



Technical Analysis for Options Trading



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Goals of today's presentation

Using Technical Analysis to plan options trades

What we will cover:

- Support and Resistance
- Trading with the trend
- Using Moving Averages
- Breakouts
- Bollinger Bands
- Exit Strategies from technical analysis signals



What is a Support and Resistance?

- Support and resistance (S&R) levels occur at reversal points. Reversal points are where buyers and sellers are evenly matched, neither is dominant.
- S&R levels are shown on the chart with a horizontal line extended in the past and future.
- Prices tend to stop at these levels in the future.
- Breaking these levels implies that the buyers or seller earlier holding the price at a support or resistance level are now gone.



How can I use Support and Resistance in options trades?

- Helps to choose strikes for Calls and Puts
- Gives you an entry point for a directional trade
- Can use for determining legs of multi leg trades i.e. middle strikes for an iron condor



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The importance of trend

- Technical analysis is based on one major principle – trend.
- Trends arise from the interaction of buyers and sellers.
- The more aggressive one is over the other, the steeper the trend.
- Profit is made from a trend in prices.
- Trend's direction is described by the relative location of peaks and troughs.



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Trend

Trade with the trend. Remember, the trend is your friend!

The trend is considered to be intact until a preponderance of evidence proves otherwise.

If the underlying is in an up trend, you would want to use bullish options strategies, i.e. buy calls or sell puts

Conversely, if the underlying is in a down trend, you would want to use bearish options strategies, i.e. buy puts or sell calls

If the underlying is trading sideways, consider options strategies that favor range bound securities, i.e. condors, butterflies, strangles, or straddles

Always be aware of signs that a trend may be ending and manage risk and trades accordingly!



What are Moving Averages (MA)?

- Indicators designed to detect the start, continuation, and reversal of a trend.
- Simple Moving Averages give equal weight to each period.
- Exponential Moving Averages give more mathematical weight to more recent data.
- MAs do not anticipate reversals. They merely confirm after the actual reversal has taken place (since they are based on historical data).
- Shorter term moving averages are more sensitive to changes in price and indicate trend reversals more quickly.
- However, shorter term moving averages also generate more false signals.
- Technical analysis traders will often use combinations of moving averages to help manage false signals and to confirm reversals through one or more “crossovers”.



Moving average crossovers as signals of trend change

- Plotting a shorter term MA vs. a longer term MA results in “crossovers”.
- Notice the 50 period SMA crossing above the 200 period SMA as confirmation of the uptrend that had begun.
- Notice the 50 period SMA crossing below the 200 period SMA as confirmation that the uptrend was correcting.
- There is no “right combination” of moving averages. Many variables determine what combination can be used.



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Breakouts defined

- The most common sign of a trend change is a breakout.
- A breakout occurs when a trend line or support or resistance, level or zone, is exceeded up or down.
- It signifies that a change in buyer and seller behavior is occurring and thus is often an early signal of a trend beginning or ending.
- Trend line breakouts (breaking higher out of downtrends or breaking lower out of uptrends) usually signal trend endings.
- Support or resistance breakouts usually signal trend beginnings.
- Many successful trading systems depend on a breakout strategy.



Breakouts

Many people like to trade stock and ETF Breakouts. Trading breakouts with options is no different. In fact, there are traders who will use options as stock/ETF replacements with >70 Delta (remember, the greater the Delta the more the option acts like the stock)

Traders will look for a confirmed breakout and use an appropriate options strategy for the direction of the break.

Breakout to the upside? Use a bullish strategy, such as buying calls or selling puts

Breakout to the downside? Use a bearish strategy, such as buying puts or selling calls



Bollinger Bands

Description

Bollinger Bands are a type of price envelope developed by John Bollinger. Bollinger Bands are envelopes plotted at a standard deviation level above and below a simple moving average of the price. Bollinger bands help determine whether prices are high or low on a relative basis.

How this indicator works:

- When the bands tighten during a period of low volatility, it raises the likelihood of a sharp price move in either direction. This may begin a trending move.
- When the bands separate by an unusual large amount, volatility increases and any existing trend may be ending.
- Prices have a tendency to bounce within the bands' envelope, touching one band then moving to the other. You can use these swings to help identify potential profit targets.
- Price can exceed or hug a band envelope for prolonged periods during strong trends.
- A strong trend continuation can be expected when the price moves out of the bands. However, if prices move immediately back inside the band, then the suggested strength is negated.

How are Bollinger Bands used for option trades?

Bollinger Bands can be extremely useful to options traders.

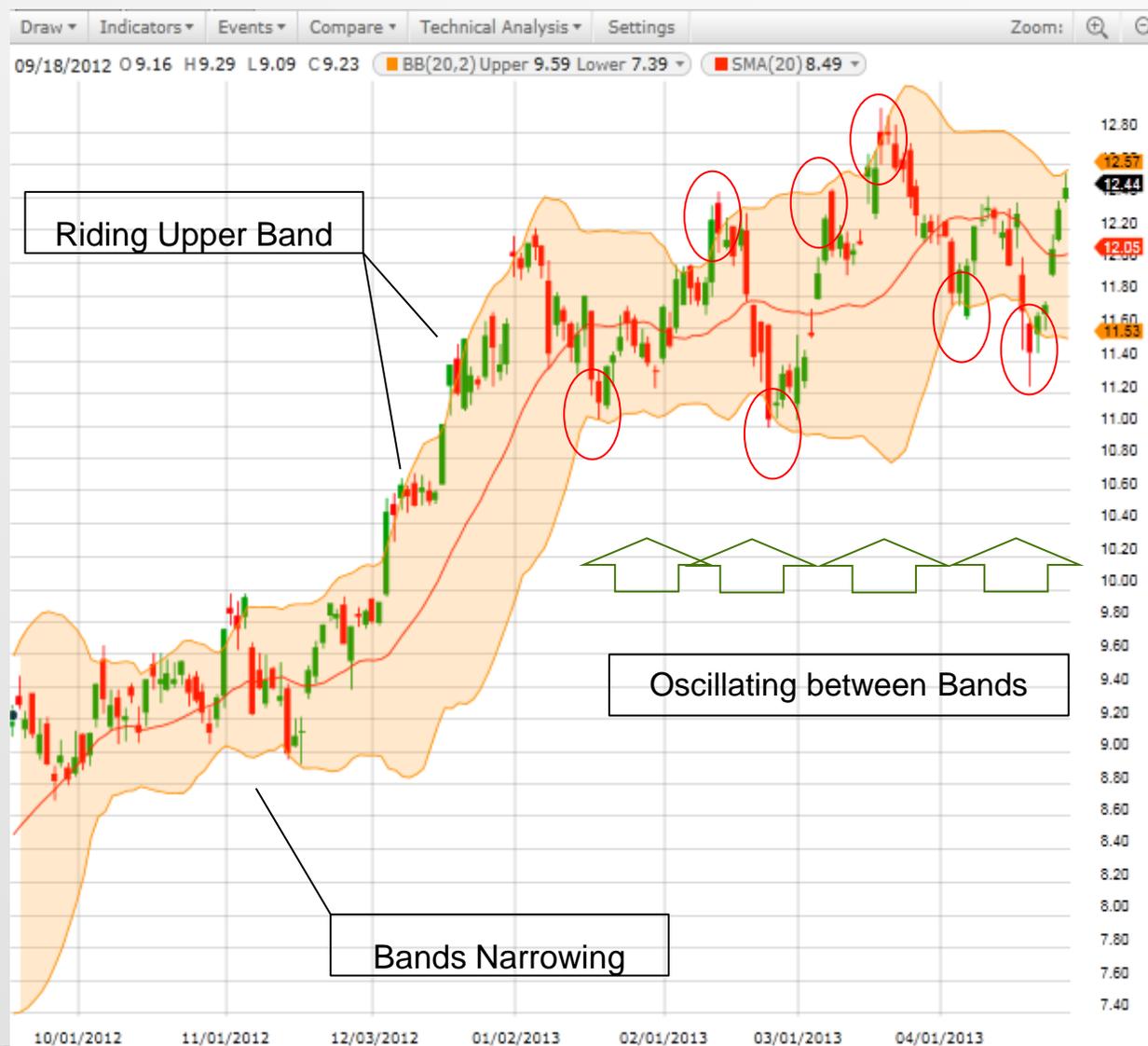
- They can give you an idea about volatility in the underlying and can help determine if the options are “expensive” and maybe a selling strategy might be more appropriate.
- They can be used to help determine if the options are “cheap” and therefore a buying strategy might be more appropriate
- Also, Bollinger Bands can be used to help with directional trades, when the price has been riding along the band for an extended period of time, it can indicate a strong trend in that direction.
- Bollinger Bands can be used to identify a range bound security and determine where the range has been.



Bollinger Bands

This example illustrates many of the central concepts employed while using Bollinger Bands:

- Narrowing or widening bands
- Riding the upper or lower band
- Price action oscillating between bands



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