Combat Trade Planning

The most important trading floor for any trader, individual or professional, is the five-inch trading floor between his or her ears. Having the proper mind-frame and controlling emotions is critical to making good decisions under the pressure of the markets and, ultimately, to trading success. It all comes down to Discipline. We need to know why we are getting in, when to stay in and when to get out of a trade. At Top Gun Options a quality trade plan is the foundation for our disciplined execution in every trade. Go to www.topgunoptions.com to enroll in our live trading programs and to see this trade plan being used by our professional traders.

Flying fighters in the US Navy we planned everything, from a simple 30 minute maintenance flight to a 7 hour combat mission. Every mission had an objective and we always had a plan to achieve our objectives. These plans spelled out exactly how we intended to achieve each objective. The team at Top Gun Options learned how to plan and plan well.

At Top Gun Options Options we were trading before we joined the Navy to fly fighters, so we had built up some habits about how we went about our business of trading. Some were good some were bad, but these habits lacked Discipline and continuity. Then one day, shooting the breeze at the Officer’s Club (which is where we solve all the world problems over a cocktail) it just kind hit us; Why don’t we apply the same planning and execution disciplines that we use flying fighters in combat to our trading?

After all, our combat plans defined many things, to include: our objective, tactical mindset, targets, Commit Criteria (our go-no-go decision), the Tactic we intend to use to achieve our objective, employment method to achieve the Tactic, our course of action (steps we are going to follow executing the plan), contingency plans in case things don’t go exactly as planned and we must also have a clear Exit Plan. So this tactical planning we used every day out on the aircraft carrier, seemed a perfect fit for the options trading world as well!

You have to plan for combat in this manner, because combat is dynamic, it’s dangerous, the battlefield is in constant change and you don’t know where your enemy will strike from next. Sound familiar? Where did this Greek debt crisis come from, how about Enron or WorldCom? Which bubble is going to burst next? Who’s cooking the books at our favorite company? Well it seems to us, this definition of combat applies directly to the financial markets.

Which is why at Top Gun Options, “Trading is Combat”, because it is!

In this lesson we are going to share with you our planning process. Is it perfect and suited for everyone? We certainly like it and we believe that you will benefit by applying the same Discipline to your trading.
Defining A Plan

So just what is a plan? You don’t have to be a Rocket Surgeon to understand this one!

A plan is a series of steps to achieve an objective.

This makes sense if you’re going to hang some shelves in the garage or cook a pot roast. A plan is just a recipe and when it’s complete you have some more shelves in the garage or a pot roast for dinner.

But, how does this the definition work when you are playing in one of the most dynamic arenas in the world, where things are constantly changing and often appear to be directly against us? It still works, but the plan has to suit the environment where it is going to be executed and we are executing plans in one of the most complex environments in the world, the financial markets. So, we need to account for a few more things than cooking a pot roast.

When I am giving a presentation on planning, I always ask the crowd to write down the components of a plan. Invariably they are always slightly different and in many cases folks can’t break a plan down into its important components. This lesson will solve this issue.

Why Plan?

Discipline

A trade plan is the foundation for disciplined execution. It allows us to keep our head on straight when all the talking heads are telling us the world is falling apart. It memorializes our reason for being in the trade and helps us make good disciplined business decisions under the pressure of the markets. It is because we built a plan, before the heat was on, that allows us to remove as much emotion as possible from our trading. In short, a trade plan is our tool to keep us disciplined in a trade.

Risk Management

Risk management is built into the plan. We know exactly when to get out, what our maximum acceptable loss is for the trade and how we are going to get out or adjust the position to save profits or limit losses. We define all of this before we get into a tight spot where emotions can take over and lead us to bad decision making. Emotions: greed, fear, attachment to a trade, whatever the issue, will influence your decision making. If you think it doesn’t, you are going to spend a lot of money realizing that you’re wrong. Laying out your risk parameters before being under the gun, will greatly assist you in suppressing your emotions and help you make good decisions.
In the Top Gun Options Pocket Checklist (OPCL), we layout planning guidelines for several different option tactics. In each, we identify our profit targets and maximum risk parameters for each trade to assist you in building your plan.
Superior Execution

When we get down to the brass tacks of trading, it's all about execution. Being disciplined and mapping out our risk parameters before we are deep in trades, leads to Superior Execution. The decisions we make in the heat of battle are key to our success in trading. We have a saying flying fighters, “A bad plan executed well is better than a good plan executed poorly, but a good plan with good execution Discipline is unbeatable!” When you go through our Top Gun Options program, we will go over several options tactics and discuss optimum execution whether the market is trending favorable or unfavorable.

Ultimately Discipline, Risk Management and Superior Execution come down to the individual trader. As traders, we have to commit to being disciplined. We have to commit to sound Risk Management. We have to commit to achieving Superior Execution with our trading. It takes practice and courage to execute your plan, but the end result is consistent Superior Execution and more profits.

Components of a Plan

A plan has to be tailored to the environment we intend to execute. The planning process needs to flow sensibly, be easily understood and address as many potential scenarios as possible that can threaten the achievement of our objective.

The very first component in any plan is “The Objective”. As traders and investors it does not matter if you are trading options, stocks, commodities, bonds, currencies or anything for that matter. Our objective as traders and investors is universal: Make Money, Don’t Lose It!

This is why we play in this financial arena; there is no other reason. We want to make money, not lose it! Every trade plan we create supports this objective…we want to make money, not lose it! If we are wrong in our trade, because we are not going to get them all right, we want to get out with minimal damage and keep our money to play another day.

Since this is our universal objective, we don’t need to write it down every time. It is our guiding precept for trading.

After the objective, a Top Gun Options trade plan has seven components, designed specifically for trading options. A Top Gun Options trade plan...

...Defines our Strategic Mindset
...Identifies our Target...which is the underlying we want to engage.
...Outlines our Commit Criteria...Our justification for the trade.
...Identifies the Tactic we will use.
Once the planning process is understood, a trader can complete the plan in as little as 5-10 minutes. We will go through each one of these components in this lesson.

Some of these terms may be new to you and that's because they have their roots in air combat, but they dovetail very nicely into our planning and, in our view, tighten our focus up another notch. We will explain each as we come across them, if not; there is a Top Gun Options Terms glossary in the back of the book for reference.

**Strategic Mindset**

Our Strategic Mindset is the stance we take regarding how we think our underlying asset (our target) or the market will perform given current financial climate. Strategic Mindset falls into one of four categories:

1. **Bullish**
2. **Bearish**
3. **Neutral**
4. **Volatile**

We can qualify our mindset if needed; we can be short-term bearish if we think something is overbought and might correct. Or we can be neutral to bearish or neutral to bullish. It just depends on our analysis of the current situation and guides our Tactic selection to fit our Strategic Mindset.

When developing our Strategic Mindset we take a big to small approach. We start with the global financial situation and drill down to specific sectors, then to the stocks within a sector using both fundamental and technical analysis. As options traders we always take a look at our main barometer, the VIX, to tell us what the market is thinking and how the current market is priced.

Our Strategic Mindset drives many of our trading decisions. It helps us to analyze potential positions with an appropriate bias for the current market. It also gives us a baseline to challenge our own market assertions and those assertions of all the information we absorb. We don’t want to be mindless sheep following the talking heads on CNBC or a tip we hear at work. We want to be proactive in the development of our Strategic Mindset and verify or disqualify the information we hear around us.

**Target**

Our target is simply the underlying asset with which we are looking to open a position. We will focus on an asset because we have clearly defined our Strategic Mindset on this target and we think we can profit from an options position supporting this mindset.
There are literally thousands of optionable targets: Stocks, ETF’s, futures commodities. We will focus on stocks while going through Top Gun Options.

**Commit Criteria**

Commit criteria is our justification for entering in a trade. Commit criteria should be easily understood and explained in 1 – 3 sentences. Commit criteria is supported by our Strategic Mindset, our fundamental and technical analysis, and the volatility of the target.

Here is an example of what Commit Criteria might sound like if we had a bullish mindset on Freeport McMoRan (FCX).

“The recent pullback in FCX is exaggerated. The stock has come off its recent lows with heavy volume and appears to be at the beginning of bullish trend with a short-term technical price target of 70. Fundamentals remain strong and copper prices are rebounding.”

This is a valid Commit Criteria for entering a entering a trade. Commit criteria memorializes why we are in the trade. During the course of a trade, if we can no longer justify our Commit Criteria then we get out, immediately.
Tactic

At Top Gun Options, a “Tactic” is the option position we are opening, and there are many different positions we can open using options: calls, puts, condors, butterflies, credit spreads, etc. In the Top Gun Options Pocket Checklist (OPCL) you will find 32 different option tactics.

In current options lingo this is referred to as a strategy, but to call this a strategy is not true to the words meaning. A strategy is a bigger vision that supports our “objective” and refers to a plan of “actions” to achieve our objective, in this case, our investment objective. The “actions” taken to achieve these goals are referred to as “tactics”. Example:

Objective: Make Money, Don’t Lose It!
Strategy: Use options to achieve our objective.
Tactics: An option position to support our strategy.

For instance: If a trader wants to earn income from stocks in their portfolio by selling covered calls. This supports our objective and the strategy is to earn extra income with options. The Tactic to achieve this extra income is to sell covered calls on stocks in their portfolio.

To us at Top Gun Options, this is a more correct way to add detail to our intentions. In short, a strategy tells us what we want and a Tactic is how we get what we want.

Tactical Employment

Tactical Employment is the set up for our option position. It includes:

- Leg Set Up
- Net Debit or Credit
- Max Profit potential
- Maximum Risk of the trade
- Break Evens
- Probabilities of success
- Greek Effects

Outlining Tactical Employment lets us know what we are getting into when we enter a trade. Think of Tactical Employment as defining the performance envelope for our trade. It defines the parameters, both good and bad, where the trade can perform.

Mid-Course Guidance

Mid-Course Guidance encompasses our trade management plan. The term comes from an air-to-air missile and refers to the control of the missile until just before it reaches its target. At Top Gun Options, Mid-Course Guidance encompasses our Risk Management parameters in terms of profit goal and max allowable loss, threats to success, contingency plans and Eject Criteria.
Max profit goals and max allowable loss are independent trader decisions based on individual investment goals and risk tolerance. At Top Gun Options we are not trying to hit the ball out of the park on every trade, base hits can add up fast. When setting our max allowable loss, we determine the maximum we are willing to lose to see if this trade will work. This does not mean we have to wait to reach this point to get out, it is simply defining the most we are willing to let this trade work against us. This keeps us from saying to ourselves, “I just need a few more days for this to work!” or “I love this trade, it will come around”, and staying in a losing trade. If we hit our max allowable loss, we get out; lick our wounds and move on to the next trade.

Threats to success are occurrences that can negatively affect our position during the life of the trade. An example of a threat to our success: We were bullish and then implied volatility increased unexpectedly due to a negative economic report.

Contingency planning is simply having a basic game plan if our trade is not going per design: do we roll up, roll down or get out?

Our Eject criteria are our “no questions asked”, just get out of this trade, examples include: our max allowable loss limit is reached or our Commit Criteria is no longer valid.

Embedded in your options PCL tactics section is guidance for setting many of these parameters and can serve as great starting point for determining your own risk parameters.

**Exit Plan**

The Exit Plan is how we are going to get out of a trade. We never get into a fight unless we know exactly how we intend to exit. Factors for planning an exit include: a sound reason for exit, layout our closing trade set up, whether we are exiting prior to expiration or taking it all the way to expiration.

It is important to know exactly how you are going to exit a trade before the volatility of the markets gets the better of you.

**Planning Complete**

That’s the plan! It’s just a logical sequence of steps that encapsulates and memorializes our research, lays out the playing field for the trade, sets risk tolerance tripwires for action while in the trade and lines out how we will exit. Don’t trade without one!

Once you have the system down it will take 5 -10 Minutes max to complete and will keep you aligned very closely with our universal objective.
Make Money, Don’t Lose It!
Example Trade Plan

Back in January 2010 we were beginning to think that Google (GOOG) was getting a little lofty in price. Even though the talking heads could not stop talking about how great GOOG was and it was going to the moon non-stop. At this point we took a short-term contrarian’s view. So we took a short term bearish Strategic Mindset on GOOG, 7 days, and decided to target GOOG with a bearish trade.

GOOG Trade Plan
January 7, 2010

**Strategic Mindset:** BEARISH, Short term
(7 days) on GOOG

**Target:** GOOG currently trading at 593.52

Our commit criterion was simple:

**Commit Criteria:**

*Thinking GOOG is going to give some back in the short term with some of the uncertainty surrounding the release of various mobile devices and some profit taking. On the technical side, the 20 day MACD is diverging to the down side and RSI is indicating an overbought condition.*

We had some technical indicators and some fundamental uncertainty we thought would lead skittish traders to take some profits off the table. The Commit Criteria is short, sweet and it made sense. Little did we know at the time but this was a turning point for GOOG and it is off about 20% since this call.
Our Tactic was a Bear Call spread two strikes above where GOOG was trading. One of our intermediate tactics and in this instance it had a high probability of success.

**Tactic:** Bear Call Spread on GOOG, 610/620

![Bear Call Spread Graph](image)

Tactical Employment is petty straight forward and requires just a little math:

**Tactical Employment:**
- **Leg Set up:**
  - Sell JAN 610 Call at 3.90
  - Buy JAN 620 Call at 2.10
  - Net Credit: 1.80

- **Max Profit:** 1.80, 22% return on risk.
- **Max Risk:** 8.20
- **Breakeven:** 611.80
- **Probabilities:** 72% probability of max profit.

**The Greeks:**

**Theta (Time Value):** Time is our Friend, the longer that GOOG stays below our breakeven of 611.80 the stronger our chance of a profit.

**Vega (Volatility):** For this trade we want volatility to decrease for the duration of the position. An increase in volatility with GOOG can easily threaten our Breakeven (B/E) on the down side.

The last part of our Tactical Employment is an understanding of the Greek effects. In this case Vega and Theta is what we were concerned with and in a bear call spread. Theta is our friend because the longer that we stayed below our breakeven, the better our chance of profit. We also wanted to keep volatility in our scan because an increase in volatility could decrease our chances of success.
Midcourse guidance, which is our trade management plan, is relatively simple:

**Mid-Course Guidance:**

**Profit Target:** Profit Target is 1.80, 22% return on risk. 100% return on premium.

**Threats to Success:**
- Jobs Data is being reported Friday, a positive report could cause a move to the upside.
- We are going against the longer-term trend of GOOG and buyers could step in if they don’t see any more down side.

**Eject Criteria/Contingency Plan:**
- Commit Criteria becomes invalid
- We will set our stop loss 25%...Eject if the premium gets to 2.25

Our threats to success over the trade are researched and listed so we don’t drop them out of our scan.

Our Eject Criteria is set in this case we had a tight stop for two reasons. First, the short term on the trade did not give us too much time for it to reverse if it went strongly against us. Secondly, we were going against the long term trend and did not want to get caught in a minor downdraft. Our only contingency plan was to get out if the trade went against us, we did not want to roll this trade.

Finally, our Exit Plan was simple:

**Exit Plan**
- Profit Target or Eject Criteria Reached.
- To close position, simultaneously,
  - Buy JAN10 610 Call
  - Sell JAN10 620 Call

This is all there is to putting a plan together. Once complete it should fit nicely onto one or two pages. The actual trade plan is depicted below:
Trade Plan
January 7, 2010

**Strategic Mindset:**  
**BEARISH, Short term (7 days) on GOOG**

**Target:**  
**GOOG currently trading at 593.52**

**Commit Criteria:**

Thinking GOOG is going to give some back in the short term with some of the uncertainty surrounding the release of various mobile devices and some profit taking. On the technical side, the 20 day MACD is diverging to the down side and RSI is indicating an overbought condition.

**Tactic:** Bear Call Spread on GOOG, 610/620

**Tactical Employment:**

- **Leg Set up:**
  - Sell JAN 610 Call at 3.90
  - Buy JAN 620 Call at 2.10
  - **Net Credit:** 1.80

- **Max Profit:** 1.80, **22% return on risk.**
- **Max Risk:** 8.20
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**The Greeks:**

- **Theta (Time Value):** Time is our Friend, the longer that GOOG stays below our breakeven of 611.80 the stronger our chance of a profit.

- **Vega (Volatility):** For this trade we want volatility to decrease for the duration of the position. An increase in volatility with GOOG can easily threaten our B/E on the down side.
Mid-Course Guidance:

Profit Target: Profit Target is 1.80, 22% return on risk. 100% return on premium.

Threats to Success:

– Jobs Data is being reported Friday, a positive report could cause a move to the upside.
– We are going against the longer-term trend of GOOG and buyers could step in if they don’t see any more down side.

Eject Criteria/Contingency Plan:

– Commit Criteria becomes invalid
– We will set our stop loss 25%...Eject if the premium gets to 2.25

Exit Plan

1. Profit Target or Eject Criteria Reached.
2. To close position, simultaneously,
   • Buy JAN10 610 Call
   • Sell JAN10 620 Call

The time invested in putting a plan together is well worth the effort.

This trade ended up working out for us and we bought it back for 10 cents and made a 1.70 on the trade. We got out prior to reaching our profit target because we had made a nice profit in the short time the trade was open and market volatility, the VIX, was starting to show signs of life heading into earnings season back in January.

Wrap Up

Having a plan will substantially increase your trading Discipline; it lays out your Risk Management plan and will lead to consistent Superior Execution. You can complete your plan before or after pulling the trigger. If we complete the plan after executing the trade, it is because we are familiar with the target and are comfortable trading it. After we pull the trigger though, we sit back and fill out the plan immediately.

Our planning process represents the minimum knowledge we want to have before we open a trade and it is the tool that gives us the confidence we need to execute our trades with Discipline, manage our risk based on our comfort with the current market climate and consistently manage our trades with Superior Execution. You may want a bit more or a bit less in your plan, but our system provides a solid foundation for customizing your own trade plans to suit your trading needs.

Your Options Pocket Checklist (OPCL) contains a planning guide that will help you build solid plans every time. Plus, we will walk you through many trade plans as we go through Top Gun Options.

Visit www.topgunoptions.com to learn more information.