TRANSCRIPT

Avoiding common option trading mistakes

James Savage: I want to welcome everyone, and just reiterate my appreciation for everyone being here. We've got a great topic to go over today of course. My name is James Savage and I'm accompanied by my friend and colleague Chase Cotnoir, and this is going to be about Seven Common Options Trading Mistakes. Now just to give you a quick background into who we are and what we do, we are 10 traders and educators primarily focused on our coaching sessions and four-week classrooms. Our coaching sessions cover a wide variety of topics, with options trading, technical analysis, trading basics, tool demos, and even daily market briefings both before and after the market. Our four-week classrooms, they are going to be going on four weeks over the course of a month, and they're going to be covering topics similar to our coaching sessions such as options trading, trading basics, technical analysis, and Active Trader Pro. And as you can tell, options trading is one of the topics that I'm usually most excited about. I am eagerly waiting to get started today.

And without further ado, let's take a quick look at some of the common options trading mistakes that we will be covering in today's one-hour-long webinar. Now these mistakes are something that you commonly come across, both Chase and myself, as well as everyone else on the team, and we want to

help you here in the audience just to be prepared if you're a beginner getting started, being prepared for some common pitfalls that you may run across during your options journey. And for any of my experienced options traders out there hopefully we're going to be offering something new for you as well as a bit of a reminder of things that you're going to want to be paying attention to. Now yes, we've chosen seven, seven being a lucky number, so it seems fitting to include them. However, that's where the luck is going to begin and end. So, we're not going to be focusing on trading with luck. We're going to be focusing on trading with a strategy.

Now again without further ado let me give my colleague a chance to introduce himself here and talk about mistake number one.

Chase Cotnoir: Yeah, absolutely, James. I want to reintroduce myself as Chase Cotnoir, another member and teammate of James on the Trading Strategy Desk. James, you and I have been working together for several years now. First, we were on our active trader services team and now here we are trying to coach and educate our clients on all things trading, whether it's options, technical analysis, or just having a trading plan.

What I want to do is just extend my warmest welcome to everyone attending today. I hope you and your families are staying safe, certainly to the best of our abilities, given the context of the world we live in right now. Additionally, I hope everyone has a wonderful holiday season whether it's in person, over the computer, just staying home. We just want to make sure everyone's staying safe and having a great holiday season.

So, James, I want to hop into this first mistake. I certainly know that I'm guilty of it. You are. And everyone who starts trading options or anything really is guilty of. So, we want to pass along some of these wisdoms if you will to anyone who's watching today. So, the first thing is not having a strategy match your outlook. Now I'm going to spend a little bit of time here at the beginning of this presentation talking about this concept of having an outlook, because it's really going to drive the rest of the conversation and really the successes of traders.

So, when I mention an outlook, what do I mean by that? Well, I mean having some sort of opinion or idea about a certain investment. So for example if you're looking at a stock, and you're looking at it and you think to yourself the stock is going to continue to go higher and higher, it's going to increase in value, we might say that's a bullish outlook. You believe, you have an opinion,

that in the future the stock will continue to rise. Simple as that. What is your opinion of the future?

A lot of traders though that we talk to both in our one-on-one sessions, our coaching sessions, and even events like these, they have a difficulty matching an options trading strategy to their outlook. So, coming back to my original example, let's say someone is bullish on a stock. They think they're going to make money if the stock goes up. We've spoken to traders who they might have an options strategy that actually makes money if the stock goes down. So, there's a misalignment between the tool they're using, the strategy, and the task they're trying to accomplish, their outlook.

Big fan of analogies. James, you know this. The analogy I would use is if you're trying to cut some wood you don't want to use a pair of scissors, you'd rather use an ax, maybe a saw, a chain saw, etc. You want to use the appropriate tool to accomplish your goal. So why is it important? What's the value to us as traders to drive this home?

Couple of things. First is profit maximization. If we don't even know our outlook or we don't match a strategy to it, then how are we going to know how much profit we're supposed to make? If we look at a $100 stock and we want

to buy some options on it and we think it's going to go to $105, well, we've defined our upside outlook. We think it's going to go up $5 a share.

On the opposite end of the spectrum the antithesis, and maybe even more important, is we can also determine how much risk we're willing to take. If we're looking at a stock that's $100 yeah, maybe we think it goes to $105 for a gain, but how low do we think it might go for a loss? When are we willing to get out of the trade? And if we focus on our strategy to align with our outlook then over time we have seen it, both you and I, James, that there tends to be an improved probability of success, because you're taking the appropriate strategy as opposed to just throwing more money after a trade that doesn't make sense.

So, what are some things to keep in mind? You want to develop this outlook first. We're always talking that you don't know where to go if you don't know where you've been, and more importantly you don't know where you're going if you don't know what the end destination is. So, you have to have that outlook first.

Now the question that I usually get after this. How do I develop an outlook? What are some tools, what are some methodologies? The first one and

probably the most common that we talk about on the Trading Strategy Desk is technical analysis, which is a fancy way of saying we're studying stock charts. It's the study of price and volume over time. And so, some traders who have their technical analysis thinking cap, they might be looking at things like identifying support or resistance. Essentially lines in the sand around the stock chart where a stock maybe goes up or down.

They might also look at trends. Is the stock making higher highs and higher lows? Is it chopping sideways? Or is it in some sort of bear market that's going down? And then of course I'm sure we've all seen these types of charts that have many different technical indicators that if used correctly like any tool can help make our job easier.

And so, if you're looking at technical analysis, you're looking at a chart, you could identify for example an uptrend. Let's say you see a stock that's consistently going higher and higher with just little dips along the way. Well, you could use that and say, "Okay, I believe this trend exists. I can see it with my own two eyes. And I think more importantly that it will persist. And so, with that I'm going to develop a bullish outlook. I think this bullish trend is going to continue."

Well, using technical analysis you've now helped yourself identify your outlook as bullish. And so just with that alone you now know that you're looking at using any options strategy that's bullish or maybe neutral, but you're simply eliminating all the strategies that might be bearish. That's critical.

Second way that you could go about it, on the other end of this spectrum if you will, is fundamental analysis, the analyzing of a company's balance sheet, their P/E ratio, their price-to-book ratio, all those kinds of data points. You could take a look at their quarterly earnings. If they have a great set of quarterly earnings and the company issues forward guidance that the next quarter is going to be good, maybe you take that and say, "Well, given that the company looks good today and prospectively they might look good in the future, that might also make me bullish. And so that's going to give me a bullish outlook. If I'm going to trade options on this company, I know I have to use a strategy that matches a bullish outlook."

And of course, these things don't exist in a vacuum. You don't have to be full-on technical analysis or full-on fundamental. You can do a little bit of both, and certainly most traders do. We say that the fundamental analysis helps us determine maybe what to invest in, where technical analysis helps us determine when to invest in it. And even for options trading.

Well, what I've been talking about is an outlook on only one component here, direction. And this is pretty intuitive. We're all stock investors when we first start out, many of us in the audience, including myself, certainly started that way, well, we only think about direction. Either the stock goes up, stock goes down, or sideways. But with options trading you're actually trading three things simultaneously. You're trading direction and time and volatility. You have to remember that these options, they don't exist in perpetuity. They have an expiration. At some point these options will expire or be exercised or assigned. So not only do we have to have an outlook on is the stock going to go up, is the stock going to go down or sideways. The question is by when. Is it a month from now? A week from now? A year from now?

And in addition to that we have to have an outlook on volatility. Do we think the stock market or this individual stock itself or ETF, is there going to be an increase in volatility? Greater ups and downs? Or is it going to calm down over time? Those three components you have to have an outlook or an expectation, an opinion, on. As we're going to see in future examples here today with James, if we leave out this volatility component specifically, that can actually wreak havoc on certain types of trades. So, we always want to have the mental checklist. Before we place a trade, define what is your

outlook or opinion on up, down, or sideways? How much time will it take for that to occur? And how much volatility do you think will occur? If you have some of those, you're going to be already setting yourself up for more success as an options trader.

But coming back to that time component, James, could you talk to us a little bit more about choosing the wrong expiration or maybe even the right expiration? That certainly feeds into these option trades as well.

SAVAGE: Absolutely, Chase. Because you mentioned how time is an important part of our outlook, and it absolutely is for any options trader out there. But we also need to know in addition to our outlook how time also affects our contract as well. So, we know options have a finite life span. Unlike a stock that could theoretically exist to perpetuity. So, we need to understand that because we're trading around an expiration, a maturity date, we need to have our outlook, have our plan, happen within that timeframe. Now also keep in mind, just to cover a few of the bases here, that there is not an absolute best expiration or a set number of days every trader should always be looking for. There's no need to set ourselves with these rigid type of constraints that we're going to be trying to fit every single trade we put on in every single type of strategy.

Any time we put on a new trade we want to take in the totality of the environment in which we're trading, whether that means the individual stock or ETF, any type of macro events, or any type of maybe trends that we're seeing. And in addition to the environment we want to consider our trading style. Can our outlook help us determine what could be an appropriate expiration?

So, when it comes to considering the proper expiration for your trade, well, let's go over a few different scenarios. Because oftentimes I find that traders tend to focus on choosing their expiration based on how long they plan to be in the trade for. Now this may again come across as being initially intuitive because if you've got an expiration date it may seem that well, why don't I just trade until that expiration date. However, the contract that you choose should not necessarily just be based on how long you want to be in the trade, but the timeframe for your outlook, the timeframe for your expiration, and the timeframe you plan to hold on to your trade could all be different. Let me repeat that. Might be helpful on this idea. So, the timeframe for your outlook, the timeframe for your expiration, and the timeframe of your trade could all be different. And that's quite all right.

Now to understand why you may decide to extend or shorten your expiration, you need to understand a little bit about time decay. So, I'm going to give you a bit of an example of what I'm referring to. So, let's say that you're possibly bullish on a given stock for the next year, but you're only planning on buying a six-month option instead of that one-year option because it's cheaper. So, all else being equal, a shorter-dated option is cheaper than a longer-dated option.

So again even though your outlook may be for a year you're choosing just versus a contract that is only going six months out due to cost. However, maybe you only want to hold that contract for half of the amount of time, for example three months, and then possibly adjust that timeframe later on to avoid time decay. So in that scenario you may be bullish for a year but you're only choosing the timeframe that's half of that, six months, due to cost, yet you only want to actually hold your trade for three months, half of that. Why? Because you want to possibly lessen the effect of time decay.

So, let's explain a little bit about what I mean by time decay for anyone not familiar with that. Again using the concept in that term, all else being equal, which I understand in the real world it often never is, but just to keep us on the same page here we need to understand that time value erodes faster the

closer we get to expiration. Now because of that fact, the trader may want to adjust their expiration to be longer or shorter to either take advantage of time decay or possibly combat that acceleration of time decay, possibly whether one would be short or long. One may want time decay to accelerate, one may want time decay to not really affect them as much.

Now this does go back to that earlier point that the expiration date of the option is not necessarily supposed to be the closing date of your trade.

Now we've got a few other considerations as well when choosing an expiration. And that is volatility and binary events. So, let's talk a bit about this. And my question would be for you do you want to trade them or not. There's not a right answer of course. But by being aware of any events that might be planned that could either increase or decrease volatility. And what are some of those events? So, when I'm referring to the term binary events, well, that's oftentimes going to be events that can come with one or two different outcomes. Hence the term binary. So, it can go one of two ways. Such as earnings. Are they going to miss or hit their earnings? Is there an FDA approval that could be on the line? Are there legal decisions scheduled to be announced on a specific date?

So, adjusting your expiration to either include or exclude these dates would be the prudent choice for any type of options trader out there.

Now we've got another component as well that can absolutely play a part in choosing your expiration, and that is liquidity. So, you may ask yourself, "Well, what does the expiration and liquidity, what do they have in common?" Well, fortunately we've got a screenshot of an options chain. And this is taken from an actual example, so this is not a textbook example here. We've taken the screenshot from Active Trader Pro. And we're looking at both a weekly option at the top and a monthly option at the bottom.

Now I want to focus on a couple of things here. First, turn your attention over to the right side, to the furthest right column. These are our strikes. And you can see the weekly, the ones on top, are in dollar increments. The monthly are on $5 increments. Well, if you were keen on trading that 147 strike, as an example, you wouldn't have any other choice but to choose the weekly. Why? Well, that monthly option does not have any 147 strikes or 148 or 149 for that matter.

Well, let's keep diving into the differences here, because that's only a small thing I wanted to highlight on this page. Let's take a look at the volume and open interest, which is I think where the majority of you might have at least

first noticed some of the differences here. But notice how both the volume, which is the contracts traded that day, and the open interest, the amount of outstanding contracts at the end of the prior day, notice how the weeklies are significantly lower than the monthlies. The monthlies are getting a lot more action, a lot more interest, a lot more trading volume.

Now why would that matter? Well, that is going to bring me to the third point that I wanted to make here. So just focus on an equal strike in both of those expirations. Let's look at the $150 strike. So, starting with the weekly option on top, it's the last row of the weeklies, that bid and ask spread is $1.92 by $2.07. We've got a 15-cent difference between the bid and the ask, 15-cent spread between what you can buy it for and sell it for.

However, let's now take a look at the monthly, where we had the majority of the volume. Look at that spread. We're at four cents between the bid and the ask. Now this is a direct result of the lower and higher liquidity between the two. The higher liquidity is giving us far more efficient pricing with our option, as opposed to the lower liquidity where we have due to lower demand wider bid and ask spread.

Now as you start to increase the amount of contract that you're using in your trade, this can absolutely start to matter. Those pennies add up to dollars as you start to increase the sizing of your trade. So just sometimes by looking at possibly a few different expirations, maybe an extra week or an extra month, finding greater volume and greater liquidity, you can sometimes help save yourself cents and dollars on your trade, which in the long run can absolutely add up and make a difference. We want to be as cost-efficient in our trading as we can.

And this goes to the next point that we had on our slide for today. So as I talked about how position sizing and the amount of contracts can absolutely start playing a role in, well, how much money you're going to save or spend, especially when it comes to liquidity, but choosing the wrong position size can lead to quite a few other problems, can't it?

Cotnoir: Yeah, absolutely, James, in our one-on-one sessions I can't recall how many times I've spoken with a trader who wasn't satisfied with the results of their strategy because their losses were too big or the rewards on their winning trades were too small. And that comes back to this concept that you were mentioning with these position sizes. A lot of traders when they first start off, they start small. And that's pretty common. The first time we learn how to ride

a bike there tend to be a very small bike, there's some training wheels, we're in a safe space, you don't get on some really big motorcycle for your first time. So, it makes sense. When we first start, we trade small.

But eventually we get to the crossroads where some traders increase their size as they increase their comfort, but maybe their risk tolerance isn't actually warranting that type of size. So, for me personally in a lot of my one-on-one coaching sessions, it's with traders who tend to trade too large. And when I say too large, when we're talking about options, we mean in terms of the number of contracts. So as opposed to trading 1 contract, maybe they're buying or selling 50 contracts, 100 contracts. That would be for some people too large because an incremental change in the underlying stock price for such a large options position, and James, coming back to your example, if there's wide spreads, well, now suddenly even if the stocks moves a tiny bit you could be losing potentially a significant portion of your capital.

On the flip side, like I mentioned, some of the newer traders, they go too small for too long. They have a difficulty building up their confidence. And what's happening is they're putting their capital at risk. Granted, it might be less. But the reward that we're getting isn't as large as maybe it should be, because

they're always trading small. So, this is a pretty common mistake that happens.

The other thing that happens too is people will trade in just one option or options on one single stock. So, they're not really diversifying their trading. So just like investing, you don't want to put all of your eggs in one basket. As traders that same rule, that same school of thought, absolutely still applies to us. So, what are some solutions to this to make sure that our position sizing is quote, unquote right? Well, that's a little bit of an arbitrary zone that we're trying to get into, this right zone. It's different for everybody. But a couple of simple rules of thumb that we could utilize is risking a fraction of our account on each trade.

Now this is pretty commonly done in terms of percentages. So, for example, someone might say, "I'm going to put 1 percent of my trading capital towards this one single option trade." Sometimes the rule of thumb or percentage is 2 percent, 0.5 percent, 3 percent. But really the goal here on this position sizing concept is we don't want to put 50 percent of our account in a single options trade, because options are inherently leveraged. So, a 1 or 2 percent move in that stock price could absolutely lead you to lose 10, 20, 30, 50 percent on an option. And if that's 50 percent of your account on a single trade, well, that's

going to devastate your capital. And we got to think about this too. Yes, we're traders, but more importantly, the most successful traders, especially when it comes to position sizing, they think of themselves as risk managers. Because at the end of the day, the second we place this trade, the risk is real. The profits are not. We have to wait for the profits, but the risk is inherently immediate the second we place that trade.

So, one way you could do it is a fraction of your account, 1 percent, 2 percent, etc. Another way you could do this is a consistent dollar value. So, you could say, "Each trade I'm going to put $500 of my capital, $1,000, $100." And again, this is where finding that right zone is difficult. If you're someone who has $1 million versus someone with $1,000, that zone is going to be a little bit different using a constant dollar value strategy, but it will still give you consistency.

One other way that I would think about this too, it's not on the slide deck, but you could also do a constant contract type of system for your position sizing. So if you're tending to trade options on the same stock over and over again, rather than on one trade you trade let's say 1 option and the next one you do 50, and then you're after the fact trying to repiece what you did right or wrong, well, there's inconsistencies. So maybe each time you do a trade you do 20

contracts, 10 contracts, whatever the number is, but each time you place that trade it's for the same number of contracts. So, keep in mind that might be a solution.

The main point though here is when it comes to position sizing the number of contracts you're trading, whether you're buying or selling, you always want to have that risk manager thinking cap on first, focusing on these potential rewards second. They may come, we hope they come. But the risk is absolutely real. It's there right from the beginning. So if you think to yourself as well after you place the trade is your position size too big now, maybe it wasn't then but now it is, well, we always want to consider a trade that we've already placed not on the merits of the past but of the future. So at the time if you place a trade and 20 contracts seem like the right trade, the right size, the number of contracts for this one trade, but then let's say down the road you place five other trades for different options for different stocks, well, now you've got a lot of capital out there invested in that risk.

Well, if you reevaluate your account in the future, you see these five different trades, well, maybe suddenly now you're not comfortable with having 20 contracts in the original trade. So, we always want to reevaluate under the current conditions to see does this still match my risk tolerance. This is not a

set it and forget it type of strategy by any means. So just keep that in mind. When you start, most people start small, and that's perfectly fine. It's that danger zone of once you start to get comfortable are you going to sequentially increase your contracts or are you just going to go for it and then pull yourself back from there. We just want to be conscious of the risks we're taking.

Now another risk to all option traders, especially those who are newer, is not understanding some of the components that affect our option prices. James, I've had this conversation many times, I know you have too. Volatility. That's one of the major ones. Can you talk to us a little bit about how that helps our options or affects them?

Savage: Absolutely, Chase. And as a trader and educator of options, I'm going to let you in on one of the questions that cuts deep. And that is that price did what I thought it would do, I picked the right strategy, why did I lose.

When I hear a client come with that question it's always something that gets to me the most, because unfortunately more often than not the trader in question ignored volatility. So, you can be right on your outlook, right on your strategy, but if you don't have the outlook on volatility, well, oftentimes that can make or break the trade.

Now ignoring volatility, it's natural at first, especially as we've talked about most options traders start trading stocks before they get into options. The stock traders are familiar with trading up-and-down movements and then when starting to focus on time it makes sense. All familiar with passing of time and trying to plan our trade around a deadline. But getting to that volatility component, learning to observe volatility changes and create an outlook on them, can be one of the most difficult aspects of starting with options.

So now that I've hopefully illustrated the importance of volatility -- and I'm going to actually illustrate it even further towards the end with a real-world example -- but let's just talk a little bit about volatility and what it is, and more specifically implied volatility. Implied volatility measures what the market expects the volatility of the security to be in the future. And it's basing this we'll say measurement on the premiums on those options contracts for that security. So, we're given a number and as we can see highlighted and boxed in on the right-hand side, we're given a number that's an annualized percentage for the expected move on the underlying. We're looking at 62.35, which is meaning 62.35 percent annualized is the expected move of that underlying stock or ETF, index, etc. Now that IV30 component is letting us know that this is based on a hypothetical 30-day option contract.

Now these are theoretical values. The 62.35 is a theoretical value based on this hypothetical option contract. And even though they're not an actual contract these are still great to give us ideas and we'll say a pulse check on where the market is expecting volatility. And we oftentimes give these for some typical timeframe such as 30, 60, or 90 days, as you can see here. Now keep in mind that these numbers, they're not static. They are absolutely dynamic and will change based on the supply and demand of options. So, in order to understand well, what's causing these IV numbers to change, whether you're looking at 30, 60, or 90, it's important to understand that relationship between supply and demand and implied volatility changes.

So, we've got an example of what may take place when the market participants expect a large move. If these market participants are starting to expect greater movements in the future, they may begin to start buying options for either protection or speculation. You can use options for a wide variety of reasons. So as this demand of options increases and the supply thus decreases, well, what would you expect that to change the price? You'd expect the price to start increasing. So as the price increases and our premiums start to get more expensive than they had been, that is going to be reflected in the higher implied volatility.

So, for anyone that's wondering well, what happens when those IV levels start to get higher, well, the price starts to increase. And why is that? Because remember, that price increase is what helps feed into our implied volatility numbers. So, if you're wondering, now maybe the question is well, as implied volatility starts getting higher, at what point does it become high. Well, like everything in life it's oftentimes relative. So fortunately, we do have a tool that is both on Fidelity.com and within Fidelity's Active Trader Pro that can help us determine whether a specific stock's implied volatility is relatively high or relatively low. Let's take a look at the small little table that is on our slide here.

So looking at the top part, which is the blue section, we can see a low of 25.58, a high of 48.45, and this is the 52-week or rolling one-year range that the implied volatility numbers have moved both on the low end and the high end. Now if we're clicking on this, which is already done on the screenshot, it would give us where the current implied volatility value is, which is 39.34. And in addition, it gives us that percentile, so this is telling us we are in the sixtieth percentile of implied volatility.

Now how can this help us? Because it's letting us know where we are compared to where we have been over the past 52 weeks. So, it is letting us compare implied volatility where we currently stand to where implied volatility

has been. So again keeping with that relative theme, we can see how high is implied volatility relative to where it's been, which we can infer is well, how expensive are our contracts due to volatility relative to where they have been in the previous time.

And in addition, this also includes HV, which for anyone who's not aware, this is historical volatility. This is the actual measure of volatility that has taken place. Now if we do want further analysis on trying to figure out whether our option is relatively cheap or expensive, we even have another tool that can narrow down and really focus in on how those changes have looked over the course of one year.

So instead of just seeing the high low as a range, looking at our IV index either on Fidelity.com or Active Trader Pro, this can help us see where we are in relation to where we have been and at what points volatility has been high or low. So again, if I could direct your attention to the chart on the right, there are two lines, one showing implied volatility, which is orange, one showing historical volatility, which is blue. Now this IV index helps us compare that current volatility to historical volatility to help identify those divergences between implied volatility and historical volatility.

Now if you're asking me, "Well, how can I use this?," well, one way is to find when volatility measures are at their extremes, maybe you see implied volatility at one end, historical volatility at the low end, and you may be then using that information to create an outlook under the premise that volatility may either increase or decrease. Volatility is oftentimes considered one of the most mean-reverting aspects of finance. So, by looking for these divergences between implied and historical, it could help use that to help formulate an outlook on when are they going to converge and merge together.

Now if you're wondering, as well, well, this is great in theory, I can see volatility high, low, where it has been, where it is now, but if you're still not convinced, I've of course got one of my favorite real-world examples for you. So, this is going to take into consideration everything we went over and use a trader's example. Now what we're looking at here, we've got two options chains, one above and one below. They're both on the same day, they're both three days until expiration. One is before an event and one is after. The one on top is before, the one below is after.

As we can see, if you can focus in, there's a price on the top one of 116.53. That is the underlying price. The price changes to 118. So, we got about a $1.50 movement in the underlying. Now these are long calls. What would you

expect, for any of my options traders out there, you probably have an idea, if the stock goes up, what would you expect the long call to do? Increase in value, right? Part of a long call gets its profit from an increase in the underlying price.

However, look at our bid and ask quote. It went from about $3 to $1.85, looking at the bid. So, we actually saw a decrease in the price of our option after an increase in the price of our underlying stock. Well, if you're wondering why that is, hopefully it's not a surprise, where we can see that illustrated under that IV column that we've also circled. Implied volatility went from a 68 percent to a 38 percent. So in this case the trader who bought calls expecting price to increase -- and even though price did increase, they picked the right strategy to play on a price increase -- because implied volatility went down significantly they still lost money on the trade. So, in the end volatility can help us determine whether sometimes our trade can make money or lose money. Oftentimes it's that X factor that can help make or break your trade.

Now throughout the slides here we've been talking a lot about risk. And volatility and risk do have a relationship. When there is an increase in volatility that could mean an increase of risk on your trade as well. Why? Well, there

could be less predictability in the underlying moves. So, some traders may wish to avoid volatility or may wish to trade into volatility.

But there is another way to balance volatility and risk, and that is the concept of adding some type of probability analysis into your trade as well. And fortunately, we've got some tools that can help out there.

Cotnoir: Yeah, absolutely, James. When it comes to volatility that is that X factor. The way I think about it is volatility is really just the mathematical representation of demand. So, if we're seeing higher implied volatility numbers there's more demand. And in your example the demand dropped by at least 50 percent, or almost. And so, we're seeing that cut in half where it basically fell through, significantly declined.

So, what we're looking at here now is how does probability correlate with that. Well, a low probability strategy sometimes if not most of the time is accompanied by someone who is paying a debit. And typically, someone who's looking for some volatility.

So, some basic strategies fall into this category, where you're paying a debit, you're hoping that some big move happens, and if it does, you'll have either

large or unlimited profit potentials. So, when it comes to volatility, well, there are certain strategies where a low probability strategy, if you will, would certainly benefit from a really big move in volatility. On the other end of the spectrum, you have these higher probability strategies. These tend to be short volatility or hoping there isn't an increase in volatility. The way that these types of general strategies might work under this category is they're typically traded for a credit. You tend to be a net seller of options. And what this does is it can affect your breakeven, so it's a higher probability trade. It also gives you some more wiggle room to allow you to be right a little bit easier than if it was a lower probability strategy. That is because it's changing your breakeven.

So, we have high probability strategies and low probability. Why would someone choose one over the other? Well, like anything in finance, there's always a risk and reward paradigm. So, if a low probability strategy gives you potentially really high or large or unlimited profit potentials, that's like saying there's bad odds but if it works out your payoff is great. Where a high probability strategy is, you're maybe more than likely to win this trade, you have a higher probability, but since there's less risk or more certainty, you get less reward. So, there's a smaller profit potential capability in these types of trades.

Now things to consider is how do you evaluate what the probability of an outcome is. Well, Fidelity has a tool, this is both available on Fidelity.com and Fidelity Active Trader Pro. This screenshot is within Active Trader Pro. It's called the probability calculator. And what you can do is, as we've been talking about, you can put in your expectations for price, time, and volatility. What this lets you do is put in those three different components to some time in the future, and it will give you the probability of that outcome occurring.

So, if we zoom in and we take a look at that screenshot, we've put in a target price of 210 and 200 with a date of June 17th. Now this is an older screenshot, 2016. Historical volatility is based on the last 90 days at 15.76 percent. And what this tells us here on this chart down below is there's almost a 35 percent chance, 34.99, that this stock is going to stay in between 210 and 200. We've got basically a third of probability left above or below it. And so for anyone who's wondering, if they're placing an option trade, maybe something that has a lot of volatility or a little volatility, and you're wondering what's the probability of this occurring, having the stock do what you want it to do, you can input those type of parameters into this program, and that will hopefully let you see and model around what might occur in the future. That's going to help you with some of your game-planning endeavors and setting up your trading plan.

But it's not just probability that comes into play here. The next thing that we want to think about is expiration or time. We do have some analytical tools about that, where focusing on expiration can really sometimes make or break a trade, just like volatility and probability.

Savage: Yeah, Chase. So as everyone can probably tell here, I've been trying to focus on when I brought up expiration earlier and not to base the life of your trade necessarily on the expiration date, well, let's go back to that concept of understanding expiration and how your trade can revolve around what expiration that you choose. And fortunately, we do have a tool, we call it the expiration graph, here on the next slide it's called the profit and loss graph. And this allows traders to not only think about their profit and loss at expiration but to help analyze their profit and loss throughout the life of the trade.

And hopefully that makes sense why we would want to be analyzing our trade throughout its life instead of just figuring out what's our breakeven at expiration. Because a prudent trader will not place their trade and forget about it until expiration. We don't place an options trade for a month out, close our computer, and then check in on the date of expiration and at that

point figure out well, what am I going to do now. At that point it's oftentimes too late to make any corrections. You're either going to be at max gain or maximum loss at that point in time.

So by using an expiration graph such as our profit and loss calculator we can incorporate the changes of time, changes of volatility, and the changes in price into our option, and we can use that calculator to spit out a value that we would expect that option to be worth. So, this is illustrating that dynamic nature of option pricing. So by having an understanding of those three different outlooks and even having an expectation of those three different outlooks, we can figure out a theoretical value of our option's price, and by continuing to model our option value in a wide variety of scenarios, a trader can be prepared to react when that change happens instead of being surprised.

So, let's take a quick look at that profit and loss calculator here. So similar to the probability calculator where I inputted the components of price, time, and volatility, we're going to be doing the same thing for our profit and loss calculator. We're going to be inputting that data. And that will create what we can see is the orange line. So, there are three lines here on our profit and loss calculator just by default. We're looking at the profit and loss at expiration, the

profit and loss as it looks today, and then most importantly how that profit or loss will look at a specific date in the future.

And with that theoretical price we can figure out if our strategy is not only matching our outlook but if it will achieve our stated objective. And I use objective as opposed to profit because sometimes traders will use options not necessarily for profit but for protection as well. And even more so than we'll say viewing to see if our trade matches with our objective and achieves our objective this more importantly can help us with our risk. This will also let us see those theoretical losses in a wide variety of scenarios and this can sometimes help cooler heads prevail when the red starts to affect them because I'm sure Chase can back me up here, that when we start seeing red on our trades, when it starts going against us, when the news is not sometimes advocating in our favor, our emotions start to get the best of us. And even a well-thought-out plan can start to get a little bit shaky when the time comes.

So, using this tool it can at least help you as a trader not only have a plan but be more educated to the wide variety of scenarios that could take place and how those prices would be looking on your option.

Now Chase, talking about using this profit and loss calculator for the sake of a plan, I think it's a perfect segue into that final mistake. And last but absolutely not the least, we want everyone here to be trading with a plan.

Cotnoir: Yeah, absolutely, James, I can't recount how many -- recall, excuse me -- how many times we've spoken with a trader, whether it's on a one-on-one session or in a group setting, and they've told us that they're trading without a plan. They entered in some sort of trade, and let's say it's a week or two later on. Now they're not sure what to do. And I'll ask them, "What is your exit strategy? What is your plan that you had put in place at the beginning that you're looking to keep yourself between those guidelines, those rail lines if you will?" And a lot of times the answer is, "I don't know. I never really thought about it."

So, I would say after everything we've learned and covered today, if you've absorbed all of that then the worst thing you can do is not apply that knowledge to develop a plan. So, the reason we always say you want to have some sort of plan is exactly what James was just mentioning. If a trade starts to go against you, our emotions are absolutely going to get the best of us from a behavioral finance perspective. Many studies show that we do not make our best decisions under duress. Emotional duress, financial duress. So, we

should make all these decisions ahead of time. These are going to help us be consistent in our trades that are both winners, but most importantly those losers. Doesn't necessarily make them less painful. But you understand what you're agreeing to and there's no surprises. If you're planning to sell at X amount of loss and that really does occur, well, that was part of your plan all along, then you should be okay with it.

What I want to focus on is what I would call sort of like our preflight checklist. Before every plane takes off our talented pilots and everyone who tries to keep us safe, they go through the same checklist every time. Not because they forgot, but because they want to be diligent to make sure they don't miss anything. So, for us as traders we have our own preflight checklist. And that is this list of questions.

If you don't download this slide or you don't come back to watch this presentation, the best thing you could do is take a photo receipt, write down some notes on these questions. Every trade you should be asking yourself, hold yourself accountable, "Why are you entering this position? What is your outlook on price, time, and volatility?" If you can't define that you can't explain to yourself or a buddy, a friend, spouse, why you're entering a position, then right there you shouldn't be entering it. You need to have some

clear thesis and justification. And on top of that not only why are you entering it, how much are you willing to allocate up front, and as we've been focusing or driving home, on the risk side of things, how much are you willing to accept if it goes down, how much capital are you willing to put at risk and lose. And lastly, what is your criteria for exiting. Now yes, we want to exit on the upside. Hopefully at a profit. But the most important thing is defining what being wrong looks like. You want to define that ahead of time, back to the beginning of our conversation, whether you're using technical analysis. Maybe you use a trend line. And you could simply say, "If the stock goes below this trend line, I will close out my option trade." Even something as simple as that incorporated into your plan is absolutely going to be better than nothing, better than winging it.

So, for us, we think that the most important takeaway from today is absolutely developing some sort of plan, now that we recognize the importance of an outlook on price, time, volatility, looking at probability, all those kinds of factors.

Now I know we're being a little bit general. The question might be well, geez, what is my specific plan. Well, that's where the proverbial rubber meets the road. That's where it's more of an art than a science. It depends on what

options you're trading, what's the stock the options are based upon, what's your risk tolerance. But you want to piece together something. Write it in a Word document, on a notebook. Put it together and review it, so that once you place the trade you know exactly what you're doing.

So, James, that's probably my most important key takeaway, is going over some of these plans. But talk to me a little bit about some of these other key takeaways.

Savage: Yeah, absolutely, Chase. I know it's popular to pick a favorite. But it's absolutely a difficult one, especially when we've got seven crucial, I would say common trading mistakes that hopefully any trader here that attended this webinar is going to at least be cognizant of going forward. We want to develop an outlook before thinking about the right strategy. As Chase used a great analogy earlier, we want to pick the right tool for the job. We don't want to start with the tool and try to find a job that we can use it for. We want to have our outlook whether that's on price, time, volatility, and hopefully all three, and then picking from our toolbox, which is our box of various strategies, and applying the one that makes the most sense.

We want to trade the expiration that makes the most sense for the outlook. That's a tough question to answer. Fortunately, it's made easy by using tools such as the probability calculator and the profit and loss calculator. See what the various expirations can result in due to the various scenarios that you want to stress-test your trade on.

Make sure that strategy matches your risk tolerance. As we went over, certain strategies have a trade-off between risk and probability, between reward, risk, probability. So, factor in those three when considering if you truly want to choose that strategy. And then make the proper adjustment on the number of contracts that you had. And finally, have a trading plan and stick to it. When it comes to making adjustments on your trade on the fly, you want to make sure you're making those adjustments in a well-thought-out manner based on the previous lessons that you had going into the trade. We don't want our trade to turn into investment when it starts going against ourselves, because we don't want to either realize a loss or give up the hope that the strategy may work, because as we know, hope is not a strategy. A well-informed trading plan is going to be one of the key ways to differentiate yourself among the vast majority of traders out there and hopefully achieve long-term success.

END OF AUDIO FILE

Charts, screenshots, company stock symbols and examples contained in this module are for illustrative purposes only.

Options trading entails significant risk and is not appropriate for all investors.
Certain complex options strategies carry additional risk. Before trading options, contact Fidelity Investments by calling 800-544-5115 to receive a copy of Characteristics and Risks of Standardized Options. Supporting documentation for any claims, if applicable, will be furnished upon request.

There are additional costs associated with option strategies that call for multiple purchases and sales of options, such as spreads, straddles, and collars, as compared with a single option trade.

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.

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

Fidelity Brokerage Services, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

958484.1.0