

# **THE SHORTEST BOOK THAT REVEALS**

**#1**

**MISTAKE**

**OPTIONS  
TRADERS  
MAKE**

**AND HOW TO NEVER  
MAKE IT AGAIN**

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# Chapter 1: The Core of the Mistake

In my **12 years of trading and investing in the Indian stock markets**, I've witnessed countless traders make the same fundamental mistake when buying options. This mistake isn't about misjudging the market or not understanding complex strategies—it's about the selection of stocks. Specifically, the **#1 mistake option buyers make is trading stocks that lack momentum.**

Most traders are drawn to options because of the potential for high returns with a relatively small investment. The allure of leveraging options to make a significant profit is undeniable. **However, in the pursuit of these gains, many traders overlook the importance of choosing the right underlying stock itself.** They get caught up in the intricacies of options strategies—analyzing the Greeks (delta, gamma, theta, vega) and experimenting with various complex spreads—without giving enough consideration to the stock's potential for movement. **But here's the harsh truth: No matter how sophisticated your strategy is, if the stock doesn't move, your options trade won't make money.**

## **Understanding the Root of the Mistake**

Options are time-sensitive instruments. Unlike stocks, which you can hold indefinitely, options come with an expiration date. This time decay (theta) is a significant factor in options pricing, and it works against you every single day. If the stock you're betting on doesn't move in your desired direction within a certain timeframe, the value of your option will erode, and you could end up with a worthless contract.

The problem with trading stocks that lack momentum is that they are more likely to stay within a narrow price range. This lack of movement means that your option is unlikely to increase in value, even if you correctly predicted the stock's eventual direction. In essence, you're fighting against time decay without the stock doing the heavy lifting.

## **Why Do Traders Make This Mistake?**

One reason traders make this mistake is that they focus too much on the potential payout without considering the probability of the stock moving enough to make that payout a reality. They might choose a stock with a low price, thinking it's "cheap" to trade options on it. However, a low-priced stock might not have the volatility or momentum needed to make a profitable options trade.

Another reason is the misconception that understanding complex options strategies is the key to success. Many traders believe that if they can master concepts like delta neutral trading or iron condors, they will have an edge. While these strategies have their place, they won't save you from a poor choice of underlying stock. In reality, the most critical factor for success in options trading is the momentum of the stock you're trading.

Real-Life Example: Reliance Industries

Consider Reliance Industries, one of India's largest companies, as an example. On July 25, 2023, Reliance's stock price was trading in a tight range between ₹2,470 and ₹2,500 (See Image 1). During this period, many traders were buying options, expecting a breakout. However, the stock lacked momentum, and despite occasional attempts to break out, it remained largely within this range. Those who bought options without considering the lack of momentum saw their options lose value rapidly due to time decay.

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In contrast, had these traders focused on a stock with strong momentum, like Jindal Steel (See Image 2), which was in a steady uptrend during the same period, their options would have had a much higher probability of success. Jindal Steel was consistently moving up, supported by strong volume, indicating that the trend was likely to continue. Traders who bought call options on Jindal Steel during this period saw substantial gains as the stock price moved from 630 to 665.



## Conclusion

The key takeaway from this chapter is simple: **Stock selection is crucial in options trading.** No matter how well you understand options strategies, if you choose a stock that lacks momentum, your chances of success are slim. The first step to avoiding this mistake is to recognize the importance of momentum in stock selection, which we'll delve deeper into in the next chapter.

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# Chapter 2: The Power of Momentum

**Momentum is the lifeblood of successful options trading.** It's the force that drives stock prices to move significantly, creating the opportunity for profitable options trades. In simple terms, **momentum refers to the strength and speed of a stock's price movement.**

When a stock is in strong momentum, it tends to continue moving in the same direction, either up or down, for a period of time. Understanding and leveraging momentum is the key to making money consistently in options trading.

## **The Science Behind Momentum**

Momentum can be compared to the inertia of a moving object. According to Newton's first law of motion, an object in motion tends to stay in motion unless acted upon by an external force. Similarly, **a stock in momentum tends to continue moving in the same direction unless there is a significant reason for it to stop or reverse.** This is where price action and volume come into play, as they provide clues about the strength and sustainability of the momentum.

**In options trading, momentum is particularly important because options are time-sensitive instruments.** Unlike stocks, which you can hold indefinitely, options come with an expiration date. If the stock doesn't move significantly in the direction you expected within that timeframe, the value of your option will decline, and you could end up losing money. Therefore, identifying stocks with strong momentum increases the likelihood that the stock will move enough to make your options trade profitable.

## **How to Identify Momentum**

Momentum can be identified by looking at a stock's price action and volume. Price action refers to the movement of a stock's price over time, while volume measures the number of shares traded during a specific period. When a stock is in momentum, it typically exhibits one or more of the following characteristics:

- **Breakouts:** A breakout occurs when a stock's price moves above a significant resistance level or below a significant support level. Breakouts are often accompanied by an increase in volume, indicating strong momentum. See Image 3 where Jindal Steel was in a consolidation zone for a long period and how it moved after a breakout with strong volumes.



- **Trends:** A trending stock is one that consistently makes higher highs and higher lows (in an uptrend) or lower highs and lower lows (in a downtrend). Trends supported by strong volume are a sign of sustained momentum.
- **Volume Spikes:** An increase in volume often precedes or accompanies a significant price move. When you see a stock's price break out of a consolidation phase with a sharp increase in volume, it's a strong signal that momentum is building.

## Real-Life Example: REC Ltd.

Let's look at REC Ltd. as an example. From January 2023 to April 2023, REC Ltd. was trading in a tight range of 110 to 125. In Mid of April REC Ltd. broke out of a consolidation phase with huge volumes as shown in Image 4 below. And, the stock moved from 125 to 170 in a short period of 2 months. Imagine the kind of profits that could be made in options if you have right stock at the right time.



- **Why Momentum Matters in Options Trading**

The significance of momentum in options trading cannot be overstated. When you trade options on a stock with strong momentum, you align yourself with the market's natural tendencies, giving your trades a higher probability of success. Strong momentum increases the likelihood that the stock will move significantly in your favor, allowing you to profit from the options trade. On the other hand, trading options on stocks with weak or no momentum is a recipe for failure, as the lack of movement will result in time decay eating away at the value of your options.

## Conclusion

Momentum is the key to successful options trading. By identifying stocks with strong momentum, you increase your chances of making profitable trades. In the next chapter, we'll delve deeper into the practical steps you can take to identify momentum stocks using price action and volume.

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# Chapter 3: Identifying Momentum Stocks

Identifying stocks with strong momentum is a critical skill for any options trader. Momentum stocks are those that are likely to continue moving in the same direction for a significant period of time, providing the opportunity for profitable options trades. The challenge, however, lies in finding these stocks before the momentum starts. In this chapter, we'll explore the practical steps you can take to identify momentum stocks using price action and volume.

## **Step 1: Scan for Breakouts**

One of the most reliable indicators of momentum is a breakout. A breakout occurs when a stock's price moves above a significant resistance level or below a significant support level. Breakouts are often accompanied by an increase in volume, which indicates strong momentum. To scan for breakouts, you can use a stock screener that filters for stocks making new 52-week highs or lows, or stocks that have broken out of a consolidation phase.

For example, let's consider the case of Persistent Systems. On August 31st, 2023, Persistent broke out of a key resistance level of ₹2,600 with a significant increase in volume. This breakout was a strong signal of momentum, and traders who bought call options on Persistent saw substantial profits as the stock continued to rally to ₹3,000 over the next few days.



## Step 2: Look for Volume Spikes

Volume is a crucial indicator of momentum. When a stock's price breaks out of a consolidation phase with a sharp increase in volume, it's a strong signal that momentum is building. To identify volume spikes, you can use a stock screener that filters for stocks with above-average volume.



For example, let's look at Voltas Ltd. On May 06th, 2022, Voltas's stock price broke down of a consolidation phase at ₹1,140 with a significant increase in volume. This volume spike was a clear signal that momentum was building, and traders who bought Put Options on Voltas saw substantial profits as the stock rallied downwards to ₹920 in just 7 days.



### Step 3: Monitor News and Catalysts

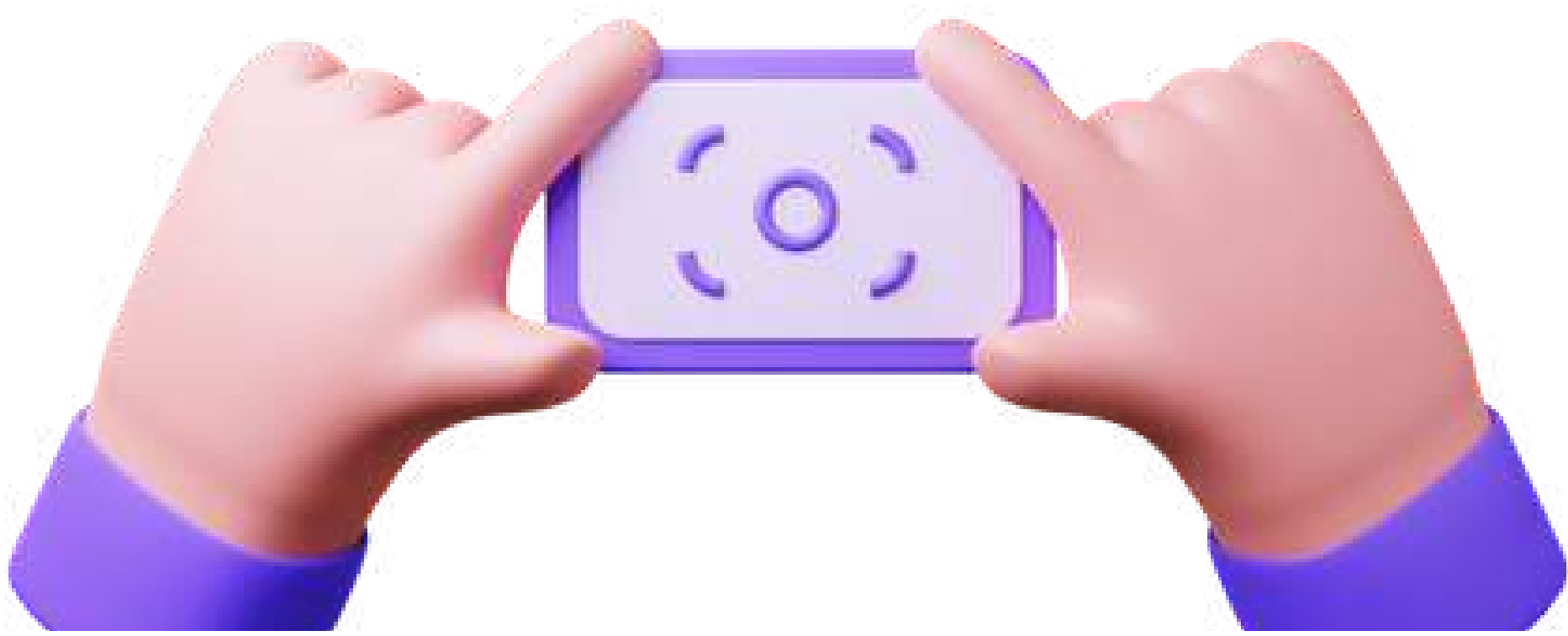
News and catalysts can also drive momentum in stocks. A positive earnings report, a new product launch, or a favorable regulatory decision can trigger a strong price move. To monitor news and catalysts, you can use financial news websites, social media platforms, or a stock news alert service.

For instance, When Tata Motors announced a new electric vehicle (EV) launch, which led to a significant increase in its stock price. Traders who were quick to act on this news and bought call options on Tata Motors saw substantial gains as the stock rallied on the back of the positive news.

## **Conclusion**

Identifying momentum stocks requires a combination of technical analysis and market awareness. By scanning for breakouts, analyzing price trends, looking for volume spikes, and monitoring news and catalysts, you can increase your chances of finding momentum stocks that are likely to make significant price moves. In the next chapter, we'll explore the importance of volume in options trading and how it can be used to confirm momentum.

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# Chapter 4: The Role of Volume

Volume is one of the most important indicators in options trading. It provides insight into the strength and sustainability of a price move, helping traders confirm whether a breakout or trend is likely to continue. In this chapter, we'll explore the role of volume in options trading and how it can be used to confirm momentum.

## **Why Volume Matters**

Volume measures the number of shares traded during a specific period. It reflects the level of interest and participation in a stock's price move. When a stock's price rises or falls on high volume, it indicates that there is strong conviction behind the move, making it more likely to continue. Conversely, if a price move occurs on low volume, it suggests that the move may lack sustainability and could reverse.

In options trading, volume is particularly important because it helps traders confirm the strength of a price move. Since options are time-sensitive instruments, traders need to be confident that the stock will continue moving in their desired direction. Volume provides that confidence by indicating the level of interest and participation in the price move.

## **How to Use Volume to Confirm Momentum**

1. **Volume Spikes on Breakouts:** When a stock breaks out of a key resistance or support level, a spike in volume confirms the breakout. A breakout on low volume is more likely to be a false breakout, while a breakout on high volume is more likely to be sustained.

**Example:** On October 7th, 2021, Tata Motors broke out of a key resistance level at ₹360 with a significant increase in volume. This volume spike confirmed the breakout, and traders who bought call options on Tata Motors saw substantial profits as the stock rallied to ₹530 in just 5 days.



**2. Volume During Trends:** During a strong trend, volume should increase on moves in the direction of the trend and decrease on pullbacks. This pattern indicates that the trend is likely to continue.

**3. Volume Divergence:** Volume divergence occurs when the price is moving in one direction, but volume is decreasing. This divergence can be a warning sign that the momentum is weakening, and the price move may be nearing its end.

Example: From January 2024 to May 2024, Hindustan Unilever Ltd. was in a downtrend, but the volume was decreasing as the stock continued to fall. This volume divergence indicated that the downward momentum was weakening, and traders who ignored this warning sign and bought put options saw their options lose value as the stock eventually reversed and showed a huge movement upwards.



## Conclusion

Volume is a critical indicator in options trading. It helps traders confirm the strength of a price move and increases the likelihood of making profitable trades. By paying attention to volume spikes on breakouts, volume patterns during trends, and volume divergence, traders can improve their chances of success in options trading. In the next chapter, we'll discuss the importance of risk management in options trading and how to protect your capital.

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# Chapter 5: The Importance of Risk Management

Risk management is a crucial aspect of successful options trading. While identifying momentum stocks and confirming price moves with volume are important, it's equally important to manage your risk to protect your capital. In this chapter, we'll explore the importance of risk management in options trading and discuss practical strategies to mitigate risk.

## **Why Risk Management Matters**

Options trading offers the potential for high returns, but it also comes with significant risk. Options are leveraged instruments, meaning that a small move in the underlying stock can result in a large percentage gain or loss in the option's value. This leverage can work in your favor, but it can also lead to substantial losses if the trade goes against you.

Without proper risk management, even a few losing trades can wipe out your trading account. This is why risk management is essential—it helps you protect your capital and ensures that you can continue trading even after a series of losses.

## Practical Risk Management Strategies

- **Position Sizing:** One of the most effective ways to manage risk is by controlling the size of your positions. As a general rule, you should never risk more than 1–2% of your trading capital on a single trade. This means that if you have a ₹1,00,000 trading account, you should risk no more than ₹1,000 to ₹2,000 on any one trade.

Example: Suppose you have a ₹1,00,000 trading account, and you want to buy call options on Nifty. You calculate that the maximum you can afford to lose on this trade is ₹2,000. Based on this, you decide to buy two call options contracts, each costing ₹1,000. If the trade goes against you and you lose the full ₹2,000, your trading account will only be reduced by 2%, allowing you to continue trading.

- **Stop-Loss Orders:** If you ask me or any successful trader, loss is the first step before any other factor in trading. A stop-loss order is a predefined price level at which you will exit a losing trade to prevent further losses. By using stop-loss orders, you can limit your losses and protect your capital.

**Example:** Let's say you buy call options on HDFC Bank at ₹50 per contract, with the expectation that the stock will rise. However, to protect yourself in case the trade goes against you, you place a stop-loss order at ₹30 per contract. If the stock moves in the wrong direction and the option's value drops to ₹30, your stop-loss order will be triggered, and you will exit the trade, limiting your loss to ₹20 per contract.

- **Diversification:** Diversifying your trades across different stocks and sectors can reduce your overall risk. By spreading your capital across multiple trades, you reduce the impact of any single losing trade on your overall portfolio.

**Example:** Instead of putting all your capital into call options on Reliance Industries, you decide to diversify by also buying call options on ICICI Bank and Infosys Ltd. If one trade goes against you, the other trades may still be profitable, helping to offset your losses.

- **Risk-Reward Ratio:** Before entering a trade, it's important to assess the potential reward relative to the risk. A common rule of thumb is to aim for a risk-reward ratio of at least 1:3, meaning that for every ₹1 you risk, you should aim to make ₹3 in profit.

**Example:** Suppose you're considering buying call options on Maruti Suzuki. You estimate that if the trade goes in your favor, you could make ₹6,000 in profit, but if it goes against you, you could lose ₹2,000. This gives you a risk-reward ratio of 1:3, which is a favorable setup.

## Conclusion

Risk management is the cornerstone of long-term success in options trading. By controlling your position sizes, using stop-loss orders, diversifying your trades, and maintaining a favorable risk-reward ratio, you can protect your capital and increase your chances of consistent profitability. In the next chapter, we'll explore one simple options buying strategy that you can use with price action and volume to maximize your chances of success.

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# Chapter 6: A Simple Options Buying Strategy

In this chapter, I will share a straightforward yet effective options buying strategy that relies solely on price action and volume. This strategy is designed to help you capitalize on strong momentum in stocks, giving you the best chance of making profitable options trades.

## **The Strategy: Price Action Breakout with Volume Confirmation**

The strategy is based on the idea that when a stock breaks out of a significant resistance or support level with strong volume, it is likely to continue moving in that direction. By buying options on these breakouts, you can position yourself to profit from the ensuing momentum.

### **Step 1: Identify the Setup**

Start by scanning for stocks that are trading near key resistance or support levels. A resistance level is a price point where the stock has historically struggled to move above, while a support level is a price point where the stock has historically found buying interest.

**For Ex:** Bhel was trading near its strong resistance of 150 for over a period of 2 months.

## **Step 2: Wait for the Breakout**

Once you've identified a stock trading near a key level, the next step is to wait for a breakout. A breakout occurs when the stock's price moves decisively above the resistance level (or below the support level) on strong volume.

**BHEL broke the resistance with huge volumes on November 11th, 2023.**

## **Step 3: Confirm with Volume**

Volume is a crucial component of this strategy. A breakout on low volume is more likely to fail, while a breakout on high volume is more likely to be sustained. Look for a sharp increase in volume that confirms the breakout.

## **Step 4: Enter the Trade**

Once the breakout is confirmed by volume, enter the trade by buying call options if the breakout is above resistance or put options if the breakout is below support.

If someone bought the call options of BHEL on the day of breakout, traders would have made significant profits as the stock of BHEL moved from 150 to 180 in a matter of just 8 days.

## Step 5: Manage the Trade

As with any trading strategy, risk management is key. Use a stop-loss order to protect yourself in case the trade goes against you, and consider taking partial profits as the stock moves in your favor.

## Conclusion

This simple options buying strategy is a powerful way to capitalize on momentum in the stock market. By focusing on price action and volume, you can increase your chances of making profitable trades while minimizing your risk. This strategy is easy to implement and can be used by traders of all experience levels.

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