Lessons From The Trader Wizard

by Bill Cara

SAMPLE CHAPTER:

Part 4: SPECIALTIES TO TRADE

Yes, trading gives us hope in the same way that the struggling people in other lands managed to take control, doing it one stop at a time to build a mountain. Working together, we can do it. In a virtual world, you and I and our brothers and sisters do not have to lock arms and raise our rifles to get ahead. We must, however, connect intellectually. We must share the same dreams, and we must plan, organize, implement and control our actions the same way that others have planned, organized, implemented and controlled us in order to get theirs. So the question is, are you going to adapt to the changes that are being forced upon us, or are you and I going to work together to bring about the change that benefits us? I think I know what you want. It's now up to us to put it together. — from Bill's blog

1. About trading options

What we can do before Financial Armageddon inevitably strikes is to watch prices. We can continue to buy them when they are low and sell them when they are high based on relative historical performance and trading patterns. We can stick to trading the shares of quality corporations and buying risk-adjusted high-performance fixed income securities if that is our need. — from Bill's blog

Options on stocks are time-based contracts, each with an expiry date.

In buying or selling an option, you are buying or selling time. As you learn throughout this book, there is no concept more important in capital markets than time.

Rather than try to educate you directly, I'll point you to the best source of information, which is the Options Institute Online Learning Center of the Chicago Board Options Exchange (http://cboe.com/LearnCenter). Another excellent source of options education plus tools is at Yahoo Finance (http://biz.yahoo.com/opt).

As a time-based trading instrument, options on stock are "rights" to buy or sell a specified number of shares (100 per contract) of a specified stock at a specified price (the striking price) before a specified date (the expiration date). You may have to read that sentence a few times.

By definition, options are diminishing assets and pay no dividends. The closer the expiration date, the less time there is for their value to rise or fall, which limits the trading or speculation interest in them.

While it's not altogether simple, the act of buying an option alone without it being part of a larger plan is speculative trading, and selling an option is conservative trading.

The most popular and widely used option is a "call", which is the right to buy the underlying stock on certain specified terms. A "put" is opposite to the "call" as it is the right to sell the stock, also with the terms attached.

For sophisticated traders, there are seemingly complex combinations such as spreads, “strips”, “straps” and straddles. All this, however, you can learn with several hours study.

The cost of an option is called “the “premium””. It varies with:

- the duration of the contract
- the type of stock
- the general activity of the stock market
- the corporation’s status and prospects

By looking at the options data for a stock, you can see that premiums run as high perhaps as 15% of the value of the “underlying” stock.

For an example, let’s turn the clock back to November 200X, where for about $270, the trader could control 100 shares of Dow 30 stock “ABC” (the name’s not important) selling at 74.53 ($7,453) for about 45 days. Once the price of ABC stock moves close to the exercise price of the option at 75, both stock and option will usually move together, often in small fractions of a point. Thus, the $270 investment can be just as profitable in absolute dollars as the $7,453 investment (not counting any dividends ABC might declare in the next 45 days).

What is most interesting about the options market is that a single trade involves both prudent trading and speculation together. When options are used to protect positions or to acquire stock as part of a trading strategy, the other side of the trades in these puts and calls are speculations. One side of the trade is trading in the traditional sense and the other is probably speculating.

Be careful when speculating with calls. As the broad market tends to move up say 80 or 85% of the time (over say 20 to 40 years), you have to be careful buying puts as well.

However, selling (writing) calls on stocks you own can be a conservative strategy.

With experience, and the support of a knowledgeable broker and a good market, I believe a call-writing trader should obtain total returns at an annualized rate of 18—20%, which would be 13—15% from option premiums and 3—5% from dividends (as long as the stock is owned and used as collateral rather than cash, but, even with cash for margin you are going to earn interest on your credit balance).

Mystique

There has always been a mystique about options. I suppose it’s because options trading represents a “zero-sum game” where there is one winner and one loser and no other value created except for the employment of intermediaries.

In my opinion, for 20—25 years after exchange trading of options was organized in 1974, no part of the securities markets has changed more. In the beginning, the number of options was limited, the volume was small and price changes were closely related to those of the related stocks. In time, that became less so.

Today, there are options on everything from stocks to indexes, commodities and futures as well as esoteric things I don’t even want to get into. Annual volume of equity options is into many billions of contracts representing probably trillions of shares of stock in the aggregate.

It is a mature and sophisticated market today, but options prices occasionally move inexplicably with little relation to the price movement in the “underlying” securities. So, be careful.

Still, I believe that every trader should use options as part of an overall trading strategy. With careful management, options can boost income or bring short-term gains. Buying and selling techniques can also be structured for tax benefits.

Trying to figure out options premiums

When a stock trades at its exercise price, the options “premium” percentage, as part of the “underlying” stock price, will vary simply depending on the volatility of the stock price. This is the table I use to explain the options “premium” percentage differences of low, average and high- volatility stocks:

Months to expiration	Premium as % of underlying stock		
	Low volatility	Average	High
1	1.8-2.6	3.5-4.4	5.2-6.1
2	2.6-3.9	5.2-6.6	7.8-9.2
3	3.3-5.0	6.7-8.3	10.0-11.7
4	3.9-5.9	7.9-9.8	11.8-13.8
5	4.5-6.8	9.0-11.2	13.5-15.8
6	5.0-7.5	10.0-12.5	15.0-17.5
7	5.5-8.2	10.9-13.7	16.4-19.2
8	5.9-8.9	11.8-14.8	17.7-20.6
9	6.4-9.5	12.7-15.9	19.0-22.2
10	6.8-10.1	13.5-16.9	20.2-23.6
11	7.2-10.7	14.3-17.9	21.4-25.0
12	7.5-11.2	15.0-18.8	22.5-26.2

- **Dividends and “rights”**
  As long as you own the stock, you continue to receive the dividends. That’s why calls for stocks with high yields sell at lower premiums than those of companies with small dividend payouts. A stock dividend or stock split automatically increases the number of shares covered by the option in an exact proportion. If a right is involved, its value will be set by the first sale of rights on the day the stock sells “ex rights”.

- **Commissions**
  These depend on your broker-dealer.

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