



Two Outcomes Or None

About Those Binary Options

Whether you're a scalper, an intraday trader, or a longer-term trader, binary options can provide several types of trading opportunities and can work in any type of market condition. What are they and how can you trade them? Find out here.

by Gail Mercer



You have probably heard the term *binary options*, but what are they really? They're different from traditional options and if you aren't all that familiar with them, now's your chance to get to know them better. Before jumping into all the different opportunities they provide, I'll start with a review of what binary options are.

WHAT ARE THEY?

While there are three binary options providers (Canton LP, CME, and Nadex) that are designated by the Commodity Futures Trading Commission (CFTC) as contract markets in the US, in this article, I'll use the Nadex binary options since they offer several choices when it comes to expirations and markets (futures, commodities, and forex markets).

Binary options are short-term expiration contracts that provide a limited risk and limited payout environment for traders. The maximum payout on any binary option is \$100. Risk is always limited to the price paid on entry. If the binary option indicative price expires in-the-money (ITM), the full payout is received (\$100). The actual profit is \$100 minus price paid on entry.

OPTIONS

The binary option consists of a strike statement that shows the following:

- instrument
- price statement
- expiration date and time.

The binary option ladder chart in Figure 1 identifies the following information:

- Point A—Instrument and expiration time
- Point B—Strikes closest to price for the specified time period (6 am–8 am EST). On the GBPUSD, there are always nine strikes offered for the two-hour expiration
- Point C—Indicative price, which is used as the expiration
- Point D—Date and time axis.



FIGURE 1: BINARY OPTION LADDER, GBPUSD. On this binary option ladder chart of the GBPUSD, you see the instrument, price statement, expiration date, and expiration time.

CHOOSING RISK LEVELS

A trader with a bias to the upside on the GBPUSD believes the binary option statement will be *true* at expiration. If the trader believes the statement will be true at expiration, then he clicks on the blue button to buy. The risk is limited to the price identified on the blue button (unless the trader modifies the price using a limit order).

Using Figure 1, the long opportunities with risk and profit potential are:

- The > 1.2618 strike is the deep ITM (DITM) option, as price is trading at least two strikes above this level. The risk is \$85 with a profit potential of \$15 (\$100 minus \$85).
- The > 1.2628 strike is the ITM option, as price is trading at least one strike above this strike. The risk is \$71.75 and the profit potential is \$28.25 (\$100 minus \$71.75).
- The > 1.2638 strike is the at-the-money (ATM) option, as price is currently trading at this level. The risk is \$55.50 strike and the profit potential is \$44.50 (\$100 minus \$55.50).
- The > 1.2648 strike is the out-of-the-money (OTM) option, as price is currently trading below this strike level. The risk on this option is \$38.75 and the profit potential is \$61.25 (\$100 minus \$38.75).
- The > 1.2658 strike (also OTM). The risk is limited to \$24.50 and the profit potential is \$75.50 (\$100 minus \$24.50).

A trader with a bias to the downside on the GBPUSD believes that the binary option statement will be *false* at expiration. If

the trader believes the statement will be false at expiration, then he clicks on the red button to sell. The risk is limited to the maximum payout minus the price shown on the red button (unless the trader modifies the price using a limit order).

Using the earlier example, the binary short opportunities are:

- The > 1.2658 strike is considered DITM because price is trading at least two strikes under it. Risk is limited to \$82.00 (\$100 minus \$18.00). The profit potential would be \$18.00.
- The > 1.2648 strike is considered ITM because price is trading at least one strike under it. Risk is limited to \$67.75 (\$100 minus \$32.25). The profit potential would be \$32.25.
- The > 1.2638 strike is the ATM because price is currently trading at this strike level. Risk is limited to \$51.00 (\$100 minus \$49.00). The profit potential would be \$49.00.
- The > 1.2628 strike is the OTM because price is trading above this strike level. Risk is limited to \$34.75 (\$100 minus \$65.25). The profit potential would be \$65.25.
- The > 1.2618 strike (also OTM). Risk \$21.25 (\$100 minus \$78.75). The profit potential would be \$78.75.

When trading binary options, traders can never lose more than what they paid on entry.



In addition, because there are several expirations available at any given time, the trader could also have chosen additional two-hour binaries, as well as daily expiration, since Nadex offers multiple daily expirations on the forex pairs. For example, there is also a 7 am, 11 am, 3 pm, 7 pm, and 11 pm daily expiration, providing traders with even more opportunities.

TECHNICAL ANALYSIS AND BINARY OPTIONS

Technical analysis in the simplest of terms is a mathematical approach to creating visual tools for forecasting the direction of prices using historical data points. It is this forecasting ability of technical analysis, combined with the power of limiting risk, that makes binary options ideal for technical analysts. Take the case of divergences between indicator and price as an example.

The chart of the GBPUSD in Figure 2 indicates that a position to the upside was more likely because as price was making lower lows, the slow stochastic was making higher lows—also known as divergence. Plus, the close of the price was greater than the open, providing further confirmation that the market would likely go up.

When trading leverage accounts, traders hesitate to enter these types of trades because the trade is going against the trend (known as countertrend trading). If price were to spike down, then the trader could lose more than he anticipated as price could jump over the stop price, which is why margins are required. However, that cannot happen with binary options and therefore, margins are not required. Remember, when trading binary options, traders can never lose more than what



FIGURE 2: DIVERGENCES BETWEEN INDICATOR AND PRICE. When you look at this chart of the GBPUSD with the slow stochastic indicator, you see that price was making lower lows while the slow stochastic was making higher highs. This divergence indicates that an upside move is likely and you could take a position that supports an upside price movement.

they paid on entry.

In this case, if the trader entered the five long positions described earlier using only the two-hour binary options from 6 am–8 am and trading only one contract each, the results would be what you see in the table in Figure 3.

Of course, the trader could have entered a single binary option or any multiple of the binary options you see in Figure 3 plus any of the daily or weekly options that were offered at the time.

Binary options are also great for trending markets because the trader can simply build positions throughout the day, using different option strikes as well as weekly expirations that end on Friday. And if markets are moving sideways, traders can limit their trades to either ITM or ATM strikes.

LEAN TOWARD SIMPLE

When trading binary options, keep these two points in mind:

- For long positions, the indicative price needs to expire one tick greater than the strike price.
- For short positions, the indicative price needs to expire equal to or less than the strike price.

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Strike (GBPUSD)	Risk (\$)	Gross Profit (\$)	Exchange Fee (\$)	Net Profit (\$)	ROI (%)
1.2618	85.00	15.00	1.80	13.20	16
1.2628	71.75	28.25	1.80	26.45	37
1.2638	55.50	44.50	1.80	42.70	77
1.2648	38.75	61.25	1.80	59.45	153
1.2658	24.50	75.50	1.80	73.70	300
totals	275.50	224.50	9.00	215.50	78*

FIGURE 3: TRADING THE TWO-HOUR BINARY OPTIONS FROM 6 AM–8 AM. Here you see the results of trading five long positions, one contract each. *Total ROI% is based on total net profit/total risk.

FURTHER READING

Mercer, Gail [2016]. “Choosing A Binary Option Provider,” *Technical Analysis of STOCKS & COMMODITIES*, Volume 34: November.

‡NADEX

†See *Traders’ Glossary* for definition

‡See *Editorial Resource Index*

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