

All right, folks. Welcome back to the Rude Awakening for Friday, February the 5th, 2021. And we're starting on day one of a 10-part series here on how to set up an asymmetric trading approach. That's a way to build a trading system that gives you very, very little risk with lots and lots of upside potential. And today we're starting on step one, which is the problem.

What is the problem that we have with normal investing approaches? Well, the problem boils down to two issues that are separate but actually combine to create one big issue. That is number one, Probabilities of Profit, P.O.P. It's the probability that we have of making a profit on any given trade. And then number two is the risk/reward ratio. How much money are we risking versus what is the potential reward? And it is how these two issues interact, the risk/reward ratio and the P.O.P., the Probability of Profit.

We can take an example here by just looking at a stock. It doesn't matter which one we pick. We'll pick IBM here, and we could go build a trade. And let's just say that we do the simplest trade in the book, and that is just simply going long, some shares of IBM, buying IBM. So I just click on this right here. We're going to buy some stock. I'm just going to use an example of one share here. It doesn't really matter if we're using one share or a million shares, the risk graph here is going to look the same. And if you've never looked at a risk graph before here, what this is showing us is here's the price of the stock, and below this level right here would be a loss, above this level right here would be a profit. So you can see right now IBM's trading for about \$120, and this would be our purchase price right here.

Now you can see obviously, if the stock goes up, we make money. If the stock goes down, we lose money. That's pretty obvious and straightforward, but the P.O.P. is what's interesting. What is our probability of profit? What is our probability of success when we go out and buy a share of stock? Well, the probability is 50%, and that kind of makes sense, right? Because there's only two things that the stock can do, it can go up and it can go down. And we're right on the very center of that as we purchase it, and so there is a 50/50 shot that we're correct in our assumptions. That's not very good. That's about as good as going to the roulette table in Las Vegas. So the probabilities of a profit are not very good.

Now we could also say, "Hey, well I think the stock is going down, I'm going to short it." And of course we would make money there if the stock did go down. We would lose money there if the stock went up. But the probability of profit is still only 50%.

So what could we do about this? Well, there are things that we could do to raise our probability of profit, but they're going to affect our maximum risk and our maximum loss. So let's go back here to purchasing this stock, and let's say that we buy a share of stock here. Stock is trading again for about \$121 a share. What would the max profit be on purchasing a share of stock? Well, you can see that little number right there. That's infinite, right? And it is infinite because we don't know how high IBM's going to go, it could be infinite. But what is the max loss? Well, the max loss is \$121. It's the same as our purchase price.

Now is that reality? Is it reality that IBM is going to go to zero? Probably not, but that is the risk anytime we buy shares of stock is that it goes to zero, right? So we're risking all of our capital. All of our capital is at risk for only a 50% probability of success. Neither one of these numbers is very enticing. So we could say, "Hey, you know what? Instead of actually purchasing this share of stock, I'm going to use some option strategies that can improve my probability of profit." So we could come out here and say, "Listen, I think that IBM is going to go up in value, and so I'm going to go out here to my table. I'm going to get some options, and I'm going to sell a credit spread down here on the bottom." If you look at that in the risk graph, you can see that that again represents an idea that when the stock goes up, we'll make money. If it goes down, we'll lose money.

Now, this is interesting because it improves our probability of profit. Our probability of profit now is 74%, much higher likelihood that we would make money with this strategy rather than just buying IBM outright. However, look at our max risk versus our max loss. We're going to spend about \$148 to do this trade, and our maximum loss is \$148. So we've got a \$52 potential profit, but our max loss is \$148. So again, the risk/reward ratio is simply not there.

So this is the problem that we have with normal trading strategies. If we have a really high probability of profit, we are risking a loss of almost three times what our profit potential is. I don't want to risk losing \$158 to try to make \$50. That's not going to work for me over the long period of time. And if we just go out and buy the stock, I don't want to do anything that's only going to have a 50/50 shot of success.

So this is the problem, folks. Tomorrow we'll come back with the solution. Have a good trading day. We'll talk to you guys soon.