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How to manage risk in Option Selling?

10 frameworks to improve your risk management in 1 month:

Collaborated with @niki_poojary

In this thread you'll how to manage risk with:

1. Directional markets
2. Range-bound markets
3. Mtm stop loss
4. Booking profits
5. Overnight hedging
6. Event Risk
7. Position Sizing
8. No leverage
9. Reducing positions when wrong
10. Calculating risk upfront

Let's go ↓

Directional markets:

There is no point in the market being directional and you adjusting a non-directional trade.

As a general rule, you should only adjust once or maximum twice and then give up on firefighting.

Then you should side with a directional move.

Mistake of a non-directional trader:

Non-directional traders face heavy losses in directional markets.

If you are able to limit your losses in such scenarios, your risk management will improve.

The "I can adjust any move" mindset has to vanish for this to improve.

Big Range:

Moves in a big range are usually violent, and this is where non-directional traders lose money despite the fact that they are correct in assuming that the market is range bound.

Level-based stops work best in such an environment with reduced quantities.

Mtm Stop losses:

In addition to level-based stops, you should also have an mtm based stop loss.

Don't fight with the market just because you have a "view".

Your view can always go wrong & when it does, usually traders lose a lot of money and most blunders happen.

2% Rule:

You should lose a maximum of 2% of your capital on any day, including whenever your view goes wrong.

Limiting yourself to a 2% loss ensures that you never take a big enough dent to impact you psychologically.

If you're a beginner start out risking 0.25% per trade.

Booking Profits:

Controlling Risk is important but so is booking profits.

Once you have booked your profits, if premiums increase or if the market goes against your initial trade then you don't lose profits already made.

This is a very healthy habit in trading.

For example:

So many times markets close at day high, Option sellers sell puts, and they get crushed the next morning.

Option sellers don't exit as they are in profit and then the market falls one way down taking away all the profits made.

Sometimes you come into loss.

If you have sold an option for 60-70 rs and it has come to 20rs in a gap, just book it and trade fresh for that day.

Or can skip intraday trades altogether and just trade post-3 pm again for the next day.

This way you won't get trapped in intraday volatility and premium spikes.

Overnight Hedged:

Overnight hedging should be done by those traders who keep fearing a black swan.

Whatever option you sell in bank nifty if you buy an option 1000 points away from it you have limited your losses to 25000 per lot.

Assuming you haven't taken leverage the max loss you will have will be between 20-25% of your capital, regardless if we open at a circuit.

I personally don't hedge and neither do I recommend hedging, but if this kind of risk bothers you, you can hedge.

Event Risk:

New option sellers should stay away from event trading.

For example, budget day, inflation data, RBI policy, etc. are all days where, unless you are used to exiting early, risk management can go for a toss fairly quickly.

As a beginner, you should try trading with 10% of your capital or avoid trading altogether.

Small quantities should be deployed just for you to get a sense of how these events and premium movements work.

With 10% qty only, you cannot lose a lot.

Know Risk upfront:

Risk should always be known before entering into a trade. You should also be comfortable with the risk you are taking.

It is preferable to risk profits rather than capital. You can make a rule of losing a maximum of 2 weeks profit in a week.

This way you never waste a month and even in a bad month you can still end up making 1-2% returns rather than it being a loss-making month.

If you're not comfortable with losing 2 weeks profit, just risk the previous weeks profit.

Position Sizing:

Position Sizing should always be in check to have good risk management.

Learn to play on 2 lots per 10 lakhs at first and then slowly scale to 4 lots and finally 6 lots per 10 lakhs once the profit cushion is there.

With a small size of 2 lots per 10 lakhs, you will learn to handle the capital and manage gaps and losses.

If profitable, can risk the profit and take higher quantities.

I have scaled up this exact the same way. Now I fearlessly punch any quantity.

When unable to read the market:

There are some weeks or months where, whatever you do, you are unable to read the market at all.

Immediately reduce the quantity for the week/month so that even if you lose further, you don't lose money on your entire capital's quantity.

For many traders, this happens when the vix is rising, so it would be an ideal time to sit out or trade with lower quantities.

The past month has bee difficult for sellers, and they knew vix would rise before the budget.

No leverage:

It is critical not to use leverage as an option seller until you have at least doubled your capital. Leverage by itself isn't wrong—but how it impacts us is too dangerous if not handled well.

If you are someone who is trading with 10 lakhs capital and selling naked options, you would be used to selling either 150 to 200 quantities.

If you take advantage of leverage, you can even go up to 700 quantities on a 10 lakh account. ↓

Quantity Increase:

Regardless of how good a trader you are, this is a significant increase in MTM fluctuations.

There is a difference in trading with a 10 lakh capital quantity sizing and a 30 lakh capital position sizing.

Traders who don't follow or stick to trading within their quantity limits, find it difficult to be great at risk management.

If you lose on a big enough quantity, your psychology will go for a toss.

These are my experiences for tackling:

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Comment if you have a query

That's a wrap!

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1. Follow us @Adityatodmal & @niki_poojary for more threads on Price action, Option Selling & Trading growth.

We've got you covered.

2. RT the first Tweet to share it with your audience.

I appreciate it!