YES, YOU DO HAVE OPTIONS

13 RULES FOR OPTIONS TRADERS TO LIVE BY

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EXPLOSIVE OPTIONS

Introduction

When it comes to options, well, you have options.

That might sound a bit corny, but it's nonetheless a crucial point for traders to internalize.

Throughout my years of talking to options traders, I've found that most people – no matter their level of experience – either don't know or don't believe they have flexibility when trading.

Because of this uncertainty, many of them will lose control over the decision-making process, thus allowing the market or other forces to dictate their next move. This clearly shouldn't be the case - as a trader, the last thing you want to be is out of control.

I have found that the only way you can surmount that psychological hurdle is if you understand and exercise your options, in every sense of the word.

In this e-book, I will address the many possibilities available to you, all of which will be summed up as rules that should become a permanent part of your trading toolbox.

Above all, never fear that you have no way out of a trade. You *always* do.

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Chapter 1:
You Have Freedom of Choice

When I talk about "freedom of choice," I'm not talking about that Devo tune from the 1980s. I'm talking about your ever-present ability, when trading, to make choices and avoid feeling as if you're trapped in a corner.

Yes, the market is a vast ocean of nameless and faceless players, all attempting to achieve a return on risk – and the cruel reality is that financial pain is part of the game.

But the more you realize that you can control the fate of your results amid this plethora of participants – and the more you know about trading – the better you will be at recognizing what's right or wrong for your strategy. The world will open up to you, and you'll be able to think clearly, instead of relying on the one choice that happens to be in front of you.

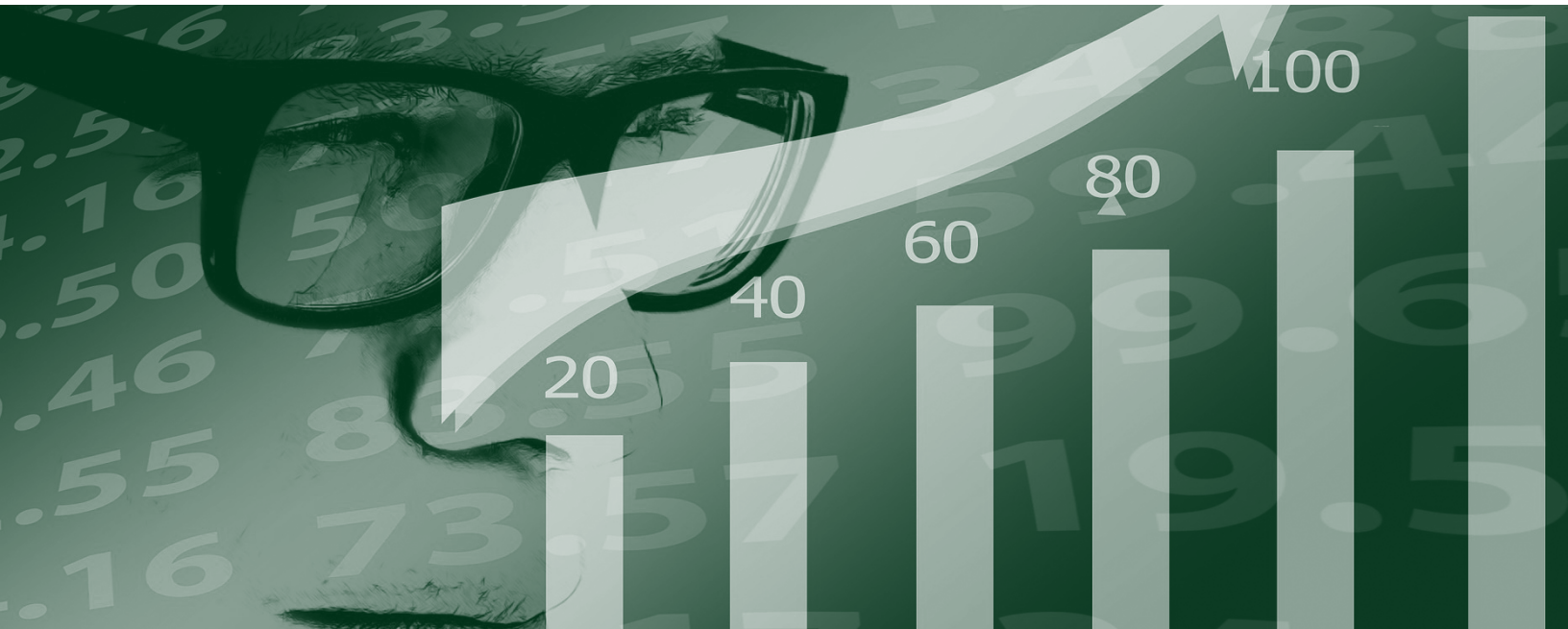
As for the options market in particular, the beauty of it lies in the tremendous leverage it grants you; the stories of extraordinary returns on short-term options are legendary.

Trading shares for a 30% move is nice, but options enable you to capture dramatic moves up and down that can produce 5, 10 or even 20 times a return on the stock.

I remember one options-expiration week that saw Google (GOOG) options pop more than 1,600% over about two sessions. The stock itself rose only about 2.5% Of course, the timing and risk would have been correct if you'd bought the stock, but which result would you have preferred?

Note that I'm using the example of a high-dollar stock, but remember that a 25% gain on a $500 name is no different from a 25% gain on a $50 stock – excepting dollar terms, capital outlay or volatility.

Rule #1:
Always keep in mind that the account you manage is entirely under your control.



Chapter 2:
The Wisdom of Letting Go

This option is certainly the easiest one to implement. We are not married to our positions, and we should never think we need to hold on to them until some magical future date.

Despite the benefits of trading options, your timing and direction have to be spot-on, or you'll be looking at a loss – but so what? Losses happen all the time, and trading is not a game of perfect. If you lose some ground, cut bait. You can always come back later if you see a great setup materializing.

Just as important, you'll find colossal relief in unloading that albatross of a loss from your books. There is nothing worse than looking at a loser day after day and hoping it'll turn for you. Selling is the most liberating experience.

What if you have a winner? Feels good, doesn't it? Yet this should also prompt you to take some money off the table, because that warm feeling could otherwise be ripped out in a split-second, to be instantly replaced by sadness and regret.

When we enter an equity-option trade, we usually aim to book a large gain. We feel bold, empowered and ready to take our share out of the market. But, on the way to nirvana, we face bumps and obstacles, and our timing might not be precise – so it's important to remember that you can be partially right and still pocket a gain.

If your timing is off, that's OK. Take a gain, even if it's not as substantial as what you had originally intended.

Too many traders will not accept a win that's smaller than their original target, choosing to treat it as a defeat if the setup hasn't reached their profit goal. Nonsense! Cash in any gain you get, and consider it a good win under any circumstances.

Much like selling a loser, unloading a winner is a liberating thing to do. Not only does it bestow on you an aura of confidence, but it also allows you to move on – to prepare and to think clearly about the next trade.

Rule #2:
Options trading is not a game of perfect. It is OK to sell for a loss if you're losing ground. Likewise, it's OK to sell for a smaller gain than what you had anticipated.

Chapter 3: The Art of the Graceful Exit

Options are filled with time decay; they are a wasting asset. If you own them, you are always fighting the clock.

In view of this, the best opportunity to sell is when you're working within an accommodating market. You may not be in control of the game, but you can always take advantage of moments that allow for a graceful exit.

For instance, I will often sell long call positions into a solid up session or trend day. Why is that? A market in accumulation mode is brimming with willing buyers.

Frankly, this isn't part of the original plan when I enter a trade, but I am always looking for a profitable way out. There is no worse feeling than when you're stuck on the wrong side of the market, ultimately getting blown out of a position too soon because you couldn't take the heat.

Rule #3:
Sell when the market swells with buyers, even if the timing is not part of your original strategy.

Chapter 4: Get Time on Your Side

Because of the leverage inherent in options, your percentage win can be substantial if you get the direction right prior to expiration. But, in order for you to gain that leverage, you have to give up something – and that something is intrinsic value.

As you probably know, options give you the right to exercise at certain strike prices at or before a given date. An option price comprises time and, potentially, intrinsic value –and the more you pay for that latter component, the lower your overall return will be.

However, this only matters when the shares are priced above the strike; otherwise, there is no intrinsic value. On the other hand, an option always has time value, up until the last moment of expiration, and you might choose to only buy time decay if you are expecting a massive move in a stock.

For instance, if IBM (IBM) were sitting at $194 the day before the company's earnings report, there would be no intrinsic value to the $200 calls expiring next month. But they would have some time decay, based on the expected implied move after the report. The $200 calls may be selling at pennies – perhaps 70 cents – but the stock might shoot to $205 post-earnings, thereby creating intrinsic value and time decay overnight. If you'd bought 10 contracts for 70 cents apiece, or $700 less commission, you would now be looking at a value close to $5.80, or nearly a 725% gain.

Rule #4:
Choose time decay over intrinsic value if you are expecting a dramatic move in the stock.

Chapter 5:
Don't Supersize It

Naturally, taking that IBM trade we talked about in the previous chapter would entail some risk.

If the earnings report was poor, followed by a downward or sideways move, the time value in those options would collapse to virtually nothing. This is what's called a "binary" trade: you either win big or lose it all. On the other hand, buying an IBM call in the money – say with the $190 strike price – would have netted you a nice win, but you would have gained far less on a percentage basis.

So which do you choose?

Well, in this case you have options based on your risk tolerance, so know where you stand on the spectrum of risk and proceed carefully on that basis.

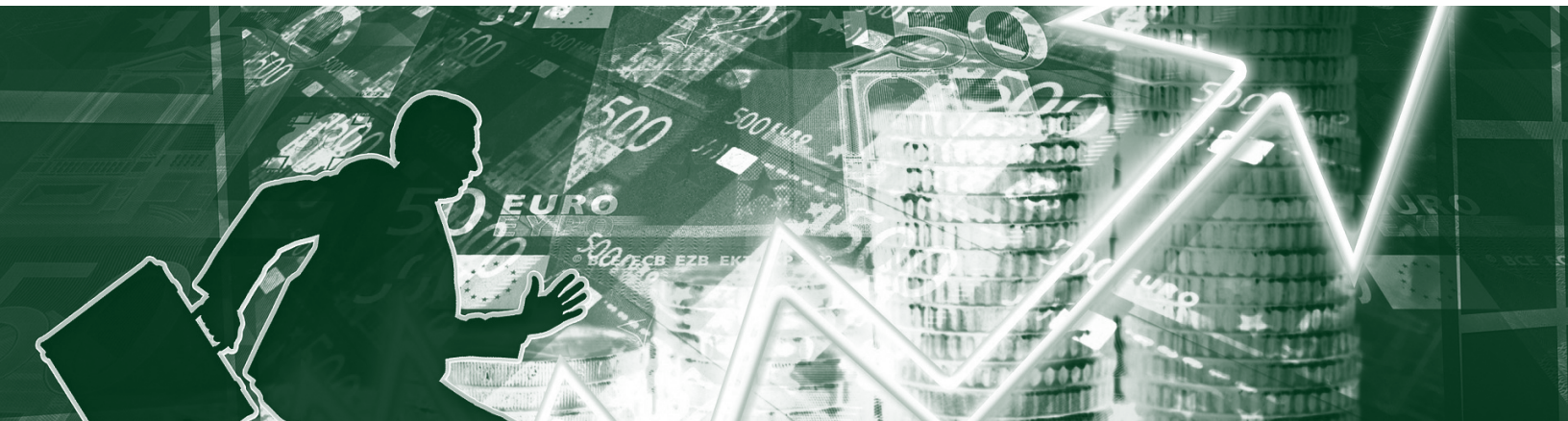
Regardless of your risk tolerance, it's important that you know how to size your trades properly. You'll likely be doomed if you tend to supersize your trades, even if you're a skilled trader with a bulletproof system. While massive wins are certainly possible here, the odds are quite simply stacked against you much of the time.

Another important point: when you start placing outsized bets in the hopes of landing a windfall gain, a dangerous mentality can take over – one that's no different from that of an overzealous gambler.

I have seen trader after trader take too much risk on a few trades, basically going all in, and then get blown out and forced to watch from the sidelines. The sad irony is that, if those folks had implemented smaller trades, the following couple of plays would have had a reasonable chance of producing winners that could have dug them out of that hole.

Aside from these considerations, holding a large position can also make you feel uncomfortable and restless, and lead to sleepless nights. So never use up all of your capital on only a handful of trades, let alone just one. Instead, you'd do well using that great leverage to your advantage by allocating a limited percentage of your account to each trade idea. In this way, you'll give yourself a chance to stay in the game even if one particular trade doesn't work out for you.

Rule #5:
Size trades properly. Never go all in on one or a few stocks – you could lose all of your money in one fell swoop.



Chapter 6:
Gauge Your Risk Tolerance

Any market player can reap the benefit from leveraging options. A small-sized trader, for instance, can define their risk, gather several contracts on a directional bet and pocket a huge percentage win.

On the other end of the spectrum, a big player might use options to capture premium or make hedged bets against existing stock positions. Whatever the case, the options are vast.

But which do you choose?

Most options expire at the end of their life, so it makes sense to find the ones that don't expire worthless. These are considered high-probability plays, purchased deep in the money or sold deep out of the money – and, for these, many traders look to a delta figure with at least a 95% chance of success. The tradeoff, of course, is a lower profit; the reward becomes richer as you lower the probability bar of success.

Somewhere along that line is a sweet spot that matches both your risk tolerance and your desire for a high reward. In order to determine where that is, you have to ask yourself:

- How often am I willing to possibly be on the losing end of a trade?
- Can I cut my losses before they become total losers?
- Can I take winners off the table?
- Am I able to hold a trade into and through event risk?

One might guess that, while the high-probability trader wins far more often, they may not be positioned for big payoffs. But that isn't necessarily true.

On the flip side, the low-probability player may just be getting crushed in every trade as they put on trades against the tide of the market. A series of losses like these could lead to incredibly risky behavior and possibly usher in the gambling approach of "winning to get even at any cost," with a trader ceaselessly attempting to recover amid ever- dwindling capital. Risk-management discipline would get tossed out of the window, and another account would eventually go bust.

Which approach is best? It depends. If you pursue the low-probability play, buying long calls or puts that are several strikes out of the money, you're betting on a very big move based on some unknown future event. I have seen some massive gains from these kinds of bets over the years, and there is a proper time to put them on, but they aren't wise to implement as a general rule of thumb.

The high-probability bet, meanwhile, would mean either purchasing at- or in-the-money calls or puts, or selling calls or puts out of the money. These will generate lower overall gains, but they also tend to produce more consistent winners over time. They're the smart bets that will keep you in the game for longer.

Rule #6:
Even though they generate lower overall gains, you can consistently win with high-probablity bets.

Chapter 7:
Enjoy Better Odds Than "The House"

What if I told you that options-trading could offer you more robust odds than those enjoyed by casino operators?

You might think I am crazy. After all, the options market can seem like one big game of chance. However, that isn't necessarily the case. In fact, if you have some patience to wait it out a bit, you can craft a nice income stream by using one particular strategy.

That strategy is selling premium as opposed to *buying* it.

It's a fact that nearly 80% of all options expire worthless each month. What this means is that you could wait for expiration and collect the premium, and you'd have a four-fifths chance of winning *every* time.

Most traders believe they can only be buyers of options but, in fact, there are no restrictions on these matters – you need only possess the capital to buy a stock put to you, or the cash or stock when one is called away.

As a seller, you'd also have the *option* to roll a play to another month if the trade isn't working out exactly right. (That's because we're talking about U.S. options, which can be exercised at any time prior to expiration.)

You could also pick up a protective put below or a protective call above. Any option can be sold, but the further out of the money you go, the less premium you'll capture, and the shorter the time to expiration. Time is always on the side of the seller.

Keep in mind that, regardless of how you implement it, this strategy will require margin posted, per broker rules.

Rule #7:
You can sell options, thus putting time on your side.

Chapter 8:
A Rundown of Your Trading Options

Given the numerous factors that could wreck any trade – time decay, market volatility, news – successful option trading requires great skill and precision. Huge winners can become losers instantly, and vice versa.

But, as you can see below, you have other options when it comes to protecting yourself or, at least, mitigating risk. Don't worry, these ideas are not too complex.

Note that the below descriptions apply only to long positions, though all of them can be reversed to accommodate a short play.

Vertical Spreads

This involves combining a long strike and a short strike above the long – but in the same month. The strategy serves to cut down the risk on the long call and, as with all spreads, it can be created from an existing long call or put position. But there is a tradeoff here: the gains are limited to the sum of the spread.

Example

Say you are long an Amazon (AMZN) $250 call for June that costs $6, and the $260 call is selling for $1.75.

In this case, buying the $250 call and simultaneously selling the $260 call would create a vertical call spread with a cost of $4.25 per contract. (You would buy and sell the same number of contracts.) Breakeven would now be $254.25, rather than $256. The spread would be 10 bucks, so that would be your maximum gain if Amazon stock went past $260. However, if the stock fell below the long strike of $250, or if it failed to rise above the breakeven level, the loss on the spread would be less than that of a straight call play.

Calendar/Diagonal Spreads

With a calendar or a diagonal, you're taking advantage of moves based on time and volatility, but not price – so it would make sense to put one of these on prior to an event such as earnings.

For the calendar spread specifically, you would simply sell a front-month contract and buy one for the next month with the same strike price. The play is a debit spread wherein the difference in strikes is the time decay.

Diagonals embody the same concept, but for that strategy you'd use different strike prices as well as different months.

Example (calendar spread)
You may believe Las Vegas Sands (LVS) shares will manage to get past $55 after earnings.

In that case, you would sell the October $55 call, perhaps priced at $2.65, and buy the November $55 call at $3.25. The debit would total $0.60, and you would be long the November $55 call at a price that's considerably cheaper than the cost of the call.

The best scenario here would be if the stock stayed under $55 through October expiration, and then powered past the strike following that date. The October $55 call would decay to nothing (we are short, so you want that to happen here), and then you'd be long the November $55 call at a cost of $0.60.

Straddles/Strangles

These types of option plays are generally volatility-driven. Suppose you believe an event is bound to have a very positive or negative outcome on a company, and that this will be reflected in the stock price. The straddle looks at the price of a put and a call with the exact same strike and month. The total cost of the trade would represent the stock's "expected market move," in either direction, following the event.

A strangle is similar, but in this case you'd pick up a call and put above and below the current stock price, respectively. The expectation here would be for a large move, but since there is no intrinsic value to a strangle, it costs less than a straddle does.
Example

Let's say the stock of Chevron (CVX) is at $110, and we expect a big move either up or down. The $110 straddle might cost a combined call/put price of $7. A move in either direction would be fine, but the stock would need to either rise or fall by $7 in order for the trade to break even.

A strangle might mean purchasing the $115 call and the $105 put at a total cost of $3.40 – far less than the straddle – but the stock would need to move out past one of these strike prices. So you could buy twice as many strangles as straddles here and, if you were correct, you'd be able to leverage up for a sizable move.

Condors

These are interesting structures, and not just because of their name. Condors allow for participation in a big volatility move on either side of the trade, and they do this by combining features from both vertical spreads and strangles. The advantage is that you get coverage on either a positive or a negative move, yet you also mitigate your risk by selling outside strikes for both the put and the call.

Example

Let's say IBM has earnings out next week. The market is expecting a big move, but you just don't know what direction to expect, so you'll want to cover yourself on both sides. IBM is at $195, and the $200/$190 strangle is priced at a hefty $9 (debit) since it's the front-month contract.

Because the move could be substantial, this is where we want to be long – but, along with that expensive strangle, we would look to sell the $185 put and the $205 call, collecting a credit of $6 for both sides.

In this way, we would be cutting our risk by more than half, and we would be limited to a maximum gain equaling either spread – $5 – if the stock were to reach the short strike of either $185 or $205. That's a cost of $3, with a net potential gain of $2, or a 67% win.

That's not bad for a bidirectional play. The structure looks like this: Long IBM $200/$205 call spread, long $190/$185 put spread.

Rule #8:
Get comfortable with different kinds of plays, because they offer a great deal of flexibility.

Chapter 9: Repair Strategies for Trades Gone Wrong

Above we discuss the various *options* you have when it comes to gaining an edge and mitigating risk. But what if you are in a trade and need to fix something that's gone astray? Can you turn a loser into a breakeven trade – or even a winner?

As luck would have it, the toolbox remains full if you need to get out of a jam. You can always turn to repair strategies; it just takes some creativity and knowledge of your own odds and risk.

For instance, let's say you bought a long call on Intuitive Surgical (ISRG) ahead of earnings – after which the shares see an intraday plunge on sour news from a research firm. Implied volatility screams higher, and now your long call is down a hefty 40%.

What do you do? Don't panic, first of all, because your *options* are numerous.

The simplest one, of course, would be either selling the call or just holding and waiting. You could also buy a put, though the best time to have done this probably would have been at the inception of your trade.

On the other hand, if you think the news is bogus and that the stock should eventually bounce, another possibility is adding to the position, or even buying a call spread. Perhaps you could sell a put or a put spread, thus capturing premium as the volatility temporarily rises. This is risky, of course: at least on the face of it, you would seem to be grabbing at a falling knife. But the risk would at least be defined if you were selling a spread.

Rule #9:
Don't just sit there in a shocked state when a trade goes off the rails. Make a move!

Chapter 10: The Messy Adventure of Buying In and Cashing Out

As I often say, trading is not a game of perfect, and this also applies to pricing in the options market. The reality is that the art of entering and exiting trades can be a messy adventure.

We all would like to say we got in at the bottom of a price and cashed in at the top, but that is not always going to happen. In fact, such precise timing is quite rare, and it happens far less than you might think or hear about.

When you enter or exit a trade, keep in mind the spread that's being held by the market- maker. He or she is trying to make a living, and that is where the spread comes in: It's the difference between the bid and ask prices, wherein a seller is on the ask (offer) side and a buyer is on the bid (taker) side.

When I am putting a trade together based on a setup, I am aware of these prices, and it's entirely up to me whether I want to accept them or just wait for my ideal quote – but if I go with that latter decision, I'll risk missing out on any future move.

In my view, it's "pound foolish" to wait for a better price when an expected reward is far greater than the pennies saved. My goal is to make dollars and not cents – but, of course, yours may be different.

So, I accept that I won't always get the best pricing on the way in or on the way out. Instead, I will execute the trades as I want them done, and when I want them done, always accepting the risk associated with the trade.

Rule #10:
Don't hold out for a better price tif the savings are minimal.

Chapter 11: Carve Out a "Free" Trade

They say there are no free lunches, and if someone promises you something for nothing, it's probably too good to be true.

This is usually true – but, with a bit of work, an option trader can create what's known as a "free" or "no-cost" trade. Simply put, this means using your options to create a situation in which you can't possibly lose.

To illustrate, you might be long Occidental Petroleum (OXY) September $85 puts, and the stock might start to decline sharply – i.e., in your direction. Let's say the puts had cost $4, and they've since doubled to $8.

At this stage, the easy move would be selling half, thus putting the original cost back in your pocket. You could then let the remainder run as far as you wish without running any risk to your capital. Anything you'd sell at this point would be for pure profit.

An alternative could be selling that call and rolling it up and out to another month, with a strike at or below the cost of the original position. For example, if you were holding those $8 September $85 puts, and if the October $80 were priced at $4, you could sell the former and buy the latter. Here, as well, you'd be taking your original outlay off the table and riding a free trade.

Rule #11:
If puts double in price, sell half and let the "free" money ride.

Chapter 12: When It's Time to Head for the Exits

The hardest part of trading is knowing when to depart from a trade, or even the game as a whole. I'm not talking about permanent leave but, rather, taking time for a rest. Have you ever had your confidence shot by a vicious drawdown or losing streak? If not, believe me: it happens.

Of course, even though you can easily book a winner or cut a loser, and even though this may be part of the trading plan, there's a good chance that disengaging is rarely at the front of your mind. How many times have you deviated from that plan of yours, only for it to turn out negatively? I'm sure it happens more often than you would admit.

In any case, there are indeed times when we need to disconnect and step back. I'll admit that it's nearly impossible to find the right moment, but a particularly good time to take a breather is after a drawdown to your account. This may have happened through fault of your own, perhaps because of some unfortunate external circumstances. Whatever the reason, the simple act of selling what you have, or most of it, relieves the stress of trying to reach back for those losses. It clears your head and really allows you to start fresh.

Oftentimes I will use this time to watch the action, write some notes, read up and learn something about my trading, or even paper-trade in order to rebuild confidence. There is nothing wrong with slowing down, stepping back and rejuvenating. You certainly have the option to pause. You'll trade better when you come back.

Rule #12:
If your confidence, wallet, or both get battered, it is OK to take a break from trading and focus on something else.

Chapter 13:
Don't Just Sit There, Do Something!

Have you ever had that "deer in the headlights" feeling as you've seen your trade move? Whether it's a slump or a bounce, you might feel frozen, unsure of what to do next.

This is entirely psychological, of course; we get stuck in cement because we are unaware of the options we have in front of us. Tunnel vision takes over, and we can only see the binary result of a huge win or a big loss. It's at this point that the market has taken control of us.

Should that situation ever arise in the future, you now have the tools to handle it smartly. Here are the 12 options trading rules on flexibility that I laid out in this ebook:

#1: Always keep in mind that the account you manage is entirely under your control.

#2: Options trading is not a game of perfect. It is OK to sell for a loss if you're losing ground. Likewise, it's OK to sell for a smaller gain than what you had anticipated.

#3: Sell when the market swells with buyers, even if the timing is not part of your original strategy.

#4: Choose time decay over intrinsic value if you are expecting a dramatic move in the stock.

#5: Size trades properly. Never go all in on one or a few stocks – you could lose all of your money in one fell swoop.

#6: Even though they generate lower overall gains, you can consistently win with high-probablity bets.

#7: You can sell options, thus putting time on your side.

#8: Get comfortable with different kinds of plays, because they offer a great deal of flexibility.

#9: Don't just sit there in a shocked state when a trade goes off the rails. Make a move!

#10: Don't hold out for a better price if the savings are minimal.

#11: If puts double in price, sell half and let the "free" money ride.

#12: If your confidence, wallet, or both get battered, it is OK to take a break from trading and focus on something else.

You are now prepared for the next repair job, purchase or selling opportunity. Every trader has these options, but you can only exercise them if you know they exist. Be different and stand out from the crowd. Do something!

ABOUT EXPLOSIVE OPTIONS

Explosive Options is an options trading service.

Founded in 2011 by Bob Lang, the industry's leading technical expert, we provide proprietary options trading knowledge to people who are committed long-term to trading. Our members join because they want to learn more about options trading and grow their portfolio, but they don't have the time or knowledge to do it full-time.

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