Optionality and Convexity

[00:00:00] All right. How ya doin friends? Ernie here. This is the zero dash DTE podcast. This is episode number 43. And today, today we're going to get a, or delve a little bit deeper into the, I guess you could say the philosophy of the zero dash DTE strategy. And there are two principles.

[00:00:29] Well, it’s one principle. Often stated as two, that come from some of the seminal works by the well-known, academic mathematician and philosopher, Nassim Taleb, who is widely known as the author of the Black Swan and Antifragile, Fooled by Randomness, and Skin in the Game, and other books.

[00:00:54] He has a principle in there that he refers to, uh, particularly in antifragile. As the convexity principle and optionality.

[00:01:05] Now, what is optionality? First, optionality is this idea that you want to put on bets or wagers or things that have a lot of different potential positive outcomes and relatively few negative outcomes. And then convexity is this idea that.

[00:01:27] Well, if you are familiar with a convex mirror in a telescope, it's a mirror that is shaped in such a way that no matter where light hits it, the light always reflects back to a focal point. From a odds point of view, you can think of convexity as an asymmetric bet, where if your bet where to lose. Then the risk would be very small. If it were to win, then it would follow along this kind of exponential path to profit. And that's exactly what we do here. We put on bets that, that have optionality and convexity.

[00:02:10] Now, what that means is that we're putting on asymmetric wagers, where we wager just a very small amount of money for the potential of making a very large amount of money.

[00:02:21] It's not a binary thing. Either you lose or you win. Of course it is a, um, it's a loser. If it goes way in the wrong direction. So Monday we had such a bet on, a very small amount of risk for potentially large reward, which is diametrically opposed to what happens with other zero DTE services. That had a max loss of.

[00:02:50] $80, but it had a potential gain of about $1,100. So, you can see that's where the asymmetry is.

[00:03:00] Now we're in the final day of expiration of these options, we're placing our, position in such a way that as time during the day starts ticking away, the decay starts working in our favor. So even if we just hang out right where we were, uh, as time goes on, and even if we go down a little bit, we're making money, but of course, if you go down way too much, then you're, you're outside of that, that realm.

[00:03:30] But even if you do that, go way too far and hit a max loss. The loss is still very small. If you stay where you are, move down a little bit or start moving towards the convexity part of this trade, the asymmetric, the asymmetry, the big winner. Then the winds can be dramatically larger. Now on, on average, we'll be in now.

[00:03:56] We were in profit earlier today. And I told the group] that look, you could take a 50% win right now, which by most accounts would be a fantastic return. If you were trading options now for us, it was, well, you know, do we want to take a 50% return or are we going to stick with this trade and see if the market is going to come down and the market was already down.

[00:04:22] I just thought it was going to go down a little further. And it started banging on floor, I want to go down, but it wouldn't make it. And finally, I guess what had happened was that Mitch McConnell had come to some sort of agreement in principle that they were going to extend the budget until December.

[00:04:46] Apparently was a big surprise to the market. And then the market popped up a little bit. Uh, you know, as if, but anyways, that's why I didn't go down. Like we all thought it was going to go down or the way I thought it was going to go down. So, it's no big deal. So, we lose another small bet.

[00:05:11] If it did go down. The market, then we would have been huge winners anywhere from 300 to as much as 1100%. So, if $80 was our risk, then our potential profit was about a thousand dollars. Uh, and then along that spectrum, we could have made any F anywhere from, you know, $80 on top of our original bet to, you know, maybe a few hundred dollars, 500, whatever it was.

[00:05:41] That's typically the way it goes like last week, two bets on Monday and Wednesday that were, you know, about between 75 and 150 to 200% winners. And then Friday a much larger one, probably on the order of 500 or 600%. So those are good. Those are great returns.

[00:06:02] Now, when you compare that to other option services, they're completely the opposite. Instead of putting up, say $80 to make a much larger amount, they're putting up a much larger amount to make that $80. And because of the nature of their bets, they are not convex. They are concave. So, they, aren't getting better as you are, as you're moving into the bet, they're getting worse and as they get worse,

[00:06:37] They must be careful because they have the opposite of optionality. They don't have many ways that they can win the bet. They have many ways that they can lose. They must make sure that they are within this very small, tight range that they make their money. And because of that, they will add stops to the trade in such a way that if they threaten, uh, one of these concave situations, this lack of optionality, they want to be able to get out very quickly.

[00:07:09] And if they are within their profit range, they are satisfied with taking only 50% of the maximum potential profit, which is a very, very small amount. So, imagine putting up a thousand dollars to try to make $80, but you don't take the 80, as soon as you hit 40, you get out very quickly.

[00:07:32] And then the rest of the time, you're sweating bullets wondering whether you're going to achieve a max loss or not. Now the difference with what we do is we start with a max potential loss of just that $80. That's the maximum we can lose, not a thousand. And if we do nothing, if the price does nothing, or if it goes down a little bit, or it goes up a little bit, we start gaining profit.

[00:07:59] As a matter of fact, this morning, we were at about 50 to 60% profit and we just hovered there and then finally something happened at, just about. Oh, about a half an hour ago and the market shot up and overall, the market was down for a while, but it looks like it has regained everything that it lost from last night.

[00:08:22] So we, we hit max loss on that, but the max loss again is very small. So that is in a nutshell, a real-life situation of our optionality and convexity principle.

[00:08:35] Let's see,

[00:08:36] We have a question. Do you get in more than once? If there is a loser. Generally, no, we don't. Although it has happened before we have turned around and then taken an opposite bet before. Right now, I didn't really feel comfortable because that would mean going against this larger trend. And right now, we have this big trend or a developing trend.

[00:09:01] It appears. The market is moving down off of this, and it could just be a correction and that correction might be over. In general, that's one of the principles that I follow on with that. If there is a trend in place and it's the major trend, then I'm not going to really bet against it.

[00:09:17] We'll take our shot at it. And if it works, then that's great. If it. We move on because there's three of these opportunities every week. If there was only one opportunity a month, that might be a different story. We might be chasing after, those other opportunities that are out there. But because we have three opportunities a week and in general, our hit rate is very high.

[00:09:38] Usually, in very low volatility regimes we are hitting maybe 60% of these trades in high volatility regimes. And we're just about getting in there. With trying to get up into that higher volatility regime, then we can be 70, 80, even 95% a win rate. And so, we just take it as it comes.

[00:10:00] We're not worried. Let's see. The follow up question is what is your percent of winners for the system? So, as I said, that is highly dependent, I think upon. The current volatility regime. And when I say regime, what I'm saying, that's a synonym for range that we're currently in.

[00:10:22] And for the longest time, for a long time, we've been in a very low volatility area or range or regime. And just recently with this pullback, we've started to move up. But it's really, hasn't been, we're not really moving up, deep into that volatile range, that area of the VIX that gives us that sort of sustained movement.

[00:10:43] Almost there last week was great the week before that was great this week. Eh, not so great. So, our general return in this type of market right now appears to be about 65% or so when. Where we work best is on the falling edge of volatility. So, in other words, trades like this work best when volatility is on the decline and that's when you're going to get your maximum convexity, right?

[00:11:16] Because that's when premium accelerates in its decay. So, for example, if you had a market disruption and say there was a five or a 10% correction in the market, something violent and volatility shot way up.

[00:11:35] Typically, you'll see that when volatility shoots way up, it takes a long time for it to work its way back down to that previous level, and it might take weeks that range as it's coming down is the absolute best time for this strategy, because that's the time when everything is lining up for you. Your convexity is at its peak.

[00:11:58] The asymmetry is at its peak. We have high enough volatility that we can put on very asymmetric trades. In other words, low risk. Hi reward. And typically, we use the butterfly so we can create much wider wings on that butterfly to capture a bigger range because the volatility is high.

[00:12:18] So we've had this correction going on now. So, we're on that leading edge. It hasn't really completed it yet. So, we're now waiting for that falling edge to happen, or maybe there's going to be a much bigger correction, which is what I think a lot of people think.

[00:12:34] So we're in that, in between stage, are we going to have a good correction with a spike in volatility and then play that, falling edge? Or are we going to whimper away.

[00:12:44] How do your members get the alerts? Do they need to be watching Discord, text, email, et cetera?

[00:12:52] Everything that we do is done in the Discord. So, you get your alerts in the Discord. The Discord can produce notifications from your computer, you can also put it on your phone and they produce notifications on your phone. Very similar to a SMS or text alerts.

[00:13:09] It looks just like an SMS or a text alert. The only difference is that when you click on it, you go directly into the Discord app, which provides way more context. And much more usable than say just a text thing because it's text and graphics and video and everything else. So, it's a true chat system.

[00:13:29] So that's how alerts come. We don't do alerts via email or SMS because it's unnecessary seeing that you have this application both on your desktop and your mobile that provides essentially the same thing. So that's how we do it. And if you'd like to give it a try. What you do is you go to 0-dte.com/try, and you can try out this idea of convexity and optionality, taking asymmetric bets, betting a little to make a lot, potentially a lot.

[00:14:05] And it's really a relaxed way of trading the difference between what we do and what most other people are doing. And just about any other type of trading is that. Because we're not attached to that idea of making income in the market, which I believe is a false concept. We are students of the growth aspect of what the market will provide for us.

[00:14:30] Right. So, we're putting ourselves into the right position with small insignificant bet. Waiting for the market to come to us and to give us an opportunity to grow our account in leaps and bounds, as opposed to trying to make systematic steps, which I'm sure, you know, if you've been trading for a while, most of your best returns have all come either on a mistake or some, an anomalous action that happened in the market.

[00:15:06] And it's the same way in life, too. It happens in life too. Life. Isn't a steady as you go step by step gradual increase to Nirvana. That doesn't happen. So, our way of trading, I think, is more coincident and more in line with the way the real world works.

[00:15:26] Right. It's sort of this black Swan theory of the way things happen, things happen, and advancements happen in, in civilizations, in markets and in our own lives, in spurts, in unpredictable events that happen. And then either where they are ready to take advantage of them or we're in. And so that's what we do is we constantly put ourselves in a position that we can take advantage of these spurts that are unknowable when they're going to happen.

[00:16:02] And then from those we can grow, and we grow dramatically. And when they don't happen, because we've not taken huge risk, it's not a big loss. So, another question, your system does seem better. I was in a zero DTE room and when they lost, they lost big, which wiped out a few or more winners. Sometimes more than that.

[00:16:24] Uh, sometimes they could wipe out as much as a month or two of wins because, what happens is that they need to necessarily put on stops in order to protect themselves from that concave nature of their system. Because if they start heading towards a max loss, what they do is they'll put stops in and yeah, sure.

[00:16:50] You could lose three or four previous wins from that one stop when you get stopped out, which happens. But what will happen often is that instead of being really systematic about that, you start getting frustrated and you take that stop off. And then just when you least expect it, of course, no one ever expects that you go to a max loss, which will end up removing 10 or 15 of your previous wins.

[00:17:19] And that happens probably more often than you. I'm sure that there are discipline traders out there that can keep to that, that three X or four X loss, but on the same token there, as soon as they put a trade on, they're always anxious. They're anxious because as soon as they put that trade on, any movement, left or right, and they're immediately in the red.

[00:17:41] And so they're hoping that price will stay stabilize and they'll stay within the middle of their very wide iron condor, which very rarely happens. So that's really a big difference rather than getting into a trade and feeling immediate anxiety. And then hope that you're going to maintain that center position and maximize your profit and take what you can.

[00:18:09] We're never in that situation. We're never axed. First, we're not putting up a lot of money. We're putting up a very small amount of money. We have no stops. So that if something seems to go against us, there are times when it can come back. So, we're not stopped out. I mean, how many times have you been in a trade where you get stopped out only for the trade to then reverse and come back and had you been in the trade you would have profited.

[00:18:36] We don't have that problem because we have no reason to get out of the trade because our risks are asymmetric. A risk to our reward is asymmetric. So, it's a huge, huge difference. Huge difference in your mentality, the anxiety level anxiety is eliminated in this system. And the big benefit of that is.

[00:18:58] Because you're not anxious. You're clearheaded, you can think logically, and you make better decisions. So, the strategy itself, the asymmetry and the convexity promote better. Decision-making all right. Here's another question. Do you take your trades off closer to the end of the day, or do you just set a profit amount?

[00:19:21] Everybody has a different strategy there. I believe in managing our risks as we’re managing our profits. We don't manage risks. We manage the profits as the day goes on because we don't know what to expect. And it really depends on the size of your position too.

[00:19:39] You know, we put our positions on in tranches, so you could have a singular tranche, which might be good for a very small account, but if you have a larger account, you might have several trenches on. And so, if you have achieved 50 or a hundred percent return in a trade and there's a potential to achieve much more, what you might do is take that first a hundred percent off, maybe three quarters of your positions off guaranteeing you a profit, enabling you to then take what we call a free.

[00:20:10] And then go with the rest of your position to see if you can achieve what we call a pin trade. And that would be where you achieve that max profit, which happens about 10 to 15% of the time. So hopefully that answers your question. All right. Well, thank you very much for those questions. They were very good.

[00:20:28] Very well. Very well stated. All right, there you go. There's an episode 43 in the bag. Peace. Hope you enjoyed that. And don't forget, go to 0-dte.com/try take care. And we'll see you Friday.