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Avoid the10 Most Common Mistakes in Options Trading

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Agenda

1. Relying solely on market timing.
2. Using an all-purpose strategy in all market conditions
3. Buying ‘cheap’ options.
4. Ignoring implied volatility.
5. Disregarding earnings and dividend payment dates.
6. Waiting too long to close your positions.
7. Omitting to plan an exit or repair strategy.
8. Compromising your risk tolerance to make up for past losses.
9. Trading too many positions at once (over trading).
10. Investor Psychology.

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Relying Solely on Market Timing

Relying Solely on Market Timing

- Trader wishes to benefit from a potential movement in a stock using options.
- Rationale can be either technical or fundamental.
- The mistake is overlooking the other variables influencing the option premium.

Option Pricing Variables

- Option premiums will not reflect the exact move in the stock because of the unique pricing variables:

    1. Price of the underlying.
    2. Strike price of the option.
    3. Time until expiration.
    4. Volatility of the underlying.
    5. Dividend.
    6. Interest.

Managing Expectations

- Many investors are attracted to options for the following reasons:
  - Leverage with limited risk.
  - Protection.
  - Income.
  - Flexibility.
- However, investors do fail to respect the unique trading characteristics.

Using an All Purpose Strategy

Strategy Selection

- Options can be used under a variety of market conditions.

- The investor must:
  - Identify the market conditions.
  - Determine their objectives.
  - Apply the appropriate strategy.

What are Your Options?

- These are just a select few strategies to consider under different market conditions to meet a variety of objectives.

Direction	Protection	Income
Long Call/Put	Long stock/long put	Credit Spreads
Debit Spread	Short stock/long call	Iron Condor
Directional Condor	Collar	Iron Butterfly
Directional Butterfly		Covered Call
Straddle		Put Writing
Strangle		

Considerations

- All strategies have unique considerations such as:
  - Risk/reward.
  - Impact of time depreciation.
  - Impact of implied volatility changes.
  - Commissions.
  - Level of experience.

The Reality

- Each strategy will perform differently depending on market conditions.

- Investors must:

  – Assess market conditions and determine objectives.
  – Research available option strategies.
  – Create a plan to manage the position.
  – Execute the trade.
  – Manage expectations accordingly.

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Buying ‘Cheap’ Options

Strike Price Selection

- Many investors wish to leverage their capital by purchasing cheap options.

- Options are priced based on the probability of being in-the-money on expiration.

- Out-of-the-money options are often considered cheap.

Strike Price Comparison

- Barrick Gold (ABX) is trading at $34.50 on July 25, 2012.
- September 2012 Call options

Strike Price	Premium	Delta	Break Even
Sep 30.00	$4.80	0.85	$34.80
Sep 34.00	$2.00	0.56	$36.00
Sep 40.00	$0.30	0.15	$40.29

Strike Price Break Even Points

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Strike Price Selection

- Out-of-the-money
  - Perform best when a quick and volatile move is anticipated.
  - Probability of expiring worthless is high
  - They lose their value quickly on an adverse move.

- At-the-money and in-the-money
  - More expensive but are
  - Less impacted by time
  - Higher delta.

Expiration Month Selection

- Short-term options are cheap relative to longer term options.
- They are cheaper because of the lower probability of the option being in-the-money on expiration.

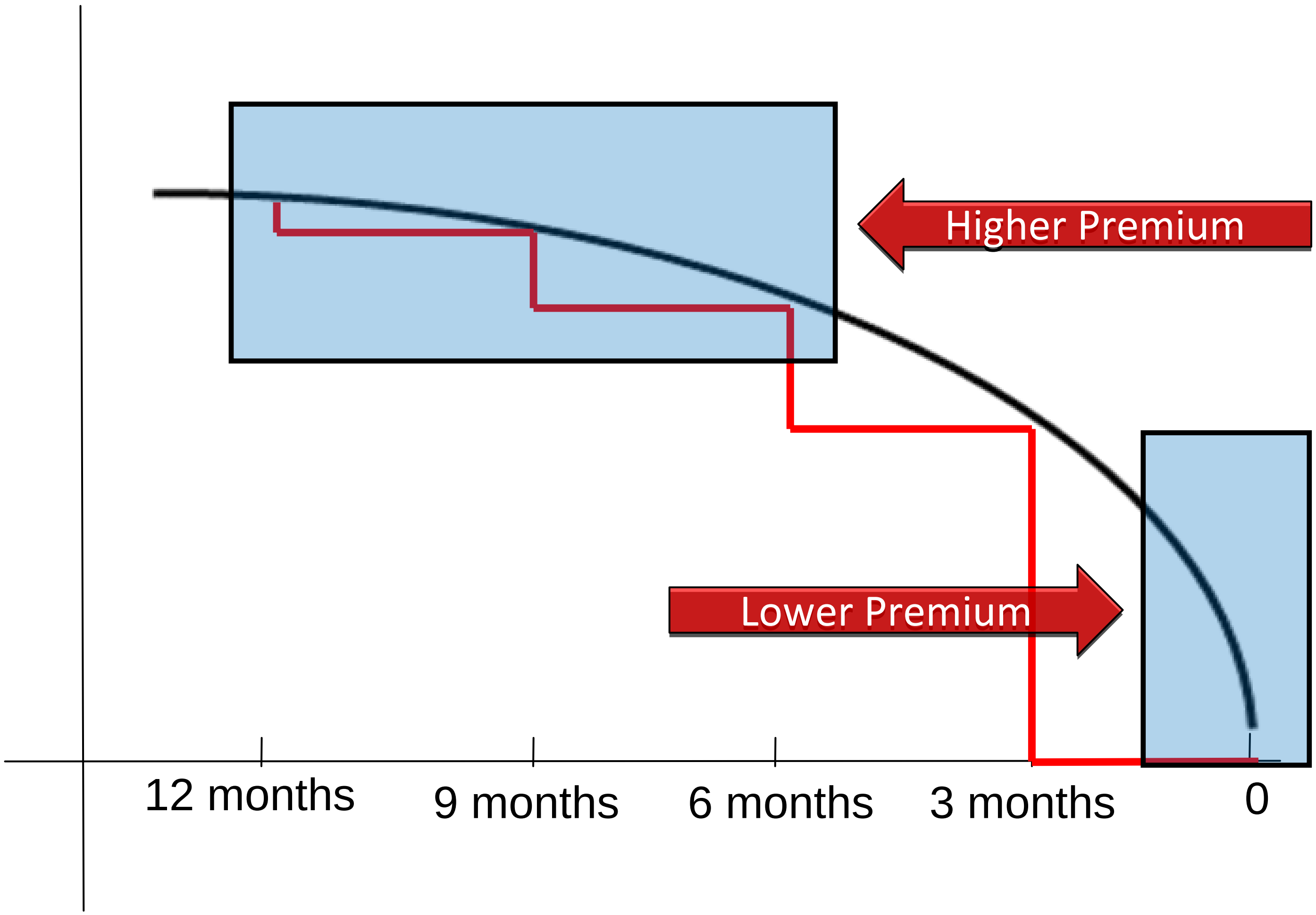
Time Value Considerations

- The Greek variable theta.
- Reflection of an estimated value that the option will lose due to time depreciation each day.
- Works against the option buyer.
- Works in favor of the option writer.

Typical Mistake…

- Investor wishes to purchase “cheap” short term options.
- As a result, they may be right about the direction, but wrong in terms of how long it will take.
- The probabilities of an option being in-the-money on expiration diminish as expiration gets closer.

Time Decay is not Linear



Theta Example

- Agrium (AGU) is trading at $94.30 on July 26, 2012.
- Call option with a strike price of $96.00.

Expiration Month	Premium	Theta
August	$1.60	-0.049
September	$3.00	-0.029
Jan 2013	$6.25	-0.017

Considerations

- The option buyer must understand why the options are cheap and manage accordingly.
- A longer dated option is more expensive, but allows for more time for a forecast to play out.
- Profits will diminish as time passes.
- If a longer term expiration is selected, a position can be closed at any time before expiration.

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Ignoring Implied Volatility

TMX Group	Equities	Derivatives	Fixed Income	Energy	Data
	Toronto Stock Exchange	**Montréal Exchange**	Shorcan	NGX	TMX Datalinx
	TSX Venture Exchange	CDCC			TMX Atrium
	TMX Select	Montréal Climate Exchange			PC Bond
	Equicom				

Implied vs. Historical Volatility

- Historical Volatility
  - Past realized volatility.
  - Measured by the deviation of the price from the average.
- Implied Volatility
  - Market expectation of future volatility and an adjustment for risk.
  - Company earnings, pending announcements or mergers.
  - Economic and market environment.

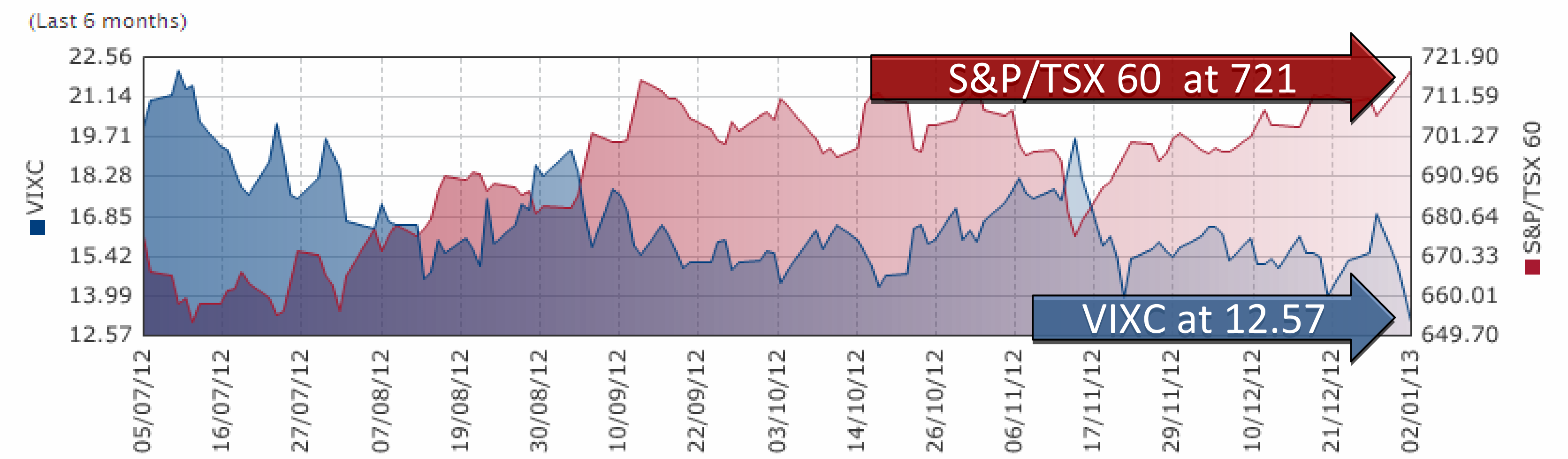
Price Adjustment

- Changes in Implied volatility will influence the option price even if the stock remains stable.
- An understanding of implied volatility helps the investor:
  - Manage expectations.
  - Make a better contract and strategy selection.

The S&P/TSX 60 VIX® index (VIXC)

- Estimates the 30-day volatility of the stock market that is implied by the near-term and next-term options on the S&P/TSX 60 index.

- VIX has negative correlations to the stock market historically.



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Disregarding Earnings and Dividend Payments

Earnings

- Options premiums typically increase into earnings due to an increase in implied volatility.
- This reflects option sellers demanding compensation for increased risk and uncertainty.

Typical Mistake

- Investor believes that a stock is going to make a significant move lower on earnings.
- Wishes to buy a put option to participate.
- Investor does not realize that implied volatility has been expanding.

RIM Before Earnings on December 20, 2012

RIM - Research in Motion Limited

Last update: December 20, 2012 at 5:30 p.m.

Last price: 13.950 | Net change: 0.460 | Bid price: 13.930 | Ask price: 13.950 | 30-day historical volatility:

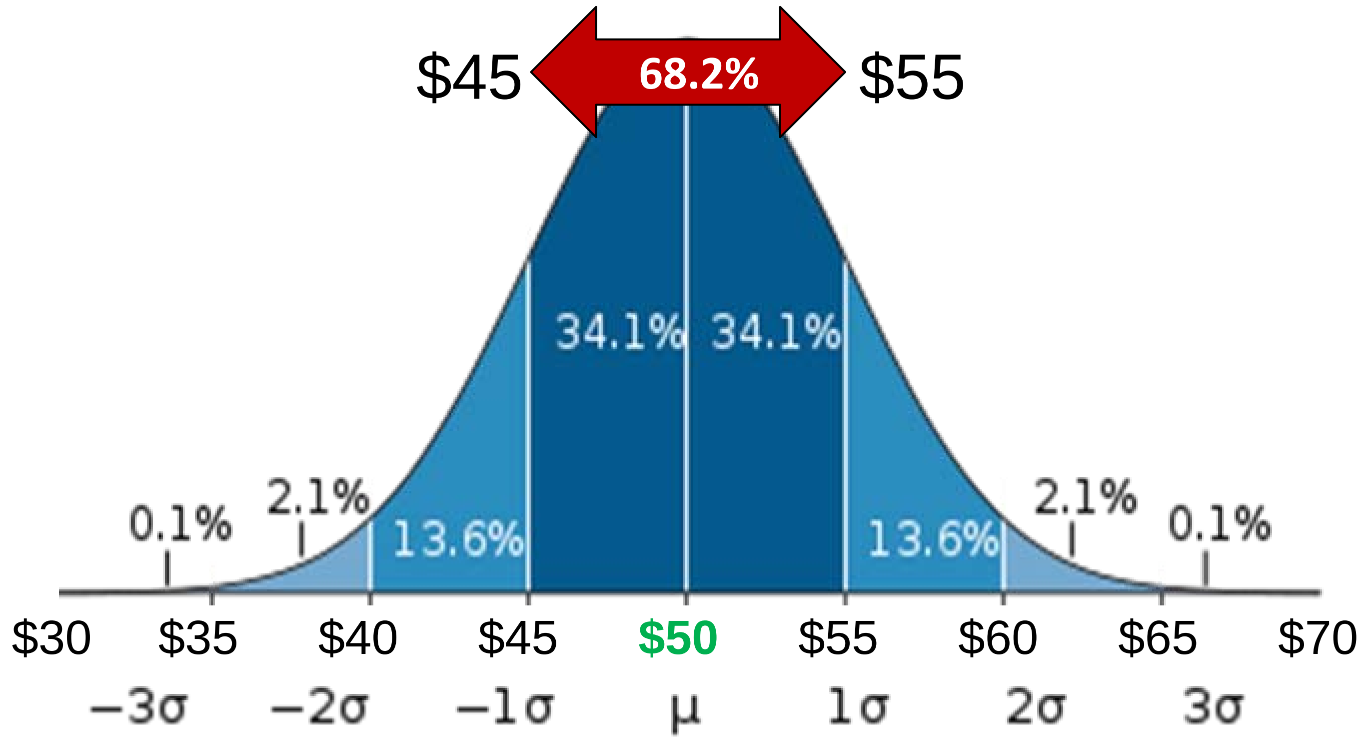
Calls

Month / Strike	Bid price	Ask price	Last price	Impl. vol.	Open int.	Vol.
12 DEC 14.000	0.660	0.740	0.740		2,094	471
12 DEC 15.000	0.350	0.400	0.400	106.2%	2,603	701
12 DEC 16.000	0.160	0.200	0.200	--	168	664
12 DEC 17.000	0.080	0.090	0.090	--	296	192
13 JAN 4.000	9.850	10.050	10.050	155.2%	10	0
13 JAN 5.000	8.850	9.050	9.050	125.8%	11	0
13 JAN 6.000	7.850	8.100	8.100	101.9%	125	25
13 JAN 7.000	6.850	7.050	7.050	81.8%	466	0
13 JAN 8.000	5.900	6.100	6.100	88.0%	640	0
13 JAN 9.000	4.900	5.150	5.150	79.3%	1,734	35
13 JAN 10.000	4.000	4.100	4.100	80.5%	835	20
13 JAN 11.000	3.200	3.350	3.350	79.8%	444	42
13 JAN 12.000	2.460	2.680	2.680	81.2%	1,188	193
13 JAN 13.000	1.880	1.970	1.970	81.1%	1,063	123
13 JAN 14.000	1.330	1.460	1.460		919	413

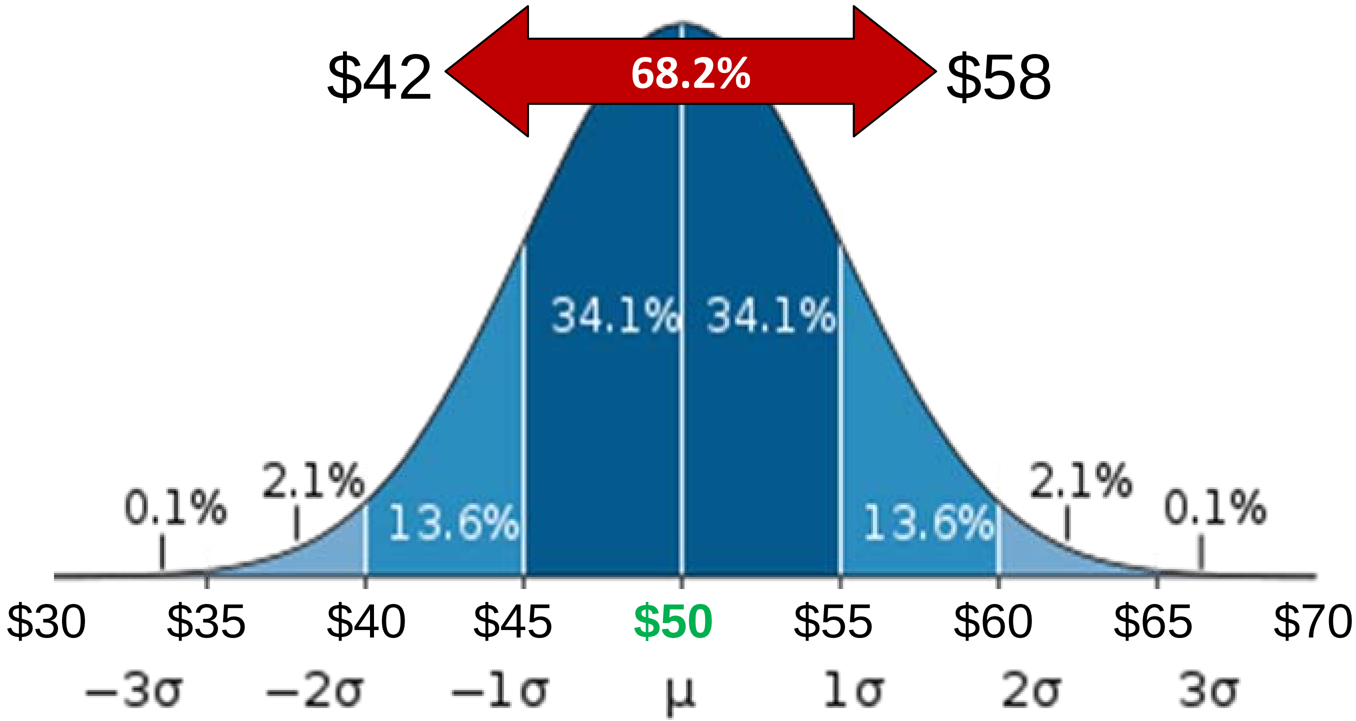
Puts

Month / Strike	Bid price	Ask price	Last price	Impl. vol.	Open int.	Vol.
12 DEC 14.000	0.780	0.840	0.840		208	37
12 DEC 15.000	1.340	1.520	1.520	105.0%	34	0
12 DEC 16.000	2.160	2.340	2.340	--	117	10
12 DEC 17.000	3.100	3.300	3.300	--	246	0
13 JAN 4.000	0	0.140	0.140	185.7%	60	0
13 JAN 5.000	0	0.140	0.140	153.6%	355	0
13 JAN 6.000	0	0.140	0.140	127.6%	240	0
13 JAN 7.000	0	0.140	0.140	111.5%	420	0
13 JAN 8.000	0	0.140	0.140	97.5%	471	0
13 JAN 9.000	0.050	0.150	0.150	90.3%	512	50
13 JAN 10.000	0.160	0.180	0.180	81.8%	554	37
13 JAN 11.000	0.320	0.360	0.360	79.8%	217	72
13 JAN 12.000	0.600	0.630	0.630	79.8%	309	307
13 JAN 13.000	1.000	1.010	1.010	79.6%	244	16
13 JAN 14.000	1.420	1.510	1.510		254	8

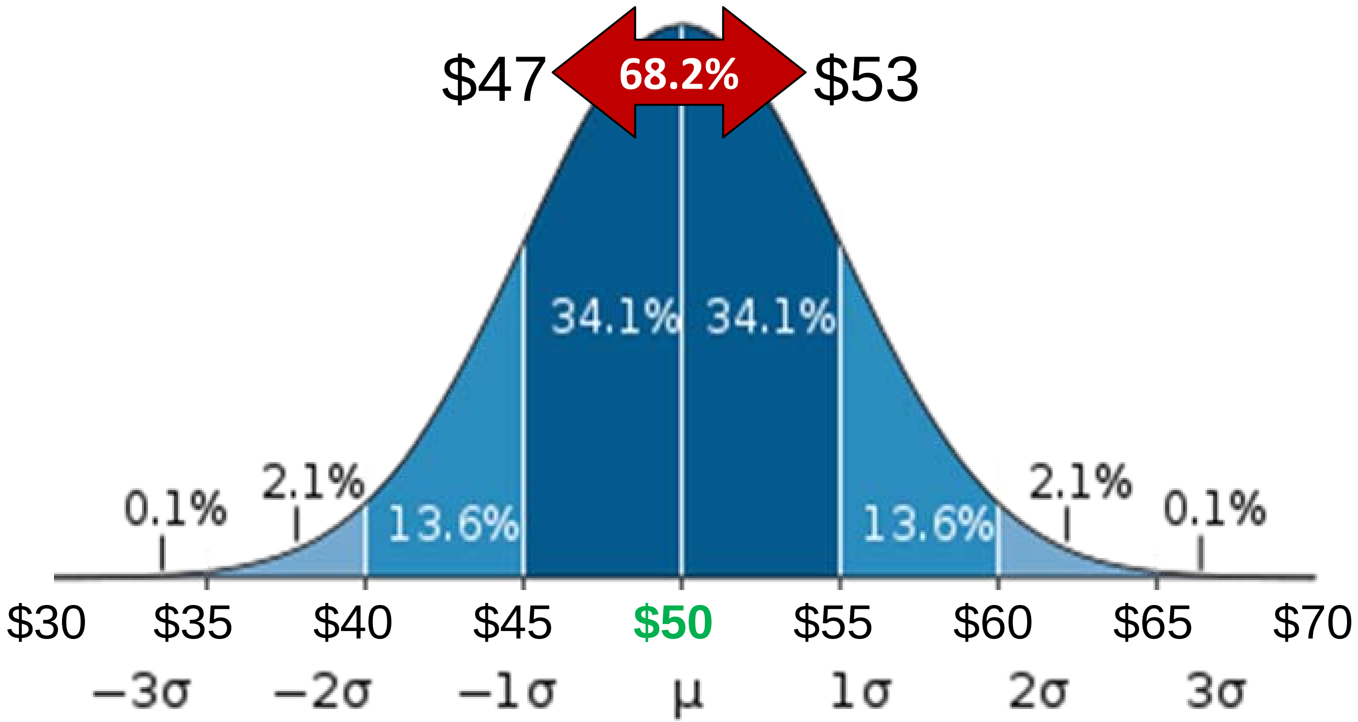
Normal Distribution Bell Curve



Expanding Implied Volatility



Contracting Implied Volatility



The Risk

- If implied volatility contracts, the option premium will drop in value.
- The stock could move in the investors favor, but not enough to compensate for the drop in implied volatility.
- The investor is correct in the forecast, but incurs a loss because of the option selection.

Uncertainty

- Earnings also represent significant uncertainty in the pricing of the stock.
- If all known information is priced in there is the potential for a surprise on new information.
- It could result in a significant move that may be different from the one anticipated.

Dividends

- The option writer may be assigned to deliver the shares ahead of the ex-dividend date.
- Early assignment is greatest if the remaining time value is less than the dividend to be issued.
- The call buyer may feel there is financial benefit in owning the shares and receiving the dividend.

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Waiting too Long to Close Your Positions

The “Buy and Hold” Mentality

- Many novice options traders embrace a “buy and hold” mentality.
- The more time passes the faster the rate of time depreciation.
- The more time value that depreciates, the greater the stock has to move in favor to compensate.

RIM Example, January 2013

January 18th 2013 expiration
14 strike call option

Earnings December 20th 2012

Will expire worthless if the shares are below $14.00 on expiration.

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Failing to Plan an Exit or Repair Strategy

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Fixed Income
Shorcan

Energy
NGX

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TMX Datalinx
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PC Bond

Plan the Trade

- Plan the trade and trade the plan.
- Failure to plan generally results in an unwilling investor who:
  - Makes emotional and often irrational decisions.
  - Never feels in control.
  - Allows profitable trades to turn into losing trades.
  - Holds on to losing investments, clinging to hope.

Create a “Road Map”

- Setting price targets where action is to be taken before the position is executed will help:
  - Preserve capital.
  - Manage risk.
  - Maximize returns.
- Investors can use pre-determined technical signals such as support and resistance levels or other indicators.

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Comprimising Your Risk Tolerance to Make Up For Past Losses

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Follow Your Plan

- Losses are a part of trading and investing.
- The decision to take on more risk to compensate is generally an emotional one.
- Know your risk tolerance and trade and invest with in it.
- If you follow an appropriate plan, you can avoid falling into this trap.

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Trading Too Many Positions At Once

Too Many Positions

- A common misconception is the belief that a strategy that limits risk requires little management.
- This false sense of confidence can lead to opening too many positions.
- Each position must have it’s own plan for management.
- Like a juggler, the more balls in the air, the more skill required to keep them from falling.

Slow and Steady

- When learning a new strategy, start with a few positions and smaller position sizes.
- Follow a plan and evaluate often.
- Add positions as you demonstrate your proficiency.
- Make sure that the number of positions is in line with your trade plan.

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Investor Psychology

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Typical Psychological Traps

- Many beginner investors (and some experienced):
  - Overestimate the probability of positive results.
  - Underestimate the risk of loss.
  - Use the “I knew it” mentality as validation.
  - Fall victim to analysis paralysis.
  - Suffer from denial.
  - Are swayed easily by fear and greed.
  - Follow a herd mentality.

Successful Traders and Investors

- Successful traders and investors possess the following traits:
  - Disciplined.
  - Follow a methodology.
  - Posses good money management skills.

Mr. Market

'He is your eternal partner in investing. He is a patient if somewhat bipolar fellow. Subject to wild mood swings, he is always willing to offer you a bid or an ask. If you are a buyer, he is a seller – and vice versa. But do not mistake this for generosity: he is your opponent. He likes to make you look a fool. Sell him shares at a nice profit, and he happily takes their prices so much higher you are embarrassed to even mention them again. Buy something from him on the cheap, and he will show you exactly what cheap is. And perhaps most frustrating of all, Mr. Market has no ego – he does not care about being right or wrong; he only exists to separate the rubes from their money….'

Benjamin Graham

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