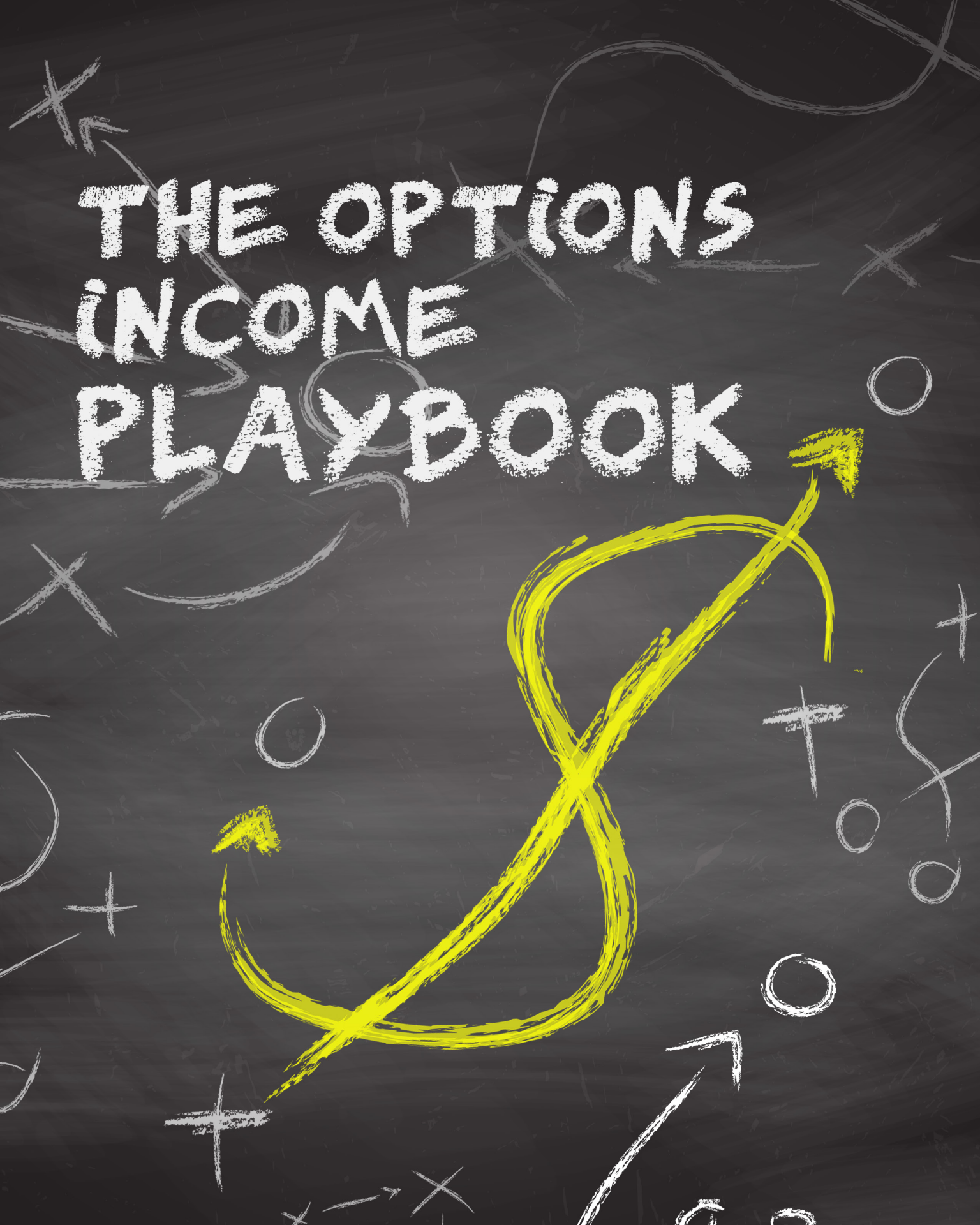
THE OPTIONS INCOME PLAYBOOK



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HOW TO GET THE MOST OUT OF THIS BOOK

Thank you for downloading “The Options Income Playbook”. This book is designed for beginning, intermediate and advanced traders. The authors in this book are leading experts in trading options and stocks.

As you read this book, you will be exposed to multiple strategies that have high probabilities of success and/or high profit. Most of the strategies in this book are divided into three sections:

- “**The Game Plan”** - An introduction to a charting technique. The strategy is then thoroughly explained along with illustrations and examples.

- **“The Movie”** - The chapter is accompanied with a video which outlines how to use this strategy, with examples.

- **“Special Offers”** - If you really like a strategy, you can follow the presenter and the strategy. There are thousands of dollars’ worth of trading tools, indicators, training and mentoring services, books and videos available at steeply discounted prices.

In short, you will have all of the information you need to trade your new favorite strategy tomorrow. Some of the things you will learn in this book are:

- How to Schedule a Quarterly Payday Trading Options During Earnings Season
- How to Avoid the Number One Mistake that Options Traders Make
- How to Use “Measured Moves” to Trade Credit Spreads
- Developing a Fighter Pilot’s Tactical Mindset for Planning your Options Trades
- How to build an “Income Pyramid” to generate consistent income

At **OptionPub**, it is our sincere hope that you take away several strategies that you can use when you are done reading this book. You will also learn about markets that you currently don’t trade, and you will find out if they are suited to your trading personality.

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THE #1 WAY TO MAKE WEEKLY INCOME WITH WEEKLY OPTIONS IN ANY MARKET CONDITION

By Jack Carter, SuperiorInformation.com

Trading weekly options can be a great way to generate consistent weekly income, but the key is to learn how to trade them the right way. In this discussion, you will learn how most people trade weekly options and why they fail. Next you will learn a simple strategy for trading weekly options that can consistently put money into your account on a weekly basis.

WEEKLY OPTIONS

"Weekly options are the biggest game changer for the independent investor since the invention of the Internet."

And now, thanks to three recent changes in the options market, you can get an even bigger advantage. Here's why. The first big change:

1. The invention of weekly options. Normal options are listed in months. You can buy and sell stock options several months out in time. Weekly options expire weekly. These weekly options give you a new way to trade.

2. Weekly options volume has soared. When weekly options first got traction back in 2010, they were small in scope and volume. But by 2016, weekly options volume skyrocketed. This gives you a liquidity advantage.

3. The number of stocks with available weekly options has grown 200%. The list of stocks is at the point where you can now find several great weekly options trades, regardless of market conditions.

As a result of these changes, you get great liquidity and more available trading opportunities with weekly options.

I'm Jack Carter, and I have over 30 years and close to $1 billion in trading experience. I was trained at the World Trade Center in 1985. I traded throughout the largest up and down market in history. My record was over $8 million of stock in one day.

In my career, I've been a stockbroker, a NASDAQ market maker, a professional day trader, and a hedge fund manager. But most importantly, I've successfully taught traders from 43 countries to make profit-rich trades. I'm not telling you all of this to impress you, rather to impress upon you that this is 100% real, not some hypothetical stuff some guy made up but never made any real money on.

Now I've discovered what I believe is the biggest trading advantage for the little guy since the invention of the Internet.

THE #1 WAY TO MAKE WEEKLY INCOME WITH WEEKLY OPTIONS!

After losing my own money early in 1984 as a stockbroker, I went on to find success with options *after* working as a hedge fund trader. From this experience, I can save you a lot of time and lost money right now.

At some point in your journey, if you don't get wiped out along the way, you'll discover that there are definitely winners and losers in the options market. The reason is because options are a "zero sum" game. But it's simpler than that. Here's why:

When you own a stock, you can own it forever.

But when you own an option, it's only good for a certain amount of time, until expiration. And the cold hard truth is that **most options expire worthless.**

The reason is, because **options buyers run out of time.**

This means **options buyers lose** all their money most of the time.

The real money in the options market is in **selling options.**

The **odds are in your favor, simply by being an options seller.**

Weekly options give you a huge edge because they expire every week.

This means you can make **weekly income selling weekly options that expire worthless.**

But how can you make it work?

There are three parts to this.

Part 1. The stocks

Part 2. The options

Part 3. The strategy – getting paid

Part 1: The stocks

This is the most important part. Not all stocks have available weekly options. And the ones that do aren't always good to trade.

First and foremost, we want a stock with available weekly options that's in a good trend. We take the list and look at each stock with available weekly options and narrow it down to three to five of them that are in good trends.

Part 2: The options

There are only two types of options, puts and calls. And there are only two things you can do with options—you can buy puts and calls or you can sell puts and calls. If you buy a put option, you own the right to "put" the stock to someone at the strike price until expiration. If you sell a put, you sold someone the right to "put" it to you at the strike price until expiration.

If you buy a call option, you own the right to “call” the stock away at the strike price until expiration. If you sell a call, you sell someone the right to “call” it away from you.

Part 3: The strategy

I’ve already given you the million-dollar secret to making money with options—be an options seller. The reason is because most options expire worthless. Time decay is what makes them expire worthless.

So we profit by selling options while they still have some time value, and we profit when they expire worthless four days later. Most of the time, using put options works best. Which put options expire worthless? The simple answer is: any put options at strike prices that are “out of the money” at the close of the market every Friday.

Here’s an Example

Let’s use a stock called XYZ as an example. If XYZ stock price closes on Friday over $100 per share, then any put option with a strike price lower that $100 is “out of the money” and will be worthless because there is no value in owning the right to put the stock to someone at $99.50 or less, if XYZ is worth $100 or more in the open market.

To get paid every Friday, we want to sell “out of the money” put options early in the week while they still have some time value, and let them expire worthless so we keep all the money we made selling the put option. I’ll give you two examples.

The first example will help you understand how the parts work together and the principals and concepts involved. The weekly options strategy is a **credit spread**. There are many ways to use it. There are as many ways to use this strategy as you can imagine.

But here’s the thing, it’s not what strategy you use, but rather how you use the strategy. I have discovered a low-risk way to use weekly options to **get rich slowly** using time decay, and this is how to do it step-by-step.

1. Before you trade, you always put your fingers on the pulse of the market. The reason is because my research proves you can increase the odds of success on any trade by 85% simply by trading in the same direction as the broad market. If the broad market is even slightly bullish, you use the bull spread strategy, if it's bearish, I use the same strategy in reverse (called the bear strategy.)

2. Next, focus on the right stock, not the options. In a bullish market, you start with a stock that has available weekly options, is in an uptrend, and has a little volatility. Conversely, in a bear market, you start with a stock that is already trending down and has a little volatility.

3. The next step is to have an "exit strategy." Always know how and when to get out if the trade goes bad. We can "automate" the entire exit strategy with a few conditional orders. Now you have checked the market. You have found a stock trending in the same direction and you have an exit strategy to apply after you get in the trade.

Let's assume the market is bullish. The next step would be to find a stock that is more bullish than the broad market. The next step is to find a put option on the stock you can sell at a strike price that is lower than where the stock price will drop to in the next four days.

You sell a put option against that stock to bring in cash, and, at the same time, buy a lower strike priced put as a hedge. A lot of people ask me, "Why buy the lower strike-priced put as a hedge, why not just sell naked puts?"

There are three reasons to buy the lower strike priced put as a hedge.

1. This is a biggie. The reason to buy the lower strike-priced put as a hedge is: it lowers the capital required to do the trade. If you sell puts naked, you're required to have 50% to 100% of the price of the underlying stock in cash in your account. By buying the lower strike-priced put, it lowers the capital required to do the trade.

The capital required now is limited to the difference in strike prices of the two put options times the number of options contracts involved. So where a trade that involved selling naked puts would require $250,000 in cash in your account, you can do a hedged trade for $2,500 or even $250.

2. Buying the lower strike-priced put as a hedge limits your risk. This way, instead of having to place $250,000 up front to do the trade and risk 100% of it, you can take less risk when we buy the lower strike-priced put as a hedge.

3. Buying the lower strike priced put as a hedge gives us a chance to make 200% to 300% if we're wrong about the stock. If the stock does drop an abnormal amount, we can buy back the short put and stay long the lower strike-priced put, which will skyrocket in value if the stock drops. This is how we make a huge gain, but only if we're wrong. (More on this later.)

Let's move on.

Here's how you make money with these two options.

We sell a put and buy a lower strike-priced put. We get more for the put we sold than we spend on the lower strike-priced put that we buy, and the difference is called a **net credit.**

The net credit is our profit.

Here's an example to help you grasp the principals and concepts. Let's say ABC is trending higher. And let's say it trades at $100 per share. On Tuesday, you sell the ABC weekly $90 strike-priced put and buy the ABC weekly $85 put as a hedge.

When you sell the ABC weekly $90 strike-priced put, you bring in cash. Let's say you sold the ABC $90 put for $1.00. You sold someone the right to "put" the stock to you at $90 until Friday. This won't happen as long as ABC stays above $90 through Friday's close.

At the same time you sell the ABC $90 put, you will also buy the ABC weekly $85 put as a hedge. This dramatically lowers the capital required to do the trade and limits your risk. Let's say you spend .50 buying the ABC weekly $85 put.

OK, at this point you sold the ABC $90 put for $1.00. You bought the ABC $85 put for .50, so your net credit is .50. In this case, the difference in strike prices is $5.00, and let's say you used 10 contracts. Your capital required is $5,000 and your credit is $500.

That's a 10% return in one week!

In this case, ABC is at $100. If ABC stays above $90 through Friday's close, you will make $500 or 10% for the week on this trade. If the stock goes up, you win. If the stock goes sideways, you win. If the stock goes down, you can still win. As long as it stays above $90, you win. If ABC drops below $90, you will lose some or all your net credit and some or all of your $5,000 capital required to do the trade.

To avoid that, you can get out of this trade anytime, even before ABC drops below $90, so you have total control. The best way to avoid a loss is to use stocks that are already trending higher and going deep out of the money, below the stock's current price, so you have some "cushion" in case the stock drops.

OK, let's have a quick review.

My 7 Simple Steps to Weekly Options Profits…

Step 1: Get the list of stocks that have available weekly options.

Step 2: Pick a couple of stocks you're at least somewhat familiar with.

Step 3: Look at a six-month chart on each of the stocks you've chosen. What you want to do is determine—as best as you can—the pre-existing trend of the stock. For example, if the broad market's trend is up and the stock's pre-existing trend is up and looks good… then, and only then, do I take a look at the stock's weekly options to see if there is a potential trade.

If you want, you can use some "trend criteria" to help you see the trend.

This trend criteria can be anything you want that helps you identify the underlying stock's

current trend, because the current trend of the underlying stock is critical. Some people use moving averages, but you can use whatever you're comfortable with. When you find a stock that is in a nicely rising trend and you can clearly see support, then picking the options becomes easier.

Step 4: After you find an appropriate stock, look at strike prices that are **below** the current stock's price, at a level that the stock is not likely to hit in the next week. You can base this on the "average true range" of the stock—or however else you'd like to.

Step 5: Next, go online and look at the live, weekly put options quotes. Look for a spread between two put options that have strike prices that are **below** the current stock's price and support levels.

Also look for a specific difference in options prices to create a net income by getting more for the put you sold than the put you paid for.

Step 6: Enter your order using a "limit order" and apply your exit strategy at the same time.

Step 7: Sit back, relax, and let time pass, *as it always does.* One week later, both options will expire and the "net credit" you took in can be transferred into your wallet—or you can leave it in your account. It's up to you!

This is the #1 way to make weekly income with options.

THE SPECIAL OFFER

Here's something that may help you even more. I'm giving a free webinar all about this strategy. You can register to attend the webinar on this page -

Let me Show you My Full System for Weekly Income

ABOUT THE AUTHOR

Jack Carter began his trading career as a Wall Street trained stockbroker in 1984. He later founded Superior Information, a company focused on publishing opinionated stock and options information for traders and investors, in 1997.

Throughout his career he has also been a Nasdaq Market Maker and a "fast money" trader. Jack Carter is also known as a top consultant. He has customers and clients on every continent and regularly consults with traders and individual investors. His company now has a team of contributors and top traders serving stock and options traders and investors with their own stock and options trading services.

JACK CARTER

PRESENTS

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ROAD MAP TO TRADING SUCCESS

By Chuck Hughes, Tradewins.com

"What goes up must come down spinning wheel got to go around."

- Blood, Sweat and Tears

What really makes stock prices go up or down? Is it really as simple as what goes up must come down and vice versa? How do I select stocks with the best profit potential? Stock prices are constantly fluctuating and many times there seems to be no 'rhyme or reason' to this constant price fluctuation. The air waves and the Internet are flooded with analysts and experts who try to predict the future price moves for stocks.

Often they have no real answers to our same questions and are just as baffled by why a stock is going up or going down. Where does that leave us? Let's face it; to the average investor the stock market can seem complicated and confusing.

Stocks can go up or down for no apparent reason. Apple reports great earnings but the stock plummets. The price of oil drops and the inflation report is tame but the major stock market indexes dive. Pfizer reports terrible earnings but the stock rallies. With the spinning wheel, going round and round, the ups and downs of the markets can leave anyone's head going round and round. When it comes right down to it, the reason why stock prices are going up or down seems to be anybody's guess. You might as well try to read tea leafs.

Highly paid analysts would have us believe that a company's earnings outlook drive stock prices. Yet how many times have you seen the stock of companies with good earnings plummet while those with terrible earnings soar? Just like bad things happen to good people, big stock declines can happen to good companies. It is a fact of life with no true explanation.

But none of that matters for one simple reason. At the end of the day, if there are more buy orders for a stock than sell orders then the price of the stock will go up. And if there are more

sell orders for a stock than buy orders, then the price of the stock will go down. It's just that simple. Everything else is just noise. Everything else does not matter.

To make real money in the stock or options markets you don't need to know why a stock price rises or falls, you just need to know two things: when to buy and when to sell. If you can quantitatively measure the buying and selling pressure of a stock then you will know in advance whether the price of a stock is likely to go up or down. And you will then know if you should take a bullish or bearish option position.

In other words, if you get a reading on the buying pressure and selling pressure for a stock you can successfully assess whether a stock is likely to go up or go down in price. There are numerous ways to measure the buying and selling pressure of a stock. We want to teach you several methods. That way you can use all the methods or just work with the methods you are most comfortable. Remember comfort and ease are what we are aim for!

Successful options trading can be reduced to two simple rules:

1) Buy call options on a stock if the buying pressure exceeds the selling pressure

2) Buy put options on a stock if the selling pressure exceeds the buying pressure

The best way to measure buying and selling pressure is to track the daily price movement of a stock. If the daily price of a stock is increasing then the buying pressure is exceeding selling pressure and the stock is a 'buy'. If the daily price of a stock is decreasing then the selling pressure is exceeding buying pressure and the stock is on a 'sell' signal.

One of the most important rules we learned as a novice investors was that you want to purchase a stock or call option only if the buying pressure exceeds selling pressure as indicated by the price of the stock trending up.

Trying to profit by investing in a stock with a price that is trending down is very difficult as it requires that you correctly predict when the price of the stock will 'bottom out' and resume a price up trend so that your stock or call option purchase can be profitable.

Buying a stock because it is cheap and then trying to predict when a stock's price will bottom out can be nearly impossible to forecast correctly on a regular basis. This 'crystal ball' type of approach can leave the investor in a vulnerable position. A safer approach would be to wait until a stock's price is in an uptrend before investing.

A stock's price movement reflects all of the known information about a company so let the price movement of the stock tell you when you should buy and sell!

One of the most effective ways to measure buying and selling pressure is to look at the daily price movement of a stock. There are numerous methods for tracking the daily price movement. We want to teach you one of our favorite and most effective ways. It is using a price chart.

Price charts are a great way to get a visual look at the daily price changes and the price trend of a stock. It is the price trend that will determine if the stock is on a 'buy' or 'sell' signal and whether a bullish or bearish option trade should be taken.

For example, if the daily price trend of a stock is increasing then the buying pressure is exceeding selling pressure and a call option position should be initiated. If the daily price trend of a stock is decreasing then the selling pressure is exceeding buying pressure and a put option position should be initiated. Let's take a closer look at price charts and how this tool will lead us to the path of success.

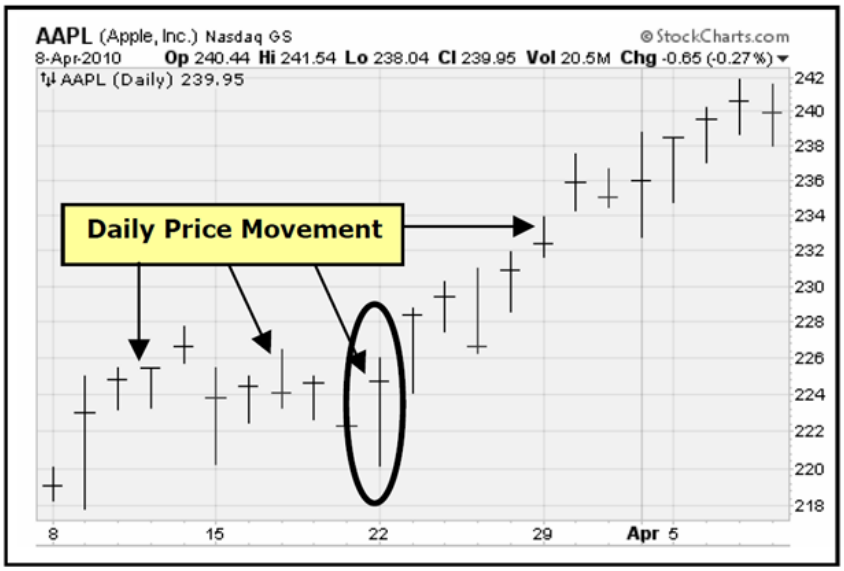
Daily Price Trend of a Stock Is Increasing = Call Option Position

Daily Price Trend of a Stock Is Deceasing = Put Option Position

USING PRICE CHARTS

Price charts are a great tool that helps us determine a stock's price trend. The daily price chart below displays the daily price movement for Apple stock over a one month period. The horizontal axis at the bottom of the chart references the time period of the chart which is one month in this example from March 8th through April 8th. The vertical axis on the right side of the chart represents the price of Apple stock and in this example ranges from 218 to 242.

The vertical bars display the daily price movement of the stock. Each vertical bar has a horizontal line which represents the stock's closing price for the day. On March 22nd the daily bar shows that Apple stock traded in a range from about 220 to 226 (circled). The closing price on March 22nd which is represented by the horizontal bar was about 225.



DETERMINING THE PRICE TREND

As noted previously we only want to buy a stock or call option if the buying pressure is exceeding the selling pressure as indicated by the price of the stock trending up. The best time to buy a call option is after the stock is already in a price up trend. We want to avoid stocks that are in a price down trend.

Daily price charts like the one just presented for Apple allow us to instantly see the price trend of a stock. We like to take this visual look at a stock's price movement one step further and actually measure the price movement. The easiest and simplest way to measure price movement is to use what are called 'moving average lines'.

Next, we are going to take a look at when to buy and when to sell. This concept always reminds me of an old Kenny Rogers song:

You got to know when to hold 'em, know when to fold 'em - Know when to walk away, know when to run.

Yes, with stocks you need to know when a stock is on a 'buy' signal or 'sell' signal. You are about to learn indicators that can quantitatively measure if a stock is moving up in price or moving down in price.

These indicators let us know in advance the most likely future price movement of a stock. We will then know if we want to buy call options or put options.

DETERMINING THE MOST LIKELY FUTURE PRICE MOVEMENT

Moving Average lines are a great trading tool that allows us to know in advance the most likely future price movement for a stock. We know the term Moving Average line may seem complicated but a Moving Average line is simply the average closing price of a stock over a specified time period. For example, the 50-Day Moving Average line represents the average closing price of a stock over the past 50 days.

Many times the real price trend of a stock can be obscured by the daily price fluctuations. The daily price chart below for Apple stock covers the 3 month period of November, December and January. As we learned in the previous price chart example for Apple, the vertical bars display the daily price movement of the stock.

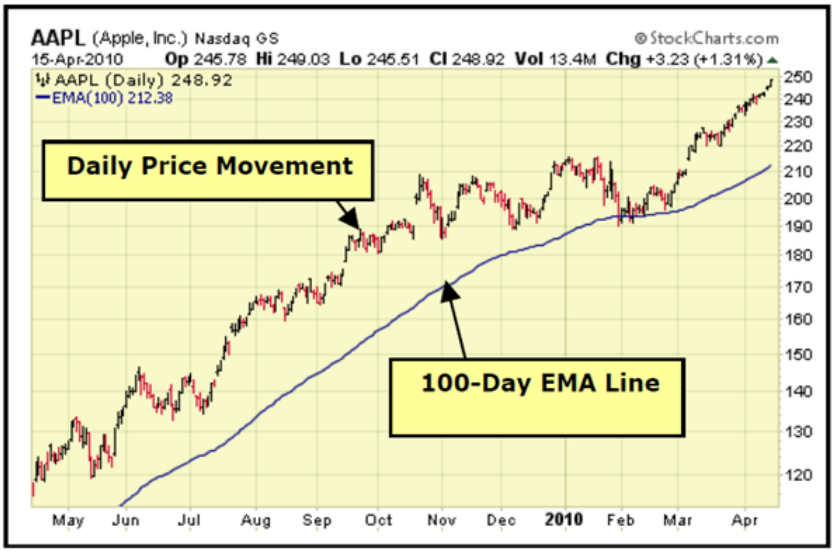
This price chart shows a rally for Apple stock until mid-November and then a price decline into mid-December. This price decline is followed by another rally into the beginning of January followed by another price decline in January. Despite the daily price fluctuations the stock price was little changed over the 3 month period.

Three Month Price Action Shows No Clear Trend

Let's take another look at a price chart for Apple stock that covers a longer time period but includes the November, December and January period just mentioned. This price chart also includes the 100-Day Exponential Moving Average (EMA) line for Apple stock. We prefer to use Exponential Moving Averages over Simple Moving Averages as we have found Exponential Moving Averages to be more accurate in determining the price trend. Exponential Moving Averages give more weighting to recent price movements than Simple Moving Averages which give every day an equal weighting.

100-Day EMA Line is Sloping Up

Clearly Indicating a Price Up Trend



The 100-Day Exponential Moving Average (EMA) line is sloping up clearly indicating Apple stock is in a price up trend. Moving average lines give us an instant visual reference of the current price trend of a stock.

4. If the moving average line is sloping up, the stock is in a price up trend and buying pressure is exceeding selling pressure. Call options should be purchased.

5. If the moving average line is sloping down, the stock is in a price down trend and selling pressure is exceeding buying pressure. Put options should be purchased.

It is that simple! Moving averages tell us if a stock is on a 'buy' signal or 'sell' signal instead of trying to predict the future price movement of a stock. You can easily and quickly obtain moving average lines from numerous websites which will be covered shortly.

BUY AND SELL SIGNALS

One of the easiest ways to clarify whether a stock is a 'buy' or a 'sell' is to look at the shorter term 50-Day Exponential Moving Average (EMA) line in relation to the longer term 100-Day Exponential Moving Average (EMA) line.

If the shorter term 50-Day EMA line is ***above*** the longer term 100-Day EMA line it indicates the price momentum for the stock is to the upside which confirms the price up trend. We should initiate a call option trade for the stock.

If the shorter term 50-Day EMA line is ***below*** the longer term 100-Day EMA line it indicates the price momentum for the stock is to the downside which confirms the price down trend. We hould initiate a put option trade for the stock.

50-Day EMA Line Above 100-Day EMA = Price Up Trend = Buy

50-Day EMA Line Below 100-Day EMA = Price Down Trend = Sell

BUYING AND SELLING PRESSURE

When the shorter term 50-Day EMA line is ***above*** the longer term 100-Day EMA line it is an indication that the buying pressure for a stock is exceeding the selling pressure. And the most likely future price movement of the stock is up. The stock is on a 'buy' signal.

When the shorter term 50-Day EMA line is ***below*** the longer term 100-Day EMA line it is an indication that the selling pressure for a stock is exceeding the buying pressure. And the most likely future price movement of the stock is down. The stock is on a 'sell' signal.

50-Day EMA Line Above 100-Day EMA = Buying Pressure Exceeding Selling Pressure

50-Day EMA Line Below 100-Day EMA = Selling Pressure Exceeding Buying Pressure

'BUY' SIGNAL EXAMPLE

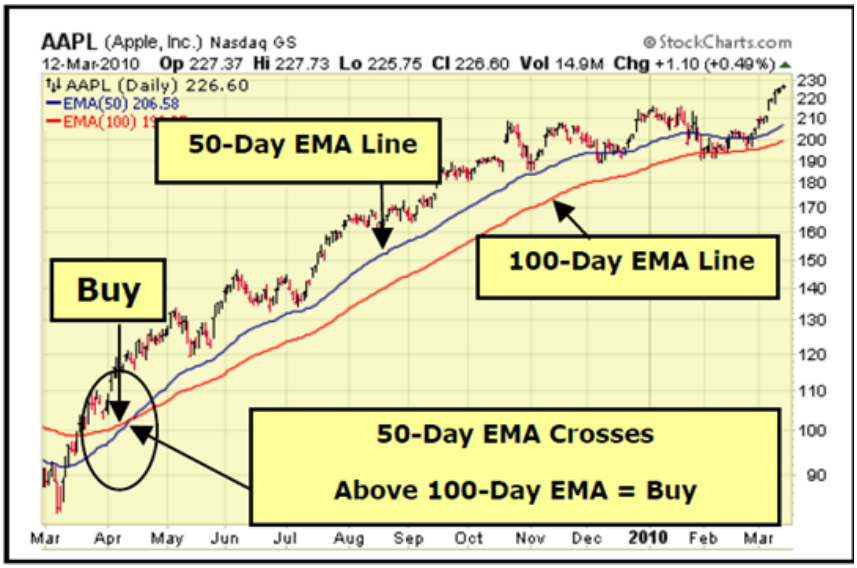
Let's look at an example of a 'buy' signal. The Apple stock daily price chart below displays the 50-Day EMA line and the 100-Day EMA line. The moving average lines indicate that Apple stock entered a price 'up' trend in April (circled) as the 50-Day EMA crossed above the 100-Day EMA line.

When the 50-Day EMA crossed above the 100-Day EMA it was a good indication that buying pressure was exceeding selling pressure and you want to take bullish option trades for Apple. As long as the 50-Day EMA line remains above the 100-Day EMA line Apple stock remains a 'buy' and bullish option trades should be maintained.

In this example the Apple 50-Day EMA line crossed above the 100-Day EMA line in April. We purchased Apple stock and call options after the April buy signal. Apple remains in a price 'up' trend if the 50-Day EMA line remains above the 100-Day EMA line indicating that buying pressure continues to exceed selling pressure. Monitoring the 50-Day and 100-Day EMA lines is an easy and effective way to determine the current price trend which tells us if we should be taking bullish or bearish option trades for Apple stock.

If the 50-Day EMA crosses below the 100-Day EMA it would indicate a reversal to a price 'down' trend as the selling pressure is now exceeding the buying pressure. You should take bearish option trades for the stock when this occurs. We will look at an example of a sell signal next.

50-Day EMA line Above 100-Day EMA line = Buy



SELL SIGNAL EXAMPLE

Let's look at an example of a 'sell' signal. The daily price chart below shows the daily price movement and the 50-Day and 100-Day EMA lines for Merck stock. This chart reveals that in February the Merck 50-Day EMA line crossed below the 100-Day EMA line (circled) resulting in an EMA System 'sell' signal for Merck stock.

When the 50-Day EMA crossed below the 100-Day EMA it was a good indication that selling pressure was exceeding buying pressure and you want to establish bearish option positions for Merck stock. You want to hold on to the bearish option positions for Merck while the price trend is 'down' and at this point the length and severity of the price decline is still unknown.

As long as the 50-Day EMA line remains below the 100-Day EMA line Merck stock remains a 'sell'. Merck does not qualify as a buy until the 50-Day EMA line crosses above the 100-Day EMA line.

Monitoring the 50-Day and 100-Day EMA lines is an easy and effective way to determine the current price trend which tells us if we should be establishing bullish or bearish option positions for Merck stock.

50-Day EMA Below 100-Day EMA = Sell

The 50/100-Day EMA trend following system is your road map to investing success. Trend following is a powerful, systematic approach that allows us to profit from the powerful profit opportunities available from trading weekly options.

HISTORICAL RESULTS OF EMA SYSTEM

The 50/100-Day EMA System is a rule based system with clearly defined 'buy' and 'sell' rules. This enabled us to do historical testing with the help of the Omega Research Trade Station program using the 50/100-Day EMA Cross Over System just presented. Historical profit results are based on buying a stock when its 50-Day EMA line crosses above the 100-Day EMA and selling a stock when its 50-Day EMA line crosses below the 100-Day EMA. The profit/loss for each trade is calculated and a cumulative total is maintained for each testing period.

The EMA System is universal in nature and has been profitable for short term investing across a wide range of markets including: stocks, options, indexes, closed-end funds, zero coupon bonds, mutual funds, index funds and sector funds. The fact that the system is

profitable in virtually every type of market confirms its credibility as a viable, robust approach to trading the financial markets.

Included on the following page are profit results for a well-diversified sampling of both growth and value stocks that represent a broad cross section of 26 different industry groups. This sampling includes small, mid and large cap stocks. Historical profit results were generated over a recent twenty four year period.

PROFITABLE WITH LOW RISK

Keep in mind that four bear markets occurred during this period. Results are based on trading one hundred shares of stock for each 'buy' signal and do not include commissions.

Let's review the tests conducted using the first stock tested Aetna Health Care (AET). The first time Aetna's 50-Day EMA crossed above the 100-Day EMA during the test period one hundred shares of Aetna were purchased at 10.18.

The profit/loss for each AET trade was calculated by the Trade Station software and the profits totaled $5,376 over the test period based on trading 100 shares for each buy signal. This $5,376 profit represents a 528% return on the initial investment of $1,018.

The software divides the total profits by the total losses to calculate the Reward to Risk Ratio. Aetna had a Reward to Risk Ratio of 3.9 as there were 3.9 dollars of profit for each 1 dollar of loss. There were 10 losing trades over the 24-year period and the average losing trade incurred a -$120 loss.

24-Years of Historical Results

Stock	Profit on 100 Shares	Profit Factor	Initial Cost 100 Shares	% Return on Initial Cost	Avg Loss
Aetna	$5,376	3.9	$1018	528%	-120
Adobe Systems	$5,679	4.4	$5	126200%	-173
Altria	$4,602	3.2	$220	2092%	-180
Analog Devices	$3,559	2.0	$92	3868%	-251
Applied Materials	$2,419	3.0	$3	96760%	-70
Auto Data Process	$2,878	3.5	$182	1581%	-98
Bunge	$3,282	100.0	$1,585	207%	0
Centex	$3,810	4.3	$216	1764%	-143
Cisco Systems	$5,474	10.1	$8	68425%	-100
Corning	$6,153	12.4	$178	3457%	-54
CVS Drug	$4,237	2.7	$505	839%	-250
Eaton Vance	$1,682	6.7	$10	16820%	-27
eBay	$2,453	3.7	$120	2044%	-156
EMC Corp	$7,257	80.0	$5	145140%	-18
Franklin Resources	$5,264	3.2	$5	112000%	-18
General Electric	$3,675	5.2	$130	2827%	-97
Golden West Fin'l	$3,700	4.4	$40	9250%	-78
Home Depot	$4,092	4.0	$4	102300%	-174
Illinois Tool Works	$5,924	4.8	$176	3366%	-225
Intel	$2,845	3.5	$39	7295%	-71
Johnson & Johnson	$4,877	4.5	$227	2148%	-181
KB Homes	$6,654	3.4	$840	792%	-202
Legg Mason	$4,212	7.1	$187	2252%	-78
Microsoft	$2,651	2.8	$10	26510%	-108
M&T Bank	$6,445	5.5	$37	17419%	-95
NVR Inc	$50,070	5.0	$1,080	4636%	-1050
PMC Sierra	$15,603	41.5	$225	6935%	-48
Procter & Gamble	$3,096	3.1	$223	1388%	-108
Sun Microsystems	$3,342	7.5	$25	13368%	-26
Texas Instruments	$4,227	3.7	$184	2297%	-111
Taro Pharma	$4,551	4.7	$87	5231%	-113
Unitedhealth	$7,627	9.5	$32	23834%	-91
Water Corp	$4,898	4.5	$375	1306%	-471
Yahoo!	$7,964	63.0	$132	6033%	-129
Totals / Averages	$210,578	12.7	$8,204	2,567%	-150

AVERAGE YEARLY RETURN OF 107%

The total initial investment required to buy 100 shares of each of the 34 stocks over the test period was $8,204. This $8,204 initial investment produced a total of $210,578 in profits over the test period which equates to a 2,567% return. The average yearly return was 107% which would enable us to double our initial investment every year on average. This average 107% annual return was achieved without the use of leverage or margin. Trading options instead of stock would have resulted in a much higher rate of return over the test period as options provide leverage.

The historical results demonstrate that the EMA System has the ability to produce ample profits with very low risk. Of the trades that were losing trades, the average loss over the twenty four year period was $150 and when compared to the total profits of $210,578 demonstrates the ability of the system to keep losses to a minimum. The average Reward to Risk ratio was a very healthy 12.7 with over 12 dollars of profit for each 1 dollar of loss again demonstrating a very healthy risk-adjusted return.

The preceding investing results demonstrate the importance of 'investing with the trend' if you are a short term investor. The 50/100-Day EMA System allows us to know in advance the most likely future price movement of a stock and reduces the entry and exit timing risk associated with short term investing.

It is a versatile, effective method for profiting in any type of market and can quickly identify stocks on a 'buy' or 'sell' signal. This allows us to profit from trading options by purchasing call options for a stock on a 50/100-Day EMA System 'buy' signal and purchasing put options for a stock on a 50/100-Day EMA System 'sell' signal.

Equally important is the ability of the system to avoid large losses which can quickly ruin an investment plan. The system keeps losses to a minimum and almost always exits a trade before a big loss occurs. Following a discipline that keeps losses to a minimum is one of the most important characteristics of a successful short term investing program. Keep in mind that the worst bear market since 1932 occurred during this test period.

The 50-Day and 100 Day-EMA Lines Are the Key to Developing a Profitable Strategy

The stock market is in a constant state of flux. The constant up and down price movement of a stock makes it difficult at times to see the real price trend of a stock. That is why it is important for an investor to become comfortable with the 50/100-Day EMA lines.

The position of the 50-Day EMA in relation to the 100-Day EMA gives us a quick and accurate indication of a stock's current price trend. If the stock is in a price up trend call option trades should be initiated. And if the stock is in a price down trend put option trades should be initiated. In order to be a successful option investor we do not have to know what

an analyst's rating is for a stock or the current earnings projection. All of that information is already reflected in a stock's price movement which can be quantitatively measured by the 50/100-Day EMA lines.

This simple but effective trend following system is mechanical in nature and instantly tells you if you should be taking a bullish or bearish option position. We prefer mechanical systems as they take the emotion out of trading. There is no judgment or interpretation involved. You don't have to rely on trying to predict future price movement.

Follow the Price Trend Instead of Trying to Predict It

"Prediction is very difficult, especially if it's about the future."

- Nils Bohr

The 50/100-Day EMA System allows us to 'invest with the trend' instead of trying to predict the price direction of a stock. The historical studies presented demonstrate that price trends tend to continue in the same direction and can continue on longer than one may initially expect.

Our investing experience confirms that the 50/100-Day EMA System allows us to know in advance the most likely future price movement of a stock and whether we should be initiating bullish or bearish option trades.

THE SPECIAL OFFER

To learn more about Chuck's unique approach to options trading, tap the link below to get a free copy of his new eBook "Options Trading Made Easy".

SIMPLY CLICK HERE! to get your copy now!

This free options trading course will teach you everything you need to know if you want to start trading options in the simplest, most profitable way possible.

ABOUT THE AUTHOR

Chuck started out flying jets for the US Airforce and then became a commercial pilot. So his background is much different from the hotshots on Wall Street.

Still, he was intrigued by the fact that the majority of 1-percenters in the United States made their billions in the stock market.

So, on his days off and during layovers he read everything he could find on trading. But, being adverse to losing money, he never did much with it. Until one day he figured out a way to actually engineer an option trade in a way that automatically wins big & eliminates losses!

So he scraped together $4,600, opened his first trading account, and within two years earned a total profit of $460,164!

Elated by his instant success, and being somewhat competitive by nature, Chuck began competing in the same International Live Trading Championship that brought Larry Williams instant fame. And so far he's taken 1st place a record-breaking 8 times… more times than anyone else in the 33-year history of this prestigious competition.

Yet, most important and heartwarming of all was the way Chuck's trading success became his family's salvation. Because, by the time Chuck was grounded due to a rare vertigo-causing disease he earned more money trading part-time than he did as a commercial pilot… So his wife and six kids never wanted for a thing.

Realizing all too well that there's no such thing as financial security without an alternate source of income you can fall back on, Chuck began sharing his good fortune with fellow Americans… Options Trading Made Easy is Chuck's gift to you.

CREATING INCOME WITH OPTIONS

By Doc Severson, TheoTrade.com

THE IMPORTANCE OF CREATING INCOME

Let me start by asking you a question...

How are you going to get to where you want to go in life?

Now I don't know what your answer is, nor do I know your situation. You might be a 35 year old with a great career and a clear path to your golden years. You might also be 63 years old and recently furloughed, replaced by a 22 year old that knows a fraction of what you do. It really doesn't matter where you currently are in life, nor does your current situation have any bearing on it, because all situations share the same need:

To get where you want to go in life, you need to generate income.

Notice that I didn't say "a lot of money" nor did I challenge you to come up with a massive figure that you're supposed to carry around. Sure, having a big pile of money solves a lot of problems for you if you already have it. But for most of us, that reality changed over the past few years. We're not focused on generating income, we've been told to think that we need to grow ourselves a huge pile of money. And we've been taught - ironically, not by our education system, but by watching TV commercials - that the magic formula to attaining this "pile of money" is to create ourselves a "great portfolio." If you believe the TV ads put out by the brokerage houses, you can be an infant in a crib or a guy sitting outside with a laptop and build this wondrous collection of stocks and bonds which magically goes up every month.

Sure, it's certainly possible. But what do you do when the market no longer supports your "great portfolio?" Markets don't always move straight up, and no "green line" will protect you against that if your portfolio is not risk-adjusted.

You see, most individual stock traders don't know how to build income, nor do they see a need for it. The dream that they've been sold is that they can ride the market up and build their portfolio to "their number" so they can magically take their funds out of risk at exactly the right time to fund their retirement for as long as they need it.

Wait, haven't we just seen two recessions in the past two decades? Haven't we seen enough unexpected downdrafts and corrections that have wiped out trillions in investor wealth from investors trying to "ride out" the pullback and not knowing when to get out? If your primary strategy is to time the market by buying low and selling high, and selling out at the very top, be aware that this is a very, very difficult game that you're playing and that you're probably not managing your risk nearly as well as you need to. You're betting the farm that you'll have enough of a lump sum someday to turn into an income source.

What if we were able to generate cash flow and income right now?

Think about what that would mean to our ability to grow our account incrementally, through the power of compounding. None other than Albert Einstein was quoted to have said: "The most powerful force in the universe is compound interest." Warren Buffett will not consider investing in a company unless it can prove the ability to compound their earnings growth through reinvestment.

Quick, if I earned 1% on my capital every month, what would my annual return be? Most will quickly say "12%" without thinking through the question, but let's take a look at the power of compounding income growth if we were able to just earn 1% a month on our starting capital of $10,000:

Figure 1

Month	Starting $	Gain $	Ending $
January	$10000	$100	$10100
February	$10100	$101	$10201
March	$10201	$102	$10303
April	$10303	$103	$10406
May	$10406	$104	$10510
June	$10510	$105	$10615
July	$10615	$106	$10721
August	$10721	$107	$10828
September	$10828	$108	$10936
October	$10936	$109	$11046
November	$11046	$110	$11156
December	$11156	$112	$11268

In this example we showed how a very conservative 1% monthly return ends up turning into an annualized 12.67% return, larger than a simple linear addition of the monthly returns due to the re-investment or compounding. Higher monthly gains can produce even more compound growth; for example, a 3% monthly return on capital produces not just 36%, but a compounded annual return of about 42.5%! We would double our capital every two years with that kind of return.

Can we do that kind of performance with stocks? Well, it's certainly possible, but unrealistic to earn consistent returns. Dividends just aren't paid often enough to enjoy the true power of compounding. And with typical annual dividend yields of 3% or so (ex: PG), it just won't provide the income acceleration that we're looking for, nor do dividend-paying stocks usually show much growth in the share price.

So it's clear what we need to do to develop income:

Find an investment vehicle that we understand, without having to understand the company's business model or financial statements.

Find an investment vehicle that allows us to earn monthly income.

Find an investment vehicle where we clearly understand the risks, and can manage them proactively.

Find an investment vehicle where we can re-invest our income to enjoy the compounding effect.

As you probably expected me to say, the investment vehicle that allows us to accomplish those objectives are OPTIONS. How can we create an income stream through options?

METHODS OF CREATING INCOME

When you think of generating Income, what are the typical methods and strategies that you hear floating around out there? Here is a list of the usual suspects:

Salary - of course we think of trading our time and skills in exchange for a salary, which generates income. However it's extremely high-effort and may not be realistic in our retirement years.

Stocks - certain stocks generate a quarterly dividend which can generate a regular check.

Preferred Stock Shares - some companies offer preferred shares in addition to common stock shares; these typically offer a larger dividend payment in exchange for a higher share price.

Real Estate Rental - owning all or part of a property and receiving rental income.

REITs or Real Estate Investment Trusts - these are based on a portfolio of real estate, where income is passed along to shareholders.

Bonds - generally pay interest twice a year.

Annuities - depends on the structure, but the back-end is a set income stream for a period of time after you pay in for an agreed-upon timeframe.

Limited Partnerships - income is passed along to the partners.

The whole idea behind investing is that we someday replace our existing salary income with some other type of generated income, so that we can travel the world and enjoy retirement. And for those really on the ball, we could even generate a stream of income to replace our existing salary and break the paradigm of having to wait until we're 65 before we can retire.

I think that the "typical" retirement income strategies might have worked out OK until a few years ago, but some things have changed recently that have put a damper on these methods:

- Interest rates are so low these days that bond income is insufficient;
- The real estate market is struggling to recover;
- Stocks have been more volatile/unpredictable over the past 16 years than any time since the Great Depression.

As a result, we have a huge number of retirees—or people closing in on retirement age—that have not built up enough capital to generate living income.

And we all know that Social Security payments don't cut it. We have parents moving back in with their children for the first time in generations. It's reality.

Why are these situations happening? In simple terms, it's because the "old" systems discussed above are not working in today's paradigm. And many of you have already figured this out and have tried to take control by learning to trade your own portfolio. We all arrive at this step due to the many powerful media messages that we're bombarded by constantly:

"YOU CANNOT TIME THE MARKET. BUY GOOD QUALITY STOCKS FOR THE LONG HAUL. GET THE TOOLS AND RESEARCH THAT YOU NEED TO MAKE INFORMED DECISIONS. ALLOW US TO HELP YOU REACH YOUR INVESTMENT GOALS."

If it was really that simple to just follow a "green path" to reach your retirement goals, then you wouldn't be here, either. After watching one of the well-respected companies in the "managed money" space crush my retirement portfolio to 30% of its former worth, I knew that no one had as much of a vested interest in my future as I did. **I found out that they didn't have a clue how to grow an account unless the market was going straight up!**

So if you're going to wrestle this assignment back into your control, how are you going to generate consistent income? Are you really going to sign up as a limited partner with firms that you don't know what they do? Are you going to expose yourself to the risk of a REIT? Are you going to depend on the quarterly dividend payment of a stock that has flatlined and not going up in value?

If you follow all of the traditional income strategies above, you end up investing in things you don't understand and becoming a Jack of All Trades and a Master of None. And do you really want to respond to your tenant's complaints of blocked pipes at 3 a.m? There's got to be a better way. All of us are running out of time; let's see how we can get some of it back.

GENERATING AN INCOME STREAM FROM THE MARKET

Before we can start to pull out a consistent income stream from the market, it's important that we understand what we're doing wrong first. Yes, "we" who have gotten most of our education about the stock market through watching E*Trade commercials and TV personalities like Jim Cramer.

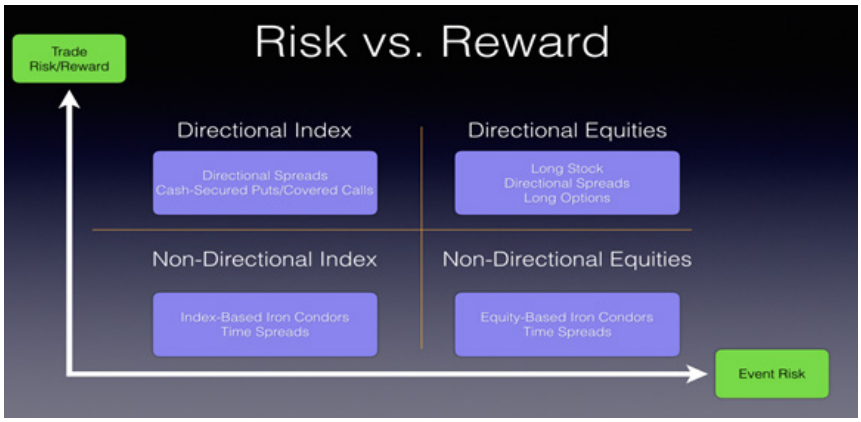
Let's step back from the process for a second and classify our trades in a couple of different dimensions:

Trade Risk/Reward: When we're trading, there is no reward without risk. Conversely, if there is no risk, there is no reward. Generally, the more risks that you face on a trade, the higher the reward should be. Usually, the risk/reward equation is a function of how "directional" the trade set-up is, with a reward being placed on being "right" directionally.

Event Risk: This is the risk that some event could come along unexpectedly and influence the supply or demand for your trade. This could have a positive or negative impact on the price, you just don't know ahead of time.

These are not the only two dimensions that we can plot our trades on, but these are very important. Let's combine these dimensions by plotting the risk/reward of a trade on the vertical axis of a chart in Figure 2, and let's use event risk as the variable on the horizontal axis.

Figure 2



So risk/reward increases as we go higher on the vertical axis, and event risk increases as we move to the right on the horizontal axis.

Now let's fill in the quadrants, starting with risk/reward:

Non-directional trades are going to have less risk and less reward than directional trades are, so the bottom two quadrants are non-directional and the top two quadrants are directional.

Now let's rank positions by event risk:

Index trades are going to have less event risk than individual equities due to the lack of earnings reports, management changes, warnings, surprises, etc.

When we put it all together, we can see that the quadrant with the least amount of risk/reward as well as the quadrant with the least amount of event risk is the lower-left quadrant. Conversely, the quadrant with the highest risk/reward and event risk is the upper right quadrant.

Now let's start to fill in the quadrants with actual trading strategies:

Lower Left: non-directional index-based trades like Iron Condors and Time Spreads.

Lower Right: non-directional equity-based trades like Iron Condors and Time Spreads.

Upper Left: directional index-based trades like ETF/futures swing trades, weekly spreads, debit spreads, and Covered Calls/Naked Puts.

Upper Right: directional equity-based trades like stock, single-stock futures, long options, etc.

Question for you: In what quadrant do 99% of all newer traders begin their trading careers?

You guessed it, the upper-right quadrant, the riskiest quadrant of the four.

Next Question: Which quadrant should traders begin their careers in?

Where else can you find a profession where all of the entry-level trainees start right at the top level? It's like saying that you think you can swing a bat, so you'd like to try out for your local Major League baseball team. You hit a golf ball at the range pretty well the other day (one out of a whole bucket) so you feel it's time to tee it up at the Master's in Augusta, and you check your mail every day for your invitation.

Your son just passed his driver's permit, so it's time to put him in the Ferrari. Example after example where we all have tons of common sense—except when it comes to trading the Market!

And believe me, when you place your position in the market, you're going up against the very best in the world, every day. There are no minor leagues in trading.

Now, maybe you didn't recognize the names of some of those trading strategies; that's OK, we'll get to those shortly.

CREATING THE INCOME PYRAMID

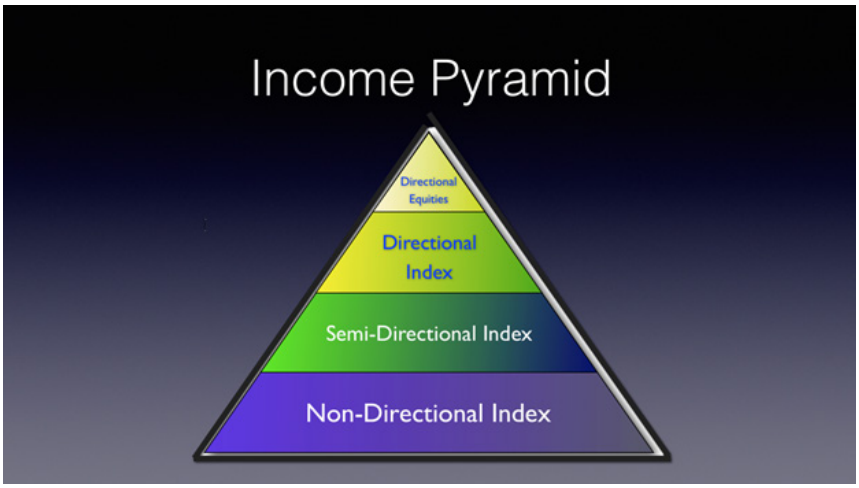
So far you've learned that you should be trading non-directional index trades to start, whatever those are. Does that mean that we should NOT be trading stocks or other valid strategies? NO, of course not...all in good time, and when you've "earned the right." It's time to build our trading "house," which happens to be in the shape of a pyramid.

When you build a house, what is the most important floor of the building? The first floor with the family room and kitchen? The second floor with the bedrooms?

HOW ABOUT THE FOUNDATION?

Without a doubt that's the most important floor of the house; without a solid foundation, every floor above it will sag/settle and show cracks. It's a nightmare that never ends. The same thing applies to your trading. You must build a solid foundation for your trading business that is solid as a rock, and is available month after month. Once you set the foundation, you can build on top of it. And this is exactly where our "Income Pyramid" comes in.

Figure 3



We will set up the “floors” of this Income Pyramid in this manner, using the appropriate trading strategy at each level. The shape of the pyramid represents the amount of capital that we will bring to bear with each strategy as well.

Each of the floors will have the following income-earning strategies in play:

Foundation: non-directional index strategies like High Probability and Low Probability Iron Condors or Time Spreads like Calendars and Diagonal Spreads, being played on an index chart, can offer consistent monthly income and are limited risk/limited reward yet yield excellent probabilities.

First Level: semi-directional index strategies like cash-secured Puts/Covered Calls can be played during favorable trends using index charts, also offering consistent monthly income with slightly higher risks and higher potential rewards vs the non-directional trades. These trades do require somewhat of a positive trend to be effective.

Second Level: directional index strategies like long stock, index futures, and/or directional and weekly spread strategies offer occasional, higher-reward opportunities when high probability set-ups are present.

Third Level: directional equity stock strategies using stocks or directional spreads offer occasional, high-reward “home run” opportunities when high probability set-ups are present.

When you put all of these strategies together, you have a vertically-integrated set of trading strategies that all work together harmoniously to provide consistent streams of income without much regard to what the underlying market is doing; this is why I call it the “Income Pyramid.”

Something else that the pyramid represents is your progression as a trader; once you master each level, you will “earn the right” to move to the next level and attain higher potential returns. With this in mind, notice how trading individual stocks is at the very top of the pyramid, using the smallest amount of capital.

Isn’t this exactly the opposite of what you have been doing to this point?

It was for me when I first started trading, and it’s the same for 99% of traders that I come across. It requires you to break your current paradigm of thinking that the way that you must trade is to find that “needle in the haystack” stock that Goldman Sachs and their billions in research somehow overlooked. One of the COOLEST things about this income pyramid is that the first three levels can be played using ONE STOCK CHART, like the S&P 500 or the Russell 2000. I cannot possibly be an expert in 6,000 individual stocks but I can get to know one or two charts really, really well.

And you can, too.

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ABOUT THE AUTHOR

Doc Severson has been actively trading the U.S. stock, futures, and options markets since the mid-90s and his specialty is trading the U.S. equity options market. With a background in engineering, Doc is able to break down complex market ideas into an easily digestible format.

For the past ten years he has provided daily insights and market analysis via market newsletters, as well as helping students learn the complexities and edges of the options markets through live training and courses. Doc can be found at TheoTrade.com, daily in TheoChat® and twice per week in TheoNight® providing market insights and trade ideas.

THE STRATEGY FOR A SCHEDULED OPTIONS PAYDAY EACH QUARTER

By Christopher Irvin, MarketTraders.com

Four times each year, stock and equity options traders' ears perk up.

Like clockwork, their gears start to turn and they type away at the keyboard, looking for the earnings season schedule of big-name companies like Google, Apple, Netflix, Tesla… The list goes on. It's like an appointment for profits.

Each earnings season, the stock market sees a spike in volatility, in profit potential, for traders with a weather eye on the horizon. As stock traders take to the charts, equity options traders do the same, looking to take advantage of stock movements for pennies on the dollar and get a little piece of the pie.

What if you could do the same?

What if each quarter, you set aside a handful of hours to execute a few options trades where you could potentially profit 25-30% overnight?

It happens, and more frequently than you might think. I've been trading for more than 15 years and I've not only seen it happen through my students' successes at Market Traders Institute, I've watched it happen in my own account too. The beauty of it is that no matter what time of year it is, you could be preparing for earnings season.

This is the precise strategy that I use each and every quarter…

What is the Earnings Season?

Earnings Season: The time around the beginning of each financial quarter when publicly-traded companies release earnings reports for the previous quarter.

THE CATCH

Despite what some traders will tell you, as an equity options trader, the actual earnings number is not the issue. I really don't even care if the company makes money or loses money. What counts is how investors react to the news.

What is the important part? The knee-jerk reaction of investors.

Because investors assign a positive or negative emotion to those numbers, the stock can jump, or dump. These moves can make for great opportunity if you know how to play the move.

I focus on the reaction that the stock's price has to the earnings number.

That's what will drive the intrinsic value in my options, and therefore the profitability in the trade. The intrinsic value of an option is the component of the options price that is DIRECTLY affected by the movement of the underlying stock. If the stock goes up $1.00, the intrinsic value goes up $1.00. That is why we need the stock price to move big. In order for a straddle to work, intrinsic value needs to take off.

The other day, Netflix (NFLX) had its earnings announcement. The company made $0.06 per share, but the bigger story to me was that the $100.00 stock moved approximately $17.00 the next day. That is the type of move that we are after. The total cost of the straddle in this situation was on $12.80 per share. Since the underlying stock moved $17.00, the intrinsic value boosted the trade to a profit. Like I said, I don't care about the $0.06. I care about the $17.00 and what that move will do for my options.

One of the great things about a straddle trade is that I really did not even care if the stock moved up $17.00 or down $17.00. I would profit either way. That is correct – I do not have to choose a direction. It's just one more way that this strategy takes the stress out of your trades.

THE 4-STEP EARNINGS SEASON PROFIT PLAN

THE STRADDLE TRADING STRATEGY

An options straddle blows some traders' minds. You don't pick the stock's direction. Truly, your only concern is that the stock moves. Period.

Not a bad strategy, right?

Volatility: The amount of market action. Also known as "the spread" in the market's waves or the price fluctuations a stock experiences.

Typically, if you're buying a call option, you're looking for the stock price to go up.

If you buy a put option, you are looking for the stock's price to move down.

In an options straddle, you buy a call and buy a put simultaneously.

When you place these orders, you just want the stock to react to the earnings announcement. The bigger the reaction the better.Positive or negative does not matter, we just want it to move dramatically.

Options Straddle: When you buy a call option and buy a put option at the same time, you straddle the market price so that no matter which direction the stock moves, you could profit.

Why Trade In Both Directions?

So you might be thinking, if I'm trading in both directions, won't the trades cancel one another out? Or worse, won't that mean that the market will inevitably go against me?

Yes and no.

When the market moves big in one direction, one of your options, either the call or the put, will increase in value. The other decreases in value. You will be losing money in that negative trade, but the objective is to have the winning trade outweigh your losing side.

This is where you start to see profit. The profit of the winning trade should be much larger than the loss in the losing position.

As a matter of fact, your loser may get crushed into oblivion. The good news is that when you buy options, your risk is limited to the cost of the option, and your reward is unlimited. So if your winner increases by more than the cost of the total loser, we have a winning straddle.

HOW IT WORKS

The key is buying equal numbers of “at the money” calls and puts prior to the announcement. This is why having the announcement release date on your calendar is so critical. When you buy an equal number of at-the-money calls to puts, you are creating a “delta neutral” strategy. At-the-money call options will have deltas of .50, and At-the-money put options will have deltas of -.50. When these deltas are added together, we end up with a delta of “0,” or delta neutral.

Delta: Stemming from the Greek word diaphora, which means “difference.” This number tells you how much you will profit based on a $1.00 move of the stockl e.g., if a trader buys an option with a 0.75 delta, and the underlying stock moves $1.00, the option will increase in value by $0.75.

Delta Neutral: Puts always have a delta from -1 to 0 and calls from 0 to 1, so when you buy a put with a delta of -0.5 put and a call 0.5 delta, your deltas will cancel each other out and you will be left with a delta neutral position.

You are dealing with two deltas in this case.

Let’s say that we get into a straddle trade where the call option has a delta of 0.50 and the put option has a delta of -0.50. The earnings are released and the stock gaps up in the pre-market. This causes the call options to increase in value, and along the way the delta is ratcheting up, 0.50, to 0.55, to 0.60, to 0.65 eventually moving up to 0.85. This means that my call option is now making me $0.85 every time the stock move up $1.00. That is great!

But what about the put positions? The put delta will start moving in the opposite direction; -0.50, to -0.45, to, -0.40, eventually falling to -0.20. The put, being on the losing side of the trade, is actually losing money slower. In this case, at this level, the put option is losing $0.20 for every $1.00 the underlying stock price moves up. Here is the great thing about the current state of our hypothetical trade. We are making $0.80, with our Call option, for every $1.00 move of the underlying stock, while we are losing $0.20 for the same move with the put. The net result is a $0.60 profit. That is why straddles work!

PRO TIP: The Ultimate Stock and Options Course teaches to buy options with deltas between 0.5 and -0.50 for straddle trades during earnings season. (The trade is not a straddle if you use options with deltas other than 0.50 and -0.50.)

WHEN TO STRADDLE THE MARKET

It's simple really. The straddle strategy allows a trader to take advantage of a known event that has a high probability of causing the stock to move 10% to 15%, regardless of direction. This is why it's a perfect strategy to master when trading earnings announcements.

THE KEY TO THE STRADDLE

Understand this: a straddle is not an ideal strategy for every stock at earnings. The reason is that not every stock has the potential for the required move it will take to put the trade into a profitable position. For this reason, you will need to do your homework before placing a straddle.

Now, let's explain the top five ways to judge whether or not a particular trading opportunity is a good pick for an earnings season straddle trade.

5 STEPS TO SUCCESSFUL OPTIONS STRADDLES

STEP 1: STALK YOUR PREY

First and foremost, you'll need potential stock shares that you'll want to monitor. All of the following steps require that you have particular companies in mind, access to their current share prices and, preferably, have an idea of when their earnings reports will be released for the coming quarter.

STEP 2: LOOK TO THE PAST TO PROFIT IN THE FUTURE

Now that you have several stocks in mind, you'll want to look back on the historical data for the stocks in question, be it Apple, Google, Netflix, Tesla,whichever stock you're looking to profit from.

To do this, you want to look back on the stock charts and identify the four most recent earnings report releases dates. Once you have found them, check out the price fluctuations in that company's stock price following each announcement.

You'll want to answer three questions:

1. What was the closing price prior to the announcement's release?
2. What was the opening price the day after the announcement's release?
3. What was the peak or valley before turn price – after the announcement's release?

Peak or Valley Before Turn Price: The price the stock hits, before its first reversal, after the report's release.

The measurements from close to open, and close to peak/valley can give you an indication as to whether the stock has moved substantially in the past at earnings announcements. If the cost of the straddle is less than the historical movement at earnings releases, you may have a potential straddle candidate.

Example:

Let's take a look at an older example of this for the sake of clarity.

Below are four consecutive earnings report numbers for Netflix (remember that you'll always want to pull the four MOST RECENT earnings numbers for judging your potential straddle trade):

Earnings Report from 1/20/15

Pre Earnings Close - $349.40

Post Earnings Open - $414.68 ($65.28 move or 18%)

Post Earnings Peak - $457.38 ($108.28 move or 30%)

Earnings Report from 10/15/14

Pre Earnings Close - $448.59

Post Earnings Open - $332.73 ($115.86 move or 25%)

Post Earnings Low - $331.00 ($117.59 move or 26.2%) – immediate bounce

Earnings Report from 7/21/14

Pre Earnings Close - $452.00

Post Earnings Open - $442.98 ($9.02 move or 1.9%)

Post Earnings Low - $412.51 ($39.48 move or 8.7%)

Earnings Report from 4/21/14

Pre Earnings Close - $348.49

Post Earnings Open - $376.63 ($28.14 move or 8%)

Post Earnings Peak - $380.88 ($32.39 move or 9.2%) – immediate drop

In these examples, you can see that the two most recent earnings releases caused the stock's price to move between 18% and 30%. If we were looking at a straddle that hypothetically cost 15% of the current cost of the stock's price, the trade would have potential.

WHAT'S THE MAGIC NUMBER?

Unfortunately, there is no magic number and there's no holy grail. In the past, I have looked for stock price fluctuations between 12-15% minimum. That often creates enough movement to produce a profitable trade in a straddle situation. The only way to truly make a sound judgement is to determine the current price of the straddle and compare that price against the average price movement over the past four earnings releases. If the cost of the straddle is greater than the average move, the trade probably will not work. If the average move is greater than the cost of the straddle, the trade has a good chance of working.

STEP 3: LET THE BIG DOGS WEIGH IN

Now, this is a dangerous one if you're not careful. While we want to consider what key analysts are projecting, we don't want to trade the news, we want to trade the moves. At the same time, once you have your stock picked out in Step 1, it's good to check in on the analysts' insights.

You want to focus in on the highest analyst price target. When the cost of the straddle is added to the current value of the stock, you arrive at a number that is less than the analyst target, indicating that your straddle has the potential of working out.

PRO TIP: Don't pay attention to the earnings estimates. Instead, look to see where the analysts have set their highest price targets for the stock. This is what they think that the stock is worth. Traders like to drive prices up to the analyst targets and stop, so if the straddle profit target is lower than the analyst price target, the straddle should be in good shape.

STEP 4: DON'T FORGET THE FIBS

The Fibonacci sequence is an old mathematical golden ratio you probably learned in some middle school or high school math class and quickly forgot about it, dismissing it as something you couldn't possibly, ever in a trillion years use… That is, until you began to trade the markets.

The next step (the decision-making process) for your trade is to draw out the Fibonaccis.

In this instance, you want another point of confirmation. You're looking to be able to say that the stock has the potential to make the range of movement you're after within the current extension or retracement. If it is not, then your technicals do not match up with what you require to be profitable in your trade. While this may not be a 100%, sure-fire way to decide whether or not to avoid the trade, it is a critical component many traders take into consideration in passing up a trade.

See what the Fibs look like on the charts:

STEP 5: GIVE THE VOLATILITY CHARTS A VOTE

Have you ever seen a volatility chart? These charts help options traders determine whether an option is overpriced or underpriced. This is a wonderful gauge for seeing if the options are priced at a level that is just too expensive to place the straddle.

The chart is very visual, and simple to read. The chart will have two lines. One shows the historic volatility and the other represents the implied volatility. If the implied volatility line is higher than the historic volatility line, the options are thought to be expensive. If, on the other hand, historic volatility is higher than implied volatility, the options are thought to be inexpensive.

What we really want to see is just how expensive our options are. What you're looking for is the skew between the historic and implied volatility. The closer these two numbers are together, the smaller the skew. The smaller the skew, the less expensive the options and the better your chances will be of covering the cost of the straddle. The wider the skew, the more expensive the trade becomes and your chances of covering the straddle cost goes down.

Skew: A fancy math term for the difference or distance between two numbers.

Historic Volatility: Gauge of how much the stock's price has flopped around and moved based upon past data.

Implied Volatility: Representation of the average analyst sentiment as to what they believed the volatility will be in the future. (This directly ties into Step 2!)

THE SPECIAL OFFER

Earnings season trading is as close to appointment-style trading as you can get. With just one strategy, the options straddle strategy, you could have a payday scheduled for every quarter.

Do you want to get more hands on experience with this strategy?

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ABOUT THE AUTHOR

Chris Irvin is a real Trader. Over the past 15 years, he's traded stocks, options, futures and currencies. For him, trading is more than being your own boss; after all, he's been an entrepreneur since 1996. He knows that trading is a way to take control of your life. For him, being able to rely on himself is true freedom. Recognized for his trading skills in 2011 by Trade King and being an expert contributor in publications such as Invezz, Chris has put his trading knowledge to use in developing training materials and teaching traders across the globe since 2004. Now, after joining MTI in 2012, Chris continues to actively trade and teach others how to do the same without going through the school of hard knocks like he did.

TRADING CREDIT SPREADS FOR INCOME USING MEASURED MOVE TARGETS

By Andrew Keene, AlphaSharkTrading.com

Many options traders prefer to avoid making directional plays with options. The idea that time decay will eat away at the value of a position if it does not move quickly enough turns a lot of traders away from directional strategies and outright call and put trading. Traders who want to avoid this type of trading often turn to credit spreads and non-directional options strategies that create “income” from being short options premium. While this is a very popular method of trading, most traders that run these types of strategies lack a systematic and methodical approach to setting them up. Here we’ll discuss a simple method for setting up these types of trades in individual equities, indices, and ETFs.

Before we can dive into the actual trading plan, a trader needs to have a good understanding of the options strategies that we will be using. To set up credit spreads for income, a trader will use a variety of short premium trading strategies. In this piece, we will cover iron butterflies and credit call and put verticals. To trade income strategies successfully, a trader needs to have a solid understanding of these options set-ups.

The Income Trading Tool Kit:

Credit call vertical: Known as a short call spread or a bear call spread, this is a directional trading strategy that gives a trader an alternative to naked short calls. This spread involves a trader selling a call while buying a higher strike call to cap risk. The main advantage of the strategy is that it allows a trader to get short implied volatility and benefit from time decay with much less overall risk than a naked short call.

Example: A trader sells the XYZ Jun 100-105 call spreads for $3.00.

Risk: $200 per 1 lot

Reward: $300 per 1 lot

Breakeven: $103.00

In this example, a trader has sold the 100 strike calls and bought the 105 strike calls for a net credit of $3.00. The maximum value of the spread is $5.00, so the most a trader can lose is $2.00. This is a trade that a trader would do if they wanted to set up an income play with a bearish bias. This spread will benefit from time decay and any move lower in implied volatility. A graph of the positions profit and loss profile is below.

Bear Call Spread Profit and Loss Profile:

Credit put vertical: Like a short call spread, this is a strategy that benefits from time decay and drops in implied volatility. This strategy is also known as a bull put spread. This trade set-up allows a trader to take a bullish view on the price of the underlying while getting long time decay. This strategy also offers a much less risky way of doing this than a naked short put would.

Example: A trader sells the XYZ Jun 100-95 Put Spreads for $3.00.

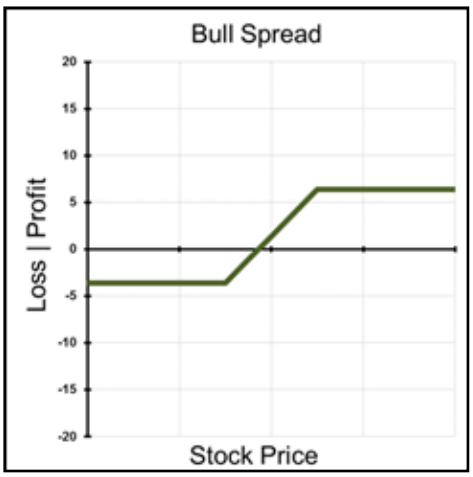
Risk: $200 per 1 lot

Reward: $300 per 1 lot

Breakeven: $97.00

In this trade, a trader has sold the 100 puts and bought the 95 strike puts. Again, the maximum value of the spread is $5.00, so the most a trader can make in this position is $300 per 1 lot, and the most they can lose is $200 per 1 lot. This trade offers the trader a way to get short premium, long time decay and short implied volatility with much less risk than a naked short put. A graph of the positions profit and loss profile is below.

Bull Put Spread Profit and Loss Profile:



Iron Butterfly: This is a more complex spread that a trader can use if they do not have any bias on the direction of the underlying. A trader would put this spread if they think that the market's expectations for movement are higher than they should be. This spread can be thought of as a combination of a short call and short put vertical spread or a combination of a short straddle and long strangle. Typically this strategy is run at the money and is put on if a trader thinks the stock will move less than the market expects by options expiration.

Example: A trader sells the XYZ Jun 95-100-105 Iron Butterfly for a $4.50 Net Credit.

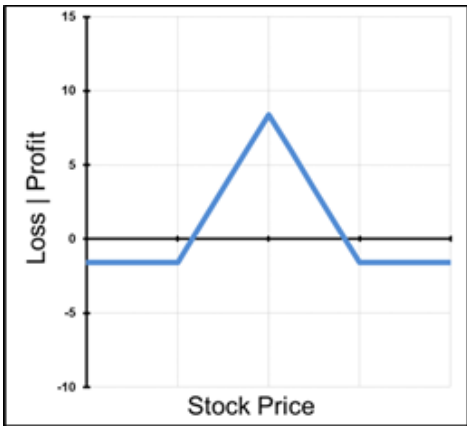
Risk: $50 per 1 lot

Reward: $450 per 1 lot

Breakeven: $95.50 and $104.50

This trade profits if the stock is anywhere between $95.50 and $104.50 on option expiration. In this trade, a trade is long the 95 puts, short the 100 calls and puts, and long the 105 calls. If run at the money, it is a delta neutral, non-directional trade. Since the trader is giving himself an upper and lower bound for profitability, the premium collected can be much higher. The reward to risk set-up in this trade is also more favorable than the directional plays a trader might make using individual call and put spreads. This trade benefits greatly from time decay and any drop lower in implied volatility. This type of strategy essentially offers a trader the same benefits as a short straddle but with a limited maximum risk level. Below is a chart of the profit and loss profile for an iron butterfly.

Iron Butterfly Profit and Loss Profile:



WHEN TO TRADE THESE SPREADS

With a solid understanding of the different types of income trades, a trader then needs to understand exactly when and why he might choose to trade them. Generally speaking, traders will put on strategies like this when they believe that the level of volatility being priced

into the market is too high. There are times when implied volatility is inflated, namely ahead of catalyst events, where this type of trading might be attractive. Let's review what some of these situations might be.

1. Ahead of an earnings announcement: Before a company reports earnings, the uncertainty around the release can cause a move higher in implied volatility. If everything is working the way that it should be, no member of the trading public knows what the earnings are going to be, and this uncertainty is reflected in higher options premiums. Implied volatility also describes the supply and demand relationship in options markets and the potential for a large gap higher or lower on an earnings announcement, creating increased demand from both hedgers and speculators looking to put on a position in the options market. This increase in implied volatility can give traders the opportunity to sell "expensive" options ahead of the announcement if they believe that the move being priced into the market is too high. Traders can approach this by using call or put verticals if they want to be directional, or an iron butterfly if they want a more delta neutral trade set-up.

2. Ahead of a macro data release: For traders who are interested in more macro plays in ETFs or indices, they may want to focus on the periods ahead of an important data release. Indices don't report quarterly earnings, so there the opportunities to trade inflated implied volatility happen ahead of market-moving announcements. Traders who want to take positions in index ETFs like the SPY, QQQ, DIA or other sector ETFs can use verticals or iron butterflies to get short premium when they expect the move might be too high. Events like Fed announcements, the employment situation, crude oil inventories, and other macro data events can present a trader with the opportunity to get short premium and long time decay in an inflated implied volatility environment when they have a lower expectation for movement than the market does.

3. In a week or month where there is an expected range: A trader does not necessarily need to wait for a catalyst event to trade a credit spread. Most traders will use these types of strategies when they have an expectation for muted movement in the underlying stock over a certain time frame. Traders can set up weekly or monthly income trades in stocks that they think will be relatively flat but still have options markets that offer a good amount of premium to sell. In general, these trades will not have as good of a reward-to-risk set-up as a trade taken head of a catalyst event because implied volatility will not be as inflated. With that being said, implied volatility tends to be priced to highly on a monthly basis in names like SPY. Straddle sellers on a monthly basis are winning traders in the long run, but that does not mean that markets are setting up well for an income trade every single month.

While there are many other times that trading a credit spread might make sense, these are probably the most common set-ups. After a trader has determined that they are going to trade a credit spread, they then need to figure out if they are going to put on a directional trade or a non-directional trade. Whichever they choose, they will need to first calculate the expected move in the underlying and then develop measured move targets.

CALCULATING MEASURED MOVE TARGETS

Before traders can select a strategy, they need to determine what the market's expectations for movement in the underlying security are. To do this, they can use the options market to back out the market makers' expected move. In order to make this calculation, a trader needs to understand how to find the price of the at-the-money straddle.

At-the-money straddle (ATM straddle): The price of the ATM straddle is calculated by adding the price of the ATM calls to the price of the ATM puts. This shows us how much movement the market makers are pricing into the options market for that given expiration. This price represents the expected up or down move between the present and options expiration. For

example, if the XYZ Apr ATM Straddle is trading at $5.00, that tells a trader that the market makers think XYZ will be higher or lower by $5.00 on April expiry. A trader can then use this expected move to calculate implied closing prices for expiration day. Look at the example below.

Example: The SPY is trading around $204.00, and a trader wants to know where the market makers are expecting the stock to trade on May expiration. First he has to look at the price of the May ATM straddle.

We can see that the May 204 straddle is trading at around $8.20 at mid-market. This is the size of the up or down move that market makers are pricing into the May options. Using this straddle price, we will calculate upside and downside closing targets for May expiry.

Measured Move Targets:

Upside Target = $204.00 + $8.20 = $212.20

Downside Target = $204.00 - $8.20 = $195.80

Once these targets are calculated a trader can use them to set up a credit spread. The goal for the spreads should be for the short strikes in the spread to be as close to one of these levels as possible if a trader is putting on a directional trade. If a trader is choosing a delta neutral iron butterfly set-up, he will sell the at-the-money strike.

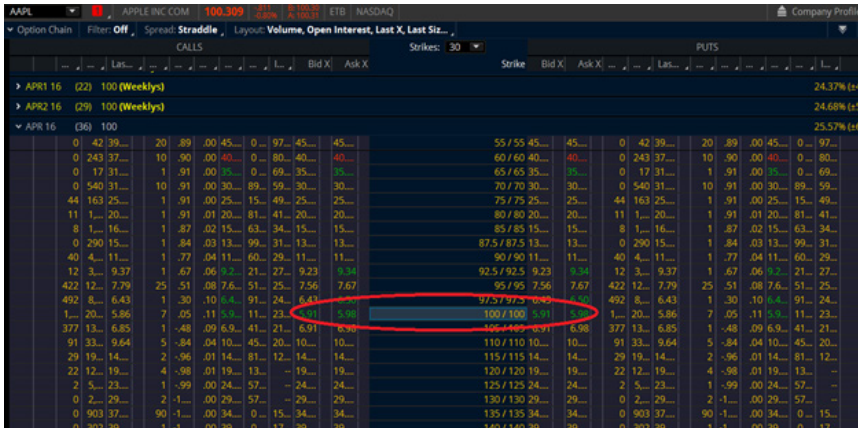
Anytime a trader wants to set up a credit spread, he should use this method for calculating targets and then use those targets in the strike selection. To illustrate this further, we will break down a trade setup in AAPL.

PUTTING THE PLAN TO WORK

We will start with a non-directional iron butterfly setup in AAPL. To set this trade up, we will go through three steps that will help guide us to a trade set-up. Since we are looking at an iron butterfly, the trader that does this trade should have an expectation for little to no movement in AAPL by expiration.

First traders need to decide what stock they want to set up a credit spread in. They can use any technical or fundamental analysis method they choose to select a stock, but they should be looking for a stock that they think will not move much in either direction by options expiry. Once they have made this selection, they need to calculate how much the market is expecting the stock to move, then use these calculated levels to select strikes for a credit spread. In the example below, we will set up a credit spread in Apple Inc. (AAPL) with the expectation that the stock does not move much by options expiration. (Note: we do not necessarily think this will be the case, we are just using AAPL for the purpose of the example.)

Step 1: Calculate the expected movement in AAPL by options expiration. We are looking for a trade through Apr expiry, so we first must calculate the at-the-money straddle price in April. AAPL is trading at $100.30 so we will look at the Apr 100 strike straddle.



As can be seen in the above options chain, the 100 strike straddle is trading around $5.95. This tells us that the options market is expecting a move higher or lower of $5.95 by April options expiry. We can then use this expectation to calculate implied closes for expiration.

Step 2: Calculate an upside and downside target for expiration:

Upside Target = $100.30 + $5.95 = $106.25

Downside Target = $100.30 - $5.95 = $94.35

With these calculated targets a trader can now select options strikes to set up a credit spread. We will look at a non-directional example of an iron butterfly.

Step 3: Set up the spread.

We will use the calculated targets to set up the spread. To set up an iron butterfly, a trader would short the at-the-money straddle and buy a wider strangle with strikes closest to the calculated targets. In this case, a trader might choose the following trade.

Trade: Selling the AAPL Apr 95-100-105 Iron Butterfly for $3.70.

Risk: $130 per 1 lot

Reward: $370 per 1 lot

Breakeven: $96.30 and $103.70

The breakeven points are inside of the calculated targets. But remember the reason traders put this position on is because they expect the stock to move less than what the market maker is implying in options. This spread puts time decay on the side of the trader and also gets them short implied volatility. This simple three-step plan is something that a trader can use to set up credit spreads in any optionable security.

The same concept can be applied to directional trade set-ups. If we use the same calculated targets in AAPL, we can set up directional bets using call or put spreads. When setting this trade up, traders can choose how aggressive they want to be. If they want to be more aggressive, then they can sell either half of the iron butterfly without setting the other half of the spread.

Aggressive bullish trade: Trader Sells the AAPL Apr 100-95 Bull Put Spreads for $1.85.

Risk: $315 per 1 lot

Reward: $185 per 1 lot

Breakeven: $98.15

Aggressive bearish trade: Trader Sells the AAPL Apr 100-105 bear call spreads for $1.85.

Risk: $315 per 1 lot

Reward: $185 per 1 lot

Breakeven: $101.85

These are more aggressive positions because the trader is selling the at-the-money strike. If traders sell a further out-of-the-money strike, they will collect less premium but have a higher chance of success. It's up to the trader to determine the right direction to play. But using this method to calculate key levels and set up credit spreads will lead to higher success rates and smarter, more thoughtful trade set-ups.

CONCLUSION

These methods can be used to take more informed trades in equities, futures, indices, and any other financial instrument that has listed options. It is important to remember, however, that credit spreads do expose a trader to implied volatility, and any significant move higher in volatility can cause these positions to experience a loss. In any event, any trader who does not have a method in place for setting up trades like this should be considering using a plan that develops targets and levels in this manner. Selecting strikes and price levels to run credit spreads at, without a thoughtful analysis method, is a path to trading losses and a lower probability of success.

MORE ON ALPHASHARK TRADING

AlphaShark offers a Live Trading Room and a Premium Alert Service, and most importantly an Options Education and Mentorship program. The Trading Room serves to facilitate what Andrew Keene has dubbed the “new wave” of trading—individual retail investors actively trading their own accounts.

In the Trading Room, our team of moderators provide seven hours of market commentary each day, to an audience ranging from hobbyists to hedge fund managers. The Premium Alert Service is a scaled-back version of this: Andrew sends filtered text messages of what he says to the room and the positions that he monitors.

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ABOUT THE AUTHOR

Andrew Keene is President & CEO of AlphaShark Trading, which he originally founded as KeeneOnTheMarket.com in 2011. Previously, Andrew Keene worked as a proprietary trader at the Chicago Board Options Exchange. He began his career in the prestigious Botta Capital "clerk-to-trade" program, and would eventually co-found KATL Group, where he was the largest, independent on-the-floor Apple trader in the world.

Keene has earned millions in profits in the course of his trading career. He has traded profitably for six years straight and counting, and is profitable 11 of the past 12 years.

Andrew currently actively trades futures, equity options, currency pairs, and commodities. He is a regular guest market commentator on such networks as Bloomberg TV, CNBC, and Fox Business.

Keene's first love will always be trading, but he is arguably even more well known for building one of the biggest live trading rooms in the world. Andrew is especially proud of having taught his personal strategies to over 50,000 students over the past four years.

In 2015, Andrew began appearing as a regular guest on CNBC's Trading Nation, where he focuses on educating viewers on equity options markets and the trading insights they provide.

Andrew received a B.S. in Finance with a concentration in Accountancy from the University of Illinois.

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A 6-STEP PLAN FOR TRADING MARKET VOLATILITY SELLING OPTIONS FOR PROFITS & HEDGING

By Larry Gaines, PowerCycleTrading.com

Trading for yourself can be one of the most rewarding jobs on the planet, if you are educated about what you are trading and if you stay focused on managing your trading risk. I tell my clients and members "there's no perfect trader…there's no perfect system… it's a journey of learning and I am on that journey too…constantly learning each and every day…"

My real "Aha" trading moment came when I reset my trading mindset and started to incorporate a variety of well-defined, low-risk option strategies into my trading. To have a successful trader mindset, risk management and consistency is what wins out, and this is what I'll cover in this chapter.

A 6-Step Plan for Option Trading Success

Step 1. Avoiding the #1 Option Trading Mistake

Step 2. Most Important Option Factor

Step 3. How Option Pricing Works

Step 4. Knowing & Using the Market Makers' Secrets

Step 5. Highest Probability Option Strategies for Every Market

Step 6. Risk-to-Reward

STEP 1.

Avoiding the #1 Option Trading Mistake

Option trading has many more advantages than trading stock, but, as you probably know, it is a bit more complicated, as well.

And, for the individual trader, options can be a little intimidating. That's why many investors trade options by purchasing Out-of-the-Money options (often short-term options), since they cost less than long-term options, and it's a simple strategy.

For example, Out-of-the-Money calls are especially popular because they are cheap and seem to follow the old Warren Buffet paradigm we all love: **buy low, sell high**.

But is this always the best option strategy?

Imagine you're bullish on Facebook (FB), trading at $100.

As a beginning option trader, you might be tempted to buy calls 30 days from expiration with a strike price of $120 at a cost of $0.15, or $15 per contract.

Why? Because you can buy a lot of them.

Let's do the math.

Purchasing 100 shares of FB at $100 would cost $10,000. But for the same $10,000, you could buy 666 contracts of $120 calls and control 66,660 shares. WOW!

Imagine FB hits $121 within the next 30 days, and the $120 calls are trading at $1.05 or $105 per option contract just prior to expiration.

You'd make $59,940 in a month!

At first glance, this kind of leverage is awesome!

But don't let this glitter FOOL YOU . . . because not losing money is just as important

as making money!

One problem with short-term, Out-of-the-Money options is that you not only have to be right about the direction the stock moves, but you also have to be right about the timing.

- That ratchets up the degree of difficulty.
- To make a profit, the stock doesn't just need to go past the strike price but also must do this within a defined period of time.
- In the case of the $120 calls on FB, you'd need the stock to reach $120 within 30 days to make a profit.

This dual objective of having to be right on direction plus on timing really **lessens the probability of an option trade being a winning trade when buying options.**

And everything that I teach my clients is based on managing risk and **increasing the probability of winning trades.**

In the Facebook option trade, you are wanting the stock to move more than 20% in less than a month. This would be like a 2-Standard Deviation move!

How many stocks are likely to do that?

"Not many." In all probability the stock would not reach the strike price, and the options would **expire completely worthless.**

Based on probability, using Standard Deviation, there is only about a 5% chance of this stock reaching $120 to $121 by expiration.

So in order to make money on an Out-of-the-Money call, you either need to outwit the market or get plain lucky.

Being close means no cigar.

- Imagine that FB rose to $110 during the 30 days of your option's lifetime.

- You were right about the direction the stock moved.
- But, since you were wrong about how far it would go within a **specific time frame**, you'd lose your **entire investment**.

And this is outright painful!

So, based on this trade example, a better goal for every trader would be to select trades based on what provides the most consistent, positive returns, not a one-time big winner.

And consistency is derived from making HIGH PROBABILITY trades based on reliable data and facts.

Where there's a big disadvantage, such as the one you saw in the option buying scenario, you can usually just look at the flip side of the coin and see an equal and opposite advantage.

In this case, **being a SELLER of options gives you a huge advantage over being a buyer of options.**

All of the pros know this and take advantage of it, and so can you.

So as a seller, all of the things in this example are the same, but in your favor, instead of against you.

This is why a lot of people take advantage of <u>selling options for profit generation and hedging...</u>

- By selling options, we are, in essence, "selling time."
- What a powerful dynamic...
- And it's a strategy that's yours for the taking...
- An option is like a coupon that must be redeemed by an expiration date or else it is no longer valid.

But how is this done & what is involved?

STEP 2.

The most important option factor for income generation is understanding the concept of TIME, and that's pretty simple, as you just saw . . .

Time Value

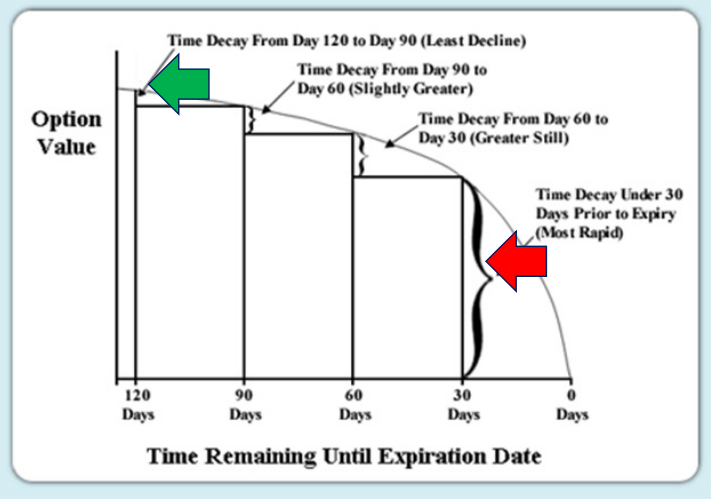
Time Value is used for trading strategies that take advantage of the accelerated Time Decay of an option into its Expiration.

Option Income Strategies are very tied to Time Value and the impact it has on the price of an option.

What exactly is Time Value?

- **Time value (TV)** (extrinsic) of an option is the premium a rational investor would pay over its current exercise value (intrinsic value), based on its potential to increase in value before expiring.
- This probability is always greater than zero, thus an option is always worth more than its current exercise value.

Take a look at the following chart to see just how predictable and powerful this option paradigm is! And answer the question that follows:



So if the underlying security price were to go sideways, having no directional trend, would you have wanted to have BOUGHT an option 120 to 90 days out, or would you have rather SOLD an option?

This is the common natural time value progression for all options.

And it's seriously like falling off a cliff . . . blindfolded!

STEP 3.

How Option Pricing Works

Here's how to value an option: Time Value (x) Implied Volatility (x) Intrinsic/Extrinsic Value...

Once you know these variables, then you are ready to price an option & know what its option premium should be.

OPTION VALUE- NUMERICAL APPROACH

	Time value	Implied V	Intrinsic/Extrinsic	Premium
Thursday	1.00	300	1.00	$ 300.00
Friday	0.88	300	1.00	$ 262.50
Saturday	0.75	300	1.00	$ 225.00
Sunday	0.63	500	1.00	$ 312.50
Monday	0.50	800	1.00	$ 400.00
Tuesday	0.38	500	1.00	$ 187.50
Wednesday	0.25	600	1.00	$ 150.00
Thursday	0.14	100	1.00	$ 14.29
Friday	0.00	50	1.00	$ -

STEP 4.

The Market Makers' Secret

What they don't want you to know...

Option Implied Volatility

Standard Deviation

Option Delta

- Broad markets tend to have two- to three-week cycles and will trade in sideways channels 70% to 80% of the time.
- Based on this sideways price movement, Out-of-the-Money (OTM) option buyers will lose approximately 70% of the time.
- Market makers know these statistics and, therefore, tend to trade from the sell side.
- This is the professional money, so you need to think like a market maker.

It's all based on the Math!

- Market Makers use mathematical market probability statistics for pricing the movement of an option to its expiration.
- Knowing the probability of an underlying security finishing within a certain range at expiration is key when determining what options to buy or sell and what option strategies to implement.
- These statistics forecast how likely it is that an option will fall within a certain price, up or down, by its expiration.
- This statistical forecast is referred to as the Implied Move of the Stock.

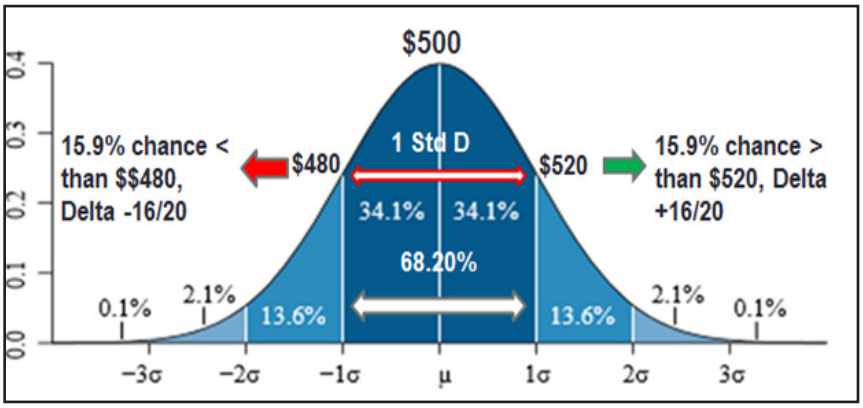
- The Implied move is an estimate of a +/- standard deviation move of the underlying security by its expiration.

Based on these probability statistics, selling options and option spreads, when used correctly, provides the highest probability trade set-ups for generating consistent profits and is also a great way to hedge risk...

And it's all based on the math of probabilities . . .

GOOGL – Implied Move: +/- 4

Option Expiration 10 days



Trading Probabilities

Trading is a business of probabilities, and to be successful, a trader needs to focus on controlling risk. One important step is to know the winning probabilities of any trade taken.

One simple and free tool for measuring probabilities is:

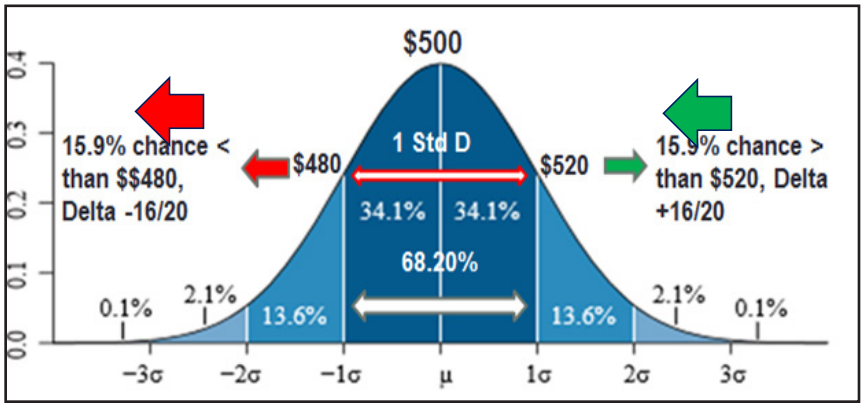
The Option Delta

- It will tell you the value of an option based on the underlying move.
- It is also used to measure the probability of a price move on the underlying move itself.

An Option Delta of 68/70 equates that the strike has a 68%/70% probability of being ITM at expiration.

An Option Delta of approximately +/- 16 is equivalent to the outside point of a 1 STD Implied move at expiration.

This equates that the 16 Delta strike has only a 16% theoretical probability of being ITM at expiration.



GOOGL: A 1-Standard Deviation Implied Move using the ThinkorSwim (TOS) Option Analyzer and showing the call option delta.

- Using this probability analysis provides traders with a very useful tool for determining price targets to trade against, and it's also very useful for setting hedges.

- So, based on the math of probability, you can see that approximately 68.2% of options bought expire worthless, and, based on this, it's a good idea for all traders or investors to consider selling options as well as simply buying them.

This added option strategy for profits and hedging will make a dramatic and positive difference in one's trading performance when used correctly.

And this is why professional money takes advantage of Selling Options for Profit Generation & Risk Management.

STEP 5.

Selecting the Right Income Option Strategy

- The goal of every trader should be to select trades based on what provides the most consistent positive return and not always the greatest return.
- And one of the best ways to achieve this is by knowing the income option strategies that are available and then selecting the one that is best for your trading style and trading plan.

Income Strategies

» Covered Calls

» Calendar Spreads

» Diagonal Spread

» Long Iron Condors

» Credit Spreads

My favorite income option strategy is the Credit Spread for four reasons:

- » It can work regardless of market direction.
- » It almost always works, even if you're wrong!
- » The winning probability of profit is over 68% even without adding technical analysis, which then increases the profit probability even more.
- » They're perfect for Hedging.

There are three types of Credit Spreads:

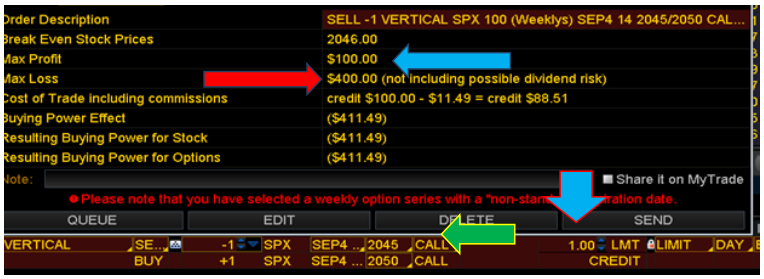
1. Bear Call Credit Spread
2. Bull Put Credit Spread
3. Long Iron Condor

1. Bear Call Credit Spread is best if you think the market is probably going to go down.

Strategy: Selling one call with a lower strike while simultaneously buying one call with a higher strike in the same month.

Selling a Bear Call Credit Spread → 25% Return on Margin

Credit Spread/Max Profit: $100/Ct. Return on Margin: $100/$400 = 25%



2. Bull Put Credit Spread is best when you think the market will probably go up

Strategy: Sell one put while simultaneously buying one put with a lower strike in the same month.

Selling Bull Put Credit Spread

Credit Spread/Max Profit: $130/Ct. Return on Margin: $130/$370 = 35%

Order Description	SELL -1 VERTICAL WYNN 100 JUN 14 187/182 PUT
Break Even Stock Prices	185.70
Max Profit	$130.00
Max Loss	$370.00 (not including possible dividend risk)
Cost of Trade	($130.00)
Buying Power Effect	($370.00)
Resulting Buying Power for Stock	$199,260.00
Resulting Buying Power for Options	$99,630.00

3. Long Iron Condor – Known for being a non-directional, low-risk trading strategy

Strategy: Combine Bull Put Credit Spread and a Bear Call Credit Spread

STEP 6.

Comparing the Risk vs. Reward

Two Long Directional Options Strategies

<u>Strategy 1.</u> Buying Directional Calls

Strategy 2. Selling an Out-of-the-Money Bull Put Credit Spread

Wynn Resorts: Bullish Option Strategies

(1) Buying Directional Calls vs (2) Selling Bull Put Credit Spread

Entry: May 1 Wynn Trading at $207

Strategy 1: Bought the ATM June $207 Call Strike for $11.40 or $1,140 per option contract.

Strategy 2: Sold the $187/$182 OTM Bull Put Credit Spread. Spread sold below Wynn's prior low of $189, which was 9.50% below its trading price of $207 on May 1st.

Strategy 1: Buying Long June $207 Calls

Entry: May 1

Trading at: $207

Debit and capital at risk: $1,140 per option contract

Return potential = Infinite

Order Description	BUY +1 WYNN 100 JUN 14 207 CALL @11.40 LMT [...
Break Even Stock Prices	218.40
Max Profit	Infinite
Max Loss	$1,140.00 (not including possible dividend risk)
Cost of Trade	$1,140.00
Buying Power Effect	($1,140.00)
Resulting Buying Power for Stock	$194,700.00
Resulting Buying Power for Options	$97,350.00

Open position P/L May 8

June Monthly $207 call original cost: $1,140 per option contract

WYNN trading at $196 P/L: - $583 per option CT.

Open position P/L May 21

June Monthly $207 call original cost: $1,140 per option contract

WYNN trading at $205 P/L: - $518 per option CT.

Strategy 2: Selling Bull Put Credit Spread

Entry: May 1

Trading at: $207

Credit Spread/Max Profit: $130/Ct. Return on Margin: $130/$370 = 35%

Strategy 2: June $187/$182 Bull Put Credit Spread: $130/Ct.

Open position P/L May 8:

WYNN trading at $196 Credit Spread: -$38.50/Ct. Vs Long Call -$583

Strategy 2: June $187/$182 Bull Put Credit Spread: $130/Ct.

Open position P/L May 21

WYNN trading at $205 Credit Spread: $78.50/Ct. Vs Long Call -$518/Ct.

Based on this example, which option strategy would you prefer?

CONCLUSION

Whether trading a small account or large account selling options and option spreads will have a major positive impact on your trading bottom line while reducing your trading risk. These low-risk trading strategies offer income and profit while also providing the perfect hedging strategy.

The single trader can easily execute these option strategies that can turn that small trading account into a large trading account and with much lower risk than the traditional buy-only option strategy.

THE MOVIE

Watch the Video – Larry Gaines covers how to sell options using defined,

low-risk option spreads to generate consistent monthly income.

THE SPECIAL OFFER

Larry's option course, "How to Sell Options for Profits & Hedging, Make Money Blueprint" is a complete step-by-step program on how to trade the option credit spreads for consistent monthly income and for hedging other trading positions.

Credit spreads are sort of like having insurance on your home, but this insurance actually pays you…and pays you very well (unlike the miniscule returns from common annuity contracts touted as income tools).

This comprehensive option credit spread course is more than five hours of training that you can watch at your own pace as often as you want and includes the 270-page training manual of the entire program…**Click here to learn more!**

ABOUT THE AUTHOR

Larry Gaines has been involved in trading and brokering commodities and financial markets for over thirty years. He started his career trading tanker cargos of foreign crude oil for a large independent oil company in the 1980s in their Houston and Singapore offices. He quickly advanced his career to become an Executive Vice President of one of the largest international oil trading companies in the world. In this position he managed their international trading and marketing for over ten years from their corporate office in Bermuda. During his tenure he traded and managed billions of dollars worth of oil, foreign exchange and financial market derivatives, including futures and options. His trading group was one of the first to trade over-the-counter options on cargoes of foreign crude oil and traded millions of barrels of North Sea Brent crude oil options.

Larry has also worked with a number of hedge funds on a consulting basis and in 2009 set up an “over-the-counter” crude oil options brokerage desk for the world’s largest privately owned oil brokerage company.

Today, Larry trades options and futures and is the Founder and CEO of Power Cycle Trading™, where he enjoys teaching others to generate income from trading using a disciplined, systematic approach through a price-cycle trading system he developed based on decades of trading experience. The model is successfully used by his clients for options, stocks, ETFs, futures and Forex trading to capitalize on achieving higher trading profit margins with smaller capital investments. This same model is also used by investors for swing trading in addition to longer term investing.

COMBAT TRADE PLANNING

By Matt Buckley, TopGunOptions.com

The most important trading floor for any trader, individual or professional, is the five-inch trading floor between his or her ears. Having the proper mind-frame and controlling emotions is critical to making good decisions under the pressure of the markets and, ultimately, to trading success. It all comes down to **discipline.** We need to know why we are getting in, when to stay in and when to get out of a trade. At Top Gun Options a quality trade plan is the foundation for our disciplined execution in every trade.

As flying fighters in the US Navy we planned everything, from a simple 30 minute maintenance flight to a 7 hour combat mission. Every mission had an objective and we always had a plan to achieve our objectives. These plans spelled out exactly how we intended to achieve each objective. The team at Top Gun Options learned how to plan and plan well.

At Top Gun Options, we were trading before we joined the Navy to fly fighters, so we had built up some habits about how we went about our business of trading. Some were good, some were bad, but these habits lacked discipline and continuity. Then one day, shooting the breeze at the Officer's Club (which is where we solved all the world problems over a cocktail) it just kind of hit us; why don't we apply the same planning and execution disciplines that we use flying fighters in combat to our trading?

After all, our combat plans defined many things, to include: our objective, tactical mindset, targets, Commit Criteria (our go-no-go decision), the Tactic we intend to use to achieve our objective, employment method to achieve the Tactic, our course of action (steps we are going to follow executing the plan), contingency plans in case things don't go exactly as planned and we must also have a clear Exit Plan. So this tactical planning we used every day out on the aircraft carrier seemed a perfect fit for the options trading world as well!

You have to plan for combat in this manner, because combat is dynamic, it's dangerous, the battlefield is in constant change and you don't know where your enemy will strike from next. Sound familiar? Where did this Greek debt crisis come from, how about Enron or WorldCom? Which bubble is going to burst next? Who's cooking the books at our favorite company? Well, it seems to us, this definition of combat applies directly to the financial markets.

Which is why at Top Gun Options, **"Trading is Combat"** because it is!

In this lesson we are going to share with you our planning process. Is it perfect and suited for everyone? We certainly like it and we believe that you will benefit by applying the same discipline to your trading.

DEFINING A PLAN

So just what is a plan? You don't have to be a Rocket Surgeon to understand this one!

A plan is a series of steps to achieve an objective.

This makes sense if you're going to hang some shelves in the garage or cook a pot roast. A plan is just a recipe and when it's complete you have some more shelves in the garage or a pot roast for dinner.

But, how does this definition work when you are playing in one of the most dynamic arenas in the world, where things are constantly changing and often appear to be directly against us? It still works, but the *plan has to suit the environment where it is going to be executed* and we are executing plans in one of the most complex environments in the world, the financial markets. So, we need to account for a few more things than cooking a pot roast.

When I am giving a presentation on planning, I always ask the crowd to write down the components of a plan. Invariably they are always slightly different and in many cases folks can't break a plan down into its important components. This lesson will solve this issue.

WHY PLAN?

Discipline

A trade plan is the foundation for disciplined execution. It allows us to keep our head on straight when all the talking heads are telling us the world is falling apart. It memorializes our reason for being in the trade and helps us make good disciplined business decisions under the pressure of the markets. It is because we built a plan, before the heat was on, that allows us to remove as much emotion as possible from our trading. In short, a trade plan is our tool to keep us disciplined in a trade.

Risk Management

Risk management is built into the plan. We know exactly when to get out, what our maximum acceptable loss is for the trade and how we are going to get out or adjust the position to save profits or limit losses. We define all of this before we get into a tight spot where emotions can take over and lead us to bad decision making. Emotions: greed, fear, attachment to a trade, whatever the issue, will influence your decision making. If you think it doesn't, you are going to spend a lot of money realizing that you're wrong. Laying out your risk parameters before being under the gun, will greatly assist you in suppressing your emotions and help you make good decisions.

In the Top Gun Options Pocket Checklist (OPCL), we layout planning guidelines for several different option tactics. In each, we identify our profit targets and maximum risk parameters for each trade to assist you in building your plan.

Superior Execution

When we get down to the brass tacks of trading, it's all about execution. Being disciplined and mapping out our risk parameters before we are deep in trades leads to Superior Execution. The decisions we make in the heat of battle are key to our success in trading. We have a saying as flying fighters, "A bad plan executed well is better than a good plan executed poorly, but a good plan with good execution Discipline is unbeatable!" When you go through

our Top Gun Options program, we will go over several options tactics and discuss optimum execution whether the market is trending favorably or unfavorably.

Ultimately **Discipline, Risk Management and Superior Execution** come down to the individual trader. As traders, we have to commit to being disciplined. We have to commit to sound Risk Management. We have to commit to achieving Superior Execution with our trading. It takes practice and courage to execute your plan, but the end result is consistent Superior Execution and more profits.

COMPONENTS OF A PLAN

A plan has to be tailored to the environment we intend to execute. The planning process needs to flow sensibly, be easily understood and address as many potential scenarios as possible that can threaten the achievement of our objective.

The very first component in any plan is "The Objective," As traders and investors it does not matter if you are trading options, stocks, commodities, bonds, currencies or anything for that matter. Our objective as traders and investors is universal:

Make Money, Don't Lose It!

This is why we play in this financial arena; there is **no other reason**. We want to **make money, not lose it!** Every trade plan we create supports this objective…we want to make money, not lose it! If we are wrong in our trade, because we are not going to get them all right, we want to get out with minimal damage and keep our money to play another day.

Since this is our universal objective, we don't need to write it down every time. It is our guiding precept for trading.

After the objective, a Top Gun Options trade plan has seven components, designed specifically for trading options. A Top Gun Options trade plan…

…Defines our **Strategic Mindset**

…Identifies our **Target**...which is the underlying we want to engage.

…Outlines our **Commit Criteria**…Our justification for the trade.

…Identifies the **Tactic** we will use.

…Sets up our **Tactical Employment**.

…Outlines our **Mid-Course Guidance**…which is our trade execution plan.

…And finally outlines our **Exit Plan**…

Once the planning process is understood, a trader can complete the plan in as little as 5-10 minutes. We will go through each one of these components in this lesson.

Some of these terms may be new to you and that's because they have their roots in air combat, but they dovetail very nicely into our planning and, in our view, tighten our focus up another notch. We will explain each as we come across them if not,there is a Top Gun Options Terms glossary in the back of the book for reference.

STRATEGIC MINDSET

Our Strategic Mindset is the stance we take regarding how we think our underlying asset (our target) or the market will perform given the current financial climate. Strategic Mindset falls into one of four categories:

1. **Bullish**
2. **Bearish**
3. **Neutral**
4. **Volatile**

We can qualify our mindset if needed; we can be short-term bearish if we think something is overbought and might correct. Or we can be neutral to bearish or neutral to bullish. It just depends on our analysis of the current situation and guides our Tactic selection to fit our Strategic Mindset.

When developing our Strategic Mindset we take a big to small approach. We start with the global financial situation and drill down to specific sectors, then to the stocks within a sector using both fundamental and technical analysis. As options traders we always take a look at our main barometer, the VIX, to tell us what the market is thinking and how the current market is priced.

Our Strategic Mindset drives many of our trading decisions. It helps us to analyze potential positions with an appropriate bias for the current market. It also gives us a baseline to challenge our own market assertions and those assertions of all the information we absorb. We don't want to be mindless sheep following the talking heads on CNBC or a tip we hear at work. We want to be proactive in the development of our Strategic Mindset and verify or disqualify the information we hear around us.

TARGET

Our target is simply the underlying asset with which we are looking to open a position. We will focus on an asset because we have clearly defined our Strategic Mindset on this target and we think we can profit from an options position supporting this mindset.

There are literally thousands of optional targets: Stocks, ETFs, futures, commodities. We will focus on stocks while going through Top Gun Options.

COMMIT CRITERIA

Commit criteria is our justification for entering in a trade. Commit criteria should be easily understood and explained in 1 – 3 sentences. Commit criteria is supported by our Strategic Mindset, our fundamental and technical analysis, and the volatility of the target.

Here is an example of what Commit Criteria might sound like if we had a bullish mindset on Freeport McMoRan (FCX).

"The recent pullback in FCX is exaggerated. The stock has come off its recent lows with heavy volume and appears to be at the beginning of bullish trend with a short-term technical price target of 70. Fundamentals remain strong and copper prices are rebounding."

This is a valid Commit Criteria for entering a trade. Commit criteria memorializes why we are in the trade. During the course of a trade, if we can no longer justify our Commit Criteria then we get out, immediately.

TACTIC

At Top Gun Options, a "Tactic" is the option position we are opening, and there are many different positions we can open using options: calls, puts, condors, butterflies, credit spreads, etc. In the Top Gun Options Pocket Checklist (OPCL) you will find 32 different option tactics.

In current options lingo this is referred to as a strategy, but to call this a strategy is not true to the word's meaning. A strategy is a bigger vision that supports our "objective" and refers to a plan of "actions" to achieve our objective; in this case, our investment objective. The "actions" taken to achieve these goals are referred to as "tactics."

Example:

Objective: Make Money, Don't Lose It!

Strategy: Use options to achieve our objective.

Tactics: An option position to support our strategy.

For instance: If a trader wants to earn income from stocks in their portfolio by selling covered calls. This supports our objective and the strategy is to earn extra income with options. The Tactic to achieve this extra income is to sell covered calls on stocks in their portfolio.

To us at Top Gun Options, this is a more correct way to add detail to our intentions. In short, a strategy tells us **what** we want and a Tactic is **how** we get what we want.

TACTICAL EMPLOYMENT

Tactical Employment is the set up for our option position. It includes:

- Leg Set Up
- Net Debit or Credit
- Max Profit potential
- Maximum Risk of the trade
- Break Evens
- Probabilities of success
- Adjust and Eject Criteria
- Greek Effects

Outlining Tactical Employment lets us know what we are getting into when we enter a trade. Think of Tactical Employment as defining the performance envelope for our trade. It defines the parameters, both good and bad, where the trade can perform.

MID-COURSE GUIDANCE

Mid-Course Guidance encompasses our trade management plan. The term comes from an air-to-air missile and refers to the control of the missile until just before it reaches its target. At Top Gun Options, Mid-Course Guidance encompasses our Risk Management parameters in terms of profit goal and max allowable loss, threats to success, contingency plans and Eject Criteria.

Max profit goals and max allowable loss are independent trader decisions based on individual investment goals and risk tolerance. At Top Gun Options we are not trying to hit the ball out of the park on every trade; base hits can add up fast. When setting our max allowable loss, we determine the maximum we are willing to lose to see if this trade will work. This does not mean we have to wait to reach this point to get out, it is simply defining the most we are willing to let this trade work against us. This keeps us from saying to ourselves, “I just need a few more days for this to work!” or “I love this trade, it will come around,” and staying in a losing trade. If we hit our max allowable loss, we get out; lick our wounds and move on to the next trade.

Threats to success are occurrences that can negatively affect our position during the life of the trade. An example of a threat to our success: We were bullish and then implied volatility increased unexpectedly due to a negative economic report.

Contingency planning is simply having a basic game plan if our trade is not going per design: do we roll up, roll down or get out?

Our Eject Criteria are our “no questions asked,” just get out of this trade; examples include: our max allowable loss limit is reached or our Commit Criteria is no longer valid.

Embedded in your options PCL tactics section is guidance for setting many of these parameters and can serve as a great starting point for determining your own risk parameters.

EXIT PLAN

The Exit Plan is how we are going to get out of a trade. We never get into a fight unless we know exactly how we intend to exit. Factors for planning an exit include: a sound reason for exit, layout our closing trade set up, whether we are exiting prior to expiration or taking it all the way to expiration.

It is important to know exactly how you are going to exit a trade before the volatility of the markets gets the better of you.

PLANNING COMPLETE

That’s the plan! It’s just a logical sequence of steps that encapsulates and memorializes our research, lays out the playing field for the trade, sets risk tolerance tripwires for action while in the trade and lines out how we will exit. Don’t trade without one!

Once you have the system down it will take 5 -10 minutes max to complete and will keep you aligned very closely with our universal objective.

Make Money, Don’t Lose It!

EXAMPLE TRADE PLAN

Back in January 2010 we were beginning to think that Google (GOOG) was getting a little lofty in price. Even though the talking heads could not stop talking about how great GOOG was and it was going to the moon non-stop. At this point we took a short-term contrarian's view. So we took a short term bearish Strategic Mindset on GOOG, 7 days, and decided to target GOOG with a bearish trade.

GOOG Trade Plan
January 7, 2010

Strategic Mindset: ***BEARISH, Short term (7 days) on GOOG***

Target: ***GOOG currently trading at 593.52***

Our commit criterion was simple:

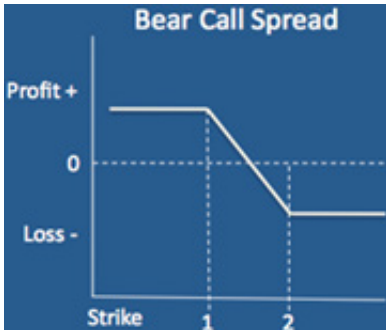
Commit Criteria:

Thinking GOOG is going to give some back in the short term with some of the uncertainty surrounding the release of various mobile devices and some profit taking. On the technical side,the 20 day MACD is diverging to the down side and RSI is indicating an overbought condition.

We had some technical indicators and some fundamental uncertainty we thought would lead skittish traders to take some profits off the table. The Commit Criteria is short, sweet and it made sense. Little did we know at the time but this was a turning point for GOOG and it is off about 20% since this call.

Our Tactic was a Bear Call spread two strikes above where GOOG was trading. One of our intermediate tactics and in this instance it had a high probability of success.

Tactic: *Bear Call Spread on GOOG, 610/620*



Tactical Employment is petty straight forward and requires just a little math:

Tactical Employment:

Leg Set up: *Sell JAN 610 Call at 3.90*

Buy JAN 620 Call at 2.10

Net Credit: 1.80

Max Profit: *1.80, 22% return on risk.*

Max Risk: *8.20*

Breakeven: *611.80*

Probabilities: *72% probability of max profit.*

The Greeks:

***Theta (Time Value)**: Time is our Friend, the longer that GOOG stays below our breakeven of 611.80 the stronger our chance of a profit.*

***Vega (Volatility)**: For this trade we want volatility to decrease for the duration of the position. An increase in volatility with GOOG can easily threaten our Breakeven (B/E) on the down side.*

The last part of our Tactical Employment is an understanding of the Greek effects. In this case Vega and Theta are what we were concerned with and in a bear call spread. Theta is our friend because the longer that we stayed below our breakeven, the better our chance of profit. We also wanted to keep volatility in our scan because an increase in volatility could decrease our chances of success.

Mid-course guidance, which is our trade management plan, is relatively simple:

Mid-Course Guidance:

Profit Target: *Profit Target is 1.80, 22% return on risk. 100% return on premium.*

Threats to Success:

– *Jobs Data is being reported Friday, a positive report could cause a move to the upside.*

– *We are going against the longer-term trend of GOOG and buyers could step in if they don't see any more down side.*

Eject Criteria/Contingency Plan:

– *Commit Criteria becomes invalid*

– *We will set our stop loss 25%...Eject if the premium gets to 2.25*

Our threats to success over the trade are researched and listed so we don't drop them out of our scan.

Our Eject Criteria is set; in this case we had a tight stop for two reasons. First, the short term on the trade did not give us too much time for it to reverse if it went strongly against

us. Secondly, we were going against the long term trend and did not want to get caught in a minor downdraft. Our only contingency plan was to get out if the trade went against us; we did not want to roll this trade.

Finally, our Exit Plan was simple:

Exit Plan

- Profit Target or Eject Criteria Reached.
- To close position, simultaneously,
  - Buy JAN10 610 Call
  - Sell JAN10 620 Call

This is all there is to putting a plan together. Once complete it should fit nicely onto one or two pages. The actual trade plan is depicted below:

Google

Trade Plan

January 7, 2010

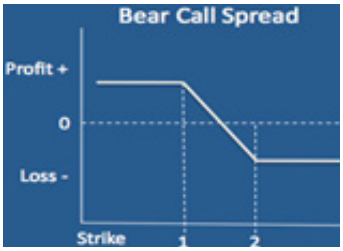
Strategic Mindset: ***BEARISH, Short term (7 days) on GOOG***

Target: ***GOOG currently trading at 593.52***

Commit Criteria:

Thinking GOOG is going to give some back in the short term with some of the uncertainty surrounding the release of various mobile devices and some profit taking. On the technical side, the 20 day MACD is diverging to the down side and RSI is indicating an overbought condition.

Tactic: *Bear Call Spread on GOOG, 610/620*



Tactical Employment:

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Mid-Course Guidance:

Profit Target: Profit Target is 1.80, 22% return on risk. 100% return on premium.

Threats to Success:

– *Jobs Data is being reported Friday; a positive report could cause a move to the upside.*

– *We are going against the longer-term trend of GOOG and buyers could step in if they don't see any more down side.*

Eject Criteria/Contingency Plan:

– *Commit Criteria becomes invalid*

– *We will set our stop loss 25%...Eject if the premium gets to 2.25*

Exit Plan

1. Profit Target or Eject Criteria Reached.
2. To close position, simultaneously,
   - Buy JAN10 610 Call
   - Sell JAN10 620 Call

CONCLUSION

The time invested in putting a plan together is well worth the effort.

This trade ended up working out for us and we bought it back for 10 cents and made 1.70 on the trade. We got out prior to reaching our profit target because we had made a nice profit in the short time the trade was open and market volatility, the VIX, was starting to show signs of life heading into earnings season back in January.

WRAP UP

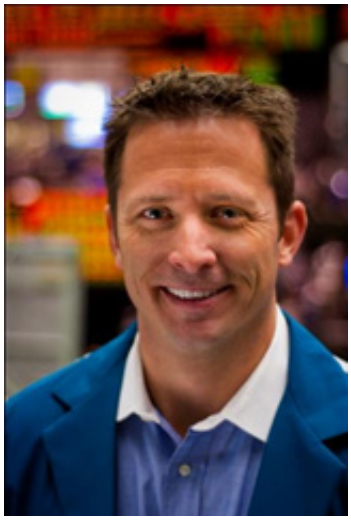
Having a plan will substantially increase your trading Discipline; it lays out your Risk Management plan and will lead to consistent Superior Execution. You can complete your plan before or after pulling the trigger. If we complete the plan after executing the trade, it is because we are familiar with the target and are comfortable trading it. After we pull the trigger though, we sit back and fill out the plan immediately.

Our planning process represents the minimum knowledge we want to have before we open a trade and it is the tool that gives us the confidence we need to execute our trades with Discipline, manage our risk based on our comfort with the current market climate and consistently manage our trades with Superior Execution. You may want a bit more or a bit less in your plan, but our system provides a solid foundation for customizing your own trade plans to suit your trading needs.

Your Options Pocket Checklist (OPCL) contains a planning guide that will help you build solid plans every time. Plus, we will walk you through many trade plans as we go through Top Gun Options.

SPECIAL OFFER

CLICK HERE to enroll in our live trading programs and to see this trade plan being used by our professional traders. Visit our site www.topgunoptions.com to learn more information.



ABOUT THE AUTHOR

E. Matthew “Whiz” Buckley is the founder and CEO of Top Gun Options LLC and is the Chief Development Officer and a partner at Black Bay Fund Management LP.

Whiz is a highly experienced financial business executive with decades of leadership and execution experience from the front lines to the front office. Whiz was the founder and CEO of PEAK6 Media LLC, a financial media company. The company provided options and futures news, commentary, analysis, entertainment, and up to the minute reporting directly from the floors of the Chicago Board Options Exchange (CBOE) and Board of Trade (CBOT). This exclusive information allowed retail and professional options and futures traders around the world to execute at a higher level.

Whiz has written a book called From Sea Level to C Level: A Fighter Pilot’s Journey from the Front Lines to the Front Office, which combines his experiences in the military and in corporate America.

Whiz is a decorated Naval Aviator who flew the F/A-18 Hornet for the United States Navy. He flew 44 combat sorties over Iraq and graduated from the Navy Fighter Weapons School (“TOPGUN”).

MINIMIZE RISK AND MAXIMIZE GAINS WITH OPTIONS

Geoffrey A. Smith, DTItrader.com

There are many ways to trade options or use options in trading. Many people trade options for the sole reason that they are much cheaper than trading stocks. It is interesting that it's rare to find an options trader that would ever buy a stock, or a stock trader that would ever buy an option. I believe that both camps are wrong. You need to be able to trade both, or at least take advantage of both. The reason for this is that if you trade stock, you can minimize risk and maximize gain using options. If you trade options, you do not get the full benefit of the stock's move if you are right, and you "run the risk" of being assigned the stock, which scares option traders, and it shouldn't. I'm not going to get into the fundamentals of options, but let's digress for a paragraph or two to get some understanding before we talk about the strategy I want you to learn.

Buying is the opposite of selling. Long is the opposite of short. Bull is the opposite of bear. There are only two things that matter in options; if buying an option, it must go beyond strike (in the money) for you to be paid on expiration day, and if selling an option short, you can end up long or short the underlying stock at the strike price. If you keep these two things in perspective, your option trading will go a little smother.

If you buy a call option, you are buying a right, not an obligation, to purchase a stock at a specific price (the strike price) on or before a specified date. When buying a call option, you want the stock to go higher. If you buy a put option, you are buying the right, not the obligation, to sell a stock at a specified price on or before a specified date. When buying a put option, you want the stock to move lower.

Now the opposite side. If you sell a call option (going short the option) then you are selling

the right to buy to another party, and if they exercise their right to buy, you must sell to them (you are taking on an obligation) and you could end up short the stock unless you already own at least 100 shares of it. Selling a call option when you do not own the stock is called a naked call, but if you own the stock it is a covered call. If you sell a put option, then you are selling the right to sell to another party, and if they exercise their right to sell, you must buy from then. If you are short the stock, you will buy it back (this is a covered put), but if you are not short the stock, then you could end up long the stock.

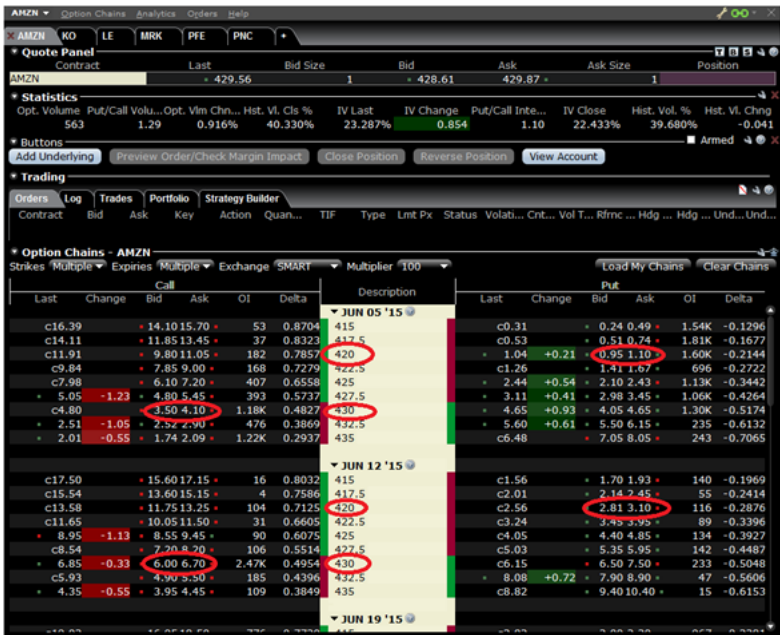
Now that we have that out of the way, let's use these concepts to try and make a little money. Let's make the assumption that we want to buy a stock. Let's pick an expensive stock to prove a point, and then we will look at a "normal priced" stock. Everyone has heard of Amazon, so we will start with it. Below is a daily chart of Amazon (AMZN). You can see back in April when their earnings came out. Notice since then that Amazon moves down to the 420 area and then back up to the 430 area. So let's say we want to buy AMZN when it gets back down to 420. Now we can put a buy limit in, good till canceled, and wait for AMZN to sell back off and exercise our limit order. Then when it gets back up to 430, sell it and make $1000 for every 100 shares we buy. If we buy the stock, we will need to put a protective stop below 415 (notice that is the lowest it has been since earnings), so we will risk about $500 to make $1000. Nice trade, pat yourself on the back. Now let's do it using options.

Daily AMZN Chart

Same trade, but with a twist. Instead of putting in a buy limit, let's sell a 420 naked put option. Now this does two things: a) if AMZN gets to 420 or lower at expiration, you will end up long the stock (that is what is desired in this case); and b) by selling a put option, you will bring in money. In other words, the market is going to pay you to place a buy limit on a stock (that is pretty cool). Below is an option chain for AMZN. Based off the chart, AMZN is trading at 430.92, so AMZN is going to have to drop 10 points to exercise us. So it would probably be good to wait a while before selling the put to get more premium, but since we cannot put extended time in an article, we will use what we have (the concept is the same). Look at the Jun 12 2015 options. The 420 put is selling for around 3.00 (midpoint between bid and offer). So if we put an order to sell at 3.00 and are filled, we will bring in $300 of credit. If by June 12, AMZN does not get to 420, we keep the $300 just for trying.

Note: if AMZN drops to 420 from 430, the put option will increase in value and your account will show that you are losing money on the option. This is not the case unless you buy it back at a loss. Remember the end game, you want to be long the stock from 420. AMZN will have to be below 417 for you to start to lose money (420 – 3 [premium brought in from the sold put] = 417.00). Let them exercise if they can, that is what we want.

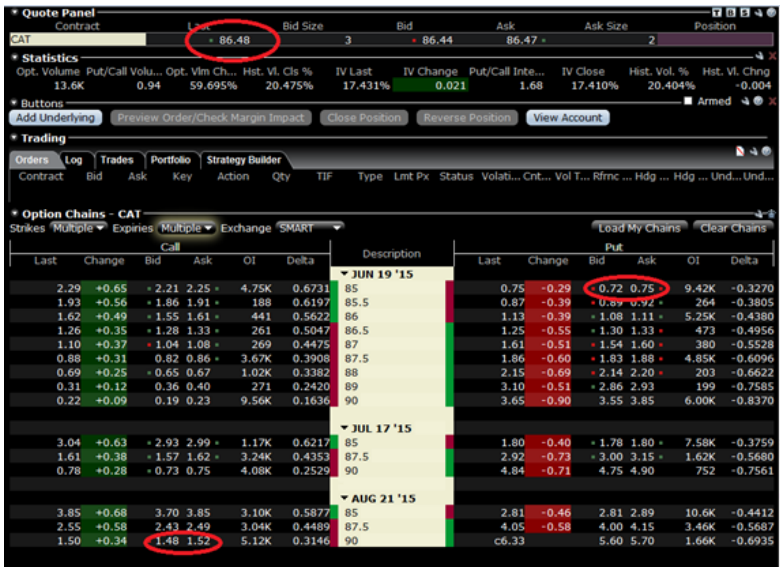
If we get exercised, then we will put a stop below 415 and 414.89 (just below 415 by a little bit), risking $511. We will then sell a 430 covered call and probably get another 3.00 or so. So total premium brought in will be $600. If AMZN drops and stops us out, we will need to buy back the covered call (that now has turned into a naked call), but since AMZN has dropped, the call will decrease in value and we will probably be able to buy it back around 1.00 or so. So we get $500 in premium and lose $511 on the stock for a total of $11 loss. Now, if AMZN goes up, and we get called away at 430, we get $1000 off the stock and $600 off the options for a total of $1600. So in this case, we are risking $11 to make $1600. Which scenario do you like best, a 1:2 risk/reward or a 1:145 risk reward? This is the luxury of options.



AMZN Option Chain

AMZN is a bit extreme since it is an expensive stock and is quite volatile. Let's go to the blue chips and grab a stock like Caterpillar (CAT). Below is a daily chart of CAT. Notice it has support around 85 and resistance around 90. Next support is around 83, so we will use 82.89 for a stop if we get filled. Using the same technique let's look at selling the 85 put. In the option chain below, the 85 put is going for around 0.75. Again, if it does not get there we get to keep the $75 and try again. If we get exercised, we place the protective stop at 82.89 and sell a July covered call at 90 for around 1.50. There are weekly options on CAT; however, we want to be able to finance the protective stop the best we can. By going out to the monthly option, we can get there. If we add the two options together (0 .75+1.50=2.25) we will bring in about 2.25. If we are long from 85 and need to risk to 82.89, we risk 2.11 on the stock. The premium we bring in will cover the protective stop. If we get stopped out, we buy back the short call and will probably lose around $25 or so depending on how much time is left in the option. If CAT moves up and we get called away at 90, we pick up $500 from the stock and $225 from the option premium for a total of $725. Again we can have the standard 1:2 ratio, but the 1:29 ratio of this trade seems much better.

Daily CAT Chart



CAT Option Chain

We do have to throw the glass half empty theory in here since there are those who are pessimists and will ask, “what if CAT is at 80 when you get exercised, or what if AMZN is at 410 when you get exercised? What will you do then?” You’ve got to love those people. First, panic never solved anything, so please get that out of you mind. But think about it

very quickly. We did bring in premium when we sold the put, so we have reduced the risk somewhat. Next question is, if you just put a buy limit in and it's sold off to that level, what would you normally do? You could sell a covered call at entry (85 on CAT or 420 on AMZN) and if you get called away, then you will make nothing on the stock but get to keep the premium from the options, still not losing anything. You could sell at the money calls and it will reduce your loss considerably, especially on AMZN but not as much on CAT.

Another thing, what if you end up long the stock, it does not stop you out, but is not called away from you. Even better in my opinion. You brought the money in from the naked put and the covered call, and now you get to sell another covered call. Before selling the same strike price, however, look at higher strikes. You may be able to get the same premium as before if the stock has moved higher.

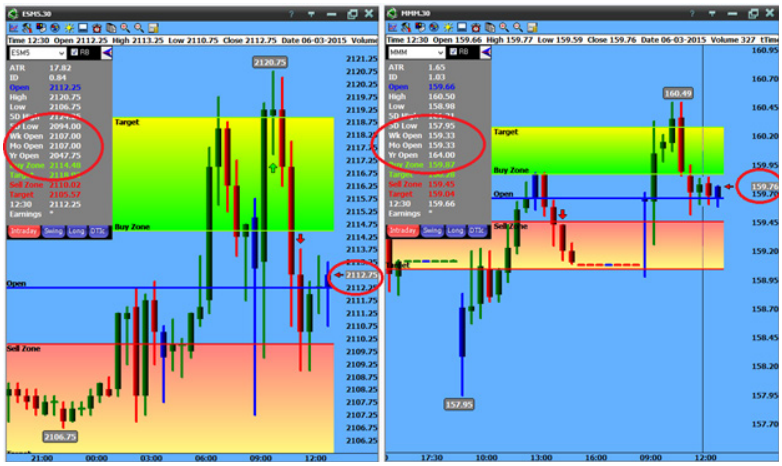
There are many ways to scan for stocks. Many traders have their own favorite stocks that change over time. You will find some stocks that do not have options. I do not like stocks that don't have options for the simple reason that I cannot minimize my risk and maximize my gain. The key is to trade stocks that have some volatility so that the option premium is higher. Coke (KO) has options but since the stock does not move much, the option premium is low and therefore you cannot finance the protective stop. Below is a scan for stocks out of the DTI RoadMap software. It scans for optionable securities that are between $50-$600, and are recommended buys/sells between June 3 and July 31 (it is sorted by highest Profit & Loss).

DTIC Report

Date	Win %	Avg P/L %	Std Dev	Total	Type	Symbol	Days
06-06-2014	100.00	2.01	4.97	8	Long	ILMN	20
06-13-2014	100.00	0.99	3.84	8	Long	SLB	20
06-27-2014	100.00	0.96	3.73	8	Long	LMT	20
06-13-2014	100.00	0.87	3.98	8	Long	ILMN	20
06-06-2014	100.00	0.82	2.89	8	Long	ILMN	30
06-27-2014	100.00	0.82	1.98	8	Long	KSU	10
06-27-2014	100.00	0.75	2.29	8	Long	TMO	20
06-13-2014	100.00	0.63	4.89	8	Long	SLB	30
06-27-2014	100.00	0.56	21.51	8	Long	AAPL	30
06-27-2014	100.00	0.52	1.50	8	Long	ABC	20
06-13-2014	100.00	0.48	1.22	8	Long	SBAC	30
06-27-2014	100.00	0.46	2.18	8	Long	FRT	20
06-27-2014	100.00	0.46	1.38	8	Long	BAX	10
06-20-2014	100.00	0.44	3.31	8	Long	UTHR	20
06-27-2014	100.00	0.38	0.91	8	Long	NSC	10
06-27-2014	100.00	0.35	0.97	8	Long	PG	10
06-27-2014	100.00	0.34	2.20	8	Long	UTHR	10

Starting in the middle to end of June, stocks begin to move again after the “when in May go away” occurrence is over. Look at the Standard Deviation (Std Dev) column. The higher the standard deviation, the more volatile the stock. So I will look at these to see if they are trending with the overall markets, and if so, then they are prospects for trading.

Market direction is also important. You can do this same strategy on the short side as well. When markets are bearish like we saw back in 2008-2009, selling calls many times did not get exercised; however, if they did, then we sold a covered put to use the premium to finance the stock. But direction is important. First look at the year open, month open, and week open, and compare it to the current price of the stock. If the stock is above all three it is strong, if below all three it is weak. If it is between some of them then look at the indexes (S&P, Dow 30, NASDAQ) and see if they are doing the same. If they are, then wait until a clearer picture can be seen. Below is a chart of the S&P and 3M. Notice on the right chart that the S&P is above the year, month, and week open. However, 3M is below the year open but above the month and week open. If the market falls from here, 3M would be a good candidate to sell calls on and see it drop. But the S&P will need to begin to drop and take out some support levels before doing that.



S&P and 3M chart

The same can be done for futures contracts if you have experience with them. I like using options on bonds to help pay for the utilities each month. Utilities: no one likes to pay for them, but they are necessary. To help pay for the utilities, trading bond futures options seem to work well.

Let's discuss bond futures and their options a bit before we get to trading them. Bond futures are a commodity that trades in 1/32 increments and are worth $1000 per point and $31.25 per tick (1000/32 = 31.25). It controls a $100,000, 30-year U.S. treasury bond. It is traded by the bond price, not the interest rate of the bond, though it is interest-rate sensitive. So if interest rates go higher, bond price goes lower, and if interest rates go lower, bond prices go higher. Bonds open at 17:00 and close at 16:00 CT. The price is displayed in decimal form or with a dash; 147.23, or 147-23, and sometimes 147'23. The 23 is in 32nds. So the price is 147 and 23/32. If you multiply that by 1000, the bond is worth $147,718.75. Par value is $100,000, so in this case you would be paying a $47,718.75 premium. Economic news will affect bonds, as they look for inflationary (rising interest rates) or deflationary (falling interest rates) indications.

Options on bond futures trade in 64th increments. They trade as long as the bond futures are open and trading, so you can actually get out of your trade in the middle of the night, if

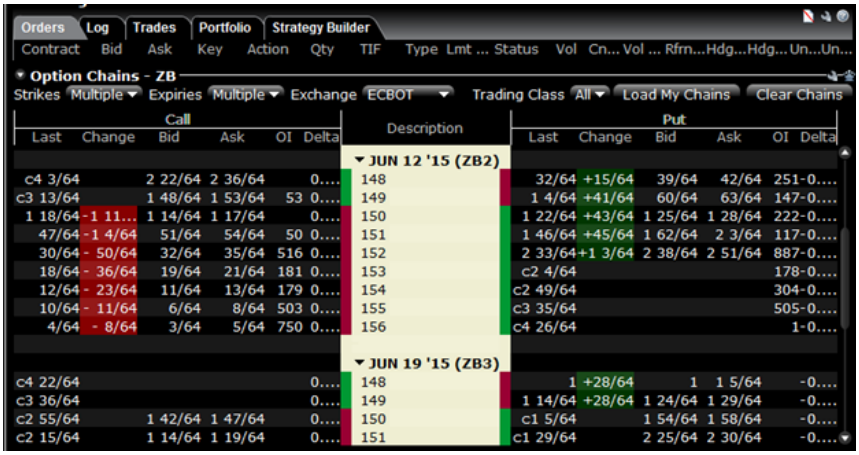
need be. They are still $1000 per point, but since they are half of a bond future tick, then they trade $15.625 per tick. The options are no different than equity options, except the price per point/tick is different and you are only controlling one bond futures contract as opposed to 100 shares of stock. You will also notice that the strike prices are every point. This should give us enough background to discuss the utility trade.

There are weekly options on the bonds. Some platforms only offer the monthly options, so beware of that. We are looking for income, so we will be selling the options to bring in premium. We want the option to deteriorate over the time of the option. So if we sell a bond option at 16 (16/64) we will bring in $250. If we buy back the option at 5 (5/64), we pay $78.125 for it. The difference is the profit, 250-78.125 = $171.875. If we do this two to three times per month, this will generate $400 - $500 per month, per contract, to help pay the utilities.

To set up the trade, first we don't want to risk more than $300 per contract in any trade. So if we sell an option at 16, then if it doubles or goes 19 ticks against us, then we will get out of the trade. If using weekly options, we will not be bringing in much premium, so we will look for something between 10 and 20 ticks on the options ($150 - $300), and look to get out between 0-5. Next we need to look at the trend of bonds. Here is a daily chart on the ZBU5 (September 2015, 30-year Treasury bond future):

Notice bonds are in a downtrend. So selling call options will be the safest play since bonds will have a tendency to go down. We will try to sell options at the resistance point (R1 or R2). Of course, the closer it is to the resistance point the more premium that will be brought in and the further away from that point brings the least premium unless we go out further in time. If your platform only does monthly options, then I'd use a resistance point further back, but if using weekly options, use the closest. Another thing to keep in mind, find out when the big economic news is coming out since bonds will react to it.

Look at the option chain below. Our R1 is around the 154 strike. The Jun 12 call option is trading at 12/64. The 156 is at 4/64. The 156 is around the R2 on the chart and a little less risky since bonds have to decline another point to get to that strike. So you have to make a decision on which option to sell. Let's be a little more risky and do the 154 strike. The current bid and offer are 11/64 – 13/64. If we put an order to sell at 12/64 and get filled, we will bring in about $187.50. If today is June 3 and bonds are trading at 149-28, we will have to wait eight days for the option to expire. As long as the bond futures stay below 154-00 then the option will lose value each day. If there is a big economic news day next week, we will need to either get out and take the profit we have, or be ready to exit if the bonds drop off the news.



Doing this trade a couple of times a month can cushion the blow of the bills that come once a month. We can't win them all, but remember, we will not risk any more than $300 per

contract. So one loss will scratch one win and a half for the most part. If you have never traded options on bonds, paper trade it for a couple of weeks to see how it goes. Once you get the hang of it, start paying some bills.

We have walked through a couple of ways to bring in a little income and reduce the risk by financing the stops. Buying equities is a good thing, but being able to gain more on the position from using options can help boot the account. If we expand to trading options on futures, we can help pay those utilities a little and have more for the grandkids when they come over. Remember that there is always risk in trading and we will not ever be 100%. But taking a little loss is not so bad when the return is much greater.

THE MOVIE

CLICK HERE to watch the video discussing the trade shared in this article.

THE SPECIAL OFFER

SIGNUP HERE for your FREE copy of the Trade of The Day video emailed to you each day!

ABOUT THE AUTHOR

Geoffrey Smith is DTI's Chief Instructor. He teaches Level 1, 2, and 3 Core Curriculum Classes, he's a regular educator and instructor on the 24-hour Educational TradeRoom, he does GPS Coaching, and he's one of Tom Busby's first students.

An active trader and investor for 25+ years, Geof focuses in futures, equities and option trading including trading commodity option futures. Geof took an instrumental role in developing the DTI Method. The Platinum Experience core level classes took first place in SFO Magazine and Trader Planet's STAR awards in the best trading courses category. Before coming to DTI, Geof was a pipeline engineer working in Oklahoma and Texas.

JACK CARTER

PRESENTS

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USING PROBABILITIES IN TRADING FOR INCOME

By Don Kaufman, TheoTrade.com

Welcome to TheoTrade®. Before we dive head-on into Selling Vertical Spreads for Income, it is imperative to set the trade stage with the proper approach and logic of your trading strategies. The following are key components of TheoTrade's principles and should be strongly considered prior to entering into a trade or investment.

TheoTrade PRINCIPLES

1. Trade Logic
2. Capital Allocation
3. Directional Bias

1. Trade Logic. At TheoTrade we put your strategy and trade logic first. The vast majority of people involved in markets are infatuated with market direction, attempting to predict the next move a stock is going to make. In reality, what you "think" a stock is going to do does not always translate into profits. Many investors and traders alike place far too much emphasis on being right or picking the next move a stock might make. Our veteran traders dictate the right strategy coupled with established entry and exit criteria. You do not need to be "right" in picking a direction in a stock or the markets in order to be profitable.

2. Capital Allocation. How and where you allocate capital should be strongly considered as a viable portion of your trading methodology. At TheoTrade, capital allocation takes precedence over being "right" in the markets. Why, you ask? Experience and watching order flow for decades has taught us invaluable lessons. Have you ever been stopped out of a trade or bailed out of a position only to see the markets turn around shortly thereafter? How

and where you allocate capital can define not only losses but it can be the defining factor in your overall success or failure in the markets. Our war cry is “duration over direction”, you need to be capable of sustaining trades long enough to be profitable.

3. Directional Bias. We are not anti-charts. Rather we recognize where you “think” a stock might go does not always mean the markets will agree with your sentiments. Being right directionally cannot define us as investors or traders for we may not be “right” often enough. At TheoTrade we are realists of the marketplace and we must place our capital at risk ONLY with the correct trade logic and a comfortable allocation.

SHORT VERTICAL SPREADS

The most important and sound method of looking at a vertical spread is from the viewpoint of probabilities. All trading strategies and logic need to account for all possible outcomes. Examining outcomes will help a trader determine a price at which a vertical spread must be sold in order to make a profit. However, a diligent trader must also recognize and offset losing trades,, for winning trades alone DOES NOT make traders profitable in the long run. A winning streak one receives when selling vertical spreads means little or nothing and without adequate principles will be short lived.

THEORY BEHIND VERTICAL SPREADS

Probabilities are a fact of life. The second we are born the nurses weigh us, measure our length and assign an Apgar score to group us into certain categorical components that allow the doctor to make statistical assumptions about our physical health. Car insurance, mortality rates, point spreads in sporting events all use probabilities to make an educated guess/ approximation of what to expect under certain circumstances. Insurance companies make and lose great deals of money based on when you die compared to the mean (average) age of death for a male or female. Vertical call and put spreads are no different.

Assume that we sell an October 60-55 put vertical spread at $1.50 in stock ABC trading at $60 per share. Will we make money? Your initial thought is to ask, “is the stock in a bull or bear trend?” In trading we must account for all outcomes; therefore, the trend will end 50% of the time once you identify it to be a trend and act on it. In the TheoTrade aforementioned principles, please recall, “Being right directionally cannot define us as investors or traders for we may not be right often enough.”

A more simple question would be to first ask, “What is the likelihood that the stock is going to be above (our winning area) or below (our losing area) $60 at some point in the future?” We all know, even if we don’t believe it, that the answer is 50% of the time the stock will be above $60. That means that roughly 50% of the time the stock will be below $60, resulting in us giving back some, if not all or more, of the premiums received when we sold the spread.

Now, with this said, what is the amount that we should receive for the sale of the call spread to be a fairly priced trade? Our first instinct may be to say, “Since the vertical spread we are looking to sell is a $5 spread; and since we can lose $5 on a $5 spread; and since the stock will go down about 50% of the time; thus, we must get at least 50% of the $5 (or $2.50) for the spread to be fairly priced”. CLOSE – BUT NO CIGAR!

One must remember what the statement “50% of the time the stock will be above $60” means. Certainly it has been displayed that half the time an underlying will rise, and the other half of the time it will fall. This, however, does not say ANYTHING about the extent to which it can move. Or stated another way, if the stock is below $60, thus resulting in a potential loss on the sale of the vertical put spread, it could be $0.10 below $60 (at $59.90) or $20 below $60 (at $40). At either price the statement is true.

Many factors play a crucial role in predicting what we can expect a stock’s movement is likely to be. Seasonality, time until expiration (the more time – the more the stock is likely to move), geopolitical events, the economy, and volatility (as well as many other factors) all have an integral impact on how much ABC is likely to move beyond what direction it is going to move.

Should the stock ABC move against us, but by a small amount of say $0.10, the vertical spread would be a winner provided we sold it for anything more than $0.10, even though the stock went in the wrong direction. Had we received $5 for the sale of the vertical spread when we sold it, there is no way we can lose money. The worst that could happen is the stock moves against us in a large dollar move to the point where the spread is worth $5 at expiration, and we therefore have to give back all we have originally collected.

As this exaggerated example shows us, the amount we receive is very important in predicting our success on the trade. The more we sell a spread for, the more of a "buffer" we have against loss.

Another way of looking at this is from the reverse perspective of what we are doing (selling the spread) from the perspective of the buyer. Let us evaluate two different spreads using TheoTrade logic to see which the better candidate for purchase is. Movement will likely be the determining factor. Take a look at the two spreads below.

Example:	Stock ABC	Stock XYZ
Stock Price	$60	$60
Time Until Expiration	20 Days	20 Days
Last Month's High	$80	$61
Last Month's Low	$39	$59
Cost of Spread	$1.50	$1.50

All other variables being equal, it is evident that the purchase of the ABC spread is the better of the two. If for no other reason than the individual who purchases the XYZ spread can't have any reasonable expectation (based on the past) of ever making money on a long put spread with the long put (the put purchased) being at the 60-strike. Based on the stock's history from last month, in which it had a $2 range with a low of $59, the long put spread is unlikely to make any significant amount of money. Should the stock sell off to reach last month's lows ($59), the 60-55 put vertical spread (long the 60 put—short the 55 put) will have $1 of intrinsic value at expiration. Since the spread sale resulted in a credit of $1.50 to initiate, the net result will be a $0.50 per share loss ($1.50 credit from sale - $1.00 intrinsic value given back as the 60-put sold is $1 ITM = $0.50 loss).

Even if the stock moves the full amount of last month's range of $2 ($61 high - $59 low) to the downside, that would put the stock at $58. With the stock at $58 on expiration, the 60-55 put spread would only be worth $2 intrinsically, thus resulting in a profit of $0.50, or +33%. Now a 33% return is not horrific compared to expected annualized returns of 8% when owning a diversified portfolio; however, it is far inferior to the vertical spread in ABC.

Do not get confused with this example. It may seem logical to think that since ABC can move so far up, given last month's performance of a high of $80, that a put spread would certainly be a loss in that direction, especially seeing that stock XYZ reasonably can only get up to $61 should the stock run up, that the ABC spread may be better. This is not true, in that the XYZ spread at its full range of profitability in our favor (down) reasonably could only expect a profit of $0.50 when the stock closed at a new low of $58.

Yet, the ABC spread needs to only see the stock get as low as $55 per share for us to make the maximum on the spread. Since last month the stock got as low as $39 a share, it is not at all difficult to assume that the stock can get down to a place where we will make the maximum on the spread, that being $55.

In an additional example, assume there are only two possible prices for each stock at expiration, that of its high or its low. Which spread would you rather own IF IT WERE FREE, knowing that each stock can only close at either its high or low for last month? The math below should answer that for you in a way that is likely more obvious than it was minutes earlier.

	Stock ABC		Stock XYZ	
	High End of Range Closing Price	Low End of Range Closing Price	High End of Range Closing Price	Low End of Range Closing Price
	$80.00	$39.00	$61.00	$59.00
60-Strike Put as Expiration	$0.00	$21.00	$0.00	$1.00
55- Strike Put at Expiration	$0.00	-$16.00	$0.00	$0.00
Spread Net Value at Expiration	$0.00	$5.00	$0.00	$1.00
Spread Net Value at Expiration	$0.00	$5.00	$0.00	$1.00
Minus Cost	-$1.50	-$1.50	-$1.50	-$1.50
Net Profit / Loss	-$1.50	$3.50	-$1.50	-$0.50

Looking above it becomes clearer which of the spreads is the preferable one to own, especially if it were free. As only two possible scenarios at expiration make it easier to understand, we will look at them both.

STOCK GOES UP

Using the example of the stock moving up first, we see that both spreads are equivalent. It doesn't matter if the stock closes at $61, $80 or $300, the put spread is still going to go out worthless, resulting in a complete loss of the investment. Thus, both spreads are equivalent should the stock increase in value between the time it was initiated and that of expiration.

STOCK GOES DOWN

Should the stock decline in price to the only possible downward closing price, it becomes clear which of the two is the preferable spread to own, whether it is free or costs us the $1.50. Stock ABC will be worth the maximum it can be worth on the downside, whereas, stock XYZ will still result in a loss. XYZ's loss is a result of the stock going down, but not down enough to offset the cost of premiums invested at the time of purchase.

OVERVIEW OF COMPARISON

As is evident from above, it doesn't matter what the stock does as each spread, in the worst scenario, is equivalent in loss. On the other hand, if you were correct in the predication market direction (down) for each stock, the former (ABC) will result in a profit whereas the other (XYZ) will result in a loss. The determining factor in how much to pay when buying a spread, or how much you will want to receive when selling the spread, is based primarily on how volatile the stock is. The more the stock is capable of moving in either direction will determine, to a large extent, what the spread is worth. The more the stock can move, the

higher the price of the spread. It is the same thing as if you own earthquake insurance. The higher the likelihood of your house moving (California San Andreas Fault vs. Hartford, Connecticut), the more your insurance is likely to cost.

SUMMARY

What it all comes down to is probabilities. Since a stock that can move more has a greater chance of moving in the direction we want, we are willing to pay more for it than for a stock that isn't moving enough to likely make us a profit. So what is the mathematical probability of ABC or XYZ closing at $55 or lower so that we can make the maximum on the spread? Or, what is the likelihood that the stocks can get down to $58.50, a place where we break even on the trade? We have no idea (yet), but whatever that number is, it will likely tell us how much the spread is worth.

SIMPLIFIED EXAMPLE OF PROBABILITY WITH BALLS

Suppose you were involved in an office lottery pool but only four people were playing, and someone has to win the $100 prize. Every contestant pulls a ball out of a bucket containing three black balls and one white ball. Whoever gets the white ball gets the $100 prize, and the three contestants who got black balls lose their wager. What is the most you would pay to get into this office pool? Would you pay $10? $20? $40?

Obviously the correct answer to the question is anything up to $25. As there are only four possible winners, someone has to win, and each has an equal chance of pulling the white ball out of the bucket, each ball has a theoretical value of $25. Or, if you were the only player and bought all four balls chances for $25 each, you would be assured of getting your money back.

If the ball game is organized and selling each chance at $20 per ball, you could go out and buy all four balls for $80 ($20 a ball X 4 balls = $80), and be assured the $100 prize, thus netting a $20 profit without risk.

SIMPLIFIED EXAMPLE OF PROBABILITY WITH VERTICAL SPREADS

Let's expand this example to include making some real money by trading vertical spreads. We saw earlier that the XYZ 60-55 put spread could at best be worth $1.00 at expiration, but cost $1.50 initiate. Thus, the absolute best that we could expect is to lose $0.50, and could just as likely lose $1.50. So, does paying $1.50 for the XYZ spread make reasonable sense? Obviously not. But what constitutes a bad purchase almost always constitutes a good sale.

If buying the spread can at best result in a loss of $0.50, then the individual who sold the spread will likely make at least $0.50 every time he/she sells this spread under these conditions. And if the stock stays in the same spot, or goes higher, he/she will make the full $1.50 he sold the spread for!

This, albeit an extreme example, is the thought pattern we will undertake to initiate the sale of a short spread. As stated earlier, the mathematical concepts behind pricing out a short vertical spread are far more complicated (as the stock has a wide variety of possible closing prices) than the bucket of four balls example. TheoTrade has developed detailed entry and exit criteria (a recipe) for selling vertical spreads using probability and outcomes to determine expected returns.

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Don Kaufman is one of the industry's leading financial strategists and educational authorities. With 18 years of financial industry experience, Mr. Kaufman oversees TheoTrade's firm-wide strategy and deployment initiatives, while designing and executing upon innovative content in the financial education space.

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