Options: How A Million Dollar Options Trader Sets His Stops: Underhanded Tips and Tricks

When a options trader understand that it is important to set stops on all their positions, they often don`t know where to set them. As a options trader, how close should a stop be to price of the position they are entering? Should they be tight, set quite close to the price, or a little looser? What about trailing stops? Here are some factors to consider that will help the options trader decide where to place your stops. Not every one of these applies to every trade, but the ones that do will give you some useful guidelines.

Perhaps the most important factor that affects stops is the question of how much you`re willing to lose on a single trade. My rule of thumb is that the options trader should never lose more than 2 percent of your trading capital on any one trade. Yet this can be tempered by other considerations, such as how much money you have in the position. If you have a large amount of money in a position, 2 percent may be much more than you`re willing to lose. If so, the options trader should set stops accordingly. However, if your account is small and you`re not well diversified, a 2 percent stop may be so tight that you stop out of the position almost immediately. If this is the case, the options trader should think seriously about whether you have enough money to trade.

Another matter to take into account is how risky you believe the trade to be. If you think the trade is a sure winner and market conditions are favourable, the options trader may give the position more room to move. But if you think it`s got only a fair chance of working out, or if the position has serious potential to drop, set a tight stop. Also consider how volatile the position is. If the position routinely moves up and down in a range of 15 percent or more over the course of the day, you can`t set tight stops. If you do, you`ll be taken out by the position`s normal volatility. If the position is choppy and too risky to trade without tight stops, maybe you`d better look for a better position to trade.

If you have reason to be confident that the position will move upward even if it swings around a bit first, it doesn`t make sense to set a tight stop because you`ll just stop out as it swings. However, if you think it might possibly move up but will definitely drop if it slips below a certain price, then tight stops are a must.

There are also a couple of basic questions to ask yourself about the position to help the options trader decide where to place the stops. First, is the position cheap? When a position is inexpensive, even the smallest decimal price movement will be fairly large in percentage terms. This means tight stops may be knocked out more easily. It also means that if your broker has a rule that the options trader can`t set a stop closer than .25 below the current bid, you may not be able to set a tight stop until the price moves up. And second, what is the time frame for the trade? On a quick day trade, tight stops are a good idea. On a position, you expect to hold for a week or two for a trend play, tight stops may or may not be a good idea depending on other factors that you`re aware of.

Market conditions should always be an important part of your decision. If the market is trending sharply upwards, tight stops may not be necessary. If you`re trying to go long in a bearish market, tight stops are absolutely necessary. If the market is choppy, if it has no clear direction or if it`s full of nervousness and fear, use tight stops, and ask yourself whether you should be trading at all that day.

Which of these considerations is the most important? Since no two trades are the same, different factors will dominate on different trades. Think about all of them on every trade. If you don`t, you`ll miss something important. Setting stops is an art. You`ll have to experiment a bit and learn what works for you. Occasionally the options trader may stop out of a trade too soon and feel frustrated, but remember this is just like paying for insurance. Sometimes you`ll be stopped out, but other times, you will save your capital.

Over time, you`ll get better at setting stops. Eventually, you will be able to have a sense of each trade, and set the stops that work best for you. Then you will be a nimble and successful options trader who can trade with any market.

About the Author

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