>: My Rules for Options Trading

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The Dow is making new highs! WHOO HOO, break out the champagne baby!

Er, not! Thirty stocks do not a market make.

The metals sector is red hot right now, and yesterday's takeover of Alcan by Rio Tinto has reignited such stalwart names as Alcoa, which also happens to be a DOW component.

The time to be aggressively buying stocks is when people hate them, not when the collective masses love them.

Last summer, bombs were dropping in Beirut and yours truly was pounding the table to own stocks. You should have seen the hate mail I received! It was enough to transform the saltiest of sailors into a shrinking violet!

It ain?t easy to buck mass psychology, but it?s very profitable. To maximize your gains, you want to buy when stocks are hated, and sell when stocks are adored. You will not catch the bottom, and you will not catch the top, BUT you will catch a whole lot of meat in the middle. Just as important, *you will be taking a fraction of the risk of the typical investor*.

The broad market, as measured by my internal indicators, is sick. Events like yesterday's rally are excellent opportunities to short stocks. Yes, there will be pockets of strength in any market, and that strength is skewing the indexes right now. But the broader market is actually getting weaker, not stronger.

I wrote an articlethe other week that details some of the steps that you can take RIGHT NOW
to identify some great shorting candidates. When going short, my favorite trading tools to use are PUT options. The simple reason is that you can strictly define how much you are willing to risk. You can never lose more than you put up, unlike shorting a stock, where the risk is theoretically unlimited.

But there are some rules you need to know before plunging head first into the choppy waters of options:

With options, time is your friend. The worst feeling in the world is being dead right in your analysis and a day late on your options expiration cycle! So always BUY TIME! You want to go out a minimum of five months on your options, and preferably six months.

The second rule I use is that I want to buy DEEP IN THE MONEY, at least five points in the money. Yes, you give up a factor of leverage by doing this, but you also dramatically increase the odds of creating a profitable trade.

You have multiple forces working against you when you put on a PUT trade, and you want to be able to counter them. By buying deep in the money, you help insure against total loss in your position if the underlying stock does nothing at all.

Research indicates that 68% of the time, sectors, ergo stocks, are within one standard deviation of the mean. That means that most of the time they are just ?middling? and not doing a whole lot. Buying PUTS deep in the money helps insulate you to a degree from the very large statistical odds of the stock doing nothing at all.

Additionally, by going deep in the money, your Delta (delta is a measurement of how closely your option mimics the action of the underlying stock) will be much closer to 1 to 1. That is, for every one point move in the underlying stock, your option will move one point.

Use common sense, and remember to start out small until you get comfortable. It?s OK to just trade one contract at a time until you build up your confidence. It?s a learning process, and losing money is a great teacher! Just make sure that you?re not going hog wild. Think of this as just one approach that you can employ in your arsenal of investment weapons.

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Remember that option trading should only be part of your overall investment plan, NOT THE WHOLE THING!

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