most simple and basic strategy we will use when trading weekly options. The buyer of a **call** has the right, but not the obligation, to "call" the stock from the seller at any time prior to expiration at the strike price that is underlying the call. You may sell the call at any time prior to expiration at the market price.

The buyer of a **put** has the right, but not the obligation, to "put the stock" to the seller at any time prior to expiration at the strike price that is underlying the put. You may sell the put at any time prior to expiration at the market price.

The purchase of a call or put always has limited risk and unlimited reward (call only). The maximum you can lose is the debit you paid for the option. A call has unlimited reward to the upside because the stock can technically go as high as it wants. The put has its reward limited to the stock going to zero, but again the loss is limited to the debit you paid if the stock rallies to infinity.

Buying a Call to Open

Your technical analysis has shown you that it's time to get long the Russell 2000 Index (The indexed ETF for the Russell is IWM, and ETFs trade exactly like stocks). We see a double bottom, and now we are going to react.

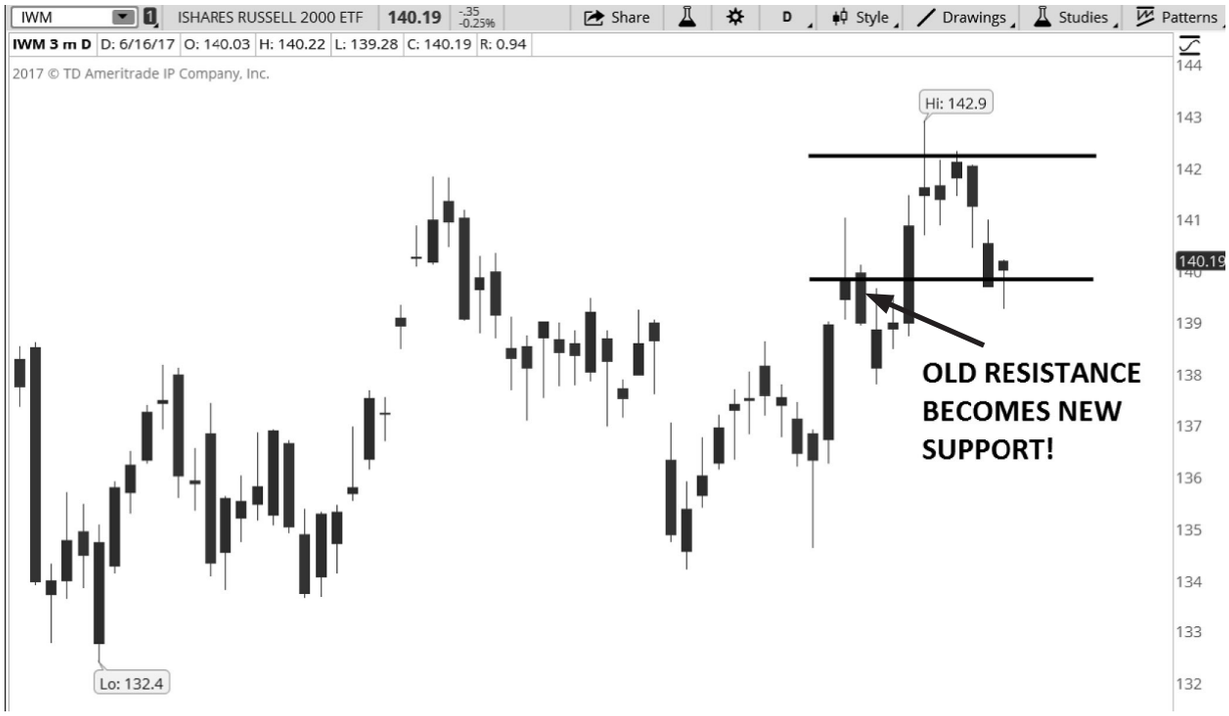


Figure 8.2 IWM 3-Month Chsrt

Now if we take a look at the option chain for IWM, you might be wondering which call option is the right one to buy. **We want to buy as close to the ATM strike as possible!**

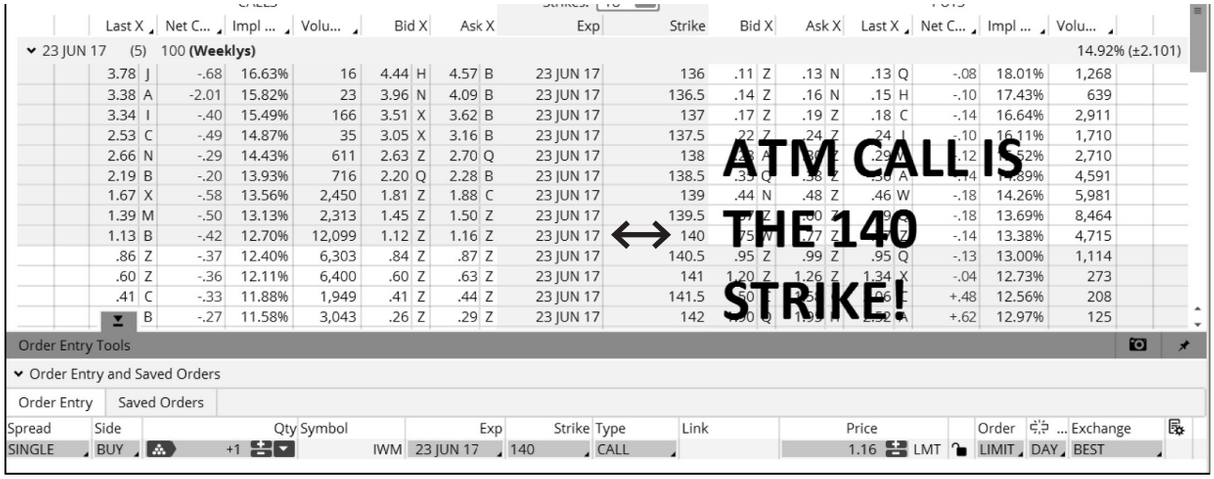


Figure 8.3 Five-Day Option Chain

I was looking at this order screen on a Sunday. How can we tell? Look at the top left corner of the chain. We're looking at the 23 JUN 17 Weeklys expiring in 5 days, and since every option expires on Friday at the market close, it must be a Sunday! These are small details that you will become accustomed to the more you become familiar with options. For example, if it were the Friday before expiration, that (5) would now be a (7).

There is no such thing as the absolute right option, but there is a wrong way to buy. That would be buying "cheap calls" (calls that are very far out of the money). There is no such thing as cheap calls, they are either fairly priced or they are expensive in relation to the ATM calls.

We want to buy as close to the ATM calls as possible! Remember that there is the most air in balloon ATM, and this is where we get the most "bang for our buck." If you buy the ATM call for IWM, you would be buying the 23 JUN 17 140 Strike call for $1.16. The bottom bar gives you all the details of the perspective trade. Our spread is single because we are only buying one option; if we were putting on a credit spread (which we will detail later), **SINGLE** would now read as **VERTICAL.** Our side is **BUY,** because we are buying a call option. Our quantity is **+1,** because we are buying one option. The rest of the information gets into more specifics of the trade, we are buying one call option for the **IWM 23 JUN 17 140 STRIKE**. Remember that you'll be dealing with time decay in any sort of option you trade. We have reacted to our technical analysis, and now price must go in the right direction (up) for us to make money.

How far does price have to go in order for me to make money? The math is very simple, and you can do it in your head! The underlying ATM strike is the 140 and you paid a debit of 1.16. In order to figure your breakeven price at expiration, add the strike to the debit and you have the breakeven price.

140 + 1.16 = 141.16, so the stock must close above 141.16 to break even.

What is your risk? You would think the answer is the $1.16 ($116) that you paid for the call, but this isn't **necessarily correct.** If IWM expires at the current price of around 140.19 your risk is only $0.97, not $1.16 (1.16 – 0.19). We can see all of this information in the risk graph for the trade. (The graph shows a breakeven of 141.14 and a debit of -114.00 because the software uses the mid-price of 1.14 to calculate instead the debit we **actually** paid of 1.16. Don't get lost in the semantics, the concept still remains clear).

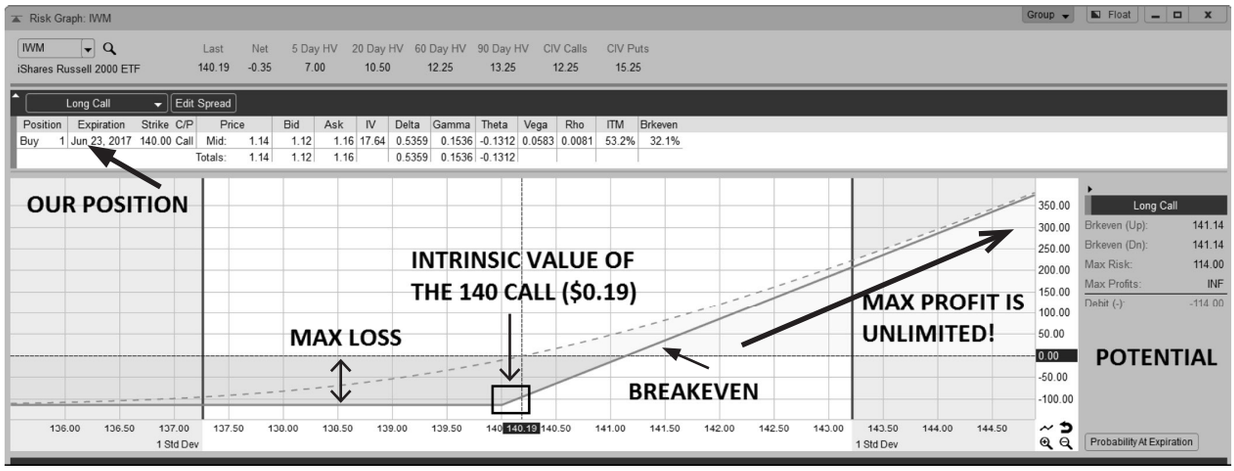


Figure 8.4 IWM 140 Call Risk Graph

How can I know that to be true if I can't see the underlying strike price? When we talked about options pricing, we said that the ATM call and put are all air when the underlying stock is settled exactly on a strike. The amount of air is constant in the strike at all times until expiration. What this means is the premium in the put and call will be constant. Even if the 23 JUN 17 140 call expired today, it would still be worth $0.19, and you can see that in the box on the risk graph.

To figure the premium in any strike, subtract the intrinsic value from the current price and it will give you the premium left in the strike. Both the put and call will have the exact same premium (plus or the minus the bid/offer spread). The 140 strike has an intrinsic value of 0.19 (current stock price is 140.19 minus the strike of 140 equals 0.19). The premium in the 140 strike is 0.97 (1.16 (the ask price) minus 0.19 (intrinsic value) equals 0.97).

I mentioned before how we get the most bang for our buck when we stay **ATM. The ATM strike has most air in the balloon, premium, or "time value" compared to any other strike.** Let me show you what I'm talking about.

23 JUN 17 CALLS on IWM (last price $140.19)

Strike Price	Price	Intr. Value	Time Value
$138.50	$2.28	$1.69	$0.59
$139.00	$1.88	$1.19	$0.69
$139.50	$1.50	$0.69	$0.81
$140.00	$1.16	$0.19	$0.97
$140.50	$0.87	$0.00	$0.87
$141.00	$0.63	$0.00	$0.63
$141.50	$0.44	$0.00	$0.44

ATM STRIKE → $140.00

$0.97 ← MOST PREMIUM!

Figure 8.5 IWM Premium Chart

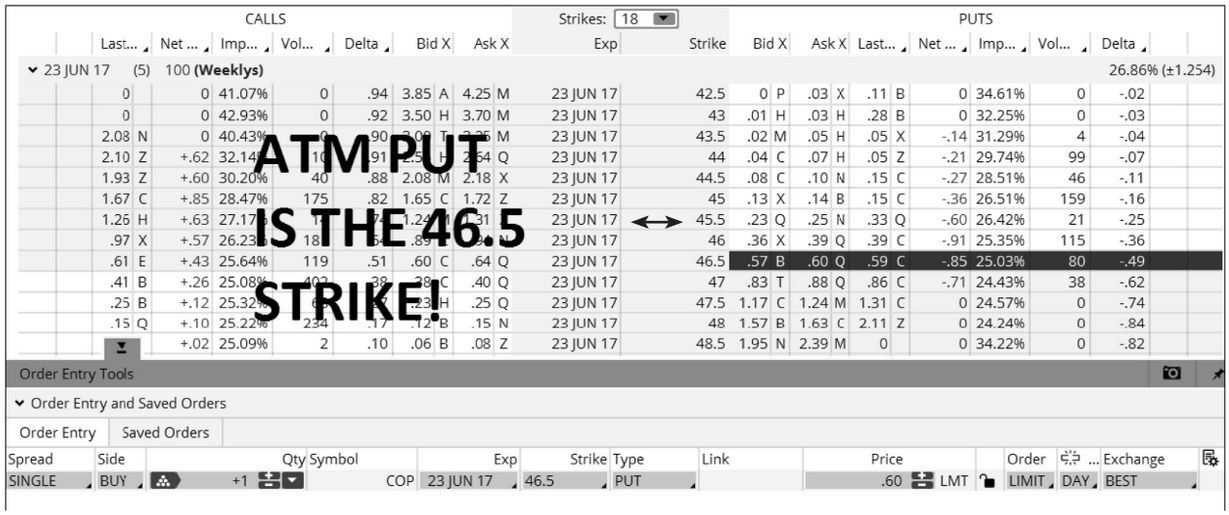
Remember than you can sell the call back that you purchased any time before expiration.

Buying a Put to Open

Buying a put is the mirror image of buying the call; everything is exactly the same except the reward is limited to the underlying asset going to zero. Our risk is still defined to what we paid for the put option. Your technical analysis has shown you that it's time to get short Conoco Phillips (COP). We see a double top, and now we are going to react.

Figure 8.6 COP 3-Month Chart

Now if we take a look at the option chain for COP, you might be wondering which put option is the right one to buy. Remember, **we want to buy as close to the ATM strike as possible!**



CALLS										Strikes: 18		PUTS								
Last...	Net ...	Imp...	Vol...	Delta	Bid X	Ask X		Exp		Strike	Bid X	Ask X		Last...	Net ...	Imp...	Vol...	Delta		
23 JUN 17 (5) 100 **(Weeklys)**																		26.86% (±1.254)		
0	0	41.07%	0	.94	3.85	A	4.25	M	23 JUN 17	42.5	0	P	.03	X	.11	B	0	34.61%	0	-.02
0	0	42.93%	0	.92	3.50	H	3.70	M	23 JUN 17	43	.01	H	.03	H	.28	B	0	32.25%	0	-.03
2.08	N	0	40.43%	0	.90	3.00	T	3.25	M	23 JUN 17	43.5	.02	M	.05	H	.05	X	-.14	31.29%	4	-.04
2.10	Z	+.62	32.14%	10	.91	2.50	U	2.64	Q	23 JUN 17	44	.04	C	.07	H	.05	Z	-.21	29.74%	99	-.07
1.93	Z	+.60	30.20%	40	.88	2.08	M	2.18	X	23 JUN 17	44.5	.08	C	.10	N	.15	C	-.27	28.51%	46	-.11
1.67	C	+.85	28.47%	175	.82	1.65	C	1.72	Z	23 JUN 17	45	.13	X	.14	B	.15	C	-.36	26.51%	159	-.16
1.26	H	+.63	27.17%	1	.72	1.24	[illegible]	1.31	[illegible]	23 JUN 17	45.5	.23	Q	.25	N	.33	Q	-.60	26.42%	21	-.25
.97	X	+.57	26.23%	18	.64	.89	[illegible]	.92	[illegible]	23 JUN 17	46	.36	X	.39	Q	.39	C	-.91	25.35%	115	-.36
.61	E	+.43	25.64%	119	.51	.60	C	.64	Q	23 JUN 17	46.5	.57	B	.60	Q	.59	C	-.85	25.03%	80	-.49
.41	B	+.26	25.08%	402	.38	.38	C	.40	Q	23 JUN 17	47	.83	T	.88	Q	.86	C	-.71	24.43%	38	-.62
.25	B	+.12	25.32%	6	.23	.23	H	.25	Q	23 JUN 17	47.5	1.17	C	1.24	M	1.31	C	0	24.57%	0	-.74
.15	Q	+.10	25.22%	234	.17	.12	B	.15	N	23 JUN 17	48	1.57	B	1.63	C	2.11	Z	0	24.24%	0	-.84
		+.02	25.09%	2	.10	.06	B	.08	Z	23 JUN 17	48.5	1.95	N	2.39	M	0		0	34.22%	0	-.82

Order Entry Tools

Order Entry and Saved Orders

Order Entry | Saved Orders

Spread	Side	Qty	Symbol	Exp	Strike	Type	Link	Price		Order	...	Exchange
SINGLE	BUY	+1	COP	23 JUN 17	46.5	PUT		.60	LMT	LIMIT	DAY	BEST

Figure 8.7 COP Five Day Option Chain

The same principles apply when we are buying puts. There is no such thing as “cheap puts”. They are either fairly priced or expensive in relation to the **ATM** puts. With that being said, we are going to buy the 23 JUN 17 46.5 Strike put for $0.60. The bottom bar gives us all of the information. Our spread is **SINGLE** because we are only buying one put option. Our side is BUY, because were a buying a put. Our quantity is **+1**, because we are buying one option.

How far does price have to decline in order to make a profit? The underlying strike is the 46.5 and you paid a debit of 0.60. In order to figure your breakeven price at expiration, subtract the strike to the debit and you have the breakeven price.

46.50 - 0.60 = 45.90, so the stock must close below 45.90 to break even.

What is your risk? Although the same principles apply for buying calls and puts, this example is just a tad different because the 46.5 strike has no intrinsic value. It has 3 cents of extrinsic value. We know this because if our option expired today, it would be worthless. You wouldn’t exercise your right to sell the stock at 46.50 if it’s currently trading at 46.53. All the necessary information is in the risk graph below. (Again, the software uses the mid-price of 0.585 ($58.50) to calculate instead of the debit we **actually** paid of 0.60).

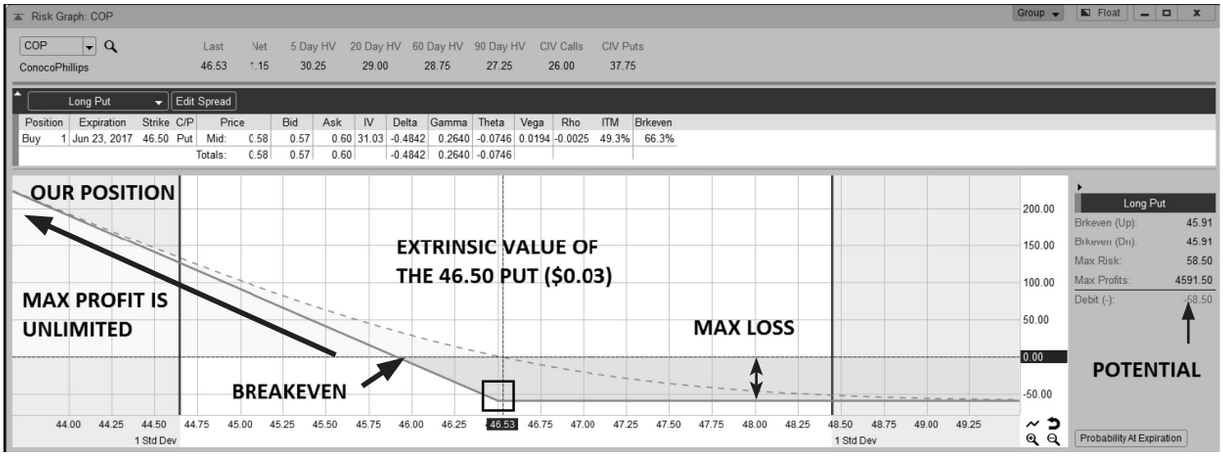


Figure 8.8 COP 46.5 Put Risk Graph

For the purposes of the graph, I wrote that the max profit is unlimited. I know the profit is limited to the stock going to zero, but in reality that will never happen so just take the graph for what it is, an example! It's all about understanding the concept.

The Credit Spread

A credit spread is a trade that we will refer to as a **vertical spread**. The trade is initiated by selling an option closest to the ATM strike price and buying one that is further away. The idea of the spread is to **collect a credit**, and if we have predicted the price correctly, it will expire worthless at expiration. This is my favorite type of weekly options trade.

Vertical spreads are a great way to make money in any type of market. They reduce risk and still rely on the same principles of reading charts and identifying levels. You will not hit any homerun with this strategy, but that's okay. If you execute this strategy right, you will hit so many singles that you'll lose track of them!

When we make a vertical spread trade, our maximum risk is defined right when we click the send button, and so is our maximum profit. Although there are two types of vertical spreads, we will only be dealing with credit spreads (the other type of vertical spread is called a debit spread). With credit spreads, we can win three different ways; the market can go in the direction we are predicting it will go, the market can do nothing, or the market can go against us, but not enough to overcome our credit. We can only lose if the market goes against us by more than the credit we received. A debit spread, on the other hand, will only allow us to profit one way; the market must go in the direction we are predicting it will go.

The **reward** in a credit spread is the amount of **"credit"** you receive when you sell the option nearest to the money and buy the one that is further away. **The risk is the difference between the credit and the spread between the two strikes. The breakeven point is the strike of the purchased call minus the credit received.**

Here's an example: you want to get long AAPL and sell the 146/145 put credit spread for $0.47 (credit).

Max Profit: Difference between option prices: (1.67 – 1.20) = 0.47 per share or $47 per contract
Max Loss: Difference in strike prices – net credit: (146-145) – 0.47 = 0.53 ($53 per contract)
Breakeven Price: Sold strike – credit received: (146 – 0.47) = 145.53

Initiating a credit spread is very simple. Just right click on the option you want to sell, click sell, and then click vertical. The strikes will then appear on the bottom of the screen. **For credit spreads, and any other type of option trade that you want to put on, YOU CAN ADJUST THE STRIKES ON THE BOTTOM OF YOUR SCREEN!**

Put Credit Spread (Bull Vertical)

That might seem pretty complicated at first, but it will make much more sense when we look at the numbers. Let's say we have observed the same double bottom in IWM that we used when buying a call, and we see an opportunity to get long. We would open up the trade tab and open the WEEKLY option chain for IWM (just as we did when we were buying a call on IWM). Time is our friend when we trade credit spreads, because we want the spread to expire as quickly as possible. When we are bullish on a stock and want to put on a bull credit spread, we would look over to the put side and from that point we are going to sell the put that is **CLOSEST TO THE ATM STRIKE, AND AT THE SAME TIME BUY A PUT BELOW THE ATM PUT**.

You'll notice that some option strikes are 50 cents wide, some are a dollar wide, and some are 2.50 wide. We generally want to stick to **a 2/3 risk/reward ratio when trading credit spreads**. This means that if we sell a spread that is 50 cents wide, we'd want to receive at least a 20 cent credit. If we sell a spread that is a dollar wide, we'd want to receive at least a 40 cent credit. If we sell a spread that is 5 dollars wide, we'd want to receive at least a 2 dollar credit. I like to stick to spreads that are a dollar wide. For some higher priced stocks, this won't be possible as the strikes are 2.50 apart, but that is okay as long as the stock you are trading options on is within your parameters.

We can think about this logically to decipher why we would be dealing on the put side when we want the stock to go up. So far we have only talked about buying options, but you can also sell them. So buying a call would be the same thing as selling a put, except the risk for both sides of the trade look a little different.

When we sell the put in our credit spread example, we are receiving the price of the put as "credit" to our account and then we are going to buy a put under the one we just sold (a put at a lower strike) and receive a net credit of the more expensive option minus the cheaper one. One key note is that we are always going to be selling the more expensive option; this is how we receive a net credit. Here's a picture of what the screen would look like if were selling a bull vertical credit spread. Remember that the current price of IWM is 140.19 so the ATM strike is still 140.

Figure 8.9 IWM Five-Day Option Chain

Every time you set up a vertical spread, this is the basic setup of the screen. You are selling one option and buying another for a **net credit**. In this case, we are **selling the 140 put for 76 cents, and buying the 139 put for 46 cents, which gives us our net credit of 30 cents!** We are selling the 140 put because it is the **ATM put.** (The risk graph will detail the exact numbers because the bid/offers may be off by a couple pennies).

If you noticed that our risk/reward ratio is a little off you're catching on! I mentioned that we wanted to operate on a 2/3 ratio for our credit spreads. In this dollar wide spread, we are only receiving 30 cents, which would not technically be at a 2/3 reward ratio. We would need 40 cents to accomplish that goal, because we would be risking 60 cents to make 40 cents (In a dollar wide spread we define our risk as the width of the spread – the credit received, so $1 – 40 cents = 60 cents). IWM has an implied volatility that is quite a bit lower than most of the stocks we will trade, so the option prices are not as far away from each other as I would like. Remember though that is **just an example.** I realize that we are not receiving enough credit relative to our position, but these examples are more to teach you what to look for. But also be aware that since IWM is trading at 140.19, we are getting back some extra reward because we can still gain max profit even if the stock drops 19 cents to 140.

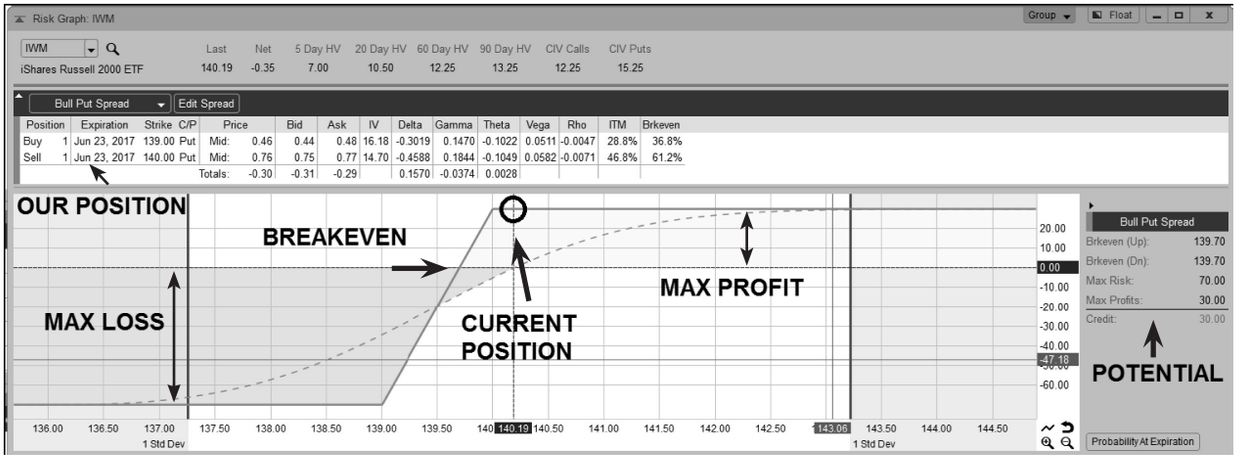


Figure 8.10 IWM 140/139 Bull Put Spread Risk Graph

At first glance, there are a lot of arrows and writing on the graph. But everything is exactly what we talked about! We sold the 140/139 IWM put spread, and IWM is currently trading at 140.19. The current position circle represents exactly where the market is right now, and you can see that we can still make our max profit (30 cents) even if the stock goes down to 140! Our breakeven price is 139.70 and we know this because we collected 30 cents and subtract that from the price of the put we sold, which was the 140 put. Our max loss is $70 per contract in this trade, and our max profit is $30 per contract. As long as IWM stays above 139.70 before expiration this Friday, we will make money!

Here's what the numbers look like for this trade (140/139 IWM Bull Put Spread):

Max Profit: Difference between option prices: (0.76 – 0.46) = 0.30 per share or $30 per contract
Max Loss: Difference in strike prices – net credit: (140-139) – 0.30 = 0.70 ($70 per contract)
Breakeven Price: Sold strike – credit received: (140 – 0.30) = 139.70

We know that whatever happens in this market, our risk is already defined. We will never get blown out of the water while trading credit spreads (on either side!).

Call Credit Spread (Bear Vertical)

We are now going to detail the exact same type of trade, except now we're on the other side of the market. Just like we sold a put spread when we were bullish on a stock, we're going to sell a call spread if we're bearish on a stock. Remember that selling a call is like buying a put; it's a bearish strategy. Take a look back at the chart of COP in Figure 8.6. We are at a level of resistance, but this time instead of buying a put, we are going to sell a vertical call spread. To

receive a net credit in any type of vertical spread trade, we must sell a more expensive option and simultaneously buy a cheaper one. So the roles will be reversed in call credit spreads. We are going to sell the call that is **CLOSEST TO THE ATM STRIKE, AND AT THE SAME TIME BUY A CALL ABOVE THE ATM CALL**.

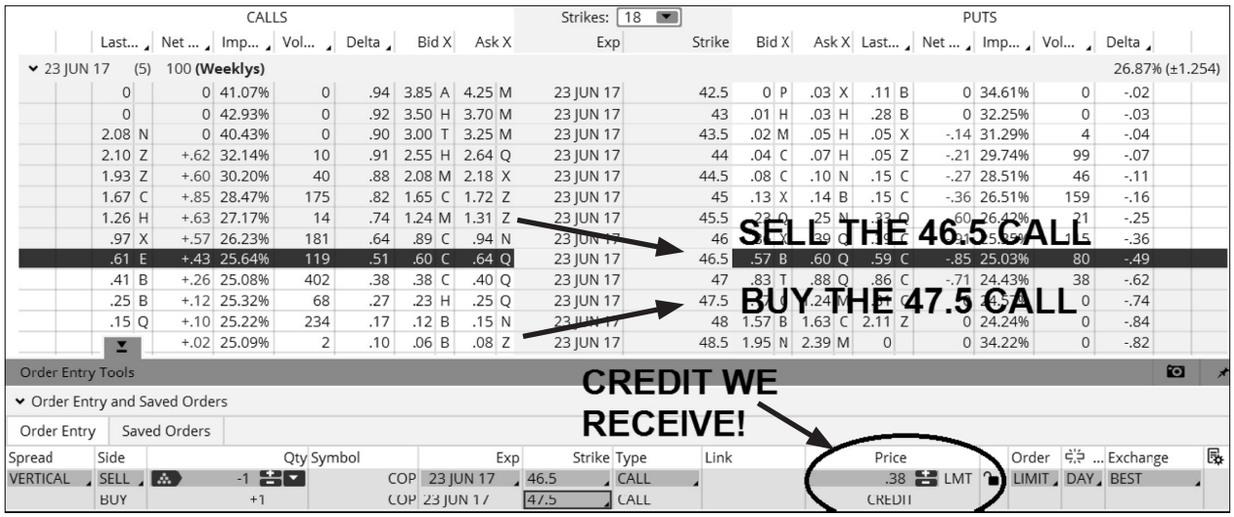


Figure 8.11 COP Five-Day Option Chain

We are still s**elling one option and buying another.** In this case, we are **selling the 46.5 call for 62 cents, and buying the 47.5 call for 24 cents, which gives us our net credit of 38 cents!** We are selling the 46.5 call because it is the **ATM call.** (The risk graph will detail the exact numbers because the bid/offers may be off by a couple pennies).

Our risk/reward ratio is basically right where we want it to be; we are risking 62 cents to gain 38 cents (because our spread is a dollar wide). Let's take a look at the risk graph.

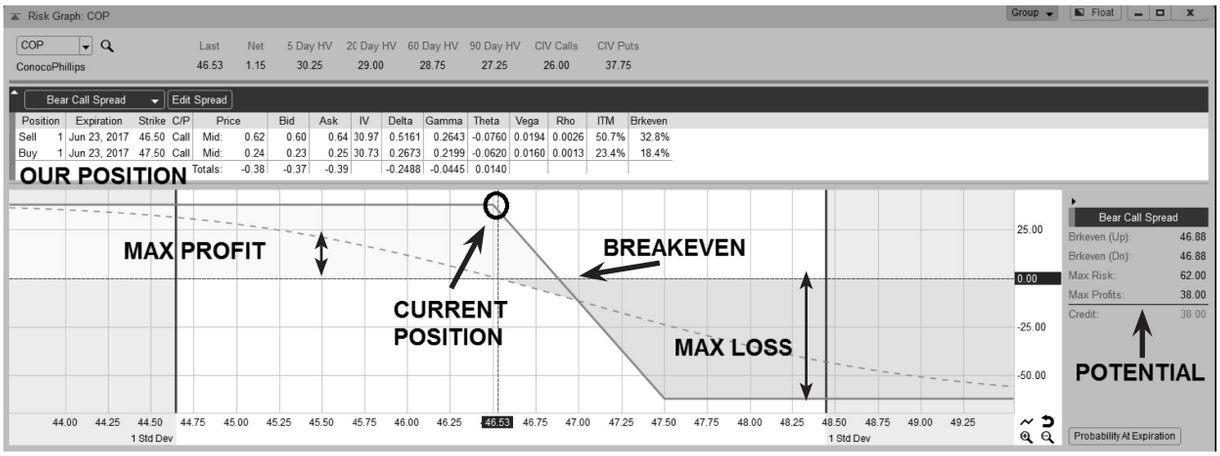


Figure 8.12 COP 46.5/47.5 Bear Call Spread Risk Graph

We sold the 46.5/47.5 COP call spread, and COP is currently trading at 46.53. The current position circle represents exactly where the market is right now. Our breakeven price is 46.88 and we know this because we collected 38 cents and ADD (exact opposite of a put spread) that to the price of the call we sold, which was the 46.5 call. Our max loss is $62 per contract in this trade, and our max profit is $38 per contract. As long as COP stays below 46.88 before expiration this Friday, we will make money!

Here's what the numbers look like for this trade (46.5/47.5 COP Bear Call Spread):

Max Profit: Difference between option prices: (0.62 – 0.24) = 0.38 per share or $38 per contract
Max Loss: Difference in strike prices – net credit: (47.5 – 46.5) – 0.38 = 0.62 ($62 per contract)
Breakeven Price: Sold strike + credit received: (46.5 + 0.38) = 46.88

We know that whatever happens in this market, our risk is already defined. We won't get killed on any one trade when we are trading credit spreads.

Inside/Outside Credit Spreads (60/40)

The inside/outside spread is very similar to a regular credit spread. However, instead of selling the ATM put or call, we are now going to sell the put or call closest to 60 delta and buy the put or call closest to 40 delta, hence the name 60/40 spread. **We are selling one option INSIDE THE MONEY (ITM) and buying one option OUTSIDE THE MONEY (OTM).** As options become more in the money, their delta increases. So inside/outside spreads will net us a bigger credit because we are selling options that are farther in the money than regular spreads. This is a more aggressive strategy because although we will receive more credit, we need the underlying price to move more than we would under regular credit spread circumstances. If the stock price stays flat, this type of trade will not be a winner. On the other hand, if we've correctly predicted price, it will be a much bigger winner than a regular credit spread. Let's take a look at an order screen for AAPL and what a 60/40 Bull Vertical Put Spread would look like assuming we are bullish on AAPL in the short term.

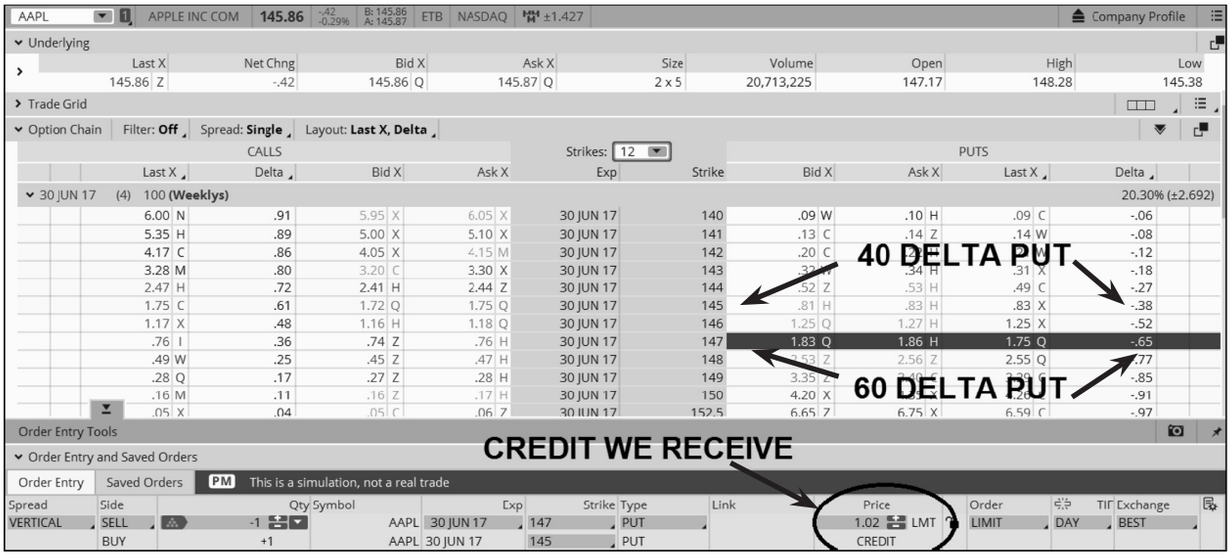


Figure 8.13 AAPL Inside/Outside (60/40) Bull Vertical Credit Spread

I made this example on a Monday, hence the (4) days until expiration. We typically would like to put these trades into motion on the previous Friday because we get a little premium for the spread, and more credit. Notice that the 60 delta put and the 40 delta put are now **2 dollars away from each other.** The delta's will not always be **exactly** 0.60 and 0.40, but our trading is not an exact science. Also remember that delta's on the put side are always negative, and delta's on the call side are always positive. You can see that the 147 put (60 delta put) is two strikes **ITM (ITM -2)** and the 145 put is **ATM**. This is only one trade and not all inside/outside spreads will look like this, but remember our focus is the 60 delta option and the 40 delta option.

The math for inside/outside credit spreads is exactly the same! Check out our example below:

Here's what the numbers look like for this trade (195/197 AAPL 60/40 Bull Put Spread):

Max Profit: Difference between option prices: (1.83 – 0.81) = 1.02 per share ($102 per contract)
Max Loss: Difference in strike prices – net credit: (197 – 195) – 1.02 = 0.98 ($98 per contract)
Breakeven Price: Sold strike - credit received: (197 – 1.02) = 195.98

Although we are receiving a 1/1 risk/reward ratio (1.02 max profit versus 0.98 max loss), we need AAPL to make a much bigger move compared to a normal bull put spread. See if you can spot the difference in the risk graph below (remember the software numbers might be a couple pennies different than the numbers above).

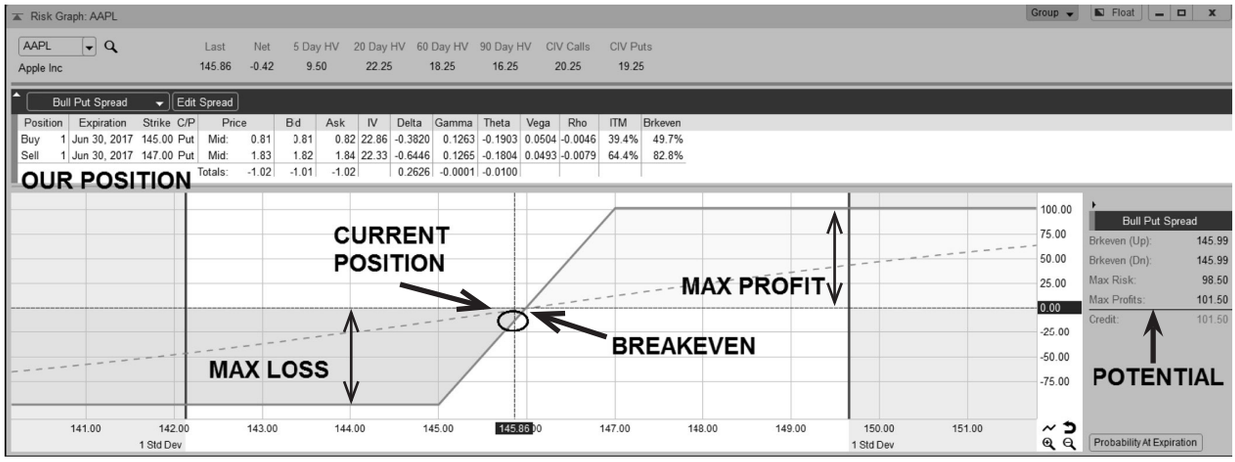


Figure 8.14 AAPL Inside/Outside (60/40) Bull Vertical Spread Risk Graph

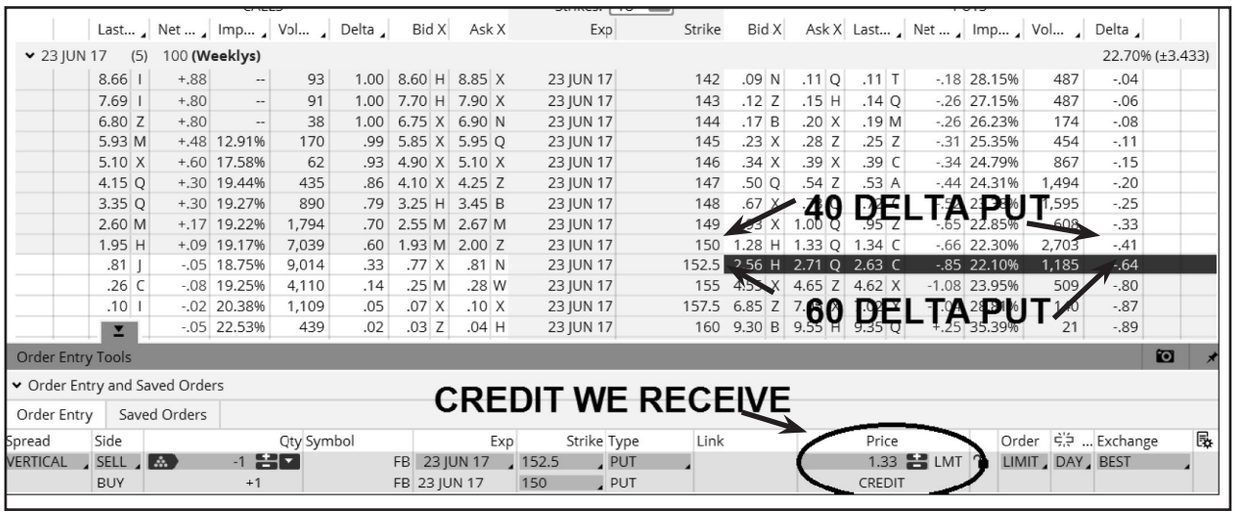
The biggest difference between an inside/outside spread is that if the spread and the underlying stock price stays exactly where it's at, we will lose money. Look at the current position circle; we need AAPL to make a 14 cent move upward just to break even. We get the benefit as collecting just as much premium as we are selling, but need a bigger move in order to make a profit. We don't achieve max profit in this trade until AAPL hits 145.99. We don't achieve max loss until AAPL hits 145.00.

Inside/Outside Put Spread (60/40 Bull Vertical)

I just showed you a 60/40 bull vertical spread for AAPL, but I'm going to show you another example because you can never have too much practice! Again, this spread is initiated by selling the 60 delta put and buying the 40 delta put. Your technical analysis is telling you it's time to get long Facebook (FB), and instead of putting on a regular bull put vertical spread, you want to receive a bigger credit (be more aggressive) and put on a 60/40 bull put vertical spread.

Figure 8.15 FB 3-Month Chart

Now let's take a look at the order screen for what a 60/40 put spread would look like for FB.



Figurw 8.16 FB Inside/Outside (60/40) Bull Vertical Credit Spread

This is a 60/40 spread, so why are the options we are buying and selling only one strike apart? In our case, the options near the money are priced 2.50 apart instead of a 1 dollar, that's why the 60 delta put and 40 delta put are only one strike apart. This will not be the case in every

60/40 spread we put on (as we saw with AAPL in the previous example), but just remember what the strategy for each specific trade is! Our order screen is telling us that we are **selling one 23 JUN 17 152.5 put while simultaneously buying one 23 JUN 17 150 put for a 1.33 credit.** On this 2.50 wide spread, we are receiving a 1.33 net credit, so a little better than a 1/1 risk reward ratio. But, like I mentioned before, we now are going to need a bigger move in FB in order to get to our max profit!

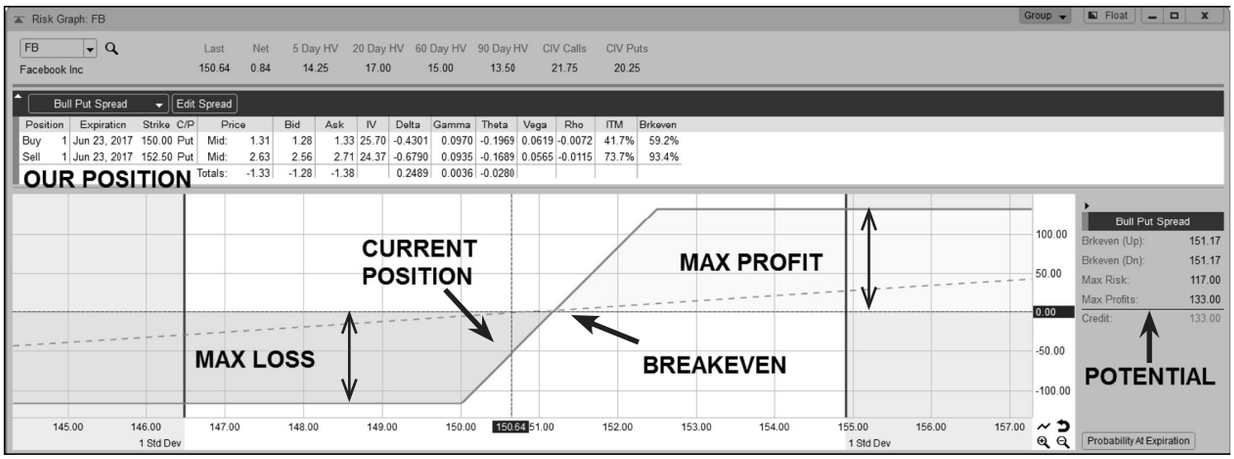


Figure 8.17 FB Inside/Outside (60/40) Bull Vertical Credit Spread Risk Graph

Notice the key differences in a 60/40 spread compared to a regular spread! If our spread expired today where FB currently sits at 150.64, we would lose money. Our max loss is achieved if FB expires under the price of the put we sold (150 strike). We need FB to reach at least 151.17 to break even. We know this because the 151.17 is 1.33 (credit we collected) less than 152.50 (the put option we sold). FB must make a move upward for us to make money! This is difference between a regular spread and a 60/40 spread. We receive more credit, but require a bigger move in the underlying stock price.

Inside/Outside Call Spread (60/40 Bear Vertical)

This spread is initiated by selling the 60 delta call and buying the 40 delta call. We go through the same exact process as the 60/40 bull put spread! Everything is the mirror image, except now we're on the call side. We are going to use COP again (Figure 8.6) as our example for our technical analysis. We are bearish on COP and want to put on an inside/outside call credit spread.

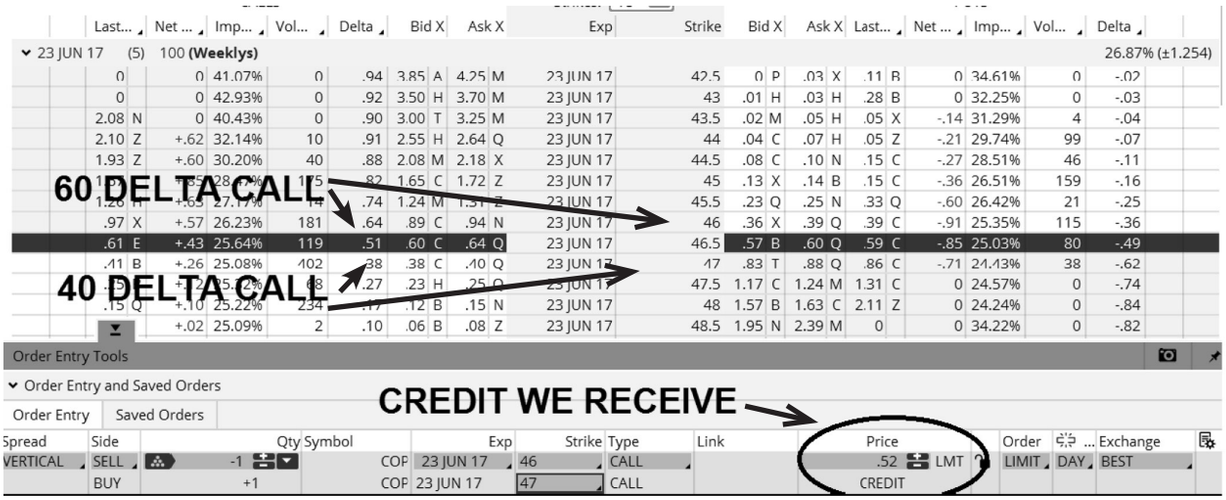


Figure 8.18 COP Inside/Outside (60/40) Bear Vertical Credit Spread

This looks awfully similar to the bear call credit spread we used for COP in an earlier example. However, we are now s**elling the 60 delta call which is the ITM -1 call and buying the 40 delta OTM +2 call.** We are receiving a net credit of 52 cents for our dollar wide spread, which is a 1/1 risk reward ratio (collect 52 cents credit, risk 48 cents). This is a better ratio than we received with the normal bear call credit spread with COP before, but now we need a bigger downward move in COP to achieve our max profit!

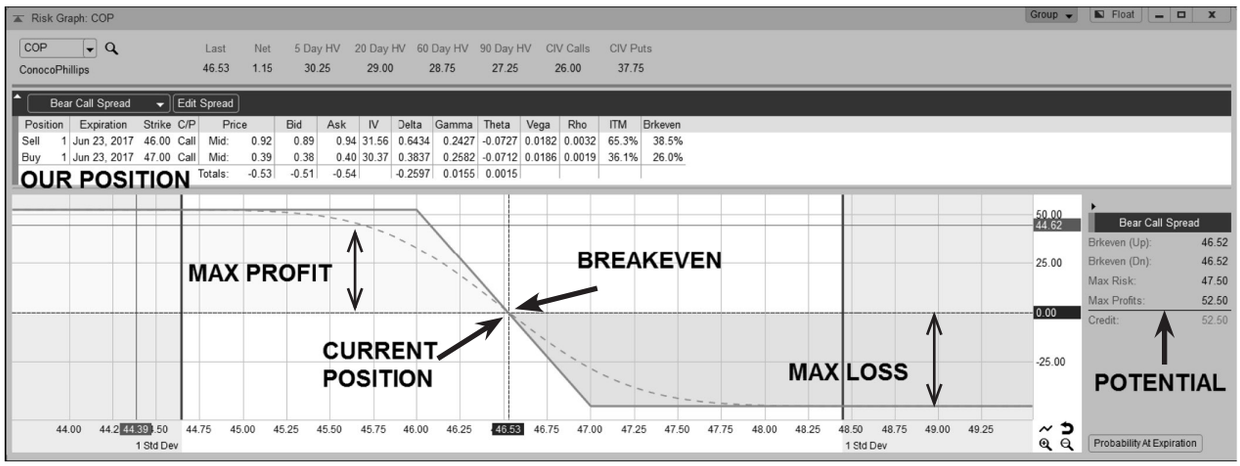


Figure 8.19 COP Inside/Outside (60/40) Bear Vertical Credit Spread Riak Graph

Our breakeven price and current position are essentially identical in this example. COP is trading at 46.53 and our breakeven price is 46.52. If COP stays at its current price at expiration, this trade will be a scratch (not factoring in commissions). However, unlike our previous bear call spread on COP, we need the underlying stock price to drop in order to make money. We

achieve max profit when the stock price drop below the price of the call we sold, the 46 call. The key point to remember with inside/outside spreads is that we need the stock to move in the direction we have predicted in order to make money!

The Risk Reversal

Risk Reversal (Synthetic Long Stock)

Earlier I said that the simplest trade was to buy a call or put outright. The problem with that trade is that you must overcome the air that you have purchased before it can become a winner. I prefer a synthetic trade known as a risk reversal. I call it being "synthetic long" because you are essentially controlling (buying 100 shares of stock) for a lot less money.

The trade is executed by purchasing a call (ATM, -1, -2, or -3 strike) and simultaneously selling a put credit spread with the sold put having the same strike as the call. A true risk reversal only involves buying a call and selling a put, but this puts at the mercy of extremely large margin requirements, that's why we turn the sold put into a put spread! This entire position creates a synthetic underlying purchase of 100 shares of stock. Your reward in this trade will be the same as an outright purchase of a call from a price perspective, but by using a put credit spread, you will diminish the premium risk. Your risk is limited to the price of the call plus the difference in strike prices minus the premium collected in the credit spread. It has unlimited reward and limited risk.

Here's an example trade on the SPY ETF:

- SPY trading @ 200.00
- Buy the SPY 195 call and sell the SPY 195/190 put spread

This specific trade would require around $5,000 of risk capital, but our biggest advantage is that we can essentially buy the SPY ETF which is currently trading near $20,000 (for a 100 share investment) for as little as $500 margin. Let's look at a real-time example of a risk reversal in FB. Our technical analysis is telling us to get long FB (Figure 8.15). We are going to initiate a risk reversal!

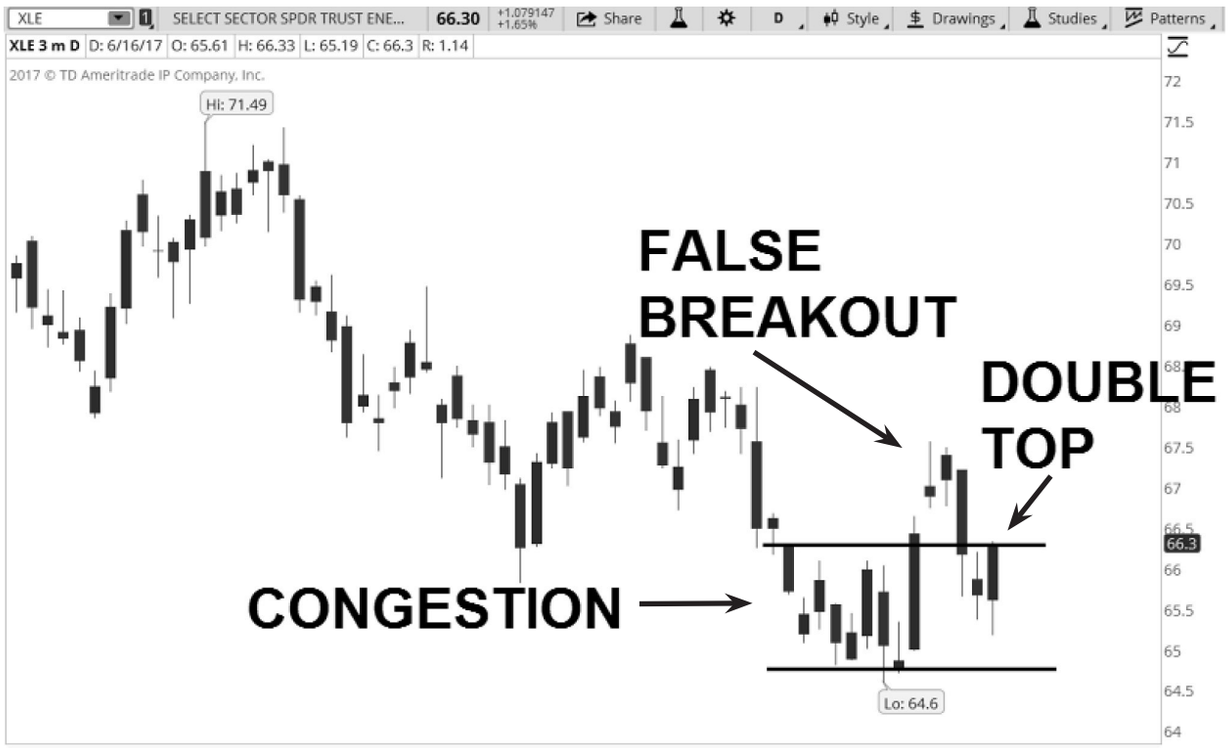


Figure 8.22 XLE 3-Month Chart

Now let's take what we see in the XLE chart and put it into action!

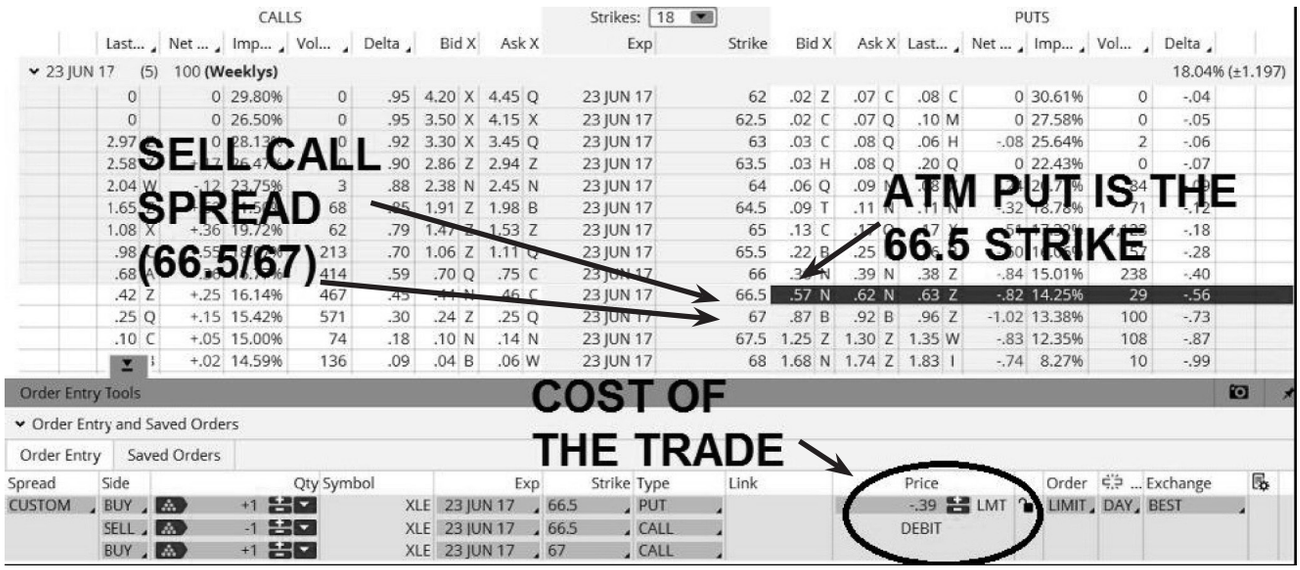


Figure 8.23 XLE Risk Reversal (Synthetic Short)

We are buying the ATM put (66.50 strike). At the same time, we are selling the 66.5/67 call spread for a total net debit of 0.39 (39$ per contract). Our risk is limited to the price of the put plus the difference in strike prices minus the premium collected in the credit spread (max loss below).

Max Profit: UNLIMITED (to the stock going to 0)
Max Loss: 0.59 (price of the put) + 0.50 (difference in call strikes) – 0.20 (premium received) = 0.89 ($89 per contract)
Breakeven: 66.50 (strike price of the put) – 0.39 (debit for the trade) = 66.11
Here's what that looks like in our risk graph.

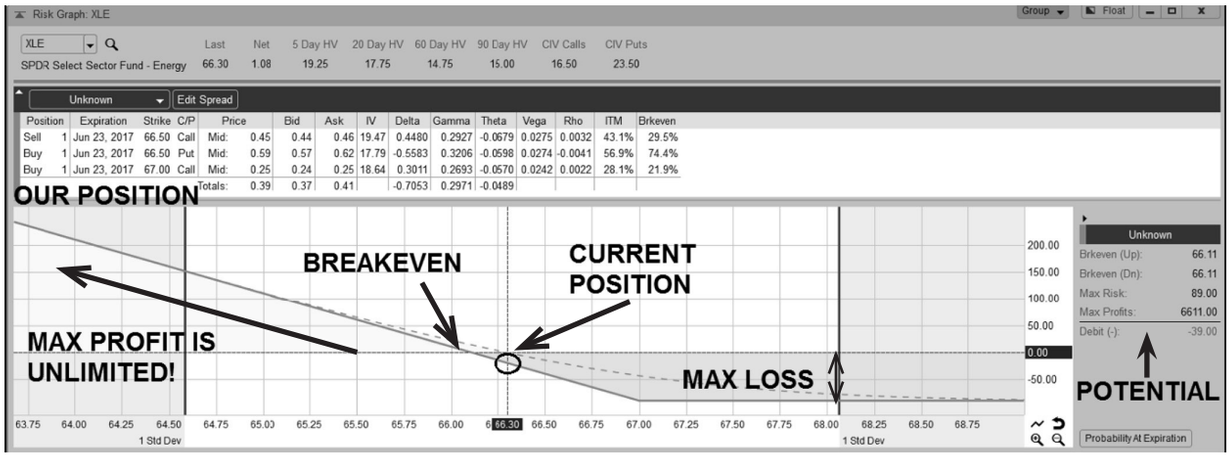


Figure 8.24 XLE Risk Reversal (Synthetic Short) Risk Graph

XLE is currently trading at 66.30, and we need it to reach 66.11 before expiration in order to break even. Notice how buying the 67 call limits our risk to the downside! If XLE goes all the way up to 67.00 before expiration, we are only at risk for $89 per contract ($50 more than our original debit.

The risk reversal essentially combines the two greatest elements of a straight buy of a call or put and a credit spread; we have unlimited profit to the upside and are protected to the downside. We need to correctly predict the direction of the stock, but in the worst-case scenario we are protected, and that's the most important part.

This is a much larger trade than a credit spread, and is slightly larger than buying the put outright, but the fact that you must overcome very little premium risk and with a margin of slightly under $90 to short over $6,500 of XLE stock gives you leverage of over 70 to 1. **This is how the big traders get around the SEC/FINRA shorting regulations; they use options to create synthetic short stock positions.**

The Ratio Backspread

This trade is the most **aggressive** out of all the trades we have covered so far. Call ratio backspreads allow us to take an outright **long** or **short** position in **relation** to the market without buying a **put** or **call,** outright. This position on the put or call side is always technically "long" because we are buying more options than we are selling. In some cases, the ratio will allow us to put on a spread that will limit risk without limiting reward for a credit. This size of the contracts used and strike differential will determine if the spread can be done for a credit, or if it will be for a debit. The closer the **strike** prices are the less market risk, but the greater the **premium** risk. All Call ratio backspreads have unlimited reward and limited risk.

A Call ratio backspread involves selling (short) at or in the money options and buying (long) a greater number of out of the money options of the same type. In this type of trade, we are taking a specific side (bullish or bearish) and can make money in either scenario. The advantage of putting on a Call ratio backspread compared to buying or shorting stock is that we have limited risk, use less capital, and have greater leverage.

Call Ratio Backspread (1x2)

This is a bullish strategy. We expect the stock to make a large move higher. In this strategy, we will purchase calls and sell fewer calls at a lower strike, usually in a ratio of 1x2. The lower strike short calls finance the purchase of the greater number of long calls and the position is usually entered into for no cost or a net credit. The stock has to make a large enough move for the gain in the long calls to overcome the loss in the short calls because the maximum loss is at the long strike at expiration. Because the stock needs to make a large move higher for the backspread to profit, use as long a time to expiration as possible. In our case, this trade works the best when it is put on early in the week.

If this trade goes in our favor, we can close the trade by buying back the short options and selling the long options for a profit. If the trade goes against us and neither option is in the money, the trade will expire worthless and we will keep the credit. However, if the short option is in the money, you will need to buy the short option back. The position will expire worthless if the price of the stock falls below the price of the option you sold. So if the stock price falls below the ITM price, you don't have to do anything.

The Call Ratio Backspread profits when the stock price makes a strong move to the upside, **so there is no limit to the maximum possible profit!** The maximum loss for this kind of spread is limited and is taken when the underlying stock price at expiration is at the strike price of the long calls purchased. At this price, both the long calls expire worthless, while the short call expires in the money.

When we break down this trade in terms of risk vs. reward, it definitely looks different than the other four trades we've covered. Our worst case scenario in a call backspread is when the stock moves up a little bit, but not enough. This will all become clear once we take a look at the risk graph.

We're going to make this trade off of the IWM I showed you before (Figure 8.2). We are bullish on IWM and want to put on a 1x2 Call Ratio Backspread. It is called a 1x2 spread because we are selling one call ITM or ATM, and simultaneously buying 2 calls that are OTM.

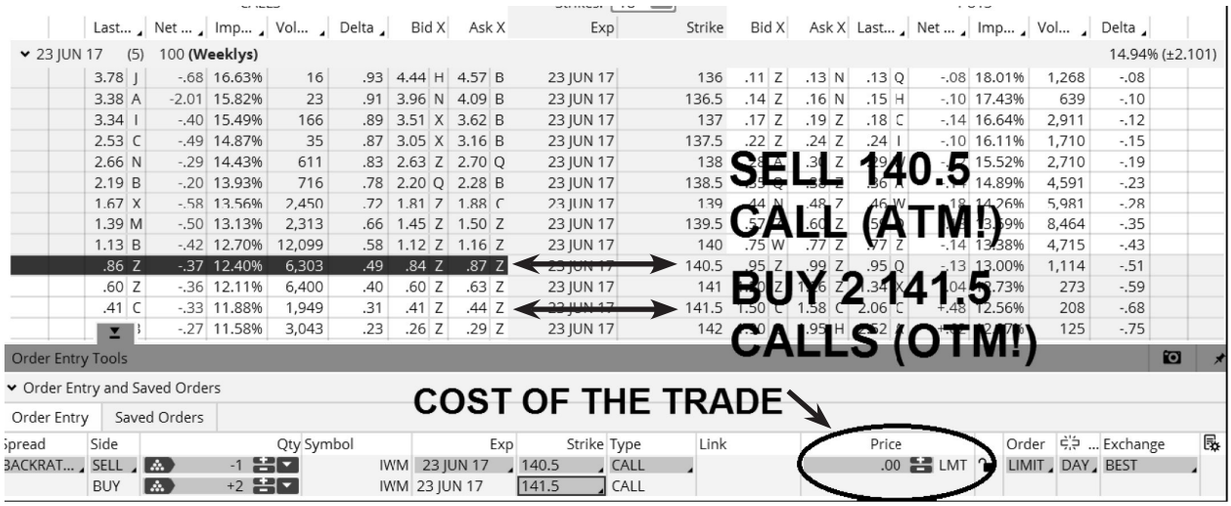


Figure 8.25 IWM Call Ratio Backspread (1x2)

So what do we have going on here? First, we're **selling the ATM call (140.5). At the same time, we are buying 2 OTM calls (141.5).** The cost of this trade… is nothing! This will not happen with every call backspread that you do, but generally these trades should be put on for no cost or a minor credit. You might hear this kind of trade referred to as a 1x2 for even, because we are essentially selling as much premium as we are buying.

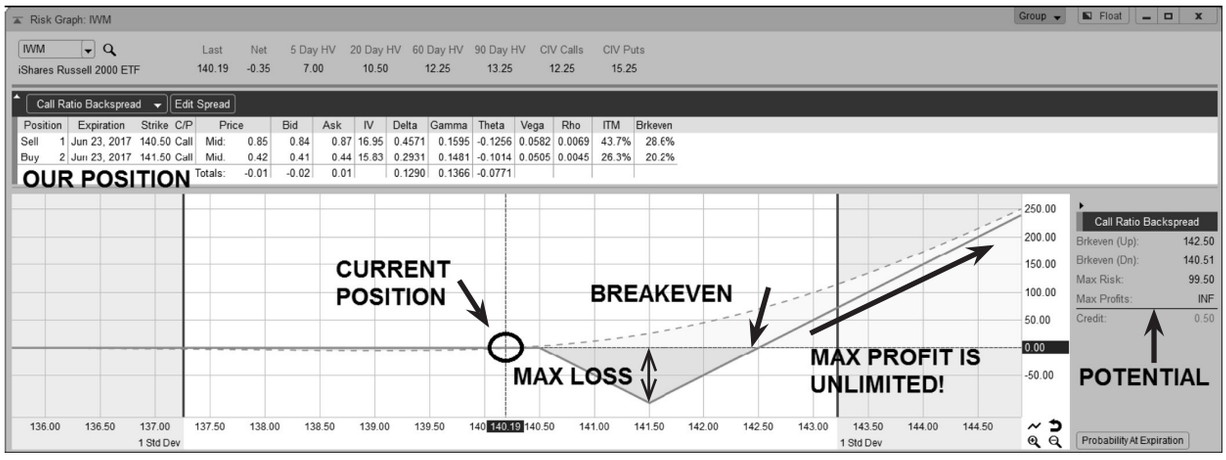


Figure 8.26 IWM Call Ratio Backspread (1x2) Risk Graph

This is by far the toughest risk graph to understand, **so don't get discouraged if you don't get it right away.** It takes time to understand these trades, and I'm going to break it down step-by-step for you. If you look at our current position, if the trade were to expire today, we would get to keep our 84 cent credit we sold the 140.50 call for (for example's sake let's just say 84 cents instead of the 85 cents the software gives us). We will lose 42 cents (2 times) on the 141.50 calls we bought. This is because all of our calls will expire worthless. **We would break even.** Notice that there are now **2** breakeven points in this trade. I've just detailed the first one. The second breakeven point is at the price of the long calls that you bought. At this price point, the (two) long calls will now have more value than credit you received for the call you sold.

Now the tricky part about backspreads is that we lose the max when IWM expires **EXACTLY** at the same price as our long calls. **Our biggest risk comes when IWM expires at 141.50**. We lose 2 times 0.42 on our 141.50 calls, and 0.16 on the 140.50 call (1.00 – 0.84). That brings our max risk to almost $1.00 ($100 per 1x2's you have on, labeled as $99.50 on the risk graph). We lose 0.15 on the 140.50 call because we take the 1.00 that it's worth (remember that we **SOLD** this call) and subtract the 0.85 credit that we received for it.

You can see that our loss continues to decline as IWM continues to increase above 141.50. To simplify this down a little more, think about the 2 calls you sold. They are OTM, so they have no intrinsic value if expiration were today. They don't start to add value until IWM rises above 141.50, then they start to gain value. The 140.50 call you sold will continue to increase in price as IWM goes up, and that's not a problem as long as IWM makes a big enough move to the upside. After 142.50 (breakeven price), the calls you bought will add more value to your position than the credit you received for the short call. You only run into to trouble when the long calls have no value (expire worthless), and the short call is worth more than you sold it for.

We still have unlimited max profit once the stock reaches 142.50. So we are essentially **long IWM at 142.50.** The sky is the limit after that. So remember that with call backspreads we want a BIG move in the stock. We're okay if it stays where it's at or declines. We are okay if it makes a big move in the direction we've predicted. We only run into trouble when the stock goes in the direction we've predicted, but not by enough.

Put Ratio Backspread (1x2)

The put ratio backspread position is used when you are bearish on a stock. The spread is created by buying a bigger quantity of out of the money (OTM) put options (put options whose strike price is lower than the current stock price), and selling a smaller number of in the money (ITM) or at the money (ATM) put options, so in our case we would buy two OTM put options and sell one ITM or ATM put option (1x2). The "1x2 for even" terminology still applies here because we are still trying to buy as much premium as we sell (if not selling more in the

example below).

If the stock moves above the strike price of the ITM (or ATM) put option you sold, you can allow the position to expire and keep your original credit premium, since all three put options will be worthless. If the stock price ends up between that ITM strike price and the strike price of the two OTM put options you bought, then you will incur a loss, since you will need to buy back the ITM put option which is now worth something, but the two OTM put options are still worthless. Once the stock price drops below the strike price of the OTM put options, you will start to see unlimited profit since the cost of buying back the ITM put option is more than offset by the profits (credit) from selling the two OTM put options.

We're going to make this trade of off the XLE chart (Figure 8.22) we looked at before. We are bearish on XLE and want to put on a 1x2 put ratio backspread.

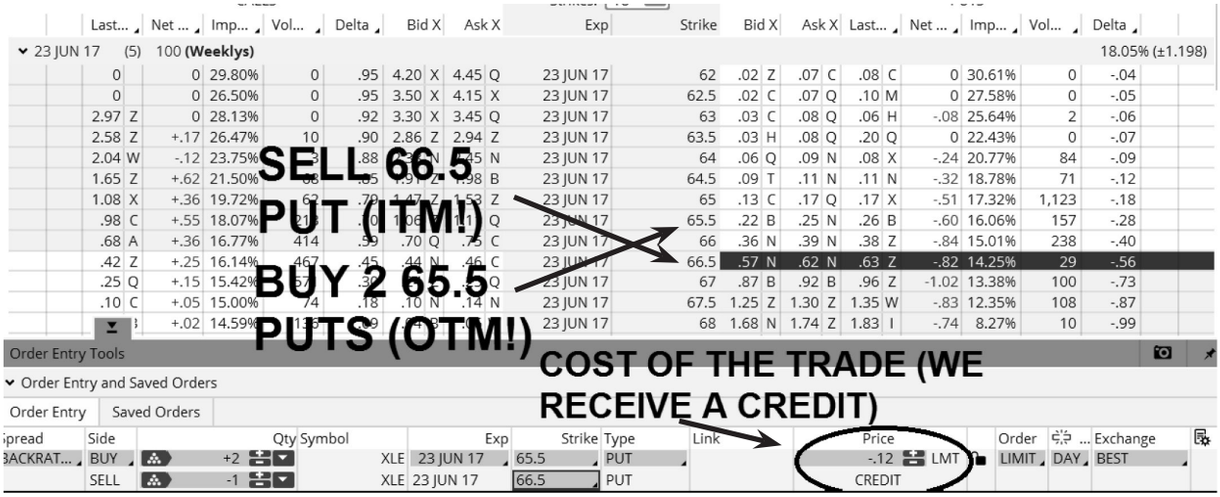


Figure 8.27 XLE Put Ratio Backspread (1x2)

Unlike the call backspread, we can do this put backspread for a net credit! Obviously each trade will be different, but notice that we are selling on ITM call (66.5) and buying 2 OTM calls (65.5). Just as a refresher, XLE is trading at 66.30, so the 66.50 puts are ITM because they have an intrinsic value of 20 cents! Let's now take a look at our risk graph for this trade.

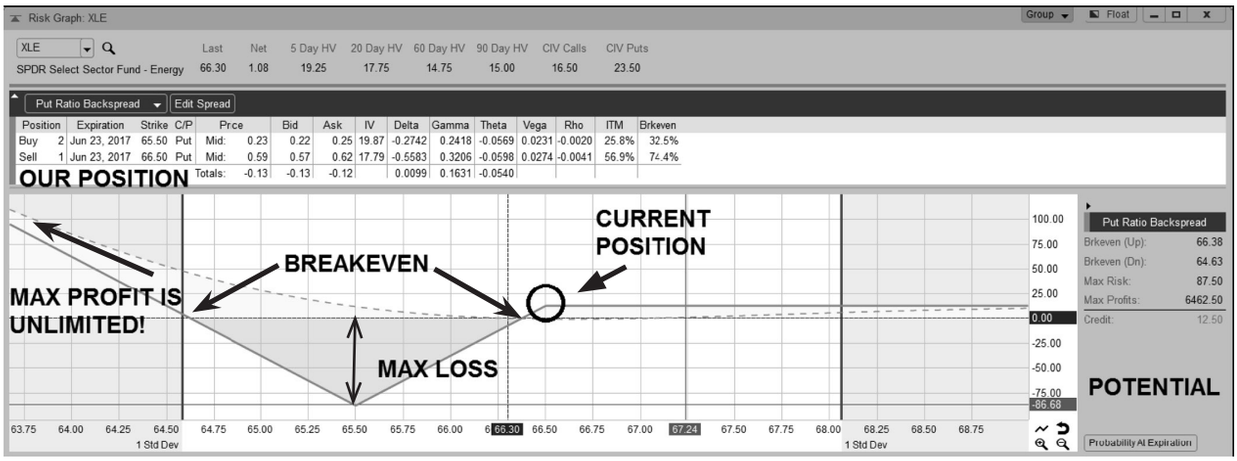


Figure 8.28 XLE Put Ratio Backspread (1x2) Risk Graph

The same principles apply to this graph as the IWM call ratio backspread. If you look at our current position, if the trade were to expire today, we would get to keep our 59 cent credit we sold the 66.50 put for. We will lose 23 cents (2 times) on the 65.50 puts we bought. **We would profit $13 on this trade ($12.50 on the risk graph)**. Notice that there are **2** breakeven points in this trade. Because we received a net credit to put on this trade, the first breakeven point is at 66.38. We get this number from subtracting our net credit (0.12) from the strike price of the put we sold (66.50). The second breakeven point is at the price of the long puts that you bought. At this price point, the (two) long puts will now have the same value of the short put.

I mentioned before how the hardest part to understand about backspreads is that we lose the max when XLE expires **EXACTLY** at the same price of our long puts. **Our biggest risk comes when XLE expires at 65.50.** We lose 2 times 0.23 on our 65.50 puts, and 0.41 on the 66.50 put (1.00 – 0.59). That brings our max risk to 0.87 ($87 per 1x2's you have on, labeled as $87.50 on the risk graph). We lose 0.41 on the 66.50 put because we take the 1.00 that it's worth (remember that we **SOLD** this put) and subtract the 0.59 credit that we received for it.

You can see that our loss continues to decline as XLE continues to decrease below 65.50. To simplify this, think about the 2 puts you sold. They are OTM, so they have no intrinsic value if expiration were today. They don't start to add value until XLE declines below 65.50, then they start to gain value. After 64.63 (breakeven price), the puts you bought will add more value to your position than the credit you received for the short put. You only run into trouble when the long puts have no value (expire worthless), and the short put is worth more than you sold it for.

We still have unlimited max profit (to XLE going to 0) once XLE reaches 64.63. So we are essentially **short XLE** at 64.63. We're okay if XLE stays where it's at or makes a move to the upside. We are okay if it makes a big move to the downside in the direction we've predicted. We only run into trouble when the stock goes in the direction we've predicted, but not by enough.

Clarifying Weekly Options

All the trades I have just shown you are based off of a five-day option chain, but this is not the only chain we can use when putting on our "weekly options" trades or adjusting our positions. Take a look at the trade screen for Facebook below. You'll notice that weekly options actually cover five different serials (including the normal monthly serial).

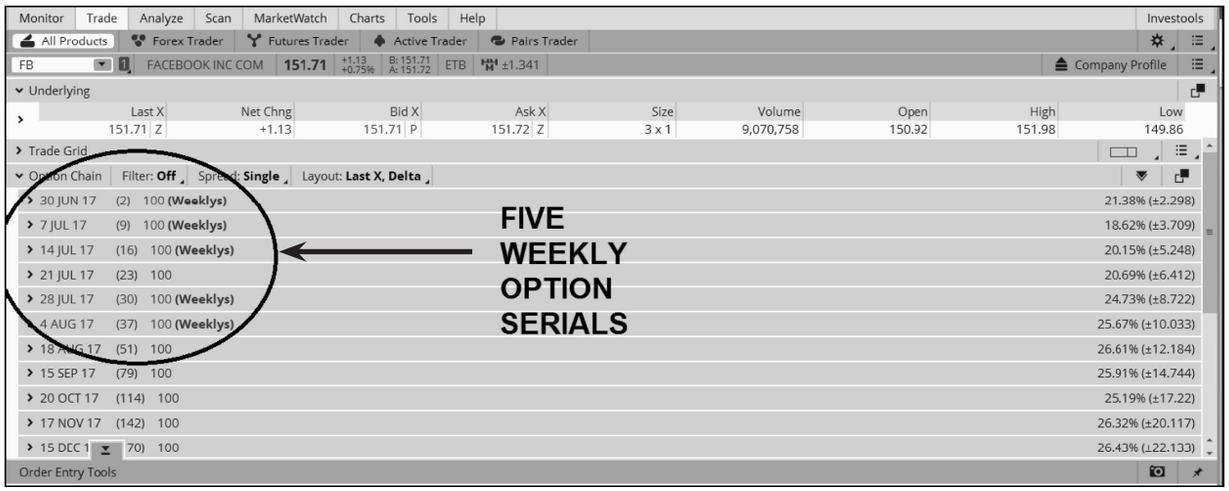


Figure 8.29 (FB) Weekly Option Serials Example

Summary

You can use these trades however you see fit. If you are a conservative trader, maybe you just want to stick to credit spreads. If you're more aggressive, you can use risk reversals and ratio backspreads. It doesn't matter! These are all effective strategies that I've used during my 30+ years as a trader. The main takeaway from all these trades is that we have limited risk **IN EVERY SINGLE TRADE THAT WE MAKE.** We will never take a major hit to our portfolio if we stick to the principles and strategies that I've detailed for you. This is a lot of information to take in all at once, but practice is the only way you will get better as a trader. Identify your levels, develop your strategy, and make the trade! It's that simple. One of the best ways to describe our type of trading is that when we trade, we are trading with a butcher knife, not a scalpel. Whether it's identifying double top or double bottoms, or developing strike prices for specific trades that you want to use, don't get caught up in the pennies. They will take care of themselves. If we try to make every level and every trade as perfect as possible, we will never make a trade! Be confident in your plan and stick to your approach, and you will be successful. This doesn't only go for trading, but any aspect of life. Take a major league hitter, for example. Every single player has a different stance, but if you take a side-by-side picture of these hitters at the point of contact, they all look the same!

Chapter 9: The Benefit of Trading Weekly Options

Weekly options have become increasingly popular over the last decade, and for good reason. In 2005, 32 years after introducing the call option, the CBOE began a pilot program with "weeklys" options. Investors who had historically enjoyed 12 monthly expirations per year now could enjoy 52 expirations per year! As of early 2011, the weeklys were available on 40 different underlying securities, including indexes and ETFs. Weekly options are a game changer for traders like us. They provide us the opportunity for massive amounts of leverage on a short-term time frame.

Since options are based purely off of statistics, we can relate trading options to the challenges of a zero-sum game. Trading options, stock, and futures are all zero-sum games. When you buy or sell something in an auction market, you must find a buyer or seller who is willing to do the opposite of the trade. In the end, one person will win, and the other will lose. If you think about making the same trade until infinity with someone, the profit and loss will always balance out, minus commissions. Since our capital is not infinite and commissions are, both of us will eventually end up broke.

Why would we then embark on a career of trading options? Here's why. Think about poker again, another game of chance. If you sat down at a cash game with nine other players, each bringing $100 to the table, the total amount of dollars on the table would equal $1,000. For those of who have played live poker before, you know that house must take a "rake". The rake is the scaled commission fee taken by a cardroom operating a poker game. You have to pay to play. This is just like the commissions we pay when trading options. Now let's say the rake is $1 per hand in this particular game. In this case, the game would last approximately 1,000 hands. At this point the house would have taken everybody's money in the form of commissions.

Now imagine you are sitting at the same table where everyone has $100. The rake, however, is now only 10 cents per hand instead of $1. This is still a zero-sum game, but it will now take 10,000 hands to take everybody's money in the form of commission. Instead of everyone going broke, you'll now see a much different result. At least one of the players will be a winner, and most likely three or four will also win. The rest will lose, as their lack of skill will come to fruition over this extended time period. Even though this is still the same zero-sum game, the superior knowledge of a few players will give them an edge in the long-run, and a positive expected value! We are going to be these players with superior knowledge when it comes to trading options. Yes, we will have to pay commissions just like everyone else, but not everyone else will have the knowledge and skill that it takes to consistently grind out a profit when trading weekly options, just like in the game of poker.

What was the third piece of the puzzle I talked about before that we needed to trade options? **Liquidity**! Liquidity is something that we can use to make trading options a favorable game for us. Liquidity allows us to move in and out of trades very easily, so it is a must when it comes to trading weekly options.

Let's look at two different stocks and their respective (2) and (9) day weekly option chains, Ford Motor Co. (F) and Facebook Inc. (FB).

CALLS						Strikes: 12		PUTS					
	Last X		Delta	Bid X	Ask X	Exp	Strike	Bid X		Ask X		Last X	Delta
30 JUN 17 (2) 100 **(Weeklys)**													21.22% (±0.164)
	2.63	Q	.93	2.62 Q	2.68 Z	30 JUN 17	8.5	0	P	.01	A	0	-.01
	0		.93	2.12 Q	2.16 Q	30 JUN 17	9	0	P	.01	A	0	-.01
	1.54	M	.94	1.63 N	1.66 X	30 JUN 17	9.5	0	P	.01	X	.01	Q .01
	1.20	C	.94	1.12 X	1.16 X	30 JUN 17	10	0	P	.01	A	.01	M -.01
	.62	H	.93	.62 X	.65 C	30 JUN 17	10.5	0	P	.01	H	.01	C -.03
	.17	Q	.75	.16 Z	.17 Q	30 JUN 17	11	.02	Z	.04	X	.03	M -.24
	.01	C	.06	0 P	.01 H	30 JUN 17	11.5	.35	C	.38	X	.37	Z -.94
	.01	M	.02	0 P	.01 M	30 JUN 17	12	.85	C	.88	C	.83	C -.97
	.02	Z	.01	0 P	.01 C	30 JUN 17	12.5	1.33	M	1.38	Z	1.42	X -.98
	0		.01	0 P	.01 X	30 JUN 17	13	1.83	C	1.88	X	1.85	B -.98
	.01	N	.01	0 P	.01 C	30 JUN 17	13.5	2.35	Q	2.38	Z	0	-.98
	0		.01	0 P	.01 C	30 JUN 17	14	2.84	Q	2.90	Q	2.90	B -.99
7 JUL 17 (9) 100 **(Weeklys)**													24.16% (±0.351)
	0		.93	2.62 Q	2.82 X	7 JUL 17	8.5	0	P	.01	X	0	-.01
	2.08	M	.93	2.11 Q	2.16 Q	7 JUL 17	9	0	P	.01	C	0	-.01
	1.58	B	.93	1.61 Z	1.67 Q	7 JUL 17	9.5	0	P	.01	C	0	-.02
	1.20	C	.93	1.13 N	1.16 X	7 JUL 17	10	0	P	.02	X	.01	I -.03
	.66	B	.90	.64 N	.66 Q	7 JUL 17	10.5	.01	H	.02	H	.01	M -.07
	.23	X	.64	.22 X	.24 H	7 JUL 17	11	.08	X	.10	H	.08	Q -.35
	.03	C	.18	.03 Z	.04 X	7 JUL 17	11.5	.37	X	.40	N	.37	Q -.90
	.02	H	.03	0 P	.01 H	7 JUL 17	12	.83	X	.88	H	0	-.99
	.02	C	.02	0 P	.01 H	7 JUL 17	12.5	1.34	Q	1.41	C	0	-.99
	.01	Z	.01	0 P	.01 H	7 JUL 17	13	1.85	Q	1.93	C	0	-.99
	0		.01	0 P	.01 H	7 JUL 17	13.5	2.33	Z	2.59	X	0	-.99
	0		.01	0 P	.01 X	7 JUL 17	14	2.84	Q	2.91	X	0	-.99

Figure 9.1 F Two- and Nine- Day Option Chains

CALLS						Strikes: 12		PUTS					
	Last X		Delta	Bid X	Ask X	Exp	Strike	Bid X		Ask X		Last X	Delta
30 JUN 17 (2) 100 **(Weeklys)**													21.37% (±2.273)
	7.45	C	.97	7.20 M	7.30 M	30 JUN 17	145	.04	N	.05	H	.04	X -.03
	6.75	Q	.96	6.20 X	6.30 C	30 JUN 17	146	.05	Q	.06	H	.06	Z -.04
	5.75	C	.94	5.25 X	5.35 M	30 JUN 17	147	.07	H	.08	W	.08	H -.06
	4.60	H	.91	4.30 Z	4.35 Z	30 JUN 17	148	.11	H	.12	H	.11	C -.08
	3.76	C	.86	3.35 C	3.45 C	30 JUN 17	149	.18	Z	.19	H	.17	C -.13
	2.50	N	.80	2.49 Z	2.53 Z	30 JUN 17	150	.29	H	.31	Z	.30	Q -.20
	.83	Z	.45	.80 Q	.82 Z	30 JUN 17	152.5	1.08	Q	1.10	H	1.10	H -.55
	.16	X	.13	.16 N	.17 Z	30 JUN 17	155	2.93	Z	2.98	Q	2.93	A -.87
	.06	N	.04	.05 N	.06 H	30 JUN 17	157.5	5.30	Q	5.40	X	5.15	M -.95
	.03	I	.02	.02 H	.03 Z	30 JUN 17	160	7.75	M	7.85	Q	8.40	Q -.95
	.02	I	.01	.01 H	.03 H	30 JUN 17	162.5	10.10	Q	10.50	M	8.85	Q -.95
	.02	I	.01	0 P	.02 H	30 JUN 17	165	12.60	Q	12.95	Q	0	-.94
7 JUL 17 (9) 100 **(Weeklys)**													18.49% (±3.68)
	7.00	Q	.92	7.35 X	7.50 X	7 JUL 17	145	.16	Z	.17	Z	.15	I -.07
	6.10	Q	.89	6.45 C	6.55 X	7 JUL 17	146	.23	Z	.24	H	.20	C -.10
	5.67	C	.86	5.55 Z	5.65 X	7 JUL 17	147	.32	Z	.33	H	.31	I -.13
	4.83	C	.81	4.65 X	4.75 X	7 JUL 17	148	.45	Z	.46	H	.45	Z -.18
	4.11	C	.76	3.85 Z	3.95 X	7 JUL 17	149	.63	Z	.64	H	.59	C -.23
	3.15	C	.69	3.10 H	3.15 C	7 JUL 17	150	.86	Q	.88	H	.82	C -.30
	1.56	Q	.48	1.55 H	1.58 Z	7 JUL 17	152.5	1.80	Q	1.82	Z	1.75	H -.52
	.64	X	.26	.63 Q	.64 Z	7 JUL 17	155	3.35	H	3.40	B	3.30	Z -.75
	.25	C	.11	.23 Z	.24 Z	7 JUL 17	157.5	5.45	N	5.60	X	5.50	I -.88
	.11	B	.05	.09 H	.10 Z	7 JUL 17	160	7.80	N	7.95	H	9.51	C -.93
	.05	B	.03	.05 Z	.06 H	7 JUL 17	162.5	10.25	H	10.40	H	11.70	N -.94
	.02	C	.02	.03 H	.04 H	7 JUL 17	165	12.65	C	12.95	C	10.50	C -.94

Figure 9.2 FB Two- and Nine- Day Option Chains

The bid/offer spreads in FB in Figure 9.2 are about four to five pennies apart near the ATM strike (150). That means if you were to pay the offer and sell the bid, you would have to give up $4 to $5 to trade an outright option that has the potential to control over $15,000 worth of equity! This is what I mean when I'm talking about liquidity. We have ability to control massive amounts of stock for very little cost, and can move seamlessly in and out of positions.

You'll notice that the bid/offer spreads in Ford in Figure 9.1 are one to two pennies apart near the ATM strike (11). The spreads are much tighter for most options, but this market is not liquid – do you know why? There is not enough air in the balloon. No matter how tight the

options are, you are only controlling $1,100 worth of equity. Commissions are not discounted just because Ford has a much lower stock price, and this smells very similar to our zero-sum game plus commissions! No matter how much skill you have, you can't overcome the lack of price movement in this stock. Eventually, the "rake" will prove to be too much. Now you have more of an idea of what it takes to win at the game of options; you need a combination of tight bid/offer spreads, low commissions, and more skill than your opponent.

Are weekly options different than longer-term serials?

Weekly options are absolutely different than longer-term serials. They are in a sense a miniature version of the long-term, but that's about it. I'm going to prove to you that using weekly options can drastically improve your risk/reward over time. Take a look at the AMZN weekly option chain expiring in nine days.

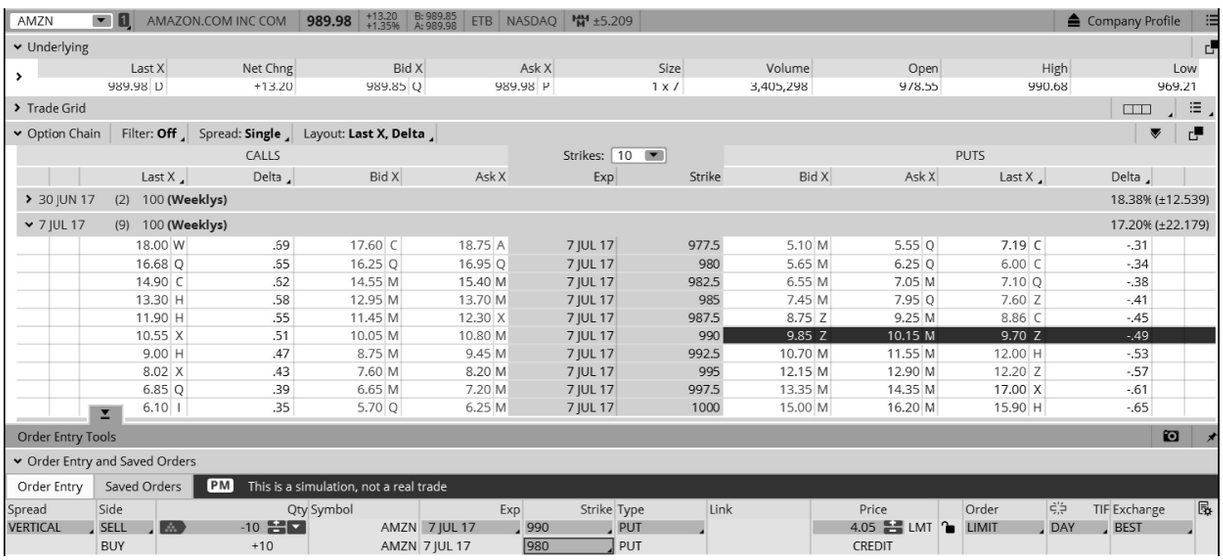


Figure 9.3 AMZN Nine-Day Option Chain

AMZN is trading almost exactly at 990, so 990 would be the ATM strike. We can sell the ATM 990/980 vertical put spread for $4.05 right now. This number sticks to our 2/3 risk/reward ratio for credit spreads; we are receiving a $4.05 credit on a $10 spread, which is a little better than 2/3. We're risking $5.95 to make $4.05. Now let's take a look at the option chain for AMZN expiring in 142 days.

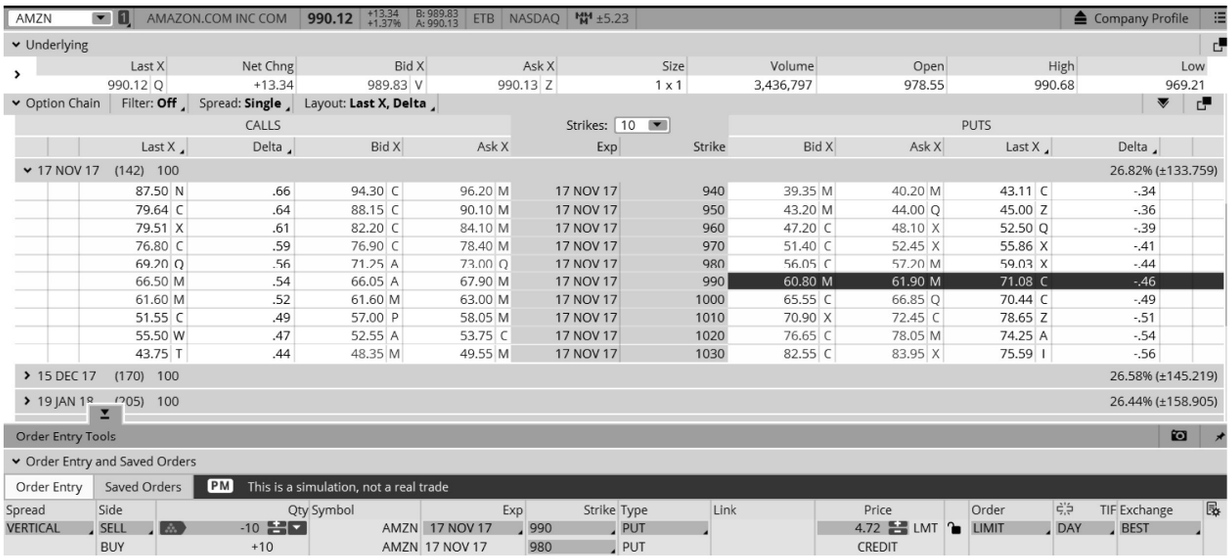


Figure 9.4 AMZN 142-Day Option Chain

If we put on the same position by selling the ATM vertical bull put spread in AMZN (990/980) we can now receive a $4.72 credit. This easily covers our 2/3 risk/reward ratio when dealing with credit spreads because we are risking $5.28 to make $4.72. On the surface, this second trade looks like the better one. But is it? Let's compare the math of the two trades again:

- Trade one: Sell the 990/980 vertical bull put spread of nine days for a credit of $4.05. We risk $5.95 to make $4.05 for a period of nine days.
- Trade two: Sell the 990/980 vertical bull put spread of 142 days for a credit of $4.72. We risk $5.28 to make $4.72 for a period of 142 days.

The advantage of trading weekly options credit spreads should now be extremely clear! Why would you make a trade for 142 days that could only make 65 cents more than a trade will mature in 9 days? You wouldn't if you understand our method of trading options! You could sell the weekly nine-day serial credit spread 15 times for a total credit of $60.00 in the same time that would make 65 cents in the 142-day serial!

The credit spread strategy has a **HUGE ADVANTAGE** over longer-term serials, but how will the numbers look when we use a more aggressive strategy like an outright buy. I'm now going to move a lower-priced stock, but still one of the most liquid around, AAPL. Figure 9.5 is a combination of two serials in AAPL. One is expiring in 2 days and the other is expiring in 170 days.

CALLS								Strikes: 12		PUTS					
	Last X		Delta	Bid X		Ask X		Exp	Strike	Bid X		Ask X		Last X		Delta
30 JUN 17 (2) 100 **(Weeklys)**															17.57% (±1.754)
	5.99	X	.95	5.75	X	5.95	M	30 JUN 17	140	.03	H	.04	H	.04	Z	-.03
	4.62	C	.94	4.75	A	5.00	X	30 JUN 17	141	.04	H	.05	A	.05	A	-.04
	4.00	Z	.89	3.90	H	4.05	H	30 JUN 17	142	.06	H	.09	H	.08	C	-.07
	2.86	Z	.88	2.87	T	3.05	X	30 JUN 17	143	.11	H	.13	H	.12	E	-.11
	2.02	A	.80	1.99	H	2.12	Z	30 JUN 17	144	.20	H	.23	H	.22	Q	-.19
	1.22	Q	.66	1.27	N	1.30	Z	30 JUN 17	145	.40	X	.44	Q	.42	B	-.33
	.66	X	.47	.66	Z	.69	Q	30 JUN 17	146	.79	M	.83	Q	.87	Z	-.54
	.28	X	.27	.29	H	.31	N	30 JUN 17	147	1.41	N	1.49	M	1.56	A	-.74
	.11	I	.13	.12	N	.13	H	30 JUN 17	148	2.18	Z	2.36	T	2.13	I	-.89
	.05	Q	.06	.05	A	.06	H	30 JUN 17	149	3.10	X	3.30	X	3.09	M	-.97
	.03	I	.03	.02	X	.04	H	30 JUN 17	150	4.10	A	4.25	X	4.35	C	-1.00
	.02	X	.01	.01	C	.02	W	30 JUN 17	152.5	6.60	H	6.75	X	6.60	I	-1.00
15 DEC 17 (170) 100															24.04% (±19.304)
	27.50	M	.87	27.00	X	27.40	X	15 DEC 17	120	1.49	N	1.53	C	1.56	I	-.11
	21.00	X	.82	22.70	X	23.10	X	15 DEC 17	125	2.20	N	2.25	M	2.21	Z	-.16
	19.10	N	.77	18.90	X	19.00	N	15 DEC 17	130	3.20	M	3.25	H	3.20	Q	-.22
	15.25	I	.70	15.20	X	15.35	M	15 DEC 17	135	4.55	C	4.65	X	4.69	C	-.29
	12.00	A	.62	12.00	X	12.10	Q	15 DEC 17	140	6.30	X	6.40	X	6.30	Q	-.37
	9.35	Z	.53	9.15	X	9.35	C	15 DEC 17	145	8.55	X	8.60	B	8.52	A	-.46
	7.01	B	.45	6.90	X	7.00	B	15 DEC 17	150	11.20	X	11.30	T	11.35	Z	-.55
	4.95	P	.36	5.05	E	5.15	C	15 DEC 17	155	14.35	Q	14.45	T	15.04	M	-.64
	3.69	B	.28	3.60	X	3.70	C	15 DEC 17	160	17.90	M	18.00	B	19.16	C	-.72
	2.60	C	.22	2.56	N	2.60	Q	15 DEC 17	165	21.80	N	22.10	M	21.85	Z	-.79
	1.81	A	.17	1.79	N	1.84	P	15 DEC 17	170	26.00	P	26.40	A	28.11	C	-.85
	1.29	X	.12	1.27	N	1.31	N	15 DEC 17	175	30.45	X	30.90	X	27.45	P	-.89

Figure 9.5 AAPL 2- and 170-Day Option Chains

Buying a Call or Put Outright

We talked before how we want to stay near the money when purchasing calls or puts outright. Generally we want to use the ATM, or ATM -1 calls and ATM, or ATM -1 puts. Because the strikes are different the further you go out in time, I'm going to stick to the ATM calls for both serials (145).

Buy one 30 JUN 17 145 call for 1.30. If we look over to the 145 puts, we can see that we've purchased approximately 42 cents of air. For this trade to be a winner, it must surpass the breakeven price of 146.72 before the serial expires in two days. The expected value in two days is +/- 1.70 (about 1.30 + 0.42), so there is a good chance that we will get there if the market is rallying.

Buy one 17 NOV 17 call for 8.75. If we look over to the 145 puts, we can see that we've purchased approximately $8.50 of air. For this trade to be a winner, it must surpass the breakeven price of 153.75 before the serial expires in 170 days. The expected value is +/- 17.25 (8.75 + 8.50). I would stay away from this trade all the way in November. I would much rather use the weekly option and roll back (to roll a trade, we simultaneously close our existing position and open a new one). If I still have a buy signal from looking at my chart, I could roll back more than 10 times and not have the huge premium risk. Do not get confused by the term roll! It simply means changing your position to give yourself the best advantage given what the market has done.

Basic Overview

It's important to look at the individual stock before you decide which type of trade is best to use. Some trades are better than others in an individual stock, depending on the way premium is priced.

Weekly Credit Spreads (and 60/40 Spreads)

This is a type of trade you can use with any stock as long as you can maintain your 2/3 risk/reward ratio. I personally like to stay as close to the money as possible when putting on spread trades because you reduce your premium risk.

Outright Buys (Calls and Puts)

This strategy will really depend on the price of the stock. As you move further up the price ladder, the amount of air you must overcome makes this trade very hard to make. The premium in stocks over $100 usually keeps us from making this type of trade.

Risk Reversals (Synthetic Long/Short)

When you get to higher-priced stocks, you have to use a synthetic position to overcome the premium risk you'll face. Although the option-model works the same for any-priced stock, your dollar risk might come into play. We're going to use risk reversals on higher-priced stocks since our goal is to minimize dollar risk and maximize leverage.

Ratio Backspreads (1x2)

This spread works the best when you can use touching strikes. In higher-priced stocks, the strike risk usually becomes too large and you probably shouldn't use this trade. You usually want to put on this type of trade for either a slight debit or credit. This is also a strategy that you want the ATM for, because the further you move from the ATM, the less chance you have to cash the trade.

Chapter 10: Why it Always Comes Down to the Math!

We've talked about the option pricing model and how it relates to a bell-shaped curve, also known as a binomial distribution. It's a really cool phenomenon because not only can we relate the curve to the option pricing model, but the market itself. Take another look at the bell curve below. This time, the graph includes percentages and the Greek symbol sigma (σ).

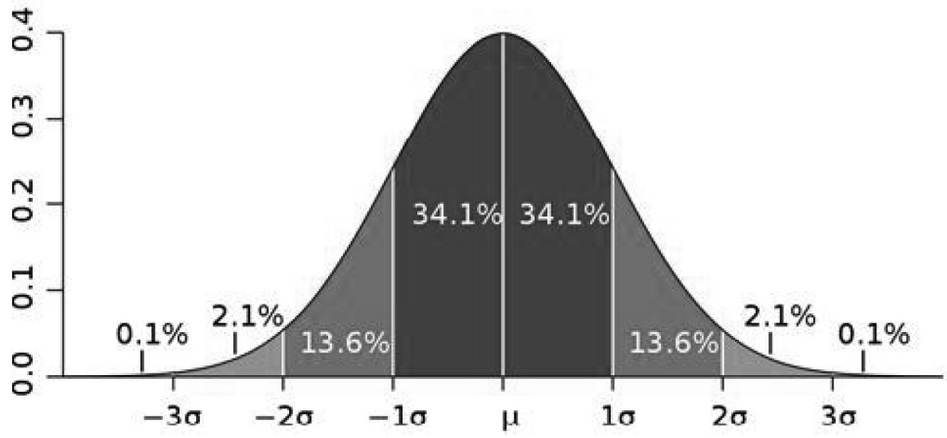


Figure 10.1 Bell-Shaped Curve with Sigma (σ)

What exactly does σ tell us? It indicates a standard deviation. **A standard deviation is a measure of volatility; as data points move further from the mean, the population of the sample grows more unstable.** That really takes me back to a statistics course I took a thousand years ago. Basically, if you are getting a return on an investment, you want it done with low volatility. In the world of financials, a standard deviation is used to measure the risk associated with an asset and the amount that the risk varies from the mean over time. If a certain asset has yielded 15% over the past 20 years, you want to be aware of the amount of variance that has occurred during the time frame. If the asset lost money in 18 out of 20 periods, then no matter what, it can't be used for a normal investment because the volatility is too high. On the other hand, if the asset made money in 18 out of 20 periods, it is very reliable.

Since we are only dealing with liquid assets when we trade, you'll notice that with each one of these assets, the price data are evenly distributed above and below the mean, just like Figure 10.1. When we are trading, we know the mean is always the ATM strike, the place where the most uncertainty is associated. As we get more information and the market moves further from the mean, the options either move closer to parity or lose all value.

Look at the percentages within one standard deviation of the mean in Figure 10.1. If you add both together, you get approximately 68%. This is where we can relate the curve to any liquid asset we trade (which functions as its own market!) I mentioned before how the market is in congestion roughly 65 percent of the time, so from that information we can deduce that the

market stays within (or rotates around) one standard deviation of its mean price! For example, if a $100 stock is trading with a 20% implied volatility, the standard deviation ranges are (in any given time period):

- Between $80 and $120 for 1 standard deviation
- Between $60 and $140 for 2 standard deviations
- Between $40 and $160 for 3 standard deviations

The congestion phase is where the market will stay about 2/3 of the time. When we think about our charts and levels, these will be your double tops and double bottoms when price is constantly fluctuating between two levels. The reason that the markets remain in congestion is that the uncertainty about the direction of the current price causes the strong hands and weak hands to constantly change the dominance until one of them overwhelms the other and the market breaks out. You'll have your typical false breakouts when the strong hands can't quite make the market break in either direction, but all false breakouts end up back in a level of congestion!

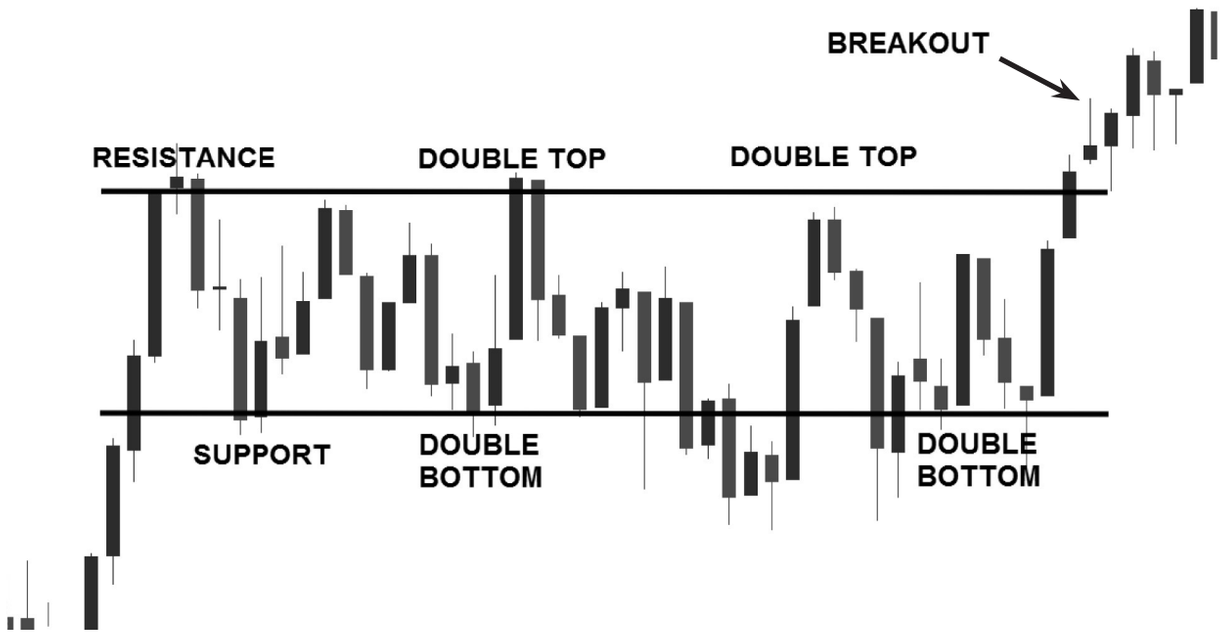


Figure 10.2 Congestion Phase

This chart shows a market that is in congestion. Every congestion level is not perfect! We do have a little dip below the level of support, but get right back into congestion after that. In terms of the bell-curve, we fell a little bit out of that +/- 1 σ range for a bit, but came right back and continued to rotate around the mean price.

Eventually, the market breaks out. In Figure 10.2, it's to the upside. The breakout is

where we get to the second part of the bell-shaped curve. This is where the market operates within two standard deviations of the mean (+/- 2 σ), something that doesn't happen nearly as often. When the strong hands begin to overwhelm the weak hands, we "breakout to the trend" in either direction.

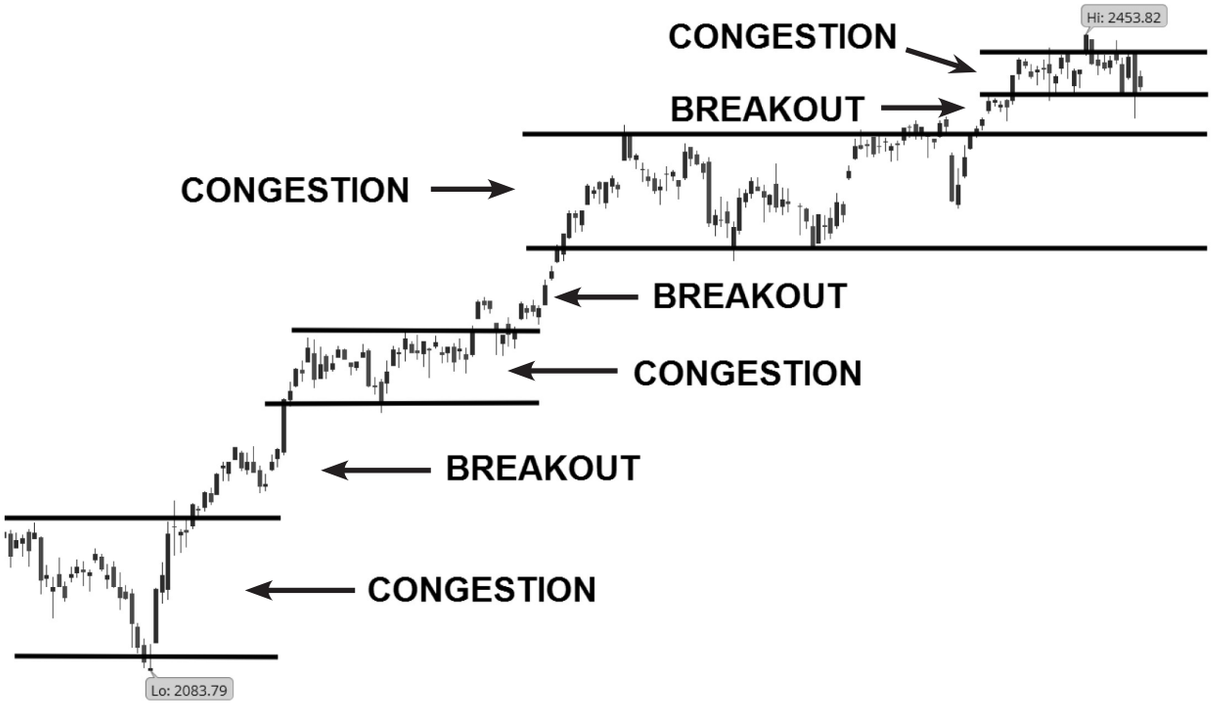


Figure 10.3 Congestion to Breakout Phase Over Time

Like I said before, it doesn't matter what a chart's time frame and price are when we observe levels, because all charts are the same. Figure 10.3 is a great representation of what the congestion to breakout phase looks like in an uptrending market. Every level of congestion breaks out to the upside, and then into another level of congestion back and forth! The strong hands were able to force the weak hands out of the market until they went to battle again at new levels. Although there is no time and price axis in this chart, you might've been able to figure out the chart we're looking at by the Hi and Lo bubbles. This is actually a nine-month chart of the S&P 500! The market has been in uptrend to say the least.

If the new strong hands begin to run over their opponents, the market transitions to the third phase, and a blowoff will occur. The blowoff brings us to the third portion of the bell-curve, where price fluctuates within three standard deviations (+/- 3 σ) of the mean. The amount of time the market will spend in this phase is very small in relation to the two other phases, but that doesn't make it any less important. The price movement you could see in this phase might be greater than the other two phases combined!

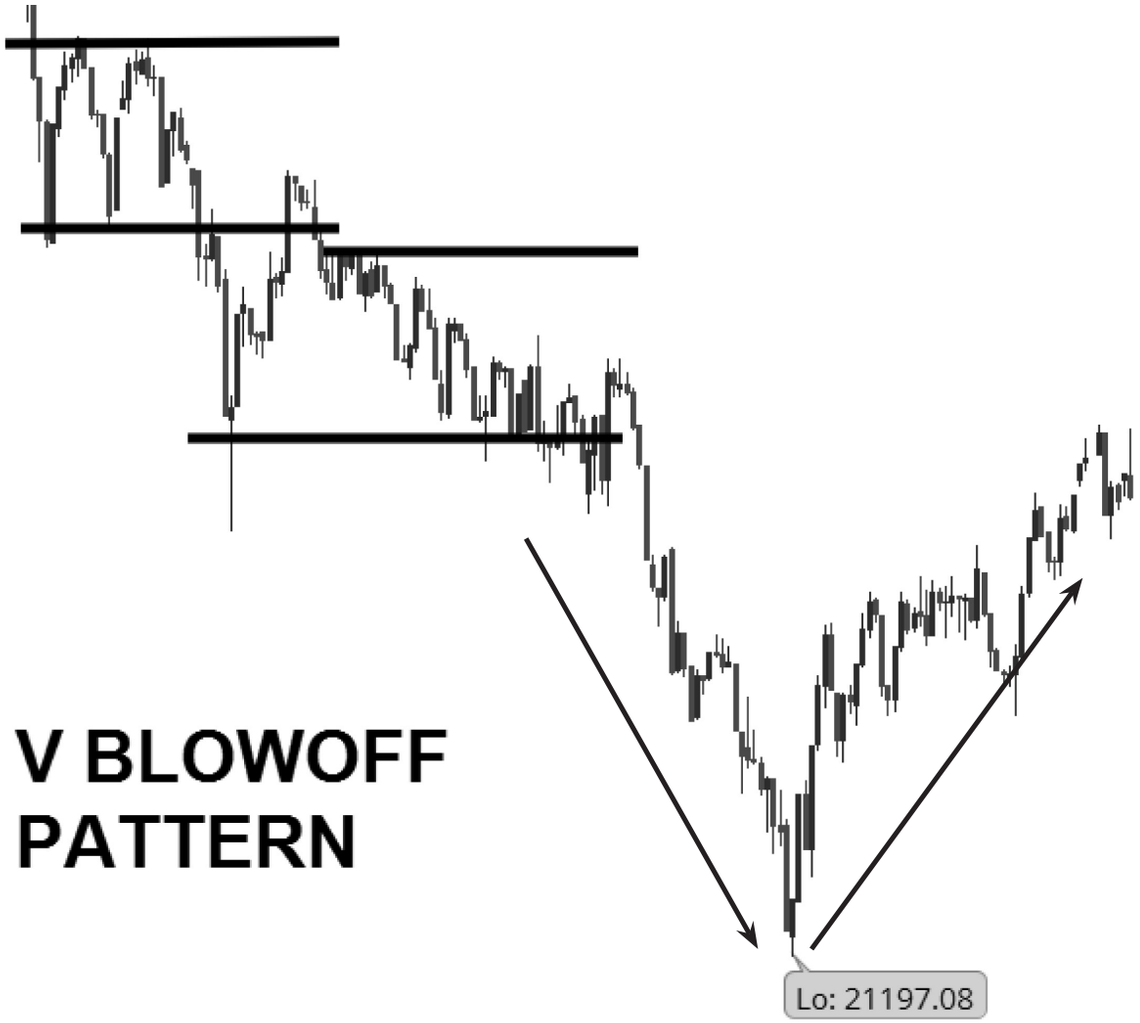


Figure 10.4 Blowoff Pattern

The blowoff, and V blowoff pattern definitely bring some excitement to the market. Look at that price movement! The strong hands have overwhelmed the weak hands so much at this point that the weak hands "puke out" and finally get out of their positions. As the weak hands become price insensitive, meaning they'll do anything to get out, the blowoff attracts "new money" that has been waiting on the sidelines. New money signifies participants that are not currently in the market. They could have been the strong hands that took profit on the way up/down or they could be the pukers that now join the new money. New money can also include people that weren't even in the market to begin with.

After the cycle is complete, it will start over again. The market will constantly rotate around the current price level, which is the ATM strike. The market can jump around however it wants. We can go from congestion level to congestion level without any clear trend, or we can go from one blowoff to another without any warning.

Always be aware of the opportunity the market is presenting to you. The market doesn't announce itself to anyone, so you must be ready to expect the unexpected. The greatest part about our trading is that our strategies can function well in any market phase. As long as we learn to identify which strategies will best suit our needs at any given time, we will be successful.

Why is the ATM Straddle the Backbone of Trading?

I have yet to mention the "straddle" in this book on weekly options, but I believe it's important to understand when we think about the concept of our trading. The ATM straddle is simply the addition of the call and the put ATM. A straddle is simply defined as an options strategy in which the trader holds a position in both a call and put with the same strike price and expiration date, paying both premiums. The ATM straddle gives us the expected price range of a stock in a given time period. The ATM is the current price of the stock and gives us all of the information necessary to calculate the probability of future price movement in front of us. If we know the current price, then on a theoretical basis the chance of a stock going up or down should be close to 50%, and in fact it is! **The price of the ATM is all air; it has no intrinsic value. From that information, market makers can price the probability of any option ending up in the money at expiration!** How is it possible to see future price action from the information given by the ATM? The answer is because your opponent (market maker) is setting the ground rules for you to play. They are doing all of the heavy lifting and they are now giving you a fair chance to play the option game. A game that we can win!

We've now covered all the aspects of the option model, but you still might be wondering, why weekly options? The answer is very simple; **it speeds up time!** I'm going to show you another very simple example of how you can speed up time. As I am writing this guide AAPL is trading at $123 a share. The one week ATM straddle is trading at $3.24. If I look out a year from now the yearly ATM straddle is trading at $8.56, which also makes sense because there is more time and more uncertainty until expiration. However, the Black-Scholes model is indicating with better than a 90% certainty that AAPL will be within a $115-131 share price range a year from now. **So how can you take advantage of this information?** Let's do the math. **If you can sell the ATM air for a week at $3.24 and have a conclusion at expiration six days from now, why would you wait a year and sell it at $8.56? You can sell the ATM at $3.24, 52 times for a total of $168.48 instead of $8.56! What you are doing is speeding up time; you are now trading like a market maker!**

Understanding Assignment

Assignment takes place when a written option is exercised by the options holder. Remember that we can be on both sides of assignment because the strategies I detailed in Chapter 8 involve both buying and selling options. Because we are operating on a shorter time frame with weekly options, I don't really advocate holding options until expiration unless you want to be long or short any given stock depending on your position. If you own a call option that is ITM at expiration, it will have value. You will have the right to buy 100 shares of the underlying stock if you choose, but for our purposes we will either want to sell these options for profit or "roll" them into the next week or time frame to keep our position on, depending on what the levels in our chart are telling us. On the other hand, if you have sold a call option that is ITM, you are obligated to deliver the terms of the option contract, which would be 100 shares on one contract. We don't want to hold short options until expiration, we either want to buy them back if we have a loss on the position, or roll them to collect more credit and continue our position. Because every strategy I went over besides an outright buy of a call or put involves multiple legs, you will have to determine what you want to do with your position when expiration is near. A credit spread has two legs, because you are buying one option and selling another. A risk reversal has three legs, because you are buying two different options and selling another. A ratio backspread has two legs because you are selling an option and simultaneously buying two contracts of another option. In Chapter 11, I am going to detail what different market phases mean for various positions. Chapter 8 focused solely on trades, regardless of what was happening in the market. Now we are going to combine all aspects of what we've learned in terms of our trades and the phase that the market is in.

Chapter 11: How to Trade the Three Major Phases of the Market

We've got our trades all set up and understood. We've gone over the three major phases of the market and how they function, pairing that with the market psychology that goes along with any given pattern in a chart that we see. If you think about all the phases married together, it's just a back and forth between the strong and weak hands.

The congestion phase showed us that the battle is relatively equal; the strong and weak hands will fight back and forth until one of them eventually overcomes the other, and we get to a breakout. Remember that this breakout can be to the upside or the downside. It's just a function of when the players decide to change their strategy. We'd usually think of a breakout as being to the upside, but you could take an upside breakout, flip it over, and you'd see the exact same pattern to the downside.

When the strong hands overwhelm the weak hands so much that price and time no longer matters, we get to the blowoff. Each chart is like a different story. As the story unfolds, it becomes much clearer what the characters are feeling and what they are doing. Our advantage comes with the knowing the characters and what they are generally feeling at any given time. Will we be able to correctly predict what they are going to do with certainty every time? Of course not. But the game of trading is just like any other game. You'll have winners, and you'll have losers. However, if you can have more winners than losers, you yourself will be a winner in the long run. When we talk about time frames and our trading bankroll, the long run is the one we focus on. You're not just going to make a couple trades and call it a career are you? Stay committed to your game plan and be confident in it.

Trading in the Congestion Phase

We've learned that congestion is the most common price pattern. The market trades in congestion almost 2/3 of the time. The first trade I make in congestion is generally a loser. It can be tough to identify the correct support and resistance levels as the markets form their double tops and double bottoms. But a good congestion pattern can last for a very long time, offering us plenty of opportunities to capitalize on the back and forth that congestion brings us. Once you see a pattern change, you can initiate a trade.

I want to stress again how important it is not to get caught up in **exact levels**. Remember we are trading with a butcher knife, not a scalpel. Congestion can look 1,000 different ways on 1,000 different charts, but the theme remains the same. Price is rotating around its mean and staying within one standard deviation of that mean! Figure 11.1 is basically perfect congestion (if such a thing exists, which it really doesn't). On the other hand, Figure 11.2 is another market in congestion, but the levels don't look exactly the same as Figure 11.1.

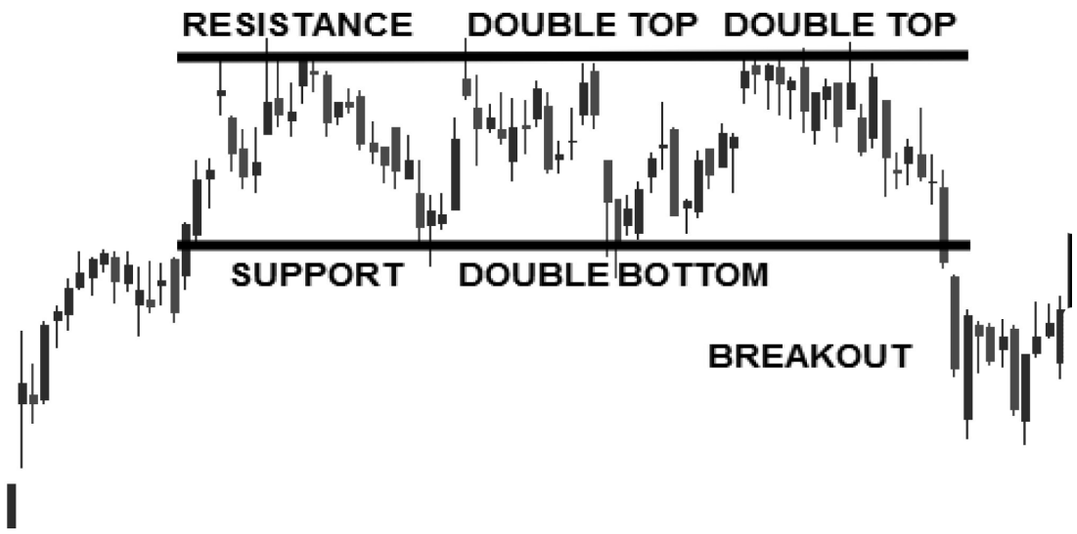


Figure 11.1 Perfect" Congestion

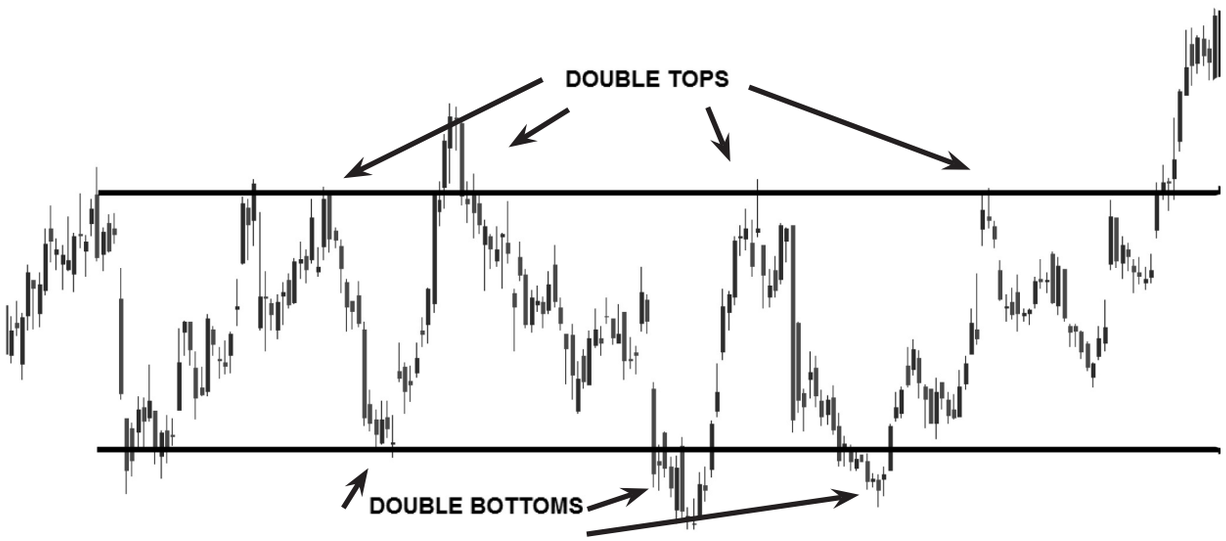


Figure 11.2 Regular Congestion

In Figure 11.2, we've got some double tops and double bottoms that either over extend across the range a little bit, or don't quite get there. That's why I like to use more than one time frame to execute trades. If you can see that you're around 5 percent from a support or resistance level, you can look for a spot to enter a trade. Look to your shortest time frame and as soon as your technical analysis gives you a signal, get to that order screen!

Figure 11.3 shows a market in two different time frames. Market (1) looks to be a 45 degree bull market with pretty low volatility. Market (2) looks totally different! It's still the same market, just in a shorter time frame. As you can see, the shorter time frame has a lot more volatility and therefore offers us more opportunities to trade.

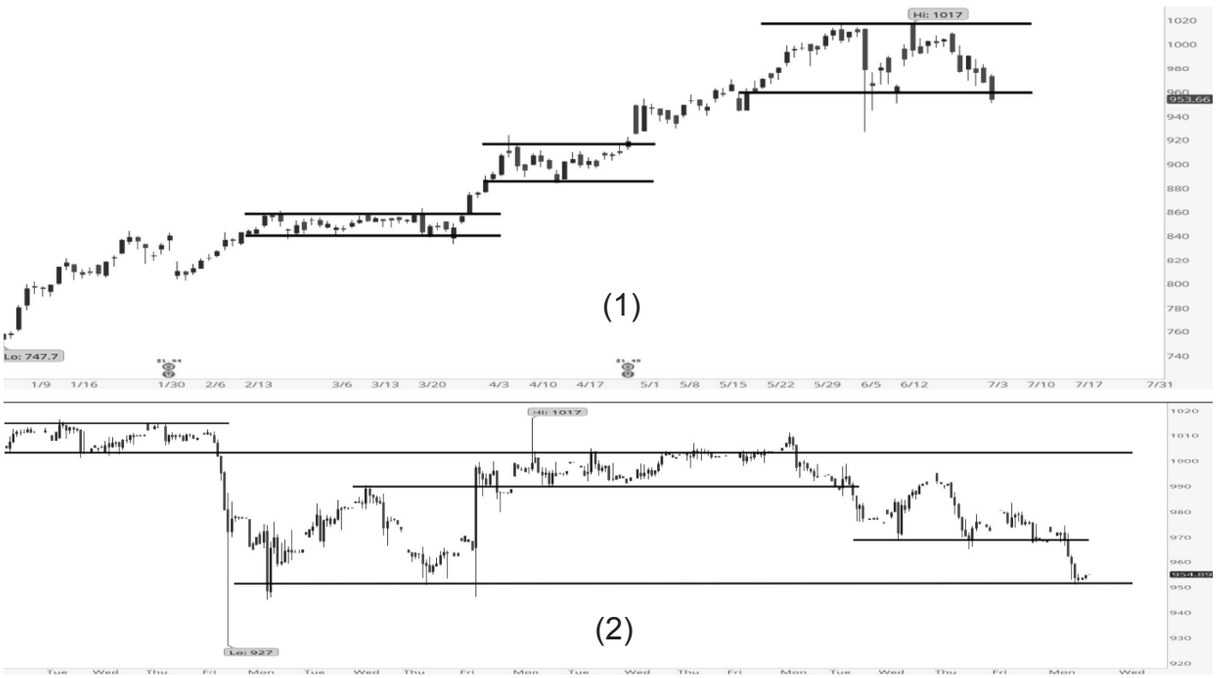


Figure 11.3 Observing a Market in Two Timeframes

To simplify everything down, we're always going to execute our trades off of the Alibaba (BABA) option chain. We will assume for the purposes of this book that the chart of BABA and the buy point on the shortest time frame is the ATM strike. BABA is trading at 140.99, so 141 will be the ATM strike. We're going to cover all trades from the outright buy of a call or put all the way to a ratio backspread and how to manage them in the congestion phase of the market! Here is the option chain we're going to be looking at, the ATM strike is highlighted.

CALLS							Strikes: 12	PUTS				
Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng			
7 JUL 17 (4) 100 **(Weeklys)**												26.00% (±3.299)
6.20 Z	-.25	6.05 M	6.30 X	7 JUL 17	135	.15 Q	.17 Z	.15 H	-.08			
5.45 Z	-.36	5.15 X	5.35 N	7 JUL 17	136	.23 N	.27 N	.26 C	-.04			
4.30 Z	-.67	4.25 X	4.45 N	7 JUL 17	137	.35 C	.41 X	.38 C	-.12			
3.58 C	-.22	3.45 M	3.60 N	7 JUL 17	138	.53 N	.59 N	.57 C	-.14			
2.75 Z	-.27	2.76 M	2.85 Q	7 JUL 17	139	.78 M	.85 Q	.80 X	-.16			
2.20 N	-.17	2.11 M	2.18 N	7 JUL 17	140	1.12 M	1.20 Z	1.14 X	-.06			
1.60 C	-.17	1.57 X	1.62 Q	7 JUL 17	141	1.55 M	1.64 Q	1.58 C	-.18			
1.15 C	-.16	1.09 X	1.16 N	7 JUL 17	142	2.09 M	2.18 Q	1.99 Q	-.27			
.80 W	-.16	.77 H	.81 N	7 JUL 17	143	2.72 M	2.82 N	2.95 C	+.31			
.55 Z	-.09	.47 X	.53 N	7 JUL 17	144	3.45 N	3.60 N	3.70 Z	+.29			
.34 C	-.09	.29 C	.34 Q	7 JUL 17	145	4.25 N	4.40 E	4.50 Z	+.40			
.23 Z	-.05	.17 M	.22 Q	7 JUL 17	146	5.10 M	5.35 X	5.55 Z	+.40			
14 JUL 17 (11) 100 **(Weeklys)**												28.00% (±5.63)
6.46 C	-.46	6.65 B	6.90 N	14 JUL 17	135	.74 C	.80 N	.86 I	+.06			
6.17 X	0	5.80 C	6.30 X	14 JUL 17	136	.93 C	1.00 Z	1.06 I	+.05			
5.17 I	-.43	5.10 X	5.30 N	14 JUL 17	137	1.17 C	1.24 Z	1.24 Q	-.06			
3.92 I	-1.19	4.40 X	4.60 N	14 JUL 17	138	1.45 C	1.53 Z	1.66 X	+.10			
3.90 B	-.50	3.75 X	3.90 N	14 JUL 17	139	1.78 C	1.87 Z	1.75 H	+.05			
3.40 Q	0	3.15 C	3.30 N	14 JUL 17	140	2.16 C	2.27 Z	2.13 I	-.07			
2.73 Q	-.17	2.63 C	2.75 N	14 JUL 17	141	2.62 C	2.73 Z	2.67 Q	-.02			
2.26 M	-.14	2.16 C	2.28 N	14 JUL 17	142	3.10 X	3.25 Z	3.75 H	+.50			
1.88 X	-.18	1.77 C	1.87 N	14 JUL 17	143	3.65 C	3.85 N	3.91 C	+.32			
1.50 Q	-.13	1.42 C	1.49 Q	14 JUL 17	144	4.30 N	4.50 E	3.73 C	-.55			
1.07 C	-.22	1.12 C	1.22 N	14 JUL 17	145	5.00 N	5.25 X	4.94 I	+.22			
.92 Q	-.12	.88 C	.97 N	14 JUL 17	146	5.65 C	6.15 X	5.93 C	-1.71			

Figure 11.4 BABA Four- and Eleven-Day Option Chain

We've got three things to focus on in this chapter: the trade, rolling up/down or rolling back, and managing risk. Let's get after it!

Trade One: Buying an Outright Option

Buying a Call

The most basic option trade is to buy one outright. You have limited risk and unlimited reward. One of the problems you face with buying outright options is that you're fighting time decay (the premium you paid for the option). That's going to be a lot in the weekly option serial. I only like to buy outrights when volatility is high. This might sound a bit counterintuitive, but the price movement is usually so high that you can overcome the time decay in the option. Even if you are slightly wrong in terms of price, you can still make money because nervous sellers keep bidding up the price in the option market. I said before that we want to buy ATM, or very close to it. Because BABA is so perfectly priced on a strike (141), we are going to buy the 141 call, which is the ATM call. I generally like to stick to the **ATM to ATM -1 calls when I am buying.** The ATM

strike has a bid/offer spread of about 8 cents. If you look at the ATM -6, the bid/offer is almost up to 25 cents. The closer from the ATM strike you go, the more illiquid options become. Even in a very liquid contract like BABA, you can't make money when you buy deep ITM calls. The bid/offer spread is just too wide. Another reason not to buy deep ITM calls is that you risk your option mimicking the underlying stock. Remember that deeper ITM options have a much higher delta, meaning that they will move much more proportionately with the stock as compared to the ATM option. Even though you still have limited risk, if you buy an option near parity and get a big move against you, it will lose almost as many deltas as the underlying stock, giving you a big loser.

Buying an outright call at a double bottom gives you a nice shot at a winner. First, you have support that is close by. Second, there is some volatility, and with the price angle accelerating it has a good chance to advance to the mean +1σ very quickly.

Rolling Up or Rolling Back

You have to manage risk once you enter into any given trade. As long as the trade goes in your favor, let the trade run. Your only adjustment would be to **"roll up or roll back.**" A rule of thumb to go by is that you should **never roll up until the new ATM strike is at least four strikes above your current long call.** Let's go over "rolling" one more time. It's not as confusing as it might sound. When you roll an option position, you are simply closing your current position and at the same time opening another position with the same goal. So in terms of BABA, the ATM strike is 141. If BABA makes a big move to the upside and is trading at 145 by the end of the week, we will sell our long call for a profit, and buy another ATM call, which would now be the 145 call. You are essentially creating a vertical spread! Our vertical spread trades deal with options that are in the same serial with different strikes. This time, we are using a different serial. With BABA, we would sell our ATM 141 7 JUL 17 call, and at the same time buy an ATM 145 14 JUL 17 call. This is a vertical spread using the 141 and 145 strikes! We are "rolling up" our position into the next serial! Now let's say you had purchased a 14 JUL 17 141 call in the first place which has 11 days until expiration (meaning that you would be purchasing the call option in the second option chain of Figure 11.4). The same rules would apply if BABA made a big move near the end of the week of July 7th! You would still create a vertical spread, you would just be using the same serial this time because the July 14th weeklys would still have 7 or 8 days until expiration.

When we roll up, we are limiting our intra trade risk. We are willing to pay the premium for the 145 call because with the 141 call being so deep ITM, it protects us in case of a sudden move in BABA. Remember that deep ITM calls have a very high delta, meaning the option will essentially move with the stock tick for tick. We don't want to mimic the underlying asset (BABA) tick for tick on the way down if the stock makes a big move against us, because we already have such a profit in the 141 call.

We roll back when the market is still in our favor on Friday. Rolling back is the term we use when our position hasn't quite reached a point where we need to roll up, but the technicals are still on our side. Let's say that BABA has only gone up a little to 141.30 by the Friday of the July 7th expiration. Your chart is still telling you that BABA is at a level of support, so you would roll back and create a "horizontal spread". I know that we haven't talked about a horizontal spread, but it's very logical when you think about it. We are still using the same strike! We would sell our 7 JUL 17 expiring weekly call that we're long, and buy the next weekly ATM call, which would be the 14 JUL 17 141 call! We are getting horizontal because we are staying at the same strike. What if BABA has gone down 30 cents to 140.70? The same rules apply. Remember the butcher knife versus the scalpel! If our chart is still telling us that BABA is at a level of support, then we keep our position going by creating a horizontal spread!

Managing Risk in a Call Buy

We know that our risk is limited to the debit we paid when we buy an outright call. We have positioned ourselves with a nice risk/reward trade. We can get out at any time, if our bottom or level of support is violated, or our short-term time frame tells us to take a loss. You can get out by simply selling the call. If we had bought the 7 JUL 17 141 ATM call and BABA has fallen to 139 by Friday, we would sell our call and take our loss. Then we move on to the next trade! I usually like to get out of a trade when my position has decreased by 30%. You can still watch the chart if BABA decides to get back into its level of congestion. If you reach the other side of congestion, you can look to reverse your previous position and get short if the double top holds and your shortest time frame gives you a reversal signal.

Buying a Put

Buying a put is the exact mirror image of buying a call. **The only difference is that it is initiated at the double top in congestion.** When we are buying a put, we are going to use the exact same strikes as buying a call because we want to trade **ATM.** The same principles apply to deep ITM puts as they do for calls; the bid/offer spreads are too high for us to trade! Just like the ATM -6 call, the ATM -6 puts also have a bid/offer spread of 25 cents. If we were going to buy a put in our current scenario, we would be buying the 7 JUL 17 141 put, which is the ATM put.

Rolling Down or Rolling Back

The same principles still apply with a put buy. We only adjust our position by **"rolling**

down or rolling back." A rule of thumb to go by is that you should **never roll down until the new ATM strike is at least four strikes lower than my current long put.** Rolling down with a put is the same thing as rolling up with a call. If we have purchased the 7 JUL 17 141 put and BABA is trading at 137 on Friday, we would roll down our position by selling the 141 put and buying the 137 put in the next serial, which is the 14 JUL 17 serial. We would be creating a vertical spread with the 141 and 137 strikes.

We roll back when things are still in our favor on Friday. If BABA has only gone down a little to 140.70 by the Friday of the July 7th expiration, but our levels are still telling us that BABA is a double top or level of resistance, we would roll back and create a "horizontal spread." We're still using the same strike. We would sell our 7 JUL 17 141 expiring weekly put that we are long, and buy a 14 JUL 17 141 put! We are getting horizontal because we are staying at the same strike. If BABA has gone up 30 cents the same rules still apply. If the levels are still telling us that BABA is at a level of resistance, initiate your horizontal spread.

Managing Risk in a Put Buy

Our risk is still limited to the debit we paid for the put. We can still get out at any time if our double top is violated. I generally use the same rules as I do on calls, if the value decreases 30% I get out of the position. If we had bought the 7 JUL 17 141 ATM put and BABA has risen to 143 by Friday, we would simply sell our put and take our loss. Then we move on. You can still watch the chart if BABA decides to come back down into its level of congestion.

Trade Two: The Credit Spread

Selling a Bull Vertical Put Spread

A double bottom is a great place to sell a bull vertical put spread. You have support and also a lot of room to the upside. Remember that we want to stick to our 2/3 risk/reward ratio when dealing with credit spreads. It's hard to say what credit we would receive when look at Figure 11.4, but if you take the midpoint of both the 141 and 140 puts and subtract them (1.59 and 1.16), it's around 40 cents which satisfies our 2/3 ratio. The exact credit you receive for the trade will obviously depend on your timing, but let's move forward with this example.

If we sell the 141/140 ATM put spread, we would receive approximately 40 cents. We could sell the 141 put for 1.55 and buy the 140 put for 1.15 (I know the ask is 1.20 right now, but imagine it's at 1.15). On this dollar wide spread, we are risking 60 cents to make 40 cents. The risk/reward is very good and exactly where we want it to be. If you're a more aggressive trader, you could consider the inside/outside (or 60/40 delta) put spread. This would most likely be the

142/140 put spread. With this trade, you could collect a credit basically equal to the debit. If the spread expires here, it will be near a scratch. Unlike the ATM put spread, the 60/40 doesn't give us the same reward if price doesn't change. The 60/40 gives us more upside if we're correct because we collected a bigger credit, but we can only make money if we've correctly predicted price. In a normal put spread, we can make money even if the stock remains neutral.

Rolling Up or Rolling Back

Let's say the market rallies after you put on your bull put spread. That's great! But we still have to manage the winner. You can do nothing and let the spread expire worthless. This means that you get to keep your initial credit that you received and move on. However, just like buying a put or call, you can roll up your position into the next serial. Similar to the outright buy of a call, I **never roll up until price advances to at least four strikes above my short leg of the credit spread.** In our case, the short leg is the leg that we sold. That would be 141 put in a regular bull put spread (or 142 if we put on a 60/40). You would roll up by selling the ATM +4 +3 put spread. That would be the 145/144 put spread if we did a normal put spread. If you are aggressive, you can let your first spread stay on because you are a **very big favorite to cash the trade**. If you are more conservative and worried that you might see a big swing in price, you can buy back the short leg (141 put) of the original spread. I like to leave the long leg on and here's why: the 140 put that I bought is most likely a teenie by now. If I do experience a major change in fortune, this teenie could turn into a monster winner! You should never sell your long leg and hold the short leg because you'll create a situation with unlimited risk. As long as the market stays in your favor, continue to roll the spreads up to maximize your gains.

Rolling back a credit spread operates under the same scenario as call and puts. The position has not really changed that much, but our technicals are still telling us that we want to be in the trade. On Friday, you can roll back your bull spread by selling the new ATM put spread. That could be the same spread (141/140) just in the next serial. It might be the 140/139, it all depends where BABA is trading. I only buy back my original spread if it is danger of being a loser. If BABA is trading at 142 very late on Friday, I can let the spread expire worthless because it most likely won't come back enough for me to make any money. The tricky part with credit spreads is when the price of the stock looks like it's going to be stuck right in between your two strikes. If I sold the 141/140 put spread and BABA is trading at 140.80 late in the day on Friday, I would personally buy back the spread, regardless of whether or not I am going to roll back. Because the 141 put I sold is ITM and the 140 put I bought is OTM, I put myself at risk of being "put" the stock at 141. This means that I could get assigned and be forced to deliver 100 shares of BABA at 141 because the put I sold is ITM. The put I bought is OTM, so it would be worthless. Think about it from this perspective: If I sold the 141 put to someone and the stock is now trading at 140.80, they would definitely want to exercise their right to sell the stock at 141 right? Exactly!

If the stock price is above 141, both of my puts would expire worthless, so I wouldn't have to do anything. If the stock price is below 140, both of my puts would be ITM, so my position would cancel out and I wouldn't be assigned anything, even though my spread would be a loser. Remember that you can always take the expiring spread off.

Managing Risk in a Bull Vertical Put Spread

Because we trade credit spreads ATM, just by luck we should cash 50 percent of these trades because that is what the delta calls for. With your skill, that number should be well into the 50's or maybe even low 60's. Cashing the 60/40 spread has the same odds, but it's tougher to break even in this kind of trade because of the price movement that you need.

How we will manage winners is pretty simple: As long as the trade is going our way, we can let it run. If it goes a great deal in our favor, we can "roll it up" or "roll it back." We roll up when the new ATM is at least four strikes above our current short leg, the leg we sold. I usually don't buy back the original spread in this scenario because it has such a high chance of being a winner, but that all goes back to how aggressive/conservative you are.

Selling a Bear Vertical Credit Spread

A double top is a great place to sell a bear vertical credit spread. You have resistance and also a lot of room to the downside. The 2/3 ratio is the most important thing we can look for with credit spreads. If we look at Figure 11.4, selling a bear vertical credit spread would look like this: sell the 141 call for 1.62 and buy the 142 call for 1.09. That would give us a credit of 41 cents for our 141/142 bear call spread. If we want to get more aggressive and sell a 60/40 spread, we would sell the 140 call and buy the 142 call. It's all a matter of preference.

Rolling Down or Rolling Back

Let's say the market falls after you put on your bear credit spread. This is good news, but we still have to manage our winner. You can do nothing and let the spread expire worthless and keep your initial credit. You can also roll up your position into the next serial. **I never roll down until price advances to at least four strikes below my short leg of the credit spread.** In our case, the short leg is the 141 call that we sold (in a 60/40 spread, that short leg would be the 140 call). We would roll down by selling the ATM -4 -3 call spread which would be the 137/138 call spread. If you are aggressive, you can let your first 141/142 spread stay on the books because **you are a very big favorite to cash the trade.** If you are more conservative and worried that you might see a big swing in price, you can buy back the short leg (141 call) of the original spread. I like to leave the long leg on and here's why: the 142 call that I bought is

most likely a teenie by now. If I do experience a major change in fortune, this teenie could turn into a big winner. Just like put spreads, you should never sell your long leg and hold the short leg because you'll create a situation with unlimited risk. If things stay in your favor, continue to roll down the spreads to maximize your gains.

We roll back when our position has not really changed that much, but our technicals are still telling us that we want to be in the trade. On Friday, you can roll back your bear spread by selling the new ATM call spread. That could be the same spread in the next serial. It might be the 142/143, it all depends where BABA is trading. I only buy back my original spread if it is in danger of being a loser. If BABA is trading at 140 very late on Friday, I can let the spread expire worthless because it most likely won't come back enough for me to make any money. The tricky part with credit spreads is when the price of the stock looks like it's going to be stuck right in between your two strikes. If I sold the 141/142 call spread and BABA is trading at 141.20 late in the day Friday, I would personally buy back the spread, regardless of whether or not I am going to roll back. Because the 141 call I sold is ITM and the 142 call I bought is OTM, I put myself at risk of being "called" the stock at 141. This means I could get assigned and be forced to deliver 100 shares of BABA at 141 because the call I sold is ITM. The call I bought is OTM, so it would be worthless. Think about it from this perspective: If I sold the 141 call to someone and the stock is now trading at 141.20, they would definitely want to exercise their right to buy the stock at 141 right? Absolutely!

If the stock price is below 141, both of my calls would expire worthless, so I wouldn't have to do anything. If the stock price is above 142, both of my calls would be ITM, so my position would cancel out and I wouldn't be assigned anything, even though my spread would be a loser. Remember that you can always take the expiring spread off.

Managing Risk in a Bear Vertical Call Spread

Let your winners run the same way you would in a bull put spread. If the trade is in our favor (depending on how much) we can "roll it down" or "roll it back." We roll down when the new ATM is at least four strikes below our current short leg, the leg we sold.

Trade Three: Risk Reversals

Risk Reversal (Synthetic Long)

The risk reversal is the first aggressive spread trade that we can make. We're essentially getting long the stock, creating a synthetic position. Our risk in this type of trade will be the same as an outright call buy from a price perspective, but by using the premium in the put we

will diminish our premium risk. The same rules apply for your time frames; when your shortest time frame gives you a buy signal, initiate the risk reversal! We limit our margin risk by selling a put spread on the opposite side of our call. Think back to the SPY example!

We know that BABA's current price is right at 141 (140.99). We can buy the ATM 141 call for approximately 1.62 and sell the ATM put spread (141/140) for about 40 cents as I mentioned in the previous section. This makes us long from about 142.22. We get this number by taking the price of the ATM call (1.62), subtracting the credit we receive from selling the ATM put spread (0.40), and adding that number to the ATM strike of the call, which is the 141 (141 + 1.22 = 142.22). The risk reversal combines all of the power of the naked option, but with less overall premium risk because of the put spread. Your risk is limited to the price of the call plus the loss in the put spread. For the 7 JUL 17 weeklys, our risk would be 2.12 (or $212 per contract). We get this number by adding the price of the call (1.62) to the max loss in the put spread (0.60).

The biggest edge in risk reversals is reducing the margin we would need to buy the stock outright. If you were to buy 100 shares of BABA (100 x $141 = $14,100!) and had a normal margin requirement of 50%, you would need at least $7,050 in your account to buy the stock. Using the risk reversal, the cost down to about $200 and gives you the same reward if the trade goes the way you've predicted. If BABA were to have a disastrous opening and was down $40, your total risk is about $200 versus $4,000 owning the stock. If it gaps $40 higher, you make the same amount as owning the stock outright! This kind of leverage is what I love about weekly options.

Rolling Up or Rolling Back a Synthetic Long

We will roll up our synthetic longs if the ATM moves more than two strikes to the upside. In our case, we would need the ATM to move to the 143 strike. Our original position includes buying the 141 call, and simultaneously selling the 141/140 put spread. If BABA makes a move to 143, **we will sell a vertical call spread and replace our old ATM call (141) with a new ATM call (143).** We don't need to replace the put spread because it is a winner, and you can use the credit you received in this put spread to help finance the new call that you buy. If you want to reduce your premium risk, you can sell the new ATM put spread (143/142), but you don't have to. If you roll up, you are reducing your intra trade risk, because the protection that your put spread offers you is now closer to the price of the new ATM call you bought. When we roll up, we have already booked a $2 winner (143-141) and can now be long with a premium risk of around $1.50 (price of the BABA ATM call).

The methodology for all of our trades is still the same. We roll back when the market is

still in our favor and our technical analysis shows us that we still want to be in the trade. In the case of a synthetic long risk reversal, we would roll back by first **selling the horizontal call spread.** We are simply moving option serials. In this case, we would sell the 7 JUL 17 141 call, and buy the 14 JUL 17 141 call. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our put spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back just as I detailed in the credit spread section. After we've determined what needs to be done with the old put spread, we will sell the 141/140 in the July 14th serial, creating the same position we just had in the July 7th serial!

Managing Risk in a Synthetic Long

All of our trades have limited risk and we can get out if we need to. The risk reversal (synthetic long) is managed similar to owning a call outright. We're just also dealing with a put spread at the same time. If you think back to the risk graph, the risk reversal looks exactly the same as buying a call. We can hold this type of trade all the way to the other side of congestion, and look to reverse our position and get short if the double top in the chart holds. If the double top doesn't hold, we can let the trade run and turn it into a monster winner. This is what I love about congestion! We can go back and forth with the same type of trade, and if our congestion level breaks out to the trend, we are saddled in for an incredible winner!

Risk Reversal (Synthetic Short)

If you can't tell already, the sections detailing our bearish positions are definitely shorter in length than our bullish positions. That is because the same principles apply, just in the opposite direction! The synthetic short works exactly the same as a synthetic long, except instead of buying a call and selling a put spread; we are buying a put and selling a call spread! The biggest edge using the short risk reversal is that it allows you to short the stock, with no FINRA restrictions. When you hear about large hedge funds shorting stock, it is almost always through options. If they are wrong their risk is limited just like ours. If they're right, they get the stock through exercise. Additionally, they are not subject to the short-selling margin.

We initiate the short risk reversal by buying the ATM put, and simultaneously selling the ATM bear call spread. We know BABA's current price is at right at 141. If we look at Figure 11.4, we can buy the ATM 141 put for approximately 1.55 and sell the ATM call spread (141/142) for about 41 cents. That makes us short from about 139.76. We get this number by taking the price of the ATM put (1.55), subtracting the credit we receive from selling the ATM call spread (0.41),

and subtracting that number from the ATM strike of the put, which is the 141 (141 – 1.14 = 139.86). Our risk is limited to the price of put plus the max loss in the put spread. For the 7 JUL 17 weeklys, our risk would be 2.14 (or $214 per contract). We get this number by adding the price of the put (1.55) to the max loss in the put spread (0.59).

Rolling Down or Rolling Back a Synthetic Short

We will roll down our synthetic shorts if the ATM moves more than two strikes to the downside. In our case, we would need the ATM to move to the 139 strike. Our original position includes buying the 141 put, and simultaneously selling the 141/142 call spread. If BABA makes a move to 139, **we will sell a vertical put spread and replace our old ATM put (141) with a new ATM put (143)**. We don't need to replace the call spread because it is a winner, and you can use the credit you received in this call spread to help finance the new put that you buy. If you want to reduce your premium risk, you can sell the new ATM call spread (139/140), but you don't have to.

If we need to roll back a synthetic short, we do this by **first selling the horizontal put spread.** We are simply moving options serials. In this case, we would sell the 7 JUL 17 141 put, and buy the 14 JUL 17 141 put. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our call spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back. After we've determined what needs to be done with the old call spread, we will sell the 141/142 in the July 14th serial, creating the same position we just had in the July 7th serial.

Managing Risk in a Synthetic Short

All of our trades have limited risk and we can get out if we need to. The risk reversal (synthetic short) is managed similar to owning a put outright. This type of trade can also be held to the other side congestion and if we see a reversal signal, we can get on the other side of the trade.

Trade Four: Ratio Backspreads (1x2 for Even)

Call Ratio Backspread (1x2)

This is the final trade in our sequence. This spread can be tricky and needs to have the right amount of air in the balloon or the strikes may be too wide to use it properly. I don't like to use this trade during periods of high volatility; I like the risk reversal or outright buy better. This strategy is the most effective when you can use **"touching strikes" (strikes that are right next**

to each other in the option chain). When premium is extremely high, the strikes won't match up the correct way to use this trade. You must be cognizant of this! If you look at Figure 11.4, you can tell right away that we wouldn't be able to use touching strikes to put this type of trade on for even money. We would have to use the 141/143 spread to achieve this goal.

Remember that with ratio backspreads, we are selling on option ATM and simultaneously buying two options OTM. If the market is trading near our OTM option(s) near expiration, we'll basically be at our max loss. The ATM will be trading near parity, and OTM options will be basically worthless. **The main danger of this spread is that the market goes in the direction we predicted, but it will move too slowly and will threaten to stall near our long strike.** Our risk in this type of trade can still be minimal even if we are completely wrong on the price direction. This stems from the fact that we usually put this trade on for a minimal debit or slight credit. I wouldn't recommend putting on this trade in BABA given the current option prices because we would have to use the 141 and 143 strikes to do the trade for even, meaning we could sell the 141 ATM call for 1.57 and buy two 143 OTM calls for 0.81 each, making the cost of the trade 0.05 (1.57 (credit) minus (0.81 x 2 = 1.62 (debit)) = 0.05).

If you're still confused on the math behind this type of trade, that's okay. Here's how backspreads first clicked for me. Think about your position as two completely different trades. In the first trade, we would be selling a BABA 141 call. When you sell a call, if the stock goes up, you are losing money. If I sold a BABA 141 call to you, and BABA is now trading at 142, you would want to exercise your call right? That's correct. Because you could now buy 100 shares of BABA at 141 when the stock is trading at 142, and immediately sell back your shares for a profit of $1 ($100 per contract). Now think about the second trade. You have bought two OTM calls at 142. If BABA expires at 141 on Friday, what are these calls worth? They're worth nothing! You would lose the debit you paid for these two calls.

All that information is great, but why would we lose the max when the price of BABA settles exactly at 142? I thought this was a long position, and BABA has gone up! This is true, but it hasn't gone up by enough. At 142, you have lost money on the call that you sold at 141. The 142 calls that you bought have no value because the stock is trading exactly at that price. You have basically lost the max amount you can on the short call without getting any value from your long calls. When we think about the risk graph for a call backspread, we start to lose less money when the stock gets past 142, because our 142 calls are now gaining value. We get to our breakeven point at 143 (assuming we did this trade for even) because our two 142 calls are now worth $1, and we have lost $2 on our 141 call. After 143, our position will return a positive value and create an unlimited reward situation as long as BABA keeps going up!

We can use the same thought process to see why a massive drop in price wouldn't hurt us either (meaning we were completely wrong on the price direction). If we do the trade for even or a slight credit, only the short call that we sold will come into play. If we put on a 141/142 call backspread and BABA drops to 130, our 142 calls are still worthless. The 141 call will now be

worth a lot more, but remember that we sold it for a credit, so we don't get to take advantage of the downward price movement because of the spread that we have on. The 141/142 is now worthless because neither call is ITM. So, if we have put on the trade for no cost (even) a major drop in price doesn't hurt us at all. This is why so many traders like to use this spread. It's not completely without risk, but basically we want some major price movement. If we are right on the price direction, but not by enough, that's where we get into trouble.

Rolling Up or Rolling Back the Call Ratio Backspread

Although I wouldn't make this type of trade in BABA at the current price, I'll still teach you to how to manage this type of spread. For the purposes of **THIS** example only, let's pretend that we could make this trade for even by using the 141 and 142 strikes. I know that we would never make this trade in real life, but before we make real trades it's important to understand the concept of trade. The reason I want to use the 141/142 1x2 example here is because under normal circumstances, **you want to roll up when your short strike is more than two strikes in the money.** This would be the 143 strike in this example. **The first step to rolling up a 1x2 is to sell your extra-long call. This turns the original spread into a long put spread.** Woah woah woah! What do you mean long put spread? Here's what I mean: Think about your original position. You have sold a 141 call, and bought two 142 calls. If BABA reaches 143, your two 142 calls are now worth $1 a piece (assuming we are right at expiration with no premium, I'm just trying to keep things consistent here so you can understand). If we sell **one** of our long calls (142) we receive $1. When we originally bought these calls at 142, they wouldn't have been worth anything at expiration because BABA was trading at 141. Now we are left with one 141 call that we sold, and one 142 call that we bought. Does that sequence look familiar? It should, this is what we would call a bear vertical credit spread! I thought a bear vertical meant that you wanted the stock to go down? This is true, but remember that there is another factor to our position with a call ratio backspread. This other factor brings a different outlook to our position.

We want to put on our ratio backspreads for no cost, or sometimes even a minor credit. Let's say we've put on this 141/142 1x2 spread on for no cost. If BABA reaches 143 and we sell one of our 142 long calls for $1, we are now up $1 in this particular position. The sale of this long call creates a vertical call spread with our remaining 141 call and 142 call. The 141 and 142 calls (short call spread) now function as a long put spread with no risk for this reason: we have already maxed out our risk on this spread. If we originally sold the 141/142 credit spread, we would lose the max at 143. We would let the spread expire worthless and move on with our day. How can we have no risk on this spread when we relate it back to a 1x2 call backspread? We've sold one of our longs calls for $1. We are now left with a call spread that is worthless. Since we've already maxed out our risk, if the market continues to rally, we wouldn't lose any more money on just the call spread that we're left with. However, if the market would suddenly

reverse, it would act as a long put spread and if BABA happened to break below 141 with some crazy end of the day price action, the credit spread would go to zero and we would theoretically get to keep the credit we received for the spread. And we've already made $1 by selling one of our calls! Let's say our original position consisted of selling the 141 call for 1.50, and selling two 142 calls for 0.75. When BABA got to 143, we sold on of our 142 calls for $1 (probably wouldn't be exactly $1 in real trading, but just follow the example). We are now left with a vertical call spread that we theoretically sold for 0.75 (1.50 – 0.75 = 0.75). This call spread is worthless when BABA is trading at 143, but BABA happens to drop $3 to 140 by the end of the day, the spread would be worth 0, and we would get to keep our original credit of 0.75. This would bring our profit for the trade to 1.75 ($1 for the long call we sold, and $0.75 for the credit we received when the spread went to zero). By selling one of the longs calls, we have locked in a winner for the trade, and the call spread is just there to help us make some extra money if the market happens to break. That is a lot of information for one simple trade! But it really makes it a lot easier when you break it up into pieces.

Let's get back to our roll. We've sold on of our 142 calls and are left with a credit spread that has a chance to make us some more money. We are now going to **sell the new ATM strike and buy two of the next higher strike!** If BABA does get to 143 like I said, we would then sell the 143 call in the next serial (ATM strike), and buy two 144 calls. It's that easy!

Rolling back on Friday will all depend on where the trade is in relation to where we initiated it. If the trade is in our favor (the market is above our long strike, which is the 142) we start with the same first step that we did when rolling up. We would **sell** one of our 142 calls creating a credit spread in the original trade. If it is at a loss (the market is below your long strike, 142, but above the short strike, 141), we cover the initial trade, meaning we would buy back the credit spread for whatever its worth. Remember the risk graph for call backspreads. We lose money in any scenario when the price of the stock is between our two strikes. That would be between 141-142 in this example. If BABA has risen to 141.80 (meaning that we would be taking a minor loss on the trade) by Friday and our technicals are still telling us that we want to be long, we will just move on to the next serial. We must still monitor our credit spread (because we've sold one 142 call) but in the new serial we would now probably sell the 142 call and buy two 143 calls. The 142 call will not be exactly ATM, but it is the closest to the ATM strike.

Managing Risk in the Call Ratio Backspread

We've already gone into **a lot** of detail on how to manage the call ratio backspread, and that is because it is slightly different than the other trades we have in our toolbox. It has virtually no downside risk if we are wrong in predicting the correct price movement, and that comes with the fact that we want to put this trade on for even. You can't have the former without the latter. I don't adjust this type of trade until one of these scenarios occurs:

a) The long side of our trade (2 calls) becomes at least the ATM -1 strike (it has moved 2 strikes)
b) The market arrives at the long strike on expiration Friday

In scenario (a), the trade is a winner, and we now want to take advantage of that by rolling up into the next serial. After we sell one of our long calls, we are now short a call spread that is acting as a long put spread if the market happens to break. Our roll up consists of putting on the same position (with the new ATM strike) in the next serial.

In scenario (b), we are at our max loss for the trade, but that doesn't mean our technicals can't still be favorable. This is due to the unique risk setup for a backspread. In this case, we would still sell one of our long calls, and monitor our credit spread that we now have on. If our chart is still telling us that BABA is at a double bottom, we can put on the same position using the ATM strike in the next serial. It could be the same strike, or it might be one above, it all depends. One of the most important things to remember with backspreads (call or put) is that you want to use touching strikes. When you "split the strikes", you put yourself at much greater risk.

Put Ratio Backspread (1x2 for Even)

The put ratio backspread is the exact opposite of the call ratio backspread. Because volatility is generally higher during breaking markets, I don't get a chance to use this bearish spread as much as the bullish one. When we see a break from the top of congestion, volatility normally hasn't reached a level that would rule this type of trade out. But if we try to execute this trade at a double top in a breaking market it will be much tougher with more air in the balloon. In bear market, I like to stick to risk reversals or credit spreads.

More air in the balloon makes it much tougher to buy options outright and use the 1x2 spread. When volatility is higher, the premium will be higher, and it's likely that you won't be able to use touching strikes. This is what we want to stay away from when using backspreads. When we have to split the strikes, we put ourselves at a lot more risk. Just like the call backspread example, we wouldn't be able to use touching strikes in BABA at this level. Instead of using the 141 and 140 strikes, we would have to use the 139 strike to buy our puts, which still wouldn't allow us to put the trade on for even.

Rolling Down or Rolling Back the Put Ratio Backspread

Rolling down the put backspread is the mirror image of rolling up the call backspread. You want to roll it down when your short strike is more than two strikes ITM. The first step to rolling down a put backspread is to sell one of your extra-long puts. Theoretically, if we could use the 141/140 1x2 in BABA, we would be selling one of our 140 puts. **This turns the original spread into a long call spread with no risk.** It's the same thought process that we used for the call backspread. The next step is to **sell the new ATM strike and buy two of the next lower strike.** If BABA fell to 139, we would initiate our roll by selling the 139 put, while simultaneously buying two 138 puts.

Rolling back all depends on where your spread is in relation to the initial position. If the trade is in our favor (the market is below our long strike, which is the 140) we start with the same first step that we did when rolling up. We would **sell** one of our 140 puts creating a credit spread in the original trade. If it is at a loss (the market is above your long strike, 140, but below the short strike, 141), we cover the initial trade, meaning we would buy back the credit spread for whatever its worth. If our technicals are still telling us that we want to be short, we will just move on to the next serial. In the new serial, **we would sell the new ATM strike, and buy two of the next lower strike.** If BABA goes down to 140.20, we could now sell the 140 put in the next serial and buy two of the 139 puts.

Managing Risk in the Put Ratio Backspread

All the same rules still apply, just in the opposite fashion. I adjust this type of trade when either my long side of the trade is at least two strikes in the money, or the market is trading right around my long strike on expiration Friday. Remember that you want to use touching strikes!

Overview of the Congestion Phase

We have now matched our trading knowledge with the phase of the market we will deal with the most, congestion. It's important to not only recognize what phase the market is in, but what trade will best suit your needs. You can always use credit spreads, because they represent the greatest chance for you to turn a profit. Whether that's regular credit spreads or 60/40's, it's all up to you. The theory doesn't change.

An outright buy needs some more volatility (air coming into the balloon, more premium) to be effective, but you need to be aware of situations when too much premium has already been priced in. This could cause a major headache if you correctly predict the price action, but end up not making any money due to a decrease in volatility. That's why I like to use risk reversals better, they put us in a position with less premium risk.

The risk reversal might have more price risk than an outright buy, but because we greatly reduce our premium risk, I like this strategy the best when predicting direction. It offers unlimited reward and limited risk no matter how much air is in the balloon.

The backspread also has unlimited reward, but you need to use touching strikes to maximize its effectiveness. If there is too much air in the balloon, using touching strikes most likely won't be possible. That's why low volatility environments are best suited for backspreads.

Trading in the Breakout Phase

We are finally out of congestion! All markets will eventually break out of congestion when a double top or double bottom fails to hold, hence giving way to the breakout. Markets that are breaking out are different. When they begin, the style that we use to trade will also change. The actual trades will not change, but when and how we use them will change. You wouldn't shoot something with a shotgun when it's over a mile away right? Take out that sniper!

The first trade we make in the breakout phase will usually be a pretty nice winner. This is because we should either be long or short from the other side of a double top or double bottom, and create one of those situations where unlimited reward seems like it's taking place! Weak hands will be covering their losses, and they might decide to join the strong hands on their march. New money might also come into play for those waiting for an opportunity to join the trend. When the market makes a higher low or lower high, we can confirm the trend! I still like to use two time frames in a trending market, because I like to confirm my findings.

We're going to use the same option chain as the congestion section. Here it is again.

CALLS							Strikes: 12	PUTS					
Last X		Net Chng	Bid X		Ask X		Exp	Strike	Bid X		Ask X	Last X		Net Chng
7 JUL 17 (4) 100 **(Weeklys)**														26.00% (±3.299)
6.20	Z	-.25	6.05	M	6.30	X	7 JUL 17	135	.15	Q	.17 Z	.15	H	-.08
5.45	Z	-.36	5.15	X	5.35	N	7 JUL 17	136	.23	N	.27 N	.26	C	-.04
4.30	Z	-.67	4.25	X	4.45	N	7 JUL 17	137	.35	C	.41 X	.38	C	-.12
3.58	C	-.22	3.45	M	3.60	N	7 JUL 17	138	.53	N	.59 N	.57	C	-.14
2.75	Z	-.27	2.76	M	2.85	Q	7 JUL 17	139	.78	M	.85 Q	.80	X	-.16
2.20	N	-.17	2.11	M	2.18	N	7 JUL 17	140	1.12	M	1.20 Z	1.14	X	-.06
1.60	C	-.17	1.57	X	1.62	Q	7 JUL 17	141	1.55	M	1.64 Q	1.58	C	-.18
1.15	C	-.16	1.09	X	1.16	N	7 JUL 17	142	2.09	M	2.18 Q	1.99	Q	-.27
.80	W	-.16	.77	H	.81	N	7 JUL 17	143	2.72	M	2.82 N	2.95	C	+.31
.55	Z	-.09	.47	X	.53	N	7 JUL 17	144	3.45	N	3.60 N	3.70	Z	+.29
.34	C	-.09	.29	C	.34	Q	7 JUL 17	145	4.25	N	4.40 E	4.50	Z	+.40
.23	Z	-.05	.17	M	.22	Q	7 JUL 17	146	5.10	M	5.35 X	5.55	Z	+.40
14 JUL 17 (11) 100 **(Weeklys)**														28.00% (±5.63)
6.46	C	-.46	6.65	B	6.90	N	14 JUL 17	135	.74	C	.80 N	.86	I	+.06
6.17	X	0	5.80	C	6.30	X	14 JUL 17	136	.93	C	1.00 Z	1.06	I	+.05
5.17	I	-.43	5.10	X	5.30	N	14 JUL 17	137	1.17	C	1.24 Z	1.24	Q	-.06
3.92	I	-1.19	4.40	X	4.60	N	14 JUL 17	138	1.45	C	1.53 Z	1.66	X	+.10
3.90	B	-.50	3.75	X	3.90	N	14 JUL 17	139	1.78	C	1.87 Z	1.75	H	+.05
3.40	Q	0	3.15	C	3.30	N	14 JUL 17	140	2.16	C	2.27 Z	2.13	I	-.07
2.73	Q	-.17	2.63	C	2.75	N	14 JUL 17	141	2.62	C	2.73 Z	2.67	Q	-.02
2.26	M	-.14	2.16	C	2.28	N	14 JUL 17	142	3.10	X	3.25 Z	3.75	H	+.50
1.88	X	-.18	1.77	C	1.87	N	14 JUL 17	143	3.65	C	3.85 N	3.91	C	+.32
1.50	Q	-.13	1.42	C	1.49	Q	14 JUL 17	144	4.30	N	4.50 E	3.73	C	-.55
1.07	C	-.22	1.12	C	1.22	N	14 JUL 17	145	5.00	N	5.25 X	4.94	I	+.22
.92	Q	-.12	.88	C	.97	N	14 JUL 17	146	5.65	C	6.15 X	5.93	C	-1.71

Figure 11.4 BABA Four- and Eleven-Day Option Chain

Let's take a look at a market that is breaking out, or "trending." You can see that although the overall trend is positive, it is still rotating around its mean. Unlike congestion, the mean is positive and you can see that the market rally is pretty consistent.

Figure 11.5 Trading Market

The trades and explanations will be explained just like they were in congestion, but there are some minor differences in the theory, so make sure you're aware of these differences! For the most part, the explanations will be the same. But it never hurts to get more practice thinking about the trades we are going to make!

Trade One: Buying an Outright Option

Buying a Call

Buying calls in a bullish market is tough. In congestion, I mentioned that we like volatility to be increasing rather than decreasing when buying outright options. The market in Figure 11.5 is a very slow moving bull market. The VIX is usually declining in a low volatility bullish market and this is the reason I would stay away from buying calls in this kind of scenario. We can't get the best bang for our buck when we buy calls in this environment. However, if we do decide to buy a call, we are still sticking to the ATM strike. Our technical analysis is still the same. If we are observing a breakout in our longer time frame, and see a double bottom in our shortest time frame, then we can initiate the buy!

Rolling Up or Rolling Back

The phase of the market doesn't change the fact that we still have to manage a trade once we are in it. As long as the trade is in our favor, we can let it run. The breakout phase gives us a unique opportunity to take profits. If we're using two time frames, and our shortest time frame gives us a sell signal, we can scale down your position and take some profit. This

comes with a caveat. If we are only dealing with one contract, we can't scale down your position because selling our call would result in the end of a trade. However, if we're dealing with multiple contracts (let's say two), we can lock in a profit if price has gone in the right direction by selling half of our position. If we're dealing with more than two contracts, then the amount that you want to scale down your position is all up to you. This goes back into the theory of how conservative or aggressive you are. **When we are long multiple contracts, I recommend selling 50 percent when my shortest time frame turns negative.** If we have bought two calls in BABA and our shortest time frame reaches a double top (even though the longest time frame is still in a breakout), we would then sell one of our calls and lock in a profit. This is simply a recommendation. If we are trading the breakout phase using only one time frame, we can simply stay in our position until that time frame gives us a sell signal. Regardless of how many time frames we are using, we can roll up the same way we did in congestion. **We never roll up until the new ATM is at least four strikes above our current long call**. This roll would again create a vertical credit spread; we are selling our old ATM call(s), and buying a new ATM call(s). If we bought an ATM call on BABA at 141, and it is now trading at 145, we would roll up.

We still roll back by creating a horizontal spread. If BABA has only gone up to 141.20 by expiration Friday, we can create a horizontal spread by selling our 141 call in the old serial, and buying a 141 call in the new serial. In Figure 11.4, the old serial would be the 7 JUL 17's and the new serial would be the 14 JUL 17's.

Managing Risk in a Call Buy

Our risk is still limited to the debit we paid when we buy an outright call. Always allow trending trades to run as long as our techicals stay positive. There's no telling how long the stock will run up, and hopefully it runs on forever!

Buying a Put

Flip Figure 11.5 upside down. What do you see? It's a bear market! Bear markets generally have higher volatility because they are characterized by fear, which means higher volatility. Buying a put is similar to buying a call except for this major difference: **The VIX should be rising and not falling.** Buying puts in a rising volatility market is very different than buying calls in falling volatility. Even if you are slightly wrong on the price direction, you can still make money if more air is being pumped into the balloon. In a rising volatility environment, this could very well be the case. We are still staying ATM when we are buying puts.

Rolling Down or Rolling Back

The phase of the market doesn't change the fact that we still have to manage a trade once we are in it. If we are dealing with one contract, we can't scale down our position in the same way that we couldn't scale down with a call. However, when we are dealing with multiple contracts we can use the same rule of thumb by selling 50 percent of our position when our shortest time frame turns negative. We still don't roll down **until the new ATM is at least four strikes lower than our current long put.** We can roll down by doing a vertical spread, selling the long put, and buying a new put ATM. If we have bought a put on BABA at 141 and the stock has gone down to 137, we would sell our 141 put and buy a 137 put, which is the new ATM put.

We still roll back by creating a horizontal spread. If BABA has only gone down to 140.80 by expiration Friday, we can create a horizontal spread by selling our 141 put in the old serial (7 JUL 17) and buying a 141 put in the new serial (14 JUL 17).

Managing Risk in a Put Buy

Our risk is still limited to the debit we paid when we buy an outright put. Allow these trades to run as long as our technicals stay negative, there's no telling how long a bear market can last!

Trade Two: The Credit Spread

Selling a Bull Vertical Put Spread

We initiate our credit spreads in the congestion phase by observing double tops and double bottoms. Selling credit spreads in a market that is breaking out or trending is a little bit different. We won't have a double top or double bottom in our time frame (assuming we are using one). The market will be in rotation about its mean, but now the mean will have a positive slope. Remember that we want to stick to our 2/3 risk/reward ratio when dealing with credit spreads. It's hard to say what credit we would receive when look at Figure 11.4, but if you take the midpoint of both the 141 and 140 puts and subtract them (1.59 and 1.16), it's around 40 cents which satisfies our 2/3 ratio. The exact credit you receive for the trade will obviously depend on your timing, but let's move forward with this example.

If we sell the 141/140 ATM put spread, we would receive approximately 40 cents. We could sell the 141 put for 1.55 and buy the 140 put for 1.15 (I know the ask is 1.20 right now, but imagine it's at 1.15). On this dollar wide spread, we are risking 60 cents to make 40 cents. The risk/reward is very good and exactly where we want it to be. If you're a more aggressive trader, you could consider the inside/outside (or 60/40 delta) put spread. This would most likely be the 142/140 put spread. With this trade, you could collect a credit basically equal to the debit. If the spread expires here, it will be near a scratch. Unlike the ATM put spread, the 60/40 doesn't give

us the same reward if price doesn't change. The 60/40 gives us more upside if we're correct because we collected a bigger credit, but we can only make money if we've correctly predicted price. In a normal put spread, we can make money even if the stock remains neutral.

Rolling Up or Rolling Back

Let's say the market rallies after you put on your bull put spread. That's great! But we still have to manage the winner. You can do nothing and let the spread expire worthless. This means that you get to keep your initial credit that you received and move on. However, just like buying a put or call, you can roll up your position into the next serial. Similar to the outright buy of a call, **I never roll up until price advances to at least four strikes above my short leg of the credit spread.** In our case, the short leg is the leg that we sold. That would be 141 put in a regular bull put spread (or 142 if we put on a 60/40). You would roll up by selling the ATM +4 +3 put spread. That would be the 145/144 put spread if we did a normal put spread. If you are aggressive, you can let your first spread stay on because **you are a very big favorite to cash the trade.** If you are more conservative and worried that you might see a big swing in price, you can buy back the short leg (141 put) of the original spread. I like to leave the long leg on and here's why: the 140 put that I bought is most likely a teenie by now. If I do experience a major change in fortune, this teenie could turn into a monster winner! You should never sell your long leg and hold the short leg because you'll create a situation with unlimited risk. As long as the market stays in your favor, continue to roll the spreads up to maximize your gains.

Rolling back a credit spread operates under the same scenario as call and puts. The position has not really changed that much, but our technicals are still telling us that we want to be in the trade. On Friday, you can roll back your bull spread by selling the new ATM put spread. That could be the same spread (141/140) just in the next serial. It might be the 140/139, it all depends where BABA is trading. I only buy back my original spread if it is danger of being a loser. If BABA is trading at 142 very late on Friday, I can let the spread expire worthless because it most likely won't come back enough for me to make any money. The tricky part with credit spreads is when the price of the stock looks like it's going to be stuck right in between your two strikes. If I sold the 141/140 put spread and BABA is trading at 140.80 late in the day on Friday, I would personally buy back the spread, regardless of whether or not I am going to roll back. Because the 141 put I sold is ITM and the 140 put I bought is OTM, I put myself at risk of being "put" the stock at 141. This means that I could get assigned and be forced to deliver 100 shares of BABA at 141 because the put I sold is ITM. The put I bought is OTM, so it would be worthless. Think about it from this perspective: If I sold the 141 put to someone and the stock is now trading at 140.80, they would definitely want to exercise their right to sell the stock at 141 right? Exactly!

If the stock price is above 141, both of my puts would expire worthless, so I wouldn't have to do anything. If the stock price is below 140, both of my puts would be ITM, so my position would cancel out and I wouldn't be assigned anything, even though my spread would be a loser. Remember that you can always take the expiring spread off.

Managing Risk in a Bull Vertical Put Spread

You should expect to cash a higher percentage of your bullish put spreads than you do in congestion. If our bull spread goes against us by more than one strike (that would be the 142 strike if we sold the 141/140 ATM put spread) but our technicals are still positive, we can simply sell another put spread at a lower price. If BABA keeps breaking upward, we can keep adding spreads as long as our technical analysis tells us to stay long. Remember what we talked about with ratio backspreads and how put spreads turn into debit call spreads and vice versa? The same principle still applies here. A worthless put spread can be used as protection after we initiate another put spread when a major reversal in price happens.

Selling a Bear Vertical Call Spread

Flip your brain into call spread mode! Nothing changes; we are just on the other side of the market. The 2/3 ratio is the most important thing we can look for with credit spreads. If we look at Figure 11.4, selling a bear vertical credit spread would look like this: sell the 141 call for 1.62 and buy the 142 call for 1.09. That would give us a credit of 41 cents for our 141/142 bear call spread. If we want to get more aggressive and sell a 60/40 spread, we would sell the 140 call and buy the 142 call. It's all a matter of preference.

Rolling Down or Rolling Back

Let's say the market falls after you put on your bear credit spread. This is good news, but we still have to manage our winner. You can do nothing and let the spread expire worthless and keep your initial credit. You can also roll up your position into the next serial. **I never roll down until price advances to at least four strikes below my short leg of the credit spread.** In our case, the short leg is the 141 call that we sold (in a 60/40 spread, that short leg would be the 140 call). We would roll down by selling the ATM -4 -3 call spread which would be the 137/138 call spread. If you are aggressive, you can let your first 141/142 spread stay on the books because **you are a very big favorite to cash the trade.** If you are more conservative and worried that you might see a big swing in price, you can buy back the short leg (141 call) of the original spread. I like to leave the long leg on and here's why: the 142 call that I bought is most likely a teenie by now. If I do experience a major change in fortune, this teenie could turn

into a big winner. Just like put spreads, you should never sell your long leg and hold the short leg because you'll create a situation with unlimited risk. If things stay in your favor, continue to roll down the spreads to maximize your gains.

We roll back when our position has not really changed that much, but our technicals are still telling us that we want to be in the trade. On Friday, you can roll back your bear spread by selling the new ATM call spread. That could be the same spread in the next serial. It might be the 142/143, it all depends where BABA is trading. I only buy back my original spread if it is in danger of being a loser. If BABA is trading at 140 very late on Friday, I can let the spread expire worthless because it most likely won't come back enough for me to make any money. The tricky part with credit spreads is when the price of the stock looks like it's going to be stuck right in between your two strikes. If I sold the 141/142 call spread and BABA is trading at 141.20 late in the day Friday, I would personally buy back the spread, regardless of whether or not I am going to roll back. Because the 141 call I sold is ITM and the 142 call I bought is OTM, I put myself at risk of being "called" the stock at 141. This means I could get assigned and be forced to deliver 100 shares of BABA at 141 because the call I sold is ITM. The call I bought is OTM, so it would be worthless. Think about it from this perspective: If I sold the 141 call to someone and the stock is now trading at 141.20, they would definitely want to exercise their right to buy the stock at 141 right? Absolutely!

If the stock price is below 141, both of my calls would expire worthless, so I wouldn't have to do anything. If the stock price is above 142, both of my calls would be ITM, so my position would cancel out and I wouldn't be assigned anything, even though my spread would be a loser. Remember that you can always take the expiring spread off.

Managing Risk in a Bear Vertical Call Spread

Let your winners run the same you would in a bull put spread. If the trade is in our favor (depending on how much) we can "roll it down" or "roll it back." We roll down when the new ATM is at least four strikes below our current short leg, the leg we sold.

I have one new concept that I want to introduce to you when dealing with credit spreads in the congestion phase or the breakout phase, **it is called the "Iron Condor."** I never liked the name because it sounds too complicated to use, but it's really not. An iron condor is simply the combination of a bull put spread and a bear call spread. When we put on our credit spreads, we are dealing with one spread. To manage risk with these spreads, **we can turn them into iron condors when we get a reversal signal in our chart**.

The methodology is the same when we sell a bull put spread, but because we are talking about managing risk in a bear call spread, I'll use that as our initial trade. I have to give some love to short side! Let's say we have sold the ATM 141/142 bear call spread on BABA and the

stock is trading at 143 on Friday and our chart tells us that we should be on the other side of the market. We don't buy back the 141/142 call spread because it is worthless. If expiration were right now, we would lose the max. Due to our reversal signal, we would create an "iron condor" by selling a bull put spread on the other side of the market. In this case, we would probably sell the 140/139 bull vertical. We wouldn't be able to collect as much credit as we would ATM, but we would still collect something. One of these spreads will expire worthless. That is a fact. Our most beneficial scenario will come if they both expire worthless! We will get to keep the credit we received for both spreads and move on to the next trade. Both spreads would expire worthless if BABA settled at 140.50, below our bear call spread and above our bull put spread.

Trade Three: Risk Reversals

Risk Reversal (Synthetic Long)

The risk reversal in a trending market functions very similarly to a market in congestion. Our main advantage is that we can get long the stock and at the same time diminish our premium risk by adding the put spread. For risk reversals, I suggest using two time frames. We know that BABA's current price is right at 141 (140.99). We can buy the ATM 141 call for approximately 1.62 and sell the ATM put spread (141/140) for about 40 cents as I mentioned in the previous section. This makes us long from about 142.22. We get this number by taking the price of the ATM call (1.62), subtracting the credit we receive from selling the ATM put spread (0.40), and adding that number to the ATM strike of the call, which is the 141 (141 + 1.22 = 142.22). The risk reversal combines all of the power of the naked option, but with less overall premium risk because of the put spread. Your risk is limited to the price of the call plus the loss in the put spread. For the 7 JUL 17 weeklys, our risk would be 2.12 (or $212 per contract). We get this number by adding the price of the call (1.62) to the max loss in the put spread (0.60).

The biggest edge in risk reversals is reducing the margin we would need to buy the stock outright. If you were to buy 100 shares of BABA (100 x $141 = $14,100!) and had a normal margin requirement of 50%, you would need at least $7,050 in your account to buy the stock. Using the risk reversal, the cost down to about $200 and gives you the same reward if the trade goes the way you've predicted. If BABA were to have a disastrous opening and was down $40, your total risk is about $200 versus $4,000 owning the stock. If it gaps $40 higher, you make the same amount as owning the stock outright! This kind of leverage is what I love about weekly options.

Rolling Up or Rolling Back a Synthetic Long

We will roll up our synthetic longs if the ATM moves more than two strikes to the upside. In our case, we would need the ATM to move to the 143 strike. Our original position includes buying the 141 call, and simultaneously selling the 141/140 put spread. If BABA makes a move to 143, **we will sell a vertical call spread and replace our old ATM call (141) with a new ATM call (143).** We don't need to replace the put spread because it is a winner, and you can use the credit you received in this put spread to help finance the new call that you buy. If you want to reduce your premium risk, you can sell the new ATM put spread (143/142), but you don't have to. If you roll up, you are reducing your intra trade risk, because the protection that your put spread offers you is now closer to the price of the new ATM call you bought. When we roll up, we have already booked a $2 winner (143-141) and can now be long with a premium risk of around $1.50 (price of the BABA ATM call).

The methodology for all of our trades is still the same. We roll back when the market is still in our favor and our technical analysis shows us that we still want to be in the trade. In the case of a synthetic long risk reversal, we would roll back by first **selling the horizontal call spread.** We are simply moving option serials. In this case, we would sell the 7 JUL 17 141 call, and buy the 14 JUL 17 141 call. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our put spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back just as I detailed in the credit spread section. After we've determined what needs to be done with the old put spread, we will sell the 141/140 in the July 14th serial, creating the same position we just had in the July 7th serial!

Managing Risk in a Synthetic Long

The two time frame setup has a great advantage over one time frame with risk reversals. This is because you know that your longer time frame will be bullish, but that doesn't necessarily mean that your shortest time frame will be. Since you are long and the market trend is bullish, you are essentially neutral the market. **We can exit this trade by selling our long call if we get a reversal signal in our shortest time frame**. We will leave the put spread in place because it can help us in two ways. First, if the rally continues and we took profits a little early, it will provide us with extra profit. Second, if we did happen to exit at the right time, we won't have to reenter the entire trade if we want to get back in on the long side. We can simply rebuy the call because our put spread is still in place.

Risk Reversal (Synthetic Short)

Just like the synthetic long, the synthetic short works well in either the congestion or breakout

phase of the market. Our biggest advantage is still the fact that we can essentially short the stock without any restrictions. We initiate the short risk reversal by buying the ATM put, and simultaneously selling the ATM bear call spread. We know BABA's current price is at right at 141. If we look at Figure 11.4, we can buy the ATM 141 put for approximately 1.55 and sell the ATM call spread (141/142) for about 41 cents. That makes us short from about 139.76. We get this number by taking the price of the ATM put (1.55), subtracting the credit we receive from selling the ATM call spread (0.41), and subtracting that number from the ATM strike of the put, which is the 141 (141 – 1.14 = 139.76). Our risk is limited to the price of put plus the max loss in the put spread. For the 7 JUL 17 weeklys, our risk would be 2.04 (or $204 per contract). We get this number by adding the price of the put (1.55) to the max loss in the put spread (0.59).

Rolling Down or Rolling Back a Synthetic Short

We will roll down our synthetic shorts if the ATM moves more than two strikes to the downside. In our case, we would need the ATM to move to the 139 strike. Our original position includes buying the 141 put, and simultaneously selling the 141/142 call spread. If BABA makes a move to 139, **we will sell a vertical put spread and replace our old ATM put (141) with a new ATM put (143).** We don't need to replace the call spread because it is a winner, and you can use the credit you received in this call spread to help finance the new put that you buy. If you want to reduce your premium risk, you can sell the new ATM call spread (139/140), but you don't have to.

If we need to roll back a synthetic short, we do this by **first selling the horizontal put spread.** We are simply moving options serials. In this case, we would sell the 7 JUL 17 141 put, and buy the 14 JUL 17 141 put. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our call spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back. After we've determined what needs to be done with the old call spread, we will sell the 141/142 in the July 14th serial, creating the same position we just had in the July 7th serial.

Managing Risk in a Synthetic Short

I want to reiterate the benefit of using two time frames with risk reversals. Sometimes we can see something in our shorter time frame that we wouldn't be able to see in our longer time frame. If you happen to get a buy signal in your shortest time frame, **we can exit the trade by selling our long put.** We keep our call spread on for the same reasons we talked about in the synthetic long section.

Trade Four: Ratio Backspreads (1x2 for Even)

Call Ratio Backspread (1x2)

I really like the ratio backspread in a trending market. It works better in a downtrend because the price action is usually better, but both kinds of trends will work. A market that is breaking will most likely have rising volatility and this greatly benefits us because we are long two options for every one that we are short. The air coming into balloon is good for us! I want you to be wary of volatility levels before you initiate a backspread. If volatility is already extremely high, we probably want to stay away from this trade because we're going to have to split strikes. Remember that with ratio backspreads, we are selling on option ATM and simultaneously buying two options OTM. If the market is trading near our OTM option(s) near expiration, we'll basically be at our max loss. The ATM will be trading near parity, and OTM options will be basically worthless. **The main danger of this spread is that the market goes in the direction we predicted, but it will move too slowly and will threaten to stall near our long strike.** We are hoping that the trend accelerates and gains momentum when we use the backspread. Our risk in this type of trade can still be minimal even if we are completely wrong on the price direction. This stems from the fact that we usually put this trade on for a minimal debit or slight credit. I wouldn't recommend putting on this trade in BABA given the current option prices because we would have to use the 141 and 143 strikes to do the trade for even, meaning we could sell the 141 ATM call for 1.57 and buy two 143 OTM calls for 0.81 each, making the cost of the trade 0.05 (1.57 (credit) minus (0.81 x 2 = 1.62 (debit)) = 0.05).

Rolling Up or Rolling Back the Call Ratio Backspread

I went into great detail about the ins and outs of this kind of theoretical backspread in BABA in the congestion phase, so I'll spare you all the details this time. If the spread goes in our favor, **we want to roll up when our short strike is more than two strikes in the money. The first step to rolling up a 1x2 is to sell you extra-long call. This turns the original spread into a long put spread**.

Rolling back on Friday will all depend on where the trade is in relation to where we initiated it. If the trade is in our favor (the market is above our long strike, which is the 142) we start with the same first step that we did when rolling up. We would **sell** one of our 142 calls creating a credit spread in the original trade. If it is at a loss (the market is below your long strike, 142, but above the short strike, 141), we cover the initial trade, meaning we would buy back the credit spread for whatever its worth. Remember the risk graph for call backspreads. We lose money in any scenario when the price of the stock is between our two strikes. That

would be between 141-142 in this example. If BABA has risen to 141.80 (meaning that we would be taking a minor loss on the trade) by Friday and our technicals are still telling us that we want to be long, we will just move on to the next serial. We must still monitor our credit spread (because we've sold one 142 call) but in the new serial we would now probably sell the 142 call and buy two 143 calls. The 142 call will not be exactly ATM, but it is the closest to the ATM strike.

Managing Risk in the Call Ratio Backspread

Managing risk in a call backspread in a trending market is definitely different compared to a market that is in congestion. We still have the same risk! If the market has a massive reversal compared to when we put on the spread, we're still only at risk for the initial debit (or hopefully credit) that we put the spread on for. Our max risk is still when the stock settles on the price of our long strike. However, if the trade is going our way and we receive a sell signal in our shortest time frame, it's important **that we take the whole spread off!** This might seem a bit counterintuitive, but you must remember how the risk for this particular trade is set up. If price goes in our direction, but too slow for us to make a profit, we are kind of stuck right? Choppyness is the worst kind of thing the market can do near the end of our backspread if price hasn't gone far enough to the upside. If we get a sell signal in our shortest time frame, we could experience the negative side effects of the trade "racing" to the downside. If we didn't roll up (this would be the case if our short strike wasn't more than two strikes in the money), we will essentially be naked a near parity call, and short a near parity put spread. Our long call spread will have rolled over into a short put spread. This is why I mentioned closing the entire trade in the roll back section if we don't have the ability to monitor the call spread after we sell one of our long calls.

Let's say we put on a 141/142 call backspread for even and BABA rallies to 142.95 late on Friday, but we don't have enough time to monitor the call spread to see if we need to make any adjustments if BABA closes within the two strikes (assuming we would sell one of the long calls, turning our position into a bear vertical call spread). Assuming we have done nothing to our original position (meaning we still have a 1x2 on), we will be short a 141 call, and our long call spread (1x2) will now act as a short put spread (bull vertical). This happens when price is above the long strike of the spread, 142 in our case. This 1x1 spread will now act as a short put spread because if price declines back into the 141-142 range, we will lose money (on that particular spread). So just like in a short put spread where we want price to stay above a certain level, we need price to stay/get above 143 because that is our breakeven on the upside in a 1x2, but the position is complicated. If we get that reversal signal, we put ourselves at risk to lose the max for this trade, and a lot of inexperienced traders will learn this the hard way. Here's

why I want you to cover this type of trade if you haven't rolled up or back yet: if the market starts to break back down, we're putting ourselves at major risk. Yes, our spread is about even right now, but with our long call spread acting as a short put spread, the worst thing that can happen is if the market breaks back into the dangerous range near our max loss, which is at 142. We lose the max at 142 because our long calls are worth nothing, and we will lose money on the short call we have sold at 141. This type of trade is fantastic when the market is in a big trend, but if it suddenly reverses and turns choppy we'll be in store for a major headache. When in doubt, we must cover and get out of the trade. Everything about this trade and its management is intuitive. First, we must understand the goals and scenarios for the trade. Second, we must understand how our position can rapidly change once we are near expiration. Once we put those two pieces together, we will be dangerous traders!

Put Ratio Backspread (1x2)

I love the put backspread in a downtrending market because volatility is usually on the rise. Think about an uptrend versus a downtrend in terms of volatility. In an uptrending market, volatility is usually lower because the market is grinding upward and there is really no reason for people to be fearful because, well, the market is going up and everyone is happy and carefree! In a downtrend, volatility is usually on the rise because the market is continually going and lower and people are fearful that it might break into a free fall. This is good for us in a put backspread because we are long two options for every one that we are short. The air creeping into the balloon is good for us! This strategy in a downtrending market is the kind of thing that makes us dangerous traders. Everyone else might be panicking but we will not be!

The same principle applies though if volatility is **already too high.** We won't be able to use touching strikes, which is essential when using the put backspread. We want volatility to increase drastically **once we are already in the trade.** Just like the call side, we wouldn't be able to use touching strikes in BABA on the put side. This is because if we used the 141/140 1x2 put backspread, the trade would cost us much more than even. The 141 put is trading around 1.58 and the 140 put is trading around 1.15, so if we did a 1x2 in this scenario if would be for a debit of around 70 cents. We would have to go to the 143 strike to even think about doing this trade, so for real purposes we are not going to use this trade in this current scenario given in Figure 11.4

Rolling Down the Put Ratio Backspread

Rolling down this spread is the mirror image of rolling up the call backspread. For the purposes of this example, we are going to pretend that our position consists of selling the 141 put and buying two 140 puts. Imagine BABA has fallen to 138.50, which is two strikes below

the 141 put we sold. **We roll down when our short strike is more than two strikes in the money.** The 141 put is more than two strikes ITM at 138.25. **The first step to rolling down a 1x2 is to sell our extra-long put. This turns the original spread into a long call spread with no risk.** We have made money on this trade, and now this new spread is acting a long call spread because it is now a 1x1 bull vertical. We have already lost the max on **THIS** particular spread in terms of this spread only. Don't confuse this with the original trade, because we have already profited from selling one of our long puts. Now we have a 141/140 put spread on that has lost the max, and can only protect us if BABA makes an enormous move to the upside. We roll down by selling the new ATM put (138 strike) and simultaneously buying two of the 137 puts in the next serial. The previous put spread that we have on is protection for BABA making a move back to the upside. If BABA continues to go down (which is good) this former put spread will expire at 0, which is fine because we have already made the proper adjustment in the position.

Managing Risk in the Put Ratio Backspread

The difference in management for a put backspread is the same as it was for a call backspread in a trending market. It's better to take this trade off too early rather than let it "blow back" in your face. Exactly like the call spread, if you get a short term reversal signal, close the entire spread. Don't think twice about it.

Overview of the Breakout/Trending Phase

We still covered all of our trades in this phase of the market, but we did have some different things to look for. When the market breaks out of congestion (+/- 1σ), it moves to the trending phase (+/- 2σ). This brings us new opportunities that we might not have had in the congestion phase! Like we talked about in the phases of the market section, the trending phase will not happen nearly as often as the congestion phase, but that doesn't mean we can't take advantage of the unique opportunities it can bring.

The risk in the trending phase is very different than in congestion. Generally speaking, a bullish trend will be characterized by low volatility and a smooth process. Markets can have volatile rallies, and many times the first break above a double top can be quick and very wild. But for the most part, when the long-term trend is positive, the pattern will become more passive and so will volatility.

A breaking market is usually driven by fear, and as the trend grows, dip buyers will usually be hiding in a cave somewhere. We've been in a bull market for so long now that it's hard to remember what the panic of 2008 was like. But you can bet your bottom dollar that the market will break again. When that happens, we will be ready to take advantage of it.

Trading in the Blowoff Phase

We are at the final stage of the market! This stage, although small in its time, is mighty in its price action. That's what makes it so interesting. When a trade is initiated in the blowoff phase, almost all of the information about the current market is in place. First, we broke out above or below congestion. Then, we moved through the trend. Now, we are +/-3σ and all hell has broken loose! Do not fear the blowoff phase; although it has only a small amount of data under the distribution curve, it offers us one of the most unique opportunities to trade. Let's see what a blowoff looks like again in the chart below:

Figure 11.6 Market in a Blowoff

We had a minor level of congestion near the top of the chart, then BOOM! The market went into a freefall. Price eventually bottomed out as it always will in a blowoff. It's just a matter of when that will happen!

At this point in the market, the greed of the strong hands will nearly be satisfied. The fear of the weak hands will have reached a point where they no longer care about price; they just

want to get out of their positions. Volatility will be through the roof if the market is bottoming. It will be high on a massive rally, but not nearly as high as if it were breaking.

Here's a great example of how high volatility can get in a breaking market. During the housing collapse of 2008, the VIX reached all-time highs and hit its peak at 89.53. Today's market? Completely different story. As I sit here and write this, the VIX is currently trading at 10.72. Just a little bit different than it was during the collapse of 2008. Why is it so different? Think about what's going on and what's been going in the market for the past 10 years. It has been going straight up! There has been no fear, and hence there has been no volatility.

Let's make this comparison to the individual stock that we've been looking at, BABA.

CALLS							Strikes: 12		PUTS				
Last X	Net Chng	Bid X	Ask X				Exp	Strike	Bid X	Ask X		Last X	Net Chng
7 JUL 17 (4) 100 **(Weeklys)**													26.00% (±3.299)
6.20 Z	-.25	6.05 M	6.30 X				7 JUL 17	135	.15 Q	.17 Z		.15 H	-.08
5.45 Z	-.36	5.15 X	5.35 N				7 JUL 17	136	.23 N	.27 N		.26 C	-.04
4.30 Z	-.67	4.25 X	4.45 N				7 JUL 17	137	.35 C	.41 X		.38 C	-.12
3.58 C	-.22	3.45 M	3.60 N				7 JUL 17	138	.53 N	.59 N		.57 C	-.14
2.75 Z	-.27	2.76 M	2.85 Q				7 JUL 17	139	.78 M	.85 Q		.80 X	-.16
2.20 N	-.17	2.11 M	2.18 N				7 JUL 17	140	1.12 M	1.20 Z		1.14 X	-.06
1.60 C	-.17	1.57 X	1.62 Q				7 JUL 17	141	1.55 M	1.64 Q		1.58 C	-.18
1.15 C	-.16	1.09 X	1.16 N				7 JUL 17	142	2.09 M	2.18 Q		1.99 Q	-.27
.80 W	-.16	.77 H	.81 N				7 JUL 17	143	2.72 M	2.82 N		2.95 C	+.31
.55 Z	-.09	.47 X	.53 N				7 JUL 17	144	3.45 N	3.60 N		3.70 Z	+.29
.34 C	-.09	.29 C	.34 Q				7 JUL 17	145	4.25 N	4.40 E		4.50 Z	+.40
.23 Z	-.05	.17 M	.22 Q				7 JUL 17	146	5.10 M	5.35 X		5.55 Z	+.40
14 JUL 17 (11) 100 **(Weeklys)**													28.00% (±5.63)
6.46 C	-.46	6.65 B	6.90 N				14 JUL 17	135	.74 C	.80 N		.86 I	+.06
6.17 X	0	5.80 C	6.30 X				14 JUL 17	136	.93 C	1.00 Z		1.06 I	+.05
5.17 I	-.43	5.10 X	5.30 N				14 JUL 17	137	1.17 C	1.24 Z		1.24 Q	-.06
3.92 I	-1.19	4.40 X	4.60 N				14 JUL 17	138	1.45 C	1.53 Z		1.66 X	+.10
3.90 B	-.50	3.75 X	3.90 N				14 JUL 17	139	1.78 C	1.87 Z		1.75 H	+.05
3.40 Q	0	3.15 C	3.30 N				14 JUL 17	140	2.16 C	2.27 Z		2.13 I	-.07
2.73 Q	-.17	2.63 C	2.75 N				14 JUL 17	141	2.62 C	2.73 Z		2.67 Q	-.02
2.26 M	-.14	2.16 C	2.28 N				14 JUL 17	142	3.10 X	3.25 Z		3.75 H	+.50
1.88 X	-.18	1.77 C	1.87 N				14 JUL 17	143	3.65 C	3.85 N		3.91 C	+.32
1.50 Q	-.13	1.42 C	1.49 Q				14 JUL 17	144	4.30 N	4.50 E		3.73 C	-.55
1.07 C	-.22	1.12 C	1.22 N				14 JUL 17	145	5.00 N	5.25 X		4.94 I	+.22
.92 Q	-.12	.88 C	.97 N				14 JUL 17	146	5.65 C	6.15 X		5.93 C	-1.71

Figure 11.4 BABA Four- and Eleven-Day Option Chain

In Figure 11.4, BABA is trading at a volatility of 26 percent (top right hand corner). The ATM straddle with four days remaining until expiration is trading a little over $3 (ATM call plus the ATM put). That means that market makers have factored into the market a price movement of (+/-3σ) around $4.50 (1.50 times 3). We have learned that option prices are a factor of air coming into the balloon. To figure out the price of the ATM if BABA went from 26 percent to 89 percent, we would divide 89 by 26 to first get the factor for which the price of the ATM would increase. That factor is about 3.4 times as much volatility. If we multiple the ATM straddle of BABA ($3) by 3.4, we get a little over $10. That means the ATM straddle in BABA would go to +/- $10, a more than 300 percent increase! And that is with only four days to go until expiration!

Many TV and market experts would lead you to believe that this would never happen again. They were saying the same thing before the housing collapse. They were also saying the same thing before 1987. If you don't think that something like this can't happen again, you are just like all of these other "experts." The truth is that this can happen again, and it will. It's just a

matter of when! **This is why we are never naked options.** Some of the biggest traders of all time have learned this lesson the hard way. We never want to learn this lesson, and we won't have to if we are prepared.

When the market is at extremes, many traders will say that "it is impossible to catch a falling knife." I will show you that it is not only possible, but one of our best opportunities to trade! The key is in our preparation and initiation of the trades.

Using two time frames in the blowoff phase is an absolute must! I can't stress this enough. To best demonstrate this to you, I am again going to use my favorite sport, baseball. Let's say you have a team, the Hoppers, that has gone completely off the rails. They are an average team, but have dropped nine out of their last ten games. From an outsider's perspective, they want no part of this team! They have been absolutely terrible as of late and have shown no signs of turning the tide. Now let's say we are an avid fan of this team and have stuck with them the entire season and are not going to stop now.

In their eleventh game after this ten game spiral, they are fighting the good fight with a division rival. The game has gone back and forth, but they are down 6-4 in the seventh inning. The outsider's perspective still remains the same; "Of course the Hoppers are down again, they're terrible!" You as an avid fan don't care what the outsiders have to say because this is still your team. In the seventh inning, your team has men on 1st and 2nd with two outs and the opposing team brings in their best reliever to shut down inning. Against all odds, the eight-hitter of all people hits a three-run homer and your Hoppers take a 7-6 lead! What a turning point! This is how the sport of baseball can change on a dime; all it takes is one key play in one key spot for a team to go on a run. The Hoppers hold on to win the game and proceed to win their next six games against all odds. If you are a baseball fan, you might understand what I'm getting at. The rest of you are sitting there thinking, "This guy is crazy, what the hell does this one fake baseball play have to do with the blowoff phase of the market?"

It has everything to do with it! The outsiders (those with one time frame) were still thinking that the Hoppers were going to drop another game because they only had one perspective; the Hoppers have lost nine out of their last ten games and are losing in this one, and they are going to lose again. You as an avid fan (one with two time frames!) are seeing something completely different. This one homerun, this **ONE PLAY,** could've been the turning point in an otherwise dismal stretch of baseball for the Hoppers. And in fact it was! It is impossible to catch the falling knife, but it is not impossible to catch it on the first bounce. This scenario with the Hoppers is a perfect example of this. Yes, the Hoppers have been terrible as of late, but it only takes one strong shift in momentum to change a game, and possibly an entire season! Think about a V blowoff pattern. Once price bottoms out, it comes all the way back to make that V!

The Hoppers losing streak represented them blowing off the downside. They found the bottom of the blowoff when their eight-hitter hit that homerun and they proceeded to go on a winning streak which perfectly describes the V blowoff pattern.

Trade One: Buying an Outright Option

Buying a Call

Buying a call in a blowoff is extremely difficult. The premium levels are way too high and it will be very tough to make money. For this reason, buying a call is not the correct play. **Because there are many other trades that are better than this one, never buy calls in a blowoff!**

Buying a Put

You'll face the exact same problems with buying a put in a blowoff as you will with a call. The premium will just be too much to overcome. If you buy a put in a blowoff and the stock keeps moving downward, you could actually lose money if air comes out of the balloon at a quicker rate than the stock is going down. **Never buy puts in a blowoff; there is a huge downside to this trade and very little upside.**

Trade Two: The Credit Spread

Selling a Bull Vertical Put Spread

Credit spreads in a blowoff are a completely different animal than the trending and congestion phases, respectively. This is because premium levels are extremely high. This excess air in the balloon is going to make the ATM and ATM +/- 1 option prices nearly identical. This makes sense theoretically AND mathematically because the market will still move around its mean, but with so much more uncertainty, the strikes near the ATM will all have similar amounts of premium. This will make it almost impossible for us to get our 2/3 risk/reward ratio that we want when dealing with credit spreads. **For this reason, 60/40 spreads are a much better option in blowoff markets**. The blowoff is the most directional trade that we will make, and we want a trade that will give us the best chance for a winner. That's why 60/40 spreads are the best in blowoff markets. Using our two time frames, when our shortest time frame gives us bullish technical indicator, such as a double bottom, we can initiate a 60/40 bull put spread. The key to all blowoff trades is to let the market tell us that it's ready to change its course. We are not catching the falling knife, but catching it off its first bounce. In this scenario with BABA, we

could sell the 142/138 (60/40 spread) for a little over $1.50. That is ALMOST at our proper risk/reward ratio of 2/3. It's not quite there, but it's close. We can sell the 142 put (60 delta) for about $2.12 and buy the 138 put (40 delta) for about $0.56. That would bring our net credit for this trade to $1.56, which is about a 2/3 ratio on a four dollar-wide spread (remember 40 cents per dollar would be a 2/3 ratio).

Rolling Up or Rolling Back a 60/40 Put Credit Spread

Even though we are in the blowoff phase, we still have to manage this type of spread to make sure that get the most out of it. Because the price action will be so quick in a market that is blowing off, it can cover as much ground up or down in one day as the congestion phase did in multiple weeks. Rolling up in a blowoff is much more important than the other two phases. You don't want to give up a big edge in your position if the market suddenly reverses and heads back to the bottom. **When the market advances to at least four strikes above our short leg of the credit spread, sell the new ATM 60/40 bull put spread.** The same rules apply for your old spread. You can let it stay on the books because you are a very big favorite to cash the trade and keep your credit. If you are more conservative, you can buy back the old spread and still profit.

On Friday, we can roll back our 60/40 bull put spread by first selling the new 60/40 spread in the next serial (14 JUL 17 in Figure 11.4). Depending on how much BABA has moved, this could still be the 142/138. Could it be the 141/137 or 143/139? Absolutely, it all depends. We only buy back our original spread if it is danger of going out a loser. If BABA is trading at 140 on expiration Friday, we would want to buy back our original spread. This is because we are losing the max on the trade (our breakeven is the difference in strikes – net credit, which is 140.44 in this example). We are in danger of being "put" BABA at 142 because our 142 put is ITM, and our 138 put is worthless. We could get assigned and be forced to deliver 100 shares of BABA at 142, and since our other put is OTM (worthless) our position won't cancel out. This is the same risk we deal with in any type of put spread, no matter how far the strikes are apart. The math is still the same.

We are not going to roll back if our shortest time frame turns negative, and our longest time frame is still negative. We will take our loser and move onto the next trade. However, if our shortest time frame turns negative but our longest time frame has turned positive, **we can initiate our roll back by selling another 60/40 spread at a better price. If BABA's price moves to the ATM -2, we can sell the new ATM +2/-2 60/40 put spread.** If the market continues to break, we can keep adding spreads as long as our longest time frame remains bullish.

Managing Risk in a Bull Vertical Put Spread

It will be much harder to manage risk and turn this spread into an "iron condor" because in a 60/40 spread, the strikes are spread wider due to increased premium levels. If the spread is a loser when our shortest time frame turns negative, we can't roll back unless our longest time frame has turned positive. As traders, we must learn how to cover our losses. When the technicals aren't showing us what we need to see, take your loss and move on. Learning how to take losses is just as important as taking profits.

Selling a Bear Vertical Call Spread

We will sell bear call spreads when the market is in a blowoff to the upside, exactly the opposite as a bull call spread in a blowoff. However, the scenario is slightly different in a blowoff to the upside. In this case, the bulls are now the strong hands and the shorts are waving the white flag. We should expect high volatility, but in general volatility won't be as high as it would be during a breaking market. Due to the high volatility, the regular credit spread most likely won't offer us the proper 2/3 ratio. We will again look to the 60/40 spread. In the case of BABA, we could sell the 139/143 bear call spread for a little under $2.00, which would satisfy the ratio.

Rolling Down or Rolling Back a 60/40 Call Credit Spread

Due to the quick price action in a blowoff, we don't want to give up big profits if the market reverses its course. We roll down **when the market advances to at least four strikes below our short leg of the credit spread.** We can now sell the new ATM 60/40 bear call spread. We can let the old spread stay on the books, or buy it back. It all depends on what you want to do.

We roll back into the next serial the same way we did in the bull put spread. If our old spread is in danger of being a loser, simply cover it. You can always take this spread off.

Managing Risk in a Bear Vertical Call Spread

Managing the call spread will entail the same rules and principles as managing the put spread. The key point to remember in a blowoff market is that we are not going to be trading traditional credit spreads, but rather 60/40 spreads.

Trade Three: Risk Reversals

Risk Reversal (Synthetic Long)

The risk reversal in a blowoff market is one of the best weapons in our arsenal. We talked about how it is almost impossible to buy outright options when volatility is at extreme levels and that's why the risk reversal works so well. It allows us to make a very directional trade that we wouldn't be able to make with outright buys. We get to combine the little premium risk with the full punch of the price movement if we're correct. If we're wrong and the market gaps against us, our risk is still limited to the strike risk in the corresponding call/put spread. I haven't touched on this yet, but during the blowoff phase I like to widen the length of my put spread to reduce my premium risk further. I do this for the exact same reasons that I use 60/40's instead of regular credit spreads during a blowoff. Don't let the premium take advantage of you, take advantage of the premium! Because volatility is high, the option prices near the ATM will be closer in price than normal. So with BABA, instead of buying the 141 call and selling the 141/140 put spread, I would still buy the 141 call but sell the 142/138 put spread and this would allow me to basically put on the trade for even. By selling a wider put spread, although my strike risk is increased, I drastically reduce my premium risk. This is a minor variation to the trade, but the end goal remains the same. We want the stock to go up! We will initiate a synthetic long when our shortest time frame turns positive. That doesn't change.

Rolling Up or Rolling Back a Synthetic Long

We will roll up our synthetic longs if the ATM moves more than two strikes to the upside. In our case, we would need the ATM to move to the 143 strike. Our original position includes buying the 141 call, and simultaneously selling the 142/138 put spread. If BABA makes a move to 143, **we will sell a vertical call spread and replace our old ATM call (141) with a new ATM call (143).** We don't need to replace the put spread because it is a winner, and we can use the credit we received in this put spread to help finance the new call that we buy.

The methodology for all of our trades is still the same. We roll back when the market is still in our favor and our technical analysis shows us that we still want to be in the trade. In the case of a synthetic long risk reversal, we would roll back by first **selling the horizontal call spread.** We are simply moving option serials. In this case, we would sell the 7 JUL 17 141 call, and buy the 14 JUL 17 141 call. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our put spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back just as I detailed in the credit spread section.

Managing Risk in a Synthetic Long

This trade is managed basically the same as it was during the breakout phase. If we get a sell signal in our shortest time frame and our longest time frame is still negative, we can exit the trade simply by selling the call and buying back the put spread. If our longest time frame has turned bullish, we can exit our call and leave the put spread in place. If our short term signal turns bullish again, just replace the original call with the ATM call and recycle the trade.

Risk Reversal (Synthetic Short)

We treat this trade very similarly to a synthetic long at a blowoff bottom. Since we are putting on this trade from the short side of the market, the OTM calls should not be as pumped up with air as the OTM puts in a blowoff low. For this reason, we can reduce the difference in strikes in our call spread. In the long example, we sold the 142/138 put spread to go along with our 141 call. In this example, we could use the 141 put and sell the 139/142 call spread, which is one strike closer together than the 142/138. We initiate this trade when our shortest technical time frame turns negative.

Rolling Down or Rolling Back a Synthetic Short

We will down our synthetic shorts if the ATM moves more than two strikes to the upside. In our case, we would need the ATM to move to the 139 strike. Our original position includes buying the 141 put, and simultaneously selling the 139/142 call spread. If BABA makes a move to 139, **we will sell a vertical put spread and replace our old ATM put (141) with a new ATM put (139).** We don't need to replace the call spread because it is a winner, and we can use the credit we received in this put spread to help finance the new call that we buy.

The methodology for all of our trades is still the same. We roll back when the market is still in our favor and our technical analysis shows us that we still want to be in the trade. In the case of a synthetic long risk reversal, we would roll back by first **selling the horizontal put spread.** We are simply moving option serials. In this case, we would sell the 7 JUL 17 141 put, and buy the 14 JUL 17 141 put. We are staying "horizontal." After we make this roll, we are going to make the appropriate adjustment in our call spread. If the spread is going to expire worthless, leave it be. If it's close, we can buy it back just as I detailed in the credit spread section.

Managing Risk in a Synthetic Short

This trade is managed basically the same as it was during the breakout phase. If we get a buy signal in our shortest time frame and our longest time frame is still positive, we can exit

the trade simply by selling the put and buying back the call spread. If our longest time frame has turned bearish, we can exit our put and leave the call spread in place. If our short term signal turns bearish again, just replace the original put with the ATM put and recycle the trade. Risk reversals are really the only option when you want to get short a runaway market and want an unlimited reward and limited risk trade.

Trade Four: Ratio Backspreads (1x2 for Even)

Call Ratio Backspread (1x2)

The ratio backspread works well most of the time, but for the same reason that it can be very hard to sell regular credit spreads in a blowoff environment, that goes for backspreads as well. Because you are buying two options and selling one, you are essentially "long volatility" (vegas). It's not a very good idea to be long volatility when volatility is at its highest levels right? Essentially the only thing that can happen in an extremely high volatility environment is that air comes out of the balloon. That works against us with backspreads. We talked before about how you can buy outrights in a blowoff, be right on the price direction, and still lose money. The same goes for backspreads, and when you couple that with the risk we are already putting ourselves at with our position expiring at the long strike, we are doomed!

The purpose of a backspread is to put it on for even. That will be almost impossible in a high volatility environment like a blowoff because we won't be able to use touching strikes. Unlike the low premium environments where the tight strike prices offset almost all of the expiration risk, in a high volatility environment, they do the opposite and create a huge risk. If you have to split your strikes by 3 or even 4 to get a proper price for the trade and the market decides to pin on your long strike expiration, there is no defense we can counter with. Your short strike will now be near parity, and even though your long strikes will contain two options with some air in them, the trade will blow up on you. In a blowoff market, don't use 1x2 backspreads unless you can get touching strikes, which will be almost impossible. Use 60/40 credit spreads or risk reversals instead.

Overview of the Blowoff Phase

The blowoff phase of the market is the most unique, and therefore it must be treated with caution. This does not mean that you can't make trades in the blowoff phase! But you must be privy to volatility and what that means for each respective strategy that you can employ. You can use any trade in this market, but before you use a trade you must make sure the conditions are right for it.

Summary

You are now a certified master in trading the phases of the market! This is such a great place to be in because so many people don't understand how the phases of the market affect different types of trades and volatility. I am confident in saying that you now have more information on how to trade the market as a whole than 95% of the other traders out there. The more you trade options, the more you will learn that volatility is such a key piece in executing trades. And sometimes the right trade is no trade at all! If you are seeking out a trade and can't get the correct price or environment for it, simply wait until the next trade. Nobody is holding a gun to your head telling you that you have to make a trade. Let's go over some of the key concepts we learned in this chapter.

Using two time frames is one of the overarching principles that we want to stick to in our trading. Why not use all the tools that we have to our advantage? Sometimes we can see things in our shortest time frame that we wouldn't be able to see in our longest one. This becomes extremely important when we not only put on trades, but manage them as well. Let your time frames speak to you. They tell a good story.

Buying outright options is one of the trickier trades to use in any type of market. Just like Goldilocks, we don't want volatility that is too low or too high, we want it just right. It's tough to pinpoint an exact range of volatility that would make it conducive for us to buy outrights, but generally speaking you would want to buy outrights in a **rising volatility environment**. This will more conducive when buying puts for the obvious reason that volatility is usually increasing as the market is going down.

Let's talk about volatility environments we **WOULD NOT** want to buy in. The first and most obvious scenario is when volatility is extremely high and near its historical limits. The premium levels in this type of environment are too high to justify and we lose money even if we are right on the price direction if too much air comes out of the balloon. We also don't want to buy outrights when volatility is very low. Because we most likely won't get much price movement, we are fighting time decay (the premium we paid for the option). This is a lot to overcome in the weekly option serial.

The best place to buy outrights is when volatility is at a medium-higher range and is rising. What that range is I can't exactly tell you, but the idea is that when volatility is high (but not too high!) the price movement will usually overcome the premium you paid for the option. The best opportunity for an outright buy is probably at a double top in your shortest time frame in a downtrending market. I say probably because there is no magic secret that will pop up and say "This is the time to buy outrights." This is just my insight. Before you have the correct environment for outright buys though, you must first have stocks with options that are volatile enough to trade in the first place. Think all the way back to the AMBA vs. KO example. Even if we were in a rising volatility environment, KO would not even be on our radar because the stock

is not volatile enough to begin with. We have talked about volatility in many different aspects and scenarios and if you've gotten the sense that more volatility usually comes into a market that is going down rather than going up, you have got it correct. When the market is driven by more fear, it will tend to go down faster, and fluctuate more in general. But people generally become more fearful when the market is going down. What makes options so interesting is that they are not just a function of stocks going up or down. They are derivatives that are based off of a stock, but that is not all that goes into it. Remember the Greeks? There are multiple aspects of options that make up their given prices. You'll have to ask Fischer Black and Myron Scholes to get into all the dirty mathematics behind them, but for our purposes the complex math doesn't matter. All we have to do is be aware of what different environments will do to option prices. We also can't forget about the bell-shaped curve and how that curve relates to option pricing. Every option is priced off of a bell curve. How much air is "in the balloon" at any given time will change as the market and individual stock changes, but these are all things we can observe as traders and students of the market.

A credit spread within our parameters (2/3 risk/reward ratio) is the type of strategy that is least affected by the condition of the market. Because we have two different types of spreads to trade (regular spread and 60/40 spreads) we can usually find a way to make one work. Both types of spreads function the same way as we are always collecting a net credit. However, the regular credit spread is a lower risk/lower reward play. We will not collect as much credit as we do in a 60/40 spread, but we will have less price risk and the underlying stock won't need to move as much. Whatever the case, both spreads will be suitable in the congestion phase and breakout phase as long as we can maintain our 2/3 ratio. It really doesn't matter. Volatility isn't of as much importance with credit spreads because our number one objective is to receive the correct price for any given spread. Whether the market is in congestion, a breakout, or a blowoff, if we can't get the right ratio for any given spread, we simply won't make the trade.

Volatility will come into play the most during the blowoff phase of the market when we trade credit spreads. The theory does not change at all, but due to the increased premium levels, we most likely won't be able to use regular credit spreads. Because the air comes into balloon evenly across all strikes, the strikes that are closer together will be more evenly priced than ones that are farther away. When we are dealing with a blowoff environment with very high volatility, 60/40 spreads are much more suitable. We're much more likely to get our 2/3 ratio with 60/40's, which is the main thing we're looking for. If you're not comfortable with trading 60/40 spreads in general, you don't have to. It's all up to the individual.

I believe that risk reversals give us the best opportunity to make money in any type of market environment. I mentioned way back in Chapter 8 how a true risk reversal (synthetic long) is just buying a call and selling a put (or vice versa for a synthetic short). Because this puts us at an unnecessary margin risk, we add a put/call **SPREAD** on the other side of the trade instead of just one option. Risk reversals essentially give us the same price risk as buying outrights, we

need the stock to move in the right direction in order to make a profit. However, we get to reduce our premium risk by selling a spread on the other side of our long trade. These two advantages make risk reversals my favorite. How you decide to use them will differ. The example I showed you in Chapter 8 featured an ATM call/put and a regular ATM credit spread on the other side of the trade.

In the blowoff section, I showed you how you can reduce your premium risk even further by selling a wider spread on the other side of your long position, hence collecting more credit and reducing the cost of the trade. While you reduce your premium risk in that kind of situation, your price risk increases because you have sold a wider spread, and need more price movement for your spread to be profitable. This scenario works better in the blowoff phase for the exact reason we talked about with 60/40 spreads in the blowoff phase. When volatility is very high and there is more air in the balloon, selling spreads with strikes right next to each other probably won't allow you to get the correct ratio. Obviously the risk reversal involves more than just a credit spread, but just realize that you can manipulate the trade in whatever environment you may be trading in to make it the best possible trade. Can you put on a risk reversal (with a 60/40 spread instead of a regular spread) in the congestion or breakout phase of the market? Absolutely. Just be aware of how that affects your position. As long as you know your risk/reward before you get into a trade and you know how to manage it, everything else is immaterial.

The ratio backspread is the hardest to understand in my opinion, but once you are able to break down all the aspects of this type of trade, it's extremely interesting. The coolest thing about ratio backspreads is that you can be dead wrong on price movement and still break even or make a profit. However, the only way you can accomplish this is by making sure the trade is set up correctly in the first place. I call it the "1x2 for even" because our goal is to put this spread for even money, or even a slight credit. The key is that you use "touching strikes" when trading backspreads. When you don't use touching strikes, the risk/reward becomes very unfavorable because we will have to "split the strikes" and therefore need a lot more price movement to overcome the difference in strikes. The basic idea of this trade functions similarly to an outright buy in the sense that we want to be in a **rising volatility environment.** This makes a lot of sense because we are long two options for every one option that we are short, meaning we are essentially long volatility. Using the backspread in a market that is breaking out or trending to the downside is my favorite because this type of market will most likely feature rising volatility. If we are "long volatility", we want volatility to rise! We don't typically use these trades in the blowoff phase for the same reason we don't use regular credit spreads. Because air comes into balloon evenly across all strikes, when volatility is extremely high, we won't be able to use touching strikes. Air coming out of the balloon works against us when using backspreads, so we shouldn't use them when the balloon is essentially full.

We will all make mistakes when we trade. No matter how prepared you are, sometimes things will just go wrong. It's important not to dwell on these mistakes, but rather learn from

them. Nobody who ever done anything worthwhile has gotten good at it over the course of a day. It takes time. It takes practice. It takes motivation. It takes patience. Those are four things that you'll find essential when trying to master anything.

Bonus Example

It's about volatility again! I believe this example is key to making our understanding of volatility come full circle. We have talked about the option model and how it is "like a balloon," because it really 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 premium levels, but we've gone over how we 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 (the ticker symbol used to identify index options traded on the Standard & Poor's 100 index).** There is going to be a positive correlation between the stocks that you trade and the VIX.

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 (except in obvious blowoff phases of an individual stock). Let's take a look at two charts, the OEX and the VIX, both from September 2008 to July 2009.

Figure 11.7 OEX Chart

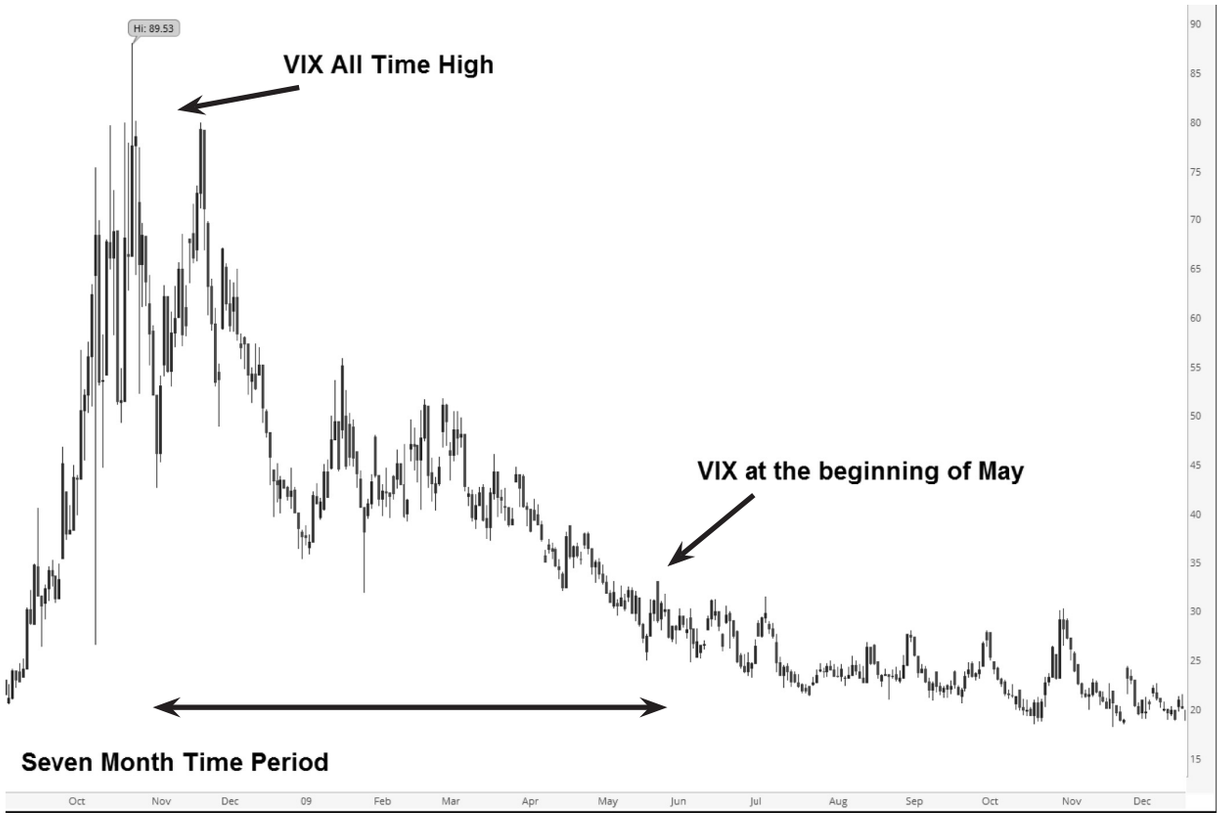


Figure 11.8 VIX Chart

Notice that the price of the **OEX** went below 420 on November 15th 2008. Seven months later in May of 2009, it went above 420. **So in the seven 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 almost 90 when the **OEX** price penetrated 420. However, **seven months later with the price exactly the same, the VIX had decreased "air" in its premium level by more than 60%!**

How could this happen? The price is exactly the same as it was seven 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 May of 2009, **although it was in the same chaos**, the market expectation was that the world had become a safer place. Our style of trading that we've gone over in this book will allow you to successfully trade options at these extreme levels and in any market condition!

Chapter 12: Choosing the Right Options to Trade

You can be the best option trader in the world, but if you aren't trading the **right options**, you will fail. We've talked about all the aspects that go into options trading so far except how to make a portfolio, which might just be the most important part. The strategies and concepts we've gone over can only be successful if we use the correct tools. For example, imagine you are an expert sculptor. You have made hundreds of intricate designs and your work is seen as exemplary in your field. Now somebody asks you to cut down a tree using the same tools you use to make sculptures. You sit at the edge of this massive tree with your wires, wood carving set, alabaster and whatever else sculptors use. You try for hours and hours to cut down this tree, but to no avail. Does this mean you're now considered a bad sculptor? Of course not. But you're trying to cut down this tree using the same tools you use to sculpt things, and they are completely different from each other. You are using the wrong tools!

All of the technical work we've done so far won't mean a thing if we don't know how to organize a portfolio of stocks. If we don't know where to invest our money, our chances of beating the market will go to zero. The portfolio we select must be in proportion to the amount of risk capital we have to work with. We also have to know how to diversify.

Our selection process is really a screening process that is universal. The only thing that will change from trade to trade is our amount of risk capital. The principles and strategies remain the same. The more stocks which you can identify as tradable, the more potential action there is. There will be more opportunities, and more chances to profit on your trading. If you can handle 50 stocks, that's great. Just remember that you should be following at least ten. Any less will greatly diminish your profit potential. The tradable stocks and their respective markets will be referred to as your **portfolio.**

We're going to look at four things when selecting stocks for our portfolio: liquidity, volatility, product diversification, and dollar risk diversification.

Liquidity

We first talked about liquidity all the way back in Chapter 2. We're talking about it again because it is so important! Recognizing stocks that have liquid options is the first key element when adding stocks to your portfolio. Take a look at the option chain for Ford (F) below.

Underlying

Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low
11.405 D	+.065	11.40 N	11.41 N	444 x 1,343	19,178,130	11.31	11.43	11.30

Trade Grid

Option Chain | Filter: **Off** | Spread: **Single** | Layout: **Last X, Net Change**

Strikes: 12

CALLS							PUTS			
Last X	Net Chng	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Last X	Net Chng	
14 JUL 17 (3) 100 **(Weeklys)**									26.05% (±0.241)	
0	0	2.86 Z	2.93 Z	14 JUL 17	8.5	0 J	.01 H	0	0	
2.55 Z	0	2.38 H	2.53 I	14 JUL 17	9	0 J	.01 H	0	0	
1.60 B	0	1.89 H	1.93 H	14 JUL 17	9.5	0 J	.01 Z	0	0	
1.34 X	0	1.40 Z	1.41 Z	14 JUL 17	10	0 J	.01 H	.01 C	0	
.78 C	0	.90 H	.91 Z	14 JUL 17	10.5	0 J	.01 Z	.02 M	0	
.37 C	+.02	.40 H	.41 Z	14 JUL 17	11	.01 Q	.02 I	.01 Q	0	
.04 H	+.01	.03 H	.04 Z	14 JUL 17	11.5	.13 H	.14 Z	.14 H	-.04	
.01 X	0	0 P	.01 H	14 JUL 17	12	.59 Z	.60 Z	.60 Q	-.19	
.01 X	0	0 P	.01 H	14 JUL 17	12.5	1.09 Z	1.10 Z	1.13 C	0	
0	0	0 P	.01 H	14 JUL 17	13	1.59 Z	1.60 Z	1.71 C	0	
0	0	0 P	.01 H	14 JUL 17	13.5	2.05 Q	2.37 I	2.55 I	0	
0	0	0 P	.01 H	14 JUL 17	14	2.56 X	2.85 X	2.84 Q	0	

Figure 12.1 (F) Ford Three-Day Option Chain

Ford is one of the most liquid stocks around. The number of shares traded each day in Ford and the tightness of the bid/offer spread make it so. At first glance, this seems to be an ideal candidate for a small trader to get involved in, but when we examine the option chain, we can see there are some problems to overcome.

First is the absolute size of the stock. It is priced around $11 a share and doesn't really move much off of that number. The expected range is less than 50 cents a week, and the entire value is only $1,100 per contract (100 shares). Because of the absolute dollar size of the underlying stock, it is not tradable. The credit spreads are extremely small and the commissions don't shrink just because of the size of the stock. This is the type of stock that we don't want to use in our portfolio. One of the key components of trading options is the leverage that they provide us, and we barely get any leverage from trading a stock like Ford. Although the stock is very liquid, when we take a closer look we can realize that it can't be traded.

Figure 12.2 is a three-day option chain for AAPL. It is also a very liquid stock and you can see that from the small bid/offer spreads near the money. AAPL has all the characteristics that us as traders would want, good bid/offer spreads, a much wider expected price range (almost $3), and the credit spreads have enough juice to enable us to trade them. The total value of the underlying stock is a little over $14,500. **This is the type of stock that we want to trade options in!**

Underlying

Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low
145.535 D	+.475	145.53 Q	145.54 Q	6 x 2	13,453,249	144.73	145.85	144.38

Trade Grid

Option Chain | Filter: **Off** | Spread: **Single** | Layout: **Last X, Net Change**

Strikes: 12

CALLS							PUTS			
Last X	Net Chng	Bid X	Ask X	Exp	Strike		Bid X	Ask X	Last X	Net Chng
14 JUL 17 (3) 100 **(Weeklys)**										16.26% (±1.919)
5.70 M	+.35	5.55 X	5.65 X	14 JUL 17	140		.05 Z	.06 C	.05 Q	-.01
4.75 A	+.38	4.60 C	4.65 Z	14 JUL 17	141		.07 Z	.08 H	.07 Z	-.05
3.71 C	+.26	3.60 X	3.70 X	14 JUL 17	142		.11 Z	.12 H	.11 H	-.07
2.80 C	+.36	2.71 C	2.76 Q	14 JUL 17	143		.18 Z	.19 H	.19 C	-.11
1.89 B	+.16	1.87 Q	1.90 Z	14 JUL 17	144		.32 H	.33 Q	.32 C	-.19
1.18 T	+.14	1.16 Z	1.18 Q	14 JUL 17	145		.60 Z	.61 H	.61 N	-.29
.61 X	+.04	.61 H	.63 Z	14 JUL 17	146		1.05 H	1.07 H	1.06 H	-.38
.30 X	0	.29 Z	.30 H	14 JUL 17	147		1.71 Z	1.74 T	1.74 B	-.43
.13 C	-.03	.12 Z	.13 H	14 JUL 17	148		2.54 Z	2.58 Z	2.50 Z	-.54
.06 N	-.02	.05 C	.06 Z	14 JUL 17	149		3.45 X	3.55 H	3.40 Z	-.37
.04 I	-.01	.03 H	.04 Z	14 JUL 17	150		4.40 X	4.55 X	4.24 I	-.21
.02 I	-.01	.02 Q	.03 X	14 JUL 17	152.5		6.90 X	7.05 X	6.85 A	0

Figure 12.2 (AAPL) Apple Three-Day Option Chain

AAPL gives us the essential factors of liquidity that we look for in the stocks we select: tight bid/offer spreads, the expected range of the stock, and the size of the underlying security. When we compare AAPL to F, we can see that F only covers one of these factors. Now let's look at the other end of the extreme, Amazon (AMZN).

Underlying

Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low
993.46 K	-3.01	993.36 Q	993.68 P	2 x 2	2,382,651	993.00	995.28	983.72

Trade Grid

Option Chain | Filter: **Off** | Spread: **Single** | Layout: **Last X, Net Change**

Strikes: 12

CALLS							PUTS			
Last X	Net Chng	Bid X	Ask X	Exp	Strike		Bid X	Ask X	Last X	Net Chng
14 JUL 17 (3) 100 **(Weeklys)**										19.73% (±15.882)
16.68 M	-4.04	16.50 Q	16.85 Z	14 JUL 17	980		2.67 M	2.90 Q	2.76 I	-.49
13.61 B	-6.49	14.35 Z	14.80 Q	14 JUL 17	982.5		3.25 H	3.50 B	3.34 M	-.26
12.95 Q	-4.05	12.50 M	13.00 Q	14 JUL 17	985		3.90 M	4.20 M	4.00 Z	-.36
11.40 Z	-3.70	10.80 M	11.25 Q	14 JUL 17	987.5		4.65 M	5.00 Q	4.68 C	+.10
9.75 C	-3.60	9.25 M	9.65 Z	14 JUL 17	990		5.55 M	5.90 Q	5.70 Q	-.30
8.05 B	-4.00	7.80 Z	8.15 Q	14 JUL 17	992.5		6.70 Q	6.95 Z	6.75 A	-.15
6.80 H	-3.55	6.60 Q	6.80 Q	14 JUL 17	995		7.75 M	8.10 Q	7.95 Q	-.05
5.45 W	-3.69	5.35 Q	5.65 Z	14 JUL 17	997.5		9.05 Z	9.45 M	10.15 C	+1.05
4.54 C	-3.04	4.40 C	4.60 X	14 JUL 17	1000		10.45 M	10.95 M	10.50 N	+.10
3.75 Q	-2.90	3.45 M	3.75 Z	14 JUL 17	1002.5		12.10 Z	12.60 Q	12.46 B	+1.69
2.94 Z	-2.56	2.80 B	2.99 M	14 JUL 17	1005		13.75 M	14.45 Q	14.25 Q	+1.60
2.40 Q	-2.50	2.25 Q	2.37 Z	14 JUL 17	1007.5		15.60 Q	16.35 Q	17.50 E	+3.28

Figure 12.3 (AMZN) Amazon Three-Day Option Chain

The first thing to notice in AMZN is that the bid/offer spreads are much wider. The expected range is almost $15 and the total price for the stock is almost $100,000. This is the opposite extreme of F. This stock is tradable, but you need to have a very large amount of risk capital to even think about trading this stock.

We're going to be looking for stocks that are somewhere in between F and AMZN. There are plenty of stocks that fit that mold, and they are constantly changing. Facebook's stock didn't exist too long ago, and now it is one of the most liquid in the world. Tight bid/offer spread, a price of over $50 a share, and good ranges are things we look for when selecting stocks for our portfolio. Stocks that are priced over $50 a share usually have a good history of volatility.

Volatility

It's hard to think we talk any more about volatility right? I almost thought we were done! Liquidity was the first trait we looked at; the second is volatility. **Volatility is the amount of air in the balloon in relation to the underlying stock.** Think back to the KO vs. AMBA example. Those two stocks are priced relatively the same at $50 a share. However, KO is much more stable. It is possible that something could happen that would change the price of KO suddenly? Yes, but the chances are slim to none. The average expected weekly range in KO is around 75 cents, not a very big range.

AMBA is also trading at $50 a share, but it is much more volatile. It has an expected weekly range almost three times more than KO. When we price our portfolio, we need to factor in volatility in addition to liquidity. If we have two stocks with similar prices, we would want the more volatile one in our portfolio. It will give us more opportunities to trade.

An investor would look at the situation very differently. They would probably prefer KO to AMBA because it is more stable. All it does is grind. As traders, we want price movement. We want stocks that are more volatile.

Product Diversification

This step is something that we might not think of at first when putting together our portfolio. It's important to diversify by product because if we pick all of our stocks from the same sector, we'll be dealing with essentially the same market across different stocks. We want to deal in all types of markets, bullish, bearish, and everything in between! This will help balance our portfolio.

The stocks we pick are still going to follow our liquidity and volatility rules. Picking stocks from different sectors will broaden our technical analysis horizon. If we are constantly observing different markets, we will be more prepared to make trades. With my portfolio, I like to observe stocks that fall into five different groups. There are many different market groups (sectors) out there. Just make sure that your portfolio of stocks is diversified! Whether you are trading with $100,000 or $1,000 doesn't matter.

Dollar Risk Diversification

This is probably the most complex concept to understand when it comes to putting together a portfolio. I've seen so many traders misuse it. We use dollar diversification to offset our probability risk. Think about this example. We are at the casino again, but this time we are the house. We are dealing with two players at the blackjack table. One of them is betting $100 per hand, and the other is betting just $1 per hand. As the house, we know that the long-term probability for us to win is in our favor. Those are simply the mathematics of the game. We should be happier to see the guy who is betting $100 per hand at the table because in theory, he should lose more in the long run. Here's the caveat. Let's say the big player is an expert card counter and the $1 player is there simply to have fun. He's there for the thrill of the game. If he loses $10, it won't have any effect on the rest of his night. The $100 is trying to beat us, the house. In the long run, he might just be good enough to do it. Since the players are so unbalanced, the casino could theoretically win its mathematical percentage of hands, but also lose money. This is not a very good situation for us to be in as the house.

We can encounter this same type of problem if we don't account for the dollar difference in our portfolio. I used the $50 stocks KO and AMBA earlier to show you that diversification by price and group is simply not enough. If our portfolio holds 100 shares of a $50 health care stock that has an average weekly move of $1 and 100 shares of a $50 technology stock that has an average range of about $4 a week, we are not balanced! We will need to win four times as much in the health care stock on average to offset one theoretical loss in the technology stock, assuming our loss was realized at the expected move.

Think about it this way. You could win 75 percent of your trades and still lose money! An unbalanced dollar portfolio is more dangerous than one containing too many stocks from the same group. 100 shares of Tesla (TSLA) is not the same as trading 100 shares of Facebook (FB)!

Let's take a look at a sample portfolio I've created. It contains five stocks from five different underlying groups and has good product diversification.

Stock Symbol	Current Price	Weekly EV (+/- 3s)
UAL	76.92	2.19
BABA	145.81	3.06
LVS	61.86	1.14
AAPL	145.60	1.85
DIA	214.09	1.49

Figure 12.4 Five Stock Sample Portfolio

Here's how we can balance out our portfolio dollar wise. It takes two steps:

Step One: Take the stock with the highest Weekly EV and assign it a value of 1. In our case, that would be BABA, which has a weekly expected range of 3.06.

Step Two: Divide the EV of all other stocks by the EV in the highest stock (1) to see how many contracts you should be trading in that particular stock compared to the highest EV stock.

UAL: 2.19 ÷ 1 = 2.19 contracts

LVS: 1.14 ÷ 1 = 1.14 contracts

AAPL: 1.85 ÷ 1 = 1.85 contracts

DIA: 1.49 ÷ 1 = 1.49 contracts

We're always going to round to the nearest number of contracts. Don't be concerned if your ratios are slightly off; unless you are trading hundreds of contracts, the rounding will have no effect. The idea is to balance the dollars in the portfolio as close as you can to the current EV levels. Let's look at all the numbers when we put them together.

Stock Symbol	Current Price	Weekly EV (+/- 3σ)	# of Contracts/Spreads
UAL	76.92	2.19	2
BABA	145.81	3.06	1
LVS	61.86	1.14	1
AAPL	145.60	1.85	2
DIA	214.09	1.49	1 or 2

Figure 12.5 Five Stock Sample Portfolio by Contract

In Figure 12.5, you can see that the correlation between price and volatility doesn't hold as much weight as you'd think. BABA is second highest priced stock (essentially tied for 2nd with AAPL), but it is almost twice as volatile as the top dollar weighted stock DIA. UAL is the perfect example. If we look at the portfolio in terms of nominal, you might think at first that you would want to trade roughly two contracts of BABA for every one you'd trade in UAL, when in fact it's the exact opposite!

Overview

This chapter gives us the foundation on which to build a portfolio. Before we start making trades, we need to have the right portfolio to work with. Managing cash is the most important part of trading. If we want to compete at the highest levels of trading, we need to know how to look at the market and select the right stocks. This will reduce our exposure. Trade in liquid markets and have a balanced portfolio. The rest will take care of itself!

Chapter 13: Taking Care of Our Money

We are almost there! So far, we've learned how to look at trades and execute them. We've also learned how to take those trades and turn them into a workable portfolio. What we haven't learned yet is how to manage these trades in relation to how much capital we're trading with. Understanding risk and the management of that risk will be vital to our success. If we're strictly using credit spreads, our risk/reward is clearly defined at the start of the trade. If we want to use more aggressive strategies that allow for unlimited reward and limited risk, we have to have more capital. We're going to go over how you can calculate risk and what that means in terms of the type of trades we can afford to enter into.

Risk of Ruin

The risk of ruin is a concept that relates to all forms of gambling, insurance and finance. Earlier we talked about probability models. Probability models are how casinos create games that favor them. They run **favorable games** in which in the long run it is impossible for the house to lose. **Unfavorable games** are just the opposite; the chances of winning in the long run are very slim at best. The object of our option trading is to create a favorable game in which you become the casino. You will have drawdowns in your capital account but in the long run you will win! Your trading will run in a series streaks **commonly known as the variance.** Sometimes it will be in a congestion pattern that will rotate around the mean of your risk capital. It may last for days or weeks even longer before it breaks out. When you are winning everything will go your way.

If the market is in congestion you will be buying the double bottoms and selling the double tops and it will be magical. When the market is trending you will hit it perfectly taking profit on retracements and then reentering to stay with the trend. When the conditions favor a blow off trade and your short term technical indicates an entry point the market will magically turn for you on a dime.

When things are going wrong the opposite will happen, double tops and bottoms will fail to hold and the market will breakout to the trend just in time to reverse your position at a false breakout. When the blow offs occur it will move just far enough to get you out of your position before it reverses. **However, if you are trading correctly you will begin to notice**

that your capital resembles a bull market; it will have a positive slope but will also have retracements where it will dip below the mean, recover and then go higher.

In order to insure your success your capital must be managed prudently, the big question is what is sensible when it comes to your capital? Every trader has a different idea of what is rational. Some traders believe that they are being conservative while actually they are wildly aggressive. Others think that they are aggressive while in actuality they are just the opposite.

Risk Capital

The term risk capital means exactly that – it is money that, if lost, will not affect the way you live. It doesn't mean it will be like the blackjack player with $50 who wants the thrill of trying to beat the house. It will be more important to you than that, but if everything were to go wrong in your trading, it won't change your lifestyle. If you put too much capital at risk, the markets will beat you. Your decisions will be influenced by the risk and you will not be able to handle the pressure. All traders reach a point where they can no longer effectively handle the risk, and if you have too much of it, the pressure will get the best of you.

Volatility

We've talked about how volatility is just a measure of the amount of "air in the balloon." I will show you how this affects your risk capital mathematically. Essentially, the higher the volatility, the less risk capital you have to play with. The reason is that the amount of "noise" or rotation around the mean will become greater. The market will still fluctuate within 1σ of itself, but the difference is that if the current 1σ is +/- 3.00, that number could double or triple as the uncertainty increases. That will place additional strain on your capital base, and that means more fluctuations in your trading profits.

Win Rate

The win rate will have a strong effect on your ability to trade. It is the percentage of trades that are winners. Here are a couple of examples of what it can mean. Assume that you have two possible methods to trade.

The first method picks 90% winners and has an average win of .25% with an average loss of 1%. In this case the win rate is .90 and every 10 trades that you make, you will average .125% profit (.90 x .25 – 1.00) = .125. If your risk capital is $1000 after 10 trades, you will have made $125.00. It doesn't seem like much of an edge, but if you are making are 3 trades a week you will have more than doubled your bank roll with very little risk.

The second method picks 10% winners and it has an average win of 10.5% with an

average loss of 1%. In this case your average win is higher, .150% vs. .125%. We get .150 this way (.10 x 10.5) (-1.00 x .90) = .150 and after 10 trades you would have made $150 on average. If the second method of trading returns 20% more than method number one, which method should you choose?

If you took the higher return you are a risky trader because even though on average, you get a 20% higher return per trade **the variance is nine times as great.** The first method has a very low variance and will make your trading much smoother. There is nothing wrong with the second method but your losing streaks will be much worse and it will be more stressful. **The greater the variance, the longer the losing streaks will be when you are trading.** If you trade with a method that has a higher percentage of wins, you will be able to withstand losing streaks much better. In general, go with the method that gives you the highest percentage of winning trades. Figure 13.1 shows how this concept looks when you apply a little statistical analysis to the problem. It assumes a constant win rate and then looks at starting capital and how much it will be affected by a rise in volatility. The actual numbers are not important, but you can see that the lower amount of capital you start with in relation to volatility, the higher your chances of going broke become. The more equity that you start with gives you a much better cushion even as volatility rises significantly.

Capital	Win Rate	VIX	Risk of Ruin
20XWin	0.005%	10%1	.7%
40XWin	0.005%	10%	0.5%
80XWin	0.005%	10%	0.1%
Capital	**Win Rate**	**VIX**	**Risk of Ruin**
20XWin	0.005%	20%6	.2%
40XWin	0.005%	20%	1.8%
80XWin	0.005%	20%0	.3%

Figure 13.1 Risk of Ruin

Overview

This chapter detailed some very important concepts that we need to be aware of in our trading. We first talked about what the risk of ruin is and how that changes as the amount of air going in and out of the balloon varies. Next we talked about the components of risk and how each component interacts with our portfolio and starting capital. Finally we set some parameters for how we should manage risk in relation to our capital. I tried to make this chapter short and to the point, and this is the way we should manage our risk. Keep it as simple as possible!

Chapter 14: Common Trading Mistakes

Mistakes will find their way into your trading no matter how prepared you are. Instead of dwelling on mistakes, just learn from them! We all make mistakes, even me. As long as we learn from our mistakes, we won't make them as much.

If we think about sports and games in general, there are two kinds of mistakes we can make, physical mistakes and mental mistakes. Physical mistakes are simply a part of any game. We are not perfect, and in a game scenario we are also playing against someone who is trying to beat us! Think about the game of baseball again. Everybody strikes out once in a while right? There are some players that strike out more than others, but strike outs are a part of the game. As a hitter, we are doing everything in our power to get that base hit. However, sometimes we will fail and strike out. Strike outs in baseball are a physical part of the game. When we strike out, it's not because we haven't tried to get a hit. We have simply gotten beat by the pitcher. This will happen! The best thing you can do after you strike out is get back up to the plate the next time and try to get a hit.

Now let's go over the other kind of mistake you can make in baseball, a mental mistake. Mental mistakes are due to a lack of preparation. Either we are not paying attention or aren't prepared for a situation. Without getting into the detailed strategy of the game of baseball, I'm going to try and make this example as simple as possible just to prove a point. Let's say we're on second base and there's one out in the inning. The hitter pops up to the center fielder and we immediately start sprinting from second, trying to score. The center fielder catches the easy pop up, throws the ball second to second base, and records a double play because we started running without knowing what was going on in the situation. If you're an avid baseball fan you have already realized the mistake we have made as the baserunner. For those of you who know nothing about baseball, I'll explain it to you. There are three outs in each inning of a baseball game. As a baserunner, we shouldn't be running to the next base with less than two outs in this type of situation because we will get doubled up! The probability of an easy fly ball getting caught is around 99% of the time, and as a baserunner we can't advance to the next base until the ball is caught if we decide to tag up. Think about probabilities and how they relate to our trading. You wouldn't take a chance on something that has a 1% chance of being right, because 99 times out of 100, you will lose.

There is one out in the inning. After the center fielder catches the ball there are two outs. Because we have tried to score and left second base way too early, the center fielder

simply throws the ball to second base to record the third out of the inning. Regardless of what you know about baseball, we as the baserunner have made a **mental mistake.** We either didn't know or weren't aware of how many outs there were when the batter hit the ball, and we paid dearly for our mistake by letting the other team get a double play. Was the double play a result of us making a physical mistake? Absolutely not. It was the result of us not being aware of the situation and what it entailed.

Buying Far Out-of-the-Money Options

One of the most common themes in the book in terms of our trading is that we want to trade ATM or near-the-money options. The biggest mental mistake I see in all types of traders is when they try to buy far OTM options. This strategy is financial suicide, and it all comes back to our probability model. Buying far OTM options is a strategy in which people are trying to "hit a homerun." Is it possible that someone could buy a bunch of far OTM options and hit that homerun? It's possible, yes, but it's not probable. There are so many things wrong with buying far OTM options, and I'm going to show you an example of why we shouldn't ever try to trade them. Take a look at this option chain for LVS.

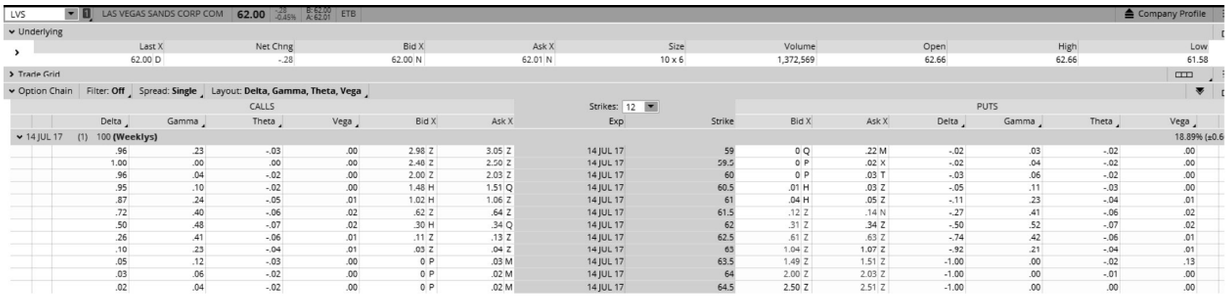


Figure 15.1 LVS One-Day Option Trend

LVS is trading exactly at $62.00, so 62 is the ATM strike. We have $1000 to trade with. In scenario one, we spend all of our money buying the ATM 62 option, which we can buy for 34 cents ($34 per contract). We can buy approximately 19 contracts in this case. In scenario two, we spend all of our money buying the far OTM 64 option, which we can buy for 2 cents ($2 per contract). We can buy approximately 500 contracts in this case. Before I even get into the math and probability of the problem with far OTM options, the first problem should be obvious. Think about the commissions! Just because we are buying far OTM options, that doesn't mean our commissions will change. It might cost you $1000 in commissions just to make this type of trade! Whatever the case, let's assume for the simplicity of the example that commissions

aren't a factor. We are also going to assume that everything else about these two options stays consistent, including delta. Now I know that we've talked about how an option's delta increases as it gets farther ITM, but as a pure book example just follow the numbers.

LVS makes a $5.00 move to the upside. The ATM 62 option (which has a delta of 0.50) will now be worth 2.84. We know this because for every dollar increase in the stock, this option will acquire 50 cents of value, because that is its delta. If LVS increases $5.00, the option will increase $2.50 in value, 2.50 + .34 = 2.84. The far OTM 64 option (which has a delta of 0.03) will now be worth 0.17. We know this because for every dollar increase in the stock, this option will acquire 3 cents of value.

The ATM 62 option has increased to 8.35 times its value and your $1,000 investment is now worth $8,350. The far OTM 64 option has increased to 8.50 times its value and your $1,000 investment is now worth $8,500. I thought you said it was bad to buy OTM options?! How can this be after the example you just showed us?

I showed you what the position would look like assuming we would win, and win in absurd fashion. The chances of LVS making a $5.00 move to the upside by expiration are so infinitesimally small that it's not even worth telling you what the percentage is. As traders, we know that it's not only about how much you win, but what percentage of the time you will win. It's about the **expected value** of your position. We know that an ATM option has a 50% chance being ITM or OTM at expiration (assuming constant volatility). Theoretically, if we buy the ATM 62 option in an infinite amount of scenarios, half the time we will win, and half the time we will lose. Now let's think about the far OTM 64 option. This option's delta (0.03) is telling us that 3% of the time it will expire ITM, and the other 97% of the time it will expire worthless. As low as 3% is, it doesn't even really tell the whole story. Look at the ATM straddle in LVS in Figure 13.1. It's trading at about 64 cents right now. If we think about this in relation to the bell-shaped curve, we know that there is about a 99% certainty that LVS will expire somewhere in between 61.68-62.32 by the end of the expiration. The $5.00 move I detailed earlier actually has **much less** than a 3% chance of happening, rendering the profit in the far OTM 64 calls even more ridiculous!

We can prove our theory that far OTM calls are not worth it by looking **at expected value.** In our first position, we have a 50% chance of being right. So our win rate is 0.5. In this one trade, our average win is 735% (percentage increase from 0.34 to 2.84). Our average loss is 100% (because half the time we will lose our entire investment if the 62 calls expire OTM). Our expected value is (0.50 x 735%) – (0.50 x 100%) = 317.5. In our second position, we have a 3% of being right (and it's not even that much)! In this one trade, our average win is 750% (percentage increase from 0.02 to 0.17). Our average loss is 100% (and we have a 97% chance of being wrong). Our expected value is (0.03 x 750%) – (0.97 x 100%) = -74.5. Look at the

difference in expected value! It's enormous. This is a perfect example of why we should never be buying far OTM calls. They are simply not worth it! For every time that we are right and hit that homerun, there will 99 times where we are wrong and lose our entire investment. Those are not very good odds. If you ever think of buying far OTM options, think back to this example. It holds true for every trade that you will ever make.

Using an All-Purpose Strategy in Different Market Conditions.

This is another fallacy that a lot of people don't understand because they don't get how the option model works. There is no single strategy that you can use in different market conditions because the trades that we use will change as the market conditions change! We can't ignore volatility because it such a critical concept in our trading. Credit spreads are the closest thing that you will find in terms of a strategy that doesn't really change when market conditions change. But even credit spreads change in periods of extremely high volatility! Remember when we talked about using 60/40 spreads instead of regular spreads in a blowoff-type scenario? Every one of our strategies is catered to condition that the market is in. Those who tell you differently are either trying to sell you something, or they don't understand volatility! Don't fall into this trap.

Not Having a Definite Exit Plan Prior to Expiration

The most important part of our trading is that we must always be prepared! A lack of preparation will most certainly catch up with us if we are careless when trading. Always be prepared. Whether that's rolling up/down, rolling back, or getting out of a position, we must be ready for anything that happens. Don't be the trader who is scrambling to fix their position when expiration Friday rolls around. It will come back to bit you.

Making Up for Past Losses by "Doubling Up"

We talked about this all the way back in Chapter 1, but it is such a critical concept to trading. Have a plan, and stick to that plan. When we try to make up for losses by increasing our positions, we are doomed for failure. The markets will beat us when we engage in this type of behavior. Remember that when we are trading, we are not gambling. Doubling up on trades will get us on the fast track to going broke.

Trading Illiquid Options

Stay away from illiquid options. It's as simple as that. When we trade in illiquid options, we are putting ourselves at unnecessary risk. There are so many great stocks to trade options

on, so why waste our time trading options that will only get us in trouble? Remember your rules for liquidity and stick to those rules.

Choosing the Wrong Expiration

This is one of those mental mistakes that a lot of traders make because they are careless. Before we put on a position, we have to make sure we are aware of all aspects of the trade! It's easy to make a mistake with trades that have multiple legs, as most of our trades do. Know your levels, know your strikes, and know your expiration.

Not Covering Written Options

It's important to remember that as option writers, we now have an obligation to deliver the underlying asset at a specific price and time. Except for buying outright options, all of our strategies have some form of written options. We must be aware of our position at all times in a trade! If we forget to cover our written options, we'll be forced into assignment. This is something that can cause us a major headache if we're not careful.

Overview

Part of the reason I am writing this book is to not only teach you what can go right, but what can go wrong! I have made every mistake in the book during my time as a trader. I have learned so much more from my mistakes because they have taught me how I can improve as a trader. It's easy to trade when everything is going right and you're making a lot of money. It's not so easy when everything seems to be going wrong. Always take a deep breath and relax. Trading is a process just like anything else. Don't ever let the situation get to big for you.

Chapter 15: Organizing Trades and FAQs

We've covered all the X's and O's. It's time to implement everything we've learned so we can be successful weekly options traders.

Step One: Observing Your Portfolio

We've gone over how to create a portfolio and that we must constantly be observing it as the market fluctuates. Some stocks will follow the underlying indexes very closely (high beta correlation) and other will trade in their own pattern; volatility within different groupings will vary quite a bit, so being diversified is a must! Even if you are a very small trader and never have more than one position on at any one time, you want to have the best opportunity to pick winners.

Always concentrate on the stocks with the highest EV; those stocks will be the most liquid, and the more liquidity, the better chance that we will be able to overcome the bid/offer spread and commissions. Remember, we don't get a commission discount because the price of the stock is lower! As our EV declines, it means that the commission dollar we're spending increase in relation to our potential profit, even when we are trading a position that has limited risk and unlimited reward.

Step Two: Observing the Major Trend and Making a Trade

Once we've narrowed our selection of stocks down to a couple of candidates, we must match the trade with the market conditions. As an example, we've decided that we want to trade AAPL or GS or both, but we're not sure which one gives us the best chance to have a winner. Look at the major indexes to see what phase they are trading in. Is the market in congestion, is it trending, or is it in a blowoff pattern?

Suppose the NASDAQ has been in congestion and is nearing a double top. Most likely, AAPL will be in a very similar pattern. GS is in an uptrend, but he S&P 500 is also in congestion and nearing a double top. Both of these stocks are now very good

candidates, but we still need to observe them until we get a signal in the individual stock. When our shortest-term indicator turns negative at the double top, we can initiate the trade!

If the major indexes were in a different pattern, we would use that as a guide until our selected stocks meet the requirements and we can enter the trade. The higher the correlation between the individual stock that we're trading and the index that it is associated with, the better the chance that we have to cash the trade.

Step Three: Amount of Equity Needed to Trade Each Strategy

We've talked about the risk for any given trade we can make. The higher the risk is, the higher the reward should be! However, depending on our risk capital, the number and quality of trades will vary significantly. Figure 15.1 shows us how much equity we need to trade a specific strategy, given the fact that we can't risk more than three to four percent of our risk capital on any one trade and still be successful. There is a minimum amount of capital necessary to trade below that critical percentage. It is very difficult to win when we overextend above that number because it becomes impossible to keep the risk/reward ratio in line.

To trade weekly options, I believe the minimum amount necessary is around $1,000. At that level, we can trade one $0.50 wide vertical credit spread. If we get the proper ratio of 2/3, our maximum risk is about $30 per trade, which is in line with the overall risk strategy. If we have $2,000 in risk capital, we can go to the stocks that have $1.00 strikes and our 2/3 ratio is again in line, as our risk is only $60. Figure 15.1 shows that the more risk capital that we have at our disposal, the more aggressive our strategy can become and still be within the risk tolerance we have discussed.

Risk Capital	Credit Spreads	Outright Buys	Risk Reversals	1x21
1K	X			
2K	X			
3K	X			
5K	X			
8K	X	X	X	
10K	X	X	X	X
15K	X	X	X	X
20K	X	X	X	X
25K	X	X	X	X
50K	X	X	X	X
75K	X	X	X	X
100K	X	X	X	X

Figure 15.1 Amount of Equity Needed to Trade Each Strategy

If we have $5,000 or more in our account, we can begin to expand our strategies to include limited risk and unlimited reward trades. When we reach the top bracket of $100,000, we can not only trade all of the strategies but we should probably be trading multiple stocks and multiple contracts within those stocks. Once we have phased into a cycle, it is simply a matter of repeating the trades each time the market conditions are met.

Frequently Asked Questions

There are several questions that come up often when I talk to my students. A lot of the questions are catered to the individual, but some of them are very important to the overall concept of trading. **(Add FAQs**)

That's it! We are officially ready to trade weekly options. We went from describing what a market was all the way to the multiple option strategies. I hope you enjoyed this book as much as I enjoyed writing it. Teaching people how to trade has been a lifelong passion of mine and I know you can be successful if you stick to the plan we went over in this book.