

LEARNING MADE EASY



4th Edition

# Options Trading

for  
**dummies**<sup>®</sup>  
A Wiley Brand



Analyze and  
trade options like a pro

Generate income and  
reduce risk in any market

Stay ahead of AI in today's  
complex markets

**Joe Duarte, MD**

Started trading stocks and options as  
a hobby 34 years ago



# Options Trading

4th edition

**by Joe Duarte, MD**

**for  
dummies®**  
A Wiley Brand

## **Options Trading For Dummies®, 4th edition**

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# Introduction

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Welcome to *Options Trading For Dummies*, 4th Edition!

Although this book is still about introducing you to option strategies for managing risk, delivering profits, and navigating a variety of market conditions, a lot has changed since the last edition. In fact, a lot has changed since I first wrote its predecessor *Futures and Options For Dummies* in 2006. Indeed, the most radical of all changes in the financial markets is the role of *artificial intelligence (AI)*, otherwise known as *trading algorithms*, also known as *algos* or *bots*. Algos are program or computer traders, and they're now responsible for more than 80 percent of the trading volume on any given day. Even more spectacular is the fact that options trading volume now dwarfs individual stock trading volume, which means, that as I explain throughout this book, the proverbial tail now wags the dog.

Of course, most investors, especially those who are in the early stages of their career, are in a hurry and their number one goal is profits. And why not? Who wants to lose money? Still, options trading is very different from stock trading. Unlike other investments books, this one is geared to managing risk first, with the knowledge that profits will follow. With that in mind, the approaches I describe here focus on reducing potential losses from traditional stock positions and building an option strategy repertoire that's designed to increase your chances of making sound trades whether the markets are moving up, down, or sideways. Because I'm an active stock trader and because all the markets are now intimately interrelated via money flows and the actions of trading algos everywhere, I aim to connect the key dots between stocks and options for you so not only you



can trade options profitably, but you also actually know why any market is acting in a particular way.

An option contract is a unique security that comes with contract rights and obligations. When used correctly, an option contract strikes a balance between the risk of loss, the amount of money you put at risk, and reward, providing you with *leverage*, the ability to amplify the amount of profit via the use of margin, while still allowing you to reduce overall trade risk. Of course, there's another side to that leverage, increased risk. That's because margin, or the practice of trading with borrowed money, works both ways. But don't worry, the strategies in this book can help you understand and manage the risks connected with leverage and the tools that allow you to trade them.

When applying for options trading with your broker, the broker will send you the reference guide *Characteristics and Risks of Standardized Options*. This publication, written by the Options Clearing Corporation (OCC), must be distributed by brokers to their clients prior to allowing them to trade options. It describes option contract specifications, mechanics, and the risks associated with the security. Together, that publication and the one you're reading right now help you to understand your risks and use options effectively.

## ***About This Book***

This book now its fourth edition is great for you. Not only has it stood the test of time, but I've been able to address many of the quirks and other technical issues that arose with the book's earlier editions. Of course, nothing is perfect, but as you find out when you start trading options, the more you do anything, the better it gets. And so it is with this book.

Regardless of the reviews that you may read, comments from friends, or clever marketing on the Internet, options trading isn't a simple task. Don't get discouraged. If it were difficult, then why would so many people do it?

You can find hundreds of trading titles out there, including those focusing on option strategies. But this one primarily focuses on approaches aimed at managing risk and in giving you the information you need to trade successfully against clever day traders and algos. And if you're an experienced trader looking for something specific, feel free to jump around to areas that interest you most. Otherwise, if you're a beginner, I recommend you start at the front and work your way carefully through each chapter before you risk any money. If, as you read through the book, you find a strategy that's particularly appealing, feels natural to you, and makes you money as you deploy it, feel free to spend as much time as you need on getting it under your belt.

No matter your trading experience, you certainly can read this book cover to cover or use it as a reference guide, because each strategy provided identifies risks and rewards associated with the position as well as ways to implement those strategies. This book also identifies alternative strategies to consider for risk management, when applicable. There are a million ways to successfully trade the markets, but certain challenges are universal to all of them, especially when you're trading against algos and other entities in the market — day traders and market makers. To make life as easy as possible for you, I give you tools and techniques to address these challenges throughout.

## ***Foolish Assumptions***

This section is a hugely important part of the book, which many readers unfortunately skip and then voice their frustration about things they missed. If you're a beginner, you may find a lot of the material in this book confusing. And that's not your fault, or mine. That's just the way it is because although options trading originated in ancient Greece, in its modern form, it has been modified by guys with PhDs and further altered via trading algos. Thus, my goal is to make it as simple as I can for you. But there is only so much I can do with such a complex topic, so please be patient.

That means reading this material may initially be challenging. But, let me share one thing: I'm a dummy too, and that's precisely why Dummies books are so important because they make challenging topics like options trading (and algebra and anatomy and the LSAT) easier to understand. By reading this section you can understand my intentions when I wrote this book. Here's what I assume about you:

- » **You have some experience.** If you've chosen this book, you probably have some familiarity with the stock market and the risks and rewards it presents to you. As a self-directed investor, you seek ways to manage those risks and rewards. However, if you're not familiar at all with options or you've just had a little exposure to them, don't worry — I cover option fundamentals and mechanics, and they may be a great way to improve your knowledge base. Even if you've traded these instruments before, you can consider this book a review if you're looking for one.
- » **You're smart enough to know when you're over your head.** If you've never traded stocks or are new to investing, I assume that you can figure out whether this book is right for you at this time. I also hope that if

that's the case, you'll come back to it in the future when you're ready.

- » **You've read investing books before and you'll read this section carefully at some point in order to avoid pitfalls and misunderstandings as you go through this book.** I assume you know that this book won't have all the answers to your trading needs, but you also know that I wrote it carefully and thoughtfully. Also keep in mind that options trading isn't a simple concept. Although I've made this content as easy to understand as possible, some readers may find it difficult to initially grasp some of the concepts. That's okay. When I started trading options, I found them confusing as well. I've gone the extra mile and really worked hard to make this material as accessible as possible. I'm not trying to make anything difficult, yet some things are difficult by nature. But if you find something challenging, go to another part of the book and come back to it later. You may find it easier the next time.
- » **You hold longer-term investments.** Regardless of whether or not you choose to actively trade options, you hold or have held longer-term investments such as stocks and mutual funds. For that reason, I include core strategies aimed at managing risk associated with longer-term holdings. The small amount of time needed to implement them may be well worth it.
- » **You've already decided how to allocate your investment and trading dollars.** Although I distinguish investment assets from trading assets, I don't address how to allocate those dollars because everyone's financial situation is different. I do assume this is something you've already completed, because plans should strike a balance between the two (long term and short term) to grow assets.

- » **You have computer and Internet access.** I can't imagine trading or investing without a computer and reliable access to the Internet ... so I assume you have both. High-speed Internet is the best option if it's available in your area.
- » **You use a broker.** I assume you contact a broker to further manage your risk when needed, and I assume you also have a comfort level with your broker's web platform. It may serve as a resource for some of the ideas in this book.

## *Icons Used in This Book*

I've also added icons to highlight and reinforce different core ideas and give you some hard-earned trading insight. I use the following icons to point out these insights:



**TIP**

This icon is used to give you experienced insight to the current discussion. Consider this icon to be an aside that any trader might mention to you along the way.



**REMEMBER**

This icon flags important things to keep in mind as well as reinforces key concepts. If you hesitate for a moment when reading the core content, check for one of these icons to keep progressing smoothly.



**WARNING** Concepts that reiterate ways to manage potential risks appear with this icon. This icon highlights important things to watch out for if you want to avoid trouble.



**TECHNICAL  
STUFF**

When encountering this icon, you'll find slightly more detail-oriented tools and considerations for the topic at hand, but the information included with icons isn't necessary to your understanding of the topic at hand.

## ***Beyond the Book***

In addition to the material in the print or e-book you're reading right now, this product also comes with some access-anywhere goodies online. Check out the free Cheat Sheet at [www.dummies.com](http://www.dummies.com). Just search for *options trading*.

If you're looking for trading ideas, you can also visit my website: [www.joeduarteinthemoneyoptions.com](http://www.joeduarteinthemoneyoptions.com).

## ***Where to Go from Here***

Whether you're seeking to improve longer-term investing or shorter-term trading results, you can find strategies aimed at both goals in this book. By using the techniques on these pages and viewing yourself as a risk manager, your losses should decrease allowing you to move forward to increased profits.

You may decide to pick up this reference while evaluating your investments on a quarterly basis or keep it handy at your desk for weekly trading assessments. During your regular review routine, you may also find that current market conditions that once kept you on the sidelines are now ideal for strategies you reviewed here.

Ready to go? You have lots of options ahead.

If you've recently been perplexed with action in the markets, you may want to start with [Chapter 5](#). It identifies and explains different things happening in the options markets and the way its relationship to the stock market is evolving.

If you're new to trading options or are looking for a refresher, check out [Part 1](#). Because the markets are ever-evolving, [Chapter 3](#) gets you up to speed on current conditions.

If you have a basic handle on option contracts and want to quickly access unique ways to capitalize on different stock movement, consider jumping to [Part 4](#). This part includes a variety of trading strategies you just can't match with stocks.

[Chapter 18](#) provides my thoughts on what it takes to be a successful option trader. Because trading options comes with many of the same challenges encountered when trading any security, you may want to make it the first thing you read to help you succeed with your current trading.

## **Part 1**

# **Getting Started with Options Trading**



## IN THIS PART ...

Appreciate and analyze options while making the market work for you.

Get introduced to options contracts and values to give you a good foundation on terms and general concepts you need to know.

Find your way around options markets and discover the Greeks and how you can utilize them.

Become familiar with option risks and rewards before you start developing your trading plan and skill set.

Familiarize yourself with the artificial intelligence algos and how they affect the options and stock markets.

# Chapter 1

## Options Trading and You, the Individual Investor

---

### IN THIS CHAPTER

- » Getting to appreciate options
  - » Analyzing options with any market in mind
  - » Making the markets work for you
- 

Depending on your level of experience and risk profile, whether you're a trader or a longer-term investor, you can trade options on individual stocks, indexes, and exchange-traded funds (ETFs) after you master the craft or improve your skill set. Of course, the best reason to add options to your trading or investing strategies is the fact they allow you to both manage your risk and grow your assets while using less money per trade rather than by owning individual stocks.

No matter what your options strategy or your time frame are at any time — whether you hold positions for short or long periods — your goal is essentially the same. You want to have more money at some point in the future than what you have now and increase your wealth using opportunities provided by the markets. This chapter is all about starting the rewiring process by giving you the big picture on options and thus setting the stage for the more detailed chapters that follow.

## *Rewiring Your Thinking*

Trading options certainly has a learning curve, so make sure you take the time to study the trading techniques that suit you best and the associated risks and rewards. Throughout this book I give you the information to rewire your brain and think in a slightly different way about the markets and how your trading fits into what's happening at any time during the trading day. More important, the rewiring also includes how the market is affecting your trading and how you can turn this knowledge into your advantage. And no, rewiring your brain doesn't hurt. But it does help you to see the markets in a different and more profitable way. [Chapter 7](#) is an excellent rewiring chapter.



**REMEMBER** Keep these points in mind about the rewiring process:

- » **Options trading, as all types of trading, is an adversarial process — a fight if you will.** In other words, whomever or whatever is on the other side of your trade has one goal in mind: to take your money. Of course, whether you realize it or not, you have the same goal. After all, unlike central banks that create money out of thin air, trading profits for one side come at the expense of trading losses for the other side.
- » **Trading algorithms dominate the market, making trades lightning fast.** In the past, stocks were the key to options; however, in the present, the options market influences the stock market more because 80 percent of all trades in the stock and related markets are now made by trading algorithms. These machine traders are also known as *algos*. In

effect they're computer programs, also referred to as *artificial intelligence (AI)* or *bots*.



**REMEMBER** In this book I refer to them as *algos*. But no matter what I call them, they're the major influence on prices, and they're everywhere in the markets just waiting for your order. In fact, the market makers, the entities that match buy and sell orders, are all computerized. As a result, events in the markets now happen literally at the speed of light due to the involvement of algos.

I examine this dynamic throughout the book. I show you how to spot them and how you can prepare to trade against them with frequent success. For now, my goal is to plant this thought in your mind and thus start the rewiring. [Chapter 5](#) discusses the technical aspects of trading with the algos.



**WARNING** Algos day traders, and whomever else is trading at any time, don't have your best interest in mind. Moreover, you don't have their best interest in mind either, which means you should prepare well before trading.

In addition, because algos move fast, prices also change rapidly in the market, especially in options. As a result, there is little room for investing over the long term in options. Let me be clear: *Investing* is all about using the power of time and the benefits of compounding to build wealth over long periods. The traditional *buy-and-hold* strategy for stocks is a perfect example, as is the owning of rental properties for long periods to generate income.

This long-term-oriented, patient mind-set often, but not always, works well for stocks and mutual funds, but it doesn't work for options because of the way the algos move the markets and because of the time limit in the life of an option. One partial exception, that of trading long-term options, is a viable trading tactic that I address in this book (see [Chapter 11](#)).

The bottom line is that you may trade any option for a few minutes, a few days, or a few weeks, but no matter how long you're in an options position, even if it's part of your long-term investment plan, it's a trade. At the same time, don't confuse options trading with some random, haphazard activity. Options trading is a cautious and very precise exercise, which is why it's an exercise in risk planning. [Chapter 8](#) shows you how to design a "killer" trading plan.

## ***Preparing to Trade: Take a Pre-Trading Flight Check***

You wouldn't fly a plane before doing a pre-flight check, so before you start any kind of trading or investing program, it's a good idea to know three things:

- » Your risk profile
- » Your financial situation
- » Your time commitment possibilities

As you begin to trade options, be patient and prepare to spend as much time as you need learning the craft, or you'll lose money, often in a hurry, because the algos aren't your friend.

Even if you're experienced in other forms of investing, or have experience with options, you should still stop and consider the following:

- » **Check your financial balance sheet.** Before you start trading any financial instrument, go over your living expenses and review your credit card, loans, mortgages, and life and health insurances. Put together a financial net worth statement. Make sure it's healthy before you take extraordinary risks.
- » **Set realistic goals.** Don't trade beyond your experience levels, and don't risk too much money in any one trade. ***Bottom line:*** If you have \$1,000 in your account, don't trade more than one options contract at any one time and don't expect to be a millionaire in a few days. Instead concentrate on learning the craft and adding money to your account. But don't be discouraged with patience, attention to detail, and time because the odds are in your favor.
- » **Know your willingness to take risks.** If you're a cautious person who thinks that mutual funds are risky, you may not be a good options trader. But don't count yourself out either. Many different options strategies may suit you, especially after you understand the built-in safety nets that make some of them really decrease your risk. Just make sure you read through the book and find the ones that make you comfortable before you jump in. The chapters in [Part 4](#) have excellent information on this topic.
- » **Become a good analyst.** If you like to roll the dice without doing your homework, you can get in trouble with options pretty rapidly. In order to maximize your chances of trading options successfully, place a high priority on improving your technical and fundamental analysis skills. You should be both a good analyst of