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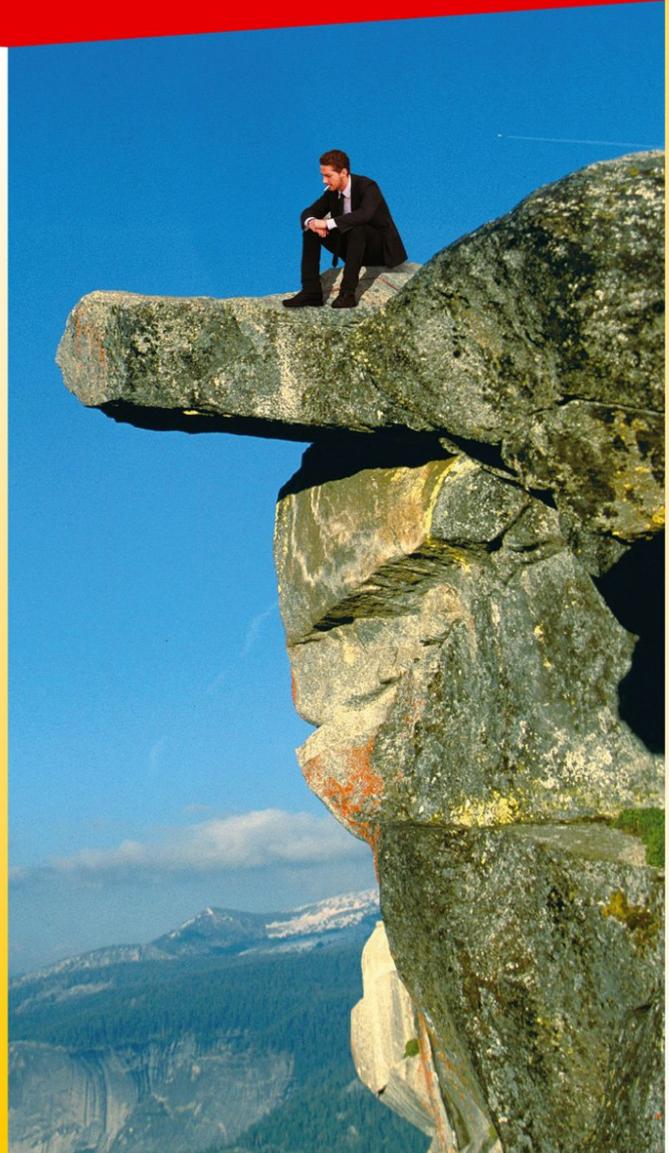
## **EXPLORING THE EDGE**

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## *Exploring the Edge*

Before getting into the importance of having an edge, it should be helpful to define just what is meant by “having an edge” in the business of trading.

Edge is what a seven-foot tall basketball player has over a five-foot player when all of the other attributes are equal.



The thesaurus says, edge is synonymous with advantage and the advantage we are seeking is an improvement in the odds or probability of a favorable outcome like counting cards in blackjack or knowing which hands to bet on in poker. Edge is what the Las Vegas casinos have over the players - the probability of success. While casinos do not always win, as long as they can keep the players in the game, in the long run they will end up with all the money.

The definition of gambling is taking a risk when the odds are against you while successful speculation is taking a risk when the odds are in your favor – this is the edge.

Since traders have to pay commissions and transaction slippage, unless you can find an edge and get the odds in your favor, trading will be a losing proposition.

In his book *The New Market Wizards*, Jack Schwager sums up the importance of an edge as follows,

“It is Absolutely Necessary to Have an Edge. You can’t win without an edge, even with the world’s greatest discipline and money management skills. If you could, then it would be possible to win at roulette (over the long run) using perfect discipline and risk control. Of course, that is an impossible task because the laws of probability. If you don’t have an edge all that money management and discipline will do for

you is to guarantee that you will gradually bleed to death, Incidentally, if you don't know what you edge is, you don't have one.”

Some examples of edge are intuitive and easy to understand, others may not be so apparent.

### ***Information***

One of the most obvious examples of an information edge is insider trading, long considered an entitlement of the privileged and well connected, fortunately for the rest of us, is now illegal. However, the ability to collect, process, organize and reach conclusions from the massive quantities of market data now available provides a definite edge for those with these skills.

Here is something to keep this in mind when evaluating information sources, especially stock tips.

“Those who know do not tell; those who tell do not know”  
Lao-Tsu (604-531 B.C.)

### ***Fundamental Analysis***

Good fundamental analysis skill may be intuitive, but going one-step further and identifying the fundamental factors that actually move stock prices may not be so obvious. For example, although a stock may have a low price-to-earnings ratio it may not be important if the company is the subject of a class- action lawsuit. The ability to dig into the news releases and research reports to determine what moves the stock price is an important edge. Those who have spent a career in a medical research have an edge when evaluating companies in the biotech sector just as petroleum engineers have an edge in the oil and gas sector.

Another less obvious example is to focus on companies that are not widely followed by Wall Street analysts (although options liquidity may be an issue for some less actively traded issues).

### ***Technical Analysis***

Just as there are many fundamental analysis techniques the same is true for technical analysis, from Edwards and Magee classical bar charting analysis to Elliott wave. With the widespread use of personal computers, moving averages, stochastics, MACD, point and figure charts are examples of technical analysis that can provide an edge when consistently applied. Another subtle but effective technical analysis tool is a correctly drawn trendline. Other popular tools used for trend determination are moving averages, sum of the least square calculations and point and figure charts.

This quote attributed to John Magee the co- author of the classical bar charting book, *Technical Analysis of Stock Trends*, sums up the most important difference between fundamental and technical analysis,

“Don’t tell me what to buy - tell me when to buy it.” - John Magee

### ***Systems***

For those with mathematical interests mechanical systems, sometimes called non-discretionary trading systems, are designed to enter orders automatically based upon predetermined, and most often back tested and optimized, sets of rules. While the programmed correlations remain relevant, these systems can provide an edge. Two important components of any successful system is a defined edge and sound money management techniques.

### ***Pliability***

This advantageous trait refers to the ability to change ones beliefs about what the markets or an individual security is doing compared to what they are expected to be doing. When correlations and relationships change the ability to change direction is a definite advantage and is sometimes cited as a weakness of the mechanical systems approach.

There is little disagreement that there is no edge in trading what the market should logically be doing, so the ability to change your mind and not remain fixated on what should be happening is an edge. Therefore, the ability to recognize errors and quickly take corrective action is an important edge.

### ***Risk Aversion***

Recently there have been many examples of significant losses realized from excessive risk so it is easy to understand those with a natural risk aversion have an advantage since they are more likely to remain in the game while applying their discipline in the pursuit of long- term results. Here is a quote making this point.

“Rule number one: never lose money. Rule number two: never forget rule number one.” - Warren Buffet

Here are two more thoughts about risk from well-known and respected traders.

“Risk no more than you can afford to lose, and also risk enough so that a win is meaningful” - Ed Seykota

“I have two basic rules about winning in trading as well as in life: (1) if you don’t bet you can’t win. (2) If you lose all your chips, you can’t bet.” - Larry Hite

## ***Money Management***

Traders are not evaluated for their knowledge of technical or fundamental analysis but on their money management skills and trading performance based upon -how much money is gained versus how much is lost. Limiting position size and knowing when to increase the position size is the essence of money management. Many writing on the importance of money management often suggest limiting single position risk exposure to a fixed percentage of the available trading equity. However, other successful traders advise there are times when position size should be increased. For example,

“The way to build long-term returns is through preservation of capital and home runs. You can be far more aggressive when you’re making good profits.” - Stanley Druckenmiller

Traders with well-defined money management techniques applied with discipline have an edge since they are more likely to be in the game longer, thereby improving their odds of success.

## ***Trade Plans***

Using predetermined written trade plans defining why a particular trade is being made, along with stop-loss limits and portfolio size limits offer an advantage since subsequent management decisions are less likely to be controlled by emotional actions taken in reaction to daily events. They can help to remain focused on the original objective of the trade.

This thought applies to trade plans.

“If I had eight hours to chop down a tree, I’d spend six sharpening my ax.”  
Abraham Lincoln

## ***Trade Timing***

This broad catchall category includes some of the most important considerations for both fundamental and technical analysis. There are certain groups that perform better, with statistical significance, at certain times of the year. Some examples of these are seasonal trades like agriculture and energy in the spring and gold in December.

For another example, some professional traders only participate in the opening or close of the markets having found an edge in offsetting very short-term supply and demand imbalances.

## ***Exploring the Options Edge***

Most traders are familiar with the advantage options offers for increasing leverage however, many may not be as familiar with the disadvantages, including time decay and the affect changing volatility has on options prices.

### ***Spreads***

Using spreads is one way to retain leverage while offsetting much of the time decay and volatility risk. For example, with a long call vertical spread, the long call leg has positive delta, gamma and vega, but with negative theta. By using a spread, the short leg has negative delta, and vega, but with positive theta. By choosing the right leg combinations, positions can be created that retain the positive directional delta while offsetting most all of the theta and vega risk.

### ***Limit and Define Risk***

Another widely known options advantage is the ability to limit risk to the price of the option thereby defining the position risk. Spreads can also be constructed so the position risk is defined and limited while greatly offsetting the time decay and volatility risk. The ability to define and limit risk is one of the keys to staying in the game in order to benefit from improved long-run odds.

### ***Hedging***

Options are often used to hedge other positions long or short with the options offsetting the directional risk. Hedges can be constructed for short periods when specific event risk is abnormally high or matched for longer periods to hedge risk for the life of the asset or liability. Option combinations can also be created to hedge volatility risk during periods of rising or declining market volatility. In addition, the flexibility of options allows partial hedges to be used just during the periods of maximum perceived risk at correspondingly lower costs.

### ***Understanding the Valuation Models***

In the options valuation models option prices are based on an assumption that price movements are log normally distributed, however we find many examples of price movements exceeding the numbers expected by the log normal distribution assumption. As a result, options prices are often adjusted to compensate for the actual price estimates. This can be seen by looking at the pricing skew where the out-of- the –money calls appear less expensive than the in-the-money calls and the out-of-the money puts appear more expensive than in-the-money puts offering an advantage to put sellers.

Here is Jeff Augen's explanation in his book *The Volatility Edge in Options Trading*.

“Since then [1987], implied volatility profiles for equity and index options have taken on a distinctively negative skew- that is, volatility tends to rise as the strike price decreases. This effect causes out-of-the-money puts to be relatively more expensive than the Black-Sholes theory predicts. Additionally, because put-call parity dictates that the relationship between implied volatility is the same for both types of contracts, in-the money calls should also be more expensive.”

This example of skew suggests when a defined uptrend is underway, there is an edge selling puts in combination with long call spreads.

Further, by comparing the price movement of a stock after past reporting dates, an estimate can be made of about the accuracy of the current implied volatility. There are examples when the implied volatility underestimates the stock movement after reporting thus providing more option-trading ideas. This is also seen in the movement of smaller capitalization stocks, but the implied volatility has usually been adjusted to compensate for the larger price move potential of smaller stocks.

Another skew example is comparing the implied volatilities of the calls to the puts. Discrepancies here offer a clue as the degree of motivation between buyers and sellers of calls and puts. Short-term directional opportunities are often found by making these comparisons.

### ***Trend***

Since the most popular option pricing models use a log normal distribution assumption it is interesting to note there is no variable in the model for trend, suggesting an advantage for trend followers especially when the underlying has been trending upward as the implied volatility declines thereby reducing the net debit cost of bullish long call debit spreads. Further, due to volatility skew out-of-the-money puts offer a pricing edge when puts are sold on uptrending stocks.

In the case of defined downtrends, using options strategies with more long options such as put ratio backspreads can create a bearish strategy with a volatility edge as implied volatility rises since the position has more long options than short options it has long volatility, or vega, adding edge to downtrending trades.

### ***Volatility***

An understanding of the relationship between implied volatility and historical volatility offers options traders another edge opportunity. Implied volatility measures how the options are currently priced based upon actual market activity using an options pricing model, while historical volatility also called realized volatility or statistical volatility, measures how the underlying security has actually moved in the past. Many believe that

implied volatility offers the best estimate of the future historical volatility, but in the final analysis, at expiration it is the movement of the underlying security that matters and implied volatility is often higher than warranted by the movement of the underlying. In these cases, the edge goes to the seller of options. On occasion, the implied volatility may be lower than the historical volatility indicating the options may be underpriced. This is true when the lower implied volatility prices are not accurately forecasting a decline in the historical volatility, creating an edge for the buyer of underpriced options. Likewise, when a spread is created by selling expensive options as expressed by implied volatility and buying inexpensive options, again expressed by implied volatility, then an edge can be created. Using spread scanner tools set to uncover differences between implied volatility and historical volatility or between the implied volatilities of two different strike prices is a good way to discover this edge.

### ***Volatility Forecasting***

The most important volatility measure is the forecasted historical volatility of the underlying security for the period of the option. Understanding that volatility is mean reverting in conjunction with the ability to recognize volatility ranges, usually caused by changing fundamental factors, helps to make volatility forecasts. Volatility charts showing implied and historical volatility are important tools for volatility forecasting and creating a volatility edge.

### ***Trade Size***

This reference to trade size is not related to trade size as a certain percentage of equity as often used in risk management calculations; it refers to an operational edge. For individual traders there is an advantage in using small orders, usually 10 contracts or less since they receive automatic execution based upon the posted bid or ask prices. Often larger orders will cause the bid price to drop or the ask price to rise reducing the expected edge. Therefore, small traders have automatic execution edge.

### ***Information Processing***

An example of an options information organization and processing edge includes is the ability to scan the entire options database and rank underlying securities based upon their implied volatility relative to their historical volatility, or rank securities based upon their changing implied volatility, or their implied volatility compared to their 52 week range. Another edge example is the application of a ranking tool that finds securities with active options, rising implied volatility and a low put-call ratio. Structuring trades using the securities from these scans and rankings will greatly improve the odds of success and by definition creates an edge.

## *Edge Summary*

There are many edge examples in different forms for different trading styles depending upon the preference, experience and skill of the trader. We have offered just a few examples of trading edge and a few ideas available to option traders. The purpose of having an edge is to improve the odds of success and it is important is to know your edge, because if you don't, you don't have an edge.

IVolatility.com Team

*As a part of our continuing effort to expand our Knowledge Base, we encourage you to send your ideas and experience with the importance of having an edge. Please send them to [support@IVolatility.com](mailto:support@IVolatility.com)*

