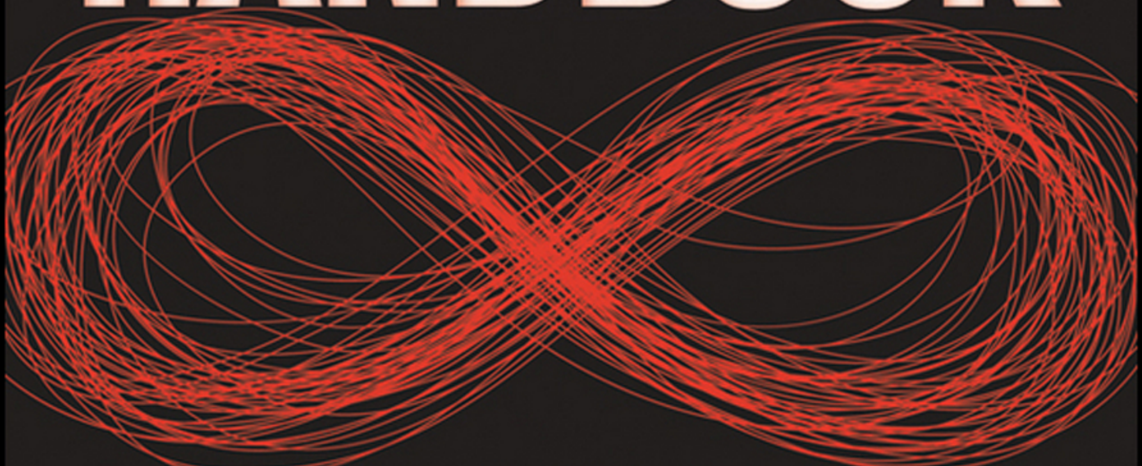
WILEY Trading

YOUR OPTIONS HANDBOOK



THE PRACTICAL REFERENCE AND STRATEGY GUIDE TO TRADING OPTIONS

JARED A. LEVY

With a Foreword by MARK DOUGLAS

Your Options Handbook

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market's ever-changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional, or somewhere in between, these books will provide the advice and strategies needed to prosper today and well into the future.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Your Options Handbook

The Practical Reference and Strategy Guide to Trading Options

JARED A. LEVY

WILEY

John Wiley & Sons, Inc.

Copyright © 2011 by Jared A Levy. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750–8400, fax (978) 646–8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748–6011, fax (201) 748–6008, or online at http://www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762–2974, outside the United States at (317) 572–3993 or fax (317) 572–4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Levy, Jared, 1976–
Your options handbook : the practical reference and strategy guide to trading options / Jared Levy.
p. cm. – (Wiley trading series)
Includes index.
ISBN 978-0-470-60362-8 (hardback); ISBN 978-1-118-04118-5 (ebk);
ISBN 978-1-118-04119-2 (ebk); ISBN 978-1-118-04120-8 (ebk)
1. Options (Finance) I. Title.
HG6024.A3L485 2011
332.64′53–dc22
2010049287

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

This book is dedicated to those who lost their lives in the attacks of September 11, 2001, and to all those who have been innocent victims as the human race struggles for peace.

Contents

Foreword

When the first Treasury Bond option contracts were introduced in 1982, I was working as a retail commodities broker for Merrill Lynch at their Chicago Board of Trade office. At the time, options on futures were relatively new products, so Merrill sent a team of experts to each of their offices to instruct us (the brokers) on how to use them and of course how to sell them to our customer base.

During this presentation, one of the experts explained that there were over eight billion possible spread combinations between the new Treasury Bond options, bond futures, and cash bonds. That number, eight billion, really surprised me. But at the same time I was immediately fascinated with the idea that it could take years for traders to discover even a small percentage of the various ways that options could be used to make money.

Now for those of you who are new to options, the implications are really exciting. Even though it is almost 30 years later, options still represent an arena of vast untapped potential for creative expression. In other words, there are still countless ways of using options that no one else has thought of yet.

But there's more; besides the seemingly endless possibilities to make money, trading certain types of options strategies can also have a beneficial effect on helping you develop into a "consistently" successful trader. You can be the kind of trader whose equity curve rises at a nice steady angle, free of inordinately large drawdowns, and, most importantly, engenders a sense of confidence that causes one to believe he can actually make a living as a trader.

Here's what I mean.

If you're going to be in this business for any length of time, you will eventually come to the realization that there's more to developing into the kind of trader that has the ability to produce a consistent, reliable income than finding a good trading method or strategy. You also have to develop the ability to utilize that strategy to its maximum potential. Meaning there's a performance component to trading that people typically take for granted by assuming that if they get the right method or do the right market analysis, everything else about their trading will just take care of itself.

This assumption couldn't be further from the truth. The only way you can transform good analysis or a good trading method into consistent profits is if you can execute your trades properly. Flawless execution is not something that can be taken for granted because it requires the ability to achieve an objective state of mind and stay positively focused on doing exactly what you need to do, when you need to do it, without fear, hesitation, second thoughts or any other negative encumbrances that would cause you to make a trading error.

The consequences of not being able to properly implement your analysis or method will eventually create what I call a profit gap. A profit gap is the difference between what your method or analysis made available in the way of potential profits over a series of trades and the reality of what you actually ended up with, which in virtually all cases, except for a professional trader, will be less. To say the least, unrealized potential is something that most people find very painful and therefore would like to avoid.

So how do you go about learning to implement your analysis or method as it was designed to be traded? Not exactly a simple task when you consider there are several psychological factors that can cause people to "get in their own way," so to speak. However, there is one performance factor in particular that has a negative effect on nearly everyone who decides to step into the process of trying to become a successful trader.

Most of the difficulties that people experience performing as needed to properly trade their analysis or follow the rules of their trading methodology stem from not fully "accepting the risk that anything can happen." What do I mean by "accepting the risk that anything can happen"?

It's believing at the very core of your trading personality that the market is capable of doing anything, for any reason, at any moment. It means that regardless of how good your analysis or method has been in the past or the extent to which you may go to convince yourself the next trade you are about to put on will be a winner, the risk of losing is *always* present, it *never* goes away—*ever*. And, regardless of how it may seem, there's no method or form of market analysis that can prevent experiencing a losing trade.

As much as traders like to think of themselves as risk takers, the reality is that only the very best have truly accepted the inherent risks of trading at a deep enough level that would allow them to achieve an objective state of mind and stay confidently focused on performing flawlessly.

Which brings us to the point where I can explain why trading options can be so beneficial to your overall development, as well as why I like this book.

One of the most distinctive characteristics of an options contract is that you can genuinely limit the risk of your trade. When you buy an option contract you are not putting up margin. What you pay is the actual cost of the contract. And what you are buying is the opportunity to profit, if the value of the contact increases. But since the contract is paid for, you can't lose more than what it cost no matter what the market does.

This is blatantly not the case with trading stocks on margin, trading futures, and Forex contracts where the risk of how much money you can lose is virtually unlimited. When you are putting up margin to trade stocks, futures or, Forex, nothing is paid for. As a result, if the market moves against your position, there's nothing to limit the amount of money you could lose except whatever psychological resources you have to get out of a losing trade.

One of the most common mistakes traders make is not predefining the risk of a trade. Which means determining in advance of getting into a trade the dollar value of how far the market has to move against your position to tell you the trade isn't working and therefore not worth spending any more money to find out if it will. If you haven't considered or don't know in advance of getting into a trade what the market has to do or not do to tell you the trade isn't working, then you are setting yourself up to experience a catastrophic type of loss.

Think of it like this: If you find yourself in an unanticipated situation where you're losing, to get out of the trade will require admitting that you're wrong and of course taking a loss. Not exactly a desirable or easy thing to do, especially when it's far easier and more appealing to talk yourself into believing you're not really in a losing trade. Certainly the market could come back and make you whole. But if it doesn't, choosing not to get out could result in a loss far greater than anything you could have ever imagined possible.

Unfortunately for many people, it only takes just one of these catastrophic type drawdowns and for all intents and purposes their trading career is over. Because even though most people will recover financially, only a small percentage find their way to a full emotional recovery. To be more specific, the kind of recovery that allows one to eventually develop into a consistently successful trader, someone who has a profitable trading method and the ability to stay positively focused on executing that method flawlessly. In other words, no "profit gap" because she's no longer to susceptible to fear-based trading errors.

What makes options so attractive is there are plenty of strategies available that make money and at the same time automatically compensate for the fact that "anything can happen." So, if you can accept the cost of an option, at least to the extent that you can "get your wallet out" so to speak and actually pay for it, then from a psychological perspective you'll be in a much better state of mind to trade properly than anyone trading on margin who hasn't fully integrated the "anything can happen" principle into their trading regime.

The reason why I like Jared's book is because he champions limited risk options strategies. He is going to teach several limited risk strategies that not only have a high percentage for success, they also have excellent profit potential. And more importantly, at least with respect to your long-term success, his strategies will help you naturally ease into a complete acceptance that really "anything can happen."

I know many of you reading this book want your success to be "right now." But if you cultivate a genuine appreciation for the process of becoming a successful trader, and study Jared's book, the journey will be a lot less arduous and definitely more fun.

MARK DOUGLAS
Author of *The Disciplined Trader™: Developing Winning Attitudes* and *Trading in the Zone™: Master the Market with Confidence, Discipline, and a Winning Attitude*
February 2011

Preface

In 22 years, from modest beginnings and even after leaving school without a degree I found myself responsible for millions of dollars and making decisions about money and risk that most people would never experience in their lifetimes. It was extremely humbling, although I didn't realize or understand that emotion at first—I guess I couldn't. What I did realize was that I didn't have the gift of an Ivy League education, nor did I have the risk capital to throw into too many ideas that might not work. What I did possess was an extreme focus and obsession for the markets and, most importantly, derivatives. I was also following my passion without a real mentor or guide, which led to inevitable, but tolerable mistakes.

I realized as I became successful that there was *no* specific guru, method, or model you need to follow per se, and there was not even a perfect personality suited to being a trader (although some may be better suited than others). I also realized that there were literally hundreds of ways to make money (and lose it) in the markets and many of them seemed so logical and some of them realistically ascertainable. Unfortunately, all of these possible paths seem to lead to confusion and failure for many, partially because there is not really one concise guide to becoming a successful trader or investor, and once you start down one path you may pick up a book or listen to a speech that sends you down another.

I believe that what most of us really need is someone to help cut through the tangled web of information, nonsense, and hype to develop a method that works for you as an individual. Now, of course, that method needs to have some sort of basis, credence, and consistency and should be tested. You can't just arbitrarily choose a way to invest and hope it works or coat-tail someone else's. (You can, but it's a tough course to take).

In this book I offer you the indicators, methods, and data that I examine and use. I'll explain what I look for in them as well as the technique I use to find stocks to trade, and finally teach you the options strategies I use to trade them in simplified, specific, and practical detail.

Much of these methods are interpretations and combinations of all my mentors' teachings and my own personal experiences over the years. There is no perfect system and every person rationalizes data, situations, risk, and problems differently. My goal is to level the peaks and valleys, styles, and formats, and offer a real options trader's handbook, which I hope can make you some extra money, save you from losing more money than you would have, or just offer some cool insight to our little world of derivatives.

In this book are the most of the tools and knowledge that you must know to become a consistent, successful trader or to start your own trading business.

My approach is not perfect, but the methods and suggestions that you find in this book not only have worked for me in the past, they enabled me to make my living as a trader, both on and off the floor. I can't promise that everyone who picks up this book will walk away an expert options trader, but what I can promise is that you will get your money's worth. I left behind $70,000 to my first trading partners because they taught me the craft—that was my *options training tuition.* I think the cost of this book is a much better deal! But in all sincerity, teaching, along with trading, are my passions and this book is packed with tips, suggestions, and tricks of the trade from a professional market maker's perspective, I know that some of the data contained within this book will help you become a better trader, at least on some level.

I tried my best to write in plain language and do my best to ensure your complete understanding of any unique verbiage or nomenclature that is used.

Don't be discouraged if it all doesn't make sense at first. The seeds of information that you sow today will germinate into the wisdom that will carry you through your trading journey.

At the end of the day, it is my belief that the understanding of human behavior as well as recognizing your own, in conjunction with the detailed knowledge of a stock or sector, its typical behavior, and the management of your personal risk will lead you to success.

I know that's a ton to handle, but be patient.

The subtle nuances and "intuition" that it takes to be a successful trader *cannot* be taught in a book or a series of books, much like reading your state's driving laws and studying the mechanics of the automobile won't make you the world's top Formula 1 driver. You must get in the driver's seat. Like racing, there are risks and rewards, and this book teaches you how to minimize the risks and reap the most consistent reward.

I do want to give thanks to the great traders, risk managers, game theorists, and so many other brilliant minds out there that have influenced me directly or indirectly over the years. There have been many great books written, which I am sure have found their way into my head in bits and pieces and formed the amalgamation of styles, beliefs, systems, and techniques that I have made my own and made me successful.

HOW AND WHY I BECAME A MARKET MAKER

I now realize that growing up in a middle class diverse neighborhood in Philadelphia gave me just about everything I needed to be a successful trader. My preteen friends were probably the most assorted circle that you could imagine—from trouble makers to trust fund babies and everyone in between. Being around this group allowed me to observe the different rationales of extremely different minds at close range and at a time when I was most impressionable. For many of us, we have this intuition; sometimes we just ignore or don't trust it or maybe just don't require those intuitive skills later on in life so much, so we let them fade.

My hyperactive personality gave me a propensity to get bored easily in class and goof off. Luckily, there were some amazing and tolerant teachers in the Philadelphia public school system, in addition to my parents, who stimulated and motivated me to do bigger and better things with my life.

But it was finance that became my passion early on after an exercise in elementary school where we picked stocks in a mock portfolio.

After my first trip to visit the New York Stock Exchange (NYSE), at about 12 years old, I wanted to be a trader. I was hooked. I became obsessed with the stock exchange system and the traders standing on the floor. At first, the lure was the cool jackets, the frenetic energy that fit my persona, the excitement of all that money passing from person to person, not to mention the ability for me to go to work and yell at people I worked with. I guess from a preteen's eyes that was nirvana.

This was a kid's dream for sure, albeit a closet geeky kid, who from a young age was exposed to just about everything a kid shouldn't be exposed to. My parents, who were complete polar opposites of each other, did everything they could to make me feel so not middle class, even though the situation was tense between them most of the time.

My mother, who was a high school English teacher in an inner-city Philadelphia school, encouraged me to let my mind to run free, and to dream and follow whatever dream or vision I had. My father, who was the rational, realist of the two, tried to help me think before acting, which was definitely not my strong suit.

Most of the time I had too much freedom and for a prepubescent kid that was a problem.

I remember taking apart my new Adam computer in 1983, which probably cost my mom a month's salary. I dissected and labeled the more than 400 components on the living room floor, because I really wanted to know exactly how it worked, but that didn't go over too well.

My father, who was an electrician by trade, instilled more of my practical, logical, and realistic thought processes. We would assemble complex electronic components, go to military surplus stores to purchase gas masks and hazmat suits so we could compare the combustibility of ether versus different types of alcohol, and played with liquid mercury, definitely not typical. (Child protective services would have had a field day.)

WWF wrestlers and G.I. Joe action figures seldom found their way into my playpen. By the time I was in my teens, I had an insatiable desire for knowledge, but more importantly I broke down seemingly complex problems by using rational, practical solutions—this desire was partially blurred by chasing girls, of course.

Most humans just don't want to be bothered with the inner workings of everything around them. It's much easier to look at a device and say, "That is a clock; it tells us the time. That is a computer; it allows me to surf the net," or a process like buying a stock and think, "I am buying this stock from my stock broker so I can hopefully make money." That was never good enough for me. I wanted to know every part of every process, device, and object around me, be it man-made or organic.

My theory is that many assumptions and beliefs are only partially correct and that many of us believe certain things because a trustworthy source told us so, not because we have researched the facts. I have found that many people share these traits and it's not necessarily a bad thing.

Teachers, which include our parents and friends, are typically there to provide us with guidance or opinions on various topics and help us in our decision-making process. The problem is that the answers we receive are sometimes based on that person's specific belief system or observations, which may affect the outcome of the answer. But more importantly, an answer to a question may not give you all of the reasoning, which I always believed was the key to true understanding. I guess my strange way of viewing the world and my obsessive-compulsive nature drove me through some major twists and turns growing up, both good and bad, but that desire to be a trader was still in the back of my mind all through my teenage years.

In my late teens that dream began to manifest itself into reality when I broke into the industry. I started in retail brokerage and off-floor trading, which I loved. But I soon found out a couple things about being a stock broker:

My clients loved and hated me all at the same time, which drove me up a wall.

They were never really 100% happy with my performance, which gave me feelings of inadequacy.

I was an awful salesperson, which made it really hard to raise money.

Options and the jargon associated with them scared most people, which made business even harder.

Discount brokers and regulation were reducing commission rates drastically.

I just wanted to trade on the floor and control my own life and risk.

So with that, I made my graceful exit from the money management business and down to the floor of the Philadelphia Stock Exchange to start my options trading career on a wing and a prayer. (There were a few other stops along the way.)

The first time I walked on to the floor of the exchange as a clerk, I realized that things were completely different, the regular rules didn't apply—you could be yourself, say what you want, make your own rules, and I knew that if I played my cards right, I could really make a ton of money and maybe change my life. I knew about guys and girls who were making millions of dollars, but had no idea how. I thought I could do the same but I didn't really know how or where to start, nor did I have a wealthy family to "loan" me money to trade. I was lucky to have friends on the floor and a passion for the game and that was enough to propel me to learn more.

Being a floor trader and an options market maker was the most wonderful, enlightening, and liberating (and scary at times) experience of my life—and I have done some extremely wild things over the years. While most stock jockeys were gambling on the wrong side of the table, I had a chance to be the house. I could make the rules and I could control, to an extent, what my fate was going to be and not be a complete slave to the mysterious oscillations of the stock market that every MBA and quant from every Ivy League school has tried to master and control.

Options traders were a different breed. We took a statistical, mathematical, rational (most of the time) approach to the marketplace. We added another layer of probability and risk control that just could not be had with trading stocks alone. We made bets on things like volatility and didn't always care which way the stock went. Everything was at least partially hedged, which reduced the need for Maalox, Prozac, and heavy drinking, which many of my stock-trading brethren had to rely on more often.

We had our own rules, which many didn't understand, and, to be honest, we didn't want to in the beginning. It was pretty cool when no one really understood your business or the risks involved, but yet wanted to keep giving you money. This was in the early days of options trading and it is still true somewhat today. Most investors took long shots, buying options, and did not understand the first thing about how they derived their value or how they could consistently make money trading them. To most retail investors, they were viewed as cheap lottery tickets that, in an irrational marketplace, could be the ticket to pay dirt.

On my first day as a market maker I walked into the pits, no longer a humble clerk, but rather a (sort of) confident, combat-ready trader. I was extremely anxious, inexperienced, and frankly petrified. My heart raced as I walked into the pits as a new trader, wearing my brown badge proudly. They gave new traders brown badges to ensure that everyone knew that they were new and thus ensure that they would get extra abuse from other market makers, brokers, and surveillance there to make sure that all the rules of decorum were followed. As soon as I heard the loud, Rocky-like, open outcries of Philadelphia and New York tri-state-accented locals who obviously didn't grow up with a silver spoon, I knew that this was real. One part of me felt at home, and the other part was thinking of how tough I really needed to be. I did, however, know that this was the place for me and I was going to make this work at all costs! If I didn't, I would be doomed to failure, which was just not acceptable. I had blown off my parents' requests to be a doctor or an attorney in order to be a trader, so if I screwed this up, I would never live it down.

Most floor traders have been there awhile, some since 1973, when standard options began trading on an exchange. For many, this was all they knew and it was all they ever wanted to do—it was their home and they intended on defending it.

They were all in the same club and I was not a welcome guest. When I stood in the pit for the first time, most of the other traders looked at me like I had just repossessed their car and was having an affair with their wife, maybe at the same time. Others were friendlier, but most of them definitely looked like they had grown up hustling in the streets. Not that they weren't smart—each had his or her own unique gift and angle.

Now that's not to say we didn't have some of the white-shoe, Harvard-type guys down there, but for the most part, it was a diverse crowd of everything from professional gamblers and the world's best bridge and poker players, to the math geeks, suave neighborhood kids who had a knack for reading people, and the big oaky linebacker guys who were seven feet tall and muscled their way into trades. Heck, we even had guys who would just whine so much you had to put them on a trade to shut them up. It was awesome! It was my kind of place.

Once you're in the pit and breaking into the crowd, you're trying to figure out everyone's position and angle along with their strengths and weaknesses. It's kind of like the world's largest poker game and everyone is trying to call your bluff and find your weak spot and you theirs. It helped to be a comedian and to be loud; luckily, everyone in my family had a great sense of humor. My grandfather had told me enough dirty jokes over the years to keep the guys entertained till the Rapture. My mother was a teacher and cheerleading coach in one of the worst inner-city schools in Philly, so she could yell and hold her own, as could I. My dad was more of the quiet, intellectual type, who actually despised loud places, but his demeanor and teachings helped me relate to my inner geek and thus the other geeks and more mathematical types in the crowd.

So thankfully, it didn't take me long to become one of them and because I wasn't a complete moron, I think most of the guys respected me early on. Besides, they had more to worry about than some new kid from Northeast Philadelphia breaking into their crowd—the markets and exchanges were changing and although this change would be remarkable for the retail customer, it would be devastating for most of the independent floor traders and brokers.

In the early days, which were after the über-glory days of the late 1970s and 1980s, we all had to adapt to a changing landscape as pit traders. When I first started, there were no real computers or phones on the floor, other than the house phones to call your booth and a couple of personal computers around the floor to look at a chart and check quotes. Everything was done with paper sheets, hundreds of them, which displayed all the Greeks, prices, and volatility measurements, all printed in about a font size of one! It took a sharp mind, great math skills, and some serious options know-how to be a floor trader. The open-outcry pits were the central meeting places for all orders, and most stock options had one exchange that they traded on, which meant that if you wanted to trade the Nasdaq 100 (QQQ), you had to send your order to the American Stock Exchange.

Markets were wide and not nearly as liquid as today's marketplace, not because of open outcry, but because of less broad knowledge of options and relatively low overall options volume traded by retail customers and even professionals.

I remember trading Dell Computer stock, which traded only on the Philadelphia Stock Exchange. Our markets would be something like $1 half-bid to $2 ask, 20 up (yes, we still used fractions back then), which basically meant that you could buy or sell 20 contracts at those prices. If you wanted to trade more, the price might change. It wasn't that we were trying to steal from anyone wanting to trade options, we just had to have some extra edge in our trades because of the smaller amounts of liquidity and the lack of high-speed, real-time monster computers that figured and measured changes in risk, volatility, news, order flow, arbitrage opportunities, and so on. When an option is bought or sold by a customer, typically the market maker who trades on the other side will hedge that trade by buying or selling stock or another option. Without computers, we had to manually keep track of all of our positions and how they influenced one another.

At the time, most of our positions and risks were either in our head or written on little cards and sheets of paper that stuck out of the top pockets of our trading jackets. This made risk management a bit more difficult in the beginning. So at that time, because of the lack of computers and technology in general to assist me and for the fear of not being able to feed myself, let alone pay for my car and condo, I was generally willing to buy or sell 100 contracts on either side of the market if needed. This means the equivalent of 10,000 shares. Even though I was a market maker, I had to control risk. Limiting my contract size (to 100 max) and hedging just about every trade I participated in were some of the methods I employed. Because of the way I traded I didn't necessarily have stop losses or target profits. As a market maker, I was really just trying to capture edge and make bets on volatility here and there. What I could control was the exposure I had to certain market variations. In other words, I could control my "Greeks" by using different methods. Greeks are a series of variables that can tell traders how their option is going to move, based on a variety of influences (but more on those later). Suffice to say that I had to look for creative ways to gain an edge.

Remember, I had to know at every moment how a trade would affect my master position of potentially thousands of options contracts all at different strikes, months, calls, puts, long, and short.

If I knew that I was short a ton of Gamma (I will explain this later, but it is ultimately tied to the price of the stock) and there was a large order to buy some calls (which would mean I would have to sell them) I may go and buy some puts as a hedge as opposed to stock if I didn't want to exacerbate my already short Gamma position. There were literally dozens of different ways that I could and would hedge myself and amalgamate these new trades into my master position. I was forced to learn these intricacies quickly, and this is why I feel confident that I'll be able to teach them to you.

Keep in mind that for the most part, I had no real-time way to monitor my positions or risk (yes, I realize I sound like a grumpy grandfather telling a group of kids how he had to walk to school in the snow—uphill both ways).

The Internet and handheld computers brought increased efficiency to the options markets, which not only helped established traders increase our accuracy, risk management, and in turn size of trades, but they also enabled some traders to get fed theoretical values from traders off the floor onto a handheld computer we dubbed *the box.* These traders, typically from larger firms, could look at risk and hedging more dynamically and thus tighten their bid-ask spreads and take down sizable volume on average.

In the late 1990s we called them *box monkeys.* I know, the term sounds harsh, possibly because we felt cheated at the time and that was a childish attempt to make us feel better about our dying breed and the coming of a new age. Many of these traders really had minimal knowledge of the options marketplace or managing risk. It was just his or her job to buy for less than the value on the screen and sell for more than the value on the screen, period. Unfortunately for us, the box monkeys were the way of the future and in many cases were able to make markets faster and deeper than we were.

Right about the time the box monkeys were coming into vogue, the United States filed suit on September 11, 2000, against the options exchanges for failing to list the same stock options on multiple exchanges. The International Securities Exchange (ISE) was *not* named in the complaint; it had just begun trading options that year. Up until 1990, the Securities and Exchange Commission (SEC) prohibited, with a few exceptions, equity options from being traded on more than one exchange. From 1990 to 1999 few new stock options were traded on multiple exchanges, even though they could have been. The late 1990s and early 2000s brought big change to the way we did business and in the blink of an eye, many exclusive products began trading on three, four, and five different exchanges, opening up opportunities for competition and better prices for consumers. Advances in hardware and software functionality and complexity were making options markets more and more liquid. Moore's law seemed to apply directly to the capabilities of the big trading firms, leaving many of the independent traders behind as they struggled to adapt to the new markets.

Mergers and acquisitions of firms and exchanges also shaped the landscape, favoring the customer and increasing speed, liquidity, and execution costs.

In late 2000, I decided to become a box monkey of sorts, opting to move to a larger, more integrated firm that could help me take down more size and price trades quicker and reduce my personal risk. I jumped from trading up to 100 contracts a trade to sometimes 10,000, if the trade was right. The train was moving fast and every day something seemed to change, when it had remained the same for so long. At the time, I was one of the largest size (volume) market makers in the QQQ (Nasdaq 100) options pit on the AMEX and Philadelphia Stock Exchange (PHLX) for about two years combined.

It was an exhilarating experience; it took courage to trade the QQQs and everyone wanted in. Our pit swelled from a dozen or so to more than 80 traders in just a couple months in 2000. We were getting in at 5 A.M. just to get the best spots. There were about three specialists and six clerks managing the QQQ options book, when the norm was maybe one specialist and a clerk or two. But those heydays were numbered as well, as things were continuing to change.

In 2001 I left the AMEX to launch a new specialist operation on the floor of the PHLX and I remember how difficult it was to compete against the four other exchanges and how they would try to pick us off at every turn. The technology on the PHLX at the time was certainly not cutting edge. Krispy Kreme Doughnuts was one of the issues I was trading at the time. What a crème-filled mess that was! I could barely keep up with the pace at which the orders flew in. Complex spread orders were being fired down to the floor at lightning speed and obviously someone at the time thought my markets were out of line in this hard-to-borrow-and-trade issue. I knew it was the beginning of the end for me (and many of my kind) on the floor. It was just too hard to do it by yourself with the technology that we were using.

For customers the markets were improving by leaps and bounds, offering them lightning, fast execution and next-to-free pricing. Internet-based tools and analysis were getting cheaper and more accessible for the mainstream investor.

For floor traders, the climate is much different. Today the exchange floors are a ghost town—a shadow of what they once were. The screams and shouts of young, testosterone-fueled traders are now gone, replaced in large by the sound of keystrokes and ESPN on the TV screens. Many of the old-timers had made enough money to retire or start brokerage firms or go into other businesses. Some of the younger generation like me were trading off-floor or educating around the world.

This is a retail trader's paradise that we live in. There is no longer a real advantage to standing in a pit. The flow of information and the amount of competition among traders from around the world equates to a well-balanced, deep, accurate marketplace that represents known data extremely efficiently. The major difference now is that you must be in tune with the forces that push and pull the markets. They are no longer able to be observed physically or audibly in a crowd, but observed through the screen of an LCD monitor. This takes skill and adaptation.

You are at an extreme advantage due to the fact that you are not *forced* to make two-sided markets and make trades when you don't necessarily want to. You have the luxury of time and flexibility. If you control your mind and risk and completely understand the strategies that you are employing, you can control your own destiny (at least to a certain extent).

IT DOESN'T HAVE TO BE THAT COMPLICATED

I am sometimes amused at the myriad of complex indicators, correlations, techniques, and theories that some professional investors utilize and claim to be the answer. I also giggle at how some hedge fund managers who can barely beat the Standard & Poor's are viewed as glorified heroes because most of their extreme wealth is not due to the amazing steady returns they are able to attain, but to the gobs of fees and commissions that their investors and limited partners feed them. This is certainly not the case for all and please don't take that as total disdain for the fund community, because it is not. Rather, it is meant to be a confidence builder for you, knowing that just because people call themselves fund managers and are wealthy, doesn't mean that they are investing gurus and should be idolized. Follow your own path and trade what you know and are comfortable with. If it doesn't make sense, learn it or leave it alone.

With the techniques and the strategies contained within these pages, you have everything you need to beat any hedge fund manager. At first, some of the information may seem overwhelming, but go through it again if it doesn't make sense. It will come into focus over time.

A CHANGING LANDSCAPE

The tactics, mechanics, and business of trading are constantly evolving. The advent of advanced computers and the integration and centralization of these systems and exchanges has created an extremely efficient marketplace that digests data at the speed of light and captures arbitrage opportunities even faster. The edge that used to belong to the greatest minds in the industry who had the ability to compute without the aid of electronic devices and could visualize risk in a dynamic real-time environment in their heads or had special access to data or a team of researchers working for them gathering data used in their analysis is no longer the case. Although it may seem like some super genius has the edge with his mind, the Internet, tools, and readily available data to all has leveled the playing field. True, some have faster and more quality information than others, but the truth is that for most of us, not running multibillion dollar hedge funds, the speed and quality of the data we have access to is more than enough to enable us to make money. You might actually be surprised in knowing that the professionals, analysts, and traders you watch on television use the same exact tools that you do and are still able to achieve the respect of the masses and hopefully profits in their accounts at the same time.

That is not to say that there is not a plethora of poor or incorrect data floating around, but I will address this later and offer you tactics to help ensure data accuracy and timeliness.

In the 15 years I have been in the industry, one thing that has not changed is the behavior of man and the hysteria of crowds, especially surrounding news events (such as earnings reports) and new, unexplored businesses and technology. If you can learn to interpret those trends and recognize opportunities within them, while they are happening, you should be able to reap success in the marketplace. More importantly, you must have a system or method and good risk management, neither of which needs to be perfect, just something that gives you discipline and guidelines to follow.

The tools available to the average investor for free today dwarf the high-priced cutting-edge tools I used to be a successful market maker on the floor more than 10 years ago. Tools, such as price and probability calculators, advanced charting packages, risk analysis tools, and real-time blogs, news, Twitter, and so on, which all enable to gauge mass sentiment and risk in record time, certainly make life easier and faster for the home-gamer trader. Both Kathy and Dean go a bit more in depth on the methods, tools, tricks, and details on trading either from home or starting a trading business.

But before we get into how to trade, let's start at the beginning. When did trading begin? And what's it all about, anyway?

Acknowledgments

It has always been a dream of mine to become an author and even with this work, I still don't feel worthy of the title. The fact that you are allowing my words, thoughts, and emotions into your mind is extremely humbling. For that, I thank you, whoever you are reading this. John Wiley & Sons has provided me with a unique opportunity and for that I am grateful.

Mark Douglas has been an amazing friend and advisor through this entire process and was kind enough to offer his words in the foreword. Thank you.

Dean Somes and Denise Shull, both of whom are good friends, were generous enough to take time out of their lives to contribute two amazing chapters for this book. Kathy Chaffee, who has been an inspiration and confidant over the years. Beth Moon has helped me keep my erratic and complex thought process, diction, and spelling in check. Darlene March, the public relations pit bull, and CNBC, for giving me an international stage to vocalize my opinions—I thank you all.

I would be remiss to not give thanks to my wonderful parents, family, friends, teachers, and colleagues who have provided me with love, support, patience, inspiration, and who have influenced me in so many ways throughout my life.

I could not possibly name everyone who deserves a thank you from me, as I believe just about everyone with whom I have interacted has helped me up the stairway of life in some way.

I am forever grateful just to have the chance to maybe help influence the way you think about the options markets and taking risks in the marketplace.

JARED A. LEVY
2011