A Fidelity Investments Webinar

Seven Common Options Trading Mistakes

BROKERAGE: OPTIONS

Seven Common Options Trading Mistakes

Learn to overcome these classic pitfalls

1. Your Strategy Doesn't Match Your Outlook
2. Choosing the Wrong Expiration
3. Choosing the Wrong Position Size
4. Ignoring Volatility
5. Not Using Probability
6. Focusing on the Expiration Graph
7. Trading without a Plan

Mistake #1:
Your Strategy Doesn't Match Your Outlook

Why is it important to choose the right strategy?

- Profit maximization
- Appropriate amount of risk
- Improved probability of success

Steps for choosing the appropriate strategy:

- Develop an outlook first
- Decide how much risk is appropriate for your account
- Analyze multiple strategies

Common Starting Points for Developing an Outlook

Technical Analysis

- Identifying support and resistance
- Trends
- Indicators

Fundamental Analysis

- Analyzing a company's key ratios
- Current business trends

Use a Combination

- Using both technical and fundamental analyses to formulate an opinion

*Technical analysis focuses on market action — specifically, volume and price. Technical analysis is only one approach to analyzing stocks. When considering which stocks to buy or sell, you should use the approach that you're most comfortable with. As with all your investments, you must make your own determination as to whether an investment in any particular security or securities is right for you based on your investment objectives, risk tolerance, and financial situation. Past performance is no guarantee of future results.

When trading options, you cannot focus on price alone

Always consider the other components that affect an option's price

Direction

Determine whether you are bullish, bearish, or neutral on the underlying stock through your analysis. How a stock's movement affects the option's premium will be an important consideration.

Directional exposure to price movement can be measured using the Greek **delta**.

Time

Unlike owning stock, each option contract has a finite lifetime. For each day that goes by, the option price loses a portion of its time value, all else being equal. This is a benefit for options sellers and a drawback for options buyers.

Time can be measured using the Greek **theta**.

Volatility

Implied volatility is an important component in determining whether an option is considered cheap or expensive. Increasing volatility increases an option's premium, all else being equal, which is positive for options buyers and negative for options sellers.

Volatility is measured using the Greek **vega**.

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

Mistake #2: Choosing the Wrong Expiration

Why is selecting the proper expiration important?

Expiration sets a timeframe for your trade:

- When you buy a **stock**, the ownership generally doesn't expire until you sell it.
- When you buy or sell an **option** contract, you must agree to an expiration date as part of that contract.

Use expirations to fit your trading style:

- Day trader
- Premium seller
- Technical trader
- Earnings trader

Considerations when choosing an expiration:

- Liquidity
- Forecasting the length of the Trade
- Expiration Cycles:
  LEAPS® > Quarterly > Monthly > Weekly
- Time decay
- Volatility
- Binary events

Reasons why you may be choosing the wrong expiration:

- No outlook has been determined
- Aversion to loss has outweighed other important factors

How Can Liquidity Affect Options Pricing?

Although both expirations are only seven days apart, they are drastically different in terms of liquidity.

Trading less liquid options may impact the premium not only when getting in, but also when getting out.

Pay attention to the bid/ask spreads, volume, and open interest.

Bid	Ask	Volume	Open Int	Delta	Chg	Theta	IV Mid	Strike
CALLS								Jun 10 (32 days)
3.90	4.35	0	7	0.5879	0.00	-0.0502	18.84 %	146
3.35	3.75	0	126	0.5403	0.00	-0.0507	18.64 %	147
2.81	3.10	0	5	0.4907	0.00	-0.0494	18.06 %	148
2.34	2.58	0	1	0.4397	0.00	-0.048	17.76 %	149
1.92	2.07	3	30	0.3874	0.10	-0.0455	17.33 %	150
CALLS								Jun 17 (39 days)
8.60	8.85	40	274	0.7886	0.25	-0.0367	20.66 %	140
4.95	5.05	317	1,190	0.6203	-0.03	-0.0446	18.92 %	145
2.30	2.34	332	2,835	0.3982	-0.06	-0.0422	17.64 %	150
0.82	0.85	106	3,969	0.1931	-0.06	-0.0284	16.84 %	155
0.24	0.26	14	1,232	0.0731	-0.06	-0.014	16.64 %	160

Fidelity.com IV Index – For illustrative purposes only.

Mistake #3: Choosing the Wrong Position Size

Common position sizing mistakes:

- Trading too large or too small a position
- Using inconsistent position sizes
- Concentrating

Thoughts on better position sizing:

- Risk a fraction of your account on each trade

  Don't put all your eggs in one basket.

- Use a consistent dollar value on each trade

  Reduce the emotional impact of your decision.

Risk Considerations

Risk management reminders:

- While considering a trade, focus on the **overall risk first** and **profit potential second**.
- When a trade goes against you, shift your focus to managing the trade **under the current conditions** rather than as initially predicted.

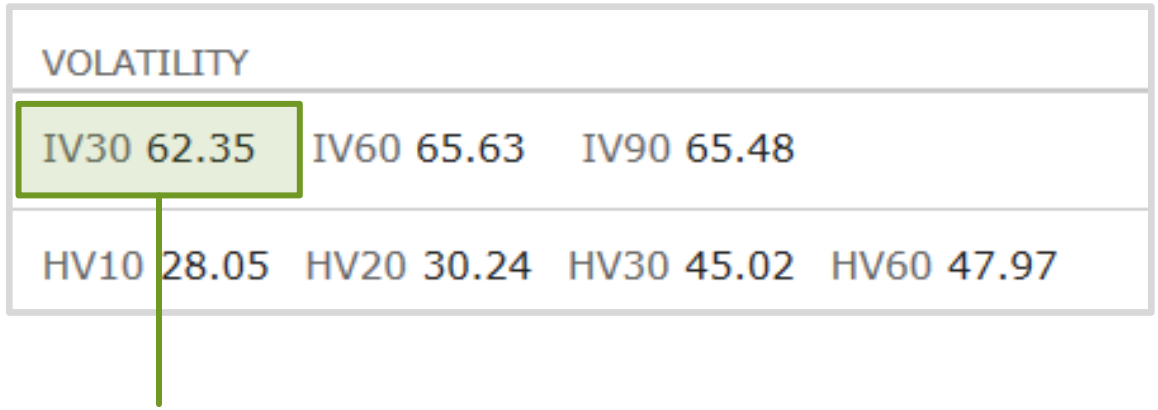
Why trade using a consistent position size?

- Reduces emotional attachment
- Reduces volatility in portfolio (equity curve)

Mistake #4: Ignoring Volatility

Implied Volatility (IV)

- Measure of what the market expects volatility of the security to be in the future, based on premiums on option contracts for that security
- Annualized percentage for future expected move
- Dynamic; changes with option prices based on supply and demand for contracts



62.35% annualized expected move based on hypothetical 30-day option contracts

Active Trader Pro – For illustrative purposes only.

What is Implied Volatility (IV)?

IV is affected by options prices

Market participants expect larger future movement

Higher expected move in the security

They buy options for protection or speculation

Higher demand for option contracts

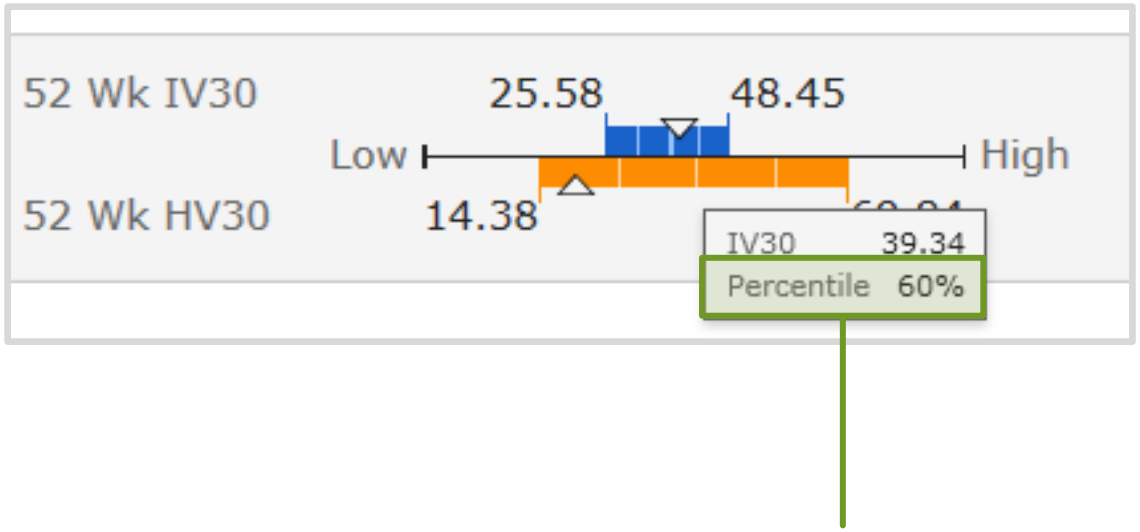
Buying pressure increases

Higher IV levels

Result: More expensive premiums

What is Implied Volatility (IV)?

How can you determine whether a specific stock's IV is relatively expensive?



IV percentile shows where a specific stock's IV is, compared to where it's been within the last 52 weeks.

Active Trader Pro – For illustrative purposes only.

What is Implied Volatility (IV)?

How can you determine whether a specific stock's IV is relatively expensive?

- Helps to compare current volatility data with historical data to identify potentially high or low levels
- Allows traders to identify divergence and convergence between HV and IV
- Is a quick way to find when volatility measures are at extremes and may revert to their mean values

IV index chart compares HV and IV over the last year.

IV Index via IVolatility.com – For illustrative purposes only.

Effects of Implied Volatility

Example:

Client is expecting a $1.50 move upward.

Client buys one 117 strike call at $3.20.

116.53 0.00 (0.00%) | V | HV30 21.46 IV30 35.02 | C/P Ratio:

E May 06 (W) | May 13 (W) | May 20 | May 27 (W) | Jun 03 (W) | Jun

Strike	Last	Bid	Ask	Volume	Open Int	Delta	IV Mid	Vega	Theta
CALLS					May 06 (3 days)				
116	3.63	3.60	3.70	0	287	0.5375	68.85 %	0.0485	-0.4461
117	3.09	3.00	3.20	0	412	0.491	68.39 %	0.0488	-0.445
118	2.63	2.70	2.80	0	791	0.4462	70.27 %	0.0485	-0.4521
119	2.26	2.15	2.35	0	185	0.3977	67.99 %	0.0472	-0.4248
120	1.95	1.80	1.95	0	658	0.3515	67.59 %	0.0454	-0.403
121	1.50	1.45	1.65	0	11,394	0.3084	66.92 %	0.0431	-0.3751

Exact expected move occurs.

Client can now close call for $1.85.

What happened?

118.00 1.47 (1.26%) | V 207,012 | HV30 21.46 IV30 25.69 | C/P Ratio: B

E May 06 (W) | May 13 (W) | May 20 | May 27 (W) | Jun 03 (W) | Jun 10

Strike	Last	Bid	Ask	Volume	Open Int	Delta	IV Mid	Vega	Theta
CALLS					May 06 (3 days)				
116	3.63	1.60	3.20	0	287	0.6819	30.98 %	0.04	-0.201
117	1.63	1.85	2.40	128	412	0.5817	38.13 %	0.0435	-0.2756
118	1.18	1.15	1.80	22	791	0.4879	34.52 %	0.0447	-0.2554
119	1.25	0.80	1.30	32	185	0.3881	34.35 %	0.0428	-0.2419
120	0.63	0.40	1.10	3	658	0.3016	35.84 %	0.039	-0.2248
121	0.60	0.35	0.70	5	11,394	0.2281	36.46 %	0.0339	-0.1924

Active Trader Pro – For illustrative purposes only.

Mistake #5: Not Using Probability

Low-Probability Strategies:

- Generally have large or unlimited profit potential
- Are typically debit trades
- Can require precise timing on the trade

High-Probability Strategies:

- Usually have a smaller and limited profit potential
- Are typically credit trades
- Allow you to be less “right”

Using the Probability Calculator

- Helps you estimate the probability of your trade being profitable
- Can be used to help with proper strike selection
- Nondirectional bias

Probability On	05/06/16	05/13/16	05/20/16	05/27/16	06/03/16	06/10/16	06/17/16	06/24/16	06/30/16	07/15/16
Above $210.00	0.00%	16.30%	24.26%	28.41%	31.04%	32.90%	34.30%	35.41%	36.19%	37.70%
Between $200.00 and $210.00	100.00%	72.67%	56.54%	47.76%	42.10%	38.06%	34.99%	32.56%	30.84%	27.50%
Below $200.00	0.00%	11.03%	19.20%	23.83%	26.86%	29.04%	30.71%	32.03%	32.97%	34.80%

Provided by Hanweck Associates LLC. For illustrative purposes only.
*Profit probability shows how likely a particular option trade (or combination of trades) could be profitable, based on a calculation that takes into account the price of the trade and the expected distribution of stock prices based on the 90-day historical volatility.

Mistake #6: Focusing on the Expiration Graph

Why this can be detrimental:

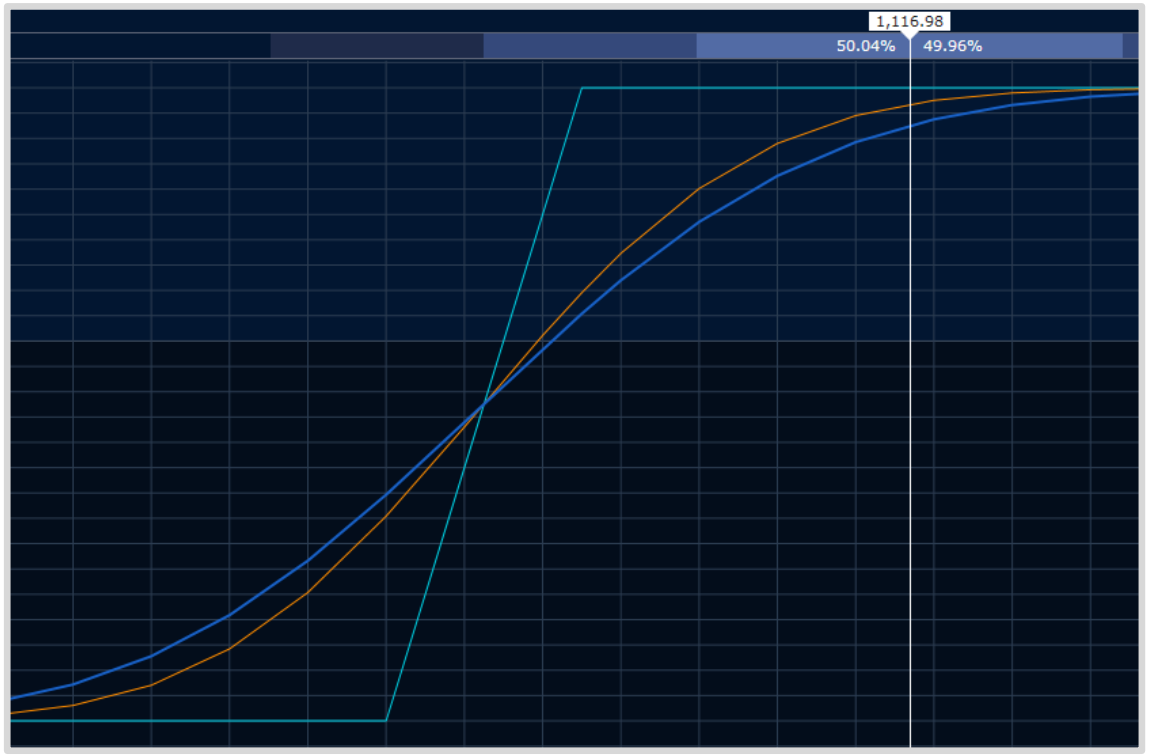
- It doesn't inform you about your position today
- It can blind you to what your position will look like tomorrow
- Many traders do not hold the position all the way to expiration

Analyzing your T+0 line can help you by:

- Showing if your position needs to be adjusted
- Providing a visual of your risk/reward
- Setting expectations for gain or loss at various price levels

Leveraging the Profit & Loss Calculator

Profit & Loss Calculator helps you visualize how your position looks today vs. how it will look at expiration.



- Profit and loss at expiration
- What you look like today
- How you look at a date in the future

For illustrative purposes only.
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Mistake #7: Trading without a Plan

How a trading plan can be beneficial:

- It helps take the emotional toll out of trading
- It helps you consistently construct trades that meet your needs
- It helps you improve as a trader/investor

What should be included in a plan?

- Conditions for opening a trade
- Conditions for closing a trade
- What you are willing to risk
- How you will gather opportunities

Some examples:

- Market Scanner (provided by LiveVol, Inc.)
- Strategy Evaluator (provided by Hanweck Associates LLC)
- Argus Focus List (provided by Argus Research)
- Advanced Trader Pro® Filters

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Considerations for Developing a Trading Plan

Before placing a trade, you should be able to answer these questions:

- Why are you entering this position?
- How much capital are you willing to allocate to the idea?
- What are the criteria for entry?
- What are the criteria for exiting, for both the upside and downside?

If you are unable to answer these questions, **you are not ready to place your trade!**

Key Takeaways

- Develop an outlook before thinking about the right strategy.
- Trade the expiration that makes the most sense for your outlook.
- Make sure your strategy matches your risk tolerance.
- Be aware of implied volatility and what it means for your trade.
- Have a trading plan, and stick to it!

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