Webinar Presentation: Quarterly Education Day

7 Options Trading Mistakes to Avoid

Presented by

Trading Strategy Desk

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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.
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Goals of this webinar

Educate traders on 7 of the more common options trading mistakes and ways to overcome these pitfalls

- **Strategy doesn’t match your Outlook**
- **Choosing the wrong Expiration**
- **Choosing the wrong Position Size**
- **Ignoring Volatility**
- **Not using Probability**
- **Focusing on the Expiration Graph**
- **Not having a Trading Plan**

Mistake #1: Strategy Doesn't Match Your Outlook

- **Importance of choosing the right strategy**
  - Profit maximization
  - Appropriate amount of risk
  - Improve probability of success

- **Steps for choosing the appropriate strategy**
  - Develop an outlook first
  - Decide how much risk is appropriate for your account
  - Analyze multiple strategies

Common Starting Points to Develop an Outlook

- **Technical Analysis**
  - Identifying Support and Resistance
  - Trends
  - Indicators
- **Fundamentals**
  - Analyzing a company’s key ratios
  - Current business trends
- **Using a combination**
  - Using both Technical and Fundamental analysis to formulate an opinion

*Technical analysis focuses on market action — specifically, volume and price. Technical analysis is only one approach to analyzing stocks. When considering which stocks to buy or sell, you should use the approach that you're most comfortable with. As with all your investments, you must make your own determination as to whether an investment in any particular security or securities is right for you based on your investment objectives, risk tolerance, and financial situation. Past performance is no guarantee of future results.

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** implies us how much an option price is likely to 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***

*Greeks are mathematical calculations used to determine the effect of various factors on options.

Mistake #2: Choosing the Wrong Expiration

Why is selecting the proper expiration important?

- **Expiration sets a timeframe for your trade!**
  - When you buy a **stock** the ownership generally doesn't expire until you sell it.
  - When you buy or sell an **option** contract you must agree to an expiration date, as part of that contract

- **Use expirations to fit your trading style.**
  - Day Trader
  - Premium Seller
  - Technical Trader
  - Earnings Trader

Considerations when choosing an expiration:

- Liquidity
- Forecasting the Length of the Trade
- Expiration Cycles
  - Leaps > Quarterly > Monthly >Weekly
- Time decay
- Volatility
- Binary events

Reasons you may be choosing the wrong expiration

- No outlook has been determined
- Loss aversion

How can Liquidity affect Options Pricing?

Bid	Ask	Volume	Open Int	Delta	Chg	Theta	IV Mid	Strike
				CALLS				Jun 10 (32 days)
3.90	4.35	0	7	0.5879	0.00	-0.0502	18.84 %	146
3.35	3.75	0	126	0.5403	0.00	-0.0507	18.64 %	147
2.81	3.10	0	5	0.4907	0.00	-0.0494	18.06 %	148
2.34	2.58	0	1	0.4397	0.00	-0.048	17.76 %	149
1.92	2.07	3	30	0.3874	0.10	-0.0455	17.33 %	150
				CALLS				Jun 17 (39 days)
8.60	8.85	40	274	0.7886	0.25	-0.0367	20.66 %	140
4.95	5.05	317	1,190	0.6203	-0.03	-0.0446	18.92 %	145
2.30	2.34	332	2,835	0.3982	-0.06	-0.0422	17.64 %	150
0.82	0.85	106	3,969	0.1931	-0.06	-0.0284	16.84 %	155
0.24	0.26	14	1,232	0.0731	-0.06	-0.014	16.64 %	160

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Although both expirations are only 7 days apart they are drastically different in terms of liquidity. Trading less liquid options may impact the premium both when getting in and out! Pay attention to the bid/ask spreads, volume, and open interest.

Mistake #3: Choosing the Wrong Position Size

- **Common position sizing mistakes**
  - Trading too large, or small of a position
  - Inconsistent with position sizes
  - Concentration

- **Thoughts on better position sizing**
  - Risk a fraction of your account on each trade
    - Don't put all your eggs in 1 basket
  - Use an consistent dollar value on each trade
    - Reduces emotional impact on decision

Fidelity INVESTMENTS

Risk Considerations:

- ## Risk Management
  - While considering a trade, focus on the **overall risk 1st** and profit potential 2nd
  - When a trade goes against you, the focus should shift to managing the trade **under the current conditions** rather than the initial prediction

- ## Benefits of trading an appropriate position size
  - Reduces emotional attachment
  - Reduces volatility in portfolio (Equity Curve)

Mistake #4: Ignoring Volatility

- **Implied Volatility**
  - Measures what the market expects volatility of the security to be in the future, based on premiums on option contracts for that security
  - Annualized percentage for future expected move
  - Dynamic - will change with option prices based on supply and demand for

VOLATILITY			
IV30 62.35	IV60 65.63	IV90 65.48	
HV10 28.05	HV20 30.24	HV30 45.02	HV60 47.97

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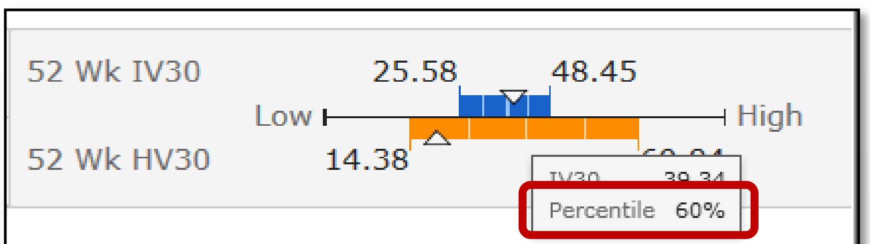
62.35% annualized expected move based on hypothetical 30 day option contracts

Implied Volatility is a product of supply & demand for option contracts, and therefore has an affect on option prices. It can be a measure of expensiveness.

Higher expected move in the security → *Higher demand for option contracts* → *Higher implied volatility (IV)* →

$$$
More expensive premiums

How can you determine whether a specific stock's IV is relatively expensive (or inexpensive?)



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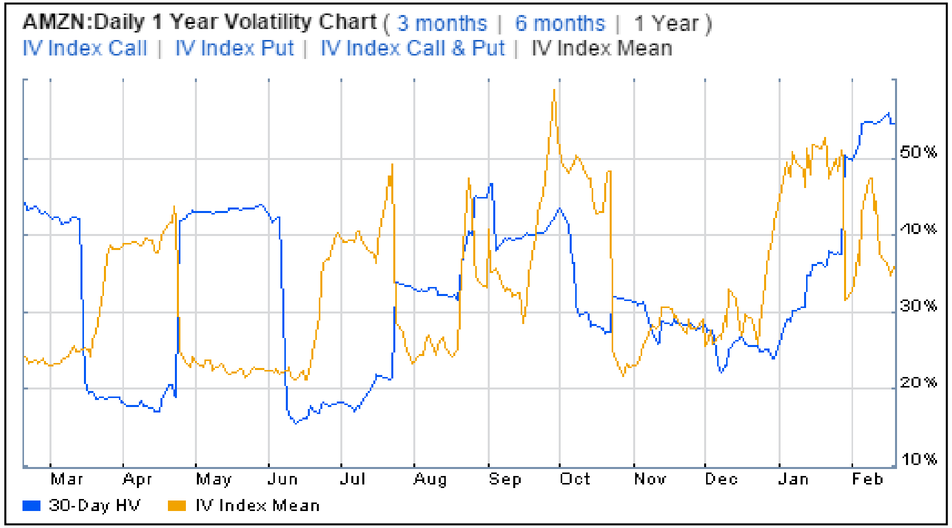
IV percentile shows where a specific stock's IV is compared to where its been within the last 52 weeks.

How can you determine whether a specific stock's IV is relatively expensive (or inexpensive?) continued…



IV index chart compares historical volatility (HV) with implied volatility (IV) over the last year
(provided by IVolatility.com)

**Fidelity.com IV Index– For Illustrative Purposes Only*

- Helps to compare current volatility data with historical data to identify potentially high or low levels
- Allows traders to identify divergence and convergence between HV and IV
- Quick way to find when volatility measures are at extremes and may revert to their mean values

Effects of Implied Volatility

CMI

116.53 0.00 (0.00%) | V | HV30 21.46 IV30 35.02 | C/P Ratio:

E May 06 (W) | May 13 (W) | May 20 | May 27 (W) | Jun 03 (W) | Jun 1

Strike	Last	Bid	Ask	Volume	Open Int	Delta	IV Mid	Vega	Theta
				CALLS	May 06 (3 days)				
116	3.63	3.60	3.70	0	287	0.5375	68.85 %	0.0485	-0.4461
117	3.09	3.00	3.20	0	412	0.491	68.39 %	0.0488	-0.445
118	2.63	2.70	2.80	0	791	0.4462	70.27 %	0.0485	-0.4521
119	2.26	2.15	2.35	0	185	0.3977	67.99 %	0.0472	-0.4248
120	1.95	1.80	1.95	0	658	0.3515	67.59 %	0.0454	-0.403
121	1.50	1.45	1.65	0	11,394	0.3084	66.92 %	0.0431	-0.3751

Example: Client is expecting a $1.50 move upward

Buys 1 117 strike call at $3.20

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CMI

118.00 1.47 (1.26%) | V 207,012 | HV30 21.46 IV30 25.69 | C/P Ratio: B

E May 06 (W) | May 13 (W) | May 20 | May 27 (W) | Jun 03 (W) | Jun 10

Strike	Last	Bid	Ask	Volume	Open Int	Delta	IV Mid	Vega	Theta
				CALLS	May 06 (3 days)				
116	3.63	1.60	3.20	0	287	0.6819	30.98 %	0.04	-0.201
117	1.63	1.85	2.40	128	412	0.5817	38.13 %	0.0435	-0.2756
118	1.18	1.15	1.80	22	791	0.4879	34.52 %	0.0447	-0.2554
119	1.25	0.80	1.30	32	185	0.3881	34.35 %	0.0428	-0.2419
120	0.63	0.40	1.10	3	658	0.3016	35.84 %	0.039	-0.2248
121	0.60	0.35	0.70	5	11,394	0.2281	36.46 %	0.0339	-0.1924

Exact expected move occurs.

Client can now close call for $1.85. What happened?

Mistake #5: Not using Probability

- **Low Probability Strategies**
  - Generally have large or unlimited profit potential
  - Typically debit trades
  - Can require better timing on the trade
- **High Probability Strategies**
  - Usually have a smaller and limited profit potential
  - Allow you to be less “right”
  - Typically credit trades

Using the Probability Calculator (provided by Convergex)

- Helps us identity the odds of our trade being profitable
- Can be used to help with proper strike selection
- Non-directional bias

Probability On	05/06/16	05/13/16	05/20/16	05/27/16	06/03/16	06/10/16	06/17/16	06/24/16	06/30/16	07/15/16
Above $210.00	0.00%	16.30%	24.26%	28.41%	31.04%	32.90%	34.30%	35.41%	36.19%	37.70%
Between $200.00 and $210.00	100.00%	72.67%	56.54%	47.76%	42.10%	38.06%	34.99%	32.56%	30.84%	27.50%
Below $200.00	0.00%	11.03%	19.20%	23.83%	26.86%	29.04%	30.71%	32.03%	32.97%	34.80%

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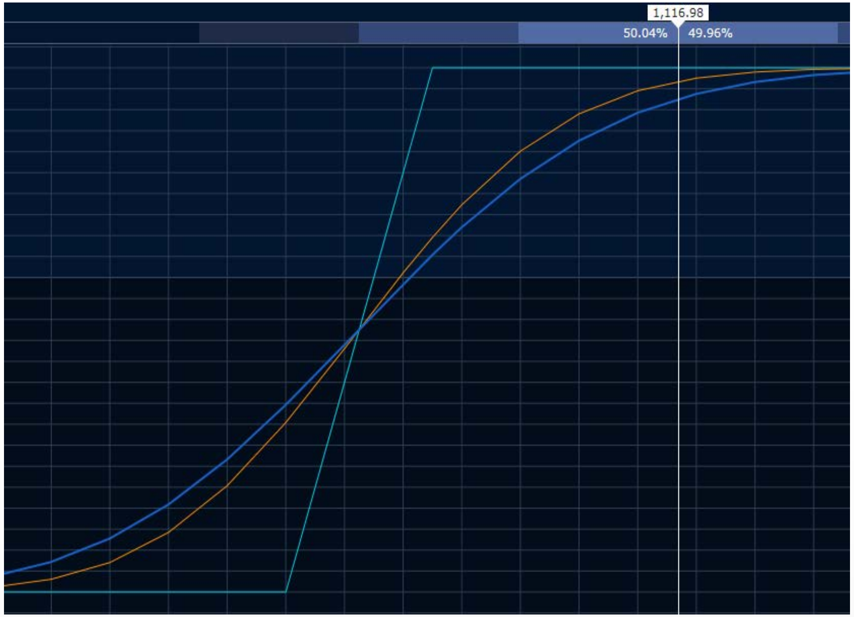
*Profit probability shows how likely a particular option trade (or combination of trades) will be profitable, based on a calculation that takes into account the price of the trade and the expected distribution of stock prices based on the 90-day historical volatility.

Mistake #6: Focusing on the Expiration Graph

- **Why this can be Detrimental:**
  - It doesn’t inform us of how our position stands today
  - It can blind you to what your position will look like tomorrow
  - Many traders do not hold the position all the way to expiration

- **Analyzing our T+0 line can help us:**
  - See if our position needs to be adjusted
  - Visually shows us our risk reward
  - Gives you future expectations of what your gain or loss will be at various price levels

Leveraging the Profit & Loss Calculator (provided by Ivolatility.com)



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Profit & Loss Calculator helps us see, visually, how our position looks today vs. expiration

– Lines:
  - **Light Blue**- Profit and loss at expiration
  - **Blue**- what we look like today
  - **Orange**- how we look at a date in the future

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Mistake #7: Not having a Trading Plan

- **How trading plans can be beneficial:**
  - It helps take the emotional toll out of trading
  - It helps you consistently construct trades that meet your needs
  - It helps you improve as a trader/investor

- **What should be included in a plan?**
  - What will make you open a trade
  - What will make you close a trade
  - How much you are willing to risk
  - How you will find opportunities
    - Some examples:
      - Market Scanner (provided by Livevol, Inc.)
      - Strategy Evaluator (provided by Convergex)
      - S&P Best 10 (provided by S&P Capital IQ)
      - ATP Filters

Considerations for developing a Trading Plan:

- Before placing a trade you should be able to answer:
  - Why are you entering this position?
  - How much capital are you willing to allocate to the idea?
  - What is the criteria for entry (at what price)?
  - What is the criteria for exiting (for both the upside and downside)?

- **If you are unable to answer these questions, *you are not ready to place your trade*!**

Key Takeaways

- **Have an outlook before thinking about the right strategy**
- **Trade the expiration that makes the most sense of your outlook**
- **Make sure your strategy matches your risk tolerance**
- **Be aware of Implied Volatility and what it means for your trade**
- **Have a game plan, and stick to it!**

7 Common Option Trading Mistakes

This concludes today's Presentation

Thank you for attending.

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- **It's All Greek to Me! – June 14th**
- **I Placed My Options Trade! Now What? – June 16th**

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