

A MARKETPLACE BOOK

McMillan on Options

Second Edition

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Given this additional information—that implied volatility is near the lower end of its normal range, and that it is normally higher than historical volatility—the trader would opt to buy the calls instead of the futures.

Another decision that must then be made is which option to buy. As mentioned earlier in this chapter, buying the short-term in-the-money option is usually the best choice. The trader obtains leverage because he owns an option, but he does not spend a lot for time value premium. The number-one reason that option buyers lose money is that they buy options that are too far out-of-the-money. These options also may have too little time remaining. This mistake can cause the trader to lose money even though the underlying may move in his favor. Whereas with the in-the-money option, he will almost assuredly make money if the underlying has a favorable move.

As for actually buying the position, be careful about using market orders in options unless (1) you are trading a very liquid option, such as OEX or IBM, or (2) you are placing a small order of 10 contracts or less. Otherwise, limit orders would serve you better in the long run. You may find that you can often “split” a market (i.e., buy between the bid and the offer), especially in a moderately active option. Don’t be stubborn about using limits, though. If you are attempting to buy a very thin (illiquid) option, the market makers may just raise their offer when they see your bid, for they don’t really want to take a position.

Risk management, through stops, of an existing position is another important factor, especially in speculative trading. Not only must you adhere to a stop loss of some sort, but you should also have a plan for taking partial profits at times along the way. I generally prefer to set my stops based on technical support and resistance levels in the chart of the underlying security. Some traders who buy options set stops based on the *option* price; this can mean that time will stop them out or that they sell their options when the underlying is sitting right on a support level—not a good idea. However, when they are trading in-the-money options, they don’t have to worry about time decay so much, so they can use the underlying’s technical levels to place their stops.

If you are trading options, use a *mental* stop; if you are trading stock or futures, you can use an *actual* stop. A mental stop means that you don't actually have a stop-loss order on the floor of an exchange; but when the underlying hits your mental stop price, you can evaluate the situation at that time. If it seems that the position should be sold, then you can decide on a market or limit order. In general, if your mental stop has been violated and if the stock or futures contract seems to be headed in the wrong direction, a market order is best. However, if the stock or futures seem stable, you might try to use a limit order to exit the position.

Perhaps even more important than limiting losses is managing profits. Everyone wants to follow the conventional wisdom to "limit your losses and let your profits run." Actually *doing* this is easier than it might appear, despite conventional wisdom to the contrary. Most traders know the anguish of seeing a position move in their favor, thereby generating an unrealized gain, only to have it fall back and stop them out. To me, this is far more devastating than taking a profit too early, although we can attempt to get the best of both worlds. There are two ways to do this: (1) take partial profits and (2) use a trailing stop.

Some traders take partial profits on a strict basis. For example, if they own options, they may sell a part of the position if they get a 25 percent profit. Then they would sell a similar portion if they get a 50 percent profit. Then they would attempt to hold the remainder with a mental stop. Other traders prefer to take profits based on the underlying's action—if it hits resistance or spurts ahead too fast, they take partial profits on their position. In either case, this is the correct approach, for it allows them to take some realized gains but still lets their profits run.

The other technique that protects profits is the *trailing* stop. Once a position begins to move in your favor, raise your stop price, whether it be a mental or an actual stop. Initially, you use a fairly tight stop in a trading position. But, if you are taking partial profits along the way, you might not want to keep the trailing stop as tight when you raise it. That is, when things are going your way, leave some extra room for a small correction to take place without stopping you out.