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Best volatile stocks for option trading

Sometimes what seems like the obvious to seasoned investors is not so clear to someone just entering the world of investing. In this article we'll take a look at how to simply buy and sell stocks, where to trade, and the types of trade orders that you can place. Where Can I Buy and Sell Stocks? Primarily, you have two options as far as where you can buy and sell stocks: Discount Broker – discount brokers originated during the internet growth stage. Essentially, you are able to buy and sell stocks at a low commission and do not receive investment advice on these transactions. Full Service Broker – stock trading originated with this model of service. With a full service broker you get advice on what investments to make in addition to other direction which may include tax advice, in depth research, and more. For the additional services and advice you end up paying a higher commission on your trades or a percentage of your total assets. If you are looking to make a simple trade and know how to do so or have a limited amount of money to manage, you are probably better off going with a discount brokerage so that the higher commissions of a full service broker do not cut into your returns. The more homework you do on your own, the better off you will be in going with a discount broker. If you have absolutely no knowledge of investing (we're talking zero, here, as index and mutual funds are really a no brainer with minimal required research) or have a very large amount of money to manage that will require effective tax strategies, then you may want to make the move to a full service broker. If you have read this far, you probably fall into the former category and would be better off in going with a discount broker. What are the Different Types of Stock Trades? 1. Stock Limit Order Definition This is an order to buy or sell a set number of shares at a specified price or better. A Limit Order guarantees price, but not an execution. There are two kinds of limit orders: Buy limit order: your trade will only be executed if the market price reaches your specified limit or goes lower. Sell limit order: your trade will execute if the market price reaches your specified limit or goes higher. 2. Stock Market Order Definition An order to buy or sell a stock immediately at the current best market price. You cannot specify the price in which you would like to buy or sell at with a market order. There are two types of market orders: Buy market order: your trade is essentially executed at the real time 'ask' price. Sell market order: your trade is usually executed at the real time 'bid' price. Market and limit buy and sell orders are by far the most common type of stock trade orders. Market orders are more common, but limit orders can help you limit losses from a wide bid-ask spread. 3. Short Selling Definition Short selling is a less common practice than typically buying or selling a stock for its value. With short selling, you are betting that a given stock is going to go down on price. You also borrow money from the broker and are obligated to buy the stock back at a lower price, should it fall. If the price goes up? You're in trouble. 4. Stop Order Definition An order to buy or sell a stock at a given price to limit losses or cash out on gains. For instance, if you want to sell all 50 of your shares of GE when it hits \$35 to take a profit, then you can set a stop order for \$35. Once the stock price hits \$35 a market order is placed on your behalf. 5. Stop Limit Order Definition Combines the features of a stop order and a limit order. Instead of relying on market bid/ask prices, you set your limit for what you want to buy and sell at. 6. Stock Option trade Definition Typically not for beginning or even intermediate investors. Therefore, we'll save it for another post. 7. Trailing Stop Order Definition An advanced order type in which an order is executed at a certain fixed percentage above or below the market price. In my previous experiences, I personally recommend opting for buy and sell limit orders for beginning and intermediate investors. Rarely will you have a need for placing any other type of order on a simple trade. Why limit orders versus market orders? Something can be said for the peace of mind that comes with setting your own price. What is Stock Trade Duration? Stock duration is the time limit for which your order is good for and can be one of three options: Good for today (4 PM EST): this is the only option for a market order. It is also available for all other types of orders. Good until canceled: not available for market orders. Your order is good indefinitely until you personally cancel it. Good til date: also not available for market orders. Your order is good until a date that you specify. If it reaches that date your trade is canceled. Stock Trading: It's not too hard! The short summary of this post is to sign up with a discount broker, do some homework, and use buy and sell limit orders to make your trades. It's not rocket science, so get out there and start investing wisely! Stay linked in for an upcoming post on the basics of buying and selling mutual funds. Related Posts: Index Funds or Mutual Funds Ally Invest Review How to Buy a Mutual Fund Stock certificates (or shares) are partial ownership of a publicly traded company. As a shareholder, you are entitled to, at a minimum, dividend payments as released by the officers of the company when made available. This dividend is a share of the profits of the company. Shares are bought and sold, like any other good, within marketplace exchanges. The price of the share is the current market place valuation of the company, and it is usually expressed in dollars and cents. The price of a stock can go up or down based on both market trends (traders will sell stocks when they need cash to cover other positions or to buy other stocks) and on news from the company. Companies that continually report negative quarters (ones where they lose money) have their stock prices go down. Companies that produce innovative products can have their prices rise, somewhat spectacularly. Stock Trading Strategies The most basic strategy for trading stocks is Buffett strategy, named after Warren Buffett. In this strategy, you study the underlying business principles under a company in order to invest accordingly. These underlying principles include who the business's customers are, what their customers need, whether there is any significant competition for them in meeting the customers' needs, and overall balance sheets for assets, asset depreciation, and debts owned by the company. This takes enormous amounts of patience and tends to focus on finding businesses that are fundamentally sound yet poorly managed, buying shares of the company, and then waiting for the expected company turnaround. This form is called "Buy & Hold:" you buy the stock and hold on to it while helping the business achieve a turnaround. There are other strategies for buying and investing stocks beyond the "Buy & Hold" strategy. Day traders look at stocks as patterns of prices over a given period of time, then they try to buy stocks right after they've had a minor fluctuation in price and sell them when the price has gone up. When using a short-sell strategy, they borrow a stock for a given amount of money and return it back to the lender at the expected lower price and pocket the difference. Day trading and short-selling isn't necessarily easier for an investor to handle; it requires a different perspective on the market as a whole, rather than focusing deep on a given stock. There are a continuum of strategies between "Buy & Hold" and "Day Trading," and most stock investors use a mixture of the two. In fact, the vast majority of stocks traded on the stock exchange aren't handled by individual investors, they're handled by retirement funds and mutual funds, which have money managers to pool numerous stocks into a given portfolio for buying and selling decisions. Advantages & Risks The primary advantage of stock trading is that stocks are largely self-indexing to inflation, as opposed to bonds or a savings account, where inflation percentages should be subtracted from the estimated rate of return. Stocks, over the course of a 30-year investment pattern, have a very good track record, around 6-8% compounded annually, versus about 1-3% for bonds and worse than that for a savings accounts. The risks are that stocks are volatile; you only need to look back to the period between 2008 and 2009 to see the stock market losing half of its value in a 9 month span, and it's taken nearly six years for that value to return. Investors can select from several trading strategies to take advantage of high volatility options. These strategies can be used with all types of options, and they can be used weekly, monthly or on longer time frames. You can use a free online stock scanner to select a high volatility security that has options. After analyzing the security to be sure it's a suitable trading candidate, you can select which option strategy is best suited for the trade. The straddle option strategy is used when you believe the security will make a sharp move up or down but are not sure in which direction. You open the trade by buying an equal number of at-the-money calls and puts at the same time with the same expiration. For example, if the stock is trading at \$50, you could buy three call options and three put options at the \$50 strike price. As long as the stock price is above the call option strike or below the put option strike before expiration, you have a profit. The amount you make on the winning side of the trade will offset the amount you paid for the losing side. The strangle option strategy is another nondirectional strategy that uses less expensive out-of-the-money options. It is a cheaper strategy than the straddle strategy but can be just as effective. This trade consists of buying an equal number of out-of-the-money calls and puts with the same expiration. For example, a stock is trading at \$40 and you believe the price will go up \$5 to \$45. You go out \$5 from the \$40 strike price and buy one call option at the \$45 out-of-the-money strike and buy one put option at the \$35 out-of-the-money strike. You make your profit when the stock price is either above the call option strike or below the put option strike. As the name implies, you use a bull call spread when you believe a volatile stock will make a modest move up. The spread consists of buying an in-the-money call and selling an out-of-the-money call with the same expiration. For example, if the stock is selling at \$50 a share, you could buy a call option with a \$45 strike and sell the call with a \$55 strike. The spread profits when the stock price moves higher than the call strike purchase price. The bear put spread is used when you believe the underlying security will decline in price. You open the spread by buying an in-the-money put and selling an out-of-the-money put. For example, if the stock is selling at \$40, you could buy an in-the-money put option with a strike price of \$45 and sell the out-of-the-money put at \$35. You make a profit when the stock drops below the put strike purchase price. Emerging market stocks are volatile because they trade in countries with developing economies. Hemera Technologies/PhotoObjects.net/Getty Images While stocks as an asset class can be labeled as volatile, some groups that tend to exhibit more dramatic performance than others. Volatile stock prices can produce jarring price swings within moments, days or weeks, and can turn investors' profits into losses with little warning. Volatile stocks also have the potential to rise to seemingly unreasonable levels and provide investors with the returns they seek in a short amount of time. As a result of the uncertainty surrounding volatile stocks, these investments are considered risky. Small-cap stocks have a market capitalization, which reflects a company's size, of less than \$1 billion. Small stocks are volatile because they have fewer financial resources than larger companies to draw from when business or the economy slows, which places stock prices at risk for declines. Small-cap stock investors are willing to accept that risk in exchange for the growth potential that small stocks possess. Volatility can also work in small-cap stocks' favor to produce higher returns than those offered by the broader stock market. Stocks with prices that rise to unjustifiable levels considering current earnings or physical assets are volatile investments. While rising prices produce high profits for investors for a time, prices are generally unsustainable without profit growth. During the Internet bubble of the mid-1990s, technology stocks were setting record-high prices with seemingly no end in sight but most did not have tangible assets or profits. By March 2000, the true value of many Internet companies became apparent, and stock prices crashed. Performance in stocks that trade in the biotechnology sector is generally tied to the success or failure of new drug developments. Considering that drug trials are lengthy and expensive endeavors with unpredictable results, biotechnology stock prices can be highly volatile. In early 2012, when new drugs were approved by regulators sooner than expected, stock prices in this sector advanced 17 percent, which was better than the performance in the broader stock market, according to a 2012 CNBC article. Only months prior, however, some biotech stocks were losing more than 50 percent of their value amid declining drug sales. Stocks that trade in the green technology or renewable energy sectors are volatile because the industry is less proven than more traditional energy sources. Performance in renewable energy stocks can be subject to prices in fossil fuels, including oil and gas, in addition to public policy, which makes them vulnerable to changing or expiring laws and incentives, such as tax credits. In 2012, as government subsidies surrounding solar power investments were becoming less generous, investors decided to cash in on their solar-stock investments, causing the sector to lose approximately one-quarter of its value in weeks, according to a 2012 CNBC article. Whether you are a trader or an investor, your main goal is to make money. Your secondary goal is to make the most amount of money with the smallest amount of risk. Striking that balance may take practice. It is common wisdom that buying something now and selling it later at a higher price is the path to making profits in the market. But it's not so simple with options: since option prices do not always behave as traders expect them to, those who are new to this type of trading have a subtle knowledge gap, and with it a greater chance to incur unexpected losses. Here we'll cover the tools that come with options, and how to use them to make money while keeping risk in check. One of the major hurdles for new options traders comes from trying to trade options the same way they traded standard stock. In essence, options are really holds on future decisions: when you buy an option (on any kind of security), you're claiming your ability to decide in the future whether you'll purchase that security or not. Using options to meet financial goals can be tricky because there are many factors involved, and many branches of outcomes. You also retain a great deal of control when buying options, which, if you know how to use it, can help create outcomes in your favor. For instance, experienced traders do not always buy stock. Sometimes they know to sell short, hoping to profit when the stock price declines. Too many novice option traders do not consider the concept of selling options (hedged to limit risk), rather than buying them. "Selling short" is a technique of selling stock and then buying it back quickly to return to the broker; the idea is to make profits on the drop in price that happens in between. Options are very special investment tools, and there is far more a trader can do than simply buying and selling individual options. Options have traits that can't be found elsewhere in the grand scheme of investing. For one thing, they contain the Greeks—a set of mathematical tools that traders use to measure risk. This is crucial for a new trader to learn, and if you're not quite sure how or why being able to measure risk plays such a large role in trading, then think about this: if you can measure risk (i.e., the maximum gain or loss) for a given position, you can also minimize it. In other words, savvy traders can avoid nasty surprises by knowing how much money they stand to lose if the worst-case scenario occurs. Also, traders must know how much they stand to gain, or the reward for any position, in order to decide whether seeking a certain reward is worth the required risk. Below are a few of the ways that options traders use to gauge risk and reward potential. Unlike stock, all options lose value as time passes. The Greek letter theta is used to describe how the passage of one day affects the value of an option. Unlike stock, all options lose value over time. This is simply because options get their value from the promise of a choice to purchase something else, which expires after a given date: when the choice is made, or when it's no longer on the table. Delta measures how a change in price, either higher or lower, of the underlying stock or index will affect the price of an option. As a stock continues to rise or fall, the rate at which profits or losses occur will also change, and the option to buy a stock at a certain date will shift in value. By its nature, delta is not constant, and can be positive or negative. Some traders use delta as a shorthand way to guess how likely an option is to expire. The Greek gamma describes the rate at which delta changes. This is a more complex figure, since it relies on a variable that itself changes. Tracking rates of change, and the risk that follows, is very different for stock: no matter the stock price, the value of one share of stock always changes by \$1 when the stock price changes by \$1. A new options trader must learn to deal with these changes. When trading stock, a stable market makes for more modest gains or losses, while a less stable market translates into larger daily price changes for stocks. In the options world, market volatility plays a large role in the pricing of the options. Vega measures how much the price of an option changes when estimated volatility changes. Options are often used in combination with other options (i.e., buy one and simultaneously sell another). That may sound complex, but the main idea is simple: When you can predict how an underlying asset will behave, you can construct option positions that earn money when your expectations come true. A stock, index, or other asset may follow these market trends: Bullish (the price rises, by 20% to be proper) Bearish (the price drops, by 20% to be proper) Neutral (expecting a range-bound market) Becoming much more, or much less, volatile There are a large number of ways to combine options, and the guidance on how to do so is vast, the most common strategies use spreads. Spread trading is when you buy and sell many options at once, which, simply put, spreads the risk of losing money over many assets. Traders who deal in spreads use the gap between prices to predict a net gain. Spreads have limits when it comes to risk and rewards. However, by playing it rather safe, trading spreads comes with its own perks, such as a greater chance to earn (rather than lose) money: the tradeoff is that you may not see a massive windfall. A newer options trader who has some fear of taking big risks might take well to trading spreads and making a decent profit by owning a range. Stock traders, on the other hand, have nothing like option spreads. Options trading is not stock trading. For the savvy option trader, this is a good thing because option strategies can be designed to profit from a wide range of stock market outcomes, which can be accomplished with limited risk. The Balance does not provide tax, investment, or financial services and advice. The information is presented without consideration of the investment objectives, risk tolerance, or financial circumstances of any specific investor and might not be suitable for all investors. Past performance is not indicative of future results. 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