

# **Options Magic**

**By Rob Abels**

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## Introduction

### The Last Wave in Price Patterns and How to Trade It Successfully

All investment markets have prices that go up and down primarily on two human traits, **'fear and greed'**. The fear comes in when you suddenly discover that you're being left out of what appears to be a sure thing and the greed takes place when you like your investment so much you just can't wait to own more of it. Greed is something that traders must learn to overcome because the professionals look for it and take advantage of it.

Fear and greed are not such a bad thing. In the pages of this book, our goal is to teach you how professional traders and institutions take advantage of these two human emotions to make huge profits for themselves and their clients.

Successful trading is nothing more than identifying this fear and greed, not only in yourself, but in the actions of other traders and investors. The more experience you get as a trader, the more confident you'll become with your own levels of fear and greed and the more you'll see these emotions in the actions of others.

Regardless of the market you become interested in, whether it's real estate, commodities, collectables or stocks, prices will go up and down in what we refer to as **'price waves'**. Successful traders make use of a lot of tools and our favorite is a plain and simple price chart. In all markets, values change for various reasons and it's our opinion that those changes are all expressed in a price chart.

Being a successful trader doesn't take an MBA from Harvard. Anyone can do it. It's simply a matter of understanding how prices move up and down and knowing when the pattern is about to change.

## Price Patterns

Identifying a price pattern is easy, you basically have two to choose from. When prices are going up or down in a steady manner, the prices are **'trending'**. A pattern of higher price swings is an **'uptrend'** and lower price swings is a **'downtrend'**. In the pages of this book, we'll teach you how

institutions and professional traders take advantage of **both** of these types of trends.

The other type of pattern is a choppy or non-trending pattern. During a choppy period, **'inconsistency'** is the name of the game.

## **The Up Trend**

An **'up trend'** is simply a series of **higher** price highs followed by **higher** price lows. Up trends are very easy to see on price charts, but most traders are not able to identify them as they're occurring.

## **The Down Trend**

A **'down trend'** is simply a series of **lower** price highs followed by **lower** price lows. Again, these trends are easy to see **after** they've occurred.

## **The Psychology of Price Patterns**

Before you say to yourself "Oh no – Not another book on trading psychology", just keep reading. We promise not to get into anything "way out there". But institutional traders and professionals know how to use the financial markets to their advantage. In Chapter 4, we'll teach you how to identify these patterns as they're unfolding.

## **Our Trading Experience**

I started trading in the 1980s and have traded continuously ever since. The price patterns described in this book have been a large part of my trading success. I know how to do this stuff and I'm going to teach you.

## **Automation**

The patterns you're about to learn have been completely automated. I've done this for my own family, as well as, for the continued support of our many subscribers.

## **New Traders**

These patterns are very simple. Once you've learned to spot them, you'll be able to trade any market.

## **Trading Support**

Once you learn these patterns, you can trade them on your own or you can make use of our expert traders that are available to assist with auto trading.

## **Option Trading**

If you're familiar with trading options, you may want to skip Chapter 1. But before you do, it may be worth at least flipping through the pages.

## Chapter 1

### What is an Option and How Do I Trade It?

An option is defined as the right (but not the obligation) to purchase something at a predetermined price for a specified period of time. For example, let's say that you're a real estate investor and you happen to believe that home prices in your area will probably increase in value during the next 12 months by around 10%. Because of your **'positive outlook'**, you decide to look for a home that you feel has the best chance of increasing in value should your outlook be correct.

During your search for an investment property, you come across a situation where a homeowner is expecting a job transfer to another city sometime in the near future. You also discover that the homeowner does not share your optimistic outlook for real estate prices and that he is concerned about a decline in the price of the home. Because the home happens to be in the right neighborhood and because it happens to fit with your positive outlook, you decide to talk to the homeowner about an **'option'** to purchase the home.

The home owner in this case is the **'seller'** and since he's not yet ready to move, an option contract is an excellent way for the seller to **'lock in'** the selling price at today's current market value, which we'll say is \$300,000. Because an important part of an option contract is **'time'**, you and the seller agree that the contract will terminate at the end of a 12-month period. You and the seller also agree that a **'fair price'** would be for you to pay the seller a non-refundable fee of \$10,000 as a **'premium'** which would make you the **'only'** possible buyer of his home during the next 12 months. In doing so, you and the seller have identified the three most important aspects of an options contract – time, price and option premium. When entering into this agreement, you become the **'option buyer'** and the current homeowner becomes the **'option seller'**.

As the option buyer, you have the right during the 12-month period to buy the home for \$300,000. But let's say that the seller's job transfer comes through 6 months into the 12-month contract. Let's also say that your positive outlook was incorrect and the value of the home has declined from \$300,000 to \$285,000. Because you have the **'right to purchase'** and not the obligation, you decide to walk away from the deal and forfeit the \$10,000 you paid in premium. Instead of an option contract, had the seller been willing to sell you the home for \$300,000, as an investor in the home

you'd be looking at a loss of \$15,000 and you'd be stuck with the home. But as an option buyer, your loss is limited to your option premium of \$10,000.

As for the option seller, even though you've walked away from the deal, the option contract has worked for him as well. Because his outlook for a decline in real estate prices turned out to be correct, instead of a loss of \$15,000, his loss is limited to only \$5,000 (\$15,000 less the option premium of \$10,000).

An option contract on the purchase of any other '**asset**' such as a stock works much the same way. If you happen to feel that the stock of the fast food chain McDonalds (MCD) is likely to increase in value by around 10% during the next 6 months, you could buy the stock, wait for the price to increase, and then sell it at a profit. If MCD is trading at \$80 a share on the day of your purchase and you decide to buy 100 shares, your investment would be:

**100 shares at \$80 a share = \$8,000**

If you're right and the price of the stock increases in value from \$80 a share to \$88 a share, your investment would be valued at \$8,800 and you'd have a profit of \$800 (or 10%).

However, instead of purchasing 100 shares of stock in MCD, you could have purchased an '**option contract**'. An option contract would give you the right to buy the stock at a specified price (let's say \$80 a share) within a specified period of time (let's say 6 months). The price that you would pay for the option is called the '**option premium**'. When purchasing an option contract, the option premium is determined by '**the market**'. In other words, traders around the world that are interested in purchasing this same option, all have to '**bid**' (or specify a price that they're willing to pay). The price that these interested parties are willing to pay for the item is referred to as 'the market'. For this example, let's use an option premium price of \$775. Options on stocks are created by the options exchange and one option contract represents 100 shares of stock.

Now, let's compare the purchase of a stock to the purchase of an option on the same stock. In the above example, had we purchased 100 shares of MCD at \$80 a share, the cost of doing the trade would be \$8,000. If the price of the stock goes to \$88 a share, your profit would be 10% or \$800. If the price of the stock declines to \$70 a share, your loss would be \$10 a share or \$1,000. But if MCD suddenly goes bankrupt and the price of the stock drops to zero, you'd lose your entire investment of \$8,000.

If you were to buy the option based on a price of \$775, you'd be purchasing the right to buy 100 shares of stock in MCD at a predetermined price of \$80 a share. If you're right and the price of the stock increases in value to \$88 a share, you have the right to still purchase the stock at \$80. Therefore, you have an automatic profit of \$8 a share should you decide to exercise your option. However, if you decide to hold your option until the end of the 6-month period and the stock is still trading at \$88 a share, your trade would be over at a profit of \$8 a share (or \$800).

Let's compare the two trades. First we'll look at buying 100 shares of the stock:

**100 shares at \$80 a share = \$8,000**

**The stock goes to \$88 a share = \$800 profit (or a gain of 10% on your investment)**

Now, let's look at buying one option contract:

**1 option contract = \$775**

**The stock goes to \$88 a share = \$800 profit (or a gain of more than 100% on your investment)**

If the price of the stock goes to \$88 a share, the profit on each trade is the same \$800.

We need to point out here that if the 10% gain happens within the first few months of the 6-month contract, other traders would be willing to pay more for the option because of the fact that there's still quite a bit of time left in the contract. If the gain happens quickly, the market value of the option would give you more profit than the \$800 that we're using in this example. But to keep it simple, we'll ignore the time value of the option.

But, what if the price of the stock goes up, but it only goes to \$81 a share? Let's take a look.

**100 shares at \$80 a share = \$8,000**

**The stock goes to \$81 a share = \$100 profit (or a gain of 1.25% on your investment)**

Compare this to buying one option contract:

**1 option contract = \$775**

**The stock goes to \$81 a share = \$100 profit (or a gain of 12.90% on your investment)**

As we can see, the profit is the same. In fact, as long as the price of the stock is equal to or greater than \$80 a share, the profit on both trades ends up the same.

What if the price of the stock declines to \$70 a share?

**100 shares at \$80 a share = \$8,000**

**The stock declines to \$70 a share = \$1,000 loss (or 12.50% on your investment)**

Compare this to buying one option contract:

**1 option contract = \$775**

**If the stock were to decline to \$70 a share, there would be very little value in the option. The value would depend on what other traders would be willing to pay for it. For this example, let's assume that the value of the option would be zero.**

**The stock declines to \$70 a share = \$775 loss (or a 100% loss on your investment)**

In this case, if the option has very little or no value, your loss would be limited to the option premium of \$775.

Remember our example of the real estate investor and the home owner? If the price of the home declines from \$300,000 to \$285,000 and the investor decides to walk away from the deal, his loss is limited to the option premium of \$10,000.

Worse yet, what would happen if you purchased the stock and MCD suddenly went into bankruptcy?

**100 shares at \$80 a share = \$8,000**

**MCD enters bankruptcy = \$8,000 loss**

Compare this to buying one option contract:

**1 option contract = \$775**

**MCD enters bankruptcy = \$775 loss**

In this example, as long as the value of the stock remains above \$80 a share, both the stock and the option will have the same amount of profit. However, if the value of the stock slips below \$80 a share, the option will lose value faster until it gets to the maximum loss of \$775.

Next, let's relate these examples to terms that you'll need to become familiar with if you're going to trade options.

In these examples, as the buyer of the option contract, you were purchasing what is referred to as a **'call option'**. A call option is the right (but not the obligation) to purchase the underlying asset (in this case either the house at \$300,000 or 100 shares of MCD at \$80 a share).

The seller of the option contract is sometimes referred to as the **'option writer'**. It is the seller's responsibility to 'deliver' the asset (the seller's home in our first example or 100 shares of MCD in our second example) to the buyer if he or she so desires (this is referred to as **'exercise'**).

The selling price that is specified in an option contract is referred to as the **'strike price'**. In the case of the \$300,000 home, the strike price would be \$300,000. Similarly, in our second example of 100 shares of MCD, the strike price would have been \$80. As long as the **'market value'** of the underlying asset is greater than the strike price, then the option has **'real value'**. A more familiar term that option traders will use for the real value of an option is **'intrinsic value'**.

An option contract is always written to cover a specified period of time. As a result, option contracts are terminated on what is referred to as the **'expiration date'**. When an option expires, the seller is obligated to deliver the underlying asset to the buyer at the predetermined price.

Let's take these two examples one step further. Let's look at a different real estate example. Let's say that you're a real estate investor and you own a piece of vacant land. Let's also say that you're concerned that over the next

18 months, real estate prices in your area are likely to decline by as much as 15% to 20%. Let's also say that the land has been in your family for over 50 years and you just can't bring yourself to selling it. And let's say that a banker friend of yours gives you the name of a company that sells insurance policies to land owners that will protect you from a loss should prices decline.

After several discussions with the insurance company, let's say that you decide to purchase a '**loss protection policy**' that would cover any declines in the value of your property up to 20% of today's value during the next 18 months. Let's say that the current market value of the property is \$500,000. Thus, a decline of 20% in the market value of your property would cover up to \$100,000 of lost value. Let's also say that the price for this insurance is \$8,000 (we'll refer to this as the '**premium**').

Now, let's move the clock forward 18 months and real estate values have in fact declined, but not as far as you thought. Let's say that they've declined by only 5%. Your \$500,000 property is now worth \$475,000 and let's say that you have a buyer at that price. Because you've experienced a loss in market value of \$25,000, the insurance company covers your loss and you receive a check from them for \$25,000. Thus for a premium of \$8,000, you managed to avoid \$17,000 of additional losses.

This same type of '**insurance**' is also available to owners of other assets such as stocks. Let's say that you inherited 1,000 shares of Apple Computer which was purchased in the very early days when Apple first became a publicly traded company. Because of the huge taxes that would become due from the profits that have compounded through the years, you decide **not to sell** the stock. But, because of your concern about the possibility of losing money if the value of the stock should decline, you decide to speak with your financial advisor about a loss protection policy. In the world of options trading, this type of insurance is referred to as a '**put option**'.

A put option gives the buyer (in this case the buyer is you), the right but not the obligation, to sell the underlying asset at a predetermined price for a specified period of time.

In our real estate example, let's say that after 15 months of the 18-month contract, the market value of your property has dropped by 10% and you decide to sell the property at a loss and make a claim against the insurance company. After the 10% loss, your \$500,000 property sells for \$450,000 and you receive a check from the insurance company for \$50,000. As a result, for a premium of \$8,000, you were fully protected against a loss of up to \$100,000.

But what would have happened if the value of your property had declined to \$380,000? At the time of sale, you'd have taken a loss of \$120,000. Because your policy only covers losses up to \$100,000, you'd have had a real loss of \$20,000 plus the \$8,000 that you paid for the option premium.

In the case of your 1,000 shares of Apple Computer, the price of your insurance would depend on several things:

1. The strike price of the put option. Remember, the strike price in these examples is the price that the buyer and the seller of the option contract agree is the current market value of the asset. In the case of the \$500,000 piece of property, the strike price would have been \$500,000. In the case of Apple Computer, let's say that the current price of the stock is \$100.00 a share. To fully insure the 1,000 shares, the strike price of the put option would be 100.
2. The second item is the period of time for the option contract. In other words, when does the option contract expire? In the case of Apple Computer, we want insurance that would cover a loss during the next 18 months. Therefore, we want to buy a put option that would not expire for at least 18 months from today.
3. The third item is price volatility. A discussion of price volatility can become complicated, but a simple explanation is that when price swings are mild (or minimal) and prices remain somewhat steady, price volatility is not too important and it has very little effect on the price of an option. But when prices are changing very rapidly from one day to another, the price of an option will be much higher than it would be during quiet times.

For this example, let's say that a put option that would prevent **any loss whatsoever** in the value of the 1,000 shares of Apple Computer, is currently trading at 14 points.

Remember, an option contract is equal to 100 shares of stock. Therefore, a put option trading at 14 would cost \$1,400 (\$14 times 100). But one put option contract would only cover losses for 100 shares of stock. In order for you to fully protect the 1,000 shares, you'd have to purchase 10 put option contracts. Your total cost of insuring your 1,000 shares of Apple Computer against any loss for an 18-month period would be \$14,000.

If this seems kind of high, you're right, it's very high. As we mentioned earlier, the price of an option contract is determined by **'the market'**. Like we said, the market is made up of other traders around the world that are interested in purchasing this same option. In order for any trader to buy this option, they have to **'bid'** for it (or specify a price that they're willing to pay).

During times of less price volatility, this same put option in Apple Computer could easily trade for a price of around \$12,000 for 10 put option contracts.

Is this insurance really worth \$14,000? Well, it is if the price of Apple's stock declines from \$100 a share to below \$80 a share in the next 18 months. But let's look at a few 'what ifs'.

In this example, the \$14,000 would be the option premium. If the price of Apple Computer declines to \$80 a share on the day that the put option expires, the loss in your stock would be \$20 a share or \$20,000. Because you own the put option, the value of your put option would also be \$20,000. In this example, as long as the price of the stock is below \$80 a share, the value of the put option will be equal to the loss in the stock. So, if the stock is trading at \$80 a share at the time the put option expires, the loss in the stock would be offset by the value of the put option. But because of the price you had to pay for the insurance (the option premium), you'd still have a loss of \$14,000.

Let's take another example, let's say that the price of the stock declines from \$100 a share to \$45 a share, resulting in a decline of \$55 a share in the stock. If this would occur, the loss in the stock would be \$55,000, but because the value of the put option would also be \$55,000, your loss would still be limited to the cost of the option (in this case \$14,000). A decline in the value of the stock by any amount is protected by the put option.

Now, instead of declining in value, what would happen if the price of the stock goes up to \$130 a share, resulting in a gain of \$50 a share? Because you own 1,000 shares, your profit would be \$50,000. Because you purchased the put option to protect you from any type of loss in the stock, the put option would have no value at all. In other words, it would be worthless and your loss on the option would be limited to the option premium of \$14,000.

If you own a stock, you can purchase insurance in the form of put options. You can protect either a portion or all of your investment in the stock depending on the strike price that you choose.

Another, more popular way of using put options is to purchase them on stocks that you do not own. In other words, let's say that you happen to own 1,000 shares of Apple Computer, but you're perfectly happy with the investment and you have no desire to protect it with the purchase of put options. However, you do have the opinion that possible changes in the laws that govern health care providers may cause those stocks to trade somewhat lower during the next 12 months. Because of your gloomy outlook for this industry, purchasing put options would allow you to profit if your outlook happens to be correct.

Today, with the advent of the internet, options trading is available to anyone who is interested in learning how to do it.

## Chapter 2

### The Characteristics of Options

Before we look at actual examples of how to trade options, let's briefly discuss how an options trader decides which of the many different strategies to use.

The most important element in trading options is your '**outlook**' on the particular market you're about to trade. If your outlook is '**bullish**', then you'll need to create a bullish strategy. If it's '**bearish**', you'll need to create a bearish strategy. And, of course, if your outlook is '**neutral**', it's possible to create an options strategy that will profit if the market remains neutral. If you haven't got a clue as to the direction of the market, don't trade.

There are many possibilities, here are just a few:

<b><u>If your outlook is:</u></b>	<b><u>Possible strategies are:</u></b>
Extremely bullish	Sell puts, buy calls, initiate covered calls, initiate bullish spreads
Quite bullish	Buy calls, initiate covered calls, initiate bullish spreads
Somewhat bullish	Buy calls, initiate covered calls, initiate bullish spreads
Rather Neutral	Sell straddles, strangles or combinations
Somewhat bearish	Buy puts, initiate bearish spreads
Quite bearish	Buy puts, initiate bearish spreads
Extremely bearish	Sell calls, buy puts, initiate bearish spreads

In addition to the above, we could add:

You're expecting a big move, but you're not exactly sure if the move will be up or down	Buy straddles, strangles or combinations
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When looking at your charts, only you can tell.

For our purposes, we **always** have an opinion as to the direction of a particular market.

### **Option Expiration Dates**

For options on stocks that are listed in the United States, the option contracts expire on the third Friday. If that date happens to be a holiday, the options expire on Thursday. These options are referred to as 'Monthly Expirations'.

Several years ago, the Exchange introduced options that expire **every** Friday. These options are not offered during the week that 'Monthly' options are expiring. These options are referred to as 'Weekly Expirations'.

In 2006, the Exchange introduced options that expire at the end of the yearly quarters of March, June, September and December.

For our purposes, we treat all of these options the same.

### **Choosing the Best Option for Your Trade**

To summarize, option trading is simply a way to benefit from the movement in the price of a stock or an Index. Basically, once we've decided on our trade, choosing the best option for the trade is actually very easy. Here are the guidelines we like to follow:

Call, Put or a Combination – Remember, if your outlook is '**bullish**', you want to purchase a Call option. If it's '**bearish**', look to purchase a Put option. Combinations are debit spreads, credit spreads, covered calls and so on. For our trading, we prefer the simple purchase of call and put options.

Expiration Date – Because our analysis is somewhat short-term in nature, we prefer options that expire in the next **4 to 7 weeks**.

Maximum Price for an Option – We prefer options that are priced **below 2.50**. If no options are available, it's possible that we'll go as high as 2.80. If Options are not available at these prices, we prefer to pass on the trade.

Strike Price – The best strike price is one that is very close to the price of the stock when the trade is placed. These options are referred to as **'at-the-money'**.

Volume and Open Interest – One of the most difficult things for inexperienced options traders to get use to is the lack of liquidity in many options. This lack of liquidity doesn't exist in Index options such as the SPY or the QQQ (which are quite liquid), but it often exists in options on individual stocks. There are just too many options to choose from and there are not enough traders in the world to create a liquid market in all of them. Therefore, when buying (or selling) options, you'll need to get used to the fact that in most cases, the other side of your trade will be taken by an options 'specialist' or 'market maker' or just plain and simply, 'the guy on the floor'.

The best way to become comfortable trading options with very little volume and open interest is to do an inexpensive trade. But you should only do this experiment if the price increment of the option is .01. If you look at an 'option chain' and all of the numbers in the 'Bid' and 'Ask' columns end in zero or five, chances are the price increment is .05.

Here's an option chain for a stock whose options have a price increment of .05.

CALLS					
Delta	Theo Value	Bid	Ask	Strike	
<b>Sep 16, 16 (100) - Amer Monthly 12d 8h 29m left</b>					
0.9707	46.53	44.80	47.00	<b>55</b>	
0.9621	41.53	39.90	42.10	<b>60</b>	
0.9619	36.53	34.90	37.00	<b>65</b>	
0.9501	31.53	30.00	32.10	<b>70</b>	
0.9485	26.53	25.00	27.00	<b>75</b>	
0.9386	21.53	20.00	22.00	<b>80</b>	
0.9246	16.53	15.00	17.00	<b>85</b>	
0.9308	11.56	10.70	11.80	<b>90</b>	
0.8607	6.83	5.90	7.00	<b>95</b>	
0.6463	3.07	2.30	2.60	<b>100</b>	
0.2035	0.95	0.30	0.45	<b>105</b>	
0.0919	0.19	0.00	0.25	<b>110</b>	

If we were to try and purchase one of these options at a price that does not end in a zero or five, our trade would probably be rejected.

The next most important consideration is the difference between the bid and ask prices. Before trying an experiment such as this, take a look at an option chain for a stock whose options are actively traded. For example, take a look at Apple (AAPL).

CALLS				
Delta	Theo Value	Bid	Ask	Strike
<b>Oct 07, 16 (100) - Amer Weekly-W1 33d 8h 13m left</b>				
0.8793	9.64	9.00	9.25	<b>99</b>
0.8748	9.23	8.55	8.75	<b>99.5</b>
0.8630	8.84	8.10	8.30	<b>100</b>
0.8382	8.07	7.25	7.40	<b>101</b>
0.8055	7.34	6.40	6.55	<b>102</b>
0.7705	6.65	5.60	5.70	<b>103</b>
0.7239	6.00	4.80	4.95	<b>104</b>
0.6753	5.38	4.10	4.20	<b>105</b>
0.6187	4.81	3.45	3.55	<b>106</b>
0.5592	4.27	2.86	2.92	<b>107</b>
0.4961	3.78	2.33	2.38	<b>108</b>
0.4324	3.33	1.87	1.92	<b>109</b>
0.3706	2.92	1.48	1.53	<b>110</b>
0.3119	2.54	1.15	1.20	<b>111</b>
0.2582	2.21	0.89	0.93	<b>112</b>

Locate an expiration month that is around 4 or 5 weeks away and choose a strike price that is as close as possible to the current price of AAPL. Make a note of the current bid and ask prices and the difference between the two. For this example, AAPL was trading at 107.75. Our best choice would be the 108 strike with a 'bid' of 2.33 and an 'ask' of 2.38. These prices will be representative of a market that is usually fairly liquid.

Next, do the same thing with a stock whose options have low volume and open interest. For this example, try doing this with Marriott Int'l (MAR). Locate an expiration month that is 4 to 5 weeks away and a strike price that is as close as possible to the price of the stock. Compare the bid and ask prices and calculate the difference. If the difference is not too large, choose a price that is about half way between the bid and the ask. When you're entering the trade, your 'bid' may need to be .01 or .02 higher than the half way price. And when you close the trade, your 'ask' price may need to be slightly lower than half way. In most cases, options in stocks like MAR are just as easy to trade as the options in AAPL.

In conclusion, because we ***always*** have either a '***bullish or a bearish outlook***', the strategies that are taught in the remaining chapters will illustrate how an option trader can take advantage of some of the price patterns that are used by the professional traders.

## Chapter 3

### Buy Low – Sell High

#### **The Professionals and the Institutional Fund Managers Know How to do This, But Most of us Don't**

In the introduction to this book, I mentioned '**fear and greed**'. Because it's such a boring subject, it's already had all of the discussion it deserves. It is, however, an interesting way to describe how most new traders view the markets, as well as, how many of the more experienced traders begin to fail.

I happen to have several different trading accounts, one of which is simply for 'experimenting'. I try to keep around \$30,000 in this account. Because it's an on-line account, the balance is on my screen every time I open the trading platform and much to my surprise, the balance always seems to stay around \$30,000.

I've had this account for years and because it's not a 'serious' investment account, it doesn't bother me to do really stupid trades that lose a few hundred bucks. Before we go any further, I'm not advocating that anyone open a trading account with the intention of losing any money. For me, it's for experimental trades. For things that I just want to try.

I often use this account to practice 'fear and greed'. I do it on purpose. If I'm busy with something that has my attention and I'm not watching my charts, if I suddenly see that I've missed a move that has occurred earlier in the day, I'll often purchase one option contract. I don't do it for any particular reason, I'm simply practicing what many new traders do when they feel that they're **missing out** on a good move. Of course, these kinds of trades that are not thought out and occur for no particular reason, almost always lose. As I'm doing other things waiting for a **serious trade**, I'll glance at the 'fear and greed' trade to see how it's doing. After a while, I get bored with it and having learned a little bit from the experience, I close it out.

I also use this account for training new employees and I've used it for teaching friends and relatives the advantages of option trading. They can trade in my account as long as they're learning something and they agree to trade only one contract. At the end of the year 2014, my 1099 for this

particular account was 94 pages long. For the entire 12 months, after commission and fees, the account made \$83.19.

In another trading account, I do my serious trading. I use computer software to scan for the patterns I'm about to teach you.

## **The Job of the Fund Manager**

If you had a job as a fund manager, chances are you'd have a degree in business, finance or economics and you'd have been able to spend several years learning from other professional traders that know what they're doing. In my opinion, the best way to learn to find successful stock trades is to visualize yourself trying to do the job of a fund manager. If in fact, you had such a job, you'd probably be on a team with other people. There could be as few as 2 or 3 of you to perhaps a dozen or more. Successful fund managers have to stay current with a **mountain** of information. But in the next few pages, you're about to learn a few of the very easy things that are second nature to these professionals.

The first of these is '**awareness**'. You should spend some time and focus on making yourself aware of what's going on in the world. Although most news and editorials are misleading, it's worth finding a source of business news that you can trust and one you enjoy. Thirty minutes to an hour a week is plenty. If you over do it, you'll learn to dislike it.

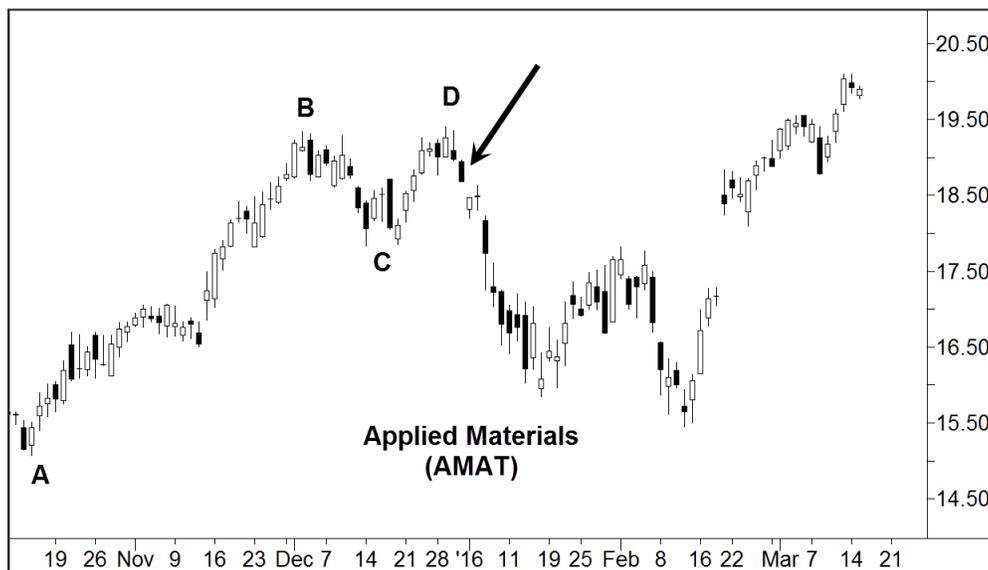
The next is a trading platform that allows you to look at charts. In fact, if you've reached this page in this book, you've probably already found a trading platform that suits you. In addition to your ability to display charts, you'll also benefit from the ability to apply some type of overbought – oversold indicator. These are usually displayed as oscillators above or below the price chart. One of our favorites is the MACD. Another is the Stochastic. These overbought – oversold indicators are a big help and are all a part of this 'awareness' thing.

For many years I've had computer software that scans for the patterns you're about to learn. Scanning software is not necessary because these patterns are easy to spot by simply looking at your charts. The only reason I use scanning software is to make sure I'm aware of all the stocks that happen to fit the patterns. It gives me more to choose from.

## Chapter 4

### The Last Wave Pattern

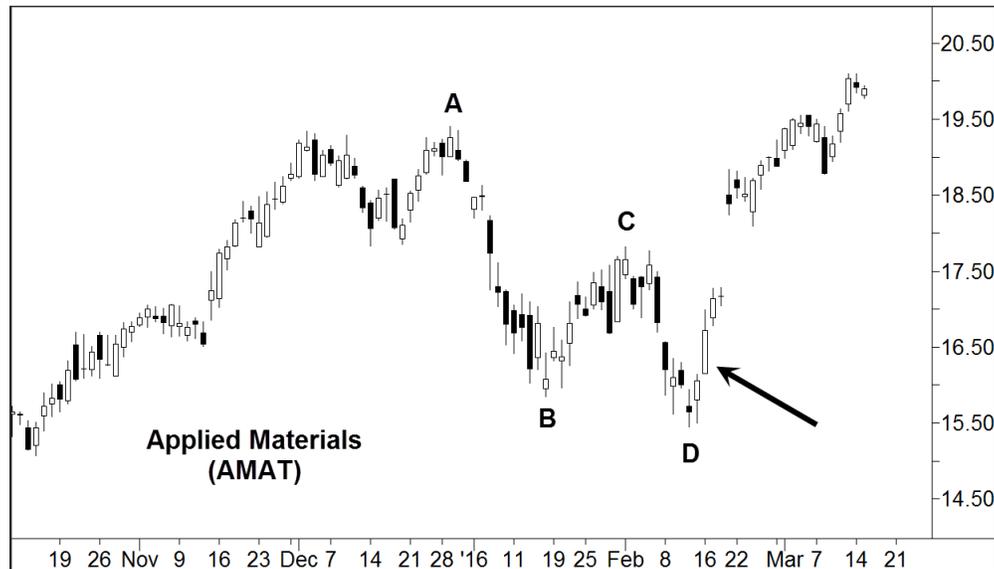
The best way to describe the Last Wave pattern is to view it in charts. The Last Wave pattern is simply the last price swing that a stock often makes when institutional fund managers and professional traders are positioning themselves for a change in the direction of prices.



In the chart above, from point 'A' up to point 'B', institutional fund managers and professional traders were accumulating shares of AMAT. Money moves into these funds on a regular basis and as they receive new money, it's the job of the fund manager to put it to work. You can see this in the slow steady rise in shares of AMAT starting at point 'A'.

Eventually, stocks like AMAT will become '**fully valued**'. This occurred in the chart above at point 'B'. When this happens, buying activity slows down as many of the professionals begin to take profits on their positions. If the profit taking becomes a minor event, a mild pull back down to the area of point 'C' will create enough room for the professionals to place AMAT back on their '**buy list**'. This renewed accumulation of shares of AMAT will push the stock once again back up to the fully valued area at point 'D'. This final move is the **Last Wave**. The black arrow in this chart represents the day that institutional fund managers and professional traders began an **aggressive** move out of the stock.

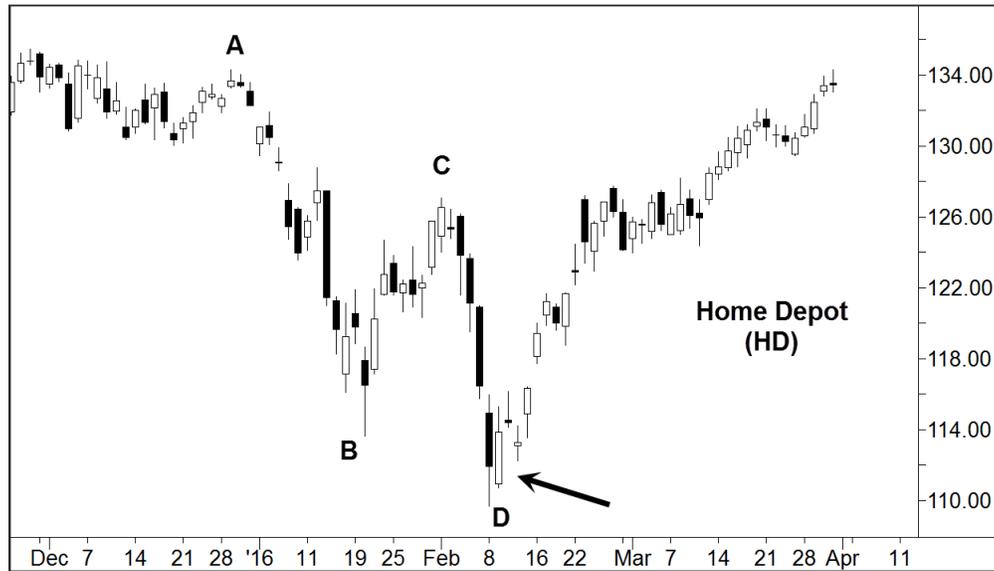
Following along with another example for the same stock, point 'D' in the chart above becomes point 'A' in the chart below.



In this example, as traders closed out their positions at point 'A', the stock traded back down to point 'B' around 15.50. There was a mild rally that took prices up to point 'C' at which time professional traders took over and pushed prices down one **last** time to point 'D'. The black arrow represents the day that institutional fund managers and professionals began to move money back into shares of AMAT. Our Last Wave **buy signal** came on that day.

If enough traders in a particular market **unknowingly** do the same thing at about the same time, significant tops and bottoms are likely to occur. This includes institutional fund managers, professional and non-professional traders. If enough traders happen to react in an area of a Last Wave pattern, this reaction will show up as a **confirmation bar**.

The Last Wave pattern is very easy to see. It occurs when the distance from C to D is less than the distance from A to B.

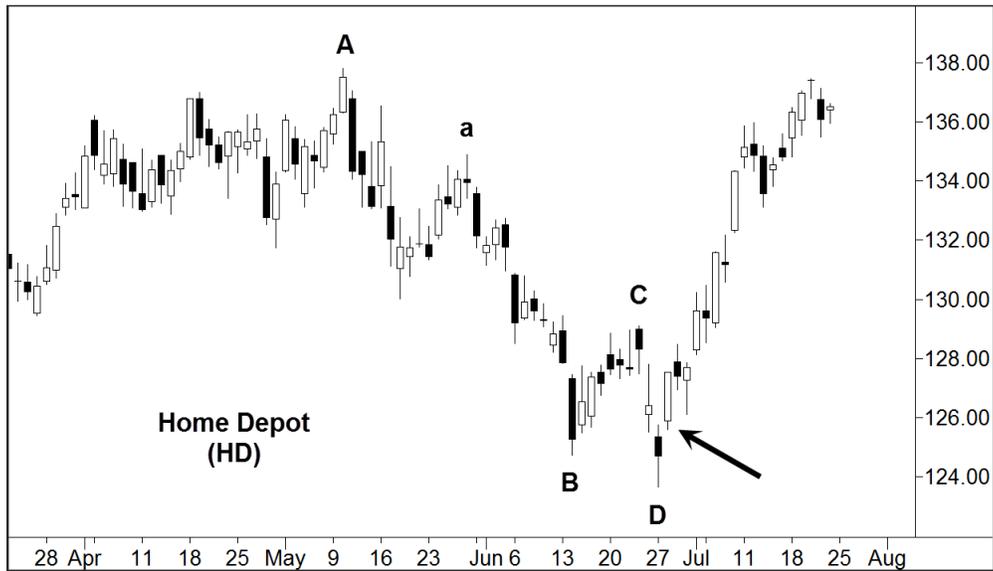


Again, put yourself in the position of a fund manager. From day-to-day, your job (if you want to keep it) is to find stocks to invest in. If your fund is successful, new money is moving into the fund on a daily basis. **That money has to be put to work and it's your job to do it.**

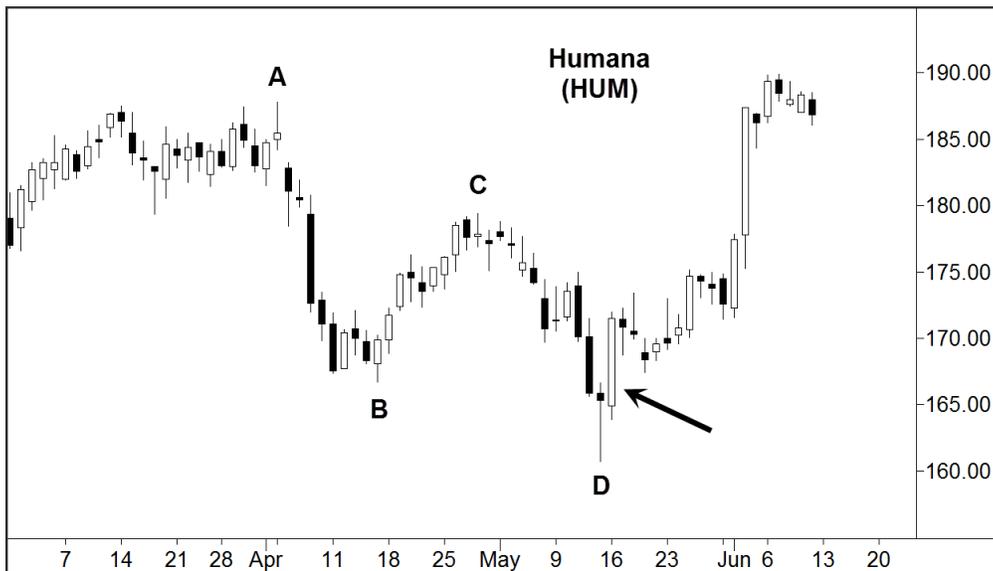
You have to find **not just one stock**, but as many stocks as possible. Your fund will be vulnerable if it's not **diversified** into many different investments. Each day, stocks that have completed a Last Wave 'Buy' pattern go onto your **buy list**. If you're right about your identification of the Last Wave pattern, the stock should not close below point 'D'. Your risk is very limited.

In the chart above of Home Depot (HD), the black arrow shows the day that new money began to flow into shares of the stock.

Here's another example of a recent trade in Home Depot.

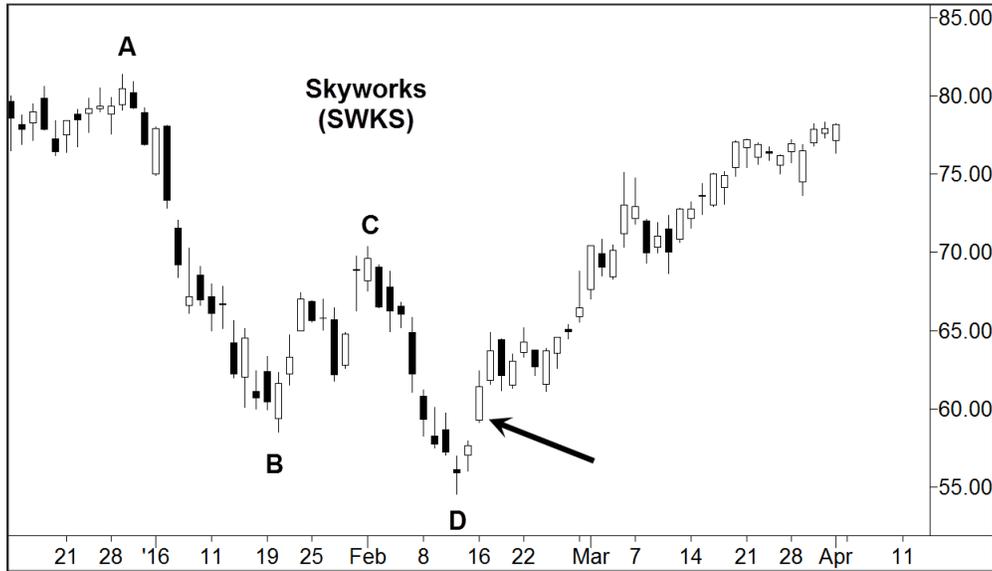


The decline in Home Depot in June 2016 ended with another Last Wave buy pattern. Whether you measure from 'A' down to 'B' or from 'a' down to 'B', the result is the same. The distance from 'C' down to 'D' is much smaller resulting in a Last Wave.

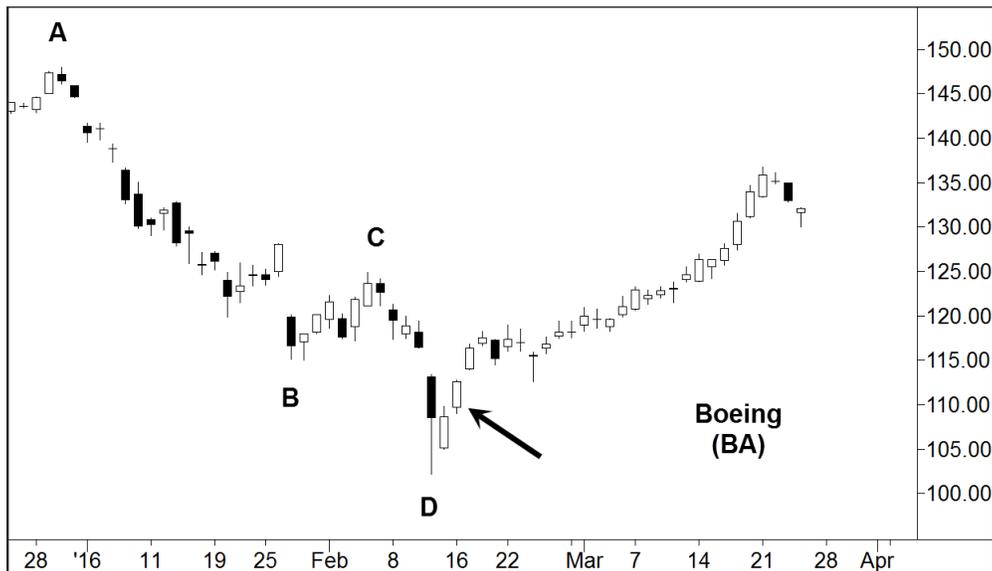


In the chart above of Humana (HUM), the distance from 'C' down to 'D' is almost the same as the distance from 'A' down to 'B'. The reversal day at

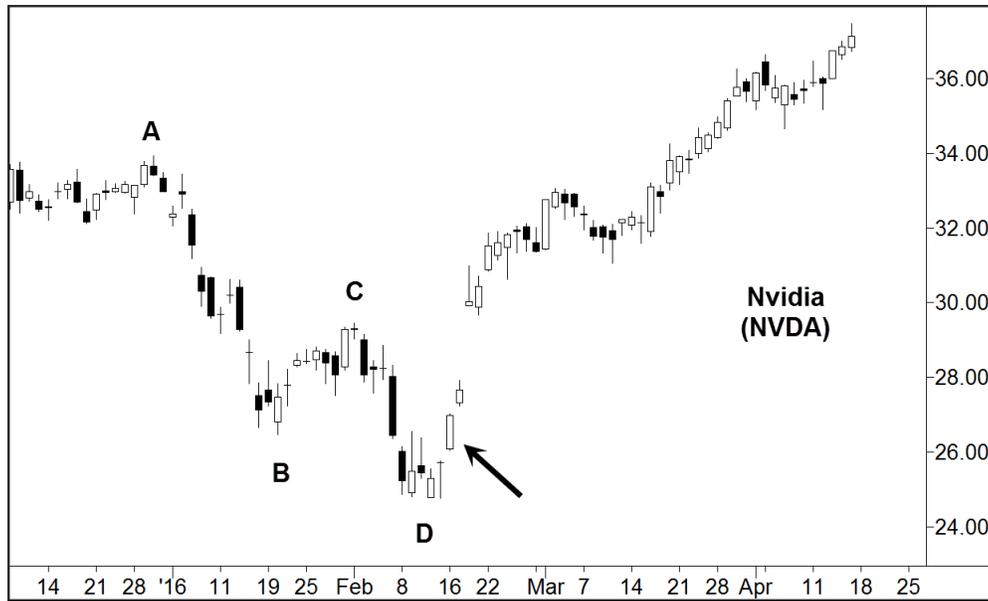
point 'D' followed by a strong day to the upside (black arrow) shows that institutional fund managers were moving new money into the stock.



In early 2016, the January and February decline in stocks created a very low risk atmosphere for institutional fund managers and professional traders.



The confirmation that the professionals are moving money back into these stocks is a price bar that starts the day at or near the low and finishes at or near the high.

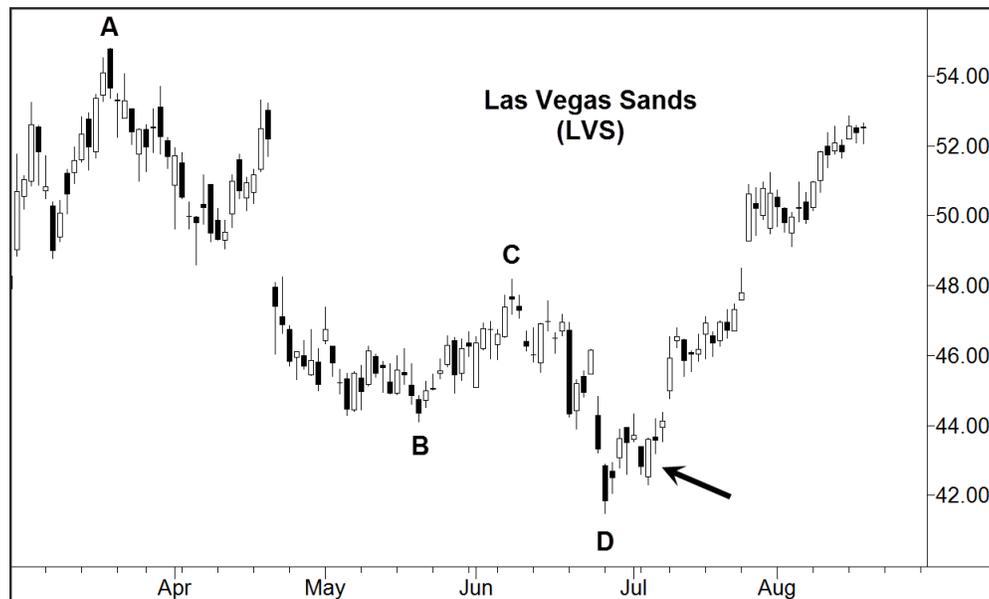


The chart above of NVDA is just another of many Last Wave buy patterns that occurred in early February 2016. These patterns were formed at a time when the television commentators were discussing that the **'new bear market'** had been confirmed by a decline in the major averages of at least 20%.



When we see a Last Wave 'Sell' pattern as the one in the chart above of LVS, all bullish option positions need to be **closed**. We can take advantage of this 'Sell' pattern by **purchasing Put options**.

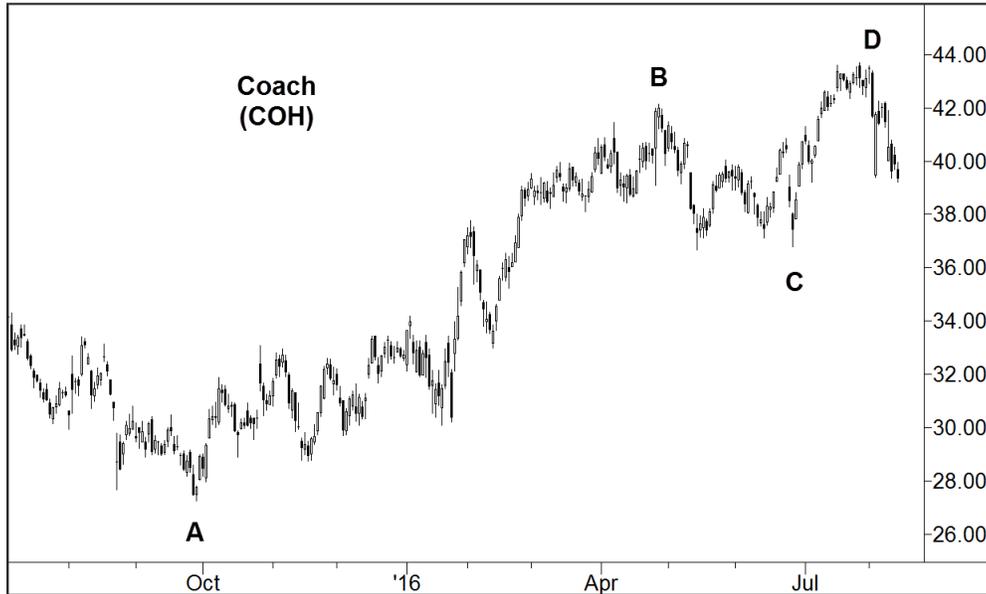
There are times when the media will focus on an industry group and feature the stocks in that group on a regular basis.



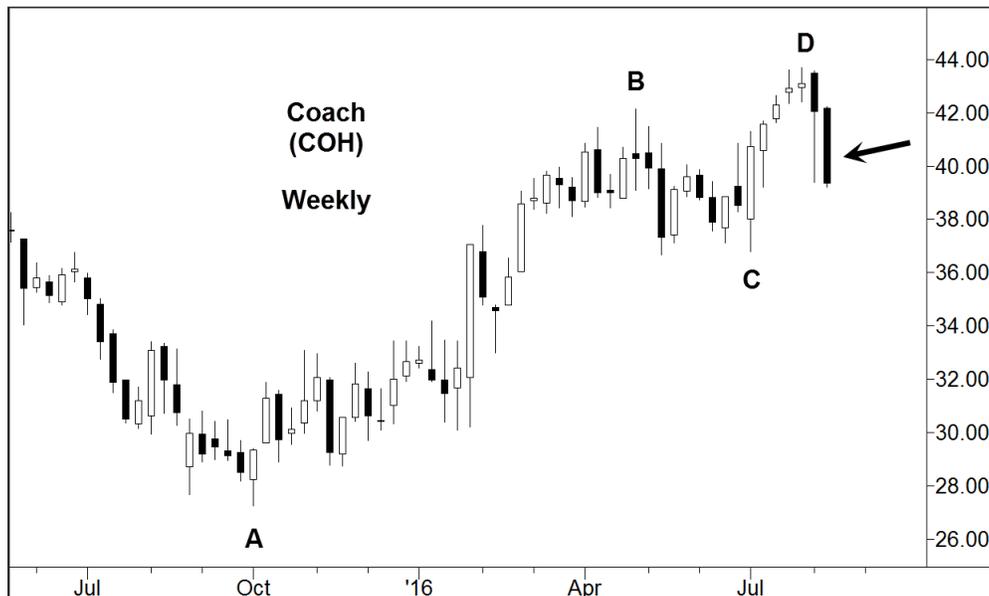
In the world of gambling casinos, Las Vegas Sands is often the victim of whether or not the Chinese government will allow (or disallow) any of their citizens to visit the casinos in Macau. In the chart above, it's interesting that news surrounding the completion of a new hotel casino by Wynn Resorts caused **'fear'** among investors as the last of the smaller, inexperienced investors in LVS finally **'threw in the towel'** and closed their positions.

When this final selling takes place, watch for the appearance of some positive trading. As the selling discontinues, the Last Wave 'Buy' signal will form and the professionals will begin placing new money into shares of the stock. With these patterns, the low of point 'D' defines our risk and Call options can be purchased. If the stock trades below point 'D', we're out of the trade with a small loss.

Occasionally, a Last Wave pattern will develop that may not be visible on a daily chart. Here's an example of a daily chart of the luxury fashion company Coach (COH).



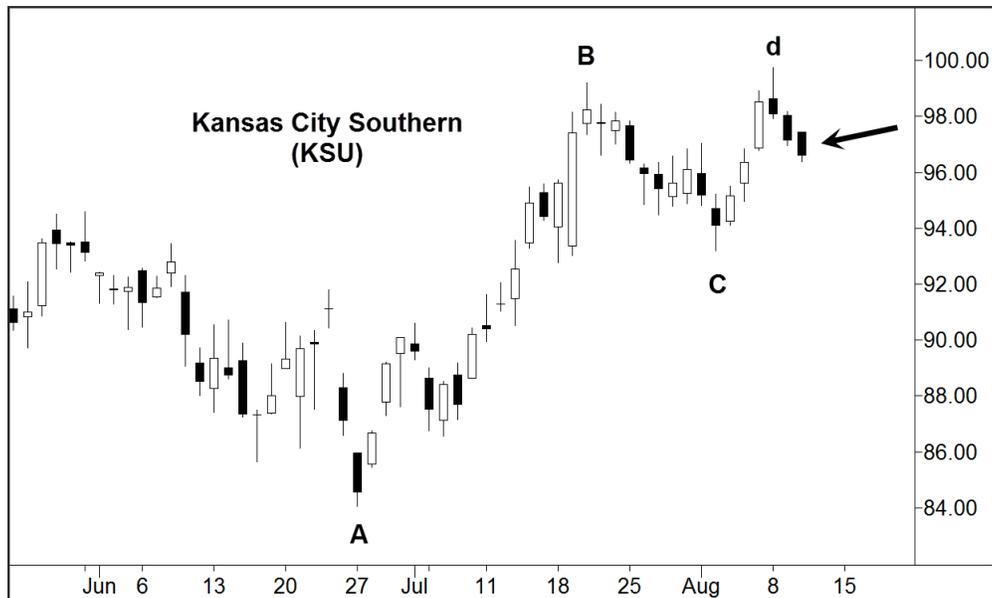
With all of the zigs and zags on this chart, the Last Wave pattern is not that easy to see. Here's a weekly chart of the same period.



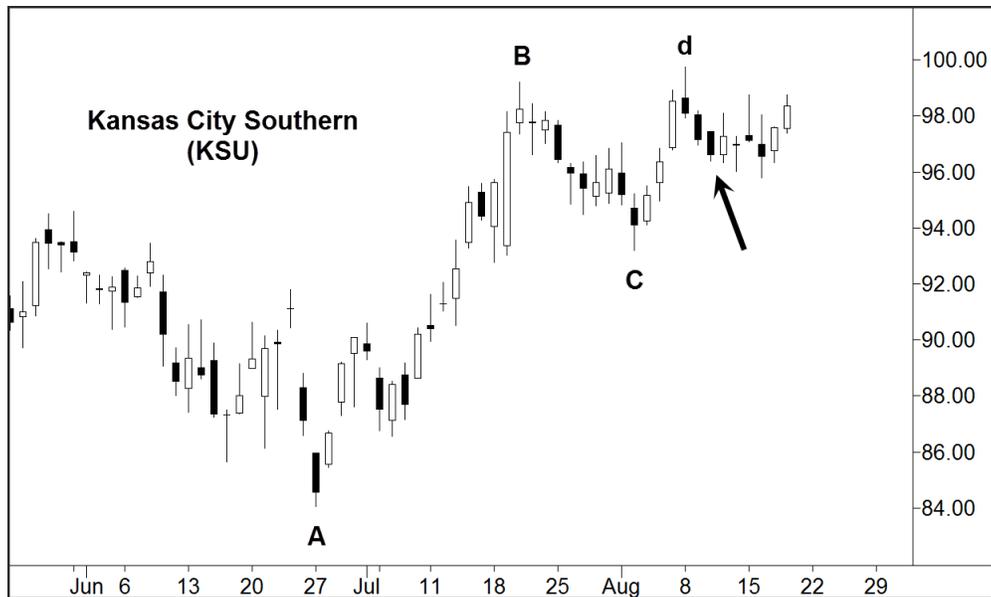
When we're scanning our charts, we look at the weekly charts as well as the dailys.



Here's a recent trade in KSU that was almost acted on about 10 days too early.

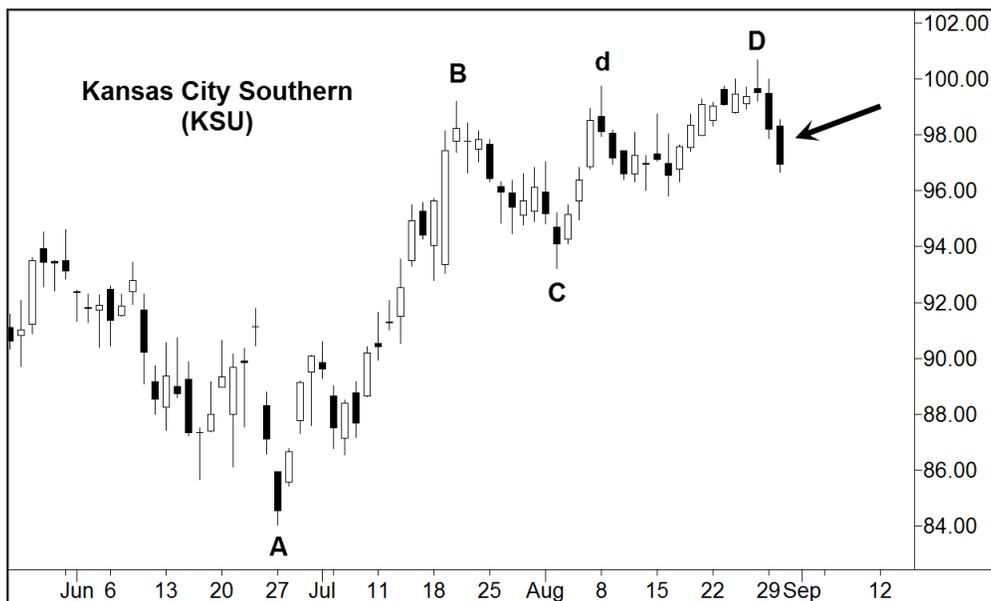


At point 'd' in the chart above, a Last Wave sell pattern appeared to be complete. The three negative bars following the high at point 'd' seemed to indicate some mild selling on the part of professional traders. However, when looking for a confirmation, we prefer confirmation bars that have a slightly wider trading range.

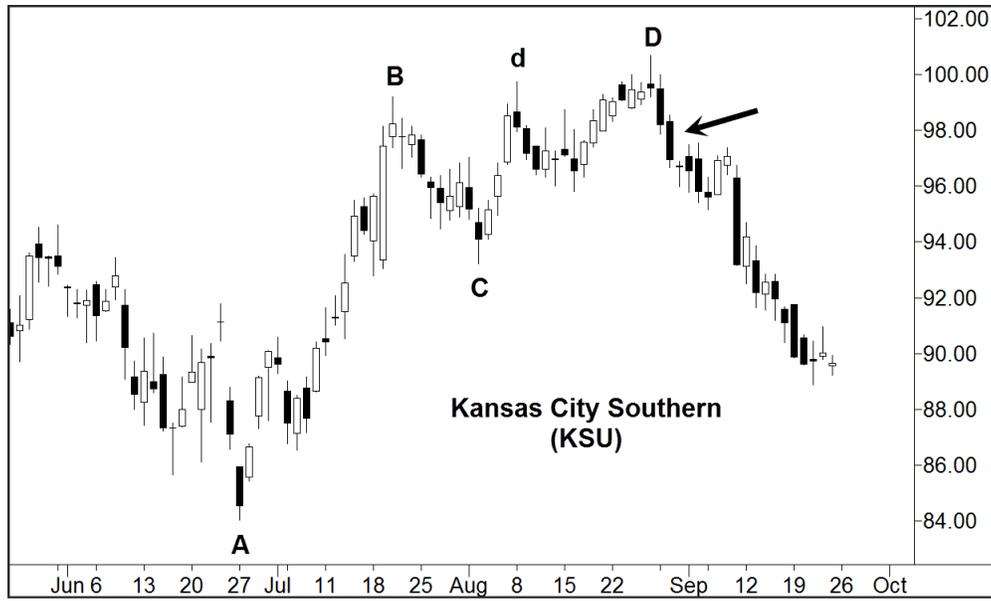


Had we done this trade, six trading days later we'd have been closing it out. When these Last Wave patterns get set up, they have a tendency to start working within the first five or six trading bars.

Here's the same chart a few weeks after point 'd'.

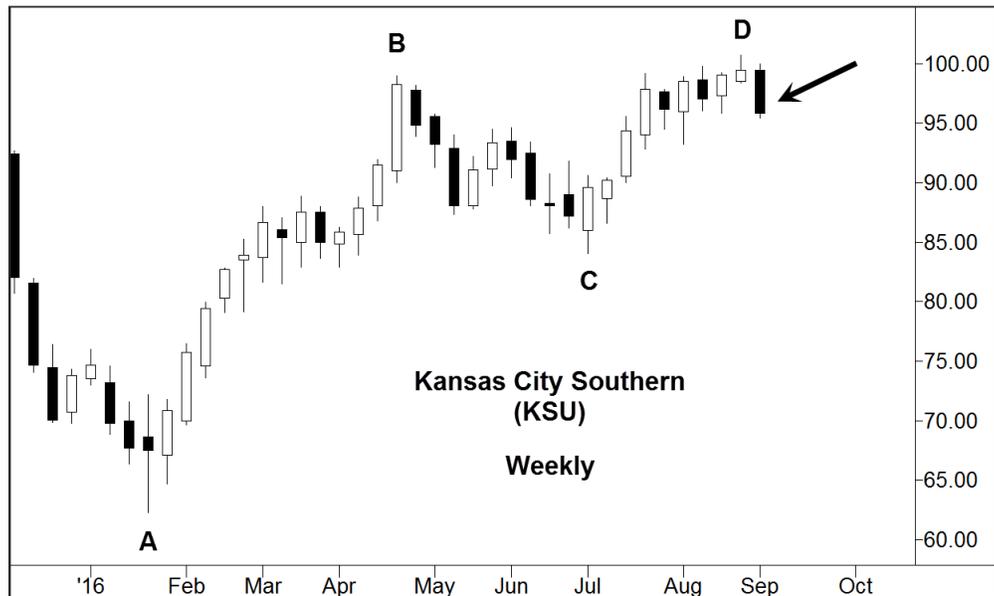


At point 'D', the stock reverses and the top is confirmed this time by two negative bars with much wider ranges.



In this chart, we can see that the trading ranges in the bars following point 'd' were rather narrow when compared to the prior bars.

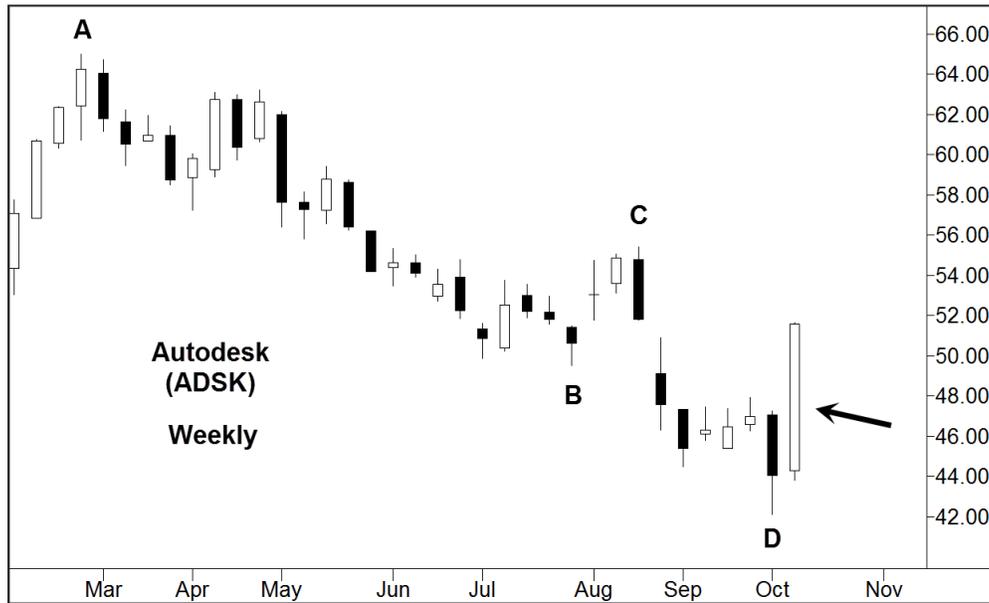
At the time of the September 2016 high in KSU, we were also monitoring the weekly chart for what appeared to be a possible Last Wave sell signal.



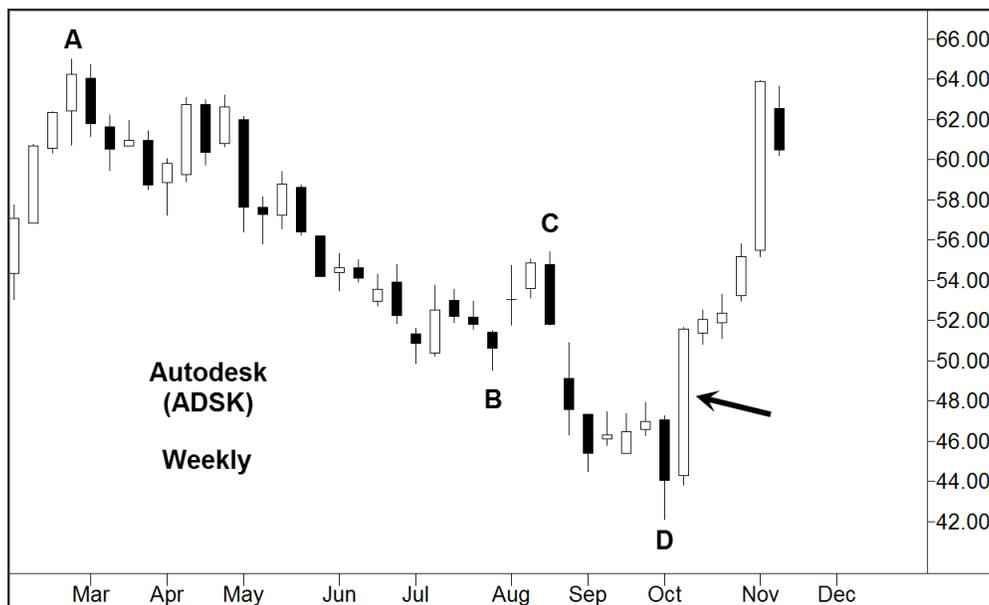
This weekly sell signal was confirmed at the same time as the daily.

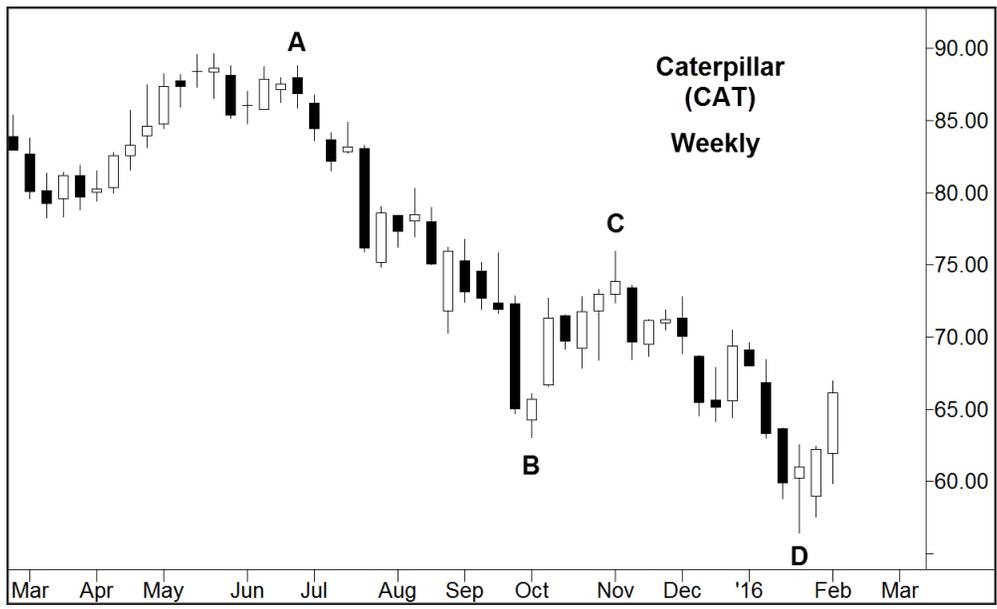
## Trading the Last Wave Pattern in a Retirement Account

If you're trading in a retirement account, Last Wave buy signals that appear on weekly charts offer reasonably 'low risk' trading opportunities.

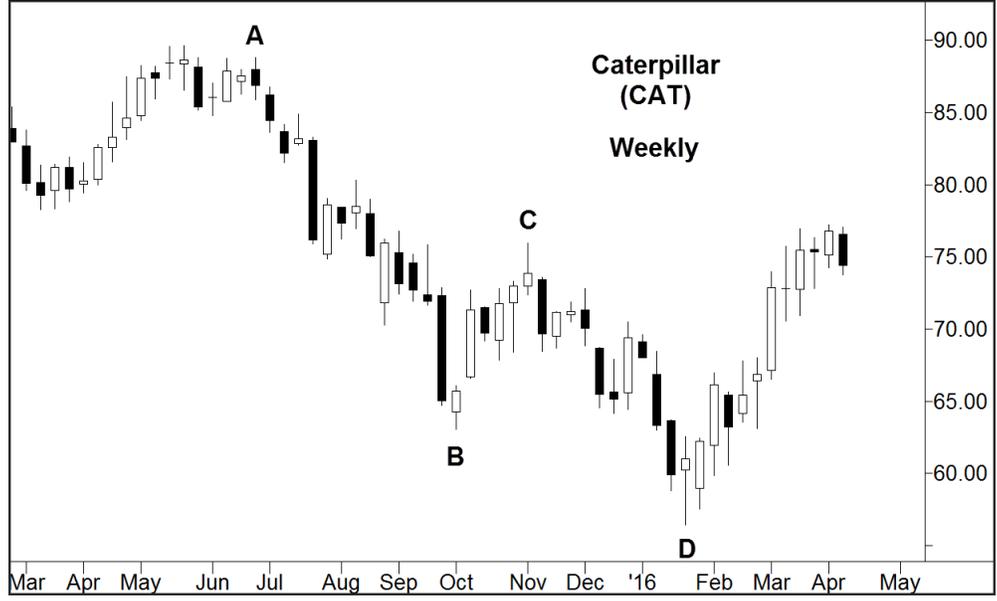


Using a weekly chart, this Last Wave buy signal in Autodesk gained more than 8% in the stock in just five weeks.

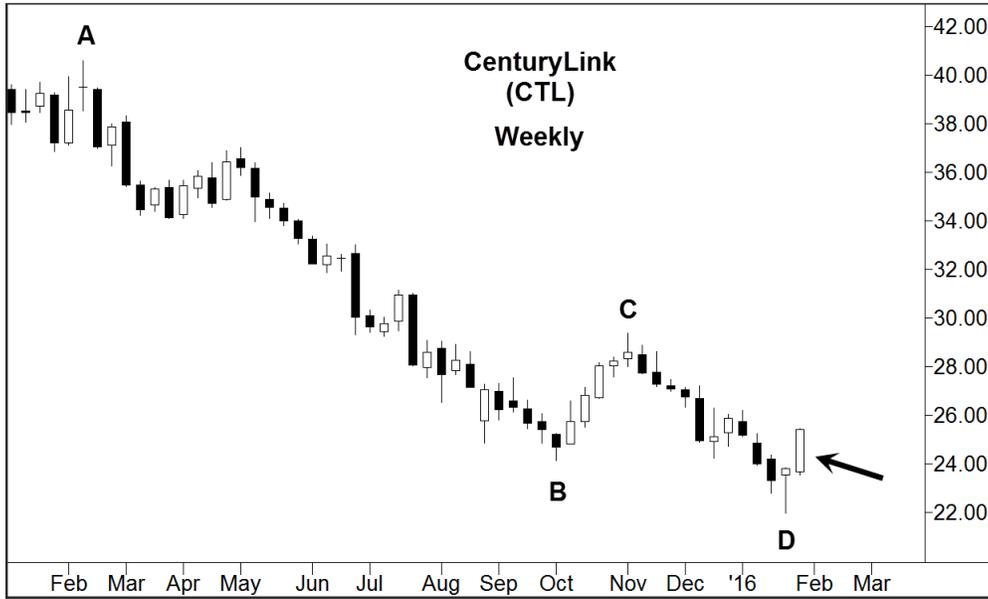




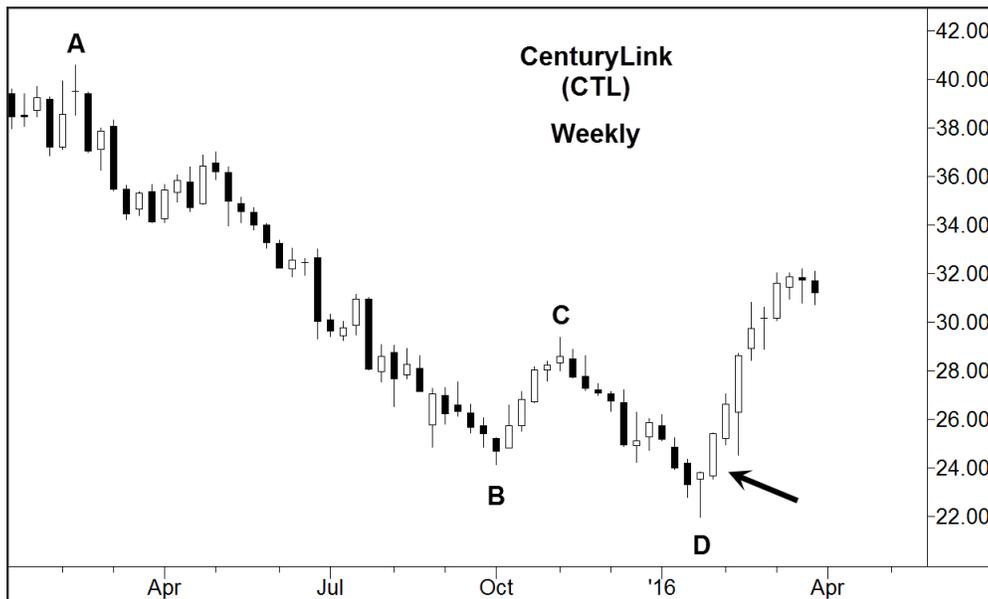
In the weekly chart above of Caterpillar, the Last Wave pattern was completed on Friday, Feb. 5<sup>th</sup> 2016.

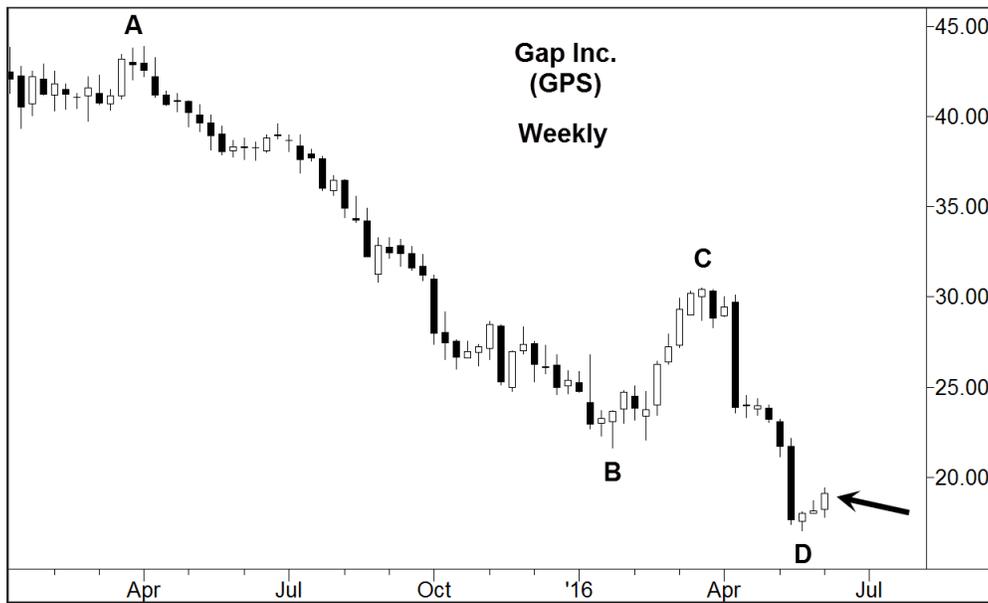


Eight weeks later, the stock was 15% higher.

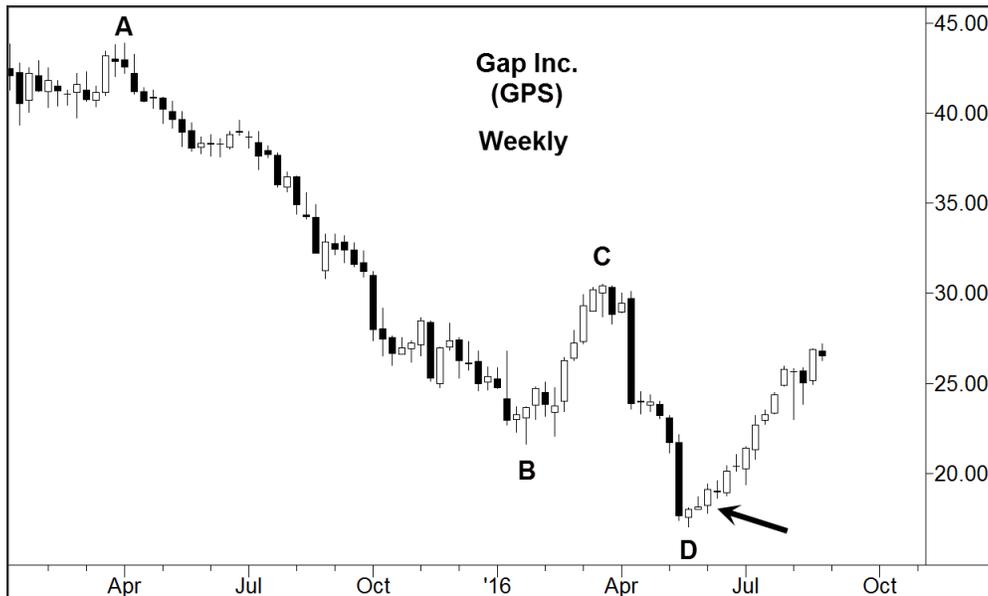


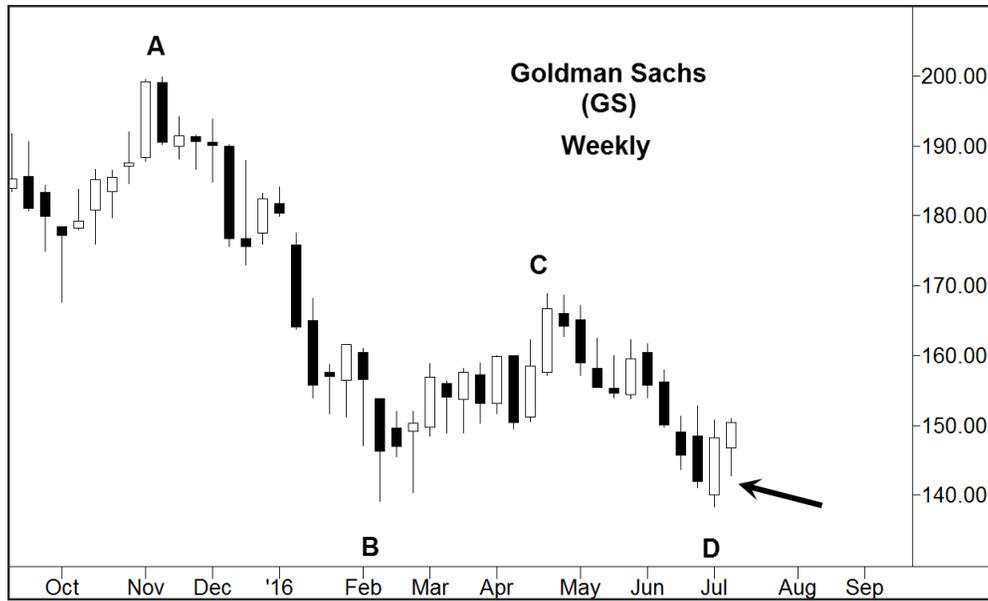
In January 2016, a Last Wave buy pattern identified a 25% gain in the stock of Century Link in just eight weeks.



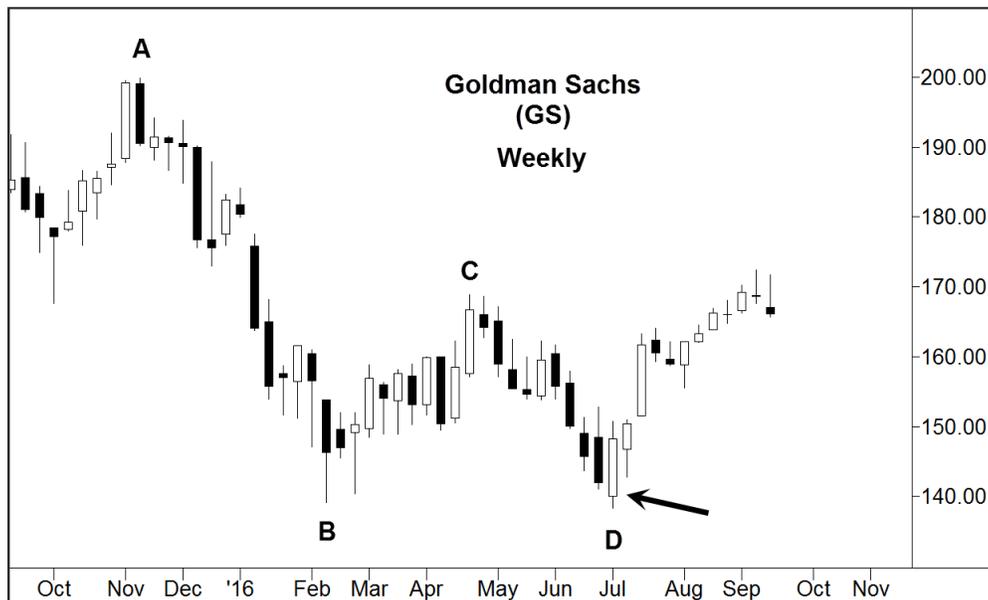


After one last sell off, in June 2016 a Last Wave buy pattern occurred in the weekly chart of GPS resulting in a 12 week gain of just over 40%.

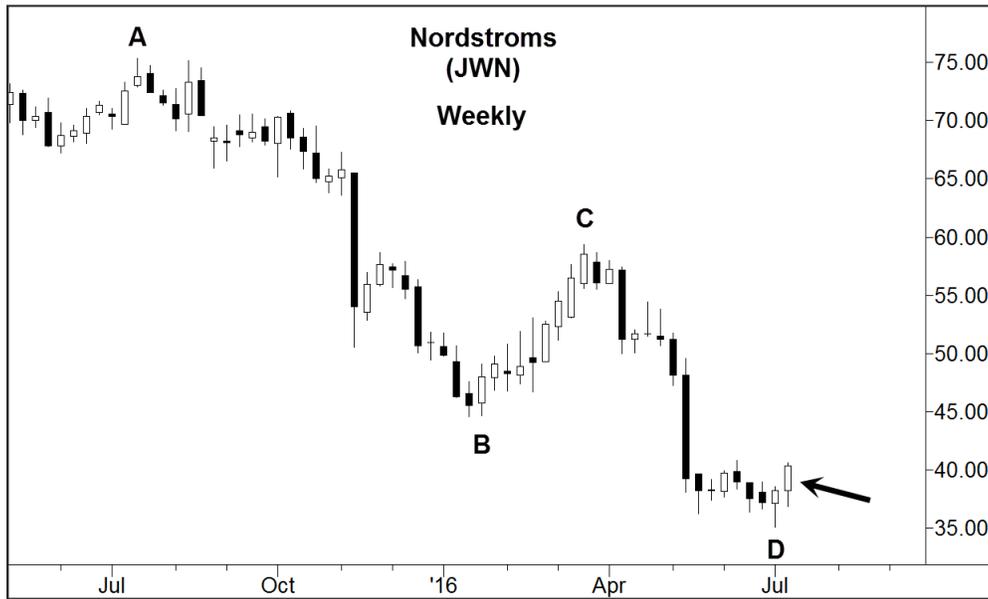




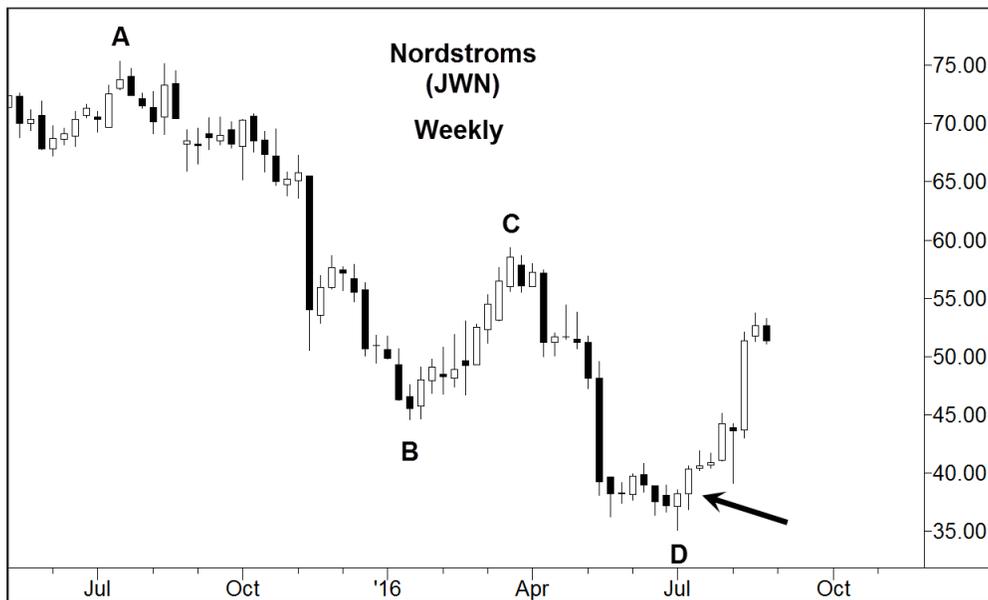
The summer of 2016 was a busy time for retirement accounts. This Last Wave buy signal resulted in a gain of around 12% in the stock of Goldman Sachs during the next 10 weeks.

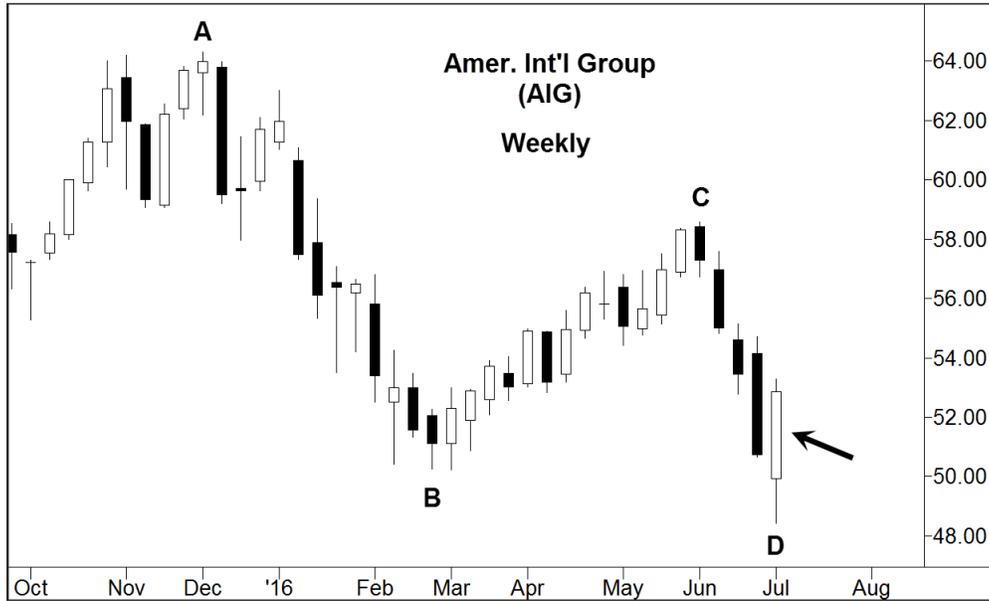


When trading from weekly charts, it's very important to wait until Friday for all trade entries. And, as a 'general rule', this is also a very good practice for closing out existing positions.

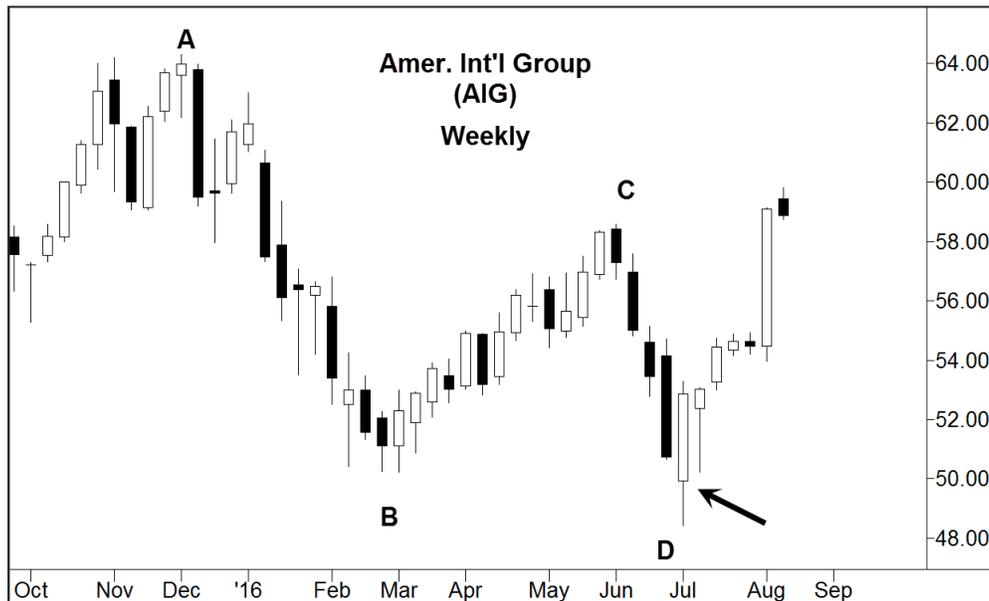


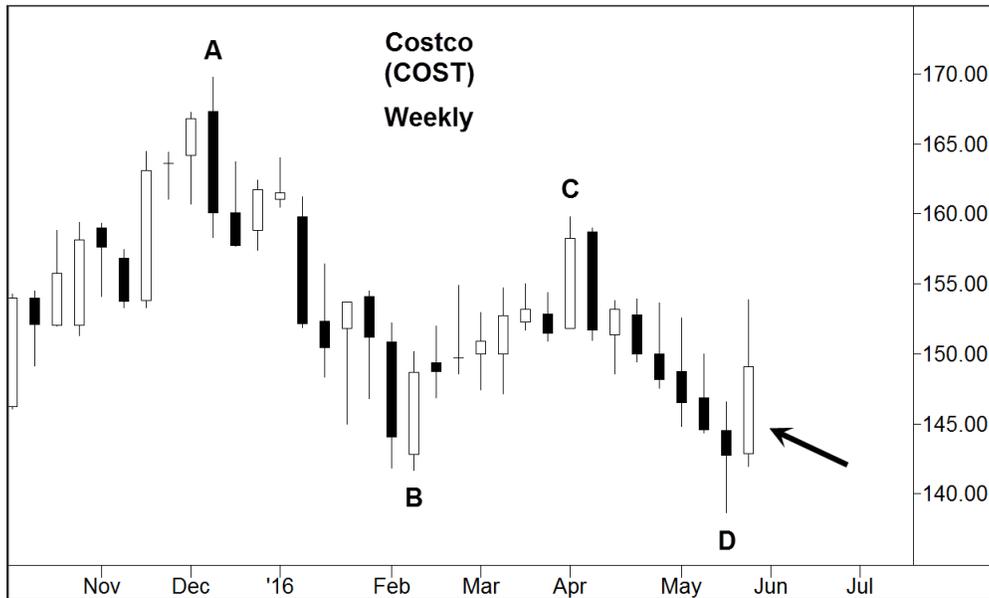
This Last Wave buy signal in JWN resulted in a seven week gain in the stock of just over 30%.



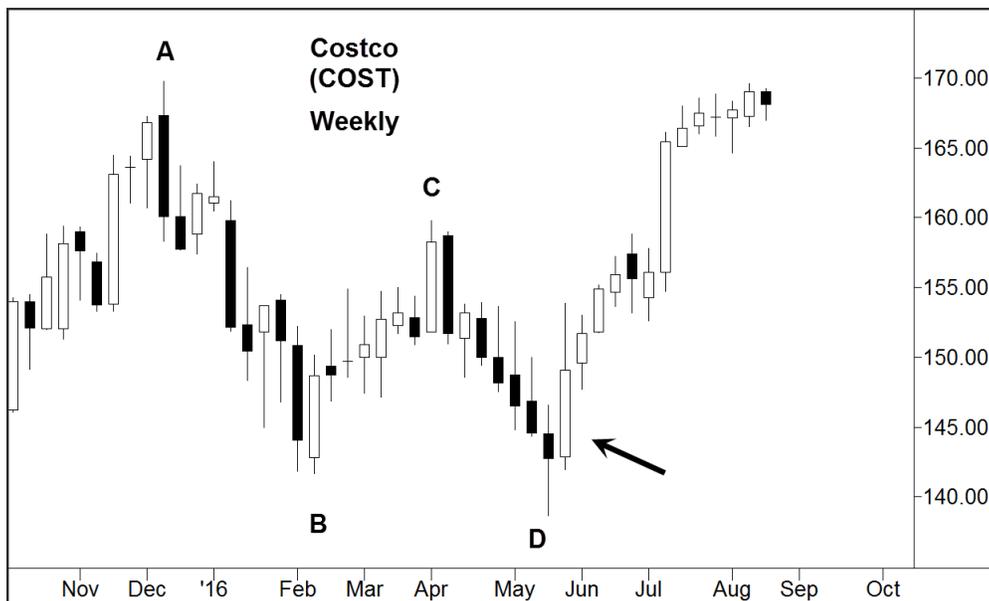


After this Last Wave buy signal in AIG, the stock gained 10% in the next six weeks.

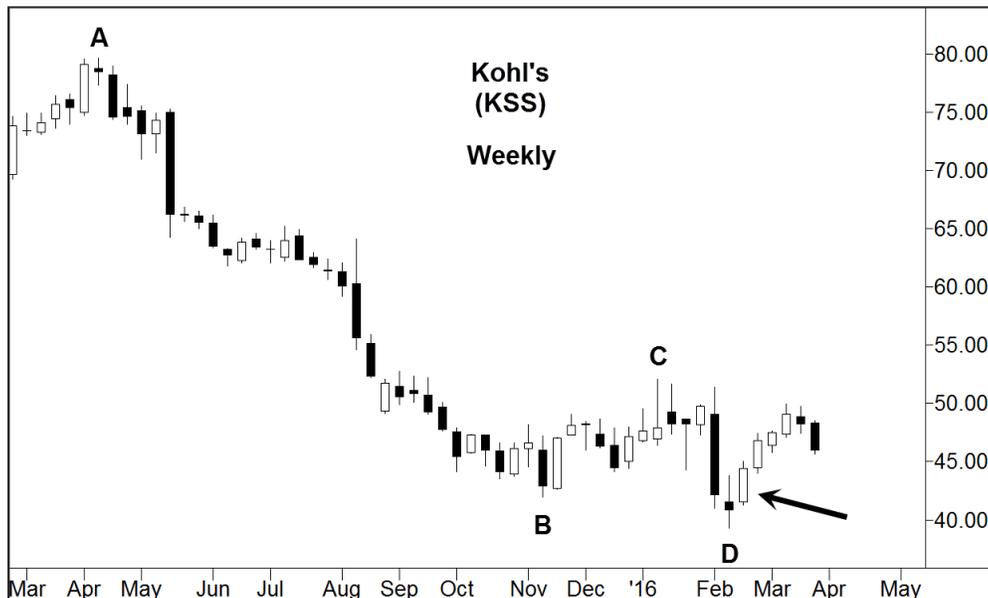
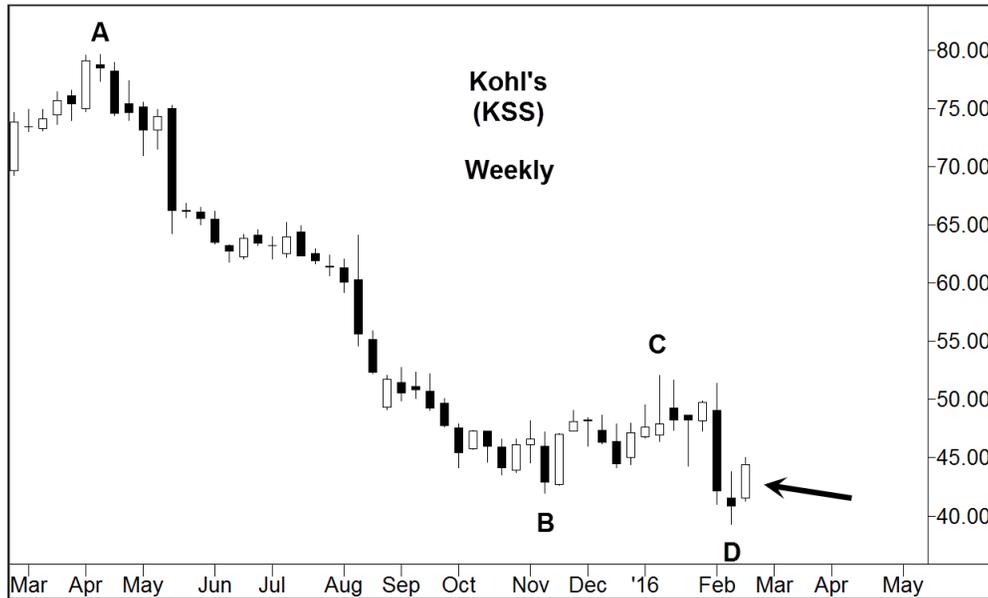




This 15% gain in Costco occurred in 12 weeks.

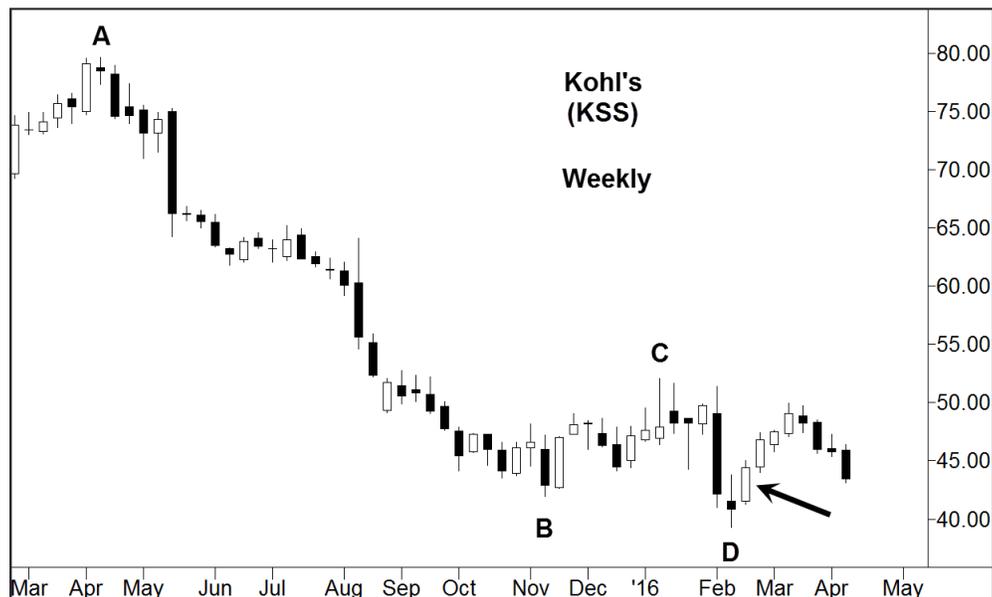


When using these Last Wave buy signals in a retirement account, they can be traded with a reasonably small amount of risk. Here's a recent buy signal in KSS that failed.



We did not do this particular trade in KSS, but if we had, we'd have been very tempted to close the trade at this point and move on to a different stock. This negative bar would have been a real concern.

Also, when trading in a retirement account, it's very important to close trades at the first sign of weakness. After an initial gain in the first three weeks of around 8%, this pull back would be kind of a 'red flag'.



As mentioned earlier, our absolute 'line in the sand' exit for our Last Wave buy signals is the low of point 'D'. However, when we trade a signal using a weekly chart, the distance down to point 'D' can sometimes be a little too much risk especially in a retirement account.

At this point of the trade, our loss would be 1% or 2% and after two disappointing bars like this we'd be closing the trade.

## How Professional Traders and Institutions Make Profits When Stocks Go Down

If you're an experienced investor or trader, the following discussion may not be of much help to you. But if you're not familiar with the advantages that professional traders have, this is a brief discussion.

The term that describes how institutional fund managers and professional traders can make profits when a stock declines is '**short-selling**'. The best way to describe this process is with a recent chart of Apple.



In the chart above, we can see that AAPL is doing fine. In early 2015, the stock broke through a parallel trading channel between 105 and 120. Within a few days of breaking the channel, the stock was trading at a high of 133.60.

For the next 6 months, AAPL traded in this new parallel channel between 120 and 134.

On July 20<sup>th</sup> and 21<sup>st</sup> of 2015 (right arrow), in anticipation of an upcoming earnings announcement, AAPL once again challenged the highs around 133.00.

The earnings announcement wasn't bad at all. In fact, AAPL came in better than expected on both earnings and revenue. But for investors that were expecting news of new product releases, the report was somewhat disappointing.

Nine days after the disappointing earnings announcement, AAPL was trading dangerously close to the lower part of this new trading range just above 120.



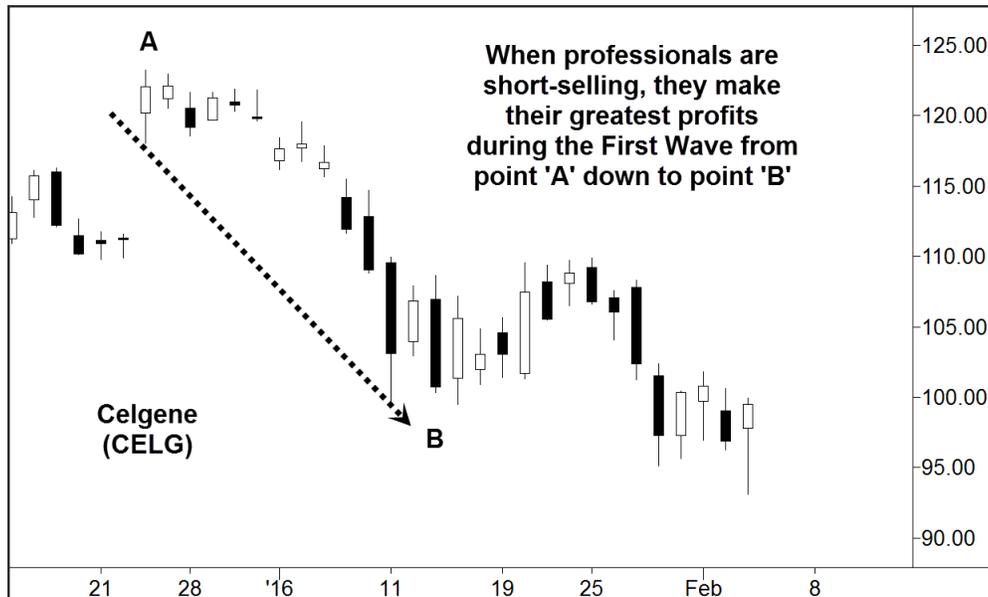
Professional fund managers that happened to feel that the low of the channel around 120 was likely to break, would have had the ability to position their fund in such a way as to profit from a decline in the stock down toward the lower level of 105. They do this by taking a **'short'** position in the stock. A short position is the process of **'borrowing'** shares of the stock which are then sold on the open market. The goal, of course, is to eventually purchase actual shares of the stock at a lower price that can be used to **'pay back'** what was borrowed'.

A few weeks later, shares of the stock were available for purchase around 106.00 allowing short sellers the opportunity to make a gain of around 10% to 15%.



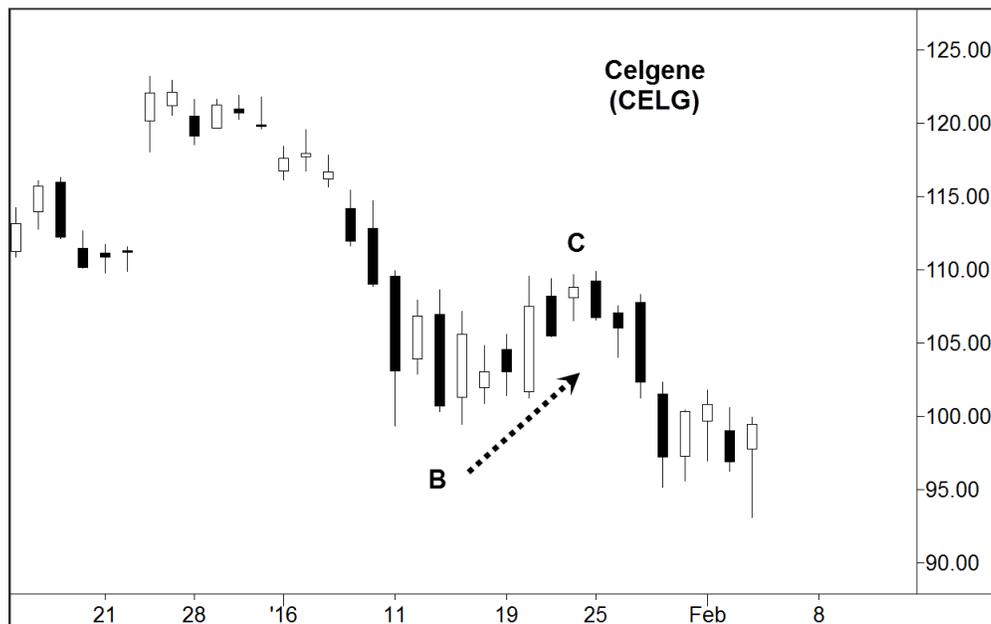
As non-professional traders, we have the ability to take advantage of these situations through the purchase of Put options.

Here's a look at how institutional short-selling effects our Last Wave pattern.

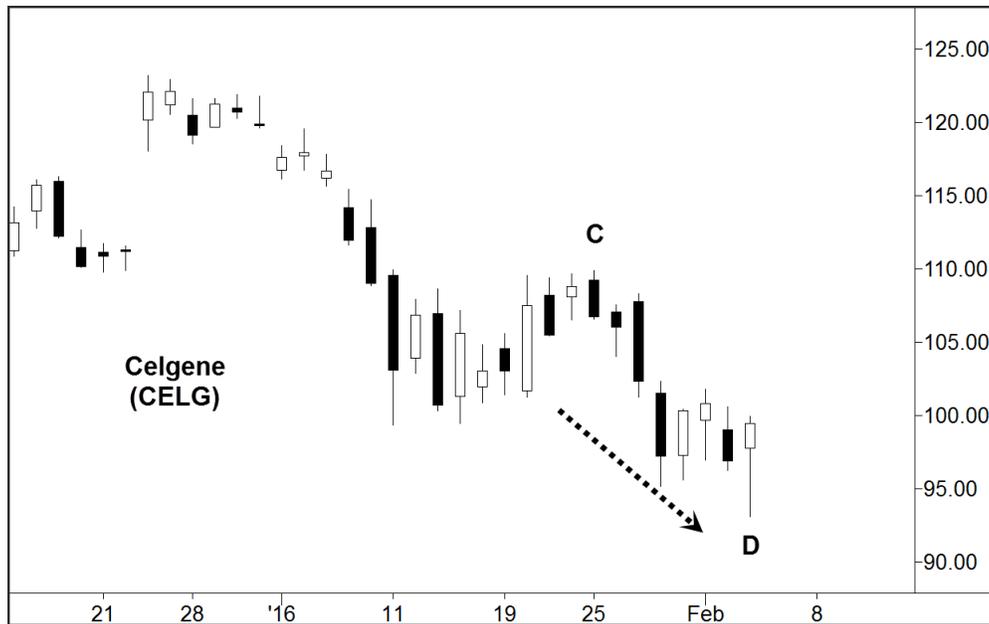


We refer to the price move from point 'A' down to point 'B' as the First Wave of the pattern. This First Wave is often when professional traders will establish short positions.

The Second Wave is the 'relax' period of the overall downtrend. During this phase, professional traders that have been short the stock will begin to buy their positions back. As the selling pressure eases and the mild profit taking begins, prices move sideways and slightly upward into point 'C'.



The next wave from point 'C' down to point 'D' is the Last Wave.



The selling during this phase is done primarily by non-professional traders who have been investors in the stock. When non-professional investors finally give up and close out their positions, the Last Wave is formed and professional traders start the process of moving money back into the stock.

## How to Use the Last Wave Pattern for Trading Options

Many years ago, during the 1990's, I spent a great deal of time trading for a European investment firm. The firm was headquartered in Geneva, Switzerland and was more or less 'de-centralized' with traders in several different countries. Most of the traders were in London, Munich and Geneva.

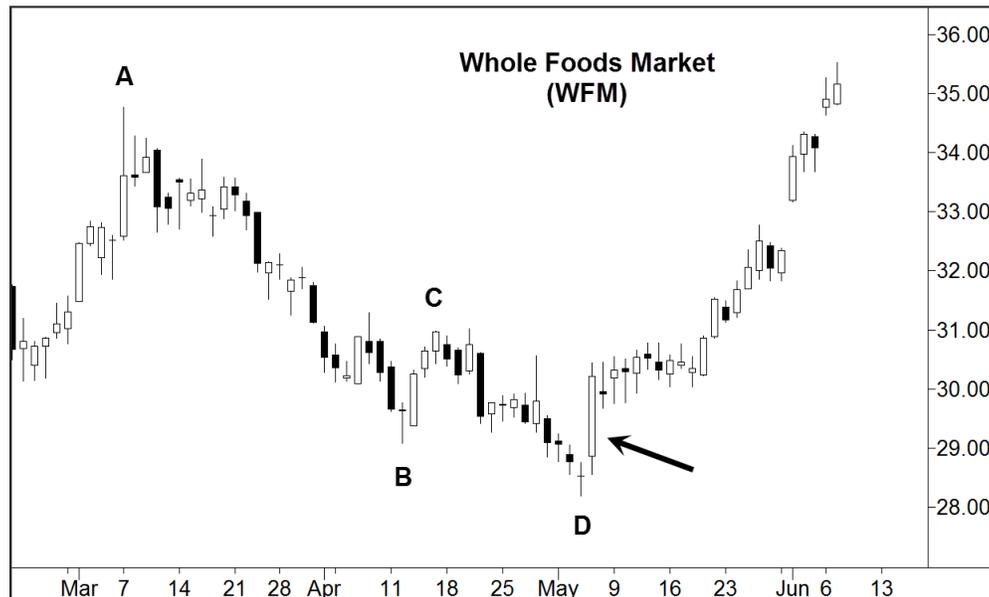
It was an interesting experience. As traders, our job was to trade in accordance with the '**outlook of the firm**'. If the firm's outlook was '**bullish**', it was our job as traders to focus on purchasing stocks or purchasing Call options. If the firm's outlook was '**bearish**' (which by the way was a **rare** occurrence) it was our job to focus on bearish strategies.

Although the firm focused primarily on '**bullish**' strategies, if a '**sell signal**' was generated, it was the firm's policy to purchase '**bearish**' mutual funds and it was our job to choose the appropriate '**bear funds**' to be purchased. Also, when a '**buy signal**' was generated (which was most of the time), it was our job to choose which stocks and options would be purchased. At the time, it was also the firm's policy that a majority of the funds be invested in Tech stocks. For stock purchases, an average trade was around \$35,000. Options were purchased in lots of 20 to 50 at a time and it was not unusual for us to purchase stocks and options in each of 20 to 30 different stocks, all in a matter of minutes.

During 1999 and the early part of the year 2000, trading was easy and we became accustomed to making large profits several times a week. Because the firm's outlook was primarily '**bullish in nature**', making money **was easy**. But all of that began to change and by October of the year 2000, it was pretty obvious that the firm's '**bullish outlook**' might not be the best strategy. Because it was our job to trade the funds in accordance with the firm's investment guidelines, most of our time was spent looking for Last Wave buy signals as opposed to sell signals. Thus, we were forced to ignore some of the best weekly Last Wave sell patterns of all time. Although profits were made in bearish mutual funds, greater profits could have been made through the purchase of Put options.

As the **bear market** of 2000, 2001 and 2002 began to unfold, health problems plagued the 72 year old Swiss-born partner and by December of 2000 all of the funds were transferred back to Switzerland. But for us, it was a very interesting experience and although we were not able to take advantage of the weekly Last Wave sell signals, we were nonetheless pleasantly surprised to see that many of the declines had been forewarned by these sell patterns.

News always moves the markets and there are certain news events whose release is known ahead of time.



Four times a year, publicly traded companies are required to file reports showing their earnings over the previous 90 days. We like to focus on these announcements because they often lead to the completion of a Last Wave buy or sell pattern such as the one above in WFM.

Let's walk through the steps of choosing an option trade for the chart above.

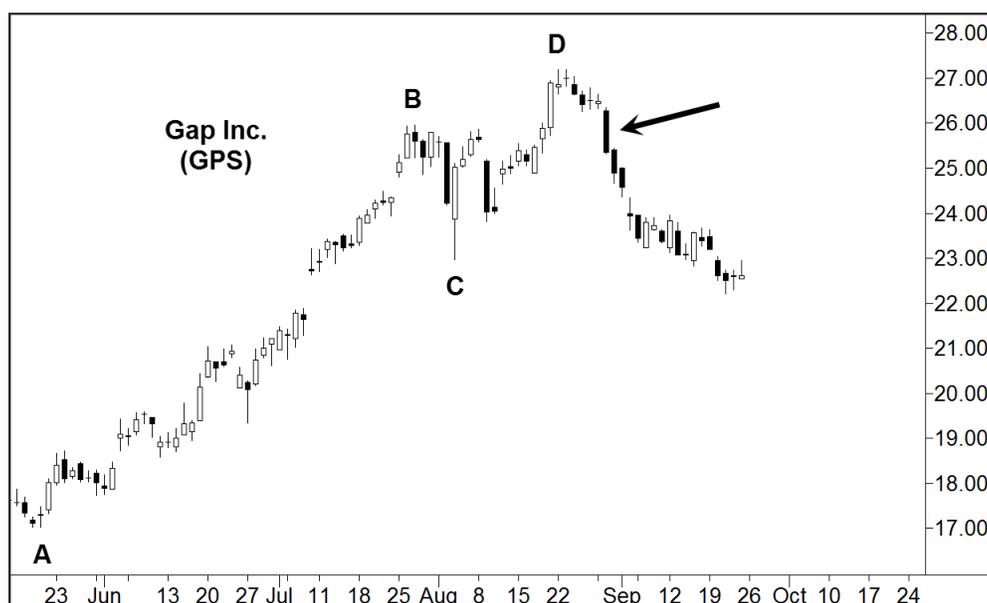
On May 5<sup>th</sup> 2016, a Last Wave pattern occurred in Whole Foods Market (WFM). When a Last Wave buy pattern occurs, our goal is to benefit from the stock moving higher. To do this with options, we'll initiate a bullish position by purchasing a Call option.

As mentioned earlier, when purchasing Call and Put options, we start by choosing an expiration date. At the time of this trade, we chose from a list of options expiring the third Friday in June. Because the stock was trading just over 30.00, we selected the **at-the-money** 30 Call expiring on June 17<sup>th</sup> at a price of 1.38. Because one option is equivalent to 100 shares of stock, the cost of this trade was \$138 per Call option.

If this trade had failed, we'd have closed the trade if it traded back down to the low at point 'D'. Also, when you start an option trade, it's very important

for you to be realistic about your expectations. If the value of an option purchase reaches a gain of 100%, it's a good idea to start thinking about an exit strategy. Each day, as the June 17<sup>th</sup> expiration date gets nearer, you have to look at the value of your trade and compare it to what your realistic expectations are for where the stock may be going. As each day passes, you need to ask yourself "If I were not in this trade, would I be willing to buy it today at the current price?". If your answer is "No", you may want to consider closing it. On June 2<sup>nd</sup>, the trade was closed at \$422 for a gain of \$284.

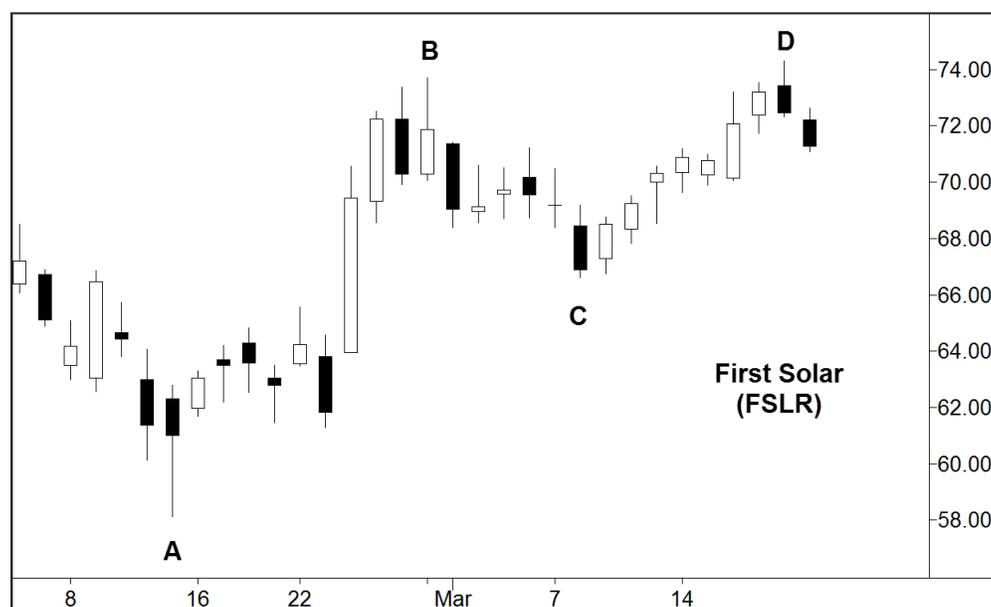
In late August 2016, a Last Wave sell pattern occurred in GPS.



The confirmation that professionals were closing their positions and moving money out of this stock came on Aug. 30<sup>th</sup>. When a Last Wave sell pattern occurs, our goal is to benefit from the stock moving lower. To do this, we initiate a bearish position with the purchase of a Put option.

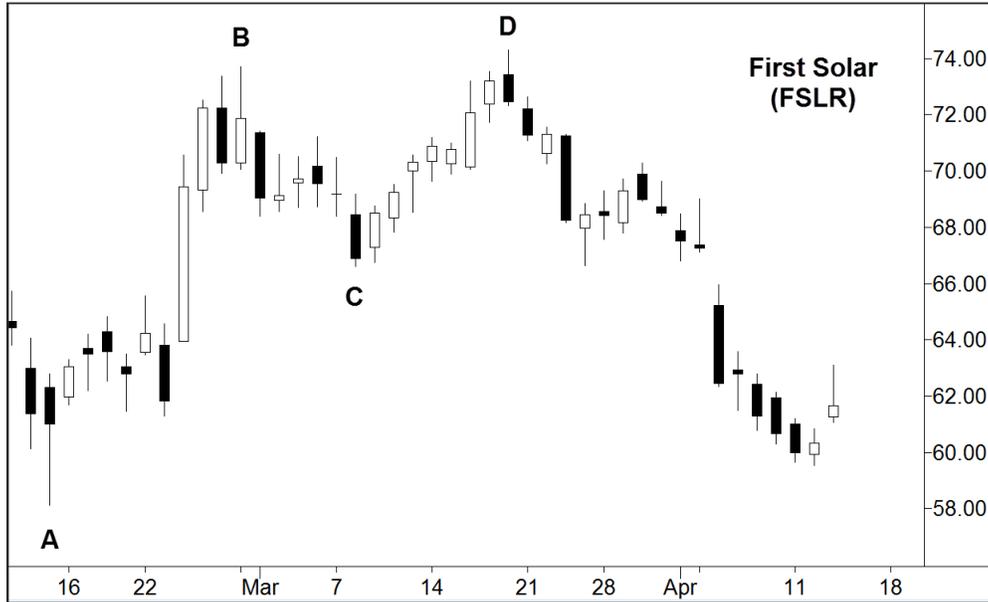
At the time of this trade, the September monthly options were expiring on Sept. 16<sup>th</sup>, which would not have given our trade enough time to work. A better expiration date would have been Oct. 7<sup>th</sup>, Oct. 14<sup>th</sup> or Oct. 21<sup>st</sup>. We chose the Oct. 21<sup>st</sup> at-the-money Put option with a strike price of 26. The cost for this trade was \$168. Our risk for this trade was a new high price above point 'D' at 27.20.

When looking for a confirmation that a Last Wave sell pattern is in place, we like to see a negative price bar whose range is greater than previous ranges, or two successive price bars such as those in the chart below.



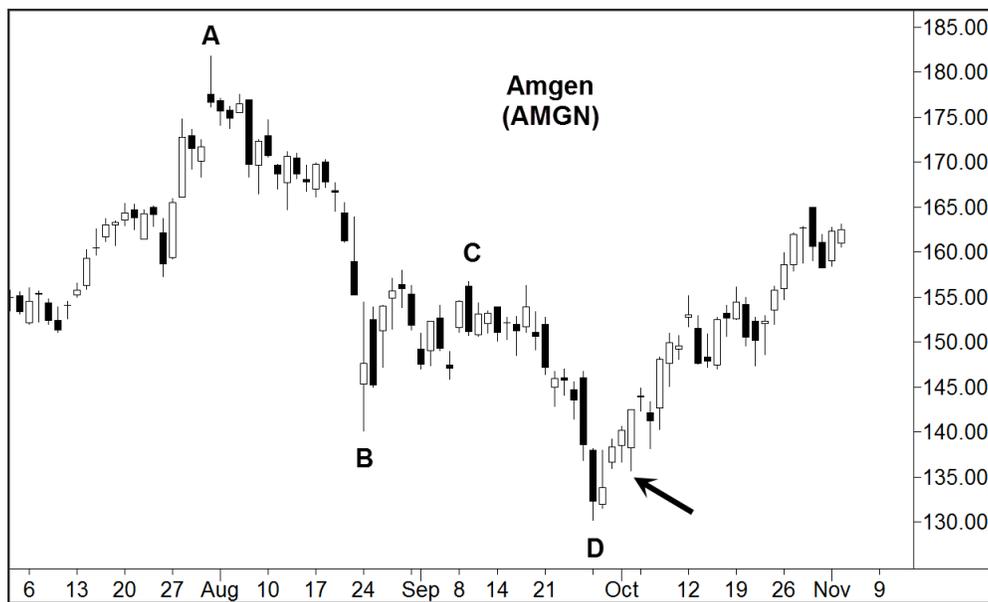
For this trade, our best choices for an expiration date were April 15<sup>th</sup>, April 22<sup>nd</sup> or possibly April 29<sup>th</sup>. At the time of the trade, the activity in the FSLR options was pretty light, especially for the April 22<sup>nd</sup> and April 29<sup>th</sup> dates.

Another 'guideline' we use when purchasing Call and Put options is a maximum price of around 2.50 per option. Because the stock was trading around 71.20, the best strike prices would have been the 72 Put, the 71 Put or possibly the 70 Put. Unfortunately, there were no options that fit into our 'preferred criteria' at a price under 2.50, so the trade was passed.



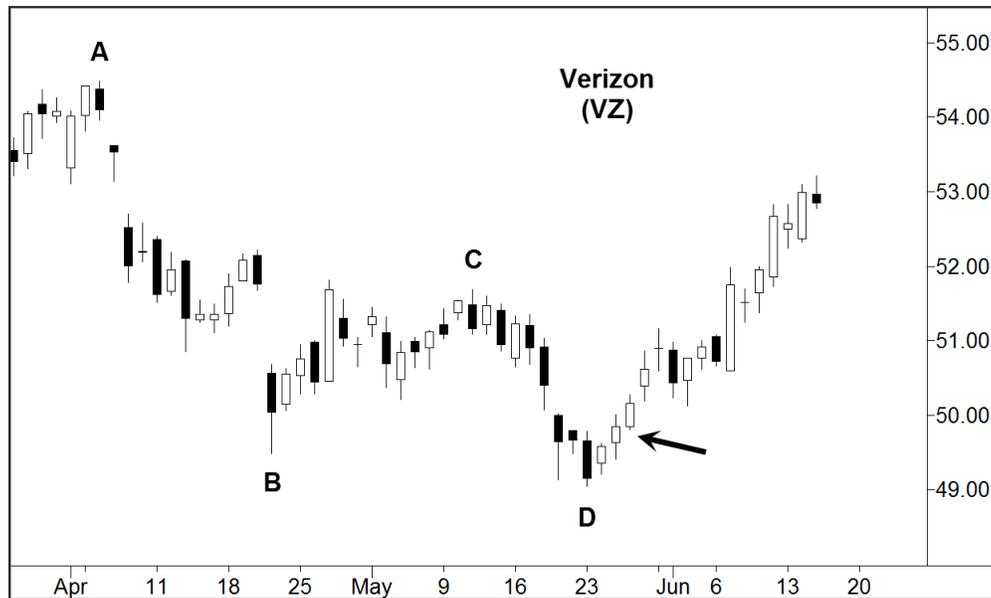
Had we been able to do this trade, we'd have probably stayed with it until April 13<sup>th</sup>. Although the available options were above our preferred price, each had gains of just over 100%.

The months of September and October will often produce Last Wave buy patterns.



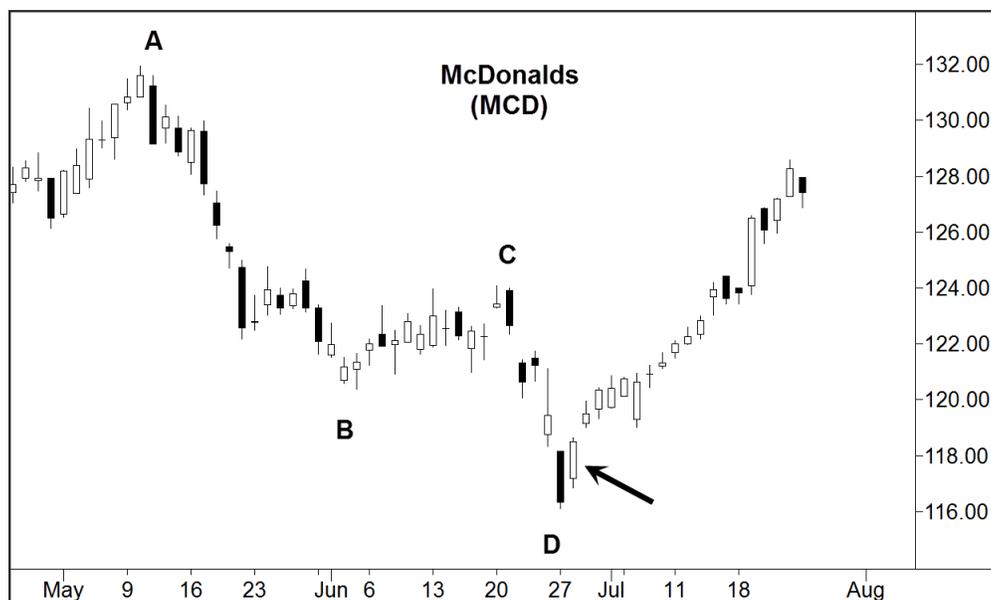
This Last Wave buy pattern in Amgen was complete on Sept. 30<sup>th</sup> 2015. These Amgen options were rather expensive, but we chose the Oct. 30<sup>th</sup> 145 Call at a price of 2.50. Fifteen days later, the trade was closed at 6.31 for a gain of \$381.

In late May 2016, a Last Wave buy signal occurred in Verizon (VZ).



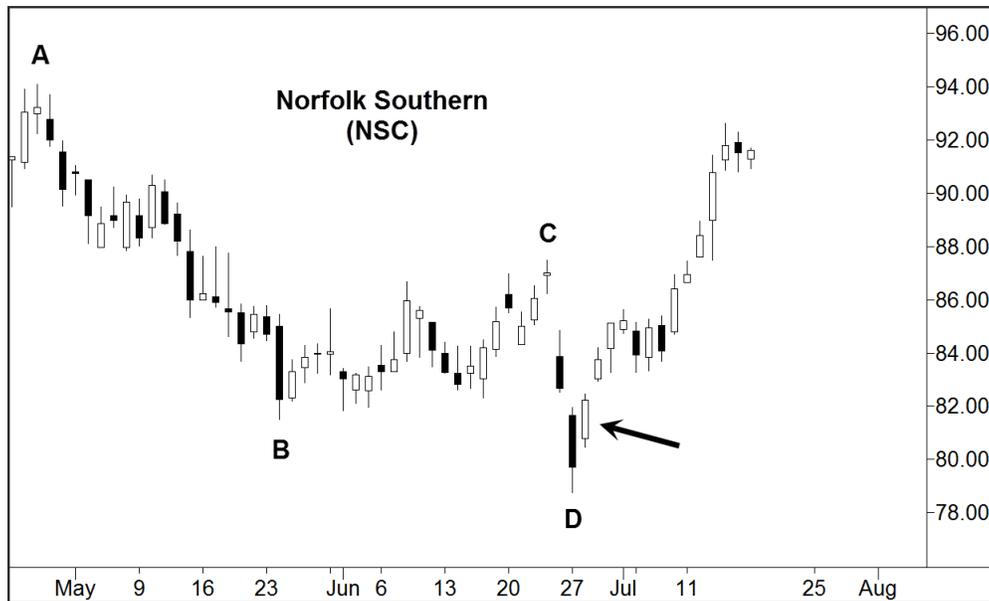
At the time of this trade, the Exchange was offering options that expired on June 11<sup>th</sup>, June 17<sup>th</sup>, June 24<sup>th</sup> and July 1<sup>st</sup>. The stock was trading around 50.00, so we chose the July 1<sup>st</sup> 50 Call at a price of .96. The trade was closed on June 15<sup>th</sup> at 3.20 for a gain of just over 300%.

For this June 28<sup>th</sup> 2016 trade in MCD, the stock was trading just under 119.



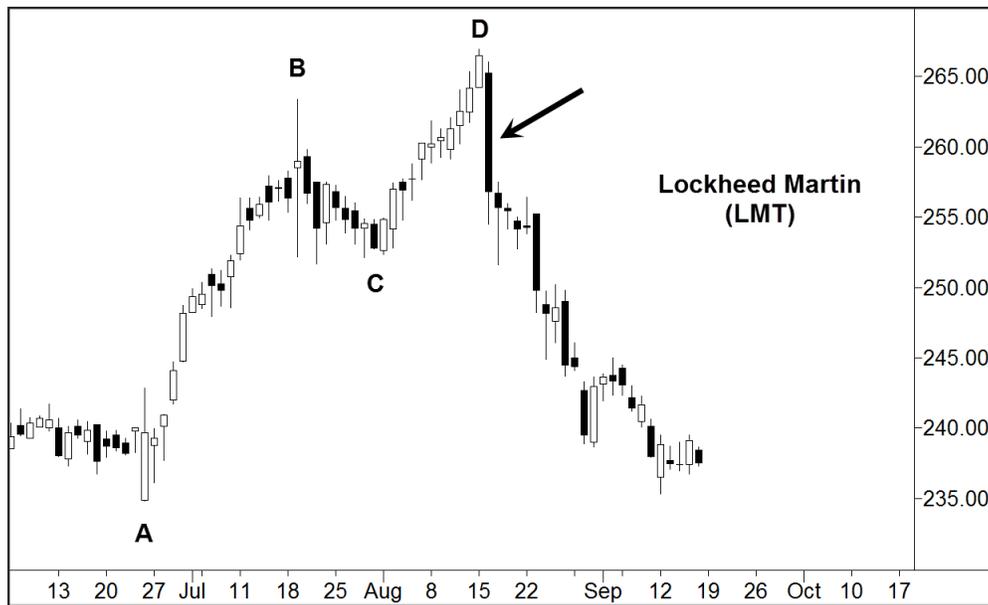
For this trade, we chose the July 29<sup>th</sup> 120 Call at a price of 1.97. Three weeks later, on July 18<sup>th</sup> the trade was closed at 4.47 for a gain of just over 125%.

Another trade that took place on June 28<sup>th</sup> 2016 was this Last Wave buy signal in Norfolk Southern.



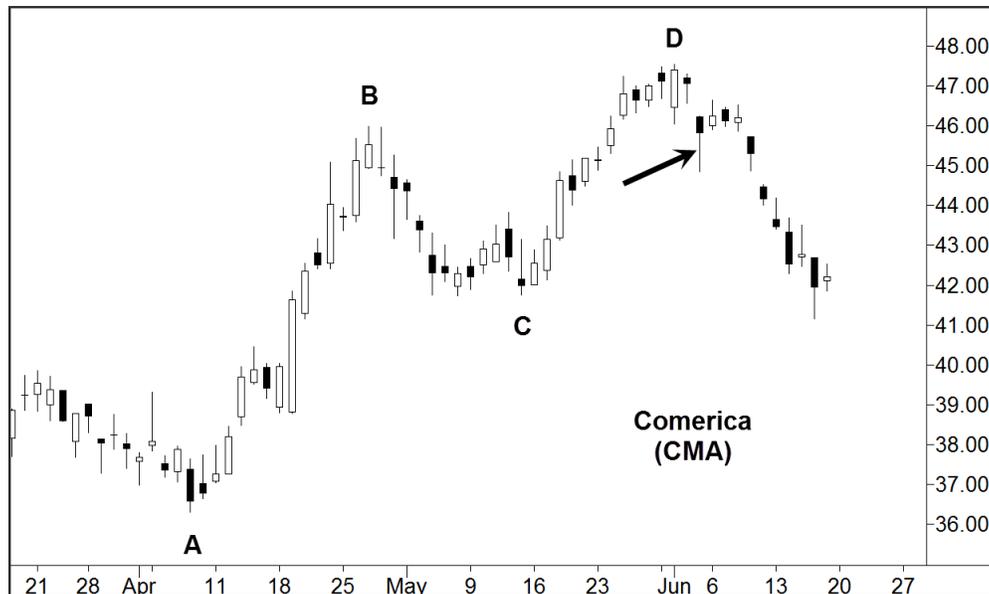
The stock was trading around 83.00 so we chose the July 15<sup>th</sup> 85 Call at a price of 1.20. The trade was closed on July 13<sup>th</sup> at 3.30.

In August 2016, Lockheed Martin completed a Last Wave pattern. As a general rule, when a stock is priced at around \$150 or more, the options are usually too expensive and more than our preferred maximum of 2.50.



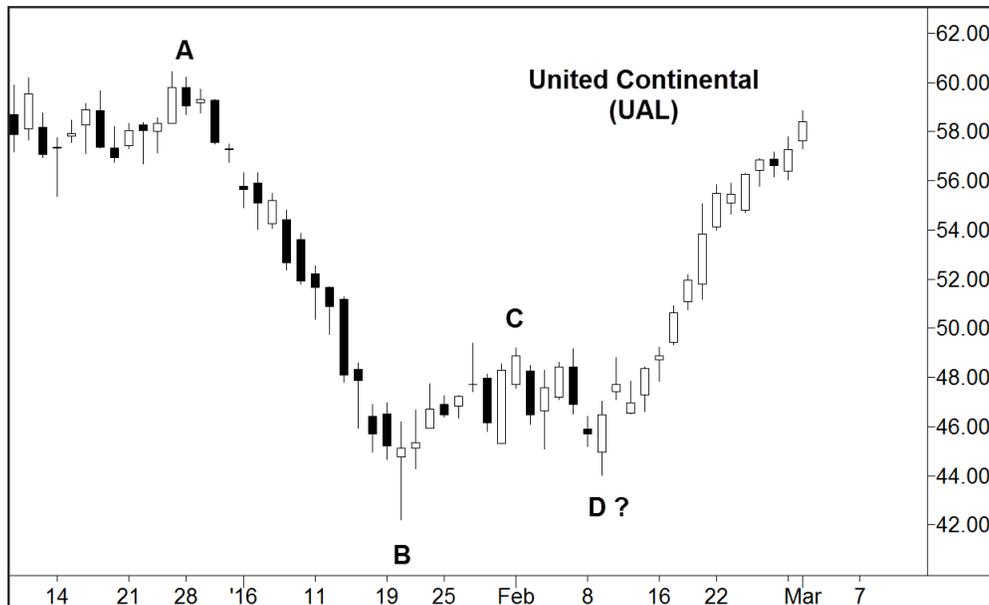
At the time of this sell signal, there were no options in LMT that met our guidelines.

In late May 2016, as we awaited the completion of the Last Wave sell pattern in Comerica, the chance for an actual trade never occurred.



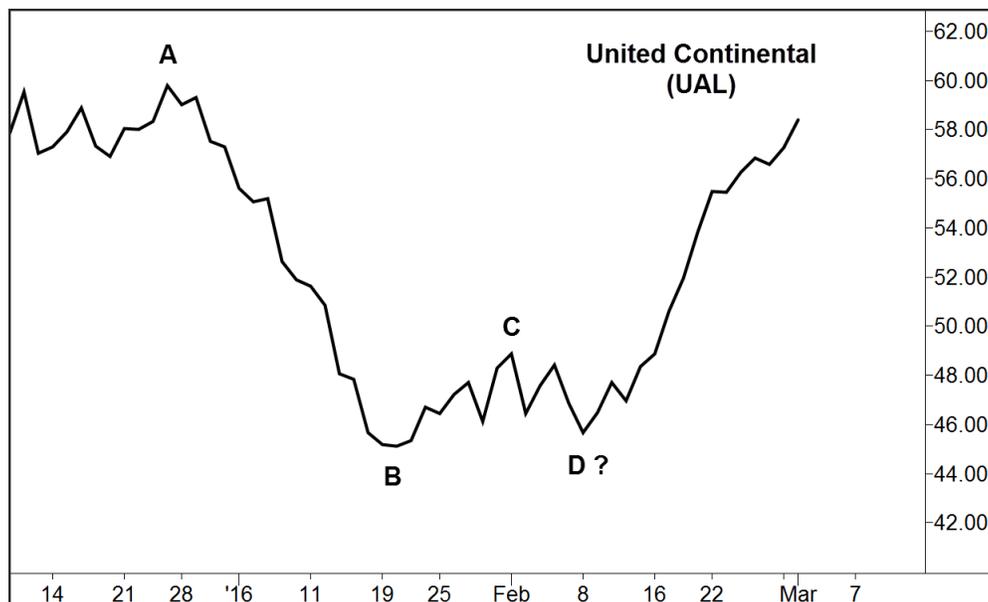
If you look closely at the chart above, the first bar after point 'D' that was somewhat negative occurred two bars later (black arrow). Although this trade would have done quite well, for a Last Wave sell signal, we prefer the close of the confirmation bar to be at or near the low of the day.

Not all tops and bottoms result in a Last Wave pattern. But if you can learn to spot them, they'll provide trades that have very low risk.



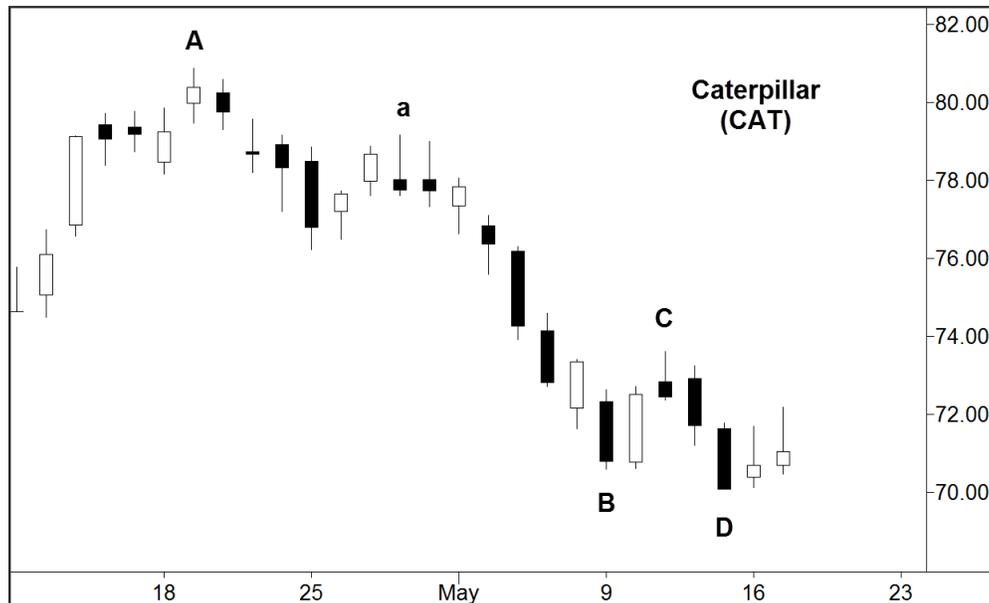
In the chart above of United Continental (UAL), at point 'C' the stock was setting up for a Last Wave down to point 'D'. We were waiting for UAL to trade slightly lower at point 'D', but it never did. As we said earlier, for a Last Wave buy signal, we prefer not only a lower low at point 'D', but also a lower close than the close at point 'B'.

If you're not sure, try changing your chart from a typical bar or candlestick chart to a chart that connects all of the closes. You'll see this referred to on some trading platforms as a 'line on close' chart.



In the 'line on close' chart above, it's easier to see that point 'D' failed to close below point 'B'. Obviously, the stock had plenty of buyers, but we prefer to see a lower close because it carries less risk.

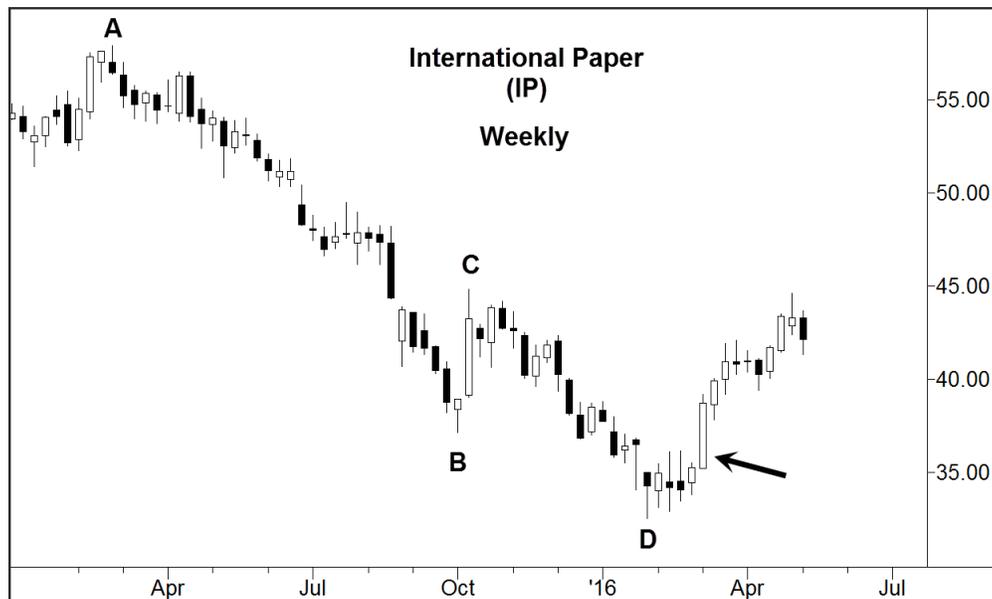
Another pattern that is less favorable is illustrated below in the daily chart of Caterpillar (CAT).



Whether we use 'A' down to B or 'a' down to B, the Last Wave pattern of point C down to point D doesn't contain enough bars. We prefer to see more bars between point 'B' across to point 'D'. In the daily chart above, there are only 3 bars between B and D. Having more bars between points B and D represents more selling (which is usually done by the way, by the inexperienced traders). Whether it's a 'buy' or a 'sell', what we like to see for the Last Wave pattern is at least 5 or 6 bars between points B and D.

Also, as we've pointed out in these charts, when we're looking for Last Wave patterns, we like to see a bar that helps confirm the change in trend. One of the reasons we favor candlestick charts is that they allow us to see the strength or weakness in each bar. Once we've identified the possibility of a Last Wave pattern, we want point 'D' to be followed by a strong move in the direction of the new trend. In the chart above of CAT, the narrow candle bodies following point 'D' are not what we look for as a confirmation.

Although this trade in International Paper would have worked out fine, we prefer more bars between point 'B' and point 'C'.

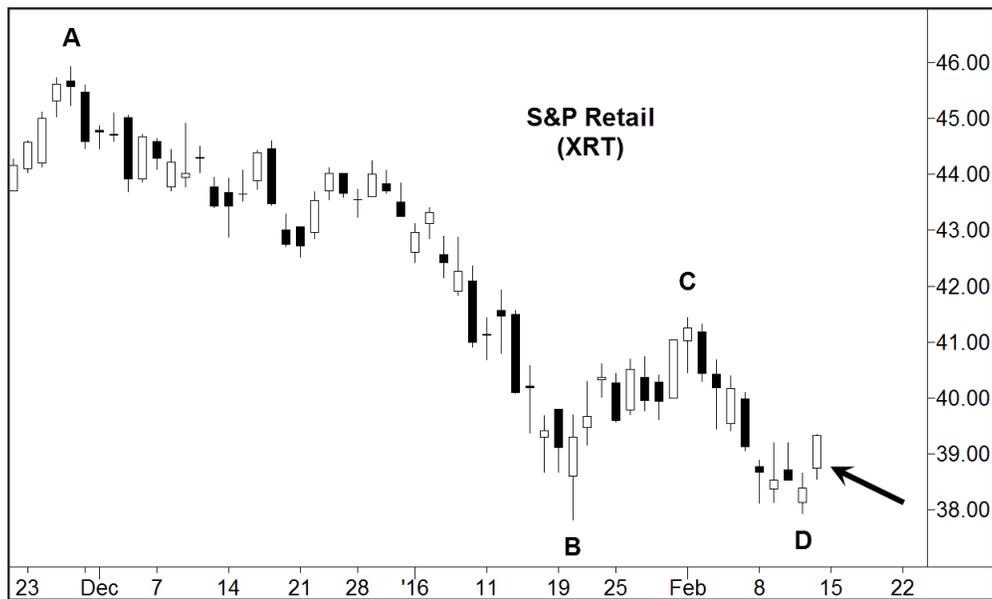


In this weekly chart, from the bottom at point 'B' to the top at point 'C' the count would be one bar. We prefer to see at least 3 bars.

## Using the Last Wave Pattern for Trading Options on ETFs

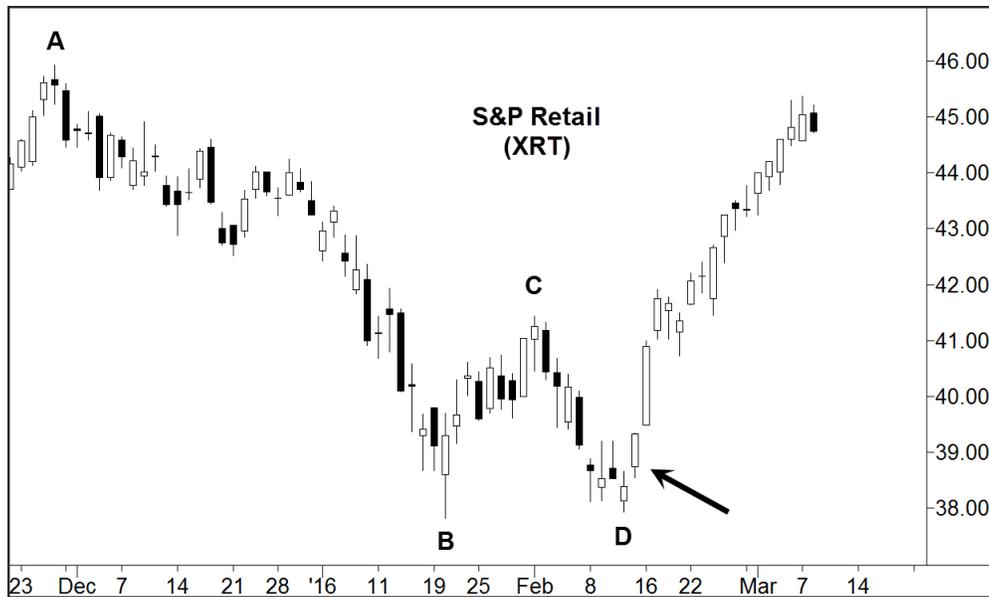
Last Wave patterns occur in any market and on any time frame. We've traded them on time frames as short as 3-minutes on the Nasdaq 100 QQQ all the way out to weekly charts of stocks and ETFs.

Here's a daily chart of the S&P Retail ETF.



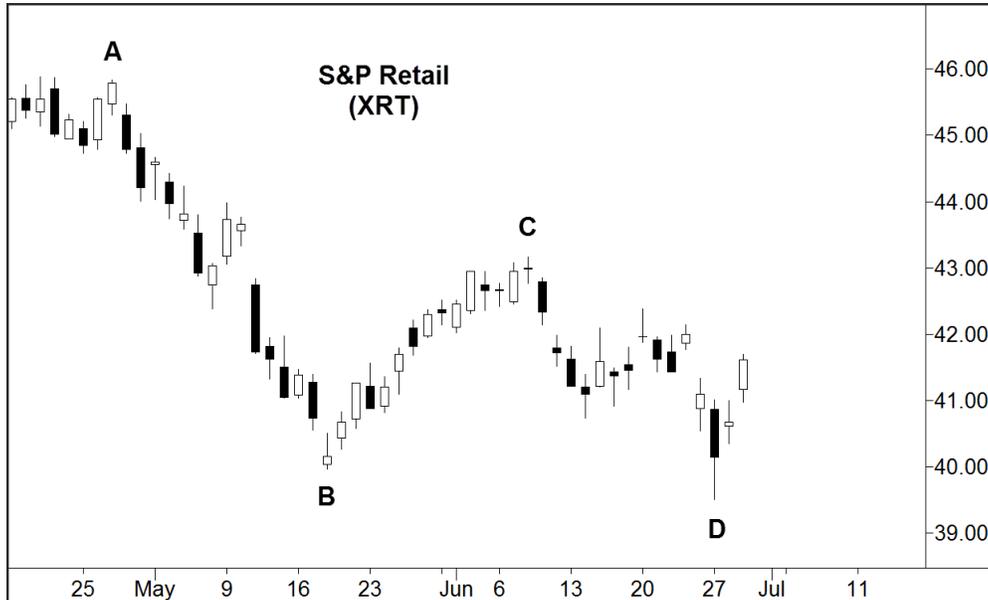
On Feb. 12<sup>th</sup> 2016, a Last Wave buy pattern occurred in the S&P Retail ETF (XRT). For this trade, we chose the March 18<sup>th</sup> 39 Call at a price of 1.54.

Three weeks later, the trade was closed at a price of 3.00 for a gain of \$146 per option contract ( $\$300 - \$154 = \$146$ ).



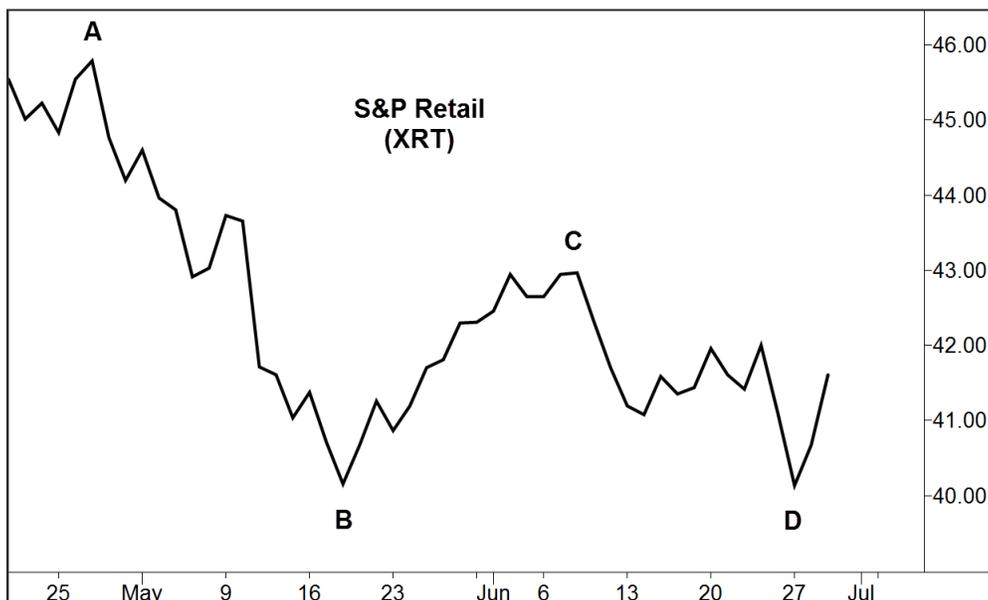
The S&P Retail ETF is comprised of many different stocks including WalMart, Target, Walgreens, JC Penney and Best Buy among others.

Several months later, on June 29<sup>th</sup> 2016, another Last Wave pattern occurred in the S&P Retail ETF.

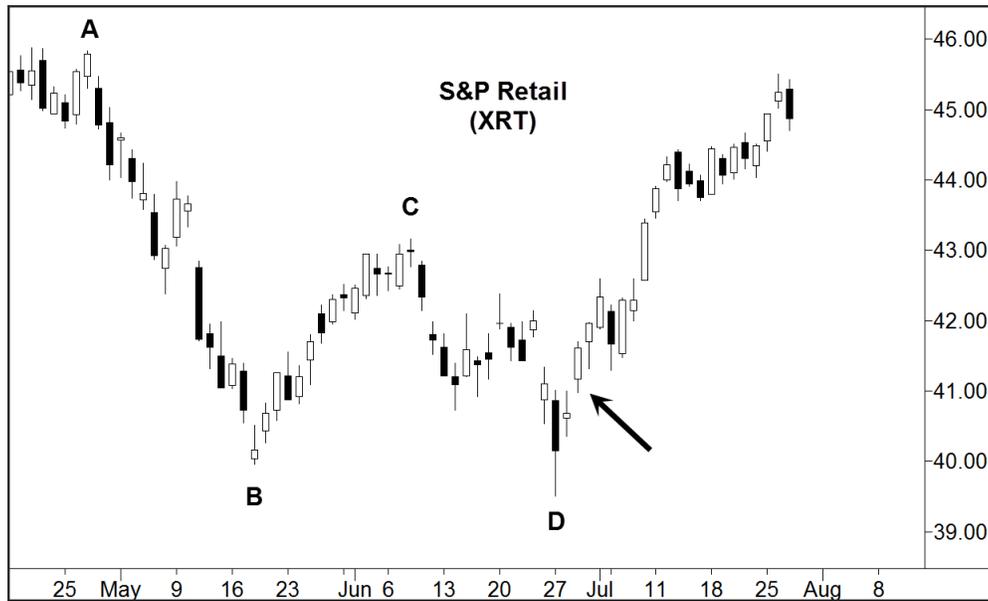


As mentioned earlier, for a Last Wave buy signal, we prefer not only a lower low at point 'D', but also a lower close than the close at point 'B'.

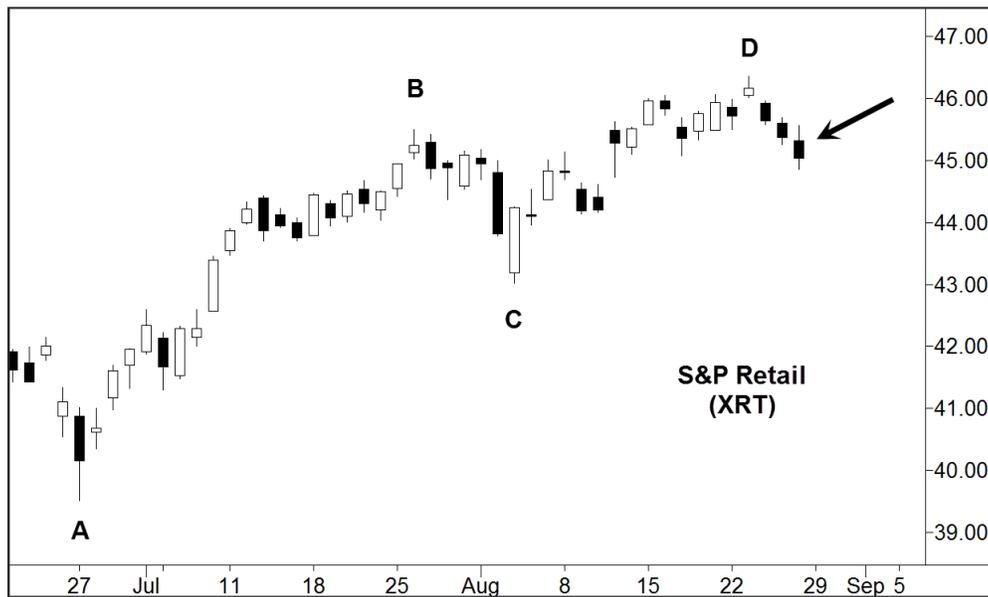
The chart below of closing prices makes it easier to see that the close at point 'D' was in fact below the close at point 'B'.



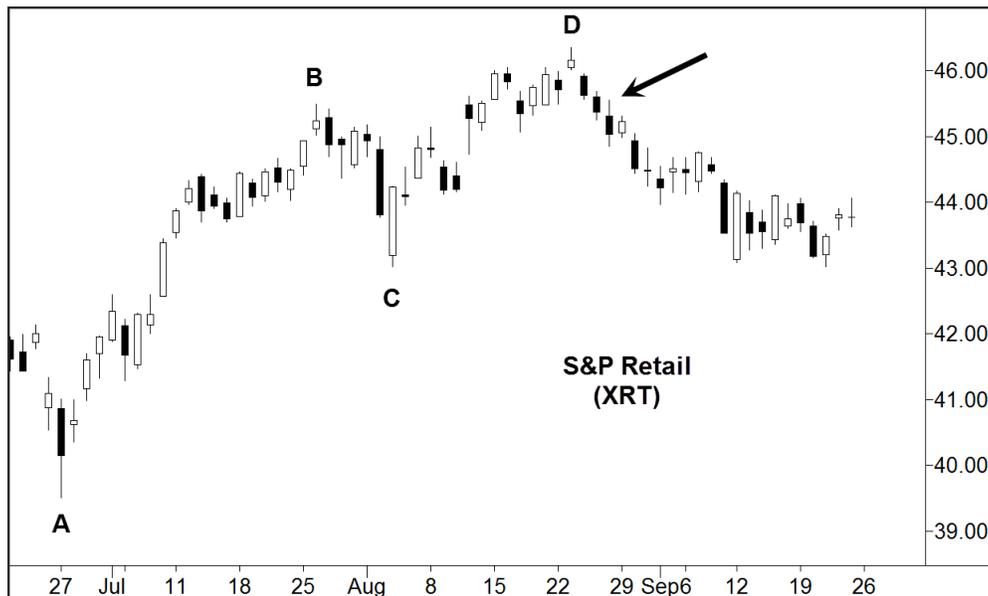
Our choice for this trade was the Aug. 19<sup>th</sup> 41 Call at a price of 1.51.



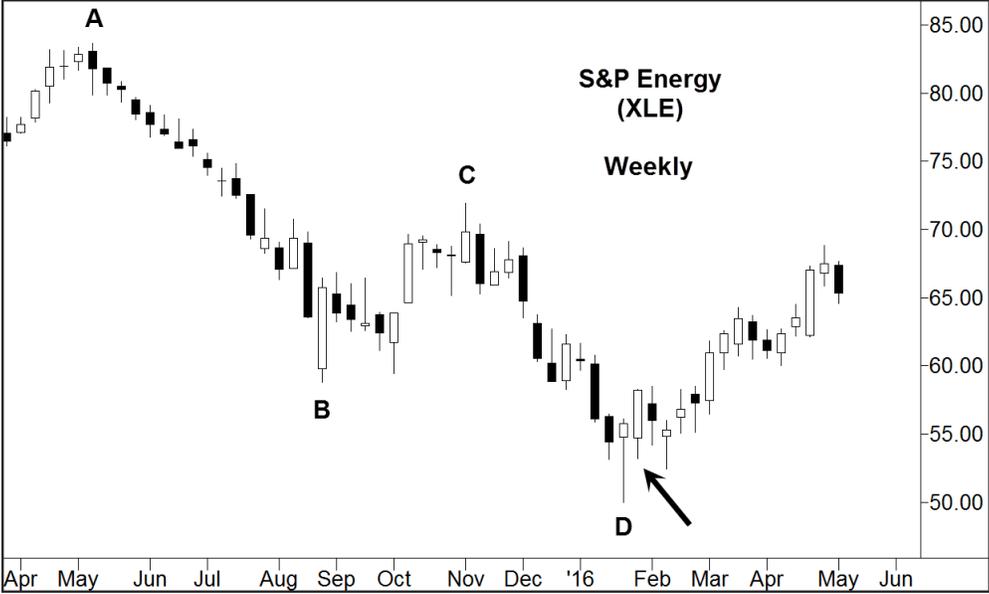
Two weeks later, the trade was closed at 3.07 for a gain of \$156.



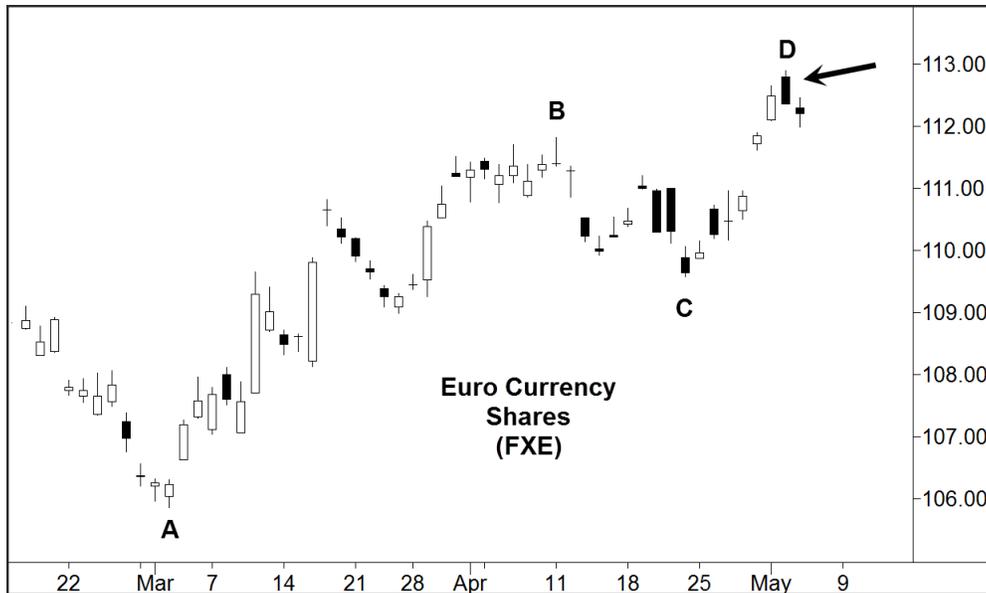
When a Last Wave pattern occurs in an ETF, it allows institutional fund managers and professionals to participate in the entire group with very little risk.



When trading ETFs, in addition to the S&P Retail ETF, some of our favorites include the S&P Energy ETF (XLE) and the Euro Currency Shares (FXE).

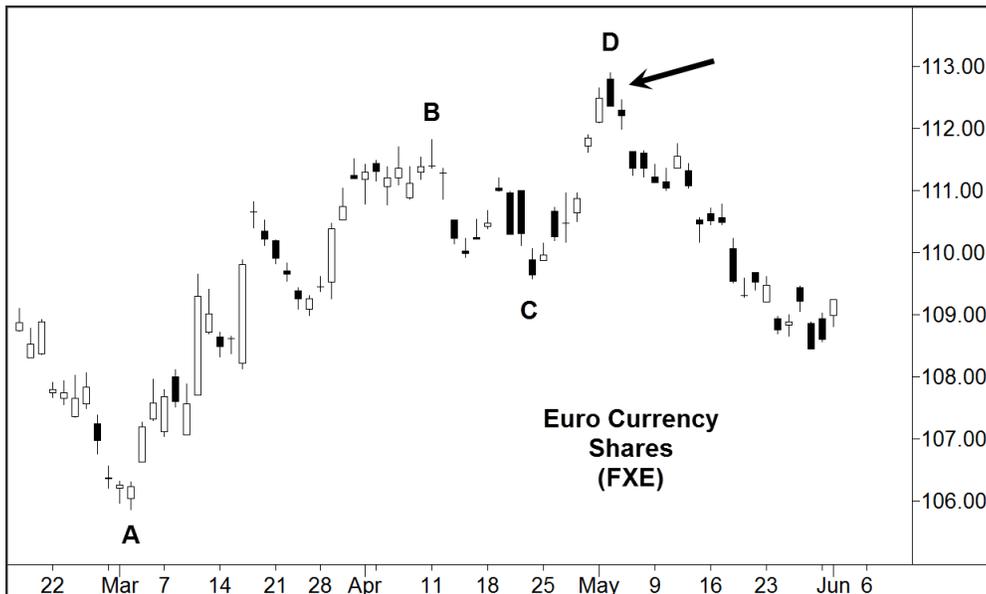


The Last Wave buy signal in this weekly chart of the S&P Energy ETF warned of the possibility of higher oil prices.



The Euro Currency Shares ETF increases in value when the US Dollar declines in value. Options on these ETFs can be traded just as quickly and easily as options on US stocks.

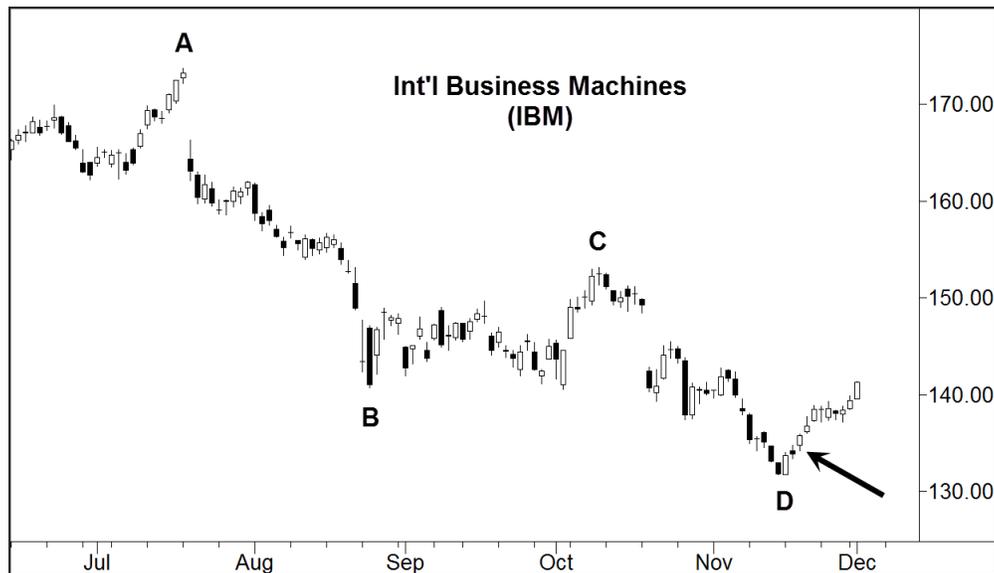
In the chart above, the FXE completed a Last Wave pattern on May 4<sup>th</sup> 2016. The best choice for this trade was the June 17<sup>th</sup> 112 Put at a price of 1.43.



The trade was closed on May 26<sup>th</sup> at 2.84 for a gain of \$141 per option contract.

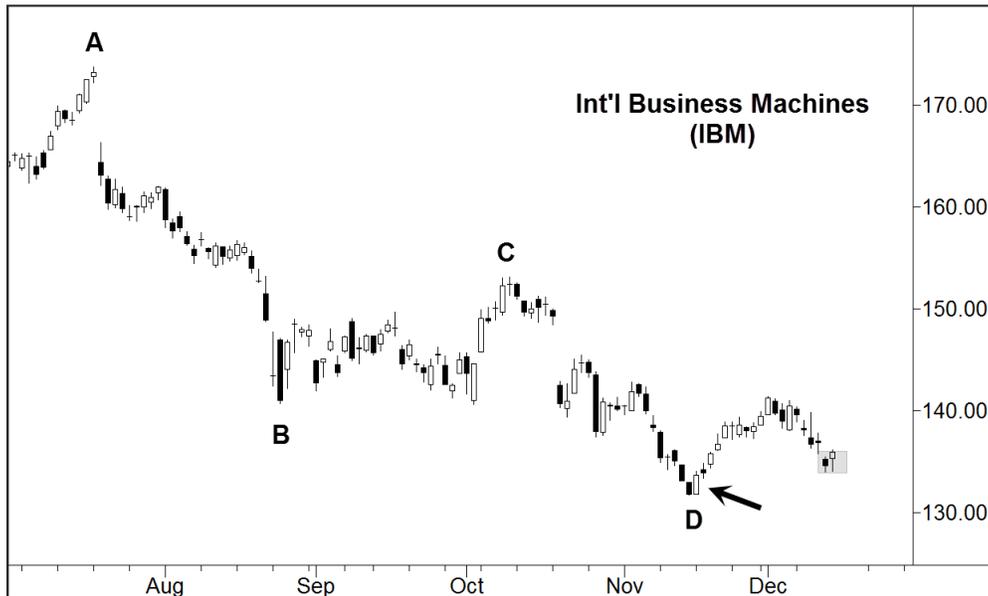
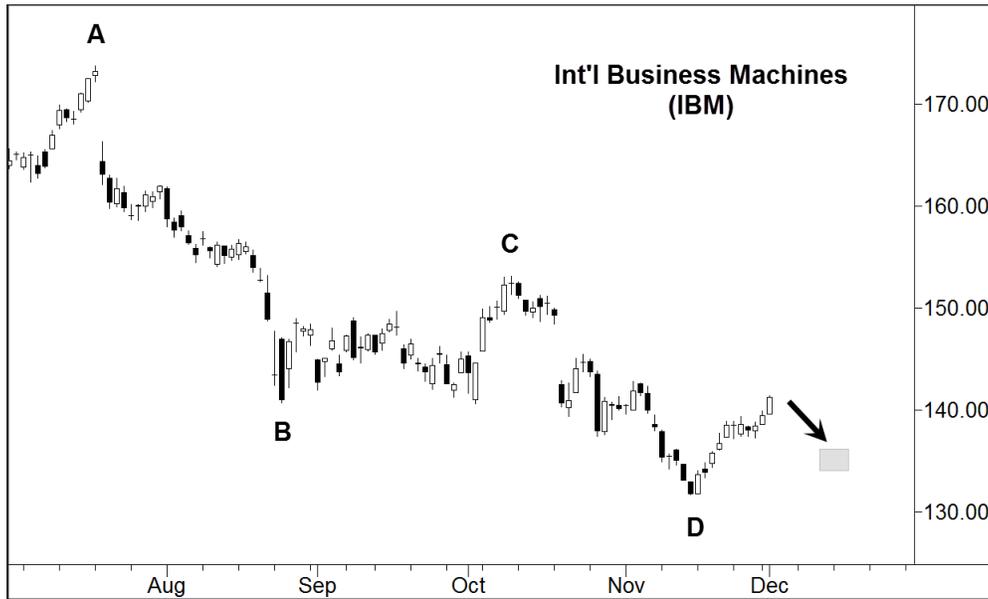
## Trade Management

Trading is easy when everything goes right, but success comes when you're able to properly manage a trade and identify a trade that needs to be closed.

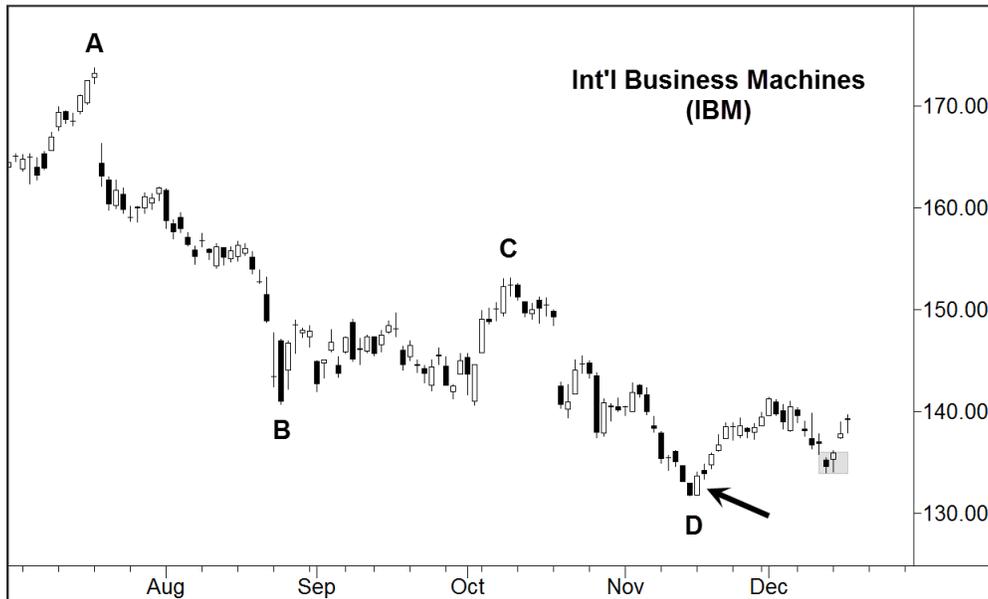


In the chart above of IBM, the Last Wave pattern completed at point 'D'. With many of these Last Wave patterns, after the first thrust in the new direction, minor profit taking comes in and the price retraces somewhere around 40% to 60% of the initial move. This retracement process is illustrated on the next page.

In the chart below, from the bottom at point 'D' to the last price shown, the stock gained roughly 10 points. A 50% retracement would be a mild pull back to around 136.00.

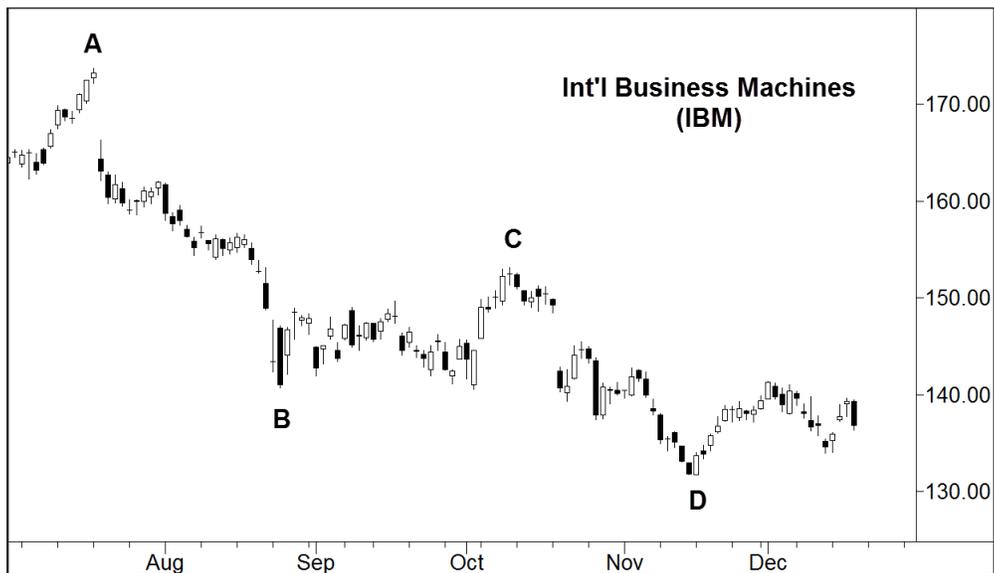


As we can see in this chart, a mild pull back brought the stock down to the 50% level.

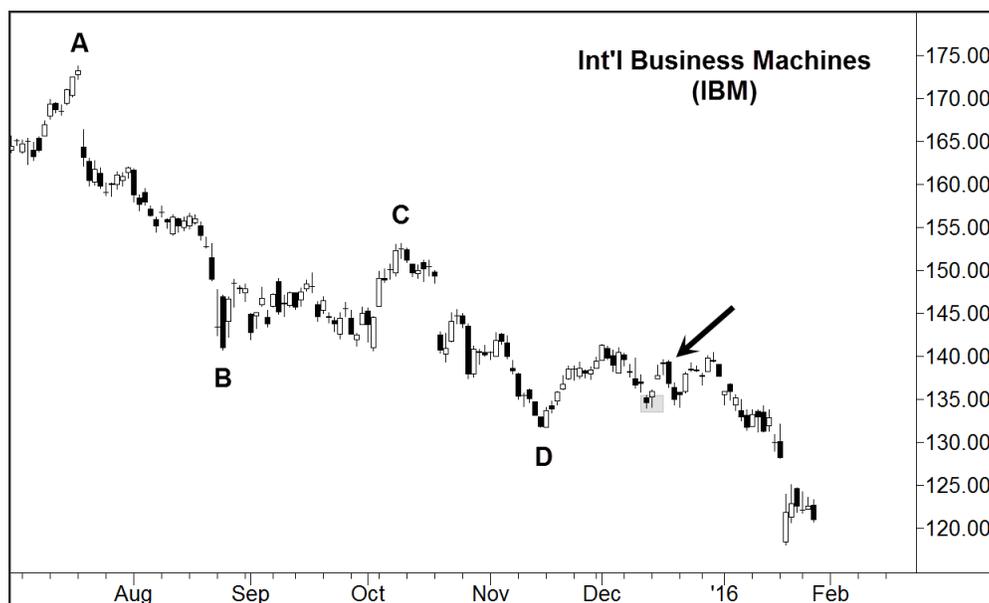


At this point, everything looks fine. The stock is doing exactly what we want it to do. The price action in the last 2 bars on this chart is indicating that institutional fund managers are beginning to move more money into shares of IBM.

Woops – This is a bad sign. This should have never happened.



A reversal such as the one in the chart above is a red flag. This trade has to be closed out as soon as possible.



In the chart above, the black arrow points to the reversal bar. As we can see in this chart, the stock struggled sideways and slightly higher before dropping to a new low price. If institutional fund managers and other professional traders are going to accumulate more and more shares of this stock, a strong reversal day is a sign that something is **very** wrong. When this happens, we close the trade, get our money back and move on to a new trade.

## Chapter 5

### Trend Lines

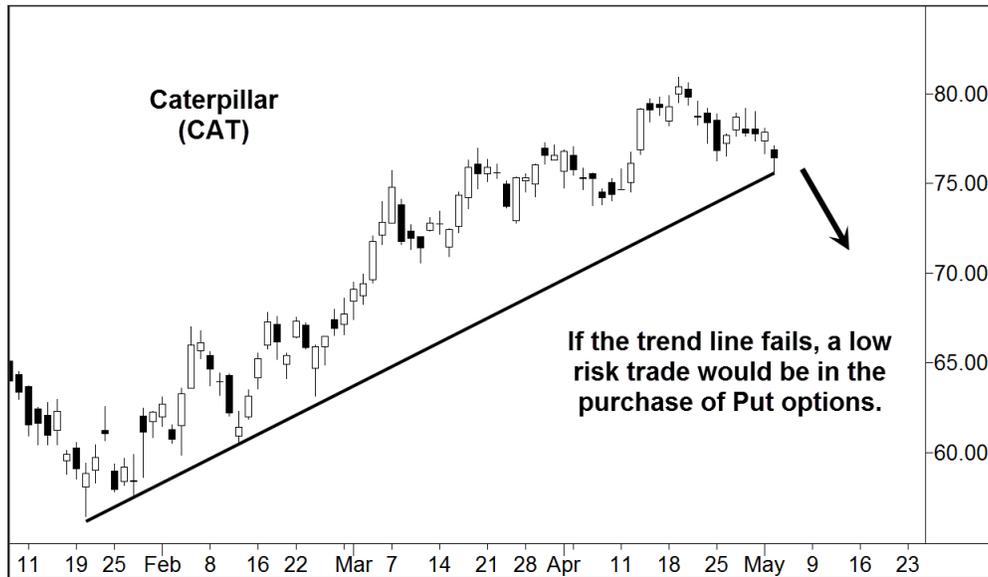
Years ago, a friend of mine whose favorite charting tool was Trend Lines said to me, "If you give three people the same chart of the stock Microsoft and ask them to draw some trend lines, you'll get three completely different looking charts". That's the beauty of trend lines; we can all draw them any way we want to.

At the time he made that comment, my focus was on trading options and I had never placed much value on trend lines. I was of the opinion that most of the options traders in the world were large institutions and professional traders. Because of their large transactions occurring all day long, I felt that trend lines wouldn't have much value to them or to myself as a technical tool. I've since learned otherwise and trend lines have now become a part of my analysis.

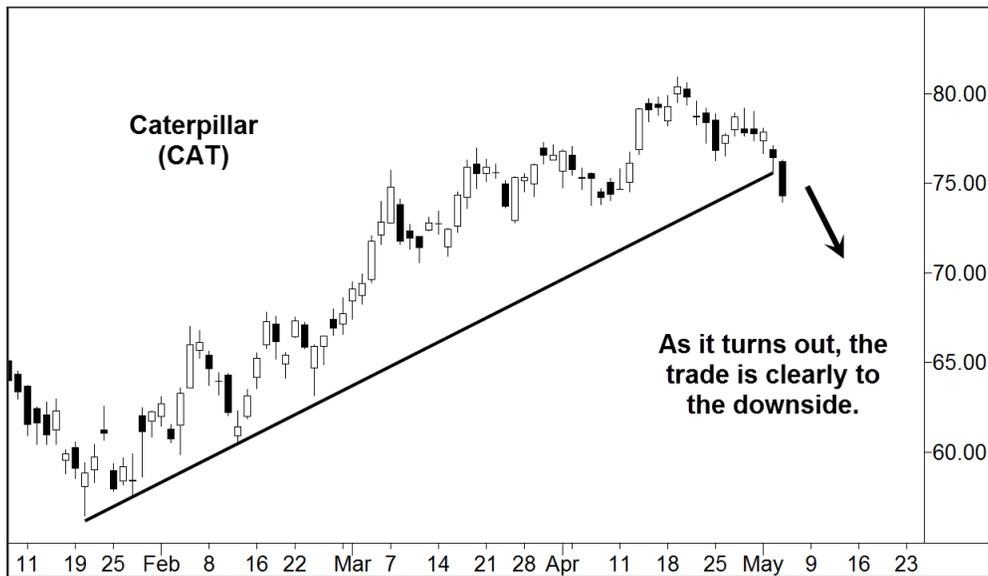
Earlier, I mentioned that if enough traders in a particular market **unknowingly** do the same thing at about the same time, significant tops and bottoms are likely to occur. Thus, if enough traders happen to react in an area of a trend line, prices just may change direction.

Here are a few illustrations of how trend lines can help identify low risk trades.





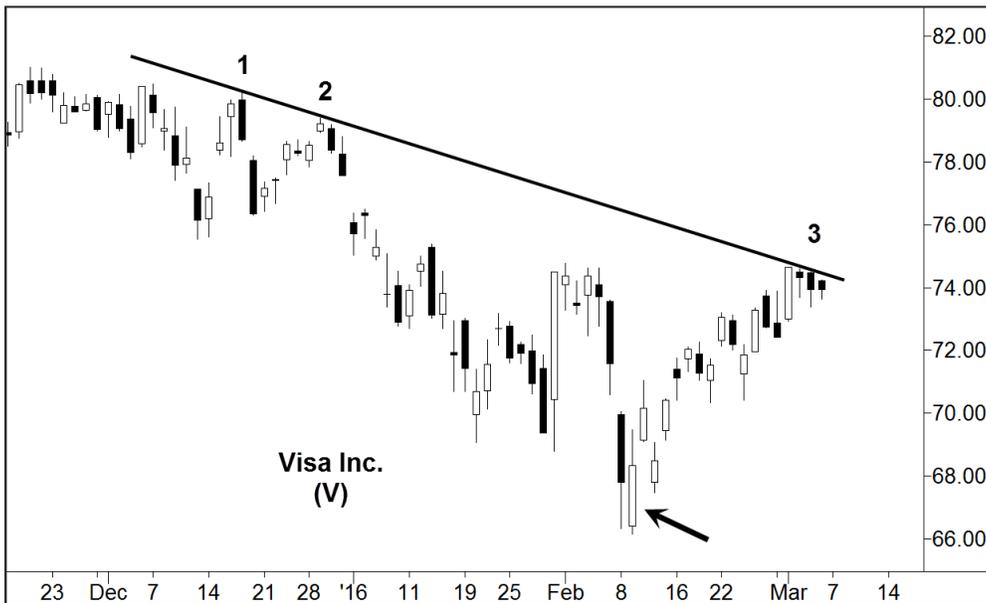
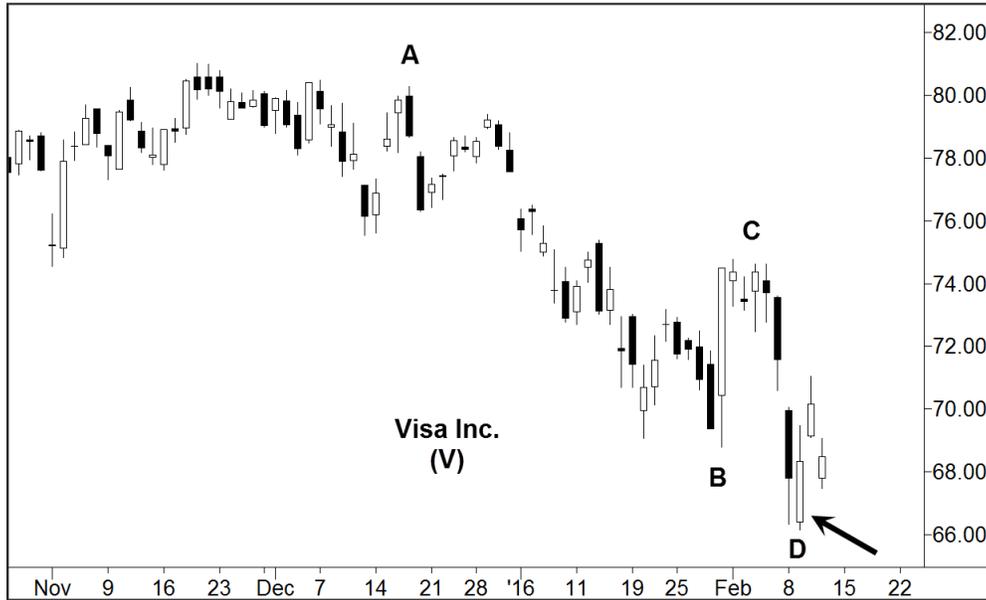
In the chart below, we can see that the trend line did not hold.



The negative bar after the trend line break was evidence that professional traders were positioning their investors to profit from a decline in the stock.

Let's look at a few more examples:

In February 2016, after completing 'Last Wave' patterns, buyers began to overtake sellers as many stocks moved higher.



After completing a Last Wave buy pattern, institutions and professional traders accumulated shares of Visa until it reached a level when the very

short-term traders decided to take some of their profits. The move from roughly the 69.00 level up to the declining trend line around 74.00 resulted in a profit in this trade of around \$5.00 a share for buyers of the stock.

Trend lines are a favorite place for professional traders to either enter, or exit a trade. In this case, the trend line in the previous chart of Visa was the very important 'Third Point'.

As every trend line forms, the first two points are random. But if a 'Third Point' develops, it's more than just coincidental. Trend lines are not guaranteed to hold back prices, but they present an opportunity for the professional traders to **'watch and see what happens'**. As we said earlier, successful trading is simply a **'matter of awareness'**. Traders that are aware of where the nearby trend lines are in a particular stock are better prepared to trade that stock than all other traders. As you follow this example, you'll see that Visa eventually breaks up through the declining trend line. But let's go through it step-by-step.



When the 'Last Wave' pattern results in a change in trend as it did with Visa, the strongest price moves often come after the first pull back. In this case, the stock bottomed just above 66.00 and it reached the declining trend line just above 74.00 for a difference of roughly 8.00 points. The best way to know if anxious buyers are outnumbering the cautious sellers is to watch for a **mild** profit taking pull back. Pull backs of around 50% to 60% indicate a mild pull back and that the new trend is **very healthy**.

Within a few days, the selling pressure eases exactly at our expected level.



At this point, it's **'do or die'** for the uptrend. As this trade unfolded, there were several reasons that we felt the professional traders would not only

**hold** their existing positions, but they'd probably **add** to them. Here are a few of those reasons:

In early February, the stock completed our 'Last Wave' buy pattern (the black arrow in the chart above). This was an indication to us that higher prices were ahead.

Several weeks later, at the 'Third Point' on the down sloping trend line, mild profit taking occurred.

The mild profit taking began to ease exactly in our 50% pull back area (the grey shadow area in the chart above).

Trend lines are a '**Decision Point**' for professional traders and the pattern has set up perfectly for new investors to begin accumulating shares of the stock.



With everything in place, this break above the trend line will cause institutions and professional traders to place Visa on their buy list and begin to accumulate more and more shares of the stock.

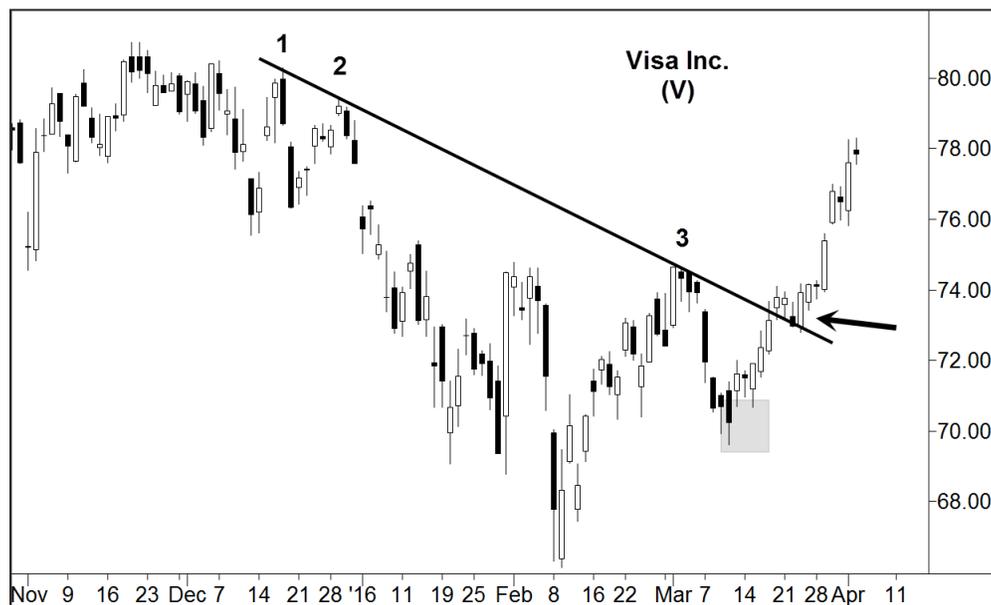
Here are the steps for choosing how to trade Call options on this stock:

The entry date of the trade is March 18<sup>th</sup> 2016.

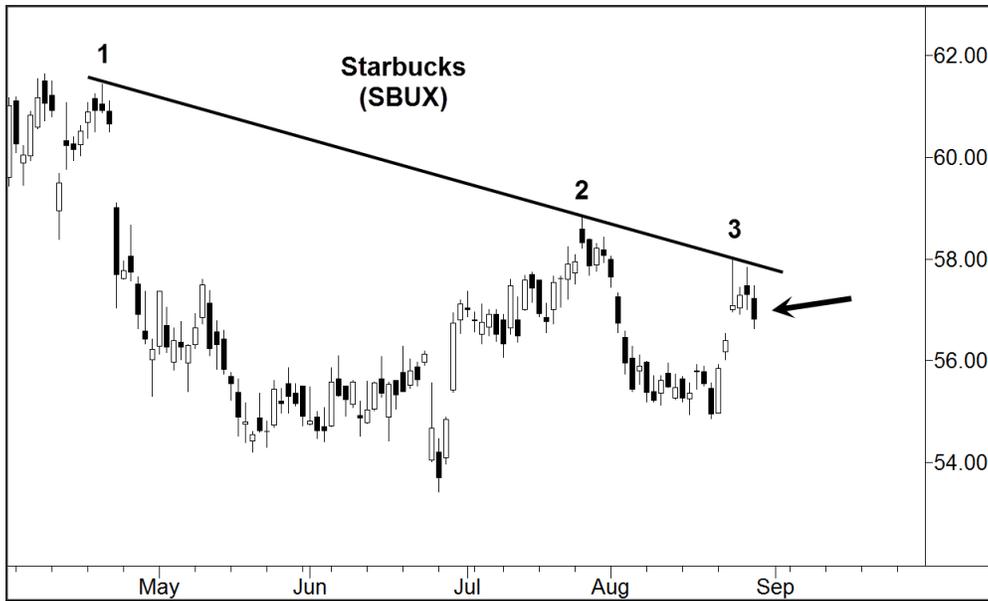
Start by looking at the available options and choose an expiration date that is 4 to 7 weeks away.

Next, choose a strike price that is at or near the current price of the stock.

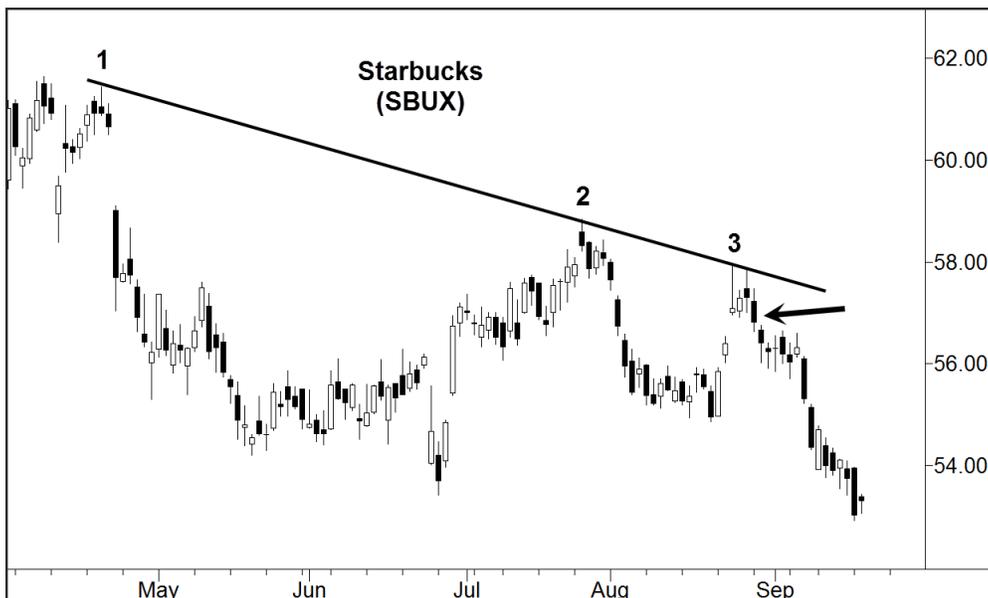
We chose April 22<sup>nd</sup> as our expiration date and we chose the 74 strike price. We'll refer to this trade as the Apr. 22<sup>nd</sup> 74 Call. Our entry price was 1.71.



This trade was closed on April 4<sup>th</sup> at a price of 4.00 for a gain of \$229 per option contract.

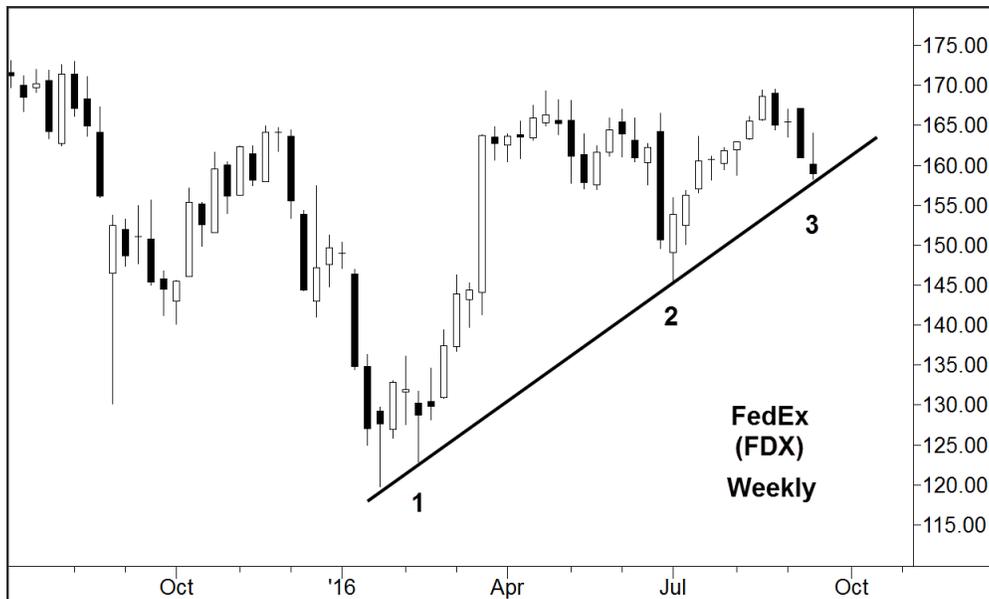


In this recent trade in Starbucks, aggressive buying in late August 2016 pushed the stock to **exactly** the third point in the trend line. When prices stop on a third point, it's definitely **not** coincidental. If traders that happen to own the stock make a decision to close their trades, slight downward pressure is placed on the price of the stock.

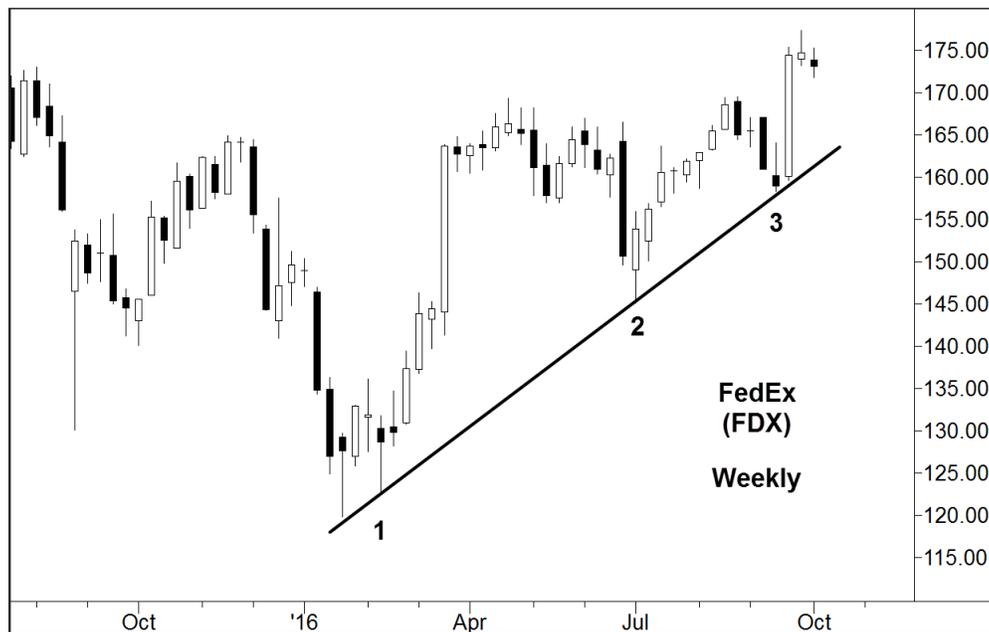


When that mild selling is combined with more aggressive selling by professional traders, prices will move much lower.

These three-point trend lines are visible as well on weekly charts. Here's a weekly chart of Fed-Ex.



The chart above ends on Friday Sept. 16<sup>th</sup>. Fed-Ex had a scheduled earnings announcement the following week on Sept. 20<sup>th</sup>. It's interesting that the week before the scheduled announcement, the stock is sitting conveniently exactly on the trend line.



As it turned out, Fed-Ex had a positive report resulting in a move in the stock of roughly 10%. Had the report been negative, there's a very good chance that the reaction would have been to the downside.

Occasionally, trend lines will serve as **'price target'** areas.



On August 25<sup>th</sup> 2016, Tiffany had a scheduled earnings announcement. The chart above ends the day before their announcement. At this point, if the report is disappointing, selling could take the stock down to the recent lows below 60.00. But if the report is positive, there's a very good chance that continued buying will move the stock up toward the down sloping trend line where professional traders could begin to take profits.

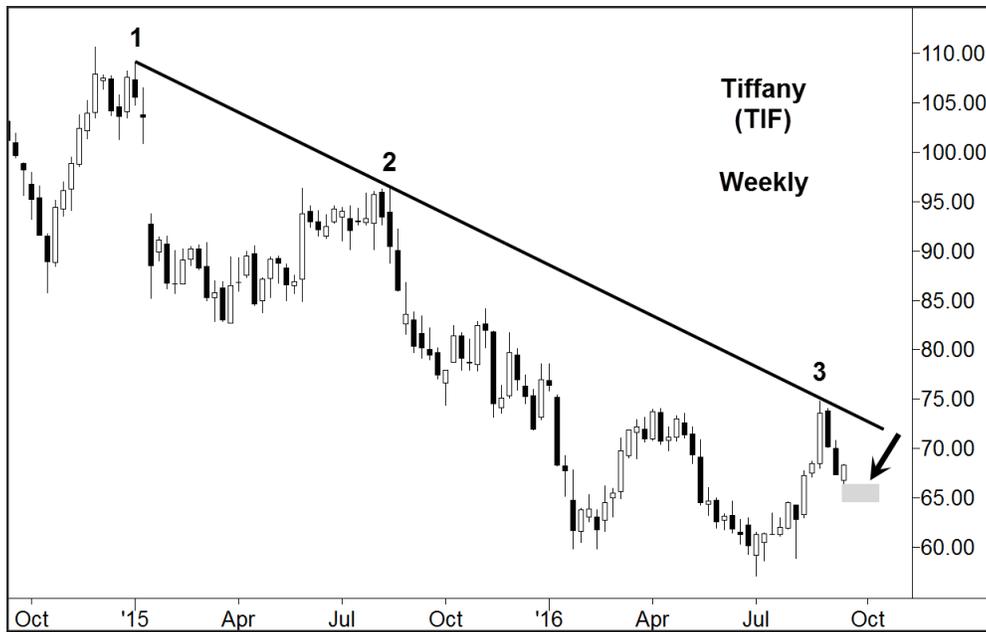
It was a positive report and the stock traded very quickly up to the trend line.



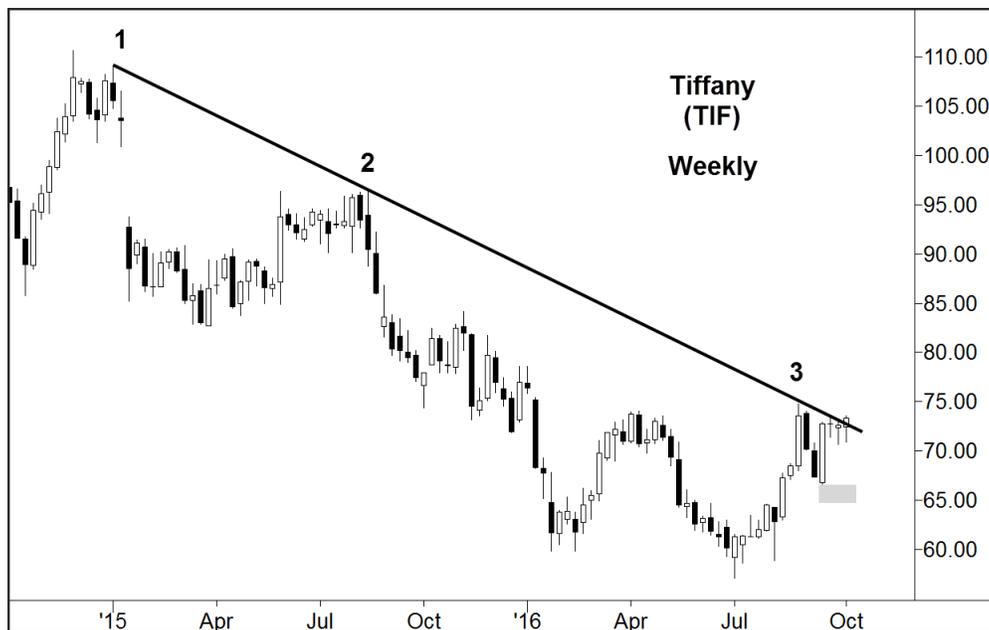
Had the stock been able to break this declining trend line, on a short-term basis continued buying would have taken the stock to at least the 85.00 area.

As mentioned earlier in the chart of VISA,

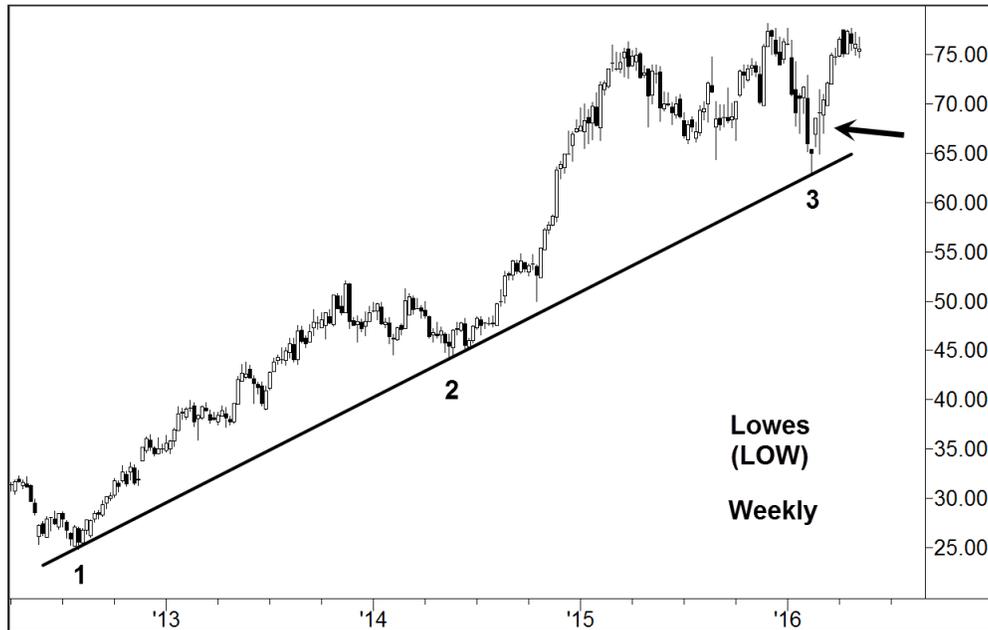
“the best way to know if anxious buyers are outnumbering the cautious sellers is to watch for a **mild** profit taking pull back. Pull backs of around 50% to 60% indicate a mild pull back and that the new trend is **very healthy**”.



After holding in the area of a **mild** profit taking pull back, the stock moved quickly back to the declining trend line.



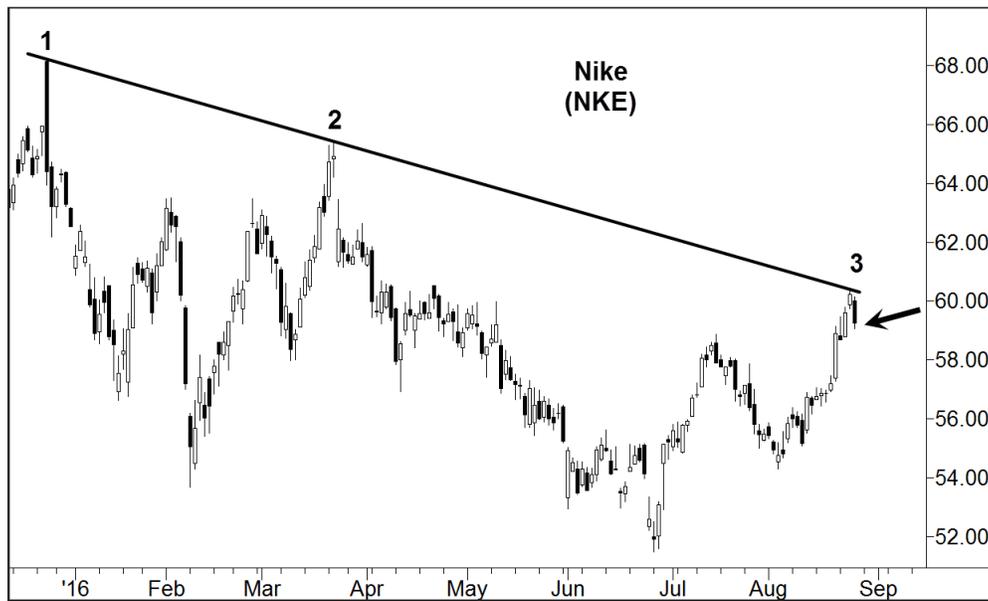
In January 2016, a 3-week selloff took most stocks lower. During this period, Lowes traded down exactly to a third point on the weekly trend line.



In July 2016, institutional fund managers and professionals reacted positively as the stock of Facebook traded exactly to a three-point trend line.



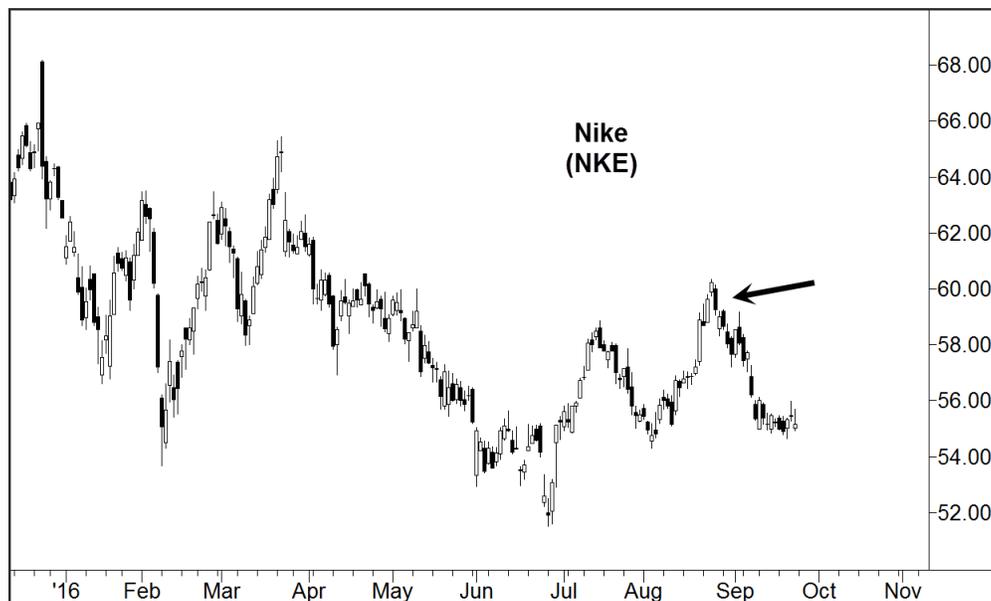
Occasionally, a stock will meet more than one condition for a trade.



On Aug. 24<sup>th</sup> 2016, Nike traded up and stopped on a declining trend line. Trading the following day confirmed that institutional and professional traders were closing out their positions (black arrow). In the chart below, we can see that Nike also completed a Last Wave pattern that same day.



Whenever possible, we like to try and do trades on the day of the confirmation. In order to avoid a last minute 'rush', we try to place our orders at least 30 minutes prior to the close of trading. On the day of this particular trade, the 60 strike Put options were trading fairly close to our maximum of 2.50. The next lower strike was the 57.50. We chose the Oct. 21<sup>st</sup> 57.50 Put at a price of 1.42.



The trade was closed on Sept. 21<sup>st</sup> at a gain of just over 100%.

## The Wedge Pattern

When scanning for potential trend line trades, it's not unusual for a stock to be on our **'sell list'** as well as our **'buy list'**.

Here's a recent trade in Akamai Technologies.

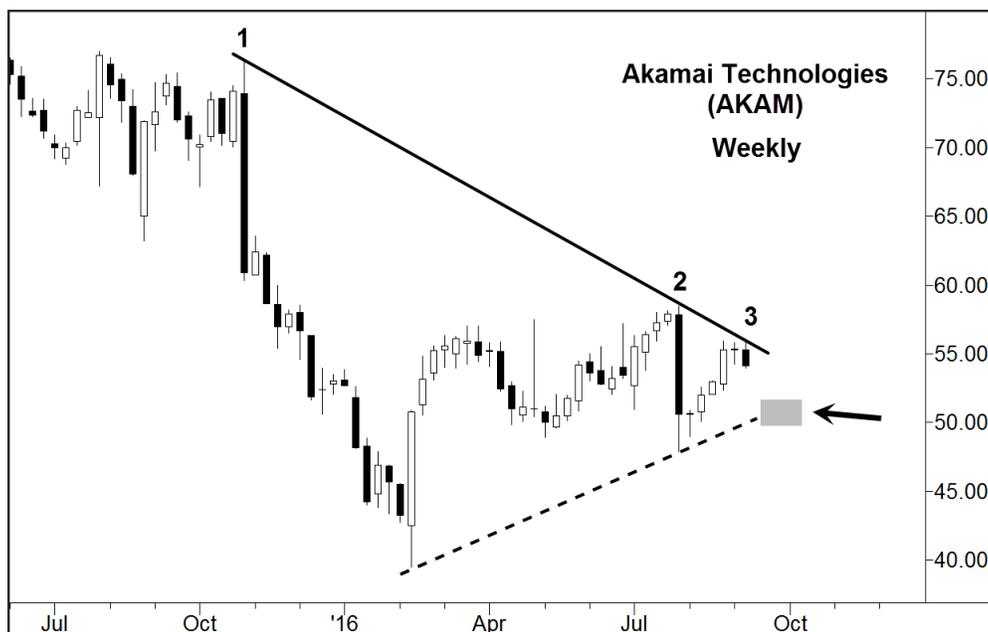


At this point, if AKAM continues to trade higher it'll eventually challenge the down sloping trend line. But if it trades lower, it could become the third point of the up sloping trend line.

Three weeks later, on Friday Sept. 9<sup>th</sup> 2016, our scan of weekly charts identified AKAM as having **completed** the third point on the down sloping trend line.



The potential for the trade was that the stock could move down to the up sloping trend line at a price of around 51.00.



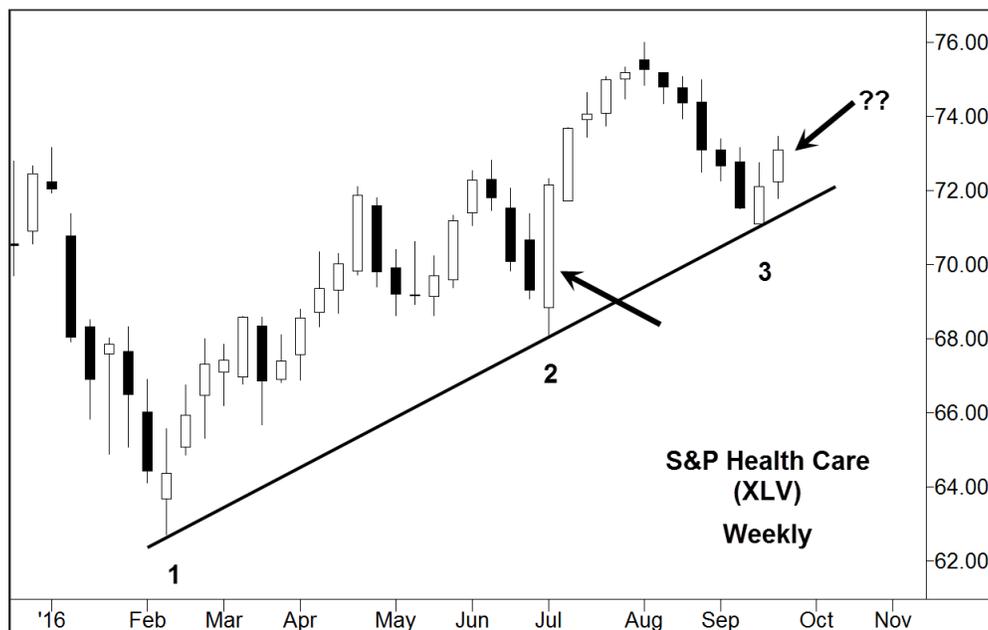
On Sept. 7<sup>th</sup> with the stock trading at 55.00, we bought the Sept. 30<sup>th</sup> 55 Put at a price of 1.26.



On Sept. 16<sup>th</sup>, the stock traded down to a low of 50.76 and our trade was closed out at 2.76 for a gain of 119%.

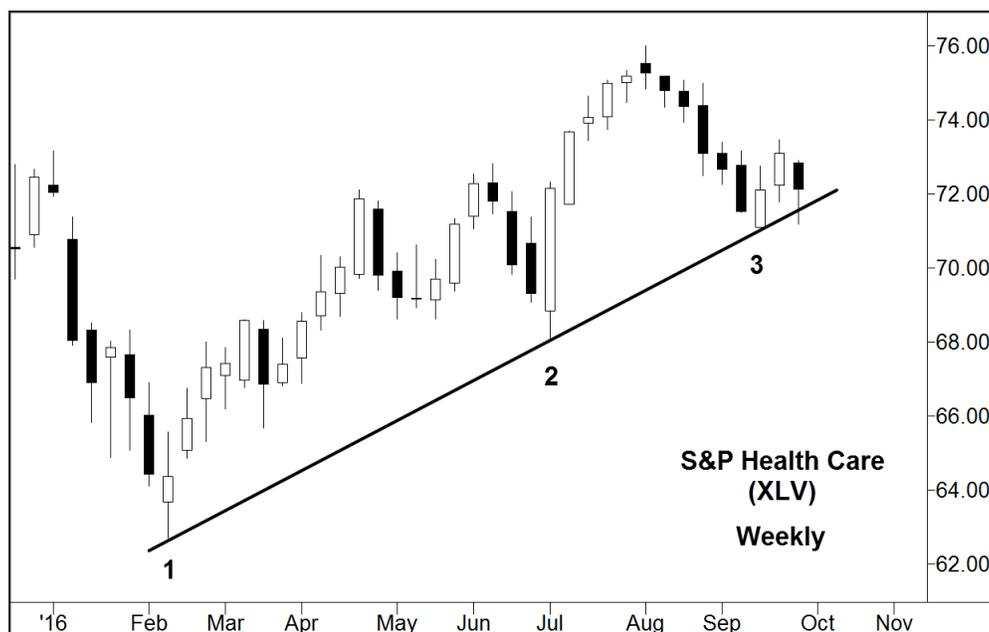
## Trend Lines on ETFs

When a stock reaches a third point on a trend line, a sign that professional traders are moving money into the stock is a positive bar with a wider trading range. In the chart below, the black arrow at point '2' is an example of a positive confirmation bar.



The trading range of the bar at point '2' is much wider than we need, but the important thing is that we see evidence of a positive bar. The two positive bars at point '3' are encouraging, but we prefer to see them to close near their highs.

A wider trading range on the confirmation bar with a close near the high is better evidence that the professionals are getting involved.



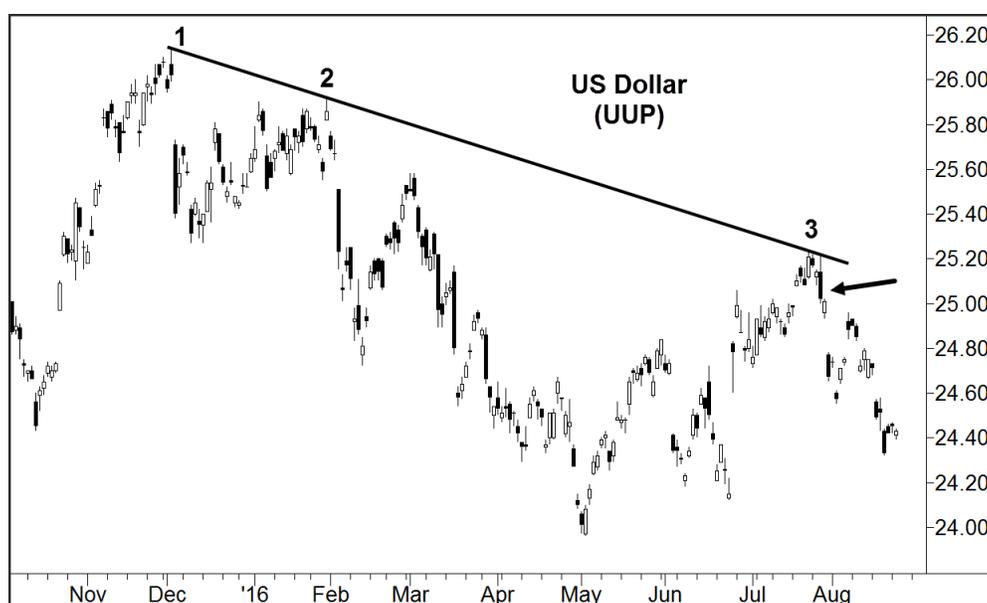
Had we done this particular trade, we'd have closed it rather quickly.

Most public utilities borrow a lot of money for improvements to their facilities and services.



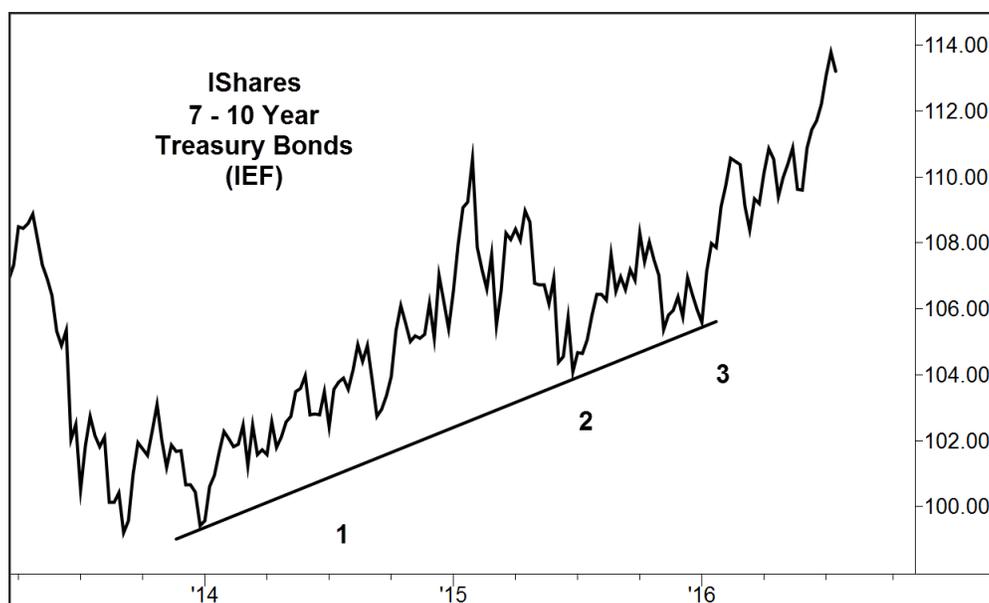
When interest rates go up, these stocks usually go down and when interest rates decline, public utilities will often move higher. In the chart above, during the early part of 2016, the anticipation of lower interest rates pushed these stocks higher.

Regardless of the market, when a third point on a trend line is reached, institutional fund managers and professionals are making important decisions.



These decisions are made individually by each professional team. It's important for you to remember that there's no conspiracy. Federal regulations prevent these companies from sharing their activities. If they decide to make an opinion public, the information is shared with all of us at the same time.

If they see an opportunity on behalf of their clients, they'll take action and if enough of these professionals do about the same thing at about the same time, prices are going to move.



We hope our discussion of how professional traders use these patterns as tools to help them trade successfully will allow you to look at your charts in a whole new way.

In summary, if you're a trader that prefers to trade intraday using 5 minute charts, you'll get an appreciation of how well these patterns work on the QQQ and the SPY.

If your trading style is a little bit longer-term and you prefer daily charts, you need to think of the confirmation bar as the '**money bar**'. When you learn to identify it properly, the money bar tells you if the institutions and professional traders are moving money into the stock or out of it. Be patient and learn to trade on the side of the professionals.

As you begin to use these patterns, remember that you won't win every trade. It's not unusual for these patterns to set up only to disappear because of news that affects the stock or news that affects the overall market. If you're trading from daily or weekly charts, keep one list of the stocks that are in the process of a Last Wave move from point 'C' to point 'D' and another list of stocks that are approaching the third point on a trend line. If you're a subscriber to our nightly email service, we'll do all of the work for you and you'll have these lists each morning.

Thanks and good luck ..... Rob