Volatile Markets Made Easy
This page intentionally left blank
Volatile Markets Made Easy

Trading Stocks and Options for Increased Profits

Guy Cohen
This book is dedicated to those who want to make money from trading.
This page intentionally left blank
chapter 2  Trends and Flags  ........................................... 27
  A Common Mistake ................................................. 28
  Benefits of this Method .......................................... 29
  Trending Stocks .................................................... 29
  What Is a Trend? ..................................................... 30
  The Challenge with Moving Averages .......................... 32
  Trendlines ............................................................... 34

Consolidating Chart Patterns ....................................... 35
  Bull Flag ............................................................... 36
  Bear Flag ............................................................... 36
  Flags Within the Context of a Trend ............................ 38
  Managing Your Profits ............................................. 41

Rounded Tops and Flag Failures ................................... 48

Cup and Handle—Two Patterns in One ............................ 51

Finding Flag Patterns .................................................. 55

Learning Points ........................................................ 55

chapter 3  Options and the Greeks  ................................. 57

Delta ................................................................. 61
  Why Does Speed Matter? ........................................... 63
  Delta Neutral Trading ............................................. 64
  Leverage and Gearing .............................................. 64
  Delta Neutral Trading for Hedging .............................. 65
  Delta with Puts ....................................................... 70

Gamma ................................................................. 71

Theta ................................................................. 75

Vega ................................................................. 82
  Implied Volatility .................................................. 83
  Theoretical Option Pricing ....................................... 84

Rho ................................................................. 91

Learning Points ........................................................ 92
chapter 4 Straddles and Strangles ........................................... 93

Straddles ........................................................................ 94

Strike Price Position and Trade Bias .............................. 94

Strangles .................................................................... 96

Factors Affecting Straddles and Strangles .................... 98

Volatility ........................................................................ 98

Straddles Versus Strangles ........................................... 100

News Events ................................................................. 104

Time Decay ................................................................ 105

Straddle Cost .............................................................. 105

Stock Chart Patterns ..................................................... 105

Breakeven Points ........................................................ 107

Managing the Trade with a Trendline to Maximize Profit 120

Time Stops ................................................................. 122

NICE Strangles .......................................................... 123

October 23, NICE Strangle Risk Profile ....................... 124

October 23, NICE Strangle Delta Profile ..................... 125

October 23, NICE Strangle Gamma Profile .................. 126

October 23, NICE Strangle Theta Profile ..................... 126

October 23, NICE Strangle Vega Profile ..................... 127

Other Factors to Note ..................................................... 129

Adjusting Trades and Gamma Trading ........................ 129

Inside Information ....................................................... 132

Strike Pinning ............................................................. 132

Learning Points .......................................................... 133

chapter 5 Ratio Backspreads ............................................. 135

Call Ratio Backspreads ................................................ 135

Context ..................................................................... 150

Greeks ..................................................................... 150

Put Ratio Backspreads ................................................ 153

Context ..................................................................... 166

Greeks ..................................................................... 166

Learning Points .......................................................... 168
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straddles and Strangles</td>
<td>278</td>
</tr>
<tr>
<td>Straddle</td>
<td>278</td>
</tr>
<tr>
<td>Strangle</td>
<td>281</td>
</tr>
<tr>
<td>Ratio Backspreads</td>
<td>282</td>
</tr>
<tr>
<td>Call Ratio Backspread</td>
<td>282</td>
</tr>
<tr>
<td>Put Ratio Backspread</td>
<td>285</td>
</tr>
<tr>
<td>Diagonals</td>
<td>287</td>
</tr>
<tr>
<td>Diagonal Call</td>
<td>287</td>
</tr>
<tr>
<td>Diagonal Put</td>
<td>290</td>
</tr>
<tr>
<td>Learning Points</td>
<td>296</td>
</tr>
<tr>
<td>Appendix I Strategy Table</td>
<td>297</td>
</tr>
<tr>
<td>Appendix II Glossary</td>
<td>309</td>
</tr>
<tr>
<td>Index</td>
<td>323</td>
</tr>
</tbody>
</table>
This page intentionally left blank
Foreword

All through my career, I have been fascinated with the technical approach to trading. At first, I was convinced that technical patterns predicted the future.

I studied the masters—Gann, Elliott, and techniques like Fibonacci—and began to apply the principles to my trading. When I trade full time, I draw my own charts. What I found was that technical analysis could explain the past but not the future.

However, I found that the technical approach could and did help me find winning trades. And even better, it helped me to exit the trade without giving back my profits. Guy Cohen has articulated in eight chapters what I spent 30 years to learn.

Volatile Markets Made Easy is not just a book; it is a full course of instruction. The student will discover so many gems of knowledge that will help with their trading throughout his or her career that this book will never be far away.

Technicians can make their language confusing and difficult to understand. That is what I call job security. In Volatile Markets Made Easy, Guy Cohen simplifies the terms and gives the reader a road map that is easy to follow and less, well, technical.

Follow the principles clearly expressed in these pages and you will trade with greater confidence and, in my opinion, trade more profitably.

There is only one reason to trade and that is to win, make money, and enjoy a lifestyle like no other. Take command; follow the guide in the chapters before you. It will be a rewarding journey.

—Ned W. Bennett
CEO/Cofounder, optionsXpress, Inc.
March 16, 2009
Acknowledgments

First, I want to say a big thank you to my colleagues at Flag-Trader. Their skill and diligence has been instrumental in improving my trading skills. Also to my business advisor and trusted friend, Howard Weisberg, whose wise counsel has proved priceless over the years. Finally, to my students all over the world, who have taught me far more than I’ve taught them.
Guy Cohen is the author of the best-selling trading books: *Options Made Easy*, *The Bible of Options Strategies*, and now, *Volatile Markets Made Easy*. He has extensive experience of the options and stock markets and his clients include NYSE Euronext, the largest stock exchange in the world.

Guy is also the creator of trading products Flag-Trader, OptionEasy, and Illuminati-Trader.

Specializing in trading applications Guy has developed comprehensive trading and training models, all expressly designed for maximum user-friendliness.

An entertaining speaker, Guy has an MBA (Finance) from City University Cass Business School, London.
This page intentionally left blank
Preface

In June 2008 the S&P 500 fell by 125 points, and the Dow Jones 30 Index fell by 1350 points. Several of my students more than doubled their money during that same time. They did it by using the techniques and strategies contained in this book.

This book is about making money. That’s my job here, to help you make money by trading the financial markets.

This is a down-to-earth book aimed at helping anyone who doesn’t have the advantage of trading within the bid-ask spread, who typically places trades via an online or full-service broker or in some countries via a spread betting firm. This book is for all private investors. There are wonderful texts for mathematicians—I’ve read a good number of them—but this book does not aspire to be one of them. My goal is to provide you with a sense of how to trade profitably from the principles I outline.

There’s a big secret that I’m going to share with you. You can make money trading the markets, and you can do it by using these methods. But until you wholeheartedly embrace the concept of wealth psychology, you won’t have cracked it to your fullest potential. What’s more, until you have adopted the right mindset, not just for trading but for creating wealth as a whole, there exists the potential for a “retracement” for want of a better expression. How many times have you heard of people making fabulous fortunes only to blow it a few months or years later? Lots! And you may personally know a few like that too. I know I do.

As the title suggests, this book focuses on how to make money from strategies that take advantage of volatility in the markets. I should distill this further by saying that we’re talking here about profiting primarily from increasing volatility. The strategies contained here will all put you in a “long” position whereby your risk will always be limited and definable. In other words, the strategies in this book will make you a net buyer of options. As such, your upside will typically be unlimited. I’m not going to be addressing short options strategies here.
There are several worthy short strategies that can work over and over again month after month. However, short strategies can put you in an unlimited loss position and typically have limited upsides. I’m aware of many people who made their living by selling short options during the late 1990’s tech bubble and who indeed made fortunes from doing so. But when the market turned, so did their fortunes and in many cases their livelihoods, their homes, their children’s education…you get the picture.

The point is, there’s plenty of profit to be gleaned with long strategies with unlimited upside and limited downside, so we’ll focus on those and make sure we do them right.

For now, here’s a summary of what you’re about to learn in this book.

**Chapter 1** is an introduction to options. If you’re already familiar with this topic, you should still go through it as a review before reading the other options chapters in the book.

In **Chapter 2** I explain my preferred technical chart patterns and why I like to trade them from a practical viewpoint. This chapter is focused on my favorite patterns and is not intended to be an almanac on all the chart patterns known to man. The aim is to be crystal clear as to what you should be looking for and why that’s such a valuable approach to take.

We return back to options in **Chapter 3** where I summarize the Greeks. The Greeks are sensitivities to various factors affecting the pricing of options. These sensitivities have a direct effect on your trading.

**Chapters 4 through 6** take you through my six favored options strategies. The aim is to trade safely, profitably, and with manageable risk at all times. Only when you witness the pitfalls of a strategy can you decide whether or not it’s right for you. In Chapter 6 I explain how to maximize your income return by trading options—without having to risk too much. The only way to demonstrate this properly is to show you how some traders get it wrong by exposing themselves to inordinate amounts of risk, in many cases without even knowing they’re doing it.

In **Chapter 7** we run through the steps of creating a trading plan. The steps are universal for all strategies.

**Chapter 8** is the most technically challenging part of the book in which I go through some of the mathematical algorithms that define the whole subject of options trading. This chapter is mathematical in nature but has a practical element to it.

Finally, in **Chapter 9** I show you how to implement a trading plan for each of the six favored strategies so you can see how the processes work in practice and what you’ll need to do as you start to implement your new trading program.
What distinguishes this book from others out there is that it is completely practical throughout. This isn’t a book about theory. It’s real world stuff, real trading world stuff, that is. I focus on six strategies that will bear fruit for you if you follow the rules and adhere to the certain principles outlined throughout this book. The most successful traders stick to just a few strategies that they understand intimately. This is what you should aspire to do as well.

I sincerely hope you enjoy reading this book and profit from it. I’m committed to communicating in a practical and down-to-earth way the same qualities I bring to my workshops and software products. Trading is a serious business, but it can be enjoyable too, especially when you’re organized, disciplined, and committed to following sound principles. Those principles are laid out in this book with a sense of enthusiasm, fun, and humor that hopefully you can take with you.

Good luck!
This page intentionally left blank
This book is concerned with making money from the financial markets. If you pick up just one thing from it that you use successfully for the rest of your life, it will be worth it. And I believe you will.

During this chapter I provide a basic overview of options and set the basic foundations that you will need for the chapters ahead.

### Definition of an Option

An option conveys the right, not the obligation, to buy (or sell) an asset at a fixed price before a predetermined date.

Here are the salient components of that definition:

- the right, not the obligation
- to buy or sell an asset
- at a fixed price
- before a predetermined date

These components play important roles in the valuation of an option. Remember that the option itself has a value (known as the premium), which we dissect later after we finish with the definitions.
Calls and Puts

The two types of options are calls and puts.

- A call is an option to BUY.
- A put is an option to SELL.

Therefore:

- A call option is the right, not the obligation, to buy an asset at a fixed price before a predetermined date.
- A put option is the right, not the obligation, to sell an asset at a fixed price before a predetermined date.

Right Versus Obligation

Let’s now look at that definition and consider each part, starting with the “right, not the obligation to buy or sell an asset.”

Buying Gives You the Right; Selling Imposes a Potential Obligation

- Buying a call conveys the right, not the obligation, to buy an underlying security (such as 100 shares of stock).
- Buying a put conveys the right, not the obligation, to sell an underlying security.
- Remember, when you buy an option you are not obligated to buy or sell the underlying instrument—you simply have the right to do so at the fixed (exercise or strike) price.
- Your maximum risk, when you buy an option, is simply the price you paid for it. In other words, your risk is limited.

Remember, when you buy something, you can only lose what you paid for it. Your upside potential is unlimited as there is theoretically no limit to what something could be valued at later. In this way, when you buy something, you want the price to rise so you can make a profit.

Similarly, when you sell something, your upside is capped to what you receive for it. However, if you sell stock you don’t yet own (that is, you short stock), you must eventually buy it back in order to close your position. In this
way, when we short stock, we want the price to fall so we can buy it back at a lower price and make a profit.

Selling (Naked) Imposes the Obligation

Now here’s where things can get a little upside-down, so if you’re new to this, take it slowly! This is also where my “Rule of the Opposites” comes into play.

- Selling a call obliges you to deliver (or sell) the underlying asset to the call buyer if he exercises his right to buy from you.
- Selling a put obliges you to buy the underlying asset from the put buyer if he exercises his right to sell to you.
- Selling options naked means you haven’t bought a position in the underlying stock or hedged your position with an option to protect yourself. Selling naked therefore gives you an unlimited risk profile, as the term naked infers.

Combined with the fact that you are obliged to do something, this is not a recommended strategy. There’s a time and a place for strategies like this, but only advanced traders should contemplate selling naked options, and even they will typically have a protective strategy in mind in order to cover their exposure.

**Rule of the Opposites**

Buying a call = right to buy the stock
Selling a call = obligation to sell the stock
Buying a put = right to sell the stock

**Fixed Price**

Now let’s look at the words “at a fixed price” from the option definition.

Exercise (or Strike) Price

The exercise or strike price is the fixed price at which the option can be exercised.

So if you buy a call option that has a strike price of $30, then you have bought yourself the option to buy the underlying stock at a price of $30 per share.
However, in the real world you will only want to exercise your right to buy that asset at $30 if the underlying asset is actually worth more than $30 in the market. Otherwise there would be no point. It would mean buying the asset for $30, when it’s only actually worth, say, $25 in the marketplace. No one would do that because they could buy it for $25 in the market, which is clearly better value.

Expiration Date

The definition of an option finishes with the words, “before a predetermined date” or its expiration date—the date before which the option can be exercised.

- At expiration, the call option’s own value is only worth the price of the asset less the strike price.
- At expiration, the put option’s own value is only worth the strike price less the price of the asset.

(For U.S. equity options, the expiration dates fall on the Saturday after the third Friday of every month.)

Types of Calls and Puts

Options can be either American-style or European-style.

- American-style options allow the option buyer to exercise the option (that is, buy or sell the underlying asset) at any time before the expiration date.
- European-style options do not allow the option buyer to exercise the option before the expiration date.

All U.S. equity options are American-style, which are technically more valuable than European-style options because of their greater flexibility. Being able to exercise before expiration is more valuable than not being able to. However, this is rarely advisable for reasons that I explain later on.

As a rule, stock options are usually American-style.

The Valuation of Options

Options have a value, known as the premium, and are totally separate entities to the underlying assets from which they are derived (hence the term derivative).

So for example, a stock is not an option, but you can have options to buy or sell stocks. The option premium can be split into two parts:
Intrinsic value

Time value

Generally speaking:

- Intrinsic value is that part of the option’s value that is In the Money (ITM).
- Time value is the remainder of the option’s value. Out of the Money (OTM) options will have no Intrinsic Value, and their price will solely be based on Time Value. Time Value is another way to express hope value. This hope is based on the amount of time left to expiration and the price of the underlying asset.
  - A call is In the Money when the underlying asset price is greater than the strike price.
  - A call is Out of the Money when the underlying asset price is less than the strike price.
  - A call is At the Money when the underlying asset price is the same as the strike price.

With puts, it works the opposite way:

- A put is In the Money when the underlying asset price is less than the strike price.
- A put is Out of the Money when the underlying asset price is greater than the strike price.
- A put is At the Money when the underlying asset price is the same as the strike price.

Rule of the Opposites

<table>
<thead>
<tr>
<th>In the Money</th>
<th>Out of the Money</th>
<th>At the Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calls: stock &gt; strike</td>
<td>Puts: stock &lt; strike</td>
<td>Calls: stock &lt; strike</td>
</tr>
<tr>
<td></td>
<td>Out of the Money</td>
<td>Puts: stock &gt; strike</td>
</tr>
</tbody>
</table>

Figure 1.2 Option premium components

Now that we know the basic components of an option’s premium, let’s look at some simple calculations for intrinsic and time value for both calls and puts.
Intrinsic and Time Value for Calls

Here’s what you need to remember in order to calculate intrinsic and time value for calls.

- call intrinsic value = stock price – strike price
- call time value = premium – intrinsic value
- the minimum intrinsic value is zero; it cannot be negative
- call premium = intrinsic value + time value

Table 1.1

<table>
<thead>
<tr>
<th>Stock price</th>
<th>34.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>5.70</td>
</tr>
<tr>
<td>Strike price</td>
<td>30.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>3 months</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Intrinsic Value</th>
<th>Stock–strike 4.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>34.00-30.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Value</th>
<th>Premium-intrinsic 1.70</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5.70-4.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock price</th>
<th>34.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>1.40</td>
</tr>
<tr>
<td>Strike price</td>
<td>35.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>20 days</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Intrinsic Value</th>
<th>Stock-strike 0.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>34.00-35.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Value</th>
<th>Premium-intrinsic 1.40</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.40-0.00</td>
</tr>
</tbody>
</table>

Intrinsic and Time Value for Puts

Now here are the calculations for puts:

- put intrinsic value = strike price – stock price
- put time value = premium – intrinsic value
- the minimum intrinsic value is zero; it cannot be negative
- put premium = intrinsic value + time value

Table 1.2

<table>
<thead>
<tr>
<th>Stock price</th>
<th>37.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put premium</td>
<td>4.80</td>
</tr>
<tr>
<td>Strike price</td>
<td>40.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>1 month</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Intrinsic Value</th>
<th>Strike-stock</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>40.00-37.00</td>
</tr>
<tr>
<td></td>
<td>3.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Value</th>
<th>Premium-intrinsic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4.80-3.00</td>
</tr>
<tr>
<td></td>
<td>1.80</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock price</th>
<th>55.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put premium</td>
<td>1.90</td>
</tr>
<tr>
<td>Strike price</td>
<td>50.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>1 month</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Intrinsic Value</th>
<th>Strike-stock</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>50.00-55.00</td>
</tr>
<tr>
<td></td>
<td>0.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Value</th>
<th>Premium-intrinsic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.90-0.00</td>
</tr>
<tr>
<td></td>
<td>1.90</td>
</tr>
</tbody>
</table>

We can see that intrinsic value is easy to calculate, and from there we can easily determine the time value portion of the total premium. However, there are many elements that make up the composition of time value.

In total, there are seven factors that converge together to make up the value of an option premium.

Remember, an option is defined as the right, not the obligation, to buy or sell an asset at a fixed price before a predetermined date.

Let’s take the seven factors one at a time:

Table 1.3  Seven Factors that Affect Option Premiums

<table>
<thead>
<tr>
<th>From Definition</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Buy or sell”</td>
<td>The type of option (call or put) will affect the option premium.</td>
</tr>
</tbody>
</table>
Table 1.3  continued

<table>
<thead>
<tr>
<th>From Definition</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Underlying asset”</td>
<td>The underlying asset price will affect the option premium.</td>
</tr>
<tr>
<td>“At a fixed price”</td>
<td>The strike price will affect the option premium.</td>
</tr>
<tr>
<td>“Before a predetermined date”</td>
<td>The expiration date will affect the option premium.</td>
</tr>
</tbody>
</table>

There are three other major influences on option pricing:

- **Volatility**: Volatility is a crucial and major influence in the pricing of options. Understanding volatility gives the options trader the ability to select specific trades most profitably. The most advanced traders always use volatility to their advantage.

- **Risk-free interest rate**: This is the short-term rate of government money. It is known as “risk free,” owing to the perceived covenant strength of (developed world economy) governments.

- **Dividends**: This applies to any asset that offers an income “reward” for owners of the underlying asset. For stock options this will be the dividend payable.

So in summary, option premiums are affected by:

1. the type of option (call or put)
2. the price of the underlying asset
3. the strike price
4. the expiration date
5. volatility – implied and historical
6. risk-free interest rate
7. dividends

**Why Trade Options?**

With the flexibility afforded to a trader by these remarkable financial instruments, there are myriad reasons to include options as part of your trading arsenal. The effort involved in your own due diligence is well worth it, but it will take some time and dedication. There are many so-called gurus out there, and yet I’m often horrified by what my students tell me they’ve learned from
instructors whose knowledge appears to be wafer thin and whose own qualifications appear to be founded merely from attending someone else’s seminar.

In this book, on the way to illustrating what you should be doing and how to achieve certain trading goals with specific options strategies, I also highlight what you shouldn’t be doing. Don’t worry; I’ll make it crystal clear so you’ll know which is which!

My own credentials come from three main sources:

- An initial academic background with options through my Finance MBA
- Trading in the field what must now be thousands of trades
- Developing my own software suite and building the engine several hundred times, covering over 60 different options strategies

During my journey in this field, I’ve discovered that the best options masters out there were either highly respected floor traders or those with a part-academic/part-software development aspect to their curriculum vitae. Engineers often make great options traders provided they can resist the temptation to over-analyze!

**Advantages of Trading Options**

So why are options so appealing, and why should you invest your time learning about them? In a world of many alternatives, what makes options so special that they’re becoming more and more popular as a trading vehicle, particularly in the U.S., the world’s largest financial market place?

Well, there is no nutshell answer other than “flexibility,” but what do we really mean by flexibility in the context of options? The answer comes in multiple forms. Following are the main advantages of trading options. Options enable us to

- **Control more assets for less money.**

  Consider the implications of this, and it becomes obvious how phenomenal this single characteristic of traded options is. Here’s the way it works for equity (share) options: One option contract represents 100 shares of stock and is only a fraction of the cost of what you’d pay for the equivalent number of shares.

  For example, ACME stock is priced at $38.40 on 25 May 2005.

  A call option to buy ACME shares might be priced at 3.80. Because one contract represents 100 shares, you can buy one ACME call contract for
$380.00 \times 3.80$. The alternative would be to buy 100 shares of the stock for a total sum of $3,840. So in this example you can buy ACME call options for around 10% of the stock price in order to control $3,840 of ACME stock until the appropriate expiration date of the option.

Call options are always cheaper than the underlying asset and put options usually are. Options are often more volatile than their underlying instruments, therefore traders get “more bang for their buck” or more action. Clearly this can also be perceived as being riskier, but in the right hands, it can also be safer and more conservative. Options will give you far greater flexibility in your trading and even give you the ability to make profit when you don’t know the direction in which the stock will move. I cover this in detail during the course of this book.

- **Trade with “leverage.”**

  This is a variation of the same theme in the first point. When we calculate a return on an investment, the numerator is the numerical return, and the denominator is the amount invested. If the amount invested is lower, then our percentage return will rise. Because our cost basis is proportionately lower with options (as witnessed here), the position becomes much more sensitive to the underlying stock’s price movements, so our percentage returns can be so much greater.

  Here’s an example: ACME stock rises from $38.40 to $42.40. This is a rise of $4 or just over 10%. The corresponding call option premium rises from 3.80 to 7.60. Do you see how a mere 10% move in the stock has helped to cause a 100% rise in the option premium? That’s leverage! Now of course, leverage can affect us both ways, either in our favor or against us. It’s our job to make the right decisions so that leverage works for us.

- **Trade for income.**

  We can structure options strategies specifically for the purpose of generating income on a regular basis. As far as I’m aware, options are the only financial instrument we can use for this. I cover income strategies in Chapter 7, “The Practical Way to Trade Volatility.”

---

1. An exception would be when a stock price has made a massive fall. The higher strike puts will have a high intrinsic value. For example, consider a stock that falls from $20.00 to $5.00 on a bad earnings report. The $20 strike puts will have an intrinsic value of $15.00.
• **Profit from declining stocks.**

One of the most important trades you’ll ever make is when you profit from a stock that has fallen in price. If you only ever consider buying stocks, then you’re bound to be looking at the stock market with an upward bias. Your analysis is therefore compromised by your desire to only see reasons for a stock to rise. Once you start making money from declining stocks as well, then you can simply look at the markets as a mechanism for making money, without a predetermined bias.

With options, we can trade puts and calls to ensure we can make money if the stock goes up, down, or sideways, giving us ultimate flexibility. Even investors with wide-ranging equity portfolios can efficiently implement protective measures in the event of a severe market downturn.

• **Profit from volatility and protect against other factors.**

Different options strategies protect us or enable us to benefit from factors such as time decay, volatility, lack of volatility, and so on.

• **Reduce or eliminate risk.**

Options allow you to substantially reduce your risk of trading, and in certain rare cases, you can even eliminate risk altogether, albeit with the trade-off of very limited profit potential.

So with all the different benefits of options, why would traders not be curious to learn more about them? Well, for a start, options are reasonably complex instruments. Once you’re over that hurdle, however, they become more and more fascinating.

Given that options can be a challenge, I’ve found it highly effective to convert the subject material into pictures so we can see what a strategy looks like. My style is designed to be user-friendly, particularly in a visual sense. I have discovered that this approach makes everything fit into place, and my students have found it the fastest way to learn. For more education visit www.optioneasy.com where there is free dynamic content where I extend logic even faster and further than in a book format.

Options give traders added flexibility, potentially much greater gains for a given movement in the stock price, and protection against risk. On the flip side, used in the wrong way, options can lead traders to serious losses. In this book you learn how to trade strategies safely and how to adhere to the simple rules governing those strategies.
Pictures are used to explain virtually every concept in this book. By using visual tools, your learning experience will be accelerated in two ways. First, you won’t have to stare at continuous lines of text throughout the book. I love books with pictures and tables because they break up the monotony of straight reading. Second, you’ll find with a bit of time that the pictures are incredibly intuitive and that you can learn at a pace that you would never have imagined possible.

Let’s now look at a risk profile chart and why I use them.

A risk profile chart shows your profit/loss position for each trade. It differs from a standard price/time chart that you’ll view to monitor stock prices. Typically we’re used to seeing time along the x-axis and price up and down the y-axis. With risk profiles we move the price to the x-axis, and we have our profit/loss on the y-axis.

There are four steps to creating a risk profile chart:

**Step 1: Y-axis for profit/loss position**

![Diagram of Y-axis for profit/loss position]

**Step 2: X-axis for stock price range**

![Diagram of X-axis for stock price range]
Step 3: Breakeven line

The previous chart shows your risk profile for buying a stock. As the stock price rises above your purchase price (along the x-axis), you move into profit. Your risk is limited to the amount you paid, as is your breakeven point, and your potential reward is uncapped as the stock rises.

Step 4: Risk profile line

What about if you short a stock? Well, in this case the opposite occurs. Here as the stock price rises above the price you shorted at, your short position shows a loss, which can be unlimited as the stock continues to rise. Your risk is therefore uncapped as the stock rises, and your potential reward is limited to the price you shorted at, as is your breakeven point.
Now we know what buying and shorting a stock looks like, let’s see what option risk profiles look like.

The four basic strategies are:

- Long call
- Short call
- Long put
- Short put

A few points before we construct the drawings. From the definition of an option, we already know that options expire and that the time value portion of the premium decays as the expiration date nears. What this means is that we’d like to own options that aren’t about to expire in order to give ourselves a chance of making money without being hammered by time decay.

The Rule of the Opposites tells us, however, that if time decay hurts option buyers, then it must help option sellers. We’ll see later that time decay increases exponentially during the last month to expiration. Therefore we typically don’t want to buy those short-dated (front month) options. Instead, we’d rather short them.

With reference to these four strategies, we would buy calls and puts with at least three months (or more) left to expiration, looking for the options to increase in value during that time without the ravages of time decay. By contrast, we would short calls and puts with a month or less to expiration, thereby gaining short-term income as the option (hopefully) declines in value or expires worthless.
Long Call Risk Profile

Let’s say we buy a call for a premium of $7.50.

<table>
<thead>
<tr>
<th>Stock price</th>
<th>$56.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>7.50</td>
</tr>
<tr>
<td>Strike price</td>
<td>50.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>2 months</td>
</tr>
</tbody>
</table>

Figure 1.4  Long call risk profile

As the stock price rises above the strike price, the option position starts to move positively.

The breakeven for the long call is the strike price plus the premium = 57.50.

While the stock remains lower than the strike, the maximum loss is capped to the premium paid.

Remember that buying a call gives you the right, not the obligation to buy the stock. You would exercise that right if the stock price exceeds the strike price at expiration.

Your risk when you buy an option is capped to what you paid (hence the horizontal line in the loss zone), and your reward is potentially unlimited (hence the upward sloping diagonal line).

Short Call Risk Profile

The Rule of the Opposites tells us that the opposite of buying a call must be shorting a call.

This is reflected in the risk profile. The call writer is therefore taking the opposite position to the call buyer.
This time we’re going to short a call for a premium of $7.50.

<table>
<thead>
<tr>
<th>Stock price</th>
<th>$56.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>7.50</td>
</tr>
<tr>
<td>Strike price</td>
<td>50.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>2 months</td>
</tr>
</tbody>
</table>

**Figure 1.5  Short call risk profile**

As the stock price falls below the strike price, the option position remains at maximum profit for the call writer. The call writer’s breakeven is the strike price plus the premium = 57.50. If the stock rises above the strike, and then beyond the breakeven, the maximum loss is potentially unlimited.

Remember that shorting a call gives you the potential obligation to sell the stock if you’re exercised. With a short call you would only be exercised if the stock price exceeds the strike price.

Your reward when you sell an option is capped to what you received (hence the horizontal line in the profit zone), and your risk is potentially unlimited (hence the downward sloping diagonal line). So here you have a position where you are potentially obligated to do something and you have uncapped risk potential. Your obligation would be to sell the stock at the strike price. But in order to sell it at that price, you’d also have to buy it at the market price, which may now be substantially higher than the strike price. Not an ideal scenario.
Long Put Risk Profile

The Rule of the Opposites also tells us that the opposite of buying a call must be buying a put.

This is reflected in the risk profile, but it’s different from shorting a call. The put buyer is taking the opposite position of the call buyer. So here we’ll buy a put option for a premium of $7.50.

<table>
<thead>
<tr>
<th>Stock price</th>
<th>$46.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>7.50</td>
</tr>
<tr>
<td>Strike price</td>
<td>50.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>2 months</td>
</tr>
</tbody>
</table>

As the stock price falls below the strike price, the long put position moves into profit. Maximum profit here is 42.50 (strike — put premium).

At expiration the breakeven is the strike price less the premium = 42.50.

While the stock remains greater than the strike, the maximum loss is capped to the premium paid of 7.50.

Remember that buying the put gives you the right, not the obligation, to sell the stock. With puts you would exercise that right if the stock price is below the strike price at expiration.

Your risk when you buy an option is capped to what you paid (hence the horizontal line in the loss zone), and your reward is potentially unlimited until the stock reaches zero, at which point your profit is capped at the strike price less the premium you paid, that is 50.00 – 7.50 = 42.50.
Short Put Risk Profile

So the other opposite of buying a put must be *selling* a put. Here, we’ll short a put option to receive a premium of $7.50.

<table>
<thead>
<tr>
<th>Stock price</th>
<th>$46.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call premium</td>
<td>7.50</td>
</tr>
<tr>
<td>Strike price</td>
<td>50.00</td>
</tr>
<tr>
<td>Time to expiration</td>
<td>2 months</td>
</tr>
</tbody>
</table>

**Figure 1.7** Short put risk profile

As the stock price remains above the strike price, the short put stays at maximum profit of the premium received.

At expiration the breakeven is the strike price less the premium = 42.50.

While the stock falls below the breakeven the loss is potentially unlimited until the stock price reaches zero, at which point the maximum loss is the strike price less the premium we received, which would be $50.00 – $7.50 = 42.50.

Remember that shorting a put gives you the potential *obligation to buy* the stock if you’re exercised. With a short put you would only be exercised if the stock price is less than the strike price. If you were exercised you would have to buy the stock at the strike price.

Your reward when you sell an option is capped to what you received (hence the horizontal line in the profit zone), and your risk is potentially unlimited until the stock reaches zero, at which point your loss is capped at the strike price less the premium we received, which would be $50.00 – $7.50 = 42.50.
The Four Basic Risk Profiles Summarized

These are the four charts you need to remember. Even if you just remember the long call option risk profile, you should now be able to construct the other three basic option positions. Once you’re comfortable with these and the logic behind them, you’ll be ready to look at multi-leg strategies with ease.

Imagine there is a horizontal or vertical mirror separating each of the risk profiles and see how each strategy is the opposite of the one on the other side of the mirror.

**Figure 1.8  The four basic option risk profiles**

*The four basic options risk profiles*

Imagine the dotted lines are mirrors and see how each strategy is the opposite of the one on the other side of the mirror.

**Buying a call**
- belief that stock will rise (bullish outlook)
- risk limited to premium paid
- unlimited maximum reward

**Buying a put**
- belief that stock will fall (bearish outlook)
- risk limited to premium paid
- unlimited maximum reward up to the strike price
- less the premium paid

**Writing a call**
- belief that stock will fall (bearish outlook)
- maximum reward limited to premium received
- risk potentially unlimited (as stock price rises)
- can be combined with another position to limit the risk

**Writing a put**
- belief that stock will rise (bullish outlook)
- maximum risk is the strike price less the premium received. We can think of this as either being “unlimited” until the stock reaches zero, or “limited” to the [strike price – premium] formula.
- maximum reward limited to the premium received
- can be combined with another position to limit the risk
Let’s now look at options in the context of the marketplace and real numbers.

Option Contracts

Stock options are traded in contracts (or lots), not as individual derivative units. Each contract represents 100 shares of the underlying stock.²

When you see a U.S. equity call option price of, say, $2.45, you will have to pay $2.45 \times 100$ for just one contract. A single contract is the minimum amount you can trade, and for U.S. equity options, one contract represents 100 individual shares. In other words, by paying $245.00 you now have the right to buy 100 shares of the stock at whatever strike price you were trading. This is important when considering multi-leg orders, which combine the trading of shares together with options in order to create a new risk profile.

Expiration Dates

Every option has an expiration date, which is usually specified as a month. U.S. equity, index, and Treasury/interest-rate options expire on the Saturday following the third Friday in the expiration month. Trading in the options ceases on that Friday, but the owner can actually exercise the options on the final Saturday.

Strike Prices

Generally, U.S. equity option strike prices start at $5 and then go in $2.50 increments; once they hit $25, they go in $5 increments; at $200 they convert to $10 increments. Anomalies can occur, however, due to stock splits and mergers.

Option Ticker Symbols

Individual options have ticker symbols just like individual stocks do. The symbol identifies the underlying stock, the expiration month, the strike price, and the type of option. It’s unlikely you’ll ever construct these for yourself, but it’s useful to understand the composition of an option ticker nevertheless.

² For the purpose of this book, I focus on U.S. stock options.
The option ticker is identified by a series of letters. They appear in the order of “root,” the expiration month, and strike price. The expiration month letter also identifies whether the option is a call or a put.

The first letter or group of letters (up to three) identifies the underlying stock and is called the root. It doesn’t have to be the same as the stock symbol. Microsoft has the stock symbol of MSFT. But because that’s more than three letters, a root symbol is devised by the standardizing authority, and a group of three letters is used. MSQ is the primary root for Microsoft options. There can be others under certain conditions, but for now let’s keep it simple. The root for Microsoft is MSQ.

The next-to-last letter in an option symbol indicates the expiration month. If the option is a call, then the first half of the alphabet is used. If the option is a put, then the second half of the alphabet is used. Table 1.4 illustrates these codes.

### Table 1.4 Expiration Month Codes

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Calls</strong></td>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td>E</td>
<td>F</td>
<td>G</td>
<td>H</td>
<td>I</td>
<td>J</td>
<td>K</td>
<td>L</td>
</tr>
<tr>
<td><strong>Puts</strong></td>
<td>M</td>
<td>N</td>
<td>O</td>
<td>P</td>
<td>Q</td>
<td>R</td>
<td>S</td>
<td>T</td>
<td>U</td>
<td>V</td>
<td>W</td>
<td>X</td>
</tr>
</tbody>
</table>

The last letter of the option symbol indicates the strike price. Again there are codes to decipher the strike price, as shown in Table 1.5.

### Table 1.5 Strike Price Codes

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
<th>K</th>
<th>L</th>
<th>M</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
<td>30</td>
<td>35</td>
<td>40</td>
<td>45</td>
<td>50</td>
<td>55</td>
<td>60</td>
<td>65</td>
</tr>
<tr>
<td>105</td>
<td>110</td>
<td>115</td>
<td>120</td>
<td>125</td>
<td>130</td>
<td>135</td>
<td>140</td>
<td>145</td>
<td>150</td>
<td>155</td>
<td>160</td>
<td>165</td>
</tr>
<tr>
<td>205</td>
<td>210</td>
<td>215</td>
<td>220</td>
<td>225</td>
<td>230</td>
<td>235</td>
<td>240</td>
<td>245</td>
<td>250</td>
<td>255</td>
<td>260</td>
<td>265</td>
</tr>
<tr>
<td>305</td>
<td>310</td>
<td>315</td>
<td>320</td>
<td>325</td>
<td>330</td>
<td>335</td>
<td>340</td>
<td>345</td>
<td>350</td>
<td>355</td>
<td>360</td>
<td>365</td>
</tr>
</tbody>
</table>
By using this information, we can decipher the option symbol MSQAF:

- The MSQ is the root identifying Microsoft, the “A” is for the month of January, and it is a call option.
- The last letter “F” tells us the option is for the $30.00 strike price.

The designation of letters is more complex for long-term options, known as LEAPS (Long-Term Equity Anticipation Securities). Because expiration months may extend out two years or more, alternative symbols are used in the root to distinguish one expiration month from another. Don’t worry about remembering or memorizing all the codes. They are readily available and easily obtained when you need them, and most traders working online simply click the applicable option rather than try to figure out the configuration of letters.

### Open Interest

Open interest represents the total number of option contracts currently open and is a measure of liquidity in a particular options class. In other words, open interest is a figure that reflects the number of contracts that have been traded but that have not yet been exercised or liquidated by an offsetting trade.

When you trade an option, you may in fact be creating a new option contract. Both buying and selling options will increase the open interest figure, providing the action opens a position. Conversely, buying or selling to close a position will cause open interest to fall. If one side is opening a buy position and the counterparty to the trade is selling his existing bought position, then the open interest will not change.

Looking at the open interest, there is no way of knowing whether the options were bought or sold. However, the figure can be compared with the volume of contracts traded on a given day. When the daily volume exceeds the existing open interest, it suggests that trading in that option was unusually high.
Open interest also indicates the liquidity of an option. When options have high open interest, it means they have a large number of buyers and sellers, and an active secondary market will increase the odds of getting an order filled at a decent price. Generally speaking, the larger the open interest, the easier it will be to trade that option at a reasonable bid-ask spread. But even when disparity exists between the number of buyers and sellers, every option trade entered as a market order will be executed. The Options Clearing Corporation (OCC) ensures an orderly market by acting as seller to each buyer and as buyer to each seller.

**Placing Your Trade**

The detailed process of placing your trades will depend on your brokerage’s practices, but the majority of firms have similar basic components. Here are a few of the major types of orders you’ll be making with your online broker.

**Market Order**

This type of order authorizes your broker to buy or sell stock or options at the best price in the market. Some brokers will be better at doing this than others according to how they route your orders.

**Limit Order**

This is where you try to get the best value for your order by specifying the price at which you’re prepared to buy at some predetermined lower price and sell at some predetermined higher price. With stocks or futures this can be relevant to support or resistance levels. So with limit orders on a stock it could mean

- only buy if share falls to a certain target price or lower or
- only sell if share rises to a certain price or higher.

Limits are recommended with options, particularly for spreads and combination trades. The reason for this is that the bid-ask spread prices can fluctuate dramatically, and more often not in your favor, so it’s better to specify the price at which you’d like to have your order filled.

**Contingent Orders**

Typically I enter contingent orders. This is where the order specifies the precise trigger requirements in order for my trade to be executed. You can combine the contingent order with a limit order. So for example, your order might be like this: *Buy 10 contracts of ACME January 2009 55 strike calls @ 7.30 limit if AMCE last price hits $55.35 or higher.*
So you would only buy the ten contracts at a limit price of 7.30 if the stock trades to $55.35 or higher. In this case the trade is triggered by two separate events. First the stock has to trade to $55.35 or higher, and second, the ACME calls must be at 7.30 or lower. Only then are the criteria met for the trade to be executed. Assuming the trade is filled at 7.30, your trade will actually cost 7.30 x 10 contracts x 100 shares = $7,300. The equivalent share trade would be buying 1,000 shares of ACME at around $55.35 making a total price tag of $55,350. We can agree that $7,300 is much friendlier.

With the limit order in place, if ACME calls are trading above 7.30, you won’t get a fill even if the ACME stock has touched or gone through $55.35.

We can also apply contingent orders to stop and limit orders. We can even enter “one cancels other” or OCO orders, which I address later.

Sell Stop Loss
This is where you sell your existing position if the price falls below a specified price. The sell stop is placed below the current price, preferably just below a support area of the underlying asset price. If the stock price rises, you can adjust your stop upwards at any time. You can also place a stop loss when trading options. The stop loss can be contingent on the underlying stock price, the actual option premium, or both.

Sell Stop to Open
This is an order creating a short position. You would do this where you want to take advantage of a falling stock, shorting it as it falls through support.

Buy Stop to Open
This order generates a buy once the stock has reached or exceeded a certain level on its way upwards. This is the opposite of a limit order where you buy below a specified price. A buy stop is appropriate where you expect the price to rise up beyond a resistance level.

Buy Stop Loss
This is an order to buy-to-close your open short position if the stock rises above a specified level. The buy stop is placed above the current price, preferably just above a resistance area if we’re talking about stocks. If the stock price falls, you can adjust your stop downwards at any time. You can also place a buy stop loss when trading options. The stop loss can be contingent on the underlying stock price, the actual option premium, or both.
Buy Stop Limit to Open
This order is triggered as the price rises through resistance but you only want to enter your order at a specified price. The buy stop limit will protect you against trading an upward gap or spike that is now trading above the breakout point.

Buy Stop Limit and Stop Loss
This is an extension of the buy stop limit order but includes an “if done” provision specifying that if the buy stop is executed, it triggers a stop loss order at the level you set.

Good till Cancelled (GTC)
This order is valid until you cancel it or until it is filled. For example, a limit order GTC means you authorize your broker to buy at a particular price or lower, today or any time in the future where the price is at that particular level, until you have bought the requisite number of shares or contracts.

Day Only
The order will be cancelled if it is not filled by the end of the trading day on which the order is placed. This is a good ploy because it encourages the floor traders to deal. If they don’t fill the order by the end of the day, they won’t get their commission, so there is an incentive for floor traders to put this type of trade nearer to the top of their list.

Week Only
The order will be cancelled if it is not filled by the end of the week.

Fill or Kill
The fill or kill order has maximum priority. If it isn’t filled immediately, the order is cancelled. This order is bound to capture the attention of the floor trader, but if it’s a limit order, then you need to make it realistic.

All or None
Either the entire order is filled or none of it. This is not generally a good idea given that many trades aren’t filled all at once anyway because there has to be a buyer or seller on the other side, and most of the time they won’t be specifically dealing in the same lot sizes as your order.
Other Market Considerations

Always have a stop in mind when you make a trade

This point is discussed in more detail in Chapters 10 and 11. It is vital to know where you will exit a position, whether it is a profitable situation or otherwise. Some people don’t like to actually place stops with their brokers. This can be risky, so at the very least you must have one firmly in your mind, and you must act on it if the stop level has been breached. Also you must always have in your mind when you are likely to want to take profits, and you must act on that too if and when the situation occurs.

I talk about where to place your stops later in the book, but I recommend that when trading options, you base your stops on the stock price, not the option prices unless you are creating combination spreads or day-trading options.

Whipsaws

A whipsaw occurs when a price changes direction rapidly and violently twice or more in quick succession; in intra-day trading terms, this can happen in just a few ticks. The danger is that the whipsaw may trigger your stop loss by a few ticks before the stock continues in the direction you envisaged—but without you on the profit-ride! Whipsaws happen and are part of the trading game. What do you do about them? Well, if you get caught by one, just accept it as part of your trading costs. If you’re getting whipsawed over and over again, you’ll need to examine why. Could it be because your stops are too tight? Or could it be because of the types of stocks you’re trading?

Learning Points

In this chapter you’ve learned what options are, how they’re valued, and how they’re traded in the markets. You’ve learned about risk profiles and how they relate to the position you’re trading through the use of options. You’ve also learned about the main advantages of trading options, the components that make up an options premium, and the main types of orders you can place in the markets.

In the next chapter I show you how you can use certain chart patterns (trends and flags) to help you improve the timing of your trades.
Index

Symbols
100-110 call back ratio
backspread, 146
1:1 theory, 41-48
2:1 call ratio backspread, 169
2:1 put ratio backspread, 171
3:1 call ratio backspread, 169
3:1 put ratio backspread, 172

A
acceleration, 71
adjusting trades, 129-132
all or none, 25
American style, Black-Scholes
model, 260
American-style options, 4
analyzing options prices, 237-239
At the Money, 5
Augen, Jeff, 132

B
bear flags, 36-38, 233
trading plans for, 275-278
bid-ask spreads, straddles
(breakeven points), 117-120
Binomial model, 256, 262-265
Black, Fischer, 256
Black-Scholes model, 256-261
Greeks formulae
components, 258
breakeven points
straddles, 107-120
risk profiles, 111
strangles, 107-110
breakevens
straddles, 101-102
strangles, 101-102
Buffett, Warren, 250
bull flags, 36-37, 231
  trading plans for, 268-275
buy stop limit, 25
buy stop limit to open, 25
buy stop loss, 24
buy stop to open, 24

calculating historical volatility in Excel, 246-249
calendar call scenarios, 194-198
calendar call spreads, 190-194
  risk profile, 190
calendar calls, diagonal calls versus, 210
call options, 2
call ratio backspreads, 135-136
  context, 150
  Greeks, 150-152
  risk profiles, 136-143
  strike price impact, 144-150
  trading plans for, 282-285
calls, 2
  covered calls. See covered calls
  intrinsic values, 6
  time value, 6
CBOE (Chicago Board Options Exchange), 256
chart patterns
  flags, 35
  strategies, 240
Chicago Board Options Exchange (CBOE), 256
 choosing strategies, 240
  context
    call ratio backspreads, 150
    put ratio backspreads, 166
contingent orders, 23
continuous compounding, 252
contracts, option contracts, 20
cost, straddles, 105
covered calls, 175-177
  calendar call scenarios, 194-198
  calendar call spreads, 190-194
    risk profiles, 190
  covered short straddles, 184
    risk profiles, 184-186
  covered short strangles, 186-189
    risk profiles, 188
diagonal calls, 175-177
  risk profiles, 177-182
spending less to increase yield, 190
  synthetic short straddles, 182-184
covered short straddles, 184
  risk profiles, 184-186
covered short strangles, 186-189
  risk profiles, 188
Cox Ross Rubinstein model, 256, 262-265
  Greeks, 265
Cox, John, 256
cup and handle pattern, 38, 51-54
D

day only, 25
delta, 59-63
   call ratio backsplits, 150
diagonal call spreads, 70
leverage and gearing, 64
neutral trading for hedging,
   65-67
position summary, 68
puts, 70-71
delta neutral trading, 64
derivatives markets, 132
diagonal call spreads, delta, 70
diagonal calls, 198-211
   Greeks, 214-216
risk profiles, 199
scenarios, 212-214
trading plans for, 287-289
   versus calendar calls, 210
diagonal puts, 216-218, 222-225
   Greeks, 221
net position, 219
option legs, 220
risk profiles, 220
time decay, 219
trading plans for, 290-292
diagonal spreads, 175
   covered calls, 175-177
direction neutral trading, 236
directional trading, 236
downtrending stock, 31
downtrends, 30

E

EMH (efficient market hypothesis), 250
European style, Black-Scholes model, 260
European-style options, 4
Excel, calculating historical volatility, 246-249
exercise price, 3
expiration dates, 4-5
   options, 20
expiration day trading, straddles, 133

F

factors that affect option premiums, 7-8
fill or kill, 25
finding
   flag patterns, 55
   tradable chart patterns, 229-236
fixed price, exercise price, 3
flag-trader.com, 230
flags, 35
   bear flags, 36-38, 233
      trading plans for, 275-278
   bull flags, 36-37, 231
      trading plans for, 268-275
within the context of trends, 38-41
finding flag patterns, 55
managing profits, 41
   One to One theory, 41-48
rounded bottom patterns, 50
rounded top patterns, 48-50

gamma, 59, 71-75
   call ratio backspread, 151
gamma scalping, 132
gamma trading, 129-132
Gaussian distribution, 249-250
gearing Delta, 64
Good till Cancelled (GTC), 25
Greeks, 57-58
   Black-Scholes model, 258
call ratio backspreads, 150-152
Cox Ross Rubinstein model, 265
delta, 59-63
diagonal call spreads, 70
leverage and gearing, 64
neutral trading, 64
neutral trading for hedging, 65-67
position summary, 68
puts, 70-71
diagonal calls, 214-216
diagonal puts, 221
gamma, 59, 71-75
put ratio backspreads, 166-168
rho, 60, 91-92
theta, 60, 75
time decay, 75-81
vega, 60, 82-83, 89-90
implied volatility, 83
theoretical option pricing, 84-89
volatility, 88
zeta, 60
GTC (Good till Cancelled), 25

hedging
delta neutral trading, 65-67
risk, 243
historical volatility, 245-246
calculating in Excel, 246-249
implied volatility versus, 245
normal distribution, 249-254
vega, 83

identifying trends, 34-35
Illuminati Trader and Flag-Trader software, 236
implied volatility, 254-255
   historical volatility versus, 245
vega, 83

zeta, 60
In the Money (ITM), 5
income, reasons for trading options, 10
interest, open interest, 22-23
intrinsic values, 5
calls, 6
puts, 6-7
ITM (In the Money), 5

L
lagging indicators, 32
leverage, 10
delta, 64
Levy Flight, 254
limit orders, 23
long call risk profiles, 15
long put risk profiles, 17

M
Malkiel, Burton, 250
managing trades, 241-242
managing profits, flags, 41
One to One theory, 41-48
Mantegna, Rosario, 254
market considerations, placing trades, 26
market orders, 23
maximizing profits by managing trades with trendlines, 120-122
mistakes, staying in too long, 28
Monte Carlo option models, 264
moving averages, 32-34

N
net position, diagonal puts, 219
neutral positions, delta, 62
neutral trading, delta, 64
news, researching, 236
news events, 104-105
normal distribution, historical volatility, 249-254

O
obligations
selling (naked), 3
versus rights, 2
OCC (Options Clearing Corporation), 23
one to one theory, 41-48
open interest, 22-23
option contracts, 20
open interest, 22-23
option legs, diagonal puts, 220
option prices, analyzing, 237-239
option pricing, theoretical option pricing (vega), 84-89
option pricing models, 256
Black-Scholes model, 256-261
Greeks formulae components, 258
Cox Ross Rubinstein model, 262-265
Greeks, 265
Monte Carlo option model, 264
option risk profiles, 14-19
  long call risk, 15
  long put risk profiles, 17
  short call risk, 15-16
  short put risk profiles, 18
option ticker symbols, 20-22
options
  American-style options, 4
calls. See calls
defined, 1
European-style options, 4
expiration dates, 20
hedging risk, 243
puts. See puts
sensitivities, 57
trading, reasons for, 8-11
Options Clearing Corporation (OCC), 23
orders, 23
OTM (Out of the Money), 5
OTM options, time decay, 75

P-Q
patterns
cup and handle pattern, 38, 51-54
finding flag patterns, 55
reverse cup and handle pattern, 54-55
tradable chart patterns
  finding, 229-236
  requirements for, 27
placing trades, 23-25
market considerations, 26
plans, trading plans, 28-29
premiums, 4
  factors that affect option premiums, 7-8
  intrinsic values, 5
calls, 6
puts, 6-7
time value, 5
calls, 6
puts, 6-7
profits
  flags, 41
  One to One theory, 41-48
  maximizing by managing trades with trendlines, 120-122
put options, 2
put ratio backspread
  2:1, 171
  3:1, 172
put ratio backspreads, 135, 153-154
  context, 166
  Greeks, 166-168
risk profiles, 154-158
strike price impact, 159-165
trading plans for, 285-286
puts, 2
delta, 70-71
intrinsic values, 6-7
time value, 6-7

R

A Random Walk Down Wall Street, 250
random walk model, historical volatility, 250, 254
ratio backspreads
call ratio backspreads,
135-136
context, 150
Greeks, 150-152
risk profiles, 136-143
strike price impact,
144-150
trading plans for,
282-285
put ratio backspreads,
153-154
context, 166
Greeks, 166-168
risk profiles, 154-158
strike price impact,
159-165
trading plans for,
285-286
researching news, 236
reverse cup and handle pattern,
54-55
rho, 60, 91-92
call ratio backspreads, 152
put ratio backspreads, 168
rights versus obligations, 2
risk
hedging, 243
option risk profiles, 14-19
long call risk, 15
long put risk profiles, 17
short call risk, 15-16
short put risk profiles, 18
reasons for trading options, 11
risk profile charts, 12-13
risk profiles
calendar call spread, 190
call ratio backspreads,
136-143
covered calls, 177-182
covered short straddles,
184-186
covered short strangles, 188
diagonal calls, 199
diagonal puts, 220
put ratio backspreads,
154-158
straddles, 94, 111
strangles, 97
Nice example, 124
synthetic long call, 244
Ross, Stephen, 256
rounded bottom patterns, flags, 50
rounded top patterns, flags, 48-50
Rubenstein, Mark, 256
Rule of Opposites, 2
Scholes, Myron, 256
sell stop loss, 24
sell stop to open, 24
selling naked, obligations, 3
sensitivities, options, 57
short call risk profiles, 15-16
short put risk profiles, 18
short stock, 3
SmartMoney, 237
speed of speed, 71
spreads,
calendar call spreads,
190-194
call ratio backspreads. See call ratio backspreads
diagonal call spreads,
delta, 70
diagonal spreads, 175
put ratio backspreads, 135, 153-154
ratio backspreads. See ratio backspreads
Stanley, Gene, 254
staying in too long, 28
stock chart patterns, 105-107
stocks, trending stocks, 30-31
stop loss, 25
straddles, 93-94
adjusting trades, 129-132
breakeven points, 107-110, 112-120
risk profiles, 111
breakevens, 101-102
cost, 105
covered short straddles, 184
risk profiles, 184-186
expiration day trading, 133
gamma trading, 129-132
inside information, 132
managing trades with trendlines, 120-122
news events, 104-105
risk profiles, 94
strangles versus, 100-104
stock chart patterns, 105-107
strike pinning, 132
strike price position and trade bias, 94-96
synthetic short straddles,
182-184
time decay, 105
time stops, 122
trading plans for, 278-280
volatility, 98-100
strangles, 96-97
breakeven points, 107-110
breakevens, 101-102
covered short strangles,
186-189
risk profiles, 188
news events, 104-105
NICE example, 123-129
risk profiles, 124
risk profiles, 97
strangles versus, 100-104
stock chart patterns, 105-107
time decay, 105
trading plans for, 281-282
volatility, 98-100
strategies, 240
strike pinning, straddles, 132
strike price, 3
strike price impact
call ratio backspreads, 144-150
put ratio backspreads, 159-165
strike price position, straddles, 94-96
strike prices, 20
symbols, option ticker symbols, 20-22
synthetic long call, risk profiles, 244
synthetic short straddle, 182-184

T
theoretical option pricing, vega, 84-89
theories, one to one (1:1), 41-48
theta, 60, 75
call ratio backspreads, 151
time decay, 75-81
Theta Decay, 77
time decay
diagonal puts, 219
straddles, 105
strangles, 105
theta, 75-81
time stops, straddles, 122
time value, 5
calls, 6
puts, 6-7
tradable chart patterns
finding, 229-236
requirements for, 27
trade biases, straddles, 94-96
trades
adjusting, 129-132
gamma trading, 129-132
managing, 241-242
placing, 23-25, 241
market considerations, 26
trading options, reasons for, 8-11
trading plans, 28-29
for bear flags, 275-278
for bull flags, 268-275
for call ratio backspreads, 282-285
for diagonal calls, 287-289
for diagonal puts, 290-292
for put ratio backspreads, 285-286
for straddles, 278-280
for strangles, 281-282
strategy matrix, 293-294
trending stocks, 30-31
identifying, 34-35
moving averages, 32-34
trendlines, 34-35
managing to maximize profits, 120-122
trends, 30
  cup and handle pattern, 51-54
downtrends, 30
flags, 38-41
reverse cup and handle pattern, 54-55
uptrends, 30

U
uptrending stock, 30
uptrends, 30

V
valuation of options, 4
vega, 60, 82-83, 89-90
call ratio backspread, 152
implied volatility, 83
put ratio backspreads, 167
theoretical option pricing, 84-89
volatility, 88
volatility
  historical versus implied, 245
  historical volatility, 245-246
calculating in Excel, 246-249
normal distribution, 249-254
vega, 83
implied volatility, 254-255
vega, 83
straddles, 98-100
strangles, 98-100
vega, 88
volatility smile, 258-259

W-X-Y-Z
week only, 25
whipsaws, 26
Yahoo Finance, 237
Zeta, 60