Get a Plan! How an options trading plan can help avoid large losses

Trading Strategy Desk

Disclosures

- ✓ Options trading entails significant risk and is not appropriate for all investors. Certain complex options strategies carry additional risk. Before trading options, please read Characteristics and Risks of Standardized Options, and call 800-544-5115 to be approved for options trading. Supporting documentation for any claims, if applicable, will be furnished upon request.

- ✓ Examples in this presentation do not include transaction costs (commissions, margin interest, fees) or tax implications, but they should be considered prior to entering into any transactions.

- ✓ The information in this presentation, including examples using actual securities and price data, is strictly for illustrative and educational purposes only and is not to be construed as an endorsement, recommendation.

Goals of Today's Webinar

The focus of today's webinar is to show investors how having a plan for trading can assist in the decision making process. We will walk through examples of trades and review how to analyze, define your exit strategy, and manage the position along the way.

- Why a trading plan is needed
- How to create a plan
- Managing your trade when your outlook has changed
- Common pitfalls traders make

The Trading Process

How will a plan help improve my trading?

Many traders tend to focus on the profits a trade may bring at the start without fully understanding the risk of an incorrect assumption.

Having a plan can assist with taking away the emotional attachment to a trade by clearly defining when to exit a trade that isn't working.

Trading Scenario: A trader thought XYZ stock was in line for a big jump on earnings. He fully leveraged his margin account to buy as many shares as he could. The stock fell 10% on the earnings announcement. The trader, now believing the stock would rebound, continued to hold. A week later the stock was down over 40%.

The Trading Process

Risk Management

- While considering a trade, focus on the overall risk first and profit potential second
- When a trade goes against you, the focus should shift to managing the trade under the current conditions rather than the initial prediction

Trading Discipline

- Take steps to reduce emotional attachment
- Try not to think only in terms of gains/losses
- Trade what you see and not what you think

Creating a Plan

- There are various forms of analysis that traders use to determine an outlook on direction. Some of the more common methods of analysis include fundamental, technical, or even combination of both.

- Use your analysis to define your outlook.
  - Start with your outlook on direction whether it's bullish, bearish, or neutral
  - For options trades time and volatility assumptions also need to be made

- The strategy should be selected to match your outlook

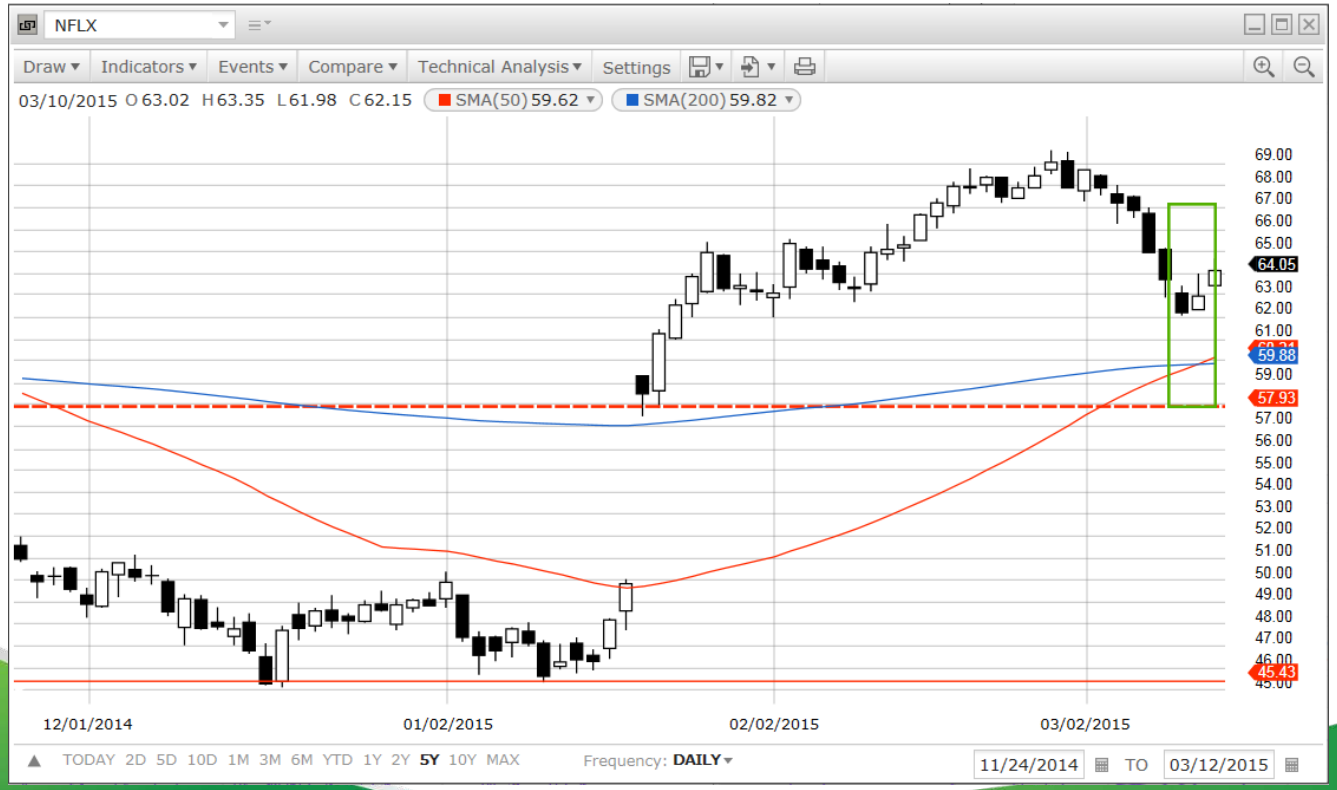
Creating a Plan

Before placing a trade you should be able answer

- ✓ Why you are entering this position?
- ✓ How much capital you are willing to allocate to any idea?
- ✓ What is the criteria for entry (at what price)?
- ✓ What is the criteria for exiting (for both the upside and downside)?

Defining an Outlook with Technical Analysis

A common signal traders use in technical analysis is the moving average crossover. When a faster moving average crosses above a slower moving average it creates a bullish signal. When the faster moving average falls below the slower it is considered a bearish signal. We will walk through the steps of creating and managing a plan using technical analysis.



The highlighted area is where the faster 50 day moving average crosses above the slower 200 day moving average.

Outlook is bullish.

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Determining Entry and Exit Points

The ***entry point*** is created through moving average crossover at approximately $63. For the ***exit*** we also want to focus on the moving average crossover, remember the signal generates for the sell when the faster moving average crosses back below the slower. A ***downside exit point*** is critical to managing the trade should your initial signal fail. In the chart below you will see two red support lines that could be used when considering a lower exit. Some traders will also use a set percent stop or trailing stop amount.

Trading Pitfalls: *Many traders fail to properly create a plan for managing their downside risk which can result in small losses turning into large losses*

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What's the Plan?

- **Outlook:** Bullish. Determined by technical analysis.

- **Entry point:** $63. Determined by using the 50 and 200 day moving average crossover (Golden Cross)

- **Exit point (upside):** 50 and 200 day moving average crossover (Death cross)

- **Exit point (downside):** 10% trailing stop loss

Trading Pitfalls: *Many traders lose track of the plan they had in place as time goes by. Take note of your trading plan on the Fidelity Notebook tool to help you maintain discipline.*

Managing the Trade

- Entry point: 3/11/15 at approximately $63
- Exit point (downside): 10% trailing stop loss triggered on 7/28/15 at 106.10.
  **Stop loss orders automatically become a market order when the stop price is reached. Therefore, there is no guarantee that your order will be executed at the stop price.*
- Exit point (Death Cross): 2/22/16 at approximately $91

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Defining an Outlook for an Options Trade

When trading options we can not focus on price alone as there are other components that affect the options price.

- **Direction:** Determine whether you are bullish, bearish, or neutral on the underlying stock through your analysis. The Greek **Delta** tells us how much an option price will change given a $1 change in the underlying price
- **Time:** Unlike owning stock, each option contract has a finite lifetime. So for each day that goes by the option price loses a portion of it's time value, all else being equal. This a benefit for options sellers and a drawback for the options buyers. This can be measured using the Greek ***Theta***
- **Volatility:** Implied volatility is an important component in determining whether an option is considered cheap or expensive. Increasing volatility increases options premium all else being equal which is a benefit to options buyers and a negative for options sellers. This is measured using the Greek ***Vega***

Defining an Outlook for an Options Trade

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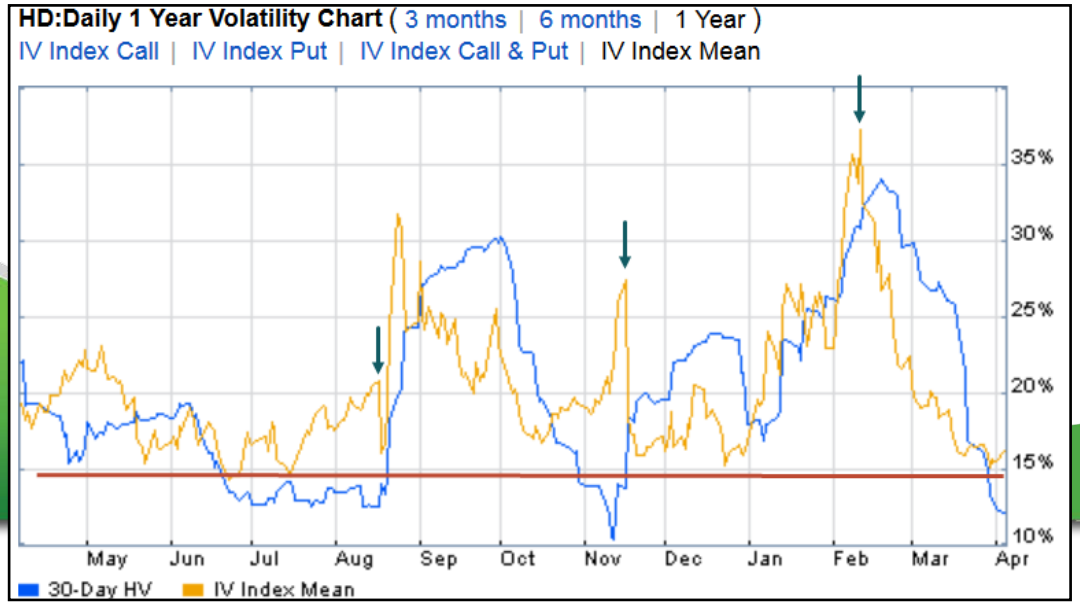

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Direction: Bullish. The stock is currently at a resistance level and the price is above the 50 and 200 day moving averages. The trade plan is based on the price breaking through resistance and rising into next months earnings.

Time: This is an earnings trade with the earnings date on May 17th. We will look for the first expiration date after earnings which is May 20th.

Volatility: The current level of implied volatility (IV) in this example is 16.6 which is in the 10th percentile. The past 2 quarters the IV has risen into earnings and fell after the announcement. Although the past does not guarantee a future result, we can use this pattern to form our outlook on IV which we'll assume will increase into earnings and begin to revert back down after.

Finding the Right Strategy

How would various options strategies fare if the assumption (increase in price and IV) was correct?

Strategy	Impact from Price	Impact from Time	Impact from Volatility
Long Call	Benefits from increase in price.	Loses value from time decay	Benefits from increase in IV
Short put	Benefits from increase in price.	Benefits from the loss of time decay	Loses from increase in IV

Trading Pitfalls: *Many traders fall into the habit of sticking to only one strategy and letting that strategy define your outlook. Let your outlook on the underlying define the strategy you are implementing.*

What's the Plan?

In the following examples we will compare both strategies at two different strike selections

Current Price

Long call

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Call	SIM	1	6.75	6.85	6.85	22.27	68.731	-4.234	16.733
May 20 2016 140 Call	SIM	1	1.41	1.46	1.46	18.25	28.218	-3.278	15.966

For the long call strategy we review an ITM 130 call and an OTM 140 call. The two biggest differences between the two are in the price per contract and delta.

Short Put

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Put	SIM	-1	2.10	2.16	2.13	21.78	30.943	3.982	-16.658
May 20 2016 135 Put	SIM	-1	3.85	3.95	3.90	19.73	50.129	4.053	-18.852

For the short put strategy we will review an ATM and an OTM put. You will also notice the differences between the two in price and delta

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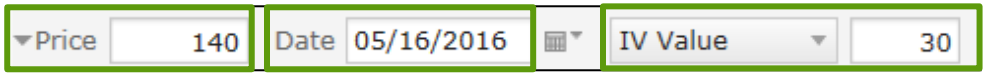
Managing the Trade

Using Fidelity's Profit/Loss Calculator we can model our assumptions to see the impact of changes in price, time, and volatility.



Price increases *Time passes* *Volatility increases*

Long call

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Call	SIM	1	6.75	6.85	10.04	30.00	98.339	-2.171	0.676
May 20 2016 140 Call	SIM	1	1.41	1.46	1.97	30.00	50.762	-19.684	6.535

The 130 call increased by $3.10 or 46.5% while the 140 call increased by $.051 or 35% Both have benefited from the increase in Price and IV.

Short Put

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Put	SIM	-1	2.10	2.16	0.03	30.00	1.66	2.027	-0.677
May 20 2016 135 Put	SIM	-1	3.85	3.95	0.37	30.00	14.573	11.219	-3.748

The 130 put decreased by $2.07 or 99% while the 135 put decreased by $3.48 or 90%. Both have benefited from the increase in price and passage of time

With earnings being the next day, the trader now needs to decide whether to take profits now or to formulate a new assumption on price and volatility.

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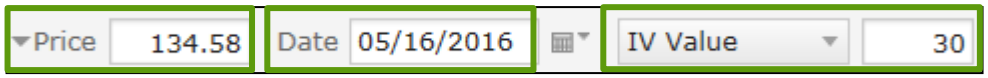
Managing the Trade



Price is flat *Time passes* *Volatility increases*

Long Call

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Call	SIM	1	6.75	6.85	4.98	30.00	84.261	-11.494	3.791
May 20 2016 140 Call	SIM	1	1.41	1.46	0.32	30.00	13.448	-10.254	3.411

Although the price hasn't changed the 130 call decreased by $1.87 or 27% while the 140 call decreased by $1.14 or 78%. The increase in volatility was not enough to make up for the loss from time decay

Short Put

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Put	SIM	-1	2.10	2.16	0.40	30.00	15.738	11.35	-3.792
May 20 2016 135 Put	SIM	-1	3.85	3.95	2.10	30.00	52.776	18.725	-6.269

From the put side the 130 put decreased $1.76 or 84% while the 135 put decreased by $1.75 or 45%. Both of these trades have benefited from time decay.

Trading Pitfalls: *Many traders lose sight of their original plan when facing a losing position. Remember why you entered into the trade and consider the additional risks of continuing to hold a losing position.*

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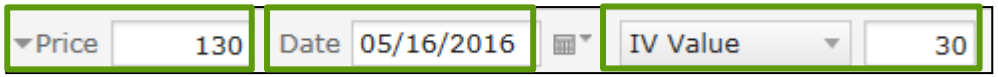
Managing the Trade



Price falls *Time passes* *Volatility increases*

Long Call

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Call	SIM	1	6.75	6.85	1.83	30.00	50.762	-18.278	6.068
May 20 2016 140 Call	SIM	1	1.41	1.46	0.03	30.00	1.825	-2.047	0.681

The 130 call decreased by $5.02 or 73% while the 140 call decreased by $1.43 or 98%. Both trades have been negatively impacted by the passage of time as well as the drop in price.

Short Put

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
May 20 2016 130 Put	SIM	-1	2.10	2.16	1.82	30.00	49.237	18.134	-6.069
May 20 2016 135 Put	SIM	-1	3.85	3.95	5.33	30.00	85.446	10.302	-3.477

The 130 put decreased by $0.28 or 13%, the loss from time decay had a greater impact than the drop in price and increase in IV resulting in a profitable trade. The 135 put increased in price by $1.48 or 38%. This trade was negatively impacted by the drop in price and increase in IV.

With options trading there is not a “one size fits all” strategy. Each strategy, strike, and expiration has it’s own set of trade offs that need to be considered before putting on a trade.

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Managing Risk through Strategy Selection

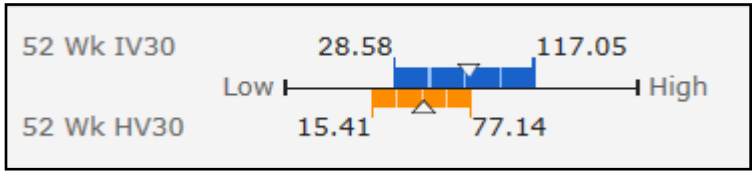
There are a number of options strategies that assist traders with risk management by defining your maximum risk at the outset of the trade.

Long Call or Put: By purchasing an option your risk is limited to the debit paid. While the loss can still be 100% of your investment, this is usually less capital than would have been required to buy or short the stock itself.

Credit Spread: Options sellers can change define their risk profile through credit spreads. To accomplish this a put seller would buy a put at a lower strike or a call seller would buy another call at a higher strike. The difference between the strikes minus the premium received becomes the max loss. The trade off here is less overall premium received

Protective Put: A long stock trader can purchase a put contract to protect from drop in price. The risk is limited to the difference between the current price of the stock minus the strike price selected minus the premium paid. The trade off here is the premium that is paid to purchase the contract

Creating a Plan for Defined Risk Trade



Directional bias: Neutral to Bearish

Time: Time decay is non-linear with the amount of decay increasing the closer the contract gets to expiration. Because of this many traders look for expirations between 30-45 days out where time decay begins to increase more on a day to day basis.

Volatility: Volatility is slightly above it's 50th percentile. The assumption for this example is for volatility to remain near it's mean.

One strategy that takes advantage of this outlook is the Bear Call Spread

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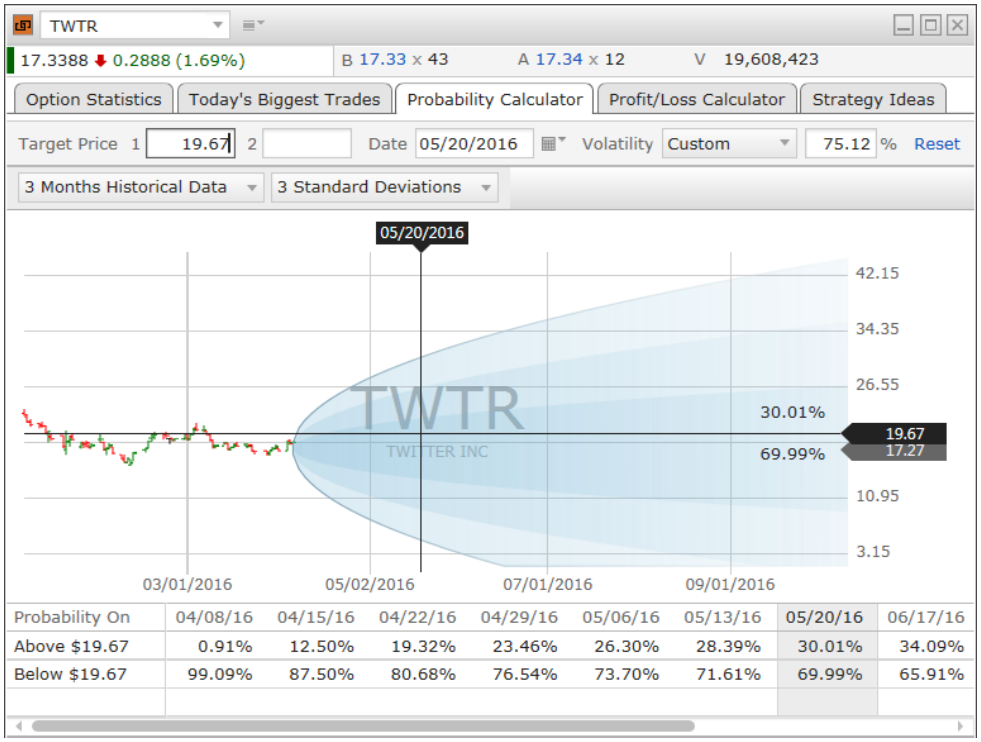
Creating a Plan for Defined Risk Trade



Probability On	04/08/16	04/15/16	04/22/16	04/29/16	05/06/16	05/13/16	05/20/16	06/17/16
Above $19.67	0.91%	12.50%	19.32%	23.46%	26.30%	28.39%	30.01%	34.09%
Below $19.67	99.09%	87.50%	80.68%	76.54%	73.70%	71.61%	69.99%	65.91%

One method that can be used in strike selection is probability analysis. An option seller will look at probability that the option expires worthless on expiration. The trade off here is that the higher the probability of success, the lower the premium that is being received. For this example we are looking for a strike price with approximately a 30% probability of it finishing above the lower strike price using the current 30 day IV.

Our expiration selection is 44 days out to May 20th attempting to take advantage of increasing time decay. Probability analysis has determined the lower strike price of $20. The last selection is the upper strike which will define the risk on the trade.

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Creating a Plan for Defined Risk Trade

In choosing the upper strike again there is trade off between risk and reward.

- The higher the strike the more up front premium that is brought in, however the greater the defined risk parameter.
- Choosing a lower strike will reduce the premium received, however it will also lower the defined risk

Strategy		Qty	Bid	Ask	Theo Price	IV	Delta	Theta	Vega
Spread: May 20...	SIM		0.32	0.36	0.33		-122.283	3.775	-5.122
May 20 2016 22 Call		10	0.36	0.38	0.3665	67.969	183.051	-12.291	15.927
May 20 2016 20 Call		-10	0.70	0.72	0.6994	67.189	-305.335	16.066	-21.05

This is an example of a 2 point spread. The credit received is $0.32. The max loss is $1.68 which is calculated by taking the difference between the strikes ($2) and subtracting the premium received ($0.32).

*To compare, a naked call writer would have brought in $0.70 premium by selling the 20 strike call. Without buying the $22 strike though they are exposed to **unlimited** risk.*

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Key Takeaways

- *Have a method of analysis for time, direction, and volatility.*
- *Use the analysis to choose the right strategy*
- *The strategy should also match your risk tolerance*
- *Define your entry and exit strategy points before putting on a trade*
- *Use the Fidelity Notebook tool to capture the details of your plan*

Get a Plan!

This concludes today's presentation.

Thank you for attending.

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