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High Probability Trading

It is common to see web site banners or other advertisements touting the benefits of high probability options trading with probabilities of success of 90% or better. Technically, these trades indeed have a high probability of success, i.e., if you placed a trade with the same parameters every month of the year, you should see about 10 or 11 trades per year result in gains and one or two result in losses. And the longer you traded in this way, the more likely your results would conform to these averages.

The underlying probability calculation assumes that the stock price movements are random events, like throwing dice. Of course, stock price movements are not purely random, but are affected by news, rumors, crowd psychology and many more factors. But it isn't a bad approximation for the reality, especially when averaged over many stocks and over long periods of time. You may test this yourself. Plot one year of your favorite stock or index with Bollinger bands positioned at plus and minus two standard deviations from the 20-day moving average. The two standard deviation spread should encompass about 95% of the prices. Count the market closes inside the bands. You will be surprised at how close the Bollinger bands will come to containing 95% of the data.

The essence of the problem of high probability trading derives from the old financial adage, *there's no free lunch*. If you were to establish trades with high probabilities, the returns will be rather small, of the order of 7% to 10%. But the losses would be huge, of the order of 90% to 100%. The bottom line is that the one or two losses each year would be large enough to wipe out all of the gains for the year. Thus, there is only a small probability of a losing trade, but when it happens, it will be a devastating loss.

Some traders readily acknowledge the downside of these high probability trades and will sell the idea of so called "low risk" trades, where the potential loss is small, hence the label of low risk. These trades are simply the mirror image of the high probability trade; they are low probability trades. Marketing a low probability trade doesn't sell as well as the low-risk trade. The low probability trade is characterized by a very large potential gain, perhaps several hundred percent, but there is a very small probability of that successful outcome. In this style of trading, one would lose a small amount on the trade 10 or 11 months out of the year and then have 1 or 2 large gains. However, those one or two large gains would not compensate for the large number of small losses. Does that sound familiar? It is the mirror image of the high probability trade.

In either case, the long-term outcome is the same, a small net loss, especially after commissions and other costs of trading.

Is options trading inherently a losing game? No, not necessarily. There are many examples of successful, long term options traders. The secret of their success may be summed up in two words: Risk Management.

Option prices are fundamentally derived from the probabilities of the options expiring with value. If the trader enters trades with a consistent level of probability, high or low, the end results will be near zero, or slightly negative after trading commissions and other costs. Risk management ensures that the maximum loss of any trade is rarely, if ever, incurred. The simplest risk management tool is a stop loss price set upon entry of the trade. Other more sophisticated hedging techniques are also employed by successful traders. Risk management serves to give the trader an edge in the probabilities underlying the typical stock or options trade. The success of the gaming tables in Las Vegas demonstrates the power of the underlying probabilities of those games. The casino games always hold a small percentage edge for the house. Over many plays or spins of the wheel, the house will come out a winner.

Risk management techniques make a similar adjustment to the trader's probabilities and give the trader an edge. One's choice of either the high probability trade or the low probability trade is not a financial issue – neither is inherently superior. Neither style of trading will be successful over the long term without risk management. One's choice of the high probability or the low probability trade is primarily a matter of matching one's trading style and risk tolerance with the right trade. Disciplined risk management is the secret to the trader's success. Risk management gives the trader the edge in the probabilities. Trade with the probabilities in your favor. Be the casino rather than the player at the tables.

If you want to learn more about real world trading absent the marketing hype, check out the private coaching, group classes, and trading services offered by Parkwood Capital.

You have entered The No Hype Zone!

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