

Don't Let this Options Trading Trap Put You on Ice

Investors love the end-of-year holiday season. Most traders hate it, especially when using options.

Markets get quieter and, for the most part, float higher in a slow, steady manner. Investors watch their accounts grow while traders struggle to find opportunities to earn quick profits.

I see this dynamic play out almost every year, setting up traders for a difficult January.

And options traders stand to lose the most because they often don't realize that low volatility typically compresses options prices for the last two months of the year, in sync with slower holiday trading...

But when the action picks up in January as earnings roll in, volatility picks up, too. And that can easily lead to options price expectations getting out of line.

Think about it this way.

Let's say you are actively trading options on Advanced Micro Devices (AMD), just to use an example of a popular large-cap tech stock whose options chain gets plenty of action.

Typically, options that are \$5 out of the money and expire in two weeks trade between \$1 and \$2. January rolls around, and all of a sudden, these same options are trading at \$2 to \$3:

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Latest Price
(12:58 PM EST)

\$167.24

Indicators

GREEN ZONE (3m+)

UP-TREND (2m+)

HIGH RISK: 40.39%

Stop Loss Analysis

Statistics

My Opportunities

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List

Straddle

In The Money

Expiration

February 09, 2024

✓ Calls

Puts

Ticker	Strike ▲	Latest Price	Daily Gain	Bid	Ask	Volume	Open Interest
• AMD240209C00157500	\$157.50	\$11.45	-\$0.10 (-0.87%)	\$11.35	\$11.55	22.00	395.00
• AMD240209C00160000	\$160.00	\$9.43	-\$0.32 (-3.33%)	\$9.35	\$9.50	343.00	1,075.00
• AMD240209C00162500	\$162.50	\$7.58	-\$0.20 (-2.63%)	\$7.50	\$7.65	201.00	574.00
• AMD240209C00165000	\$165.00	\$5.98	-\$0.22 (-3.63%)	\$5.95	\$6.00	2,531.00	2,596.00
• AMD240209C00167500	\$167.50	\$4.60	-\$0.35 (-7.07%)	\$4.55	\$4.65	5,094.00	1,443.00
AMD240209C00170000	\$170.00	\$3.45	-\$0.40 (-10.39%)	\$3.40	\$3.50	7,740.00	2,402.00
AMD240209C00172500	\$172.50	\$2.55	-\$0.40 (-13.73%)	\$2.53	\$2.56	3,916.00	1,757.00
AMD240209C00175000	\$175.00	\$1.84	-\$0.38 (-17.12%)	\$1.83	\$1.85	6,094.00	2,603.00
AMD240209C00177500	\$177.50	\$1.31	-\$0.35 (-21.08%)	\$1.30	\$1.32	3,815.00	3,054.00
AMD240209C00180000	\$180.00	\$0.93	-\$0.31 (-25.00%)	\$0.92	\$0.94	7,320.00	9,044.00

Right away, you might think these options are expensive. And compared to the prices you would have seen back in December, they are. But don't forget that December is a low-volatility outlier, not the norm.

Or, if you could turn the clock back even further, you'd have seen options with those same criteria trading between \$3 and \$4, meaning January options prices are actually at or near a historical low.

That's why I always compare the price of an option contract I'm willing to buy or sell to similar options contracts going back a few weeks and a few months. This used to be a labor-intensive exercise, until I got ahold of *TradeSmith's* tools.

Checking Volatility Is Easier and Faster with *TradeSmith* VQ%

Our proprietary Volatility Quotient (VQ%) provides you with an objective measure of how current volatility stacks up to historic volatility.

This percentage looks at the volatility for the stock over the past year, updated every week. I like to compare this to the current implied volatility index for the stock and the VQ% over time.

Let's keep using AMD as a real-time example.

This is a weekly chart of AMD, with the price of the stock at the right edge and the VQ% at the bottom in green.



Immediately, I see that AMD's VQ% has been relatively stable since 2022, despite recent price gains in the stock. That's not entirely surprising, as the recent price movement is large relative to its historical price action.

AMD's current VQ% reading is 40.39%.

But the implied volatility for AMD near-term options (February: 68.9%, March: 55.1%) is significantly higher right now than AMD's historical VQ% of just 40.39%.

This is a snapshot of the options chain for the stock that shows you the implied volatility (IVx):

AMD

IV Rank97.9

TRADE MODE

TABLECURVEA

STRATEGY

CONFIG

POSITIONS

▼

Strike

Jan 30 Δ→

TRADE

▼

Feb 2, 2024

3d

IVx: 125.6% (±14.33)

TRADE

▼

Feb 9, 2024

10d

IVx: 80.4% (±16.74)

TRADE

▼

Feb 16, 2024

17d

IVx: 68.9% (±18.63)

TRADE

▼

Feb 23, 2024

24d

IVx: 62.7% (±20.30)

ACTIVITY

▼

Mar 1, 2024

31d

IVx: 58.9% (±21.85)

ACTIVITY

▼

Mar 8, 2024

38d

IVx: 56.3% (±23.10)

ACTIVITY

▼

Mar 15, 2024

45d

IVx: 55.1% (±23.68)

ACTIVITY

▼

Apr 19, 2024

80d

IVx: 50.0% (±29.03)

ACTIVITY

▼

May 17, 2024

108d

IVx: 50.8% (±34.61)

Source: TastyTrade

In this case, we're looking at the options chain right before the company reported earnings. For most stocks, implied volatility increases into earnings and decreases immediately after.

Nonetheless, we know that AMD's current implied volatility, and therefore its option-contract prices, are expensive right now. And we can use this to our advantage.

You see, implied volatility is mean-reverting. Just like a rubber band stretched too far in one direction, it eventually snaps back.

In the same way, when implied volatility gets too high compared to its historical averages, the odds are that implied volatility will decline. And when it gets too low compared to its historical averages, the odds increase that implied volatility will increase.

Implied volatility's tendency to gravitate back to its historical average offers a strategic edge.

By recognizing when it strays too far from the baseline — either swelling too high or dipping too low — astute traders can decide to either buy or sell options with an edge, playing the market's cyclical nature to their advantage.

In fact, I built a simple options screener to find stocks in the S&P 500 with implied volatility greater than their historic VQ%.

How to Screen for Implied Volatility with Options360

Simply login to your *TradeSmith Finance* platform and click on **Options** from the top menu bar, then **Options Screener** on the next row down. Note you'll need a subscription to our screening tool and *Options360* to get the most out of this screen.

(And if you don't see *Options360* in your *TradeSmith Finance* dashboard — and would like to — call 888-623-0858 to learn more.)

Next, click the **+ Create new screener** button.

For **Underlying Asset Filters**, click on **+ Manage Filters** and add:

- **Markets**, then select **S&P 500**
- **Average VQ**, and set to less than **50%**

For **Option Filters**, click on **+ Manage Filters** and add:

- **Options Strategies**, and click on **Options360**

- **Probability**, set to more than **75%**
- **Implied Volatility**, set to more than **50%**
- **Max Profit**, set to more than **\$30**

Then for **Display & Sort Results**, choose **Probability DESC** (descending).

The screenshot shows the TradeSmith Finance Options Screener interface. The navigation bar at the top includes links for Dashboard, My Portfolios, Markets, Invest, Options, My Services, Calendar, Pubs, and Baskets. A green arrow points to the 'Options' link. Below the navigation bar, the interface is divided into sections for filtering and sorting results. The 'Underlying Asset Filters' section includes a 'Markets' filter set to 'S&P 500 (SPX)' and an 'Average VQ' filter set to 'less than 50%'. The 'Option Filters' section includes an 'Options Strategies' filter set to 'Options360' and three filters: 'Probability' set to 'more than 75%', 'Max Profit' set to 'more than \$30', and 'Implied Volatility' set to 'more than 50%'. The 'Display & Sort Results' section shows 'Show top 50' and 'Sort results by Probability DESC'. A green arrow points to the 'Run Screener' button.

TRADESMITH FINANCE

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1 Underlying Asset Filters

Markets X S&P 500 (SPX) +

Average VQ less than 50%

2 Option Filters

Options Strategies

Buy Calls Buy/Write Covered Calls Sell Calls Sell Puts

All Strategies

Options360

Trade Cycles

Probability more than 75%

Max Profit more than \$30

Implied Volatility more than 50%

Display & Sort Results Show top 50 Sort results by Probability DESC

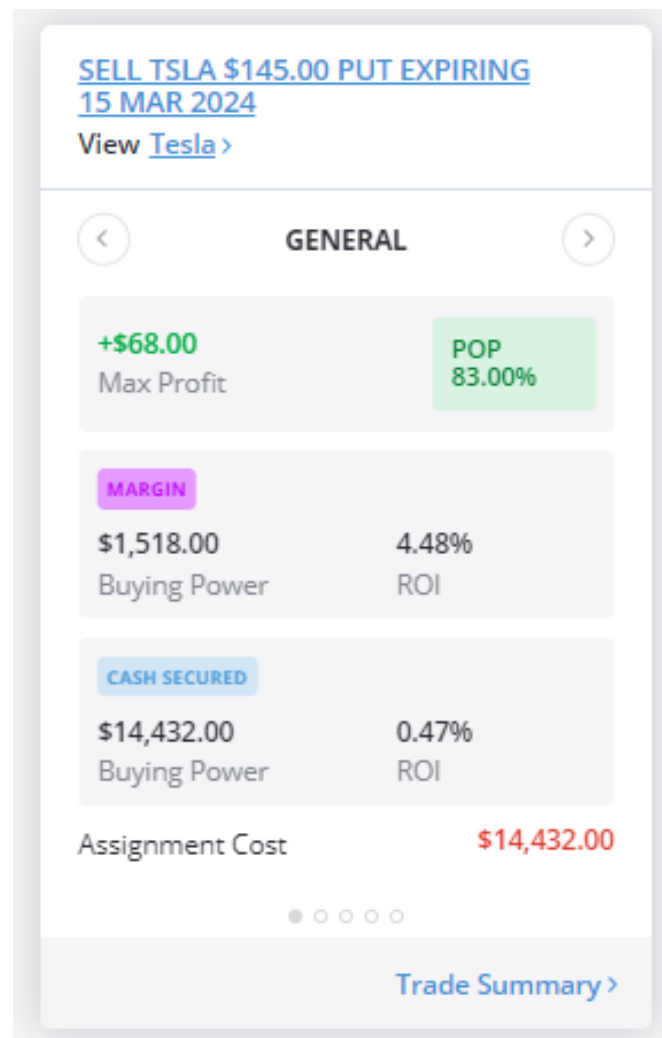
Save As New Save Changes Run Screener

This will help you find optionable stocks in the S&P 500 with an average VQ% lower than the current implied volatility of the underlying stock.

The Screener also searched for trades including selling puts, buying and selling calls, and buy/write covered calls that fit the bill (Probability more than 75% and Max Profit of \$30 or more).

My screen returned just four options, all on Tesla (TSLA). But keep in mind, you can always adjust the filters listed above to get even more results.

Let's take a closer look at the TSLA trade with the best return on investment (ROI).



By selling the TSLA \$145 Put expiring 15 March, you can earn \$68 in Max Profit with the upfront cash premium. That's a 4.48% ROI for just over a one-month holding period. This trade has a probability of profit (POP) of 83%, which is high odds that it will expire out of the money and you'll keep the Max Profit.

Mike Burnick's Bottom Line: *TradeSmith's* powerful VQ% isn't just another tool -- it's a compass to the ever-shifting landscape of options volatility. And with a simple options screener, you can find income-earning options trades with a high probability of winning.

Good investing,

A handwritten signature in black ink, appearing to read "Mike Burnick". The signature is fluid and cursive, with the first name "Mike" and last name "Burnick" clearly distinguishable.

Mike Burnick

Senior Analyst, *TradeSmith*