



Options Trading Information[©]

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INTRODUCTION

This material assumes that you have a basic understanding of what Option Contracts are, how they work, and the terminology associated with Option Contracts. *If you do not have that basic understanding at this time, Options Contracts may not be a good choice for you.* If you would like to learn more, you may find our “Options Basics Course” helpful. You can find out more about this course by [clicking here](#).

In FollowMeTrades “Stock and Options Picks Service,” we publish the trades that Dean Jenkins is taking in his own account.

The published trades can be traded with either shares of stock, or in most cases, option contracts.

We provide the details to trade either way, i.e., we publish the **Entry** (price), **Stop** (price), and **Target** (price) for the trade based on the movement of underlying security symbol. We also publish, for most of the trades, a corresponding Option Contract with the Expiration Date, Strike Price and Ideal Price entry zone.

The advantages of using Options are as follow;

1. **Capital Efficiency.**

- a. Option Contracts are “Leveraged Instruments” meaning you put up a relatively small amount of capital and control shares with a much higher value.
 - i. E.g., If we are trading AAPL (Apple Inc.) and wanted to buy 100 shares, it would cost about \$16,500 at today’s price. Buying **one** Option Contract, which “controls” **100 shares**, would cost about **\$850**. For \$850, you are controlling and benefitting from the price movement of \$16,500 worth of shares.

2. **Reduced Risk.**

- a. With the method that we use at FollowMeTrades, that we are outlining in this material, our risk is 100% defined and contained to an acceptable level.

*****Note: Not all Option Strategies control risk in this way. Other strategies, notably “Naked Option” positions carry significant risk.***

1.1 BASIC APPROACH TO POSITION SIZING

The “Basic” approach to position sizing, or determining how many Option Contracts to buy, is simple. Our recommendation is to only spend 2% of the trading account on the Option Contracts.

This is a good approach for those who are new to option trading or are unavailable to manage their account during the regular market trading session.

**Note: In section 1.3, we do provide information on how to use a “Conditional Order” to manage an Options Position.*

Here is an example using the Basic Approach:

Trading Account Size = \$50,000. 2% of Account = \$1,000

Option Contract Price = \$500. Buy 2 contracts = $\$500 \times 2 = \$1,000$

***Note: You can round up 10-20%, e.g. if the option contract is \$600, you can decide to buy 2 for \$1,200. This is because using our method, the Option Contract is not going to go to Zero, we will not lose the entire amount because we have stops in place. In addition, we select contracts that are deep in the money and are relatively far out in time. So even if the price of the underlying security gaps through our stop price, the option contract will still retain some value when we exit the trade.*

****Note: Using the “Basic” approach to position sizing will result in relatively small position sizes and smaller gains and smaller losses. As noted, this is a good approach for beginners. Given our typical open positions of about eight trades on average, using this approach will mean that not all of your trading capital will be in the market at any given time.*

1.2 ADVANCED APPROACH TO POSITION SIZING

The “Advanced” approach to position sizing requires the use of an Options Calculator to project what the price of the Option Contract will be at the stop price of the underlying security.

We like to use the free Options Calculator that is available from the CBOE (Chicago Board of Options Exchange).

You can access a free Options Calculator (provided by barchart.com) by [clicking here](#). It would be helpful to bookmark this website for future use. ****Note: providers and URL's change over time. If this link does not work, use Google to find another free source.**

The most common formula for calculating Option Prices is the Black-Scholes Model and the CBOE calculator is based on this formula. The Black-Scholes Model requires several variables for its calculations and the CBOE tool is linked to a database that automatically loads the necessary variables. This is very nice and convenient!

In the video that accompanies this document, we demonstrate how to use the CBOE calculator.

In the “Advanced” approach to position sizing, we want to estimate how much we could lose per contract if the trade fails and the underlying shares hit the stop price. We still adhere to the 2% rule, meaning we want to control the loss of any given trade to no more than 2% of the trading account.

Here is the formula:

Trading Account Size = \$50,000. 2% of Account = \$1,000

Option Contract Purchase Price = \$500

Projected Price of Option Contract at stop price of underlying shares (using calculator) = \$250

Projected Loss per Contract = \$500 - \$250 = \$250 per contract.

Number of Contracts to Buy = \$1,000/\$250 = 4

This is double the size of the “Basic” approach.

****Note: Depending on the trade parameters, this “Advanced” approach may suggest a very large number of contracts to buy. Only trade the number of contracts that you are comfortable with. Use common sense and don't let greed lead you to an inappropriately large position size.***

*****Note: It is possible that the underlying shares may gap beyond the stop price of the underlying shares and result in a larger than projected loss. This needs to be factored into the decision about how many contracts to buy.***

******Note: The projection of future Option Contract price, at the stop price of the underlying shares, is based on the variables at this given point in time. These variables WILL change over time, particularly if there is a major change in price of the underlying shares. It is important to re-calculate the option price projection at least ONCE per week, or after a major move in price, and adjust your position size accordingly.***

1.3 TRADE MANAGEMENT

It is **NEVER** a good idea to enter or exit Option Contract positions using a “Market Order.”

A “Market Order” is telling your broker to “execute this trade at **ANY** price.”

Option Contracts trade at significantly lower volumes than the underlying shares and, at times, can have a large Bid/Ask spread. A “Market Order” can result in having your order filled at a price that you will not be happy with – to say the least.

We always use “Limit Orders” for Option Contracts. A “Limit Order” tells your broker, “I am willing to buy/sell this contract at this price or better.”

Entering New Positions

Look at the current Bid/Ask price for the contract.

Enter a “Buy to Open” order at the current “Bid” price. Your order may or may not be filled.

If it is not filled within about a minute, increase your Limit Price to the next increment.

****Note: Each Option Contract has an increment price based on the underlying share price. It could be \$1, \$5, \$10, etc.***

Raise your Limit price until the order is filled, typically this will be below the current Ask Price. This approach will help you get the best possible entry price.

It should only take a few minutes to get into a new position.

Scaling out of Positions

At FollowMeTrades, we typically “Scale Out” of positions, meaning that we close a portion of the position to lock in profit, but keep a portion in the market to stay with the trend for as long as it will run.

To Scale out of a position, when that alert is given, enter a “Sell to Close” order for a portion of the position, as directed in the alert.

Set the initial “Limit Price” at the current **ASK** price and then increment it downward towards the BID price until your order is filled.

Closing out of Positions

When the latest stop price of the underlying shares is hit, it is **essential** to exit the trade completely, this is to ensure that we limit the loss on the trade.

We recommend having an alert set up with your broker or trading platform so that you are notified when the underlying shares hit the current stop price.

To exit a position, when the stop price of the underlying share is hit, enter a “Sell to Close” order for the entire position.

Set the initial “Limit Price” at the current **ASK** price and then increment it downward towards the **BID** price until your order is filled.

Placing Conditional Orders

You may not always be available to react to an alert, when the stop price of the underlying shares is hit. This is not a problem, you can place a “Conditional Order” so that the trade can be exited automatically without you having to take any action.

Most brokers and trading platforms have the ability to place a “Conditional Order,” or to define a trade “Activation” rule.

You want to have the activation or conditional order based on the current stop price of the underlying shares.

If the stop price of the underlying shares is hit, you need to have a “Limit Order” for the Option Contract position activated.

The “Limit Price” for the Option Contract Order is determined using the Option Calculator discussed in the “ADVANCED APPROACH TO POSITION SIZING” section above.

You need to project the price that the Option Contract will be at, when the underlying shares hit the current stop price, using an Options Calculator.

[Click here](#) to access the CBOE Option Calculator.

Here is an example of a conditional order for a hypothetical short trade:

“If AAPL is greater than or equal to \$180.00, then activate Limit Order to Sell to Close AAPL August '18 Strike \$160 PUT Option at limit of \$4.75.”

You should add some “buffer” to the limit price to ensure your order gets filled when the underlying shares hit the stop. E.g., if the calculator projects a price at the stop of \$5.00, enter a conditional limit order of \$4.75.

****Note: If price gaps dramatically your limit order may not be filled. This is an inherent risk that you must accept with the advanced position sizing approach, your loss may be larger than planned.***

Watch the accompanying video for this training material for a live example of order placement

Feel free to send any questions or comments that you have to: support@followmetrades.com

End of Options Trading Information©

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