THE WAR ROOM - DAY 4

(22-06-20)

Anton

Raj

Common Mistakes of Retail Traders in Options

- You look for an Options strategy before doing Fundamental Work. You get a good stock idea then see if an options trade makes sense not vice versa.
- Make sure you understand Volatility and how it's priced. However, don't get bogged down into the deep mathematics of the Black-Scholes Model.
- Trading Options in dead periods of Volatility. Trade options with catalysts.
- Not having enough risk reward in a trade. I generally look for at least a 3 to 1 payoff in an Options trade because you won't always be right.
- Remember you are adding Timing risk. You need to get paid for that risk. If your timing is off, the trade can blow up. (BIG SHORT!)
- Spending too much money on an Options trade. Remember you aren't going to make money on every trade. Must be properly risked.

Why do an Options Strategy vs. Stock Trade

- You have done the Fundamental work and you now want to have a position in the stock.
- You are looking for leverage in the trade and have identified catalysts that could move the stock in a certain time period.
- Your two choices are to do a properly risked options trade vs. a stock trade because you like the risk/reward of an Options trade better.
- Look for trades where you expect to be very right or very wrong. Buying a Call Option and expecting the stock to rally 5-10% in a month is likely to be a consistent loser.
- Make sure you are comfortable losing all your premium. Don't go into an options trade planning an exit strategy for a loss. Think all or nothing!
- Look at more advanced trade structures rather than just an outright call if possible.
- Call Spreads, Calendar spreads, Ratio spreads all may have better risk rewards than just outright calls.

What is a Call Spread?

- The strategy uses two call options to create a range consisting of a lower strike price and an upper strike price.
- In a call spread, you typically buy the lower strike call and sell the upper strike call in the same maturity.
- The bullish call spread helps to limit losses of owning stock, but it also caps the gains.
- Call spreads are used to benefit from from upward moves in a stock.
- Let's look at example from a name I highlighted in WOYM a few months back.

DOCU

Option chain

Symbol	Expiration	Strikes
DOCU	Jul 24 2020	All

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
7.40	9.10	167.5	13.50	15.40
6.30	8.20	170.0	13.60	17.30
4.00	7.10	172.5	16.70	18.50
4.30	6.80	175.0	18.80	20.10
3.90	5.90	177.5	20.30	22.60
3.10	5.40	180.0	20.60	24.70
2.60	5.00	182.5	23.20	26.60
2.20	5.20	185.0	25.20	27.80
1.65	4.30	190.0	29.50	32.20
1.00	3.80	195.0	34.00	37.50

In the money

View full chain

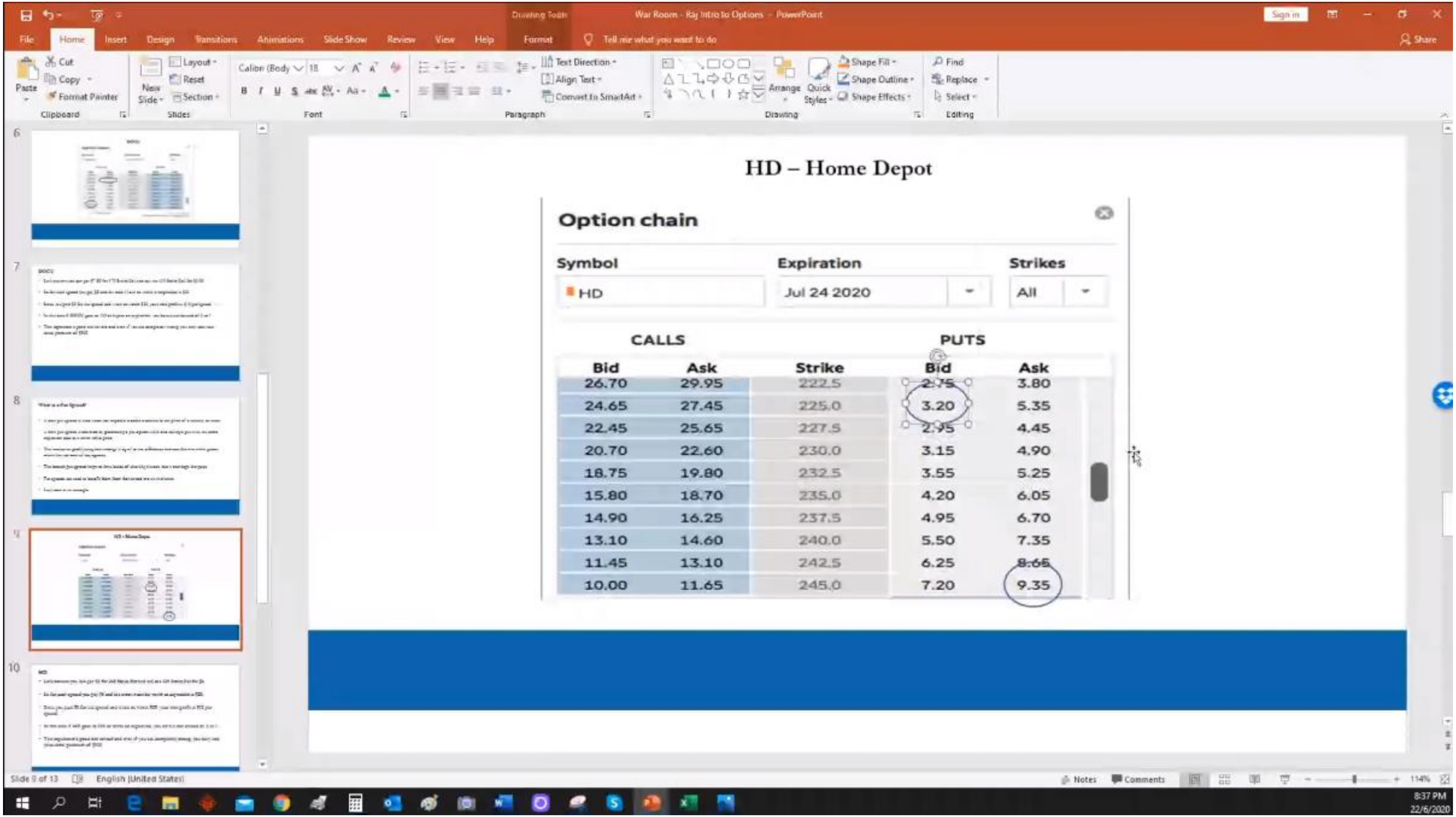
Delayed up to 15 min Learn more

DOCU

- Let's assume you can pay \$7.50 for 170 Strike Call and sell the 190 Strike Call for \$2.50.
- So for each spread you pay \$5 and the most it can be worth at expiration is \$20.
- Since you paid \$5 for the spread and it can be worth \$20, your max profit is \$15 per spread.
- In this case if DOCU goes to 190 or higher on expiration, you have a risk reward of 3 to 1.
- This represents a good risk reward and even if you are completely wrong, you only lose your initial premium of \$500.

What is a Put Spread?

- A bear put spread is used when you expect a moderate decline in the price of a security or asset.
- A bear put spread is achieved by purchasing a put option while also selling a put with the same expiration date as a lower strike price.
- The maximum profit using this strategy is equal to the difference between the two strike prices, minus the net cost of the options.
- The bearish put spread helps to limit losses of shorting a stock, but it also caps the gains.
- Put spreads are used to benefit from from downward moves in a stock.
- Let's look at an example.



HD – Home Depot

Option chain

Symbol	Expiration	Strikes
HD	Jul 24 2020	All

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
26.70	29.95	222.5	2.75	3.80
24.65	27.45	225.0	3.20	5.35
22.45	25.65	227.5	2.95	4.45
20.70	22.60	230.0	3.15	4.90
18.75	19.80	232.5	3.55	5.25
15.80	18.70	235.0	4.20	6.05
14.90	16.25	237.5	4.95	6.70
13.10	14.60	240.0	5.50	7.35
11.45	13.10	242.5	6.25	8.65
10.00	11.65	245.0	7.20	9.35

HD

- Let's assume you can pay $9 for 245 Strike Put and sell the 225 Strike Put for $4.
- So for each spread you pay $5 and the most it can be worth at expiration is $20.
- Since you paid $5 for the spread and it can be worth $20, your max profit is $15 per spread.
- In this case if HD goes to 225 or lower on expiration, you have a risk reward of 3 to 1.
- This represents a good risk reward and even if you are completely wrong, you only lose your initial premium of $500.

What is a Calendar Call Spread?

- A Calendar Call spread is a seasoned options strategy where you buy a longer dated call and sell a shorter dated call against it.
- You do this in hopes that the stock doesn't move up much in the short term but a lot in the long term.
- When this happens, you cheapen the purchase price of your long call because of the premium that you collect.
- If done properly, the trade can be profitable even if your timing is wrong.
- This strategy works best when short dated volatility is high, because you collect more premium than if implied volatility is low.
- The strategy also works in Put spreads but let's look at Calendar Call spread example.

TDOC – Teledoc

Option chain

Symbol: TDOC **Expiration:** Jul 31 2020 **Strikes:** All

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
17.50	22.00	200.0	15.70	20.00
16.50	21.00	202.5	16.90	21.50
15.20	19.50	205.0	18.40	23.00
14.20	18.50	207.5	19.60	24.00
13.10	17.50	210.0	21.10	25.50
12.50	16.50	212.5	22.50	27.00
11.10	15.50	215.0	24.10	28.50
9.40	14.00	220.0	27.30	32.00
7.80	12.50	225.0	30.90	35.50

Option chain

Symbol: TDOC **Expiration:** Oct 16 2020 **Strikes:** All

CALLS			PUTS	
Bid	Ask	Strike	Bid	Ask
30.20	33.00	195.0	23.40	25.90
27.80	30.90	200.0	25.80	29.20
23.20	26.40	210.0	31.80	34.60
20.10	22.30	220.0	37.40	40.80
16.50	19.10	230.0	43.80	46.90
14.10	15.90	240.0	50.90	54.40
11.10	13.30	250.0	58.50	61.90
9.20	11.50	260.0	66.40	69.90
7.20	9.10	270.0	74.90	77.90
5.30	8.60	280.0	83.20	86.40

TDOC

- Sell the July 220 Call for $11.
- Buy the Oct 200 Call for $30.
- Spend ~$5,000 on this strategy. Sell 1 of the July Calls and Buy 2 of the October Calls.
- You collect $1,100 on the July call you sell and pay $6,000 for the October Calls. Total $4,900 in Premium.
- Make sure $4,900 isn't too big of loss in your portfolio for your Capital size.
- If the July Calls go out worthless you added $1100 to your strategy. In this case, you essentially paid $24.50 per option ($4,900 / 2 / 100 = $25.50.)
- Should TDOC go to $350 on October expiration, you make $125.50 per option. (350 – 200 – 24.5)
- Risk Reward of ~5.1 to 1. ($125.5 /24.5). Total P&L of $25,100 ($125.5 x s x 100)
- Even if the stock goes up a lot in the short term, it will still be profitable. I will go into more depth for Calendar spreads in our next session together.