The 3 Secrets to Making Money With Options

by Ed Downs, CEO Nirvana Systems

Introduction:

Options are amazing! They are the only trading instrument where you can:

- Control $10,000 in stock for as little as $100,
- Make TONS of money if the chart moves in the predicted direction,
- Completely Control Your Risk.

In this article, we will explore the **Three Secrets to Making Money with Options**, in order to guide a new or somewhat experienced Option Trader to focus on what's important when trading options.

Could AT&T reach $32 in 3 months? Buy the March 29 Call to control $3,000 worth of AT&T for just $123. Make 139%!

About the Charts: The above chart and charts in this article are from Nirvana's OptionTrader. We use OptionTrader because it's the only software that shows the future value of options in the stock chart. More information on OptionTrader and the web site link is presented at the end of the article.

Why Option Traders Lose Money

As powerful as options are, you do need to know a few things to make money trading them. The main reason people lose money trading options is they don't take into account (a) the movement that is required to make a profit, (b) the liquidity of the options, or (c) have unrealistic expectations about the outcome - they look at buying Puts and Calls as gambling.

But as much reputation as options have for being a gamblers game, they are actually the safest way to trade if you follow three key guidelines.

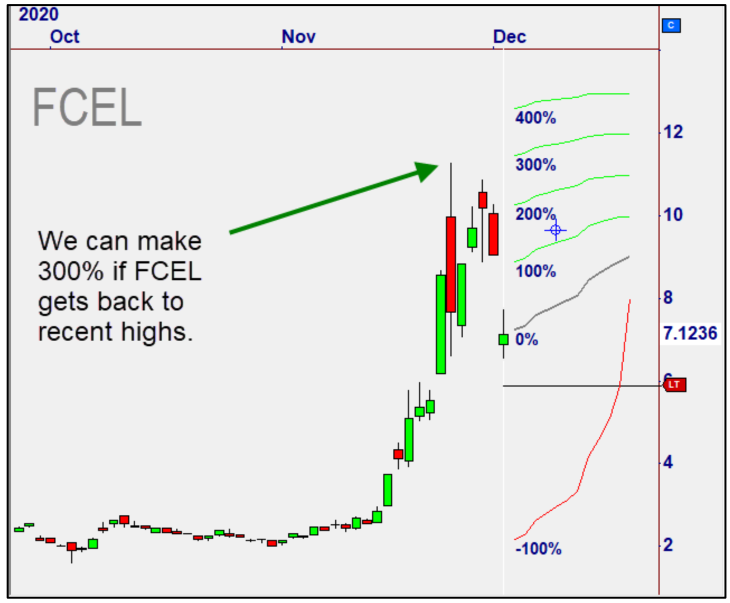
The Three Secrets to Profitable Option Trading

1. Trade Small Bid-Ask Spreads with Limits
2. Reward:Risk of 3 to 1 or more, with Stops.
3. Put Time on Your Side.

Secret #1: Small Bid-Ask Spreads with Limits

The chart to the right shows the setup on FCEL after buying the **December 8 CALL** for just $0.94. The green and red curves show the profit and loss percentages when we sell the option at various prices in the future for FCEL.   The **Expiration Date** of the CALL option is the 3rd Friday in December.

If the stock shoots up to **$11** dollars by expiration, we will make THREE TIMES or 300% the price of the option. That's the reason so many are trading options on Robin Hood right now. It's exciting. It's exhilarating. But you have to be careful.



FCEL just pulled back from highs, and is sitting at $7. We can purchase the December 8 CALL for just $0.94 ($94 for a contract controlling 100 shares). If it gets back to recent highes we will make 300% on the trade!

The next chart is for another hot stock, NTLA with the July $45 CALL Profit and Loss curves. <u>But Houston, we have a problem</u>!   The green profit zone doesn't start until we get past $51. The stock has to move $6 just to break even.

The reason we will lose money is the **BID-ASK Spread** is very large for NTLA options right now. On the $45 July CALL, the BID (what the market will pay for the option) is $7.10 and the ASK (what WE have to pay) is a whopping $12.00. Therefore, we will suffer a $4.90 (41%) loss if we sell the option *immediately*. That's a lot!

Here are Profit and Loss Curves for the July $45 Call on NTLA. Problem: The BID on this option is $7.10 and the ASK is $12. So we will lose $4.90 immediately on the trade. The stock has to get to $51 before we can make money.   No trades on NTLA today!

Going back to FCEL, the BID is $0.92 and the ASK is $0.94 for a BID-ASK spread of just 2 cents! That's why we make money quickly on FCEL.

So, when we buy CALL options, we need to look for options with small BID-ASK Spreads.   A general rule of thumb is "less than 5%" but 2% is ideal (as was the case with FCEL in this example.)

Entering Limit Orders:

The other important topic related to this is the price you ACTUALLY GET when you place your trade. The Options Market Makers will usually give you the current BID or ASK if you are buying or selling under 10 contracts. But it makes sense to put a Limit half-way between the two. So, if price is BID $2.00 and ASK $2.10, set your order at Limit $2.05:

"Buy 1 Contract, XYZ December 25 CALL Limit $2.05"

You may not get "filled" on the trade if price starts going up, but there is enough up and down movement in most stocks that you will get the trade about 80% of the time. If you miss one, just move on to the next one. If you don't use Limits, you will be at the mercy of the "Market Makers" who control option pricing.

Secret #2: Reward:Risk of 3 to 1 or more, with Stops

The second secret to making money is to make sure that you make more than you lose! If what you make is called the Reward and what you can lose is called the Risk, our Reward-to-Risk ratio should be at least 3 to 1 – my average gain should be at least 3 times my average loss.

How you can Lose on Half Your Trades and Still Make a Mint

When trading leveraged vehicles like options, you should plan on losing on about half of your trades. If the ratio of profits to losses is 3 to 1 or more, you will make a profit.

The math is pretty simple.

Say you invest $2 in an option on a particular stock, and are expecting it to rise to $3 dollars for a $1 profit. If your loss stop (the place where you get out of the trade and sell the option because it is losing money), is at $1 .70 that will be a $.30 loss. $1 Wins and $.30 losses are $1 to $.30 or about 3 to 1.

If we do 10 of these $2 trades and lose $.30 on five of them (total loss of $1.50), but make $1 on the other five trades (making $5), we end up with a profit of $5.00 - $1.50 or $3.50. **That's a 17.5% gain on our initial $20 investment!** That's not bad, folks, considering we won on just half our trades!

Stopping Out vs. Holding to Expiration

The key is to get out of the positions at the Stop Loss level if a trade goes against you. Now, let's say that you don't use any Loss Stops at all, and five of the options you bought expire worthless but the other 5 make $2 each. In that case, you break even. If the trades make more than $2 that is going to be profit.

This "lazy" way of trading options is called **Holding to Expiration** and is commonly how Option Purchases are taught. The thinking is, "You can only lose your option premium, so your loss is limited, but your profits are theoretically unlimited." And that's true. <u>But you MUST find trades that will make substantial moves in order to achieve the required profits</u>.

“What a minute…”, you may ask, “The examples above show potential gains of 300%. So why isn’t it easy to make 100% or more?” If you pick the right stock, these gains are possible. But options are priced according to volatility, so CALLs on “hot” stocks are going to be somewhat expensive. You can end up buying an expensive option and watch it “deflate” as volatility decreases.

How do you know if an option is overpriced? All options software and broker web sites show a value called **Implied Volatility**, which is directly tied to option prices. In general, when buying CALL Options, you should generally look for Implied Volatility below 0.5.

HOWEVER, to determine if an option is expensive or cheap, you also need to factor in what the stock is likely to do, how much you want to risk, and your time horizon. And that requires looking at the stock chart and establishing Profit and Loss Targets.

> *How OptionTrader can help: OptionTrader can automatically determine which options are the best to trade by combining Implied Volatility, Strike Price, Time to Expiration AND Chart Objectives – **automatically**. It also shows potential gain **graphically**, so you don’t have to learn about Implied Volatility or the “Greeks”. More about this in Secret #3.*

Secret #3: Put Time on Your Side, and Enjoy the Ride!

Option prices are based on **Strike Price**, **Time to Expiration**, and **Volatility**. Many very long books have been written about the effects of these metrics on option pricing. While that knowledge is useful, the basic concept is simple enough that anyone can apply it immediately in their trading if they understand just a few things.

Strike Price

Strike Price is the price of the “underlying” stock that the option is written at. Let’s say a stock is trading at $30 and we buy the $32 January CALL on December 15. The Strike Price is $32. For American options, expiration on standard monthly options is the 3rd Friday so Time to Expiration is about 4-5 weeks in the future. Because the Strike Price is $32 (i.e., higher than the current stock price), this option is said to be “Out of the Money”. The $28 January Call is “In the Money” and the $32 January Call is “At the Money”.

The further away from price the Out of the Money the option is, the less chance we have of getting to that price by Expiration. So those options are cheaper than near-price Out of the Money options. Most option purchasers buy slightly In the Money options because the chance of their appreciation is higher than buying Out of the Money options (though they do cost more).

Time to Expiration

If your option expires far in the future (say 6 months or more), it’s “Time Value” is high, so it will be more expensive. If your option expires in a few days, its Time Value is low, so the option will be cheap. You must decide what your objective is.

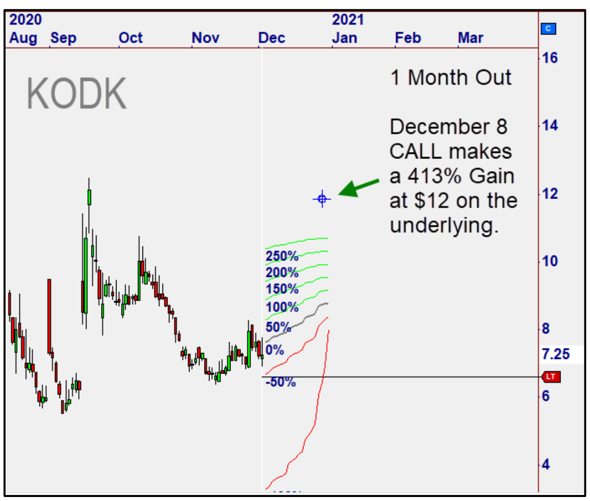
If you are investing in a stock but buying the option on it (because it costs much less than the stock) you want expirations that are further in the future. In the option market, there are options available one, two and in some cases three years out. These are called LEAPS which stands for "Long Term Expiration Options". If you are sure Zoom (symbol ZM) will go up a LOT in the next year, buying a LEAP may be a good move – if you are right.

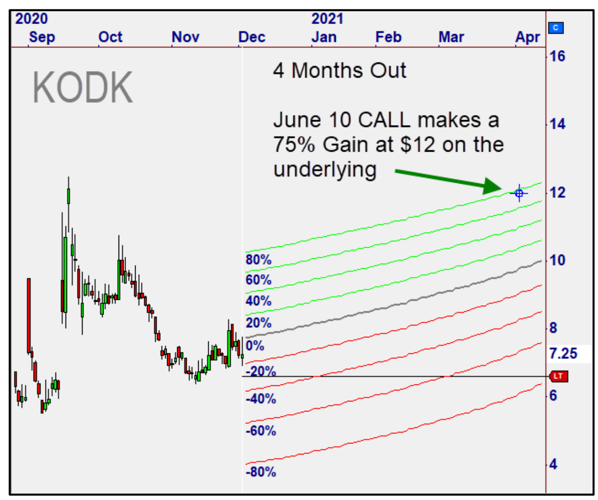
But if you are trading stocks short term (such as Swing Trading) and expect a move to happen in the next 5-7 days, <u>buying a near option will result in much more profit, for much less risk – if you are right</u>.

The answer to the question, "Which Strike Price and Expiration?" are determined by what you expect the stock to do. Below are two charts of the same stock in OptionTrader, each with a Profit Target of $12. The difference is, <u>one of them expires in a month while the other expires in four months</u>.

In the first case, OptionTrader tells us that December $8 CALL is the best option to trade, and we will make 413% if we hit the Target in a month. The second case will make about 75% if we buy the June $10 CALL and hit the green Target Line within the next 4 months.

The latter case is more likely, but if we think Kodak can get to $12 in the next month, our profits trading that scenario will be astonishing!





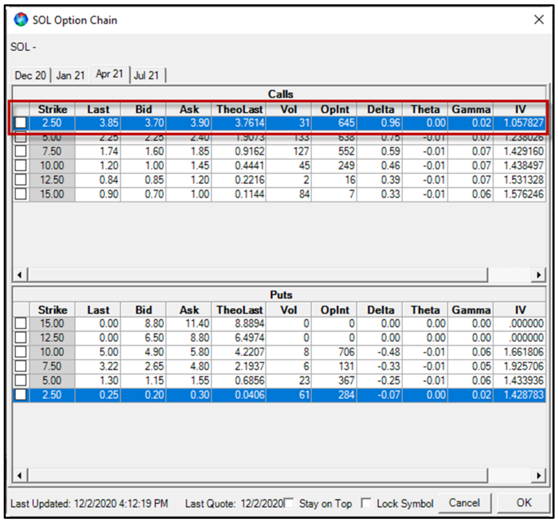
In Summary, if you are purchasing CALL Options, you should have reason to believe the stock can reach your Target before the Options expire.

What about the 3rd Ingredient – Volatility?

Volatility is key to determining the price of an option. If a stock is moving up and down very quickly, its Volatility is high and the options will be more expensive. If the stock has been moving like a turtle, its Volatility will be low and options will be cheaper.

If you use classic option methods and option chains on broker web sites, you will need to learn about Implied Volatility, Delta and Theta – Greeks that can help you price and compare options. Option Chains will show you the Greeks, but they won't tell you which option to buy. The Expiration Curve will show you Option Value at Expiration but not how price will change at all dates in the future.

Below is an example of an Option Chain and Expiration Curve for one option – the April $2.50 Call. While almost all option books show Expiration Curves for every possible option strategy, we don't think they are very easy to make decisions from. Fortunately, there is a better way…



SOL Option Chain

SOL -

Dec 20 | Jan 21 | Apr 21 | Jul 21

Calls

Strike	Last	Bid	Ask	TheoLast	Vol	OpInt	Delta	Theta	Gamma	IV
2.50	3.85	3.70	3.90	3.7614	31	645	0.96	0.00	0.02	1.057827
5.00	2.25	2.25	2.40	1.9073	133	638	0.75	-0.01	0.07	1.238026
7.50	1.74	1.60	1.85	0.9162	127	552	0.59	-0.01	0.07	1.429160
10.00	1.20	1.00	1.45	0.4441	45	249	0.46	-0.01	0.07	1.438497
12.50	0.84	0.85	1.20	0.2216	2	16	0.39	-0.01	0.07	1.531328
15.00	0.90	0.70	1.00	0.1144	84	7	0.33	-0.01	0.06	1.576246

Puts

Strike	Last	Bid	Ask	TheoLast	Vol	OpInt	Delta	Theta	Gamma	IV
15.00	0.00	8.80	11.40	8.8894	0	0	0.00	0.00	0.00	.000000
12.50	0.00	6.50	8.80	6.4974	0	0	0.00	0.00	0.00	.000000
10.00	5.00	4.90	5.80	4.2207	8	706	-0.48	-0.01	0.06	1.661806
7.50	3.22	2.65	4.80	2.1937	6	131	-0.33	-0.01	0.05	1.925706
5.00	1.30	1.15	1.55	0.6856	23	367	-0.25	-0.01	0.06	1.433936
2.50	0.25	0.20	0.30	0.0406	61	284	-0.07	0.00	0.02	1.428783

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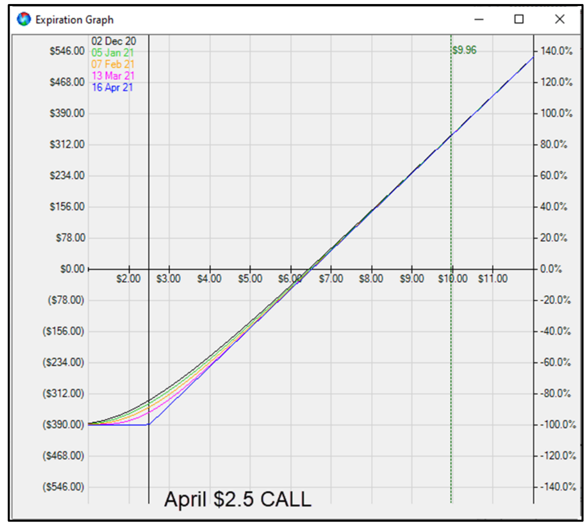
Standard Option Chain with Prices & Greeks



Expiration Curve showing Price at Expiration.

About OptionTrader

Option Educators have been using Option Chains and Expiration Curves since options were invented to teach people how to trade options. But we think it's easier if you can SEE the option values in the price chart.

That's why we created OptionTrader. Not only does it show you Profit and Loss curves in the future, it does everything required to value ALL options on a stock and COMPARE THEM based on a Profit Target and Stop Loss level so you pick the most profitable or lowest risk option every time.

OptionTrader has the following benefits that no other software has:

- Examines all options for a stock or ETF, plus Volatility, Time to Expiration, and Strike Prices.
- Shows you P&L curves in the future for each potential option trade.
- Tells you Profit & Loss, and Reward:Risk ratio based on your Price Target and Stop Loss
- Sorts the options for the highest Reward:Risk, highest Gain, or lowest Risk (your choice) – so you select the best option to trade *in seconds.*
- It's 100% Automatic. All you do is place a Target and let OptionTrader do the work!

To learn more and watch our amazing 3-Minute Demo,

Visit www.nirvanasystems.com/optiontraderplus