Section 1. Introduction to Option Trading

Trading stock options is a much different game from trading the underlying stocks. When options are traded for appreciation, it is a game of leverage, with big risks and associated big returns. One of the attractions of trading options is that you do not need a large amount of starting capital. It's also easy to play both sides of the market by purchasing call options for the upside and put options for the downside.

AIQ OptionExpert supports all types of option trading. The system's Position Analysis function is capable of analyzing simple buy and write strategies as well as the more complex spreads and straddles.

Rules of the options game

Remember that in the game of options time is your enemy. If the market moves against you, then get out of the position and take your lumps. Save the remaining principal for the next play.

When you play options, you should use stop prices. Because of the volatility of option prices, it is suggested that you use a principal-protect percentage of 50%, a profit-protect percentage of 75%, and a trigger percentage of 25%.

Also, watch for sufficient volume in the option to allow for liquidity when it's time to release the position. Adequate volume would be an average volume of 100 contracts a day.

Diversify

Because of the risk involved, the principal allocated to option trading should be limited to only a small portion of your investment capital. To spread the risk, total assets should, of course, be diversified over multiple types of investments.

Because trading options is a different game, it is recommended that no more than 20% of your option trading principal be committed to any one position. Then, if, as can easily happen, you loose 25% on one trade, you have lost only 5% of your original principal.

Wait for proper timing

It is not important to be in the market all the time. Unless you have sufficient information to make an informed decision, wait. When everything is right, profits will come quickly.

You should not only wait for proper timing but also keep your expectations within limits. In the game of trading options, there will be a few large gains but, unfortunately, a significant number of losses can also be expected. Since losses are unavoidable, it is essential to keep them as small as possible.

Don't buy or sell too early

One of the difficulties with buying options is knowing when to enter a position. Buying early at the lowest premium possible is important, but if you buy early the chance of a losing trade is necessarily greater.

Skills in selling are also very important. Do not try to sell at the very top. Wait until the top is reached. Set stops and follow your positions with the OptionExpert tracking windows. Do not sell early but only after a reaction to a new high.

It is also important to remember not to chase a bad position after the price drops. If you have taken a position and the price decreases beyond your preset limit, let it go. It is never too late to sell. If you are taking losses, take your lumps. Get out when your stops tell you to and don't wait for the position to go even lower and possibly expire worthless.

Use fear and greed to your advantage

The emotions of fear and greed are well known to any stock or option trader. These emotions are normal and need only be harnessed in the right direction to benefit the trader and increase returns. Your strategy should be to let your profits run and to cut your losses.

The emotion of greed should be used when a position is advancing. Greed should generate a hope that the advance will continue, and should be used to keep you from selling the position prematurely. Use greed to strengthen your patience in order to let your profits run, and to wait for your stops to indicate a sell. Consider selling if a reaction to a new high or low fails to result in further gains.

The emotion of fear should be used to cut your losses. The fear should be that of losing additional principal. Instead of allowing losses to continue, it's far better to take your losses and save the remaining principal for another day.

Always track your positions with the OptionExpert tracking function, and heed any sell signals to help keep your losses small.

Market timing is important

It's important—even critical—to know the phase of the market. Experts agree that 60% of a stock's movement is the result of the market's movement, and 30% is the result of the movement of the group within which the stock resides. That leaves only 10% of a stock's price movement attributed to the stock itself. It's important to understand the phase of the market.

A market timing system, which is part of AIQ TradingExpert Pro, is a valuable companion to AIQ OptionExpert. AIQ's market timing system has a very good track record for signaling when the market is likely to change direction and move up or down. It can help you keep track of the current phase of the market and anticipate its next move.

Follow-up actions

The importance of thoroughly understanding a strategy and its suitability for your personal investment objectives cannot be over-emphasized. You should also be aware of the follow-up protective actions that can be employed to limit losses should the market move against you.

These follow-up actions are particularly important with some of the more complex strategies. Unfortunately, as these actions are rather involved, AIQ cannot begin to adequately cover this topic and must refer you to references on option trading.

Recommended books for the newcomer to read before, or while, using AIQ OptionExpert include:

- Gastineau, Gary L. THE OPTIONS MANUAL, 3rd ed. McGraw-Hill, New York 1988
- McMillan, Lawrence G. OPTIONS AS A STRATEGIC INVESTMENT, 2nd ed. New York Institute of Finance, New York 1986
- Cox, John C. and Mark Rubinstein, OPTIONS MARKETS, Prentice-Hall, Englewood Cliffs, NJ 1985

Section 2. Introduction to the Strategies

A built-in feature of OptionExpert's Position Analysis function enables the user to select from a menu of strategies. The list of strategies includes the simple Buy and Write strategies plus 16 special strategies. In addition, the Strategies menu allows you to find the most profitable positions (up to 10) from any of the following combinations of strategies:

- All Option Strategies
- All Bullish Strategies
- All Bearish Strategies
- All Covered Strategies

Some of the special strategies are relatively simple. In this category are the basic spreads (bull, bear, neutral, and time) and the straddles. Others, such as the sophisticated variable ratio call write, are very complex.

OptionExpert Strategies menu

The strategies can be categorized into four groups:

1. Aggressive: very bullish/bearish
2. Less aggressive: moderately bullish/bearish
3. No directional bias
4. Conservative

1. Aggressive strategies: very bullish/bearish

In this group are strategies that rely heavily on the trader's ability to foresee moves in the underlying stock. Users of AIQ's TradingExpert Pro are able to take advantage of TradingExpert's capability to signal short-term stock moves. Generally, the strategies in this group are the more aggressive strategies such as:

- Put and call writing
- Bull and bear spreads of high profit potential

2. Less aggressive strategies: moderately bullish/bearish

This second category of strategies is most appropriate for traders with a less bullish or bearish market bias. With these strategies, maximum loss is limited as is maximum profit. These less aggressive strategies are:

- Lower profit potential variety of bull and bear spreads
- Bullish and bearish time spreads

3. Strategies with no directional bias

The third general group of strategies involves a neutral approach toward the underlying stock. These strategies are not oriented toward picking the direction of the stock. There are generally two types of neutral positions. The first is designed for the trader who expects declining volatility. Strategies of this type are geared toward earning time value premium, and take advantage of the fact that the time component of option value erodes with the passage of time. Profit is limited but the probability of a loss is relatively low. Included in this group are the following:

- Neutral time spreads
- Butterfly spreads
- Naked straddle writing
- Naked strangle writing or combination writing
- Ratio call writing (includes variable ratio call writes)

The second type of neutral position is designed for the trader who expects increasing volatility. This type involves the simultaneous buying of put and call options. These are speculative strategies that are profitable only if the underlying stock moves either up or down. Although the maximum loss is limited, the probability of a loss is high. In this group are the following:

- Buying of straddles and strangles (combination options)

4. Conservative strategies

The last group of strategies is more conservative. These strategies provide limited return coupled with decreased risk exposure. Although these strategies are less dependent on market prediction, knowing the direction of the stock is advantageous. While being very wrong can result in a large loss, if you are only slightly wrong, the position may still be profitable. This group includes:

- Covered call writing
- Covered straddle writing
- Covered strangle or combination writing
- Low-risk in-the-money spreads

Section 3. Simple Buy and Write Strategies

In this section, several stock option positions are discussed. The examples are limited to the simplest forms of option trading - buying and selling (writing) puts and calls for capital gains. In addition, an example of one of the more common stock ownership hedging strategies, covered call writing, is included.

Buying options for short-term appreciation

This section will focus mainly on the speculative strategy of buying options for capital appreciation. This strategy involves the purchase of put or call options with the expectation that the options will increase in price. The buying of options provides great leverage but the trader runs the risk of the loss of all committed funds.

The premium or price of an option responds directly to changes in the price of the underlying stock. Option premium is also affected by market conditions, the public's appraisal, and very directly by the remaining life of the option. This latter aspect of premium is called the time value. As the calendar moves toward the expiration date, the time value diminishes and the value of out-of-the-money options will go to zero. For the buyer of options, a horizontal market is doom, and time is the enemy.

The degree of leverage associated with a particular option depends on several factors. Strike price and the time remaining to expiration are both important factors. Leverage is always greater for out-of-the-money options and decreases as the option moves deeper in-the-money. (The terms out-of-the-money and in-the-money refer to the strike price of the option relative to the current stock price. A call is out-of-the-money if the stock is below the strike price, and in-the-money if the stock is above the strike price. The opposite is true for a put.) Leverage also increases with decreasing time to expiration.

Another factor which influences leverage is the volatility of the underlying stock. More volatile stocks have higher premiums and lower volatility generally translates to higher leverage. However, this does not necessarily mean that you should look for low volatility when buying options. Low volatility implies a stock with relatively small ability to move and, therefore, limited gains.

To evaluate options, AIQ OptionExpert uses a modified form of the Black-Scholes probability model (see User Manual for formula). Using those factors that directly affect option price (stock price, volatility, option strike price, and time to expiration) the model determines a theoretical “fair value” for an option. Fair value is simply the option price plus any expected profit, or less any expected loss to the buyer.

Taking advantage of option pricing discrepancies can be profitable. By comparing the price at which an option currently trades with its fair value, it is easily possible to judge if an option is under or overpriced. The ratio of price to fair value provides a consistent measure for comparing individual option contracts. Although not essential to profitable trading, superior results are generally achieved by buying undervalued options and selling those that are overvalued.

Selling or Writing options

Both puts and calls can be sold on the option market. The put writer enters a contract to take stock from the buyer at a fixed price if and when the holder chooses to exercise. The call writer is obligated to deliver stock at the price specified.

The selling of options without owning the underlying stock is known as uncovered or naked options. Although no actual cash investment is required to write a naked option, the writer must meet certain minimum collateral requirements. OptionExpert computes collateral from the margin parameters entered in Properties (see Margin Criteria in *Customizing Properties*, Chapter III in the User Manual).

The price of a call, which increases with the underlying stock price, is theoretically unlimited. For this reason, selling uncovered or naked calls, a bearish strategy similar to selling stock short, is usually considered to be a very high risk approach to trading options. The degree of risk, however, depends on the time to expiration and the strike price relative to the current stock price. Selling near-term, deeply out-of-the-money calls is a relatively low risk strategy while selling in-the-money calls is high risk. Of course, as with most games of chance, the higher the risk, the higher the potential for profit.

Similarly, selling uncovered puts, an aggressive bullish strategy, can be very risky, especially when selling in-the-money puts.

Covered Call Writing

The writing of covered calls has become a popular strategy. With this strategy, calls are sold with a long position in the underlying shares of stock used as collateral. The option premium gives protection on the downside should the stock decline. However, if the stock should rise above the strike price of the call, the writer stands to lose all appreciation above that price.