



SPECIAL REPORT

Guide to Option Trading

TABLE OF CONTENTS

- Introduction
- [An Easy Way to Understand Calls and Puts](#)
- [How to Pick the Right Options Trade](#)
- [How to Calculate Risk and Reward](#)
- [A Brief Options Glossary](#)
- [Three Major Factors that Determine the Price of Options](#)
- [Figuring Profit Potential](#)

Introduction

When you talk about options, most people think of risk... Dangerous leverage... Speculation... Gambling...

I guess there is that aspect to it, if you don't know what you're doing.

See, most people don't understand options. The reason they were created in the first place is to reduce risk. In fact, the original options were designed to help investors hedge their portfolios against bad moves in the market. Unfortunately, what's happened over time is what happens to a lot of good ideas on Wall Street... options have morphed into a commission-generating vehicle they sell to folks as a way to get rich quick.

If you think trading options will help you get rich quick, I've got some bad news for you. While using options can make you a lot of money, it's not going to happen overnight. Trading options is a process. And if you want to be in the options market for any length of time... you have to do it the "right way."

Learning the "right way" to use options might involve a little extra effort on your part if you want to trade in the market successfully. But I can help you master the basics... I've traded options for nearly three decades. During that time, I've also been teaching folks just like you how to reduce their risk with options and add a little bit of "pop" to an otherwise conservative portfolio.

This report contains everything you need to know about options, and nothing you don't. First... here are a few things you must keep in mind:

Truth No. 1: Buying and selling options is about the least risky and potentially most rewarding game on Wall Street.

Options master Victor Sperandeo racked up a nominal rate of return of 70.7% without a losing year between 1978 and 1989. With his astounding track record, we'd be foolish not to pay attention to what he has to say:

"Options are, many say, the riskiest game in town. Certainly they are by far the most challenging, flexible, and potentially profitable financial instruments available. But if you trade them prudently, if you apply sound principles of money management, trade only when the risk/reward ratio is highly in your favor, and execute your trades with diligence and patience, then in all likelihood you will be profitable over the long term. I can say, conservatively, that at least 40 percent of all the returns I've made in my life have been with options."

Truth No. 2: Want to be a winner? Watch your losers!

To succeed in trading options, you really need to limit your trading to opportunities that have at least a 3-to-1 payout. A 5-to-1 reward-to-risk ratio, of course, is better. But at minimum, you want to have the potential to pocket \$3 in return for every dollar you risk.

You accomplish many things by forcing a minimum 3-to-1 discipline on yourself. For one, it forces you to think in terms of reward and risk, which is extremely important. Most failed options traders, even ones that may have had good trading systems, fail because they

didn't pay enough attention to risk. If you're willing to lose 50% on a position, you'd better be expecting a gain of 150% or more – at least. That's a tall order.

If you're willing to lose it all (meaning have the potential for a negative 100% return on a position), then you'd better be expecting a 300% to 500%-plus gain in that position.

When you see it in terms of risk versus reward, and you realize that 500% winners don't come along every day, you can see "risking it all" is a bad bet.

Options are a lot like poker. Your hand is only a small portion of the battle. Betting appropriately for the entire game is really what's important, which leads us to...

Truth No. 3: Big winners make small bets

You've got to know when to hold 'em and when to fold 'em. But you'd sure hate to fold 'em and take a total loss with a big bet on the table... So don't ever put

yourself in that boat. Limit the size of your positions. You should only have 2%-3% of the money you've set aside for trading at risk on any one trade. We really can't imagine any combination of circumstances where you should consider putting more than 10% of your trading money on one play. Don't do it!

To end up like Vic Sperandeo over the long run, you've got to stick to the program. Limit the size of your positions. (We'll explain how to do this later on in this report.) And limit your downside by never allowing a small loss to turn into a big loss. Traders who follow this have a chance of being winners in options over the long run. Those who don't do this will be quickly drummed out of the club, taken for every penny.

Now, I'd like to turn your attention to the basics of call and put options. The next section comes from my colleague and friend, Dr. Steve Sjuggerud. It's one of the best explanations I've seen on the subject...

An Easy Way to Understand Calls and Puts

By Dr. Steve Sjuggerud

There's a piece of land on the beach that I have my eye on. Empty lots on the water are hard to come by around here – they rarely go on the market. And when they do, they're snapped up pretty fast.

I drive by it around dusk one day on my way to a dinner party and see an old man on the property. I get out of my car and strike up a conversation, looking over the water. It turns out he's the owner. I ask him if he'd ever consider selling the property. "Sure," he says. "A million firm."

Right on the spot, I try to work a deal. I think a million is actually a good price for oceanfront around here, but I don't want to tell him that. And I need a little time to do my homework and get my finances together.

Here's the deal I offer: "I'll give you \$10,000 right now – that you can keep – if you can give me a piece of paper giving me the right to buy this property for \$1 million

any time in the next 30 days. If I decide not to buy it, you keep the money."

"You've got yourself a deal right there," he says, happy to pocket the no-risk \$10,000.

I head out to the dinner party. At the party, I meet some folks who've been looking to buy on the ocean for months, but nothing has come on the market. They mention that they'll snap up the first thing available, even over \$1 million.

Long story short, I sell them the old man's oceanfront lot for \$1,050,000. I made a 400% profit in a few hours, by selling an asset that I controlled, but didn't own.

I could have completed the transaction two ways:

- 1) I could have exercised my right to buy the land, and gone through all the paperwork hassles and

documents, taxes, and fees, only to turn around and go through all that again with the sale.

2) I could have simply sold my "right to buy" piece of paper to the couple for \$50,000.

For \$10,000, I had the "option" to buy this land over the next 30 days. I could either buy the land or sell my right to buy. That's exactly what an option is...

Okay, I confess, this isn't a true story. [But it is a perfect example of buying a call option.](#)

A **call option** is the right (but not the obligation) to buy something at a particular price. That's pretty much it. I paid \$10,000 to the old man for the option to buy his property. I paid \$10,000 for a call option.

A call option has an **expiration date**. In this case, in 30 days, my call option would have expired – worthless. Options are worthless after their expiration date. You'd better either **exercise the option** by buying the property or **sell the option** to somebody else before it expires.

With stock options, you have the same choices as I did. You can either exercise the right to buy the stock at a certain price (like the \$1 million figure), which is called the **strike price**... or you can sell the option to somebody else through the options market, basically just like the New York Stock Exchange. Only it's the options exchange. And it's in Chicago.

The reality is, nobody goes through the hassle of exercising their right to buy, just like I didn't when it came to the land. I didn't want the land transferred to me before I sold it to the couple. And the same is true for stock options. Because there is an options exchange, people are trading these options all the time.

Those are the basics of a call option. Now let me cover the basics of a put option...

USING YOUR HOMEOWNER'S POLICY TO UNDERSTAND PUTS

Every time you buy an insurance policy, you are essentially buying a **put option**.

Take your homeowner's policy as an example. When you sign on the dotted line and write your check, you are essentially buying the right to sell your house back to the insurance company for a certain value, under certain conditions, for a limited period of time. By accepting your money, the insurance company has taken on an obligation to buy your house back from you under the same terms. The longer your policy has to run, the more the insurance company will charge you. A six-month policy costs less than a 12-month policy. It works exactly the same way with put options. The longer it's good for, the more it costs.

As put-option buyers, we have two big advantages over insurance-policy holders. First of all, most options are not subject to the terms and conditions of many insurance policies. A disaster is not necessary for them to "pay up." In the case of put options, the stock has to go down. That's it.

Secondly, unlike the insurance-policy holder, buyers and sellers of options are free to change their minds about a position for any reason. You can always exit or add to your position by simply buying more or selling it in the market.

For the most part, options are as easy to buy and sell as stocks. This makes them an ideal investment for those who wish to take advantage of big moves, because it can be done without the expense and risk of buying or selling huge chunks of stock.

In short:

Buyers of call options want the stock to go up. They only make money if the stock goes up.

Buyers of put options want the stock to go down. They only make money if the stock falls.

How to Pick the Right Option Trade

I've found that one of the reasons many people shy away from the options market is that there are hundreds of options to choose from for any one stock. Remember... as Steve explained, an option is a contract. It gives you the right to buy or sell a stock at a specific price by some predetermined date in the future... And picking the best one can be confusing.

For example... A reader recently e-mailed me a question about buying call options on SLV (the iShares Silver Fund). "How do you know which option to trade?"

You can buy SLV calls that expire a few weeks from now... You can go all the way out to January 2018... Or you can pick from any number of expiration months in between.

You also have a number of strike prices to choose from. That's the price at which you can either buy (in the case of call options) or sell (in the case of put options) the underlying stock. The strike prices in SLV range from a low of \$10 per share to a high of \$72.

Picking the right option can be a tough decision. And it often makes the difference between a good trade and a bad one. So, I'm going to teach you how to pick the right option.

First, let's get one disclaimer out of the way...

What you're about to read is an example of how I would select an option on SLV. **It is for educational purposes only and is not a recommendation.** That's why we're using a chart from way back in 2012. Also, remember... option trading involves risk, and you can lose all the money you put into a trade. While there are ways you can limit your downside (as I'll also show you in this report), do not risk more than you can afford to lose.

Now, let's figure out how to pick the right expiration month...

TWO WAYS TO "TIME" YOUR TRADES

When you buy an option, you're buying time for the stock to do something. The more time you buy, the more expensive the option. You want to be sure to buy

enough time for the stock to complete the move you're anticipating. But you don't want to pay extra for the time you don't need...

If you're anticipating a stock will move higher because of some fundamental factor – like a positive earnings report or a favorable introduction of a new product – you need to buy an option that expires after the event.

For example, if you think XYZ biotech stock is going to shoot higher after an FDA meeting in late May, you need to buy an option that expires in June. An April contract does you no good.

There's no point buying July or August options in this case, as you'd simply be paying for time you don't need.

However, if you're buying an option based on a technical chart pattern for a stock... things get a little trickier.

Some chart patterns resolve quickly. Rising and falling wedges, for example, usually lead to sudden moves in the stock once support or resistance is taken out. In these cases, you can trade options with short expiration dates.

But in the case of SLV, we're looking at a complex inverse "head and shoulders" pattern. This is a potentially bullish formation that could lead to huge gains. In this pattern, symmetry is important, and it's going to take some time to play out. On the next page is SLV's chart in April 2012...

There are two potential price targets on this chart. The first is the top dark red resistance line (neckline) at about \$34.50 per share. The more significant target is the blue resistance line at \$42.

If this pattern develops into an inverse "head and shoulders" pattern, SLV should form the right shoulder by rallying up to the neckline. The right shoulder began forming in late September and hit the neckline in late October. So it took one month to form the shoulder.

iShares Silver Trust (SLV)



The left shoulder looks like it started forming around mid-March. So to create a symmetrical pattern, SLV would need to rally back to the neckline by mid-April. Anyone looking to trade this move should look to buy an option with a May expiration date – just to be on the safe side.

I recently put together a full options video course, covering everything from the basics (understanding options) to the advanced (how to project where a stock is headed next). You can access all of these videos in the [Delta Report Training Center](#).

The bigger move, however, will come if the inverse “head and shoulders” pattern plays out and SLV breaks above the neckline. The pattern projects an \$8 move higher, which is the distance from the head to the neckline. This move should take another two months to complete. Here’s how we figure that out...

The decline from the neckline down to the head started in late October and finished in late December – a period of two months. The rally from the head back up to the neckline also took two months. So again, for the sake of symmetry... once SLV breaks above the neckline, it should take two months to complete the projected move.

To sum it all up... SLV should rally back up to the neckline by mid-April. Then, a breakout and a rally up

to the \$42 resistance line should take another two months. That brings us to mid-June.

Traders looking to take advantage of this trade should look at the July series of SLV options. The May contracts don’t give us quite enough time. And there’s no need to pay extra for the October options (the next month available), since this pattern should play out well before then.

Selecting the appropriate expiration date is one of the basics of picking the right options trade for you. Next, we’ll look at the key concept a successful options trader needs to understand before jumping into the market...

THE KEY TO SUCCESS IN THE OPTIONS MARKET

Options traders need to understand probability. What are the odds a stock will move in the direction you expect it to?

A stock can do three things: It can go up... It can go down... Or it can stay the same. So by betting on one of those outcomes, you have a 33% chance of getting it right. In other words, for every three option trades you make, you’re going to have one winning trade and two losers.

This seems simplistic. There are strategies traders can use to increase their odds, and there are definitely

mistakes we can make that reduce them. But for the most part, a 0.333 batting average is a safe assumption.

So if we're only going to make money on one out of every three trades, we need to make enough on the one winner to counter the two losers. Since the losses can be as much as 100% each, it's important to only consider trades that can produce 200% gains or more. Of course, we're not holding out for gains of 200% on every trade. That's unrealistic. And we won't be suffering 100% losses all of the time, either. But the potential for a 200% gain has to exist for a trade to offer the proper risk/reward setup.

That potential is what I look for most when deciding which strike price to buy on an option.

Let's take another look at our mock options trade from earlier: buying the SLV July options. Let's narrow down which strike prices offer the best setup for the trade...

Here's a look at the pricing of some of the July call options with strike prices close to the price of SLV shares as of April 2012 (\$31.50)...

STRIKE PRICE	OPTION PREMIUM
\$30	\$2.95
\$31	\$2.40
\$32	\$1.90
\$33	\$1.50
\$34	\$1.20

Let's set an upside target of \$41 per share for SLV stock by option expiration day in July. From here, it's really just a matter of simple mathematics to determine which option would give us the best return based on that target price.

But SLV could run into resistance at \$34. It's possible the stock will get pinned at that price and fail to break out to the upside... So we also need to consider how the trade will work if SLV shares get stuck at \$34 rather than jumping all the way to \$41.

Here's the minimum price for each of those option contracts if SLV hits the target prices of \$34 and \$41 by option expiration day in July...

STRIKE PRICE	OPTION PREMIUM AT \$34/ SHARE	% GAIN	OPTION PREMIUM AT \$41/ SHARE	% GAIN
\$30	\$4	36%	\$11	273%
\$31	\$3	25%	\$10	317%
\$32	\$2	5%	\$9	374%
\$33	\$1	-33%	\$8	433%
\$34	\$0	-100%	\$7	483%

In every case, these options offer the potential for at least a 200% return on the trade if SLV rallies to our upside target. So we have a favorable risk/reward setup. The July \$30, \$31, and \$32 call options, however, are profitable at the lower \$34 price target.

The July \$34 call option offers the highest potential return, given our expectation of SLV rallying to \$41 by July. But it also has the most risk if SLV can't get above the initial resistance level of \$34.

I prefer to go with the trades that have the highest probability for a profit. At first glance, that would be the SLV July \$30 call option. The stock doesn't have to rally much to recoup our initial premium of \$2.95 per contract. And it's a profitable trade at both the \$34 and the \$41 price targets.

Since each option contract covers 100 shares of stock, it would cost \$2,950 to purchase 10 SLV July \$30 call options (\$2.95 premium x 100 shares per option contract x 10 contracts). A trader would have the potential to make \$8,053 on this trade if SLV rallies to \$41 per share.

Now let's move on to how to protect your downside...

HOW TO LIMIT YOUR LOSSES

In the case of SLV, I'd probably set a stop of 50% on the trade to limit my losses. That means if the options lost 50% of their value, I'd admit I'm wrong on the trade and get out of it with a \$1,475 loss. So we're risking \$1,475

here in an effort to potentially make \$8,053. That's five times as much potential reward as risk. That's a good setup.

Of course, this setup requires that you actually stick to your original plan and cut the losses if the option loses half of its value. That seems like an easy enough thing to do. But most people – including experienced traders – have a tough time cutting their losses. It can be emotionally painful. So here's a different tactic...

If you struggle with discipline, you need to find a way to limit the dollar amount of your losses if the option goes to zero. In the previous example, we were willing to risk \$1,475. But if the option goes to zero, the loss would be far worse – \$2,950.

Instead, we could take an option position where the initial investment is less than \$1,475 at the outset. We could buy 10 of the SLV July \$34 call options for a total

of \$1,200 (\$1.20 premium x 100 shares per contract x 10 contracts). If we're right and SLV rallies to \$41, these call options will be worth at least \$7,000. That's a gain of \$5,800. Yes, that's less than we'd make with the SLV July 30 calls if we're right on the trade. But the risk is now just \$1,200 – even if the option goes to zero. (Again, **this is just a sample trade**. I'm not saying you should go out and buy the SLV July \$34 calls. I just picked them to show you how the math works.)

When trading options, the emphasis is on limiting your risk.

Figure out how much you're willing to risk on a trade, and then select the option that offers the best risk/reward scenario based on your risk tolerance. Be honest with yourself. If you struggle with cutting your losses – and most traders do at one point or another – set up a trade where a 100% loss is less in dollar terms than the trade with the best setup.

How to Calculate Risk and Reward

In every option trade I make, I establish a target price for the stock. Most of the time, I base this on technical analysis. For example, in May 2012, shares of Seabridge Gold (SA) presented a compelling opportunity. The stock had sold off with the rest of the gold sector. But where most investors avoided Seabridge, we saw a good trade.

The Seabridge Gold January \$15 calls were trading for just \$1.40. And based on the chart pattern, I set a minimum target price for the stock at \$20.

When I made the trade, I knew if the stock made it to \$20 before option expiration in January, the SA January \$15 calls would trade for at least \$5. So my readers were essentially risking \$1.40 to make \$3.60 – a little better than a 2.5-to-1 reward/risk ratio.

If I set a 50% stop loss on the option, we were really risking just \$0.70 (50% of \$1.40) to make \$3.60 – a 5-to-1 reward/risk ratio and a terrific trading opportunity.

HOW TO DETERMINE PROPER POSITION SIZING

The most common mistake option buyers make is that they overleverage. In other words, they buy far more options than their account size justifies.

Options are purchased in blocks of 100. So, for example, if the Microsoft April \$30 calls are priced at \$2.30, you'll pay \$230 for one contract, a call option on 100 shares of Microsoft.

Traders should use options as a substitute for the underlying shares. In other words, if you typically buy 1,000 shares, then you should buy only 10 contracts. If you trade in lots of 500 shares, then you should buy just five contracts.

Of course, most people don't think that way. Most people think, "I can deposit \$10,000 and sell short 1,000 shares of Company X at \$10 a share, or I can purchase \$10,000 worth of put options."

This type of thinking is foolish. Rather than using options to reduce risk, they've actually increased their potential maximum loss. Instead of substituting 10 puts for their normal trade of 1,000 shares, they've overleveraged and bought 100 puts, which cover 10,000 shares.

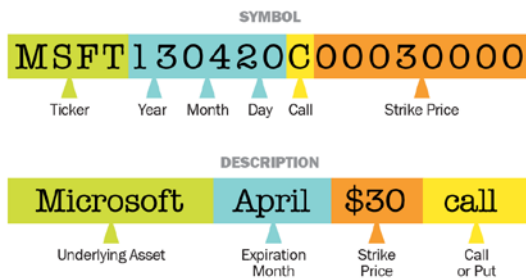
One of the annoying characteristics of options is that they have this nasty habit of expiring worthless.

Consequently, you have to be willing to accept the potential loss of 100% of the capital you put at risk in options.

So you should never, never, NEVER buy more put options than that which is necessary to control the number of shares you normally trade.

A Brief Options Glossary

Anatomy of an Option



This option is betting that Microsoft's share price will be above \$30 on option-expiration day in April, which is the third Friday of the month.

Underlying Instrument: The stock, stock index, or any other financial instrument that you have the right to buy and sell.

Premium: The price of the option.

Expiration Date: Options expire on the third Friday of the month. You must sell on or before the expiration date.

Exercise: You can either sell your option, or exercise your right to buy (in the case of a call) or sell (in the case of a put) the underlying instrument at the strike price.

Bid: The highest price option buyers are currently willing to pay.

Ask: The lowest price option sellers are currently willing to accept.

Strike Price: The price at which you can "exercise" your option. This price is based on the underlying instrument. Call option buyers have the right to buy the underlying instrument at the strike price. Put option buyers have the right to sell at the strike price.

In the Money: Calls are "in the money" if the price of the underlying instrument is HIGHER than the strike price. Puts are "in the money" if the price of the underlying instrument is LOWER than the strike price. (A put with a \$20 strike price is "in the money" with the stock at \$19.)

WHERE CAN I FIND OPTION PRICE?

You can find 15-minute-delayed data on Yahoo Finance. Go to finance.yahoo.com. In the "Enter Symbol" box, enter the ticker of the stock you'd like to find options for. Once you pull up the main page for that stock, look to the center navigation bar beneath the security price."

Select your expiration month along the top. You'll see the calls at various strike prices. Scroll down to see the puts at various strike prices.

You should also be able to look up option prices on your broker's website, though it may display the data differently. Call your broker's customer service line for help.

At the Money: When the price of the underlying instrument is identical to the strike price. Same for both puts and calls.

Out of the Money: Calls are "out of the money" if the price of the underlying instrument is LOWER than the strike price. Puts are "out of the money" if the price of the underlying instrument is HIGHER than the strike

price. (A crude-oil call with a strike price of \$25 is "out of the money" if crude is at \$20.)

Symbol: The basic parts of an option symbol are: Stock Symbol + Expiration Year + Expiration Month + Expiration Day + Call/Put Indicator + Strike Price. You can see how this works in the earlier example.

Three Major Factors that Determine Option Prices

1) Distance of the Strike Price from the Market

Price: For out-of-the-money options, the closer the market is to the option's strike price (the closer the option is to being "in the money"), the more expensive the option will be.

2) Time Until Expiration: The longer an option has to work, the more expensive it will be. Extra time simply gives the stock more time to make the move. An option

is known as a "wasting asset." It loses value with the passage of time.

3) Volatility: The more volatile the stock, the more expensive the option will be. Because volatile stocks have greater potential for large price moves, there's a higher probability that an out-of-the-money option will at some point be in the money.

Figuring Profit Potential

Profit potential for both buying and selling options is typically figured at expiration. At expiration, hard-to-figure pricing variables, such as time and volatility, drop from the equation... making profit calculations much easier.

However, that doesn't mean you need to hold an option until expiration, and you do not need to exercise your option to profit from a position. To take a profit on a put or call, simply sell it. You can also cut losses in losing positions by doing the same thing.

The vast majority of options are not carried through until expiration at all. Rather, they are sold on the options-exchange market.

On the next page, there are some simple formulas for determining risk and profit potential, based on the market price of the underlying instrument at expiration.

Buying a call:

Let's say you think Company X, now at \$29.50, has a rosy future. You expect the stock to hit \$35 in the next six months, so you buy the Company X April \$30 calls at \$1.20. Here's how to figure what you would need to break even and what your profit would be on expiration day if Company X moved in the right direction...

Strike Price	\$30.00
+ Amount Paid for Option	+ \$ 1.20
Breakeven Price	\$31.20

The market price of the stock needs to be above the breakeven price at expiration for a call to be profitable.

Market Price of the Stock	\$33.86 (Company X's price at expiration)
- Strike Price	- \$30.00
- Amount Paid for Option	- \$ 1.20
Your Net Profit	\$ 2.66 (222% profit)

Buying a put:

Let's say, conversely, you think Company X is going downhill. You expect the stock to sink to \$25 in the next six months, so you buy the Company X April \$30 puts at \$1.50. Here's how to figure what you would need to break even and what your profit would be on expiration day if the stock took a turn for the worse:

Strike Price	\$30.00
- Amount Paid for Option	- \$ 1.50
Breakeven Price	\$28.50

The market price of the stock needs to be below the breakeven price at expiration for a put to be profitable.

Strike Price	\$30.00
- Market Price of the Stock	- \$26.20 (Company X's price at expiration)
- Amount Paid for Option	- \$ 1.50
Your Net Profit	\$ 2.30 (153% profits)

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