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» Thinking of options as income-producing tools

» Analyzing options with any market in mind

» Making the markets work for you

Chapter 1

Options Trading and You, the Individual Investor

Whether you're an experienced risk taker, a trader, or a longer-term investor, you can trade options on individual stocks, indexes, and exchange-traded funds (ETFs) with the information in this book. And the best reasons to trade options is that you can manage risk and develop a reliable income stream risking less money than by trading stocks without having to wait for dividends.

The ultimate goal for any trader is to make money. For options traders in the post-pandemic era, the primary goal is income — money to use for paying bills, buying groceries, and paying expenses that have risen due to inflation. This chapter is about providing the mental foundation (rewiring of your brain) to become a successful income generator via options trading.

Rewiring Your Thinking

Generating income via trading options takes some time and requires patience, so stay patient, study the trading techniques, and understand associated risks and rewards. The information in this book will slowly rewire your brain and reshape the way you look at the markets with the ultimate goal of grabbing a paycheck. Moreover, rewiring your brain can help you to use volatility (the fluctuation of prices) to your advantage. Higher levels of volatility raise option premiums and allow you to sell options for income at a higher price. The best part is it doesn't hurt. Chapters 7 and 8 are also great for rewiring your brain.

REMEMBER

Keep these points in mind about the rewiring process:

- **Options trading, as all types of trading, is a competition.** Whoever or whatever is on the other side of your trade is trying to take your money; and you theirs.
- **Trading algorithms dominate the market, making trades lightning fast.** Once, long ago, stocks were the key to options. Now, the options market influences stocks because 80 percent of all trades in the stock and related markets are now made by trading algorithms. These machine traders are also known as *algos.* In effect they're computer programs, also referred to as *artificial intelligence (AI)* or *bots.* And bots follow the money, which often starts its journey in the options market.

  REMEMBER

  I refer to trading bots as *algos.* But no matter what I call them, they're the major influence on prices, and they're everywhere in the markets just waiting for your order. Indeed, the market makers, the entities that match buy and sell orders, are all computerized. As a result, events in the markets now happen literally at the speed of light due to the involvement of algos.

  I explore this concept throughout the book, showing you how to spot them and how to trade against them with frequent success and reliable income. For now, my goal is to plant this thought in your mind and start your rewiring. Chapters 5, 6, and 8 dive headfirst into the rewiring process.

WARNING

Algos, day traders, and whoever else is trading at any time, don't have your best interest in mind. And neither do you in their regard, which means you should have your act together before you start real-time trading.

In addition, because algos move fast, prices also change rapidly in the market, especially in options. As a result, options are not to be used for long-term wealth-building strategies. Let me be clear: *Investing* is all about using the power of time and the benefits of compounding to build wealth over long periods. The traditional *buy-and-hold* strategy for stocks is a perfect example, as is the owning of rental properties for long periods to generate income. This long-term oriented, patient mind-set often, but not always, works well for stocks and mutual funds. It doesn't work for options because of the way the algos move the markets and because of the time limit in the life of an option. One partial exception, that of trading long-term options, is a viable trading tactic that I address in this book (see Chapter 11).

The bottom line is that you may trade any option for a few minutes, a few days, or a few weeks, but no matter how long you're in an options position, even if it's part of your long-term investment plan, it's a trade, and your focus should be primarily on producing income or hedging via the trade. Simultaneously, don't confuse options trading with some random, haphazard activity. Options trading is a cautious and very precise exercise. Chapter 8 shows you how to produce income through a "killer" trading plan.

Preparing to Trade: Take a Pre-Trading Flight Check

Imagine if a pilot tried to fly a plane without doing a pre-flight check. In similar fashion, before you start trading options, it's a good idea to know three elements:

- Your risk profile
- Your financial situation
- Your time commitment possibilities

WARNING

Please be patient and be prepared to spend as much time as you need learning the craft, or you can lose money, often in a hurry, because the algos aren't your friend.

Even if you're experienced in other forms of investing or have experience with options, it's still worth considering the following:

- **Review your financial balance sheet.** Before you start trading any financial instrument, go over your living expenses and review your credit card, loans, mortgages, and life and health insurances. Put together a financial net worth statement. Make sure it's healthy before you take extraordinary risks.
- **Be honest with yourself.** Don't trade beyond your experience levels, and don't risk too much money in any one trade. ***Bottom line:*** If you have $1,000 in your account, don't trade more than one options contract at any one time and don't go for big returns. Instead concentrate on learning the craft and adding money to your account. But don't be discouraged. With patience and attention to detail, you will improve.
- **Manage your risk.** If you're a cautious person who thinks that mutual funds are risky, you may not be a good options trader. But don't count yourself out either. Many different options strategies may suit you, especially as you focus on income production via options and you understand the built-in safety nets

that make them attractive. Read through the book and find the most suitable strategies to your risk profile. Part 4 covers this in detail.

- **Become a good analyst.** If you like to gamble without doing your homework, options trading may be painful at times. To maximize your odds of success, improve your technical and fundamental analysis skills on both the markets and the specific trade setups for individual securities that can optimize your success. Part 2 is a must-read in order to strengthen your market analysis chops.
- **Don't be afraid to test your strategies before deploying them.** Doing some paper trading on options strategies before you take real-life risks is an excellent idea that is certain to provide both practice as well as saving you some headaches. Chapter 7 guides you through this process.
- **Set up a separate account for your options trading.** I have the full details in Chapter 8.
- **Never trade with money that you aren't willing to lose.** Even though options are risk-management vehicles, you can still lose money trading them, especially with the algos in the mix. And as you progress to more sophisticated and riskier option strategies, your losses can be significant if you don't plan your trades beforehand. ***Bottom line:*** Don't trade options with your car payment or your rent money. Part 4 is all about advanced trading strategies.

WARNING

Understanding Options

Options are financial instruments priced based on the value of another underlying asset (known as the *underlying*) in the language of the markets. At the same time, because of algo mechanics, the price action in the options markets inversely influences the price of the underlying asset. As you plan a trade, you must think in terms of three details:

- The underlying
- The option
- What the algos and other market participants such as day traders may do at any time during your trade

Incidentally, in this book, I focus mostly on options on individual stocks, but you can apply these general concepts to all markets. The following sections address these key components of options trading.

Getting the complete picture

To fully understand and use options to generate income or to limit risk, you must understand the asset on which the option is based, which may require deeper analysis and detail beyond your current routine. For example, because volatility is a key component of option prices, reviewing the underlying's historical volatility more carefully as part of your analysis is necessary.

This book helps you by focusing on techniques that compare options to their underlying security or other securities. Chapter 9 details several approaches that you can apply when you analyze stocks and index options.

I primarily think of options as income producing as risk-management tools and trading them separately as income vehicles and as hedges in overall portfolio strategy. In other words, I always ask myself three questions before I make any trade:

- Is this an income producing trade or a hedging trade?
- Am I trading with the trend? (Chapter 5 helps you with both.)
- If it's a hedge, I ask how will this trade affect the overall value of my account? (Refer to Chapter 7 for more information.)
- If it's an income producer, I ask what I will use the money for? This question helps me to manage the trade as I may reach my goal before the expiration date.
- Can my account handle the potential loss for this trade? (Check out Chapter 8 to answer both of these questions.)

In other words, your primary focus varies with the goal of the trade, although in both cases, managing your risk is wise (lose as little as possible if trading goes wrong) by making sure the trade is right for your goal and by understanding the risks associated with the trade and the underlying. Always focus on safety by:

- Knowing applicable conditions both in the markets and in the individual security, to consider when planning a trade
- Using the right trade for the right setup
- Following trading rules and requirements for the trade
- Understanding what individual variables make any position gain and lose value

Trading anything, especially options, is complex. But attention to detail helps you work things out.

Knowing option essentials

The two kinds of options are *calls* and *puts.* After you add them to your current trading tools and strategies, you can participate in both *bullish* (rising markets) and *bearish* (falling markets) moves in any underlying you select. The primary use for options is income production via spreads and related strategies. But a very close second and equally important use is to limit your total portfolio risk — to protect an individual existing position such as a stock or ETF, via hedging strategies.

Making quick work of definitions

A *listed* stock option is a contractual agreement between two parties with standard terms. All listed options contracts are governed by the same rules. When you create a new position, one of two events is triggered:

- By buying an option, you're buying a specific set of rights.
- By selling an option, you're acquiring a specific set of obligations.

These rights and obligations are standard and are guaranteed by the Option Clearing Corporation (OCC), so you never have to worry about who's on the other end of the agreement — assume it's an algo. Chapter 3 provides more information and detail on the OCC and its central role in options trading.

Time is everything to option traders. Indeed, the one particular wrinkle in options, and the primary risk involved, is twofold:

- **Time-value decay:** Where the time value of the option falls on a daily basis until the expiration date.
- **Leverage:** The factor that causes option prices to change in larger percentages moves both up and down more aggressively than stocks under conditions of high volatility.

Pricing relationships

The price of a call option rises when its underlying stock goes up. But if the move in the stock is too late, because it happens too close to the expiration date, the call can expire worthless. You can literally buy yourself more time, though — some options have expiration periods as late as nine months to 2½ years.

When you own call options, your rights enable you to

- Buy a specific quantity of the underlying stock (exercise).
- Buy the stock by a certain date (expiration).
- Buy the specific quantity of stock at a specified price (known as the *strike price*).

Thus, the price of the call option rises when the underlying stock price goes up because the price of the rights you bought through the option is fixed while the stock itself is increasing in value.

Conversely, a put option gains value when the underlying stock falls in price, while the timing issue is the same. The move in price still has to occur before the option contract expires or your option will expire worthless. Your put contract rights include selling a specific quantity of stock by a certain date at a specified price. If you own the rights to sell a stock at $60, but events such as bad news about the company pushes the stock price below $60, those rights become more valuable.

A significant part of your skill as an options trader is your ability to select options with expiration dates that allow time for the anticipated moves to occur. As you discover more, it will make perfect sense because successful options trading is all about giving yourself and the option time to deliver on your expectations. Of course, some basic trading rules can help, including the development of proper trade design, based on the right setup for the right trade and management techniques, such as planning your exit from a position before you trade in order to cut losses.

All stocks with derived options available for trading have multiple expiration dates and strike prices. The two important pricing factors to keep in mind are

- Options with more time until the expiration date are more expensive.
- Options with more attractive strike prices are more expensive.

Information about options and your available choices are widely available on the Internet. For serious trading using the pricing data from your broker's platform and a premium charting service for the trade setup is best.

Trying different strategies before deploying them in real time

Options are different from stocks both in terms of what they represent — leverage, rights, and obligations instead of partial ownership of a company — and how they're created, by demand. These important distinctions result in the need for additional trading and decision making beyond the basic buy or sell considerations, especially in the context of income generation in complex markets.

To successfully expand your trading repertoire from stock trading to options trading, you have to think like an options trader, which means you're evaluating the underlying asset as a potential income producing asset or a hedge, how your trade fits into the market maker's trading decisions. The trick is to look at the right price chart setup as I discuss in Chapters 10 and 11.

Your final decision, as the trade develops, may be to exercise your rights under the contract or simply exit the position in the market. Fortunately, market prices will help you with those decisions, and so will some thoughts from Chapters 9 and 18.

TIP

If you think you're reading a familiar concept, you probably are. Repetition is an important part of rewiring your brain. Indeed, the more you hear or read something, the more it's likely to stick!

Crawling before walking

If you haven't traded options in the past, your best approach (as I mention repeatedly throughout this book) is to try some trading strategies on paper and see how things work out. Your goal here is simple: You want to get to the point where you think of your option trades based not just on the option, the underlying security, and what the trader on the other side is doing by learning to spot telling price chart setups.

Before you invest real money, you should be able to do the following:

- Gain a comfortable feel for the activity and characteristics of underlying stocks or indexes — on which you're looking to trade options and understand their relationship both to the market and to the options related to them, through the eyes of a price chart analyst.
- Be able to mix and match sound option strategies to particular market situations and specific price chart setups.

Is this extra work worth it? Absolutely! Let me put it this way: You wouldn't want to trade a bullish strategy if a stock has a bearish chart. On the other hand, a correctly constructed bearish strategy based on a bearish chart pattern is more likely to deliver that sought-after income.

Relying on paper trading and backtesting

Certainly, trading options isn't all fun and games. For instance, an important aspect involves paying special attention to how passage of time affects the value of options over time. After you get this part of the puzzle locked in, the rest will fall into place more easily, and your paper trading will be more satisfying. Along with paper trading, you can also backtest options trading. *Backtesting* means that you review how a set of strategies has worked in the past. Don't worry about how long this rewiring process may take. Any time you spend on decreasing your risk of big losses in the future is worth your trouble. Chapter 7 is all about paper trading.

TIP

Widely available options trading and technical analysis programs let you backtest your strategies. Some brokerage houses offer sophisticated analytical packages to their active traders for low prices or free of charge.

REMEMBER

Paper trading and backtesting an options-based trading approach may take a little more time than a stock approach. The flip side is that they can save you a lot of money. Even though paper trading may slow down your pace, and possibly delay your getting started in real-time trading, this type of studious approach lets you address different option-trading nuances in advance and gets you in the habit of being a disciplined trader.

Putting options in their place

Take your time when trading options. There is a time and a place for everything, and options are used best when deployed optimally — meaning when the risk-reward ratio offers you the best mix of both profit potential as well as risk reduction. That's why the price chart setup is crucial. When you see a bullish or bearish pattern, that's the time to start looking at your strategy choices.

When you buy an option contract, you have two choices: You can exercise your rights, or you can trade your rights away based on current market conditions and your trading objectives. If you made that car payment before expiration, take the money and run. You can do either one based on what is happening in the markets or to any individual position at the particular time and by executing the best strategy for what the situation calls for. The most important detail is that you know what your choices are before making the trade because you have planned for the trade to deliver a predetermined sum with a purpose.

If your goal is risk management, you can use options by hedging a particular position or by hedging your whole portfolio. The goal of a hedge is to reduce the potential loss when the market turns against you. That's because a properly designed hedge is one in which the value of the option goes in the opposite direction of the underlying, thus keeping the total value of the combined position as high as possible when the underlying falls in value. What that means is that if your analysis of the situation makes you so bearish that you are looking to capitalize from a falling market, options are much less expensive and have lower risk of dollar losses than selling individual stocks short. Chapter 10 is all about portfolio protection.

Options also let you leverage your positions. Because options cost less than stocks, you can participate in a market for less than if you owned the actual shares. For example, a $500 investment in an option strategy may give you as much profit potential as a $5,000 investment in an individual stock. This is an excellent way to reduce risk, because you're spending less capital but potentially getting a similar percentage rate of return to what you might receive if you owned the actual underlying stock, depending on your position size. You can apply this leverage even more astutely if you're speculating and are willing to cap your profits.

TIP

Speculating with options, via strategies such as buying call options based on a bullish-looking price pattern on an underlying stock can make more sense than stocks in small accounts, especially when the stock trades at a lofty price.

Differentiating between Option Styles

This book focuses mostly on options related to individual stocks. Yet, index options are also important and may be of interest and use to you at some point in your trading life, especially when analyzing what the big money traders are doing at any one time.

That's because even if you don't trade index options, by analyzing what those traders are doing, you may be able to have a better idea as to what the stock market is thinking at the moment in terms of safety and expectations. For now, the most important matter is to understand the major differences between options on indexes and individual stocks. Here are some important general facts:

- You can trade stocks but you can't trade indexes.
- The dates for exercise (of your option rights) and the last trading date for the option fall on the same date. These two important dates can be variable for index stocks, meaning that you may be able to trade the option on a different day than the exercise date.

- Two types of options are: American and European style. Each has its own set of characteristics that will affect your ability to make decisions about exercise. Always know which style option you are using and the particular factors associated with it before you trade. Chapter 9 is all about option styles.

TIP

Even if you don't trade index options, big traders do. Therefore, make sure you know how they work so that you can at least keep track of where the big money is moving and consider whether it makes sense to follow them.

Using options to produce income and limit your risk

Getting the details of option risk profiles is important and is useful. But designing and using strategies in trading is even better, and you start by evaluating the many options that are available for income production and asset protection. Sure, you may not think that asset protection is sexy, but if the market turns on you and you're prepared, spending the time upfront to figure out what options work better than others in different situations isn't only a good step in your learning process, it's also practical. When using options to limit your risk:

- You can reduce risk for an existing position partially or fully and adjust the hedging process gradually based on changing market conditions. Check your price chart setup. See Chapter 10.
- You can reduce risk for a new position to a very small amount by using a combination of options or by using single long-term options. Refer to Chapter 12.

You need a margin account for these strategies, and you can get one by filling out and signing the margin account agreement that you obtain from your broker. You can work toward these complex strategies as you gain experience. Some of these more complex strategies include

- Vertical spreads are great for income (refer to Chapter 11).
- Calendar spreads let you fine-tune your time frame (check out Chapter 12).
- Diagonal spreads are useful for hedging (head to Chapter 12).

The most influential factor in determining when to use these spreads are market conditions and price chart setups. And this book helps you make those decisions.

Applying options to sector investing

The creation and proliferation of ETFs offers a new set of opportunities for options traders. Through these vehicles, you can make sector bets without having to drop down to the individual stock level of decision making or research beyond some basic steps. ETFs are great trading vehicles because

- **You can trade them like stocks.** That means you can buy and sell shares and trade options for income production and hedging purposes through them at any time during the trading day instead of waiting until the market closes, as with nonexchange-traded traditional mutual funds.
- **ETFs offer listed options.** You can apply all option strategies to sectors of the stock market by trading and setting up income -producing option trades on the underlying ETF. You can also make index bets without using index options with expiration and last day of trading may cause you some extra steps.
- **You find ETFs based on commodity indexes.** These let you participate in commodity markets without trading futures. When you add the extra dimension of options being available, you have a nice array of different strategies available.

ETFs are an excellent trading vehicle category, for all those reasons and more. You can design entire diversified portfolios with ETFs and then use options to hedge individual positions or the entire portfolio. Chapter 13 gives you all the details. You can trade ETFs via my Sector Selector service (`buymeacoffee.com/wsdetectivx`).

Using Options in Challenging Markets

You can participate in rising or falling markets directly through stocks and ETFs, via owning these securities in up markets, or selling them short in down markets. On the other hand, it's often less expensive to use options for similar purposes depending on the market's direction. But what do you do in a sideways market, except maybe sitting it out or collecting a few dividends?

Guess what? You can craft option strategies such as spreads, condors, and butterflies (but not animal crackers) as I discuss in Chapters 14 and 16 for sideways markets, to produce income, whether you have any underlying positions or not.

Reducing your directional bias and making money in flat markets

Directional bias refers to the connection of profits to the direction of prices. To make money when you're long, you need prices to rise. And to make money when you're short, you need falling prices. When you use option combination strategies, you design trades that let you earn income when the underlying stock moves up or down. Consider this:

- You can set up strategies that let you profit whether the underlying rises or falls, depending on your trade setup. Chapters 14 and 15 tell you all about these trades.
- Options let you set up strategies that earn income in sideways markets.

Controlling your emotions

The most difficult part of trading is the effect of emotional responses triggered by price movements in open positions, or in positions you wish you had pulled the trigger on. Being emotional is part of being human. The problem is that emotional trading is usually the path to big losses. That's why option traders have rules and why you design an anticipatory trading plan, in order to control the emotion that goes along with trading.

A good options trading plan has these key characteristics:

- **A concise definition of purpose whether income production, hedging, or a mix of both.**
- **Access to the proper equipment.** Make sure you have all the technology you need: computers, mobile devices, reliable Internet, and backup systems along with a quiet place to work.
- **Knowledge of time commitment.** Think about how much time you're willing to give to your trading endeavor. Start with your learning phase and transfer the good habits you learned to your trading. If you can't devote or manage the appropriate time to monitor a position, review your plans.
- **Access to good information.** Put together a good list of websites and a reliable real-time quote-charting service.
- **Flawless trade execution.** Pick an online broker that has some scale and can execute your trades in a timely fashion without leaving you in the cold.

- **An excellent educational component.** Work on your analytical skills, technical and fundamental, every day. You need to be a crack chartist and hone your decision-making skills.

Each chapter is this book reveals new information that is intended to make it easier to appreciate and execute the end game, the successful trading of options. Chapter 2 is all about the different types of options.