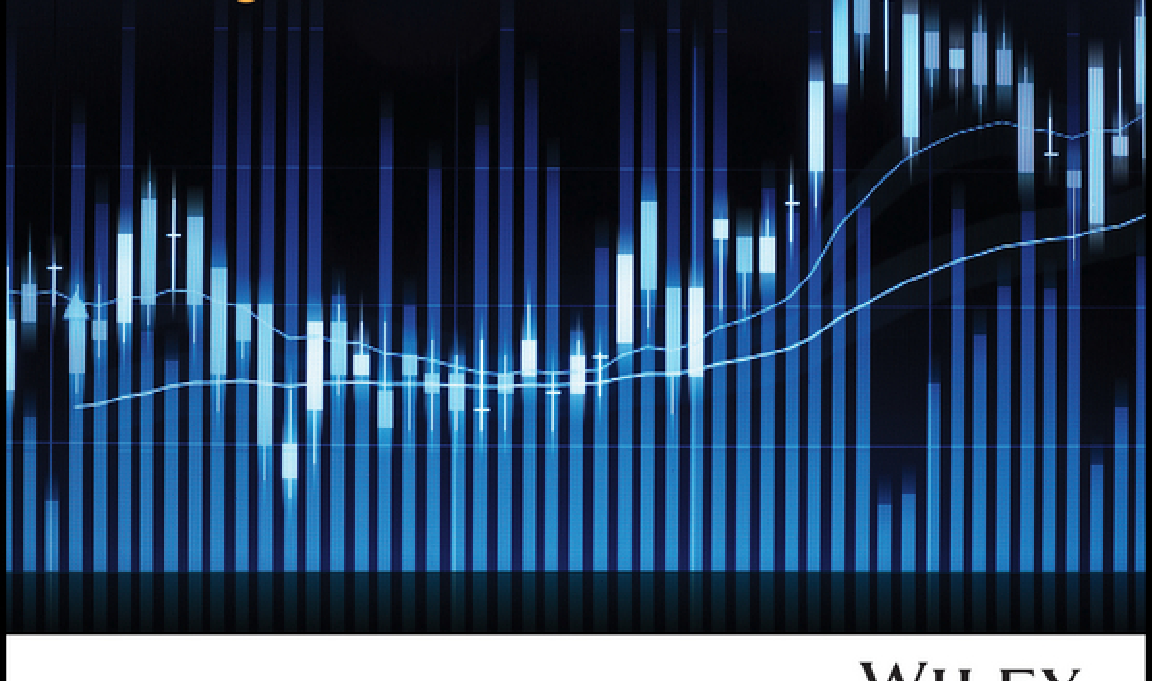
JJ Kinahan

ESSENTIAL OPTION STRATEGIES

Understanding the Market and Avoiding Common Pitfalls



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To Karen, Kaitlin, Kevin, and Kelly. Your love and support make all things possible.

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Foreword

I began trading options on the floor of the CBOE in the early 1980s, just a few years before JJ. Back then, we were trader indifferent, which meant we would trade anything with anybody. Today, we would say the same about our approach to the products and strategies that we choose. These days, the counterparty to our trades is a computer with theoretical algorithm with unlimited funding. Back then, it was some kid just like us—nervous and sweating while trying to make a few eighths.

JJ and I traded together, played together, worked together, and learned together. Luckily, we were among the survivors. We excelled at our craft by managing our egos and not getting caught in the fat tails (volatility) of a few explosive moves. But the business changed as it grew exponentially, and open outcry faced certain extinction around 2000.

Now, the original trader cowboys are gone. Billions of new dollars, lightning-fast servers, and hard-coded theoretical models have taken over. Still, JJ, myself, and a handful of others decided we still had a lot left to learn and to share publicly. The same customers we lived off of were now our partners. And with strong beliefs that options remain the greatest strategic instrument in the world, our new mission was clear: Let's gather the gang together and share our stories. First came the technology to facilitate our mission, and next came the content.

In his first book, JJ reviews, discusses, and critiques almost every progressive strategy available. He puts great context around those ideas, so they are usable in real time. You'll see through his stories that the trader spirit remains in his words and transcends decades and advancements in technology.

Tom Sosnoff

Preface

A lot has changed in the options world since I started my career as a floor trader on the Chicago Board Options Exchange (CBOE) thirty years ago. Obviously, technology has transformed the exchanges, and with one or two exceptions, the live pits with crowds of screaming traders, like in Figure P-1, are largely a thing of the past.

At the same time, options markets are no longer confined to industrial countries or limited to instruments such as stocks and commodities. Contracts are now listed on a wide array of different asset classes, including fixed income, precious metals, energy, and even volatility. In addition, sufficient advances in technology have enabled many emerging economies to offer options as investment opportunities and as tools to manage risk.

My focus in this book is helping you, the retail client, understand some of the more actively traded securities in the U.S. markets, where options on equities and futures trade on more than a dozen different exchanges today, and only two—the Chicago Board Options Exchange and the Chicago Mercantile Exchange—are hybrid markets with both electronic and floor-based pit trading.

Technology is not only driving how instruments are traded, but it has changed how information flows as well. It has leveled the playing field for individual investors. When I started my career, professional traders largely relied on the same sources for price information and financial news. Research was at a premium, and analysts provided reports only to their investment advisers, salespeople, and selected clients.

Today, real-time price quotes are readily available by looking online, through brokerages, and with mobile apps. Wall Street research faces competition from financial websites, blogs, and independent analysts. While information flows freely, social media drives increased interaction among individual investors and encourages the sharing of experiences and ideas.

Figure P-1 Live trading pits like this one are largely extinct
Source: Shutterstock

I have seen the evolution firsthand and from a unique vantage point. Prior to joining TD Ameritrade, I worked for thinkorswim® (TOS), a Chicago-based brokerage firm with a focus on options trading. It was a revolutionary standalone trading platform specifically designed for individual traders. At that time, average daily volume across the listed options market in the United States was about 2 million contracts. Just ten years later, in 2009, that figure had increased to more than 14 million.

That same year, TD Ameritrade acquired thinkorswim and has continued to develop and improve the thinkorswim trading platform. This book includes many charts, examples, and ideas that have been developed over the years by the great team I am on at TD Ameritrade. As the markets change, so do our technology and tools.

Despite the fact that the number of trading instruments has increased exponentially, buying and selling is faster and more efficient, and information is more readily available than ever, some things in the options market are the same today as they were thirty years ago. For example, the determinants of an option price are the same today as in the 1970s. As you will see, there are basic tenets of investing that don't really change, and once you learn them today, they are likely to still apply thirty years from now.

The aim of this book is to share my experiences to help readers better understand the options market and explore the opportunities that exist today. I want to do it in a way that offers a commonsense approach without overwhelming the reader with numbers. But, at the same time, the book won't accomplish its objective unless the reader fully understands key concepts.

In summary, the fundamentals of the investment process don't really change, but the advances in technology have created an environment where individual investors have better information and tools than they did in the past. In fact, there has never been a better time to learn the options strategies that were once the domain of only the smartest professional traders.

The book kicks off with Part 1, appropriately titled "Getting Started in Investing." Chapter 1, "The Opening Bell," begins with very basic information you need prior to investing in stocks or options. For many, this is merely review, but for those of you who are newer to trading options or newer to investing in general, it offers basic information about financial markets today, how to get started, and suggestions for creating a trading plan.

From there, the discussion continues with a list of indicators to track in Chapter 2, "First Days of Trading." Understanding underlying instruments such as stocks, futures, and indexes is important and covered in Chapter 3, "Know the Underlying." I conclude Part I with a discussion about "Avoiding Mistakes," the focus of Chapter 4.

Part II takes a basic understanding of investing to the options market. Chapter 5 covers options basics. Call and put options are defined in Chapters 6 and 7. Chapter 8 explains the determinants of options prices, and the math gets a bit more advanced when I talk about probabilities in Chapter 9. But don't worry, all of the examples are intuitive, and no advanced math is required.

Part III dives into more advanced options strategies. The basic strategies of covered calls and protective puts are covered in Chapters 10 and 11. Then my focus turns to spread trading. Long vertical spreads are the topic of Chapter 12, and short verticals are discussed thoroughly in Chapter 13. Calendar or time spreads are discussed in Chapter 14. Chapters 15 and 16 explore two advanced strategies—butterflies and condors. Chapter 17, "The Close," concludes Part III and covers the important concept of risk management.

For reference, Appendix A offers a look at delta, gamma, and the other Greeks. It offers definitions of each measure and serves as a quick reference. Appendix B shows different charts and basics of technical analysis. It also includes the payoff or risk graphs for the options strategies covered in Chapters 6 through 12. Appendix C is a primer on stock charts and volatility studies. A Glossary is provided at the end of the book as well.

I really hope this book helps you understand the fundamentals of the options market while also providing the confidence and tools you need to begin using strategies as part of a longer-term trading plan. Importantly, while I use real-world examples in this book, they are for educational and illustrative purposes only.

The securities depicted are sometimes real and sometimes hypothetical. They are specifically not solicitations or recommendations to trade a specific security or to engage in a particular trading or investing strategy. In addition, transaction costs, such as commissions and other fees, are important factors that should be considered when evaluating any trading opportunity.

The book starts at a very basic level, and for experienced traders, Part I might seem like a 101 material. But in the end, the reader will come away with a thorough understanding of options, techniques the pros use, and why the industry has experienced exponential growth since I started my career on the trading floor.

Please use this book to help you and your family pursue your investing and trading goals. Keep in mind that options trading entails significant risk and is not appropriate for every investor. Complex options strategies can carry additional risk. And futures and futures options trading is speculative and not suitable for all investors.

For me, the options business is something that I love and am passionate about. Hopefully, after digging through the early chapters, you will share the same appreciation about this business . . . and how it can provide tremendous opportunities for anyone willing to work hard and learn.

Acknowledgments

I was very happy to be given the opportunity to write a book designed to help retail investors as they embark on their journey into options investing. My goal was to provide information that demystified much of the difficulty by making the approach straightforward, using common sense rather than complicated math. I have been lucky to meet so many of you who are out there day after day working to get better. I admire your desire to learn and your commitment to improving your lives through investing. You are the inspiration for this book, and I hope you find it useful.

This was a large undertaking, and so many TD Ameritrade partners helped make it a success. A big thank you to CEO Fred Tomczyk, President Tim Hockey, and EVP Trader Group Steve Quirk for allowing me to pursue this undertaking. Thank you to the Active Trading Team for letting me work alongside you every day and seeing all your amazing accomplishments. I want to thank the Compliance Team. This took many hours of your time, and I greatly appreciate it. Thanks to the Marketing Team for all the help getting started and the constant guidance along the way. CAPAE Team, you are always a pleasure to work with, and Legal Team, thank you for your trusted counsel.

Fred Ruffy, it was great working with you. Thank you for the insight and suggestions. Thanks to the folks at Wiley. You are wonderful partners who made the process easy.

Thanks to both Zack Fishman and Paul Picchietti for taking a chance on me straight out of college and beginning to teach me the world of options. And also, thanks to Tom Sosnoff, from whom I have learned so much.

Most importantly, I want to thank my family—my late parents who did an amazing job of showing me the meaning of work ethic and sacrifice; my brothers and sisters for helping their youngest sibling every step of the way; and, of course, my wife, Karen, and our children, Kaitlin, Kevin, and Kelly.

About the Author

An options industry veteran, JJ Kinahan started his trading career in 1985 at the Chicago Board Options Exchange (CBOE). As a market maker, he traded primarily on the floor in the S&P 100 (OEX) and S&P 500 (SPX) pits. Later, he worked for ING Bank and Blue Capital. He then became managing director of options trading for Van der Moolen, USA.

In 2006 JJ joined the Chicago-based options trading brokerage firm thinkorswim where he served many roles, including developing educational content and helping build the tools that are integrated into the thinkorswim® platform today. JJ is now chief market strategist for TD Ameritrade, which acquired thinkorswim in 2009.

JJ is a frequent CNBC guest, a *Forbes* contributor, and often quoted in *The Wall Street Journal*, *Financial Times*, Reuters, and many other respected media outlets. He is on the Advisory Board at the CBOE. When not busy working or trading, he is an avid Chicago sports fan who enjoys reading, fishing, and spending time with his wife and three children.

PART I

Getting Started in Investing

CHAPTER 1

The Opening Bell

At 9:30 a.m. (EST) on every business day, a bell at the New York Stock Exchange sounds, and trading on the exchange floor begins. Investors buy and sell stocks like jockeys scrambling for positions at the Kentucky Derby. News flow drives the buying and selling decisions from one day to the next.

When the day's news doesn't deviate too much from expectations, the result is typically orderly and normal market action. However, when unexpected events result in dramatic changes in the expectations, large price moves and fast trading ensue. In other words, the day's news events can result in changes in investor sentiment and result in higher or lower levels of market volatility.

It can seem overwhelming. I remember when I left the trading floors after twenty-one years at the Chicago Board Options Exchange (CBOE). My focus shifted from a small number of instruments to a huge universe of different opportunities. I started trading in markets that were unknown to me. The results were horrible. Over time, I realized that it was better to keep a laserlike focus on markets that I understood and believed in. It is simply impossible to track the moves of every different market, much less trade them all effectively.

Moreover, the importance of news events will also vary from one investor to the next. A large pension fund taking positions in a widely held stock like Apple (AAPL) or General Electric (GE) for a longer-term portfolio isn't likely to react to a news report the same way as a stock trader buying and selling stocks for short-term profits. A retiree has a different set of goals than a recent college graduate.

An options market maker on the CBOE is using equity options differently than a financial adviser selling options in an attempt to generate income for a customer's portfolio.

Although we all have different goals and objectives, the millions of participants in the financial markets digest the day's news, and the results move asset prices as the information becomes available. This is not only true of U.S. markets, but of financial instruments around the globe.

My focus in this book is primarily on U.S. Exchange listed equities, options, and equity futures markets that are open during the regular hours of 9:30 a.m. to 4:00 p.m., Monday through Friday, but there are many investments that trade beyond that. In 1985, regular trading hours were expanded beyond these hours. Premarket trading now begins at 4:00 a.m., and the after-hours session runs from 4:00 to 8:00 p.m.

Options, meanwhile, trade on thirteen different exchanges from 9:30 a.m. to 4:00 p.m. currently, and those hours may soon be expanded. Trading hours for futures and futures options vary by product, but more popular instruments like S&P 500 futures now trade nearly around the clock beginning Sunday at 6:00 p.m. and continuing through Friday evening. So when you come home at 2:00 a.m. after a few drinks at a neighborhood party, you can trade S&P 500 futures from your online brokerage account. However, that is not really recommended!

The expansion of trading hours and growth in financial markets is being driven by the exchanges to satisfy investor demand for new investment products and opportunities. At the same time, technology has created better efficiency and linked global markets. News flow travels fast and often results in sudden market moves that ripple from one economy to the next.

Yet, while today's faster and more complex market sometimes seems daunting to investors, the principles of investing have not changed. With a bit of time and effort, the fundamentals are easy to understand. So let's begin.

Probabilities

"How do I get started?"

I hear that question a lot. Many people understand the importance of investing and building wealth but don't know where to turn. Interest rates have been historically low for quite some time, and traditional banking instruments like money markets and savings accounts are not offering much in the way of yields. So what choices exist when seeking returns on one's hard-earned money?

Before I dive into specific instruments, let me introduce the probability concept. There are a myriad of different opportunities available to investors today, and all of them have varying probabilities of success. We can never predict the future with certainty, and so investments decisions are based on expectations about probable outcomes. We might say, based on our expectations, that an outcome is likely, is probable, or has a good chance.

Just like risk and reward, probability and strategy selection are two sides of the same coin. You have no doubt heard the expression, "high risk, high reward." It refers to the fact that investments that offer the highest rewards typically have the greatest risk. Playing the lottery is an example of an extreme high-risk, high-reward endeavor. There is a very high rate of failure, but a winning ticket would mean a big payoff. On the other hand, burying your life's savings in the backyard is probably a low-risk, low-reward scenario (although risks increase if you bury everything near the family dog's bone stash).

In trading options, and remember, options are simply pricing probabilities, a strategy that has a very high probability of success and a low probability of loss is likely to have smaller potential for profit. On the other hand, a strategy with a small probability of profit should generate a larger potential profit when successful.

In later chapters, we will explore simple probability concepts and ways to compute probabilities for various options strategies. The important point to take home for now is that various investments or strategies are more than just good or bad ideas. Each strategy has a quantifiable probability of success.

Getting Started

What investments have the greatest probability of helping you attain your goals? There's no one single right answer, because every individual and institution is different. It's like asking, what's the best car to buy? It really depends on what you're using it for.

The first step to finding appropriate investments is to outline longer-term goals and objectives. Obviously, we all want to build more wealth, but unless we outline a concise plan, we are unlikely to set money aside each month or invest on a regular basis to achieve our objectives. The best investment choices often depend on a person's age, ambitions, and investment time horizon. For instance, as you will see in later chapters, some options contracts exist for a mere week, while others have lives that span many years. What is your investing time horizon, and how much are you putting away each paycheck?

Five Steps in the Investment Process

1. Set longer-term goals and objectives.
2. Develop a trading plan.
3. Identify investment opportunities.
4. Execute (open) trades.
5. Monitor, adjust, and exit open positions.

After the decision to invest has been made, the next step is to develop a plan. How will you try to reach your goals? Can you trade actively during the trading day, or will your investments be made only once per week or per month? Are you investing for five days, five years or fifty years? How much risk are you willing to take? What financial instruments—stocks, futures, bonds, options, commodities—will take part of the trading plan?

Developing a relationship with a brokerage firm is a key part of the trading plan. A brokerage (or broker-dealer) like my firm, holds customer funds and places buy and sell orders as instructed by you, the client. The first step is to open an account and submit any trading approval request forms. For example, investing in options requires applying for options trading approval from your broker.

While many investors focus on brokerage commissions and fees, there are a number of other things to consider besides price. The primary thing to consider is service. For example, does the firm have people that can answer my questions and help me when needed? Make sure they can help you pursue your trading goals. As you read through the chapters of this book, you will likely find the investments and strategies that match your longer-term goals and trading plan.

Research

Believing in your trading plan and your investment choices will lower your stress levels during times of increasing market volatility.

Research is often a key to maintaining that conviction and also to finding attractive investment opportunities. In addition, it often makes sense to research companies or investments that you already know and love.

For example, let's say you own a pizza restaurant and a salesperson from The Pizza Sauce Company stops by your shop with samples of his newest sauce. You like the taste, and the price is $0.10 per can below your current supplier. You agree to sample a few cases and discover your customers love it. Your pies have never tasted better. Mama mia!

Convinced that The Pizza Sauce Company will soon gain substantial market share from its pizza sauce competitors, you check with your broker for any research available on the company. You discover that the stock is trading under the symbol PZZA. Two analysts currently cover the stock, and both agree that the company has a clean balance sheet, and shares are attractive at current levels, according to the research. Both analysts have a twelve-month price target of $26 per share.

At $20 per share, you note on the daily stock chart that the stock hasn't moved much during the past six months, but you believe that is likely to change once it becomes clear that the company is gaining market share over competitors. Your trading plan states that you do not invest more than 5 percent of your $200,000 portfolio, or more than $10,000, on one position. Instead, you place on order on your broker's platform to buy 250 shares of PZZA, for an investment of $5,000, or 2.5 percent of your portfolio.

Fast-forward one year, and as you had anticipated, The Pizza Sauce Company is outperforming its competitors, and the share price has increased to $25. You still hold 250 shares, now worth a total of $6,250, for an unrealized gain of $1,250.

However, a few weeks later, Pepperoni & Mozzarella Inc. says its cheese sales are falling short of previous expectations, and its stock drops 20 percent. The steep decline triggers a ripple effect that is felt across nearly every pizza company, as investors interpret the news as sign that pie sales are falling across the board.

Shares of The Pizza Sauce Company fall back to $22. However, your research continues to indicate that PZZA has strong fundamentals and is still gaining market share. Rather than sell hastily based on the headlines related to Pepperoni & Mozzarella, you are more likely to maintain your conviction in PZZA and possibly even buy more shares on the pullback. And that's exactly what you decide to do.

You place an order electronically to buy another 250 shares of The Pizza Sauce Company for $22 per share. You now own, and you are long, 500 shares at an average cost of $21 per share, for a total investment of $10,500. Assuming you earned 2 percent on the other assets in your account during the past year, the portfolio is now worth $204,150, or $193,650 plus the $10,500 of PZZA.

Long versus Short

- Going *long* is taking a new position as a buyer. If you are long a stock, you want the stock to increase in price so you can sell it at a profit.
- Going *short* is initiating an opening position as a seller. If you are short a stock, you want the stock price to fall so you can buy it back at a lower price. The mechanics of selling stock short are covered in detail in Chapter 3.

Your analysis was correct. Four months later, shares of The Pizza Sauce Company have recovered some losses and now trade for $25. You own 500 shares at a cost basis of $21, and the position is now worth $12,500 for an unrealized profit of $2,000. The total portfolio is now worth $207,700, or $195,200 and $12,500 of PZZA shares.

The stock position now accounts for 6 percent of your portfolio and exceeds the 5 percent threshold dictated by your trading plan. You sell 100 shares at $25 a share and reduce the position in The Pizza Sauce Company to 400 shares. The adjustment leaves you long 400 shares worth $25, or $10,000. You have booked $400 in realized taxable profits and have $1,600 of unrealized gains.

Indeed, as you will see in later chapters, sometimes the best investment opportunities happen when the news headlines seem the worst. At the end of the day, there is no substitute for timely, thoughtful research. Once you have a trading plan and have determined what instruments you will use to pursue your goals, find a broker who offers the type of research that will help you make informed decisions and keep you focused on the bigger picture when short-term events cause momentary setbacks. Research when combined with probability is a powerful combination.

Data

It wasn't that long ago when, outside the trading desks and the professional investment community, most investors relied on printed newspapers to see price changes to their stock positions. Periodicals like *The Wall Street Journal* and *Investor's Business Daily* provided tables of stocks listed alphabetically, and the prices represented the closing prices from the day before.

Five Components of a Stock Quote

- Open: The first price of the trading day.
- Last: The most recent price.
- High: The highest price of the trading day.
- Low: The lowest price of the day.
- Close: The final price of the trading day. It will be the same as the last price at the end of the trading day.

Wow, a lot has changed since that time! Many websites readily offer free delayed intraday prices. Brokerage firms typically offer free real-time quotes to their customers as well. Offerings might include a symbol quote box where you can type in a ticker symbol or tables that include lists of multiple symbols along with relevant information, including last, high, and low prices.

Figure 1-1 is a snapshot of what I watch on the thinkorswim platform each day. It includes indexes like the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite, as well as some widely held names like Apple (AAPL), Netflix (NFLX), and General Electric (GE). I also watch some of the action in the futures markets, especially the S&P 500 Futures (/ES), and the US 30 year Treasury Bond Futures (ZB), as well as the Euro/US dollar (EUR/USD) currency pair.

I can also see the price quote for any stock by using the Quick Quote tool. First, identify the ticker symbol of the company you're researching. It's simply an abbreviation to uniquely identify a publicly traded instrument like a stock, index, or fund. For example, the ticker for General Electric is straightforward. It's GE. However, sometimes the ticker is less intuitive and requires a symbol lookup. This is easy to do using most brokerage platforms.