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28339 Beck Rd Unit F1

Wixom, MI 48393

www.profitsrun.com
Our objectives are to understand the management rules, the position sizing rules, the number of positions on a one time, and the dynamics of discipline and psychology. This module is perhaps the most important. If you don’t follow the risk management rules and the impact they have on position sizing, then you don’t have any business trading. That’s how important these are. They are not difficult, but they are extremely critical to your success. Any long time successful trader will tell you the same thing.

It’s all about managing risk first and foremost. Only then can you go after profits. With Options Income Engine, the odds of success are greatly in your favor. The percentage of winning trades should be in a neighborhood of 70% based on the last 20 years of test data. Because you have an objective set of rules supported by the trade alert software, it will be pretty difficult to make mistakes.

For Option Income Engine students, adhering to these to these risk management position size rules, and staying disciplined in the face of fear and greed should be far easier for you than for your average trader. With that, let’s get into it.
You must always apply strong risk management when trading. It is the most important success factor. Let me give you a simple example. A winning method wins, let’s say, 66% on average, but that method then has a probability of three successive losing trades at 4% of the time. It will happen. Not often, but it will happen.

If you risk 33% of your initial capital on each trade, you will eventually be wiped out. It is that simple.
Then what do you do? You risk no more than 1% to 2% of your trading account on each trade for larger accounts. Risk no more than 5% of your trading account on each trade for smaller accounts. I would say a smaller account would be less than $10,000.

Risk means the amount you are willing to lose or the amount you would lose if the trade was stopped out. With Options Income Engine, the maximum you could possibly lose is the debit that you pay for the option. To make this point further, for a $50,000 account you would risk no more than $500 to $1,000 per trade.

If on the next trade you bought four call options for $2.50, that would be $250 for each option times four, $1,000. If the options expired as being worthless, you would lose $1,000 and your account balance would be $49,000. That would limit your risk on the next trade to $980, 2% of $49,000. If you have a losing trade like that, your next trade will not be able to risk as much.

The converse is true as well. As your trades become profitable, you’ll be able to risk more absolute dollars. That will make your account grow even faster.
By limiting your risk to 2% on each trade, using the first example of losing three trades in a row, your account would only be down $2,940 to $47,060 versus being wiped out.

As your account grows, you can risk 1 to 2 percent of the growing account balance.

Do you see the difference? As your account grows, you could risk 1% to 2% of the growing account balance. It will allow you to put on larger and larger positions but only in a responsible, prudent manner.
With action and option trades you should assume that the debit paid for the option, which is your maximum, possible loss is your likely risk in the trade. While a losing trade will likely lose less than maximum, possible loss it’s best to take a conservative approach. With being able to achieve in the neighborhood of 70% winners, there’s no need to take unacceptable risk on any one trade. Your account will grow fast enough, and in a safe, secure manner. By buying options instead of the underlying security, you know your maximum risk right up front no matter what the market does.

This is a great advantage to trading stocks or ATFs directly because if the trade initially goes against you, you can stay with the trade a lot longer than you could if you owned the stock, giving you a lot more time to be right in the trade without incurring unnecessary risk. This is a big deal.
Position size. Example A: Large account. Let’s assume you have an account size of $50,000, and you’ve decided to risk no more than 2% on your next trade. If the option purchase price was $2, you would determine your maximum position size by dividing 2% of your account size by the debit you will pay for the option times one hundred, or in this example, $50,000 times 0.02 / $2 * 100 = 5 options.

In this example, 5 options is your maximum position size. Using this approach, you always know the maximum number of options to put on any one trade.

That allows you to trade five options. Now why is that? Just think about the arithmetic. Two percent of fifty thousand is one thousand dollars. Each option in this example would cost you two hundred dollars. So, dividing two hundred into a thousand would allow to trade five options responsibly. In this example, five options is your maximum position size. Using this approach, you always know the maximum number of options to put on any one trade.

Could you buy twenty options with a fifty thousand dollar account? Let’s see. Twenty times two hundred dollars per option would be four thousand dollars. Sure you could. Would that be a responsible thing to do? No. Why? Because now you would be risking eight percent, four thousand divided by fifty, of your account size. Could you by two hundred and fifty options in this example? Well, let’s see.
Two hundred and fifty times two hundred dollars and option is fifty thousand dollars. Yes you could. Would that be responsible thing to do? In spite of the huge, huge profit potential? No. Because if it’s a losing trade you wipe out your entire account. That’s just plain dumb. You may think that I’m over doing it on this point, but this is precisely where options traders go awry. Don’t do that.

Example B – Small Account
- Let’s assume you have an account size of $10,000 and you have decided to risk no more than 5% on your next trade
  - If the option purchase price was $2 you would determine your maximum position size by dividing 5% of your account size by the debit you will pay for the option x 100, or $10,000*0.05 / $2*100 = 2.5 options.
- In this example, 2 options is your maximum position size. Using this approach, you always know the maximum number of options to put on any one trade.

Example B: Small account. Let’s assume you have an account size of ten thousand dollars, and you decided to risk no more than five percent on your next trade. If the option purchase price was two dollars, you would determine your maximum position size by dividing five percent of your account size by the debit you will pay for the option times one hundred, or ten thousand dollars times .05 divided by two times a hundred, equals two and a half options.

In this example, two options is your maximum position size. You want to round down, not up because if you round up to three options, now you’re risking more than five percent. Don’t do that. Using this approach, again you will always know the maximum number of options to put on any one trade.
So, you know my main point is here. Proper position size is the key difference between success and failure trading options with a good method. It’s also the difference between success and failure trading a great method, like options/ income engine. In summary, the reason options are viewed as risky is that trader consistently do at least two things wrong. They trade the wrong options, and they over trade, or put large position sizes on that violate our options income engine position size rules.
I’m going to beat this up one more time because I don’t want anybody coming back at me telling me they did not understand this concept. Let’s just do one more go at this.

Example C: Small account. Let’s assume you have an account size of ten thousand dollars. You do not understand how to set the proper position size and furthermore you are enamored by the tremendous leverage with options.

- If the option purchase price was $2 you could actually buy 50 options ($10,000/$2*100)
- However, your maximum risk for that trade would be $10,000

You are going to get rich in a matter of a few weeks. If the option purchase price was two dollars, you could actually buy fifty options. Ten thousand dollars divided by two times one hundred. However, your maximum risk for that trade would be ten thousand dollars. Doesn’t make any sense.
If you sold the option at a profit for say $5, you would make $3 \times 100 \times 50$ or $15,000$, more than doubling your account size on one trade.

However, if the trade suffered the maximum loss of $2 \times 100 \times 50 = 10,000$ your account would be wiped out.

This go for broke approach to trading is not trading, it is gambling and you never want to fall victim to this.

There is plenty of money to be made by following the Options Income Engine risk management rules, no need to gamble.

If you sold the option at a profit for say, five dollars, you would make three dollars, five minus two, times one hundred, times fifty, or fifteen thousand dollars, more than doubling your account size on one trade. This is why I am hammering on this so much. Doesn’t that sound exciting? Of course it does. Is it the prudent thing to do? Absolutely not. If the trade suffered the maximum loss, your account would be wiped out. This go for broke approach of trading is not trading, as I’ve said repeatedly now, it is gambling. You never want to fall victim to this. There is plenty of money to be made following the options/income engine, risk management rules.

There’s no need to gamble. Okay, I’ve done my job. You now are among those traders that understand trading options is less risky than trading the underlying stocks in ETFs provided you follow these risk management and position size rules.
Okay, well what about the number positions on at one time in your account or portfolio? I say that you ought to have a maximum of ten percent risk among all your trades when all totaled up at any one time. For example for a fifty thousand dollar account, the maximum risk to that account for all open trades would be five thousand dollars. If there were ten open trades, that means that the average risk per trade could not exceed 1.0% (10%/10)

That would expose to twenty percent risk at one time of your account size. That’s why I say you can risk up to two percent. It doesn’t mean you have to risk two percent. If your plan is to put on up to ten positions know that ahead of time. Only risk one percent per trade. You must be sure to diversify your trade among different sectors and industries. Do not put multiple trades on at the same time, in the same sector.
Okay with that background let’s talk a little bit now about fear and greed. In the emotions that drive traders to make dumb decisions. As a trader you really want to be like the casino. What does the casino have that you don’t have when you walk into a casino? It has an edge. It has the advantage. The more you gamble at the casino, while you may win a few pots here and there, if you keep playing you’re going to lose it all back because the casino has the edge.

Because they do, they’re not concerned about the outcome any one bet. In fact, they’re happy to pay a jackpot because they know you’ll keep coming back for more. In the end, you will gamble away that jackpot, and they’ll still be ahead. Like the casino, as a trader you need to stay in the game, and realize that individual trade outcomes are not important as long as you have a good or great trading method that gives you an edge where you put responsible position sizes on.

That’s what the casino does, and they just keep raking it in.
What about discipline and psychology? You might consider this the soft side of trading, but believe me it’s very important because your mind will play tricks with you especially if you have three losing trades in a row. With a lack of discipline, you will probably start thinking, “Gee, this doesn’t work, and you may give up, not realizing when any good method has three losing trades in a row, it’s probably going to have several winning trades in a row thereafter. So you throw in the towel at exactly the wrong time.

Without discipline you will lose. There’s no doubt about it. Fear and greed will take over, and cause you to make the wrong decision at the wrong time. You just have to understand there will be losing trades, and that’s okay.
Here are some eventual experiences that traders have. I want to you understand these ahead of time so that when it happens, you won’t fall victim to fear and greed, and you’ll maintain your discipline. First, you will win several trades in a row and start to feel good about your ability. You will feel like King Kong. You may become reckless in your trading, increasing the amount of risk per trade, ignoring stop loss points, etc.
Or, on the flip side, you will have several losses in a row and feel depressed, thinking your method no longer works. Caution, you may become reckless in your trading and increase the amount of risk per trade attempting to win back your recent losses all at once. This is a common behavior that just simply does not work. Don’t fall for this.
Or you will make several trades and experience a number of winners and losers that keep you at breakeven. This makes you bored and complacent. Again, you don’t realize that when that happens there’s probably a big string of winners right around the corner. Caution, you may become reckless by trying to make something happen. This is called “forcing the market.” Don’t do that.
Okay, these are all emotional reactions that you have to guard against so don’t fall victim to these reactions. Winning traders have learned these experiences will occur, but they recognize them for what they are and they stay disciplined. This is a primary reason that winners are winners.
I like T. Harv Ecker’s concept of your body’s thermostat. He calls it your emotional thermostat. If it’s set on, “I have to win every trade, or I’m a failure”; you are going to be a failure. If it’s set on, “I have to get rich quick. I can’t wait around”; you’re going to take undue risk and fail. That’s what you’re used to. You have to recognize that ahead of time. Reset your thermostat to, “I understand I have a great trading method. I have an edge. I’m going to win most of the time, but not all of the time. I am going to use sound risk management principals and position sizing rules. I’m going to trade with absolutely no stress as a result.” That’s where you want your emotional thermostat set.

That way you have confidence in your trading method and risk management rules, and that way you’ll always know what to do.
Okay, action steps. Review this material, and email us with any questions please. Promise yourself that you will never violate these risk management, position size, and number of positions rules.
Well, hearty congratulations. This concludes the options/income engines course. You now own this trading knowledge for life. Go through all the material whenever necessary to make sure you understand it. Paper trade and practice if you’re new to options trading, and good luck and good trading.