The Power of Options to Slash Your Risk and Make You Money

A Money Morning
Step-By-Step Tutorial

The Power of Options to Slash Your Risk and Make You Money

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Introduction The Power of Options

"Read the directions and directly you will
be directed in the right direction."

Lewis Carroll, *Alice in Wonderland*, 1865

If you feel like Alice, lost in Wonderland, when you start to explore options, you're not alone.

So many traders and teachers and even so-called "experts" struggle with options. It gets even uglier when they attempt to bring it down to earth for their readers.

Yet that's just what Money Map Press Publisher Mike Ward has asked me to do for you. My job in this book is to show you the beauty of options – that part will be easy – and then demonstrate how these trades work.

If anyone can do it, I can. I have written six books about options, and probably more importantly, I have been trading options myself for more than 35 years (meaning I have already made every possible mistake you can make).

Here's my promise to you.

I promise to make everything as clear I can, and to keep it as simple as possible. I'll show you how to open an options account in a matter of minutes, so you can get your options trading career off the ground as painlessly as possible. Then I'll help you expand your vocabulary so you can talk options. Next, I will show you some easy techniques, and a few more complicated ones. You can start off paper-trading them to get the hang of it, or you can jump right in.

Finally, I'll show you how Money Map's expert editors, including Keith Fitz-Gerald, Kent Moors, Michael Robinson, Peter Krauth, Shah Gilani, Robert Hsu, Sid Riggs, and Bill Patalon, have made real money for their VIP Subscribers harnessing options.

The Power of Options… to Juice Up Your Profits

Done right, options can create a cash cow in your portfolio – often quickly, and often at considerable levels. Consider the case of tech favorite **Netflix Inc.** (NasdaqGS:NFLX).

In April 2013, shares of NFLX were trading for around $200. Say you felt pretty confident that Netflix was going to continue its meteoric rise over the next eight months.

You could go long on Netflix and buy 100 shares for $20,000. Over the next eight months, those shares would rise to a high of $380, making your shares worth $38,000. This strategy would give you a gain of about 90%. Not bad.

Or, you could have used options.

You could have bought a **December 2013 $200 call** option (a "call" is just a bet that NFLX will go up from $200 – the same thing you're doing when you buy the stock).

In April 2013, December 2013 $200 call options for Netflix were trading around $16.43. You could have bought one option for $1,643 (I'll explain why in a moment).

By December 2013, the price of that call option had risen to $177.30 – leaving you with $17,730 – a gain of over 970%. In other words, you would have made 10x more money *on the same price increase of Netflix.* You could then sell the option and pocket the difference without ever taking a share of Netflix stock. And there's more.

The Power of Options… to Manage Your Portfolio

Options are amazing, versatile tools. They can be very speculative and high-risk and give you spectacular returns. On the other end of the spectrum, they can be very conservative, produce consistent double-digit returns, and serve as tools for portfolio management.

Here's what I mean by "portfolio management." You can apply option strategies to a traditional portfolio of "long" stock positions – remember, those are stocks you own because you expect them to go up in price – to manage, reduce, and even eliminate risks.

For example, you can buy puts to play a bear market. This means you can avoid the high risks of shorting a stock (because you are "long" the puts), yet still profit from a falling market (even while everyone else sings the blues). There is just no other way to do this so safely.

Risk management has become one of the most exciting uses of options, as well as the focus of much of the huge increase in options trading in recent years. Because truly, this is a huge trend.

Don't Miss the Options Party

By now, you're probably starting to see how – and why – traders use options. You can be a part of it. All you need is some good information (you're looking at it), a

short learning curve, and a sense of where the market is heading.

The option market is not as isolated as you might think, nor is it some exclusive club for the experienced high-risk trader. Options have become mainstream.

To get an idea of how the market has grown since its beginnings in the early 1970s, take a look at this table.

OPTION TRADING VOLUME OVER THE YEARS	
Year	**Number of Contracts Traded**
1973 (first year options were available)	1,100,000
1980 (first time over 100 million)	109,400,000
1999 (first time over 500 million)	507,900,000
2005 (over one billion per year)	1,500,000,000
2012 (most recent data)	4,000,000,000
Source: Chicago Board Options Exchange, 2012 CBOE Market Statistics	

The Rise of Option Trading

There are a number of forces behind the surge in option trading in recent decades:

- Greater knowledge among traders. Sure, some people are stuck in the past, but generally speaking, today's traders are more informed, more open to a range of strategies and portfolio management possibilities.
- Broader education of individual investors, too. A guy sitting in front of his desktop computer, or even his iPad, has just as much access to the market as anyone else. One of the great advantages of the Internet has been the vast growth of free education, not just about options, but about the market as a whole.
- Increased market volatility. The volatile markets of the past few years have scared many investors completely out of the market. They park their cash in low-yielding (but "safe") accounts in their bank or brokerage house. They might buy bonds or shares of conservative mutual funds, or limit their stock investments to a few trusted companies. But consider what has happened recently to some of the "safest" companies, like General Motors or Eastman Kodak. Options are a smart way to hedge not only a portfolio, but to hedge risk itself.

Today, options are being traded on hundreds of stocks, ETFs, and indices. No longer are they viewed as exotic, high-risk, and impossible to understand. And there is no reason that you should not be grabbing your share of those profits.

In the pioneer days of options, back in 1973, you could buy a call option on one of 16 publicly traded companies. Puts – the other side of the coin; a bet that a stock will fall – weren't available at all.

I remember my first exposure to options, in the late 1970s. I was working in San Francisco as an accountant, and one of my friends told me I should sell options. He explained it like this:

> "You own 100 shares and you sell a call. You get the money right away and you keep it no matter what. It could get exercised and your stock sold, but most of the time the call expires. Then you can sell another one."

This, in a nutshell, is how "covered call writing" works, and to this day it remains one of the most popular – and profitable – strategies. But when I first heard about it, I wasn't buying it.

So you can sell something, get the money, and wait for it to expire; then do it again? How could you sell something you didn't own? That's exactly where a lot of investors find themselves when they first hear about options. It's a journey from there to a full understanding. But the journey isn't as long or as difficult as you might think.

Of course, some people are too close-minded to take the leap and try something new, no matter how powerful a tool. That's their loss.

With the help of our experts to guide you through the option maze, you could easily find yourself trading options – and making money – very soon. Read on. I am going to walk you through the basics of option trading. (And we'll leave the White Rabbit behind.)

Chapter 1 Getting Started

"Skewered through and through with office pens, and bound hand and foot with red tape."

- Charles Dickens, *David Copperfield,* 1850

Here it is. The most important piece of advice I have for anyone thinking about trading options.

Don't let the red tape hold you back.

A lot of experienced and sophisticated investors shy away from anything that involves paperwork. They think they're not qualified or not ready, or simply that it's not worth the trouble. Don't be one of them.

Yes, you will have to fill out an options application with your broker, but it's easy. You had to file a similar form just to open a trading account in the first place. Now, if you want to upgrade your account to "options approved," it's just a small step away.

The application may look intimidating at first glance. It is full of disclosures and legal qualifications. Yet the purpose is simple enough. Your broker just wants you to state that you know enough about options to make your own trading decisions.

And not to worry… It's not a quiz.

The disclosures will gauge your level of experience, but their real goal is to let the brokerage firm off the hook in case things go terribly wrong. (Of course, that's not going to happen to you.) If a broker lets anyone trade without at least appearing to check them out first, they could be liable for your losses. And no one wants that.

Because options are by definition speculative, the New York Stock Exchange (NYSE), Financial Industry Regulatory Authority (FINRA), and National Association of Securities Dealers (NASD) all have rules and policies about "suitability." That's the real reason you have to go through this (very small) hoop.

So you'll fill out the application… they'll file it away into the "just in case" drawer… and everyone's happy.

What's on the Application

The option application will ask some questions you would expect: name, address, employment and employer name, annual income and all sources of income. They also want to know your net worth and liquid net worth; marital status; and number of dependents.

Then there are a few questions you might not expect.

Like questions about your "affiliations." Are you a member of a stock exchange, or do you hold 10% or more in stock of any publicly traded companies? Most likely not. You will also be asked to identify both your stock trading and option trading experience: knowledge level, number of years actively trading, average number of trades per year, and the average dollar amount of trades.

So the application has a few surprises, but nothing difficult to complete.

The biggest time-consumer is the pages of disclosures and qualifiers, about option trading risks, margin accounts, and financing disclosures – all of which you are required to acknowledge and sign off on.

Getting Options Approved

Here's a pretty standard example of what you'll have to agree to:

I, JOHN SMITH, (SSN ***-**-****) hereby apply for an Option Account and agree to abide by the rules of the listed options exchanges and the Options Clearing Corporation and will not violate current position and exercise limits.

I have read, am aware of, and accept the provisions on Option Trading in the sections entitled Option Trading in the Client Agreement and Online Disclaimer (Options Account Agreement) that will govern my option account, and agree to be bound by them as currently in effect and as amended from time to time.

I acknowledge that I have been furnished and have received the document Characteristics and Risks of Standardized Options. I am aware of the risks in options trading, and represent that I am financially able to bear such risks and withstand options-trading losses.

Source: TD Ameritrade

Once you send in the application, the brokerage reviews it and assigns you to an "options approval" level. The level defines your ability to take risks based on knowledge levels and experience. While terminology varies among brokerage firms, there are always four levels:

Level 0 – At this basic level, you are not allowed to do very much. You can write covered calls and protective puts, and not much more.

Level 1 – You can do everything in level 0, plus buy calls or puts and open long straddles and strangles.

Level 2 – Now you're getting somewhere! Here you can do everything in the previous two levels, plus open long spreads and long-side ratio spreads. (And no, there is no VIP lounge or mileage bonus for getting to this level.)

Level 3 – This is for the big dogs. At this level, you can enter into just about any kind of options positions. This includes all of the other level trades, plus uncovered options, short straddles and strangles, and uncovered ratio spreads.

Your broker is going to assign a level to your options account based on what you say on the application, and (although they don't tell you this) based on the amount of cash you put into your account when you open it. You need at least $5,000 to trade on "margin" (and option trading requires a margin account), and the more you start out with, the better your chances for landing in the higher levels.

Remember, this is all designed to cover the brokerage risks of letting you trade options. The higher the level, the higher your risks. But remember, the higher your level, the higher *their* risks – especially if you lose a lot of money and then hire a lawyer to sue, claiming you didn't know what you were doing.

Now, is your brokerage firm actually going to investigate your claims about knowledge and experience levels? Probably not. But again, they want you to fill out the form so they cannot be held responsible, just in case your lawyer later tries to claim you were allowed to trade above your experience level. Should it ever go to trial, the application is potentially your broker's "Exhibit A:" It is designed to make sure they don't lose that lawsuit.

So, just like that, we're ready to trade options.

Let's start by nailing down a few simple concepts.

Chapter 2 Vocab and Definitions

"Ours is the age of substitutes; instead of language, we have jargon; instead of principles, slogans; instead of genuine ideas, bright ideas."

- Eric Bentley, *The Dramatic Event*, 1954

The hardest part of learning options is getting used to the language. Once you nail that, you're most of the way there.

Here are the terms you are going to need to learn to understand and use options. Keep in mind that the best way to master jargon is by applying it in real situations. I've broken down the jargon into four groups. Let's jump right in with…

Vocab Group No. 1: Standardized terms

These are the key fixed ingredients of an option – fixed, meaning they never change. They tell us what the option stands for and what it is worth.

An option ***type*** refers to the kind of option. Lucky for us, there are only two kinds.

A ***call*** is a contract that gives its owner the right to buy 100 shares of stock at a fixed price (known in advance). A ***put*** is just the opposite, and completes the transaction. It's a contract giving its owner the right to sell 100 shares of stock.

These concepts are the keys to exactly what an option is. The option is a contract granting you as buyer control over 100 shares of stock. This is always the case – one option per 100 shares. So when you buy a call, one major benefit is that you *control* 100 shares. This means that:

a. You can exercise the call and buy 100 shares at a fixed price per share (though you would only do this when the current market price was higher than the fixed strike; it makes no sense to pay full price when you don't have to); or

b. You can sell the call and take a profit (the profit comes into the picture when the stock rises, making the option more valuable, too).

A put gains in value when the stock price *falls*. You still have control over 100 shares, but in a different way. When you own a put:

a. You can exercise the put and *sell* 100 shares at a fixed price per share.

b. You can sell the put and take a profit (the profit is there if the stock price falls, making the option more valuable).

Once you get "call" and "put" straight in your mind, you're most of the way there.

Every option controls 100 shares of a specific stock, index, or fund. This is called the ***underlying security***. It cannot be changed during the lifetime of the option, and options are not transferable. By the way, we in the biz often just call this asset the "underlying," so be ready to hear that.

Every option has an ***expiration date***. That is the third Saturday of the expiration month, but the day before (the third Friday) is the last trading day, since the markets are closed on Saturdays. After the expiration date, the option no longer exists.

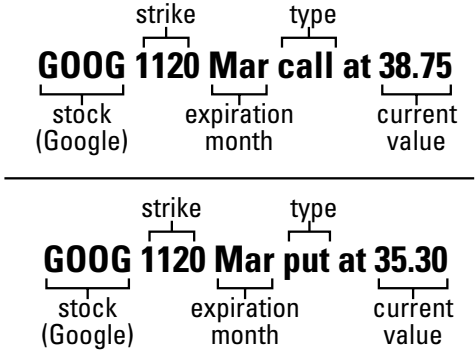
Finally, there is the ***strike price***, which is the fixed price per share of the underlying. If an option's owner decides to "exercise" (meaning she decides to buy 100 shares through a call, or to sell 100 shares through a put), the strike is the fixed price.

These four standardized terms define each and every option and, collectively, set them apart from one another. Again, none of the terms can be changed or transferred. If you have an open options position and you want to make a change, you need to close it and replace it with a different option.

All four defining terms are expressed in every option listing.

Take a look at this next figure showing the collective terms for a call and a put on **Google Inc.** (NasdaqGS:GOOG). The values were based on closing prices of the stock and options as of January 13, 2014. Note that all of the terms are highlighted: type (call or put), underlying security (Google), expiration date

(February 2014), and strike (1120). The listing also summarizes the current value for each option. Here, the call's value was 38.75 ($3,875, because it controls 100 shares of GOOG), and the put was valued at 35.30 ($3,530).



Vocab Group No. 2: Actions and status terms

These next terms describe how options act, as well as how they change in value, based on the distance between the current price of the underlying, and the fixed strike price of the option.

Let's start with the ***premium*** you will pay (if you buy the option) or receive as a credit in your account (if you sell it). Three attributes determine the price of the premium:

1. The distance between the strike price of the option and current price of the underlying security;

2. The amount of time until expiration; and

3. The level of volatility in the underlying security. The greater the volatility, the higher the risk, and the higher the option's premium.

Options are subject to exercise – remember that word? – meaning the owner has the right, at any time before expiration, to buy (through exercise of a call) or to sell 100 shares (through exercise of a put). The owner will buy only if the underlying security's current value is higher than the strike of the call, or sell only if it is lower than the strike of the put.

By exercising the call, the owner buys 100 shares below market value; by exercising a put, the owner sells 100 shares above current market value. If the stock's price is lower than the call strike or higher than the put strike, there is no risk of exercise. It just wouldn't make sense to pay more for a security than market or to sell it for less.

In Practice: How Trading Options Works

Buying and selling options on a stock is not the same as buying or selling shares of the stock itself (though how the stock price moves will certainly affect you).

If you exercise an option, you get the right to buy (call) 100 shares or sell (put) 100 shares. But you can also buy and sell the options and make money from changes in their value.

When you buy a call or a put, you enter a ***buy to open*** order. You have to specify that it is a buy order, whether it is a call or a put, the underlying stock, strike price, and expiration date – all of the standardized terms. Once the order has been executed, money is taken out of your account to pay for the option.

At some point before expiration, you either exercise the option (meaning buy 100 shares by exercising a call, or sell 100 shares by exercising a put); or you can sell the option. The value of every option declines due to time decay, and as expiration approaches, time decay accelerates. Offsetting this, options gain value if the stock prices in the desired direction. If you own a call, you hope the price of the underlying will rise. If you own a put, you want it to fall.

When you sell the option, you enter a ***sell to close*** order, and proceeds are then placed into your account. If you are able to sell for a price higher than your original purchase price, you make money; if it is less, the net "round trip" (buy and sell) results in a net loss.

This gets more interesting when you sell, or "write," an option.

In this case, your opening move is to enter a ***sell to open*** order. You specify the terms, and when the option sale is executed, funds are placed in your account. If the stock price moves up (if you sell a call) or down (if you sell a put), you can lose money. So you want the price to fall if you sell a call, or rise if you sell a put. Funds are placed into your account and the money is there for you to take out, spend, or reinvest. It's real money and it's yours, at least for the moment.

The short position can expire, in which case all the money you got is 100% profit. Or you can close the option by entering a ***buy to close*** order. When this is executed, money is taken out of your account. If the original sales price was higher, the round trip yields a net profit. But if your closing buy price is higher, the net difference produces a net loss.

Exercise can also occur automatically, but only on the last trading day before expiration. On that Friday, the Options Clearing Corporation (OCC) automatically exercises all calls when strike is below current value of the underlying, and automatically exercises all puts when strike is above current market value of the underlying.

This condition – with the call strike below current value of the underlying, or the put strike above – is referred to as ***in the money (ITM)***. This distinction is of great interest to anyone who has shorted options, because with the status of being ITM comes the risk of exercise, which can occur at any time. It is also a key attribute of owning options. When an option is in the money, the premium will move point for point with changes in the underlying security.

When the current value of the underlying is below the call's strike (or above the put's strike), its status is ***out of the money (OTM)***. In this condition, there is no immediate risk of exercise and the option premium will be less responsive to movement in the underlying. The degree of change relies on the same three factors.

One final definition (and it'll make perfect sense to you now):

When the current value of the underlying and the option's strike are identical, the option is ***at the money (ATM)***. While this condition does not usually last long, it is a benchmark for identifying how value changes. Comparisons of option premiums often are based on assumed value when ATM.

Vocab Group No. 3: Valuation

Remember, the option's premium is based on the proximity between strike and current value of the underlying; the time remaining to expiration; and volatility (another word for market risk). These next terms are really just another, more detailed, way of saying that…

An option's premium consists of three parts:

Intrinsic value is the part of option premium equal to the points "in the money."

For example, if a 35 call is valued at 5 ($500) and the current price per share of the underlying is $37, then the call is two points in the money (37 - 35). So the call has two points of intrinsic value (and three points are something else).

For a put, the same rule applies – just in the opposite direction. Let's say a 40 put is valued at 3 ($300), and the current price per share is $38. The put is two points in the money, so there are two points of intrinsic value included in the premium. (The remaining point, again, is a different kind of value.) If an option is at the money or out of the money, it contains no intrinsic value.

Next up is the ***time value*** of the option premium.

Now, a lot of people consider time value as comprising the entire option premium except intrinsic value. But that's not quite true. Strictly speaking, "time value" relates solely to the degree of an option's premium based on time remaining until expiration. Time value is very predictable. The longer the time remaining until expiration, the higher the time value. The closer expiration gets, the more rapidly time value falls (this is called time decay). At the point of expiration, time value has fallen to zero.

As you can see, both intrinsic and time value are extremely predictable; they can be estimated based on price proximity and the date. The third portion of an option's premium is where all of the uncertainty resides.

Extrinsic value – also called an option's "implied volatility" – varies based on proximity, time, momentum in the underlying, and the underlying security's own volatility (its historical volatility). It's complex to calculate, but extrinsic value is easy to observe. You just look at the entire option premium, minus intrinsic value, leaves time and extrinsic value. Time value can be estimated based on time remaining, and whatever is left over is extrinsic.

You can make some generalizations about extrinsic value. For example:

1. When expiration is a long way off, the overall option premium tends to be less responsive, even when in the money. Here's how that looks. If the option is in the money, the stock might make a three-point move, but the option premium might only move one point. In this situation, intrinsic value increases three points, but extrinsic value declines as an offset by two points. That's because expiration is a long way off, so there's more uncertainty about what the price might do.

2. When the option strike is close to the underlying equity's current price, extrinsic value tends to be less of a factor (assuming there is no change in the underlying's volatility). So the price will be more likely to follow the point-for-point movement in the money. That's especially the case as we near expiration.

3. The confusion between time and extrinsic value has led some analysts to assign characteristics to time value that are not accurate. All of the uncertainty in an option's current and future value is found in extrinsic value. Changes in value assigned to intrinsic and time value are well known and easily predicted.

Alright, now let's move on to the really good stuff: profits.

Vocab Group No. 4: Returns

The last set of definitions relates to how you calculate net returns on option trades. It's more complex than for regular trades, because you're not just subtracting your buy price from your sell price. Option returns involve the time a trade remains open, option cost or income, dividends earned, and capital gains or losses.

The first term is ***return if exercised***. This one has several components. You have to calculate the return on the option portion alone, as a percentage of the stock's value. However, you can compare the option premium to your basis in the stock, the strike price, or the value at the time of exercise. Consistency is important in comparing outcomes, so using the strike is logical; this is the price at which the stock is called away.

Some people add dividends into the calculation, but do you count the dividend as addition to premium, or annualize the quarterly cash value? The so-called "total return" that includes dividends may raise more problems and create inaccuracy.

Finally, what if the underlying stock zooms up? Obviously, the outcome is going to be vastly different if you gain 20 points than if you make only a few bucks. For accuracy, it makes the most sense to include only the option premium received, and to calculate percentage return by dividing the premium by the strike price.

A second outcome is called ***return if unchanged***. This means the underlying is not exercised, and the option is held to expiration or closed at a gain. In either case, simply divide the net profit by the strike price to get the return.

A final piece of the return puzzle is ***annualized return***.

To understand why we talk about annualized returns, consider two profit scenarios: a 6% profit during a one-month period versus 6% in a 12-month period. Personally, I'd rather have the 6% in 30 days. And I have a funny feeling you would, too.

This is for comparison only. If you're going to take responsibility for your finances, you need to be able to compare outcomes on a variety of different situations, some with open positions of a few weeks and others for several months. For this you need to calculate the return as it would have been if all positions were held for exactly one year. Caution: Don't take annualized returns as representations of what you expect to make on your options trades throughout the year.

Here's how to calculate them:

First calculate the return by dividing option profits by the strike. Then divide by the holding period (in months). Finally, multiply by 12 to get the one-year annualized return.

Holding period	Strike	Premium	Calculation
Three weeks	35	2.25	(2.25 ÷ 35) ÷ 0.75 months x 12 = 102.9%
Two Months	35	2.25	(2.25 ÷ 35) ÷ 2 months x 12 = 38.6%
Five Months	35	2.25	(2.25 ÷ 35) ÷ 5 months x 12 = 15.4%
Nine Months	35	2.25	(2.25 ÷ 35) ÷ 9 months x 12 = 8.6%
15 Months	35	2.25	(2.25 ÷ 35) ÷ 15 months x 12 = 5.1%

A quick note about calculating return on an expired covered call, because it's not as simple as with most other trades. The entire premium was profit, so you could say it works out to 100% profit. But that's not really accurate: after all, you are committing yourself to the chance of exercise at the strike price. So it's more accurate to calculate the return from an expired covered call based on its exercise price.

Chapter 3 How to Read an Options Listings

"If ignorance paid dividends, most Americans could make a fortune out of what they don't know about economics."

- Luther Hodges, in *The Wall Street Journal*, March 14, 1962

Ahh, the options listing… Trust me, it isn't as bad as it looks.

You've already run across a rather long set of symbols that looks something like this:

GOOG140621C00515000

This code is simply the ticker symbol for your option. And once you break it down, you'll find that it holds a wealth of information, including all the "standardized" terms we just talked about. The first three or four letters are just the stock ticker for the specific underlying stock, in this case, **Google Inc.** (NasdaqGS:GOOG):

GOOG140621C00515000

The next two digits tell you the year the option expires. This is necessary because long-term options last as far out as 30 months, so you may need to know what year is in play. In this case, the Google option is a 2014 contract:

GOOG**14**0621C00515000

The next four digits reveal the month and the standard expiration date. The expiration date does not vary; it's always the third Saturday of the month. And the last trading day is always the last trading day before that Saturday, usually the

third Friday (unless you run up against a holiday). In this case, you've got a June contract (06). And the third Saturday of June 2014 is the 21st.

GOOG14**0621**C00515000

Now you'll see either a C or a P, to tell you what kind of option you're dealing with – a call or a put. This one happens to be a call:

GOOG140621**C**00515000

After that comes the fixed strike price, which is 515:

GOOG140621C**00515**000

Finally, any fractional portion of the strike is shown at the end. This comes up only as the result of a stock split, where a previous strike is broken down to become a strike not divisible by 100:

GOOG140621C00515**000**

Now that you're a pro, let's take it a step further.

Reading the Options Table

The numbers part doesn't have to be painful or tedious. In fact, when "real money" (translation: your hard-earned cash) is at stake, I think you'll find this data is suddenly much more interesting.

An options listing gives you the status of the four standardized terms you already know: type of option, expiration, strike, and the underlying security.

The listing is set up for all of these criteria, and then also provides the two current prices for each strike – the bid and the ask. Why two prices? Well, the bid is the price at which you can sell an option, and the ask is what you'll pay to buy it. And the difference between the prices – the bid-ask spread – is the profit for the "market maker" who places the trades.

Now let's look at a typical options listing.

SPDR S&P 500 ETF (SPY)

current price per share $135.11

expiration date Feb 18, 2012

strikes	**option type**			
	calls		puts	
	bid	ask	bid	ask
133	2.65	2.61	0.53	0.54
134	1.89	1.91	0.78	0.80
135	1.25	1.26	1.14	1.15
136	0.75	0.76	1.63	1.64
137	0.39	0.40	2.27	2.29

premium

This one is for options on the **SPDR S&P 500 ETF** (NYSEArca:SPY), with the expiration date and five different strike prices. After that date, all of the options will expire worthless, so you have to take action (closing a position, exercising, or for short sellers, being exercised) by the last trading day of the period (the Friday right before the listed dates). After that, the options contract is over, and the "option" to act simply ceases to exist.

The strikes for this example range from 181 to 185.

By the way, this ETF is an example of a very flexible option trading venue, because strikes are found in one-point increments. In comparison, stocks selling in this price range usually provide strikes in 10-point increments, so you would only be able to choose from strikes of 170 or 180 or 190. That gives you much less flexibility for any combination strategies (spreads or straddles).

Okay, so as you can see, the four columns are broken down into two main parts. The first two are the bid and ask prices for calls, and the second two are bid and ask for puts.

Notice how the prices move. For calls, the lower the strike, the higher the premium. This is because, remember, a call is a bet that the price will go up; a lower strike, closer to the current price, is more probable, so you have to pay more for it (or you get more, if you're selling). Below the current price of the ETF ($135.11 per share as I write this), the calls are "in the money" (ITM); and above, they are "out of the money" (OTM). The further in the money, the richer the option premium.

You see the opposite price movement in the puts. The higher the strike, the larger the premium – and for the same reason. Remember, puts are ITM when the strike is higher than the current price per share. The *more* in the money, the higher the premium.

Don't Let a Different Format Throw You Off

You may see option listings are set up in a few different formats. Don't let it throw you. They all provide the same information.

For example, the Chicago Board of Options Exchange (CBOE) lists all available options in one series. If you want more detail, you need to go to the next page. Check out http://www.cboe.com/DelayedQuote/DQBeta.aspx to see how it looks.

Most brokerage firms list in a format closer to the one on page 17. Charles Schwab provides an option summary page highlighting the most popular options for each underlying; you can go to a more detailed page, where you can pick a range of strikes and expirations for review. You can also link directly to the trading page to place orders. This is typical of online brokerage listings.

The later expirations are all more valuable than the earlier ones, even though the strikes are the same. That's thanks to – you guessed it – time value. One additional month is in play. There's more time value left, and more likelihood of some crazy price swing, so the premium is higher.

There's a trade-off, of course.

Later expirations means you have to leave those positions open longer. So the desirability of a higher premium depends on whether you take up a long position or a short one.

Long positions are more expensive when you have more time to expiration. At the same time, this provides more chance for the underlying to move in the desired direction. So picking a long position is a balancing act between time and cost.

Short positions, on the other hand, benefit from time decay. When you sell an option, you receive the premium and wait out the time decay. Depending on whether the option is ITM or OTM, you can let it expire, close it out with a "buy to close" order, or roll it forward. (More on that soon.)

And that's all! See, I told you it wasn't that complicated.

Chapter 4 Basic Strategies

"Investors want to believe. Always looking for a better way, a chance to gain an advantage in the market, they are particularly susceptible to arguments that use statistics."

- Mark A. Johnson, *The Random Walk and Beyond,* 1988

There are hundreds of option strategies. And they can be vastly different in terms of tactics and desired outcome. Covered calls are very conservative, for example, while uncovered or "naked" calls are high-risk. How you select them depends on your risk tolerance and comfort level with different degrees of exposure.

But in fact, there are really only a few basic strategies, and everything else is built on these in some form.

At Money Map Press, we use eight general strategies (and "families" of strategies). These will cover most of the approaches you are likely to see and to take in your own trading. And in the next chapter, I'll walk you through a real-life example of each one – how our Money Map experts made real money for real subscribers with options plays.

But I do want to mention something first.

This same huge range of possible strategic designs is what makes the options market so interesting, challenging, profitable… and also nice and risky.

Are you surprised by my characterization of risk as "nice?" Well, "risk" and "opportunity" are really the same thing, and every option trader needs to accept this. If you want to go fast and get some serious movement, well, you have to climb on board the rollercoaster first, even if it scares you a little bit.

Okay, here we go.

1. Long calls

The long call is a cinch. You simply buy a call – often for as little as 5% of the value of the 100 shares it controls. You wait for the underlying to rise in value, which is what you're betting on. And then you either sell the call (at a profit) or exercise.

Now, as attractive as the long call may be at first glance, it is not easy to make money consistently. It's a matter of time, timing, and proximity, and almost never a matter of price only.

Let me explain that.

Time describes the endless dilemma of the long call trade. You want to find the cheapest long call you can, knowing that you need to build profits, not just above the strike, but far enough above to cover your cost, too. So the more expensive the call, the further the price needs to move. At the same time, focusing on cheap calls will leave you with very little time for the call to appreciate.

Timing is the key to creating profitability in long call positions. If you are going to pick calls at random, you'll lose more often than you'll win. But if you know how to time your trade, your odds of profiting go way up. All stocks, ETFs, and indexes go through predictable cycles. The time to buy calls is right when the underlying is at the bottom of a cycle. This is where the chances of reversal and upward movement are highest, whether you seek a five-day turnaround or a two-month turnaround. Whatever your timeframe, timing is key.

Proximity is the third decision point in picking a long call. The distance between the price of the underlying and the option's strike is what determines not only current premium price, but how responsive that price is going to be to movement in the underlying. When the two are far apart, you cannot expect a lot of point-for-point reaction, even in the money. The extrinsic value (implied volatility) will dampen reaction due to the distance.

In other words, the further away from the strike, the less the underlying price matters in terms of option premium. This is especially true for deep OTM options. The way the market prices options, the less chance that price will catch up to strike, the less faith there is in even strong price movement.

ATM options tend to be far more responsive to underlying price movement. That's because the chance of the call moving into the money is quite high. And once it is in the money, you do get that point-for-point intrinsic reaction (even though, for options with a lot of time to expiration, you are going to experience some offsetting changes in premium; the more time left, the more unknown changes can occur, and this is factored into the proximity play).

With any option position, but especially going long, you need to set goals for when to exit the position. Your goals should include knowing when to take profits, as well as when to cut losses. Without goals, you have no exact idea when or how to get out of a position even when it becomes profitable.

Going Long and Going Short

The traditional (and best-known) sequence of trades is buy-hold-sell.

This sequence is known as the long position. I'm sure you've done it yourself. As long as the position is open, you own the security – whether stock, option, index, fund, or any other product. When it comes to long options, though, about three out of four expire worthless, so they're no slam-dunk.

Less familiar, but of great interest in option trading, is the short position.

In this opposite format, the sequence is sell-hold-buy. By going short, you expose yourself to a different set of risks, specifically the risk of "exercise." However, when you sell options, you receive the premium rather than paying it.

2. Long puts

Just like the long call, trading long puts involves the three issues of time, timing, and proximity. The only difference is, it's a play on the underlying falling in value. Buying puts (being "long" puts) at the top of the cyclical swing – even a very short-term one – improves timing and presents opportunities to take profits, often in only a matter of days. (See Chapter 6 for more on how short-term "swing" traders can benefit from the use of options.)

3. Short covered calls

The ***covered call*** is one of the most popular strategies – the "rock star" of options.

Now, it may be a rock star, but it is generally thought of as a conservative strategy. That's because, when properly designed, a covered call generates profits no matter how the stock price moves.

(Are you starting to see the beauty of options?)

It consists of owning 100 shares and selling (being "short") one call against those shares. It's for a trader who believes the stock price will go down. The position is "covered" in the sense that, if the call is exercised, the stock is called away, but you don't lose (even though the stock's value will be higher than the strike). The idea is that the assurance of known profits from the covered call is worth the occasional lost opportunity.

You have to be cautious in how you set up the covered call to make sure that you "program" net gains no matter what.

Here's the idea: With the covered call, you create a "cushion" with the premium you receive, so that your breakeven is below your original cost per share. For example, if you sell a call and get three points, that moves your breakeven down to three points below your cost. That is the initial benefit to selling covered calls. But it does not address the larger market risk of having long stock. If the price falls below your strike, you lose. The short call is not a culprit in this scenario; in fact, the call reduces your exposure. But it does not eliminate the market risk, and that's the point I want you to keep in mind.

On the upside, you face a different risk – that the underlying price could move well above the strike, meaning the call will be exercised, and your shares called away at the strike. Since the market price would be higher at this point, it creates a loss – the difference between the fixed strike and the underlying current value. Is this potential loss acceptable to you, or not? If not, then you should not write covered calls. But realistically, it's unusual for the underlying price to soar so far above the strike. Most of the time, the short call is going to expire worthless, or can be closed at a profit, or can be rolled forward. Yet even if none of these can occur, you can exercise the call at any time before expiration.

To ensure the greatest success in writing covered calls, follow these guidelines:

1. **Focus on very short-term contracts.** Returns on short-term calls are better than on longer-term ones, because time value declines at an accelerated rate. If you sell covered calls that expire in one to two months, you can maximize your annualized return (we covered that term in Chapter 2). Even though you get more cash premium selling longer-term contracts, you make more in the end with short-term ones. You are better off writing six two-month calls than one 12-month short call. Another reason to avoid longer-term covered calls is that they keep you and your cash tied up that much longer. Anything can happen, but in the market, the longer you remain exposed, the greater the risk.

2. **Buy the right strikes.** The ideal short call is going to be *slightly* out of the money. This is where the premium is at its best. Far OTM calls are going to have dismal premium in comparison, especially for soon-to-expire contracts. An ITM premium will be higher, but more likely to get exercised. Slightly OTM is the way to go.

3. **Remember, exercise can happen at any time.** The most likely day of exercise is on the last trading day for any ITM option. The second most likely date is going to be on or right before the ex-dividend date. Traders exercise to become stockholder of record and get the current quarter's dividend. So if you want to avoid early exercise, stay away from covered calls on stocks with ex-dividend in the current month. Or, as long as they are ATM or ITM, you probably don't have to worry.

4. **Open profitable positions.** Pick strikes above your basis in the underlying so that you get a capital gain, and not a capital loss, when exercise occurs. This is often overlooked, but it is essential. Now, there is an exception: You can sell covered calls below your basis, so long as premium is rich enough and exceeds the loss. For example, you buy stock at $37 per share. The 40 call is not attractive, but the 35 call can be sold at 5. If the call is exercised, you will lose two points in the stock, but the net outcome is a three-point profit.

5. **Remember the underlying.** Another easily overlooked aspect of covered call selling is the stock, ETF, or index you select. You're going to find the most attractive premiums in the most *volatile* underlying. Lower premiums are symptoms of low-volatility issues. This is yet another balancing act. High-volatility underlying issues are higher-risk, so if you buy shares solely to write covered calls, you expose yourself to higher market risk – a problem that can easily offset the benefits of the covered call.

You can also "cover" a short call by offsetting it with a later-expiring long call, or with a call that expires at the same time, but at a higher strike. However, these forms of cover are difficult to make practical; the cost element net of outcomes will usually be negative.

A lot of people wonder if you can create a "covered put" in the same way as a covered call. No. Here's why: If you have shorted stock, a short put protects you to a degree, in the event the stock price rises; it's kind of like insurance. But on a practical level, a long call provides better protection because it will offset loss in the stock all the way up. A put protects you only to the extent of the premium you receive. And if the stock declines as short sellers want, the short put is at risk of exercise. So, realistically, all short puts are uncovered.

And the bigger risk is going to be found in the uncovered, or "naked" call.

When you sell a call naked (without owning 100 shares of stock), you face a bigger risk. In theory, a stock's value could rise indefinitely; but at exercise, you have to satisfy exercise at the strike price. So, for example, if you sell an uncovered 30 call, and the stock then skyrockets to $90 per share, your loss is $6,000 (minus whatever premium you got for selling the call). Of course, it's pretty unusual for stock prices to rise so dramatically. But it could happen. And therein lies the risk.

Every short put is uncovered, unless you offset it with a later-expiring long put. However, the risk is much smaller. Can you guess why?

Even in the very worst-case scenario, a stock's value cannot fall below zero. So risk is quantified as the difference between the strike and zero. Actual risk is much less, of course. The true risk to an uncovered put is the difference between the strike and tangible book value per share (again, less the premium received). Realistically, a stock is very unlikely to fall lower than its tangible book value.

The risk, in all short options, is exercise. For covered call writing, exercise can be desirable since it produces a net yield; but for other covered call writers, as well as virtually every uncovered option writer, exercise is not desirable. It can be delayed or avoided by rolling forward. (See the sidebar on page 24 for more.)

You can also take the covered call up a notch – creating even more profit in exchange for somewhat higher risks – with a ***ratio write***. This is just a covered call involving more calls than you cover with shares. For example, if you own 200 shares and sell three calls, you set up a 3:2 ratio write. The market risk is greater, but so is the premium income – by 50%. For this reason, many covered call writers like the ratio write, and accept the risk.

You can address the risk, somewhat, too. If the underlying begins moving up, you can partially close the ratio write to eliminate risk. Or you can roll forward one or more of the short positions. Given the fast decline in time value, there is a reasonable chance that the premium value of the calls is going to fall enough to wipe out the risk. Close the extra leg of the shorts and take a small profit.

An even better variety is the ***variable ratio write***. The risks with this one are very small compared to the straightforward covered call – which makes it a desirable expansion of the strategy. The "variable" portion refers to the strike. You set up the ratio, but use two different strikes.

For example, say you bought 300 shares of stock at $38 per share, and today's market value is $39. You can set up a variable ratio write by selling two 40 calls

Rolling Forward

In a roll, you close the current short position and replace it with a later-expiring new position. If you also increase the call's strike or decrease the put's strike, you achieve two benefits. You defer exercise and you also reduce the loss or increase the profit if and when exercise does occur.

Covered call writers are avid rollers. However, I want to warn you that rolling forward can sometimes be a mistake. Several reasons:

- The roll produces a profit, sure. But if you roll to a different strike and take a loss, you may be rationalizing a future net loss. So before undertaking this, a sensible step is to compare outcomes. Call writers may do best to simply accept exercise and then move on to another position.
- The roll extends the amount of time your capital is committed. The desirable short-term covered call is converted to a longer-term one, which may reduce annualized returns with little or no net reward later.
- There's a nasty little tax surprise: A forward roll can convert a qualified covered call into an unqualified one. Capital gain on the stock upon exercise could be treated as short-term, even when held for more than a year. As long as an unqualified covered call remains open, the required one-year clock is tolled. "Unqualified" usually translates to a deep ITM call. Before rolling, be sure you and your tax pro take a look at the quirks of option taxation.

The covered call and, possibly, rolling techniques, make selling options challenging and exciting. Like a naked dip in the neighbor's pool, there's always the risk of getting caught… but most options traders are willing to live on the edge just a little, so this danger is more appealing than troubling.

and two 42.50 calls. Now your premium income is increased, but your risk is not that much higher, because all of the calls are OTM. If the stock price rises to $40, you have no immediate market risk, because the higher strike is still OTM. But if the price continues to rise and approaches the $42.50 threshold, you can close or roll forward one or both of the higher-strike calls.

4. Short puts

Remember, with the call, you offset the exercise risk by owning 100 shares of underlying for each call sold. When you sell a short put, however, you cannot cover the position in the same way.

But uncovered puts are not as risky as uncovered calls. That's because the underlying price cannot fall indefinitely, though the price can rise indefinitely (at least in theory). So in the worst case, your risk with the short put is the difference between the strike price and zero. (The price can't go negative.) However, the *true* maximum risk is the difference between strike and tangible book value per share.

A couple of rules here.

First, focus on puts expiring within one month. That will help you maximize your profit potential. Time value is going to evaporate very quickly, so even if the stock price falls below the strike, you can close the short put often at a profit ITM. You can also roll forward the short put. However, the likelihood of expiring worthless is quite high, so the short put, like the covered call, is a potential cash cow.

Second, the risk here is exercise, in which case you have to buy shares at the strike, which will be above market value. So if you are going to write short puts, make sure you consider the strike a good price for the underlying; be realistic about the potential of exercise at any time; and be willing to either hold onto shares or develop a strategy for offsetting the paper loss.

5. Insurance puts

You already know how the insurance put works. You buy the long to offset possible losses in the underlying. If the price falls below the put's strike, the intrinsic value of the put rises for each point lost in the underlying. The downside, of course, is that you have to pay the premium for the put – meaning the cost of insurance reduces any potential net gain in the underlying.

With this in mind, the insurance put makes sense when a specific condition exists: The current price of the underlying is higher than your basis (and the paper profits should be higher than the cost of the put); at the same time, you do not want to sell the underlying, because you think more upside potential is likely.

For example, say you bought stock at $38 per share and the current price is $44, a paper profit of six points. You can buy a 44 put for 2. In the event you have to exercise the put, you will take a $600 profit. Subtracting the $200 cost of the put, this leaves four points of profit with the insurance put. However, if the stock's value continues to rise, you make more profit in the future and the cost of the insurance put is absorbed through higher profits in the underlying.

Again, you can always close the insurance put at a profit if the market value of the underlying declines. In this scenario, the underlying loss is offset by the put gain. It also leaves in place the potential profits if the underlying rebounds.

As an alternative, if you decide the underlying is simply too weak to keep, you can also exercise the put and sell your shares at the strike.

6. LEAPS options

This one can be an attractive alternative to the otherwise very short lifespan of most options. And the potential for gains in either long or short LEAPS trades is substantial.

The ***LEAPS***, or ***long-term equity appreciation securities*** contract, is simply a long-term option. They are available, as calls and puts, on 20 indexes and approximately 2500 equities. The life span of a LEAPS option is as long as 30 months. In the options world, that is something akin to "forever."

LEAPS provide a lot of interesting strategic possibilities. You can open long LEAPS call positions as a "contingent purchase" strategy, so 100 shares can be bought in the future; or you can buy puts as insurance or as contingent sales positions.

The big disadvantage of a long-term option is going to be the very high time value – you have to pay for the luxury of a long-term play. This is true, at least, if you buy long-term contracts. But if you sell them instead, that high time value works in your favor.

That's why my favorite way to play the LEAPS is to sell an ATM call. Your return can be significant. And the premium provides a cushion that makes LEAPS sales very desirable, especially if it's part of a long-term contingency plan. If you are willing to sell shares at a specific price at any time between now and two years from now, selling a LEAPS option brings in high current income and a desirable exposure to exercise.

Let me show you how this works.

In mid-February 2013, shares of **Google Inc.** (NasdaqGS:GOOG) were at $790. The January 2014 $790 call was trading at $65.00 – or $6,500 per contract. If you sell that call, that's an 8.2% return based on the strike, or 4.3% annualized [(8.2 ÷ 23 months) x 12 months = 4.3%)]. If you bought Google shares anywhere below $790, this is a decent return. There is also the chance that the stock price would decline below $790 over the coming 23 months. In that case, the premium value of the call would decline, and you could close your position for a profit.

Finally, I'm going to explain the basics of spreads and straddles. That's where the hedging potential of these combined strategies comes in…

7. Spreads

You enter a spread by buying and selling an equal number of calls or puts on the same underlying, but with a different strike or expiration.

Spreads come in many variations. But there are some common features, like the combined positioning of offsetting calls, puts, or both, and in configurations both above and below the current value. This price cushion makes spreads attractive on both long and short sides.

The best way to analyze spreads, and to decide which one is a good match for you, is to study "profit zones" and "loss zones."

A ***long spread*** is constructed with a long call and a long put. Of course, you will pay a premium to own both. This sets up a "loss zone" in a middle range between the two strikes, and extending above and below those strikes the number of points paid for the options. If you open a long spread, you have to expect considerable price movement before expiration.

A ***short spread*** also creates income from selling both a call and a put. Your "profit zone" is created both above the top strike and below the bottom strike, equal to the premium you get when you open the short spread. So long as the underlying market price remains in between the strikes, there is no exercise risk. Even in the event of exercise within this range, of either option, the premium income covers you. However, if the underlying price moves above or below this middle-range profit zone, then it becomes a loss zone. And the farther it moves, the greater the loss.

On short spreads, you can mitigate or defer that loss zone by either closing one of the short positions, rolling forward, or covering the short (with stock purchase in the event of the short call, or in either case with a later-expiring long option). Spreads of this type – with the same expiration but different strikes – are called ***vertical spreads***.

Horizontal spreads (also called ***calendar*** or ***time spreads***) have the same strike but different expirations, and can be either long or short. I'll give you an example of one in the next chapter.

Spreads with different expiration and different strike are called ***diagonal spreads***, and also can be either long or short.

8. Straddles

Straddles are similar to spreads, but they have the same strike and expiration. What's especially appealing about straddles is, you can profit based on how much the underlying moves – regardless of the direction of the price movement.

A ***long straddle*** will have a middle-range loss zone extending both above and below the strike by the number of points you pay for the two options. If the underlying price moves above or below this middle loss zone before expiration, your profit zone is set up. Long straddles can also be timed to take advantage of volatile price swings in the underlying.

In a ***short straddle***, the premium you get for selling the call and the put set up a profit zone extending from the strike, both above and below. The zone covers the

same number of points as the premium you received. So if your total premium was 7 and your strike was 30, your profit zone extends from the high of $37 per share, down to $23 – a range of 14 points. If the underlying closes within this range, you earn a profit. Your breakeven prices, before deducting trading costs, are $37 and $23. If the underlying price moves above $37 or below $23 by expiration, you will have a loss.

The short straddle can avoid exercise on both sides. Either side can be rolled forward if the underlying price moves too far in the money (it will always be ITM on one side or the other). It can also be closed; if time value has evaporated, even an ITM short option might be closed at a small profit. Or, as long as the price is within the profit zone, accepting exercise produces a net profit due to the combined premium income from selling the two options.

Chapter 5 Time to Cash in on the Opportunities

"Thou strong seducer, opportunity!"

- John Dryden, *The Conquest of Granada*, 1670

Now let's dig in and discuss some of the key strategies I just outlined. To help you understand how they work, I've found a real-life example of each strategy from one of our Money Map VIP Services.

Long calls

The long call is not expensive, so it is quite possible to squeeze double-digit returns out of one. Here's an example of a very successful long call.

Commodities expert Peter Krauth presented it to his *Real Asset Returns* readers in August 2013. He recommended **Market Vectors Gold Miners ETF** (NYSEArca:GDX) for a long call. Here was his reasoning:

> Yesterday, both Barrick Gold Corp. (NYSE:ABX) and Kinross Gold Corp. (NYSE:KGC) announced major write-downs on their assets. In the case of ABX, it was $8.7 billion, plus a loss of $8.6 billion in Q2, while also cutting its dividend. Kinross suspended its dividend, announced a delay in the mill expansion decision at its African Tasiast mine, and announced a large $2.5 billion loss for Q2.

> The amazing thing is, Barrick was barely down and Kinross only lost about 2.5% on these terrible earnings announcements. If the biggest players in the space hardly budge on such bad results, chances are the market's already priced in the bad news.
>
> And gold is behaving well around the $1,300 area, especially with today's bounce from the $1,282 area.

Peter advised buying **GDX Dec 2013 $28 calls** up to $1.90, with no trailing stop. The premium for the call was $1.75. A few days later, on August 12, it had risen to $2.78, and Peter recommended selling a portion of the position for the 58% gain. A few days later, the premium hit $4.21. Peter again recommended selling a portion of the position, netting a 140% gain from the entry price for his happy subscribers.

POT (Potash Corp. Saskatch, Inc) NYSE

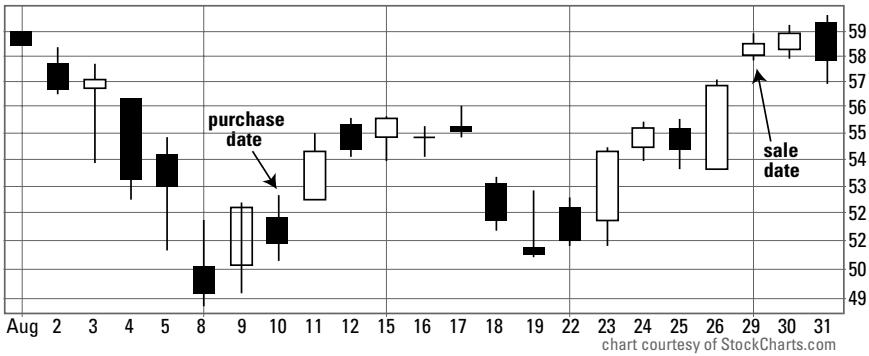


chart courtesy of StockCharts.com

The chart for GDX during this period shows a straightforward long call play that generated a tidy profit in very short order. Peter reasoned, quite correctly, that since the market had already priced in bad results from the miners, any future "good behavior" in gold would boost the sector.

Long puts

Remember, puts increase in value when the price of the underlying falls. So you want to time your purchase for moments when you think the underlying stock is "overbought" and likely to see a pullback.

Shah Gilani – himself a former "market maker" on the CBOE, and a master of options – presented a great example of timing the long put. His *Capital Wave Forecast* subscribers took home a triple-digit gain in early summer 2012, during a period of serious market turbulence and macroeconomic uncertainty.

On May 4, 2012, Shah recommended that his readers purchase **QQQ July 2012 $58 puts** up to $0.65. He explained:

> When it comes to being protective, I'll always risk losing some "hedge" money to rest easy at night knowing I've got some protection against a severe downdraft.

Powershares QQQ was trading at $63.27 on that day; the closing premium on a QQQ 58 put was $0.67. Following Shah's advice, you would have seen the put grow in value to $1.50 on June 1. That's a profit of 123.88% in 33 days – not too shabby!

The chart for this period shows how the timing worked out and how Shah picked the exit. All of the action here took place in the last two weeks – not unusual at all with option trades. In those two weeks, QQQ fell in price from $63 down to $59. Given the sizeable put profits available at the moment, well, it was time to close it out and call it a (very profitable) day.

Remember, like long calls, most long puts are going to expire worthless. But these are no casino odds… Following the proven expert advice of folks like Shah, you can time your entry and exit based on their technical observations. And suddenly, your odds are vastly improved. Again, it doesn't guarantee 100% winners. But it sure does give you better chances than most other investors.

Short covered calls

The covered call is that treasured "cash cow" most every investor seeks, because, when done right, it generates income that you never have to pay back. What's more, risk is very low. In a minority of cases, you expose yourself to lost opportunity, but overall, you can rake in double-digit returns over and over and over.

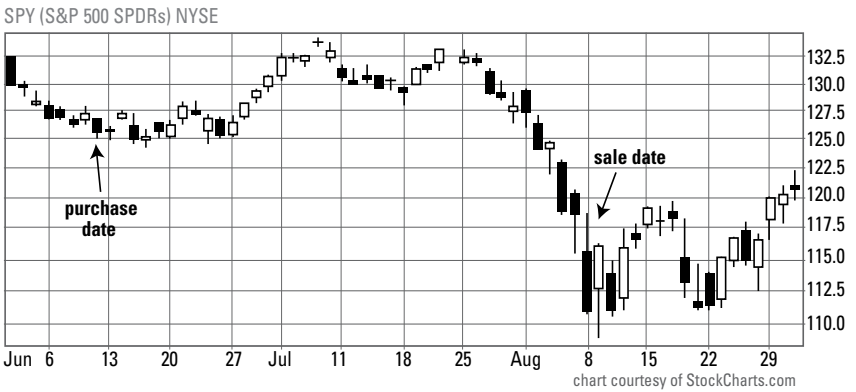
On July 23, 2013, *The Geiger Index* subscribers received instructions to sell-to-open calls on **Caterpillar Inc.** (NYSE:CAT) – a company that was part of the

portfolio. Subscribers sold one **CAT September 2013 $92.50 call** per 100 shares held long, at a price of at least $0.65. The company then announced a $1 billion share buyback and on July 30, Keith recommended that his subscribers enter buy-to-close orders on those calls for $0.10 or less.

His reasoning was:

> If shares of CAT continue to trade up on Monday's news of a share buyback, our CAT130921C00092500 call options will likely trade higher. If shares of CAT close above $92.50 on September 21, 2013, our shares will be called away, which will mean subscribers who are following along will log at least an 8.27% profit for our effort – excluding commissions and fees that vary broker to broker.
>
> On the other hand, if CAT backs off the 1.17% it rallied Monday, the price of our recommended CAT130921C00092500 call options should deteriorate quickly. If that happens and our exit goes as planned, we'll harvest a quick $0.56 in less than three weeks. At that point, we'll simply sell another call and continue to accelerate our income, effectively boosting CAT's already healthy 2.9% yield. We'll also be capitalizing on a lot of global momentum even though the stock market doesn't seem to broadly reflect that at the moment.

The trade closed on August 7, with the September options trading around $0.10. Subscribers who followed along netted themselves a 0.6% return.



Now, a 0.6% return might not seem like much, but remember, it only took 15 days to get there. So when you annualize it, this amounts to a nice 14.6% [(0.6% ÷ 15 days) x 365 = 14.6%].

Here's what's interesting…The underlying price didn't change very much by the closing purchase date. It didn't have to. The entire change in value from $0.66 down to zero represented time decay, even with the brief move into the money in July. So those who followed the instructions got a nice credit, right up front – $66 for each contract – and then got to just sit back and watch the time value of the contract dry up.

Protective puts

Remember, a protective put provides you a form of insurance against falling value in the underlying. The intrinsic value of the long put rises one point for each point lost in the value of the stock or index. For the example, here's another good one from *Permanent Wealth Investor*.

On January 4, 2011, subscribers received the following instructions when the new 2013 series of puts were published for the **SPDR S&P 500 ETF** (NYSEArca:SPY):

> Since the market has risen significantly over the last year, I think we should aim to buy options with a strike price of 700, rather than the 600 strike price we bought last year. But there is no need to buy the new option immediately – these options tend to be somewhat overpriced in their early months of existence, as the market sees more buyers than sellers.
>
> The December 2013 700 options are currently trading at $38 to $44, well above our proposed buy price of $25 (to give us one $2,500 contract for each $100,000 of portfolio value). If the market drops sharply in the near future, we are still well protected by our 2012 option, so I propose putting in an order, good until canceled (GTC), to buy the 700 series of 2013 at $25. A further market upsurge and/or a decline in 2013 option values as they become more seasoned will then cause our order to fill.

A December 2013 put with a strike of 700 was valued on January 4, 2011, at $24.50. You could have bought this and had up to two years of price protection. By January 17, 2012, 378 days later, the put had increased to $48.00, a nice profit of 95.92%.

Cash-secured puts

Keith's *Geiger Index* may be the best example of how to sell cash-secured puts. As I write this, the Geiger's record is an 98.78% winning trades over five years.

That's the beauty of this low-risk strategy. You can do it time and time again, keeping the money you collect by selling a put, and moving on to the next opportunity. As Keith puts it, "Our put-selling strategy is merely a way of getting paid to go shopping for an asset we like... at a price of our choosing."

But you'll never catch Keith using the nickname "naked puts." That's because he always advises keeping the full "assignable" capital in reserve, in case of exercise, and selling puts only on stocks you actually want to own. That way, you avoid any nasty surprises if the options do expire with underlying price below the strike – unlikely, but possible. So the contract isn't technically "naked" (meaning unsecured).

Here's an example of how his "shopping" strategy works. On June 6, 2013, Keith thought **ProShares UltraShort 20+ Year Treasury** (NYSEArca:TBT) was due for a correction, and wanted to get a good price for them. He recommended that his subscribers sell-to-open one **TBT June 2013 $62 put** (TBT130622P00062000) for $0.65 or more for every 100 shares they wanted to own.

Here's what Keith said about the trade:

> As I write this, the TBT130622P00062000 options are trading at $0.37 so we'll need a 2.85% pull back of approximately $1.93 to get our fill. Odds suggest we'll get that in the next few days.
>
> Why really doesn't matter but if you're interested, I think it will be a headline or two that prompts the brief flight to safety that will set our trade up for us.
>
> Assuming the markets cooperate and we get what we want in terms of a fill at $0.65 or better, the Geiger assigns this trade an 85.51% probability of profit.
>
> The $62 strike it's targeting is only a 7.94% discount to where TBT is trading currently so that's a little tighter than the typical trade. But then again, so is the time horizon of only 18 days versus our more normal 21- to 40-day window.
>
> I'm okay with that because what the Geiger is really suggesting is the tactical equivalent of a base hit in baseball. We want to put runners in a position to score while not risking the entire "inning" on a single pitch.

GLD (SPDR Gold Trust Shares) NYSE

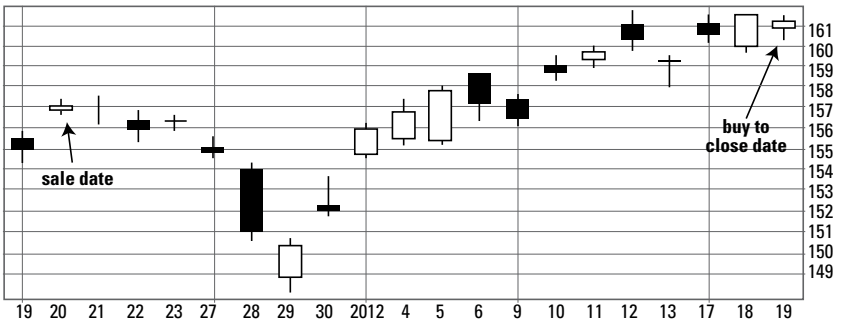


chart courtesy of StockCharts.com

Shares of TBT got hammered over the next week and on June 11, Keith recommended that subscribers enter buy-to-close orders on their options at $0.05 or lower. The position closed on the 17th at five cents, giving subscribers who followed along a quick 4.92% return that annualizes to 163.0%.

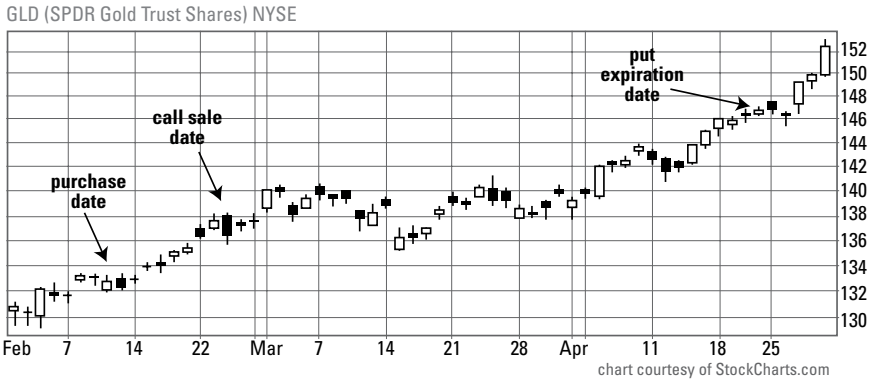
Long straddles

The long straddle involves a long call and a long put at the same time. Of course, only one can be profitable at expiration, so it often plays out with you closing one side before the other. The ideal outcome would be for one side to close at a profit, then have the underlying move in the opposite direction, and the second side also closes at a profit. But don't hold your breath; this hardly ever happens. More realistically, you hope for the profit from one long position to exceed the cost of the other.

That's just what happened with the gold recommendation Shah offered to his *Capital Wave Forecast* readers on February 1, 2011:

> We're going to put on a speculative position on the direction of gold. Technically, we are putting on a type of "straddle" to try and profit from a big move in gold, either way – up or down.
>
> We are going to buy both calls and puts on the **SPDR Gold Shares ETF** (NYSEArca:GLD).
>
> Buy **GLD April 2011 $140 calls** for up to $1.05. And buy **GLD April 2011 $120 puts** for up to $0.95. Apply only 2.5% of your trading capital to this combined position. We are paying $2.00 in the hopes that gold goes through the roof or collapses altogether.

The outcome? A very nice profit on the 140 call, from $1.14 cost up to $2.43 sale; and a total loss on the put, from a cost of $0.85 down to zero. Net outcome: $2.43 sale versus $1.99 cost, for a net profit of $0.44.



The chart shows how the price of GLD moved during this period. The fast five-point rise presented an opportunity to sell the call side of the straddle at a profit adequate to cover the entire cost. The put was left open until expiration; there was always a chance the price would fall, and the put would become profitable. This didn't happen, though, and the straddle was profitable because of the fast appreciation in the call.

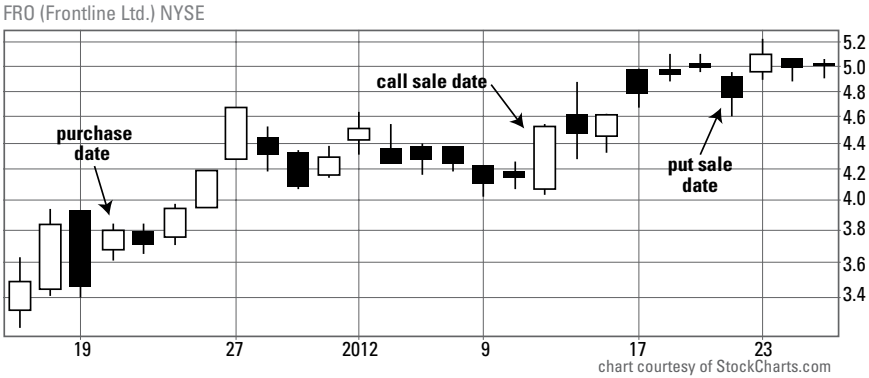
Long strangles

Kent Moors of *Energy Inner Circle* opened a good strangle on **Frontline Ltd.** (NYSE:FRO) on December 20, 2011:

> Our move today is a called a "strangle." This occurs when a call and a put are bought on the same underlying stock... with the same expiration date... but at different strike prices. The call allows a purchase at a given price (the strike), providing a profit if the underlying stock is moving up. The put also allows the purchase at a given price, but is profitable if the underlying stock declines. This approach is used when factors point to a stock moving significantly in one direction or the other, but there is no clear indication which one.
>
> That is the case here, with **Frontline Ltd.** (NYSE:FRO) – the leading company in an otherwise dismal sector. FRO is the largest oil tanker transport company in the world, but has lost some 80% of its value since June 1.
>
> Remember, we are not buying the underlying stock here (although it is now so undervalued it will be rising), but seeking to make money off of the spread in options on that stock.
>
> The advantage of options is clearly manifested in this example. The premium for either the call or put on FRO is currently running about 21% of the underlying stock price, yet the short-term profit potential is greater. FRO has been advancing of late, meaning a further increase or a retreat is likely. Hence the reason for a strangle.
>
> It could, therefore, make money in both directions if the stock's performance remains bounded. Meanwhile, a major move up or down would provide a significant return in one direction to more than offset the loss in the other.

Kent recommended buying both a **FRO February 2012 $3 call**, and a **FRO February 2012 $4 put**, both at the market. On December 20, the call was at $1.14 and the put was at $0.78, so the total cost of the strangle was $1.92.

He closed the call on January 12, 2012, for $1.65 – a profit of 44.74% in 23 days. The put was closed on the last trading day at $0.25, a loss of 67.95%. So overall, this trade lost a marginal $0.12 ($1.92 - $1.80). This shows that making a nice profit on long combinations is difficult; at least in this case, the loss was quite small.



The price movement was minor during the month, but the call was profitable.

Again, the idea behind the strangle is to create potential profit zones above the call strike and below the put strike. In this example, the midrange between the two strikes was profitable for either side, so long as the price moved far enough in one direction or the other. That didn't happen, but I hope you can see that the potential is there.

Calendar spreads

The calendar spread (also called a "time spread") has two options with different expiration and the same strike. Keith used this strategy to tremendous effect in his *Geiger Index* back in 2010, when **Toyota Motor Corp.** (NYSE:TM) was looking like a seriously troubled company. As you may remember, Toyota had just recalled millions of cars and trucks worldwide and briefly halted production and sales.

On February 25, 2010, Keith wrote:

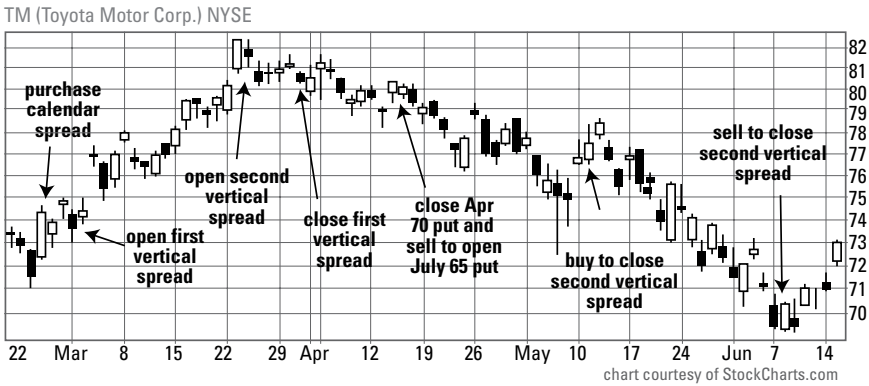
> Now let's capitalize on some chaos with a stock that even we didn't believe the Geiger had selected – **Toyota Motor Corp.** (NYSE:TM). Here's what to do: Sell one **TM April 2010 $70 put**, and simultaneously buy one **TM July 2010 $70 put**. Based on market conditions as I write this, this trade will cost approximately $2.20 (or less).
>
> But here's the exciting part. Unlike some of the limited risk/limited return trades the Geiger has preferred in recent months, this one has home-run potential of 100% or more by the time we're done with it. And that's worth noting because it speaks to the patience and deliberateness that makes the Geiger so effective.
>
> Lots of traders think you need to swing for the fences every time you step up to bat. In reality, it's the cautious batter that puts players on bases (and profits

in our pockets) to win the game. Homers are really only hit every once in a while, but boy, are they fun to tee up – just like this trade.

The other thing that's worth noting here is that the Geiger is suggesting buying this spread instead of selling it. That means if it cost us $2.20 to put on, that's all the skin we have in the game. Our risk is completely limited to the money we spent, and there are no unknowns to come back to haunt us.

Keith used the calendar spread as a starting point for a nice series: the calendar spread, then a vertical spread. Here is a table of the outcome between February and June 2010:

Toyota "sell April 70 put/buy July 70 put" Calendar Spread			
Action	**Date**	**Net debit/ credit**	**Running Total**
Buy 1 calendar spread (April/July 70 put spread)	2/25/10	$-2.20	$-2.20
Sell to open 1 Apr 70/65 put vertical spread	3/11/10	$0.50	$-1.70
Sell to open 1 May 75/70 vertical put spread	3/24/10	$0.75	$-0.95
Buy to close 1 Apr 70/65 vertical spread	3/31/10	$-0.05	$-1.00
Buy to close 1 Apr 70 put	4/14/10	$-0.05	$-1.05
Sell to open 1 July 65 put	4/14/10	$0.45	$-0.60
Buy to close 1 May 75/70 vertical put spread	5/11/10	$-0.46	$-1.06
Sell to close 1 July 70/65 vertical put spread	6/8/10	$1.72	$-0.66
			Gain: 62.26%



Now, while profitable, this was a very unusual trade. It was a complex series of positions, including a roll, replacement of one calendar spread with two vertical spreads, and eventually an overall net profit of 62.26%.

While not every transaction has to be this complex – and very few that Money Map editors bring you will be anywhere close – this one demonstrates how skillful management of positions with net profit and looming strikes in mind, all timed to take advantage of time decay, can and does produce some very impressive outcomes.

Chapter 6 A Little Advanced Trading (But Not Much)

"Let me smile with the wise, and feed with the rich."

-Samuel Johnson, in James Boswell, *Life of Samuel Johnson*, 1791

In this brave new world of options trading, it has become impossible (or at least very unwise) to ignore the potential that options offer.

Who doesn't want additional profits, lower risk, better diversification, or powerful leverage?

That's why I'm dedicating this chapter to a few more advanced trades that you can use to expand your playbook and potential profits. Even if you're not ready for them, you should be aware of them. These are great strategies. They allow you to augment the opportunity, while still keeping your risks in check. Let's go over each one quickly, so you can decide for yourself if any look appealing to you.

Collars

When properly timed and placed, the ***collar*** is a method for riding the price of stock upward, while eliminating the risk of losing profits if the stock price were to tumble. The only problem with a collar is that, while it removes all possibility of loss, it also caps your potential gains.

The collar is made up of three parts:

- 100 shares of stock,
- One long put, and
- One short call.

This is an elegant strategy; the call is covered by the stock, and the price of the put is paid by income from the call.

Ideally, both options are out of the money (OTM). For example, if the stock price is $41.25, the short call strike is 42.50 and the long put strike is 40. If the stock price moves above the 42.50 call strike, the shares are called away, and your profit is limited to the difference between the basis and the strike.

If the underlying moves *below* the put's strike, the paper loss is offset by intrinsic value of the put, which can be sold to recapture the loss, or exercised to sell stock at the put's strike (which is below the market value of stock when the position is opened, but limits the loss to the proximity of strike and price).

Now, you could open a collar by buying all three parts at the same time. But in practice, you're more likely to want to create it after some underlying stock you own has appreciated – when you want to protect those paper profits and would be willing to sell above a certain price (the call strike).

For example, say you bought 100 shares of **Navios Maritime Holdings Inc.** (NYSE: NM) at $4.35, when Keith recommended it to *Money Map Report* members in March 2013. The stock then appreciated to $9.00 in December. At this point, you may not be ready to sell outright, but you surely want to protect the profits you've already earned. (Incidentally, this was one of Keith's big free trades, producing a 126% gain from March 2013 to January 2014.)

You could create a collar. Buying a protective put at $7.50 ensures a profit of $3.15 (7.50 – 4.35). And the put is paid for with the sale of a $10 call. If it is exercised, your capital gain is $565 [(10 – 4.35) x 100]. In this way, the collar protects those paper profits while ensuring profits of some kind, no matter what the outcome. Plus, you continue earning dividends from owning the stock.

Even better, as you might guess, the chances of the call getting exercised are relatively small. You can avoid exercise by closing the call if and when the price moves close to the money, or by rolling the call forward (and using the additional premium to buy a later-expiring put and continue the collar at higher strikes on both sides).

I'd say that's a powerful strategy – no matter what happens.

Other spread varieties

First, let me give you that definition again. Remember, a ***spread*** is an option position established by buying and selling an equal number of options on the same underlying, but with different strikes or expirations. The strategy limits risk, but it also limits profits. There are dozens of variations on the spread. I'm just going to point out a few special ones.

First, there's the ***butterfly spread***, and it's a thing of beauty.

Because it combines both long and short options, the overall cost of the butterfly spread is minimal, or can even create a small credit for you. The butterfly presents an interesting way to hedge options against one another. It has two sides:

- A bull spread; and
- A bear spread.

One side will benefit from price movement in the underlying (upward with the bull, or downward with the bear). But not both sides.

The butterfly may consist of all calls, all puts, or both.

Three strikes are involved with the butterfly. One option is opened at the higher strike, one at the lower, and two options in the middle. The middle positions are opposite the higher and lower strikes. For example, if higher and lower are long, the two in the middle are short (or vice versa).

When the mid-strike positions are short (and the higher and lower are long), the outcome is a mid-range profit zone, offset by higher and lower losses at a fixed level. When the mid-strike options are long (and the higher and lower short), the outcome is a mid-range loss zone, offset by higher and lower profits at a fixed level. Make sense?

Now, the butterfly's costs often offset its limited value. The offset of acceptable and fixed losses for equally fixed profit potential are so complex that opening a butterfly and leaving it until expiration may be futile.

Realistically, traders who open butterflies are likely to close parts of the strategy over time. One side or the other is going to become profitable and can be closed. The danger in this is that if long sides are closed and shorts left open, this opens up unplanned risks.

So the practical approach would be to close a profitable long on one side, while also closing a profitable short on the other side, and waiting out the remaining spread. The remaining short position, while exposed, can be managed by closing after time value declines, rolling forward, or later covering with different options or with stock.

The best use of a butterfly is to plan to close portions of the overall based on emerging profits, but to also keep an eye on the newly created risk exposure, and mitigate or remove it at the same time.

Now let's look at a couple of ***reverse spreads*** (just what we call any spread set up opposite of its better-known version).

First, the ***reverse calendar spread***. Remember, the calendar spread (or time spread) involves identical strikes but different expirations. In most versions, the

later-expiring option is long, and the shorter-expiring option is short. In this respect, the longer-term long position "covers" the exposure of the earlier short position. A calendar spread is usually constructed using calls; however, if your view of the market includes likely shorter-term bearish sentiment, a calendar spread with puts makes just as much sense.

In the reverse calendar spread, the short position expires later. This invariably means that the net difference between the two is a net credit (because the short option has more time value). That is advantageous, no doubt about it. But it sets up a different potential problem: What are you supposed to do when the long side expires, and you are left with the uncovered short position?

The rationale for the reverse calendar spread demonstrates why traders like it.

First of all, you make money when the short side expires later, so the initial position is set up as a credit. Second, if the underlying moves in a desirable direction for the long option, you can close it at a profit.

For example, if you use calls, the sooner-expiring long call gains value when the underlying price rises. However, the longer-term short call is less likely to respond to price movement; the farther away expiration is, the less responsive the option premium. So a trader can dispose of the long call at a profit, while hoping that time value of the later-expiring short call will decline as expiration nears, enabling a "buy to close," also at a profit. However, the exercise risk is very real for the uncovered short side.

The same rationale applies when you use puts.

The sooner-expiring long put gains value if the stock falls, and you can then close the put at a profit. However, the longer-term short put needs to lose time value in order to squeeze a profit from that one.

The second variety of reverse spread is the ***backspread***, also called the ***reverse ratio spread***. Naturally, this one is related to the better-known ratio spread, in which you sell more calls than you have covered with stock. For example, say you own 300 shares of **Microsoft Corp.** (NasdaqGS:MSFT) and sell four calls on MSFT, creating a 4:3 ratio write.

In the backspread, you sell one call, often covered by 100 shares of stock. At the same time, you buy higher-strike calls. Depending on the premium levels at play, the number of higher-strike calls and time to expiration will vary. A backspread works best when the options create a net credit. This is quite possible to do, so long as the higher-strike long positions are far enough out of the money to make their value relatively small. The increments between strikes will also affect the viability of the backspread.

In this example, you own 100 shares of MSFT you bought at $38, and you sell a 40 call, reaping a premium of 5 (in dollar terms, that's $500). If this call is exercised, you keep the $500 premium, plus you get a $200 capital gain on the stock.

This is a very attractive situation. Not only will you profit if and when the short call is exercised… but the $500 premium gives you a five-point "cushion" of downside protection. But what if the stock price rises far above the level of the 40 strike?

Given that the short call produces a $500 profit, you can expand the position into a backspread.

For example, the 42.50 calls may currently be worth one point each. You can buy two of the 42.50 calls and pay $200. Now your net on the call position is $300 – still an impressive level of income in the event of exercise. However, if the underlying rises above $42.50 per share before the long calls expire, two things occur.

First, the short call is exercised and stock called away at $40 per share. The profit is $500 ($200 capital gain plus $300 option premium). Second, the long calls remain open, and if the stock price rises above $42.50, the options gain two points of intrinsic value for each point gained in the stock. Accordingly, these can be closed at a profit twice the level of profit in the stock.

As a further contingency, if you want to get back the shares that were called away, you can exercise one (or both) of the 42.50 calls. That way you can buy shares at the strike, for less than market value.

The backspread, oddly enough, provides a form of "upside protection" and offsets the potential loss critics of covered calls like to cite: the lost profits from fixing a strike in the event the stock rises above that level. With the backspread, you profit from the covered call and from the long call positions. So a strongly rising stock price creates more profits, not lost opportunity.

Straddle varieties

Straddles also can be expanded into some very interesting advanced strategies. These are just as flexible as spreads. They can consist of long or short positions, calls or puts, or, in advanced formulations, combinations of both.

One especially noteworthy strategy is the ***calendar straddle***.

Much like the butterfly combines a vertical use of bull and bear spreads, the calendar straddle combines a short position near-term straddle and a long position long-term straddle.

This is likely to create a net debit because the long-term later-expiring options will have more time value. So the calendar straddle should be used only to address a very specific perception of likely price movement in the underlying.

The net risk in this position is, in fact, the net debit up to the date of expiration of the short-term positions. Ideally, it will be possible to close one or both sides of the short straddle at a small profit. This is realistically possible given the rapid time decay of both sides. So by closing the short leg of the calendar straddle, you can hold the remaining long side at leisure until expiration.

Two points to remember here…

First, it might be possible to close the short positions with enough net profit to offset the net debit from the overall straddle; in that case, you end up with a "free" longer-term straddle. One side will always be in the money, in this case. So either the long call or the long put can be closed at a profit. The best of all worlds occurs when the underlying moves first in one direction and then in the other, so that both long options can be closed profitably.

Second, a "profitable" close of a long position normally is a problem because the underlying has to move far enough in the money to offset the original cost of the two options. This is a long shot. However, in the calendar straddle, it is entirely possible to profit from both long and short sides. If you are able to close the short positions to cover the initial debit, your net basis in the remaining long positions is zero. So any intrinsic value will be profitable. Furthermore, if you accomplish that zero basis, you might also be able to close both sides and profit from the combined intrinsic value in one option and time value in both.

Not bad, eh?

The calendar straddle can be a very profitable strategy, and it minimizes market risk, because the combined call and put on both sides creates profits in any circumstances, when price is either above or below the strike. It will almost always be at one or the other. Given this feature on the long side, the worst outcome occurs when the underlying is exactly at the strike. And that's rare.

Condors

I want to make sure we cover one final strategy. You may never use it, but you'll almost certainly hear about it. The ***condor*** is popular with traders who are willing to live with modest profits, in exchange for conservative limitations on risk levels. It works best when the underlying is going to have very low volatility and involves short and long positions at different strikes. For

example, using calls with the same expiration, a condor is set up with four different positions:

- A short ITM call,
- A long ITM call at a lower strike,
- A short OTM call, and
- A long OTM call at a higher strike.

What does this accomplish? It limits losses, but it also limits profits. That makes the condor a very conservative strategy, but also one with little potential. Maximum profit is achieved when the underlying price ends up between the two middle-range strikes; but maximum profit is equal to the net difference in these strikes, and it can never be greater. Given the trading costs involved and the margin requirements, the net outcome is hard to justify for most traders.

A final note about strategic uses of options…

Options are the Perfect Vehicle for Swing Trading

A lot of traders are swing traders – even if they deny it.

The "active trader" universe (including both day traders and swing traders) has a bad reputation today, due in part to past abuses and also to past losses coming from highly leveraged and reckless trading. But realistically, if you like moving in and out of positions rapidly to take a lot of small profits (versus waiting out the elusive "big" profit later), you are in fact a swing trader.

Short-term trends tend to last between three and five days, and swing traders look for immediate and clear reversal signals. These include reversal days, narrow-range days (days when the underlying opens and closes very close together in price), and volume spikes. If any two of these three occur in close proximity, swing traders take it as a confirmed signal of likely change in price direction. Swing traders also look for candlestick reversal signs, traditional failed tests of resistance or support, and changes in the indicators in momentum oscillators.

There are several problem in playing the swing:

- Capital limitations: The limitations of a portfolio, in terms of available cash and margin, may make swing trading inadequate. Many swing traders have to use small numbers of shares and limit activity to three or fewer issues.
- Short-selling risks: Playing the top of the swing and using stock involves selling open positions, but swing traders are then supposed to short stock in expectation of a downswing. Shorting is a high-risk move, however. So many only play the bullish side.

- Profit limitations: The limited amount of capital available to swing trade also limits potential profits. That's because, other than the use of margin, stock-based swing trading has no leverage.

Swing traders attempt to capture gains in a stock within a very short window – usually five days. They use technical analysis to single out stocks that have short-term price momentum. These traders aren't interested in the fundamental or intrinsic value of stocks, but in their short-term price trends and patterns.

Using options solves each of these problems. First, it opens up the potential of swing trading by lifting those capital limitations. Each option "controls" 100 shares of stock, so you can get some serious leverage going. Yet – for long options – your maximum risk is limited to the cost of the option, which you can keep quite low when you choose the right one. Select an option set to expire within one month, with strike ATM. That's ideal, in terms of price, as well as potential intrinsic gain.

Perhaps more important, the short-selling risk – which is considerable – is entirely removed by the use of long puts at the top of the swing. Your maximum risk is the cost of the put premium. In comparison, short selling stock can involve much greater risks (not to mention the cost of borrowing stock and paying interest to your broker).

Finally, because each option controls 100 shares of stock, profit limitations are a thing of the past. Think about it… You can swing trade many more positions and earn the same profits per option as you would for an equal degree of price movement for 100 shares.

An option-based swing trading strategy can be based on long calls and long puts only; on long calls at the bottom and short calls at the top; on short calls at the bottom and long calls at the top; on any combination of these long or short positions; and with covered calls in a 1:1 arrangement or using ratio writes.

This is one of the few option strategies in which soon-to-expire long positions offer the maximum advantage. With expiration looming, and little to no time value remaining, intrinsic value is going to track the underlying movement very closely. Because the "swing" normally lasts between three and five days, options are much better than shares of stock within this strategy.

Synthetic varieties

Another way you can use options (in a swing trading strategy or otherwise), is through the creation of a ***synthetic stock position***. This is a combination of options designed to mirror the movement of the underlying, for little or no cost. That's an intriguing idea, isn't it?

A ***synthetic long stock position*** consists of buying a long call and selling a short put. The premium you get from the put will cover most (if not all) of the premium you have to pay for the long call. As the stock rises, the long call's value grows and the short put loses value. Growth in the call mirrors the underlying point-for-point as long as the synthetic strikes are at or near the market value of stock at the time the position is opened. The risk of the synthetic long stock position is that if the underlying market value falls, the long put will be exercised, and 100 shares of stock "put" to you at the strike.

In a ***synthetic short stock position***, you buy a long put and sell a short call. Here again, the short option premium pays for all or most of the long option's cost. The combined long put and short calls mirror stock movement as it moves downward.

Here's the risk. If the underlying price rises, the short call gets exercised. If uncovered, this could be a considerable loss – especially if the underlying price move is substantial. You can eliminate this risk if you pair the synthetic short stock position with ownership of 100 shares of stock, creating a covered call with a protective put, which – depending on proximity of the strikes – could be either a straddle or a collar.

But again, the synthetic short stock addresses both sides of the risk picture. If the underlying rises, the 100 shares are called away at the strike, creating option profit, dividend income, and capital gains. If the underlying price declines, the put grows in intrinsic value point-for-point with the decline. You can sell the put at a profit, to offset losses, or exercise it, so that the 100 shares can be sold at the higher strike.

Chapter 7 Here's What Options Can Do for You

"There are two classes of people who tell what is going to happen in the future: Those who don't know, and those who don't know they don't know."

- John Kenneth Galbraith, in *The Washington Post*, February 28, 1988

It used to be that the "buy and hold" approach to investing was the only strategy people really used. Investors used to hold stock for years and years and even pass it down from one generation to the next.

Today, holding periods have fallen to the point that the average is now measured in *days*. That's because of the Internet and discount brokerage. Together they

have proven to be quite an empowering combination. Today's markets have opened up to just about everyone.

The cheaper, faster market has been great for value investors. It's even greater for anyone who wants a lot of action in their portfolio. Sure, options can be speculative, but they can also be effective tools for portfolio management – reducing and controlling risk while bringing home the cash. This trend will only continue as the exponential growth of option trading spreads throughout the market.

If you have only recently started looking at the world of options, one thing is for sure: You are not alone. And in the future, you will have a lot of company, but it's not really competition. More participants will be good for the entire market and for your ability to combine investing in equities and trading to hedge risk.

Some critics of the options market have claimed that high-volume trading harms the rest of the market. They say buying and selling options adds to volatility, or that it somehow exploits the more conservative investor. Some even call options traders "pirates."

Are option traders pirates? No way.

There's nothing manipulative or abusive about maximizing your own profit opportunities and enhancing your portfolio.

Say you head to the supermarket to pick up some essentials, and you notice that the store is holding a one-cent sale on the very peanut butter that's at the top of your shopping list. Doesn't it make sense for you to take advantage of that deal? The low-price offer is made for a reason, and smart consumers take advantage of it. If some other peanut butter company complains that no one is buying their product that day, do you think they are being exploited? Of course not!

In fact, I challenge anyone to demonstrate how option trading hurts the market.

There is no evidence that it is unfair or that it distorts the market. The activity might contribute to a shorter holding period in equities, but there is a bigger reason for that change. The equities market has become far more volatile than it was decades ago – and not because of the Internet or the options market, but because the whole culture of the market has changed.

You can see this by comparing today's professional advisor to advisors of the past.

In that sense, all of Money Map's editors – Keith, Kent, Peter, Shah, Michael, Sid, Bill, and Robert – are revolutionaries, every time they help their subscribers trade options. The purpose is simple: to make money and hedge positions. It is simply smart trading to listen to these guys; they are enlightened pros who know what their clients need and want.

But in decades past, professionals (financial planners, RIAs or investment advisors by any other name) were more likely to be nothing but commission-based salespeople under another name. They even charged a fee to give clients advice, and then collected a commission on top of the fee.

In those days, most financial planners tended to pour client money into load mutual funds. Many had a favorite fund into which they channeled *all* of their clients and their assets – great for the fund, and great for the advisor, but not always in the best interests of the client.

My point is this: You expect – and deserve – much more from an advisor today. You don't want your money and your future to be put into the same mold an advisor pours everyone else into. You want a creative, aggressive, and experienced advisor who knows what works… and what will work best for you.

You have every right to expect a professional who has the big picture in mind, and not just a simplistic programmed response. Not everyone "needs" to put money into a massive load mutual fund that under-performs the market. Some conservative investors will want to put money into the funds, but today the typical investor is more informed.

And thanks to the Fed's current low-interest rate policies, you can't just park your money into Treasury bonds anymore. In today's market, you have to be savvy and ready to move money around among all the products that are available to you – whether equities, debt, options, even futures – through direct trading, ETFs, index funds, and, of course, options.

Today, with the help of a few skilled planners, and with the guidance of Money Map's experts, we "common folk" can take advantage of the great benefits the option market offers.

And to those who <u>still</u> call options traders "pirates," I have only one thing to say: "Arrrgh!"

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