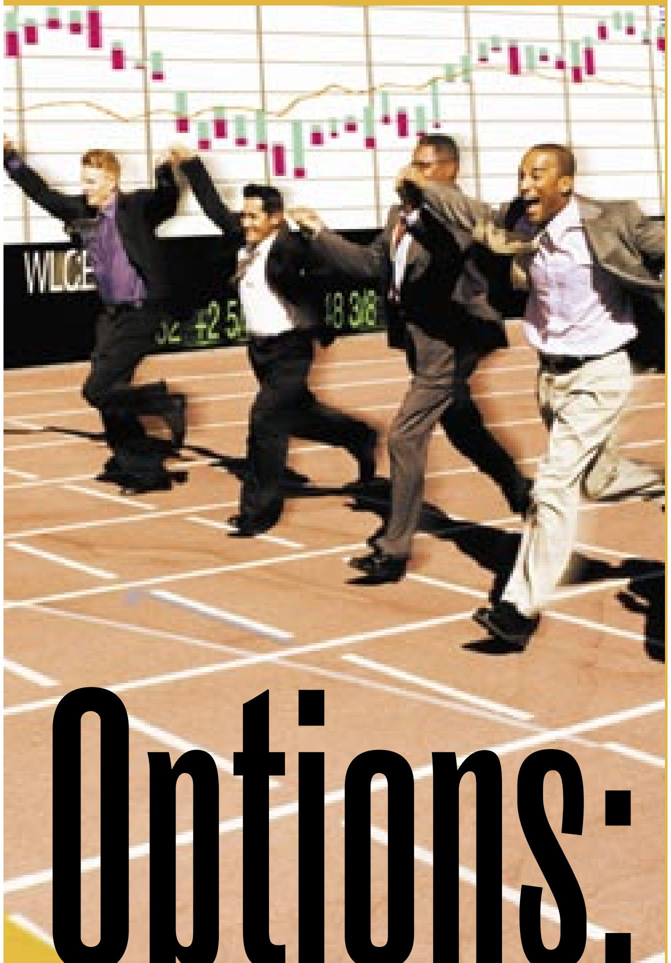

Options: Who Wins Who Loses

By John A. Sarkett

[*Editor's Note: Last month we took a broad view of the options industry. We found a consensus that, powered by institutions, the options industry would grow 15 to 20 percent each year across the next several years. This month we "zero in" on the retail options trader: who wins, who loses and why.*]

The Options Industry Council announced in January that daily equity options volume increased by 71 percent over 2003 volume. The Boston Options Exchange (BOX) became the sixth options exchange to join, according to some, an already highly competitive field in the U.S. Yet, apparently, there's enough potential in options land to warrant a run for the business.

Despite exceptional growth in the options industry, market participants still have a lot to learn even after 30 years of operation. Success stories, which tend to get much less ink than tales of the less-than-successful, are the product of those who have learned that having a plan and a good dose of "stick-to-it-iveness" is more important than being lucky in the options market (or any market, for that matter). Success indeed is good fortune, but it is not for the lazy or for those who feel they have a divine right to win. Sometimes it makes sense, too, to lay out who loses and why. Turn that on its head, and the result may be to push those on the edge to the winning column, if they are willing to listen to the lessons.

What Not to Do

First, who are the losing options traders? The losing options trader falls into some of the same traps to which all other traders succumb. First, and certainly not unique to options, losing traders let their losses run, hoping desperately that the market will turn in their favor and cut their profits short, nervous that the market will turn against them. They try to "feel" the right trade rather than execute a trade based on study.

Second, losing traders often fail to formulate a plan. They don't properly educate themselves on how to manage their money in options, which leaves them with no understanding of the risk inherent in options trading.

Options Traders Education Group (a suburban Chicago group, meeting twice a month) leader, Jerry Murray, likens losing in options to losing in stock trading.

"Generally, the losing options trader will parallel the habits of a losing stock trader, i.e., they look to someone else for advice or tips and, as a result, never take full emotional responsibility for their own trades; they fail to protect their risk position; they manage their trading account poorly, or they overtrade." And, says Murray, "They often have not learned to win the mental wrestling match with fear and greed." As a result, many traders, unable to weather the extreme ups and downs of the market, simply give up, falling by the wayside.

Failure to manage money and controlling greed and fear are typical of any trader who loses in any market. So what does the options trader do that will cause him to lose?

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"That would be the 'shooter,' the premium buyer," contends thinkorswim's Tom Sosnoff. The premium buyer typically is a retail investor who becomes bullish on a stock, based on something he or she has read or heard, and buys calls more often than not. He normally is regarded as a "newbie" in the options ranks, because he has set up several hurdles to overcome on the way to a profitable trade: 1) direction 2) timing 3) theta, i.e., options decay and 4) implied volatility. Translated: 1) the price of the underlying must move his way, 2) very quickly, 3) faster than options decay, and 4) he must have not overpaid for the option. That may be a somewhat tall order for the uninitiated.

Alex Jacobson, vice president of the all-electronic International Securities Exchange (ISE) believes that, "The loser is a straight trend trader." Jacobson means a trader who does not take implied volatility of the option into account and, instead, roars into the market to "get long" as fast as possible and as much as possible.

In his seminar appearances, Jacobson often asks his audience to describe how retail options buyers pick which and how many options to buy. The punchline: the farthest out-of-the money option. Why? "Because you can buy more of them, and they're cheaper." It always gets a laugh. Experienced options strategists know, however, that out-of-the-money options have the lowest probability of being in the money – and the highest probability of expiring worthless.

The Winners

When is a win a win? Because options trades tend to be two-sided, defining a win can be tricky. Let's say you own stock and put contracts on the stock; the stock price rises, rendering the put contracts worthless. Is that a win or a loss? Options author and educator, Larry McMillan perhaps says it best – "Whenever insurance is employed, whether with options or on your house, or whatever, you'd just as soon the insurance was not used and that the asset it's insuring increases in price."

But whether you profit on the options contract, or on a stock, most would agree that it is a combination of spreading (buying one option and selling another against it), using risk management and having adequate capitalization. Of course, specific strategies on how to win vary.

Says Sosnoff, "The winning options trader captures theta (options decay) in a risk-controlled environment. He has losing trades, too, but our research tells us that the premium seller can expect to win nine out of 12 times. The business of achieving this typically involves building somewhat complex spreads and typically requires an advanced options education."

Sosnoff means that traders must become familiar with spreads and all that goes into them: which underlying to pick, the relationship of implied to historical volatility, and the selection of the spread type itself – bull or bear, debit or credit, iron condor, straddle, strangle, etc. Applying these considerations, for example, a trader seeking theta capture might well choose: 1) a stable stock, e.g., Bristol-Myers (BMY), that doesn't move much, relatively speaking, 2) with puts and calls showing implied volatility priced above the recent historical volatility, and employing 3) a short straddle (short both puts and calls at the same strike). (These and other considerations can be scanned for, tabled and graphed in software like Option Wizard® Scan.)

What advantage does this kind of advanced approach yield versus "shooting," i.e., premium buying? In terms of direction, BMY doesn't have to go from 25 to 30 to make money in a short straddle; it can bounce around 27.50, plus or minus a point or two, as it usually does, and the strategist can still generate a profit. Considering volatility, the strategist can wait for target prices to sell a bit above the recent norm, instead of charging into the market on a CNBC news report – and typically paying the highest dollar for his options – along with hundreds of similarly motivated and newly informed buyers.

He is making money from both the short and long side – not just the upside.

Says Jacobson, "The winning options trader is well educated with a good understanding of both trend and volatility. We also see much more spreading as electronics have emerged and costs have declined."

Todd Salamone, vice president of research at Schaeffer's Investment Research, notes that the winner cuts losses short and allows wins to run, thereby creating a high average win to average loss ratio. He focuses on options that can deliver larger profits while allowing loss control when wrong and understands the importance of a sound money management system. He also understands trading probabilities in terms of how expected win rates, average wins and average losses work together in producing an overall winning portfolio.

A Winning Approach: Ideas All around You

If Fidelity's Peter Lynch became an options trader, what would he do? He would sell puts on the stocks whose products he knows, uses and likes.

That's the approach of Harry G., 56, a semi-retired real estate developer in southern California. He was an on-again-off-again options trader for the past 20 years, working the entire time with his broker, Jerry Kopf, Benjamin & Jerold, in Chicago.

In the last six months, because interest rates paid so little, he turned to premium selling and started to "treat options more like a business," increasing his exposure to the markets and his profits as well.

He counts some 60 trades during a recent six-month period. Trades in sizes that varied from 10 to 50 lots helped him generate $6,000 to $10,000 of additional monthly income. Uncharacteristic of most traders, all but one trade was profitable. Collateral: seven-figure portfolio of stocks and mutual funds.

For about half of the trades, he followed his broker's auto-trading program, put selling on favorites like Walgreen's, Starbucks, Exxon, Royal Dutch Shell, and the like, with an occasional call buy as well, e.g., Genentech and XM Satellite Radio Holdings.

The other half? His own ideas. Like Peter Lynch, he looks around for ideas at places he shops, like Costco and Home Depot. And places his children shop. That's how he found Netflix (NFLX), a stock that soared from the teens to the 40s. His timely call buying was well rewarded.

The one losing trade during that period? Royal Dutch. Last June, he sold Jan. 2004 50 puts when the stock was at 49. It declined to 45.75, and Harry got out with a loss of less than $1,000.

"Not good to sell premium six months out," he contends.

Should markets change, Harry says his approach will, too. "Right now I feel like the insurance company, taking in premium, but in the future I might be buying puts and selling calls. It all depends on the economy and the markets."

McMillan describes the winner as one who uses a model for judging option profitability and does a "what if" analysis. He changes strategy as volatility dictates and uses logical follow-up strategies to take partial profits, letting the major profits run.

Says McMillan, "In speculation, the winning trader uses options as a stock proxy – tailoring the striking price and expiration date to the trading system he is using. If short term, then he buys short-term in-the-money options. If longer term, he buys at-the-money slightly longer-term calls."

Bevy of Resources Help Traders Succeed

In the three decades that options have been offered for trading, more resources logically have been developed to help the trader, including better software (enhanced versions from stalwarts like OptionVue®, OptionStation® and newer offerings like Optionetics Platinum and Option Wizard® Scan) and better educational tools (seminars from the Options Industry Council, firms such as Optionetics and others, online tools from brokers like OptionsXpress). Each of these, as well as scores of others, help traders improve their options experience. On top of that, options exchanges are highly competitive, and that's a positive for retail customers and institutional users alike.

Options Traders Education Group's Murray says he believes that "options traders are becoming more sophisticated in the market as a result of the educational and trading tools available to them. The playing field, too, has become a lot more level versus a decade or two ago."

Still don't want to make the effort? Some trading tools do not require users to have an extensive education. A high number of OptionsXpress clients use their auto-trading feature, David Kalt, president of that company, says. This is where a trader can have his account automatically trade the recommendations of any of some 36 advisors. OptionsXpress.com offers an extensive overview of options information to help investors understand how to use them for portfolio protection, additional income and speculation/leverage.

Jacobson says that "users today have better resources (both online and physical) than ever before. Websites like Kalt's OptionsXpress and Tom Sosnoff's thinkorswim are classic examples . . . that is why their firms grow at the rate they do, but a good percentage of their business is poaching other firms, so no real industry growth here, but much better longevity for the individual trader."

Perhaps these online resources – more retail-friendly exchanges, brokerage firms, software and the like – eventually will become potent enough to lower the percentage of unsuccessful option traders – along with smarter trade planning and risk management.

Meanwhile, the game goes on every business day. As broker Jerry Kopf says of options prices, "they never stop dancing."

For many, the lure of the dance never stops either.

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John A. Sarkett is developer of Option Wizard® Scan software (http://option-wizard.com), and author of Option Wizard Trading Method. Sarkett can be reached at jas@option-wizard.com.