THE OPTION TRADER'S HEDGE FUND

A BUSINESS FRAMEWORK FOR TRADING EQUITY AND INDEX OPTIONS

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One caveat: There are times when a small trade with unusual strikes may fall into a spot in which an algorithm wants to execute the trade. So nontraditional spreads may fill at prices that surprise you.

Size of Order

Trades under ten contracts will have an easier time filling than trades larger than ten. Most algorithms are designed to let the market maker know that there is an order to trade and not set to trade a massive spread, unless it has a ton of edge, or the firm runs an airtight quoting system. Starting small with a spread of fewer than ten contracts helps you get a better fill.

Working an Order

Just because the quote gives a "midprice" does not mean the quote is the midprice. "Book orders" can throw off the bid-ask spread. Book orders can also throw off volatility calculations because they can artificially lower or increase the IV of the calculated midprice. What you are using as a calculation when trading volatility affects this. Once you have established the midpoint, it never hurts to try to do better than that price.

Just because it is a computer quoting the price doesn't mean that it can't screw up. If you have dumped in the wrong IV, the computer might fill the order. Also, a trader or trading group might trade in a manner that causes the trading group to fill the order even if it is above the quoted midprice. Chalk this one up to the "it never hurts to try" category.

Most market makers train for at least a year before "getting on a badge." As a TOMIC trader, you are self-backed, trading your own money. Be as rigid as possible with how you trade and become skilled in getting the absolutely best possible price you can. Remember, saving .05 on a ten-contract trade every day equates to $12,500 a year.

So, to make things easy, here is the thought process I go through and encourage all traders to go through when they enter the market. By following this checklist, traders can develop an approach that will hopefully hone them in on a trade with edge.

Trade Execution Checklist

Before the trade:

- What market are you going to trade?
- What is the direction of the market?
- Did you check the volatility conditions of the market? What is the historical volatility of the market? What is the implied volatility? Did you check the skew?
- What is the strategy you will be using?
- If this is a complex spread, how will it be executed? Is it worth executing at the individual component level? Will you be legging into the spread? Will it be sent as a complex order?
- What is the maximum allowed loss?
- Is the expected return within the underwriting parameters?
- What is the target profit for this trade?
- What is the size for this trade?
- Does it conform to the position sizing parameters?
- At what point would the trade require adjustment (if any)?
- Do you know the possible adjustments to make to the trade (if needed)?

During the trade:

- Has the trade hit an adjustment point?
- Has the trade hit the profit/loss target?

After the trade:

- Did you log the trade in the trading diary?
- Did you follow the trading plan?
- If you did not follow the trading plan, why not?

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The Trading Plan

"Failing to plan is planning to fail."

—Alan Lakein

Not every business has a business plan, but every successful trader has a trading plan. To make money consistently, you need a plan giving yourself a framework, defining the parameters, and keeping your focus.

Having a plan is not a prerequisite to starting a business. However, having a plan is usually a precursor to creating a *successful* business. Many people can start a business. The number of startups per year is large; but, in the end, only the ones with a plan that can be implemented well will survive and flourish. In the business of trading, successful traders have a trading plan that they follow. The reason for creating a trading plan is to guard against the emotional swings that you go through when trading. The trading plan establishes a framework. It gives you as a TOMIC trader a process to follow. The trading plan describes what to do in each scenario. It is like a flight plan and an emergency plan in one.

The trading plan contains guidelines for trading. It defines how you plan to play the game. In trading you make your own rules, but the key is to be consistent. If your rules do not work, get new ones, create a new plan. However, the only way you will know whether they work is by sticking to the plan and evaluating your performance continuously.

When a casino sets up a blackjack table, it gives its dealers specific parameters to follow when dealing cards to its clients. For example, the dealer must stay on 17 and must hit (take a card) on less than 17. This is a specific rule that the casino imposes on the dealer to have consistency across the casino, and it is done so that the casino has an edge. A trading plan works the same way; it gives the trader a framework to generate a consistent outcome. The trading plan gives you a chance to win by following a process providing measurable outcomes that can be improved continuously.

The Mind-Set

The mind-set of a successful manager of TOMIC or of any business is very important. When a U.S. Marine goes into the battlefield, he knows that he is fighting for his country and that no matter what, he won't be left behind. Marines can go into any scenario confident that their fellow marines are watching out for them.

The feeling of confidence in a trading plan is what you need to manage the TOMIC portfolio. The belief in the trading plan keeps you out of trouble and leads to profits consistently. However, confidence or belief in the plan is not enough. Following the plan will get difficult at times. That is why, as the successful manager of TOMIC, you have to be dedicated, disciplined, bold, flexible, and humble.

TOMIC is a business, and it will take a lot of dedication and commitment to follow the trading plan to make profits. There will be a lot of ups and downs that will impact your management psyche. It is not an easy business. The market will constantly challenge you. However, the commitment to the business will overcome the emotional swings.

You will need to be extremely disciplined in order to follow the trading plan, making sure that the entries and exits are followed, and that the underwriting is done correctly. The discipline helps you overcome the emotions of trading. One of the biggest reasons that traders blow up their portfolios is not taking losses early enough. This is because the emotion of losing is so great that taking a loss is undesirable. Even though the plan will say to take the loss early to avoid a larger one later, the undisciplined trader will freeze. You have to be prepared for this so that when the time comes to take the loss, you actually take it and follow the trading plan.

As the manager of TOMIC, you also need to be bold and decisive. There will be times when opportunities abound and you must decide whether to take them. Then there will be times when you will need to not trade, when opportunities are scarce. Also, being bold allows you to make critical decisions at the appropriate time.

Flexibility is one of the most underrated characteristics of a good TOMIC manager, but one of the most important. Being flexible together with boldness allows you to change course when things are not going your way. Let's say that you have a portfolio leaning net long and the market has reversed and gone from a bull to a bear market. You need to make the decision to change the portfolio from leaning long to leaning short. This is not easy to do if you are not flexible and decisive.

One more important characteristic of the successful TOMIC manager is humility. The market will send many curveballs. It is very unlikely that you will have 100% successful trades every year. Remember, even Warren Buffett has had his share of bad investments; for example, Salomon Brothers, US Airways, silver (way before silver took off in 2010–11). However, think of bad trades as learning opportunities. Bad trades provide feedback that teaches you how to do better next time. Being humble is the key to not taking losses personally. Losses are part of the business. If there were no losses, no one would need to insure and then TOMIC would be out of business.

In conclusion, your mind-set as the manager and trader is the key. You need to be dedicated, disciplined, bold, flexible, and humble in order to be successful at TOMIC. If you have a strong mind-set, you will succeed.

When a trade goes against you, be prepared but do not panic. Fortunes are made and lost in times of great uncertainty. Mental toughness is required in this business. It is like the great champions in sports, Michael Jordan and Tiger Woods. They have the mental toughness to be disciplined and come through at the end. It's the same in trading: You must have the worst-case scenarios planned out so that when something happens you don't freeze and you know what to do. Just like a commercial airline pilot, in case of emergency you calmly go through your checklist. An example of having a plan was that of Captain Chesley B. Sullenberger, who had to ditch a US Airways jet in the Hudson River in Manhattan on January 15, 2009, when the plane was hit by a flock of Canadian geese. Fortunately, Captain Sullenberger had trained for emergency situations, and he had a plan he was able to execute perfectly. In so doing, he saved the lives of all his passengers. Having a trading plan will help you have the scenarios mapped out and will give you that guide of what to do in an emergency.

The Importance of Sticking to the Process

When you're running a business, what do you think is better: sticking to a process or going with your gut? Being lucky or being good? The saying goes, "It is better to be lucky than to be good." However, you can't be lucky all the time. So, where does that leave you?

Assuming that you know how to play blackjack, take a look at the following scenario. You are dealt a 10 and an 8, making your count 18. The dealer is showing a 6. Potentially, the dealer could have a 16, in which case he would have to draw a card and probably bust. You hit (ask for a card) and fortunately get a 3, making your hand 21, a winner. There are high-fives all around the table and you think you are a great gambler. If you had been your TOMIC manager, would you have been happy with what you did? Hitting on an 18 with the dealer showing a 6...was that a good move? Even though you won, did the outcome justify the risk you took?

In reality, being lucky works great, if you are lucky all the time. However, the move you made at the blackjack table was a lousy move. The odds of your busting (losing) were very high if you drew a card, while the odds of the dealer having a 16 and having to draw were very high also. The dealer had a good chance of busting. So you should have stayed and let the dealer draw instead. You had a much better chance of winning if you had stayed with 18. Taking the hit was a bad (one could say stupid) decision. Hey, you won. But we absolutely would not hire you to manage our money. You won because you were lucky. But do you think that over the long run you would continue winning by making those kinds of decisions?

Here at TOMIC, it is extremely important to stick to your investing process. When you see good trades that give you a winning edge, you do them. It does not mean you will win every time, but over the long run