Notes on Trading Options…
Rick Warner, D.C.
For the full options trading video, go to www.massivebankaccount.com

The Big Myth About Options

I know… you’ve probably heard that trading options is risky and difficult.

Let me dispel that myth right now. With specialized knowledge, trading options provides less risk, and more return on investment than trading stocks.

So, take a deep breath. I’m going to try to make this easy for you.

Basically, options are “contracts” to buy or sell 100 share blocks of an underlying stock. An option contract allows one the right (but not the obligation) to buy or sell 100 shares of a particular stock at a defined price by a defined date. A call option allows one the right to buy a 100 share block of a specific stock by a specific date, and a put option allows one the right to sell a 100 share block of a specific stock by a specific date.

What the heck!

Don’t worry, it’s easy. We’ll do this step by step.

Some Analogies First

Some people have a hard time wrapping their heads around what an option is. Even if they have some knowledge of options, most don’t know how to trade them profitably.

Okay, for starters, from now on when you hear the phrase “stock options,” think of “contracts.” They are called “options” because the owner has the option to exercise it, or not. In our strategy, we will never exercise the option. We just buy and sell them.

Sounds complicated, doesn’t it? It’s not really. Contracts are used all the time.

Let’s say you are transferred to Tampa, Florida from Minot, North Dakota. The company needs you right away, so you head down there, leaving your wife and kids...
behind until you can find a house. In Tampa, you find a beautiful four bedroom house right on the bay. You email your wife a bunch of pictures, but you want her to actually see it.

So, you offer the seller $5,000 for an option to buy the house for $350,000 within 60 days. He agrees, and you have a deal. The option is transferable.

A month later your wife makes it down to Florida, and she hates the house. She’s afraid of hurricanes, and falls in love with another house away from the water.

But, the good news is that you find out that the house has already appreciated by 5% to $367,500. And, you find someone who wants the house so you sell him your option for $10,000.

You just made $5,000.

What just happened? Basically, for $5,000, you controlled an asset worth (originally) $350,000 with a contract.

You never actually owned the house, but you profited by buying a contract and selling it.

Here’s another example of the use of a contract. Do you remember when Southwest Airlines did better than other airline stocks when the price of fuel shot up in 2008?

The reason Southwest did okay was that when fuel prices were low, they purchased contracts (options) to purchase fuel at lower prices at future dates. They paid a premium, or cost, for those rights.

It’s basically the same thing in buying call or put options on stocks. Let me explain…
“Great traders control risk, while amateurs only think of profits…”

Why Options Can Be Safer and More Profitable than Stocks

Let’s say our stock trading system tells you that F5 Networks, Inc. (FFIV) will appreciate in price.

If we know how to trade options, we now have two methods of trading FFIV.

You could buy 1000 shares of FFIV (as an example). In that case, you’d pay $85 x 1000 or $85,000 (as I write this). Now you control 1000 shares of FFIV.

Or, instead of buying the stock, you could buy call options. Ten call options (again, think “contracts”) on FFIV controls 1000 shares of the underlying stock. If those call options cost $3 each, you’d pay $3,000 to control 1000 shares of FFIV ($3 x 100 x 10 contracts).

Let’s say FFIV goes up $1. If you bought FFIV stock, your $85,000 investment is now worth $86,000. You made $1,000 or 1.18%.

If you bought the calls, and FFIV went up $1, your calls may be worth $4 each (as an example). So, your original $3,000 investment in calls is now worth $4,000. You made 33.33%. Not bad.

Leverage

The best thing about options is that they provide leverage. With small amounts of money, you can control large amounts of stock. And, obviously, you can reap large gains with small investments.

Risk

If you trade options correctly, your risk is less than you’d have going long in stocks. Using our strategy in stocks, our risk in buying 1000 shares of FFIV is 7% (we used a maximum of a 7% trailing stop loss in trading stocks), or $5,950 ($85,000 x .07 = $5,950).
Using our option trading strategy (using a 50% trailing stop loss), our risk in buying 10 FFIV call options is only $1,500 ($3,000 x .5 = $1,500).

Option Terminology

Before we get in option trading too deeply, let’s get the lingo down.

At the money option- An option with a strike price that’s the same as the current price of the stock (note that some old-timers refer to “one-out-of-the-money” or “one-in-the-money” options as “at the money.” An “at the money” option may appreciate more closely as the stock rises, as compared to options that are further “out of the money” option.

Calls- a.k.a. “call option” or “call contract” is a contract giving one the right (not the obligation) to buy 100 share blocks of an underlying stock at a specific price by a specific date. In calls, think of “going long.” You buy calls when you believe the underlying stock will go up. By the way, you don’t have to sign this contract or even see a contract.

Expiration Date- Options expire at the close of trading on the third Friday of the month of its expiration. A November call, for example, expires on the third Friday of November.

In the Money- An option with a strike price that’s less than the current price of the stock. If a stock is trading at $75, a “November $70 Call” would be an “in the money call” option. An “in the money” option may appreciate more closely as the stock rises, as compared to calls that are “out of the money.”

Open Interest- The number of contracts available on the market. You want to trade options where there is at least 100 contracts available. This way you’ll have no trouble getting out of the trade when the time comes to close it out.

Out of the Money- An option with a strike price that’s more than the current price of the stock. If a stock is trading at $75, a “November $80 Call” would be an “out of the money call” option.
“Great traders control risk, while amateurs only think of profits…”

**Premium**- the cost of the option, or what a trader pays for the option.

**Puts**- a.k.a. “put contracts” or “put options” is a contract giving one the right (not the obligation) to sell 100 shares of the underlying stock at a specific price by a specific time. When thinking of puts, think of “going short.” You buy puts when you believe the underlying stock will go down.

**Strike Price**- The price at which the option allows one to buy (in the case of a call) the stock. For example, a November 75 Call on POT allows the contract holder to buy 100 shares of POT by the third Friday of November at $75 per share.

**Time Decay**- The price of an option may decrease or decay as it nears its expiration date. This decay can increase dramatically in the last two weeks before expiration.

**Williams %R**- an overbought/oversold indicator that we use in trading options. Along with other parameters, we buy calls when the Williams %R begins to rise after being between -80 and -100.

**Time**

Let’s say it’s August. A November 240 call will cost more than a September 240 call because you are “buying more time.” As it gets closer to the expiration date of the option, the price of that option will start to decay due to lack of time left to exercise the option. Again, the option price drops dramatically beginning about two weeks before the expiration date.

**A Typical Trade**

*The following is an example…*

Let’s say AAPL (Apple Computer) makes your watch list and meets your fundamental (the IBD criteria) and technical charting criteria for going long. You see that there’s two months before its earnings report. AAPL is selling at $239 a share, and let’s say the date is August 15, 2010.

“Always walk away with a profit… never let a green trade turn red.”

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You decide to buy AAPL options. You see that the November $240 call options on AAPL are selling for $4.75 (option pricing is based on a “per stock share” basis, but the contracts are for 100 shares, so $4.75 really means $475).

That AAPL call option gives you the right (but not the obligation) to buy 100 shares of AAPL at $240 a share by the third Friday of November.

Let’s say you bought five calls of the November $240 AAPL calls for $2,375 (5 x $4.75 x 100 = $2,375). A week later the same calls are selling for $6.25 each, or $3,125. So, in a few days you made $750 ($3,125-$2,375=$750). Not bad. That’s over 31% on your original $2,375 investment.

Compare that to buying 500 shares of AAPL. That would cost you $119,500. If the stock goes up a dollar, you make $500. You made 0.42% on your original $119,500 investment.

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<th>Investment</th>
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<td>500 Shares of stock</td>
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See why options can be a great way to go?

**How option contracts are identified**
(As of 2010 and beyond. Note that the online video was made pre-2010, and options were identified differently then).

The October, 2010 AAPL $240 call option is identified as “AAPL 100918C240”

AAPL 100918C240 AAPL refers to the underlying stock, AAPL

AAPL 100918C240 10 refers to the year, 2010

AAPL 100918C240 09 refers to the month, September

AAPL 100918C240 18 refers to the day after the Friday expiration date.

AAPL 100918C240 C refers to a call option.
How are Options Priced

Options are priced with a complicated formula called the Greeks (which you don’t need to know) based on the underlying stock’s volatility in price, and the time before the contract expires. Options quickly lose value as the contract nears its expiration date.

Where to view option chains

You can see the option chain for a stock by going to www.BigCharts.com (or possibly your trading platform’s website), putting in your stock, and then clicking “option chain.”

Our General Strategy for Trading Options

Remember, we are not “buy and hold” investors. In option trading, we use our system to find the stocks with the best chance of moving up rapidly. Due to leverage, the right options on that underlying stock will soar at an even greater rate than the stock.
As with stocks, in trading options, we want the overall market (DOW and NASDAQ) in an uptrend (in the case of going long). Thus, we’d want the DOW and NASDAQ to be above the 10 day moving average.

Only 20% of stocks are optionable; look for the “O” to left of the stock in the IBD, or go to FINVIZ, or www.BigCharts and plug in your stock.

You want to pick an option that is “at the money.” If an “at the money” option is not available, then trade a contract that’s closest to “in the money” or “out of the money” as possible. These options tend to move better. We want that volatility.

We are looking for options that will give us some time for the underlying stock to move… so, look for options that are 60 to 90 days out. If it’s August, look for November options.

In deciding to trade option, we first want to make sure the underlying stock meets all the criteria of our system, plus we want to add two additional criteria.

1. We want the Williams %R to be between -80 and -100. All the indicators should line up within a few days (as in the chart below). Naturally the price is the leading indicator and will increase first.

2. We also want the stock price to be above the 10 day moving average, but not so high that it’s due for a moving average pullback (MAPB). Recall that with stocks we used a 15 day moving average. Using a 10 day moving average in options
“Great traders control risk, while amateurs only think of profits…”

takes into account the volatility of options. You want the overall market to be in an up-trend. You want the volume to be above its average and increasing. You want the MACD crossed, on the rise and diverging.

**Setting up BigCharts.com for Option Trading**

- Use a six month chart.
- Use a MACD.
- Use Volume +.
- Use a 10 and 40 day SMA (in stocks we used a 15, 50, and 200).
- Use the Williams %R.
General criteria for all option trades

- We buy options for watch-list stocks.
- We check earnings dates for underlying stock as usual.
- We buy options between $1 and $5 (as a novice trader).
- We purchase 5 or 10 contracts (as a novice trader).
- There must be at least 100 contracts available in the “open interest.”
- The calls should be “at the money” or the closest “in the money” or “out of the money” options you can get that meet the other criteria.
- Buy and sell your contracts at a limit price, good till canceled, (not on a market order). Put your limit .05 cents less than the ask price and you will usually get filled.
- Place a 50% trailing stop loss under your purchase immediately after purchase.
- Print out your order for safe keeping.

Strategy for buying calls

- The underlying stock in an uptrend.
- The overall market (DOW and NASDAQ) in an uptrend.
- The underlying stock to be above its 10 day moving average (use a 10 day and 40 day moving average).
- Within two to three days, you want the Williams %R, a MACD cross to the upside, the price above the 10 day moving average, and increasing volume. The Williams %R usually comes first.
- The Williams %R is at -80 to -100 and rising (off the bottom).
“Great traders control risk, while amateurs only think of profits…”

Once in the trade, here’s the strategy for selling your calls

- The close bar of the stock is below the previous day-warning!
- The underlying stock turns down, and falls below the 10MA.
- The Williams %R is now at -20 to 0 and falling (it’s overbought).

Buying a PUT (going short)

- The underlying stock has turned down.
- The overall market (DOW and NAZ) has turned down.
- The underlying stock fell below its 10 day moving average.
- The Williams %R indicates overbought, and is at -20 to 0 and falling.

Selling the PUT

- The underlying stock has turned up-warning!
- The overall market (DOW and NAZ) has turned up.
- The underlying stock rises above its 10 day moving average.
- The Williams %R indicates oversold, and is at -80 and 100.
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Trade Options

Above is part of a platform for placing an order for an option. In this example, we would “buy to open” 5 September 47 calls on AKAM (AKAM 100918C47) at a limit of $2.14 each. So, the cost of this order would be $1,070 ($2.14 x 100 x 5). All trading platforms are different, but this is shown to give you an idea. Remember, to buy the calls, you “buy to open.” To sell the calls, you’d “Sell to Close.”

If you believe the stock will go down you buy puts. You’d “buy to open” the puts, and “sell to close” the puts to close the trade.

Resources

www.cboe.com
1-800-OPTIONS
The Bible of Option Strategies-Guy Cohen
New Market Wizard-Jack Schwager

“Always walk away with a profit… never let a green trade turn red.”

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McMillan on Options-Lawrence McMillan
Technical Analysis-Gerald Apel

Rick Warner’s phone: 813-924-3776