

Mark's Top 5 Trading Commandments

Hey Traders,

I'm not going to sit here and pretend like I know it all ...

But I will say ... I've literally written the book on options (two of them!), and after 20 years in the biz, I've learned a few things.

Now, I can't impart 20 years of trading experience into your brain all at once, in one single article ... or even a couple books. There's just *so much* to learn, and so many different approaches you can take to trading, I couldn't begin to give you an all-inclusive "how to trade" guide.

But I have learned a few rules that I always follow -- and I think you should, too.

And those are what I'm going to share with you today.

1. Know Your Vol

It should come as a surprise to no one that I'm preaching the importance of following volatility in your trading.

After all, I was literally in the room as the CBOE Volatility Index (aka the VIX, aka the "fear gauge" of the market) was created!

Volatility is such an important part of trading, but too many traders simply don't understand what it is, or don't understand how they can use it to profit.

That's part of why I publish my daily VIX Edge newsletter -- to help traders understand what's actually going on in the market. Each trading day, I email out commentary and the latest Option Pit VIX Traffic Light reading to help traders just like you turn the VIX into their own trading edge. If you're not already subscribed, [you can do so by clicking here](#). (Did I mention it's totally free?)

Now, there's two basic kinds of volatility out there: historical volatility (HV) and implied volatility (IV).

Historical volatility is volatility that has already occurred, and usually compares a stock's price from close to close (although you can measure a stock's intraday volatility as well, but I'm not going to get *too* into the volatility weeds here). Looking at HV can give you an idea about how dramatically a stock's price is fluctuating, and comparing HV over different periods of time (such as 10-day, 20-day, six months, and so on) can help you determine if the stock is currently more or less volatile than usual.

Implied volatility is forward-looking -- that is, it is a measure of how much volatility is expected going forward. As an options trader, implied volatility is something you really need to be aware of, as it has a huge impact on the price of options. Higher IV generally indicates more uncertainty in an equity, and therefore a greater demand for options.

Plus, the more likely it is we will see movement out of a stock, the more likely an option is to end up in-the-money. Therefore, high IV translates to more expensive options.

You can also compare HV to IV to check whether future volatility is expected to be higher or lower than normal.

It is important to note that volatility is not directional. High IV or HV doesn't indicate that a stock's price will be going up or down, just that it is likely to move in one direction or the other.

Volatility also tells us a lot about trader sentiment towards the market at large. The VIX measures the 30-day volatility expectations for S&P 500 options. When traders are more uncertain about future market conditions, they're more likely to hedge their portfolios using S&P 500 options. Therefore, higher uncertainty in the market pushes the price of S&P 500 options higher, which in turn pushes the VIX higher.

The VIX isn't the only volatility index out there -- many sectors, commodities, and even individual stocks have their own volatility index. For example, oil volatility is measured on the CBOE Crude Oil Volatility Index (Ticker: OVX), and the CBOE Apple VIX Index (Ticker: VXAPL) measures the IV of Apple options!

2. Know Your Risk, Know Your Reward

Now, risk management is somewhat of an art form in and of itself.

So without getting too granular, the most important basics for you to know are: managing your capital allocation, and knowing what gives your trade an edge.

Smart money management is absolutely paramount when it comes to trading options. I've been trading for years, and you still won't see me betting a big chunk of my portfolio on any single trade, no matter how certain I am that it will make me money!

The trader who lives to trade another day is always the winner compared to the trader who gambles away their entire account, and ends up with nothing!

You have to decide for yourself what your own trading risk tolerance is, but generally, it is recommended that you put no more than 5% of your trading capital into a single trade.

Of course this will vary depending on the size of your portfolio -- if you're trading a \$5 million portfolio, then 5% may be way too much to sink into one trade. Or, alternatively, if you're trying to trade a \$1,000 account, you may need to allocate a bit more to enter your position.

One thing that it is crucial to keep in mind is some options have unlimited risk, such as selling naked calls. In this case, it is crucial you closely monitor your position, and know what your "emergency eject" button is (such as setting a stop-loss).

Not only is it important to know your own risk exposure and tolerance (and give yourself a solid foundation in risk management techniques), but you should also know going into a trade why you expect a reward -- in other words, what gives your trade an edge over other traders?

What's the "why" behind this trade? Is the potential reward worth the potential risk? And further, how much 'reward' are you going for? You should always know your profit target ahead of time, and avoid getting greedy when you hit it.

3. Don't Let The Greeks Get Away From You

Ugh, I know -- the Greeks. By now, hopefully you've at least heard terms like 'delta' and 'gamma.'

And as much as you may not want to ... you *need* to learn what these are, and their potential impacts on your trading.

The Greeks can be complex, but they are important, and neglecting them is one way you can end up with catastrophic losses.

Here's a very brief, ELI5 explanation of each of the Greeks:

- **Delta:** Delta refers to how a \$1 move in the underlying stock will affect the price of an option. For example, if an option has a delta of 0.5, a \$1 move in the stock means the price of the option will change by \$0.50. People also use delta as a "back of the napkin" way to gauge the probability that an option will end up in-the-money -- so a 0.5 delta option has about a 50% chance of ending up in-the-money. (However, this is a *very* rudimentary estimation!)
- **Gamma:** Gamma measures the rate of change of delta for each \$1 change in the underlying. So if an option on XYZ has a delta of 0.5 and a gamma of 3, then a \$1 increase in XYZ stock price means the option now has a delta of 0.53. Or, if the price of XYZ stock falls \$1, the delta is now 0.47. The closer an option is to being at-the-money, the faster the delta will change, and the higher the gamma of that option. Options that are further in-the-money or out-of-the-money will have lower gammas. I suggest reading up on gamma, because incorrectly managed gamma exposure can be *disastrous* for your trading account.
- **Theta:** Theta measures the time decay of an option -- or how much time value an option loses for each day that passes. So if a \$2.00 option has a theta of -0.02, then after one trading day that option will now be worth \$1.98, after two trading days \$1.96, and so on (of course, theta itself will also change as an option nears expiration).
- **Vega:** Vega measures how sensitive an option is to a change in the underlying's IV. For example, if the IV of a stock goes up 1%, a \$2.00 option with a vega of 0.15 will now be worth \$2.15. On the other side, if the IV declines by 1%, the \$2.00 option will now be worth \$1.85. Vega declines the closer an option gets to expiration, and increases the closer an option is to being at-the-money.

There's way more to the Greeks than this, but this should give you a basic handle on what each Greek means for your trading. Like I said, it's important to familiarize yourself with how each Greek operates, and how they can affect your portfolio.

4. Have A Plan, Even When You Don't Have A Plan

You need to have a trading plan going into every trade you take. Point blank, period. That includes knowing what you're looking for, and what you're going to do if things don't go as planned.

For example, it's important you have a target profit in mind before you enter the trade. Once you're in the heat of the moment, it is way, way too easy to get greedy, and end up losing it all instead of walking away with a profit! (*Ask me how I know.*)

Similarly, you need to know what your limits are if a trade starts to go sideways. Will you have a stop-loss set? How long are you willing to give this trade to turn around? How big of a loss are you willing to take on this trade before it's just not worth it?

But here's something a lot of people don't do -- you need to have a plan *for not having a plan*.

Even the most meticulous trade plans can't account for every possibility -- so what do you do when something totally unexpected happens?

You should be able to step back from the trade, and reevaluate and analyze the situation. Knowing your own trading process and flow means you'll always have a plan -- even when you don't have a plan!

5. Don't Go It Alone

I know trading can be a very individual process, and it doesn't necessarily lend itself to person-to-person interaction.

But one of the most important pieces of advice I can give you is to find someone to talk through your trades with you.

When you're wrapped up in the heat of the moment, and it's your money on the line, it can be too easy to lose sight of the forest for the trees. You may be tempted to bet big on a half-baked trade idea, simply because you're too close to it to see potential holes in your plan. Having another trader, or trading mentor, can bring another point of view and a fresh pair of eyes to the table to help you spot the weaknesses in your trade.

Find a friend or an online community (*not WallStreetBets!*) that you can "talk stock" with -- you'll be glad you did.

I regularly turn to fellow Option Pit trader Andrew Giovinazzi to help me evaluate my own trades, and the value of having input from other traders is why we have such a die-hard

group of traders in our Pro chat room every single day. (If you want to learn more about our Pro program, give our Customer Care Team a call at (888) 872-3301.)

No one can guarantee success in trading options (if they do, they're lying!). But I *can* promise you that following these five rules will definitely increase your chances at success.

Trade smart, and live to trade another day!

Your Only Option,

Mark Sebastian