

Probability of Touch Before 0-DTE

[00:00:00] Yep. We live. I don't know why I always must rearrange my seat when I just, when I go live, but there we are. How are you doing friends? Ernie here with the zero dash DTE podcast. It is, I can't believe it's Monday. It is Monday a brand-new week. And I think that we are some of the few people that enjoy Mondays because Mondays mean three more chances at trading.

[00:00:30] This is the zero dash DTE strategy. Today, episode number 48, we're going to talk about expected move and probability of touch. Two very, very important concepts in zero D T E trading. Now, most people that are options trading, when they're figuring their strategy, they're always figuring it about, where are they going to be at expiration?

[00:01:04] What strikes going to be in the money? They put on a strategy with a profit graph that is showing the potential profit at expiration, and that is their goal.

[00:01:21] Now, the problem with that is that is extremely limiting. I guess it's limiting depending on what strategy that you're putting on and how you decide to use that strategy. So, for example, if you're using a butterfly as a market neutral strategy, or let's say that you just like to use the butterfly in sh with short-term trading in the zero DTE world and you place the short strikes at the money.

[00:01:54] So in other words, you're banking on for whatever period that you're going to achieve enough premium collection before price has time to go outside of the wings of the butterfly. Now this is a super risky way to trade it. Doesn't give you a whole lot of opportunity to profit, and it gives you a lot of opportunity to be in the red almost immediately as you start or engage in such a trade.

[00:02:28] And it's the same way even worse. So, with an iron condor. So, the key here is. Why then are you using it as a market neutral strategy? When in fact it is far more effective as a directional strategy, it has properties in terms of its Delta and its data, or I should say the profit curve is flatter and rises faster and has a greater risk to reward than you could ever get trading directionally compared to trading it as a market neutral strategy.

[00:03:15] So that makes it in fact, a superior strategy, even to a spread because of those properties, because of the property of being able to extend the profitability and the probability of touch well beyond the wings of the strategy.

[00:03:34] So think about this by moving this strategy further out of the money from where you're starting your trade, you're doing two things now, of course you could just as easily, if you move it far enough, there's really not much difference in putting a butterfly as just putting a simple, oh, a long vertical, but you'll want that butterfly you'll want that extra wing there to reduce your risk and to also to increase your potential profitability, should price start moving towards that short strike.

[00:04:13] And so, as a matter of ease, it's usually easier just to put the butterfly on as opposed to legging in, but you can leg into about a fly as well, but you're going to get much better characteristics if you start off as a butterfly with your profit curve, because it's going to be low and flat.

[00:04:33] And by putting it further out of the money, you're going to have a much better risk to reward. In other words, you can control your risk to a very, very small amount, very, very tiny versus the potential profit. Now, of course, if it's so far away, what's the probability that you're going to be able to reach those short strikes and make all these gobs of profit in general, it's relatively low, but let's say that you place the short strikes far enough away.

[00:05:06] So that about 10 or 15% of the time, you're going to end up by the end of the day, near those short strikes and from. You could say then that your strategy about 10 to 15% of the time is going to achieve an incredible risk to reward. Sometimes as much as 10, 15, 20 times or a thousand 1500%, 2000% return on your money.

[00:05:34] But that's a small amount of time. It's a relatively long bet, but it's not a binary choice here either. You make the 10 to 15%. Well, you don't because there is a whole scale or spectrum of profitability or potential profit between there and where you got in. Now, of course, having a good sense of direction is going to make a difference.

[00:06:02] However, if you're close enough to your, those short strikes and even outside of the wing of the butterfly, you can still make profit SIM simply from being inside of the feta envelope or the premium envelope that is rising now to a lot of people. You know, what I'm saying is going to sound kind of Greek to them.

[00:06:26] And which makes a lot of sense because I am Greek and there are Greeks involved, in the calculation of these things and understanding of them. But it's not necessary that you understand Greeks to any great extent. It's really the methodology that you're interested in. If you can place a butterfly or even a long call vertical far enough out of the money and understand what the probabilities are of you being close enough, or at least, what is the expected move and what is the probability of touch of getting near those center strikes and not so much with the vertical, but with the butterfly, because with the butterfly, you have a completely different profit curve that will aid you.

[00:07:17] Even if you don't get close to the wings of the butterfly or inside the tent of the butterfly, it is very possible for you to make two to 300% return on your risk with another out of the money butterfly without ever entering the tent of the butterfly. Now think about that. If the strike that you want to hit, let's say the wing of the butterfly is within, let's say 30 or 40% probability of you achieving being in the money with that strike.

[00:08:00] So in other words, if you're, if you have a 30 or 40% probability of profit being inside of being outside of a button.

[00:08:08] Which means that by expiration, you will land somewhere inside of the prophet tent of the butterfly. What is the probability that sometime during that trade, that you're going to be able to hit that point as well? That's a concept called probability of touch. The probability of touch of hitting that strike at some time during that trade is approximately double what it is for the, for expiring or being in the money at expiration.

[00:08:45] So if it's a 30 to 40% profit or probability of profit of that butterfly, then the probability of touch. And that's, if you get inside there, right, is double that or 60 or 65% or as high as 80%. Now think about that for a second. And then think about the profit curve that appears outside of that butterfly, if you have a high enough or enough potential profit in there, and you could be outside of that butterfly and have about a 60 to 80% probability of being close enough to that butterfly.

[00:09:27] At some point during that trade where you're going to achieve a great deal of profit because of the rising profit curve.

[00:09:36] And if it's far enough away from you from the start and you create a situation where you have very, very little risk. In other words, let's use some real numbers. Let's say that you have, a butterfly where you have a total of \$50

risk, but a potential of, and this is not unusual, potential if it's far enough out of the money, potential of \$600 of profit, right?

[00:10:02] \$50 risk, \$600 of profit.

[00:10:05] So the max you could lose is \$50. The max you can win is \$600.

[00:10:13] That's pretty big difference. Six times, 600%. However, during that trade, you'll be approximately one standard deviation away from the meat of the short strikes, which is about a 65% probability. I'm sorry, the long strikes about a 65% probability that you will reach those.

[00:10:44] That will put you in range because at that point, as the profit is rising, it will rise normally within the first I'd say four hours of the market to be able to return as much as a hundred to \$150. So, that's 200 to 150% of the risk that you're taking on.

[00:11:07] Let that sink in. So, with an average trade, you have about a 65% probability of touch within the first few hours of the execution of that trade or the entering of that trade to achieve a hundred to 150% return on your risk

[00:11:30] for most people that should be mind-blowing numbers, especially when you compare it to what is happening in other zero DTE strategies where they're trying not to go for that hundred and 50% return or that \$150 there. Their risk is exactly the opposite where it will be 600 to \$800 trying to go for that \$50.

[00:11:57] And they don't even try to go for the \$50. They usually put stops in and have rules to get out when they achieve half of that profit. So, they're really trying to go for \$25.

[00:12:09] So while you're going for \$150, they are going for \$25. Your risk is minuscule \$50. Their risk is almost 10 times as much.

[00:12:25] And the odds of achieving the same thing are almost identical.

[00:12:31] That is the power of understanding your probability of profit, your expected move and your probability of touch. And these are things that need to be calculated. It, you can, it's easy to just eyeball it. Quite frankly. It's really the methodology that is different. The understanding that you never actually have to go inside of the butterfly in order to profit.

[00:13:04] Now, sometimes you do. And when you do, it's a whole different ball game. You're not limited to that 25% profit that most others are. DTE guys get organic. And you're not limited to 150% return on your profit. You have the potential of making the full potential profit, or as much as 600 or a thousand percent return on your risk, because there will be some percentage of time where you will reach those short strikes during that trade either before expiration or at expiration.

[00:13:45] What we've found is that while putting on our trades, we will reach the, within a few percentages of the short strikes where you reach maximum profitability, about 15% of the time

[00:14:01] near expiration. So, in other words, we will achieve a pinned trade. Most people talk about pin trades with butterflies. That's where you expire near the short strikes or near the apex of the butterfly, which is like the holy grail. It's a low probability outcome, but it's still something that you can have in your repertoire and count on if you do it enough times about 10 to 15% of the time, or about one out of 10, maybe one out of eight trades.

[00:14:36] So what we're saying now is that about one out of 10, one out of eight trades, you can make 600 a thousand 1500% return on your money. All right, that in of itself is mind blowing because you could have a positive expectation with just that trade alone and only have a 30%-win rate.

[00:14:59] But in fact, we have something closer to, depending on volatility in the market, anywhere from a 55 to 90%-win rate during very low volatility times, our win rate is somewhere between 55 and 65%. We still have a positive expectation or outcome during what we call the Goldilocks zone or volatility somewhere between on the VIX between 17 and 34, our win rate increases dramatically.

[00:15:33] And that's because our probability of touch and the expected move also increased dramatically.

[00:15:41] And so then the probability that we will achieve a pinned trade goes up and the probability that we will achieve profit also goes up dramatically when we're in those higher volatility times. So, in the lowest volatility times, like we have. We are more profitable by orders of magnitude with respect to how much we use or how capital efficient we are, by an order of magnitude than other zero DTE traders.

[00:16:15] During very good times, we are at least two orders of magnitude more profitable. So that's the difference. That's the difference in the way we trade and the way other zero DTE strategists trade. It's a huge difference. Now it takes a different mindset though, and because you're going after a different problem, you're not going for what is the traditional use of a butterfly or an iron condor.

[00:16:51] In fact, we consider those uses exactly what they are, low probability events. We're going for the high probability event, which is the probability of touch. And it's extremely high probability. And by having and pushing the strategy far enough out of the money, we can control our risk so that our risk is extremely small and our probability of touch of getting it least, or on average, 150% of the risk that we take on very high.

[00:17:25] Now, imagine if you could trade with those kinds of numbers, just think of that. Now, most people, when they first come into the strategy, they start off with just one contract at a time or a minimal size position. And so, the question might be, well, why am I putting all this effort in to make 20, 30, 50 bucks?

[00:17:46] You know, for these smaller wins, these 150% wins. It's well, you're losing the point there. You're making a hundred dollars, but risking only 25 or \$50, once you get good at returning consistently \$150 using 25 or \$50, then you can start scaling up. But you're also missing the point that occasionally, not every once in a while, but a regular amount of time, you're making something better than the 150%. And for a small portion of the time, you're making something dramatically better than that.

[00:18:30] 150%.

[00:18:32] So the other point here is that the time that you lose, let's say that somewhere between 10 and 40%, your risk is always super small, always super.

[00:18:46] And so it changes the whole dynamic of the trade. It changes the dynamic of your mental state getting into the trade.

[00:18:54] There's no anxiety because that risk is extremely small. You can employ different entry strategies. What we call trenches in scale in so that you don't even have to risk the full amount that you want. So, you can go in with an even smaller risk. And then if the trade starts working in your favor, you can add onto it and then do the same thing on the other side of the trade scale out.

[00:19:23] In fact, one of our strategies is that if early on, you've gone in with say three trenches and you're at a hundred percent return, take two of them off. Let the other one ride. You still have something like a 40 to 50% chance of making an even higher profit and about a 25, maybe 20 to 25% chance of pinning the trade.

[00:19:53] So you enter with a guaranteed riskless trade with the possibility of turning it into a three, four- or five-times winner. And then even if it totally reverses, you're still profitable and you have zero anxiety. You're not setting stops. You're not biting your nails. You are completely lucid clear zero anxiety, and that produces one thing.

[00:20:24] That's very important. And that's the ability to make good decisions because you have a clear mind that is zero dash D T E trading. All right, let's see.

[00:20:39] nobody in the chat. That's okay. All right. That's about all I have to say. Uh, and, uh, again, the, um, that important point that I'm talking about is expected, move, understanding what well, here's another important thing about expected move. Some people look at expected move when they first entered the trade, and let's say it's 25 points, right?

[00:21:01] And that is measured at the time that you take the trade and what the market is pricing in, where it thinks it's going to move at expiration. So, when we get into this morning, At, um, nine 30, the expected move was approximately 24 points and the IES was at 44 37. So that would bring it to about 44 61 as the expected move.

[00:21:30] Well, it, in fact it hit 44 61 and it did that by 11:15 AM 10:45. So did that mean that it had spent it, it had shot its wad that it no longer had anything left in the tank, because it had reached its expected move. We don't expect it to move even further. No, 'cause now you can look at what the expected move is from there.

[00:22:00] And from there it might, it's probably not 24 points, but might be 20 points. So, it's a, there's a very real possibility now that you could move another 20 points higher, there's a possibility you could also move back down 20 points, but in this case, what did we do? We moved and we're about 10 points higher right now.

[00:22:21] Now right now, if I were to look at the expected move, it is approximately

[00:22:29] nine points. So here we are sitting at about 44 70, and there's a reasonable expectation that we could move down to 44, 60 or 44 80. If we move to 44 80, we are now inside the prophet tent. And I'm far enough that trade ad expiration would yield about 300 to 400% return on our risk. There were at least two other opportunities leading up to that where you could have gotten out at any time and making a hundred or anywhere from say 75 to 150% return.

[00:23:13] It was one time at about 1115, where we moved up very sharply and there was an opportunity to get out with about, 125% return. And so, since then we've been moving sideways. However, we're sitting here right now at, 2:30, we have an hour and a half left in the market. Now that's a very important idea or concept when you have expected move that just because you've moved the total expected move from where you started.

[00:23:44] It doesn't mean that there's no more gas in the tank. And so, it's a statistical probability based on volatility price and where you are at that moment in time. And how much time is.

[00:23:56] So this still time left. So, there is still expected move left in the tank. And it's the same thing with like actuary tables. So, for instance, if the average age of a man is 80 years old and he's say 20 years old, he can reasonably expect to on average live to 80 years old, what's his expectation when he gets to be 60 years old.

[00:24:26] Is it still 80? No, it's a little bit more. What happens when he's 75? Is it still 80? No, it's more, what happens when it's 80? Does that mean that he can just turn off the lights? Cause he knows that he's going to pass? No, there's his actual expectation now is about 10 years more, maybe more

[00:24:45] so it's the same in trading.

[00:24:48] So you must set your expectations correctly. You must understand where you are and what are the future possibilities. And you also have to understand what your probability of touch is, which actually works out to be about two times your probability of profit.

[00:25:10] So if you went to a trade and your probability of profit is about 30%, your actual probability of touch is something much more than that. About two times that,

[00:25:23] and that's the basis that we work on. Of course, we put a lot of other things in our favor so that when we model the butterfly, we put it in a place and

align it, align the strikes in such a way that gives us an even better probability, based on our analysis of the market structure, using volume profile.

[00:25:45] So there you go.

[00:25:46] Here we are. All right. I hope you enjoyed this conversation and or this explanation of expected move and probability of touch and how it benefits us as traders by using option strategies in a non-conventional way or not the normal way or the way most people approach strategies to use them.

[00:26:14] All right. That's all I got. Thank you very much. We'll see you Wednesday. I always have these windows hidden, trying to find the button there. It is peace to you.