Trading Foundation

The First Class

Disclaimer

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Agenda

- Security Analysis
- Option Theory and Pricing
- Option Strategies
- Risk Management
- Practical Application and Lab

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Investment Foundation

What is Success?

**Perception
of success**
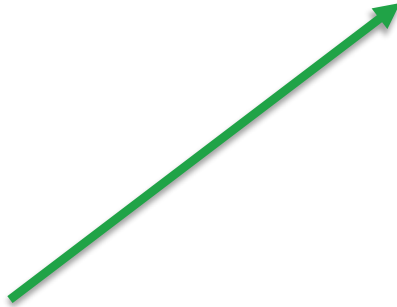
**What success
really looks
like!**
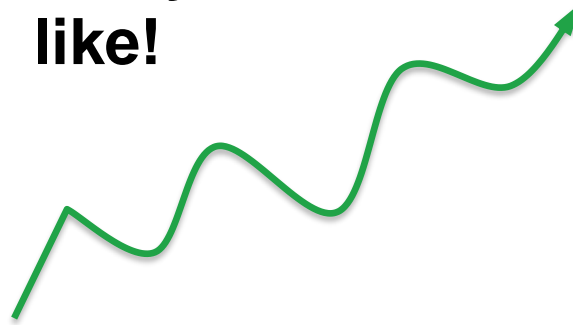
**Long Term – Retirement and Slow Growth Strategies
Moderate Approach – Growth Strategies
Short Term approach – Aggressive or Swing Strategies**

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Security Analysis

- Fundamental Analysis
  - Quantifiable
  - Non-Quantifiable
- Technical Analysis
  - Price
  - Time
  - Indicators

Fundamental Analysis

- Quantifiable
  - Ratios
  - Dollar Figures
- Non-Quantifiable
  - Management Team
  - Market Outlook

Fundamentals

- Growth
- Profitability
- Viability
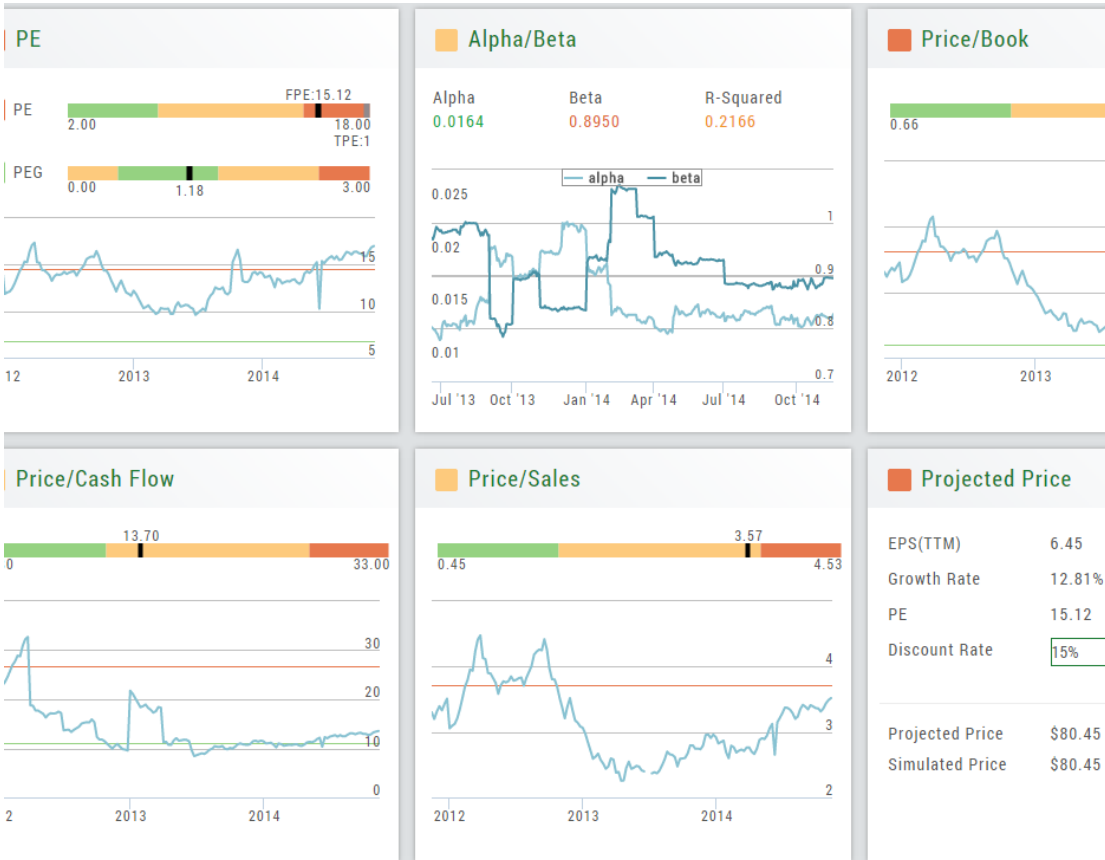
- Ratios
- Projections

Valuation
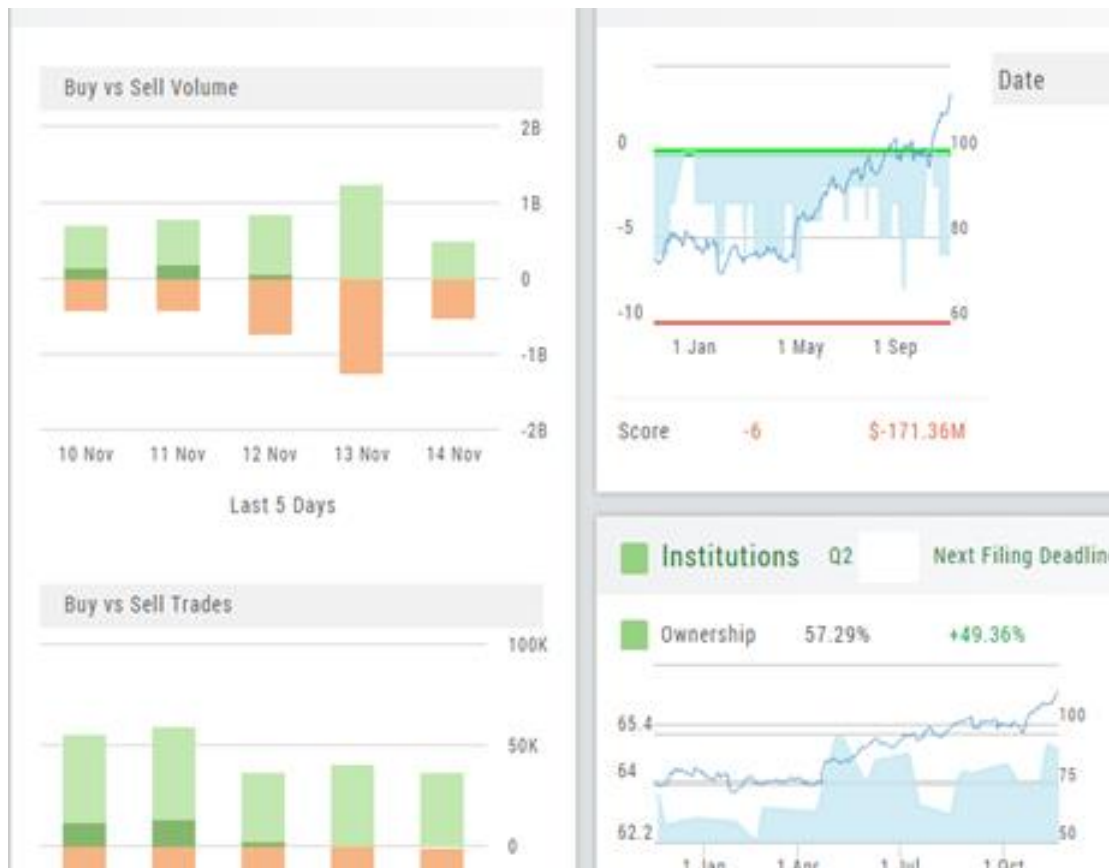
- Money Flow
- Buy vs Sell
- Filings
- Institutions

Inner Circle

Technical Analysis

- Price forecasts based on patterns
- Visual indication of supply and demand
- Focus on "what" rather than "why

Technical Analysis

- Chart Styles
- Trend
- Support/Resistance
- Indicators
- Chart Patterns

Investment Foundation

What are Charts?
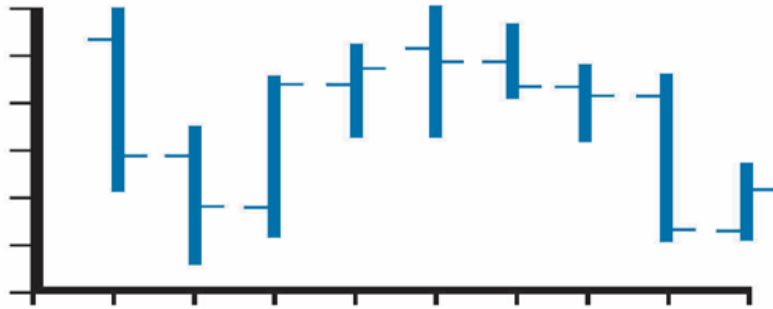
Bar Charts
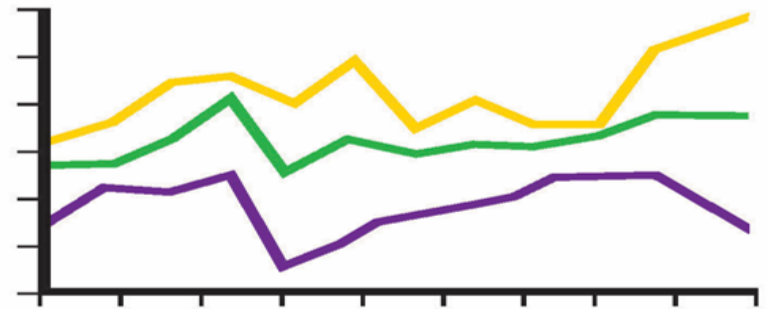
Line Charts
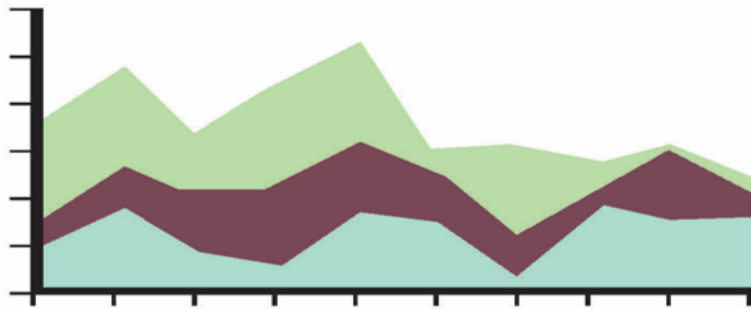
Area Charts
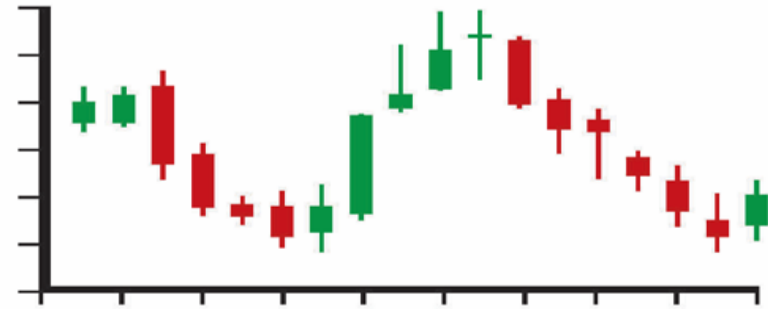
Candlestick Charts

Support and Resistance

» Stock can move:

1. Up
2. Down
3. Sideways

» Near major levels of support and resistance

Technical Analysis

Identifying trends
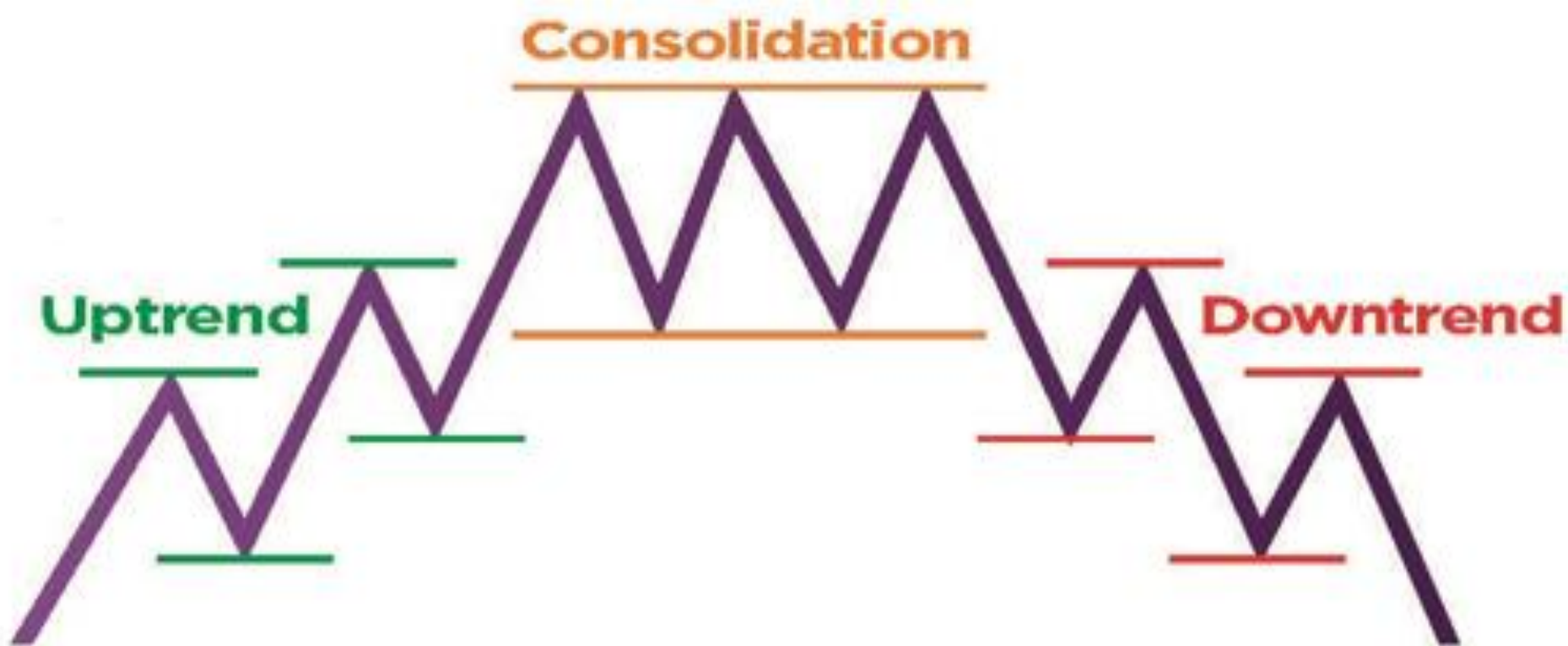
Uptrend – Higher highs and High Lows

Downtrend – Lower highs and lower lows

Consolidation – Lack of a trend

Technical Analysis

Identifying trends
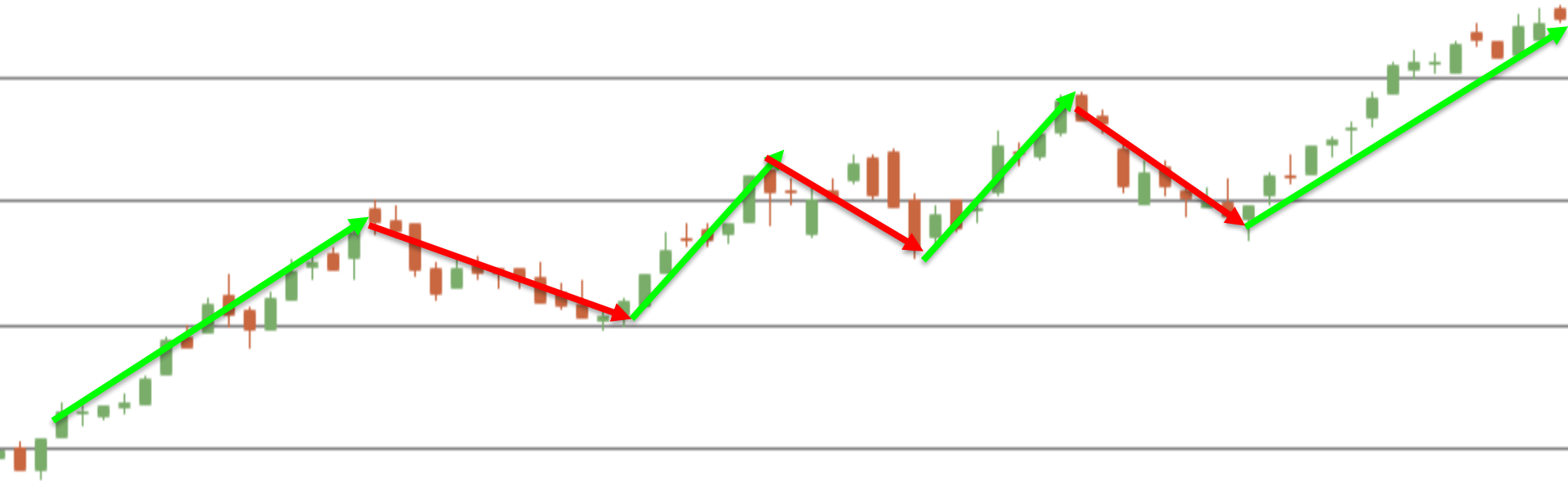
Technical Analysis

Identifying trends
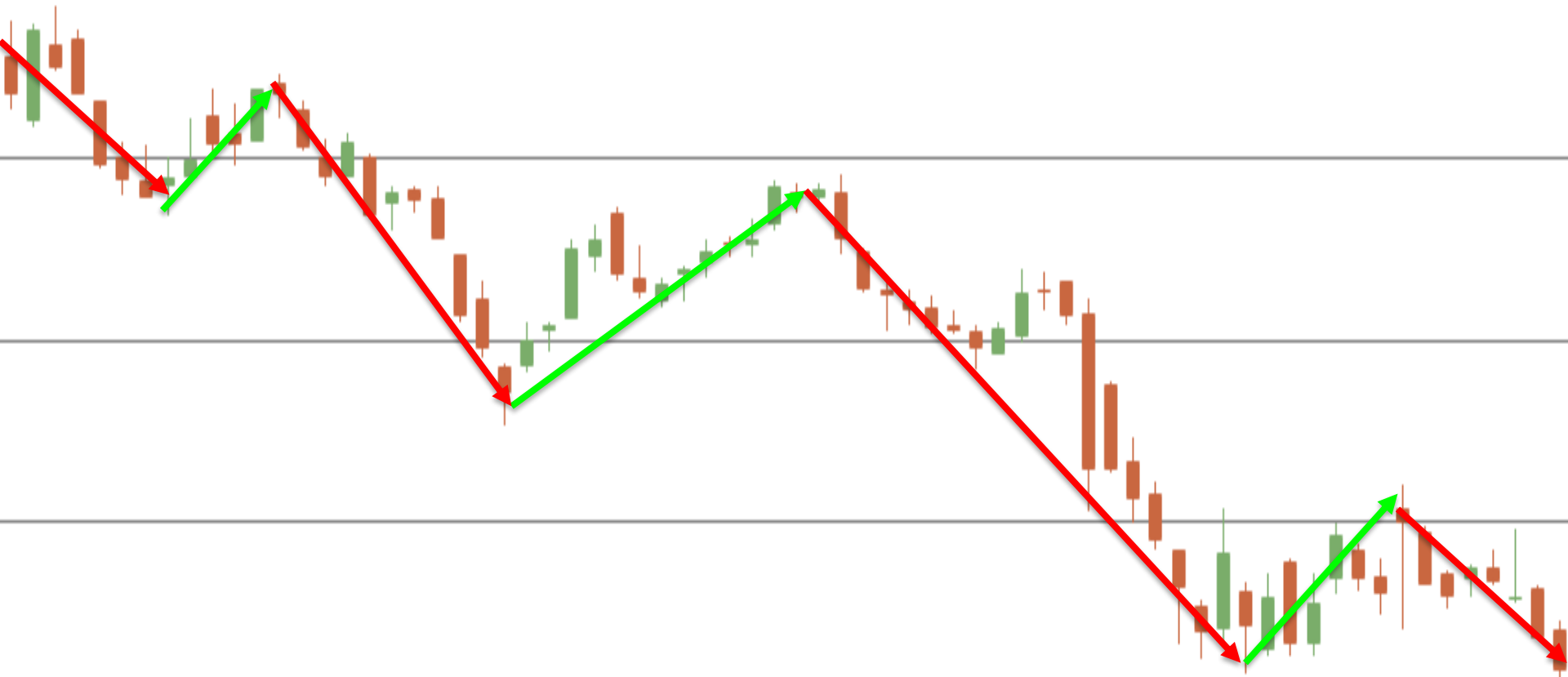
Technical Analysis

Identify major levels of resistance

Technical Analysis

Identify major levels of support

Technical Analysis

Resistance followed by support

Technical Analysis

Support followed by resistance

Technical Analysis
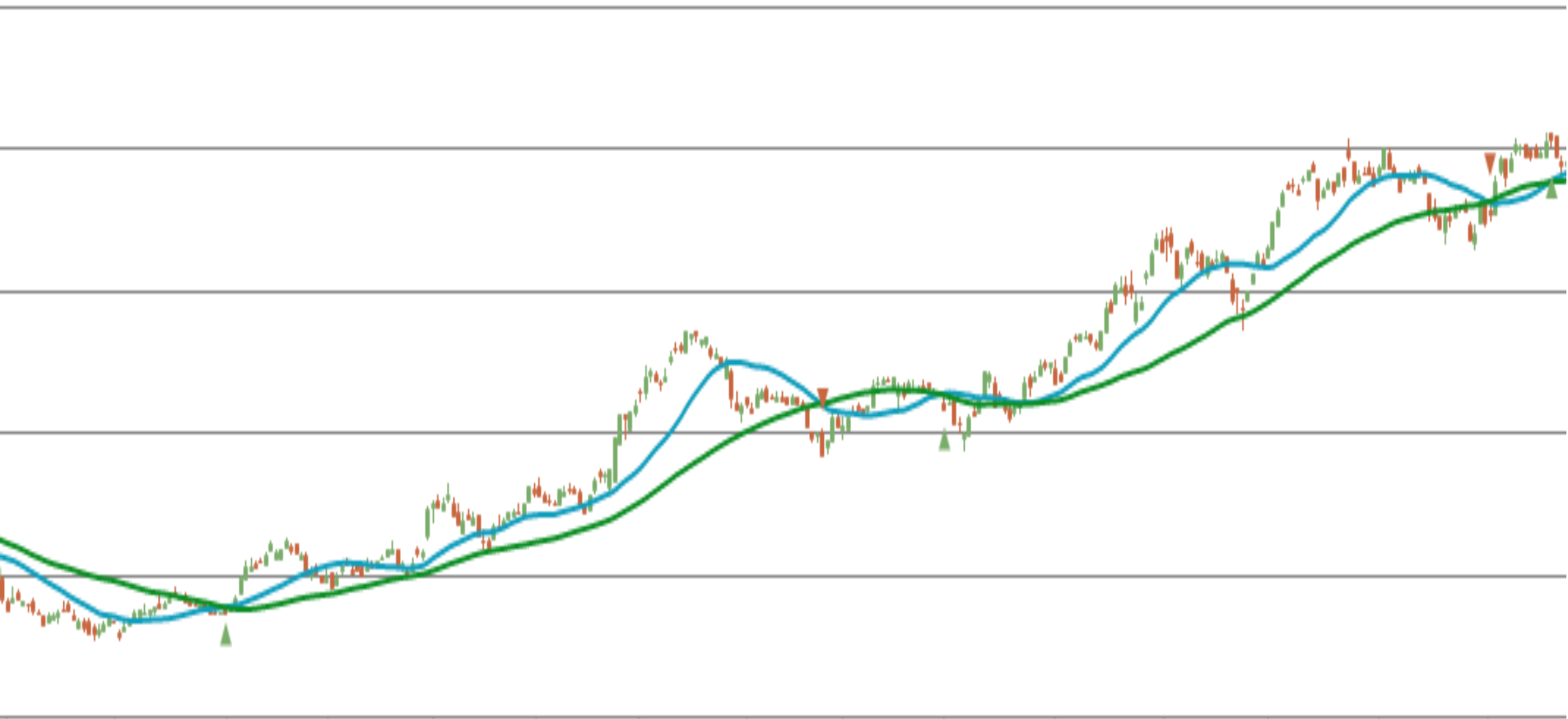
Technical Analysis

Linear Regression Channels

Technical Analysis

➢ Chart Patterns

   ➢ A series of support and resistance points that forecast a movement

➢ A Chart Pattern has two functions

   ➢ Trend Confirmation

   ➢ Trend Reversal

Double Top

Double Bottom

O: 52.07 H: 52.35 L: 50.80 C: 50.96

Breakout entry to
bullish trade

RESISTANCE

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Symmetrical Triangle

Descending Triangle

(Bearish Breakdown)

Ascending Triangle

(Bullish Breakout)

Option Principles

➢ Basic Contractual Obligations

➢ Risk vs Reward

➢ Option Lingo

➢ Pricing Model

➢ Greeks

Option Principles

➤ **What is an Option?**
  ➤ A Contract
    ➤ Buyer
    ➤ Seller
➤ **Buyers Have Rights**
➤ **Sellers Have Obligations**

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Option Principles

	Right (Buyer)	Obligation (Seller)
Call	Buy the stock	Sell the stock
Put	Sell the stock	Buy the stock

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Option Principles

➤ Buy a Call

| Limited Risk | Unlimited Reward |

➤ Sell a Call

| Limited Reward | Unlimited Risk |

➤ Buy a Put

| Limited Reward | Limited Risk |

➤ Sell a Put

| Limited Risk | Limited Reward |

Lower ⟵ Stock Price ⟶ Higher

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Option Principles

➢ Option Lingo
  ➢ Strike Price
  ➢ Expiration
  ➢ Contract Size
  ➢ Long
  ➢ Short
  ➢ Bid
  ➢ Ask
  ➢ ITM/ATM/OTM

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Long

Sell to Close $10

Buy to Open $5

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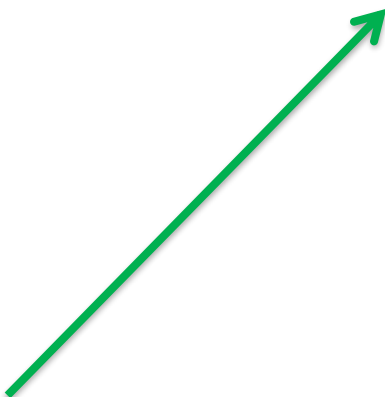
Short

Sell to Open $10
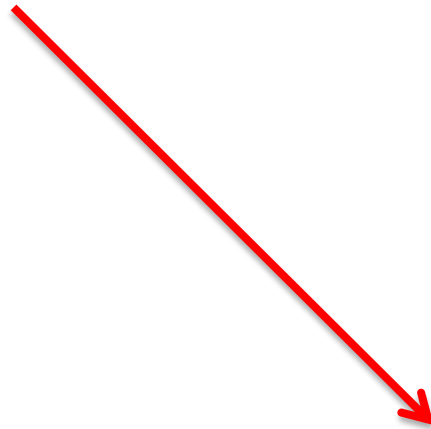
Buy to Close $5

Option Principles

Intrinsic Value

- ➤ Real value
- ➤ In the money options (ITM) options have intrinsic value

Extrinsic Value

- ➤ Time value
- ➤ Extrinsic value will drop to zero at expiration

Option Principles

Option Price = Intrinsic Value + Extrinsic Value

Option Principles

Intrinsic Value

> ➢ Stock Price = $50
>
> ➢ Call Strike = $45
>
> ➢ Intrinsic Value = $5

Intrinsic Value

> ➢ Stock Price = $50
>
> ➢ Call Strike = $55
>
> ➢ Intrinsic Value = $0

Option Principles

Extrinsic Value

- ➤ Stock Price = $50
- ➤ Call Strike = $45
- ➤ Intrinsic Value = $5
- ➤ Call Cost = $7
- ➤ Extrinsic Value = $2

Price = Intrinsic Value + Extrinsic Value

$1.31 = $0.97   + $0.34

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Option Principles

6 Inputs to an options pricing model
1. Stock price
2. Strike price
3. Volatility
4. Expiration
5. Interest rates
6. Dividends

Option Principles

The Five Greeks

1. Delta – Rate of Change, Price Sensitivity
2. Gamma – Rate of Change of delta
3. Theta – Time Decay
4. Vega – Sensitivity to Volatility
5. Rho – Sensitivity to Interest Rates

Option Principles

Delta

The rate of change of the option value for the next $1 move in the underlying security

Option Principles

Theta

The amount by which the option value changes after one day of time

Theta – Time Decay
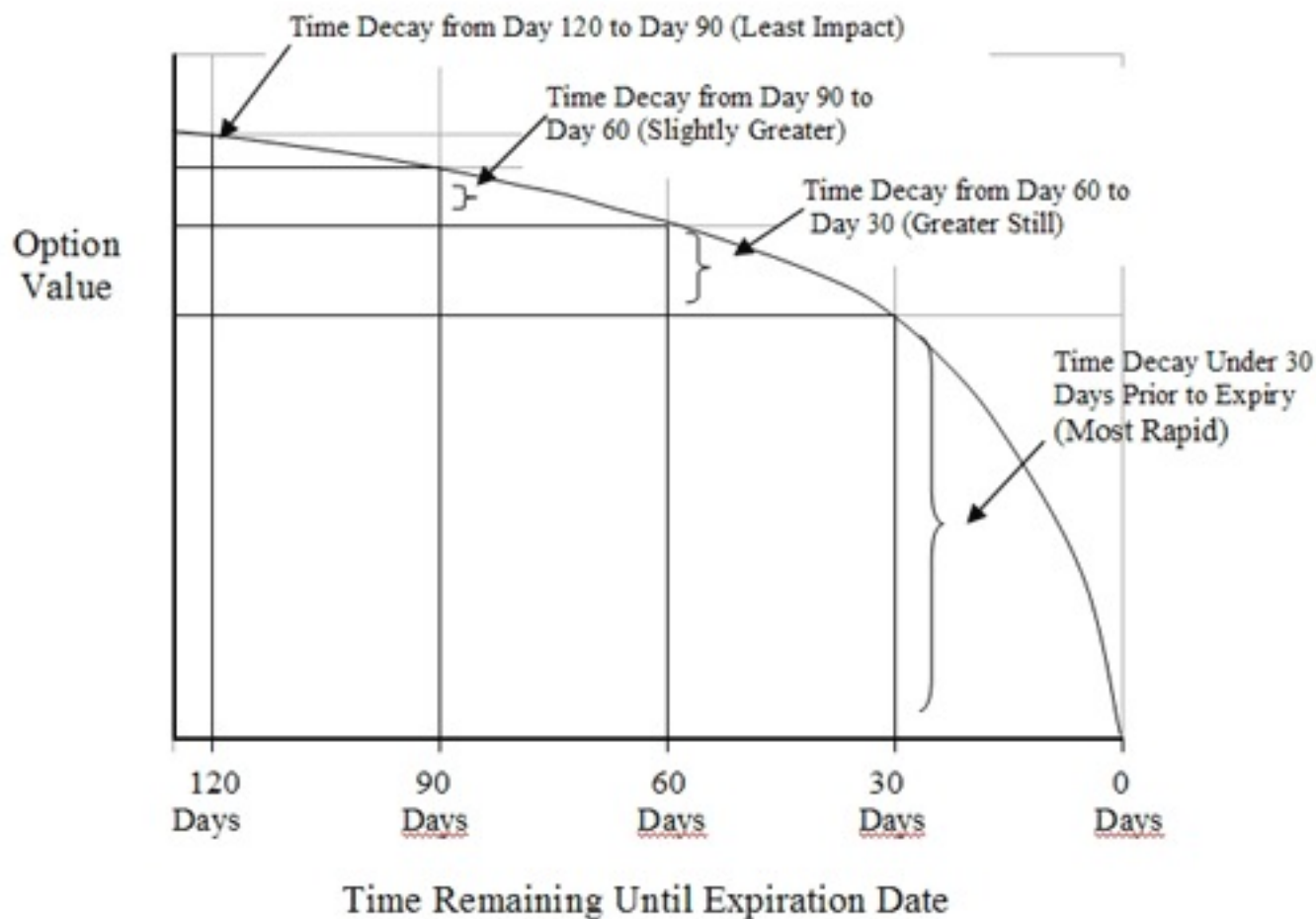
Option Strategies

➢ Long Options

➢ Vertical Debit Spreads

➢ Vertical Credit Spreads

➢ Iron Condor Credit Spread

➢ Practical Application

Selecting the correct strategies will directly affect your ability to succeed.

Option Strategies

Go through the following four steps for every trade.

1.   Select Stock

2.   Build the strategy

3.   Calculate the risk

4.   Calculate the reward

Option Strategies

➢ **Long Options (Buy)**

1. Extremely Directional
2. Build the Strategy
   - ➢ Construction Rules
     - ➢ Delta 80-85, Time as Needed
   - ➢ Exit Rules
     - ➢ 50% loss, Take Profit at 75%
   - ➢ Alternative Profit Rules
     - ➢ Roll or Exit at delta 90-95
3. Max Loss = Option Cost
4. Max Profit = Unlimited for Calls, Limited for Puts

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Risk vs Reward

➤ Long Call
   ➤ Limited Risk
   ➤ Unlimited Reward

Lower   Stock Price   Higher

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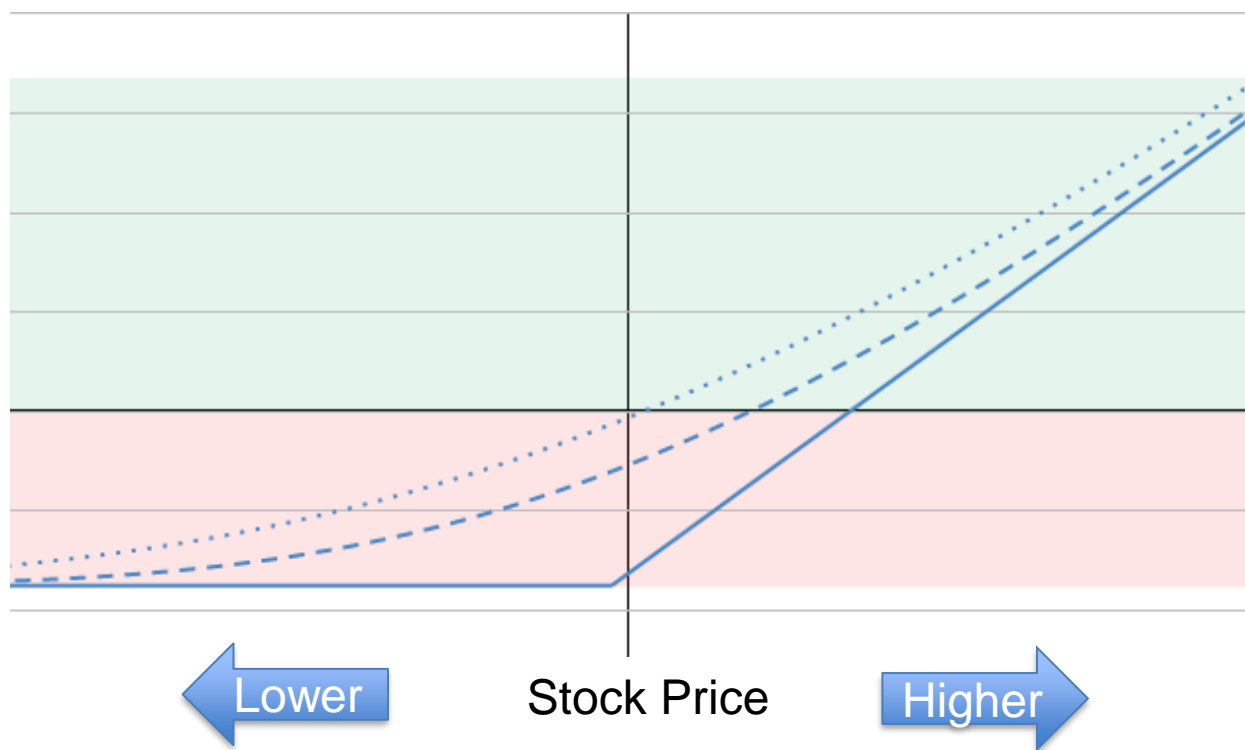
Risk vs Reward

➢Long Put
  ➢Limited Risk
  ➢Limited Reward
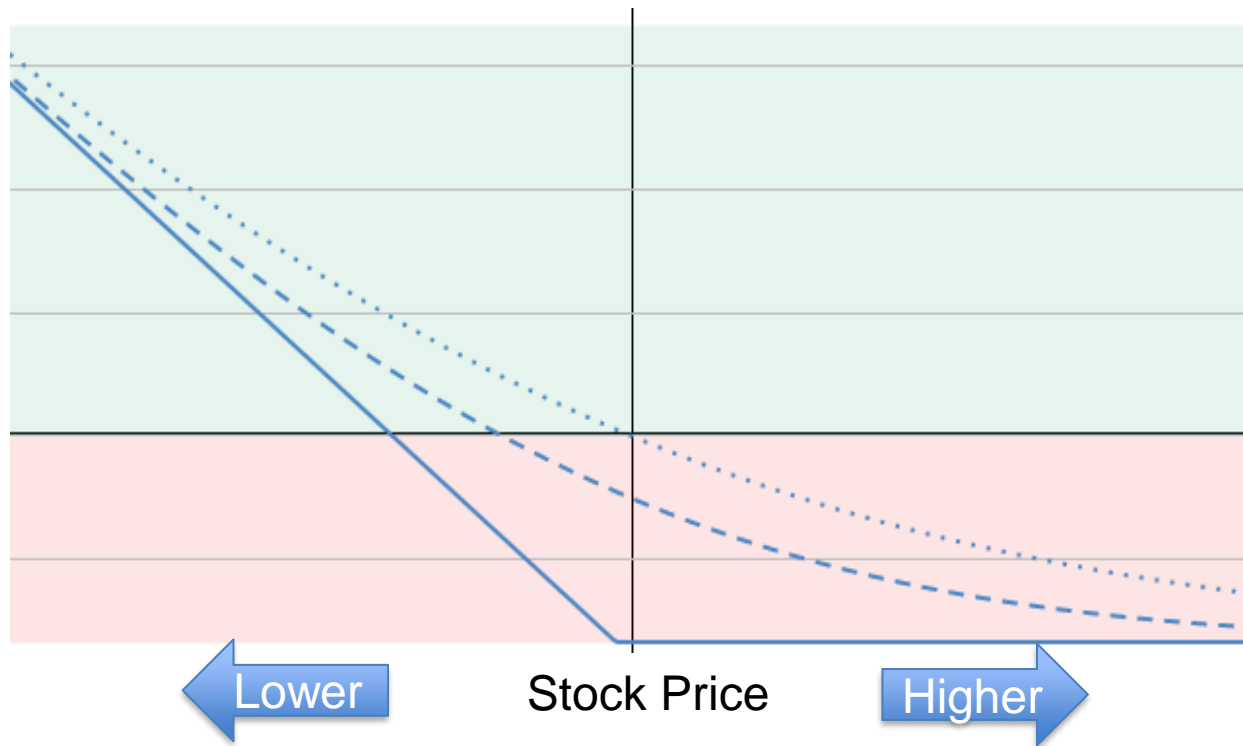
Option Strategies

➢ Bullish Vertical Spreads

1. Mildly Bullish or Neutral

2. Build the Strategy

   ➢ Entry Rules

      ➢ Sell the Strike You Expect the Stock to be Above at Expiration

      ➢ Buy a Lower Strike

   ➢ Exit Rules

      ➢ 50% loss, Exit for Profit at 50% of Max Profit

Option Strategies

➢ Bullish Vertical Spreads

3. Max Loss

➢ Max Loss for Debit Spread = Net Debit

➢ Max Loss for Credit Spread = Spread - Credit

4. Max Gain

➢ Max Gain for Debit Spread = Spread - Debit

➢ Max Gain for Credit Spread = Credit

Risk vs Reward

➤ Bullish Vertical

   ➤ Limited Risk

   ➤ Limited Reward

Lower   Stock Price   Higher

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Bull Call Spread

$50 Stock

Sell $50 Call — $4

Buy $45 Call — $7

Total Debit $3

- Maximum Loss = $3
- Maximum Gain = $2

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Bull Put Spread

$50 Stock

Sell $50 Put — $4

Buy $45 Put — $2

Total Credit $2

- Maximum Loss = $3
- Maximum Gain = $2

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Option Strategies

➢ Bearish Vertical Spreads

1. Mildly Bearish or Neutral

2. Build the Strategy

   ➢ Entry Rules

      ➢ Sell the Strike You Expect the Stock to be Below at Expiration

      ➢ Buy a Higher Strike

   ➢ Exit Rules

      ➢ 50% loss, Exit for Profit at 80-90% of Max Profit

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Option Strategies

➢ Bearish Vertical Spreads
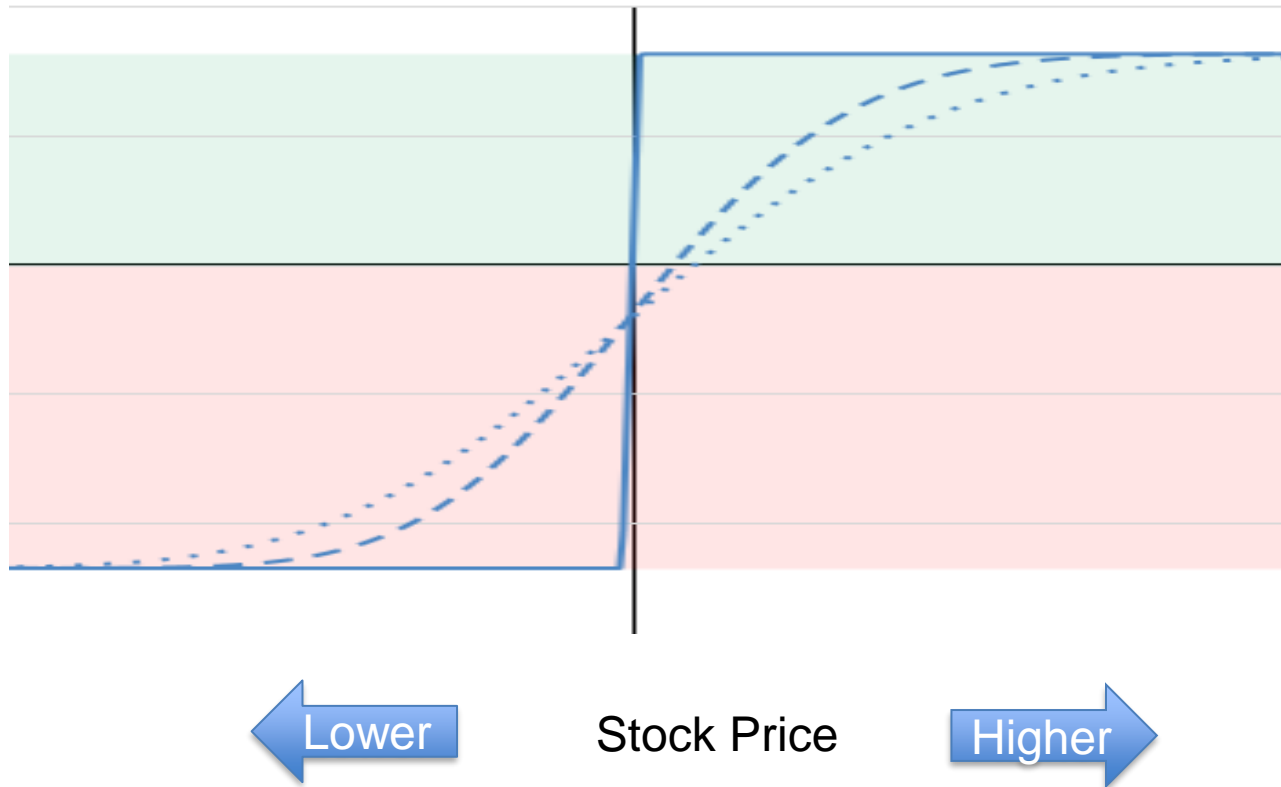
   3. Max Loss

      ➢ Max Loss for Debit Spread = Net Debit

      ➢ Max Loss for Credit Spread = Spread - Credit

   4. Max Gain

      ➢ Max Gain for Debit Spread = Spread - Debit

      ➢ Max Gain for Credit Spread = Credit

Risk vs Reward

➤Bearish Vertical
  ➤Limited Risk
  ➤Limited Reward
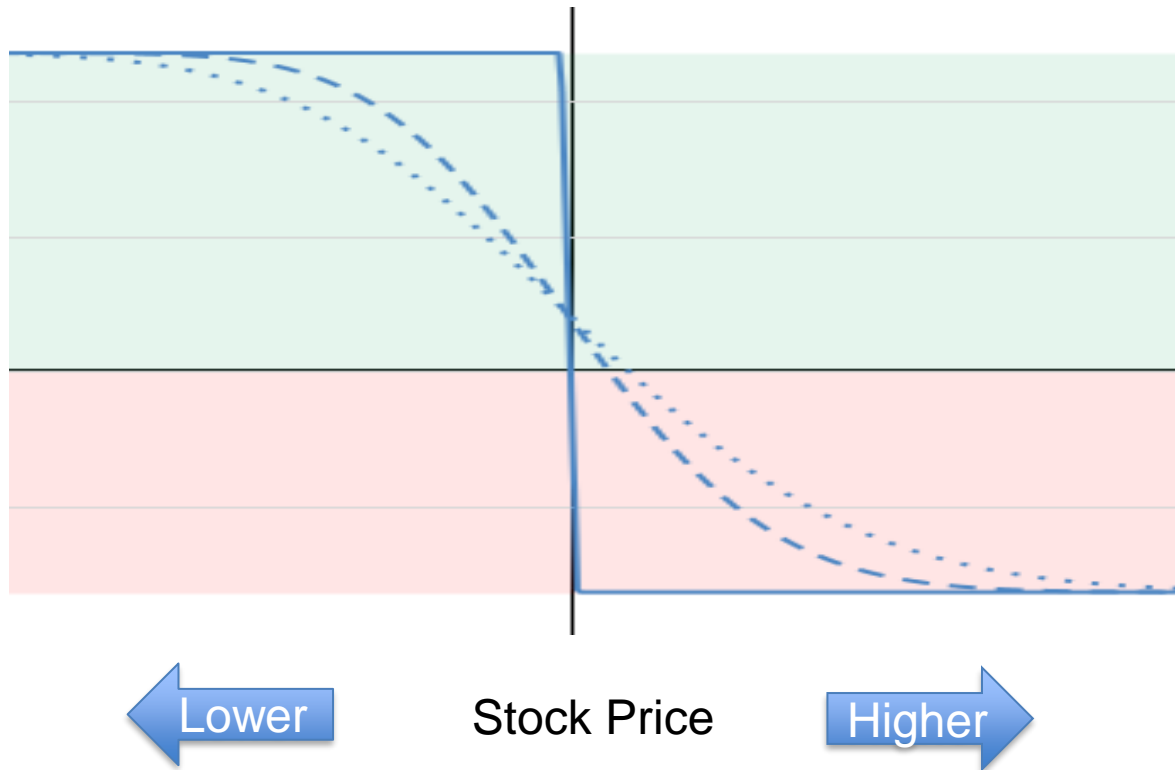
Lower   Stock Price   Higher

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Bear Put Spread

$50 Stock

Buy $55 Put — $7

Sell $50 Put — $4

Total Debit $3

- Maximum Loss = $3
- Maximum Gain = $2

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Bear Call Spread

$50 Stock

Buy $55 Call — $2

Sell $50 Call — $4

Total Credit $2

- Maximum Loss = $3
- Maximum Gain = $2

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Option Strategies

➤ Iron Condor

1. Neutral Outlook
2. Combine the Bull Put and Bear Call Spreads on the Same Underlying
3. Max Loss = Spread – Credit
4. Max Gain = Credit

Iron Condor Credit Spread

Bear Call Credit Spread

+C ——— 55
$0.50
-C ——— 50

Profit Range

-P ——— 35
$1.00
+P ——— 30

Bull Put Credit Spread

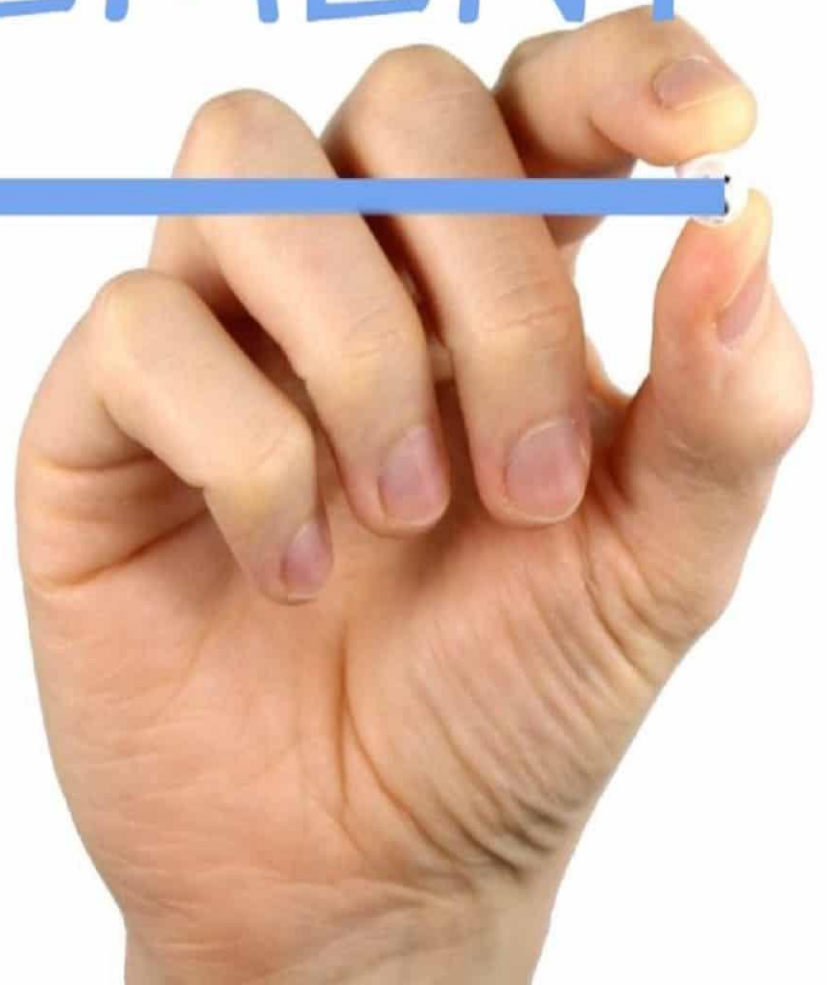TACTICAL INCOME
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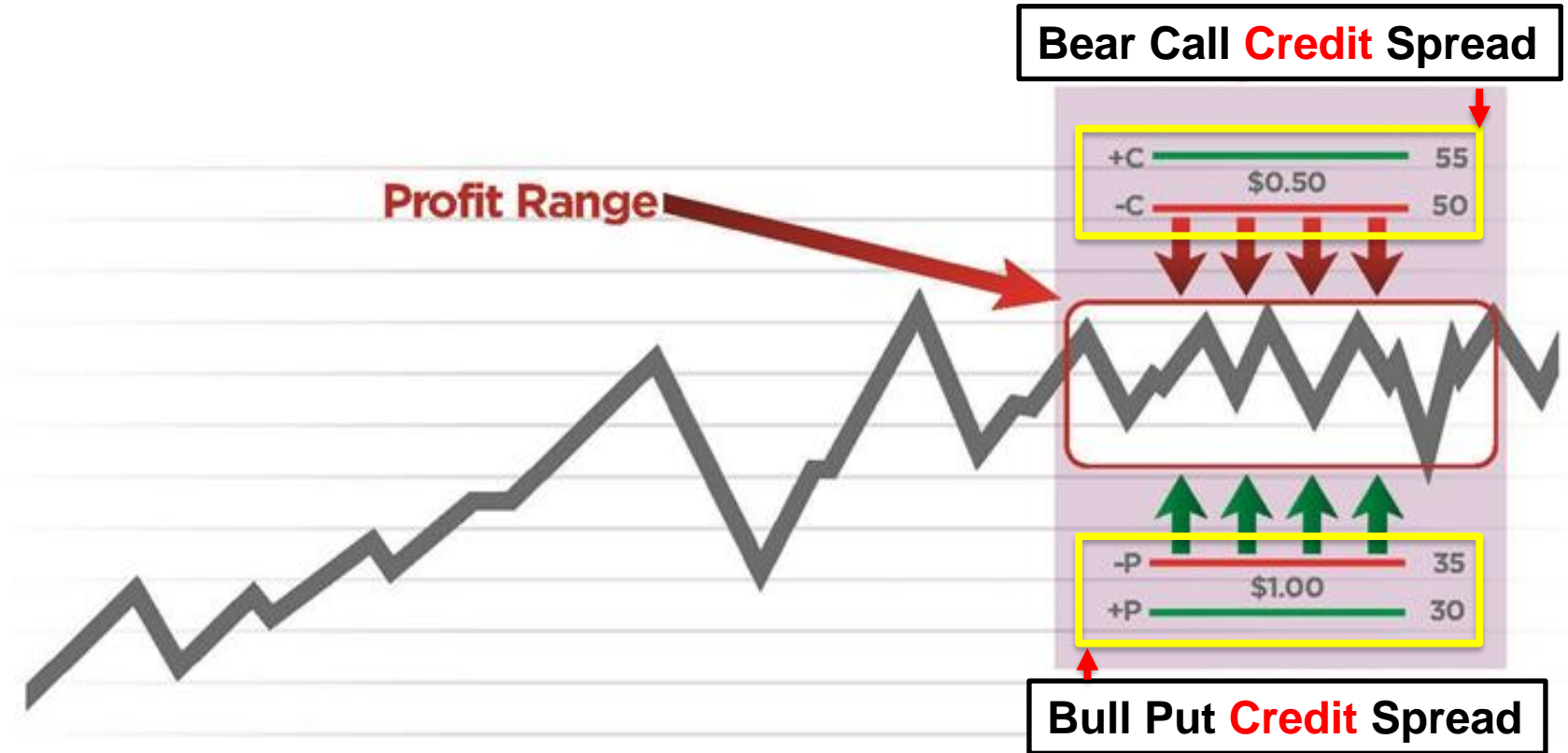
Rights and Obligations

Options that are ITM at expiration will be exercised!!!

RISK MANAGEMENT

➢Have a plan

➢Know what type of trader you are

➢Understand and follow analysis rules

➢Understand and follow risk rules

Risk Management

➢Risk Rules

   ➢Rule #1 – Position Risk

      ➢How much risk per trade?

   ➢Rule #2 – Portfolio Heat

      ➢How much total risk at once?

Risk Management

➢ Example

 ➢ $10,000 Account

  ➢ Rule #1 – 2%

  ➢ Rule #2 – 10%

 ➢ Maximum Position Size

  ➢ $200

 ➢ Maximum Portfolio Heat

  ➢ $1,000

Action Items

➤ Monitor Account

  ➤ Monitor and adjust paper trades

  ➤ Place paper trades using all the strategies

  ➤ Use the Resource Line

➤ Solidify Risk Rules

  ➤ Test variations to find your comfort level