Working Money

TRADER'S NOTEBOOK

10 How-Tos For Option Trading

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by Ron Ianieri

Trading options can be risky business at best and disastrous at worst. Here, then, are 10 how-tos on how to handle it.

1) Get educated on option theory and option strategies and the greek risks.
Acquire an option theory education, especially about the greeks, and become well-versed in core option strategies. Without this knowledge you shouldn't be actively involved in the option markets. Options are great tools but they are not a "straight up" proposition like stocks or exchange traded funds (ETFs). There are complexities and risks to options that are not readily apparent. Not fully understanding how options work and how to assess the risk that an option position may entail puts a trader at a disadvantage. Put simply, the greeks identify and quantify the risks of the individual option or position for you *prior* to your putting on the trade. Who would enter any investment without knowing the potential risks before they entered? This is why the greeks are so important.

2) Be patient in the learning process and then trade small until you develop a comfort level.
A good way to get started is to build on a solid option theory education from an experienced trainer. Make sure the trainer is actually someone with professional option trading experience. From there, the use of a paper trading system is advised. Once you have experienced, and are comfortable with, the way the option or option strategy trades and reacts to movements of stock, time, and volatility, you can go to trading real money. As you start to trade real money, stay with very small amounts at first. Why? People get too comfortable and confident when paper trading. Things change drastically when real money is on the table. That cool confidence goes to hell in a hand bag when your nerves have your stomach feeling like a washing machine. Learning at a smart, patient pace then trading small to start can save a trader a lot of money.

3) Acquire a basic knowledge of charting.
While it may frustrate the diehard fundamentalists and random walk theorists among us, charting plays a significant role in today's markets. Chart theory and application are

increasingly cited in publications and other forms of media. Published studies now suggest that even modest technical analysis tools can greatly enhance returns over time. Having an idea of the potential future movement of the stock will make it easier to pick and construct the optimal strategy for the identified opportunity. Further, knowing even just a few key concepts of technical analysis can assist traders/investors in avoiding dangerous situations that are better left alone.

4) Get a broker who understands options, provides good option support, and will supply a set of tools to monitor and assess risk.
There really is no substitute for this requirement. If you're just starting to delve into the option markets, the last thing you need is a broker who's not experienced enough or well-equipped enough to assist you as their client. After all, that's what the commissions they are charging you should cover. Situations can unfold in the markets that will have even a seasoned professional option trader hesitating at times. It's times like this that your broker will need to be there to guide you through the trials that the market may conduct. At this point, there's no excuse for not providing some basic option risk assessment tools for clients. Option volume growth has been impressive over the last decade. A sure sign of an inferior broker is one who cannot provide you with adequate tools to assist your trading and position management.

5) Always know the risks of the trade and any possible news events that could affect your stock and options price -- that is, earnings, dividends, announcements.
The markets can be very unforgiving at times. In fact, with so many unforeseen events occurring in the markets, traders can at times do everything right and *still* lose money. However, there's no substitute for preparedness. The markets do not think of themselves as domains for people's hobbies. They are usually heart attack-serious, especially to most traders when their own capital is on the line. Traders have to understand as much about their risks as they possibly can. Staying apprised of the news and keeping an eye on known events or dates is the minimum requirement. It's better to have a beat on the sector or at least the macro market picture in general. While pure chartists may eschew any and all knowledge beyond the chart, things tend to happen in real-time that require a trader to think fast.

6) Develop or locate tools to help better rank and evaluate tradable opportunities.
The option trading arena is a vast one ripe with potential opportunity. While options can be of value to a trader who likes to look at 20 or so stocks, they are undoubtedly of greater value to a trader who has refined his approach with technology to effectively screen the more than 2,000 instruments available in the US markets alone. Many directional traders eventually transition into the option markets for superior risk management, cost effectiveness, and leverage. Most need only modify their approach to synergize with option strategies. That's an ideal way to go because they maintain their familiarity and thus their level of comfort while entering unfamiliar markets. Others new to both option and directional trading may be advised to explore several websites that cater to the option trading community. Becoming familiar with tools that help rank and evaluate potential trades is a great way to learn and improve as it expands the trader's scope of opportunities.

7) Consider subscribing to some type of mentoring program. Make sure to research potential mentoring providers.

For traders who think that the stock market can move fast at times, the option markets can move at warp speed! The leverage of options can accelerate matters. This can be bewildering for some new option traders who enter the markets without fully appreciating the risks involved. In fact, professional floor traders have been known to leave the floor at times in a daze. One way to avoid this scenario early on is to become involved in a mentoring program. While not inexpensive, this type of program is usually much less expensive than the market tuition many new traders find themselves paying at some point (usually much sooner than they expect). The truth, and most professional traders will tell you this, is that without a strong mentor at the start of their careers, most veteran traders wouldn't have lasted a year. Guidance from a true, expert guide can be priceless. One key is to check on how previous students are doing. It is one thing to be a good trader yourself, but it is another to be a good teacher as well.

8) Always analyze your future price and volatility movement and the effect of time to understand the inherent risk of your possible and current trades.

This is where a good risk management system is essential. Being able to walk forward in terms of time and option volatility levels is a feature found in most risk systems. This allows traders to anticipate profitability and risk in advance and thus prepare themselves to lock in profits, limit losses, and mitigate risks or to roll into other strategies. This is also one of the best ways to not only learn how options really work but to make sure it becomes second nature. Once a trader has reached that point, his or her confidence begins to lift and trading results rise in tandem.

9) Always evaluate where you are in the implied volatility range.

While there are many components that affect option prices, it's a rarity when any are more important than volatility. Extrinsic value is the essence of an option and volatility is the biggest component of extrinsic value. It's an absolute must to know where the current implied volatility of an option is in relation to its preceding range. This is volatility stochastic, if you will. Not understanding this has left many new option traders baffled when they've gotten their anticipated move from an underlying, only to *lose* money on the trade. Not knowing what volatility is and how it works is unacceptable. It's critical to have volatility working for you and not in opposition. A solid option theory education and a mentoring program will assure that a new trader knows the ins and outs of volatility. A rudimentary understanding of the math involved or definition of volatility is not enough. Unfortunately, most new traders tend to learn this fairly late into the game.

10) Do a volume/liquidity analysis.

Always try to initiate positions in products with liquidity. Options with low volume or poor liquidity are more difficult to extract profits from or to neutralize risk. The bid/ask spread can be much more cost-prohibitive than in the equity itself if it's a low-option volume equity. Trading against a specialist who knows your specific trade will not help you when it's time to close out the trade. This can be frustrating and costly. Restricting screening criteria to a certain level of option volume, market size, or bid/ask spread will keep traders from getting involved in thin issues. Be aware that open interest is not a truly telling form of measuring liquidity. True liquidity is determined by the size and spread of the market, not open interest.

Ron Ianieri

Ron Ianieri is a professional options trader with more than 100,000 trades under his belt and 14 years' experience on the option floor of the Philadelphia Stock Exchange, including a stint as the specialist in Dell Computer options.

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