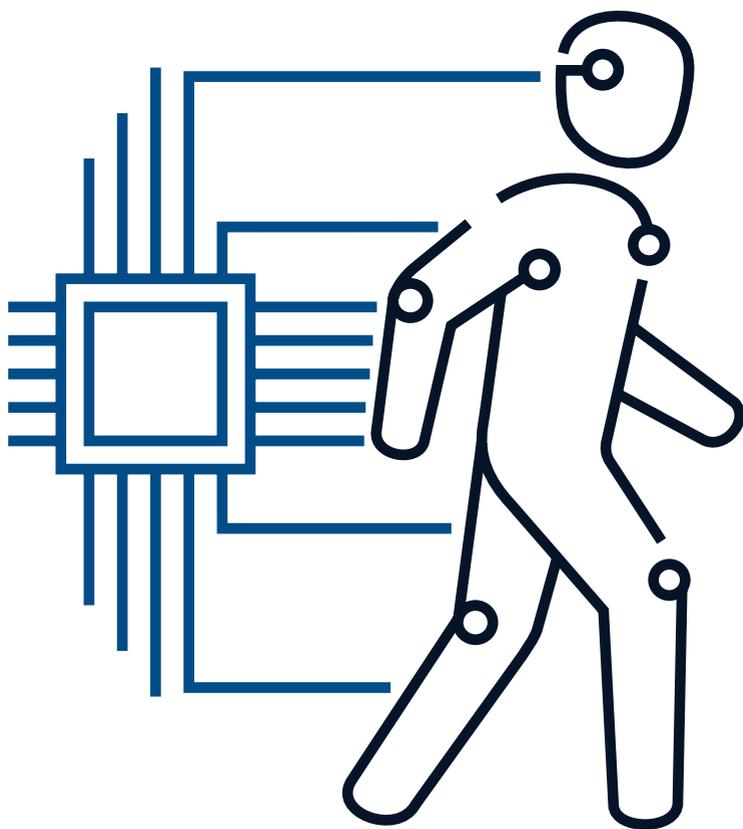


The Future of Options Trading:

Where Trader Meets Machine



PROSPER
TRADING ACADEMY

**The Future of Options
Trading: Where Trader
Meets Machine**

by

Michael Shorr

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Prosper Trading Academy

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Why you need to study this eBook!

Options trading has been around since the early 1970's. It has evolved from very basic strategies to the complex strategies we are used to today. Believe it or not, when options trading first came to the trading floors of Chicago, they didn't even list put options. As far as we have come since those days. Whether you are new to trading options or a seasoned professional, there is always more to learn. What our options instructors have found in our decades of educational experience is that many, if not most, traders are simply not maximizing the potential of trading options. We utilize proprietary trading methodologies and ARTIFICIAL INTELLIGENCE technology to give us our edge!

We are here to change that.

What you will find in this eBook:

- What are options spreads?
- How to use capital allocation regimens to lessen the variance of your returns.
- Employing risk management disciplines designed to maximize your winning trades and mitigate your losing ones.
- Avoiding the pitfalls of throwing good money at bad.
- How to utilize **ARTIFICIAL INTELLIGENCE** to uncover directional options strategies!
- ...and much more more.

About the Author

Michael Shorr

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Since 1994, Michael has been an on-the-floor market maker, Vice-President of Interest Rate Derivatives and options educator. He is the Director Of Trader Education at Prosper Trading Academy and the Instructor in the Short Term Options Room at Prosper. He makes the oftentimes complex world of options and trading accessible to the novice and advanced trader alike. Michael has a Bachelor of Science degree in Statistics and Finance from the University of Illinois Champaign-Urbana.



What Is An Options Spread?

An option spread is a trading technique that involves trading multiple options (legs) at the same time. Typically, the spread will consist of two legs. Options spreads can have as many as four legs. The types of spreads you will encounter in my methodology will consist of equal weighting on both legs.

We break our trades into two distinct categories: active and passive.

An active entry is based on the fact that you believe that something **IS GOING** to happen. For example, you have identified that USO has broken out of its trading range and we want to take advantage of the breakout.

A passive approach signifies that you think something **IS NOT GOING** to happen. For example, you have determined that you believe that a stock or ETF has found support or resistance. You think **IT IS NOT** going to move through that support/resistance level. Let's explore each.

ACTIVE ENTRY

Like we discussed, we think something IS GOING to happen. We don't mind paying a debit if we can be properly compensated for the risk. We are looking for a minimum of 2:1 reward to risk. This is typically accomplished by purchasing a vertical call spread or vertical put spread. An example of this would be: let's say that we have identified that USO has broken out to the upside at 14.50. Let's assume our target price is at 16.00. You want your short strike of your vertical to be the that target price. Then you want to find the lowest strike that still affords you at least a 2:1 reward to risk ratio. Your time to expiration should be no shorter than 4 trading days and no longer than 10 trading days. So, in this case if we buy the two week out 15/16 call vertical for \$0.33 or less. This would satisfy our risk parameters.

PASSIVE ENTRY

We characterize a passive entry as a set up where we think something is NOT GOING to happen. The stock or ETF has traded to support/resistance levels. We do not necessarily believe that the stock is going to turn around and do a massive retracement, but we feel confident in the fact that the support/resistance levels will hold. A passive approach would make a lot of sense here. A set up like this looks to profit from the fact that the stock will not break through the identified s/r. A credit spread makes sense for this type of set up. Here you want your short strike to be the price level that you think will be defended. Then choose your debit strike to adhere to the risk reward parameters you have set.

Capital Allocation

Before you can even consider putting on an options trade, you have to address the concept of capital allocation. Options trading, specifically options spread trading, is different than other types of trading. You may hear a trader say: “I trade 10 lots of Crude Oil futures” or “I am a two lot e-mini S&P trader” or things along that line. That is because traders like these measure their risk in ticks. A tick is the minimum amount that an underlying contract can move. For example, in Crude Oil, a future can move one cent (\$0.01) at a time, like from \$50.50 to \$50.51. In pure dollar terms, that translates into \$10 per one-cent move. However many lots that trader trades at one time is their risk per trade. That tick size is a constant value. The size of the tick never changes. This type of trader measures their risk in what they are willing to make or lose on a certain price movement. That determines the amount of lots they trade.

That is not the case for an options spread. The price of an option spread depends on many things. Let’s take the example of an equity option. The options spread has many variables, but it all comes down to dollars at risk. Even if we are talking about two different spreads in the same underlying, the allocation will be different. Let’s look at an example in Facebook (FB). Let’s look at two call spreads with the same strikes, but different expiration dates. Consider the June 175/180 call spread that is trading \$1.80 and the January 175/180 call spread which is trading \$2.25. In order to have the same dollars at risk for each trade, we can trade

more of the June spread than we can trade of the January spread. The June costs less. As a rule, I allocate 3% of my account value to any given signal. With the example of a \$25,000 trading account, 3% represents \$750 of capital at risk. For the June spread trading \$1.80, that means that a one lot will cost \$180.00. To allocate \$750 of capital risk means that I can trade 4.17 lots of that spread (you cannot trade fractions of an options contract or options spread, but this is just a theoretical example). Using the same calculation, I can invest in 3.33 January spreads ($\$750/\225). In each case, I have the same dollars at risk which will help to smooth out the variance of my returns.

Risk Management

Once you are in your trade you have to manage your risk. First, we manage where we are going to stop ourselves out in the case of a losing signal. I teach that you should stop yourself out when your spread has lost 50% of its value. For example if we paid \$1.80 for the June 175/180 call spread in our FB example above, we would stop ourselves out and realize a loss when our spread was worth \$0.90. Next, you have to define your winning exit strategy. I teach that you should start to take your winners off the table when your spread increases by 70%. In this case our exit signal would be set for \$3.06 ($\$1.80 \times 1.7 = \3.06). The parameters you set are aligned with your own risk tolerance. What is important is that you allow your winners to run a little bit and have your stop-loss parameter less than your winning parameter. You cannot take profit when you realize a 10% profit and let your losers go to a 100% loser. That is formula for failure.

Throwing Good Money At Bad

I am often asked about “rolling” or “adjusting” signals that are not working out. In all but the most rare circumstances, my answer is a resounding “No!” Why is that? In all my years of training clerks who were trying to become traders and students who are trying to learn about trading, one factor was prevalent in almost all failures. That factor was that person’s unwillingness to realize a loss. You could be a math genius. You could be a street-savvy scrapper. People from all walks of life and backgrounds proved that they had the aptitude to trade. But, if they could not manage their risk by know when to cut bait and acting on it, it meant trading doom. “Rolling” and “adjusting” are just fancy ways of not realizing a loss. There is an old trading joke. “It’s not a loser until you get out!” That’s true. You do, however, run the very significant risk that you turn a small loser into a huge problem. Your time, effort and money would be far better spent looking for a new opportunity than to try and chase a losing trade and break even. If you lose money in a FB trade, does it make a difference whether you make that money back in FB or any other stock? It does not matter where you make your money. The only thing you should concern yourself with is finding the best opportunity to be profitable, not revenge trading in a stock that you got wrong.

Using Artificial Intelligence To Identify Options Trading Opportunities

I use a trading platform call VantagePoint. I use a proprietary combination of predictive moving average cross-overs, neural indexes, predictive ranges and momentum indicators to formulate buy and sell signals and then apply my proprietary options methodologies to leverage the signal.

VantagePoint uses neural networks to identify which global markets have the most influence on a target market, then produces a set of intermarket data to generate predictive technical indicators that give you short-term price and trend forecasts. Most trading tools focus on past-price data that's already occurred. VantagePoint applies an AI Neural Network to forecast market data, allowing me to get into trades days before other traders know what's happening. The predictive indicators give you a head start on trend changes.

