

Trading Plan

Adjusting Common Open Trades

Lesson 8

Beginner Options Teaching Lessons

Plan and Manage

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Topics for this Lesson:

1.Goal setting

- Process
- Personal Review
- Goals
- Evaluation of Expectations
- Commitments
- Trading rules

2.Adjusting the Trade

- Trade selection
- Trade sizing

3.Adjusting the Trade

- Flow charts

Personal Review

What is my personality type -

- conservative – lean more to safety

- moderate – balance of safety to risk based assets

- aggressive – higher weight on risk based over income

What time horizon do you have to complete your plan:

Anticipated needs:

- Family obligations

- Health care or long term care needs

- Outflows vs Inflows

1.Goal setting

What Are Your Goals

5 yr.. goal –

What are the inflows to building my portfolio:

employment: 401K, IRA, Savings
pension, profit sharing, annuities

What will be my outflows needs be:

health care;
vacations;
living expenses;
Family commitments;

Asset valuation to meet this goal:

1yr goal –

Expected return on trades for plan year: 10 - 20%

Sectors –

- rotation
- in momentum
- Trending

Viable watchlist

20-30 active issues

(not including indexes / ETF's)

Issues that may raise or lower these expectations:

1. changes in market / stock EPS (evaluated quarterly)
2. market sentiment oversold / overbought
3. inflation
4. Sentiment issues – many and always changing
5. commodities - gold & oil specifically

1yr goal – road to the plan

How do I get to this goal?

- Target returns on investment to: **20%** - (adjust to your target return)
 - **MILESTONE** – when I reach 20% and the trade continues to build profit -> becomes **FLOOR** – next milestone would be 30%.....
 - Limit trade losses to less than 15% of investment
 - goes for SE exits and subsequent SE's if needed
- Design trades with high profitability of any profit on the trade
 - use an analyzer like the one in TOS platform for potentials
- Define time to hold options trades for meeting goals
 - Credit trade less than 2 months - not a hard and fast rule – guideline
 - Debit trade at least 45 days to expiration (the more the better if possible)
- Limit the number of open trades to a maximum of 10
- Exit follow through reserve capital towards 20% equity holdings

• Financial Commitment

- Starting capital \$25,000
- Capital expenses
 - Computer / software
 - Subscriptions
 - Internet \$50/month - \$600/yr. (business – 15%)
 - Cell phone - \$65/month - \$780/yr. (business 15%)
 - Advisory / information - \$400/ yr. (business 15%)
 - Miscellaneous – \$500 (business 100%)

• Goals / Objectives

- An expectation of a 20% return on capital invested
- Focus on % return rather than \$ return
- Limit an individual option trade $\leq 8\%$ of total portfolio value at the time of the trade
- Review open trades at least 1X per week
- Review all closed trades at the end of the month
 - Rank trade performance by trade type
 - List strengths/weaknesses in trades closed
 - Hone strengths for next monthly trades
 - List weaknesses to be aware of for next set of trades
- No more than 10 trades running at any one time
- Write all trades to a journal
- Re-evaluate business plan quarterly

• How To Write Your Trading Plan

- To design your trading plan start by evaluating the assets and liabilities that will affect your asset base. Once you have that listed, evaluate **real** expectations that could effect your long term to short term goals. Now you have the basis to design your trading plan.
- A **trading plan** can be as simple or as complex as you want (or need) it to be. Of course, if it's too simple, you may not have enough information to successfully implement key points, rules, and/or strategies during each trading session. Conversely, if it's too complex, you may find it hard to adhere to and forego using it altogether.
- The main point of a **trading plan** is to keep you calm and relaxed during a trade, as all thinking should have been done prior to your entry – not during your trade. Professional traders are relaxed and composed when trading. Amateurs are nervous before the trade and reckless during the trade.
- Keep your **trading plan dynamic**! Modify it (only) when your experience and knowledge of the markets (grows), and your trading activities & data analysis tell you to do so... but never during a trade or trading session!
- Once your **trading plan** is complete, you'll find that trading will become more objective, you will be less emotional, and your trades will be more selective. It will add structure and organization to each trading session. It will be your ally when dealing with unexpected moves in the market, rather than making unjustified decisions when a trade does not go as expected.

Your Trading Plan is written – NOW WHAT?

- Now what? The next step is to develop a ***Trading Journal***, a daily diary where you record the history of your trading, and all the thoughts and feelings that motivated you to each action. A Trading Journal is your learning tool, designed to help you stay on task. You'll use it to review your trades, find more trading system resources, and keep you focused. It's not a complicated tool, but its importance can help increase your profits and reduce stress over time.
- **“What do I do on a daily basis?”**
- **“How do I keep up with this daily activity?”**
- **“What type of tasks should I be doing?”**
- These are all important questions you should be asking. This part of trading is like working out. You probably won't notice any change the day after, or even the week after, but if you stay with it long enough, eventually you'll notice the positive effects of your hard work.
- The same goes for writing in your Trading Journal. The Trading Journal may not be your favorite part of each day, and require more discipline than you're initially comfortable with, especially if you don't see any immediate improvements in your portfolio.

- Position size should be based on acceptable levels of risk for you
 - How much risk are you willing to take on?
 - 2%? 3%? 4%? 20%?
 - Do all types of trades have the same risk of loss?
 - Credit trades? Risk is POTENTIAL
 - Debit trades? Risk is paid up front
 - Placement of trade strikes may affect probability
 - Equity based trades? Equities do not have expiration dates and may provide dividends

Sizing

- How much of your portfolio should be invested in a single trade?
- How much are you willing to risk in the trade?
 - 1 to 2% of your total portfolio?
- Example of a \$100,000 portfolio based on this concept
- XYZ Short Put Vertical:

STO APR 40 SP bid	\$2.85
<u>BTO APR 35 LP ask</u>	<u>1.23</u>
Net Credit =	\$1.62
- Trade Risk = $5.00 - 1.62 = \$3.38$ (or \$338 per contract)
- Based on a 2% allocation, how many contracts could you open?
- $\$2,000 / 338 = 5.9$, so you could open 6 contracts (a tich over the 2%...)

• What if the trade does NOT go as expected?

- Bad things CAN and DO happen
- Secondary exits MUST be well defined and feasible
 - **These secondary exits should already be in your trade plan writeup**
- Proper planning makes for a less emotional experience
- Position sizing is critical
- Evaluate the news that's moving your equity
 - Is it sentimental?
 - Is it fundamental?
 - Is it technical?
 - Is it macro economic?
 - Adjust/close accordingly

From the previous trade example

• What if you wanted to follow through on a secondary exit of stock ownership?

- 6 contracts, 600 shares @ \$40.00 less the short put vertical credit of \$972
- \$23,028 net investment
- What is your investment percentage now? 23.8% Yikes! We're out of control here!
- What is your risk? \$23,028
- Is there something that we can do to reduce our risk?
- Add a protective put @ strike 40.00 (September), debit 7.15
- Cost basis = 40.00 (stock) + 7.15 (long put) – 1.62 (bull put cr) = \$45.53
- Risk = 45.53 – 40.00 = 5.53 (per share)
- Total risk in the position is now \$5.53 * 600 = \$3,318
- Still too much risk – Is there something else that we could do?

6 contract XYZ Short Put Vertical:	
bid	STO APR 40 SP \$2.85
ask	<u>BTO APR 35 LP</u> <u>1.23</u>
Net Credit = \$1.62	

- Add a short call to complete the collar (stock + LP + SC) and reduce our risk
 - STO Sep strike 50 short call bid 4.80.
 - Cost basis = $40.00 + 7.15 - 1.62 - 4.80 = \40.73
- Total trade risk = $40.73 - 40.00 = 0.73$ per share
 - $0.73 * 600 = \$438.00$ Total risk to the portfolio. (0.438%)
- Potential reward = 50.00 (short call strike) – 40.73 (cost basis) = 9.27
 - Return = $9.27 / 40.73 = 22.7\%$

Monitoring the Trade

- Monitoring the Trade

- Each morning, before market open, review your open trades
- Is there any macro economic news?
 - If so, does it affect the investment communities opinion about the your equity's ability to generate profits going forward?
- Is there any equity specific news?
 - Same question as above
- Then look at the technicals for your open positions
 - Changes in support, resistance, trend lines
- Then check your watch list for the same items above to see if a new trading opportunity is presenting itself

Monitoring the Trade

- Monitoring the Trade

- Has the trade reached its primary exit?
 - You might want to use good till cancel orders if you can not always be at your computer
 - If the trade is at or beyond its primary exit and you did not enter a good till cancel order, close the trade manually
- Is the trade progressing towards its primary exit?
- Are the greeks behaving as expected?
 - Delta based trade (directional trading)
 - Gamma based trade (explosive movement trade)
 - Theta based trade (credit spreads)
 - Vega based trade (predictable changes in Implied Volatility)
- Is the trade trending towards a secondary exit and in need of adjustment?

Adjusting the Trade

- Adjusting the Trade
- Once the trade is in need of adjustment, what must we do before we adjust?
- Everything that we did in preparation for the initial trade!
 - Develop expectation
 - Brainstorm ideas
 - Select appropriate secondary exit strategy based on situation
 - Define new primary and secondary exits
 - Place adjustment
 - Monitor, adjust (repeat process above) and close
- If necessary, keep repeating this process until the trade is ultimately closed profitably

Summary

- Define your goals – if you don't know where you're going, how will you know that you've arrived?
- Proper Portfolio Management is a matter of identifying risk and keeping it within the guidelines that YOU choose for your trading style
- Maintain enough cash in your portfolio to follow through on secondary exit strategies
- Transitioning from paper trading to trading with real money is a big step
- Live money trading must be well thought out and planned
- Emotions will play a part in your trading, so understand it and stick with your plan
- By fully examining the trade and its exit points before placing the trade, we can mitigate the negative effects that emotions may create in our trading
- Keep up with the news and the technicals for your trade
- **Adjust when you have reason to do so and be clear as to your revised expectation**
- Take profits at your primary exit

Adjustment Flow Charts

Long Call Adjustments

Long Put Adjustments

Long Call Vertical (Bull Call) Adjustments

Long Put Vertical (Bear Put) Adjustments

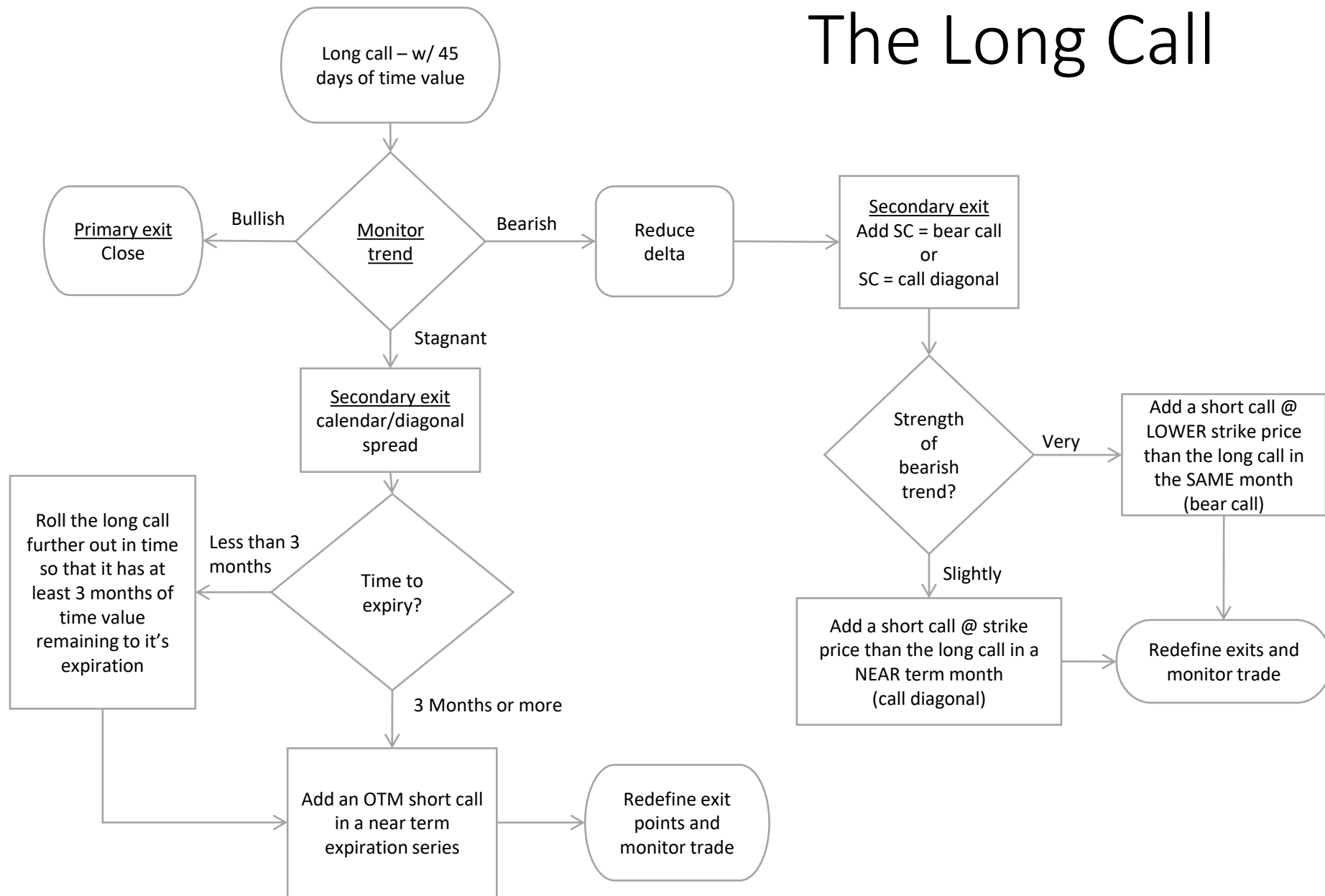
Short Call Vertical (Bear Call) Adjustments

Short Put Vertical (Bull Put) Adjustments

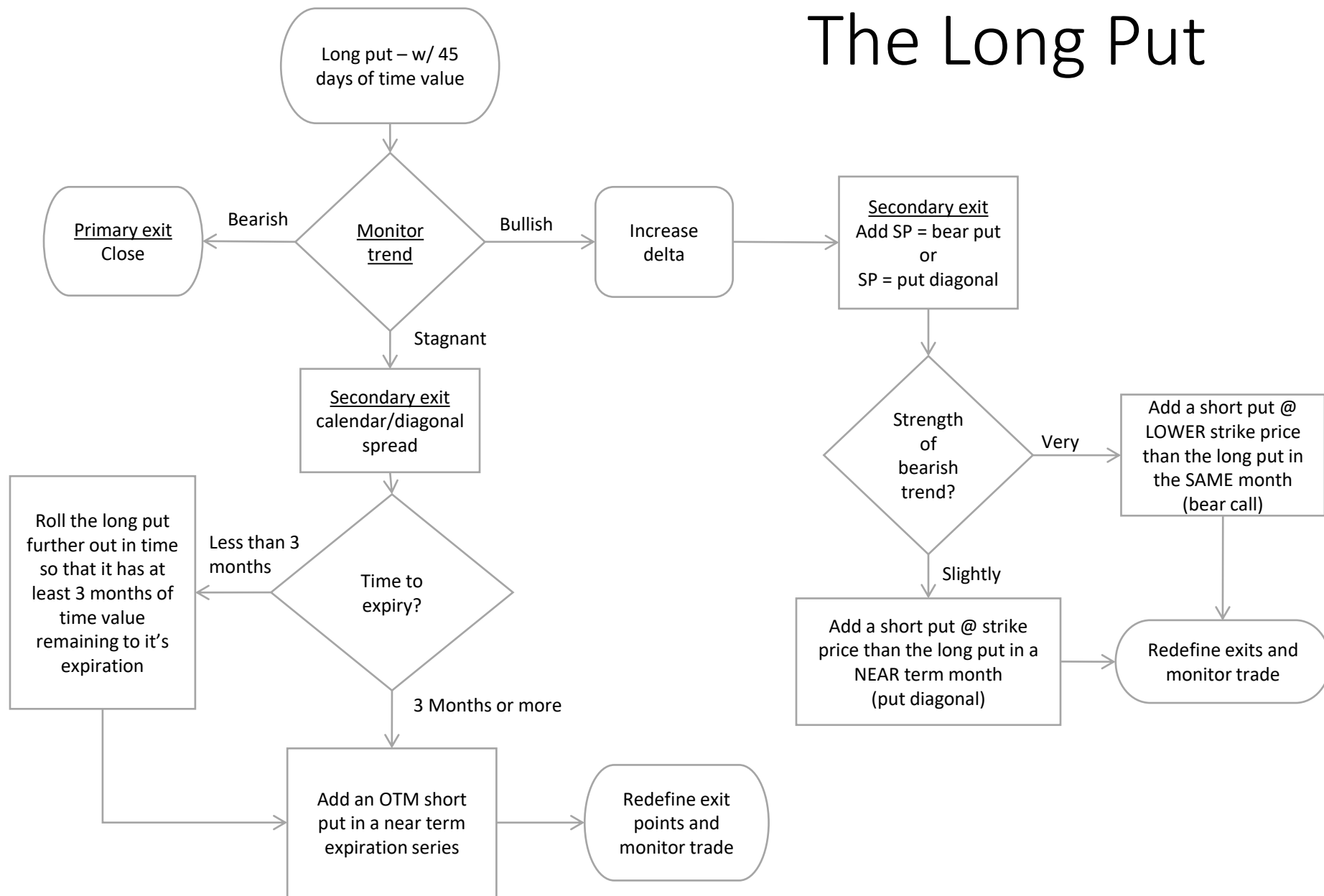
The following flow charts are a guideline to be used in your trade plan

They should be ONLY use to ascertain possible requirements BEFORE the trade is placed

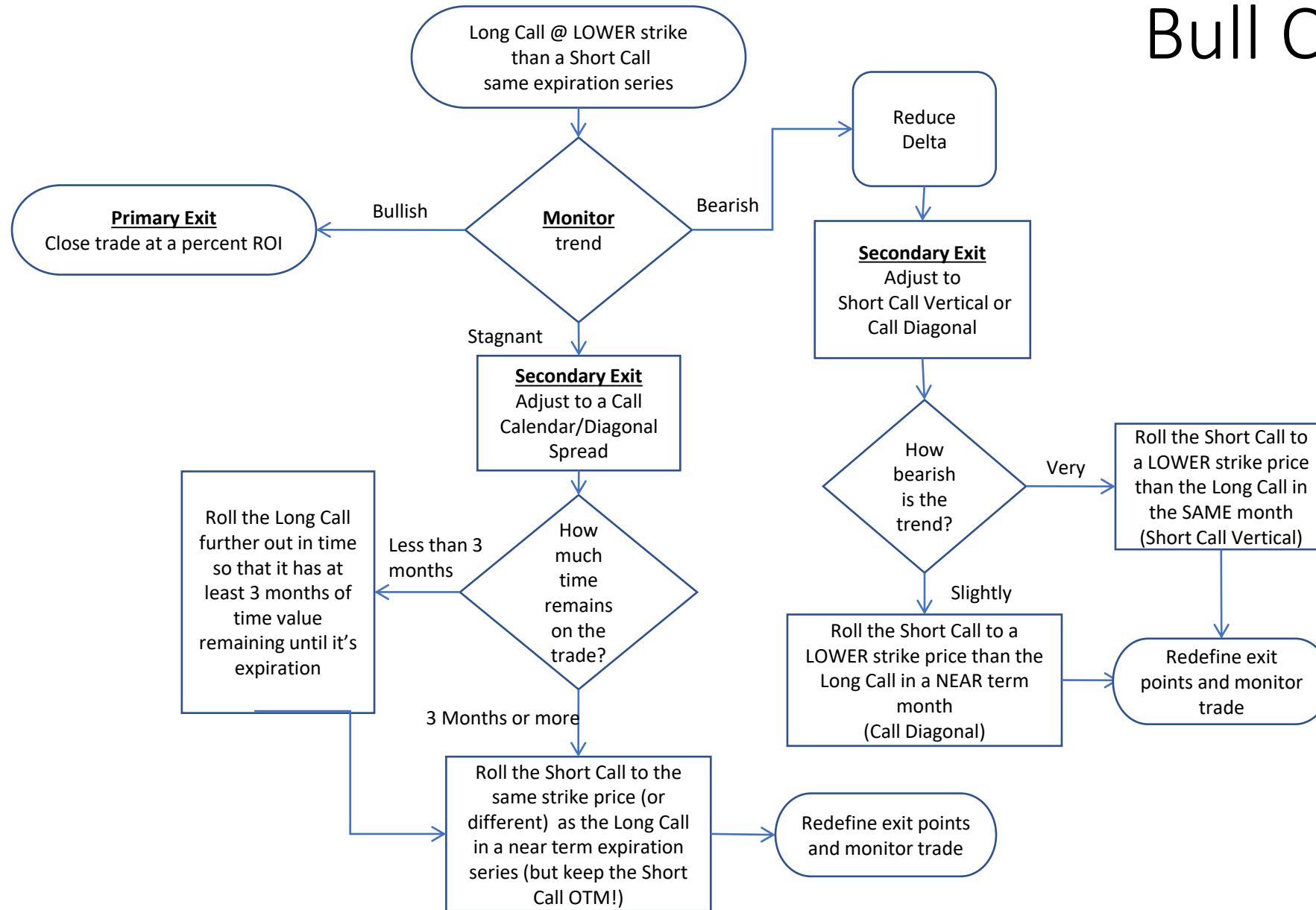
The Long Call



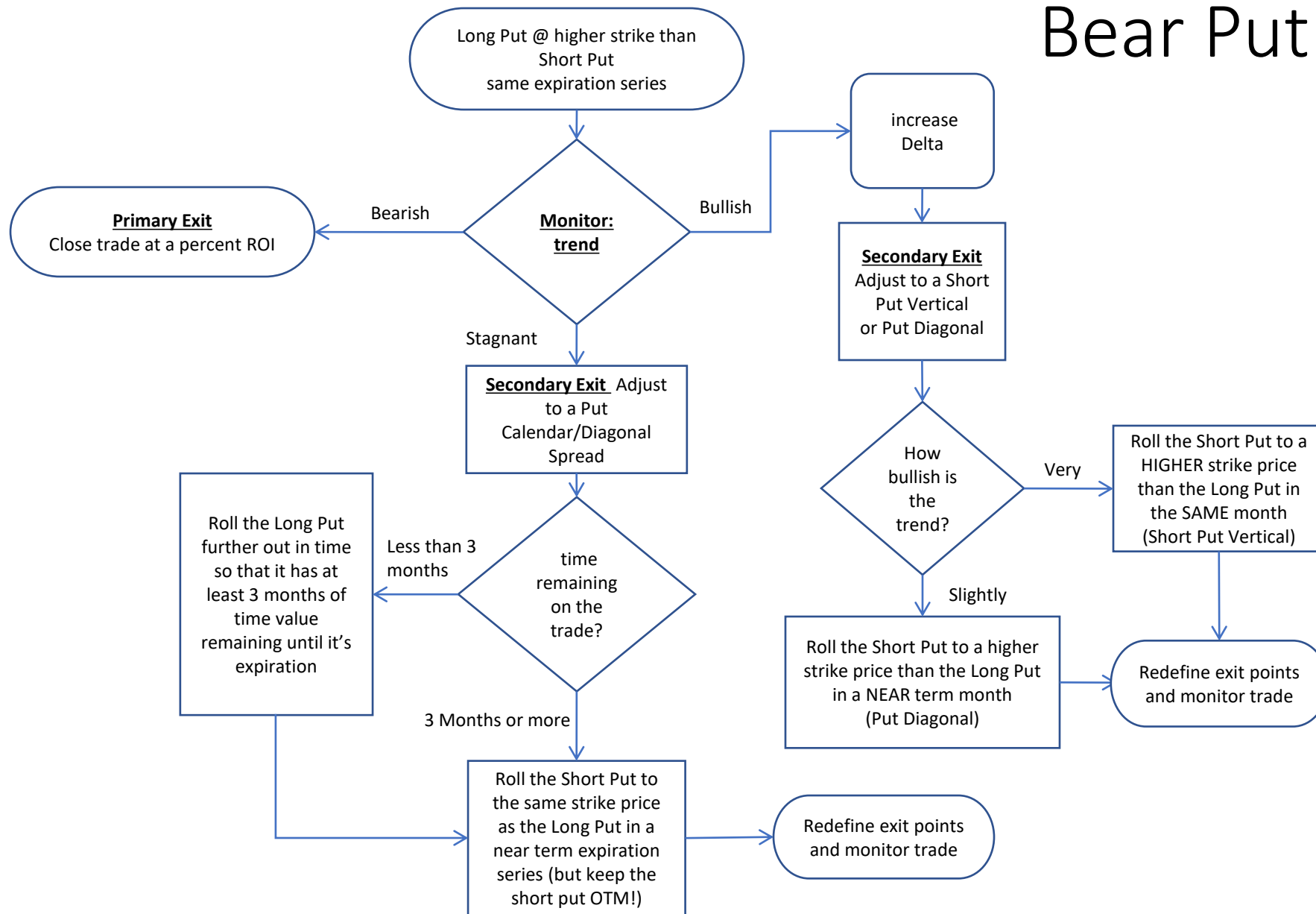
The Long Put



Bull Call

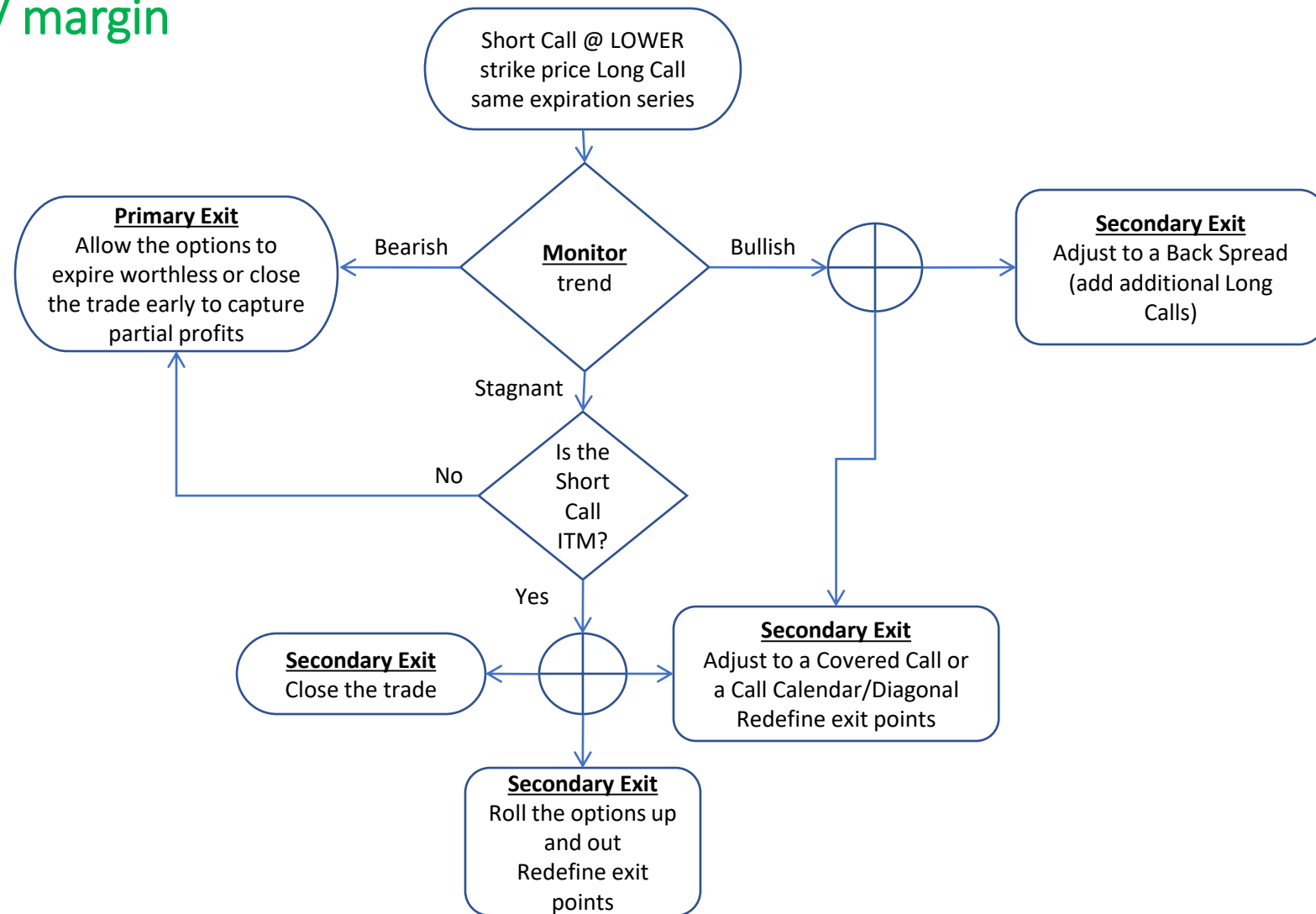


Bear Put



Short Call Vertical

credit trade w/ margin



Short Put Vertical

credit trade w/ margin

