

Necessary Options Investing Information

by Mike Restivo

Almost all introductions to options investing provide definitions and strategy, but omit the very necessary explanations of the real world applications of options. Paper or theoretical profits are the best profits but unrealistic ones. Education must concentrate on real world circumstances and realistic outcomes of either profit or loss.

For investors and speculators alike, the markets available are in descending order of size: forex, bond, stock, options and futures. The size of a market is its liquidity, giving the investor the ability to enter and exit a market with descending ability of ease. The smaller the market, the harder it is to make a buy, as the “spread” or “difference between the average selling price and the average buying price” may be relatively large, such that the spread will have a significant effect upon the actual cost of a buy.

For example, a stock listing from either a delayed quote or streaming feed quotation system may indicate the selling price, called the “ask” price is \$39.55 and the buying price offered, called the “bid” price is \$38.22. These are average prices. The spread in theory is $\$39.55 - \$38.22 = \$1.33$. Notwithstanding how “fair” the asking price may be, an investor’s return must be based upon the bid price at the moment the buy order is entered into the stock exchange system by a stock broker.

So consider a sell order is made “at the market” and in consideration that the spread is not too wide or is otherwise acceptable. The seller accepts that the actual sold price may be a little different from the indicated “sell” price. On the typical board lot of 100 shares traded, that theoretical or indicated or quoted spread was $100 \times \$1.33 = \133.00 dollars which is a not insignificant sum. On 500 shares the spread is $500 \times \$1.33 = \665.00 . Also brokers’ commissions to buy must be added which are typically \$28.00 per trade for an investor with minimal trading frequency. Finally the theoretical spread is indicated on 500 shares as $\$665.00 + \$28.00 = \$693.00$.

What if the actual spread is wider, that is the buy price was a little greater than indicated in the stock quote? The buy position obviously costs more than anticipated, but on average not much more than anticipated, depending on the volatility of the stock on that day. If the price of the stock is rapidly rising or falling, the bid-ask spread will widen more than indicated as even a few minutes can allow trading volumes to move the spread apart or narrow more. The difference from the anticipated spread and the actual cost to buy, or profit to sell can be not insignificant to the degree that a small theoretical profit can be easily erased in a fast moving market in as little as a few hours or days.

The take home lesson is that: both costs, losses and profits must be net of all associated expenses: borrowed cost of money, commissions and bid/ask spread. Given these real world constraints, any option investing or trading strategy must be carefully measured for net profit or net loss, not restricted to theoretical profits ignoring bid/ask spread, commissions and borrowing costs. Simply, market participants, due to liquidity constraints, are almost never willing to trade the investor exactly for a given position as profitably as in theory or as quoted even in real time.

Similarly, losses upon sale and costs to buy are always greater in proportion to the volatility of the stock at the time of trade. Volatility is called “beta” and has a significant effect on any trade for investors and speculators alike. No options strategy can be complete without taking beta of the underlying stock and of its option also into account. Given the much smaller market in options, the bid/ask spread difference is proportionately greater than that of the stock market and influences net options returns to a greater amount .

Razor thin profits or losses are not to be found in any environment of comparatively large bid/ask spreads and high volatility of both the underlying stock and its options.

Given the forgoing attention to the factors affecting real profits or losses in addition to theoretical or so-called “paper” trades, investors concentrating on long term positions and speculators concentrating on short term positions require that risk of all kinds be minimized. The risk of most concern is so-called market or systemic risk. That is to say, the object of most trading strategies is the minimization of systemic risk. What of other associated risks?

There is liquidity risk and financial risk involved with the fundamentals of the underlying stock. The measure of stock market and option market sentiment is rendered via graphical charts and interpreted in so-called technical analysis (TA). The premises of TA are of importance in conceiving of a practical model of equity market behaviour:

All the trader needs to know about a stock or option is represented by its charts for daily, weekly, monthly and yearly trading volume performance. Additionally, averages over 200 days or less are superimposed on the performance charts.

The performance of stock and options is “mean seeking or centered about its average price”. Thus, the 200 day moving average is the baseline for a given stock or option.

These two TA principles are based upon the economic principle that equity performance is a summary or average of market participants who have already, as rational agents, included so-called fundamental and financial analyses of equities in their selections and dispositions. It is then necessary to understand that the numbers of performance charts represent market participants’ preferences.

These preferences are not necessarily rationally based, contrary to a fundamental mathematical and economic model called the Capital Asset Pricing Model, which stipulates that all market participants are rational agents. Furthermore these preferences are not necessarily transitive: A implies B. B implies C. Therefore logically A implies C transitively. Trading preference is not determined thusly by logic alone, but largely influenced by human psychology also as in speculator versus investor mindset.

Pragmatically, TA inclined traders need only follow equity market trends up, down and neutral or “sideways”, rather than shoehorning the market observed performance into a particular theoretical mathematical model. With all due respect to theoretical models, including so-called quantitative analysis, TA encapsulates any underlying mathematics qualitatively and quantitatively as a practical consequence of merely recording the sales volume, with no prognostications, expectancies, odds, calculus, probability and statistics needed to produce optimal outcomes.

Charts, including historical data for a fee, ready to be interpreted by TA, are freely available to investors and traders by stock market and options market services online.

Online strategies exist, involving combinations of options. Presumably such strategies must be toward minimizing risk by managing it. Such presumption is foolhardy. If the authors’ strategies really produced optimal outcomes, then they would be trading to advantage, not internet writing. The precise meaning of managed risk must be comprehended in the context of trading risks. So-called managed risk implies or carries the connotation that risk is minimized or reduced to a level to permit gainful trading.

There is no promise of beating the market or excessive profits, but the implications arise from an unlearned understanding of exactly what the stock and options markets are:

The stock and options markets (and the futures, forex and bond markets) are represented by volumes and prices of trades. The transactions themselves are representative of human preferences not necessarily rational and not necessarily transitive. Market direction up down or sideways/neutral is given probabilistically:

There is probability that a market will rise or descend or remain flat.

The ratio of the probability of gain divided by the probability of loss is called the odds. This is what is at play in all markets, not probability alone, but ratios of probabilities. Certainty, as such, is 2 steps removed, as it were. Methods of so-called risk management may be insufficient to overcome the intrinsic level of risk, which if not properly understood, may falsely appear as if it is managed into minimization.

Text End