ReadySetCrypto Options Masterclass

Module Nine: Options Risk Management

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Table of Contents

Introduction to Options Risk Management

Let me guess…"Risk Management" is the first module that you tried to read from this program, right?

NO?!

Relax, NO ONE stays up at night reading about the exciting tales of battles won through Risk Management. But Money/Risk Management might actually be the most important factor towards whether you as a Retail Investor end up creating a positive return over time. Everyone wants to focus on the whiz-bang charts and studies and strategies, but few want to hear admonitions of how to protect their capital.

It's really your choice, then. Sooner or later you'll need to master the very simple concepts of taking on an appropriate level of risk, much as our business models of "Insurance company" and "landlord" have had to do for centuries.

It's really not that hard at all. Let's get started.

The First Two Rules of Risk Management

In every course that I create, I cover the same basic rules for risk management and protection of assets, because I see these as the number one and two most frequently-made mistakes that endanger their accounts. And it seems that no matter how many times that I bring up the topic, these mistakes repeat until the trader makes a “fatal” mistake that gets their attention and breaks the habit loop.

Briefly, here are the two worst offenders to retail capital:

- **Not Setting a “Stop”** - Retail investors will rush into a position entry, afraid that the market is “getting away from them” without thought to what would happen if the market reversed, or if their “read” on the market was wrong. They are optimistic and expect nothing but positive results from the trade, usually because the market was running away from them and they FOMO’ed into the trade entry. The sudden reversal puts them like a deer in the headlights and they are paralyzed by fear and inaction; they freeze and do nothing until it’s too late, usually “puking out” their position at the very bottom of the move in desperation.

- **Using Too Much Capital Per Position** - The number two offender. This goes hand-in-hand with the first issue, because not only are retail traders panicking to enter the trade, afraid that it will get away…but they also put very little thought into how much capital that they should use. They think in terms of “how much they wish to make from the trade” instead of “how much could I lose?” It’s not uncommon to have issues 1 & 2 tie together into the same disastrous trade, which wipes out a good portion of their trading capital in one massive gut punch.

Recognize yourself anywhere? After talking with literally thousands of investors over the past 15 years, it’s almost like they have the same identical story. And quite honestly, hearing one or both versions of this story is all too common.

Let’s see how we can apply these two rules in practice.

Rule Number One - Define Exits Prior to Entry

It's really that simple. Define what your exits are - both profitable and unprofitable - prior to entering the position. It really doesn't take but a moment, and when the heat comes, you'll be glad that you're just "following your prior instructions" rather than trying to figure out what to do with a live position in a volatile market. Trust me, NO ONE thinks clearly when they are holding risk in a position and you're trying to figure out the "future."

"If I sell out now, what if it bounces higher? I'll be sad that I booked my losses!"

"If I hold onto it and it goes lower, I'll be sad that I didn't sell out now and take the small loss before it got to be a big one!"

Investing and Trading is NEVER about trying to "predict the future." All the pundits and experts try to prognosticate about future events as if they can predict, but in reality no one knows. And you don't either. So make it easy on yourself by determining what your exit is PRIOR to your trade entry.

That should lead to your next question - WHERE should I define my exit? In the strategy modules we discussed how to define profitable exits ahead of time, and recommended that you pursue those through a GTC limit order which will "fire" when your limit is reached, locking in your profit.

We also discussed that you should NOT use a "stop" order to limit your risk, that you should define a "price level" instead and close the position as that "trigger level" breaks down as support. This is the first and most fundamental choice of Risk Management.

Determining a Support Level

This can be a somewhat subjective process and does require some experience, however you'll find that this technique does become somewhat simpler to apply if the underlying asset is in a primary bull market uptrend. Support levels become easier to define.

In Figure 1 below, we can see that the price offered former "resistance" at around the BTC $9100 level. Once that resistance level is broken, it becomes new "support." I might sell the $9000 put against that level. Does that mean that any price movement below that level should be considered a "stop loss?" No. You must give trades "room to breathe." There are a certain number of "stop runs" and normal volatility that occurs that indeed does wipe out those that place stops at tight, "too-obvious" levels.

Figure 1

Instead of placing my stop on any movement below $9000, I instead chose the level of the orange line at $8000, which meant that the price would have to start the process of declining into a downtrend. This meant that my position risk would have been $1000 x (position size).

How can you execute a "stop" against a Short Put or a Covered Call position? With the short put, it's relatively simple - you "buy to close" the position. With a Covered Call, it's more complex as you have to first close the short call position by buying to to close, and then close down the underlying asset, should you determine that things are truly turning south.

In a following section, I will show you how to extend the life of that position by selling more time and distance, known as the “position roll.”

Setting a price “stop” level can be somewhat tricky for a newer trader, and there’s little doubt that when you go to execute it the first few times, your stop price will be too close. This is very normal, as you don’t “trust” the markets nor your strategy yet, so it’s conceivable that you might close down the trade for a small loss only to see the price rebound hours or days later. You need to learn from these instances and not give up. Setting tight stops is very common and is something that you need to learn from and adapt out of.

Rule Number Two - Risk No More Than Two Percent

Just because you've set a "stop" for the trade doesn't mean that you're set with your Risk Management goals. We also need to ensure that a stop-out event, which is NORMAL, does not also become that "one trade" that crushes the life out of your account. It's very normal for everyone to roll their eyes and remember that "one trade" that went really sour. If "not setting a stop" is the first rule that gets violated, that error gets compounded when investors use too much capital on one single trade.

Here's the process: After you determine your "stop out" price level, calculate how large of a position size that you'd need to incur no more than 2% risk to your account for that one trade.

Example

Let's say that we used the chart in Figure 1 with the $9000 put being sold, with an $8000 "stop." What position size should we use to limit the risk to 2% of our account?

There are more efficient ways to get to that number, however let's say that we used a minimum position size of .1BTC on Deribit, how large of an account would we need to limit that stop to 2%?

First off, the spot distance is $1000 from "entry" to "stop-out" so if we were trading a full BTC in position size, that would create a $1000 loss to our account. If we divide $1000 by .02, we get a required position size of $50,000.

But using .1BTC would incur a $100 loss on the same stop level. If we divide that figure by .02, we get a $5000 account requirement.

I can hear the howls of protest from you right now that 1) this is too harsh, and 2) how are you ever going to grow your account trading those tiny little positions?

Keep in mind my goal…I don't want ONE REALLY BAD TRADE to kneecap your account. No one said that you couldn't trade SEVERAL positions, leap-frogging over several options series.

And maybe you just don't have that capital yet. OK, then set more aggressive "max loss" parameters, whatever you can absorb. Just understand that the impact of a 10% loss (let's say that you only had a $1000 account for the same trade) is going to leave an emotional scar. I'm trying to get you to trade "below your emotional radar" because ONLY THEN will you be able to properly manage a trade, and not bail at the first hint of a red candle.

The Roll-Out Adjustment

A “Roll-Out” is simply an “adjustment” of a current position. We can decide when the overall “trade” is over. I do this quite frequently when the price is really close to the short strike of a put or call option, and there are only days prior to expiration. Since it could either way, I an unwilling to flip a coin and “risk it” so I will simply “reposition” the trade further out in time and distance.

In the Equities markets with sophisticated options brokers, it’s a one-click process to select “Roll” as your action, and from there you simply select what you will pay to close down the old short option, and then select where/when you want the NEW option to be entered, and for how much credit.

With today’s crypto options brokers, no such functionality exists. We should be able to close the old position for break-even or maybe even better, and then open up the “roll” trade exactly as if we were entering a new order.

I will very commonly do this with short calls if the price gets too “enthusiastic” and rallies up to my short strike. I will pay somewhat above break-even to close down the old trade, for a small loss. But don’t forget, the long underlying asset is gaining value like crazy to compensate for that.

I am much LESS likely to “roll” a short put position, preferring instead to hang in there until a “stop” condition occurs. It is so very common to see deep “tests” occur in the price which almost invariably bounce from that level. I will consider rolling a short put position if the price is right there at the short strike price with a day or two left in the cycle.

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Take the module quiz
- [ ] Do you have any current positions that do not have a “stop” defined?
- [ ] What are the 2% parameters for your own account?

Summary - Risk Management

Following two simple rules can make all the difference to your trading.

Think about how taxing it was to carry a position that you a) weren't sure of the exit point, and b) carried too much risk for your account. If you've ever woken up in the middle of the night just to check on a position's status, you're carrying too much risk on that position and it likely won't end well.

Commit to using simple Risk Management principles with your trading from this day forward; not only will it be easier on your state of mind, but you will likely find it to be a much more profitable experience as well.