CHAPTER 1

Trade and Risk Management

COPYRIGHTED MATERIAL
http://www.pbookshop.com

INTRODUCTION

When novices begin to learn martial arts or boxing, they invariably want to start by learning how to punch or strike their opponent. To them, that is the most exciting part of learning martial arts, and they are in a rush to learn to attack. However, the trainer or coach will usually start by teaching them how to defend themselves or block an attack. If you cannot defend yourself from getting hit, then you will not last long enough to attack your opponent. Most novices fail to see the importance of defensive techniques. In sports, the motto is that defense wins championships. After all, even if you score points, you cannot win if you let your opponent score more points against you.

The importance of defense is also true in option trading. Beginners and advanced traders alike want to focus on trading strategies and making money. They usually overlook the importance of defense. Of course when trading options, we are not at risk of getting punched or attacked, but the money we invest is under constant attack. We are competing with thousands of traders and investors who want to "take" our money. Investors and traders need to learn to defend their capital against losses just like boxers need to protect their bodies and heads. Allowing too many losses, or "attacks," to your trading capital will leave you with no money, and you will be out of the trading game. Therefore, option investors must also first focus on defense before jumping into the offense of making trades or establishing positions.

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

The defensive skills that should be studied by any investor before focusing on trading strategies are risk and trade management. Learning how to control and manage the risk of each and every trade, as well as your portfolio on the whole, is vital to protecting your capital. Many investors have had the experience of making money on a series of trades only to see one or two bad trades wipe out all their hard-fought gains. Imagine working hard the first six rounds of a boxing match to weaken and hurt your opponent, only to come out in round seven with your hands at your sides and allow your opponent to knock you out. Ignoring risk and trade management is just like walking into a boxing ring with your hands stuck to your sides, leaving your whole body and face exposed.

We believe that the difference between a good investor and a bad investor comes down to the proper use of trade and risk management. This is not to say that stock picking, market timing, and analytical skills do not play a part in the success of traders. However, it is trade and risk management that allows such qualified investors to keep the fruits of their labor and not give back all their profits. We all have heard many stories of day-trading millionaires in the tech boom of the late 1990s when all it took was going long in anything with .com in the company name to make money. However, most of those millionaires walked into the year 2000 with their gloves at their sides and were systematically knocked out one by one, with many of them losing all of their gains. Again, these traders focused on the techniques of trading without worrying about a good defense—risk and trade management.

Therefore, our first step before learning trading strategies is to review the principles of good risk management. As with any skill, you will not pick it up simply by reading this chapter once. You need to study the principles and practice applying them as you trade. It takes time before it becomes ingrained into your trading style. As human beings, we are susceptible to the emotional stress, anxiety, and excitement that come with trading and making or losing money. The principles of risk and trade management help remove much of the emotion from trading and go a long way toward helping you as much as possible to avoid making costly mistakes.

http://www.pbookshop.com

THE PHILOSOPHY OF RISK

The most misunderstood concept in investments and finance is the concept of risk. However, risk is what investing is all about. Remember the old cliché: It takes money to make money. What this really means is that to

make money you need to risk money. You must put some of your capital at risk in order to receive a reward. It is the incentive of the reward that encourages you to take on the risk. Because you must risk money to receive your reward, the science of finance is all about pricing and quantifying that risk to determine whether the reward is worth the risk.

Assume that a 5-year U.S. treasury note is paying 4% interest per year. We often refer to U.S. treasuries as risk-free securities because the odds of the U.S. government defaulting on the note are so infinitesimally small; you are practically guaranteed to receive your interest throughout the life of the note, as well as the return of your principal at the end of the 5 years. Assume that a private corporation is also offering a 5-year note. This corporation is a very strong business entity but there is a small risk that the business could go under and you will not get your principal back. If the corporation is offering to pay 4% interest per year, would you consider purchasing the corporation's note over that of the U.S. government?

Naturally, the answer is no. Why should you purchase a risky security that is paying the same interest, or reward, as a security that technically has no risk? There is no incentive at all to take on the risk of the corporation defaulting and losing your money. The basic theoretical concept of risk/reward is that you should be compensated for taking on additional risk by receiving a higher reward (return). Of course, the theory of risk/reward is more complicated than our simplification, but for our purposes of understanding risk management, it is sufficient to state that investors require higher returns in order to take on increased risk. Therefore, in order for the corporation to induce you to purchase their security, they need to offer you a better reward to compensate you for taking on the additional risk over the risk-free security. Assume that the corporation and the investors decide that, using complex financial models that are beyond the scope of this book, offering an additional 2% interest per year on the note is enough of an additional reward to compensate for the greater risk that exists in the corporation's note. In other words, 6% per year in interest is perceived by the market to be a sufficient reward to encourage investors to purchase that corporation's note.

This example summarizes the basis for all investment decisions. We want to know the risk of the investment and the reward we receive for assuming such a risk. If we have two investment alternatives, the way to select the best choice for our money is to compare the risk and reward of each investment to determine which one gives us the best reward for the amount of risk we must assume. Therefore, before every trade, you should always determine and quantify the risk and reward of the investment.

http://www.pbookshop.com

With respect to options, the quantification of risk and reward is very straightforward and is covered in our first and most basic principle of risk management:

KEY PRINCIPLE

You must be able to determine and quantify the maximum risk (loss) and maximum reward, as well as the breakeven points, of a position before committing any money to that investment.

This principle requires that you calculate the maximum risk, the maximum reward, and the breakeven points for every trade you are considering. Even if you fail to make these determinations prior to entering a trade, you should be able to look at any existing trade and immediately determine the maximum risk, maximum reward, and breakeven points. Deriving these three factors should become second nature. We cannot emphasize enough how important it is for every investor to understand and be able to derive these three factors before entering into any position.

We strongly recommend that you calculate these three factors in the same order as we stated them; that is, first calculate your maximum risk, then your maximum reward, and finally your breakeven points. The reason is that for you to be truly successful, you must understand the next principle of risk management:

KEY PRINCIPLE

You are a risk manager first and an investor or trader second.

Most traders immediately start by thinking of the maximum reward because they are only focused on how much money they could make. They forget that to make that money, they first need to risk something. Greed makes you focus on your reward first and clouds your judgment regarding risk, which leads to costly mistakes. For example, many investors become enamored with the idea of selling options to take in premium because they immediately get a credit. They focus first on how much money they receive and pay little attention to the enormous risk that comes with selling naked options. Unfortunately, the time they eventually learn about that risk is when they have suffered huge losses and are forced out of the game altogether.

Always focus first on how much money you could lose. Focusing on how much money you could lose puts you in the frame of mind of a risk manager. Once you have understood and accepted the amount of money

http://www.pbookshop.com

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

you could lose, you can make a clearer decision on whether you are willing to proceed with the analysis and possibly proceed with the trade. You will begin to make decisions based on how to quantify, control, and limit your risk.

We caution the reader to not take lightly the extent of the maximum risk derived for any trade. For example, some option strategies have unlimited risk. Most traders take the words "unlimited risk" too lightly at times because ego and pride makes them feel that it really is improbable to have unlimited risk. They say things such as, "I will get out of the position if it moves against me long before I suffer any major losses." However, the market can prove us wrong in very costly ways, as the following story demonstrates.

Nick Leeson, a 28-year-old derivatives trader, worked for the 200-year-old Barings Bank out of its Singapore office. In November and December 1994, he began selling naked options on the Nikkei index (Japanese stock market), expecting the Nikkei to trade sideways over the next couple of months. As long as the Nikkei stayed in a tight trading range, Leeson would profit from his naked option positions. On January 17, 1995, an earthquake hit Kobe, Japan, and as a result of the economic aftermath, the Nikkei started to fall sharply. Instead of closing out his positions to cut his losses, Leeson began purchasing futures on the Nikkei index to stop its fall and try to reverse the declining market. The more the Nikkei fell, the more futures Leeson purchased to try to overcome his growing losses.

http://www.pbookshop.com

More and more margin was required for the naked options and growing futures position Leeson amassed until the margin calls became too much for Barings to cover. The magnitude of the losses totaled around $1.3 billion. Leeson was arrested and put in prison because he hid the size of his trades from Barings, which was forced into bankruptcy. The Dutch bank ING stepped in and bought Barings, a 200-year-old bank, for $1.00. Next time you see an advertisement for ING, remember how one trader ignored maximum risk and good principles of risk management and brought down an entire bank.

TRUTH ABOUT REWARD

Before proceeding further with risk and trade management, we clarify some myths related to the rewards of option trading. Breaking down some of the misconceptions of the potential rewards of trading options is imperative for traders to truly understand and appreciate the risk involved. The following principle seems obvious enough, but we find too many traders,

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

both novices and experienced investors, fall prey to this greatest misconception of all:

KEY PRINCIPLE

Options are not a get-rich-quick scheme.

The potential rewards of option trading are significant, but in no way should it be seen as a get rich quick scheme. Traders looking for quick cash end up trading more on emotion and greed than detailed analysis and proper risk management. The desire for money forces investors to look desperately for the next trade. They are more likely to take unnecessary risks to get their return, and those additional risks usually lead to large losses. It is even worse if they happen to have some positive results early. If investors have a string of successful trades, they develop a false sense of invincibility and ego and begin to increase the stakes in their already risky trades until they lose everything very fast.

KEY PRINCIPLE

Investing is a long marathon, not a fast sprint.

http://www.pbookshop.com

The honest truth about rewards is that they take time and effort. It is unrealistic to assume that everyone can start trading options and turn $5,000 into $100,000 in 1 year. You should therefore have a realistic plan about the type of rewards you can earn and in what time frame. Making money in options requires a lot of commitment and discipline. Investing in options is like starting a business. In the beginning, most investors lose money, and it takes a lot of effort, research, experience, and even some luck to be successful and start producing results. Therefore, the beginning stages might be quite frustrating, and you may even feel like the market is out to get you. However, the path to the rewards of investing can be a profitable one if you have the discipline, patience, and determination to do the work.

RISK MANAGEMENT

Risk

Once you have an appreciation and respect for the risks involved in trading and the hard work required to reap the rewards, you can begin to understand how to use risk management to improve your trading performance.

First, the whole point of using options to trade is that they are an excellent tool for controlling and limiting risk. Therefore, your first step is to always trade with the intent to limit or control risk. Once you have a handle on the risk, you can prevent any one trade from significantly reducing your trading capital.

The first step we have already emphasized is to know exactly what your risk is before entering a specific trade. Once you have quantified that risk, that is, say, $400 or $4,000, you need to determine what your plan is if the trade goes against you. It is nice to think that every position you enter into will make money, but you always have to consider what will happen if you are wrong. You need an exit strategy based on the price of the underlying stock or the percentage loss at which you decide to close out the position to prevent any further loss. Thus, the following is an important principle in risk management:

KEY PRINCIPLE

For each and every trade, you must determine your exit strategy for when the trade goes against you.

http://www.pbookshop.com

Assume you purchase 100 shares of ENRON at $70 for a cost of $7,000. You expect ENRON to move higher and therefore are bullish on the stock. However, before you purchase ENRON, you need to develop an exit strategy to decide when you will get out of the trade if the stock moves lower instead of higher. If you develop the exit strategy ahead of time, then you can make the decision before your capital is at risk. By developing your exit plan before your money is at risk, you can make a clear, emotionless decision as to how much loss you are willing to absorb before you decide to close the position. If you wait until the stock starts dropping in price, you may begin to panic, get frustrated, and even freeze up and fail to pull the trigger and close the trade when you should.

You may even utter the words that are the kiss of death in risk management: “The stock has to recover and move back higher; it cannot just keep falling forever!” The reason we call this the kiss of death is because as soon as you utter this phrase, you are practically giving in to the position and letting it control you. You are refusing to close out and limit your loss because of a false hope that the position will recover. So you end up waiting and doing nothing and losing even more money. That phrase is an indication of “trade freeze” where you are unwilling to make a move to limit your risk. We used ENRON as an example because we can bet that many traders held onto ENRON the whole way down until it was worth $0.10, crying the whole way that the stock just has to move back higher.

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

The stock is under no legal obligation to move back higher simply because you are holding 100 shares. Such thinking violates the following principle:

KEY PRINCIPLE

The market will tell you which way the stock is moving; you cannot tell the market where you want the stock to move.

When the stock is falling, you are in the heat of a battle and it could be too late to try to make a logical decision concerning your risk. Your perception is skewed and becomes biased because you are losing money, and you will look for things that are not there. For example, you will be so desperate for the stock to recover that you will look for any signs of life and hang your hopes on those faint signals.

If the market is telling you that the stock is moving lower, then your desire to not lose money will make you ignore the obvious signs. Therefore, we cannot stress enough that you must make an exit plan before the trade so that if the stock drops in price, you will not freeze up or panic but simply stick to your risk management plan and close out the position. This way, you will prevent any one position from wiping out your other gains or your trading capital. However, establishing a predetermined exit strategy works only if you follow the next principle:

http://www.pbookshop.com

KEY PRINCIPLE

You should have the discipline to stick with your exit strategy plan to cut your losses no matter what happens. Any decision to stray from your exit strategy should be based on sound analysis or as a result of a change in circumstances of the underlying security.

Your exit strategy is based on your personal risk tolerance. It is better to establish a specific exit strategy than a generalized plan to maybe get out of the trade if it moves against you. Assume you did purchase 100 shares of ENRON at $70. You could have decided that you would close out your position if it loses 15%. You could have used a monetary value and decided to close out the trade if it is down by more than $1,000. If you used technical analysis, you may have developed an exit strategy based on the stock price and a technical indicator you found in the price chart of ENRON. For example, if you found that ENRON has support at $67, you could have decided that you will close out the bullish position if ENRON breaks through support at $67 and continues to move lower.

There is no one right answer in developing an exit strategy. Each person has a different risk or loss tolerance or a different assumption of where the stock will move to. Therefore, we recommend that you develop an exit strategy that is comfortable for you. If you put $7,000 of your $200,000 portfolio into ENRON, you may be willing to absorb more of a loss before closing the position than someone who had $7,000 worth of ENRON in a $10,000 portfolio. As long as you are comfortable with the basis for selecting your exit strategy, then your only real concern is that you stick with your plan and act immediately when the stock hits your loss target, whether it is a specific stock price, loss percentage, or loss amount.

This approach is also applicable when trading options, because the underlying security is a stock. For example, if we bought a $70 Call on ENRON instead of 100 shares of stock, we could use the same criteria for determining when to close out our option position, with one notable exception—time. Because options have expiration dates, time affects the value of our long options as well as our short options. Therefore, we may also have an exit strategy based on time. For example, we may determine that we expect ENRON to move higher in the next 30 days or so and purchase a 2-month call. Our exit strategy could be that we close the long call if ENRON has not moved higher in 30 days because that was the time period in which we expected a move.

Therefore, the first part of risk management is determining what our maximum risk is before entering a position and then developing an exit strategy to close out the position if the trade moves against us. You will never have a perfect record when trading; you will have losing positions no matter what you do. However, if you have 10 trades and 9 move against you, you can still have an overall positive return if you practice good risk management by closing out the 9 losing trades before they produce significant losses. Always know the full risk before entering into any investment and always have a plan to get out if you start to lose money.

http://www.pbookshop.com

Reward

We do not just recommend developing an approach for handling the risk of a trade, we also advocate dealing with the reward portion as well. Most investors enter into a trade expecting to make money. They do not really develop clear reasons why they expect to make money except for such standard analysis as "I expect the stock to go up." In addition to understanding the risk involved in a trade, investors should understand the reward they hope to receive as well. Why do you expect the stock to move higher? Do you have an idea of how high you expect it to move? When will you close the position? How long do you expect to hold the stock? Most traders gloss over these types of questions and simply place their money

into the trade. However, if you do not consider these questions, how will you know the right time to get out of the trade and pocket your return? How do you prevent trade paralysis, where you watch a winning position turn into a loss right before your eyes because you failed to close it out when you had an unrealized gain?

The tendency by most investors is to simply buy and hold a stock without any clear plan as to when to get out if they have an unrealized profit. For the long-term buy-and-hold investor, this is the right thing to do. The long-term investor (e.g., someone investing for an individual retirement account, pension plan, or college fund) is buying for the long haul, and the strategy is to hold on for years and let the stock move higher over time. However, for all other investors and traders, risk management also involves properly managing rewards based on the following principle:

KEY PRINCIPLE

You should always have an exit strategy for closing out your profitable position.

http://www.pbookshop.com

Most investors ignore this tenet of risk management because they feel that if they are making money, why do they need an exit strategy? Failure to have some sort of profitable exit strategy usually indicates that you do not have a vision going into the trade. You expect the stock or option to go up in price and make money, but stocks and options do not just go up indefinitely. If you have no logical reason for the trade, then you will never know the right time to get out. What usually happens is that you end up cutting profits short or letting winners run too long until they reverse and produce losses. Therefore, you need to manage your gains as much as you need to manage your losses.

Before entering a trade, you need to develop a plan as to what your profit target is. Once that profit target is reached, you can close out the trade and pocket your returns. You do not need to be as strict with profit exit strategies as we recommend you be with exit strategies when the position is losing money. The profit in the position provides additional room to breathe, and therefore you can give the position more time as long as the stock or option continues to show strength in moving in the expected direction. For example, you could close out the position if it earns 25% or if the stock hits a certain price or resistance point. Maybe you have a predetermined dollar value you are looking to make. Another option is to close out half your position when the trade doubles in value (e.g., for option trades) to take your cost off the table and play with "house money."

In addition to an exit strategy, you should also plan potential trade adjustments to enhance the performance of your position. The goal of the

subsequent chapters is to teach you various trading adjustments to make to your trading position. Many of these adjustments are meant to reduce your risk, lock in a profit, or hedge against a loss. Making plans on how to adjust a position in the middle of the trade could lead to a rushed decision that is not that well thought out. If the market begins to move quickly, it may cause you to rush into making an adjustment that is inappropriate for your position. Therefore, we recommend that before you enter into a position, you also plan what potential adjustments you can make. You can study the various adjustment strategies covered in this book and become familiar with the ones that best fit your trading style and risk tolerance. Managing risk and reward after you open your position through trade adjustments is just as important as managing your risk and reward before you enter into the position.

Breakeven Points

Every position you enter into may have one or more breakeven points at which you either recover the costs of the position or suffer no profit or loss. When you establish a position for a net debit, the breakeven point is very significant because it tells you how far the underlying security has to move before you recover the cost of your trade. If you establish a net credit trade, the breakeven point tells you at what point you will begin to lose money on the position. Therefore, the breakeven point is a significant part of risk and reward. You should be able to calculate the breakeven point of any trade before you enter the position, as well as the new breakeven point created from any adjustments to the trade.

http://www.pbookshop.com

TRADE MANAGEMENT

Trading Theme

In the previous section we covered risk management and recommended that before every trade you should determine your maximum risk, maximum reward, and breakeven points, and also determine an exit strategy if the position is making or losing money. Taking such steps before the trade is entered into is a way for you to examine the risk, quantify it, and develop a plan on how to control it. The subject of trade management also focuses on dealing with risk in your trades and portfolio as a whole as well as your overall approach to trading.

The best way to teach the lesson of trade management is to use the analogy of chess. When learning chess, the first step you take in improving your game is to learn opening strategies, that is, specific sets of moves

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

made in the beginning of a chess game to establish a certain attack or defensive pattern. Beginners study the moves and memorize the patterns. They learn different variations of the openings so that they can adapt in case the moves occur in a different order than the memorized pattern. Chess openings usually cover the first 10 moves or so but set the stage for the entire game. If you can establish a good position through proper use of an opening strategy, then you will have a strong defensive position from which to attack and gain the advantage.

The problem is that most novice chess players merely focus on memorizing the moves. They look at the picture of where the pieces are supposed to be at the end of the opening stage and work on getting their pieces into the same position. They study the mechanics only and therefore move mechanically without thought. Their analysis is only move to move, and they do not see the bigger picture. Chess is a game of strategy and concentration and is unlike checkers, where both players simply react from one move to the other. What the beginner fails to realize is that every opening strategy has its own theme. For example, one opening has a theme of establishing a strong offensive position in the center of the board while another is focused on establishing a strong defensive position.

Each opening is not just a series of mechanical moves. To have success in executing each opening strategy, you must understand what the theme of the opening is. What is the opening trying to accomplish? Understanding the theme will allow you to move away from simple mechanical moves and force you to play with a goal in mind. As long as you have the overall theme mastered, you can execute your plan no matter what your opponent does. Even if your opponent reacts in an unexpected manner, you can still stick with your overall plan and adjust with no problem. Each move will be made within the context of the opening strategy, and you will be able to calmly execute your plan.

How is this relevant to option trading and trade management? Like chess novices, many new traders focus only on the mechanics of trading. They study the option strategies and concentrate on how to open and close positions; that is, they become mechanical traders. However, every trade has a theme behind it. When you select a stock to invest in, there is an overriding theme to your investment. You have conducted research and analysis on the security and have made a prediction or assumption about the direction you expect the stock to move and how long you think it will take to make such a move.

Another mistake novice chess players make with respect to selecting an appropriate opening strategy is that they fail to choose the strategy that best represents their playing style. For example, players with an attacking style should not choose a passive defensive opening strategy. If they do, then they will attempt to make attacking moves from a position that

http://www.pbookshop.com

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

was not intended for such attacks and will end up weakening their position and opening themselves up for severe counterattacks. This mistake is often made because the players ignore matching the theme or overall strategy of the opening they choose with their playing style and simply focus on the mechanical moves. The difference between chess players and chess experts in this respect is that experts understand the theme and the strengths and weaknesses of the opening they select as well as the strengths and weaknesses of their playing style and focus all their moves on executing that strategy.

Assume you have analyzed and researched the stock of XYZ and have decided that the stock will move higher over the next few months. Your reasons could be based on technical analysis or fundamental analysis or a combination of the two. You have established a theme for your investment in XYZ. Your theme is that you are bullish on XYZ for specific reasons and you wish to make an investment that will profit from the impending rise in price of XYZ over the next few months. In other words, you have developed a plan of attack on XYZ. Most investors do not see trading as developing themes and plans for attack, but investing without any plan or theme is simply throwing money around like a gambler would do at Las Vegas, moving from table to table. Therefore, like expert chess players who select an overall theme to their opening strategy and move each piece in furtherance of this plan of attack, the option trader must also develop a trading plan for each position.

http://www.pbookshop.com

To develop a trading plan or theme, you need to decide what your trading objectives are. Most investors simply say that their objective is to make money. However, this is too vague of an objective and is akin to the chess players simply saying they want to win the game. The more specific objective is focused on how you want to make your money. Do you want to make money buying stock, shorting stock, purchasing calls and puts, selling options, using spreads, using nondirectional strategies, using high-risk or low-risk strategies, picking specific stocks or sectors, trading volatility, picking only one strategy or various strategies, only focusing on indexes (but which ones?), and so on? As you can see, the question of how you want to make your money has numerous answers and can be quite overwhelming to a trader with so many investment choices to choose from.

When chess players are researching openings, they are encouraged to select the openings that best fit their playing style. With an almost infinite list of opening strategies, you can easily find a strategy that best fits your playing style: conservative, aggressive, offensive, defensive, direct attacking, flank attacking, slow development, quick development, and so on. The same process is required of investors. Traders need to determine what their trading style is and their level of risk tolerance.

This self-assessment process is the most important step in developing an effective trade management system. In *The Art of War*, the classic treatise on strategy, Sun Tzu wrote, "If you know the enemy and know yourself, you need not fear the result of a hundred battles." With respect to investments, the enemy is the uncertainty of the market and every trade is a battle. Knowing yourself means that you must put in the effort to classify your trading style. Are you a conservative or an aggressive investor? Is your time frame short term or long term? Do you prefer focusing on a wide array of sectors or indexes or just a few select stocks? If you study and research the market and you know your own trading style, then you need not fear the result of a hundred battles (trades). You will be able to match your trading style with the right investment choices. Although you will not win every battle, your wins will outnumber your losses as long as you always trade within your style.

If you do not know your trading style, then you will simply follow the crowd and invest blindly. You will trade without conviction and be easily swayed by the volatility of the market. Worst of all, you will look for guidance from any source to find trading ideas instead of developing them on your own. This usually results in following the wrong advice. You will never understand what is causing your losing trades to fail and your winning trades to make money, and your luck, because no skill is involved when trading blindly, will run out.

http://www.pbookshop.com

Once you have determined your trading style, you can develop the appropriate trading theme to match your style, just as chess masters select the appropriate opening theme to match their playing style. Then it will be easier to know what trading opportunities to look for. For example, if you are a long-term conservative investor, you will look for stocks of well-established companies with a history of sustained growth. You would then be inclined to select more appropriate option strategies for this type of stock—such as Long-term Equity AnticiPation Securities (LEAPS), covered calls, long calls, and bull spreads. Understanding your trading theme will narrow your focus and make it easier to research investment alternatives.

The Theme of Your Portfolio

Developing your trading theme will assist you greatly in developing a portfolio of investments that are all focused on furthering your goal of positive returns. As much as you need an overall theme for your investment strategy, you need a theme of trade and risk management for your portfolio. For example, if you have a conservative, long-term investment theme, then your portfolio should reflect this theme in your risk and trade management. You will not allow any position to make up a significant portion of your

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

portfolio and thus expose you to too much risk. You might keep a certain amount of cash in reserve so that you always have capital in case a good trading opportunity comes along. Finally, you might decide that because you are a long-term investor, you will not trade your portfolio frequently. Your investment theme will therefore affect the way you balance your portfolio and manage your risk.

If you are aware of your investment theme, you should be able to glance at your portfolio and see that theme reflected in your trades and the structure of your portfolio. To truly understand this principle, let us look at the most basic example, which is prevalent in mutual funds. Assume that you are a fund manager of a small-cap value fund. The investment theme of the fund is to find stocks with small market capitalizations (i.e., $500 million or less) that are relatively cheap based on some criteria such as price-to-book and price-to-sales ratios. You will only investigate and invest in small companies that meet your thematic criteria and select the companies that best represent your trading theme. Of course, you will also be concerned with future growth prospects, earnings, and capital appreciation. If we were to look at the stocks listed in your fund, we should be able to notice that all the stocks you are invested in appear to be small companies; that is, we will not find GE, MSFT, or IBM. Thus, a basic principle of your trading theme will be obvious in your overall portfolio.

http://www.pbookshop.com

You should conduct the same exercise on your portfolio. Do all your trades appear to represent a particular trading theme or are they a hodgepodge of different, unrelated strategies with one thing in common—your capital at risk? If that is the case, then you lack a portfolio theme. This makes it difficult to follow your investment decisions and keep track of why you made each trade, because each position will most likely have its own independent justification.

If you do not have clear guidance on why you entered into each trade, then you most certainly will not be following predetermined exit strategies. Therefore, you will also be ignoring the principles of risk management; when you fail to control your risk, your risk will control you! Investing with this kind of "trade blindness" is akin to gambling in Las Vegas, and remember the old adage in gambling, "The House always wins." If you have never gambled, let us clarify that you are not the House, and eventually you will lose everything when your luck runs out. Therefore, following your investment theme in your portfolio will keep your trades focused and allow you to better manage and control your risk.

Diversification and Flexibility

All the strategies within your portfolio need not be identical simply because they are established under the same trading theme. Diversification

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

is highly recommended in all aspects of investing, including the selection of option strategies. A portfolio theme, for example, does not envision having a portfolio made up entirely of covered calls or credit spreads. There are various option strategies that share common investment themes. Each strategy may work better under certain conditions, and therefore we need to understand the best environment for each one. Golfers have more than 10 clubs to choose from each time they hit the ball, and to be successful they must understand which club is best to use in different situations. The same is true with option strategies.

Avoid falling in love with any one strategy. If the market conditions change, a particular strategy may be inappropriate. As a result, you must be flexible in choosing a more appropriate strategy. Therefore, not only must you diversify your strategy selections, but you must also be flexible and adapt to changes in the market to switch to strategies that are more appropriate. You must adapt to the markets; the markets will not adapt to you.

http://www.pbookshop.com

TRADING AS A BUSINESS

The best way to incorporate all the principles of risk and trade management into your investments is to treat your trading as a new business. Your business is trading, and you are the president and chief financial officer of the company. This is a professional endeavor and not to be taken lightly or treated as a game or hobby—you are risking real money. You should think of trading as a career, and your job is to run the company that controls your investments. The employees of your business are your trading positions, and their jobs are to make you money. Whether you are an investor who merely trades on the side or a professional money manager or trader, you should have the same professional approach to your trading.

Start-Up Phase

At the start-up phase of a new business, there are many sunk costs and expenses required to get the business started as well as much preparation and hard work. As the owner of the new company, you need a detailed business plan, which outlines the purpose of the business and how it will get started and conduct its daily operations and also provides guidance on budgeting issues so that the company can manage its revenues and expenses. You will need to acquire assets to start the business and hire employees. The start-up phase, which usually covers the first year, is the most important and difficult part of starting a new business. Most new businesses take some

time to be profitable, and therefore you, as the owner, have to be able to bear the losses until your company can begin turning a profit.

Option trading also has a start-up phase. You will need to invest time and money to learn about options and study the market before you begin to trade. Most traders begin working hard after they start trading and fail to prepare ahead of time. Learning on the run, that is, learning while you trade and lose money, is a very expensive form of education. Of course, you will constantly be learning as you trade, but before you invest the first dollar in your new business, you need to commit yourself to learning everything you can about options.

We have dealt with many option traders, both beginners and experienced investors, who still do not understand the mechanics of options. We are not referring to the complexities of options, which take some time to master, but rather the basic mechanics that every investor must know before risking a single dollar. Investors with a couple of thousand dollars committed in a position with short options have admitted to not knowing about assignment and exercise. Some investors will place $3,000 into a position and then ask for help in how to close the trade after they have made money (imagine putting money somewhere, realizing a nice profit, and having no idea how to get that money out). Others know nothing about time decay. You cannot invest in a security such as options with expiration dates when the security will no longer exist and not understand the role time plays in the value of an option.

If you planned to start a small company, you would not commit capital without a basic understanding of how the business you are entering into operates. Why? It would be too risky. Remember, your goal is to reduce and control risk, not increase risk. Therefore, taking the time to understand the mechanics of options before committing funds will help reduce the risk you are exposed to when trading. Our advice is not just for novice traders only. Many experienced option traders only focus on one type of strategy and therefore only learn what is relevant for that strategy. However, many traders who change their strategies never bother to learn more about the mechanics of the new strategies they are trying, and as a result many experience significant losses. Losing money simply because you do not know a basic characteristic of options is akin to throwing money out the window. When running a business, which is how trading should be treated, you cannot overlook crucial pieces of information and expect to make money.

Therefore, as with starting a new company, you should put in the effort and time before you begin trading to learn the business you are about to enter. Even if you have traded stocks for years, options are completely different. The mechanics of options are not difficult, so there is no reason not to learn them. Do not just learn that you buy a call if you expect the stock to go up and a put if you expect the stock to go down. You should learn

http://www.pbookshop.com

about exercise and assignment, time value and time decay, implied volatility, the factors that affect the price of options, open interest and volume, how options are traded, and so on.

If you are an experienced option trader, then give yourself the time now to ensure that you learn as much as you can about options. You may be surprised to learn some things you never knew had a negative or positive effect on your trading. The worst trait of a trader is hubris, or excessive pride. Thinking you know everything about trading may cause you to not learn something very basic that could have helped improve your overall performance.

Just as a new company is based on a business plan, so should trading options. We have already discussed the type of business plan that is required for trading options—an investment and portfolio theme. Developing these themes is, in effect, the business plan for your investments. Therefore, before you begin trading, you should have your trading business plan developed. Write it down so you can refer to it regularly and keep focused on your trading themes. Adjust them as you and your portfolio adapt to the market. Businesses have to adapt to changing market conditions and so do investors. If you are an experienced trader and are investing without a business plan, take the time now to develop your trading and portfolio themes before putting another dollar of your capital at risk.

http://www.pbookshop.com

Remember that the first year of a new business can be difficult and that it sometimes takes a while before the business is profitable. Option trading takes the same time and effort. One of our earlier principles was that options are not a get-rich-quick scheme. You may experience some losses at first as you gain experience and get the feel of how options work. Although we stated that you should learn all you can before beginning to trade, some things can only be learned by actually trading, such as the feel of the market. Therefore, when you start trading, as with any new business, you need to be able to absorb some losses without going under. Start trading with capital you are willing and, more importantly, financially capable of losing. This way, you can learn from any trading mistakes without losing all your money and becoming unable to trade again. We all have our own learning curve, and we always learn more from our trading losses than we do from our successes.

We mentioned earlier that the employees of your new business are the trades whose job is to make you money. A new business usually hires only a few employees when starting out and is very selective about its hires. The first employees play a key role in getting the business started, implementing the business plan, and helping the company generate a profit. Therefore, the company only wants qualified employees who match the philosophy of the new business. Your option trades also have the same responsibilities. You should be very selective with your trades and only choose those

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

candidates that are qualified such that they meet the criteria laid out in your investment themes. Every trade should have some relationship to your investment themes. If you wish to move into a different area, simply adjust your investment themes.

When you are starting out in a new business, you do not want to expand too quickly and be overstaffed because it will be too difficult to keep tabs on so many employees, and this will result in overspending. With trading, you do not want to start off by opening numerous positions and being "overstaffed." As stressful as trading is, you do not want to make it worse by having to follow 15 trades at the same time. It is very difficult to monitor all those positions at once and still apply the principles of risk and trade management. Moreover, having so many trades requires much capital, and you may be spreading yourself too thin. Start small and grow your "company" as your capacity to handle more "employees" grows.

The most important part of hiring "employees" (making trades) is that you have to remember your role as employer. The job of your "employees" is to make you money. Many companies set performance standards that their workers have to meet. If those performance standards are not met, the workers lose either their bonus or their job. If your "employees" produce losses, then they are not performing as expected; consequently, fire them. There are no bonus reductions or letters of reprimand. You have to run a tight business because it is your money at stake. If you have a position that is not performing, then fire it. In other words, close out the position before you lose more money. We discussed exit strategies earlier. These exit strategies are the criteria you establish to fire "employees"—for example, losses greater than 10%, fired! Do not be afraid to fire underperforming "employees," because keeping them on the payroll will just cost you more money.

http://www.pbookshop.com

Growth Phase

When your trading "business" enters the growth phase, your portfolio is growing bigger and your trading theme is more established. You are executing trades in furtherance of your investment and portfolio themes and practicing good risk and trade management. As your portfolio grows, you are not straying from any of your original principles. You have a group of "employees" that are performing, and you routinely fire the ones that do not perform and replace them with new ones. As CEO, you are studying the market and guiding your business through the ups and downs. You have some losing months and some winning months, but you try to manage your capital so that no losses wipe out your company, and try to keep some cash in reserve for insurance and possible trade opportunities that may arise.

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

This is by far the most exciting phase of your trading "career." But it also requires the most discipline, even more so than in the start-up phase. It is very difficult to get started and actually make money. It is even more difficult to stay profitable. The tendency for most businesses when they begin making money is to think that they are invulnerable and will just continue making more and more money. They begin to stray from the business plan and make riskier choices in the desire to make even more money. They may even try to move too soon into other markets to capture as much of the business as possible and end up expanding too quickly. Once the business gets too overextended, one small slipup or a series of losing months usually has disastrous effects and could bring the business crashing down.

With option trading, once you begin to make money consistently, that is the time where the principles you followed during the start-up phase become even more important. The reason you are making money is because you followed those principles, so why abandon them now when they are more important? The principles of risk and trade management are meant to ensure that you keep the money you earned. The key to the success of wealthy fund managers is that not only did they make money, but they kept it as well.

http://www.pbookshop.com

Mature Phase

After you start your business and work to consistently grow your portfolio over time, you reach the mature phase. You worked very hard at incorporating risk and trade management into your investing, and it allowed you to stay focused on your investment themes. You have some periods where you lose money and some periods where you make money, but overall your return is positive. You use a diversified pool of strategies and because you remain flexible, you adapt to changing market conditions to take advantage of the benefits of using different option strategies.

As a mature investor, the amount of work and discipline required does not diminish. Your focus is still on controlling your risk because you do not want to watch all your hard work disappear in losing trades. Most likely, you have more "employees" than you had in the past, but no more than what you can effectively manage. You have probably adjusted your investment themes over time as you have become a better investor and learned how to use more option strategies or even the same ones you have always used but in different ways. Most important of all, you never stop learning and perfecting your trading style. Because the market is constantly changing, you cannot sit back and expect to always make money doing the same thing over and over. Remember, you always need to remain flexible.

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

Just Business, Nothing Personal

Treating your trading as a business means accepting the fact that it is just business and you should not take it personally. When you lose money on a trade, it is not a personal attack on your character or a conspiracy by the underlying security to ruin you. Losses are a part of trading, and no matter how successful you become, you will always experience losses. That is why we focus so much attention on risk and trade management, so that those inevitable losses will not hurt you.

Traders who take losses personally turn into emotional investors who resemble vigilantes. They have been wronged by the market and are out for justice. For example, assume an emotional investor purchases a long call on XYZ and instead of XYZ moving higher, it drops in price. The businesslike trader simply fires the underperforming employee and looks for another trade opportunity. Emotional investors wonder how they can make their money back on the position. XYZ has cost them money, and they feel they must make back their losses on that stock. Emotional investors usually take on more risk to get revenge on XYZ and, more often than not, end up losing even more money on a trade that should have been closed out sooner under a predetermined exit strategy.

There is no place for revenge in the business of investing. Taking losses personally is extremely unprofessional and will definitely cloud your judgment. You will trade on anger and resentment and depart from the principles of risk and trade management. We in no way recommend you take losses lightly, but losses are a part of trading; you can either learn from them and improve your performance or embark on a trading vendetta that will cost you even more money than you lost on that one position.

Whether you are a beginner or an advanced trader, at the start-up or the mature phase, you must continue to act like a trading professional. Keep your emotions in check as much as possible by not taking any losses personally. The market is not your enemy; the market is where your business will make money. If a stock does not move as expected and costs you money, then spend the time to analyze why the position did not work so you can make better decisions next time. That is the professional approach.

http://www.pbookshop.com

SCORE—THE FORMULA FOR TRADING SUCCESS

Now that you have developed a basic understanding of risk and trade management, we will provide you with a formula for how to successfully implement these principles in your daily trading. In order to make it easier to

remember our formula for trading success, we represent it by the acronym SCORE, summarized as follows:

Select the Investment
Choose the Best Strategy
Open the Trade with a Plan
Remember Your Plan and Stick to It
Exit Your Trade

Select the Investment

Before you can make an option trade, you need to find a good investment candidate. Options are derivatives whose value is derived from the price of an underlying security, which, in our case, is stocks. Therefore, before making any option trade, you have to identify what stock you are going to invest in as the underlying security. The process of stock selection is the most important and most difficult part of investing. Not only do you have to select a stock, but you also have to predict which direction it will move. An added characteristic of options is that you also have to determine the time frame of the anticipated move because options have expiration dates.

Because the value of an option is based on the underlying stock, a working knowledge of the stock market is imperative. If you know nothing about the stock market, you will know even less about how to trade options. For people who have never invested before, starting out in trading by using options is akin to trying to learn math for the first time by starting with calculus. Therefore, you need to know the stock market in order to trade options because you need to know how to pick stocks and make informed and reasonable predictions about the direction the stocks will move. The first step in placing a trade is selecting the underlying stock.

There are numerous stock-screening tools on the Internet using both fundamental and technical analysis criteria, which you can use to narrow your focus. Within these two types of stock analysis techniques are numerous indicators. There is no right answer on what combination of indicators to use. You have to research the different indicators and see which ones you prefer. You may also develop your own approach as to what combination of indicators gives the best signals.

We do not recommend one particular type of analysis over another, but rather emphasize that the selection process should involve some type of analysis to allow an educated prediction of future stock movement. You need a reason to select a particular stock for establishing a position. Part of the analysis of a potential stock candidate should include answers to the following questions:

http://www.pbookshop.com

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

Which direction do you expect the stock to move? Up, down, or sideways?
Why do you expect the stock to move in that direction?
Do you have an idea of the magnitude of the anticipated move?
Do you have an idea of the time frame of when the expected move will occur?

We are not implying that you should have specific answers to each of these questions. The questions should merely serve as focus points when conducting your analysis. Selecting stocks is not an exact science, but you can improve your chances if you make the effort to choose investments using as much research and analysis as possible.

Remember that the principles of investment themes become extremely important in the stock selection process. The stocks you are selecting and the criteria you are using to select them should be related to your investment theme. That is why we stress the importance of establishing your investment theme. It will provide a narrower focus when searching for stock candidates.

http://www.pbookshop.com

Choose the Best Strategy

Once you have found a stock through research and analysis and made an estimate about the direction, magnitude, and timing (as best as possible) of the future price movement, it is time to choose an appropriate option strategy. Before considering any option strategy, the first step is to look at the implied volatility of the underlying stock. In the next chapter we cover in more detail how to use implied volatility when trading, but we mention it here briefly because it is part of the process of choosing a strategy. Implied volatility helps us determine whether the options of an underlying stock are relatively expensive or relatively cheap. As with stocks, we do not want to buy overpriced options with inflated premiums. That is why the first step before choosing a strategy is to analyze the implied volatility of the underlying stock.

Surprisingly, most option traders ignore implied volatility when trading. Assume that you are looking to buy calls on a stock that you are bullish on and you do not realize that the implied volatility of the options on that stock is at a historical high; that is, the options are extremely overpriced. If you purchase a long call when the options are relatively expensive, you are overpaying for that long call. The more you pay for the call, the higher is your maximum risk and the higher is the breakeven point.

Once you have reviewed the volatility of the options, the next step is to select the best option strategy to match your assumption of where the stock will move to and in what time frame. There are easily more than 20

different option strategies covering bullish, bearish, and neutral positions, and choosing can be overwhelming. In the next chapter we outline most of the basic option strategies and briefly describe the best situation in which to use each one. The more familiar you are with the option strategies, the better you will get at choosing the most appropriate ones.

Finally, once the volatility and direction are determined, you must also estimate the time it will take for the underlying stock to make the expected move. For example, say you expect a stock to move higher and you purchase a 1-month call, and the stock moves sideways for the next 30 days and then starts to move higher. If your call expires, then you will not participate in the upward movement of the stock because you selected too short a time frame for your option. Therefore, when selecting a strategy, do not forget to take into consideration the time to expiration as well as the time you think it will take for the expected move in the underlying stock.

http://www.pbookshop.com

Open the Trade with a Plan

Now that you have selected a stock and the appropriate option strategy, you are ready to establish your position and open the trade. Before opening the trade, however, you must go through your risk management steps. First, you must determine your maximum risk, maximum reward, and breakeven points. Once you have selected your strategy, you should be able to immediately calculate these three factors. Review the risk/reward factors carefully. Make sure that you are comfortable with the risk and are satisfied with the potential reward. If the risk seems too high, or the reward is not sufficient given the risk or anticipated move in the stock, then either pass on the trade or return to the previous step and pick another strategy.

Once you are satisfied with the risk/reward profile of the trade you are considering, you must move on to trade management. Remember that trade management deals with exit strategies. Therefore, you must now determine your exit strategies if the stock moves as expected or moves against you. Based on your analysis of where the stock is expected to move, you can estimate what would be a good point to get out if the stock moves as expected. To limit your risk, determine a point at which you feel it will be better to close out the trade and take the limited loss rather than suffer the maximum loss.

Another part of trade management, and the main focus of this book, is planning possible follow-up trades or adjustment strategies, whether the stock moves as expected or the opposite way. It is not easy to envision every possible adjustment scenario before the trade is entered into, but you can still have a general idea ahead of time as to what kinds of adjustments

you can make. This type of preparation is useful because you can think more clearly while there is no money in the trade, and therefore no risk or stress, as opposed to waiting until something happens and possibly making a rushed decision.

Therefore, before you open the position, run through the risk and trade management process so that you are fully aware of the risks, how to control them, and how to manage your trade before any capital is committed. You will find that it is much easier to analyze the risk and plan the trade when there is no money on the line. Once the position is opened, you will have your plan in place, which will take some of the emotion and anxiety out of your trading.

One suggestion that may make this process more meaningful is to keep a trade journal for every position. In the journal you can write your notes about the stock and the fundamental and technical analysis points you used to make your investment decision. Next, you can write the option strategy you are choosing and why. Then you can write out the maximum risk, maximum reward, and breakeven points as well as your exit strategies, including any possible trade adjustments. Writing these things down helps for two reasons. First, it forces you to think out your trade, step by step. Second, it makes the exit plans and adjustments easier to follow because they are written clearly and serve as a daily reminder as to what you can do.

After numerous trades, your journal entries will demonstrate clear investment and portfolio themes. You can add notes to winning and losing trades as lessons learned from each trade to improve your performance. The journal will become a living textbook for you to document your learning process, which you can always refer to for past experiences and insight. Moreover, if you trade in the same stocks again and again, you will have your own history of what works with those stocks and what does not, as well as the relevant analysis, which you can use to find the same profitable opportunities again.

The final step in this process is simply to open the position. Once you have completed the foregoing steps, you are ready to open the trade with your broker. These steps may seem like a lot to do before every trade, and you may feel that by the time you run through this process the investment opportunity will disappear. However, the pretrade process can be done quickly if you are familiar with the various option strategies and how to calculate the risk/reward factors. That is why we stress taking the time and effort to learn all the necessary mechanics before beginning to trade. With some experience, you can run through the outlined process in less than 5 or 10 minutes and still have more than enough time to place your trade. With respect to your trading journal, you can place the trade first and then create your entry.

http://www.pbookshop.com

Remember Your Plan and Stick to It

Once your trade is established, the only thing you have to do is monitor your position and remember your trading plan. Because you put all the thought into planning the trade before you opened the position, your job is simply to remember what your plan is and stick to it. At this stage, you need discipline to follow your plan and not let your emotions bias your judgment. That is why we recommend the use of a trading journal. If you have various trades open at the same time, then your journal is a quick reminder of the trading plan you established for each position. When one of your positions begins to move one way or another, you can check your notes to see what exit strategies or follow-up adjustment you planned or suggested. You should always be prepared to make trade adjustments at any time during the position. These possible adjustments, covered in greater detail in this book, can be used to lock in a profit, hedge against a loss, or improve your overall return.

Although we recommend that you stick with your established trading plan, we also believe in flexibility. Therefore, your risk and trade management parameters can always change as long as you have good cause to adjust them. If you just change them in your head in the middle of a trade for emotional reasons (e.g., greed, anxiety, trade paralysis), then you are disregarding the principles of risk and trade management. If you change your plan, have a good reason for doing so; if you have no good reason for doing so, do not change your plan.

http://www.pbookshop.com

Exit Your Trade

Planning a trade and having it move the way you expected produces unrealized gains. In order to realize those profits, you need to exit the position. This sounds very simple, but sometimes greed and trade paralysis make you stay in trades too long and the position can move against you and wipe out that unrealized profit. Therefore, if you make an exit plan, then you need to execute that plan. Exit strategies are meant to limit your loss and take your profit off the table. This only works if you have the discipline to stick with your exit plan and actually follow through to close out your position.

On the profit side, if the position moves strongly in your favor, then you can adjust your profitable exit strategy if you feel that the trend is likely to continue. The better choice is to use one of the adjustments covered in later chapters to lock in some of that profit and let the position continue to run or to hedge against the position reversing and moving against you. With potential losses, you should not be so flexible because a small losing position can become a large losing position very quickly. In positions with

P1: SBT
c01 JWBT190-Jabbour October 27, 2009 16:58 Printer: Yet to come

an unrealized loss, either make an adjustment to limit or prevent further losses or get out altogether.

Once the trade is closed and you have limited your loss or collected your profit, we recommend that you follow up in your trading journal with some final notes on the position. If you followed your trading plan exactly and made money on the trade, then it is worth noting in the journal. If you deviated from your trading plan, then you should record what that change was and why. You should learn from your losses and gains alike, and if you close the trade and move on without realizing what made the trade work and what did not, then you will not improve as an investor. Trading is a process in which you are continuously learning and adapting, and the closing of a position should be just as educational as the process involved when you enter a trade.

http://www.pbookshop.com

http://www.pbookshop.com