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OPTION SPREADS
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*Strategies for Income Generation,
Directional Moves, and Risk Reduction*

SCOTT NATIONS

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THE COMPLETE BOOK OF OPTION SPREADS AND COMBINATIONS

Strategies for Income Generation, Directional
Moves, and Risk Reduction

Scott Nations



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FOREWORD

In this book, *Options Spreads and Combinations*, Scott takes the subject of options and option spreads and shows investors how they can be easy to understand through interesting, real world examples. Just as he does every week on CNBC's *Options Action* and in his first book, *Options Math for Traders*, Scott takes what many have viewed as intimidating concepts and breaks down the barrier of entry for the self-directed investor. Scott has a wonderful ability to use his years of experience and vast knowledge of markets and rather than use industry jargon or high-level mathematics, he breaks things down to a level that is interesting and easy to grasp for all levels of investor—from the novice to the seasoned. This ability to relate to and write for people of all knowledge levels, without arrogance or condescension is impressive when you review his track record which includes being the brains behind the "Nations VolDex®" implied volatility index.

This book encourages you to dig deeper, through poignant examples and real-life situations that can help your decision-making process when you face similar situations. Most importantly, as Scott has done this for a living and has the "battle scars" to show for it, he helps you set realistic expectations. He is not here to give a fly-by-night or get-rich-quick scheme. He is helping you become educated in the theory and reality of options trading so you can put together a realistic game plan and give yourself the opportunity for options trading success.

A prominent and important part of this book is to address some of the most common mistakes that retail traders make. All too often, when folks are starting out in the world of options trading, they only buy or sell single options in directional trades. This can be a successful strategy for some people but over time it is probably not a strategy with which

the average person can have long-term success. This book encourages you to consider spreading your trades, which spreads out your risk and the cost of your trades. As you read along, you will quickly grasp that this type of trading allows you to use less capital and define your risk right up front on your trades. You will have the opportunity in this book to learn about every type of spread trade that is realistic and imaginable.

Chapter 1 addresses the differences in risk and return and the fundamental difference in options payoffs, which sets the pace for the rest of this book and the difference in thinking about options as compared to just buying or selling stock. As Scott emphasizes, the ability for one to manage risk and exposure to the market is much easier if you understand these spreads. This concept of risk differentiates this book from others and is one to keep in mind as you read. Scott gives insight in to how a professional looks at trading. That is, the first thing he looks at is how much risk or how much exposure do I have, then he looks at potential return. This concept is so important and helps to mitigate one of the primary mistakes that many newer options traders have. By defining risk right up front, which most spreads do, it keeps the investor away from a situation where they are in over their head or have risked too much capital, while at the same time setting out a worst-case scenario right up front. You can see this clearly illustrated in Chapter 3 on vertical spreads, no matter if you are buying or selling the spread, you should view the money you can lose and the potential return on the trade. This is not to be minimized and should be heeded in every example. Read this to better understand risk and, more importantly, understand how to define the appropriate risk for you, and it can help you on your road to success.

Scott also does a great job of addressing the size of your trades and keeping risk appropriate. This helps to address another mistake that traders of all levels make; that is, they trade more contracts on a trade than they are ready to. Spreads help to mitigate this situation, but equally as important is the reminder to do what is right for you and what you are ready for in any market situation. This is an important step in achieving success in a way that does not have you up all night worrying.

As someone that talks to retail traders on a regular basis, I find it so refreshing to see someone teaching in a sensible, risk-defined manner to help the average person have a greater chance of success in the market. I commend Scott's thoughtful work delivered in fun and logical lessons in this book. I consider him one of the best options teachers. One of the great benefits of this book is that it is not going to be read and put away; this book can serve as a reference guide for the rest of your trading career. As you step up in knowledge or want to take different types of risk, you can reread the chapters on different spreads as you change your strategies based on market conditions. These lessons are timeless. I hope you enjoy this book as much as I did as you get the chance to learn from a great teacher and a great friend.

—JJ Kinahan

PREFACE

The goal of option trading is to make money. The vital element of making money over the long run is to define risk when you can and reduce the cost of your trade when you should. An option spread (essentially buying one option and selling a similar option) or an option combination (usually using two options in tandem such as buying both a put and a call or using an option in tandem with something else such as ownership of the underlying stock) is usually the best way to define risk and/or reduce the cost of your trade. Not every option spread or combination limits your risk but most do and they do it sensibly, without paying a huge penalty that destroys the mathematical advantage your option strategy might generate. In fact, certain option spreads generate even more mathematical advantage than outright option positions can. The purpose of this book is to help you understand these strategies and apply them intelligently because, again, the goal is to make money. We can and should enjoy both learning about options and trading them effectively, but both are a lot more fun when we're making money.

No trader is right every time, but you should make money more often than you lose money and your profitable trades should make more than your losing trades lose. The easiest way to do all these things is to use option spreads and combinations and to do so in a disciplined manner. That discipline includes taking your loss when your option spread trade isn't working. You will probably have lost a lot less money than if you had traded the stock or an outright option (rather than an option spread or combination) but using a lower-cost, lower-risk spread or combination doesn't mean we can ignore first principles and not take our loss when we should. A spread or combination is also a great tool when doing the hardest thing to accomplish when trading—adding to a winner well.

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