Options Trading for Beginners

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CEO & Publisher

The Diary of a Mad Hedge Fund Trader

A 50 year trading veteran and active Bitcoin miner

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NOTE: Some of this document describes instructions for PAID subscribers to my Global Trading Dispatch service and may be irrelevant to you.

Welcome to the Wonderful World of Options

Hi there, I'm John Thomas, the ***Mad Hedge Fund Trader***. Welcome to my trading desk and your new job of attaining financial independence.

The coffee machine is right over there, and the bathrooms are down the hall. Don't let all the shouting bother you. You'll get used to it after a while.

You've already made one of the best business decisions in your life, signing up for my service. And you won't just be joining me, but an entire community of thousands of successful traders and investors spread around the world in 137 countries.

Some of my best ideas are really coming from them. I just pass them on to you. You should have received your password and full access to my website by now.

So, get started on your homework, learn how the markets function, and figure out how to trade. Soon, you'll have the unfair advantage in the markets that you deserve.

I have issued more than 2,000 trade alerts over the past 12 years so I have a pretty good idea what works for followers.

Every trade alert I issue gives you the choice of buying a stock, an exchange traded fund (ETF), or an option spread.

Since we have been in a bull market for the past ten years, those who bought stock only outright made the most money. Those who used the leverage of the futures markets relied on me for their market timing and delivered the most spectacular profits, and by spectacular, I mean 1,000% in a single year.

However, those who used option spreads earned the most money with the least risk over time. I know when some of you hear the word "option", you want to run a mile.

However, if you are willing to invest of few hours of your time learning about option you will have a trading and investment skill that you can use for the rest of your life. And I'll be doing the heavy lifting for you.

When you subscribed to this service you effectively added 50 years of trading experience on to your own.

The ***good*** news is that options are not that hard to figure out.

If you can turn on a computer, click your mouse, and log into your online trading account, you have all the resources you need to trade options.

All you have to do is get some basic training on how to navigate the options market. Finish this two-hour course, and you will have most of what you need to know.

Better yet, if you implement the options strategies and disciplines that I will teach you, you can tilt the chance of making money overwhelmingly in your favor.

Working together is going to be fun. I have a chair right here for you, so sit down, let's get down to it, and put on some serious money-making positions.

It Not That Hard to Figure Out

What is an option? - The Basics

A stock option is a contract that gives the buyer the right, but not the obligation, to buy or sell a certain number of shares in a company at a specified time at a fixed price.

There are two kinds of options, and they are always defined using the same basic terms.

The terms ***“Calls”*** and ***“Puts”*** tell you whether you have the right to buy or sell the shares of the underlying company.

The ***Ticker Symbol*** tells you which company’s shares the options are on. The ticker symbol for Apple is (AAPL).

The ***Expiration Date*** is when the contract ceases to be valid.

The ***Strike Price*** indicated the price at which you have the right to buy or sell shares.

For example, if you buy <u>***one***</u> of the Apple June 17, 2016 $110 calls, it gives you the right to **BUY** <u>***100***</u> Apple shares at $110/share any time on or before June 17, 2016. If Apple shares then rise, you make a profit. This is a bullish bet.

How to Execute a Vertical Bull Call Debit Spread

We have recently had a large influx of new subscribers.

I have no idea why. Maybe it's my sterling personality and rapier-like wit.

For whatever reason, I am going to update several educational pieces that are core to understanding the ***Mad Hedge*** trading strategy.

Most investors make the mistake of investing in positions that have only a 50/50 chance of success, or less. They'd do better with a coin toss.

The most experienced hedge fund traders find positions that have a 99% chance of success and then leverage up on those trades. Stop out of the losers quickly and you have an approach that will make you well into double digits, year in and year out, whether markets go up, down, or sideways.

For those readers looking to improve their trading results and create the unfair advantage they deserve, I have posted a training video on ***How to Execute a Vertical Bull Call Spread.***

This is a matched pair of positions in the options market that will be profitable when the underlying security goes up, sideways, or down in price over a defined limited period of time.

It is the perfect position to have on board during markets that have declining or low volatility, much like we have experienced in for most of the last several years, and will almost certainly see again.

I have strapped on quite a few of these babies across many asset classes this year, and they are a major reason why I am up so much this year.

To understand this trade I will use the example of Apple trade, which most people own and know well.

On October 8, 2018, I sent out a ***Trade Alert*** by text messages and email that said the following:

BUY the Apple (AAPL) *November* 2018 $180-$190 in-the-money

vertical BULL CALL spread at $8.80 or best

At the time, Apple shares were trading at $216.17. To accomplish this, they had to execute the following trades:

Buy 11 November 2018 (AAPL) $180 calls at………….$38.00

Sell short 11 November 2018 (AAPL) $190 calls at….<u>$29.20</u>
Net Cost:……………………………..……………..….$8.80

A screenshot of my own trading platform is below:

This gets traders into the position at $8.80, which cost them $9,680 ($8.80 per option X 100 shares per option X 11 contracts).

The vertical part of the description of this trade refers to the fact that both options have the same underlying security (AAPL), the same expiration date (November 16, 2018) and only different strike prices ($180 and $190).

The maximum potential profit can be calculated as follows:

+$190.00 Upper strike price
<u>-$180.00</u> Lower strike price
+$10.00 Maximum Potential Profit

Another way of explaining this is that the call spread you bought for $8.80 is worth $10.00 at expiration on November 16, giving you a total return of

13.63% in 27 trading days. Not bad!
The great thing about these positions is that your risk is defined. You can't lose any more than the $9,680 you put up.

If Apple goes bankrupt, we get a flash crash or suffer another 9/11 type event, you will never get a margin call from your broker in the middle of the night asking for more money. This is why hedge funds like vertical bull call spreads so much.

As long as Apple traded at or above $190 on the November 16 expiration date, you will make a profit on this trade.

As it turns out, my take on Apple shares proved dead on, and the shares rose to $222.22, or a healthy $32 above my upper strike.

The total profit on the trade came to:

($10.00 expiration - $8.80 cost) = $1.20

($1.20 profit X 100 shares per contract X 11 contracts) = $1,320.

To summarize all of this, you buy low and sell high. Everyone talks about it but very few actually do it.

Occasionally, **Vertical Bull Call Spreads** don't work and the wheels fall off. As hard as it may be to believe, I am not infallible.

So if I'm wrong and I tell you to buy a vertical bull call spread, and the shares fall not a little, but a ***LOT***, you ***will*** lose money. On those rare cases when that happens, I'll shoot out a ***Trade Alert*** to you with stop-loss instructions before the damage gets out of control.

I start looking at a stop loss when the deficit hit 10% of the size of the position or 1% or the total capital in my trading account.

To watch the video edition of ***How to Execute a Vertical Bull Call Spread***, complete with more detailed instructions on how to execute the position with your own online platform, please **click here**.

Good luck and good trading.

Vertical Bull Call Spreads Are the Way to Go in a flat to Rising Market

Playing the Short Side with Vertical Bear Put Debit Spreads

I am normally a positive person.

For me, the glass is half full, not half empty, and it's always darkest just before the dawn. After all, over the past 100 years, markets rise 80% of the time and that includes the Great Depression.

However, every now and then conditions arise where it is prudent to sell short or make a bet that a certain security will fall in price.

This could happen for myriad reasons. The economy could be slowing down. Companies might disappoint on earnings. "Sell in May, and go away?" It works… sometimes.

Other securities have long-term structural challenges, like the US Treasury bond market (TLT). Exploding deficits as far as the eye can see assure that government debt of every kind will be a perennial short for years to come.

Once you identify a short candidate, you can be an idiot and just buy put options on the security involved. Chances are that you will overpay and that accelerated time decay will eat up all your profits even if you are right and the security in question falls. All you are doing is making some options trader rich at your expense.

For outright put options to work, your stock has to fall ***IMMEDIATELY***, like in a couple of days. If it doesn't, then the sands of time run against you very quickly. Something like 80% of all options issued expires unexercised.

And then there's the right way to play the short side, i.e., ***MY***way. You go out and buy a **deep-in-the-money vertical bear put debit spread**.

This is a matched pair of positions in the options market that will be profitable when the underlying security goes down, sideways, or up small in price over a defined limited period of time. It is called a "debit spread" because you have to pay money to buy the position instead of receiving a cash credit.

It is the perfect position to have on board during bear markets which we will almost certainly see by late 2019 or 2020. As my friend Louis Pasteur used to say, “Chance favors the prepared.”

I’ll provide an example of how this works with the United States Treasury Bond Fund (TLT) which we have been selling short nearly twice a month since the bond market peaked in July 2016.

On October 23, 2018, I sent out a Trade Alert that read like this:

Trade Alert - (TLT) - BUY

BUY the iShares Barclays 20+ Year Treasury Bond Fund (TLT)*November*, 2018 $117-$120 in-the-money vertical BEAR PUT spread at $2.60 or best.

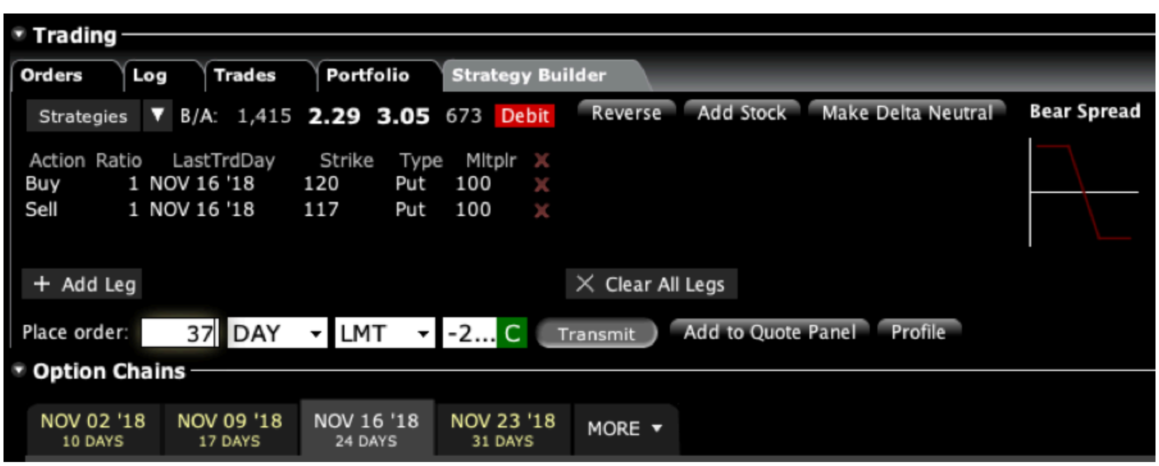
At the time, the (TLT) was trading at $114.64. To add the position you had to execute the following positions:

Buy 37 November, 2018 (TLT) $120 puts at................$5.70

Sell short 37 November, 2018 (TLT) $117 puts at.......$3.10
Net Cost:...$2.60

Potential Profit: $3.00 - $2.30 = $0.40
(37 X 100 X $0.40) = $1,480 or 11.11% in 18 trading days.

Here’s the screenshot from my personal trading account:



This was a bet that the (TLT) would close at or below $117 by the November 16 options expiration day.

The maximum potential value of this position at expiration can be calculated as follows:

+$120 puts
<u>-$117 puts</u>
+$3.00 profit

This means that if the (TLT) stays below $117 the position you bought for $2.60 will become worth $3.00 by November 16.

As it turned out that was a prescient call. By November 2, or only eight trading days later, the (TLT) had plunged to $112.28. The value of the iShares Barclays 20+ Year Treasury Bond Fund (TLT)*November*2018 $117-$120 in-the-money vertical BEAR PUT spread had risen from $2.60 to $2.97.

With 92.5% of the maximum potential profit in hand (37 cents divided by 40 cents), the risk/reward was no longer favorable to carry the position for the remaining ten trading days just to make the last three cents.

I, therefore, sent out another ***Trade Alert*** that said the following:

Trade Alert - (TLT) – TAKE PROFITS

SELL the iShares Barclays 20+ Year Treasury Bond Fund (TLT)*November*, 2018 $117-$120 in-the-money vertical BEAR PUT spread at $2.97 or best

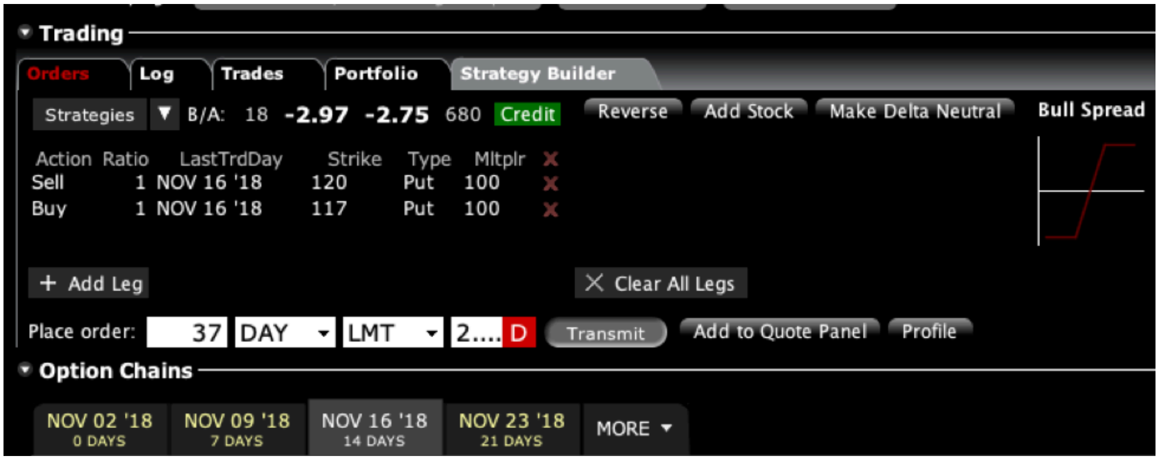
In order to get out of this position you had to execute the following trades:

Sell 37 November, 2018 (TLT) $120 puts at………………$7.80

Buy to cover short 37 November, 2017 (TLT) $117 puts at….<u>$4.83</u>
Net Proceeds:………………………….……..……………....$2.97

Profit: $2.99 - $2.60 = $0.37

(37 X 100 X $0.37) = $1,369 or 14.23% in 8 trading days.

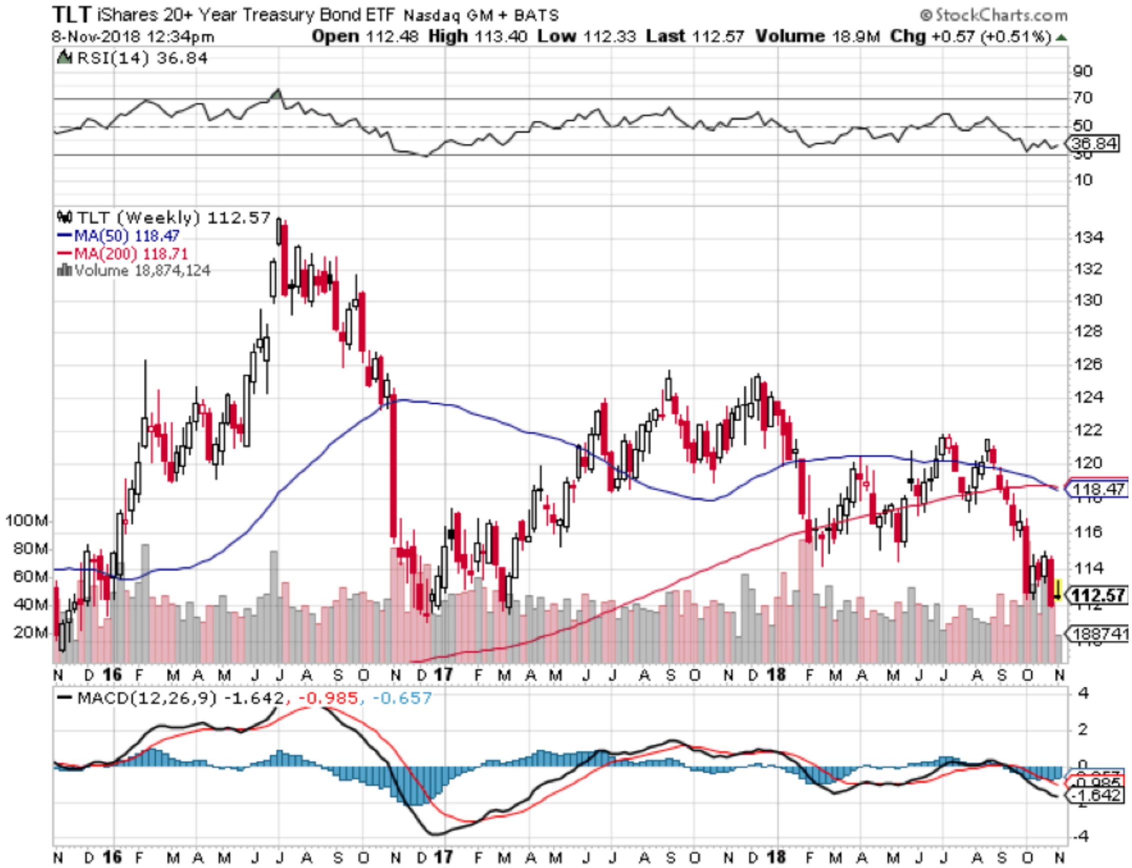


Of course, the key to making money in vertical bear put spreads is market timing. To get the best and most rapid results you need to buy these at market tops.

If you're useless at identifying market tops, don't worry. That's my job. I'm right about 90% of the time and send out a **STOP LOSS Trade Alert** very quickly when I'm wrong.

With a recession and bear market just ahead of us understanding the utility of the vertical bear put debit spread is essential. You'll be the only guy making money in a falling market. The downside is that your friends will expect you to pick up every dinner check.

But only if they know.



Understanding Bear Put Spreads is Crucial in Falling Markets

How to Execute a Mad Hedge Trade Alert

I received a call from a friend the other day.

He said he bought Goldman Sachs last summer, a great move, since it has since risen by 40%. That is until last week, when he got a margin call from Goldman Sachs. It turns out that he didn't actually **BUY** (GS), he **Sold** it short, accidently clicking the bid instead of the offer.

My friend asked if there was any recourse in this situation?

No, not a chance, not in a million years. Brokers are the most sued companies on the planet. They record absolutely everything and have massive teams of lawyers to defend themselves. Even when they mistakenly allocate someone else's trade to your account you only have 24 hours to contest it. After that, you own it.

Oh, if you accidently do the wrong trade and it ***makes*** money it will disappear from your account the second they become aware of it, even if it is months later.

What was the cost of this harsh lesson? $700,000.

So, today, I'm going to teach you how to execute one of my market-beating ***Trade Alerts*** to prevent you from suffering a $700,000 lesson yourself.

Pay attention, because if you have subscribed to ***Global Trading Dispatch*** or ***Mad Hedge Concierge***, you will receive about 200 of these a year. These alerts will bunch up at market tops and bottoms. After that, we may see weeks of no action. Ideal entry points don't happen every day of the year.

Following them is your path to understanding global financial markets.

You will also make a lot of money.

Most important is for you to add my email address to your address book. Otherwise, all my trade alerts will go into your spam filter, where they will disappear forever.

*So please add alert@madhedgefundtrader.com right now to your email address book. To sign up for the **Trade Alert Service** so you can get alerts five seconds after they are issued, please email Filomena direct at **support@madhedgefundtrader.com**. Be sure to put "Text Alert Sign Up" in the subject line.*

Let me show you a real-world example of how to do a round trip on a trade that I issued a few years ago.

First, start trading on paper only. All online brokers now give you the option to trade on paper with pretend money. They will even run a pretend P&L for you. That way, in a moment of excitement when you hit the bid instead of lift the offer, you will lose $700,000 of pretend money, not the real thing.

Here's another hint. Check your positions at the end of every day. I know this can be tedious, but that way, if a surprise $16 million US Treasury bill position suddenly and erroneously ends up in your account (which happened to me last week) you can get on the phone immediately and get your friendly broker to move it into the correct account.

There are two ways to execute a trade: like a beginner, or as a professional. I'll focus on the latter.

You may notice that I send out a lot of trade alerts for options spreads, where I believe the best risk/reward for the individual trader lies. That's because these include a hedge within a hedge within a hedge, which I will talk about another day.

These are illiquid securities which are executed by computer across 11 different online exchanges. These have wide dealing spreads. For example, yesterday I bought the **Tesla (TSLA) *August* 2024 $150-$160 in-the-money vertical bull call debit spread at $8.60 or best. These expire worth $10 in nine trading days.** The bid/offered spread was $8.30-$8.90.

This is how you enter your orders. Split you order into five parts. Then start at the middle market and place limit orders at $8.60, $8.70, $8.80, $8.90, and $9.00. You should get one or two fill at $8.80 and $8.90. If there is an intraday dip in the market, you will get all of them with an average price of $8.80. This is called ***scaling.***

For overseas traders who are asleep when the US markets are open, such as those in Australia, this is a great approach. Just enter your limit orders before the market opens, go to sleep, and dream about how you will spend your profits. When you wake up, your fills are in your in-box. I have followers in Australia who have been with me for a decade or more and they say this approach works like a charm.

Holy smokes! What's that?

That pinging sound from your cell phone tells you the ***Mad Hedge Fund Trader*** has just sent out a ***Trade Alert***! The urgent text alert says:

MHFT ALERT- Buy ETF (TBT) at $57.06 or best, Opening Trade 9-8-2014, wgt: 10% =174 shares, SEE EMAIL

A minute later I receive the following email:

Sender: Mad Hedge Fund Trader

Subject: Trade Alert - (TBT) September 9, 2014

Trade Alert - (TBT)

Buy the ProShares Ultra Short 20+ Treasury ETF (TBT) at $57.06 or best

trade date 9-8-2014

Opening Trade

Portfolio weighting: 10%

Number of Shares: 174

You can buy this in a $57-$58 range and have a reasonable expectation of making money on this trade.

Logic to follow.

Here is the specific trade you need to execute this position:

Buy 174 shares of the (TBT) at……………$57.06

(174 shares X $57.56 = $10,015.44)

So that's how it's done.

You now own 174 shares of the (TBT). That is a bet that bond prices will fall and interest rates will rise.

So let's see how that position worked out over the next several days.

Did you make money? Let's see what transpired in the weeks after this trade alert was issued.

It turned out that the TBT ***was*** the perfect position to take at that time.

Bond prices fell pretty fast, and interest rates spiked up nicely, causing the (TBT) to jump by $2.91 in the following nine days. That works out to a nice little gain of 5%.

By the way, you can pull up these charts anytime you want for free by just going to www.stockcharts.com

What's that? Here comes another text message from the **Mad Hedge Fund Trader**! Better check it out.

MHFT ALERT- Sell ETF (TBT) at $59.97 or best, Closing Trade 9-17-2014, wgt: 10% =174 shares, SEE EMAIL

The following email says:

Sender: Mad Hedge Fund Trader

Subject: Trade Alert - (TBT) September 17, 2014

Trade Alert - (TBT)

Sell the ProShares Ultra Short 20+ Treasury ETF (TBT) at $59.97 or best

trade date: 9-17-2014

Closing Trade

Portfolio weighting: 10%

Number of Shares: 174

Here is the specific trade you need to exit this position:

Sell 174 shares of the August, 2014 (TBT) at……………$59.97

Profit: $59.97 - $57.06 = $2.91

174 shares X $2.91 = $506.34, or 0.51% for the notional $100,000 model portfolio.

So there, you've just made $506 in just 9 days, which works out to 0.51% per $100,000.

You did this never risking more than 10% of your cash at any time.

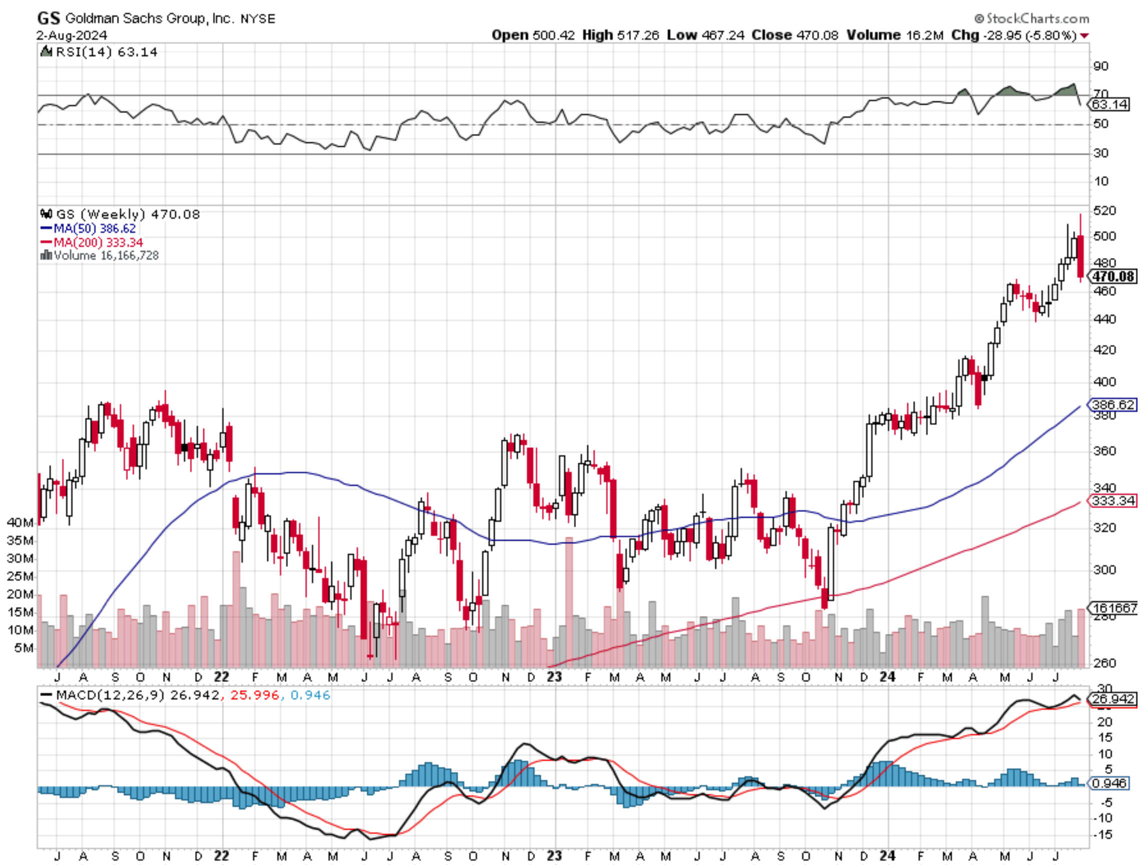
Annualize that, and it works out to 206% a year.

That's how it's done. This is how the big boys do it. This is how I do it.

Of course, not every trade is a winner, and not all do this well so quickly. Sometimes, it requires the patience of Job to see a trade through to profitability. Last year, 90% of my trades made money. The rest I stopped out of for small losses. That's because it's easier to dig yourself out of a small hole than a big one.

But one thing is for sure. You win more games hitting lots of singles. Beginners stand out by swinging for the fences and striking out almost every time.

*So, watch your text message service for the next **Trade Alert**. Watch your email. And you can follow me on your way to successful trading, and to riches.*



Learning the Art of Risk Control

Now that you know how to make money in the options market, I'm going to teach you how to hang on to it. There is no point in booking winning trades only to lose the money by making careless mistakes. So today, I am going to talk about risk control.

The first goal of risk control is to conserve whatever capital you have. I tell people that I am too old to start over again as a junior trade if I lose all my money. So, I'm pretty careful when it comes to risk control.

The art of risk control is the make sure your portfolio is profitable, no matter what happens to the market. You want to be a winner, whether the market goes up, down, or sideways.

Remember, we are not trying to beat an index here. Our goal is the make actual dollars at all times, to keep the P&L chart always moving from the lower left to the upper right. You can't eat relative performance, nor can you use it to pay your bills.

The second goal of a portfolio manager is to make your portfolio bomb proof. You never know when a flock of black swans is about to alight on the market, or a geopolitical shock comes out of the blue causing markets to crash.

The biggest mistake I see beginning traders make is that they are in too much of a hurry to get rich. As a result, they make too much money too soon. I can't tell you how many times I have heard of first-time traders losing all their money on their first trade, well before they got a handle on the basics.

I'm usually right 80% to 90% of the time. That means I'm wrong 10% to 20% of the time. If you be the ranch on one of my losing trades, you'll get taken to the cleaners. Never bet the ranch.

If you do you are turning calculated list into random risk. It is akin to buying a lottery ticket. I often tell clients they have gambling additions. Make sure you're not one of them. You can' trade yourself back from zero with no money.

If you can master the skills which I am teaching you, you can make a living at this ***FOREVER!*** So, what's the hurry? As my old trading mentor used to tell me, the Late Barton Biggs of Morgan Stanley, "invest in haste, repent in leisure," a time-tested nostrum in this business.

I recommend that you use ***NO*** real money on your first few trades. Start with paper trading only. All of the online trading platforms offer wonderful tools that allow you to practice trading before they try the real thing. If you lose their "pretend money", no harm, no foul. They don't want you to go broke either. Broke customers don't pay commissions.

The more time you spend learning trading, the more money you will get out of it. Remember, work in, money out. Spend at least an hour or two getting to know your own trading platform well.

Once you start trading will real money it will become a totally different experience. Your heart rate steps up. Your hands get sweaty. You start checking your watch. It's a lot like going into combat. In fact, combat veterans make great traders, which is why the military recruits so actively from the military. I think all these instincts trace back to our Neanderthal days, when our main concern was being chased by a saber tooth tiger.

The time to learn a trading discipline is ***NOW***. All of a sudden, your opinions, your ego, and your savings were on the line. It's crucial for you to always start small when using real money.

That way, making a beginner's mistake, like confusing "BUY" and "SELL" (I see it every day) will only cost you a cup of coffee at Starbucks, and bot your kids college education, your house, or your retirement. It won't take long for you to grown from one contracts to thousands, as I have done myself for many years.

It's all about finding your comfort level and risk tolerance. You never want to have a position that is so large that you can't sleep at night, or worse, call me in the middle of the night. My answer is always the same. Cut your position in half. If you still can't sleep, cut it in half again.

I make a bold prediction here. The more experience you gain, the faster your risk tolerance goes up.

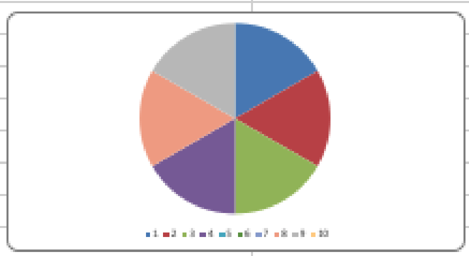
I'll give you one more piece of advice. Take you brokers technical support phone number and paste it to the top of your computer monitor. You don't want to go look for it when you can't figure out how to get out of a position, or your platform breaks. These are machines. It happens. As they teach in flight school, it's not a mater of if, but when, a machine breaks.

There's one more thing. When you'll ready to commit real money, don't forget to take your account off of paper trading. The profits you make can't be spent.

Risk management is an important part of the position sheet I will be sending you every day.

Take a look below at my a recent position sheet I sent out during sharply rising markets, which I update every day.

date:		**September 3, 2019**	**John Thomas**
see notes at the bottom of this spreadsheet			
Mad Hedge Fund Trader			
Model Trading Book			
Asset Class Breakdown			
Risk Adjusted Basis			
Current Capital at Risk			
Risk On			
World is Getting Better			
(AMZN) 9/$1500-1550	**10.00%**		
(FB) 9/$150-$160 call spread	**10.00%**		
(DIS) 9/$115-$120 call spread	**10.00%**		
(MSFT) 9/115-$120 call spread	**10.00%**		
Risk Off			
(WMT) 9/$119-$122 put spread	**-10.00%**		
(IWM) 9/$153-$156 put spread	**-10.00%**		
Total Net Position	**20.00%**		



The important thing to look at here is my long/short balance. On the left is the position name and on the right is the position weighting. I susally run 10% positions so I don't have all my eggs in one basket. Maybe twice a year, I'll run a 20% position in a single stock, and once a year I'll have a 30% weighting. Above that ***I*** start to lose sleep.

I have further subdivided the portfolio into "RISK ON" and "RISK OFF." "RISK ON" means the world is getting better, while "RISK OFF" means the world is getting worse. The long positions have positive numbers, while the short positions have negative ones.

I like to balance "RISK ON" and "RISK OFF" to remove overall market risk from the portfolio. When markets are rising, I tile positive. When markets are falling, I tilt negative. At the bottom I have my total net exposure. On this particular day, I was running 60% in long and 20% in shorts, for a total net position of 40% long. This is an aggressively bullish portfolio.

When I'm bullish, the net position is positive. When I'm bearish the net position is negative. When I have no strong views, the net position is zero. That way, if nothing happens you still get to rake the money in.

I have no positions at all only a few days a year. I only play when the risk/reward is overwhelmingly in my favor, and sometimes that is just not possible.

One more warning to the wise. There are literally hundreds of gurus out there marketing services promising 100% a year, if not a 100% a month, or even 100% ***a day.*** They are all fake, creating by 20-year-old marketing types who have never worked in the stock market, or even traded. Unfortunately, I work in industry where almost everyone else is a crook.

I have worked in the markets for more than 50 years and have seen everything. Ray Dalio is the top performing hedge fund manager in history and he only averages 35% a year. The number of real traders who are right more than 80% of the time you can almost count on one hand. If returns sound too good to be true, they never are.

I want to offer special caution about naked put shorting strategies which are promoted by 90% of these letters. This is where a trader sells short a put position without any accompanying hedge, hence the word "naked." This is an unlimited risk position.

You might take in a $1 of premium with this approach, but if the market turns against you, and implied volatilities go through the roof, your losses could balloon exponentially to $100 or more, wiping you out. The newsletters recommending these have absolutely no idea when or if this is going to happen.

I call this the “picking up the pennies in front of the steamroller strategy.” No professional trader worth his salt will put money into it. It is banned by most investing institutions. And only a few brokers will still let you do this, and then only with 100% margin requirements, because when losses exceed 100% of capital, they’re left carrying the bag.

Many of those strategies you see being hawked online look great on paper but can’t actually be executed. In other words, you just paid thousands of dollars for a service that is utterly useless. Sounds like a “No Go” to me.

Stop losses are an important part of any trading strategy. No one is right 100% of the time. If they claim so they are lying. The best way to avoid a big loss is to take a small one.

There are many possible places to use stop losses. I use 2% of my total capital. If I start to lose more than that I am out of there. It’s easy for me to do this because 90% of the time the next trade will be a winner and I’ll make back all the money I just lost.

Others use a 10% decline in the underlying stock as a good arbitrary point to limit loses. Other’s rely on Fibonacci levels (I’ll get to him later). Many traders rely at key moving averages, like the 50-Day or the 200-day.

The problem with this is that high frequency traders have access to the same charting data as you do. They’ll program their algorithms to quickly take a stock through your stop loss level, buy you stock for cheap, and then take it right back up again to book a quick profit. You are left with a “SELL” confirmation in your inbox and no position in a rising market. No wonder people think Wall Street is rigged.

Another concept is the “trailing stop”. That’s when after an initial rise, you place a stop loss order at your cost. That way you CAN’T lose money. This is known as “playing with the houses money.” This approach has one shortfall. You can't place stop losses int the options market that are executed automatically. The same is true for options spreads.

In this case, you use what is known as a "pocket stop loss" where you set your own mental level on when to get out. Also, these are no automatic, the do establish a trading discipline. Caution: You can't execute a pock stop loss when you're playing gold or on a one-week cruise in the Caribbean.

So, there you have it. By managing your risk prudently, you can tip the risk/reward balance in your favor.

I hope this helps.

Meet the Greeks

Hang around any professional options trading desk and it will only be seconds before you hear the terms ***Delta, Theta, Gamma, or Vega***. No, they are not reminiscing about their good old fraternity or sorority days (***Go Delta Sigma Phi***!).

These are all symbols for mathematical explanations of how options prices behave when something changes. They provide additional tools for understanding the price action of options and can greatly enhance your own trading performance.

Bottom line: they are all additional ways to make money trading options.

The best part about the Greeks is that they are all displayed on your online options trading platform ***FOR FREE!*** So if you can read a number off a screen, you gain several new advantages in the options trading world.

<u>Deltas</u>

The simplest and most basic Greek symbol to comprehend is the ***Delta.*** An option ***delta*** is a prediction of how much the option price will change relative to a change in the underlying security.

Here it is easiest to teach by example. Let's go back to our (AAPL) June 17, 2016 $110 strike call option. Let's assume that (AAPL) shares are trading at $110, and our call option is worth $2.00.

If (APPL) share rise $1 from $110 to $111, the call options will rise by 50 cents to $2.50. This is because an at-the-money call option has a ***delta*** of +0.50, or +50%. In other words, the (AAPL) call options will rise by 50%, or half of the amount of the (AAPL) shares.

Let's say you bought (AAPL) shares because you expect them to rise 10% going into the next big earnings announcement. How much will the above mentioned call options rise?

That's easy. A call option with a ***delta*** of 50% will rise by half the amount of the shares. So if (AAPL) shares rise by 10% from $110 to $121, the call options will appreciate by half this dollar about, or $5.50. This means that the call options should jump in price from $2.00 to $7.50, a gain of 375%.

By the way, did I mention that I love trading options?

(AAPL) June 17, 2016 $110 strike call option

50% *delta* X $11 stock gain = $5.50

$2.00 option cost + $5.50 option price increase = $7.50

<u>Deltas-the downside</u>

Now let's look at the Put side of the equation. Let assume that Apple is about to disappoint terribly in their next earnings report, and that the stock is about to ***FALL*** 10%.

We want to buy the (AAPL) June 17, 2016 $110 strike put option, which will profit when the stock falls. Remember, put options are always more expensive than call options because investors are always willing to pay a premium for downside protection. So our put options here should cost about $4.00.

If we're right and Apple shares tank 10%, from $110 to $99, how much will the put options increase in value?

We use the same arithmetic as with the call options. An at-the-money put options also has a delta of 0.50, or 50%. So the put options will capture half the downside move of the stock, or $5.50. Add this to our $4.00 cost, and our put option should now be worth $9.50, a gain of 237.5%.

Did I happen to tell you that I love trading options?

(AAPL) June 17, 2016 $110 strike put option

50% *delta* X $11 stock decline = $5.50

$4.00 option cost + $5.50 option price increase = $9.50

<u>Selling Options short and deltas</u>

Let's consider one more example, the short position. Let's assume that Apple shares are going to fall, but we don't know by how much, or how soon.

It that case, you are better off selling short a call option than buying a put option. That way, it the stock only falls by a small amount, or goes nowhere, you can still make a profit.

When you sell short an option, your broker ***PAYS*** you the premium, which sits in your account until you close the position.

Short positions in options always have negative deltas. So a short position in the (AAPL) June 17, 2016 $110 strike call option will have a delta of -50%.

Let's say you sold short the (AAPL) calls for $2.00 and Apple shares fell by 10%. What does the short position in the call option do? Since it has a delta of -50%, it will drop by half, from $2.00 to $1.00 and you will make a profit of $1.00.

Here is the beauty of short positions options. Let's assume that (AAPL) stock ***doesn't move at all***. It just sits there at $110 right through the options expiration date of June 17, 2016.

Then the value of the call option you sold at $2.00 goes to zero. Your broker closes out the expired position from your account and frees up your margin requirement.

Sounds pretty good, doesn't it? In fact, the numbers are so attractive that a large proportion of professional traders only engage in selling short options to earn a living.

To accomplish this, they usually have mainframe computers, highly skilled programmers, and teams of mathematicians backing them up which cost tens of millions of dollars a year.

However there is a catch.

When you sell short a call option, you are taking on **UNLIMITED RISK**. The position is said to be naked, or unhedged. Let's say you sell short the

(AAPL) June 17, 2016 $110 strike call option, and (AAPL) shares, instead of falling, **RISE** from $110 to $200, a gain of $90.

Then the value of your short position with the -50% delta soars from $2.00 to $45.00. You will get wiped out. It gets worse. The delta on this option is only 50% for the immediate move above $110. The higher the stock rise, the faster your delta increases until it eventually reaches 100%. You now have a loss that is increasing ***exponentially!***

This is why many hedge fund managers refer to naked option shorting as the "picking up the pennies in front of the steamroller" strategy.

For this reason, brokers either demand extremely high margin requirements for these "naked", or unhedged short positions, or they won't let you do them at all.

If you dig down behind many of the extravagant performance claims of other options trading services, they are almost always reliant on the naked shorting of options. They all blow up. It is just a matter of when.

For that reason, we here at the ***Mad Hedge Fund Trader*** **NEVER** recommend the naked shorting of put or call options, no matter what the circumstances.

We want to keep you as a happy, money making customer for the long term. If you succumb to temptation and engage in naked shorting of options, you will be separated from your money in fairly short order.

(AAPL) June 17, 2016 $110 strike call option

(AAPL) shares rise from $110 to $200

$2.00 short sale proceeds + $90 - $88.00

a loss of 4,400%!!
<u>Theta</u>

All options have time value. This is why an option with a one-year expiration date costs far more than one with a one week expiration date.

The theta is the measurement of how much premium you lose in a day. This is what options traders like me refer to as time ***decay.***

The theta on an option changes every day. For example, an option with a year until expiration is miniscule. An option that has a day until expiration is close to 100%, since it will lose its entire value within 24 hours, if it is out of the money. The closer we get to expiration; the faster theta accelerates. As mathematicians say, it is not a straight-line move.

This is why you never want to hold a long option position going into expiration. The value of this option will vaporize by the day. Unless the stock goes your way very quickly, you will have a really tough time making money.

If you are short an option, this is when you can earn your greatest profits. But you only want to consider a short option position when you have an offsetting hedge against it. That will minimize and define your risk and keep you from blowing up and going to the poor house. We'll talk more about that later.

I could go into how you calculate your own thetas, but that would be boring. Suffice it to say that you can read it right off the screen for your online trading platform.

Implied Volatility

While we're here meeting the Greeks, there is one more concept that I want to get across to make your life as an option trader easier.

You have probably heard the term implied volatility. But to understand what this is, let me give you a little background.

Back in the 1970's, a couple of mathematicians developed a model for pricing options. Their names were Fisher Black and Myron Scholes and they received the Nobel Prize for their work. Their equation became known as the **Black Scholes formula**.

The black Scholes equation predicts how much an option should be worth based on the historic volatility of the underlying securities, the current level of interest rates, and a few other factors.

When options trade over their Black Scholes value, they are said to have a high ***implied volatility***. When they trade at a discount, they have a low implied volatility.

Let’s say that a piece of news comes out that a company is going to be taken over. The shares will rocket, and so will the implied volatility of the options.

If you pay a very high implied volatility for a Call option, the chances of you making money decline, and you are taking on more risk. If you pay too much, you could even see a situation where the stock rises, but the call option doesn’t rise, or even falls.

On the other hand, let's say you buy a call option that is trading at a big discount to its theoretical implied volatility. You usually find this when a stock has shown little movement over a long period of time.

Chances are that you will get a good return on this low risk position, especially if you pick it up just before a major news event that you have correctly predicted.

At the end of the day, you should attempt to do with implied volatilities what you do with stocks and their options, buy low and sell high.

Fisher Black and Myron Scholes

Meet the Greeks- The minors

There are a few other Greek letters you may hear about in the options market or find on your screen. For the most part these are unnecessary most basic options strategies, gamma is well above your pay grade.

Gamma is the name of the most powerful type of radiation emitted when an atomic bomb goes off. But we won't talk about that here.

In the options world ***gamma*** is the amount that the delta changes generated by a $1 move in the underlying stock price.

You may hear news reports of funds ***gamma*** hedging their portfolio during times of extreme market volatility. This occurs when managers want to reduce the volatility of their portfolios relative to the market.

Vega is another Greek term you'll find on your screen. All options have a measurement called ***implied volatility*** or ***"vol"*** which indicates how much the option should move relative to a move in the underlying stock.

Vega is the measurement of the change in that option volatility. When a stock has volatility that is changing rapidly, ***vega*** will be high. When a stock is boring, ***vega*** will be low.

Finally, for the sake of completeness, I'll mention ***rho***. ***Rho*** is the amount that the price of an option will change compared to a change in the risk free interest rate, i.e. the interest rate of US Treasury bills.

Back in the 1980's ***rho*** was a big deal because interest rates were very high. Since they have been close to zero for the past eight years, rho has been pretty much useless. The only reason you would want to mention ***rho*** today is if you were writing a book about options.

With that, you should be fairly fluent in the Greeks, at least in regard to trading options. Just don't expect this to get you anywhere if you ever plan to take a vacation to Greece.

Meet the Italian Leonardo Fibonacci

I remember the 12^{th} century like it was yesterday.

In those days, the leading intellectuals used to get together and drink wine by the gallon, which then was really little more than rotten grape juice. The problem was that we all used to pass out before anybody came up with a great idea.

Then someone started importing coffee from the Middle East, and thinkers stayed awake long enough to produce great thoughts.

Enter the Renaissance.

One of the guys I used to hang out with then was named Leonardo Fibonacci. Good old Leo was a man after my own heart, a world-class nerd and geek, with a penchant for mathematics.

His dad was a diplomat from the Court at Pisa to the Algiers sultanate who had a nice little import/export business on the side. It is safe to say that there was probably as little action in Algiers then as there is today. I know, because I've been there.

Instead of camping out in his dad's basement and staying depressed like a lot of young men these days, Leo killed time trolling the local bazaars for interesting used books he could buy on the cheap.

Remember, this was before texting. That was not hard to do since most people couldn't read. He took the trouble to learn Arabic and translated them back into Latin. Ancient math books were his specialty.

It didn't take Leo long to figure out that that the Arabs had developed a numbering system vastly superior to the Roman numerals then in use in Europe. Most importantly, they mastered the concept of zero and the placement of digits in addition and subtraction. The Arabs themselves, in fact, lifted these concepts from archaic Indian mathematicians as far back as the 6^{th} century.

If you don't believe me about the significance of this discovery, try multiplying CCVII by XXXIV. (The answer is VIIXXXVIII, or 7,038). Try designing a house, a bridge, or a computer software program with such a cumbersome numbering system.

Leo didn't just stop there. He also discovered a series of numbers, which seemed to have magical predictive powers. The formula is extremely simple. Start with zero, add the next number, and you have the next number in the series.

Continue the progression and you get 0,1,1,2,3,5,8,13,21,34,55…. and so on. It's no surprise that the sequence became known as the "Fibonacci Sequence".

The great thing about this series is that if you divide any number in it by the next one, you get a product that has become known as the "Golden Ratio". This number is 1:1.618, or 0.618 to one.

Fibonacci's original application for this number was to predict the growth rate of a population of breeding rabbits.

Then some other mathematicians started poking around with it. It turns out the Great Pyramid in Egypt was built to the specification of a Fibonacci ratio. So is the rate of change of the curvature in a seashell, or a human ear. So is the ratio of the length of your arms to your legs.

Upon closer inspection, the Fibonacci turned out to be absolutely everywhere, from the structure of the tiniest cell to the swirl of the largest galaxies in the universe.

Fibonacci introduced his findings in a book entitled ***"Liber Abaci",*** or "Free Abacus" in English, which he published in 1202. In it he proposed the 0-9 numbering system, place values, lattice multiplication, fractions, bookkeeping, commercial weights and measures, and the calculation of interest. It included everything we would recognize as modern mathematics.

The book launched the scientific revolution in Europe that led us to where we are today, and was a major bestseller. In fact, you can still buy it on Amazon, making it the longest continuously published book in history.

Enter the stock market. By the end of the 19th century, some observers noticed that share prices tended to move in predictable patterns on charts. In particular, they always seemed to advance and pull back around the numbers forecast by my friend, Fibonacci, seven hundred years earlier.

These people came to be known as “technical analysts,” as opposed to fundamental analysts, who look at the underlying business behind each company.

By the 1930’s, Fibonacci numbers had worked their way into mainstream technical analytical theories, such as Elliot Wave. Today, most market tracking software and data systems, like Bloomberg, will automatically throw up Fibonacci support and resistance numbers on every stock chart.

Why am I talking about this? Because I am frequently asked how I pick the precise strike prices for options in my own **Trade Alert Service**. I use a combination of moving averages, moving average convergence-divergence (MACD) indicators, Bollinger bands, Fibonacci numbers, and a chant taught to me by an old Yaqui Indian shaman.

And I do all of this only after going over the underlying fundamentals of the stock or index with a fine-tooth comb. I can’t be any clearer than that.

Enter the high frequency traders. Knowing that the bulk of us rely on Fibonacci numbers for our short term trading calls, they have developed algorithms that seek to exploit that preference.

They enter a large number of stop loss orders to sell just below a “Fibo” support level, then put up fake, but extremely large offers just above it, which are usually canceled. Only 1% of these orders ever get executed.

When conventional traders see these huge offers to sell, they panic, dump their stocks, and trigger the stop losses. The HFT’s then jump in and cover their own shorts for a quick profit, sometimes only for a fraction of a penny.

The net effect of these shenanigans is to make Fibo numbers less effective. Fibo support is just not as rock solid as it used to be, nor is resistance. This is why the performance of several leading technical analysts has seriously deteriorated in recent years.

Although their importance is now somewhat diluted, I still enjoy Fibonacci numbers, as I see them in nature all around me. They occasionally have other uses, such as in cryptography.

When I watched ***The Da Vinci Code*** sequel, ***“Angels & Demons”***, and listened to the clues, I recognized the handiwork of my old friend Leo. The rest of the audience sat there clueless, except for the group in the next row wearing “UC BERKELEY” hoodies.

For the fellow geeks and nerds among you, here are the precise Fibonacci numbers indicating support and resistance, which you will find on a stock chart.

Fibonacci Ratios

Fibonacci ratios are mathematical relationships, expressed as ratios, derived from the Fibonacci sequence. The key Fibonacci ratios are 0%, 23.6%, 38.2%, and 100%.

$$F_{100\%} = \left(\frac{1+\sqrt{5}}{2}\right)^0 = 1$$

The key Fibonacci ratio of 0.618 is derived by dividing any number in the sequence by the number that immediately follows it. *For example: 8/13 is approximately 0.6154, and 55/89 is approximately 0.6180.*

$$F_{61.8\%} = \left(\frac{1+\sqrt{5}}{2}\right)^{-1} \approx 0.618034$$

The 0.382 ratio is found by dividing any number in the sequence by the number that is found two places to the right. *For example: 34/89 is approximately 0.3820.*

$$F_{38.2\%} = \left(\frac{1+\sqrt{5}}{2}\right)^{-2} \approx 0.381966$$

The 0.236 ratio is found by dividing any number in the sequence by the number that is three places to the right. *For example: 55/233 is approximately 0.2361.*

$$F_{23.6\%} = \left(\frac{1+\sqrt{5}}{2}\right)^{-3} \approx 0.236068$$

The 0 ratio is :

$$F_{0\%} = \left(\frac{1+\sqrt{5}}{2}\right)^{-\infty} = 0$$

Leonardo Fibonacci (Maybe)

A Note on Assigned Options, or Options Called Away

In the run up to every options expiration, which is the third Friday of every month, there is a possibility that any short options positions you have may get **assigned** or **called away**.

If that happens, there is only one thing to do: fall down on your knees and thank your lucky stars. You have just made the maximum possible profit for your position instantly.

Most of you have short option positions, although you may not realize it. For when you buy an in-the-money **vertical option spread**, it contains two elements: a long option and a short option.

The short options can get **"assigned,"** or **"called away"** at any time, as it is owned by a third party, the one you initially sold the put option to when you initiated the position.

You have to be careful here because the inexperienced can blow their newfound windfall if they take the wrong action, so here's how to handle it correctly .

Let's say you get an email from your broker telling you that your call options have been assigned away. I'll use the example of the Microsoft (MSFT) *December* 2019 $134-$137 in-the-money vertical BULL CALL spread.

For what the broker had done in effect is allow you to get out of your call spread position at the maximum profit point 8 days before the December 20 expiration date. In other words, **what you bought for $4.50 last week is now worth $5.00!**

All you have to do is call your broker and instruct them to ***exercise your long position in your (MSFT) December 134 calls to close out your short position in the (MSFT) December $137 calls.***

This is a perfectly hedged position, with both options having the same expiration date, the same amount of contracts in the same stock, so there is no risk. The name, number of shares, and number of contracts are all identical, so you have no exposure at all.

Calls are a right to buy shares at a fixed price before a fixed date, and one option contract is exercisable into 100 shares.

To say it another way, you bought the (MSFT) at $134 and sold it at $137, paid $2.60 for the right to do so, so your profit is 40 cents, or ($0.40 X 100 shares X 38 contracts) = $1,520. Not bad for an 18-day limited risk play.

Sounds like a good trade to me.

Weird stuff like this happens in the run-up to options expirations like we have coming.

A call owner may need to buy a long (MSFT) position after the close, and exercising his long December $134 call is the only way to execute it.

Adequate shares may not be available in the market, or maybe a limit order didn’t get done by the market close.

There are thousands of algorithms out there which may arrive at some twisted logic that the puts need to be exercised.

Many require a rebalancing of hedges at the close ***every day*** which can be achieved through option exercises.

And yes, options even get exercised by accident. There are still a few humans left in this market to blow it by writing shoddy algorithms.

And here’s another possible outcome in this process.

Your broker will call you to notify you of an option called away, ***and then give you the wrong advice on what to do about it.*** They’ll tell you to take delivery of your long stock and then most additional margin to cover the risk.

Either that, or you can just sell your shares on the following Monday and take on a ton of risk over the weekend. This generates a ton of commission for the brokers but impoverishes you.

There may not even be an evil motive behind the bad advice. Brokers are not investing a lot in training staff these days. It doesn’t pay. In fact, I think

I’m the last one they really did train.

Avarice could have been an explanation here but I think stupidity and poor training and low wages are much more likely.

Brokers have so many legal ways to steal money that they don’t need to resort to the illegal kind.

This exercise process is now fully automated at most brokers but it never hurts to follow up with a phone call if you get an exercise notice. Mistakes do happen.

Some may also send you a link to a video of what to do about all this.

If any of you are the slightest bit worried or confused by all of this, come out of your position ***RIGHT NOW*** at a small profit! You should never be worried or confused about any position tying up ***YOUR*** money.

Professionals do these things all day long and exercises become second nature, just another cost of doing business.

If you do this long enough, eventually you get hit. I bet you don’t.

Calling All Options!

How to Find a Great Options Trade

You’ve spent vast amounts of time, money, and effort to become an options trading expert.

You know the difference between bids and offers, puts and calls, exercise prices and expiration days.

And you still can’t make any money.

Now What?

Where do you apply your newfound expertise? How do you maximize your reward while minimizing your risk?

It is all very simple.

Stick to five basic disciplines and you will suddenly find that the number of your new trades that are winners takes a quantum leap, and money will start pouring into your trading account.

It’s really not all that hard to do. So here we go!

1) Know the Macro Picture

If you have a handle on whether the economy is growing or shrinking, you have a ***major*** advantage in the options market.

In a growing economy, you only want to employ bullish strategies, like calls, call spreads, and short volatility plays.

In a shrinking economy you want to execute bearish plays, like puts, put spreads, and ***long*** volatility plays.

Remember, the only thing that is useful for your options trading is a view on what the economy is going to do ***NEXT.***

The government only publishes historical economic data, which is for the most part useless is predicting what is going to happen in the future.

The options market is all about discounting what is going to happen next.

And how do you find that out?

Well, you could hire your own in-house staff economist. Or you could rely on economic research from the largest brokerage houses.

Even the Federal Reserve puts out its own forecasts for economic growth prospects.

However, all of these sources have notoriously poor track records. Listening to them and placing bets on their advice **CAN** get you into a world of trouble.

For the best possible read on the future of the US and the global economy, there is no better place to go than Global Trading Dispatch, published by me, John Thomas, ***the Mad Hedge Fund Trader.***

This is where the largest hedge funds and brokers go to find our what really is going to happen to the economy.

Do you want to give yourself another valuable edge?

There are over 100 different industries listed on US stock markets. However, only about 5 or 10 are really growing decisively at any particular time. The rest are either going nowhere, or are shrinking.

In fact, you can find a handful of sectors that are booming, while others are in outright recession.

If you are a major hedge fund, institution, or government, you may want to cover all 100 of those industries. Good luck with that.

If you are a small hedge fund, or an individual working from home, you will want to conserve your time and resources, skip most of US industry, and only focus on a handful.

Some traders take this a step further and only concentrate on a single high growing, volatile industry, like technology or biotech, or even a single name, like Netflix (NFLX), Tesla (TSLA), or Amazon (AMZN).

How do you decide which industry to trade?

Brokerage houses pump out more free research than you could ever read in a lifetime. Government reports tend to be stodgy, boring, and out of date. Big hedge funds keep their in-house research confidential (although some of it leaks out to me).

The ***Mad Hedge Fund Trader*** solves this problem for you by limiting its scope to a small number of benchmark, pathfinder industries, like technology, banks, energy, consumer cyclicals, biotech, and cyber security.

In this way, we gain a handle on what is happening in the economy as a whole, while lining up rifle shots on the best options trades out there.

We want to direct you where the action is, and where we have a good handle on future earnings prospects.

It doesn't hurt that we live on the edge of Silicon Valley and get invited to test out many new technologies before they are made public. My Tesla Model S1 is a perfect example.

That encouraged me to recommend Tesla stock at $16 before it began its historic run to $295. It was the best short squeeze eve.

2) The Micro Picture is Ideal

Once you have a handle on the economy and the best industries, it's time to zero in on the best company to trade in, or the **"MICRO"** selection.

It's always great to find a good target to trade in because positions in single companies can deliver double or even triple the returns compared to stock indexes.

That is because the market will pay a far higher implied volatility for a single company than a large basket of companies.

Remember also that you are taking greater risk in trading individual companies. The options market will pay you for that extra risk.

If the earnings come through as expected, everything is hunky dory. If they don't, the shares can drop by half in a heartbeat. Large indexes buffer this effect, which is why they have far lower volatility.

Of course there are gobs of market research about individual companies out there from brokers. Some of it is right, some of it is wrong, but all of it is conflicted. Recommendations are either "BUY" or "HOLD".

Brokers are loath to issue a "SELL" recommendation for a stock because it will eliminate any chance of that firm obtaining new issue business. Who wants to hire a broker to sell new stock when their analyst has already dissed the company?

And brokerage firms don't make their bread and butter on those piddling little discount commissions you have been paying them. They make it on new highly lucrative new issues business. In fact, a new issue can earn as much as $100 million from one firm. I know because I've done it.

I have been following about 100 companies in the leading market sectors for nearly half a century. Some of the management of these firms have become close friends over the decades. So, I get some really first class information.

When markets rotate to sectors and companies that I already know, I have a huge advantage. Needless to say, this gives me a massive head start when selecting individual names for options ***Trade Alerts.***

<u>3) The Technicals Line Up</u>

I have never been a huge fan of technical analysis.

Most technical advice boils down to "if it's gone up, it will go up more" or "If it's gone down, it will go down more."

Over time, the recommendations are accurate 50% of the time, or about equal with a coin toss.

However, the shorter the time frame, the more useful technical analysis becomes.

If you analyze intraday trading, almost all very short-term movements can be explained in technical terms. This is entirely how day traders make their livings.

It's a classic case of if enough people believe something, it becomes true, no matter how dubious the underling facts may be.

So it does behoove us to pay some attention to the charts when executing you trades.

Talk to old time investors and you will fund that they use fundamentals for long term stock selection and technicals for short-term order execution.

Talk to them some more and you find the best fundamentalists sound like technicians, while savvy technicians refer to underlying fundamentals.

Get the technicals right, and you can provide one additional reason for your trade to work.

4) The Calendar is Favorable

There is one more means of assuring your trades turn into winners.

I am a big fan of buying straw hats in the dead of winter and umbrellas in the sizzling heat of the summer.

There *IS* a method to my madness.

Have you heard of "Sell in May and go away?"

According to the ***Stock Trader's Almanac***, $10,000 invested at the beginning of May and sold at the end of October every year since 1950 would be showing a loss today.

This is despite the fact that the Dow Average rocketed from $409 to $18,300 during the same time period, a gain of 44.74 times!

Amazingly, $10,000 invested on every November and sold at the end of April would today be worth $702,000, giving you a compound annual return of 7.10%.

It gets better.

Of the 62 years under study, the market was down in 25 of the May to October periods, but negative in only 13 of the November to April periods.

What's more, the market has been down only three times from November to April in the last 20 years!

There have been just three times when the "good 6 months" have lost more than 10% (1969, 1973 and 2008), but with the "bad six month" time period there have been 11 losing losses of 10% or more.

So it's clear that trading according to the calendar can have a significant impact on your profitability.

Being a long-time student of the American, and indeed, the global economy, I have long had a theory behind the regularity of this cycle. It's enough to base a pagan religion around, like the once practicing Druids at Stonehenge.

Up until the 1920's, we had an overwhelmingly agricultural economy. Farmers were always at maximum financial distress in the fall, when their outlays for seed, fertilizer, and labor were the greatest, but they had yet to earn any income from the sale of their crops.

So they had to borrow all at once, placing a large cash call on the financial system as a whole. This is why we have seen so many stock market crashes in October.

Once the system swallows this lump, it's nothing but green lights for six months.

After the cycle was set and was easily identifiable by computer algorithms, the trend became a self-fulfilling prophecy.

Yes, it may be disturbing to learn that we ardent stock market practitioners might in fact be the high priests of a strange set of beliefs. But hey, some people will do anything to outperform the market.

It is important to remember that this cyclicality is not 100% accurate, and you know the one time you bet the ranch, it won't work.

Benefits of the Tailwinds

So there we have it.

Adopt these five simple disciplines, and you will find your success rate on trades jumps from a mere coin toss to 70%, 80%, or even 90%.

In other words, you convert your trading from an endless series of frustrations to a reliable source of income.

If a potential trade meets only four of these five criteria, please do it with your money and not mine. Your chances of making money have just declined.

And I bet a lot of you poor souls execute trades all the time that meet ***NONE*** of these criteria. No wonder you're losing money hand over fist!

Get the tailwinds of the economy, your industrial call, your company pick, the market technicals, and the calendar working for you, and all of a sudden you're a trading genius.

It only took me a half a century to pull all this together. Hopefully you can learn a little bit faster than me.

I hope it all works for you.

Your Guide to Winning Trades

My 20 Rules for Trading

Nothing like starting the new year by going back to basics and reviewing the rules that worked so well for us last year. Call this the refresher course for Trading 101.

I usually try to catch three or four trend changes a year, which might generate 100-200 trades, and often come in frenzied bursts.

Since I am one of the greatest tightwads that every walked the planet, I only like to buy positions when we are at the height of despair and despondency, and traders are raining off the Golden Gate Bridge like a heavy winter downpour.

Similarly, I only like to sell when the markets are tripping on steroids and ecstasy and are convinced that they can live forever.

Some 99% of the time, the markets are in the middle, and there is nothing to do but deep research and looking for the next trade. That is the purpose of this letter.

Over the five decades that I have been trading, I have learned a number of tried and true rules which have saved my bacon countless times. I will share them with you today.

1) **Don't over trade**. This is the number one reason why individual investors lose money. Look at your trades of the past year and apply the 90/10 rule. Dump the least profitable 90% and watch your performance skyrocket. Then aim for that 10%. Over trading is a great early retirement

plan for your broker, not you.

2) **Always use stops.** Risk control is the measure of the good hedge fund trader. If you lose all your capital on the lemons, you can't play when the great trades set up. Consider cash as having an option value.

3) **Don't forget to sell.** Date, don't marry your positions. Remember, hogs get fed and pigs get slaughtered. My late mentor, Barton Biggs, told me to always leave the last 10% of a move for the next guy.

4) **You don't have to be a genius to play this game**. If that was required, Wall Street would have run out of players a long time ago.

If you employ risk control and stops, then you can be wrong 40% of the time, and still make a living. That's little better than a coin toss. It you are wrong only 30% of the time, you can make millions.

If you are wrong a scant 20% of the time, you are heading a trading desk at Goldman Sachs. If you are wrong a scant 10% of the time, you are running a $20 billion hedge fund that the public only hears about when you pay $100 million for a pickled shark at a modern art auction.

If someone says they are never wrong, as is often claimed on the Internet, run a mile, because it is impossible. By the way, I was wrong 12% of the time in 2019. That's what you're paying me for.

5) **This is hard work.** Trading attracts a lot of wide eyed, naïve, but lazy people because it appears so easy from the outside. You buy a stock, watch it go up, and make money. How hard is that?

The reality is that successful investing requires twice as much work as a normal job. The more research you put into a trade, the more comfortable you will become, and the more profitable it will be. That's what this letter is for.

6) **Don't chase the market.** If you do, it will turn back and bite you. Wait for it to come to you. If your miss the train, there will be another one along in minutes, hours, days, weeks, or months. Patience is a virtue.

7) **Limit Your Losses**. When I put on a position, I calculate how much I am

willing to lose to keep it. I then put a stop just below there. If I get triggered, I just walk away. Emotion never enters the equation.

Only enter a trade when the risk/ reward is in your favor. You can start at 3:1. That means only risk a dollar to potentially make three.

8) **Don’t confuse a bull market with brilliance**. I am not smart, just old as dirt and have seen everything ten times over. I only hve to decide which movie they’re replaying.

9) Tape this quote from the great economist and early hedge fund trader of the 1930’s, John Maynard Keynes, to your computer monitor: **"Markets can remain illogical longer than you can remain solvent**." Hang around long enough, and you will see this proven time and again (ten-year US Treasuries at 1.45%?!).

10) **Don’t believe the media**. I know, I used to be one of them. Look for the hard data, the numbers, and you’ll see that often the talking heads, the paid industry apologists, and politicians don’t know what they are talking about (the Gulf oil spill will create a dead zone for decades?).

Average out all the public commentary, and half are bullish and half bearish at any given time. The problem is that they never tell you which one is right (that is my job). When they all go one way, the markets usually go the opposite direction.

11) When you are running a long/short portfolio, **80% of your time is spent managing the shorts**. If you don’t want to do the work, then cash beats a short any day of the week.

12) **Sometimes the conventional wisdom is right.**

13) **Invest like a fundamentalist, execute like a technical analyst.** This is what all the pros do.

14) Use technical analysis only, and you will buy every rally, sell every dip, and end up broke. That said, learn what an “outside reversal” is, and who the hell is that Italian guy, Leonardo Fibonacci.

15) **The simpler a market approach, the better it works.** Everyone talks about “buy low and sell high”, but few actually do it. All black boxes eventually blow up, if they were ever there in the first place.

16) **Markets are made up of people.** Understand and anticipate how they think, and you will know what the markets are going to do.

17) **Understand what information is in the market** and what isn’t and you will make more money.

18) **Do the hard trade**, the one that everyone tells you that you are “Mad” to do. If you add a position and then throw up on your shoes afterwards, then you know you’ve done the right thing. This is why people started calling me “Mad” 40 years ago. (What? Tech stocks were a huge buy the first week of January?).

19) If you are trying to get out of a hole, the first thing to do is **quit digging and throw away the shovel.** Sell everything. A blank position sheet can be invigorating and illuminating.

20) **Making money in the market is an unnatural act**, and fights against the tide of evolution.

We humans are predators and hunters evolved to track game on the horizon of an African savanna. If you don’t believe me just check out how sharp your front incisor teeth are. They’re for tearing raw meat. Modern humans are maybe 5 million years old, but civilization has been around for only 10,000 years.

Our brains have not had time to make the adjustment. In the market, this means that if a stock has gone up, you believe it will continue to do so.

This is why market tops and bottoms see volume spikes. To make money, you have to go against these innate instincts.

Some people are born with this ability, while others can only learn it through decades of training. I am in the latter group.

With all that said, good luck and good trading. Fresh content resumes next week when I am back from Australia.

Great Hunter, Lousy Trader

Decoding the Greenback

If you want to impress your friends with your vast knowledge of financial matters, then here are the Latin translations of the script on the backside of a US dollar bill.

“ANNUIT COEPTIS” means “God has favored our undertaking.” “NOVUS ORDO SECLORUM” translates into “A new order has begun.”

The Roman numerals at the base of the pyramid are “1776.” The better known “E PLURIBUS UNUM” is “One nation from many people.”

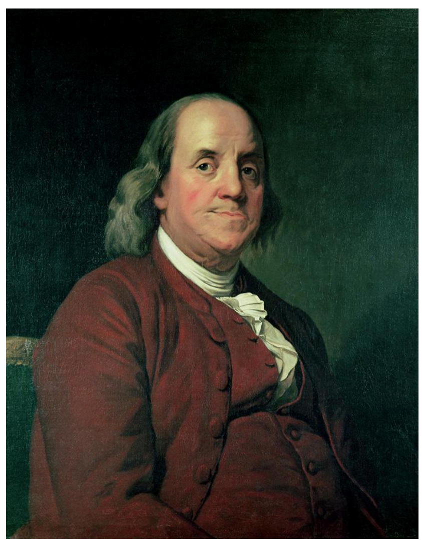
The basic design for the cotton and linen currency with red and blue silk fibers, which has been in circulation since 1957, carries enough symbolism to drive conspiracy theorists to distraction.

An all-seeing eye? The darkened Western face of the pyramid? And of course, the number “13” abounds.

Thank freemason Benjamin Franklin for these cryptic symbols and watch Nicholas Cage’s historical adventure movie “***National Treasure***.”

The balanced scales in the seal are certainly wishful thinking and a bit quaint if they refer to the Federal budget.

Study the buck closely, because there are soon going to be a lot more of them around, thanks to the borrowing history of the new president.



What Did You *Really* Mean, Franklin?

Take a Leap Into Leaps

I am repeating this story because this is the best strategy with which to cash in on the gigantic market swoons, which have become a regular feature of our markets.

Since the advent of the spectacular market volatility since the stock market topped on January 31, I have been asked one question.

What do you think about LEAPS?

LEAPS, or **Long Term Equity Participation Securities**, are just a fancy name for a stock option with a maturity of more than one year.

You execute orders for these securities on your options online trading platform, pay options commissions, and endure options like volatility.

Another way of describing LEAPS is that they offer a way to rent stocks instead of buying them, with the prospect of enjoying many year's worth of stock gains for a fraction of the price.

While these are highly leveraged instruments, you can't lose any more money than you put into them. Your risk is well defined.

And there are many companies in the market where LEAP's are a very good idea, especially on those gut wrenching 1,000 point down days.

Interested?

Currently, LEAPS are listed all the way out until March, 2020.

However, the further expiration dates will have far less liquidity than near month options, so they are not a great short-term trading vehicle. That is why limit orders in LEAPS, as opposed to market orders, are crucial.

These are really for you buy-and-forget investment portfolio, defined benefit plan, 401k, or IRA.

Because of the long maturities, premiums can be enormous. However, there is more than one way to skin a cat, and the profit opportunities here can be astronomical.

Like all options contracts, a LEAP gives its owner the right to "exercise" the option to buy or sell 100 shares of stock at a set price for a given time.

LEAPS have been around since 1990, and trade on the Chicago Board Options Exchange (CBOE).

To participate, you need an options account with a brokerage house, an easy process that mainly involves acknowledging the risk disclosures that no one ever reads.

If a LEAP expires "out-of-the-money" – when exercising, you can lose all the money that was spent on the premium to buy it. There's no toughing it out waiting for a recovery, as with actual shares of stock. Poof, and your money is gone.

LEAPS are also offered on exchange traded funds (ETF’s) that track indices like the Standard & Poor's 500 index (SPY) and the Dow Jones Industrial Average (INDU), so you could bet on up or down moves of the broad market.

Not all stocks have options, and not all stocks with ordinary options also offer LEAPS.

Note that a LEAPS owner does not vote proxies or receive dividends, because the underlying stock is owned by the seller, or "writer," of the LEAP contract until the LEAP owner exercises.

Despite the Wild West image of options, LEAPS are actually ideal for the right type of conservative investor.

They offer more margin and more efficient use of capital than traditional broker margin accounts. And you don’t have to pay the usurious interest rates that margin accounts usually charge.

And for a moderate increase in risk, they present outsized profit opportunities.

For the right investor they are the ideal instrument.

Let me go through some examples to show you their inner beauty.

By now, you should all know what **vertical bull call spreads** are. If you don't, then please click the link for a quickie video tutorial at https://members.madhedgefundtrader.com/ltt-vbcs/ (you must be logged in to your account).

Let's go back to February 9 when the Dow Average plunged to its 23,800 low for 2018. I begged you to buy the Apple (AAPL) June, 2018 $130-$140 call spread at $8.10, which most of you did. A month later, that position is worth $9.40, up some 16.04%. Not bad.

Now let's say that instead buying a spread four months out, you went for the full year and three months, to June 2019.

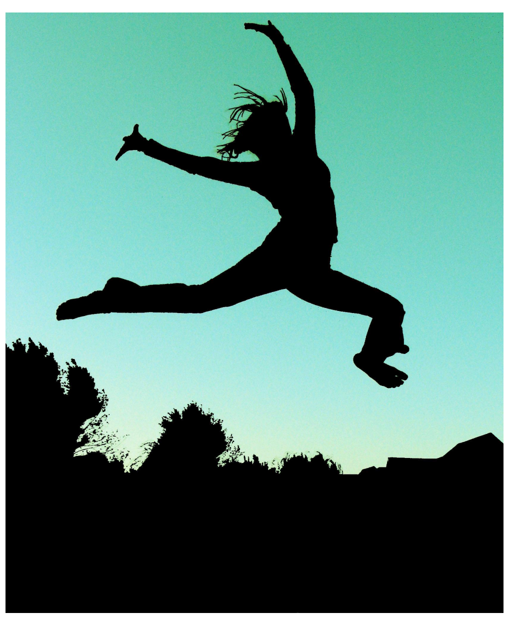
That identical (AAPL) $130-$140 would have cost $5.50 on February 9. The spread would be worth $9.40 today, up 70.90%, and worth $10 on June 21, 2019, up 81.81%.

So, by holding a 15 month to expiration position for only a month you get to collect 86.67% of the maximum potential profit of the position.

So, now you know why we leap into LEAPS.

When the melt down comes, and that could be as soon as today, use this strategy to jump into longer term positions in the names we have been recommending and you should be able to retire early.


AAPL Apple, Inc. Nasdaq GS
© StockCharts.com
6-Mar-2018
Open 175.21 High 178.25 Low 174.52 Close 176.67 Volume 51.7M Chg +0.46 (+0.26%)
RSI(14) 59.27
AAPL (Weekly) 176.67
MA(50) 158.34
MA(200) 119.48
Volume 51,663,592
MACD(12,26,9) 4.567, 4.975, -0.408
D 16 F M A M J J A S O N D 17 F M A M J J A S O N D 18 F M



Biography of John Thomas-The Mad Hedge Fund Trader

John Thomas is a 55-year veteran of the financial markets.

John graduated from UCLA with degrees in mathematics and biochemistry. He then went straight to work for the **Atomic Energy Commission** at the Nuclear Test Site in Nevada.

With the signing of the first SALT Treaty, spending on nuclear research wound down so John went to work as a war correspondent in Southeast Asia for ***The Economist*** magazine in London.

When the war ended, the magazine transferred John to Tokyo where he covered all of Asia and their stock markets. Among the notable figures he interviewed were China's Zhou Enlai, Chang Kai-shek, Deng Hsiao Ping, and the last of the WWII Axis leaders, Emperor Hirohito of Japan.

In 1982, John was transferred to New York where he became a member of the **White House Press Corps**. during the administration of President Ronald Reagan. The following year, he was recruited by **Morgan Stanley** to establish an international equity trading division. He eventually was promoted to Head of Options Trading. By 1989, John's department accounted for 80% of equity division profits.

In 1990, John retired to start his own hedge fund. He was immediately drafted as a civilian pilot to fly in Desert Storm.

After reaping a 1,000% profit in ten years, John sold his hedge fund to go into the **oil & gas business** to try out the new fracking technology.

Seeing the incredible inefficiencies and severe mispricing offered by the popping of multiple bubbles during the Great Crash of 2008, and missing the adrenaline of the marketplace, John sold his gas business and became an investment advisor.

With ***The Diary of a Mad Hedge Fund Trader***, John's goal is to broaden public understanding of the techniques and strategies employed by the most successful hedge funds so that they may more profitably manage their own retirement funds. About one third of his clients are active investment advisors and hedge funds.

John publishes 23 newsletter a week covering global macro, technology, biotech & health care, and artificial intelligence. Since 2008, his **Mad Hedge Trade Alert Service** has racked up an average annualized return of 48.16%. He currently has 30,000 followers in 134 countries.

John's career has taken him up to 22,000 feet on Mount Everest, to the edge of space at 90,000 feet in the Cockpit of a MIG-25, and to the depths of a sunken Japanese fleet in the Truk Lagoon.

Why they call him ***"Mad"*** he will never understand.

John has just returned from **Ukraine** this week where he escorted American doctors, cash, and supplies to beleaguered hospitals and orphanages.

To learn more about John Thomas, please visit
www.madhedgefundtrader.com