

ALL STAR  
CHARTS

# OPTIONS

QUICK  
START  
GUIDE

THE EASY WAY TO START TRADING LIKE A PRO

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## INTRODUCTION

### Options give us... options.

**B**y trading options, we gain leverage, the convenience of margin efficiency, and the ability to precisely define risk. Using time-tested strategies, you too can safely add options to your trading arsenal.

Our goal with this guide is to help you hit the ground running when it comes to trading options. Whether you've never made a single options trade before – or if you're just looking to add some new profitable strategies to your toolbox, the tactics we cover in the guide should help you design trades for any market environment.

First, we're going to walk through some basics. We'll touch on the meaning of all the options terms you should know. Don't worry -- this isn't a deep-dive into any complex mathematical formulas. We're simply laying out some terminology you might encounter during your options journey. If you're ever confused by the mention of delta, or premium, or implied volatility, you can always refer back to this guide to find the answers you need to put you on the right track.

Once we get these basics out of the way, we'll discuss options strategies. Specifically, we'll highlight the different market environments we'll encounter and the best strategies to use in each situation.

Here are the four basic environments we'll encounter:

Bullish Strategies for Low-Volatility Markets  
Bullish Strategies for High-Volatility Markets  
Bearish Strategies for High-Volatility Markets  
Bearish Strategies for Low-Volatility Markets

In this guide, we break down the correct plays for these four market environments. We'll detail the characteristics of each of these market conditions, how to spot them, and which options strategies are most effective in any given situation.

It's important to understand that as traders, we need to adjust our strategies as market conditions change! Careful execution of the appropriate options strategy based on current market conditions is the best way to ensure consistent trading success.

Let's get started!

# 1



# Options Terminology

**BEFORE WE GET INTO SPECIFIC STRATEGIES, LET'S REVIEW A FEW TERMS AND PHRASES WE'LL USE THROUGHOUT THIS GUIDE.**

## CALLS

A long call is a bullish position. Calls give the call owner the right – but not the obligation – to purchase shares of the underlying stock or ETF at the strike price at any time between purchase and the call's expiration date.

For this right, the owner pays a **premium** to purchase the call option.

An **out-of-the-money** call is one with a strike that is above current market prices.

An **in-the-money** (ITM) call is one with a strike that is below current market prices.

## PUTS

A long put is a bearish position. Puts give the put owner the right – but not the obligation – to sell (or short) shares of the underlying stock or ETF at the strike price at any time between purchase and the put's expiration date. For this right, the owner pays a **premium** to purchase the put option.

An **out-of-the-money** (OTM) put is one with a strike that is below current market prices. An **in-the-money** put is one with a strike that is above current market prices.

## PREMIUM

Premium is any value of an option over and above its intrinsic or in-the-money value.

For example, if stock XYZ is trading at \$47 and a 45-strike call is currently trading at \$4.75, the premium in the option equals \$2.75 ( $4.75 - 2.00$ ).

If a 50-strike call in this same stock is trading at \$1.25, that entire value would be considered Premium since that strike is currently out-of-the-money.



# GREEKS

## DELTA

Delta measures how much an option (or position) will gain or lose per \$1 dollar move of the underlying stock or ETF – all else being equal. (Pro Tip: They never are.) We use Delta when selecting strikes for our positions.

## GAMMA

Gamma measures the sensitivity of Delta to changes in the value of the underlying instrument. In other words, how much will Delta change if the underlying moves up \$1?

If an option or position has positive Gamma, the delta of the option or position will increase as the underlying moves higher (and vice versa).

## THETA

Theta measures how much the value of an option or position will change today, as a function of time.

Options are decaying assets. As we get closer to expiration, options values tend to decrease at an ever-increasing rate. If you are long an option, it will have a negative theta value, which approximates how much premium will erode from the value of the option over the next 24 hours.

## VEGA

Vega is a unit of measure that tracks the sensitivity of the option or position to changes in volatility.

Don't get lost in the complexity here. Just know that a positive value means your option or position will gain value if volatility increases and vice versa.

## WHAT IS IMPLIED VOLATILITY?

It's easy to get lost in the math here. But we just want to observe how volatility in our chosen instrument compares to where it's been over the recent past.

When it's low, we generally want to be net long premium. When it's high, we generally want to be a net seller of premium.

# BULLISH OPTIONS STRATEGIES FOR LOW-VOLATILITY MARKETS

Low volatility means call options are "cheap." This minimizes our initial cash outlay and risk and positions us for a potentially profitable spike in volatility, while minimizing the risk of volatility falling further.

## LONG CALLS

Buying calls is the most basic, but perhaps most powerful of options strategies. We want to buy calls in lower volatility environments.

Why? Because low volatility means call options are "cheap." This minimizes our initial cash outlay and risk. It also positions us for a potentially profitable spike in volatility, while minimizing the risk of volatility falling further.

Check out the risk-reward profile of a 25-delta long-call position (a \$1 change in the price of the stock generates a 25-cent change in the price of the options):



Note the limited risk and potentially unlimited gain – the power of leverage!

# MANAGING A LONG CALL POSITION

We can always set a stop loss level to exit the option if we so choose. Remember, our risk is already defined.

Next, we always remove our original risk capital when call value doubles. As our position approaches expiration, we should exit out-of-the money calls. Remember, options values tend to decrease at an ever-increasing rate as we get closer to expiration. Theta is our enemy!

If our calls are in-the-money as expiration approaches, we treat the position like a stock, using near-term support levels. Keep an eye on any near-term support (such as 5-day lows) and look to hold these calls as long as we can. Close the position whenever this trailing support level is broken.

## BULLISH OUT-OF-THE-MONEY CALL CALENDAR SPREADS

An out-of-the-money call calendar spread consists of two legs: a short call nearest to expiration (1), and a long call further to expiration at the same strike price (2).

This strategy minimizes our initial cash outlay and risk, which is an especially nice feature if we're trying to trade a higher-priced stock.

The calendar spread also positions us for a potentially profitable spike in volatility. Plus, it gives us a bonus second scenario to make unlimited profits after expiration of the short options.

Take a look at the risk-reward profile of a bullish OTM call calendar spread:



With this trade, we have limited risk and a wide profit zone.

# MANAGING A CALL CALENDAR SPREAD

Similar to a long call position, we may set a stop loss level to exit if we choose. Again, risk is defined.

We would then exit the trade if the stock touches strike prices before expiration of the short option.

For a bonus exit scenario, if the short option expires worthless, then the remaining long call observes the same rules for a normal long call trade going forward:

1. When approaching expiration (generally inside 21 days), exit OTM calls.
2. If calls are ITM, treat the position as you would a long stock position and exit at violation of near-term support.

In high-volatility environments, we're also looking at shorter duration expirations. Typically, 45-55 days to expiration (DTE) is the sweet spot.

# BULLISH OPTIONS STRATEGIES FOR HIGH-VOLATILITY MARKETS

When volatility is high, markets are choppy. High-volatility markets are not a time to be aggressive!

Instead of swinging for the fences, we should look for high-percentage base hits. Stay selective with our trades while the market is in flux and play stocks or ETFs we're comfortable owning for the long-term. I prefer to seek out dividend paying names, large-cap socks.

In high-volatility environments, we're also looking at shorter duration expirations. Typically, 45-55 days to expiration (DTE) is the sweet spot.

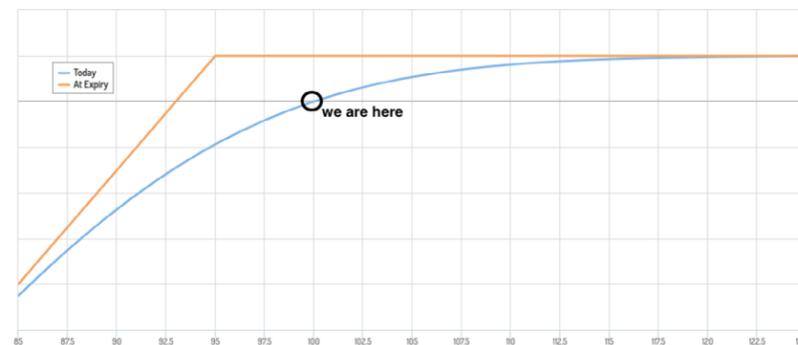
# NAKED SHORT PUTS

Naked short puts allow us to still make money, even if we don't get the directional move right. They put the high premiums of a volatile environment to work for us.

A naked short put requires margin. For a lower risk alternative, we can add a cheap, far OTM long put to limit our margin requirement.

Position sizing rule of thumb: Limit the cost of that stock to 10% of your portfolio value, in the event we were to get "assigned" stock.

Check out the risk-reward profile of a 25-Delta short put position:



Note the theoretically unlimited risk and limited gain. But the trade offers a wide margin for error if the market doesn't cooperate.

## MANAGING A NAKED SHORT PUTS POSITION

For a short put position, it's crucial to set a stop loss level and stick to it!

We cover the trade when 50%+ of credit can be captured. If we're still holding the position when expiration approaches, we'll exit the position and take the small win or small loss. Or, we can roll out to the next month for further credit, while still observing our original profit target.

## BULLISH RISK REVERSAL

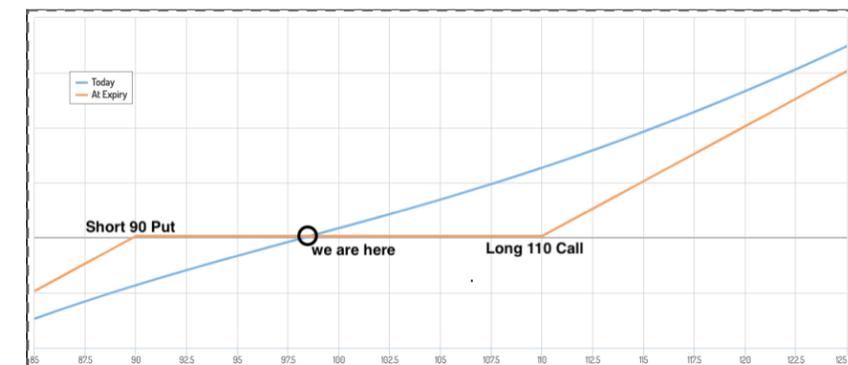
A bullish risk reversal is an aggressive twist to a naked put play. For this trade, we're putting high premiums to work for us to leverage into "cheap" or "free" long calls. Like a naked short puts position, this also requires margin.

In five possible scenarios, only one loses money (if we're patient).

The spread consists of short naked puts and an equal amount of long calls. Ideally, the credit from the short puts fully offsets the cost of the long calls so that we actually collect a small net credit for the trade.

Generally, we target 25-delta calls. And we sell whatever put strike will cover the cost of these calls.

We'll size our position such that if we were to get assigned against our short puts, then the debit to purchase the stock equals no more than 10% of our portfolio equity.



## HOW TO MANAGE A BULLISH RISK REVERSAL

The short puts strike is the stop loss level. Once again, it's important to stick with our stop loss.

When moving higher, we'll look for an opportunity to sell half of the long calls, using the proceeds to close the entire short puts leg. This removes all risk!

When approaching expiration:

1. If both Calls & Puts are OTM, then we'll let them decay to near zero and close, or hold to expiration and let them expire worthless. Any original credit received when we initiated this trade remains in our account.
2. If the calls are ITM, we'll treat as long shares of stock and close the entire position on any breach of near-term support.

## BULL CALL SPREAD

A bull call spread reduces our risk of long exposure by lowering costs. We can use this strategy when we're feeling bullish, even though the trade's upside is capped.

To trade a bull call spread, we purchase calls at a lower strike while simultaneously selling calls at a higher strike with the same expiration. By doing this, we cap our upside in exchange for a lower cost of putting on the trade.

Here's the risk-reward profile for a bull call spread:



## MANAGING A BULL CALL SPREAD

We look to close the spread for a profit whenever we can capture 50% of the total possible profit in the trade. We have no interest in holding this position all the way to expiration, which would needlessly expose the trade to a reversal in an attempt to squeeze out extra gains.

# BEARISH STRATEGIES FOR HIGH-VOLATILITY ENVIRONMENTS

Bear markets can be extremely difficult to trade. They are notorious for high volatility – in both directions. Bear market bounces can be vicious, and directional moves to the downside happen very quickly.

In a volatile bear market environment, we generally want to week out shorter duration expirations for our trades.

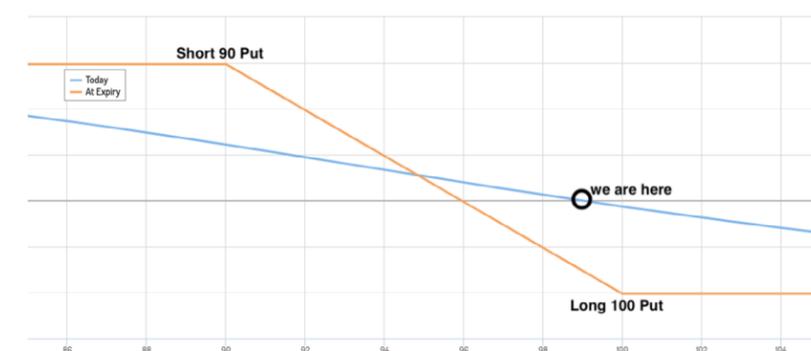
## BEAR PUT SPREAD

A bear put spread is best utilized if our analysis strongly suggests lower prices in the near term. This strategy is a debit spread, which means we will be buying and selling options at different prices, resulting in a net debit in our account.

A bear put spread is an aggressive directional bet and carries a risk of 100% loss – so as always, we'll size our trade accordingly.

Typically, we'll want to purchase a slightly ITM Put, while selling a 25-Delta put. Risk is defined at the cost of upside being limited.

Here is the risk-reward profile:



## MANAGING A BEAR PUT SPREAD

We must accept the possibility of a 100% loss and size the position accordingly. We'll cover the trade when 50%+ of the maximum available profit is captured (or sometimes when we double the premiums we paid).

If we're still holding when approaching expiration:

1. We will exit the position if OTM (might not be much left to salvage). Or,
2. We'll hold out for your profit target if the stock is between strikes (the long put is ITM).

## BEAR CALL SPREAD

A bear call spread is a more cautious bet compared to a bear put spread. This strategy is most effective if our analysis determines the stock may soon see a pause or slight pullback. The trade can also post a profit if the underlying moves sideways.

To initiate the trade, we will want to sell a slightly OTM call, then purchase a 25-Delta call, netting us a credit in our account. Our risk is defined at the cost of upside being limited.

Here's the risk-reward profile of a bear call spread:



## MANAGING A BEAR CALL SPREAD

Once again, we have to accept the possibility of 100% loss of margin and size the position accordingly.

We will cover the trade when 50%+ of credit can be captured. Don't be greedy.

If we're still holding when approaching expiration:

We will consider "rolling" the position to the next expiration month, but only if it can be done for a net credit.

If above is not possible, we will close the trade (win or lose).

# BEARISH STRATEGIES FOR LOW-VOLATILITY MARKETS

Actionable bearish setups are rare in a low-volatility environment. But because the market doesn't give us these trades very often, they tend to be exceptional setups when we find them.

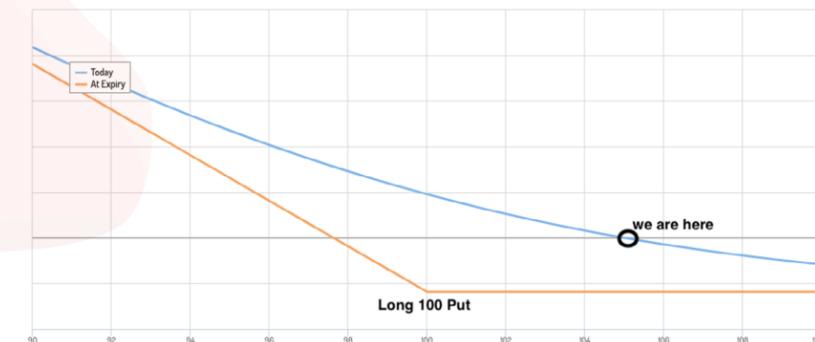
The goal of a bearish trade in a low-volatility environment is to benefit from both direction and volatility expansion. As an added bonus, low volatility affords us longer-duration trades.

## LONG PUTS

Long puts are an aggressive directional bet with defined risk and "unlimited" upside. A long put position benefits from a likely rise in volatility and works best if our analysis indicates an under-appreciated risk in the underlying.

For this trade, we once again look to purchase a 25-delta put. Our risk is then limited to the cost of the put.

Here's the risk-reward profile of a long put:



## MANAGING A LONG PUT

We must accept the possibility of 100% loss and size our position accordingly. We will plan to sell half when the price of the put doubles. This removes our original risk capital from the trade.

If we're still holding any or all of the position when it approaches expiration:

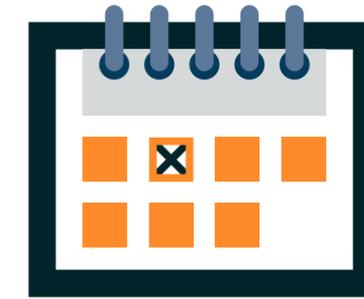
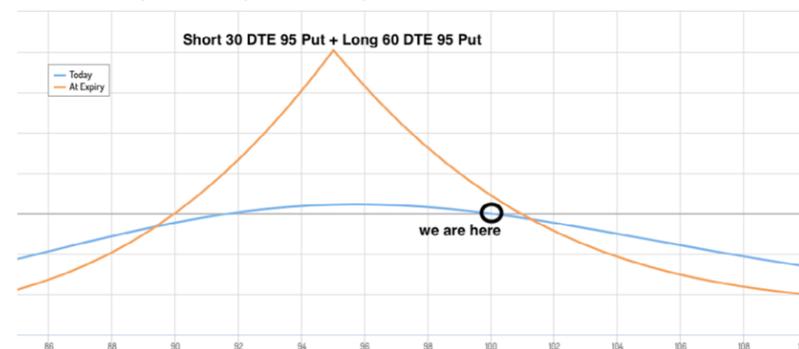
We will exit the remaining position if OTM (might not be much left to salvage).  
If ITM, we will exit at the first break of near-term upside resistance.

## PUT CALENDAR SPREAD

A put calendar spread benefits from both a directional move and a likely rise in volatility. Once again, we're dealing with a directional bet with defined risk. A put calendar spread works best when we're bearish but not expecting a dramatic fall (ex. bankruptcy risk).

To set up a put calendar spread, we're looking to short a put in a nearer expiration while simultaneously buying a long put in a further expiration, resulting in a net debit in your account.

Here's the risk-reward profile for a put calendar spread:



## HOW TO MANAGE A PUT CALENDAR SPREAD

Our risk is limited to the debit we paid at initiation.

There are two profitable exit scenarios:

1. We exit the entire position when underlying trades to or near the strikes.
2. If short puts expire worthless (underlying never went to or through the strike level), then we're left with a naked long put in the back month expiration series. We'd look to hold this put into the expiration month, giving us two final ways to close the trade:
  - a. Close the long puts if they are OTM.
  - b. If ITM, close at an upside break of near-term resistance.

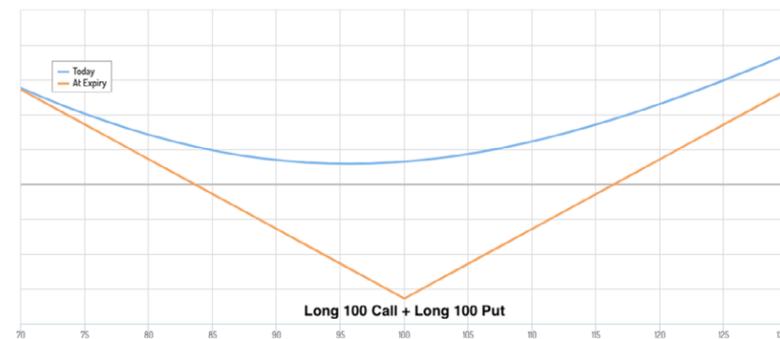
# LONG STRADDLE

A long straddle is delta neutral – and can win in either direction if the move is large enough. This is an aggressive, omni-directional bet that benefits from a rise in volatility.

A long straddle works best if our analysis is revealing an under-appreciated risk of a sudden and dramatic move.

To initiate a long straddle, we purchase an equal number of calls and puts at the same strike. Then, we simply observe profit potential in either direction.

Here's the risk-reward profile of a long straddle:



## MANAGING A LONG STRADDLE

Our risk is limited to the debit we paid at initiation. Trade management rules somewhat mirror those for long puts or long calls.

We will close half of the entire position if we achieve a double (removing our original risk capital), then hold the rest. When we get inside the expiration month, we will close the winning side when near-term support or resistance is broken. (And we'll keep the losing side for a cheap lottery ticket).



# Putting it All Together

## DEVELOPING YOUR OPTIONS TRADING PLAN

Now that we have the tools at our disposal to play options in any market environment, it's time to trade!

First, we'll need to analyze market conditions to select the appropriate strategy. Are we bullish, bearish, or neutral?

Our next step is to determine volatility in the instrument relative to where it has been. If volatility is high, we will choose strategies that benefit from mean reversion. If volatility is low, we have the opportunity to choose more aggressive strategies.

## POSITION SIZING

Proper position sizing is crucial in our quest for consistently profitable trading. No one trade should have the potential to wipe out your account! A good rule of thumb is to size defined-risk trades to no more than 1-2% of equity. Preferably less.

In undefined risk trades, size the position such that an unlikely worst-case scenario would have a less than -2% impact on our entire portfolio. When in doubt, always go smaller.

Trading small will help us manage our portfolio and emotional volatility, keep us in the game, and allow us to put on more trades. This lets the unique edges in each trade compound in our favor.

## PORTFOLIO CONSTRUCTION

All else being equal, when choosing between two or more possible new positions, we'll often choose the one that gets our Greeks closer to neutral. This minimizes "Market Risk," allowing the edges in each trade to play out to our benefit.

Delta risk is probably the top Greek I most try to manage -- at a portfolio level. Short SPY call vertical spreads or put vertical spreads offer easy delta diversification. These are credit spreads that pay off even in a sideways market.

Also, whenever possible, we try to have a healthy mix of expirations.

These are not requirements, only suggestions. In time, we develop strategies that will fit our unique trading strategy.

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## SEAN MCLAUGHLIN

Sean is the chief options strategist at All Star Charts. He began his trading career in 1998 at a Proprietary trading firm in Tampa, Florida. In his first four years, he was engaged in intraday scalping – primarily NASDAQ stocks – during the final blowoff top of the “dot com bubble” and subsequent tech & internet stocks crash. He has spent the remainder of his now 23-year trading career unlearning all of the bad habits acquired during those first four formative years. During Sean’s career, he has launched a small hedge fund with a handful of investors to execute a trend-following strategy in commodities and financial futures, tried his hand at trading electronic mini-Dow futures at the CBOT, and built options strategies to express his opinions of markets and stocks direction in defined-risk “bets” with advantageous leverage opportunities.



## JC PARETS

JC Parets is one of the most widely followed Technical Analysts in the world, and the founder of All Star Charts, a research platform for both professional and retail investors covering US and International stocks, interest rates, commodities, and forex markets. JC is featured regularly on Bloomberg, CNBC, Fox Business, ABC, CNN, Wall Street Journal and many other financial media outlets around the world. His popularity, knowledge, and ability to accurately and effectively simplify a complicated topic have made JC one of the most accomplished Chartered Market Technicians in the world. That’s why he speaks about Technical Analysis and Behavioral Finance at conferences internationally, as well as locally at institutions including Harvard, Duke, NYU, the University of Chicago.



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