Managing Positions and Risk as an Options Trader

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Outline

- Options and Risk
- Different Types of Risk
- Defining Portfolio Exposure
- Rolling Positions
  - Purpose
  - Up/Down/Out
- Managing Margin
- Hedging in the Jungle
  - Volatility Hedges
  - Beta Weighted Exposure
- Morphing the Spread
  - Being Wrong the Right Way

Options and Risk

As Options Traders, we are opening our portfolios to new and unique ways of generating profits; by taking our ideas about different markets and how they will change over time, options give us multiple ways to tackle the problem.

- Toolbelt – Right Tools for the Job

However, with any new tool, there comes a new way to hurt ourselves. Some tools can inflict more damage than others.

We must take time to understand and appreciate how these positions change our risk and exposure to the markets, along with how to apply the right tools when the job requires it.

- Still potential to get hurt (take losses), but over time, we can become more skilled and experienced, ensuring injury is less and possibly having protection for those events.

Different Types of Risk

Option Traders should know the types of Greek Metrics that change the pricing of a single option contract. These provide our foundation of how each change in premium is defined.

- Delta
- Theta
- Gamma
- Vega

Each Option Spread will start with the underlying contract's values added or subtracted to form the aggregate values. As the position evolves, each metric will shift according to the individual contract's exposures, which makes the net position grow or shrink in premium over time.

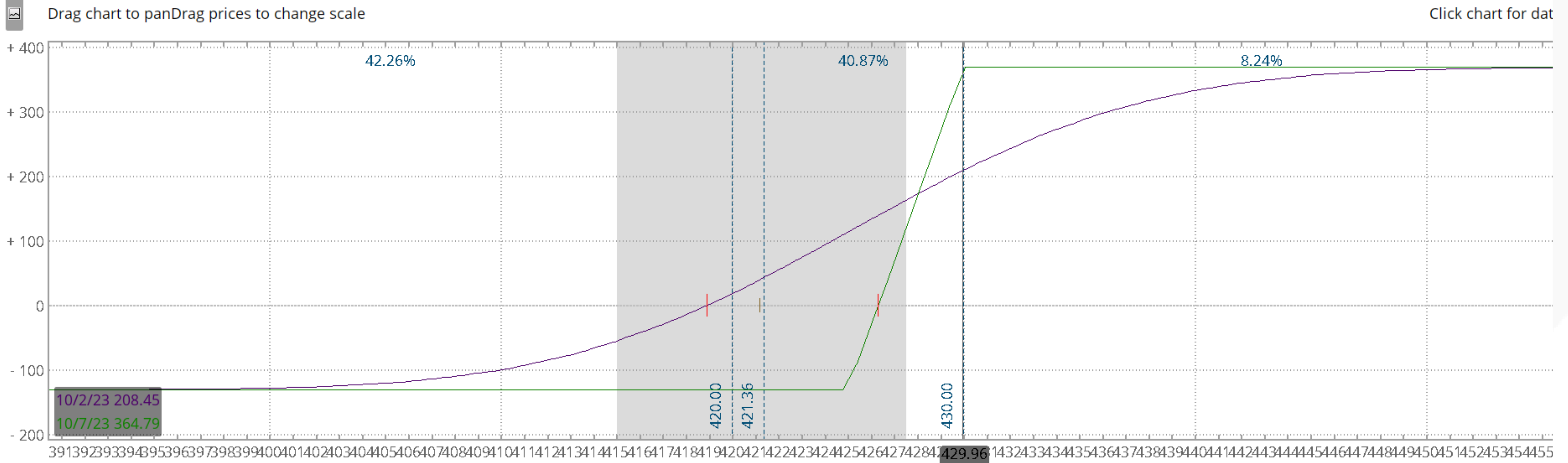
Knowing how different spreads move throughout their lifetime will help us understand how the tool is often used and how it can be creatively applied in certain situations

Example: Verticals

Debit Call Vertical

- Delta is higher on lower strike bought call compared to higher strike sold call on entry.
- Gamma will change each strike's net delta faster or slower depending on the price location
  - Gamma affects bought call's delta fastest as it goes ITM and will have the fastest slope closest to expiration.
- Vega is close to zero, unless there is a wide Volatility Skew between ITM and OTM Strikes in the Series
- Theta can be positive, negative, or zero, with the ideal scenario being the spread has no extrinsic value (bought call theta – sold call theta = 0) and the value of the spread is only the difference in intrinsic value.

Vertical Risk Profile



Defining Portfolio Exposure

How do we understand our portfolio risk exposure when we have multiple positions, all with their own unique dynamics and risk profiles?

1. We can take our total risk exposure using each Risk Component and compare it to one of the benchmark indexes (SPX, NDX, etc)
   - Beta Weighting
2. We can review our exposure compared to related industries and sectors
   - Compare changes in a specific asset’s volatility related to the Sector ETFs or a related index
3. We can accept independent trade risk exposure based on trade plan and thesis.

What actions can we take if we need to adjust our risk?

Rolling Positions

Option Traders are allowed to manage their positions in a unique way: they can move them around!

Rolling is the process of closing an existing options position and simultaneously opening a new one with the same strategy.

We do this for a number of reasons – too much exposure, early assignment, dividend risk on short puts, etc.

Rolling comes with the context of different adjustments:

1. Rolling Up: Swapping out lower price strikes with higher price strikes
2. Rolling Down: Swapping out higher price strikes with lower price strikes
3. Rolling Out: Swapping out shorter-dated strikes with longer-dated strikes.
4. Rolling In*: Swapping out longer-dated strikes with shorter-dated strikes.

Rolling Orders

To execute a roll, most platforms offer special Order Types to execute the trade in one order.

- True for Calls/Puts, Verticals, Calendars/Diagonals, Straddles/Strangles

Certain Spreads require multiple orders as they have too many ‘legs’, so traders will close the initial position first and then open the new position through two separate orders.

9/27/23 12:36:08	VERT ROLL	SELL	-2	TO OPEN	SPY	9 OCT 23 (Week...	420	PUT	-.64 LMT	DAY	FILLED
	RE #6443361...	BUY	+2	TO OPEN	SPY	9 OCT 23 (Week...	418	PUT	DEBIT		
		BUY	+2	TO CLOSE	SPY	29 SEP 23 (Qua...	427	PUT			
		SELL	-2	TO CLOSE	SPY	29 SEP 23 (Qua...	425	PUT			
9/27/23 12:34:47	VERT ROLL	SELL	-2	TO OPEN	SPY	9 OCT 23 (Week...	420	PUT	-.60 LMT	DAY	CANCEL...
	RE #6443361...	BUY	+2	TO OPEN	SPY	9 OCT 23 (Week...	418	PUT	DEBIT		
		BUY	+2	TO CLOSE	SPY	29 SEP 23 (Qua...	427	PUT			
		SELL	-2	TO CLOSE	SPY	29 SEP 23 (Qua...	425	PUT			
9/27/23 12:34:20	VERT ROLL	SELL	-2	TO OPEN	SPY	9 OCT 23 (Week...	420	PUT	-.59 LMT	DAY	CANCEL...
		BUY	+2	TO OPEN	SPY	9 OCT 23 (Week...	418	PUT	DEBIT		
		BUY	+2	TO CLOSE	SPY	29 SEP 23 (Qua...	427	PUT			
		SELL	-2	TO CLOSE	SPY	29 SEP 23 (Qua...	425	PUT			

Managing Margin

Part of the Option Trading Management involves knowing our Margin Exposure to our trades so that we're never in a position of Margin Risk.

Option Margin Requirements are complex and used as collateral to secure a position when writing contracts (selling).

Positions that are open to undefined risk or have a component of the spread that is uncovered need to be managed and monitored carefully for any major shifts in the asset price or volatility.

Positions can be altered to cap any undefined risk or to reduce the margin exposure if required by the broker.

Managing Margin Continued

How can we cap off margin risk?

- Ensure no single trade idea is consuming more than a certain % of our portfolio's margin. Ideally, no more than 10% per position.
- Buying strikes to offset any naked calls or puts in the spreads
  - Can be done using higher/lower strikes in the same series and/or out in time
  - Covering using 'garbage' strikes can significantly reduce margin exposure while not dramatically affecting the position's risk components
- Buying/Selling shares to offset the Delta and Gamma Components
  - Can be done temporarily to cover any major unexpected breakouts or spikes

Interactive Brokers Margin for Options Spreads:
https://www.interactivebrokers.com/en/trading/margin-options.php

Hedging in the Jungle

Hedging is a major topic of discussion in its entirety, so this will be focused on hedging portfolio risk related to index volatility.

How do we buffer a portfolio with a heavy long delta exposure (shares and any option positions) when we expect a market correction or downturn?

Some traders simply exit positions, but if they have a long time horizon, how do we know to re-enter and ensure we haven't affected the trade potential?

How do we add a direct 'long volatility' exposure to a portfolio no matter the market's state?

Volatility Hedges

Given market volatility is often correlated with downside action in price, some traders gravitate towards OTM Put or Put Spreads in a benchmark product like SPX or /ES.

- Cost of Trade: Net Debit of Puts
- Pros: If markets drop quickly, the Put Position will mitigate or cap any downside losses in positions that are highly correlated to the product.
  - Useful for share positions and high Delta Exposure
- Cons: Carrying the hedge will reduce profitability when the product rises or trades sideways, essentially reducing profits over time.
  - Sideways markets can be extremely detrimental as both positions suffer from the lack of direction

Other methods to hedge volatility can be done with Volatility Futures, Volatility ETNs or VIX Options.

VIX Options

Pricing of Options based on Volatility Futures (be sure you fully understand this before implementing).

Entering during times of low volatility and having a wide time horizon (~2-3 months) can offer portfolio protection for any unforeseen market events that lead to SPX volatility expansion.

Favorite spreads include Call Ratio Backspreads and Risk Reversal Strategies

- Ratio Backspread
  - Sell 1 ATM Call Contract
  - Buy 2 OTM Call Contract
  - Net Debit should be ~ 0 or possible collect Credit
- Debit Call Verticals
  - Can buy outright and/or sell Put Verticals against
  - Don't want too much Put Exposure in the overall hedge position

Morphing the Trade

Due to Option Traders unique set of tools, how can we act upon market generated information and keep control of a trade as the market changes?

Classic examples include markets moving faster or slower than expected, large changes in Implied Volatility, price whipsaw, etc.

One of the best methodologies we can learn as short-term Option Traders is how to be wrong gracefully and even how to win when our idea was wrong (i.e. collect credit on entry and keep credit on technical loss)

Being Wrong the Right Way

Spreads such as Ratio Spreads, Unbalanced Butterflies, and Broken Wing Butterflies offer asymmetric Risk Profiles, allowing for certain constructions to collect a credit on open and still offer high reward potential by accepting risk away from the intended price target.

These strategies are great when we have a market thesis that should resolve quickly, allowing for a short-term Option Series to be used, and due to the short timeline, a lack of movement or movement to the target right into the expiration can be managed accordingly.

- Often, if the move happens right around expiration, this is the best case scenario

While these strategies are not a catch-all for every directional idea, they offer unique Risk Profiles that allow traders to think about how to hold directional risk and target key technical areas while not being heavily exposed to time decay AND walking away for free or with change in their pocket for the attempt when wrong.

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