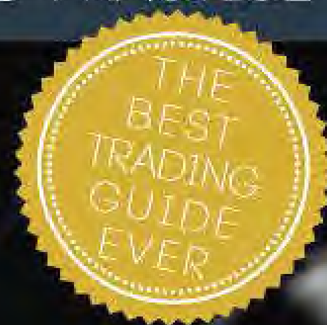
OPTIONS TRADING

A STEP-BY-STEP MANUAL TO PUT PROFITABLE STRATEGIES INTO PRACTICE



RICHARD BLOOM

OPTIONS TRADING

A Step By Step Manual to Put Profitable Strategies into Practice - Learn the Fundamentals, Positive and Negative Experiences,

and Tips and Tricks to Profit ASAP

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INTRODUCTION

Stocks, bonds, FX, derivatives, futures, options, CFDs....the list goes on and on and on. The financial world these days is diverse in nature and there is no limit to the number of vehicles you can use to make profits. Options are exactly one such instrument and come under the umbrella of derivatives.

Derivatives are instruments which are named thus because they literally derive their values from another financial instrument. Futures contracts, for example, are a derivative contract that promises a certain price of the underlying stock, or financial instrument, to be delivered at the date mentioned on the contract, no matter the market price at the time of sale, or in the future.

Options work in a similar manner but there's more nuance to them than a futures contract and as such, options greatly reduce the risk associated with a lot of trading operations. However, and this is a huge caveat, you need to know how to use them.

Is it possible to make a million dollars trading options? Yes, of course it is. Are you going to make a million dollars after reading this book? Most likely not. You see, a lot of beginners jump into trading expecting millions of untold riches and generally approach the whole discipline with ridiculous expectations.

Your trading operations are a business, and if any business could make its proprietors a million dollars with an investment of just a few thousand, you can bet no other form of business would ever exist, because what would be the point of them? A very good trader, and I mean one of the best in the world, will expect to make twenty percent returns on their capital. Warren Buffett has averaged twenty percent on his business since inception and he's considered the greatest businessman ever. So, yeah, if you're expecting a hundred percent per month, you need a reality check.

These numbers will sound low if your expectations are unrealistic. However, trading is wonderful in that it is one of those rare businesses where if you can follow correct principles, as I'll show you in this book, money and capital will find you once you establish a decent track record.

Your own money is not the only source of capital. These days, there are a number of capital sourcing programs for retail traders such as fundeseeder, psyquation, and darwinex who function as a virtual, fully audited track record which institutional investors can review and invest in. So, don't be

discouraged by thinking your thousand dollar capital isn't going to grow soon. Trust the process and follow the principles, and capital will find you.

Capital is another key issue for a lot of traders. Like every other business, trading requires a certain amount of capital for it to be worthwhile. Now, can you trade with a thousand dollars of capital? Sure, you can. You can also choose to walk from New York to LA instead of catching a flight when it comes down to it.

A lot of traders get hung up on the low barriers of entry trading provides and miss the point that low capital will only hamstring you in the long run and you'll end up spinning your wheels. In the United States, especially, it is not advisable to trade with less than $25,000, and I'll explain why in subsequent chapters.

If you do not have this much capital, my advice is to simply not trade. Focus on building your capital to this point and learning the correct mindset. Speaking of which, mindset and risk management do not get anywhere near the importance in any other trading book simply because explaining trading strategies, that is entry points, takes up a lot of time.

Here's the deal: developing entry strategies is easy. It is managing risk that is difficult. This is where options come in handy. They simply remove all aspects of risk management by defining it right at the start and all you have to do

is to monitor your trade. Options strategies, quite simply, help you get out of your own way.

Successful options trading requires you to understand the basics first, and in this book, I've given you some ready-made strategies you can use to profit immediately. To make these really work though, you will need to understand the concepts of risk and adopt the correct approach to trading.

While entire books can be written on the subject of the mindset necessary for trading success, I have addressed this topic in just one chapter. This book will begin by giving you a basic layout of what goes on behind the scenes in the markets, followed by a primer on risk management, and then mindset. It is only after this that we will look at options trading strategies.

The reason for this is because the most important things need to be addressed first. Fix your mindset and profits will follow. Options are not a magic bullet for your trading results, especially if you happen to be struggling with another instrument already. If you're a rank beginner, options don't require any special experience, but do beware that you're not exempt from following risk and mindset principles.

So, having said all that, let's dive in and peel back the curtain to reveal what goes on behind the scenes in the markets.

CHAPTER 1: MARKET BASICS

Most of us interact with the market via financial TV channels or on the internet via a few stock charts. Both of these sources, while excellent sources of information, present a very distorted view of the markets, unfortunately. They always seem to convey some sense of panic or euphoria, with nothing in between.

Hollywood doesn't help either. Traders are almost always shown trading stocks by screaming obscenities at one another, and if the glorified used car salesman who dubbed himself "The Wolf of Wall Street" is to be believed, drugs and other stimulants are quite common.

None of these depictions are necessary for success, even though one might choose to approach things in this manner.

TRADERS AND ORDERS

Fire up any trading terminal and the first thing you see is a video game like layout with flashing numbers, green or red, and a number of lines and graphs signifying who knows what. All these lines and flashes of light signify one thing and one thing only. The actions of other traders.

There are all kinds of traders in the market, all the way from retail traders who don't know their stocks from their toes, to institutional traders trading on behalf of a large bank or a hedge fund. There are speculators and investors, macro investors and high frequency traders, and quantitative traders. The market is like its own solar system with all kinds of strategies forming the various planets within it.

The equivalent of the sun, the center of it all, would be price. Price is what ultimately everyone is haggling over, and when an agreement is reached, you see a flash of red or green on your screen. Price charts depict the course of price

in certain time intervals. For example, a daily chart shows the progression of price for an entire market session, or in the case of FX, an entire twenty four hours.

Similarly, a fifteen minute chart shows the movements of price every fifteen minutes and a five minute chart every five minutes. There are different ways of representing price so let's take a look at these.

PRICE CHARTS

There are three kinds of price charts you will encounter in the markets. The first is the one which provides the least amount of information and is generally used by popular media like TV channels and so on. Perhaps there's a connection there, but anyway, this chart is the simple line chart which depicts price as a line, going up or down with the percent change next to it in either red or green.

Plotting this line is simple enough. You place a dot for the level at which price closed the previous day and connect it to the dot which symbolizes market close or current price at a given moment, and you have a line which is either above, below, or at the same level. This is what the percent change measures. The line chart looks pretty and provides easy conclusions for laymen and as such, you will not find any trader ever looking at price represented this way.

The next kind of chart, which is a huge improvement over the humble line chart, is the American bar chart. I'm calling this American because it is usually found only Stateside and not so much around the world. The representation of price

in a bar chart is shown in Figure 1 below.

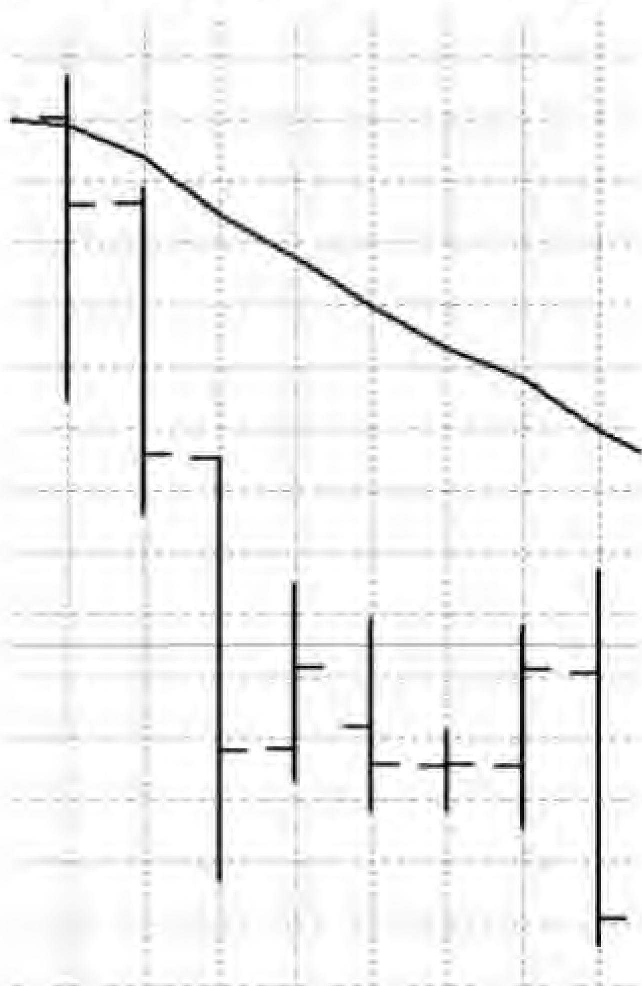

Figure 1: A bar chart (MetaTrader 4, 2015)

Each bar in this image represents price action for a given interval. So, if these bars were on a daily chart, one bar represents what price did during that entire day. If it's a sixty minute chart, it represents hourly price action and so on. Let's break this down more.

The vertical line represents the range of price movement. Thus, the top of this line is the high that price achieved dur-

ing this interval and the lowest point is the low during the same interval. The larger the vertical line is, the greater the range with which price moved. The notch on either side of the vertical line signifies the open and close, with the open on the left and close on the right.

Bars are fantastic this way because they don't need any special color or design characteristics. By just looking at the notches, we can see whether price increased during the interval or decreased. If the notch on the right is higher than the one on the left, then the price increased, and if the one on the left is higher, then the price decreased during the time interval.

The relative positions of the open and close notches to the high and low provide excellent information with regards to the price action during the session. For example, a close that's far above the low and the high, that is with a tail, signifies buying pressure that overcame selling pressure. The same applies if a wick exists to the top.

Bars, despite the amount of information they provide do have their shortcomings. For one, they're not the most graphically communicative. When seen in a cluster, the bars do tend to blend in with one another. The most informative way of communicating price action is candlesticks and this is what most professional traders use.

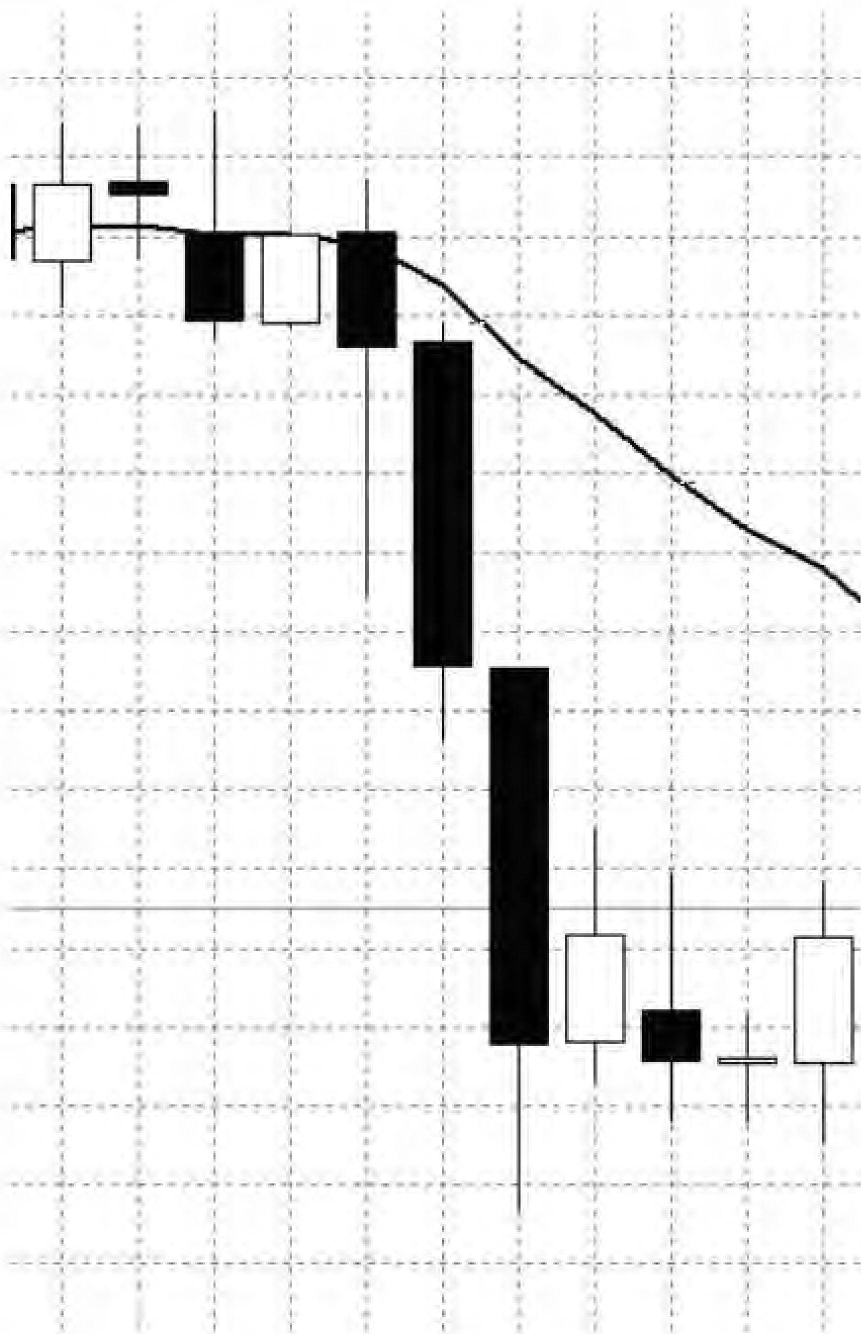

Figure 2: Candlestick chart

Candlesticks, or candles as they're called, have the same information as bars do. They communicate the open, close, high low, and the range within which price moved during

the given time interval. The difference is that the body of the candle is a far more graphic representation of the range. Aside from communicating the extent of the price range, the color of the bar informs us whether price decreased or increased during the time interval.

Bullish bars, or bars who's close is higher than the open, have a different color from bearish ones, that is bars where the close is below the open. The colors can be chosen by the trader and conventionally, charting platforms assign the color red to bearish bars and blue to bullish ones. In this book, I'll be signifying bullish bars with white bodies and bearish candles with black bodies.

Candlesticks provide an instant snapshot of price action and they can be traded individually via patterns. The highs and the lows are represented by the wicks on either side of the body and the size of the body, wick size and location with respect to the candle body form a pattern which can be used to draw conclusions.

Let's look at a few patterns which will help you get up and running quickly.

CANDLESTICK PATTERNS

The first pattern that will prove extremely useful to you is the inside bar. This is shown in figure 3.

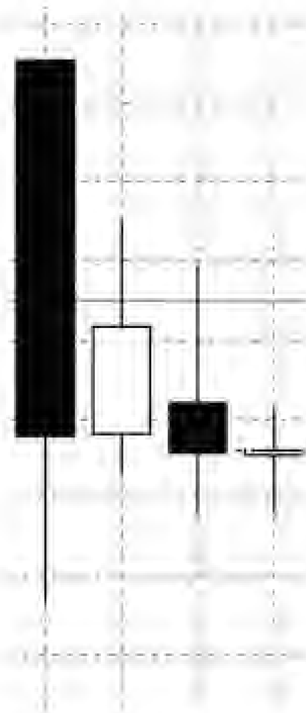

Figure 3: Inside bar cluster (MetaTrader 4, 2015)

The pattern is comprised of two bars, with the one on the right lying within the range of the body of the bar on the

left. Now, it isn't fully necessary for the smaller bar's wicks to be completely within the bigger bar's body. It's far more important that the order flow characteristics of this pattern is understood.

Inside bars are a continuation pattern which indicates that the current market situation will persist. Thus, if the market is in a bull trend and then price hesitates sideways and forms an inside bar, you can bet that the original trend will continue. This is true of bullish and bearish trends.

The only market situation where you should not be trading inside bars are in ranges. If you're not familiar with what trends and ranges are, this is something I'll address shortly in a later chapter. However, for now just remember that inside bars, and indeed all price patterns, are meant to be used in certain environments.

The next useful candlestick pattern is the pin bar which is illustrated in figure 4.

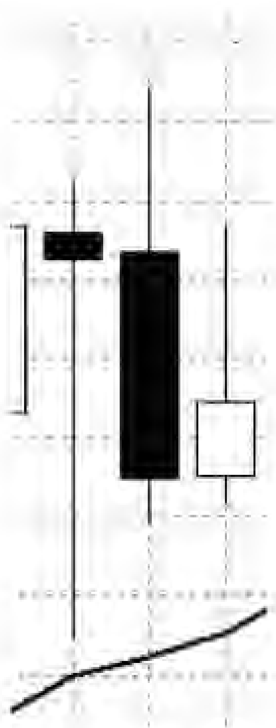

Figure 4: Pin bars on either side of a bearish bar (Meta-Trader 4, 2015)

The pin bar is a single bar formation and signifies a reversal. Despite being a reversal pattern, the best way to trade this for a beginner is to do so with trend. This means that when price moves in a small sideways pattern once it takes a breather in a trend, look out for a pin bar to signify the end of the sideways pattern and resumption of the trend. Figure 5 illustrates how this works.

Figure 5: Pin bar provides continuation signal (MetaTrader 4, 2015)

The pin bar is characterized by a small body and a wick or tail above or below the body. Generally speaking, it is preferable to have the wick or tail's length to be at least thrice the size of the body. Again, don't get caught up in measuring things, just understand the underlying trade mechanics.

Wicks and tails happen when traders reject a certain price level strongly. This is even more significant if the body is small because it indicates that the original downward or upward movement was strong but then it was rejected by an even stronger movement that produces the wick or the tail. When such a pattern occurs at or near an important support or resistance level, it is about as blaring a sign the market will ever give you as to which direction it is about to move

in.

Support and resistance is discussed in detail in a separate chapter but in case you're unfamiliar with these, they're essentially important order flow levels where traders draw lines in the sand and defend it. S/R is an important skill set for you to master in order to trade successfully.

The last candlestick pattern which will prove itself extremely useful is the climaxing pattern. The climax occurs at the very end of a bullish or bearish move and is accompanied by what can be best termed as exaggerations. The sizes of the bars involved are exaggerated far beyond the usual size in the trend, the volumes peak massively and the rebound of the climax is fast and sharp as well.

Climaxes are counter trend trades and generally, I don't recommend beginners trade in this manner but it is actually a simple trade to take once you learn how to spot a climax. The reason it is simple is because you don't need to worry about S/R or any other market events.

Figure 6: Bear trend ends in a climax

Climaxes are also referred to as exhaustive movements and are characterized by massive with trend bars accompanied by huge volumes. The bar sizes and volumes are not just larger than ordinary but far larger, almost twice the magnitude. It is important that you look for this extreme exaggeration since it indicates that weak with trend players, in other words the uninformed public, has entered the market and are jumping onto the bandwagon right when it's too

late.

What follows as climax is either a sideways movement which eventually leads to a trend reversal or a sharp counter trend bounce that is then followed by a meandering sideways movement. This is advantageous and we'll see how to trade these sideways movement when talking about ranges in a later chapter.

Climaxes are excellent in terms of the ROI they offer on your time as well. Given the pace with which price moves counter trend post the climax, you'll earn your profits soon. From a rice environment perspective, you want to look for these near the end of trends and not in ranges. Climaxes give birth to ranges and don't occur within them.

This covers the main points in terms of the market basics you need to know and understand. The key lesson to take away from all this is that the market is just a giant collection of orders being matched with one another and that these orders reflect sentiment.

Sentiment is not always logical and is always chaotic. However, over a long enough period, sentiment leaves patterns which repeat themselves more often than not. By ensuring we can spot such patterns and recognize the odds inherent in them, we can trade successfully. This will be covered in the chapter on risk management and mindset.

For now, remember that you don't necessarily need indica-

tors or special tools to trade the market. Indicators are simply derived from price and as such, the price chart has all the information you need. Traders tend to rely on indicators because the seeming complexity of the price chart scares them.

Options take away a lot of this problem but before we dive into options basics, it is important to get to know that most important person in your trading business: your broker. In addition, you will also need to learn about the laws surrounding trading and why it is important to be well capitalized.

All this and more is covered in the next chapter.

CHAPTER 2: BROKERS AND MARKET REGULATIONS

The broker is usually the only person in the market who is guaranteed to make any money. Too many beginners place far too much importance on the broker and the functions they perform. This is not to say that the broker is important, just that beginner traders tend to blame their broker for things that are really not the broker's fault.

In this chapter, we'll being by looking at brokers and price charts, cover the basics of option quotes in most broking platforms and end with a word about market regulation.

PLATFORMS

When it comes to brokerage services, you have two choices: discount or full service. Full service brokers provide end to end options (service options that is, not the instrument) to help separate you from your money. This might sound cynical but is really just the nature of the brokerage business.

A broker's only duty is to execute your trades. It is not to provide investment advice or trade ideas, neither is it to provide research reports on the market and express opinions which can guide your trading decisions. Do not make the mistake of assuming that just because a broker is an old institution and has many different lines of business, such as wealth management solutions and so on, that they are better than the rest.

For this reason, discount brokers are your best choice since they tend to reduce their focus to just what a broker is really supposed to do. They will do this at lower commissions and will remove a lot of the fancy accessories like having a personal relationship manager or a phone hotline for you to phone in your trades.

To clarify, I'm not saying that you should never invest your money in the markets with the big banks. If you have access to a good financial planner and they recommend certain services, go for it. My point is that trading is a separate business and you should not make this a part of your retirement plan. Rather, you need to treat trading profits as a nice bonus.

Having this mindset will remove the need for you to make money and will remove a lot of the emotions which will sabotage your trading efforts. For example, doubling down on losing trades and taking profits too early are telltale signs of the fact that you feel the need to earn some money to pay for your living expenses from trading.

Trading should be conducted as a business and your broker is much like a supplier if you were running a grocery store. You need a decent level of service but the costs need to make sense for you to turn a profit. If a washing powder supplier began telling a grocery store owner how to price her products or what margins to charge the customer, you can bet the supplier will be told to shut his mouth post haste.

However, people seem to expect this same nature of investment advice from a broker. The more you trade, the more the broker earns and this conflict of interest escapes a lot of beginners. The long and short of all this is, choose a discount broker and make your own trading decisions. Do not

ask for investment advice or any advice at all from your broker. It just puts both of you in an uncomfortable position.

When it comes to trading options, you need to have the basics in terms of trading platforms. These are a price chart with real time data and the ability to superimpose indicators on them. Live option chain information (I'll explain what an option chain is shortly) and metrics such as open interest and market event news and timings.

Every broker out there has these fundamental features so simply choose the one which has the lowest commissions and good rates. It is advisable to have more than one broker once your account size builds up to over fifty thousand dollars just to distribute your risk more evenly. Until then, sticking with one broker is fine.

PRICE QUOTES

When it comes to price quotes, you need to be aware of three components: the bid, the ask and the LTP. Let's start with the LTP first. LTP stands for last traded price and is the price you will see on the ticker board and on a lot of financial media. This price is simply the last negotiated price and reflects the trade price of the latest trade.

Do not make the mistake of thinking this is the market price. In reality, there is no market price but more of a band within which price trades. This band is called the spread. Instruments which are traded heavily, that is have huge demand and supply, will have a low spread and less liquid, or thinly traded, instruments will have a large spread.

Spread implies a gap between two points and these two points are the bid and the ask. When you fire up your trading platform, you'll notice that price is quoted in a box as two numbers, the bid and the ask. The ask is the price that is being offered to you on the market in case you wish to buy the instrument. The bid is the price you have to pay in order to sell it.

The gap between the two is the spread. As you can imagine, the spread size doesn't always remain the same. In periods of high volatility, that is when there is a massive demand or supply that occurs suddenly causing huge swings in the bid and the ask, the spread will increase in size and might also narrow suddenly.

This usually occurs during important news announcements or during other events such as interest rate announcements and so on. The bid and the ask will jump up and down by many greater points of magnitude than usual and this will manifest itself as major spikes and troughs in the price chart, or wider candles and gaps in between them. Figure 7 illustrates what a gap is.

Figure 7: A gap in price bars (MetaTrader 4, 2015) (MetaTrader 4, 2015)

Either way, the point is that you should be aware that the LTP is not the prevalent market price but is just a reflection of where the spread was. Where the spread is now depends on the current volatility within the market. It might be close to the LTP or it might be far away. As a beginner, it is best to stick to instruments which have low volatility and high liquidity. In other words, instruments which have a low spread and where the LTP is usually a good reflection of where the spread currently is.

Options prices are quoted in the same manner and usually, an option quote has all the information you need to know contained right within it.

OPTION BASICS

An option is a contract that is struck between two parties, a buyer and a seller or writer. As mentioned earlier, options are derivative contracts and can be derived from an underlying stock or FX pair. The writer of the option agrees, when writing an option to or selling an option to the buyer, to buy or sell the underlying stock at a given price called the strike price before a certain date, called the expiry date.

The buyer can choose to either exercise the option or not before the expiry date. In return, the buyer pays a small amount, called a premium, to the option writer/seller. Thus, when you check the price of an option on a stock, you'll see the spread indicating the premium prices at which you can buy or write the option. This premium is dependent on the underlying stock price but is not the same as it.

Options contracts come in two flavors, calls and puts. A call is where the writer agrees to sell the underlying stock to the buyer at the strike price and a put is where the writer agrees to buy the underlying from the buyer. In other words, if you buy a call, you can buy the stock at the strike price and if

you buy a put, you can sell the stock at the strike price.

As an example: Let's say you like the look of AMZN and think that the stock is going to increase in price. In such a case, buying a call with a strike price that is close to current price is a good bet. If the stock rises in price, the option will move into the money (that is it will make you money if you exercise it) and you can buy AMZN at the lower strike price by exercising the option.

Similarly, if you think AMZN is going to decrease in price, you buy a put and when it does decrease, you sell AMZN at the higher strike price by exercising the put and buy it back at the lower market price to make a profit. What happens, if AMZN doesn't move in your favor though?

Well, this is where options are great. If your option is not in the money by the expiration date, you can simply let it go. You will lose only the premium you paid for the option when you bought it. AMZN's stock price is currently around $1889. If you wish to buy a hundred shares, it's going to cost you a cool $188,900. However, the 1850 put expiring on August 2nd costs just $52.03. Each option contract represents 100 shares of underlying stock so you would pay $5203 for control over one hundred AMZN shares.

Contract, both puts and calls, exist for all combinations of prices and expiry dates. Thus, you will have a call and put option for $1800 expiring this month, next month, the

month after and so on. Usually, contracts are thinly traded, i.e. illiquid, beyond expiry dates two months out.

This collection of contracts are called the options chain and is simply the list of premiums for every combination of option type (call/put), expiry date (this month, next month etc.) and strike price ($1800,$1810, $1790 etc.). As mentioned previously, when exercising an options contract will make you money, it is said to be in the money. In the case of puts, this is when the stock price is less than the strike price and in the case of calls, it is when the strike price is below the market price.

In your trading platform, you will see a label termed "options chain" and this will display a table of strike prices for a given date for both calls and puts.

MARKET REGULATIONS

Trading options involves borrowing money or stock, also called margin. When you decide to exercise a put, you're borrowing stock from someone else, which the broker has to arrange and you will need to pay interest on that borrowing. Thus, the SEC and FINRA, who are the regulators of the stock and options markets, stipulate that brokers require a minimum investment amount in the trading account.

Now, there are usually five levels of risk, when it comes to options trades as defined by brokers. The strategies identified in this book will put you somewhere between levels one to three, depending on the broker. For such levels, you can expect a minimum balance of around five thousand to ten thousand dollars.

Furthermore, you also have to content with the pattern day trade rule. A pattern day trader is someone who executes four or more trades within five business days(Chen, 2019).

Thus, if you buy and sell two options contracts between Monday to Friday, you are a pattern day trader. FINRA stipulates that such accounts must have a minimum of twenty five thousand dollars as a balance.

This is why I mentioned this amount as being the minimum amount of capital you must have if you wish to trade options. Now, is it absolutely necessary to have this amount? Could you trade with less? Sure, you could. However, you cannot enter an exit your trades at will. Remember, every trade execution is counted, not just your entries.

Trading is not an exact science where you'll say that you'll always exit your trades after a week. This is simply handicapping yourself and will slow your progress. Using the earlier example, it's a bit like deciding to walk to LA from New York because you can't afford a flight. It's better to save up and buy a ticket than to walk all the way which will cost you more in the long run.

There are a number of experts out there who have tons of YouTube videos explaining how you can avoid the PDT tag and still trade. All I'll say is that such advice is a sure sign of a con artist. Be wary if you do choose to follow such people.

Now that we've looked at the capital you'll need and understood which regulations govern you, let's take a look at some technical analysis basics.

CHAPTER 3: TRENDS/RANGES AND SUPPORT/ RESISTANCE

Unlike other books on trading, I'm not going to list out every technical indicator out there and pretend that these constitute trading strategies? Why? Well, it's far easier to simply look at the price chart and make your decisions there when it comes to trading options.

You can use indicators, but every indicator out there is simply derived from price charts and marmet mechanics. Isn't it far better to interpret things at the source than to superimpose something else on top of it and try to draw conclusions? The source of all market information is the order flow and we can interpret order flow but looking at the presence of trends and ranges and secondly, via support and

resistance levels.

TRENDS AND RANGES

Market price action can be classified into two states: trends and ranges. Trends are when the market is headed in a definite direction and ranges are when it is going sideways. Trends have greater profit potential as you can imagine, but can be difficult for beginners to trade.

This is because the price is constantly moving away from levels and it can be difficult to spot an ideal entry point. By the time you think you've spotted a good entry point, price has already moved well beyond it or has simply not pulled back to where you think it was going to.

This is why I always recommend that beginners learn ranges inside and out and build some skill trading them first. By trading ranges, you will establish a baseline profit level which can then absorb the missed trades or losses you will incur by trading trends.

Identifying ranges is fairly straightforward as we'll see next.

RANGE IDENTIFICATION AND PROFITING

Figure 8: A Range (MetaTrader 4, 2015)

Figure 8 illustrates a classic example of a range. As you can see, looking left to right, price is moving sideways. A range

will always have easily identifiable boundaries at the top and bottom. In this case, we can see the peaks that price makes form a pretty stable boundary on top and a relatively clear one at the bottom.

Now, this is a point where most beginners trip themselves up. You cannot expect price to line up exactly in a horizontal line. In fact, price will almost never do this. Thus, when trying to make support and resistance zones or range boundaries, which are S/R zones themselves, always look for a zone.

This is why in figure 8, you can see four lines, two at the top and two at the bottom, which signify the upper boundary zone and lower boundary zone. Note that price pierces this zone multiple times to the top and bottom. However, when marking the zone, we are most concerned with the areas where the majority of price action lines up, not every single point.

Thus, as this range progresses, we have a very simple and straightforward template for making profits. As long as the price is in between the boundaries, we will short the top and go long off the bottom. In other words, we can sell the instrument when it reaches the upper boundary and buy the instrument when it reaches the lower boundary. To make a profit, we can choose to ride price all the way to the other boundary or take an earlier profit.

If you're trading directionally, as in the previous paragraph, you will need to place your stop loss orders beyond the zones. However, with options, we don't need to worry about such things. I'll later be explaining the collar trade which will eliminate all risk in such situations and is a non-directional trade. However, you can trade directionally using options as well and buy a put at the top of the range and buy a call at the bottom.

Ranges typically occur at the end of long trends and prior to the start of one. These types of ranges tend to have redistribution going on within them, in other words, the buyers and sellers are trading places of power in the market. We'll see why this happens in the next section.

Either way, you can safely trade the tops and bottoms of ranges that occur at the end of trends and within trends, it is safer to trade in the direction of the trend as use the range as an entry point. For example, in a bear trend, shorting the top of the range in anticipation of a move lower, and the trend continuing is a great example of an entry into the larger trend.

Often, you will see a trend on a high timeframe, say the daily timeframe, go sideways for a bit. This sideways movement, on the lower time frames, usually the five minute of fifteen minutes, prints as a range and you can either trade this range or use it as an entry point to enter the higher time frame trend.

Whatever you do, stay away from the middle of the range since this is where order flow, that is trader presence, is the least and price flow is unpredictable. Always trade from areas where order flow is the highest.

TREND TRADING

I will reiterate here that you need to practice and master trading ranges before trading trends. You need to understand order flow mechanics in greater depth before being able to trade trends successfully. In terms of trading options, however, you need not fully learn this before beginning to make money since the strategies I will illustrate later are market neutral, that is to say, you'll make money no matter which way the market moves.

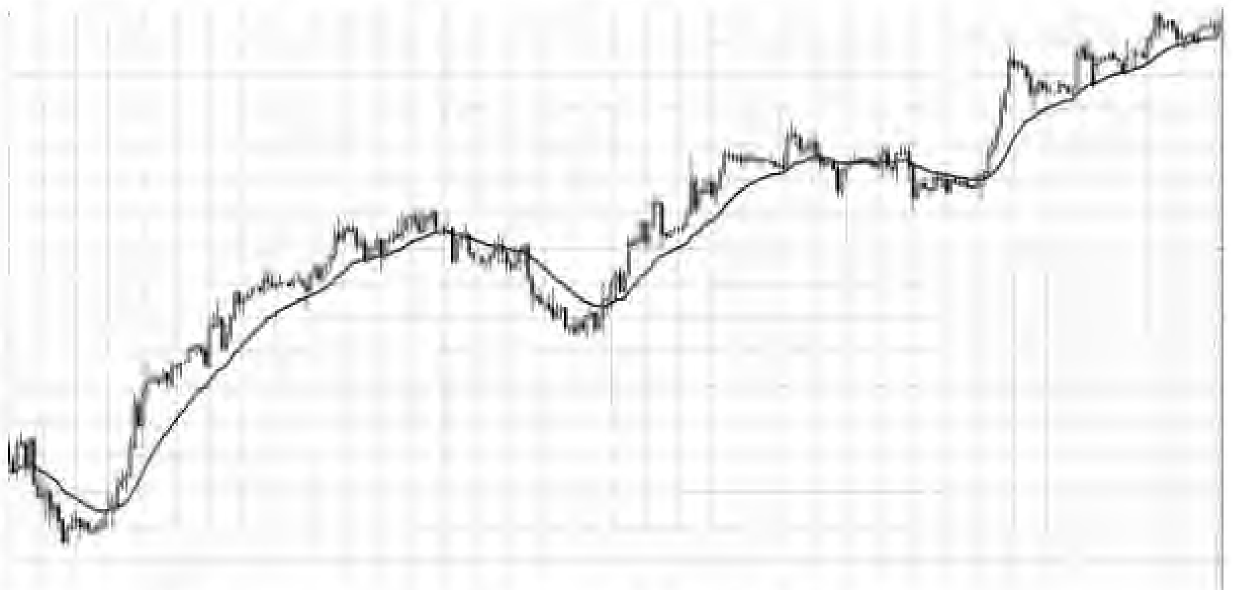

Figure 9: An uptrend (MetaTrader 4, 2015)

Figure 9 illustrates a long bullish trend. Notice how price doesn't simply move upwards at a constant angle but goes up, sideways and even down on some occasions before eventually moving upwards. Trends are fundamentally the result of one set of traders, representing one side of the market, overpowering the other side of the market and thus pushing price in a given direction.

As the other side pushes back, a struggle ensues and much like a battle, this sequence is a series of attacks, strategic retreats and defeats. The ultimate aim for both sides is to dominate the market and the stronger a side is, the steeper the price curve.

Notice how on the left of figure 9, price is almost vertical. This is because there are no sellers present and the buyer push forward with impunity. However, as the trend progresses, the angle of attack with which price moves forward becomes shallower until price moves sideways, dips back to a deep level where buyer reassert their dominance and then push prices higher.

Now, if this were a book on directional trading, I would go into identifying order flow mechanics and how to determine whether the buying pressure or selling pressure in faring. However, when it comes to trading options, all you really need to be able to do is to identify trends and ranges, especially the latter. While it is good to build your skills and identify the strength of the current trend, it isn't necessary

for you to trade options successfully.

Overall, understand that ranges result from order flow where both the bulls and bears are equally strong and trends from order where one side is stronger than the other.

Of far greater importance is your ability to draw proper support and resistance levels.

SUPPORT AND RESISTANCE

Support and resistance is quite misunderstood when it comes to trading. A lot of traders, sadly even advanced ones who should know better, treat S/R as a bunch of lines on a chart. The reality is that S/R is the biggest imprint of order flow and provides the best entry points into the market.

By best, I mean entry points where risk is as low as possible for a given reward. The risk of entering at a strong S/R level is low because this is where you will find greatest support from likeminded traders who will push the price in your favor. Reading S/R and entering correctly is thus simply figuring out the intentions of the market and joining the dominant order flow at the right moment.

Some key forms of S/R are as follows:

1. Swing highs and lows
2. Prior areas on a chart where price reacted significantly

3. Dynamic S/R like the 20EMA or Fibonacci levels
4. Range boundaries.

We've already seen how price can repeatedly ping off range boundaries and provide excellent entry points. Let's look at the other three and see how they work.

MAJOR AND MINOR LEVELS

Figure 10: S/R levels, minor and major (MetaTrader 4, 2015)

Figure 10 illustrates how powerful S/R entries can be. The picture looks a bit crowded at first but perfectly illustrates the different kinds of S/R levels you will see.

First off, from an overall market perspective, we're looking at a portion of the price action which shows the end of a

bear trend, a range where orders are redistributed and the start of a bull trend. This is on the four hour timeframe, so each bar represents price action for four hours, and the instrument is the FTSE 100 which is the UK stock market index.

If you look at the horizontal lines on top, they signify the top of the range. Now, this range isn't particularly clean but the level is valid because, as you can see from the circles on the left, price clearly is being pushed down by the bears at this level. Eventually, the bulls don't manage to bring it back here until much later, to the right of the chart.

As price re-approaches the top of the range on the right, strangely, the bears don't mount any resistance and a short at this level would have resulted in a loss. However, look at what happens next. Price goes past the level, forms a pin bar on it, signifying the continuation of the uptrend, and then dips back into the level to use it as support to move further on. Thus, we can see that the top of the range served as resistance first and then turned into support. If you were looking to trade with the trend, once the range broke, the prior top of the range was an excellent entry point.

Similarly, the triangles illustrate the price behavior at the bottom of the range. Notice how the bear trend exhausts itself at the first triangle on the left. While the retest of this level on the right is unclean, traders still remember this level and price uses it as support to ping back upwards.

These two levels, the prior range boundaries, are the major S/R levels on this chart. The greater the number of hits on a level and the stronger the reactions from that level, the greater a level's importance.

As price moves its way back up from the second triangle on the right, we encounter an example of a minor resistance level at the two squares. Here, price pull back and forms a minor swing high at the first square. It then dives down and then rushes past the swing high, and uses it as support on its way up.

Price here behaves much like it will shortly do when it will break the range boundary on top. However, the squares are a minor level and not a great entry point because at the moment they occur, the price is still stuck in a range. This level is far away from the bottom and order can be unpredictable. We could have gone down a few time frames and seen if there was an opportunity there but not on this time frame.

Next, we see a Fibonacci indicator next to the letter A. Notice how the price retraces to the 50% level of the Fibonacci and then moves back up? Well, this is another minor level for the same reasons as the squares. Price still hasn't broken out above the range and from a range perspective, this is not a good entry point.

If this had occurred during a strong trend, say right after it broke out of the range, then this minor level could have

been taken as an entry point.

The lesson for you to understand is that levels exist everywhere but stick to major levels the majority of the time and use minor levels only when the force of the order flow is extremely dominant in your preferred direction.

Now that you have a basic understanding of S/R principles, it is time to move on and look at risk management and mindset.

CHAPTER 4: RISK MANAGEMENT AND MINDSET

We've now arrived at the most important things which will ensure your trading success: managing risk and having the right mindset to ensure success. Options are an excellent choice for trading precisely because of their ability to manage risk better. This is why professional traders choose to operate with them in more complex strategies.

In this chapter, we'll dive into the basics of risk management and then look at the beliefs you need to possess in order to be successful in the markets.

QUANTITATIVE AND QUALITATIVE

Risk management is both qualitative and quantitative. The quantitative bit is far easier to understand since it is just a matter of crunching numbers and monitoring a bunch of statistics with regards to your account. Now, if you were trading directionally, the number of metrics you need to monitor are quite a lot.

Thankfully, when it comes to options, you only need to track a few. Let's take a look at these.

RISK PER TRADE

More than anything else, it is your risk per trade that determines your success. Common wisdom is to not risk more than two percent of your capital per trade and in the case of options trading, this is correct. Directional trading requires you to risk far less than this in order to be successful.

The true measure of a good trader is how consistent they are in risking the same percent of their account on each and every trade. A lot of beginners get on a winning streak at times and then start playing loose with this only to be hit by a big loss that wipes out all their prior gains.

There is a school of thought that proposes that risking a fixed amount per trade, as opposed to a fixed percent, is a better model. Now, you must understand that entire books can be written on risk management and I don't really have the space here to fully explain statistically why this is a bad idea. Suffice to say that, risking the same amount will bring you greater gains per trade and exaggerate your winning streaks but will do the same to your losses.

What's more, thanks to your losses being exaggerated, you'll have to constantly keep making more and more gains to simply breakeven and this will wipe out your account pretty soon since the basic math of all this is against you. Remember, you can't predict the outcome of most trades in advance with precision. Thus, it's best to risk the same percentage of your account every trade.

WIN PERCENT

The win percentage of your strategy, that is the number of times you make money, is one half of an important measure that determines whether you'll make money or not. Usually, thanks to the way we've been brought up and have had UR performances measured in school, we chase the highest win percentages, thinking ninety percent is better than forty.

Well, in academia this is true. However, in the chaotic world of the markets, this is far from the case. Making money on a trade is not about being right. You can be right about the markets and still lose money in the long run. This is best explained after we look at the second half of the equation.

AVERAGE WIN PERCENT

Your average win percent is the amount of money you win on average, when you do make money, expressed as a percentage of your account or as a multiple of the amount you risk per trade on average. So, if you risk R per trade, which might be 2% of your account, and if you make 4% on a win on average, you will make 2R per win.

The average win percent and the win percent together determine whether you'll make money or not. So out of ten trades, if you win two, a win rate of twenty percent, and your average win is 2R, you will not make money. This is because your eight losses will cost you -8R and your wins will only amount to 4R. This is a net loss of -4R.

However, if you make 5R on average per win, you will make money with a twenty percent win rate. In this case, your losses will add up to -8R as previously but your wins will add up to 10R, giving you an overall profit of 2R. If you risk

two percent of your account, this is a profit of 4% over ten trades.

Now if you manage to take two hundred trades over the course of a year, you'll be making 80% in a year. This is precisely what professional traders do make and it takes an extraordinarily high level of skill to hit such numbers. My point is that your profitability is determined by both numbers, not just a single one.

As you can see, it is perfectly possible to make money by being 'right' just twenty percent of the time. In a regular academic examination this will guarantee your failure, but in the markets, it's just one half of an equation.

STRATEGY EVALUATION

This gives us an excellent method of figuring out the profitability of strategies. If a strategy has a low win percent but high average win, it is perfectly valid to implement it, instead of trying to simply chase strategies that have high win percentages. For example, if you have the previously described strategy and another one with a 90% win rate but only a 0.5R average win percent.

Over two hundred trades, the previous strategy makes 80% but this strategy, which is correct 90% of the time, will make you 35% over the same number of trades. So, which is the better strategy? The one where you have more losses or the one where you have more wins? Clearly, asking which one has more wins or loses is missing the point.

So, don't blindly chase high win rates or strategies that claim you won't lose even a single trade. Such strategies don't exist, unless you run a hedge fund focused on HFT

front running strategies, in which case you might have run into this book by mistake. For the rest of us, evaluating both the win percentage and the average win size as a function of the percent risk per trade is what determines whether or not a strategy is good.

QUALITATIVE RISK

Let's say you settle down in front of your television on the weekend and switch on the TV to catch your favorite game. You're fully prepped and have your TV and assorted accessories set just so. Your friends have come over as well and all in all, it's a great atmosphere. There's just one problem: your team's star athlete, the one on whom the result of the game hinges has turned up to the game hungover.

Now, it isn't unheard of such things to happen in pro sports, but when it does happen, you can imagine the reaction that follows. The athlete is roundly criticized as a buffoon, rightly so, and the sports media have a field day debating where he's about to be traded to next. We instinctively understand that preparation is the key to success and turning up hungover is hardly good preparation.

Yet, how many of us sit down to trade after having just walked in from work? We're tired and frustrated from whatever is going on in that world and think we can simply waltz in and make money in the markets. The very same markets that are full of professionals who make a living

from it and are responsible for the management of many millions and billions.

Do you seriously think anyone can be successful trading this way? Do you think trading is simply a matter of learning the right strategies and then implementing it with the snap of a finger? If so, this is an indicator that your mindset is incorrect and that you don't understand what trading risk management involves.

Make no mistake you will need to prepare and have your wits fully about you as you sit down to trade. You cannot afford any distractions like checking your smartphone or try to wing something at the last minute. You need good sleep and need to exercise and eat well.

This is why I called the adrenaline filled, coked out atmosphere of trading floors in movies unrealistic because it is impossible to trade this way. A lot of beginners get seduced by this devil may care type of depiction and try to do the same when it comes to their own hard earned money. Needless to say, this results in a quick wipeout and the ones who will take their money are the traders who have prepared themselves.

You need to follow a specific mental and physical routine prior to operating in the markets. Meditation and other mental calming techniques are a great idea and will enable you to see things clearly, as they are. Also, avoid trading

when things are not going well for you with your regular life.

There's no rule that says you have to trade each and every day of the year. Take adequate time to reflect on your skills and practice them well. Practice them so well that you know them by heart. The live market is not a place for you to be questioning whether signal is valid or not. You simply need to pull the trigger and execute.

Sometimes, despite our best intentions, we fail to follow our plans. This is an indication that the problem is not so much with our technical strategy or risk but with our mindset.

MINDSET

Here's a fun fact for you: Our brains are not biologically wired for us to trade successfully. This is why close to ninety percent of traders washout within a year of opening their accounts at brokerages(Tradecity Trading Academy, 2019). The good news is that our brains are learning machines and we can teach ourselves the way to success.

The biggest hurdle we face is our in-built negativity bias. The negativity bias is a part of our survival mechanism that gives greater priority to things that are harmful to us than things which give us pleasure. Thus, you are more likely to remember negative experiences than positive ones.

This is precisely why a lot of people chase high win rate systems irrespective of the strategy's overall profit potential. We are so conditioned to think that a high win rate means the avoidance of a bad performance that we forget to take into account how much we make per win on average.

This is also why executing a twenty percent win rate system is so difficult and requires a very high degree of skill. A

twenty percent win rate implies losing eight out of ten trades. Most people cannot stomach losing two trades in a row, let alone being able to remain disciplined and absorb fifteen losers in a row (there is a 98% chance you will experience losing fifteen trades in a row if your strategy has a twenty percent win rate).

simply reading that last sentence has probably convinced you that taking the less profitable strategy from the previous section is a good idea but this is giving in to the negativity bias. To trade successfully, you need to build a different mental model when it comes to trading.

The type of thinking that favors a high win rate system is excellent in an ordered setting, like an academic one. In such settings, you provide correct answers and you get rewarded. The market however is not ordered. It is chaotic. There are far too many players, too many trading systems and motivation to ever be able to make sense of it all.

Thus, you need to think in terms of odds and probabilities. Probabilistic thinking is what separates the professionals from the also runs. Instead of being a gambler, you need to be the casino. This is actually a great example of how odds work so let's run with it.

A casino knows the odds of each and every game on its floor. It knows that game X has odds of sixty percent, or that sixty percent of the time, the house wins and the gambler loses.

Given this information, how does the house make money now? Well, first off, they fix the payout in proportion with the bet size.

The games that pay out a mega jackpot of over a million with low bet sizes usually have miserable odds, sometimes as much as ninety eight percent stacked against the gambler. The game pays for itself via the number of hands people play. Even if the odd gambler wins the mega jackpot, it doesn't matter since the odds will play out and even themselves out over the long run, and the house will make its money.

This is why gamblers are plied with free drinks and comped rooms. Everything is setup to get you in a good mood and ignore the fact that you're flushing your money down the toilet and are stacking the odds against you the longer you play. This is why jackpot winners are immediately comped rooms and treated like royalty because it is in the casino's best interest to get them to gamble those winnings and increase the house's profits.

Hopefully, you're seeing the parallels with trading strategies now. Why should you care about a single trade? The results of a large number are what matter since the odds express themselves over a large sample size, not a small one. Thus, even if you do lose fifteen trades in a row, this means you're more likely to win the next one since the odds will even themselves out the longer you participate.

Thus, your main focus should be in maintaining the odds and the math that goes with it. Changing your risk percent every trade skews the math out of your favor since your average win sizes are now skewed. You only focus should be to maintain the odds according to your calculations and focus on keeping your capital safe. The longer you keep your capital safe, the longer you play and the more you win.

A lot of us have toxic beliefs about money and becoming successful thanks to deeply ingrained programming. Perhaps we grew up poor or have a scarcity mindset when it comes to money. Use the below checklist to perform a mental checkup on yourself and see how you match up with those who have a proper and successful trading mindset.

Successful traders:

- Understand the odds of their system and know it inside out
- Are consistent with risk management
- Push the limits when it comes to expanding their skills
- Follow a structured and precise training regimen to develop their skills
- Recognize their negativity bias and limiting beliefs and implement techniques to combat this including:
  - Meditation

    - Visualization
    - Positive Affirmations
    - Breathing techniques
- Are well capitalized and do not seek get rich quick shortcuts
- Practice on paper first before going live
- Protect their capital at all costs
- Do not dream of Ferraris and yachts after a few wins on the trot
- Do not dream of despair and poverty after a few losses
- Do not need the market to validate their self-image
- Set their ego aside and follow their discipline and risk management rules

There are a number of books dedicated to helping you figure out how to get past your negative thoughts and to rewire your brain for success. Invest in yourself and commit to self-development. You will notice the benefits far beyond your trading results.

So now, having covered the basics, we're ready to learn options strategies which are low risk and will make you money. How well you execute them depends on your mental preparation and your dedication to your discipline.

So, without further ado, let's get into it!

CHAPTER 5: COVERED CALLS

The first options trading strategy we'll be looking at is the covered call. This is an evergreen strategy and is perfect introductory strategy to options for those who are already used to buying stocks for investment purposes. To be clear, when I say investment, I mean holding a stock for a long time frame based on fundamental factors of the stock such as revenue projections, earnings etc.

Investment of this kind is a very different beast from speculation and if you're planning on implementing the covered call with your day trading or swing trading positions, it's not going to work.

STRATEGY IMPLEMENTATION

The primary aim of the covered call is to reduce the cost of your stock holdings. For example, if you've purchased stock of say, Walmart, for $80 for your retirement account, your position is currently in a nice profit. As of the previous session, WMT is trading at $110.62. let's say you purchased two hundred shares for a total investment of $16,000.

If you could reduce your upfront investment in the stock, which is your cost basis, you stand to make a greater profit on this purchase. This is exactly what the covered call does. By writing a call option which is out of the money, you earn the option premium from the contract and thus, increase your profit. In effect, you earn money while you're holding the position. Let's look at this via an example.

KEY POINTS

Let's stick with WMT for our example. Current market price is $110.62 and your purchase price was $80. You have purchased two hundred shares. Your position is in a nice profit and you'd like to earn some additional money on this.

Covered calls require you to make a reliable estimate of future price. Now, the thing to do is to not worry about an exact price projection but to see if the ballpark projection makes sense. If WMT is in a strong uptrend, then you will need to push your projected price further away than if it is currently in a big range. If you can see that counter trend participation if becoming higher and the current trend in WMT is starting to go sideways, then you can risk a closer strike price for the call.

Let's say that WMT is in a situation where the trend is coming to an end. To earn a decent premium from writing the call, it is best to pick an option which expires at least two months from the current date. While this does expose you to price fluctuation over a longer term, if you can correctly read the market conditions, you will earn a higher

premium.

For example, the call option expiring on August 2nd, which is one month away as of this writing, with a strike price of $130 is currently trading at one cent. In other words, if you were to write this option with this strike price, you'd earn just a cent from it. However, the September 20th 130 strike call is trading at six cents.

The longer term option usually trades for a higher price because the stock has a greater chance of making it past the strike price. This is called the time premium within the option's price. If holding this position for this long is somewhat intimidating for you, you can choose a nearer term option but you'll have to pick a closer strike price to earn the same premium.

For example, the August 2nd 125 strike call is selling for four cents. This is not only lesser in value but also has a much closer strike price. The only advantage you have is that the term is closer. However, even that is offset by the fact that the strike price is a lot closer to the current market price.

A lot of beginners make the mistake of wanting quick profits and end up losing their positions because of their impatience and greed. Here we can clearly see that the longer term option is a better choice, provided our assumption of WMT ending its uptrend is true.

If WMT was in a strong uptrend showing no signs of stopping, picking a strike price that is further away, say 150, would work better. Yes, you would earn a lesser premium but your long stock position will make a nice profit so it's worth it. For now, let's stick to our original assumption of WMT ending its uptrend and write an option with a strike price of $130. All the numbers below are on a per share basis.

Cost of stock purchase= $80

Income gained from writing 130 call= $0.06

If WMT stays below the 130 level till September 20th, our numbers now look like this.

Cost of stock purchase= Original cost- Income earned from option premium= 80-0.06= 79.40

Income earned on investment= premium earned/original cost=0.06/80= 0.07%

If the market price remains the same in September as it is now, that is at $110,

Profit based on initial cost price= 110-80= $50

Revised profit= 110-79.5= $50.6

If you hold your stock position long enough and if you keep writing covered calls successfully, you will keep earning income on the investment, along with any unrealized capital

gains from the long position. In effect, it's a bit like owning a piece of real estate which appreciates in value but also provides you with rental income every month.

BOOSTING GAINS AND OTHER SCENARIOS

Keen eyed readers will have noticed that the income return on the investment doesn't really amount to much. Well, this was just an example so the strike price is not optimized for maximum income. This is a key point to note here, especially for beginners because it deals with the mindset you ought to have when writing covered calls.

The covered call is not a get rich quick strategy. In fact, nothing in this book is. The primary aim of the covered call is to enhance your long position's value and to keep reducing your cost basis over time. Thus, your primary aim with this strategy should be to supplement your capital gains with premium income that will accumulate over time.

The best case scenario for such a position is that your long investment keeps increasing in size and meanwhile, thanks

to the constant premium income, your cost basis keep decreasing until it reaches a point where it is impossible for you to make a loss because your effective purchase price is extremely low.

To optimize this strategy, do not implement it until you've already accumulated enough unrealized gains on your long position. This way in the worst case scenario, you will still be able to clear a profit. The worst case scenario would be you picking a strike price that is not far enough away and the market price crosses it thereby leading to the call being exercised by the buyer.

In this case, you will need to sell your long position at the strike price and your position will be liquidated. If the stock keeps rising, you will miss out since you won't have a position anymore. A lot of beginner traders encounter this situation and end up losing their long position.

I'll say this once again: the covered call is a supplementary income producing strategy. It is not a primary trading strategy. When you view it in this manner, you're more likely to pick strike prices on that basis of how likely the market is to cross that level instead of looking at it from a return on investment perspective.

The long position's gains should be viewed through the ROI lens, not the covered call's returns.

The best market conditions to deploy this strategy is a

ranging market, a bearish one or even a mildly bullish one. During extremely bullish markets, stay away from this since it'll be tough for you as a beginner to get a feel for the right strike price.

Is there a formula or a method to pick strike prices? Well, there isn't unfortunately. The best way to pick strike prices is to evaluate upcoming resistance levels on the price chart. If you spot a strike price that is beyond a strong resistance level that the price has previously reacted to, it is a good bet that price will react and spend time at that level again.

Thus, you need only be concerned with whether the breakout will occur prior to the call's expiry date, as opposed to whether it will ever break out at all like you would in a directional trade.

The covered call is an excellent strategy from a risk perspective as well if executed correctly. If you wait for a good profit cushion to be established on the long stock position prior to writing the call, there is virtually no condition in which you will take a loss.

Even if the call does get exercised, the strike price will be much higher than the cost price you paid. Of course, in the worst case scenario there is an opportunity cost but my point is that there isn't any risk of a financial loss if executed correctly.

This concludes our look at the covered call. Next, we're

going to look at collars which are also an excellent, zero risk strategy.

CHAPTER 6: THE COLLAR TRADE

Just like the covered call, the collar trade has three moving parts to it. It consists of a long stock position and a short, out of the money call just like the covered call strategy, and additionally a long put position.

By adding the long put position, you effectively cap the risk of this position no matter what the market does. This is something that no directional trading strategy will ever give you. Furthermore, the collar trade does not require any monitoring and pretty much runs on a little maintenance. Let's see how this works.

EXECUTION

The first step to executing the collar trade is to establish a long stock position. This can be done as part of your usual investment activities, or unlike the covered call, even speculative ones. If you become bullish on a stock because of technical reasons, but aren't fully sure which way it will go, hedging the risk of this position with a covered call will cap your maximum risk and give you a decent reward as well.

Once the long position is established, you need to buy an out of the money put, as close to the strike price as possible. Remember that buying a put gives you the right to sell the stock. Thus, if the market price decreases below the strike price of the put, you can sell the stock at the strike price and profit from the downward movement. Thus, the put protects you in case your bullish reasoning happens to be incorrect.

How far you choose to place your put is the key here. The distance between the strike price of the put and your stock purchase price is the loss you will have to take on the stock position, if it declines. Thus, if you choose a put with a

strike price just a few ticks below your stock purchase price, your risk on the stock purchase is extremely low. The farther away you go, the more you are risking.

The third step to executing a collar strategy is to write a call with an out of the money strike price, much like how you would do on a covered call. This price should be chosen with great care since it caps your maximum reward on the stock position. Thus, if you're quite bullish on the stock, you will need to pick a strike price that is farther out of the money than if you were just mildly bullish.

Writing a call will earn you a premium on this leg of the trade and will offset, by a little, the cost of buying the put to protect your downside. Thus, with your upside and downside capped, you don't need to worry about this trade anymore and are guaranteed a good profit whichever way the market moves, for an acceptable risk.

Let's further break this down via an example.

RUNNING THE NUMBERS

Sticking with WMT and its current market price of $110.62, we can see from its option chain that the September 110 put is selling for $3.45. This is the price we will have to pay if we choose this strike price for the put. Furthermore, let's say 130 is a good strike price for our call.

The premium for the September 130 call is 0.03$, which we will receive since we're writing the option. Thus, our numbers on this trade work out as:

Cost to enter per share= 110.62 (stock long position) + 3.45 (cost of put) - 0.03 (call premium received) = $114.04

Maximum risk or loss per share = Stock purchase price - Put strike price + cost of put - call premium = 110.62- 110 +3.45 - 0.03 = $4.04

Maximum profit per share = Call strike price - stock purchase price - cost of put + call premium = 130-110.62-3.45+0.03 = $15.96

This gives us a maximum reward to risk ratio of 3.95. If you were to cap your maximum risk at 2% of your account for this trade, your maximum reward will be close to 7% on just this trade. The worst case scenario would be if the stock remained firmly in position until expiry thereby making you zero profit and only costing you money, which is a highly unlikely scenario, given that we're giving this trade three months to work.

With collars, the longer you give your trade time to work out, the better your prospects are of collecting the maximum reward, provided you've read the bullish conditions correctly. If you spot mildly bullish conditions, which are not likely to turn bearish, then picking a longer timeframe for the trade to work is a good idea.

Another way of increasing the profit potential of this trade is to choose a put that is out of the money. This increases your risk, but will give you a higher reward if you're confident enough in your bullish read.

Taking the previous example of WMT, if you choose to buy the September 100 put instead of the 110, your cost of the put is only $0.77 as of this writing. This means:

Cost to enter per share= 110.62 (stock long position) + 0.77 (cost of put) - 0.03 (call premium received) = $111.36

Maximum risk or loss per share = Stock purchase price - Put strike price + cost of put - call premium = 110.62- 100 +0.77

- 0.03 = $11.36

Maximum profit per share = Call strike price - stock purchase price - cost of put + call premium = 130-110.62-0.77+0.03 = $18.64

As you can see, by choosing a put out of the money but keeping the call at the same level, you reduce your maximum reward risk ratio. The problem with this particular example is that the premium we receive for the call is not enough to compensate us for the greater risk we're taking on.

As such, picking a put strike price level for that is out of the money for WMT will not work in our favor and we'll be limiting our profits. However, this is the case with WMT because the outlook is bearish right now. Thus, the call premiums are low because no one is particularly interested in buying calls on a falling stock.

If conditions were bullish enough, you would see higher call premiums which would enable you to take a larger risk. Remember that your strike price levels need to match up with the S/R levels on the chart and that reward risk ratios alone should not govern these levels.

With WMT, if the 100 level was beyond a strong support zone, where price was unlikely to hit and 130 just before a resistance zone, this makes the trade more likely to hit its maximum profit potential than the prior case which gave us

a higher reward risk. So always remember to correlate your levels to what you see on the chart.

If the stock price does decrease, you have a decision to make. You can either exercise your put, take that profit and have it offset your long position loss by closing that lego ut as well, or you can keep your long position going and simply move the collar down by picking lower strike prices for your put and call.

This does increase the cost of your trade but if you're quite certain of the bullish nature of the market, this might be a good option to pursue. Having said that, I do not recommend beginners practice this because it is easy to fall into the trap of adding to a losing trade and trying to earn back the money you lost on the previous position. Thus, leave adjustments to when you have built up more skill.

The best method of making collars work for you is to purchase LEAPS. LEAPS are simply longer term options with expiry date which are a year or even two years out in advance. This way, you can be certain that your trade will hit its maximum reward level, no matter what. Just remember to risk the correct amount on the trade.

Collars should form the basis of your trading operations and it's a good idea to have a few collars going simultaneously in a few different instruments. This way, you'll consistently have profits flowing in and you can use these profits as a

bedrock from which you can trade directionally.

Directional trading will bring you bigger profits but carry higher risk and require greater mental skills to execute and wring every last cent of profit out of them. As we've seen with the two options strategies thus far, risk pretty much takes care of itself and all you have to do is to maintain the trade every once in a while, especially near the expiry dates.

The next strategy we'll be looking at is the spread trade.

CHAPTER 7: VERTICAL CALL SPREADS

Call spreads require less upfront capital than the previous strategies we've looked at, the collar and the covered call. While the covered call is a steady income earner for the main long position and the collar works with speculative and investment positions, call spreads are purely speculative.

The vertical in the name refers to the way the trade is structured and how it presents itself when viewed as part of the option chain. Options spread trades are a slightly more advanced form of trading and prior to getting into these strategies, it is best if you gain a thorough understanding of the collar and make steady income with it.

BULL CALL SPREAD

The bull call spread enables you to make money in up trending markets. The beauty of this strategy is that you can adjust your spread on the basis of the level of market bullishness, with more bullish markets requiring a high speed and mildly bullish ones requiring a lower spread.

The trade consists of two legs, a long call and a short call with the same expiration month. The long call should be close to or at the money and is the primary instrument for profit in this strategy. The short call should be decided on the same principles as the short on the covered call, with a strike price just far enough to provide a good premium but not too close that the market price would breach it.

As you can imagine the strike price levels depend heavily on the level of bullishness of the market. Generally speaking, it is a good idea to place your short call just beyond a strong resistance level. Let's look at how the numbers work with an example.

PROFIT AND LOSS NUMBERS

Walmart, WMT, is currently trading at $110.62. Let's assume a bullish outlook for the stock but not a heavily bullish one. Assuming we set an exit time of a month for this trade to work out within, the August 110 call, which is technically at the money will cost us $2.44 to purchase. Alternatively, you could also purchase the 112 call which can be had for $1.41. Let's go with the latter since this reduces our cost basis.

For the short call, given that our outlook is only for a month, a strike price of 120 seems reasonable since to hit this level a gain of 9% is necessary which seems unlikely to happen in just a month. The premium we receive for this option is $0.04. Thus, our numbers are:

Cost of trade entry= Premium paid for 112 call - premium received for 120 call = 1.41-.04= $1.37.

This also happens to be our maximum risk on this trade. If

the market price of the stock decreases, the long call will expire worthless but the short call premium will remain the same and thus cap our risk.

Maximum reward= Strike price of short call - Strike price of long call - Premium paid for long call + Premium received for short call = 120-112-1.41+0.04= $6.63

This gives us a very tidy 4.43 reward to risk ratio which any directional trader would give an arm and a leg for. You can increase the profit potential by laying around with the long call strike price but remember that your short call strike has to be taken into account as well.

Furthermore, you will also need to place your strike prices at sensible levels with respect to S/R zones. Your short call should ideally be beyond a strong resistance level or if your outlook is a month or less, beyond some level which is sure to give pause to price and delay its advance past it. The best level for a short call would be right at the resistance level since any price beyond this will result in an opportunity loss and any level below this will result in a less than maximum reward.

What if the market turns out to behave in the exact opposite manner than what you predicted? Well, in that case, you will need to adjust your trade by either moving your spread to lower levels, that is, picking lower strike prices for both legs and switching to a bear call spread strategy which we'll

look at in the next section.

All in all, the bull call spread relies on you reading market conditions correctly and more importantly, picking the right strike prices in line with S/R zones. If you happen to see price in a range, then using the bottom boundary as the long strike price and the top boundary as the short strike price is an excellent method to make money every month.

Start by implementing this in ranges and then progress to slow moving trends. Only once you've mastered these should you move onto fast trends.

BEAR CALL SPREAD

The bear call spread is designed to take advantage of bearish market situations. Now, keep in mind that in addition to bearish overall conditions, you can also make use of this strategy in ranging conditions, such as at the top of the range.

If you find a price at or near the top boundary of a range then implementing this strategy with a shorter term expectation for it to work will bring you good profits in the short run. The key as always is to ensure that your risk is covered and that your strike prices are in line with S/R environment.

The bear call, just like the bull call, has two legs to it. There is a short call and a long call but in the bear call spread's case, the short call is below the long call. The higher strike price long call caps our maximum risk while the short leg functions as the primary profit generator.

The short call should be at the money or as close to it as possible with the long call just beyond a strong S/R level. Let's look via an example how the numbers work for this

strategy.

PROFIT AND LOSS NUMBERS

Sticking with good old' WMT, we have a market price of $110.62 as of previous close. Let's assume this is at the top of a range currently and we expect the range to hold. Mind you, we don't know for sure which is why every trade needs risk mitigation.

You first step is to buy a call with a strike price beyond the resistance level. This will give you premium income and obviously, the closer it is to the market price, the more income you will earn. Of course, the danger of having it too close is that a momentary spike might jeopardize your strategy so you need to balance it out.

Let's say that 115 is a good level and that we expect this to hold for at least a month. The August 115 call costs us $0.50 to buy.

Next, we sell a call which is as close to the money as possible. As with the bull call spread, let's pick the 112 level

which will provide us with $1.32 in premium income. As a side note: the prices I've quoted for the 112 strike price option is different because remember that when you buy, you pay the ask price and when you sell, you pay the bid. In this case $1.32 is the bid price.

Our number work out as:

Maximum gain/cost of trade entry= Premium from short call - Premium from long call = 1.32-0.4= $0.92

Maximum loss= Strike price of long call - Strike price of short call - cost of trade entry = 115-112-0.92=$2.08

As you can see, this trade has a reward risk ratio of just 0.44. However, this is still a profitable strategy due to the fact that the win rate is usually quite high with this strategy. Recall the win rate and average win calculations we performed in the chapter on risk and you can figure out what win rate is required to break even and profit on this strategy.

Even this strategy can be adjusted to higher spread levels should you choose but this should be done only if the S/R and the market environment supports readjustment. If you misread a bear trend and the market starts becoming bullish, adjustment is not going to do anything for you.

Both the spread trades require you to read market conditions thoroughly and this why I recommend starting out with covered calls and collars which are market neutral. De-

spite the lower risk levels of the vertical spread trades, you will have to incur a higher level of directionality with them and this exposes you to further risk.

The bear call spread is a good example of this. Given the high win rate it needs to make you money, it is far less forgiving of mistakes than other strategies. Thus, you need to have a very high level of market and order flow deciphering skills, coupled with the right mindset.

There is money to be made but you need to build the correct foundation before progressing forward.

CONCLUSION

This brings us to the end of this guide to options trading for beginners. We began by looking at market basics and how price is represented in a chart. Remember that you can use candlestick price formations as a further confirmation for an entry point in your strategies.

For example, if you wish to implement a bear call spread trade then sighting a pin bar at a major resistance level is a good indicator that price might be about to experience a downswing. Any candlestick pattern you wish to trade must be backed up by an appropriate price environment. For example, sighting a pin bar in the middle of a range, or in a small sideways movement in a massive upswing is not a strong sign.

While deciphering price environments is a tough task, you can begin by trading ranges. Ranges tend to be quite stable and their sideways movement ensures that the price will not run away from you, as in trends. Trends will give you the biggest profits of course but getting into a trend at the right time is a tough task and more often than not, your

entry will be suboptimal.

Options remove this particular problem thanks to the fact that you need to pick strike prices, not entry levels as with directional trades. However, begin with ranges and then move forward. Your ability to decipher ranges versus trends is all for naught if you cannot practice proper risk management.

The true measure of risk management is consistency and this involves a lot of things, most of all discipline. It takes discipline to stick to your risk limits per trade and not fall prey to the trap of increasing your risk per trade chasing potential profits. We've seen how the math of your profitability gets skewed when you are inconsistent in this regard.

Your mindset might be at fault if you find it difficult to stay disciplined. A lot of us grow up with toxic ideas of money and success and sometimes, it's easy to view money as the only key to happiness. This puts us in a terrible position when we take a loss, as is inevitable in trading, and puts us in the all or nothing type of mindset which is common in academics and usual job scenarios.

Trading is not your usual atmosphere however and needs to be treated as a business. You need to understand how the odds work and if you keep understanding intellectually how odds work but still get upset over a few lost trades, your mindset is at fault.

Finally, we looked at four profitable options trading strategies which you can implement today. The covered call and the collar are market neutral strategies which will provide you with a decent income per month. Following this, look to implementing the call spread strategies outlined in the final chapter.

There are a number of permutations you can play around with when it comes to the strike prices so keep this in mind when you choose them.

A lot of practice is necessary for you to be successful as a trader so make sure you constantly practice your skills of identifying S/R levels and market environments. Keep practicing and you will get there.

Thank you very much for taking the time to read this book. I'm positive it will help you trade better and more importantly, show you how to make money immediately, almost risk free.

Please do let me know what you think by leaving a review, I'll appreciate it very much!

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