Options Decoded

Actionable Strategies Simplified

Investing Daily

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Hi, my name is Jim Fink and welcome to Options Decoded.

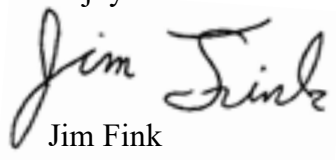
You're about to discover a few of the secrets I've used that helped me turn $50,000 of my own money into more than $5.3 million by trading options.

My team and I created this report to answer many of the important questions and challenges we see newer traders are faced with like…

- Is options trading risky?
- Is it really possible to win more than 80% of the trades you make?
- What are the different types of options trade I can make?
- Can you really make big gains in a stagnant market using options?

One last thing before we dive into the special report. If you are serious about wanting to start trading options using the exact approach that made me millions of dollars over the years, then you may want to **check out this presentation** where I share my preferred trading approach and **an exciting opportunity** I'm offering new options traders right now.

Enjoy!



Jim Fink

Exploring the Basics

Let's cover some of the basics about option trading.

Stock options are derivatives—they derive their value from the underlying value of a stock.

Each option contract gives you the right to buy or sell 100 shares of that underlying asset. Each option contract also gives you the right do so at a certain price on or before a certain date.

The profitability of an option trade depends on correctly predicting the direction that the underlying stock will move (or not move) by a particular date.

There are two sides to every option transaction: the party **buying** the option, which is known as a long position, and the party **selling** (also called writing) the option, which is known as a short position. Each side comes with its own risk-reward profile and its own strategies.

Note: Because an option is a derivative contract, it can be sold without owning it. This involves some option trading strategies that fall beyond the scope of this guide.

There are two types of options: **calls** and **puts**.

A call is the option to buy the underlying stock at a predetermined price (**strike price**) by a predetermined date (**expiration**).

The expiration is usually the third Friday of a given month but it can be as soon as next month or as much as two and a half years in the future.

If the call buyer decides to buy the stock (known as **exercising** their option), the call writer is obliged to sell his shares to the call buyer at the strike price.

If a call is the right to buy, then a put is the option to sell the underlying stock at a predetermined strike price until the expiration date.

The put buyer has the right to sell shares at the strike price, and if he decides to sell, the put writer is obliged to buy at that price.

Here's a quick chart to help you remember the differences between calls and puts.

	Call	Put
Buyer (long)	Right to buy stock at a certain price	Right to sell stock at a certain price
Seller (short)	Obligation to sell stock at a certain price	Obligation to buy stock at a certain price

A call buyer makes a profit when the price of the underlying shares rises.

The call option's price will normally rise as the shares do, because the right to buy stock at a constant strike price becomes more valuable if the stock is priced higher.

The call writer is making the opposite bet, hoping for the stock price to decline or, at the very least, not rise above the strike price by more than the amount he received for selling the call in the first place.

The put buyer profits when the underlying stock price falls.

A put increases in value as the underlying stock decreases in value, because the right to sell stock at a constant strike price becomes more valuable if the stock is priced lower.

The put writer is hoping for the stock price to rise. Or at the very least, they hope the stock price does not decline below the strike price by more than the amount he received for selling the put in the first place.

Few retail investors hold options all the way to expiration. Few investors actually see their shares change hands through the exercise process either.

So what most frequently happens?

Well, most investors opt to lock in their profits (or losses) before expiration. They do this by selling options they had previously bought or buying back options they had sold.

We will revisit this a bit later on. But for now, we'd like to take a few minutes to explain a few other important concepts you'll want to know in order to do option trading.

Understanding Option Symbols

At first glance, options come with a bunch of different symbols which can seem a bit confusing.

Let's clear up any confusion and make it easy to understand.

An option symbol consists of the following six components:

- Underlying stock's ticker symbol
- Two digits representing the calendar year
- Two digits representing the expiration month
- Two digits representing the expiration day
- Letter P or C identifying a put or a call
- Strike price

Let's look at an example: **AAPL 19 01 18 P 250**

That's an **Apple** (NASDAQ: AAPL) put option with a strike price of $250 that expires on January 18, 2019.

Here's another example: **AXP 19 02 15 C 110**

That's an **American Express** (NYSE:AXP) call option with a strike price of $110 that expires on February 15, 2019.

Pretty straightforward, right?

Great. Now let's talk about three common ways we classify all options.

"In The Money," "At The Money," and "Out Of The Money" Decoded...

If the stock price is above the strike price, the option has **intrinsic value**. This is because you're able to buy the stock at a better (lower) price than someone who doesn't own options could buy it on the open market. That makes the option **in the money** (ITM).

For puts, the reverse is true. The option has intrinsic value if the stock price is below the strike price. This is because you're able to sell the stock at a higher price than available on the open market.

If the stock price is equal to the strike price, the option is considered **at the money** (ATM), because it's "on the verge" of having intrinsic value.

When an option has no intrinsic value, then it is considered **out of the money** (OTM).

For calls, this occurs when the strike price is above the stock price.

For puts, this occurs when the strike price is below the stock price.

Take look at the following table. We'll use a fictional stock "XYZ" trading at different prices.

Notice how a $75 Call or Put option's intrinsic value changes based on the stock's current price:

XYZ Stock Price	$75 Call	$75 Put
$70	OTM by $5	ITM by $5
$75	ATM	ATM
$80	ITM by $5	OTM by $5

Prior to expiration, all options have another type of value: **time value**. Stock prices are always moving, so there is always the chance that an option will move into the money before expiration.

Time value puts a price on that potential ITM movement. At an option's expiration, there is no time value remaining, and the final value (if any) is limited to an option's intrinsic value.

The intrinsic value can't be less than zero because the call option holder can simply choose not to exercise a $75 call if the same stock is trading at $70.

An option's time value has a unique feature called **time decay**.

Options are, in essence, a bet on the future price movement of a stock. Therefore, *time* is a prime component of an option's value.

The less time remaining until expiration, the less value an out-of-the-money call option has, because it becomes less likely that the stock will rise enough to let the option expire in the money.

With each passing day, the time value of an option declines.

As you trade options, you may have to deal with option exercise or assignment. But don't worry, we're going to discuss both of them next.

Understanding Exercise And Assignment

If the option is at least one penny "in-the-money" at expiration, then the option holder is automatically exercised.

Most stock and ETF option traders close out their positions prior to expiration to avoid the complications of stock transactions and potential margin calls.

For most index options, they are settled in cash, so it's usually much less complicated.

Exercise prior to expiration (i.e., **early exercise**) must be elected by the option owner. Early exercise of options is relatively infrequent because it means that the owner is forfeiting whatever time value the option possesses.

When it does occur, early exercise most often involves an option that is in-the-money, pays a dividend and is near expiration.

With an options assignment, the writer (seller) of the option has the legal obligation to sell (for a call option) or buy (for a put option) the designated number of shares of stock at the agreed upon strike price at the expiration date.

The Options Clearing Corporation handles the matching of an exercising option holder with an assigned option writer behind the scenes. They are a triple-A-rated organization that guarantees both buyer and seller honor their end of the deal.

Do You Want to Do European or American Style Options?

Options are either "European" or "American" style. These terms don't refer to geography. They simply denote differences in the exercise stipulations attached to the options.

A European-style option is one that can ***only*** be exercised at expiration and not before. This makes European options desirable for traders who sell options because they don't risk waking up in the morning and finding out they have been assigned overnight.

An American-style option is one that can be exercised at any time right up to expiration. Most cash-settled index options are European, whereas options on individual stocks and ETFs are American.

In both styles, you'll need to understand how stocks and options are valued. And that's the next topic we're going to decode for you.

Understanding Stock Option Valuation

Understanding how options are valued and how they behave with changes in the underlying stock price is important. Can you trade options successfully without knowing this theoretical stuff?

Maybe, but when things don't go your way, you won't understand why. Just as bad, you won't have a good idea how to adjust your position.

Anybody can make a lot of money trading options if they know in advance the future direction—and magnitude—of a stock move.

The problem is, stocks often move differently than you expected them to when you put on a particular options strategy. Only great option traders can make money (or minimize losses) in those inevitable situations when the underlying stock moves differently than expected.

How Options Are Valued

Option prices are derived from stock prices. In other words, options are priced with the assumption that the underlying stock price is always fairly valued.

An option's value is based on a combination of strike price, time to expiration, interest rates, dividends, and—most importantly—expected volatility around the fair value stock price.

Most option pricing models assume that the likelihood of a stock moving up by 15% is the same in the short term as the likelihood of a stock moving

down by 15%.

Long-term calls are always more expensive than long-term puts of similar strikes. This is because calls provide investors with the upside of stock without incurring the significant cost of buying the stock itself.

The interest expense saved in not buying the stock can be substantial, especially over long periods.

Conversely, interest rates cause put option valuations to decline. This is because the sales proceeds of shorting stock can bring in income, which is lost when you buy puts for downside exposure instead.

Expected Volatility is the Kingpin of Option Valuation

The more the stock price is expected to move above and below its fair value, the higher the implied volatility (IV) of its options and, consequently, the more expensive its options will be.

This makes sense since the larger the expected move in the underlying stock price, the more valuable an option is expected to become.

When option traders speak of an option being "expensive" or "cheap" they are referring to the option's implied volatility (IV). They are not talking about the perceived fair value of the underlying stock.

The formal definition of volatility is one annualized standard deviation (in terms of percentage return) away from the current stock price. One standard deviation for a normal distribution represents the range of return outcomes that will occur 68% of the time.

Here's an example for you. We will use the fictional stock XYZ. Let's say it is currently trading at $50 per share. An IV of 20% means that over the next year, the market expects that roughly two-thirds of the time XYZ stock will be trading somewhere between $40 and $60.

Can you look at implied volatility for a time period other than one year?

Of course.

To determine the IV of a stock for a period other than one year, you multiply the annualized IV by the square root of the quotient number of days until expiration divided by the 365 days in a year. So the one-week IV of a stock option with an annualized IV of 20% would be: 20*SQRT(7/365) = 2.8%.

Please keep in mind that the 68% probability inherent in IV calculations is based on a theoretical model and is an educated guess only. It should not be confused with probabilities based on mathematical certainty (e.g., the odds of rolling a die and having it come up 3).

Option prices are based on future expectations (i.e., the IV), not on the past. Consequently, options on a stock that has recently been incredibly volatile could be relatively inexpensive if traders believe such historical volatility was an anomaly that won't be repeated in the future.

Academic studies have shown that index option IV has tended to overestimate future actual volatility, resulting in overpriced options. This explains why selling options in conjunction with long stock or long options have proven very profitable over the years.

An option's IV typically peaks at the time of earnings announcements and, for drug companies, FDA decisions as well.

Volatility tends to oscillates within a range. When it is at the low end of the range it tends to increase. When it is at the high end of the range it tends to decline.

For example, the volatility index (Chicago Options: ^VIX) is the 30-day implied volatility of the S&P 500 index options. It typically trades within a range between about 10% on the downside and 50%-60% on the upside. During the great 1987 market crash, volatility briefly reached an unheard-of 172.79%. But that's proverbial exception to the rule.

Many option traders overweight going long options when the VIX is "low" and overweight going short options when the VIX is "high."

We've taken the time to discuss volatility and how it influences option pricing. Now let's dive into one of the most commonly misunderstood option trading concepts: The Greeks.

Understanding Option Greeks

Stocks are simple, dull creatures. You can own them forever and they either go up, down, or stay flat. That's it.

In contrast, options are like peacocks because they come in many different styles.

All of these sides to options are explained by "the Greeks," which measure an option's performance characteristics.

Let's take a look at the first Greek…

Delta

Delta measures how much an option price increases for every $1 increase in the price of the underlying stock.

Options have a delta that can be anywhere between -1 and 1 (depending whether you are long or short and using puts or calls).

Prior to expiration, near-term options with a strike price equal to the stock price (i.e., at the money) have a delta of 0.50 (+ or -).

At expiration, all in-the-money options have deltas of either 1.0 or -1.0.

At expiration, all at-the-money and out-of-the-money options have deltas of zero.

Long calls/short puts have positive delta and short calls/long puts have negative delta.

Unlike stocks, an option's delta is not fixed but changes with the stock price, which brings us to the second Greek...

Gamma

Gamma measures the rate by which an option's delta changes.

All long options have positive gamma and all short options have negative gamma.

Let's look at our fictional XYZ stock again. We'll assume that it's trading for $50. We are interested in an at-the-money call option with a strike price of $50.

Take a look at the following table:

Stock Price:	Long Stock Delta	Stock Gamma	Long Call Option's Delta (Prior to Expiration)	Long Call Option Gamma (Prior to Expiration)
$30	1.00	0	0.16	0.07 (up)
$35	1.00	0	0.23	0.07 (down) 0.08 (up)
$40	1.00	0	0.31	0.08 (down) 0.09 (up)
$45	1.00	0	0.40	0.09 (down) 0.10 (up)
$50	1.00	0	0.50	0.10 (down) 0.10 (up)
$55	1.00	0	0.60	0.10 (down) 0.09 (up)
$60	1.00	0	0.69	0.09 (down) 0.08 (up)
$65	1.00	0	0.77	0.08 (down) 0.07 (up)
$70	1.00	0	0.84	0.07 (down) 0.06 (up)

Gamma is greatest right at-the-money (ATM). It diminishes the further out you go either in-the-money (ITM) or out-of-the-money (OTM).

This makes sense since an option's greatest increase in value occurs when it is transformed from an OTM option to an intrinsically valuable ITM option.

The further in the money the option becomes, the more the delta of the call will increase. It will continue to increase until it eventually equals 1.

This "delta acceleration" is the leveraged power of options: while a stock's dollar for dollar value increases, a call option's gain per dollar of stock upside accelerates.

Even better, a call option's losses per dollar of stock decline decelerates.

Look at the previous table:

When the stock increases from $50 to $55, the call option gains $2.50 in value ($5 * 0.50 delta).

But when the stock decreases from $50 to $45, the call option only loses $2.00 ($5 * 0.40 delta).

In other words, long option holders lose less on the downside than they make on the upside for the

same size move in the stock!

That's what I call a good risk/reward ratio.

Now let's look at the next Greek, Theta.

Theta

By intentional design, options are for a limited period of time. As a result, the time value portion of their prices decays as the option moves closer to expiration. Eventually, time value is zero at expiration.

Theta measures the amount of time value decay an option experiences per day.

All long options have negative theta and all short options have positive theta.

Theta and gamma are probably the two most important Greeks—they truly are what make options special.

Gamma is the secret sauce for option buyers (i.e., super-charged potential appreciation). Theta is the magical pixie dust for option sellers (income generation).

Theta, like gamma, is greatest at the money. Time value is greatest ATM; the more time value, the more available to decay. Time value does not decay at a constant rate, but accelerates exponentially the closer you get to expiration.

The decline in time value really takes off about six weeks prior to expiration, so I don't recommend buying single options during the last 42 days of their lives. However, selling options during this last six weeks is a great way to take advantage of time decay.

Gamma increases also exponentially near expiration.

In fact, gamma and theta move in tandem but benefit from completely opposite types of price movement. They are the yin and yang, the light and dark side of the Force, depending upon whether you are a buyer or a seller.

If you are long options, you benefit from gamma if the stock makes a strong move in your direction. But you are also hurt by theta if the stock stagnates.

If you are short options, you benefit from theta if the stock stagnates. But you are also hurt by gamma if the stock makes a strong move.

We have covered three of the Greeks so far... now let's look at the last one.

Vega

In reality, Vega is not a Greek letter, but it does sound like one. Vega is used to measure the sensitivity of an option's price to a one percentage point change in implied volatility.

As I previously mentioned, expected volatility is the main determinant of an options price—the higher the volatility, the higher the option price.

All long options have positive Vega and all short options have negative Vega. If you expect or are insuring against an unsettled market, you want to be long options. Conversely, if you expect a period of market calmness, you want to be short options.

According to a recent Goldman Sachs study, option trades based on volatility changes are an "alternative asset class" that has low correlation with stock movement.

The great thing about a volatility trade is that you can make money even if you don't have a clue what direction a stock is going to take. Buying a straddle (the simultaneous purchase of a call and a put) makes sense when implied volatility is very low and you expect an explosive increase.

Selling put options is a great strategy after a general market panic because the price of options skyrockets and implied volatility jumps as well. People become afraid and are willing to pay almost any price for put insurance—leaving the contrarian put seller sitting pretty collecting the rewards.

We've covered a lot of ground in this special guide, which should give you a better understanding of how option trading can work.

We have one more topic to discuss and that's on risk management.

A Short Lesson In Risk Management

If I was going to summarize trading in one sentence, then this might be what I would say: The best way to make consistent profits trading the markets is to be consistent in the methods you use in your trading.

It's not just using a proven method or system. It's not just following the advice of a proven expert like

me. It's also minimizing the amount of risk you take on each trade.

There have been entire books and courses written on risk management. This guide is not meant to cover such an in-depth subject.

However, I did want to spend a few minutes to cover a few key points about risk management that should prove to be invaluable for your future trading efforts.

First, identify what your "R" or risk unit might be. A risk unit is the amount of money a trader willing to risk losing on a single trade if the trade does not work out in their favor. Your "R" lets you know upfront what your maximum loss for each trade could be.

Obviously, every trader wishes they could win every trade. However, the reality of the markets is that no one wins all of their trades, all of the time.

If you risk your entire account on one trade and that trade doesn't go in your favor, then you will likely see your account wiped out.

That's definitely not desirable and yet many beginning traders do exactly that.

So how do you avoid being wiped out on one trade? Well one way is to use a sensible portion of your trading account funds on any given trade.

Here's an easy formula to use:

5% of your current fund account = One R unit.

If your current fund account is $10,000 then one R unit would be $500.

If that loss amount (your R) seems too much, then simply lower your R. Many hedge fund or portfolio managers will use 1-2% as their risk level on a given position. Following the same strategy may work well for you too.

Parting Words

Option trading can be as simple or complex as you would like it to be. Again, this guide is not intended to be a complete "A to Z" reference on everything there is to know about option trading.

When you look at how many books and courses have been created that cover different option trading methods and strategies, it can definitely seem a bit overwhelming at times.

That's why I'd like to simplify things for you. You see, I spent many years studying the ins and outs of option trading.

I eventually developed **my own preferred method** for option trading. A method that allows me to win over 84% of the time consistently while slashing my risk to the lowest possible level.

Why is this important?

Well, by using my preferred method, I was able to take $50,000 of my own money and grow it into a $5.3 million dollar fortune. And just as important, I still use the preferred method to keep building my personal fortune every week.

If you'd like to discover more about my personal favorite trading method, click here.

IMPORTANT NOTES:

Guidance concerning the stocks and strategies highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any recommendation in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the recommendation is still active. Furthermore, confirm that the recommended investment trades below our current buy limit. Do not buy any investment above our recommended buy limits. If an investment's price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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