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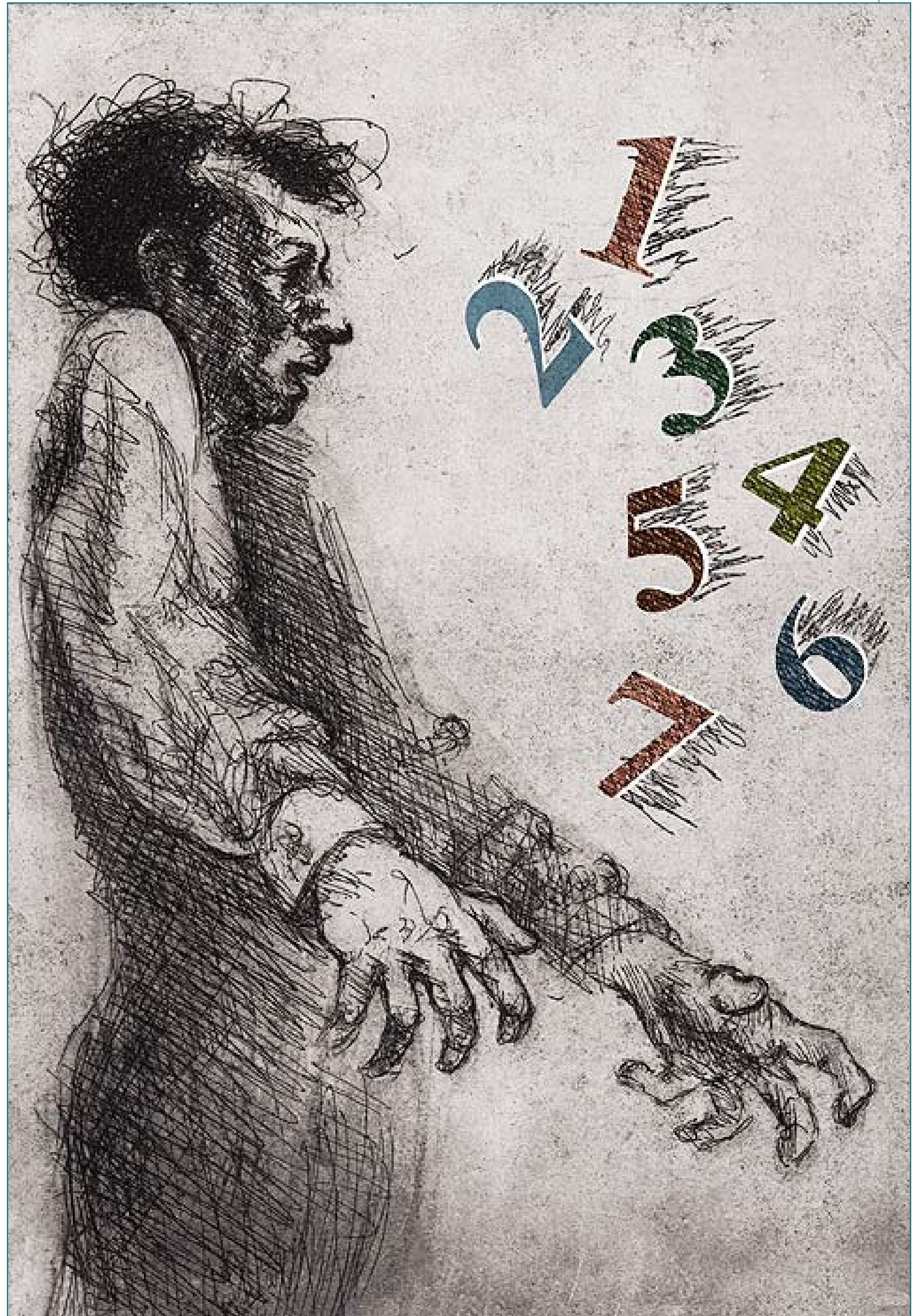
Seven Mistakes To Avoid When You're Trading Options

Before you take the plunge and start trading options, here are seven mistakes you want to avoid.

by Ron Ianieri



BRUCE WALDMAN

1. *Not understanding the independent effects of time and volatility on your option.* Have you ever bought a call when you thought a stock was going to rise, only to have it lose value when it did not? Blame time and volatility. Let's say that you believe XYZ Corp. will trade up from its current price of $47, so you buy a one-month call. You select the 50 strike calls and purchase them for $2.00. The stock moves up to $49 after three weeks. However, the calls are long and now only worth $1.00.

Many of us can relate to this scenario. Unlike stocks, an option's price relies on more than one variable. They are sensitive to the passage of time (theta) and changes in implied volatility (vega). These variables are independent of each other, the stock price movement, and the option's sensitivity to it (delta).

The selected option's delta made us money as the stock went up. Unfortunately, it was sensitive to time and volatility. These variables depleted more value out of the option contract than the delta put into it, creating a loss even with a rising stock. Without understanding time and volatility, you would not know what happened in this scenario and would probably be discouraged from trading options. By learning more about time and volatility, you can be better prepared to select the proper option.

Quick tip: Buy an in-the-money option with a delta around 80–85 the next time you want to put an option in place of a stock for a stock directional play. This option will mimic the stock closely. In-the-money options are much less sensitive to the adverse effects of time and volatility.

2. Forcing a preselected strategy on every opportunity. Too many investors and traders new to options make the mistake of learning a strategy and then applying it to every stock that comes close to fitting the profile. My colleague likens it to a carpenter going to work with only a hammer in his toolbelt. While a

hammer is a great tool, you cannot use it for every situation. If all you have is a hammer, everything starts to look like a nail!

Many different strategies are equally good under the right circumstances, but no strategy works in every condition. It is imperative to learn all strategies and be comfortable in employing them at the right time. Use the right tool for the right job.

Your eyes will play tricks on you if you look for a particular situation to employ a single preselected strategy. Instead of looking at a chart to see what the market is offering, you will force the strategy onto the chart the way someone tries to slam a square peg through a round hole. Consistent investors and traders follow one simple rule to avoid this situation: They find an opportunity, whatever it may be. Then they apply the proper strategy that fits that opportunity.

Quick tip: Learn every option strategy and understand the strengths and weaknesses of each one. This way, you are in position to apply the strategy that best fits the opportunity *and* you. First find the right opportunity, then apply the right strategy.

3. Not understanding the proper meaning of leverage as it applies to trading. "Leverage" has two definitions that apply to option trading. The first is the ability to use the same amount of money to create a larger position. The second definition of leverage is the ability to create the same-size position with less money.

As investors, the latter definition is the one we should focus on. Investors should always strive to have the same position, with less capital outlay. It shows a penchant for risk management — a characteristic possessed by all consistently successful investors.

Ten thousand dollars invested in options does not carry the same amount of risk as $10,000 invested in a stock; the option position has more. This is why we need to understand the proper use of leverage, which creates the same position size with less money.

Consider the following example. If we purchased 200 shares of a $75 stock, we would have a total capital outlay of $15,000. The entire investment would be lost if the stock traded down to $0. Although this occurs on occasion, it is extremely unlikely. The stock would have to lose 100% of its value.

If we invested that same $15,000 and bought the May 70 calls at $7.50, that would allow us to purchase 20 contracts, giving us control of 2,000 shares. This constitutes an option position that is 10 times greater than the stock position for the same amount of money. Sounds great, doesn't it?

The problem lies in the risk side of the equation. Unlike the stock position, which would lose the entire investment if the stock traded down to $0, the option position would lose the entire investment if the stock traded down to $70 by expiration. This represents only a 6.67% decrease in the stock price. A 6.67% decrease in stock price is nothing and happens often. Obviously, the risk scenarios are not balanced.

Thus, an incorrect definition of leverage is being applied here. We spent the same amount of money to obtain a bigger position. Unfortunately, an inordinate amount of risk accompanies the position and gives the entire investment an unacceptable amount of risk.

Quick tip: As an investor, you must learn to apply the proper definition of leverage to your position. You must also learn how to properly calculate the leverage of options to increase potential returns in a cost-efficient manner while incurring less risk — *not* more.

4. Not fully understanding the building blocks of option theory. Everyone wants to make a million dollars in the markets. Very few understand what it takes to do so. Most learn one strategy and then they are off to the races. What investors fail to realize is that you cannot understand a strategy that uses multiple options working in unison without understanding how the individual options work by themselves.

Selecting the right option for the right strategy is critical to your success.

There are essential and fundamental concepts in option theory that reveal an option's true nature and behavior for every individual contract. It also provides clues as to how any option will behave in conjunction with another as part of a unified strategy.

Many option instructors overlook three of the most important concepts of option theory: the greeks, synthetic positions, and the option pricing model. How and why some instructors teach option strategies without the proper foundations of option theory is almost criminal, but it happens all of the time. This is one of the biggest contributors to the failures of new option investors.

Once you have learned an options strategy you may ask, "What possible value can something called 'the greeks' have for me?" The answer will become obvious once you know what the greeks are.

The greeks are a group of statistical references that describe and quantify your option position risks to the variables that can affect the price of your options. They show you, down to the penny, what will happen to the value and nature of your position as movements occur in the stock price, volatility, and time.

If you do not know the greeks and enter into an option strategy, you are entering an investment without first knowing your risks.

Synthetic positions are constructed using a tandem of components that mimic another position identically. The value of this is multifold. It offers ways to create the same position in several different manners that show how options offer the industry's highest level of flexibility. Synthetic positions show you how options relate to each other mathematically, which in turn tell you how you can morph a position from one strategy to another in the most cost-efficient way.

Synthetic positions can also provide alternative entry and exit strategies that can increase cost efficiency, save commission costs, and avoid additional bid/ask spreads. If you do not understand and use synthetic positions, you are only using half of an option's power.

What about the option pricing model? To understand the behavior of a given thing you must first understand its nature. In order to understand a thing's nature, you need to understand its origins. The origin of an option lies in the option pricing model.

By understanding the pricing model, the investor will gain a keen insight into the nature of an option through the way in which it is priced and how it functions. From there, the investor can then get a better idea of how an option will react to changing variables by itself and in coordination with other options.

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Quick tip: Avoid courses that rush you into option strategies. They are only giving you enough knowledge to be dangerous to yourself. Consistently profitable investors and traders receive comprehensive instruction in options, not just in one strategy. Spend time and effort on your education and learn options the right way — from the bottom up.

5. Assuming that if an option is cheap or expensive is determined by dollar cost. One of the biggest mistakes investors make when looking at options is that they think that whether an option is cheap or expensive is determined by dollar cost. What they fail to see is that the strike price, among other things, predicates dollar cost.

Options with different strike prices have different values. These different option strikes have different deltas associated with them. One of the definitions of delta is that of a percentage chance. Since all of these options have an associated percentage chance of being in-the-money at expiration, they will have different values. This means that options that are already in-the-money have a better chance of finishing in-the-money and are more expensive.

Out-of-the-money options are less likely to finish in-the-money by expiration, so they are less expensive. Here, we have established that dollar cost does not dictate expensiveness or cheapness; strike price does. The question is how to relate the cost difference between options of different strikes to determine cheapness or expensiveness. This is done through implied volatility (IV), which is the only way to determine whether an option is expensive. Although options are separated by different months and strike prices, they are similar under implied volatility.

A higher level of implied volatility means a more expensive option and vice versa. Implied volatility is the unifying factor between the prices of all options. Using it, we can determine whether any option is truly cheap or expensive.

Quick tip: Education on volatility, and implied volatility in particular, is critical. This offers a better understanding of an option's true value. The study of volatility sheds new light on whether an option is cheap or expensive. It also reveals the importance of its extrinsic value, the essence of an option, which is largely a function of time and volatility.

6. Overcomplicating otherwise simple strategies. There are many different option trading strategies out there. Most are relatively easy. However, many investors wind up choosing a strategy that is much more complicated than necessary to take advantage of the given opportunity. Remember, the flexibility of options usually allows for more than one way of doing something.

This means that there is more than one strategy applicable to any opportunity. It stands to reason that an investor has a choice between different strategies to apply to the same opportunity. You would think the investor would choose the easiest strategy that fits, but many times this is not the case. All too often, investors are caught up in the "sexiness" of the market. We have all heard about the "sexy" stocks, but there are also "sexy" strategies. Everyone wants to trade the "sexy" stocks and everyone wants to use the "sexy" strategies.

Training firms, wanting to give something new to their students to solicit more money from them, exacerbate this problem. These strategies are usually more complicated forms of existing strategies that accomplish the same goal — only with added risk and costs.

Quick tip: There is nothing wrong with using a plain, old strategy that works instead of a potentially confusing strategy. Investors should remember the "KISS" strategy more often: Keep It Simple, Stupid!

7. Not knowing how to pick the correct option for the selected strategy. When an investor decides to select an option strategy to apply to a given opportunity, the investor has several choices to make.

Selecting the proper generic strategy is just the first step. Once the investor selects the strategy, they must then select the proper month and strike price that will optimize that strategy for the identified opportunity.

Every strategy has certain features that are applicable to different opportunities. Then, each of the strategies are optimized by choosing the certain months or strike prices that exhibit certain sensitivities (or lack thereof) that would allow the strategy to perform at its peak level of optimization.

Therefore, certain options work better in certain strategies while other options work best in others. Investors should then strive to learn how to pick the best options to fit into the selected strategy.

The two basic choices that investors need to make are month and strike. Month selection deals with market timing, among other things. Further, due to an option nonlinear rate of decay, a longer-term option will not decay as fast as a shorter-term option. This is important information that can lead us to the selection of the right month, depending on whether we are going to buy or sell an option in our selected strategy.

The second factor is strike price. Depending on the strategy and what it needs, the investor might select an in-the-money, at-the-money, or an out-of-the-money option.

An at-the-money option contains the most extrinsic value of any option in the month. It is also the most sensitive to movements of time and volatility. Consider these factors when deciding which option will fit best in a given strategy. Matching the right option in the right strategy can often be the determining factor in whether you will be profitable.

Quick tip: Selecting the right option for the right strategy is critical to your success. There is no such thing as the perfect strategy that works every time, but there are specific rules for choosing the right option for every strategy. Often, basic option strategies offer more than enough flexibility to take advantage of any opportunity that presents itself. There is no need to engage in complicated strategies when basic ones work just as well or even better.

Ron Ianieri is a professional options trader with 100,000 trades under his belt and 14 years of experience on the Philadelphia Stock Exchange.

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