TOP 10 MISTAKES

NEW OPTIONS TRADERS MAKE

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Dear Investor,

In my fifteen years in the securities industry, I've led more than 1,000 seminars on option trading. And during that time, I've seen new options investors make the same mistakes over and over – mistakes which can easily be avoided.

In this paper I've analyzed ten of the most common option trading mistakes. Options are by nature a more complex investment than simply buying and selling stocks. For example, when you buy options, not only do you have to be right about the direction of the move, you also have to be right about the timing.

Also, options tend to be less liquid then stocks. So trading them may involve larger spreads between the bid and ask prices, which will increase your costs. Finally, the value of an option is made of many variables, including the price of the underlying stock or Index, its volatility, its dividend, interest rate, and as with any market, supply and demand.

So option trading is not something you want to do if you just fell off the turnip truck. But when used properly, they allow investors to gain better control over the risks and rewards depending on their forecast for the stock. No matter if your forecast is bullish, bearish or neutral there's an option strategy that can be profitable if your outlook is correct.

Sincerely,

Brian Overby
Senior Options Analyst
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Options involve risk and are not suitable for all investors. Please read Characteristics and Risks of Standardized Options. http://content.tradeking.com/wiki/display/tkservice/Characteristics+and+Risks. Any strategies discussed and examples using actual securities and price data are for educational and illustrative purposes only and do not imply a recommendation or solicitation to buy or sell a particular security or to engage in any particular investment strategy. In reading content on TradeKing's website, you may gain ideas about when, where, and how to invest your money. Although you may discover new ideas or rationale that may be compelling, you must ultimately decide whether or not to put your own money at risk. Consider the following when making an investment decision: your financial and tax situation, your risk profile, and transaction costs. While implied volatility represents the consensus of the marketplace as to the future level of stock price volatility or probability of reaching a specific price point there is no guarantee that this forecast will be correct. The Greeks represent the consensus of the marketplace as to the how the option will react to changes in certain variables associated with the pricing of an option contract. There is no guarantee that these forecasts will be correct.

MISTAKE 1

Starting out by buying out-of-the-money (OTM) call options

It seems like a good place to start: buy a call option and see if you can pick a winner. Many veteran equities traders began and learned to profit in the same way. Buying calls may also feel safe because it matches the pattern you're used to following as an equity trader: buy low, sell high.

And yet, buying OTM calls outright is one of the hardest ways to consistently make money in the options world. If you limit yourself to this strategy, you may find yourself losing consistently and not learning very much in the process. Consider jump-starting your options education by learning a few other strategies, and improve your potential to earn solid returns as you build your knowledge.

What's wrong with just buying calls?

It's tough enough to call the direction on a stock purchase. But as I said before, when you buy options, not only do you have to be right about the direction of the move, you also have to be right about the timing.

Each day that passes when the underlying stock doesn't move, your option is like an ice cube sitting in the sun. Just like the puddle that's growing, your time premium is evaporating in the option's price until expiration. This is especially true if your first purchase is a near-term, way out-of-the-money option (a popular choice with new options traders because they're usually quite cheap).

Not surprisingly, though, these options are cheap for a reason. When you buy an OTM "cheap" option, they don't automatically increase just because the stock moves in the right direction. The price is relative to the probability of the stock actually reaching (and going beyond) the strike price. If the move is close to expiration and it's not enough to reach the strike, and the probability of the stock continuing the move in the now shortened time frame is low. Therefore, the price of the option will reflect that probability.

How can you trade smarter?

As your first foray into options, you should consider selling an OTM call on a stock that you already own. This strategy is known as a "covered call". By selling the call, you take on the obligation to sell your stock at the strike price stated in the option. If the strike price is higher than the stock's current market price, all you're saying is: if the stock goes up to the strike price, it's okay if the call buyer takes, or "calls" that stock away from me.

For taking on this obligation, you're earning cash from the sale of your OTM call. This strategy can earn you some income on stocks when you're bullish, but you don't mind selling the stock if the price goes up prior to expiration.

What's nice about covered call selling, or "writing," as a starter strategy is that the risk does not come from selling the option. The main risk is actually in owning the stock. The option only limits your upside, so the only risk from selling the option is opportunity risk.

Yes, you do risk having to sell the stock upon assignment if the market rises and your call is exercised. But since you own the stock (in other words you are "covered") that's usually profitable for you. If the market remains flat, you collect the premium for selling the call and retain your stock position. On the other hand, if the stock goes down and you want out, no worries. Just buy back the option and sell the stock.

As an alternative to buying calls, selling covered calls is considered a smart, relatively low-risk strategy to earn income and familiarize yourself with the dynamics of the options market. Selling covered calls enables you to watch the option closely and see how its price reacts to small moves in the stock and how the price decays over time.

MISTAKE 2

Using an "all-purpose" strategy in all market conditions

Option trading is remarkably flexible. It can enable you to trade effectively in all kinds of market conditions. But you can only take advantage of this flexibility if you stay open to learning new strategies.

Buying spreads offers a great way to capitalize on different market conditions. When you buy a spread it is also known as a "long spread" position. All new options traders should familiarize themselves with the possibilities of spreads, so you can begin to recognize the right conditions to use them.

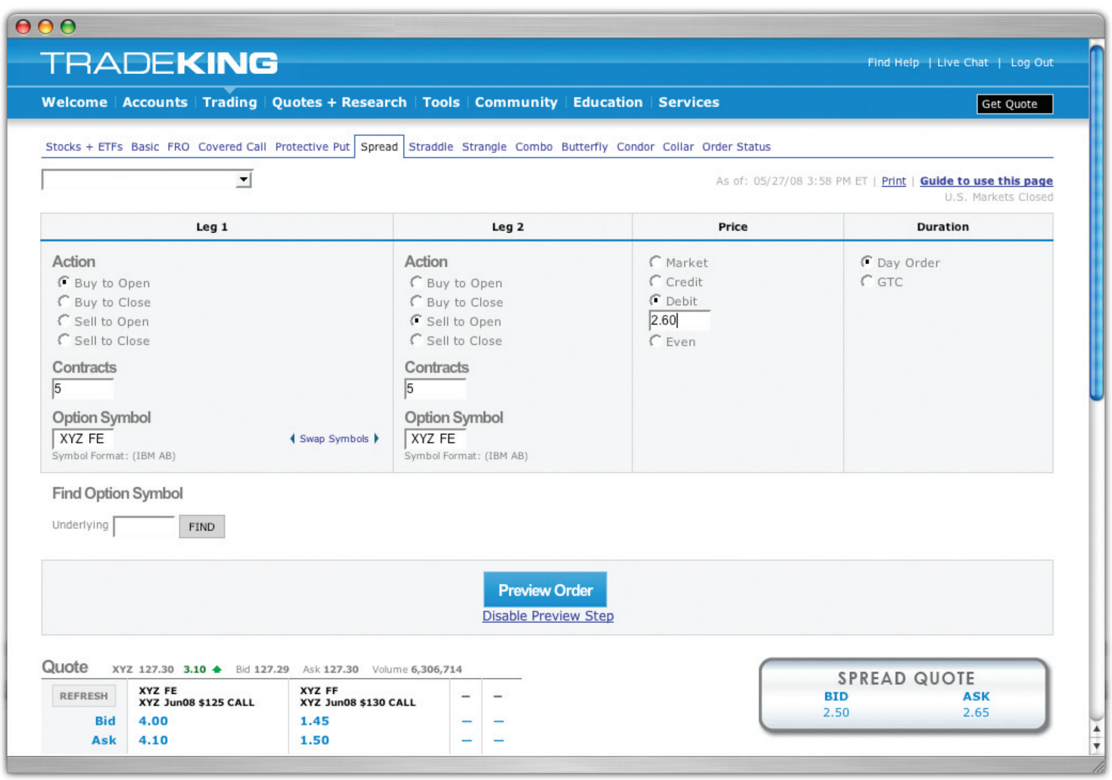
How can you trade smarter?

A long spread is a position made up of two similar options – same underlying security, same expiration date, same number of contracts and same type (both puts or both calls) differing only in their strike price. Long spreads consisting of calls are a bullish position and are known as "long call spreads." Long spreads consisting of puts are a bearish position and are known as "long put spreads."

With a spread trade, since you bought one option at the same time you sold another, time decay that could be hurting one leg is actually helping the other. That means the net effect of time decay is somewhat neutralized when you trade spreads, versus buying individual options.

The downside to spreads is that your upside potential is limited. But frankly, I don't know too many call buyers that actually make sky-high profits on their trades. Most of the time, if the stock hits a certain price, they sell the option anyway. So why not set the sell target when you enter the trade? And example would be to buy the 50-Strike call and sell the 55-Strike call. That gives you the right to buy the stock at $50, but also obligates you to sell the stock at $55 if the stock is tradng above that price at expiration.

There are two caveats to keep in mind with spread trading. First, because these strategies involve multiple option trades, they incur multiple commissions. Make sure your profit calculations include all commissions as well as other factors like the bid / ask spread. Second, as with any new strategy, you need to know your risks before committing any capital. You can learn more about long call spreads and long put spreads in TradeKing's Learning Center.



TradeKing makes it easy to open a spread as a single transaction from our spread trading screen

MISTAKE 3

Not having a definite exit plan prior to expiration

You've heard it a million times before. In trading options, just like stocks, it's critical to control your emotions. This doesn't mean swallowing your every fear in a super-human way. It's much simpler than that: have a plan to work, and work your plan.

Planning your exit isn't just about minimizing loss on the downside. You should have an exit plan, period – even when things are going your way. You need to choose in advance your upside exit point and your downside exit point, as well as your timeframes for each exit.

What if you get out too early and leave some upside on the table?

This is the classic trader's worry. Here's the best counterargument I can think of: What if you make a profit more consistently, reduce your incidence of losses, and sleep better nights? Trading with a plan helps you establish more successful patterns of trading and keeps your worries more in check.

How can you trade smarter?

Whether you are buying or selling options, an exit plan is a must. Determine in advance what gains you will be satisfied with on the upside. Also determine the worst-case scenario you are willing to tolerate on the downside. If you reach your upside goals, clear your position and take your profits. Don't get greedy. If you reach your downside stop-loss, once again you should clear your position. Don't expose yourself to further risk by gambling that the stock might come back.

The temptation to violate this advice will probably be strong from time to time. Don't. You must make your plan and then stick with it. I see far too many people set up a plan and then, as soon as the trade is placed, toss the plan to follow their emotions.

MISTAKE 4

Compromising your risk tolerance to make up for past losses by "doubling up"

I've heard many option traders say they would never do something: "…never buy really out-of-the-money options!", "…never sell in-the-money options!" But it's funny how these absolutes seem silly – until you find yourself in a trade that's moved against you.

Believe me, I've been there. Facing this scenario, you're often tempted to break all kinds of personal rules, simply to keep on trading the same option you started with. Wouldn't it be nicer if the entire market was wrong, not me?

As a stock trader, you've probably heard a similar justification for "doubling up to catch up": if you liked the stock at 80 when you bought it, you've got to love it at 50. So it can be tempting to buy more and lower the net cost basis on the trade.

Be wary, though: What makes sense for stocks might not fly in the options world.

How can you trade smarter?

"Doubling up" as an options strategy usually just doesn't make sense. Options are derivatives, which means their prices don't move the same or even have the same properties as the underlying stock. Time decay, whether good or bad for the position, always needs to be factored in.

When things change in your trade and you're contemplating the previously unthinkable, just step back and ask yourself: "Is this a move I'd have taken when I first opened this position?" If the answer is no, then don't do it.

Close the trade, cut your losses, or find a different opportunity that makes sense now. Options offer great possibilities for leverage on relatively low capital, but they can blow up just as quickly as any position if you dig yourself deeper. Take a small loss when it offers you a chance of avoiding a catastrophe later.

MISTAKE 5

Trading illiquid options

Simply put, liquidity is all about how quickly a trader can buy or sell something without causing a significant price movement. A liquid market is one with ready, active buyers and sellers at all times.

Here's another, more mathematically elegant way to think about it: Liquidity refers to the probability that the next trade will be executed at a price equal to the last one.

Stock markets are generally more liquid than their related options markets for a simple reason: Stock traders are all trading just one stock, but the option traders may have dozens of option contracts to choose from. Stock traders will flock to just one form of IBM stock, but options traders for IBM will have, perhaps, six different expirations and a plethora of strike prices to choose from. More choices by definition means the options market will probably not be as liquid as the stock.

Of course, IBM is usually not a liquidity problem for stock or options traders. The problem creeps in with smaller stocks. Take SuperGreenTechnologies, an (imaginary) environmentally friendly energy company with some promise, but with a stock that trades once a week by appointment only.

If the stock is this illiquid, the options on SuperGreenTechnologies will likely be even more inactive. This will usually cause the spread between the bid and ask price for the options to get artificially wide. For example, if the bid/ask spread is $0.20 (bid=$1.80; ask=$2.00) if you buy the $2.00 contract that's a full 10% of the price paid to establish the position.

It's never a good idea to establish your position at a 10% loss right off the bat, just by choosing an illiquid option with a wide bid/ask spread.

How can you trade smarter?

Trading illiquid options drives up the cost of doing business, and option trading costs are already higher, on a percentage basis, than for stocks. Don't burden yourself.

Here's a popular rule-of-thumb: If you are trading options, make sure the open interest is at least equal to 40 times the number of contacts you want to trade. For example, to trade a 10-lot your acceptable liquidity should be 10 x 40, or an open interest of at least 400 contracts. ("Open interest" is the number of outstanding option contracts of a particular strike price and expiration date that have been bought or sold to open a position. Any opening transactions increase open interest, while closing transactions decrease it. Open interest is calculated at the end of each business day.)

Trade liquid options and save yourself added cost and stress. There are plenty of liquid opportunities out there.

MISTAKE 6

Waiting too long to buy back your shorted options

I could boil this mistake down to one piece of advice: Always be ready and willing to buy back short options early.

Far too often, traders will wait too long to buy back the options they've sold. There are a million reasons for it: You don't want to pay the commission, you're betting the contract will expire worthless, you're hoping to eke just a little more profit out of the trade…

How can you trade smarter?

If your short option gets way out-of-the-money and you can buy it back to take the risk off the table profitably, then do it. Don't be cheap.

For example, what if you sold a $1.00 option and it's now worth 20 cents? You wouldn't sell a 20 cent option to begin with, because it just wouldn't be worth it. Similarly, you shouldn't think it's worth it to squeeze the last few cents out of this trade.

My rule of thumb goes like this: if I can keep 80% or more of my initial gain from the sale of the option, I'll buy it back immediately. Otherwise, I promise you one of these days, a short option will bite you back because you waited too long.

MISTAKE 7

Failing to factor earnings or dividend payment dates into your options strategy

It pays to keep track of earnings and dividends dates for your underlying stock. For example, if you've sold calls and there's a dividend approaching, it increases the probability you may be assigned early. This is especially true if the dividend is expected to be large.

That's because option owners have no rights to a dividend. In order to collect it, the option trader has to exercise the option and buy the underlying stock.

As you'll see in Mistake 8, early assignment is a random, hard-to-control threat for all options traders. Impending dividends are one of the few factors you can identify and avoid to reduce your chances of being assigned.

Earnings season usually makes options contracts pricier, for both puts and calls. Again, think of it in real world terms. Options work like insurance contracts. They can be used to hedge the risk on other positions. For example, if you live in Florida, when will it be most expensive to buy homeowner's insurance?

Definitely when the weatherman predicts a hurricane is coming your way.

The same principle is at work with options trading during earnings season. Pending news can produce volatility in a stock's price – like a brewing hurricane headed straight for your house. If you want to trade during earnings season specifically, fine. Just go in with an awareness of the added volatility and price premium. If you'd rather steer clear, I'd suggest trading your contract after the effects of an earnings announcement have already been absorbed into the market.

How can you trade smarter?

Steer clear of selling options contracts with pending dividends, unless you're willing to accept a higher risk of assignment. You must know the ex-dividend date. Trading during earnings season for the underlying stock means you'll encounter higher volatility – and usually pay an inflated price for the option. If you're planning to buy an option during earnings season, one alternative is to buy one option and sell another, creating a spread (see Mistake 2 for more information on spreads).

If you're buying an option that's inflated in price, at least the option you're selling is likely to be inflated as well.

MISTAKE 8

Not knowing what to do if you're assigned early

First things first: If you sell options, just remind yourself occasionally that you can be assigned. Lots of new options traders never think about assignment as a possibility until it actually happens to them. It can be jarring if you haven't factored in assignment, especially if you're running a multi-leg strategy like long and short spreads, butterflies, long calendars and diagonals.

For example, what if you're running a long call spread and the higher-strike short option is assigned? Beginning traders might panic and exercise the lower-strike long option in order to deliver the stock. But that's probably not the best decision. It's usually better to sell the long option on the open market, capture the remaining time premium along with the option's inherent value, and use the proceeds toward purchasing the stock. Then, deliver the stock to the option holder at the higher Strike Price.

Early assignment is one of those truly emotional, often irrational market events. There's often no rhyme or reason to when it happens. It sometimes just happens, even when the marketplace is signaling that it's a less-than-brilliant maneuver. It usually only makes sense to exercise your call early if a dividend is pending. But it's trickier than that, because human beings don't always behave rationally.

How can you trade smarter?

The best defense against early assignment is simply to factor it into your thinking early. Otherwise it can cause you to make defensive, in-the-moment decisions that are less than logical.

Sometimes it helps to consider market psychology. For example, which is it more sensible to exercise early: a put or a call? Exercising a put, or a right to sell stock, means the trader will sell the stock and get cash. The question is always, "Do you want your cash now or at expiration?" Sometimes, people will want cash now versus cash later. That means puts are usually more susceptible to early exercise than calls, unless the stock is paying a dividend.

Exercising a call means the trader has to be willing to spend cash now to buy the stock, versus later in the game. Usually it's human nature to wait and spend that cash later. But if a stock is rising, less skilled traders might pull the trigger early, failing to realize they're leaving some time premium on the table. That's why early assignment on calls can be unpredictable.

MISTAKE 9

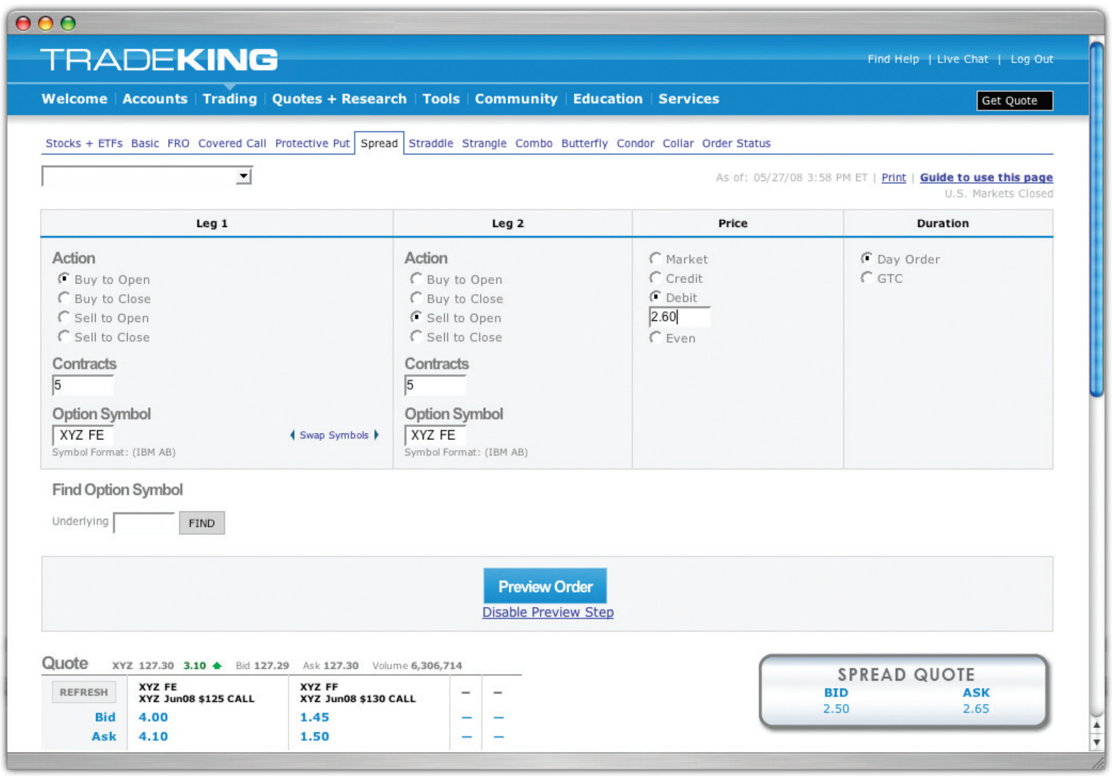
Legging into spread trades

Don't "leg in" if you want to trade a spread. If you buy a call, for example, and then try to time the sale of another call, hoping to squeeze a little higher price out of the second leg, oftentimes, the market will downtick and you won't be able to pull off your spread. Now you're stuck with a long call and no strategy to act upon.

Sound familiar? I've done it myself, unfortunately, and learned my lesson. Trade a spread as a single trade. Don't take on extra market risk needlessly.

How can you trade smarter?

Use TradeKing's spread trading screen to be sure both legs of your trade are sent to market simultaneously. We won't execute your spread unless we can achieve the net debit or credit you're looking to establish. It's a smarter way to execute your strategy and avoid extra risk.



MISTAKE 10

Failing to use index options for neutral trades

Individual stocks can be quite volatile. For example, if there is major unforeseen news in one particular company, it might well rock the stock for a few days. On the other hand, even serious turmoil in a major company probably wouldn't cause the S&P 500 index to fluctuate very much.

What's the moral of the story? Trading options that are based on indexes can shield you partially from the huge moves that single news items can create for individual stocks. Consider neutral trades on big indices, and you can minimize the uncertain impact of market news.

How can you trade smarter?

I like to trade short spreads (also called "credit spreads") or iron condors on indexes. These are strategies that will be profitable if the market stays still. Sudden stock moves based on news tend to be quick and dramatic, and often the stock will then trade at a new plateau for a while. Index moves are different – less dramatic, and traditionally less likely to hit a crazy new plateau based on any single development in the media.

Think of it this way: how often do you hear of a short-term 10% move in the S&P? That's a very strong, unlikely move. But you often hear about these kinds of swings with individual stocks.

Keep in mind that iron condors are advanced options strategies. As with any new strategy you're trying, understand the risks involved before committing capital.

FURTHER STRENGTHENING YOUR FUNDAMENTALS

Make sure your fundamentals are solid before you begin options trading. I recommend the following resources as primers on options terminology and how the market works:

The Online Options Playbook (TradeKing client login required)

The ultimate user-friendly guide to options trading, the Playbook breaks down options strategies into specific "plays", explaining in plain English how each strategy works, including both risks and the outcomes you're shooting for. Start at the Rookie's Corner to learn basics of rolling, "the Greeks" and volatility, and more. In fun, approachable language, the Playbook makes understanding options enjoyable in a way few options textbooks do.

Not yet a TradeKing client? Take our tour and see everything we offer active option and equity traders.

TradeKing Education Center

Here's your dashboard for educational resources of all kinds. Find webinars, live events and educational articles to get you started or advance your knowledge. Get the most out of TradeKing's innovative trading and research tools with video guided tours of each. You'll also find useful tidbits like an options expiration calendar, an investment glossary, recommended books, sites, software and blogs.

Brian Overby's "Options Guy" blog

I update my blog weekly with new commentary about how to trade options smarter. Check back here regularly for new ideas, strategy explanations in plain English, and more. Make sure you check out the TradeKing Community too. Lots of options traders are blogging on trades they've made or are considering, emerging trends, lessons learned, success and war stories, and much more. See how much group smarts can help you improve your skills.

The Options Institute from the Chicago Board Options Exchange (CBOE)

A comprehensive guide to terms and strategies from the leading options marketplace. CBOE also offers periodic webcasts, live seminars and more.

888options.com

Another site dedicated solely to options education, from beginner to advanced. Start with their Options Quiz to identify your knowledge base, then work through their online content and seminars to raise your skills to a new level.