Trading on a Framework

Too many new investors and traders will put money at risk without having a trading framework. A framework simply means that there is a "structure" to your thinking about the markets and how to put your hard-earned money at risk.

Understanding the markets and how they trade requires a solid framework to operate from. If you are coming from a more directional trading background, you may think that the market consists of only one dimension: up or down.

But with options, you now have to deal with time. So you need to figure out where the market is going, along with how fast and how long it will take.

This means you must have a higher-order framework than those who just think in up-down terms. Your edge in option trading lies in the fact that you understand price, time, and volatility.

If you're a new trader one of the best ideas to conceptualize this framework is the fact that markets do move in cycles, across multiple timeframes.

What Are Market Cycles?

The most well known events in the stock market are bubbles and crashes. These are extreme cases where human behavior has reached a peak in either euphoria or panic.

Bubbles and crashes are fairly rare occurrences, but they do provide some insight into how market cycles work: they are a function of human behavior.

This means smaller movements in price action and volatility can still be characterized as shifts in human emotion. Because human behavior has yet to significantly change through the history of the markets, we can characterize parts of the Market Cycle into distinct phases.

Using a more advanced framework for option trading, we can determine the best course of action when putting on an option trade.

There are three total market cycles, and they each overlap and come into play at different times. The first and most well known cycle is price, the second cycle is trend, and the third cycle is volatility.

Why are the other two important? We know that in options there are two sources of supply and demand: the stock and the options premium. This premium is reflected in the option pricing models, and these models use the other two cycles as guidelines.

Cycle 1: The Supply and Demand Wave

Basic technical analysis is widely used to understand the first market cycle: price. This cycle is broken into 4 parts: accumulation, markup, distribution, and markdown. We can put this in pictures by considering that price patterns often resemble periodic cycles, which often go along with behavioral finance patterns:
This cycle is something we are all used to—stocks go up, then they fail to make newer highs as buyers stop coming in at certain prices because of valuation or the fact that everyone already owns the stock. Then the stock sees a markdown to find new buyers until accumulation occurs and fresh players step in.

Keep in mind that these patterns are fractal, which means they happen in different timeframes. You could have a secular bear market, but a cyclical bull, while the 5 minute charts are showing accumulation.

*The best tools to measure cycle 1 are price patterns, moving averages, and trendlines.*

**Cycle 2: The Trendiness of the Market**

When a stock or market goes from markup to distribution or from markdown to accumulation, we will see the trend weaken, and the market enters a state of “mean-reversion.” This means price is in "equilibrium," and any attempt to move out of this range will be met with sellers or buyers.

This will leave the market rangebound, and momentum wanes. This is when you see breadth divergences and other secondary indicators that tell us the easy, directional trade is off the table.

We know that the market has a much lower tendency to mean revert during markup/markdown phases. In fact, that’s what we know as a “trend.”
When we compare the overlay between the price supply/demand wave and the trend/reversion wave, we get something like this:

Because the trendiness of the market slows before the trend change, this cycle will actually show up twice as often because it is independent of direction. This is useful to know because, except for rare occurrences, trends never go from down to up or from up to down—there is a range first.

We can see that the red line hits a trough (mean reversion) when supply or demand are peaking, and it hits a peak during the middle of markup/markdown phases.

The best tools to measure cycle 2 are trendline breaks, RSI, MAC-D, and breadth readings.

**Cycle 3: The Volatility Cycle**

To understand this cycle, you must have knowledge of how the options market works. What we will see during a strong markdown phase in the markets is an increased state of fear by investors—and with that fear they are willing to pay a higher price for protection in an asset. This demand for protection will raise the price of options, and increase the implied volatility in the options market.

We can take the inverse of this relationship. As a market runs higher, investors have less fear and more complacency, so the demand for premium goes lower. This in turn reduces the price of options, and decreases the implied volatility in the options market.
When we take this volatility cycle and overlay it on the third chart, we have a leading “phase shift” relative to the supply and demand cycle:

![Volatility Cycle Chart](image)

Does volatility tend to lead markets? It’s a more complicated question than that, but there are divergences with respect to how much investors want to protect themselves—this does require a little nuance, but you can see how these relationships start to take hold.

> The best tools to measure volatility are Bollinger Bands, historical volatility, average true range, and normalized implied volatility readings.

**Putting It All Together**

If you can learn to conceptualize these three market cycles, you’re going to have an edge in the market. If you see that the volatility cycle may be putting in a bottom and there may be signs that we are going into a mean reverting market, it may make sense to sell bear call spreads.

Another example, if you think that a market is still in markup mode but a smaller cycle is going from mean-reverting back to trending, it may make sense to buy calls or buy call spreads.

**How InvestingWithOptions Can Help**

We actively use all three cycles in the analysis of stocks and markets. We use this edge to teach people how to become great option traders.

With IWO Premium, you have access to:

- nightly videos detailing markets and option trade ideas
- model portfolios to help you learn about position sizing
- trade alerts sent out every time a new trade is added to the model portfolio
- weekly webinars going over active and closed trades

Interested? Simply [follow this link to learn more.](#)