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50 Trading Rules for Option Traders

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Trader Psychology Rules

1. If you fail to plan, plan to fail. You must have a plan for each trade.

2. NEVER trade with money you can't afford to lose.

3. There are no get rich quick schemes. Successful option trading requires investing a lot of work and time.

4. Understand the risk and reward of every option trade before executing the trade.

5. Don't expect to be right all of the time. Trading is not about always being right. It's about setting up a statistically advantageous trade and managing it well.

6. If you have to stare at a chart a long time to figure out what type of option strategy would work best, it's probably not a good chart and move on.

7. Take a full day off from time to time. And don't trade on your vacation away from trading.

8. Be careful not to over-trade. Know your limits.

9. Mistakes will sometimes happen. Don't beat yourself up over them.

10. Don't let your emotions get too high when winning or too low when losing. Keep yourself in check.

11. Trading isn't easy. It requires discipline and hard work.

12. Don't chase the market. "Average pricing" is an investment concept that has no place in the trader's realm. Don't catch a falling knife, just get out of the trade and let it drop.

13. Just because you made money doesn't mean you're smart! Even a blind squirrel finds a nut every once in a while. Just keep striving to get better and don't get cocky.

14. I cannot predict the future. Say it with me. "I CANNOT PREDICT THE FUTURE"!

15. If the talking heads on TV (or bloggers, Twitterers or other media pundits) really knew what the future held, they wouldn't tell you! Trade for yourself and don't listen to those who claim to be "in the know". They're not.

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16. K.I.S.S. Always keep every trade as simple as possible.

17. You're not trading what you think should happen; you're trading what you think WILL happen. As John Maynard Keynes put it "Markets can remain illogical longer than you can remain solvent."

Planning and Execution Rules

18. Planning comes first: Know your exit points, both for a profit and for a loss before entering a trade.

19. Always check for any upcoming company events, like earnings, before placing a trade on the company stock or options.

20. After hitting a set profit target or a loss target, exit—plain and simple. Fear and greed are a trader's worst enemy. They cause you to make bad decisions.

21. Always review your trades at least on a weekly basis.

22. Double check every order to make sure it looks right before executing the trade.

23. Always have your exits planned BEFORE entering into a trade.

Trading Tips

24. Cheap out-of-the-money options are cheap for a reason. They have a low probability of success.

25. Always analyze implied volatility on every option trade. If implied volatility is low, you generally want to be an option buyer. If implied volatility is high, you generally want to be an option seller.

26. Don't trade illiquid options with a wide bid-ask spread. The bid-ask spread is a transaction cost that can be very expensive. In fact, it is usually the highest transaction cost a trader has.

27. Don't trade take-over stocks, or biotechs/small pharmaceutical companies (with a small portfolio of drugs). These are very specialized trades and the pros are way ahead of you.

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28. Don’t over trade. If you don’t love the trade, hold off and wait for one you do.

Specific Strategies

Outright Long Calls or Long Puts

29. Always use stop losses. Know your exit points for a profit and a loss. Entering a stop helps maintain discipline.

30. Stop losses should be between 30 and 40 percent of the purchase price of the option.

31. Profit targets should be 50 to 100 percent of purchase price of the options.

32. Buy “low” implied volatility. That means options are cheap (good to buy).

Credit Spreads

33. Initial credit must be at least 10 percent of the width between the strikes

34. Only trade liquid options with tight bid ask spreads. The difference between the bid and ask must be no greater than five percent of the bid.

35. Only trade credit spreads with less than two months until expiration. The less time to expiration, the higher the theta advantage to the trader.

36. Check the earnings calendar! Make sure earnings does not fall before expiration.

37. Always close the trade (at least the short leg) before expiration. Once you’ve reached 80 percent of the max profit, close it and move on to the next trade.

38. Sell “high” implied volatility. That means the options are expensive (good to sell).

Straddles

39. Buy “low” implied volatility. That means options are cheap (good to buy).

40. It’s OK to buy before earnings, but volatility needs to be cheap enough to warrant the anticipated move.

41. Straddles are short-term trades. NEVER hold them until expiration.

42. Straddles are low-probability trades. Expect more losers than winners. But the winners should be much greater profits than what the losers cost.

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43. Use "time stops" on straddles. If the expected move doesn't happen within 5 business days, close the trade to avoid time decay bleeding.

44. Straddles' profit targets should be 75 to 150 percent of the purchase price.

45. Beginners should exit straddles entirely when their profit target is achieved.

46. More advanced traders can "leg out", partially closing the winning side to get delta-neutral and then the other side if and when the market reverses.

Time Spreads

47. The front-month (short) option's implied volatility should be between two and 20 points higher than the longer-term (long) option.

48. The two options should be at least two months apart to facilitate rolling the short option around its expiration.

49. The short option should be in the top half of the six-month implied volatility range and above historical volatility.

50. Earnings should not fall before the expiration date of the front-month option.

Options involve risk and are not suitable for all investors. Before trading options, please read Characteristics and Risks of Standardized Option (ODD) which can be obtained from your broker; by calling (888) OPTIONS; or from The Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, IL 60606. The content on this site is intended to be educational and/or informative in nature. No statement on this site is intended to be a recommendation or solicitation to buy or sell any security or to provide trading or investment advice. Traders and investors considering options should consult a professional tax advisor as to how taxes may affect the outcome of contemplated options transactions.

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