

Clear & Simple Option Approach Part 1, 2 & 3



Active Trend Trading



Disclaimer

U.S. GOVERNMENT REQUIRED DISCLAIMER – COMMODITY FUTURES TRADING COMMISSION FUTURES AND OPTIONS TRADING HAS LARGE POTENTIAL REWARDS, BUT ALSO LARGE POTENTIAL RISK. YOU MUST BE AWARE OF THE RISKS AND BE WILLING TO ACCEPT THEM IN ORDER TO INVEST IN THE FUTURES AND OPTIONS MARKETS.

DON'T TRADE WITH MONEY YOU CAN'T AFFORD TO LOSE. THIS IS NEITHER A SOLICITATION NOR AN OFFER TO BUY/SELL FUTURES OR OPTIONS. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE DISCUSSED IN THIS TRAINING. THE PAST PERFORMANCE OF ANY TRADING SYSTEM OR METHODOLOGY IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

CFTC RULE 4.41 – HYPOTHETICAL OR SIMULATED PERFORMANCE RESULTS HAVE CERTAIN LIMITATIONS. UNLIKE AN ACTUAL PERFORMANCE RECORD, SIMULATED RESULTS DO NOT REPRESENT ACTUAL TRADING. ALSO, SINCE THE TRADES HAVE NOT BEEN EXECUTED, THE RESULTS MAY HAVE UNDER-OR-OVER COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFIT OR LOSSES SIMILAR TO THOSE SHOWN.

ALL MATERIALS PRESENTED ARE FOR TRAINING PURPOSES ONLY. TRADERS SHOULD PAPER TRADE ANY NEW METHOD PRIOR TO RISK OF PERSONAL CAPITAL. PAST PERFORMANCE IS NO GUARANTEE OR PROMISE OF FUTURE PERFORMANCE.

Option Trading Parameters

- For Active Trend Trading System Strategies trades two types of option positions
 1. Directional – Calls going with an uptrend; Puts going with a downtrend (Strategy 2)
 2. Spreads – Credit and Debit Spreads; variations: Iron Condor & Butterfly (Strategy 2 & 3)

Option Trading Parameters

Important Factors:

- Stocks/ETFs with weekly options tend to have higher tradability - I prefer trading stocks with weekly options
- Factors I need to be aware of:
 - Time to expiration
 - Delta - how much the price of the option moves for every \$1 move of the stock/ETF
 - Implied Volatility
 - Open Interest (OI)
- How pick the strategy
 - Directional or Spread
 - Simple Spread or Layered
- Option Chain – Buying: Where is the low volatility; Selling: Where is the high volatility

Option Trading Parameters

- Simple Rules
 - Directional - Buy Options with 2-6 weeks remaining until expiration with a Delta between 60-70
 - If too Pricy - Buy (Debit) or Sell (Credit) a Spread
 - Use a 30-70% Stop Loss - Depends on Directional or Spread
 - Profit Targets at underlying price targets
 - Profit Targets at 30-40% for Credit Spread or at 60-70% for Debit Spreads
 - Prefer to close trade prior to expiration day!

Option Trading Parameters

- Simple Rules
 - Directional - Buy Options with 2-6 weeks remaining until expiration with a Delta between 60-70
 - Define Price for Entry Trigger
 - Use a 30-70% Stop Loss - Depends on Directional or Spread
 - Profit Targets at underlying price targets
 - Prefer to close trade prior to expiration day!

Option	2Aug		
Option	Amount	Stock Price	Contracts
ADP	\$ 6,106	Call	10
Strike	\$ 160.00	\$ 162.90	
Entry	5.9		P/L
30% Stop	4.13	\$ 160.26	-1770.00
Tech Stop	4.96	\$ 161.50	-938.00
15% Profit	6.79	\$ 164.22	885.00
20% Profit	7.08	\$ 164.66	1180.00
30% Profit	7.67	\$ 165.54	1770.00
60% Profit	9.44	\$ 168.18	3540.00

Option Trading Parameters

Simple Rules

- Directional - Buy Options with 2-6 weeks remaining until expiration with a Delta between 60-70

Option	2Aug		
Option	Amount	Stock Price	Contracts
ADP	\$ 6,106	Call	10
Strike	\$ 160.00	\$ 162.90	
Entry	5.9		P/L
30% Stop	4.13	\$ 160.26	-1770.00
Tech Stop	4.96	\$ 161.50	-938.00
15% Profit	6.79	\$ 164.22	885.00
20% Profit	7.08	\$ 164.66	1180.00
30% Profit	7.67	\$ 165.54	1770.00
60% Profit	9.44	\$ 168.18	3540.00

- Spread – Debit to hold down costs

Buy 2 Aug 160C at 5.90

Sell 2 Aug 170C at 1.10

Costs 4.80 for potential profit of $10.00 - 4.80 = 5.20$

Clear & Simple Option Approach Part 2



Active Trend Trading



Option Trading Parameters

- What are Spreads?
 - Buying and Selling options with different strikes or expirations at the same time to achieve a specific objective
- Why Trade Spreads?
 - Debit spreads, to reduce the premium amount payable. Paid Upfront
 - Credit spreads, to lower the option position's risk. Collected Upfront
- What are the types?
 - Verticals – Same Expiration/Different Strikes (Primary Type)
 - Diagonal – Different Expiration/Different Strikes (More Variables)
 - Calendar – Different Expiration/Same Strikes (More Variables)

Option Trading Parameters

Basic Features of Vertical Spreads

Each vertical spread involves buying and writing puts or calls at different strike prices. Each spread has two legs, where one leg is buying an option, and the other leg is writing an option.

This can result in the option position (containing two legs) giving the trader a credit or debit. A debit spread is when putting on the trade costs money. For example, one option costs \$300 but the trader receive \$100 from the other position. The net premium cost is a \$200 debit.

If the situation were reversed, and the trader receives \$300 for putting on an option trade, and the other option costs \$100, the two option contracts combine for a net premium credit of \$200.

Option Trading Parameters

Basic Features of Vertical Spreads - Continued

Here is how each spread is executed.

A bull call spread is purchasing a call option, and simultaneously selling another call option (on the same underlying asset) with the same expiration date but a higher strike price. Since this is a debit spread, the maximum loss is restricted to the net premium paid for the position, while the maximum profit is equal to the difference in the strike prices of the calls less the net premium paid to put on the position.

A bear call spread is selling a call option, and simultaneously purchasing another call option with the same expiration date but at a higher strike price. Since this is a credit spread, the maximum gain is restricted to the net premium received for the position, while the maximum loss is equal to the difference in the strike prices of the calls less the net premium received.

A bull put spread is writing a put option, and simultaneously purchasing another put option with the same expiration date but a lower strike price. Since this is a credit spread, the maximum gain is restricted to the net premium received for the position, while the maximum loss is equal to the difference in the strike prices of the puts less the net premium received.

A bear put spread is purchasing a put option, and simultaneously selling another put option with the same expiration date but a lower strike price. Since this is a debit spread, the maximum loss is restricted to the net premium paid for the position, while the maximum profit is equal to the difference in the strike prices of the puts less the net premium paid to put on the position.

Option Trading Parameters

Spread	Strategy	Strike Prices	Debit / Credit	Max. Gain	Max. Loss	Break-Even
Bull Call	Buy Call C1 Write Call C2	Strike price of C2 > C1	Debit	$(C2 - C1) - \text{Premium paid}$	Premium paid	C1 + Premium
Bear Call	Write Call C1 Buy Call C2	Strike price of C2 > C1	Credit	Premium received	$(C2 - C1) - \text{Premium received}$	C1 + Premium
Bull Put	Write Put P1 Buy Put P2	Strike price of P1 > P2	Credit	Premium received	$(P1 - P2) - \text{Premium received}$	P1 - Premium
Bear Put	Buy Put P1 Write Put P2	Strike price of P1 > P2	Debit	$(P1 - P2) - \text{Premium paid}$	Premium paid	P1 - Premium

Option Trading Parameters

Credit and Debit Spreads

Vertical spreads are used for two main reasons:

For debit spreads, to reduce the premium amount payable.

For credit spreads, to lower the option position's risk.

Let's evaluate the first point. Option premiums can be quite expensive when overall market volatility is elevated, or when a specific stock's implied volatility is high. While a vertical spread caps the maximum gain that can be made from an option position, when compared to the profit potential of a stand-alone call or put, it also substantially reduces the position's cost. Such spreads can therefore be easily used during periods of elevated volatility, since the volatility on one leg of the spread will offset volatility on the other leg.

As far as credit spreads are concerned, they can greatly reduce the risk of writing options, since option writers take on significant risk to pocket a relatively small amount of option premium. One disastrous trade can wipe out positive results from many successful option trades. In fact, option writers are occasionally disparagingly referred to as individuals who stoop to collect pennies on the railway track. They happily do so until a train comes along and runs them over!

Writing naked or uncovered calls is among the riskiest option strategies, since the potential loss if the trade goes awry is theoretically unlimited. Writing puts is comparatively less risky, but an aggressive trader who has written puts on numerous stocks would be stuck with a large number of pricey stocks in a sudden market crash. Credit spreads mitigate this risk, although the cost of this risk mitigation is a lower amount of option premium.

Option Trading Parameters

Credit and Debit Spreads - Continued

Which Vertical Spread To Use

Consider using a bull call spread when calls are expensive due to elevated volatility and you expect moderate upside rather than huge gains. This scenario is typically seen in the latter stages of a bull market, when stocks are nearing a peak and gains are harder to achieve. A bull call spread can also be effective for a stock that has great long-term potential but has elevated volatility due to a recent plunge.

Consider using a bear call spread when volatility is high and modest downside is expected. This scenario is typically seen in the final stages of a bear market or correction when stocks are nearing a trough, but volatility is still elevated because pessimism reigns supreme.

Consider using a bull put spread to earn premium income in sideways to marginally higher markets, or to buy stocks at reduced prices when markets are choppy. Buying stocks at reduced prices is possible because the written put may be exercised to buy the stock at the strike price, but because a credit was received this reduces the cost of buying the shares (compared to if the shares were bought at the strike price directly). This strategy is especially appropriate to accumulate high-quality stocks at cheap prices when there is a sudden bout of volatility but the underlying trend is still upward. A bull put spread is akin to "buying the dips," with the added bonus of receiving premium income in the bargain.

Consider using a bear put spread when moderate to significant downside is expected in a stock or index, and volatility is rising. Bear put spreads can also be considered during periods of low volatility to reduce the dollar amounts of premiums paid, like to hedge long positions after a strong bull market.

Option Trading Parameters

Factors to Consider

The following factors may assist in coming up with an appropriate options/spread strategy for the current conditions and your outlook.

Bullish or bearish: Are you positive or negative on the markets? If you are very bullish, you might be better off considering stand-alone calls (not a spread). But if you are expecting modest upside, consider a bull call spread or a bull put spread. Likewise, if you are modestly bearish or want to reduce the cost of hedging your long positions, the bear call spread or bear put spread may be the answer.

Volatility view: Do you expect volatility to rise or fall? Rising volatility may favor the option buyer, which favors debit spread strategies. Declining volatility improves the odds for the option writer, which favors credit spread strategies.

Risk versus reward: Is your preference is for limited risk with potentially greater reward, this is more an option buyer's mentality. If you seek limited reward for possibly greater risk, this is more in line with the option writer mentality.

Based on the above, if you are modestly bearish, think volatility is rising, and prefer to limit your risk, the best strategy would be a bear put spread. Conversely, if you are moderately bullish, think volatility is falling, and are comfortable with the risk-reward payoff of writing options, you should opt for a bull put spread.

Option Trading Parameters

Factors to Consider – Continued

Which Strike Prices to Choose

Which strike prices are used is dependent on the trader's outlook. For example, on a bull call spread, if the price of a stock is likely to stay around \$50 until the options expire, you may buy a call with a strike near \$50 or and a sell a call at \$55. If the stock is unlikely to move much, selling a call at the \$60 strike makes less sense because the premium received will be lower. Buying a call with a \$52 or \$53 strike would be cheaper than buying the \$50 call, but there is less chance the price will move above \$52 or \$53 compared to \$50.

There is always a tradeoff. Before taking a spread trade consider what is being given up or gained by choosing different strike prices. Consider the probabilities that the maximum gain will be attained or that the maximum loss will be taken. While it is possible to create trades with high theoretical gains, if the probability of that gain being attained is miniscule, and likelihood of losing is high, then a more balanced approach should be considered.

The Bottom Line

Knowing which option spread strategy to use in different market conditions can significantly improve your odds of success in options trading. Look at the current market conditions and consider your own analysis. Determine which of the vertical spreads best suits the situation, if any, then consider which strike prices to use before pulling the trigger on a trade.

Option Trading Parameters

Other things to consider

1. Trending – High Value stocks can trend intraday \$10 or more and not show much trend on the daily chart
2. Pullback/Pullup – Target Option Values
3. Debit or Credit - Big move Expected Lean Towards Debit

GO to the Charts -

Clear & Simple Option Approach Part 3



Active Trend Trading



Build Some Trades

TTD Option Parameters

1. Trending – High Value stocks can trend intraday \$10 or more and not show much trend on the daily chart
2. Pullback/Pullup – Target Option Values
3. Debit or Credit - Big move Expected Lean Towards Debit

GO to the Charts -

Build Some Trades



TTD Option Parameters

1. Up Trending – 7/23 Range 9.75; High = 251.03; Low = 241.28; T1 = 256.70
2. Trigger Trade on Pullback between 20/34 day EMA \approx 237.00
3. 60 – 70 Delta Call out 2 weeks or More or week of earnings 8/8
4. 2Aug 235C @ 7.50
5. 9Aug 235C @ 19.07

end Trading

Build Some Trades



TTD Option Parameters

1. Up Trending – 7/23 Range 9.75; High = 251.03; Low = 241.28; T1 = 256.70
2. Trigger Trade on Pullback between 20/34 day EMA \approx 237.00
3. 60 – 70 Delta Call out 2 weeks or More or week of earnings 8/8
4. Debit Spread 2Aug 235C/250C @ 5.60
5. Debit Spread 9Aug 235C/250C @ 6.50

Note the higher cost option approach is cut down dramatically with a Debit Spread

What about the Put Side?

end Trading

Bonus Training Option Basics

Is it worth the hassle?

PRESENTED BY: DENNIS W. WILBORN

Option Basics

What are Options?

- A Contract or Agreement between two parties
- Each Option Contract comes with Rights and Obligations

Why do people trade options? **Perceived benefit of Leverage & Variable Strategies**

New Vocabulary

More Variables than just trading stocks **(can work for or against the trader)**

Resources

www.cboe.com Chicago Board of Options Exchange

Books:

- The Option Advisor, Author: Bernie Schaeffer
- Options as a Strategic Investment, Author: Lawrence G. McMillan
- The Option Course, Author: George A. Fontanills

Option Basics

Vocabulary

Contract: Typically controls 100 shares (Mini's Control 10 shares)

Obligation: Typically the responsibility of the seller

Rights: Typically the benefit to the buyer

Premium: Price of the Option

Greeks: Variables used in the Black Scholes Option Model

Implied Volatility:

Expiration Month: Month the Option will expire typically on the Friday after the 3rd Thursday (Settles on Saturday for non-European Options)

Strike Price: Contract Price of underlying stock/ETF

Open Interest: Contracts currently open

Bid/Ask Spread: The price difference between the Bid & Ask

Intrinsic Value: The positive price difference between Strike and Stock \$

Extrinsic Value: Time Value (influenced by Vega & Gamma)

Exercise: Put to me or Called away

Option Basics

Vocabulary (Cont)

Theoretical Value: Theoretical Price of an Option determined by an option calculator

Time Decay: Amount price goes everyday (Theta)

At the Money (ATM): Price of option strike that is closest to the price of the stock/ETF

In the Money (ITM): Price of option strike that has Intrinsic Value

Out of the Money (OTM): Price of option strike outside the parameters of the trade

Volatility Inflation: Volatility is growing due to VIX or other events like earnings

Volatility Crunch: Volatility deflation due to falling VIX or event passes

Leaps: Options that expire in January each year and are more that 6 months in the future

Option Chains: List of option strike prices and months presented in a table

Directional: Option trades placed in the direction of the trend

Spreads: Credit or Debit two option trade with limited upside and fixed downside

Condors: Exotic type option trade selling premium with a very low Delta

Butterflies: Exotic type option trade made up of three separate options of the same type

Option Basics

What are Options?

- A Contract or Agreement between two parties
- Each Option Contract comes with Rights and Obligations

Types: Puts & Calls, American, European, Mini's, Standard & more

Time: Weekly, Monthly, Leaps

Variables: Greeks (Delta, Gamma, Theta, Vega, Rho)

Model Options Calculators: Black Scholes, Binomial, Brownian & Others

Option Basics

Variables: Greeks (Delta, Gamma, Theta, Vega, Rho)

- **Delta:** How much price increases or decrease per dollar movement in the underlying. Also tells us how many equivalent shares of stock one contract approximates. 50 delta is approximately like 50 shares of the stock
- **Theta:** How much value the options loses every day this is an a complex equation and not straight line decay
- **Vega:** Price variation due to Volatility
- **Gamma:** How much Delta Changes per dollar increase or decrease in movement of the underlying stock/ETF
- **Rho:** Associated with interest rates

Model Options Calculators: Black Scholes, Binomial, Brownian & Others

Option Basics

Call Options:

Long: Expect Stock Price to go up

Rights & Obligation: **Buyer** has the right to buy the stock/ETF at the agreed on price. Seller is obligated to sell stock/ETF at the agree on Price

Short: Expect Stock Price to go down

Rights & Obligation: Buyer has the right to buy the stock/ETF at the agreed on price. **Seller** is obligated to sell stock/ETF at the agree on Price

The Catch: All Options are made up of both Intrinsic and Extrinsic Value—If an option has high Extrinsic Value due to High Implied Volatility, I want to be a seller and not a buyer because even if the price of the stock goes up, the value of my option can go down!

Option Basics

Put Options

Long: Expect Stock Price to go down

Rights & Obligation: **Buyer** has the right to sell the stock/ETF at the agreed on price. Seller is obligated to buy stock/ETF at the agree on Price

Short: Expect Stock Price to go up

Rights & Obligation: Buyer has the right to sell the stock/ETF at the agreed on price. **Seller** is obligated to buy stock/ETF at the agreed on Price

Intrinsic + Extrinsic = Option Price

Intrinsic: Price of the stock/ETF less the Strike Price

Extrinsic: Primarily Time Value impacted by Implied Volatility & Time Decay

If a stock's price is currently at \$75

Intrinsic Value of a \$70 strike price would equal $(75-70) = \$5.00$

If the \$70 option is selling for \$7.50 the Extrinsic Value would be:

Extrinsic Value = Price of the option – Intrinsic Value $(7.50 - 5) = \$2.50$

If the stock stays at \$75 until expiration you loose \$2.50 on this trade.

Fatal Mistakes

1. Trying to trade options before having a strong System Foundation

Not buying enough time

Selling too much time and too little volatility (**can be an emotional roller coaster**)

Buying too far Out of the Money (**too much Extrinsic Value**)

Buying too much Volatility (**earnings are especially risky to buy premium**)

Not knowing that option market can open up to 10-20 minutes after the regular market—**Risky for Market orders**

Not knowing that volatility is inflated at the beginning of the day

Chasing the Bid/Ask—**Place your order at the Mark and it gets filled or doesn't**

How Do I Chose?

1. How long do I want to hold the option?
2. How much do I want the price to change with a move in the underlying? Choose proper Delta.
3. How much Bid/Ask Spread am I willing to risk?
4. Do I buy or sell premium?
5. How much Volatility
6. How Much Open Interest?
7. When are Earnings?

How Do I Chose?

1. How long do I want to hold the option? **Buying 2-6 Weeks**
2. How much do I want the price to change with a move in the underlying?
Choose proper Delta. **Minimum of 0.50**
3. How much Bid/Ask Spread am I willing to risk? **.10-.50 cents unless I know the Option Chain Personality**
4. Do I buy or sell premium? **Depends on volatility**
5. How much Volatility? **Find the Chain with the lowest to buy & Highest to sell**
6. How Much Open Interest? **50 – 250 Contracts Open unless I know the Option Chain**
7. When are Earnings? **Volatility tends to increase approaching earnings**
8. **Use ATTS Rules for Entry & Exit, estimate value of option**

Example

Choose a Stock?

Key Points

- Trading Options Introduces Variables to the Trading Equation
- These variables can significantly increase risk
- Directional Options & Covered Call trades are the most basic
- Complex option trades add more variables (spreads & exotics)