

Welcome back to The Rude Awakening, folks. Today is Thursday, February the 11th, 2021. We're continuing with our 10 part series on How to Create An Edge. How to create an advantage in your trading. As you remember, day one, we talked about the problem and the problem is that at best we get a 50/50 shot when we buy or even when we short something. It doesn't give us an edge. It doesn't give us an advantage in the marketplace. Day two, we talked about the solution and that is building a three to one risk reward ratio, to where we can risk only \$1 for every \$3 that we could potentially make. Day three, we talked about how to automate that process by using bracket orders that automatically set up every trade that we do in that ratio. Day four, we talked about how to filter and screen the 14,000 different underlying assets that are in the marketplace today to find maybe 50 or 60 that we can choose from to set our trades up with.

And today we're going to talk about POP, probability of profit, and how that relates to win/loss ratios. So there's a couple of things to think about. It's interesting when new traders get started, they're blown away, and sometimes don't actually believe that you can calculate POP, probability of profit. What is the chance that you're going to make money on any one individual trade? Well, there is a good chance that you can do that. And it has to do with some of the math that is involved in trading. And that is primarily IV, implied volatility, and standard deviation. So implied volatility, it's just one of the most important metrics that there is out there when you're looking at trading. And it refers to the pricing, generally speaking, of options on stocks. So in simple terms, IV IS determined by the current price of the option contracts on a stock.

And it's represented as a percentage that indicates the annualized expected one standard deviation move in that stock. for example, if we have an IV of 25% on a \$200 stock, a one standard deviation move would mean that over the next one year or 12 month period of time, that stock is going to probably fluctuate either up or down within a \$50 range. Okay. Now, one standard deviation. What do you mean? What are we talking about when we say one standard deviation? That's a 68.2% chance of a stock staying inside of that one standard deviation move. So in trading, we look at one standard deviation moves, two standard deviation moves and three standard deviation moves. A one standard deviation move, again, is about a 68% chance that a stock is going to stay within that defined range based on its past standard deviations moves and implied volatility.

So how does this all factor in with trading? Well, let's jump in and take a look at a trade. Let's take a look here at a stock with the ticker symbol, CMG, that's Chipotle. And let's say that we look at it, we've analyzed it, we research it. We like the chart. We like the flow. It looks like a good investment to us. Well, we know some of the challenges that we're going to face, right? We know that if we were to go buy the stock, let's say that we buy one share of stock. That'll obviously be \$1,527. And you can see a couple of the challenges here. Now, it tells us here in our analysis tab that the maximum profit on this transaction would be infinite. That little sign right there is infinite. Now, that's not actually true, right? We don't think that Chipotle is probably going to go up forever, but technically that's possible.

And so it gives us that infinite number. It says the max loss is 1,544, which is our total investment. Well, we don't think that's probably going to happen either. That would mean Chipotle would go to zero. But technically those are the numbers. But the reality is, if you look at your loss/win line right here, you can see that that's very linear. That it's a very, very linear trade. Problem that we've already talked about, probability of being correct in this assumption is a 50/50 coin toss. It's really just up in the air as to whether or not we're going to make it to the upside or make it to the downside once we make that purchase. And so we need to do something about that probability of profit. We need to do something about the max loss and about the max profit. Because the reality is that Chipotle is probably not going to go up infinite amounts, right?

And you can see that the profit here is linear. What can we do to create a little bit of an edge to where our profit curve is much better than our loss curve? Well, one of the things that we could simply do is buy a call option. Now, call options go up in value when stocks go up in price. And we could simply go buy a call option. You can see now that has dramatically improved the risk reward ratio. In this case, we have still unlimited upside profit potential, as long as Chipotle keeps going up and up and up and up. I mean, you can see if it went up to right here, 2,050, that's a \$44,000 profit on our \$5,000 investment. So now we've got this sort of asymmetric curve here where we have limited risk and almost unlimited upside potential. But what happens to our probability of profit?

It's actually gone down. We have more profit potential, but less chance of actually achieving that. And I don't think most of us would want to do any investment that only has a 33% chance or a one-third chance of working out. So once again, guys,

we are back to structuring our purchases with bracket orders, where we could enter that trade right up front, knowing that at maximum, we're only going to risk 1% in that trade. And we will exit at a 3% profit. And over time that will give us an edge. That will give us an advantage in the marketplace...